

Part III - Administrative, Procedural, and Miscellaneous

Guidance to clarify the treatment of certain distributions under Internal Revenue Code section 897(h)(1)

Notice 2007-55

PURPOSE

The Treasury Department (Treasury) and Internal Revenue Service (IRS) are aware of a type of transaction, described below, in which a foreign government inappropriately claims that certain distributions from a real estate investment trust (REIT) or other qualified investment entity to the foreign government are not subject to section 897(h)(1) of the Internal Revenue Code (Code) or are exempt from taxation under section 892 of the Code. This notice alerts taxpayers and their representatives that the IRS intends to challenge such claims under the relevant current statutory and regulatory provisions. In addition, Treasury and the IRS intend to issue regulations that will clarify the correct interpretation of these provisions. These regulations will apply to distributions occurring on or after June 13, 2007.

TRANSACTIONS AT ISSUE

In a typical transaction, a foreign government purchases a non-controlling interest in a privately held (and domestically controlled) REIT, with a view to receiving dividends from the REIT over the course of the remaining life of the REIT (for example, five to seven years). At the end of the REIT's life, the REIT typically sells all or a portion of its assets and distributes the sales proceeds (and any remaining assets) to its shareholders in complete liquidation. In some cases, the liquidation may take place over more than one year.

Notwithstanding section 897(h)(1), the foreign government (or withholding agent) asserts that distributions from the REIT (including distributions in liquidation) that are attributable to gain from the sale or exchange of a United States real property interest (USRPI) described in section 897(c)(1)(A)(i) are exempt from taxation (and withholding) under section 892. The foreign government (or withholding agent) may also assert that section 897(h)(1) does not apply to liquidating distributions from the REIT.

BACKGROUND

Section 892 addresses the taxation of income of foreign governments. Section 892(a)(1) excludes from gross income and exempts from U.S. federal income tax certain categories of income earned by foreign governments, including dividends from and capital gains with respect to investments in the United States in stocks, bonds, or other domestic securities. Section 892(a)(2)(A) provides that the exclusion under section 892(a)(1) does not apply to income derived from the conduct of any commercial activity (whether within or

without the United States), income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or income derived from the disposition of any interest in a controlled commercial entity. In addition, income derived from sources other than described in section 892(a)(1) is not excluded from gross income and is not exempt from tax under section 892. See the flush language following Treas. Reg. § 1.892-3T(a)(1)(iii). Under section 892(a)(3), a foreign government is treated as a corporate resident of its country for purposes of the Code.

Section 897 provides special rules for the disposition of an investment in U.S. real property. Section 897(a)(1) provides, in part, that gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a USRPI is taken into account under section 871(b)(1) or 882(a)(1) as if the nonresident alien individual or foreign corporation, respectively, were engaged in a trade or business in the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business. Section 897(c)(1)(A) defines a USRPI to mean (i) an interest in real property located in the United States or the Virgin Islands and (ii) any interest (other than solely as a creditor) in a domestic corporation that is a United States real property holding corporation (USRPHC). As defined in section 897(c)(2), a USRPHC means any corporation if the fair market value of its USRPIs equals or exceeds 50 percent of the total fair market value of its USRPIs, its interests in real property located

outside the United States, and any other assets which are used or held for use in a trade or business.

Section 897(h)(1) provides that any distribution by a qualified investment entity to a nonresident alien individual, foreign corporation, or other qualified investment entity shall, to the extent attributable to gain from the sale or exchange by the qualified investment entity of a USRPI, be treated as gain recognized by such nonresident alien individual, foreign corporation, or other qualified investment entity from the sale or exchange of a USRPI. Thus, such distributions are taxable to such nonresident alien individual or foreign corporation under section 897(a)(1). For purposes of section 897(h)(1), a qualified investment entity means any REIT and any regulated investment company (RIC) described in section 897(h)(4)(A)(i)(II).

A foreign government is treated under Treas. Reg. § 1.897-9T(e) as a foreign person with respect to USRPIs. Further, Treas. Reg. §§ 1.897-9T(e) and 1.1445-10T(b) provide that a foreign government is subject to taxation under sections 897 and 1445 on the disposition of a USRPI “except to the extent specifically otherwise provided in the regulations issued under section 892.”

The regulations issued under section 892 do not specifically exempt foreign governments from taxation under sections 897 and 1445. The flush language following Treas. Reg. § 1.892-3T(a)(1)(iii) provides that:

Income derived from sources other than described in this paragraph [§ 1.892-3T(a)(1)] (such as income earned from a U.S. real property interest described in section 897(c)(1)(A)(i)) is not exempt from taxation under section 892.

Furthermore, any gain derived from the disposition of a U.S. real property interest defined in section 897(c)(1)(A)(i) shall in no event qualify for exemption under section 892.

This language makes it clear that gain from the disposition of a USRPI described in section 897(c)(1)(A)(i) is not exempt from taxation under section 892. Gain derived by a foreign government from the disposition of a USRPI defined in section 897(c)(1)(A)(ii) (i.e., an interest in a USRPHC), however, is exempt from tax under Treas. Reg. § 1.892-3T if the USRPHC does not constitute a controlled commercial entity under section 892(a)(2)(B). See Example (1) of Treas. Reg. § 1.892-3T(b).

TREATMENT OF DISTRIBUTIONS UNDER SECTION 897(h)(1)

1. Distributions During the Life of the REIT

Section 897(h)(1) treats any distribution by a qualified investment entity to a foreign corporation as gain recognized by the foreign corporation from the disposition of a USRPI to the extent that the distribution is attributable to gains from sales or exchanges by the qualified investment entity of USRPIs. As a result, to the extent that such distributions are attributable to gain recognized from sales or exchanges of a USRPI, the distributions are subject to U.S. income taxation under sections 897(a)(1) and 882(a)(1) as effectively connected income and to withholding under section 1445(e). In addition, where applicable, such distributions are treated and taxed as gain attributable to the alienation of a USRPI under the capital gains articles of U.S. income tax treaties.

Accordingly, the IRS will challenge under current statutory and regulatory provisions an assertion that section 892 exempts from taxation (and withholding)

distributions from a qualified investment entity that are treated under section 897(h)(1) as gain recognized by a foreign government shareholder from the sale or exchange of a USRPI described in section 897(c)(1)(A)(i). In addition, Treasury and the IRS will clarify in regulations that the language in Treas. Reg. § 1.892-3T(a)(1) denying exemption from taxation with respect to a disposition of a USRPI defined in section 897(c)(1)(A)(i) applies also to distributions attributable to gain from the sale or exchange of USRPIs to which section 897(h)(1) applies. Thus, the regulations will clarify that distributions received by a foreign government from a qualified investment entity that are attributable to gain from sales or exchanges by the qualified investment entity of USRPIs described in section 897(c)(1)(A)(i) are not exempt from taxation under section 892. Instead, the regulations will clarify that such distributions are subject to U.S. income taxation under section 882(a)(1) as effectively connected income pursuant to section 897(a)(1) and to withholding under section 1445(e). In addition, the regulations will clarify that, where applicable, such distributions are treated and taxed as gain attributable to the alienation of a USRPI under the capital gains articles of U.S. income tax treaties.

2. Liquidating Distributions

Sections 897(h)(1) and 1445(e)(6) by their terms apply to all distributions to the extent attributable to gain from sales or exchanges by the qualified investment entity of a USRPI. Accordingly, the IRS will challenge under current statutory and regulatory provisions an assertion by any foreign taxpayer that section 897(h)(1) does not apply to distributions in complete liquidation under sections 331 and 332. In addition, regulations will clarify that the application of section 897(h)(1) and withholding under section

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

EFFECTIVE DATE

Regulations incorporating the guidance in this Notice will apply to distributions occurring on or after June 13, 2007.

DRAFTING INFORMATION

The principal authors of this notice are David A. Juster and Margaret A. Hogan of the Office of the Associate Chief Counsel (International). However, other personnel from Treasury and the IRS participated in its development. For further information regarding section 892 issues in this notice, contact Mr. Juster at (202) 622-3850 (not a toll-free call). For further information regarding section 897 issues in this notice, contact Ms. Hogan at (202) 622-3860 (not a toll-free call).