TAXATION
A Section of the American Bar Association

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June 10, 2008

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Real Estate Investment Trust Liquidations and Notice 2007-55

Dear Commissioner Shulman:

Enclosed are comments concerning certain tax issues arising in connection with liquidations of Real Estate Investment Trusts and Notice 2007-55. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stanley L. Blend
Chair, Section of Taxation

Enclosures

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
Karen Gilbreath Sowell, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
John J. Merrick, Special Counsel to the Associate Chief Counsel (International)
Charles P. Besecky, Chief, Branch 4, Office of Associate Chief Counsel (International)

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

REQUEST FOR GUIDANCE ON CERTAIN TAX ISSUES ARISING IN REIT LIQUIDATIONS, INCLUDING ISSUES RELATING TO NOTICE 2007-55

The following comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation ("Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Peter Genz of the Section's Real Estate Committee. The comments were reviewed by Jim Sowell, Vice Chair of the Section's Real Estate Committee, Jim Croker of the Section's US Activities of Foreigners & Tax Treaties Committee, and Kevin Thomason, Chair of the Section's Real Estate Committee. The comments were further reviewed by Michael Hirschfeld of the Section's Committee on Government Submissions, and by Barbara Spudis de Marigny, Council Director for the Section's Real Estate Committee.

Although the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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June 10, 2008

Executive Summary

These Comments address certain issues that confront liquidating real estate investment trusts ("REITs") and the guidance promised by Notice 2007-55,[1] which announced that liquidating and redemption distributions paid by REITs to foreign shareholders would be subject to section 897(h)(1)[2] and thereby give rise to income effectively connected with a United States ("US") trade or business to the extent attributable to gain from the sale of US real property interests ("USRPI") by the REIT. According to the Notice, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") will issue regulations retroactively to June 13, 2007 adopting the positions asserted in the Notice and will assert such positions under existing law for periods prior to such date.

These Comments discuss basic principles that apply to REIT liquidations, including deductibility of in-kind distributions of property by REITs and FIRPTA[3] issues that can arise in connection with REIT liquidations. The Comments then discuss the Notice and the policy choices reflected therein, and make recommendations to avoid unintend whipsaws that might arise when a foreign shareholder purchases REIT shares at a time when the REIT's USRPIs are appreciated, and to narrow the scope of the Notice to address the case where the existing provisions create a clear loophole, namely, a foreign controlled REIT that undergoes a liquidation, with the REIT deducting liquidating distributions under section 562(b) and the REIT's foreign shareholders relying on the "cleansing exception" of section 897(c)(1)(B) to avoid FIRPTA tax. Alternatively, we recommend that Treasury and the Service seek a legislative remedy to address this particular situation.

In the event that Treasury and the Service do not adopt the prior recommendations, we make a number of recommendations with respect to the implementation of the Notice, including that any regulations:

(1) Limit FIRPTA distributions to net USRPI gains and losses includible in "net capital gain" with appropriate adjustments for loss carryovers and amounts subject to tax at the REIT level.

(2) If no Non-Dividend Distributions are made, allocate Net USRPI Gain in proportion to capital gain dividends (or dividends that could be designated as such).

(3) If there are Non-Dividend Distributions, allocate Net USRPI Gain first to designated capital gain dividends, then to Non-Dividend Distributions, and then to any remaining distributions.

(4) Reduce amount realized in liquidation by amount of FIRPTA distributions.

(5) Give foreign shareholders who receive Non-Dividend Distributions an opportunity to make "outside gain" elections.

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[1] 2007-27 I.R.B. 13.

[2] 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.

[3] The Foreign Investors in Real Property Tax Act of 1980 (P.L. No. 96-499, referred to as "FIRPTA")

(6) Require timely information reporting by REIT as to FIRPTA distributions and consistent reporting by foreign shareholders absent disclosure.

(7) Adapt FIRPTA withholding scheme by requiring catch-up withholding against all distributions; withholding against Non-Dividend Distributions based on Net USRPI Gain recognized through date of distribution.

(8) Limit FIRPTA distributions in section 332 liquidation to amounts treated as a section 332(c) dividend to foreign parent.

(9) Treat Non-Dividend Distributions that qualify for 5% Exception as payments in exchange for stock and not as regular dividends.

(10) Refrain from asserting that section 897(h)(1) overrides sections 892 for pre-Notice periods.

(11) Exclude section 897(h)(1) gain from "commercial income" for purposes of section 892.

We further recommend that any regulations be issued with prospective effect and that the positions adopted in the regulations not be asserted for pre-Notice periods, particularly with respect to withholding obligations.

In addition, these Comments also address issues relating to the deductibility of in-kind liquidating distributions paid by a REIT, the deductibility of liquidating distributions when the REIT also qualifies as a personal holding company during a liquidation year, and the application of the pension-held REIT rules to a liquidating REIT.

DISCUSSION

I. Basic Tax Principles That Apply to REIT Liquidations

A. Tax Treatment at REIT Level

Section 857(a)(1) requires that a real estate investment trust distribute at least 90% of its real estate investment trust taxable income for a taxable year (determined without regard to the deduction for dividends paid and by excluding capital gain and making certain other adjustments) in the form of distributions deductible under section 561 (excluding capital gain dividends) in order to qualify as a REIT for such year. Section 857(b)(2)(B) allows a REIT a deduction for dividends paid, as defined in section 561, in computing its "real estate investment trust taxable income" ("REIT taxable income") for a taxable year.

Section 561(a) provides that the deduction for dividends paid equals the sum of dividends paid during the taxable year plus consent dividends for the taxable year. Section 561(b) provides that, in determining the deduction for dividends paid, the rules provided in sections 562 and 563 apply. Section 562(a) provides that the term "dividend" includes only dividends described in section 316, except as otherwise provided in section 562. The deduction for dividends paid includes dividends that are designated as capital gain dividends under section 857(b)(3)(C), even though from the shareholder's perspective such amounts are treated as gain from the sale of a long-term capital asset under section 857(b)(3)(B). However, for purposes of maintaining REIT status, a REIT cannot rely on capital gain dividends to meet its 90% distribution requirement with respect to ordinary REIT taxable income.

At the shareholder level, distributions made by a corporation after the adoption of, and pursuant to, a plan of liquidation are not "dividends" within the meaning of section 316, but rather are payments made in exchange for the shareholders' stock under section 331 or 332, whichever applies.[4] However, section 562(b) contains special rules which permit a REIT to deduct distributions made after the adoption of a plan of complete liquidation and distributions in redemption under section 302 if certain requirements are met.

Section 562(b)(1) provides (under the caption "Distributions in liquidation") that, "[e]xcept in the case of a personal holding company described in section 542," (A) in the case of an amount distributed in liquidation, the part of the distribution that is properly chargeable to E&P is treated as a dividend for purposes of the dividends paid deduction, and (B) in the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period pursuant to the plan is treated as a dividend for purposes of the dividends paid deduction to the extent of the corporation's E&P (computed without regard to capital losses) for the taxable year in which the distribution is made. The provision referred to in clause (B) permits the deduction of distributions made pursuant to a plan of complete liquidation (under section 331 or 332) that is completed within 24 months to the extent of the payor's current E&P (determined without regard to capital losses), even though the corporation may have an accumulated E&P deficit at the beginning of the taxable year.[5] A distribution in redemption

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[4] *See* section 331(b) (providing that section 301 does not apply to amounts received in a complete liquidation); section 346(a) (providing that a distribution is treated as in complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all of the stock of a corporation pursuant to a plan).

[5] Reg. § 1.562-1(b)(1)(ii)(b).

of REIT stock is treated as a distribution in liquidation for purposes of clause (A) above, unless the REIT is a "mere holding or investment company."

A REIT that liquidates within the 24-month period ordinarily can fully shelter its net taxable income (determined before the dividends paid deduction) for the liquidation years, provided it makes liquidating distributions (plus any ordinary, pre-liquidation dividends) for each such year in an amount at least equal to the net taxable income for the year.[6]

A REIT distribution is nondeductible if it is preferential within the meaning of section 562(c). That provision provides that a distribution is not treated as a dividend for purposes of the dividends paid deduction unless it is pro rata with (i) no preference to any shares of a class of stock as compared with other shares of the same class, and (ii) no preference to one class of stock as compared with another class of stock, except to the extent that the former is entitled to such preference. This rule applies to liquidating distributions as well as regular dividends.[7] Also, an example in the Treasury Regulations indicates that a distribution in redemption of a portion of the shares held by three of the four shareholders of a corporation is a preferential distribution and therefore nondeductible, even though the corporation is stated to have accumulated E&P and the distribution presumably was allocated a portion of such E&P (the measure of the deduction allowed under section 562(b)(1)(A)).[8] There is case law, however,

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[6] If the REIT's properties have aggregate liabilities in excess of aggregate basis, its taxable gain (after taking into account available NOL carryovers) could exceed the net liquidation proceeds available to distribute to its shareholders after payment of liabilities. This situation might arise, for example, if the REIT previously had borrowed against the property to make distributions to shareholders, or because the properties have been depreciated below the amount of the debt and the deductions used to shelter operating income. In that event, the dividends paid deduction for liquidating distributions would not fully offset the net gain and the REIT would become a taxpayer.

It is uncertain whether a REIT could use the consent dividend procedures of section 565 to solve this problem. That section provides that, if a REIT shareholder consents, the REIT is deemed to pay a deductible dividend under section 561, and the shareholder is deemed to receive (on December 31 of the taxable year) a taxable dividend and then to contribute such amount to the REIT as a contribution to capital. Such dividend is treated as an actual dividend for withholding purposes if paid to a foreign investor. Section 565(e). A REIT may not be able to use this procedure to create a hypothetical deductible liquidating distribution. Section 565(b)(2) provides that consent dividends do not include amounts "which would not constitute a dividend (as defined in section 316)" if actually paid in money on the last day of the taxable year, and distributions following the adoption of a plan of liquidation are not "dividends" (although section 562(b) treats certain liquidation distributions as deductible dividends at the REIT level only). From a policy perspective, it would seem that a REIT and its shareholders should be permitted to use the consent dividend procedure in a liquidation.

It is also unclear whether the deemed capital gain dividend election of section 857(b)(3)(D) would be available as an alternative remedy. That provision does not avoid the REIT-level tax on capital gains through a deductible deemed dividend. Instead, retained capital gains are taxed at the REIT level but are treated as having been distributed to the shareholders as capital gain dividends. The shareholder includes the deemed capital gain dividend in income, receives a credit (refundable to the extent it exceeds the shareholder's tax liability) for its proportionate share of the REIT-level capital gains tax, and obtains a basis step-up in its REIT shares equal to the amount deemed distributed less the REIT tax deemed paid by the shareholder. However, the statute provides that the amount so includable by the shareholder cannot exceed the amount "which he would have received if all of such amount [the retained capital gains] had been distributed as capital gain dividends by the trust to the [shareholders] as of the close of [the REIT's] taxable year." Because a REIT that has commenced a plan of liquidation cannot distribute actual capital gain dividends at year-end, the IRS could take the position that such election is not available to a liquidating REIT.

[7] Reg. § 1.562-2(a) (last sentence).

which suggests that a non-pro rata redemption is not necessarily preferential if the redemption opportunity is made available to all shareholders and only some take advantage of it.[9]

B. Tax Treatment at Shareholder Level

Section 331(a) provides that amounts received by a shareholder in complete liquidation of a corporation are treated as payments in exchange for stock. Section 331(b) provides that section 301 does not apply to any distribution of property in complete liquidation except to the extent that section 316(b)(2)(B) applies. Liquidating distributions received by a REIT shareholder are generally treated as payments made in exchange for his stock and not as a dividend, even though the amount is deductible by the REIT in determining REIT taxable income.[10]

If section 332 applies to a REIT liquidation, the REIT is still entitled to a dividends paid deduction for liquidating distributions to the extent permitted by section 562(b). Further, the REIT does not recognize gain or loss on the distribution of property to the 80% corporate shareholder by reason of section 337(a).[11] The distributee takes a carryover tax basis in the distributed property under section 334(b)(1) and its tax basis in the REIT stock disappears. The corporate shareholder does not recognize gain or loss on the liquidation, except to the extent required by section 332(c).

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[8] Reg. § 1.562-2(b), Example (2).

[9] *See Forstner Chain Corp. v. Commissioner*, 45 B.T.A. 19 (1941) (preferred shares of one of three shareholders were redeemed; the other two waived their right to have their preferred shares redeemed; redemption held to be preferential and did not give rise to a dividends paid credit). The courts have held that amounts paid by an "open end" RIC to some of its shareholders in redemption of their shares were not preferential dividends because all shareholders had an equal opportunity to redeem their shares and were treated with "substantial impartiality" and fairness, and the redemption price was determined by the market and so did not present opportunities for tax avoidance. *See* H.R. Rep. No. 1860, 75th Cong., 3d Sess. 23 (1938), reprinted at 1939-1 (Part 2) C.B. 728, 744 (minor differences in valuation of property distributed do not cause distributions to be preferential provided the shareholders are treated with "substantial impartiality and in a manner consistent with their rights under their stock-holding interests"); *New York Stocks, Inc. v. Commissioner*, 164 F.2d 75 (2d Cir. 1947); *National Securities Series -- Indus. Stocks Series v. Commissioner*, 13 T.C. 884 (1949); PLR 9449016 (Sept. 13, 1994). *But see May Hosiery Mills, Inc. v. Commissioner*, 123 F.2d 858 (4th Cir. 1941) (open market repurchase of shares held to be preferential because there was no "equal opportunity" to participate); *King Floor Mills Co. v. United States*, 325 F. Supp. 1085, 1087 (D. Minn. 1971) (court held that section 302(b)(3) redemption of a 50% shareholder was a preferential distribution even though the other shareholder had the right to have his shares redeemed as well; court seemed to distinguish *New York Stocks* and *National Securities* because they involved open-end RICs). Example (2) of Reg. § 1.562-2(b) does not indicate whether the redemption distribution found to be preferential therein was made pursuant to a redemption opportunity provided to all stockholders. In any case, a REIT's inability to deduct a redemption distribution (to the extent E&P are attributed to it) is itself often not a problem, because REITs typically rely on regular periodic dividends to pay out their taxable income and gain. The more significant issue is that a preferential redemption could render nondeductible a regular dividend declared or paid as part of the same transaction. *See* Reg. § 1.562-2(a) and (b), Example (3).

[10] Section 331; Reg. § 1.856-1(e)(3) (providing that section 331 applies in determining whether REIT distributions are payments made "in exchange for stock").

[11] An exception applies if the REIT distributes the property to an 80% tax-exempt shareholder that does not use the property in an unrelated trade or business (section 337(b)(2)) or if the distributee is a foreign corporation and the distribution does not meet certain requirements (section 367(e)(2)).

Section 332(c) provides that if a corporate shareholder of a REIT receives a distribution which is considered under section 332(b) as being in complete liquidation, the corporate distributee is required, notwithstanding any other provision of the Code, to recognize and treat as a dividend an amount equal to the deduction for dividends paid allowable to the REIT by reason of such distribution. Thus, if section 332(c) applies to treat a liquidating distribution as a dividend, the distributee corporation is not entitled to claim a dividends received deduction in respect of, or recover any portion of its stock basis against, such amount.[12]

Section 332(c) was enacted by Section 3001 of the Tax and Trade Relief Extension Act of 1998 (Pub. L. No. 105-277, H.R. 4328). Its purpose was to prevent a parent corporation from acquiring income-producing assets in a subsidiary REIT and then distributing the earnings on such assets pursuant to a section 332 liquidation of the REIT, with the REIT avoiding corporate level tax on the earnings through the dividends paid deduction, and the distributee parent corporation avoiding tax on such earnings by reason of section 332(a).[13]

II. Deductibility of In-Kind Distributions of Property REITs

REITs are often liquidated in a single-step transaction. For example, a private REIT may liquidate by converting to an LLC or partnership under an applicable state law conversion statute or merging into a wholly owned LLC or partnership.[14] Unless section 332 applies, the REIT

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12 *See* section 243(d)(3) (providing that any "dividend" received from a corporation that qualifies as a REIT for the taxable year in which the dividend is paid is not treated as a dividend for purposes of the dividends received deduction allowed to corporate dividend recipients in section 243(a)).

13 *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, p. 282 (Comm. Print 1998) ("[I]t appeared some corporations had attempted to use the "dividends paid deduction" for a RIC or REIT in combination with the separate rule that allows a corporate parent to receive property from an 80 percent subsidiary without tax when the subsidiary is liquidating, and had argued that the combination of these two rules permitted income to be deducted by the RIC or REIT and paid to the parent corporation to be entirely tax free during the period of liquidation of the RIC or REIT. The Congress believed that income of a RIC or REIT which is not taxable to the RIC or REIT because of the dividends paid deduction also should not be excluded from the income of the RIC's or REIT's shareholders as a liquidating distribution to a parent shareholder"). *See also* H.R. Conf. Rep. No. 825, 105th Cong., 2d Sess. 1586-87 (1998), reprinted at 1998-4 C.B. 425, 507.

14 A one-step liquidation also eliminates potential issues for private REITs with preferred shareholders. State corporate laws and the REIT's articles typically will require the first liquidating distributions to be used to redeem the preferred stockholders before any distributions may be made to the common. This puts the REIT in a dilemma, because sections 856(a)(5) and (b) require the REIT to have 100 shareholders for at least 335 days out of a full taxable year or a proportionate part of a short taxable year (this rule applies commencing with a REIT's second taxable year). Once the preferred stockholders are gone, the REIT has pulled the pin on a grenade: it will detonate its REIT status for the final liquidation tax year unless it completes its liquidation soon thereafter, so that the REIT will have had 100 shareholders for 335/365 of the short taxable year ending on the date the liquidation is completed. (If the redemption of the preferred shareholders occurs in the last 30 days of the calendar year, there is no REIT compliance issue for such year, because the 100 shareholder requirement will have been met for the requisite 335 days; however, the REIT will cease to qualify as a REIT commencing with the following taxable year.) If the REIT delays the liquidating distribution to the preferred shareholders so that it continues to have 100 shareholders but makes distributions to the common, the common distribution could be viewed as a nondeductible preferential liquidating distribution under section 562(c). *See* Reg. § 1.562-2(b), Example (3) (distribution of $50 dividend to holders of cumulative preferred shares and $75 to the holders of the common at a time when the preferred shares were entitled to a $100 preference results in a preferential dividend to the common, rendering both distributions nondeductible). Often, applicable state law and the articles will permit a common-only distribution if certain steps are taken to protect the rights of the preferred (*e.g.*, the preferred dividend is declared and the corporation retains, or

recognizes gain or loss under section 336(a), and the shareholders recognize gain or loss under section 331(a) on the exchange of their REIT shares for interests in the surviving entity (or, alternatively, for their shares of the REIT's assets which are deemed to be contributed to the surviving entity). The REIT recognizes all of its gains and losses in the conversion based on the fair market value of its assets. Similarly, taxable acquisitions of public REITs are often effected by a forward cash merger of the target REIT into a subsidiary of the acquirer, in which case the REIT is treated as selling all of its assets subject to its liabilities and distributing the cash proceeds in liquidation.

The REIT should be entitled to deduct the amount of the net liquidating distribution (subject to the E&P limitations of section 562(b)) against the gain recognized at the REIT level. However, Regulation section 1.562-1(a) provides that in the case of an in-kind "dividend" of property, the amount of the dividends paid deduction is limited to "the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution." It is not entirely clear whether the term "dividend," as used in the regulation, includes liquidating distributions that are treated as dividends under section 562(b), but assuming it does, the regulation raises a concern in that it does not distinguish between taxable and nontaxable property distributions. The regulation was issued prior to *General Utilities* repeal. Today, the only relevant nonrecognition distribution would be a section 332 liquidation where section 337(a) precludes gain recognition at the REIT level. If a REIT recognizes gain on the distribution of appreciated property under section 336(a) (*e.g.*, in a section 331 liquidation or a distribution to a minority shareholder in a section 332 liquidation), it should get a dividends paid deduction equal to the fair market value of the distributed property, which can be achieved by increasing the REIT's adjusted basis in the distributed property by the gain recognized under section 336(a).[15]

In PLR 9335030 (June 4, 1993), the Service acknowledged that Regulation section 1.562-1(a) is obsolete in this respect and ruled that a personal holding company that recognized gain on a distribution of property under section 311(b) was entitled to deduct the property's fair market value. Nevertheless, the regulation is confusing and potentially misleading, and we recommend that Treasury and the Service issue a revenue ruling or regulation confirming that a REIT's deduction under section 562(b) for an in-kind distribution of property is not subject to the adjusted basis limitation of Regulation section 1.562-1(a) where the REIT recognizes gain or loss on the distribution.

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sets apart, adequate funds for payment of the preferred liquidation preference). If these measures are complied with, the common distribution should not be preferential. In any event, these issues are eliminated if the REIT undergoes an LLC conversion or merger in which the preferred shareholders are either redeemed for cash or given mirror-image preferred interests in the successor entity.

[15] The regulation was held to be valid in *Fulman v. Commissioner*, 434 U.S. 528 (1978). In that case, the taxpayer argued that a personal holding company's dividends paid deduction as a result of a dividend of property should be the amount included in income by the shareholder under section 301 (the property's fair market value) rather than the adjusted basis of the property. This was a pre-*General Utilities* repeal case, however, and its holding should not have any bearing on how a court would interpret the regulation as applied to a gain-triggering property distribution.

III. FIRPTA Issues in REIT Liquidations

A. Tax Treatment of REIT Dividends Paid to Foreign Investors

Ordinary dividends paid by a REIT to a foreign person are subject to a 30% US withholding tax except to the extent that (i) an applicable tax treaty lowers the withholding rate, (ii) the dividends are attributable to gain from the sale of USRPIs by the REIT under section 897(h)(1), in which case they are taxed as income effectively connected with a US trade or business under section 897(a)[16] and sections 881 and 871, or (iii) in the case of a foreign governmental investor, section 892 applies to exempt the dividends from withholding tax. (As will be discussed, a persuasive argument can be made that section 892 also applies to distributions treated as FIRPTA gain under section 897(h)(1), although the Service has announced a contrary view.)

Dividends designated by a REIT as "capital gain dividends," as defined in section 857(b)(3)(C), are taxed to its shareholders as "gain from the sale or exchange of a capital asset held for more than 1 year" under section 857(b)(3)(B) and not as ordinary income. The designation must be made in a written notice mailed to shareholders within 30 days after the close of the taxable year or mailed with the REIT's annual report for such year.[17]

The aggregate amount designated as capital gain dividends (including "throwback" dividends under section 858) cannot exceed the REIT's "net capital gain" for the taxable year; to the extent that it does, the amount of each such designated dividend is scaled back proportionately.[18] Net capital gain is defined as the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.[19] Net long-term capital gain is defined as the excess of long-term capital gain for the taxable year over the long-term capital losses for such year.[20] Thus, short-term capital gains are excluded from "net capital gain."

Both capital gain dividends and ordinary dividends are deductible by a REIT in computing "real estate investment trust taxable income" ("REIT taxable income") under section 857(b)(2). While section 857(a)(1) requires a REIT to distribute at least 90% of its ordinary REIT taxable income as deductible dividends (excluding capital gain dividends) in order to remain qualified as a REIT, it is not required to distribute net capital gain. Instead, any retained net capital gain, as well as any undistributed ordinary REIT taxable income, are subject to tax at the REIT level.

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[16] Section 897 was enacted by FIRPTA.

[17] If a REIT has multiple classes of stock outstanding (*e.g.*, common and preferred), capital gain designations are required to be made on a pro rata basis among all classes of stock in proportion to the amounts of distributions on each class that are treated as dividends under section 316. *See* Rev. Rul. 89-81, 1989-1 C.B. 226 (designations of dividends paid on multiple classes of RIC stock as consisting of a particular type of income must be made in proportion to such dividends).

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

[19] Section 1222(11).

[20] Section 1222(7).

Section 857(b)(3)(D) provides an election whereby, in effect, the retained capital gains are treated as having been distributed to the shareholders as capital gain dividends. The shareholder includes the deemed capital gain dividend in income, receives a credit (refundable to the extent it exceeds the shareholder's tax liability) for its proportionate share of the REIT-level capital gains tax, and obtains a basis step-up in its REIT shares equal to the amount deemed distributed less the REIT tax deemed paid by the shareholder. The net result is to give the shareholders a basis step-up for the retained capital gains (less the REIT-level taxes paid), while the REIT and its shareholders (as a collective economic unit) bear a single tax consisting of the shareholder level tax (if any) imposed on long-term capital gains.

Capital gain dividends are not treated as gain from the sale of REIT shares; rather, the dividend is simply treated as "gain from the sale or exchange of a capital asset." Thus, absent section 897(h)(1), capital gain dividends would not be subject to tax under FIRPTA, even if the REIT's shares constitute a USRPI. Instead, they would ordinarily be US tax free to a foreign investor -- *i.e.*, neither subject to the 30% US gross basis tax nor the graduated rate tax.[21]

B. Taxation of Gain on Sale of Domestic Corporation Stock under FIRPTA

1. General Rule -- Stock of USRPHC (or Former USRPHC) is a USRPI

Under section 897(a), gain or loss of a nonresident alien individual or foreign corporation from the disposition of a USRPI is taken into account "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." The term USRPI is defined in section 897(c)(1)(A) to mean: (i) a direct interest in US real property, and (ii) any interest (other than solely as a creditor) in a domestic corporation unless the taxpayer establishes that such corporation was at no time a "US real property holding corporation" ("USRPHC") during the shorter of (i) the five-year period ending on the date of disposition of the interest, or (ii) the taxpayer's holding period for the interest.

Under section 897(c)(2), a domestic corporation qualifies as a USRPHC if, on any applicable testing date, the fair market value of its USRPIs equals or exceeds 50% of the value of its USRPIs, foreign real estate, and assets used or held for use in a trade or business. A REIT's shares are treated as USRPIs only if the REIT qualifies as a USRPHC or former USRPHC and no exception applies. Because REITs are required to hold primarily real estate interests, they generally are classified as USRPHCs unless they are mortgage REITs.

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[21] *See* Section 865 (capital gain recognized by a foreign person on the sale of personal property is generally sourced to the person's country of residence and does not constitute US source income); Reg. § 1.1441-2(b)(2)(i) (providing that gain from the sale of "property" is not "fixed and determinable annual or periodical" income -- FDAP income -- subject to two exceptions not relevant here); Reg. § 1.1441-3(c)(2)(i)(D) (a regulated investment company ("RIC") may elect not to withhold on capital gain dividends); Rev. Rul. 69-244, 1969-1 C.B. 215, obsoleted by T.D. 8734, 1997-2 C.B. 109, 138 (IRS ruled that capital gain dividends paid by RIC to a foreign shareholder are treated as capital gain, rather than dividend income, and therefore are not FDAP income subject to withholding tax; IRS reasoned that section 852(b)(3)(B) treats a capital gain dividend as gain from the sale or exchange of a capital asset, and while section 1441(b) requires withholding on certain enumerated types of capital gains, it does not reference section 852(b)(3)(B) capital gain dividends).

2. FIRPTA Exceptions for USRPHC Stock

There are several exceptions to the general rule that stock of a USRPHC (or former USRPHC) is treated as a USRPI.

Domestically Controlled REIT Exception. Section 897(h)(2) provides that shares of a "qualified investment entity" ("QIE") that is "domestically controlled" are not treated as USRPIs. A QIE includes domestically controlled REITs and RICs that are classified as a USRPHC (or would be if certain modifications were made to the USRPHC definition).[22] A domestically controlled REIT is one in which foreign persons have owned, directly or indirectly, less than 50% of the value of the REIT's stock at all times during a prescribed testing period.[23] That period is generally the lesser of the five-year period ending on the date of the disposition of the shares or the period during which the REIT has been in existence.[24] This exception applies to both public and private REITs and is referred to as the "DC REIT Exception."

Publicly Traded Exception. Under an exception provided in sections 897(c)(3) and (c)(6)(C) (the "Section 897(c)(3) Exception"), the shares of a USRPHC are not treated as USRPIs if (i) they are regularly traded on an established securities market (including a foreign exchange that meets certain conditions) and (ii) the foreign shareholder in question held (actually or constructively) no more than 5% of the publicly traded shares during the shorter of the five-year period ending on the date of the disposition or the shareholder's holding period.

Cleansing Exception. Under section 897(c)(1)(B) and Regulation section 1.897-2(f)(2) (the "Cleansing Exception"), interests in a USRPHC cease to be USRPIs on the first date on which (i) the corporation does not hold any USRPIs, and (ii) all of the USRPIs held by such corporation at any time during the previous five years were directly or indirectly disposed of in transactions "in which the full amount of gain (if any) was recognized." A sale of a USRPI pursuant to a liquidation of the corporation, or a distribution of a USRPI to a shareholder, is treated as a disposition for purposes of Regulation section 1.897-2(f)(2) if gain is recognized at the corporate level.[25]

The rationale for the Cleansing Exception is as follows. When FIRPTA was enacted in 1980, it was still possible for a domestic corporation to sell all of its assets tax free pursuant to a 12-month liquidation qualifying under former section 337, and gain from the sale or liquidation of the stock of such corporation was generally not taxable to a foreign investor. Congress wanted to ensure that at least a single level of tax was imposed where a foreign investor owned US real estate through a domestic corporation.[26] Thus, section 897 provides that gain from the sale of USRPHC stock is taxable as effectively connected income. On the other hand, Congress did not think it appropriate to extract a shareholder level tax if the domestic corporation had fully

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22 Section 897(h)(4)(A).

23 Section 856(h)(4)(B).

24 Section 856(h)(4)(D).

25 *See* Reg. § 1.897-5T(b)(2) (penultimate sentence).

26 *See* H.R. Rep. No. 1167, 96th Cong., 2d Sess. 510-11 (1980), reprinted at 1980-2 C.B. 530, 571.

recognized its USRPI gains; hence the Cleansing Exception. For example, if the domestic corporation did not meet the requirements of section 337 and recognized gain on all of its liquidation sales and property distributions, the Cleansing Exception ensured that no further tax was imposed on the foreign shareholder's stock gain. Following *General Utilities* repeal in 1986, a liquidating domestic corporation is now fully taxable on liquidating sales or property distributions, except for liquidating distributions to an 80% corporate distributee under present day sections 337 and 332. This means the foreign shareholder can generally rely on the Cleansing Exception to avoid shareholder level FIRPTA tax on gain recognized in a liquidation of a USRPHC. (The Cleansing Exception is imperfect, however, in that it permits double-taxation if a USRPHC makes interim distributions that exceed outside basis in a multi-year liquidation.)

A liquidating REIT literally meets the requirements of the Cleansing Exception because it "recognizes gain" on property sales or distributions that is included on its federal income tax return, even though REIT taxable income is typically reduced to zero through the dividends paid deduction allowed under section 562(b). (The only exception would be where the REIT makes a distribution of property to an 80% corporate distributee in a section 332 liquidation and section 337 precludes gain recognition.) "Recognition" is all that section 897(c)(1)(B) requires; it does not mandate that gain be "subject to tax" at the entity level, and neither do the accompanying regulations. The FIRPTA withholding regulations are to the same effect.[27] Indeed, the fact that the drafters explicitly incorporated a "subject to tax" requirement (even including a special rule for REITs) elsewhere in the FIRPTA regulations[28] makes it very difficult for the Service to assert (or a court to conclude) that the Cleansing Exception does not apply to REITs. As a policy matter, however, we believe it should not apply. This appears to be a drafting oversight in the original FIRPTA legislation.

C. Special Rule for REIT Distributions Attributable to USRPI Gains

1. General Rule of Section 897(h)(1)

Section 897(h)(1) provides that "[a]ny distribution" by a QIE to a nonresident alien individual, a foreign corporation, or other QIE will be treated as gain recognized by the nonresident alien, foreign corporation or QIE from the sale of a USRPI "to the extent attributable to gain from sales or exchanges by the [QIE] of United States real property interests." (For convenience, such distributions are referred to as "FIRPTA Distributions.") The only legislative history relating to this provision is a sentence in the FIRPTA Conference Committee Report. It states that the provision was intended to create FIRPTA gain to the extent of the foreign shareholder's "pro rata share of the net capital gain of the REIT."[29]

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[27] *See* Reg. § 1.1445-5(e)(3)(i) (providing that if a USRPHC "in the process of liquidation does not elect section 337 nonrecognition treatment upon its sale of [all USRPIs] held by such corporation [this regulation was issued prior to repeal of the General Utilities doctrine in 1986] and recognizes gain or loss upon such sales," interests in the corporation cease to be USRPIs and no withholding is required on the corporation's subsequent liquidating distributions to foreign shareholders of property other than a USRPI).

[28] *See* Section 897(d)(2)(A)(i); Reg. § 1.897-5T(d)(1)(i).

A foreign investor receiving a FIRPTA Distribution is subject to regular income tax at graduated rates on such gain and is required to file a US federal income tax return. Absent section 897(h)(1), a REIT could recognize long-term capital gain from the sale of USRPIs and distribute the sales proceeds as deductible capital gain dividends that would be exempt from US tax in the hands of a foreign investor, thus allowing such gains to escape the US tax system entirely. If the gain were paid out in the form of ordinary dividends (*i.e.*, the REIT failed to make a capital gain designation), such dividends would be subject to the 30% US withholding tax or lower treaty rate.

A foreign corporation receiving a FIRPTA Distribution (including a foreign government treated as a corporation under section 892(a)(3) and Regulation section 1.884-0(a)) is also subject to the "branch profits tax" imposed by section 884, except to the extent the branch tax rate is reduced by an applicable tax treaty or the corporation complies with the demanding requirements of the "branch termination exception" for the year of the distribution.[30]

By contrast, gain from the sale of USRPHC stock -- including stock of a REIT -- is excluded from effectively connected E&P ("ECEP") and is therefore not subject to branch profits tax.[31] From a policy standpoint, it is not clear why gain on an actual or deemed sale of foreign controlled REIT shares (taxable under FIRPTA) is excluded from branch tax ECEP, while FIRPTA Distributions are not. In both cases, the apparent policy underlying the exclusion for USRPHC gain from ECEP, which is to avoid potential triple taxation of the same income (corporate level tax, shareholder level FIRPTA tax, and branch tax), is not present, because a REIT pays no tax as long as it distributes its income and gain currently. A foreign investor selling shares of a foreign controlled REIT realizes the same appreciation in the REIT's USRPIs that it could have realized had it retained the shares and received distributions of URRPI sales proceeds. It may be that Congress overlooked section 897(h)(1) when it drafted section 884; on the other hand, Congress perhaps did not focus on the fact that there is no triple taxation possibility with REITs. If it had, it might have limited the ECEP exclusion for USRPHC stock gain to USRPHCs other than REITs.[32]

Section 897(h)(1) is not limited to REITs that qualify as USRPHCs; rather, it applies to any REIT that disposes of a USRPI at a gain -- *e.g.*, a mortgage REIT that holds primarily non-USRPI real estate mortgages. The REIT would not be classified as a USRPHC and thus its shares would not be USRPIs. Consequently, a sale of shares by a foreign investor would not be

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29 H.R. Conf. Rep. No. 1479, 96th Cong., 2d Sess. 188 (1980), reprinted in 1980-2 C.B. 575, 585.

30 *See* Reg. § 1.884-1(d)(2)(xi), Example (4) (foreign corporate shareholder of a domestically controlled REIT has a dividend equivalent amount based on the effectively connected E&P attributable to a distribution of ECI from the REIT, even if the shareholder reinvests the proceeds in additional REIT shares); H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 401 (2004) (stating that the branch profits tax does not apply to section 897(h)(1) distributions if the special exception in the second sentence of section 897(h)(1) -- relating to distributions by a publicly held REIT to a 5% or less shareholder -- applies).

31 *See* Section 884(d)(2)(C); Reg. § 1.884-1(f)(2)(iii).

32 Possibly Congress was concerned that treating USRPHC stock as an asset the disposition of which gives rise to ECI would have the undesirable collateral effect of causing additional interest expense to become deductible by the foreign shareholder under Reg. § 1.882-5.

subject to FIRPTA (even if the REIT is foreign controlled and not publicly traded). Nevertheless, if the REIT happened to own a USRPI, such as an equity kicker real estate loan, any distribution to a foreign shareholder attributable to gain recognized on sale (as opposed to collection) of the kicker loan would be subject to section 897(h)(1).

If a REIT sells an interest in a lower-tier REIT and the Section 897(c)(3) Exception or DC REIT Exception would apply to the shares of the lower-tier REIT if the upper-tier REIT were a foreign person, any gain recognized by the upper-tier REIT on such sale is not treated as USRPI gain for purposes of applying section 897(h)(1) to distributions by the upper-tier REIT.[33]

Section 897(h)(1) also applies to distributions to foreign shareholders by domestically controlled REITs and by publicly traded REITs in cases where the 5% exception discussed below is inapplicable.[34]

The sparse legislative history can be read to suggest that Congress understood distributions attributable to USRPI gain to be synonymous with capital gain dividends.[35] Further, the withholding mechanism created by Reg. 1.1445-8 (discussed below) was constructed on that premise. Nevertheless, capital gains dividends from non-USRPI sources are not within the scope of section 897(h)(1) as written.

2. 5% Exception for Distributions by Publicly Traded REITs

The second sentence of section 897(h)(1), added in 2004, provides that the FIRPTA Distribution rule does not apply to distributions to a nonresident alien or foreign corporation with respect to any class of stock which is regularly traded on an established securities market located

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[33] *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress, pp. 294-5 (Comm. Print 2007) (stating that "[the DC REIT Exception] applies regardless of whether the sale of stock is made directly by a foreign person, or by a REIT or RIC whose distributions to foreign persons of gain attributable to the sale of USRPI's would be subject to FIRPTA [under section 897(h)(1)]").

[34] Section 897(h)(1) was amended by Section 505(a)(1)(A) and (B) of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-22, H.R. 4297, signed into law on May 17, 2006) to deal with tiered REIT structures. As originally drafted, the provision arguably did not apply when a parent REIT made a distribution to a foreign shareholder that was "attributable to" a distribution received by the parent REIT from a subsidiary REIT, where the latter distribution was "attributable to" gain from the sale of the subsidiary's USRPIs. The argument was that section 897(h)(1) did not apply to the distribution from subsidiary to parent because the parent was not a foreign person, and therefore the distribution by the parent REIT to its foreign shareholders was simply a capital gain dividend (if so designated by the parent). As amended, the FIRPTA Distribution rule applies not only to distributions by a QIE to a foreign person, but also to another QIE. Thus, the parent's distribution from the subsidiary becomes FIRPTA-tainted, so that distributions by the parent that are attributable to such FIRPTA gain likewise become FIRPTA-tainted when paid to the parent's foreign shareholders.

[35] *See* H.R. Conf. Rep. No. 1479, 96th Cong., 2d Sess. 188 (1980), reprinted in 1980-2 C.B. 575, 585. (section 897(h)(1) intended to create FIRPTA gain to the extent of the foreign shareholder's "pro rata share of the net capital gain of the REIT"). Further, the legislative history accompanying subsequent amendments to section 897(h)(1) refers only to capital gain dividends as giving rise to FIRPTA gain. S. Rep. No. 192, 108th Cong., 1st Sess. 50 (2003) ("[t]he provision removes from treatment as effectively connected income for a foreign investor a capital gain distribution from a REIT" if the 5% Exception applies; thus, "[t]he distribution is to be treated as a REIT dividend to that investor, taxed as a REIT dividend that is not capital gain").

in the United States[36] if the investor held no more than 5% of the class of stock throughout the one-year period ending on the date of distribution (this is referred to herein as the "5% Exception"). Unlike section 897(c)(3), which uses section 318 principles to aggregate stock ownership of related persons, the 5% Exception does not include any constructive ownership rules and, indeed, does not even reference direct or indirect ownership, as does the DC REIT Exception.[37]

A foreign shareholder that qualifies for the Section 897(c)(3) Exception (which has a five-year look-back period) typically would qualify for the 5% Exception (which has a one-year look-back period).[38] Thus, the current statutory scheme produces uniform FIRPTA tax consequences for a 5% or less foreign investor in a publicly traded REIT -- namely, the investor pays no FIRPTA tax either on a sale of REIT shares or on receipt of a distribution attributable to gain from the sale of the REIT's USRPIs.

Nevertheless, Congress did not completely exempt from US tax amounts that qualify for the 5% Exception. Section 857(b)(3)(F) provides that, in the case of a foreign shareholder to which section 897(h)(1) does not apply by reason of the 5% Exception, "the amount which would be included in computing long-term capital gains for such shareholder under [section 857(b)(3)(B) or (D)]" is included in the shareholder's gross income as a dividend from the REIT rather than as long-term capital gain, and thus is subject to the 30% US withholding tax (or lower treaty rate).

The 5% Exception was originally enacted by section 418 of the American Jobs Creation Act of 2004 (Pub. L. No. 108-357, H.R. 4520) (the "Jobs Act") and subsequently amended by

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[36] The rules under Reg. § 1.897-9T(d)(2) that determine whether the publicly traded test of the Section 897(c)(3) Exception is met also apply for purposes of the 5% Exception. Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress, p. 299, n. 357 (Comm. Print 2007).

[37] The absence of constructive ownership or look-through rules raises a number of issues on which guidance is needed. For example, suppose a REIT pays a capital gain dividend to a domestic partnership with foreign partners. The partnership is not a nonresident alien or foreign corporation, but one can expect that the IRS will interpret section 897(h)(1) as applying on a look-through basis, with the partnership being required to withhold under section 1446 on the FIRPTA Distribution to the extent such gain is allocable to its foreign partners. One would think that the 5% Exception should also be available on a look-through basis, although the statute provides no clue. As another example, assume a private REIT with foreign shareholders owns 5%-or-less positions in one or more public REITs. When the public REIT pays a capital gain dividend (assumed to be attributable to USRPI gain) to the private REIT, such gain retains both its capital gain character and also its FIRPTA taint for purposes of determining whether dividends paid by the private REIT to its foreign shareholders are themselves FIRPTA Distributions. However, the private REIT itself cannot claim the benefit of the 5% Exception as to such dividends. *See* Staff of Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress, p. 300 (Comm. Print 2007). Moreover, nothing in the statute or its legislative history suggests that the shareholders of the private REIT can claim the 5% Exception as to such FIRPTA Distributions on a look-through basis, although there does not appear to be a convincing policy reason why they should not be permitted to do so.

[38] The only case where it would not is where the REIT is publicly traded on a foreign exchange -- in that event, the 5% Exception would not apply but the Section 897(c)(3) Exception could apply. Conversely, it is possible that the 5% Exception could apply in cases where the Section 897(c)(3) Exception does not, because the latter has a five-year look-back period and incorporates constructive ownership rules, whereas the 5% Exception has a one-year look-back period and takes into account only direct ownership.

section 403(p) of the Tax Technical Corrections Act of 2005 which was part of the Gulf Opportunity Zone Act of 2005 (Pub. L. No. 109-135, H.R. 4440) and section 505(a)(1)(C) of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222, H.R. 4297) ("TIPRA"). The only explanation for the 5% Exception appears in the "Reasons for Change" section of the Senate Report accompanying the Jobs Act, which simply states that "[t]he Committee believes that it is appropriate to provide greater conformity in the tax consequences of REIT distributions and other corporate stock distributions."[39] Congress did not, however, see fit to create similar uniformity of tax treatment for foreign shareholders that rely on the DC REIT Exception to avoid FIRPTA tax on sales of REIT shares. Foreign shareholders of a domestically controlled REIT that do not qualify for the 5% Exception are taxable on FIRPTA Distributions, even though they can sell their shares free of FIRPTA tax.

3. Wash Sale Rule

Congress was concerned that foreign taxpayers were avoiding tax on FIRPTA Distributions paid by domestically controlled REITs by selling their REIT shares shortly before the ex-dividend date of such distribution and then reacquiring shares in the REIT shortly thereafter. The taxpayer's sale price reflected the pending dividend (which would be paid to the buyer because the sale occurred prior to the ex-dividend date), but the sale gain was exempt from FIRPTA tax by reason of the DC REIT Exception.

Section 506(a) of TIPRA enacted section 897(h)(5) to curtail such transactions (the "Wash Sale Rule"). It provides that if an interest in a domestically controlled REIT (whether public or private) is disposed of in an "applicable wash sale transaction," the taxpayer is treated as having gain from the sale or exchange of a USRPI equal to the portion of the distribution which, but for the disposition of the shares, would have been treated by the taxpayer as FIRPTA gain.[40]

An applicable wash sale transaction means any disposition of REIT shares during the 30-day period preceding the ex-dividend date of a distribution which is to be made with respect to the shares, and which would be treated in whole or in part as a FIRPTA Distribution but for the disposition, coupled with the acquisition of (by the foreign taxpayer or a person related to the taxpayer), or the entering into of a contract or option to acquire, a substantially identical interest in the entity during the 61-day period beginning on the first day of the 30-day period preceding the ex-dividend date.[41] The Wash Sale Rule does not apply in the case of a publicly traded domestically controlled REIT where the foreign taxpayer would have met the requirements of the 5% Exception as to the FIRPTA Distribution (in such a case, obviously, there is no FIRPTA tax to be avoided by the wash sale).[42]

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39 *See* S. Rep. No. 192, 108th Cong., 1st Sess. 50 (2003).

40 Section 897(h)(5)(A).

41 Section 897(h)(5)(B)(i).

42 Section 897(h)(5)(B)(iv).

D. FIRPTA Withholding Provisions Applicable to REIT Distributions to Foreign Shareholders

The tax imposed under the substantive provisions of FIRPTA is often collected through a withholding tax regime. These rules are not always consistent with the rules that impose the substantive FIRPTA tax.

1. General Withholding Rules Applicable to USRPHCs

Section 1445(e)(3) provides that, if a domestic corporation which is or has been a USRPHC during the applicable look-back period distributes property to a foreign person in a transaction to which section 302 or part II of subchapter C applies (*i.e.*, sections 331 through 346, dealing principally with corporate liquidations), the corporation is required to withhold a tax equal to 10% of the amount realized by such person. A similar rule applies to nonliquidating distributions that exceed E&P (sections 301(c)(2) and (c)(3)).[43] In addition, the regulations make it clear that withholding is required under section 1445(e)(3) only if the shares constitute a USRPI on the date of the distribution. Thus, for example, no withholding is required under this provision if interests in the USRPHC are not USRPIs on the distribution date due to the Cleansing Exception or DC REIT Exception.[44]

A USRPHC can choose between one of two methods for coordinating sections 1441, 1442 and 1445 withholding on distributions to foreign shareholders that may be in part ordinary dividends and in part section 301(c)(2) or 301(c)(3) distributions.

Under one option, the USRPHC can withhold under sections 1441/1442 on the full amount of the distribution, regardless of whether the distribution is in whole or in part a return of capital under section 301(c)(2) or in excess of basis under section 301(c)(3).[45]

Under the second option, the USRPHC can withhold under sections 1441/1442 by making a reasonable estimate of the portion of the distribution that is a dividend, and withhold under section 1445(e)(3) and Regulation section 1.1445-5(e) on the remainder of the distribution or on a lesser amount based on a withholding certificate obtained from the Service.[46]

Regulation section 1.1441-3(c)(4)(i)(C) provides rules that coordinate the dividend withholding rules of sections 1441 and 1442 with those under section 1445. It states as follows:

> Withholding is required under section 1441 (or 1442 and 1443) on the portion of a distribution from a REIT that is not designated as a capital gain dividend, a return of basis, or a distribution in excess of a shareholder's adjusted basis in the stock

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[43] Reg. § 1.1445-5(e)(1).

[44] Reg. § 1.1445-5(e)(3)(i).

[45] Reg. § 1.1441-3(c)(4)(i)(A).

[46] Reg. §§ 1.1445-5(e)(3)(iv) and 1.1445-6. The withholding certificate can be based on the shareholder's anticipated maximum tax liability with respect to the distributions, as supported by all evidence necessary to support the claimed calculation, such as the taxpayer's adjusted basis in its USRPHC shares. Reg. § 1.1445-6(b)(2)(i).

of the REIT that is treated as a capital gain under section 301(c)(3). A distribution in excess of a shareholder's adjusted basis in the stock of the REIT is, however, subject to withholding under section 1445, unless the interest in the REIT is not a U.S. real property interest (*e.g.*, an interest in a domestically controlled REIT under section 897(h)(2)). In addition, withholding is required under section 1445 on the portion of the distribution designated by a REIT as a capital gain dividend.[47]

2. Special Withholding Rule for REIT Distributions

A REIT that is a USRPHC or former USRPHC is required to withhold 10% of the amount realized by a foreign shareholder as a result of a liquidating, redemption or section 301(c)(2) or (c)(3) distribution to a foreign investor unless the DC REIT Exception, the Section 897(c)(3) Exception or the Cleansing Exception applies.

In addition, the tax on FIRPTA Distributions is enforced by a REIT-level withholding tax. Unlike section 1445(e)(3), this withholding tax applies even if the REIT is not a USRPHC or former USRPHC because section 897(h)(1) is not limited to REITs that qualify as USRPHCs.

Prior to the enactment of TIPRA, withholding against FIRPTA Distributions was required, not by any provision of section 1445, but by Regulation section 1.1445-8, a regulation which was stated to be issued under the authority of section 1445(e)(1), notwithstanding that such provision refers only to partnerships, trusts and estates. Given the absence of any authority interpreting section 897(h)(1), this regulation not only has guided withholding agents, but has also provided *de facto* guidance to foreign taxpayers in determining their substantive FIRPTA tax liability.

In Section 505(b) of TIPRA, Congress finally supplied the missing statutory support for withholding against FIRPTA Distributions. New section 1445(e)(6) provides that if any portion of a REIT distribution to a nonresident alien individual or foreign corporation is treated under section 897(h)(1) as gain from the sale or exchange of a USRPI, the REIT must withhold a tax equal to 35% (or, to the extent provided in regulations, 15%) of the amount so treated.[48] Regulation section 1.1445-8 has not been amended since this legislative change. The TIPRA Conference Report states that "[n]o inference is intended under the existing Treasury Regulations in force under section 1445 with respect to REITs."[49]

Regulation section 1.1445-8(b)(1) provides that a REIT is required to withhold tax upon the distribution of any amount attributable to a USRPI with respect to each shareholder that is a foreign person. Regulation section 1.1445-8(c)(2)(ii)(A) provides that, except as provided in

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[47] *See* § 1.1445-8.

[48] The TIPRA amendments are generally effective for distributions with respect to REIT taxable years beginning after December 31, 2005. TIPRA Section 505(d). However, the effective date provisions state that no withholding is required under sections 1441, 1442 and 1445 with respect to any distribution before the date of enactment (May 17, 2006) if such amount was not otherwise required to be withheld under such section as in effect before the TIPRA amendments.

[49] See H.R. Conf. Rep. No. 455, 109th Cong., 2d Sess. 290, n. 532 (2006) (the "TIPRA Conference Report").

subparagraph (c)(2)(ii)(C), the amount subject to withholding is the amount of any dividend designated by the REIT as a capital gain dividend (determined on a per share basis), multiplied by the number of shares owned by the foreign person. Thus, for withholding purposes, the regulations presume that capital gain dividends paid to a foreign shareholder are attributable to USRPI gains (as discussed elsewhere in this report, this may not be true for any number of reasons). The regulation also provides that, "solely for purposes of this paragraph [meaning paragraph (c)] "the largest amount of any distribution ... 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." Absent this rule, a REIT could choose not to designate any dividends as capital gain dividends, but instead pay out its USRPI gains as ordinary dividends and avoid FIRPTA withholding.[50]

If a REIT makes an actual (as opposed to a deemed) designation of a prior distribution (or portion thereof) as a capital gain dividend, the prior distribution is not subject to FIRPTA withholding, but a special "catch-up" withholding rule applies under Regulation section 1.1445-8(c)(2)(ii)(C). Under the catch-up rule, the REIT must "characterize and treat as a capital gain dividend distribution (solely for purposes of section 1445(e)(1)) each distribution …. made on the day of, or at any time subsequent to, such designation … until such characterized amounts equal the amount of the prior distribution designated as a capital gain dividend." The determination of the amount that could have been designated as a capital gain dividend is made on a per share basis for both domestic and foreign shareholdings. Thus, the REIT must withhold against subsequent distributions to the foreign shareholder[51] until withholding against the prior capital gain dividend is caught up. It is unclear whether the subsequent "distributions" to which catch-up withholding applies include redemption and liquidating distributions to the foreign shareholder that has the withholding shortfall as to a prior distribution. However, because the regulations clearly take the position that dividends are the only "distributions" that give rise to a withholding obligation in the first instance, and the catch-up rule treats subsequent distributions as a "capital gain dividend" for FIRPTA withholding purposes, it seems highly likely that the Treasury and the Service did not intend for catch-up "distributions" to include Non-Dividend Distributions. In the only example provided in the regulations,[52] all of the catch-up distributions treated as capital gain dividends for withholding purposes are stated to be actual dividends.

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[50] Treasury first included this "deemed designation" rule in the final FIRPTA withholding regulations issued in T.D. 8321, 1990-2 C.B. 201. The preamble to the regulations explains that the rule was adopted because, at the time the regulations were issued, there was no preferential tax rate for capital gains, thus eliminating the primary incentive for REITs to designate capital gain dividends. The preamble further states that, if the preferential capital gains is later reinstated, the deemed capital gain provision in Reg. § 1.1445-8(c)(2)(ii) will be amended "in accordance with and to reflect the enactment of such preferential treatment." 1990-2 C.B. at 202. Although a capital gains rate preference was subsequently reinstated, the promised amendment to the regulations has not materialized.

[51] Because the regulations require withholding to be determined on a per-share basis, it is arguable that the catch-up withholding applies even to subsequent distributions made to a new foreign holder of the shares in question in respect of which the original section 897(h)(1) distributions were deemed to have been paid (as capital gain dividends) to a prior foreign shareholder who bore the substantive tax burden. This makes no sense but is one of many unclear aspects of the existing regulations.

Although Treasury has never issued any regulations or other authority (beyond Notice 2007-55) interpreting section 897(h)(1), it is implicit in the withholding scheme that capital gain dividends are the substantive measure of the amounts "attributable to" the REIT's USRPI gains for the year.[53] Most foreign taxpayers have operated under the assumption that if an amount they receive from a REIT is subsequently designated as a capital gain dividend, that amount has to be reported as ECI on a US federal income tax return (absent evidence that the capital gain was derived from a non-USRPI source). The catch-up rule, by its terms, is solely for withholding purposes. However, REITs almost never designate capital gain dividends contemporaneously with the distribution because net capital gain for the taxable year cannot be known with certainty until after year-end and perhaps not until the REIT's tax return is prepared.[54] This means the substantive measure of the FIRPTA tax is not known until after year-end, and catch-up withholding has been the rule, not the exception. For example, a public REIT that pays regular quarterly dividends in year 1 to a more-than-5% foreign shareholder (assumed to be ineligible for treaty benefits) will withhold at 30% on such distributions. Once the retroactive capital gain designations are made, the REIT will withhold at 35% on subsequent distributions in year 2. The foreign shareholder would report the capital gains dividends as ECI on a year 1 return and remit the FIRPTA tax on such dividends (to the extent it did not make sufficient estimated tax payments in year 1). The catch-up withholding amounts in year 2, although triggered by the designation of year 1 capital gain dividends, would not be reported on

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[52] The regulations provide the following illustrative example: A REIT distributes a $2 dividend in the first quarter of 1988. In the second quarter, it recognizes a $15 long-term capital gain on the sale of real property and distributes $5. It distributes $3 in the third quarter and recognizes a $2 long-term capital loss on the sale of real property in the fourth quarter. Within 30 days after year-end, the REIT designates a capital gain dividend of $13 for the year. It thereafter distributes a $7 dividend which is stated to be a "fourth quarter distribution" (possibly the drafters contemplated a distribution declared in the last three months of 1988, paid in January of 1989, and treated as paid on December 31, 1988 under what was then section 857(b)(8), now contained in section 857(b)(9)). Thus, the REIT has a total of $17 of distributions with respect to 1988, of which $13 are designated as capital gain dividends. The example concludes that no withholding is required on the $10 of distributions made prior to the actual designation, but under the catch-up rule, the REIT must treat the $7 fourth quarter distribution (which the example states was paid after the designation) and the next $6 of dividend distributions in 1989 as capital gain dividends subject to withholding. Reg. § 1.1445-8(c)(2)(iii), Example.

[53] The current withholding regulations can be interpreted to require withholding even against capital gain dividends (or distributions that could have been designated as such) that are attributable to non-USRPI capital gains recognized by a REIT. On the other hand, Reg. § 1.1445-8(b)(1) states that a REIT "is liable to withhold tax upon the distribution of any amount attributable to the disposition of a [USRPI] with respect to each holder of an interest in the [REIT] that is a foreign person," which suggests that no withholding is required on capital gain dividends that are not "attributable to" USRPI gains. But even if one infers that withholding is required against all dividends that are, or could have been, designated as capital gain dividends, it does not preclude a foreign shareholder from establishing that a portion of the dividends were not "attributable to" USRPI gains (assuming the shareholder has access to the necessary information).

[54] There is no formal system in place for reporting of FIRPTA Distributions. However, a REIT is required to designate capital gain dividends by mailing a written notice to shareholders within 30 days after year-end. Section 857(b)(3)(C); Reg. § 1.857-6(f)(1). (This requirement is easily missed when a REIT liquidates and its taxable year closes in mid-year; consideration should be given to providing additional time in this situation, *e.g.*, until January 30 of the following year.) REITs can also choose to wait until they file their annual report. All REITs must file Form 1099s reporting dividend payments by January 31, but non-US persons are not required to receive them if the REIT has documentation establishing their status as a beneficial owner. Reg. § 1.6042-3(b)(1)(iii). In reality, these determinations are often based on estimates that are subject to change. Thus, reliable information regarding capital gain dividends may not be available until the REIT prepares its tax return.

a Form 1042-S until year 2 and thus would only be applied against the shareholder's tax liability (if any) in respect of year 2 capital gain dividends. In practical effect, the catch-up withholding serves as an advance payment against year 2 FIRPTA tax liability, not year 1.

There are other problems with the catch-up withholding mechanism. For example, assume that a foreign shareholder receives a first-quarter dividend that is subsequently designated as a capital gain dividend, and the 5% Exception does not apply because the shareholder owned more than 5% of the outstanding stock at some point during the one-year look-back period. If the shareholder sells its shares before the next regular dividend paid after the designation is made, catch-up withholding cannot take place. In that event, it is up to the shareholder to "self-assess" and file a US federal income tax return reporting the FIRPTA gain attributable to the capital gain distribution.[55]

The treatment of short-term USRPI capital gains is reserved in the existing regulations.[56] Thus, distributions attributable to short-term USRPI gain, which are apt to be rare for REITs, currently are not subject to withholding. However, reading section 897(h)(1) literally, such distributions would still be subject to FIRPTA tax from the foreign shareholder's perspective. Similarly, ordinary USRPI gains could arise under certain circumstances, such as section 1245 recapture recognized on the sale of personal property that is closely associated with the use of US real property (treated as a USRPI under Regulation section 1.897-1(b)(4)), and gains on the sale of section 1231 real property that are treated as ordinary income under section 1231(c) due to recapture of ordinary section 1231 losses claimed in the preceding five years.[57]

The last sentence of Regulation section 1.1445-8(c)(2)(ii)(C) provides that "[t]he provisions of this paragraph do not apply in a year in which the REIT adopts a formal or informal resolution or plan of liquidation." Although not entirely clear, it appears that the reference to "this paragraph" was intended to mean subparagraph (C) only (the catch-up rule), because the sentence is included as part of that paragraph. What Treasury had in mind here is not entirely clear. However, it may reflect the belief that allowing withholding on a catch-up basis is inappropriate once the REIT adopts a plan of liquidation. Thus, the regulation can be

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[55] If the REIT could have made a capital gains designation as to a particular dividend but did not, it appears the catch-up relief is not applicable and the REIT is required to have withheld from the distribution at the time of payment -- even though it may have no way of determining, at that time, what portion of the distribution is "attributable to" USRPI gain.

[56] *See* Reg. § 1.1445-8(c)(2)(ii)(B) (reserving the treatment of REIT distributions attributable to short-term capital gains). The legislative history refers only to capital gain dividends as the measure of USRPI gains. H.R. Conf. Rep. No. 1479, 96th Cong., 2d Sess. 188 (1980), reprinted in 1980-2 C.B. 575, 585 (section 897(h)(1) intended to create FIRPTA gain to the extent of the foreign shareholder's "pro rata share of the net capital gain of the REIT"); S. Rep. No. 192, 108th Cong., 1st Sess. 50 (2003) ("[t]he provision removes from treatment as effectively connected income for a foreign investor a capital gain distribution from a REIT" if the 5% Exception applies).

[57] To the extent a REIT recognizes gain from the sale of section 1250 property, section 291(d) requires a foreign corporate shareholder's share of capital gain dividends attributable thereto to be treated as ordinary income to the extent of its share of 20% of straight line depreciation. From the REIT's perspective, however, the amount is still included in "net capital gain" so that it can be paid out as a capital gain dividend (assuming the REIT made the appropriate designation). Thus, it would be subject to FIRPTA withholding under Reg. § 1.1445-8.

read to require contemporaneous withholding against any pre-liquidation distributions that are or could have been designated as capital gain dividends and which occur in a year in which the REIT adopts a plan of liquidation.

Non-Dividend Distributions are not subject to withholding under the existing regulations. This follows because (i) the amount to be withheld under Regulation section 1.1445-8(c)(2) is the amount that is (or could be) designated as a capital gain dividend, and (ii) section 857(b)(3)(C) only authorizes a REIT to designate a "dividend" as a capital gain dividend. To be sure, section 562(b) allows a REIT to treat liquidating and redemption distributions as dividends for purposes of the dividends paid deduction (to the extent paid out of E&P), but this has no effect on the shareholder's tax treatment. Accordingly, a REIT it is not obligated to withhold against such distributions under Regulation section 1.1445-8.[58]

Special withholding rules apply to domestic nominees that hold REIT shares on behalf of foreign shareholders and receive a FIRPTA Distribution, either directly or indirectly through other nominees.[59] If the REIT provides a "qualified notice," the nominee is required to do the FIRPTA withholding and the REIT is off the hook. A qualified notice, as defined in Regulation section 1.1445-8(f), is a notice published in a manner that complies with certain securities laws notice requirements applicable to dividends and which notifies domestic nominees of a distribution that the REIT has either designated as a capital gain dividend or is treating as a capital gain dividend for purposes of catch-up withholding.[60]

E. Notice 2007-55: Section 897(h)(1) Applies to REIT Liquidating and Redemption Distributions

1. Background

Unless section 332 applies, a REIT liquidation is treated as a deemed sale of shares by the REIT's shareholders back to the liquidating REIT.[61] At the corporate level, liquidation payments are also non-dividends, which is why section 562(b) was needed to create a REIT-level dividends paid deduction for a portion of such distributions so that the REIT would not incur significant taxes on liquidation gains. Thus, unless section 897(h)(1) changes the result, a foreign shareholder is deemed to have sold its shares to the REIT in a liquidation and is not

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[58] Although liquidating distributions cannot be designated as capital gain dividends, nothing prevents a liquidating REIT from using capital gains recognized after the adoption of a plan of liquidation to support the designation of a dividend paid prior to the adoption of such plan as a capital gain dividend.

[59] Reg. § 1.1445-8(b)(3).

[60] If the REIT fails to make an actual designation of a dividend as a capital gain dividend (even though it had an available net capital gain to support the designation), the deemed designation of such dividend as a capital gain dividend required by Reg. § 1.1445-8(c)(2)(ii)(A) is not eligible for the qualified notice procedure, and technically the withholding obligation falls back on the REIT. How the REIT would get the information needed to discharge its withholding obligation in this circumstance is not clear. In any event, the rule provides an incentive for the REIT to fully designate capital gain dividends.

[61] Sections 336 and 331; Reg. § 1.856-1(e)(3) (providing that section 331 applies in determining whether REIT distributions are payments made "in exchange for stock").

subject to FIRPTA tax if the shares qualify for the DC REIT Exception, Section 897(c)(3) Exception, or Cleansing Exception, or if the REIT is not a USRPHC or former USRPHC. (The same is true of a section 302(a) redemption.)

There are several issues:

(i) whether the term "distribution" in section 897(h)(1) includes distributions made by a REIT after the adoption of a plan of complete liquidation;

(ii) if "distribution" includes a distribution in liquidation, whether the DC REIT Exception (assuming the REIT is domestically controlled) nevertheless trumps section 897(h)(1), on the ground that a liquidation "sale" of domestically controlled REIT stock back to the liquidating REIT should be treated no less favorably under FIRPTA than a sale of such shares to a third party;

(iii) what is the tax character of a liquidating distribution made by a publicly traded REIT to a foreign shareholder that qualifies for the 5% Exception;[62] and

(iv) whether a foreign government receiving FIRPTA Distributions from a REIT could claim the section 892 exemption as to such income, provided the REIT was not a "controlled commercial entity" of the foreign government.

2. Notice 2007-55

Notice 2007-55 states that regulations will clarify that the term "distribution," as used in sections 897(h)(1) and 1445(e)(6), is not limited to distributions that are subject to section 316, but rather includes any distribution described in sections 301, 302, 331 and 332 where the distribution is attributable, in whole or in part, to gain from the sale of a USRPI by a REIT or RIC or other pass-through entity.[63] The Notice states that this result applies even if the REIT is domestically controlled under section 897(h)(4).[64]

The Notice states that the regulations will apply to distributions occurring on or after June 13, 2007. It also warns that, for pre-effective date distributions, the Service will challenge "under current statutory and regulatory provisions" an assertion by a foreign taxpayer that section 897(h)(1) does not apply to distributions in complete liquidation under sections 331 and

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[62] Another case where the tax consequences are unclear -- although rarely encountered in practice -- is where the foreign shareholder qualifies for the Section 897(c)(3) Exception but not the 5% Exception because the REIT is publicly traded on a foreign exchange.

[63] The specific fact pattern addressed in the Notice is a privately held, domestically controlled REIT in which a foreign government holds a minority interest. The Notice's reference to sales of USRPIs by a QIE or "other pass-through entity" presumably is intended to include sales of USRPIs by partnerships or other pass-through entities in which the REIT or RIC owns an interest.

[64] The Notice also states that the regulations will clarify that such distributions are treated and taxed as gain attributable to the alienation of a USRPI under the capital gains articles of US income tax treaties. This is intended to ensure that the real property articles, which typically give sole taxing jurisdiction over real property income and gains to the country where the property is located, take precedence over the dividend articles or other potentially applicable treaty exemptions.

332.[65] Because section 897 does not have any express delegation of regulatory authority to the Secretary, the regulations described in the Notice will be issued under the Treasury's general authority under section 7805(a).

The Notice also states that the regulations will provide that a foreign government's FIRPTA Distributions will be treated, for purposes of section 892, as gain from the disposition of a USRPI described in section 897(c)(1)(A)(i), and not as income or gain from stock. Thus, a foreign government is subject to FIRPTA tax on section 897(h)(1) distributions notwithstanding section 892.

The Notice adopts parallel positions with respect to FIRPTA withholding on distributions to which the Notice applies. Section 1445(e)(6) requires FIRPTA withholding on all distributions subject to section 897(h)(1). While section 1445(e)(6) does not speak to the question of whether a "distribution" includes a liquidating or redemption distribution, Notice 2007-55 answers the question in the affirmative.[66] Yet, both the statute and the Notice are completely silent as to how these deceptively simple concepts are supposed to work in practice.

In this report, we use the term "Non-Dividend Distributions" to refer to section 302(a) redemption distributions and section 331/332 liquidating distributions, other than section 332 distributions that are recast as a dividend under section 332(c). We have intentionally excluded from this definition section 301(c)(2) and (c)(3) distributions (although they are covered by the Notice) because (i) a REIT will not necessarily know whether a distribution falls within the scope of those provisions, in contrast to a liquidating or redemption distribution, and (ii) we believe the principles of the Notice can be reasonably implemented without devising special rules to address section 301(c)(2) and (c)(3) distributions.

3. Policy Issues Raised by Notice 2007-55

Whether Congress intended the term "distribution" in section 897(h)(1) to be limited to section 316 dividends or to be interpreted in its broadest possible sense is unclear. The fact that Congress could have, but did not, use the narrower term "dividend," and the fact that both section 302(a) and section 331(a) use the term "distribution," arguably support the approach taken in the Notice.[67] On the other hand, there is no indication in the legislative history and no

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[65] The IRS' failure to reference sections 301 and 302 (in addition to sections 331 and 332) in its statement of intent to challenge positions contrary to the Notice "under current statutory and regulatory provisions" may have been inadvertent.

[66] In Advice Memorandum 2008-3 (February 15, 2008), the IRS Office of Chief Counsel addressed the application of the FIRPTA withholding rules in the context of a taxable forward merger of a domestically controlled, publicly traded REIT into an acquiring entity, where the REIT had a foreign shareholder that owned 10% of the REIT's stock (so that the 5% Exception did not apply). It concluded that the deemed liquidating distribution to the foreign shareholder was not subject to withholding under Reg. § 1.1445-8(b)(3) because a liquidating distribution is not described in Reg. § 1.1445-8(c)(2)(ii). However, it stated that "[nothing] 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 [the foreign shareholder] from the sale or exchange of a USRPI." Thus, in the view of the Chief Counsel's Office, the failure of Reg. § 1.1445-8 to cover liquidating distributions was remedied by the enactment of section 1445(e)(6).

interpretive authority suggesting that all REIT distributions are automatically subject to section 897(h)(1).[68] On the contrary, what little legislative history there is suggests that Congress viewed capital gain dividends as the section 897(h)(1) tax base.[69] The 2004 amendments creating the 5% Exception further support this view. Section 857(b)(3)(F), which was enacted along with the 5% Exception, provides that any distribution to which the 5% Exception applies is recharacterized as an ordinary dividend if the amount would have been taxed as a capital gain dividend. Because liquidating distributions cannot be capital gain dividends, one could reasonably infer that Congress did not anticipate that section 897(h)(1) would apply to liquidating distributions. The Senate Report accompanying the enactment of the 5% Exception is in accord with this view: it states that the 5% Exception, if it applies, "removes from treatment as effectively connected income for a foreign investor a capital gain distribution from a REIT," and that such distribution is to be taxed "as a REIT dividend that is not a capital gain."[70]

We also think it is significant that elsewhere in section 897, when Congress used the word "distribution" and intended the term to include liquidating and redemption distributions, it made that intent clear in the statute. Specifically, section 897(d)(1) provides that gain is required to be recognized (notwithstanding any other Code provision) by a foreign corporation on the "distribution" of a USRPI, subject to an exception in section 897(d)(2) if the distributee takes a carryover basis in the property and would be subject to tax on a subsequent disposition of the property. (This rule was enacted in the pre-*General Utilities* repeal era when nonrecognition of gain was the exception rather than the rule on corporate distributions of appreciated property, but now has limited applicability.) To make clear that the term "distribution" was not limited to dividends of property, Congress added the parenthetical modifier "including a distribution in liquidation or redemption." If Congress had intended the word "distribution" in section 897(h)(1) to be similarly construed, one would expect it to have included the same parenthetical in section 897(h)(1).

While a REIT is allowed a deduction for liquidating distributions as provided in section 562(b), the shareholder is still treated as receiving a payment in exchange for stock for all purposes of the Code. The FIRPTA legislation provides detailed rules for taxing sales of USRPHC stock. They apply equally to REITs that constitute USRPHCs, save for the domestically controlled REIT exception. Thus, in our view, absent compelling policy reasons to

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67 *Cf.* Reg. § 1.562-2(a) (providing that, for purposes of the regulations dealing with preferential dividends, "the term 'distribution' includes a dividend as defined in subchapter C, chapter 1 of the Code, and a distribution in liquidation referred to in section 562(b)").

68 We note that Example (4) of Reg. § 1.884-1(d)(2)(xi) states that REIT shares are not US assets for branch profits tax purposes even though "dividend" distributions from the REIT might be treated as ECI. The Example gives no hint that liquidating distributions might give rise to ECI.

69 H.R. Conf. Rep. No. 1479, 96th Cong., 2d Sess. 188 (1980), reprinted in 1980-2 C.B. 575, 585 (section 897(h)(1) intended to create FIRPTA gain to the extent of the foreign shareholder's "pro rata share of the net capital gain of the REIT").

70 S. Rep. No. 192, 108th Cong., 1st Sess. 50 (2003). *See also* H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 400 (2004) (description of "present law" with respect to the FIRPTA treatment of REIT distributions states that "[t]hese capital gains distributions from REITs are generally 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 contrary, a foreign shareholder's gain on a deemed sale of REIT shares pursuant to a liquidation or redemption ought to be taxed under the FIRPTA rules that apply to stock sales. If a third party stock sale would be exempt (*e.g.*, due to the DC REIT Exception or because the REIT is not a USRPHC), then the tax treatment of a Non-Dividend Distribution that gives rise to a constructive sale or exchange ought to be taxed the same way.

Taxpayers have also drawn some comfort from the fact that Regulation section 1.1445-8 quite clearly did not apply to Non-Dividend Distributions. Indeed, the regulation does not even reserve the treatment of such distributions, in contrast to the express reservation of the treatment of short-term USRPI gains that appears in Regulation section 1.1445-8(c)(2)(ii)(B). The preambles to the temporary and final withholding regulations likewise refer only to distributions that are or could be designated as a capital gain dividend and say nothing about Non-Dividend Distributions.[71] And Regulation section 1.1441-3(c)(4)(i)(C), which coordinates dividend withholding under sections 1441 and 1442 with FIRPTA withholding under section 1445, indicates that Non-Dividend Distributions are subject to withholding only when they create outside gain. It states that REIT distributions in excess of the shareholder's basis are subject to withholding under section 1445 (unless the shares are not a USRPI) and that "[i]n addition, withholding is required under section 1445 on the portion of the distribution designated by a REIT as a capital gain dividend," with a cross-reference to Regulation section 1.1445-8. All of this is inconsistent with the notion that Non-Dividend Distributions are within the scope of section 897(h)(1) and its withholding system.

We can see a reasonable policy justification for applying section 897(h)(1) to Non-Dividend Distributions in the case of a foreign controlled REIT that is a USRPHC or former USRPHC, if one accepts the view that the Cleansing Exception applies to REITs. Otherwise, the foreign shareholders could avoid US tax entirely (both at the corporate and shareholder levels) by causing the REIT to sell or distribute its property after adopting a plan of complete liquidation, zeroing out REIT-level taxable income with the dividends paid deduction, and relying on the Cleansing Exception to avoid FIRPTA tax at the shareholder level. It is doubtful that Congress intended such a result. In a private letter ruling issued in 1990, the Service reached a sensible result in this context, and yet its analysis seems inconsistent with the notion that section 897(h)(1) applies to liquidating distributions.[72] Taxpayers who read this ruling, and

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[71] T.D. 8114, 1987-1 C.B. 291 (temporary regulations); T.D. 8321, 1990-2 C.B. 201 (final regulations). Indeed, the preamble to the final regulations uses the term "dividend" distributions in one instance, stating that the final regulations reserve on the issue of whether and how to impose withholding "with respect to a dividend distributed by a REIT, which is not a capital gain dividend but is attributable to net short-term capital gain" from USRPIs (emphasis added).

[72] *See* PLR 9016021 (Jan. 18, 1990), withdrawn for further consideration by PLR 200453008 (Sept. 27, 2004). The ruling involved a multi-property, foreign controlled private REIT whose common stock was owned by two foreign pension trusts. It adopted a plan of liquidation on September 15, 1989 and commenced to sell off its assets. It proposed to declare and pay (i) a $96 million liquidating distribution in two installments, one in December 1989 and one in January 1990, and (ii) a second liquidating distribution of $62 million in 1990 as to which a section 858 throwback election would be made so that the distribution could be deducted by the REIT in 1989. The REIT would then pay off its remaining liabilities and distribute its remaining assets within 24 months of the adoption of the plan of liquidation.

saw no reference to Non-Dividend Distributions in the legislative history or withholding regulations, could reasonably have concluded that the scope of section 897(h)(1) was limited to capital gain dividends.

Applying section 897(h)(1) to Non-Dividend Distributions by domestically controlled REITs is far more problematic. We acknowledge that Congress intended for section 897(h)(1) to apply to distributions by domestically controlled REITs;[73] the enactment of the Wash Sale Rule, which applies only to domestically controlled REITs, confirms this.[74] However, the legislative history contains no suggestion that Congress intended section 897(h)(1) to apply to Non-Dividend Distributions by domestically controlled REITs. [75] Doing so would create a disparity

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The ruling's analysis is murky. It first observes that liquidating payments from a REIT are treated as payments in exchange for stock and not as dividends and states that the taxpayer "asks that this characterization also apply to liquidating distributions … to which section 897(h) applies." After a brief discussion of section 897(h)(1), the ruling states that "[t]he liquidating distributions received by [the REIT's] foreign shareholders, if characterized in a manner consistent with the rules of section 856 and the regulations thereunder [*i.e.*, as payments in exchange for stock under section 331 and Reg. § 1.856-1(e)(3)], will nevertheless be treated as amounts received from the disposition of a USRPI to which section 897 of the Code applies" and that the amounts received would be treated first as a recovery of stock basis and then as gain described in section 897 on the dates the liquidating distributions were received.

Although it did not say so in the ruling, the National Office apparently believed that such treatment was more appropriate than trying to apply section 897(h)(1) to liquidating distributions. Or, it may have felt that the shareholder level section 331 gain was an acceptable surrogate for REIT-level USRPI gain that was "attributable to" liquidating distributions. Alternatively, the IRS may have concluded that it was unnecessary to apply section 897(h)(1) to liquidating distributions because it considered the REIT shares to be USRPIs at the time the shareholders recognized section 331 gain. Possibly this was because the REIT, which was engaged in a multi-year liquidation with multiple asset sales, had not qualified for the Cleansing Exception at the time of the distributions in question. However, the ruling makes no mention of the Cleansing Exception. Presumably the REIT at some point would have disposed of all of its USRPIs in gain recognition transactions and the Cleansing Exception would have stripped the shares of their USRPI taint. If so, any gain recognized at that time would not arise from the disposition of a USRPI unless section 897(h)(1) applied.

[73] In describing the special rules for REITs, the FIRPTA Conference Committee Report stated "[i]n the case of REITs which are controlled by U.S. persons, sales of the REIT shares by foreign shareholders would not be subject to tax (other than in the case of distribution by the REIT)." *See* H.R. Conf. Rep. No. 1479, 96th Cong., 2d Sess. 188 (1980), reprinted in 1980-2 C.B. 575, 585. The parenthetical arguably was intended to make it clear that dividends paid by a domestically controlled REIT are still subject to tax under section 897(h)(1), notwithstanding the DC REIT Exception for stock sales; on the other hand, it could be read to mean that liquidation or redemption distributions that are treated as sales are not subject to the DC REIT Exception. In any event, the legislative history does not provide any rationale for the DC REIT Exception. (As a policy matter, it is hard to see why a domestically controlled REIT should be treated more favorably than a domestically controlled USRPHC that is not a REIT.) It is something of a mystery why Congress was willing to let foreign shareholders of a domestically controlled REIT off the FIRPTA hook when they sell stock but not when they receive distributions attributable to USRPI gains.

[74] *See* TIPRA Conference Report at 288, n. 527 (stating that distributions by a domestically controlled REIT, "if attributable to the sale of U.S. real property interests, are not exempt from FIRPTA by reason of such domestic control").

[75] It should be noted that the definition of "testing period" in section 897(h)(4)(D) -- the period during which a REIT must be domestically controlled -- refers to "the 5-year period ending on the date of the disposition *or of the distribution*, as the case may be" (emphasis added). Because the term "disposition" is clearly broad enough to encompass a disposition of REIT shares pursuant to a liquidation or redemption, it raises the question as to what purpose was intended to be served by including "distribution" in this definition. The reason relates to section

in tax treatment for which there appears to be no sound policy rationale: namely, a foreign shareholder can sell domestically controlled REIT shares to a buyer free of FIRPTA tax, whereas a sale of the REIT's property to the buyer followed by a distribution of the sales proceeds to the foreign shareholder in a complete liquidation is taxable under Notice 2007-55. In addition, the Notice's interpretation of section 897(h)(1) exposes a corporate foreign shareholder (including a foreign government) to possible branch profits tax on a liquidation or redemption of REIT shares, even though gain on an actual sale of REIT shares (even a foreign controlled REIT) is exempt from branch profits tax.[76] The rationale for including capital gain dividends in branch tax ECEP (when gain on sale of REIT shares is not) is suspect to begin with, notwithstanding statements in the legislative history of the 5% Exception to the contrary. The logic is even more strained when extended to a Non-Dividend Distribution that is treated as a stock sale.

A foreign investor in a domestically controlled REIT can avoid the impact of Notice 2007-55 simply by selling its shares to a US buyer before the REIT makes distributions pursuant to a formal or informal plan of liquidation.[77] The same is true for a foreign shareholder of a REIT that does not qualify as a USRPHC or former USRPHC (such as a mortgage REIT), or for a foreign government shareholder that qualifies for the section 892 exemption as to gain recognized on sale of shares of a foreign controlled REIT.[78] This illustrates the arbitrariness of treating gain recognized in a constructive sale of shares to a liquidating or redeeming REIT differently from a sale of shares to a third party. One possible justification might be that, in the former case, the built-in gain in the property permanently escapes US tax, whereas in the latter case the REIT continues in existence with a low basis asset. However, if the share purchaser can liquidate the REIT under section 331 following the purchase, it would get a stepped up basis in the property and generally there would be no tax paid at either the REIT or shareholder level. If the REIT is not immediately liquidated, the buyer might realize capital gain dividends from nonliquidating distributions attributable to the built-in gain, but eventually it would recover its

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897(h)(3). As noted in the text, section 897(d)(1) requires gain recognition by a foreign corporation on the distribution of an appreciated USRPI, and section 897(h)(3) provides that, in the case of a domestically controlled REIT, "rules similar to the rules of subsection (d)" apply to the "foreign ownership percentage" of any gain (as defined in section 897(h)(4)(C)). Thus, section 897(h)(3) extends the gain recognition rule of section 897(d) for foreign corporations distributing USRPIs to distributions of USRPIs by domestically controlled REITs (which are domestic persons and would not otherwise be subject to section 897(d)(1)), but only to the extent of the foreign ownership percentage of the gain. The reference to "distribution" in the testing period definition clearly was intended to refer to section 897(d)(1) distributions of appreciated USRPIs by domestically controlled REITs. It does not seem to cut one way or another on the issue of whether section 897(h)(1) applies to liquidating and redemption distributions by domestically controlled REITs.

[76] Reg. § 1.884-1(f)(2)(iii) (excluding gain from sale of USRPHC stock from ECEP of a foreign corporate shareholder).

[77] Of course, the timing and terms of the stock sale must be such that it will be respected as a bona fide transaction and not treated as a constructive receipt of liquidation proceeds under one theory or another.

[78] A foreign government or controlled entity can sell shares of a non-controlled REIT (*i.e.*, non-controlled in the section 892 sense) free of FIRPTA tax, even if the REIT is foreign controlled due to the presence of other foreign shareholders, because section 892 trumps section 897(a) in that fact pattern. Yet, under Notice 2007-55 a liquidation or redemption sale of the shares back to the REIT would be taxed to the foreign government under section 897(h)(1). The section 892 interface with FIRPTA and the Notice is discussed later in this submission.

high outside basis, either in the form of return of capital distributions, upon liquidation, or in a third party stock sale.

Applying section 897(h)(1) to Non-Dividend Distributions raises other issues as well. Consider the following example:

> Example (1). Assume a REIT's sole asset is real property with a basis of $20 and value of $100. A US pension trust owns all of the REIT common stock with a $20 basis. (In the examples that follow, the 100-shareholder rule is ignored for convenience.) The pension trust sells the REIT stock to a foreign investor for $100. The REIT thereafter sells the real property for $100, recognizes $80 of capital gain, and liquidates, distributing $100 to the foreign investor. The REIT claims a dividends paid deduction under section 562(b) of $80 and zeroes out its corporate level taxable income. Assume that section 331 applies to the liquidation.
>
> If section 897(h)(1) applies to liquidating distributions, then $80 of the distribution might be viewed as "attributable to" the REIT's $80 real estate gain and treated as capital gain that is effectively connected with a US trade or business. Under this approach, presumably only $20 of the liquidation proceeds would be treated as a payment in exchange for stock under section 331. Consequently, the foreign shareholder would report an $80 capital loss on the liquidation ($20 proceeds - $100 stock basis). If the Cleansing Exception applies to REITs (as observed earlier, it literally does), the REIT's recognition of gain on the property sale would cleanse the shares of their USRPI taint. This leaves the foreign shareholder with an $80 FIRPTA gain but no offsetting effectively connected capital loss, which overstates its economic gain.

In the partnership context, the inside/outside basis disparity that leads to this problem could be eliminated by simply making a section 754 election and obtaining an inside step-up through a section 743(b) adjustment. But while the REIT taxation rules have some rules that resemble the rules applicable to pass-through entities (primarily the ability to designate capital gain dividends), section 754 adjustments are not among them.

Of course, a domestic shareholder of a REIT or other C corporation recognizes no gain or loss under section 331 if its shares have a basis equal to value. Why is it appropriate to vary the subchapter C rules so drastically merely because a foreign shareholder is involved? Nothing in section 897(h)(1) or its legislative history suggests that Congress intended this whipsaw result, even if one is persuaded (and we are not) that it intended the term "distributions" to include Non-Dividend Distributions.

The whipsaw potential on these facts -- *e.g.*, a foreign controlled private REIT whose shares constitute a USRPI -- would be substantially eliminated if the Cleansing Exception did not apply to REITs, because then the foreign shareholder would have an effectively connected capital loss in its shares. (Of course, if the Cleansing Exception were repealed, the most compelling policy justification for extending section 897(h)(1) to Non-Dividend Distributions would be gone.) There could still be some degree of whipsaw, however, due to character differences. For example, under section 291(d), a REIT is permitted to pay out capital gain

dividends attributable to ordinary section 291(a) recapture income recognized on the sale of depreciable real property (generally, 20% of straight line depreciation claimed by corporate taxpayers, including REITs). Any corporate shareholder must report its share of such dividends as ordinary section 291(a) recapture. However, Non-Dividend Distributions cannot be used to carry out potential section 291(a)(1) recapture income to foreign corporate shareholders because they cannot be designated as capital gain dividends. Thus, if the REIT fails to pay sufficient capital gain dividends in a taxable year in which it pays Non-Dividend Distributions, it could still have ordinary recapture income at the REIT level that is sourced to the disposition of a USRPI. Assuming (as we recommend herein) that the portion of a Non-Dividend Distribution treated as FIRPTA gain takes on the character of the income or gain recognized on the sale of the REIT's USRPIs, a foreign corporate shareholder in the above example could have ordinary FIRPTA income matched by an equal, but nondeductible (except to the extent of capital gains), ECI capital loss. Permitting the foreign shareholder to recognize the gain in its shares as ECI in lieu of applying section 897(h)(1) to its Non-Dividend Distributions (what we refer to as an "Outside Gain Election," discussed *infra*) would eliminate this issue.[79]

Applying section 897(h)(1) to liquidating distributions by a foreign controlled REIT is problematic for another reason. Suppose a REIT (assumed to be a USRPHC) makes a liquidating distribution in excess of the foreign shareholder's tax basis in its shares at a time when the requirements of the Cleansing Exception have not been satisfied -- *e.g.*, the REIT has sold most, but not all, of its USRPIs at the time of the distribution. The distribution in excess of basis would give rise to "outside" FIRPTA gain subject to section 897(a). If section 897(h)(1) applies to Non-Dividend Distributions, then the portion that is treated as a FIRPTA Distribution should reduce the shareholder's amount realized on the transaction for purposes of section 897(a). While this would appear to achieve a measure of coordination between the two regimes, it may not work properly if the REIT also holds appreciated non-USRPIs. In that case, unless the Cleansing Exception is applicable, the shares retain their FIRPTA taint even if all USRPI gains recognized through a particular distribution date have been allocated to Non-Dividend Distributions under section 897(h)(1). In such a case, it would seem that the shares of the REIT ought to be cleansed of their USRPI taint to prevent FIRPTA taxation of non-USRPI gains when distributions of non-USRPI sales proceeds exceed share basis.

Similarly, a foreign controlled REIT faces conflicting withholding regimes. Section 1445(e)(3) sets out a specific withholding regime for liquidating and redemption distributions paid by USRPHCs whose shares constitute USRPIs. Consistent with the fact that sections 331 and 302(a) create a deemed sale or exchange of USRPI shares by the foreign shareholder (with the "buyer" being the corporation itself), section 1445(e)(3) requires withholding of 10% of the

[79] Repealing the Cleansing Exception would not solve the whipsaw problem if the foreign controlled REIT did not also qualify as a USRPHC or former USRPHC, because then the shares of the REIT would not constitute USRPIs in the first instance. For example, a mortgage REIT typically would not have more than 50% of its assets invested in USRPIs and thus its shares would not be USRPIs, but it would be subject to section 897(h)(1) when it makes a distribution attributable to USRPI gains. A REIT that invests primarily in foreign real property might also fail to qualify as a USRPHC, although there are few REITs whose "center of gravity" is outside the United States. In both cases, an inside/outside basis differential as described in the example leads to an overstatement of FIRPTA gain when the REIT liquidates, because the purchasing foreign shareholder is left with a non-effectively connected "outside" capital loss. The objective of FIRPTA should be to tax a foreign shareholder on USRPI gain economically realized by it and no more.

"amount realized" by the foreign shareholder on the distribution unless the shares are not a USRPI at the time of the distribution.[80] But section 1445(e)(6) also requires a REIT to withhold on a net basis against the FIRPTA gain attributable to a "distribution." If Treasury and the Service are correct that Non-Dividend Distributions are "distributions" within the meaning of section 897(h)(1) and subject to withholding under section 1445(e)(6), a foreign controlled REIT that is a USRPHC or former USRPHC but does not qualify for the Cleansing Exception is subject to two different withholding regimes: one requiring 10% gross basis withholding of the amount realized on a deemed sale of REIT shares and another requiring 35% withholding against the REIT's USRPI gain attributable to the distribution.[81] These two withholding regimes will have to be reconciled under the Notice's approach, and it is not clear that simply reducing the shareholder's amount realized in the liquidation by the portion of Non-Dividend Distributions treated as FIRPTA Distributions will eliminate all issues. Of course, there is no conflict if section 897(h)(1)'s jurisdiction is limited to regular dividend distributions (whether capital or ordinary).

Another issue relates to the interplay between the capital gain dividend rules and section 897(h)(1). Most USRPI gains will be long-term capital gain and will be includable in a REIT's net capital gain. Until the Notice was issued, the character of FIRPTA Distributions was implicitly long-term capital gain because the withholding regulations treated FIRPTA gain as synonymous with capital gain dividends (or the ability to designate dividends as such). Under the Notice, it will be necessary to assign a character to Non-Dividend Distributions that are treated as FIRPTA Distributions. However, this will create a disconnect between the FIRPTA character rules and the capital gain dividend rules. Arguably, any USRPI capital gains allocated to Non-Dividend Distributions (under whatever allocation method is ultimately adopted) should not enter into "net capital gain" and should not be available to support designation of regular dividends as capital gain. Yet, we do not believe that Treasury and the Service can properly coordinate the two sets of rules without a statutory amendment to section 857(b)(3)(C). Even though USRPI gains are allocated to Non-Dividend Distributions, it appears that a REIT could still use that capital gain (even if recognized after the adoption of a plan of liquidation) to support the capital gain designation of regular, pre-liquidation dividends made during the same taxable year.

> Example (2). Assume that a REIT has $15 of ordinary operating income and a $25 net capital gain from the sale of a USRPI for the taxable year. The USRPI gain is recognized following the adoption in mid-year of a plan of complete liquidation. The REIT makes a $10 pre-liquidation distribution on March 31 and a $40 liquidating distribution on September 30. Assume the $25 USRPI gain is

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[80] Reg. § 1.1445-6(e)(3)(i) (providing that the domestic corporation is not required to withhold 10% against distributions to a foreign shareholder if the shares are not USRPIs at the time of the distribution, *e.g.*, where the Cleansing Exception applies).

[81] This would also be true in the case of Non-Dividend Distributions to a more-than-5% foreign shareholder of a publicly traded REIT that is not domestically controlled (or cannot prove that it is) and that occur before the requirements of the Cleansing Exception are met. Although section 1445(b)(6) provides that no withholding is required under section 1445(a) with respect to a disposition of shares of a class of stock that is regularly traded on an established securities market, that withholding exception does not apply for purposes of withholding under section 1445(e)(3).

allocated (under the forthcoming regulations implementing Notice 2007-55) one-fifth to the regular dividend and four-fifths to the liquidating distribution.[82] Under section 857(b)(3)(C), the REIT is still permitted to designate the entire $10 dividend as a capital gain dividend, even though all but $5 of the underlying capital gain was allocated to the liquidating distribution for FIRPTA purposes. It does not appear that Treasury and the Service can alter this outcome by regulation. Further, under Regulation section 1.1445-8, the REIT would be required to withhold against the entire $10 distribution, even though the amount treated as a FIRPTA Distribution is only $5. Indeed, under the "designated or could have been designated" rule, this would follow even if the REIT fails to designate the $10 distribution as a capital gain dividend.[83] In addition, the REIT would be required to withhold under section 1445(e)(6) against $20 of the liquidating distribution. Any rule regarding the allocation of Net USRPI Gain to distributions will produce this inconsistency unless the allocation rule gives a priority allocation of FIRPTA gain to capital gain dividends.

Last, but not least, there is no simple or obvious way to allocate USRPI gains to Non-Dividend Distributions made by REITs (more on this in the next section). In Regulation section 1.1445-8, Treasury addressed this problem for regular dividends by simply letting capital gain designations (or the ability to be designated as such) dictate the FIRPTA tax consequences. This was a reasonable approach and achieved a fair degree of coordination of the REIT capital gain dividend rules with FIRPTA. Because that approach does not work with Non-Dividend Distributions, a wholly new set of complex rules will be have to be devised.

To conclude, we view section 897(h)(1) as not only a poorly conceived statutory concept in general, but also particularly awkward if extended to Non-Dividend Distributions. There is simply no rational, workable or sensible way to implement it, which is undoubtedly why, 27 years later, taxpayers are still without proper interpretive guidance. If anything, its reach should be curtailed, not expanded. We see no policy justification for applying that provision to Non-Dividend Distributions by domestically controlled REITs, and we respectfully request Treasury and the Service to reconsider this position.

On the other hand, we believe Treasury and the Service have a legitimate concern that foreign shareholders of liquidating foreign controlled REITs can avoid FIRPTA tax entirely if all liquidating distributions are made after (or in a transaction in which) the REIT has "cleansed

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[82] The REIT has $40 of E&P for the year, with $10 being allocated to the capital gain dividend and $30 being allocated to the $40 liquidating distribution. Consequently, $30 of the $40 liquidating distribution is deductible under section 562(b). The 90% distribution requirement is satisfied for the year because the deductible distributions (excluding capital gain dividends) are $30, which exceeds the REIT's $15 of ordinary income for the year. The sum of the $10 regular dividend deduction and the $30 liquidating deduction zeroes out the $40 of REIT taxable income.

[83] The existing regulations require 35% withholding on regular dividends (but not Non-Dividend Distributions) paid to foreign shareholders to the extent that they are, or could have been, designated as capital gain dividends. When those regulations are revised to implement the Notice, they will need to take into account the portion of USRPI "net capital gain" that was allocated to Non-Dividend Distributions in order avoid double FIRPTA withholding.

itself" by disposing of all of its USRPIs in taxable transactions. The best way to address the foreign controlled REIT problem would be to make REITs ineligible for the Cleansing Exception, but that may require legislative action.

The proposed administrative solution, which is to apply section 897(h)(1) to Non-Dividend Distributions, might prevent tax avoidance but at the expense of creating a myriad of difficult technical issues. Chief among those is potential overstatement of a foreign investor's economic FIRPTA gain where there are inside-outside basis disparities. Accordingly, absent repeal of the Cleansing Exception, we recommend that the regulations issued under Notice 2007-55 be limited to cases where the Cleansing Exception otherwise would permit complete avoidance of US tax on FIRPTA gains. Such a rule should include a mechanism to remedy the whipsaw problem in REIT liquidations where an inside-outside basis differential exists. As discussed below, we believe that the words "attributable to gain" in section 897(h)(1) are broad enough to permit an offset of outside basis, if the shareholder so elects, where necessary to avoid an inequitable result.

F. "Attributable To Gain"

Section 897(h)(1) states that a distribution is treated by a foreign shareholder as gain from the sale or exchange of a USRPI "to the extent attributable to gain from sales or exchanges by the [REIT] of United States real property interests." Although the meaning of this phrase is hardly self-evident, Treasury and the Service have not issued any regulations or other interpretive authority under that provision in the 27 years since FIRPTA was enacted. The legislative history is singularly unhelpful. The FIRPTA Conference Report only merely states that "[d]istributions by a [REIT] 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."[84]

The forthcoming regulations heralded by Notice 2007-55 must provide guidance as to the meaning of "attributable to gain" in both the liquidating and nonliquidating context.

Unfortunately, there is no obvious "right" way to link net USRPI gains to distributions. Unlike a partnership, a REIT is not a pass-through entity and its items of income, gain, deduction and loss do not flow through to its shareholders. The principal exception to pure separate-entity tax treatment is that a REIT with a net capital gain can designate regular dividends as capital gain dividends. Consequently, section 897(h)(1) cannot be applied on a simple flow-through basis, with the foreign investor being taxed only on USRPI gains recognized by the REIT during the investor's holding period for its shares and the tax being enforced with an income-based withholding mechanism similar to section 1446. Instead, some sort of allocation methodology must be devised to allocate net USRPI gains to specific REIT distributions for substantive tax and withholding purposes, although we do not believe the same methodology can be used for both purposes.

In the existing FIRPTA withholding regulations (Regulation section 1.1445-8), withholding tax liability has turned on the extent to which a dividend was characterized (or could

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[84] *See* H.R. Conf. Rep. No. 1479, 96th Cong., 2d Sess. 188 (1980), reprinted in 1980-2 C.B. 575, 585.

have been characterized) as a capital gain dividend, even though capital gain dividends can be both over-inclusive and under-inclusive of a REIT's net USRPI gains. Of course, the capital gain dividend rules do not attempt to link distributions to gains in any temporal or funds tracing sense -- that is, a REIT can designate a first quarter dividend as a capital gain dividend even though it did not recognize any capital gains until the fourth quarter.[85] Indeed, there is nothing to preclude a REIT from using capital gains recognized after the adoption of a plan of liquidation to support a capital gain designation of regular dividends paid during the same taxable year but before the adoption of the plan, as long as the aggregate amount designated does not exceed the net capital gain for the year.

As observed earlier, these regulations have effectively functioned as the determinant of the foreign shareholder' substantive FIRPTA tax liability. We suspect there are few, if any, foreign shareholders that have filed US returns reporting a section 897(h)(1) tax liability that differed from their reported capital gain dividends.

Notice 2007-55 makes it essential that Treasury and the Service issue definitive guidance as to how USRPI gains are to be attributed to particular distributions, whether dividend or non-dividend. The existing withholding regulations need overhaul, because Non-Dividend Distributions cannot be designated as capital gain dividends.[86] Further, a REIT that makes a liquidation or redemption distribution will have no opportunity, or at best a limited opportunity (*e.g.*, a multi-year liquidation), to do catch-up withholding if it waits until after the distribution is made to determine the extent to which it is properly treated as a FIRPTA Distribution.

The system we propose would incorporate the following concepts:

(1) Limit Net USRPI Gain to Long-Term Capital Gains and Losses. Section 897(h)(1) is broad enough to include short-term capital and ordinary gains and losses from the sale of USRPIs. These would be infrequent, though, because REITs are subject to a 100% prohibited transactions tax on gains from the sale of dealer property and therefore generally hold their real property investments for long-term holding periods. To synchronize more closely with the capital gain dividend rules, Treasury could reasonably adopt a rule of convenience that takes into account only USRPI gains and losses that are included in "net capital gain," including any section 291(a) recapture income that a REIT is permitted to pay out as capital gain dividends subject to the requirements of section 291(d). As noted previously, this view draws support from the FIRPTA legislative history.

(2) Determine USRPI Gain on Annual Basis and Include Both Gains and Losses From USRPI Sales. Consistent with the legislative history's reference to "net capital gain," a REIT would take into account the net USRPI gains and losses actually recognized during the

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[85] As discussed previously, the designation of capital gain dividends is purely elective -- a REIT is not required to distribute its net capital gains in order to maintain REIT qualification (although any retained capital gains are taxed at the corporate level under section 857(a)(1)(A)(i)). A REIT could, in theory, avoid tax on capital gains by paying regular dividends at least equal to the sum of its operating income and net capital gain. Leaving FIRPTA aside, however, there is usually much to gain and nothing to lose by designating dividends as capital gain dividends to the maximum extent possible.

[86] This conclusion is confirmed in Advice Memorandum 2008-3.

taxable year, as well as capital loss carryovers attributable to USRPIs sold in prior years. Unrealized gains and losses would not be taken into account. The existing FIRPTA withholding regulations implicitly permit netting of USRPI losses against gains, because (i) they only require withholding to the extent a dividend is or could have been designated as a capital gain dividend, and (ii) a REIT can designate capital gain dividends only to the extent of the REIT's net capital gain for the year, which includes capital losses. If gains were taken into account but not losses, the foreign investor's FIRPTA tax liability would clearly be overstated relative to owning USRPIs directly or through a partnership.

If a REIT's liquidation spans more than one taxable year, it could recognize USRPI gains in more than one year, or recognize USRPI gains in one year and USRPI losses in another. In the case of a non-liquidating REIT, USRPI gains and losses should be taken into account only to the extent recognized by the REIT during the taxable year, consistent with the annual accounting concept. While the idea of adopting a "wait and see" approach to determine a liquidating REIT's overall net USRPI gain from liquidation sales has some merit, on balance we believe the annual accounting concept should also govern in that situation.

(3) Net USRPI Gain Should Be Reduced by Available Net Operating Loss and Capital Loss Carryovers. A REIT can designate dividends as capital gain dividends to the extent of its net capital gain for the year, but current net operating losses ("NOL") and NOL carryovers do not enter into the calculation of net capital gain.[87]

> Example (3). A foreign shareholder acquires all of the shares of a REIT for $100. The REIT buys a $100 building and depreciates it to $60. Cash expenses equal cash income, so the REIT reports an operating loss each year equal to the depreciation deduction and makes no distributions to its shareholder. The REIT then sells the property for $100 and liquidates, distributing $100 to the shareholder. The shareholder's outside section 331 gain is zero. The REIT has

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[87] To the extent a REIT pays capital gains dividends during the taxable year, such dividends are excluded in determining the current year NOL and the amount of NOL from any prior taxable year that is carried through such year to a succeeding taxable year. Section 857(b)(3)(E). Stated differently, in determining the amount of dividends that can be designated as capital gain dividends for a taxable year, a REIT is not required to offset its net capital gain with the amount of any NOL, whether current or carried over from a previous year. The intent is to maximize the amount of REIT taxable income that would be taxed to the individual shareholders as capital gain and preserve the NOLs for use in future taxable years to offset ordinary REIT taxable income. *See* S. Rep. No. 313, 99th Cong., 2d Sess. 780 (1986). For example, if a REIT has a current $100 NOL plus a net capital gain of $40 in 2008 (a net REIT taxable loss of $60), the maximum amount of capital gain dividends that the REIT could designate is $40. If it designated the full amount, it would carry over the entire $100 NOL to 2009. If it only designated $30 of dividends as capital gain dividends, it would carry over a $90 NOL to the following taxable year. (Note that Reg. § 1.857-6(e)(1)(ii) and Reg. § 1.172-5(a)(4), Example (2), interpret the law prior to the changes made by the Tax Reform Act of 1986.)

The capital gain distribution must be supported by sufficient E&P to be fully deductible. If the NOL were treated as reducing current E&P, that typically would mean that the distribution would not be fully covered by E&P. The only way to make sense out of the rules is to treat the current year NOL as giving rise to a springing reduction in accumulated E&P as of the beginning of the succeeding taxable year, and the IRS has embraced that logic. *See* PLR 200534013 (May 12, 2005). Otherwise, the rule would apply only in rare situations, which could not be consistent with the Congressional purpose in making the change.

\$40 of unrecaptured section 1250 gain, but has a \$40 NOL (current and carried forward) for the year.

It seems clear on these facts that the shareholder should not have any section 897(h)(1) gain because the REIT should not be viewed as realizing FIRPTA gain from depreciation except to the extent such deductions have been used to shelter prior operating income which reduces the ordinary dividends that would have been subject to withholding tax under section 1441. This netting, incidentally, is precisely the result that would apply if a foreign shareholder held and operated USRPIs directly or through a partnership.

Alternatively, if Treasury and the Service take the position that the gross gain recognized by the REIT is the measure of the FIRPTA Distribution, the foreign shareholder in the example would have a \$40 section 897(h)(1) gain and would report a liquidating payment in exchange for its shares of \$60, which have a tax basis of \$100. Thus, the shareholder would recognize a \$40 capital loss on its stock. That loss would not be an effectively connected loss if the DC REIT Exception or Cleansing Exception applies, and in the case of a foreign corporate shareholder, the overstated FIRPTA gain potentially would be subject to the branch profits tax. Thus, the shareholder could get whipsawed. As discussed below, we recommend that the shareholder be allowed to elect to cap the amount of Non-Dividend Distributions that are treated as FIRPTA Distributions to its outside stock gain. Under that approach, the foreign shareholder would be taxed on the correct amount of FIRPTA gain in a liquidation, regardless of whether the NOL is netted against the inside USRPI gain.

We recommend, therefore, that to the extent a REIT's current operating losses or NOL and capital loss carryforwards are used to offset a REIT's recognized USRPI gains during a particular year, they should likewise reduce the REIT's net USRPI gain for purposes of section 897(h)(1). In the discussion that follows, we use the term "Net USRPI Gain" to mean the REIT's net recognized gains and losses from USRPIs during the taxable year, as appropriately adjusted for such losses.

(4) Allocation of Net USRPI Gain to Distributions. A central issue is how to apportion a REIT's Net USRPI Gain among distributions during the year. Apportionment based solely on the capital gain dividend model is only a partial solution because Non-Dividend Distributions cannot be designated as capital gain dividends. We have considered several approaches.

(i) One approach would be to treat all distributions (liquidating and nonliquidating) as attributable to Net USRPI Gain for the taxable year in proportion to the amount of current E&P allocated to such distributions under the rules of section 316. A distribution is treated as a dividend if it is paid out of either current or accumulated E&P, and is treated as a dividend if there are sufficient E&P by year-end, even if there were insufficient E&P when the distribution was made.[88] Further, regular dividends absorb E&P before section 302 redemption distributions.[89] Thus, a REIT's E&P for the year in which a plan of liquidation is adopted (including E&P attributable to liquidation

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[88] *See* Reg. § 1.316-1(e), Example (1); Rev. Rul. 69-447, 1969-2 C.B. 153.

[89] *See* Rev. Rul. 74-338, 1974-2 C.B. 101; Rev. Rul. 74-339, 1974-2 C.B. 103.

sales) presumably are allocated first to regular dividends paid prior to the plan of liquidation and then to liquidating distributions. To the extent a liquidating distribution is deemed to carry out E&P under these rules, it could be attributed a ratable share of Net USRPI Gain for such year based on the ratio of the E&P attributed to such distribution to the REIT's total E&P (whether earned before or after the adoption of a plan of liquidation). Because E&P determinations and apportionment rules are complicated, the REIT could be required to make such allocations in good faith using a reasonable estimate of current E&P for the taxable year, as determined after year-end. However, because only recognized USRPI gains can trigger FIRPTA gain under section 897(h)(1), any USRPI gains recognized under the installment method would be included in E&P for purposes of this allocation only as the gains are recognized, in contrast to the normal rule of section 312(n)(5).

On balance, we believe this approach is undesirable because (a) it would require difficult E&P determinations and allocation, (b) it would completely de-link section 897(h)(1) from the capital gain dividend rules, and (c) it is not clear to us why regular dividends should necessarily receive a priority allocation of Net USRPI Gain relative to Non-Dividend Distributions in a year in which both occur.

(ii) Another approach would be to treat all distributions paid during the year (regular dividends and Non-Dividend Distributions) as carrying out FIRPTA gain ratably in proportion to the dollar amounts of the distributions. This approach has the advantage of simplicity, but it is arbitrary and again departs totally from the REIT capital gain dividend rules.

(iii) Net USRPI Gain could be attributed to distributions only if and to the extent that the REIT actually has a recognized Net USRPI Gain at the time the distribution is made. This would establish a logical and intuitive temporal linkage -- that is, USRPI gains must actually be recognized before a distribution can be sourced to them. However, this would be inconsistent with the capital gain dividend rules, which allow the REIT to apply a "wait and see" approach and permits distributions to be characterized as capital gain even though the source capital gains are recognized after the distribution. Also, the administrative burden would be substantial.

(iv) The REIT could designate distributions as FIRPTA Distributions in its sole discretion, except that (i) it would be required to make minimum FIRPTA designations equal to its Net USRPI Gain for the year, and (ii) all designations would be pro rata among the holders of the class of shares in respect of which the distributions were made. We recognize that Treasury and the Service may have concerns that such discretion could facilitate avoidance of section 897(h)(1). For example, assume a domestically controlled REIT is marketing its real property for sale. The foreign shareholders negotiate to sell their shares to a US buyer and close the sale before the property sale occurs. Assume the foreign shareholders also received regular dividends prior to the stock sale. If the REIT recognizes USRPI gains after the stock sale but in the same taxable year, it would serve the selling stockholders' interest for the REIT to designate only post-stock sale distributions as FIRPTA Distributions, and a discretionary approach on FIRPTA designations would facilitate this. Given the inherent difficulty of

administering section 897(h)(1) and the need for foreign investors to be able to determine their US tax liabilities with some certainty, REITs arguably should have the discretion to assign Net USRPI Gain to specific distributions made during the taxable year, just as they do with capital gain dividends. On the other hand, because USRPI gains and losses are typically long-term capital gains and losses, a good argument can be made that the allocation of USRPI gains should track the designation of capital gain dividends to the extent feasible.

(v) A hybrid approach could be adopted under which Net USRPI Gain for any taxable year in which no liquidating or redemption distributions are made would be allocated to the REIT's distributions in the same manner, and in proportion to, the amounts thereof that are designated (or could have been designated) as capital gain dividends for the year.[90] The REIT would retain the flexibility that it has under existing law to designate capital gain dividends, except that if the REIT failed to designate the maximum amount, it would be deemed to have done so ratably as to all dividends paid during the taxable year. In the unusual case where the REIT recognizes ordinary USRPI gains or losses or short-term USRPI gains that are excluded from net capital gain, such income or gain would be allocated on a proportionate basis to all regular dividends paid during the year. In a taxable year in which a Non-Dividend Distribution is made, however, a different set of rules is needed because such distributions cannot be designated as capital gain dividends.

Example (4)(a). Assume that a domestically controlled REIT is 51% owned by individual domestic shareholders and 49% owned by a foreign shareholder. The shareholders' aggregate basis in their REIT shares is $120. The REIT holds a single US real property with a value of $200 and a basis of $120. It adopts a plan of liquidation in mid-year. The REIT has $100 of cash net operating income (comprised of rents and related cash deductions) in the pre-adoption period and pays $100 of regular dividends. In the post-adoption period, it has no operating income or loss and sells the property for $200, recognizing an $80 long-term capital gain. The REIT thus has $180 of E&P for the year and a Net USRPI Gain of $80. It distributes the $200 liquidation proceeds on December 31 and dissolves. The regular dividends receive a $100 priority allocation of E&P, while the liquidating distribution receives an $80 residual allocation of E&P, causing $80 of the $200 liquidating distribution to be deductible under section 562(b). Under current law, it is clear that a REIT has the discretion to use capital gains recognized from the USRPI sale in the post-adoption period as the basis for designating the regular dividends as capital gain dividends, provided it distributes at least 90% of its ordinary REIT taxable income in the form of deductible distributions that are not capital gain dividends (including liquidating distributions under section 562(b)). Thus, to favor the domestic shareholders, the REIT could

[90] To the extent the REIT's net capital gain includes non-USRPI gains, the amount treated as FIRPTA distributions would be less than the amount of actual or potential capital gain distributions. Conversely, to the extent net capital gain includes non-USRPI losses, the amount treated as FIRPTA distributions could exceed the amount of actual or potential capital gain dividends.

designate up to $80 of pre-adoption distributions as capital gain dividends.[91] The domestic shareholders thus have most of their regular dividends converted to capital gain, while all of their "outside" liquidation gain ([$200 proceeds - $120 stock basis] x 51%) is long-term capital gain under section 331. This result is clearly permitted under current law. The question then becomes to what extent the capital gain designations (or failure to designate) should affect the FIRPTA allocation. From an economic and funds tracing standpoint, a strong argument can be made that, because the REIT's only recognized USRPI gains occur in the post-adoption period, all of such gains should be "attributable to" the liquidating distribution made on December 31 and none to the regular dividends, which were funded by ordinary operating cash flow.

One approach to the USRPI gain allocation issue in the above example would be to adopt a "closing of the books" method, whereby Net USRPI Gain would be separately determined for the pre-adoption and post-adoption periods as if the taxable year closed on the date the plan of liquidation was adopted. The amount of Net USRPI Gain attributable to the pre-adoption period would equal the lesser of (a) the Net USRPI Gain for the pre-adoption period, and (b) the Net USRPI Gain for the entire taxable year. This would result in regular dividends carrying out FIRPTA gain only to the extent such gains were recognized in the pre-adoption period. On the other hand, this adds complexity in an area where we believe simplicity is badly needed. It would also create disconnects between the amounts of Net USRPI Gain allocated to pre-adoption dividends and the amounts thereof that are (or could be) treated as capital gain dividends by the REIT.

On balance, we favor a simpler approach whereby the extent to which the REIT designates (or fails to designate) regular dividends as capital gain would drive the allocation of Net USRPI Gain. Specifically, we propose the following:

(i) If no Non-Dividend Distributions are paid in a taxable year, Net USRPI Gain would be allocated first, to distributions actually designated as capital gain dividends, and any remaining amount would be allocated ratably to other distributions that are not so designated.

(ii) In a year in which the REIT makes both regular dividends and Non-Dividend Distributions, Net USRPI Gain would be allocated first to designated capital gain dividends, in proportion to, and to the extent of, the amounts so designated.[92] Any

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[91] The REIT in the example still meets the 90% distribution requirement because, for purposes of section 857(a)(1)(A)(i), the deduction for dividends paid under section 561 includes the deductible liquidating distribution. The REIT thus has $100 of ordinary REIT taxable income, and its deductible distributions (excluding the $80 of capital gain dividends) equals the sum of the $20 of ordinary dividends and $80 of deductible liquidating distributions, or $100, which exceeds the 90% requirement.

[92] For this purpose, consent dividends under section 565, dividends treated as paid in the current year under sections 857(b)(9), and deemed capital gain dividends under section 857(b)(3)(D)(i) would also be taken into account, as well as deficiency dividends under section 860. With respect to the latter, the legislative history of the 5% Exception indicates that section 897(h)(1) can apply to deficiency dividends. Specifically, section 403(p) of the

remaining Net USRPI Gain would be allocated to Non-Dividend Distributions to the extent thereof, and the balance, if any, would be allocated proportionately to any other distributions during the year (*i.e.*, any ordinary dividends not designated as capital gain dividends and section 301(c)(2) and (c)(3) distributions). If only Non-Dividend Distributions are made in a taxable year (*e.g.*, the second year of a multi-year liquidation), Net USRPI Gain would be allocated proportionately among all such distributions. For purposes of such allocations, the amount of paid-in capital attributable to preferred stock in respect of which a Non-Dividend Distribution is paid would be subtracted from the amount of the Non-Dividend Distribution.[93]

(iii) To simplify withholding and provide a remedy for inside-outside basis differentials, each foreign shareholder would be permitted to make an election (an "Outside Gain Election," as further discussed below) to have its outside liquidation gain serve as a substitute for its share of "inside" Net USRPI Gain that otherwise would be attributable to its share of liquidating distributions. If the election is made, the share of Net USRPI Gain that otherwise would have been allocated to the electing shareholder's

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Gulf Opportunity Zone Act of 2005 made certain technical corrections to the 5% Exception and the related effective date provisions contained in Section 418 of the American Jobs Creation Act of 2004 (the "Act"). The revised effective date provision states that the 5% Exception applies to deficiency dividends paid by a REIT under section 860 in a post-effective date taxable year but that are deductible by the REIT for a pre-effective date taxable year. The Joint Committee's technical explanation states that such deficiency dividends "qualify for the exclusion from FIRPTA treatment under the Act if the other requirements of the Act are met." This indicates that in cases where the 5% exception does not apply, deficiency dividends may be characterized as FIRPTA gain, although presumably this would occur only if the determination for the prior year resulted in undistributed USRPI gains. *See* Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of H.R. 4440, The "Gulf Opportunity Zone Act of 2005" As Passed by the House of Representatives and the Senate, p. 83 (Comm. Print 2005).

A deficiency dividend is includable in the income of the shareholder as a section 316 dividend in the year of payment under sections 860(f)(1) and 316(b)(3) regardless of whether there are sufficient E&P to support the dividend. However, it is deductible by the REIT for the prior year in which the IRS or the REIT made a "determination" under section 860(e) that the REIT had undistributed taxable income, provided it would have been included in the dividends paid deduction under section 561 if actually paid in such year. Deficiency dividends can be designated as capital gain dividends to the extent the determination results in undistributed net capital gain. Section 860(f)(2)(B). Accordingly, to the extent the deficiency dividend could be designated as a capital gain, and the capital gain results from a determination that the REIT had additional USRPI gains, it would logically follow that a corresponding portion of the deficiency dividend would be FIRPTA gain. The original FIRPTA designations for other distributions paid during the deficiency year would remain unchanged. The same analysis would apply for purposes of section 858 throwback dividends.

[93] This is necessary to prevent preferred distributions from receiving an allocation of Net USRPI Gain that is disproportionate to the preferred shareholders' economic interest in the REIT's E&P relative to the common shareholders. Section 312(n)(7) provides that if a corporation redeems stock in a section 302(a) redemption, the portion of the distribution that is properly chargeable to E&P cannot exceed the ratable share of accumulated E&P attributable to the redeemed stock. A redemption of nonparticipating preferred stock generally reduces E&P only by the amount of dividends in arrears discharged in the redemption. Rev. Rul. 74-266, 1974-1 C.B. 73. Unless there are multiple classes of common stock with different priorities, a redemption of common stock results in a reduction of E&P equal to the corporation's total E&P (less E&P allocated to preferred shares) multiplied by the ratio of the shares of common stock redeemed to the total outstanding common stock. Thus, subtracting the paid-in capital attributable to preferred shares from Non-Dividend Distributions to preferred shareholders produces an allocation of Net USRPI Gain among all Non-Dividend Distributions that roughly correlates to the manner in which E&P is allocated to such distributions.

liquidating distributions under the foregoing rules would be purged and could not be allocated to other foreign shareholders. As will be discussed, withholding would occur only as and when REIT distributions cause the foreign shareholder to recognize outside gain.

These rules may be illustrated as follows:

> Example 4(b). Assume the same facts as the preceding example. If the REIT designates $80 of pre-adoption distributions as capital gain dividends, the entire $80 of Net USRPI Gain would be allocated to such distributions and none would be allocated to the $200 liquidating distribution, even though $80 of the distribution was deductible under section 562(b). If the REIT failed to designate any capital gain dividends, the $80 of Net USRPI Gain would be allocated solely to the $200 liquidating distribution, but the domestic shareholders would lose the benefit of converting $80 of ordinary dividend income to capital gain.
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> Example 4(c). Assume the same facts as in the preceding example, except that, in addition to paying $100 of pre-adoption regular dividends, the REIT took out a $160 mortgage loan on its property and distributed the proceeds to its shareholders prior to adopting the plan of liquidation. The REIT thereafter adopts a plan of liquidation, sells the property for $200, recognizes $80 of capital gain, pays off the $160 liability, and distributes the remaining $40 to its shareholders. (We assume here that under existing law the borrowing and related distribution would not be treated as the informal adoption of a plan of liquidation.) Of the $260 of pre-adoption distributions, $180 is deemed to be paid out of current E&P (including the $80 sale gain) and thus is a deductible dividend under sections 316 and 561(a). The $40 liquidating distribution carries out zero E&P and thus no portion of it is deductible under section 562(b). The REIT has the discretion to designate up to $80 of the $260 of pre-adoption distributions as capital gain dividends. If the REIT designates the full $80, it would be required to allocate the entire Net USRPI Gain to such capital gain distributions and no portion would be allocated to the liquidating distribution. If the REIT designates zero capital gain dividends, $40 of Net USRPI Gain would be allocated to the liquidating distribution and $40 would be allocated to the $260 of pre-adoption distributions on a pro rata basis.

(5) Outside Gain Election. A major issue presented by Notice 2007-55 is whether the portion of a Non-Dividend Distribution that is "attributable to gain" from the sale of the REIT's USRPIs should be determined solely at the REIT level, focusing solely on "inside" asset gain, or whether the foreign shareholder's "outside" liquidation gain should also be taken into account. The purpose of section 897(h)(1) is to recharacterize a foreign shareholder's income or gain from a REIT as FIRPTA gain by linking distributions to USRPI gain recognized by the REIT, but we believe it should not create income or gain where the shareholder would otherwise have none as a result of the distribution. In a distribution to which section 301 applies (including a dividend designated as a capital gain dividend), the distribution is a return on, rather than a return of, the shareholder's investment. In devising the current withholding regime, Treasury eschewed any

sort of funds tracing approach and instead required the REIT's net USRPI gains for the year (to the extent included in the REIT's net capital gain) to be allocated to "dividends" paid during such year. Some might consider this as a stretch of the term "attributable to gain," in that a shareholder may recognize FIRPTA gain on receipt of a dividend even though the REIT recognized no USRPI gains during the shareholder's holding period, but at least it requires the shareholder to recognize income from its investment before a FIRPTA taint can attach to such income.

By contrast, if a REIT makes a Non-Dividend Distribution, the shareholder is treated for all purposes of the Code as selling its REIT shares back to the corporation in exchange for the liquidation or redemption proceeds. The shareholder recognizes gain only to the extent the distributions exceed the shareholder's outside stock basis. Outside stock basis may not correspond to the "inside" asset basis of the REIT's USRPIs -- typically where the shareholder purchased the shares from another shareholder. If Treasury and the Service intend to apply section 897(h)(1) to Non-Dividend Distributions, it ought to do so only when such distributions cause the shareholder to realize income from its investment in the form of outside gain. Most importantly, many of the practical issues that arise when trying to associate FIRPTA gains to distributions that are not "income" are eliminated if the measure of the FIRPTA Distribution is outside gain. In our view, limiting the FIRPTA-taxable portion of the distribution to the shareholder's outside stock gain is a reasonable interpretation of the words "attributable to gain" in a REIT liquidation or redemption and avoids taxing foreign shareholders on non-economic FIRPTA gain. It would also cure tax distortions that could arise if section 897(h)(1) were applied on an annual accounting basis to a REIT recognizing USRPI gains and losses in a multi-year liquidation.

It is true that a foreign investor's outside gain may be reduced by depreciation in value of non-USRPI assets owned by the REIT, such as foreign real estate. But such distortions are a fact of life in the FIRPTA scheme. FIRPTA is over-inclusive in taxing a foreign investor on all gain recognized on the sale of USRPHC shares, even though a portion of the stock gain may be economically attributable to non-USRPI assets. It is under-inclusive in that (i) the stock gain may reflect losses in non-USRPI assets owned by the USRPHC that effectively shelter USRPI gains, and (ii) the foreign shareholder avoids shareholder level FIRPTA tax altogether if the value of the corporation's USRPIs is (and has been throughout the look-back period) less than 50% of the value of its domestic and foreign real estate and trade or business assets.

Now consider the following example:

> Example (5). A foreign investor buys all the outstanding shares of a REIT for $100 at a time when the REIT's sole asset has a built-in loss of $60 (basis of $160 and value of $100). Thereafter, the property appreciates and the REIT sells it for $200, recognizing $40 of "inside" gain. The REIT distributes $200 to the investor as a liquidating distribution. Ignoring section 897(h)(1), the investor realizes a $100 "outside" gain on the liquidation. Yet, section 897(h)(1) would treat only $40 of the distribution as attributable to USRPI gain. The shareholder presumably would be deemed to receive the remaining $160 of liquidation proceeds as a payment in exchange for its stock and thus would recognize section 331 gain of $60, all of which is attributable to appreciation in the REIT's property

that occurred after the investor acquired the shares. The $60 of "outside" gain, however, would not be subject to FIRPTA tax if either (i) the DC REIT Exception, the Section 897(c)(3) Exception, or the Cleansing Exception applies, or (ii) the REIT is not classified as a USRPHC or former USRPHC due to the composition of its assets.

If the REIT is foreign controlled and FIRPTA taxation of the outside gain is prevented by the Cleansing Exception, Treasury and the Service could reach a sensible result by issuing regulations that exclude REITs from the Cleansing Exception -- assuming Treasury has the authority to issue such a regulation, which is far from clear -- and suspending the application of section 897(h)(1) to liquidating distributions. The shareholder would thus have $100 of "outside" FIRPTA gain and no section 897(h)(1) gain. This is consistent with the policy of the Cleansing Exception, which is to collect only a single tax on USRPI gains. To the extent the outside gain is partly attributable to appreciation in REIT assets which are not USRPIs, that simply reflects the distortions caused by using a 50% USRPI threshold in the USRPHC asset mix test.

If one of the other FIRPTA exceptions applies, however, the problem is more difficult. It is doubtful that Treasury and the Service can write a valid regulation that mandates augmentation of the section 897(h)(1) "inside" USRPI gain by a shareholder's outside liquidation gain that otherwise would not be subject to FIRPTA tax.

Now assume the REIT liquidates over a period of years:

Example (6). A REIT owns US real property A with a basis of zero and value of $100, and US real property B with a basis and value of $100, and holds no other assets. Assume all of its shares are owned by a foreign pension fund, which holds the shares with a $100 basis and $200 value. In year 1, the REIT adopts a plan of liquidation, sells property A for $100, recognizes $100 of gain, and distributes the $100 sales proceeds to the shareholder. This reduces A's basis in its shares to zero. In year 2, REIT sells property B for $100, recognizing no gain or loss at the REIT level, and distributes the $100 proceeds.

If the shareholder's section 897(h)(1) gain is limited to its outside gain recognized in year 1, there is no FIRPTA tax imposed in year 1, even though the REIT recognized a $100 gain in year 1. In year 2, the shareholder recognizes $100 of "outside" gain, but such gain would appear to be nontaxable at the shareholder level due to the Cleansing Exception. The shareholder ought to have $100 of FIRPTA gain when the dust settles; the question is how to get there. (As discussed earlier, a repeal of the Cleansing Exception for REITs would be one solution.)

Example (7). Now assume the same facts as the preceding example, except the REIT sells property B for $60 in year 2 and recognizes a $40 loss. It distributes $60 of proceeds in year 2, and the shareholder recognizes only $60 of outside gain. In this case, the shareholder ought to recognize only $60 of FIRPTA gain in

year 1 and year 2 combined, not $100, because the REIT's USRPI gains and losses over the two-year period total net to $60.

To address these issues, we recommend that a foreign shareholder be permitted to elect to treat the gain recognized on its REIT shares in a liquidation or redemption[94] as a proxy for the section 897(h)(1) gain that otherwise would be attributable to the Non-Dividend Distributions (such election is referred to herein as an "Outside Gain Election"). The election could be made (or revoked) at any time up to the filing of the shareholder's return (including an amended return), and the REIT would be provided a copy of the election for withholding purposes. We believe that using a foreign shareholder's outside gain to fix the amount of USRPI gain "attributable to" a Non-Dividend Distributions is a reasonable and administratively expedient way to extend section 897(h)(1) to such distributions, especially given the absence of any statutory guidance or legislative history on point, and that Treasury has the authority to issue regulations adopting this concept in an elective context.[95] We also believe the shareholder needs reasonable flexibility to make or revoke the election, because it often will have little or no information regarding the REIT's "inside" gains and losses and dispositions.

To ensure that the electing shareholder's liquidation or redemption gain is taxed under FIRPTA, the shareholder would be required to waive the application of any FIRPTA exception (such as the DC REIT Exception and the Cleansing Exception). In practical effect, this is similar to the result in the 1990 private letter ruling. It yields the same results as if section 897(h)(1) did not exist and the Cleansing Exception and DC REIT Exception did not apply. The Outside Gain Election would not be available if the REIT was not a USRPHC during the applicable look-back period.

(6) FIRPTA Distributions Excluded from Shareholder's Amount Realized. The regulations should confirm that, to the extent a Non-Dividend Distribution is treated as a FIRPTA Distribution, it is not treated as a payment in exchange for the foreign shareholder's stock and thus is not part of the shareholder's amount realized on the liquidation or redemption.

Assume that a foreign shareholder fails to make an Outside Gain Election and the REIT is either a foreign controlled USRPHC or a publicly held USRPHC and the shareholder owns more than 5% of its stock. Assume further that a Non-Dividend Distribution is made but the Cleansing Exception is not yet applicable -- such as a multi-year liquidation where cumulative liquidating distributions exceed the foreign shareholder's outside basis before the REIT has recognized the gains on all of its USRPIs. Also assume that a portion of the distribution is a FIRPTA Distribution. If the remaining portion of the Non-Dividend Distribution exceeds the shareholder's basis in its REIT shares, then presumably the shareholder would recognize "outside" FIRPTA gain to which section 897(a) applies in addition to the section 897(h)(1) gain.

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[94] In a complete liquidation under section 331 that involves multiple distributions over more than one taxable year, the shareholder does not recognize gain until all of the basis in its shares has been recovered, and no loss is recognized until the final liquidating distribution is received. Rev. Rul. 68-348, 1968-2 C.B. 141.

[95] *Cf.* Prop. Reg. § 1.83-3(l) (election to include as compensation income the liquidation value of a partnership interest as opposed to more traditional concept of fair market value under section 83); Notice 2005-43, 2005-24 I.R.B. 1221.

As noted earlier, the overlapping application of two different substantive FIRPTA rules seems conceptually flawed and could be distortive, depending on the facts of the particular case, and reveals the shaky analytical basis for extending section 897(h)(1) to liquidating distributions in the first place.

(7) USRPI Gains Taxed At REIT Level Should Be Excluded From Net USRPI Gain. A REIT can be subject to corporate level tax on its USRPI gains for several reasons. This could be a result of the built-in gains tax[96] or because the REIT retained and reinvested capital gains. A principal reason for the enactment of FIRPTA was to ensure that gain recognized by a domestic corporation on the disposition of USRPIs was subject to at least one level of tax. Congress knew that REITs generally are not taxpaying entities; thus, section 897(h)(1) implements the "single tax" Congressional purpose by subjecting REIT distributions to FIRPTA tax to the extent attributable to USRPI gains. When FIRPTA was enacted in 1980, there was no REIT built-in gains tax. Because the effect of the tax is to treat a REIT as if it were still a C corporation with respect to its built-in gains, its foreign shareholders ought to be treated for FIRPTA purposes in the same manner as if they owned shares of a C corporation that sold its USRPIs, paid corporate level tax on the gains, and then liquidated, with no additional FIRPTA tax at the shareholder level due to the Cleansing Exception.

Accordingly, we think it is clear that Congress did not intend for section 897(h)(1) to apply to USRPI gains that are subject to built-in gains tax or otherwise taxed at the REIT level, and the regulations under Notice 2007-55 should make this clear. This recommendation would not apply to capital gains taxed at the REIT level but deemed to have been distributed to shareholders under section 857(b)(3)(D), because the net effect of that provision is subject such gains to shareholder level tax rather than a REIT-level tax.

(8) Character of FIRPTA Distributions. Under the existing withholding regulations, only dividends that are, or could be, designated as capital gain dividends are subject to FIRPTA withholding (ignoring the catch-up rule), so the character of the FIRPTA gain by definition has been limited to long-term capital gain (including any unrecaptured section 1250 rate gain). But if Non-Dividend Distributions are subject to section 897(h)(1), and the Service determines that any ordinary and short-term capital USRPI gains are includable in Net USRPI Gain, it will be necessary to assign an appropriate character to each FIRPTA Distribution. A reasonable approach would be to allocate long-term USRPI capital gains first to capital gain dividends to the extent thereof, and allocate any remaining long-term, short-term and ordinary USRPI gains ratably to all ordinary dividends and Non-Dividend Distributions paid during the taxable year.

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[96] Under the built-in gains tax regime, if a REIT acquires property in a "conversion transaction" -- defined to be the conversion of an existing C corporation to a REIT or the transfer of assets from a C corporation to a REIT -- any gain recognized on the subsequent disposition of such assets during the ensuing 10-year period is subject to a REIT-level tax under Reg. § 1.337(d)-7 and section 1374, but only to the extent of the built-in gain in the assets at the time of the REIT conversion or acquisition. An exception exists if the C corporation makes a "deemed sale election" immediately prior to the conversion or transfer.

Recognized built-in gains are included in REIT taxable income under section 857(b)(2). Reg. § 1.337(d)-7(b)(3)(i). The built-in gain tax liability is treated as a loss sustained by the REIT during the year which has the same character as the items of gain giving rise to the tax. Reg. § 1.337(d)-7(b)(3)(ii).

(9) Information Reporting. A REIT will not make FIRPTA designations of distributions until after year-end, when all relevant facts are known regarding its USRPI gains and losses and available NOL and capital loss carryovers. This is how most REITs designate capital gain dividends. Currently, REITs are required to send a written notice of capital gain designations to shareholders (or provide such designations in an annual report). They are not, however, required to send Form 1099s to non-US persons[97] or otherwise provide them with information regarding section 897(h)(1) distributions. Form 1042S does not distinguish between capital gain dividends generally and distributions that are attributable to gains on the sale of USRPIs. Further, REIT shareholders that are pass-through entities or quasi-pass-through entities (such as domestic partnerships or parent REITs) will need FIRPTA Distribution information so that they can properly apply the FIRPTA rules to their own partners and shareholders. If Non-Dividend Distributions carry out FIRPTA gain, the information reporting system will have to be revised to provide this information along with capital gain dividend information. One approach would be to require REITs to post such information to a web site that can easily be accessed by all tax-interested parties.

(10) Foreign Shareholders Required to Conform to REIT's Determinations Unless Contrary Position is Disclosed. A REIT's designation of a distribution as a FIRPTA Distribution would be presumed to be correct, and a foreign shareholder taking an inconsistent position would be required to disclose such position on its US federal income tax return.

G. FIRPTA Withholding Issues

Section 1445(e)(6) requires withholding against the amount of each distribution that is treated as a FIRPTA Distribution. In most cases, however, there is no way to determine, at the time a distribution is made, what portion of the distribution will be a FIRPTA distribution, regardless of the methodology used to make that determination. This will vary depending on the total distributions paid for the taxable year and the REIT's Net USRPI Gain for the year. Therefore, virtually any withholding system can be criticized on the ground that it results in under-withholding or over-withholding, depending on the particular facts.

We believe a reasonable approach would be to combine the approach taken in Regulation section 1.1445-8 with special rules to deal with Non-Dividend Distributions. If the REIT makes a retroactive FIRPTA designation of a prior regular dividend (usually after year-end), a withholding catch-up rule similar to that provided in Regulation section 1.1445-8(c)(2)(ii)(C) would apply, except that catch-up withholding would apply not only to subsequent ordinary and capital gain dividends, but also to subsequent Non-Dividend Distributions paid to the foreign shareholder. In the unusual case where the REIT makes a FIRPTA designation contemporaneous with the distribution, the REIT would withhold at that time.

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[97] Reg. § 1.6042-3(b)(1)(iii).

The following rules would apply to Non-Dividend Distributions.[98] If the distributee foreign shareholder makes an Outside Gain Election, withholding would take place at the time the distribution causes the shareholder to recognize outside gain. Once the cumulative Non-Dividend Distributions exceed the investor's tax basis in its REIT shares, the REIT would commence withholding against the excess distributions at 35% (or other appropriate rate).[99] The REIT would rely on the foreign shareholder's certification of its share basis or, alternatively, the shareholder could be required to provide proof of outside basis in a withholding certificate application filed with the Service, in a manner similar to the "maximum tax liability" withholding certificate procedures set forth in Regulation section 1.1445-3(c).

In practice, we would expect that before a REIT makes a Non-Dividend Distribution, it would advise the distributee foreign shareholders of their ability to make an Outside Gain Election. If a foreign shareholder provided such an election in connection with the surrender of its shares, the REIT would withhold solely on the amount by which the Non-Dividend Distribution exceeded the shareholder's basis in its shares.

Now assume the shareholder fails to make an Outside Gain Election. As discussed above, under our proposal the REIT would be required to apportion Net USRPI Gain first to any capital gain dividends, then to Non-Dividend Distributions, and then to regular dividends not designated as capital gain dividends. Because there may be no opportunity (or at best a limited opportunity) for the REIT to do catch-up withholding, the REIT would determine its tentative Net USRPI Gain for the portion of the taxable year ending on a distribution date and allocate it among all distributions (both to domestic and foreign shareholders) through and including such date, using the allocation rules recommended earlier. The amount to be withheld against a particular distribution would be the sum of (i) the applicable withholding rate multiplied by the tentative Net USRPI Gain allocable to the distribution, plus (ii) any catch-up withholding relating to prior FIRPTA Distributions (including tentative FIRPTA Distributions in the current year) made to such shareholder. When the next distribution for that taxable year occurs (which could include a regular dividend if the Non-Dividend Distribution is a redemption distribution as opposed to a distribution in liquidation), the REIT would redetermine its Net USRPI gain as of that distribution date and reallocate it among all distributions through and including such date. If there is no Net USRPI Gain at the time of the distribution, no amount would be withheld from the foreign shareholder's distributions.

This approach could result in both under- and over-withholding. Over-withholding could result if USRPI gains are recognized early in the year and are offset by USRPI losses later in the year. Under-withholding could result if a shareholder is redeemed and USRPI gains are recognized by the REIT after the redemption but before year-end. We view these imperfections as the inevitable result of a flawed statutory concept. Moreover, the distortions are

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[98] We have excluded distributions that are a return of capital under section 302(c)(2) or that generate gain under section 302(c)(3) from Non-Dividend Distributions for the simple reason that a REIT has no way of knowing, without help from the shareholder, what portion of non-liquidating distributions constitute return of capital or gain triggering distributions.

[99] This approach would, of course, make sense for the foreign investor only if substantially all of the REIT's appreciated assets are USRPIs. If the REIT has appreciated non-USRPIs, this election would effectively tax those gains as well.

fundamentally no different from the distortions that can occur in a multi-year liquidation where USRPI gains and losses are recognized in different taxable years (thus precluding netting of all liquidation gains and losses).

In a single-step liquidation effected by an LLC or partnership merger or state conversion statute, all of the REIT's unrealized USRPI gains and losses are recognized at the same time, which facilitates the "attributable to" determination as well as withholding. The REIT would have to fund withholding either through cash contributions from the foreign shareholders or, if the REIT uses available cash or borrowed funds to pay the liability, by giving them a reduced percentage interest in the successor entity that effectively shifts the economic burden of the tax to them.

In lieu of a single-step liquidation, a REIT may make a series of liquidating distributions, which may or may not be completed within a single taxable year. In that event, the issue is how to balance the government's interest in collecting FIRPTA withholding tax as soon as possible against the taxpayer's desire to postpone withholding until the REIT's Net USRPI Gain for the entire liquidation period is known. Requiring 35% withholding against the gross amount of all liquidating distributions protects the government's interests to the maximum extent possible. However, this would result in over-withholding in most cases. Furthermore, while section 1445(a) requires 10% "gross basis" withholding, section 1445(e)(6) requires withholding only on the portion of the distribution that is a FIRPTA Distribution. The approach described above, which requires 35% withholding only to the extent the REIT has a Net USRPI Gain at the time of the distribution, is consistent with the language of sections 897(h)(1) and 1445(e)(6) and generally should work to adequately protect the government's interests.

Finally, we note that section 1445(e)(6) states that withholding is done at a 35% rate or, to the extent provided in regulations, 15% (or 20% for post-2010 taxable years). The lower rates are those applicable to long-term capital gain for non-corporate taxpayers, such as foreign pension trusts. We recommend that the forthcoming regulations implement the 15%/20% rates, as well as the 25% rate on unrecaptured section 1250 gain, for non-corporate foreign shareholders to the extent Net USRPI Gain is comprised of long-term capital gain. We understand that the Service has already issued FIRPTA withholding certificates to some taxpayers permitting such lower withholding rates. In lieu of the cumbersome FIRPTA withholding certificate procedure, we recommend that a REIT be permitted to rely on the foreign shareholder's tax status as identified in part I, line 3 of Form W8-BEN.

H. Application of Notice 2007-55 to Section 332 Liquidations of REITs

Notice 2007-55 also states that the regulations will apply section 897(h)(1) to liquidating distributions pursuant to section 332. Section 332 applies to distributions made by a REIT, pursuant to a plan of complete liquidation, to a foreign corporation that owns 80% or more of the vote and value of the REIT's stock (within the meaning of section 1504(a)(2)) at the time the plan of liquidation is adopted and made within three years after the end of the taxable year in which the first liquidating distribution occurs.[100]

[100] Section 332(b).

To the extent the REIT distributes USRPIs in kind to an 80% foreign corporate shareholder, the distribution is a nonrecognition event at the REIT level[101] and at the shareholder level,[102] except to the extent section 332(c) applies. The distributee takes a carryover basis in the distributed USRPI under section 334(b)(1),[103] and its basis in the stock of the REIT disappears. Even though the liquidation is governed by section 332, distributions of cash are deductible by a REIT under section 562(b) to the extent chargeable to E&P. In the case of an in-kind "dividend" of property, Regulation section 1.562-1(a) further limits the REIT's dividends paid deduction to the adjusted basis of the property distributed.[104]

Section 332(c) provides that if a REIT makes a distribution to an 80% corporate distributee in complete liquidation under section 332(b), the distributee must treat as a dividend (with no dividends received deduction, section 243(d)(3)) an amount equal to the dividends paid deduction allowed to the REIT by reason of the distribution. The legislative history states that a section 332(c) dividend may be designated by the REIT as a capital gain dividend.[105] The treatment of the distribution as a dividend applies only at the shareholder level; the REIT still is entitled to nonrecognition of gain or loss on the distribution of property under section 336(a). The REIT's deduction for the in-kind distribution is limited to the adjusted basis of the property, notwithstanding that the distributee is required to treat it as a dividend.

Because section 897(h)(1) applies only to the extent a REIT has recognized USRPI gains, any unrealized gain in USRPIs that are distributed to an 80% foreign corporate parent in a nonrecognition transaction do not enter into the determination of Net USRPI Gain. The foreign parent takes a carryover basis in the distributed USRPIs, thus preserving the FIRPTA gain. On the other hand, if section 897(h)(1) properly applies to a liquidating distribution under section 331, then it arguably should also apply to a distribution of cash, notes, or other non-USRPI property to the foreign parent in a section 332 liquidation, to the extent the distribution is "attributable to" any recognized gains from sales of USRPIs to third parties (or from distributions of USRPIs to minority shareholders). But all of this must be analyzed in the context of the section 332(c) overlay, because to the extent the REIT deducts cash or the adjusted

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101 Section 337(a); Reg. § 1.897-5T(b)(3)(iv)(A) (domestic corporation does not recognize gain under section 367(e)(2) on the distribution of a USRPI, other than stock of a former USRPHC which is treated as a USRPI, to an 80% foreign corporate distributee in a section 332 liquidation, but may recognize gain under section 367(e)(2) on the distribution of non-USRPI property). The REIT recognizes gain, but not loss, on property distributed to minority shareholders. Sections 336(a) and (d)(3).

102 Section 332(a); Reg. § 1.897-5T(b)(3)(iv)(A) (providing that sections 367(a) and 897(e)(1) do not override the normally applicable nonrecognition treatment under section 332(a)).

103 Reg. § 1.897-5T(b)(3)(iv)(A) (carryover basis rule applies to distributed USRPIs).

104 See the discussion of this regulation in Section I, where we conclude that such rule should only apply where the REIT does not recognize gain on the distribution.

105 *See* H.R. Conf. Rep. No. 825, 105th Cong., 2d Sess. 1586-87 (1998), reprinted at 1998-4 C.B. 425, 507 ("The liquidating corporation may designate the amount distributed as a capital gain dividend or, in the case of a RIC, a dividend eligible for the 70-percent dividends received deduction or an exempt interest dividend, to the extent provided by the RIC or REIT provisions of the Code"); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, p. 282 (Comm. Print 1998) (same).

basis of property distributed to an 80% corporate shareholder against its undistributed operating income and gain, the amount of the distribution is converted to a dividend (to the extent of E&P chargeable to the distribution), which may be designated as a capital gain dividend to the extent the REIT has a net capital gain for the liquidation year.[106] Yet, the legislative history provides that the conversion of the amount to a dividend does not otherwise change the tax treatment to the parent corporation or the REIT and specifically states that the parent takes any distributed property with a carryover tax basis, and the REIT does not recognize any gain in respect of such property.[107] Presumably the parent also recognizes no gain or loss in respect of its REIT shares.

We believe the best approach to resolving this quagmire is to suspend the application of section 897(h)(1) to section 332 liquidating distributions except to the extent that section 332(c) treats the distribution to the foreign corporate parent as a dividend (*i.e.*, to the extent the distribution was deductible by the REIT against its taxable income and gain in the liquidation year). The allocation of the REIT's Net USRPI Gain for the liquidation year to non-liquidating distributions and any section 332(c) amounts would be done in a manner similar to the allocation rules previously discussed, namely, Net USRPI Gain would be allocated first in proportion to, and to the extent of, any amounts actually designated as capital gain dividends, including distributions to minority shareholders. If no such designations are made, then Net USRPI Gain would be apportioned ratably to the section 332(c) dividend and to any regular dividends paid during the year. The withholding regime discussed earlier would also apply.

> Example (8) Assume a REIT has two USRPIs, Property A with a basis of $50 and a value of $100, and Property B with a basis of zero and value of $100. The REIT's sole shareholder is a foreign corporation. The REIT has $20 of operating income and cash flow for the year and paid a $10 regular dividend on March 31. On July 1, the REIT adopts a plan of liquidation and sells Property A for $100, recognizing a $50 long-term capital gain. The REIT has $60 of undistributed E&P. The REIT distributes the $110 in cash ($100 sales proceeds plus $10 of remaining operating cash flow), together with Property B, to the foreign corporation in complete liquidation. Because Property B has a zero tax basis, no portion of it is deductible, but the cash distribution is deductible to the extent of $60 (available E&P) under section 562(b). Thus, $60 of the distributions are converted to a dividend under section 332(c). Assume the REIT does not

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[106] We note that an amount to which section 332(c) applies is required to be treated as a dividend by the distributee "notwithstanding any other provision of this chapter." The chapter reference is to Chapter 1 (Normal Taxes and Surtaxes), which includes section 897. If section 897(h)(1) applies to a distribution to a foreign shareholder, the amount is not treated as a dividend, but rather is treated as gain recognized from the sale of a USRPI which is subject to net basis taxation rather than gross basis withholding. It might be argued, therefore, that section 332(c)'s treatment of a liquidating distribution as a dividend "notwithstanding any other provision of [Chapter 1]" precludes such amount from being recharacterized as gain from the sale of a USRPI under section 897(h)(1). On balance, however, we believe that the better reading of the "notwithstanding any other provision" clause is that it merely confirms that the amount is treated as a dividend paid by a REIT, which then becomes subject to the various provisions that affect the taxation of REIT dividends, such as section 243(d)(3), the capital gain dividend rules, and section 897(h)(1).

[107] H.R. Conf. Rep. No. 825, 105th Cong., 2d Sess. 1587 (1998), reprinted at 1998-4 C.B. 425, 507; Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, p. 282 (Comm. Print 1998).

designate the $10 regular dividend as a capital gain dividend. Under the allocation rules discussed earlier, the entire $50 of Net USRPI Gain would be attributed to the $60 dividend deemed paid in liquidation.

Section 332(c) apparently applies to convert a deductible REIT liquidating distribution to a dividend even if the 80% distributee has no unrealized gain in its shares, such as where it recently purchased the shares for their fair market value from another shareholder. This sets up a potential tax problem for the corporate acquirer -- whether foreign or domestic -- if the REIT recognizes gain on property sales prior to liquidating, because the liquidating distributions are converted to a dividend to the extent deducted by the REIT, and yet the acquirer cannot recognize any loss in its shares on the liquidation due to section 332(a). If section 332(c) does not provide any relief to a domestic corporate distributee in this situation,[108] then it seems reasonable that a foreign corporate distributee should be similarly treated. This would mean that the Outside Gain Election recommended earlier would not be available.

I. Tax Treatment of Liquidating Distributions by Public REIT Where 5% Exception Applies

The foregoing discussion has centered on private REIT liquidations, which is the stated focus of Notice 2007-55. If the liquidating REIT is publicly traded, the tax consequences and issues are different.

Assume a publicly traded REIT is acquired by a buyer through a forward cash merger of the target REIT into the buyer or buyer's disregarded entity. Such merger is treated for federal income tax purposes as a sale of the target's assets, subject to its liabilities, in exchange for the merger consideration, followed by a distribution of the merger consideration to the target shareholders in complete liquidation of the target.[109] Assume that there are foreign shareholders of the target who own the publicly traded class of stock, each of whom meet the requirements of the 5% Exception -- that is, the shares are traded on a domestic exchange and the shareholder did not own more than 5% of the publicly traded class of stock at any time during the one-year period ending on the date of the merger. While the Notice does not expressly address the application of section 897(h)(1) to liquidating distributions made by public REITs, it does not create any exception for them. Assuming, therefore, that section 897(h)(1) could apply, it seems clear that it does not apply to a shareholder that meets the 5% Exception as of the date of the liquidating distribution.

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[108] The parent corporation could minimize or eliminate the impact of section 332(c) by doing an in-kind liquidation of the newly acquired REIT before any properties are sold, thereby avoiding gain recognition at the REIT level that would have to be offset by deductible liquidating distributions. *See* Rev. Rul. 90-95, (Situation 2), 1990-2 C.B. 67 (P, a corporation, acquired all of the stock of T in a reverse cash merger that constituted a "qualified stock purchase" and promptly liquidated T by merging T upstream into P; IRS ruled that the transaction was properly treated as a taxable stock purchase followed by a tax free section 332 liquidation, and not as a taxable purchase of T's assets by P under the *Kimbell-Diamond* case). However, the parent corporation would acquire the REIT's assets with a carryover basis. Thus, the parent corporation has a strong incentive to restructure the liquidation so that it qualifies under section 331 rather than section 332.

[109] Rev. Rul. 69-6, 1969-1 C.B. 104.

But this raises the question as to whether section 857(b)(3)(F) applies in this context. That provision states that in the case of a shareholder "to whom section 897 does not apply by reason of the second sentence of section 897(h)(1)" (the 5% Exception), "the amount which would be included in computing long-term capital gains for such shareholder under subparagraph (B) or (D) (without regard to [section 857(b)(3)(F)]" shall not be so included, but rather shall be "included in such shareholder's gross income as a dividend from the [REIT]."

Section 857(b)(3)(B) provides that "capital gain dividends" are treated by shareholders as long-term capital gain, and section 857(b)(3)(C) provides that a capital gain dividend is "any dividend, or part thereof, which is designated by the [REIT] as a capital gain dividend…" Under these provisions, in order for a foreign shareholder to have an amount included as long-term capital gain, the REIT must designate a "dividend" as a capital gain dividend. A "dividend" is a distribution out of E&P within the meaning of section 316. While section 562(b) treats liquidating distributions by a REIT as dividends for purposes of the dividends paid deduction, such distributions are not "dividends" from the shareholder's perspective, but rather are payments in exchange for stock. A REIT cannot designate a liquidating distribution as a "capital gain dividend" because it is not a "dividend."

Accordingly, if the 5% Exception applies to a foreign shareholder, the entire amount of the liquidating distributions should simply be treated as payments in exchange for stock and the ordinary dividend recharacterization rule of section 857(b)(3)(F) should not apply. The foreign shareholder's gain (if any) on liquidation would be taxed under section 897(a) only if none of the FIRPTA exceptions apply.

These tax consequences not only flow from a natural reading of the statute, but are also consistent with the legislative history of the 5% Exception. As noted earlier, the Senate Report accompanying the American Jobs Creation Act of 2004 states that the purpose of the 5% Exception was "to provide greater conformity in the tax consequences of REIT distributions and other corporate stock distributions." If conformity with non-REIT distributions is the objective, that purpose clearly would not be served by treating liquidating distributions that qualify for the 5% Exception as ordinary dividends, because liquidating distributions to shareholders (whether foreign or domestic) of a regular C corporation are treated as payments in exchange for stock. To those who believe Congress originally intended section 897(h)(1) to apply to Non-Dividend Distributions, this might be perceived as a "loophole," but it is in fact quite consistent with the legislative purpose of conforming the tax treatment of small public REIT shareholders with that of shareholders of non-REIT corporations. To those who believe -- as we do -- that Congress intended for section 897(h)(1) to apply only to distributions that could carry out net capital gain, section 857(b)(3)(F) further corroborates that intent.

In Office of Chief Counsel Advice Memorandum 2008-3 (February 15, 2008) (the "Advice Memorandum"), the IRS Office of Chief Counsel addressed this issue in the context of a taxable forward merger of a domestically controlled publicly traded REIT into an acquiring entity, where the REIT had a foreign shareholder whose stock ownership was always less than 5% (FC1) and a foreign shareholder whose ownership was 10% (FC2). A qualified nominee (as defined in Regulation section 1.1445-8(d)) holds the shares on behalf of FC1 and FC2.

The Office of Chief Counsel concluded that the deemed liquidating distribution to FC1 was neither subject to FIRPTA withholding (because of the 5% Exception) nor dividend withholding (because section 857(b)(3)(F) does not apply to liquidating distributions, because they could not be designated as a capital gain dividend). However, in footnote 7 the Advice Memorandum states that "[t]he Treasury and IRS may consider whether there is any regulatory authority in the area to impose shareholder level tax." In view of the clear statutory language, we believe that Treasury does not have the authority to impose such a tax by regulation.

The Advice Memorandum also addresses the tax consequences to FC2, the 10% foreign shareholder. It first states that FC2's liquidation distributions are subject to section 897(h)(1) as provided in Notice 2007-55. It then concludes that no withholding is required "under section 1445(e) as provided by § 1.1445-8(b)(3)" because "no portion of the distribution is described in § 1.1445-8(c)(2)(ii)."[110] We agree with this conclusion. However, it goes on to state that "nothing … relieves REIT of its obligation under section 1445(e)(6) to withhold on such distribution to the extent treated as [FIRPTA gain]." It is unclear what this means. In reality, a public REIT has no way of knowing who its foreign shareholders are, or what they own or have owned, if they hold their shares through a domestic nominee, such as a bank or brokerage house. There is simply no mechanism in place for the REIT to ascertain this information. The REIT can consult its Schedule 13(g) and (d) SEC filings made by its large shareholders, but those filings will not necessarily disclose all tax-relevant information. Possibly the Service meant that the REIT is required to withhold only in the case where the foreign person directly owns the REIT's shares or the REIT otherwise has actual knowledge of a foreign owner's beneficial ownership. We recommend that the forthcoming regulations under section 1445(e)(6) place the withholding responsibility with regard to Non-Dividend Distributions on the nominee and require the REIT to pass on the necessary section 897(h)(1) information to the nominees.

J. Taxation of Foreign Governments Receiving Section 897(h)(1) Distributions

Section 892(a)(1) provides that income received by foreign governments from investments in the United States in "stocks, bonds or other domestic securities" are not includable in gross income and are exempt from tax under subtitle A of the Code. The regulations extend the exemption to income derived by an "integral part" or a "controlled entity" of a foreign government, provided the income is not derived from a "commercial activity" and is not received by, or derived from, a "controlled commercial entity" as defined in section 892(a)(2)(B).

A controlled commercial entity is an entity (i) that is engaged in "commercial activities" within or without the US, and (ii) as to which the foreign government directly or indirectly holds either (a) 50% or more of the total voting power or value of the ownership interests in the entity, or (b) "a sufficient interest (by value or voting power) or any other interest" that gives the foreign government "effective practical control" of the entity.[111] The regulations provide that a minority stock interest can create effective practical control if it is sufficiently large to achieve

[110] The Advice Memorandum observes that section 1445(e)(7) gives the Secretary the authority to impose withholding on nominees receiving REIT liquidating distributions on behalf of foreign persons, but that this authority has not yet been exercised.

[111] Reg. § 1.892-5T(a).

effective control or is coupled with creditor, contractual or regulatory relationships that create effective control.[112] "Income" from stocks includes gain from the disposition of the shares as well as dividends.[113]

A domestic controlled entity is deemed to be engaged in commercial activities if it is classified as a USRPHC, and a foreign corporation that is a controlled entity is similarly deemed to be so engaged if it would be classified as a USRPHC if it were a domestic corporation.[114] For example, a REIT that holds primarily USRPIs will be classified as a USRPHC and thus is deemed to be engaged in commercial activities under the regulations. For this reason, it is critical that the REIT not be "controlled" by the foreign government if the government intends to claim the section 892 exemption on REIT dividends.

Regulation section 1.892-3T(a)(1) identifies the types of income that qualify for the section 892 exemption, including income from stocks, bonds or other securities. It then provides that "[i]ncome derived from sources other than described in this paragraph (such as income earned from a [USRPI] described in section 897(c)(1)(A)(i) [which refers to direct interests in US real property])" and any gain from the disposition of a USRPI described in section 897(c)(1)(A)(i) does not qualify for the section 892 exemption. However, the regulations expressly provide that gain derived from the disposition of shares of a USRPHC (including a REIT that qualifies as such) qualifies for the section 892 exemption, as long as the USRPHC is not a controlled commercial entity and, if the gain is recognized by a "controlled entity" of a foreign government, such entity itself is not a controlled commercial entity.[115] Thus, for example, even though a foreign government's gain from the sale of shares of a foreign controlled private REIT does not qualify for any of the FIRPTA exemptions, such gain is nevertheless exempt under section 892 as long as the foreign government does not have actual or effective practical control of the REIT.

The section 892 regulations do not address whether FIRPTA Distributions are eligible for the section 892 exemption. Section 897(h)(1) does not provide that a FIRPTA Distribution is treated as gain described in section 897(c)(1)(A)(i). It merely states that the distribution is "treated as gain recognized [by the foreign taxpayer] from the sale or exchange of a United States real property interest." Arguably, section 897(h)(1) gain constitutes "income from stock" which is exempt under section 892, just as gain from the sale of REIT stock is exempt (as long as the REIT is not a controlled commercial entity). Stated differently, if REIT shares are not treated as an interest in the REIT's USRPIs for purposes of section 892, it is hard to see why a distribution from a REIT should be treated as if it were proceeds from the sale of a direct interest in USRPIs rather than as income from stock.[116] Many taxpayers have taken the position that

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[112] Reg. § 1.892-5T(c)(2).

[113] Reg. § 1.892-3T(a)(2).

[114] Reg. § 1.892-5T(b)(1).

[115] *See* Reg. § 1.892-3T(b), Example (1) (gain recognized by a controlled entity of a foreign government on the disposition of a 12% interest in a USRPHC is exempt under section 892).

section 892 trumps section 897(h)(1) as to regular capital gain dividends, recognizing that the position was not free from doubt.[117]

Of course, Notice 2007-55's position that section 897(h)(1) trumps section 892 applies not only to a foreign government's receipt of capital gain dividends but also to Non-Dividend Distributions. That position is much harder to justify in the context of Non-Dividend Distributions. If a foreign government's gain from an actual sale of stock of a non-controlled REIT is exempt under section 892, why should a constructive sale of shares in a Non-Dividend Distribution be taxed differently? We urge Treasury and the Service to reconsider this aspect of Notice 2007-55 for the same reasons we argued earlier in the context of a non-governmental foreign shareholder of a domestically controlled REIT that makes a constructive sale of shares in a liquidation as opposed to an actual sale.

In any event, the forthcoming regulations should make it clear that, even if section 897(h)(1) generally trumps section 892, distributions made by a parent REIT that are attributable to gain recognized by the parent on the sale of shares of a subsidiary foreign controlled REIT or other USRPHC should be exempt under section 892 (assuming the parent REIT is not a controlled commercial entity). In other words, such gain should be treated in the same manner as gain recognized by a foreign government from a direct sale of shares of a foreign controlled REIT.

Notice 2007-55 states that implementing regulations will be retroactive to June 13, 2007, and that Treasury and the Service will interpret current law for pre-effective date periods in a consistent manner. While we generally oppose the retroactivity of the Notice for the reasons set forth below, we believe that the substantial arguments on the taxpayer's side of the section 892 issue argue strongly for a prospective effective date. In particular, we believe that (i) the Service should not challenge the position that section 892 overrides section 897(h)(1) for pre-Notice periods, particularly in the context of Non-Dividend Distributions, and (ii) if Treasury and the Service do not withdraw their position on Non-Dividend Distributions, they should consider grandfathering investments by foreign governments in existing REITs and existing USRPIs as of June 13, 2007.

A second issue, not addressed by Notice 2007-55, is whether a FIRPTA Distribution received by a controlled entity of a foreign government from a REIT constitutes "commercial income" that would cause the controlled entity to be classified as a controlled commercial entity.

Assume, for example, that a controlled entity of a foreign government owns shares of a domestically controlled REIT and has no other assets. Ordinary dividends are exempt under

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[116] For this reason, the New York State Bar Tax Section urged IRS and Treasury to add a provision to the proposed section 892 regulations clarifying that section 897(h)(1) distributions are exempt from tax under section 892 unless the REIT is a controlled commercial entity. *See* New York State Bar Association Tax Section, *Report on Temporary and Proposed Regulations Under Section 892 of the Code*, Oct. 14, 1988.

[117] The February 2006 version of the instructions to Form W-8EXP, which a foreign government shareholder provides to a REIT to establish its right to the section 892 exemption, alluded to a possible issue under section 897(h)(1) by stating that "certain distributions to a foreign government from a [REIT] may not be eligible for relief from withholding and may be subject to withholding at 35% of the gain realized."

section 892 provided the controlled entity does not have effective practical control of the REIT. But what happens if the controlled entity receives a FIRPTA Distribution? Does the controlled entity become a tainted "controlled commercial entity"? Regulation section 1.892-4T(c)(1)(i) provides that "investments in stocks" are not "commercial activities." Logically, a controlled entity that receives a FIRPTA Distribution derives the income from an "investment in stock," and therefore the FIRPTA Distribution should not constitute "commercial income," even if the FIRPTA Distribution is not eligible for the section 892 exemption.

We believe that this view is widely shared by tax advisors. Yet, until Treasury and the Service issue a public pronouncement on the issue, the issue is not entirely free from doubt. One is tempted to draw some comfort from Notice 2007-55's silence on the issue, on the theory that if the government believed that section 897(h)(1) gain was commercial income, it surely would have said so at the same time it was announcing, for the first time, that section 897(h)(1) trumps section 892. The forthcoming regulations should make it clear that section 897(h)(1) gain is not commercial income.

K. Effective Date of Regulations

Notice 2007-55 states that the regulations promised by the Notice will be effective retroactively to June 13, 2007 for purposes of section 897(h)(1) and 1445(e)(6). It also warns that the Service will challenge positions taken for pre-effective date distributions under "existing statutory and regulatory provisions."

It bears repeating that section 897(h)(1) is 27 years old and there are still no regulations that interpret the provision. The only guidance of any kind is Regulation section 1.1445-8, which only informs REITs how to discharge their withholding responsibilities with respect to distributions that could be designated as capital gain dividends and does not purport to interpret the meaning of "attributable to" in the context of Non-Dividend Distributions.

We believe that any retroactive application of the principles expressed in the Notice is inappropriate, given that taxpayers have absolutely no idea how to apply the statute to Non-Dividend Distributions in the interim.[118] This is especially true for regulations implementing section 1445(e)(6). The existing withholding regulations do not require withholding against Non-Dividend Distributions. Indeed, the only provision in section 1445 that addresses such distributions specifically (in the context of corporations that are USRPHCs) is section 1445(e)(3), which requires 10% gross basis withholding. Section 1445(e)(6) requires withholding against the portion of a liquidating distribution that is treated as section 897(h)(1) gain but does not expressly state that Non-Dividend Distributions are within its purview. Until regulations are issued, withholding agents can only guess at how the many issues raised in this report will be resolved. Accordingly, REITs that comply with the existing rules set out in section 1445(e)(3) and Regulation section 1.1445-8 as to Non-Dividend Distributions should not be

[118] We note that the IRS recently issued proposed regulations relating to assets-over partnership mergers and the application of the anti-mixing bowl rules that are proposed to be effective for any distribution of property after January 19, 2005, if the property was contributed to the partnership in an assets-over merger after May 3, 2004. Prop. Reg. §§ 1.704-4(g) and 1.737-5. This effective date allows taxpayers that entered into partnership arrangements prior to any public announcement of the IRS's position to avoid the effect of the regulations with respect to distributions that occur after the general effective date. The equities involved in that situation appear to be very similar to those in the situation at hand. Accordingly, it seems that consideration should be given to providing similar effective date relief for existing structures in proposed regulations that may follow from Notice 2007-55.

subject to any additional withholding obligations until Treasury and the Service issue clarifying regulations under section 1445(e)(6).

IV. Liquidating REIT's Status as a Personal Holding Company

A. Overview of PHC Rules

Section 541 imposes a 15% tax on a personal holding company ("PHC") on the amount of its "undistributed personal holding company income," as defined in section 545 ("UPHCI"). Section 545(a) defines undistributed personal holding company income as the corporation's taxable income reduced by the deduction for dividends paid (as defined in section 561), and adjusted as provided in section 545(b) and (c). The purpose of the PHC tax was to discourage persons from transferring investment assets to closely held corporations and avoiding shareholder level tax on future earnings by accumulating the earnings inside the corporation instead of distributing them currently to shareholders as ordinary dividend income. Section 542(c) excludes certain types of entities from the definition of a personal holding company, but REITs and RICs are not excluded. Thus, it is clear that a REIT or RIC can also be classified as a PHC.[119]

To qualify as a PHC for a taxable year, a corporation must meet both an income test and a stock ownership test. Section 542(a)(1) provides that the income test is met if at least 60% of the corporation's "adjusted ordinary gross income" as defined in section 543(b)(2) ("AOGI") for the taxable year is "personal holding company income" as defined in section 543(a) ("PHC income"). This is referred to herein as the "60% Test." Section 543(a) defines PHC income (the numerator of the 60% Test) as the portion of AOGI that consists of specified categories of income, including dividends, interest, royalties, annuities and the "adjusted income from rents" ("Adjusted Rent Income"), except that Adjusted Rent Income is not included in PHC income (the "Rent Exclusion") if (i) such Adjusted Rent Income constitutes 50% or more of AOGI, and (ii) the sum of the dividends paid or considered as paid by the corporation to its shareholders during the taxable year (including consent dividends) is at least equal to the amount, if any, by which the PHC income for the taxable year (excluding Adjusted Rent Income and certain amounts received for use of corporate property by shareholders) exceeds 10% of "ordinary gross income" ("OGI").[120]

The denominator of the 60% fraction is AOGI. Section 543(b)(2) defines AOGI as the corporation's OGI with certain adjustments, one of which is that Adjusted Rent Income is substituted for gross rental income. Thus, Adjusted Rent Income is included in the denominator of the 60% fraction but is excluded from the numerator if the Rent Exclusion applies. Section 543(b)(1) defines OGI as the corporation's gross income determined by excluding all gains from the sale or other disposition of capital assets and from the sale or other disposition of property described in section 1231(b). Thus, capital gains are excluded from both the numerator and

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[119] *See* Rev. Rul. 88-41, 1988-1 C.B. 253 (RIC subject to PHC tax on UPHCI in addition to regular corporate tax on RIC's investment company taxable income).

[120] Adjusted Rent Income is defined in section 543(b)(3) as the gross income from rents, reduced by depreciation, property taxes, interest and rent allocable to gross income from rents.

denominator of the fraction, whereas ordinary depreciation recapture recognized on a property sale would be included in the denominator but not the numerator.

Section 542(a)(2) provides that the stock ownership test is met if at any time during the last half of the taxable year more than 50% in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for not more than 5 individuals, treating certain entities as "individuals" for this purpose (the "PHC Closely Held Test"). In applying the PHC Closely Held Test, the constructive ownership rules of section 544 apply. Section 544(a)(1) provides that stock owned, directly or indirectly, by or for a corporation, partnership or estate is considered as being owned proportionately by its shareholders, partners or beneficiaries (the "Upward Attribution Rule"). Section 544(a)(2) provides that an "individual" is considered as owning stock owned, directly or indirectly, by or for his family (the "Family Attribution Rule") or "by or for his partner" (the "Partner Attribution Rule").[121]

An illustration of the Partner Attribution Rule appears in Rev. Rul. 82-107, 1982-1 C.B. 103. Under then-applicable law, a RIC could not qualify as such if it was also classified as a PHC. The taxpayer RIC had as direct shareholders the following persons: (i) individual shareholder A, who owned 4% of the RIC's shares and was a limited partner in two syndicated partnerships, (ii) three other individual shareholders who also were partners in one or the other of the two partnerships and who collectively owned 21% of the RIC, and (iii) four other individual shareholders who collectively owned 26% of the RIC. The Service ruled that A was attributed the RIC shares owned by his partners, and thus A actually and constructively owned 25% of the RIC. Consequently, A and the individuals comprising the 26% ownership group collectively caused the RIC to be closely held under the PHC Closely Held Test, terminating the taxpayer's RIC status.

B. REIT Closely Held Test

Section 856(a)(6) provides that, to qualify as a REIT, a corporation cannot be "closely held" within the meaning of section 856(h) (the "REIT Closely Held Test"). Section 856(h)(1)(A) provides that a corporation is "closely held" if the stock ownership test of section 542(a)(2) is met. However, for that purpose, section 856(h)(1)(B) modifies the constructive ownership rules of section 544 by making the Partner Attribution Rule inapplicable. Because the REIT Closely Held Test relaxes this part of the PHC Closely Held Test, it is possible that a REIT that meets the REIT Closely Held Test could nevertheless run afoul of the PHC Closely Held Test. In that event, if the REIT also meets the 60% Test for the year, it could qualify as a PHC notwithstanding that it also qualifies as a REIT. For example, a private REIT could satisfy the PHC Closely Held Test if a partnership with a 1% individual partner is a REIT shareholder, and the partnership owns 50% or more of the value of the REIT's shares. That "individual" would be attributed all of the REIT shares that are constructively owned by his partners and cause the

[121] In addition, section 544(a)(5) provides that (i) stock constructively owned by a person by reason of the Upward Attribution Rule is treated as actually owned by such person for purposes of applying the Upward, Family and Partner Attribution Rules, and (ii) stock constructively owned by a person by reason of the Family and Partner Attribution Rules is not treated as owned by such person for purposes of again applying the Family and Partner Attribution Rules in order to make another person the constructive owner.

REIT to satisfy the PHC Closely Held Test, even though the REIT would not fail the REIT Closely Held Test (because the Partner Attribution Rule does not apply for the latter purpose).[122]

C. Effect of PHC Status on REIT's Deduction for Liquidating Distributions

Section 561(b) provides that the rules of section 562 apply in determining the deduction for dividends paid under section 561(a). Section 562(b)(1) provides (under the caption "Distributions in Liquidation") that, "[e]xcept in the case of a personal holding company described in section 542," the following amounts are treated as dividends for purposes of the dividends paid deduction:

(A) in the case of an amount distributed in liquidation, the part of the distribution that is properly chargeable to accumulated E&P, and

(B) in the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period pursuant to the plan, to the extent of the E&P of the corporation (computed without regard to capital losses) for the taxable year in which the distribution is made.[123]

A REIT that liquidates within the 24-month period ordinarily can fully shelter its net taxable income (determined before taking into account the dividends paid deduction) for the taxable years in which the liquidation occurs, provided it makes liquidating distributions (plus any ordinary, pre-liquidation dividends) for each such year in an amount at least equal to the net taxable income recognized during such year.

As noted above, paragraph (b)(1) of section 562 applies "except in the case of a personal holding company." The treatment of liquidating distributions by a PHC is addressed in paragraph (b)(2). It provides that if a PHC liquidates within 24 months after the adoption of a plan of liquidation, the amount of any distribution within such period pursuant to such plan is treated as a dividend for purposes of computing the dividends paid deduction only to the extent that such amount is distributed to *corporate* distributees and represents such distributees' allocable share of the undistributed PHC income for the taxable year of the distribution (determined without regard to section 562(b)(2) and section 316(b)(2)(B)).[124]

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[122] Section 856(h)(3) provides that qualified domestic pension trusts, even though treated as "individuals" for purposes of section 542(a)(2), are "looked through" to their beneficiaries for purposes of the REIT Closely Held Test. However, a REIT that relies on this relaxation of the PHC Closely Held Test to meet the REIT Closely Held Test is specifically exempt from the PHC tax regime. Section 856(h)(3)(B). This relaxation of the PHC Closely Held Test does not extend to any "taxable REIT subsidiaries" of the REIT.

[123] The provision referred to in clause (B) permits the deduction of distributions to the extent of the payor's current E&P (determined without regard to capital losses), even though the corporation may have an accumulated deficit in E&P at the beginning of the taxable year. Reg. § 1.562-1(b)(1)(ii)(b).

[124] *See also* Reg. § 1.562-1(b)(2).

In addition to the deduction for liquidating distributions made to corporate shareholders, a PHC is also entitled to deduct certain liquidating distributions made to non-corporate shareholders provided that the PHC specially designates the distribution as an ordinary dividend. This special rule appears in section 316(b) rather than section 562(b). Specifically, section 316(b)(2)(A) provides that, in the case of a PHC, the term "dividend" includes any distribution of property to shareholders (even though not otherwise qualifying as a "dividend" under section 316(a)) to the extent of undistributed PHC income for such year. Section 316(b)(2)(B) provides that, for purposes of subparagraph (b)(2)(A), the term "distribution of property" includes a distribution in complete liquidation occurring within 24 months after the adoption of a plan of liquidation, but only to the extent of amounts distributed to noncorporate shareholders that are designated as a dividend, and only to the extent of such distributees' share of undistributed PHC income.

Historically, a PHC was permitted to deduct from the PHC tax base not only regular dividends but also distributions paid pursuant to a complete liquidation, to the extent of the PHC's accumulated E&P, even though the shareholders reported the payments as payments in exchange for stock. In Section 225(f)(2) and (3) of the Revenue Act of 1964, Congress amended sections 316(b)(2) and 562(b) to permit a PHC to deduct liquidating distributions paid to noncorporate shareholders which the PHC designated as a dividend, and to corporate shareholders to the extent of the corporate distributees' share of UPHCI for the taxable year of the distribution,[125] provided the PHC liquidated in 24 months. Congress imposed these limitations because under prior law liquidating distributions gave rise to capital gain at the shareholder level and yet were deductible at the PHC level, thus permitting a PHC to avoid the PHC tax without any ordinary income being recognized at the shareholder level.[126] The amendments had the effect of allowing a dividends paid deduction for liquidating distributions only to the extent paid to corporate shareholders (for whom no preferential rate for capital gains existed) or to noncorporate shareholders as long as the distribution was designated as a regular dividend.

Ordinarily, the REIT/PHC overlap does not present a tax problem because a REIT must distribute all of its earnings currently as dividends in order to maintain REIT status and avoid corporate level tax on such earnings. Such dividends are generally deductible at the corporate level in determining both REIT taxable income and UPHCI. However, if a REIT is also classified as a PHC for a liquidation year, a question arises as to whether the REIT's dividends paid deduction for REIT tax purposes is subject to section 562(b)(1) or the more stringent provisions that apply to PHCs under section 562(b)(2). If paragraph (b)(2) applies, the REIT would not be able to deduct liquidating distributions paid to noncorporate distributees. We believe the caveat "except in the case of a personal holding company" should be read to apply only for purposes of determining a PHC's UPHCI and should not apply in determining REIT taxable income and compliance with the 90% distribution requirement. There is no indication in the legislative history that Congress intended for a REIT that happens to qualify as a PHC for a liquidation year to be subject to corporate tax on all of its income and gain for such year, including tax items that are excluded from UPHCI but are included in REIT taxable income.

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125 Pub. L. No. 88-272, 1964-1 (Part 2) C.B. 61.

126 H. Rep. No. 749, 88th Cong., 1st. Sess. (1963), reprinted in 1964-1 (Part 2) C.B. 125, 206.

This construction of the statute is consistent with the policies behind the PHC tax and the REIT rules. Further, a contrary interpretation could result in catastrophic and clearly unintended tax consequences. For example, assume that (i) a liquidating REIT's taxable income (before the dividends paid deduction) consists primarily of capital gain from sale of its real properties, and (ii) the REIT has a small amount of PHC Income (such as interest) for the year that exceeds 60% of AOGI, (iii) the REIT is closely held for PHC purposes for such year (*e.g.*, because of the Partner Attribution Rule) even though it complies with the REIT Closely Held Test, and (iv) the REIT has no corporate shareholders. The REIT would be denied a deduction for liquidating distributions in determining UPHCI for such year. But if classification as a PHC also caused liquidating distributions to be nondeductible in determining REIT taxable income, the REIT would be subject to corporate level tax on its net capital gain and, in addition, could lose its REIT status by failing to meet the 90% distribution requirement.[127] These tax results are obviously far more punitive that the 15% tax penalty on UPHCI imposed by the PHC rules, because capital gains are excluded from the PHC tax base.

While the policy considerations clearly weigh in favor of the taxpayer, the statutory language is ambiguous. We recommend that Treasury and the Service issue guidance confirming that the "except in the case of a personal holding company" limitation only applies for purposes of applying the PHC provisions.

V. Liquidating a Pension-Held REIT

A. Overview of Pension-Held REIT Rules

Without regard to section 856(h), dividends received from a REIT by a tax-exempt pension trust generally do not give rise to unrelated business taxable income ("UBTI") unless the pension trust has incurred acquisition indebtedness with respect to its REIT shares.[128] Under certain circumstances, however, section 856(h) can cause a portion of dividends received by a tax-exempt pension trust from a REIT to be taxed as UBTI.

In order to qualify as a REIT, a corporation must, commencing with its second REIT taxable year, have sufficient diversity of stock ownership to meet the REIT Closely Held Test, as set forth in sections 856(a)(6) and 856(h). Under section 542(a)(2), "individuals" include certain

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127 In general, a REIT that owns leased real property should be able to avoid satisfying the PHC Income Test for the taxable year in which it undergoes a complete liquidation if its rent income satisfies the Rent Exclusion for such year. However, this requires prior planning by knowledgeable tax advisors. For example, to ensure that the Rent Exclusion applies in the year in which a REIT liquidates, the REIT could declare regular dividends, prior to adopting a plan of complete liquidation, at least equal to the amount by which its non-rent PHC income exceeds 10% of its OGI. Because a multi-year liquidation could make it difficult to accomplish this result with certainty, the REIT could effect the liquidation by converting it to an LLC, so that it occurs instantaneously instead of over an extended period. This would allow the REIT to determine with precision (i) the amount of non-rent PHC income for the final REIT taxable year ending on the conversion date, and (ii) the amount of regular dividends that must be paid before the conversion to ensure that the Rent Exclusion applies and the REIT does not meet the PHC Income Test for its final REIT taxable year.

128 Reg. § 1.512(b)-1(a); Rev. Rul. 66-151, 1966-1 C.B. 151.

charitable organizations, trusts and pension trusts that are described in section 401(a). The attribution rules of section 544 apply except that stock ownership is not attributed between partners.[129] Under the attribution rules, stock owned by a corporation or partnership is attributed ratably to its shareholders or partners; stock owned by a trust or estate is attributed to its beneficiaries (in the case of a trust, in proportion to their actuarial interests in the trust); an individual is attributed stock owned by his siblings, spouse, ancestors and lineal descendants; and an option attribution rule applies. In addition, REIT stock held by a "trust described in section 401(a) and exempt from tax under section 501(a)" (a "qualified trust") is treated as held directly by its beneficiaries in proportion to their actuarial interests in the trust.[130] This rule allows more concentrated ownership of REIT stock by pension fund investors.[131]

Congress was concerned that its relaxation of the REIT Closely Held Test could lead to pension funds jointly creating a REIT for the purpose of making real estate investments and thus avoid UBTI they otherwise might have incurred if they made leveraged investments directly or through real property partnerships. Thus, Congress provided a special rule for substantial pension trust investors in a "pension-held REIT" under which a portion of REIT dividends received by such investors may be treated as UBTI. A pension-held REIT is a REIT that meets two requirements: it would not satisfy the REIT Closely Held Test but for the section 856(h)(3)(A)(i) pension trust "look-through" rule, and it is "predominantly held" by qualified trusts.[132]

A REIT is predominantly held by qualified trusts if either (i) at least one qualified trust holds more than 25% of the value of the REIT's outstanding stock, or (ii) one or more qualified trusts, each of which owns more than 10% of the value of the REIT's outstanding stock, collectively own more than 50% of the value of the REIT's outstanding stock.[133]

If a REIT qualifies as a pension-held REIT, then any pension trust shareholder that holds more than 10% of the value of the REIT's outstanding stock "at any time during a taxable year" is subject to a special UBTI rule.[134] Under that rule, a more-than-10% pension trust shareholder is treated as having UBTI for such taxable year "in an amount which bears the same ratio to the aggregate dividends paid (or treated as paid) by the REIT to the [pension] trust for the taxable

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[129] Section 856(h)(1)(B)(i).

[130] Section 856(h)(3)(A)(i) and (h)(3)(E).

[131] The pension trust look-through rule does not apply to a qualified trust if one or more persons who are disqualified persons with respect to the trust under section 4975(e)(2) (without regard to subparagraphs (B) and (I) thereof) hold in the aggregate 5% or more of the value of the interests in the REIT *and* the REIT has accumulated E&P from non-REIT years. Section 856(h)(3)(A)(ii).

[132] Section 856(h)(3)(D)(i).

[133] Section 856(h)(3)(D)(ii). Oddly enough, there are no constructive ownership rules in this provision, and the statute does not even say "held directly or indirectly," as it does in the domestically controlled REIT rule in section 897.

[134] Section 856(h)(3)(C).

year of the REIT with or within which the taxable year of the [pension] trust ends," as the ratio (the "UBTI Fraction") of (i) the portion of the REIT's gross income for such REIT taxable year that would be treated as UBTI if the REIT itself were a pension trust (less direct expenses related thereto) to (ii) the REIT's total gross income for such taxable year (less direct expenses related thereto). This causes the pension trust's income from the REIT to be characterized as UBTI roughly to the same extent as if the REIT were a partnership. Under a *de minimis* rule, no UBTI results if the UBTI fraction is less than 5%.[135]

B. Application of Rule in Liquidation

Assume a pension-held REIT holds debt-financed real property through a partnership and the partnership does not qualify for one of the UBTI exceptions set forth in section 514(c)(9)(E). Ordinary dividends paid to the REIT's more-than-10% pension trust shareholders are recharacterized, in part, as UBTI. The issue is whether liquidating distributions that are treated as a dividend for purposes of the dividends paid deduction are taxed, in part, as UBTI.

As noted, section 856(h)(3)(C) applies to "dividends paid (or treated as paid) by the REIT to the trust for the taxable year." The overall context -- "to the trust" -- suggests that this refers to amounts that are dividends from the *pension trust's* perspective.[136] Thus, the UBTI rule should not apply to a liquidating distribution that is treated as a payment in exchange for stock from the shareholder's perspective. This makes policy sense, because the pension trust shareholder would not recognize UBTI on an actual sale of REIT stock (assuming the stock was not leveraged). We recommend that Treasury and the Service issue guidance confirming this point.

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[135] Section 856(h)(3)(C).

[136] The reference to "treated as paid" should be interpreted to mean dividends declared in the last quarter and paid in January that are treated (under section 857(b)(9)) as paid in the year declared, not amounts that are treated as a dividend from the REIT's perspective under section 562(b).