

Rule to be Included in Final Regulations Under Section 897(e) of the Code

Notice 99-43

This notice announces a modification of the current rules under Temp. Reg. §1.897-6T(a)(1) regarding transfers, exchanges, and other dispositions of U.S. real property interests in nonrecognition transactions occurring after June 18, 1980. The new rule will be included in regulations finalizing the temporary regulations.

SECTION I. BACKGROUND

Section 897(a) of the Code provides generally that the disposition of a U.S. real property interest by a nonresident alien individual or a foreign corporation is taxable as effectively connected income under section 871(b)(1) or section 882(a)(1), respectively, as if the taxpayer was engaged in a trade or business within the United States and the gain or loss was effectively connected with the trade or business.

Section 897(c)(1) of the Code defines a U.S. real property interest as including an interest (other than an interest solely as a creditor) in any domestic corporation, unless the taxpayer establishes that such corporation was at no time a U.S. real property holding corporation during the shorter of the period the taxpayer held such interest or the 5-year period ending on the date of the disposition of such interest. Under section 897(c)(2), a U.S. real property holding corporation is defined as any corporation if the fair market value of its U.S. real property interests equals or exceeds 50-percent of the sum of (i) its U.S. real property interests, (ii) its real property interests located outside the United States, and (iii) any of its other assets used or held for use in a trade or business.

Section 897(e)(1) of the Code provides generally that a nonrecognition provision applies only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under Chapter 1 of the Code. Under section 897(e)(2), the Secretary may prescribe

regulations providing the extent to which nonrecognition provisions apply to transfers of U.S. real property interests.

Pursuant to the regulatory authority under section 897(e)(2), Temp. Reg. §1.897-6T(a)(1) provides that, subject to certain exceptions, any nonrecognition provision shall apply to a transfer by a foreign person of a U.S. real property interest on which gain is realized only to the extent that the transferred U.S. real property interest is exchanged for a U.S. real property interest which, immediately following the exchange, would be subject to U.S. taxation upon its disposition (and the transferor complies with the filing requirement of Temp. Reg. §1.897-5). In the case of an exchange of a U.S. real property interest for stock in a domestic corporation (that is otherwise treated as a U.S. real property interest), such stock shall not be considered a U.S. real property interest unless the domestic corporation is a U.S. real property holding corporation immediately after the exchange. Thus, if an interest in a U.S. real property holding corporation is exchanged in a nonrecognition transaction for stock of a domestic corporation, that is not a U.S. real property holding corporation immediately after the exchange, the exchange would be taxable under section 897.

Under Temp. Reg. §1.897-6T(a)(2), a nonrecognition provision for purposes of section 897(e) is any provision of the Code which provides that gain or loss is not recognized if the requirements of that provision are met. Thus, section 897(e) applies only to an exchange that receives nonrecognition treatment pursuant to another provision of the Code and does not create (or expand) a nonrecognition provision.

SECTION II. FINALIZATION OF TEMP. REG. §1.897-6T(a)(1)

It is recognized that the requirement in Temp. Reg. §1.897-6T(a)(1), providing that the corporation whose stock is received in a nonrecognition exchange must be a U.S. real property holding corporation immediately after the exchange, may not be appropriate for stock exchanges under section 354(a) in certain reorganizations described in sections 368(a)(1)(E)

and (F) of the Code. This may be illustrated by two examples. In both examples, the corporation, the stock of which was received in the exchange, is not a U.S. real property holding corporation immediately after the exchange, but was a U.S. real property holding corporation within the period provided in section 897(c)(1)(A)(ii) (the shorter of five years or the taxpayer's holding period prior to the exchange).

In example one, a domestic corporation engages in a recapitalization, whereby one share of common stock is issued in exchange for two outstanding shares of the existing common stock (in what is commonly referred to as a "reverse stock split"), pursuant to a section 354(a) exchange in a section 368(a)(1)(E) reorganization. The shares received in the exchange are substantially identical to the shares exchanged therefor, possessing (in the aggregate and with respect to any other outstanding stock of the corporation) the same dividend rights, voting power, liquidation preference (if any), convertibility and other legal and economic entitlements as the shares exchanged, and do not contain any additional rights or obligations.

In example two, a domestic corporation changes its state of incorporation from State A to State B, pursuant to a state law merger of the corporation into a corporation newly incorporated in State B solely to facilitate the transaction, and which is the survivor in the merger. In the merger, stock of the merged corporation is exchanged for stock in the surviving corporation, possessing (in the aggregate and with respect to any other outstanding stock of the corporation) substantially identical dividend rights, voting power, liquidation preference (if any), convertibility and other legal and economic entitlements as the shares exchanged, and does not contain any additional rights or obligations. The reincorporation qualifies as a reorganization under section 368(a)(1)(F).

Under Temp. Reg. §1.897-6T(a)(1), the exchange of stock in both examples would be taxable to foreign shareholders because, with respect to the interests exchanged, the domestic corporation whose

stock is received is not a U.S. real property holding corporation immediately after the exchange. Accordingly, when the final regulations under section 897(e) are issued, the regulations will include an exception that will provide that a foreign taxpayer will not recognize gain under section 1.897-6T(a)(1) (as finalized) for a stock exchange under section 354(a) in certain reorganizations described in section 368(a)(1)(E) or (F). The exception will apply where the taxpayer receives stock in the corporation that is substantially identical to the shares exchanged, possessing (in the aggregate and with respect to any other outstanding stock of the corporation) the same dividend rights, voting power, liquidation preferences (if any), and convertibility as the shares exchanged without any additional rights or obligations.

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

For example, if a foreign person receives substantially identical stock in a section 354(a) exchange pursuant to the recapitalization of a domestic corporation that qualifies as a reorganization within

the meaning of section 368(a)(1)(E), and the corporation ceased to be a U.S. real property holding corporation two years prior to the exchange, the sale of the stock by the foreign person two years after the exchange will constitute the disposition of a U.S. real property interest that is subject to tax under section 897(a). If the same interest were to be sold by the foreign person four years after the exchange, the sale would not be subject to tax under section 897(a), because the interest would not have been a U.S. real property interest. In such case, the interest would not have been an interest in a domestic corporation that was a U.S. real property holding corporation during the period specified in section 897(c)(1)(A)(ii).

The rule described in this notice is effective for transfers occurring on or after September 6, 1999 (the date of publication of this notice), although a taxpayer may elect to apply the rule of this notice to transfers occurring after June 18, 1980.

SECTION III. PAPERWORK REDUCTION ACT

The collections of information required by this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1660.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information required by this notice are in Temp. Reg. §1.897-

6T(a)(1) and 1.897-5T(d)(1)(iii), Treas. Reg. §1.1445-2(d)(2)(i)(A) and Temp. Reg. §1.1445-9T. This information will be used to obtain exemptions from tax under certain nonrecognition transactions and to satisfy reporting requirements regarding these nonrecognition transactions. This information will be used by the Internal Revenue Service to verify whether a taxpayer is entitled to exemption from tax under a nonrecognition transaction. The likely respondents are individuals, corporations, and business or other for-profit institutions.

The estimated total annual reporting burden is 200 hours. The estimated annual burden per respondent is 2 hours. The estimated number of respondents is 100. The estimated frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION IV. DRAFTING INFORMATION

The principal author of this notice is Robert Lorence of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Mr. Lorence at (202) 622-3860 (not a toll-free call). Comments are requested regarding this Notice, including the application of the exception to be provided for in the final regulations as described herein to other nonrecognition transactions.