A Complete History Of Firpta Reform

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FIRPTA's safety from the tumult of tax reform is an opportunity to reflect on its evolution.

As the waves of tax reform crashed upon the shores of the Code in late 2017, most of the real estate market was focused on provisions such as the mortgage interest deduction and the like-kind exchange rules. A large number of participants in the market, however, could do little but observe from the sidelines. The Foreign Investment in Real Property Tax Act (FIRPTA), it appeared, was safe from the storm.

For non-U.S. individuals and corporations that invest in real estate within the U.S., the rules that subject their gains to U.S. federal income tax generally are found under Section 897.[1] The FIRPTA rules have often been attacked as a disincentive for overseas investors to enter the U.S. real estate market.[2] While a full or partial repeal of FIRPTA would have granted tax practitioners with new and exciting ways to avoid incurring U.S. federal income tax on non-U.S. investments in U.S. real property, the reprieve of Section 897 instead presents the opportunity to reflect on how FIRPTA evolved into its current incarnation. This exercise can shed light on some of the more complex aspects of the FIRPTA regime, such as the interplay between FIRPTA and the real estate investment trust (REIT) rules, as well as suggesting a range of possible amendments once the dust from the current reform efforts has cleared.

The following discussion provides a subsection-by-subsection history of FIRPTA reform, omitting those subsections that have never been amended.

Original Section 897(a)

Section 897(a) provided that any gain or loss from the disposition of a "U.S. real property interest" (USRPI) by a non-

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U.S. corporation or individual would be treated as if such amounts were effectively connected with the conduct of a trade or business within the U.S.[3] As a result, the non-U.S. corporation or individual: (1) was subject to U.S. tax on any gain from such disposition at graduated rates of taxation otherwise applicable to U.S. persons;[4] (2) was required to file a U.S. tax return;[5] and (3) generally was entitled to reduce its U.S. tax burden by using any available deductions or tax credits to offset its taxable income.[6]

Section 897(a) modified the alternative minimum tax (AMT) rules[7] as they applied to non-U.S. individuals, such that the minimum amount of tax imposed under the AMT rules was expressed as a fixed rate of tax (20%), multiplied by the lesser of: (1) the non-U.S. individual's alternative minimum taxable income (AMT income);[8] (2) such individual's net gain from all such USRPI dispositions during the taxable year (net USRP gain);[9] or (3) $60,000.[10] This minimum amount of tax under FIRPTA only applied to the extent that the application of the AMT rules would otherwise result in the imposition of a lesser amount of tax.[11]

AMT Amendments

When FIRPTA was enacted in 1980, the AMT rules contained two marginal rates of taxation—10% of AMT income between $20,000 and $60,000, and 20% thereafter.[12] Accordingly, the practical impact of the modified AMT rules under Section 897(a)(2)(A) was that: (1) if the individual's AMT income did not exceed either $60,000 or the individual's net USRP gain, the minimum rate of taxation on such AMT income would be increased from 10% to 20%, and (2) if the individual's net USRP gain was between 50% and 100% of the individual's AMT income and neither amount exceeded $60,000, the minimum amount of tax imposed would be 20% of such USRP gain (rather than 10% of AMT income). In all other cases, the AMT rules would apply without modification by FIRPTA.

In 1982, Section 897(a)(2)(A) was amended such that a non-U.S. individual's minimum amount of tax under FIRPTA was now equal to 20% of the lesser of such individual's AMT income or that individual's net USRP gain. The AMT rules similarly were amended at that time. The two graduated rates of taxation described above were replaced with a fixed 20% tax rate, and a minimum income threshold (the AMT exemption amount) was added such that the tax calculated under the AMT rules only applied to the amount of AMT income that exceeded the AMT exemption amount (such individual's adjusted AMT income).[13] As a result of these amendments, if a non-U.S. individual's net USRP gain was greater than such individual's adjusted AMT income but less than the individual's total AMT income, Section 897(a)(2)(A) applied the AMT rules to net USRP gain rather than the individual's adjusted AMT income. Because the mechanics of Section 897(a)(2)(A) did not reflect the AMT exemption amount, however, there was a second consequence: if net USRP gain exceeded AMT income, Section 897(a)(2)(A) imposed a minimum amount of tax equal to 20% of the individual's total AMT income. Accordingly, the practical impact of Section 897(a)(2)(A) in this latter case was to apply the AMT rules without reflecting the AMT exemption amount.

In 1986, the minimum fixed rate of tax imposed on individuals under Section 897(a)(2)(A) was increased to 21%, corresponding to a similar change to the applicable rate under the AMT rules.

In 1993, the mechanics under Section 897(a)(2)(A) were revised. Prior to this change, the FIRPTA rules were used to calculate a separate minimum amount of tax to be compared with the minimum amount of tax determined under the AMT rules. After the change, the AMT rules would apply to the lesser of AMT income and net USRP gain. Although this change had no substantive effect on the interplay between the AMT rules and FIRPTA, it helped from an administrative perspective because it would no longer be necessary to make a conforming amendment to Section 897(a)(2)(A) whenever the AMT rates were adjusted.

Unsuccessful AMT Amendments

In connection with 17 failed legislative attempts to repeal the AMT regime, the rule under Section 897(a)(2)(A) applying the modified AMT rules to non-U.S. individuals would have been removed.[14]

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1 FIRPTA is an acronym for the Foreign Investment in Real Property Tax Act, which added Section 897 to the Code in 1980. In addition to Section 897 and the regulations thereunder, which govern the direct taxation of dispositions of U.S. real property interests, the FIRPTA regime also includes a withholding tax imposed by Section 1445, which was enacted four years after Section 897 as a means to enforce collection of tax under FIRPTA.

2 See, e.g., "Tax Reform and Foreign Investment in the United States" (hearing before the House Ways and Means Subcommittee on Select Revenue Measures of the H. Comm. on Ways and Means, 2011, archive.org/stream/gov.gpo.fdsys.CHRG-112hhrg72279/CHRG-112hhrg72279_djvu.txt), statement of Jeffrey DeBoer, president and CEO of the Real Estate Roundtable ("A report by University of California professor Ken Rosen found that reforming FIRPTA would unlock billions of dollars in investments into U.S. commercial real estate. This is capital that is currently sitting on the sidelines or, more likely, going to other countries that have more favorable tax rules. The time has come and gone for FIRPTA.").

3 Section 897(a)(1).

4 Sections 871(b)(1), 882(a)(1).

5 Reg. 1.6012-1(b)(1)(i), Reg. 1.6012-2(g).

6 Sections 873, 874(a), 882(c).

7 The AMT is a minimum rate of taxation imposed on U.S. persons pursuant to Section 55.

8 See Section 55(b)(2).

9 Section 897(a)(2)(B).

10 Section 897(a)(2)(A) (amended 1982).

11 *Id.*

12 Section 55(a)(1) (amended 1982).

13 The precise AMT exemption amount varied depending on the filing status of the taxpayer.

14 Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. section 1031(a)(24); Individual Tax Simplification Act of 2005, H. R. 2950, 109th Cong. section 303(b)(18); Alternative Minimum Tax Repeal Act of 2005, H. R. 1186, 109th Cong. Section 2(c)(44); Individual Tax Simplification Act of 2003, H. R. 1939, 108th Cong. section 303(b)(18); Alternative Minimum Tax Repeal Act of 2003, H. R. 1233, 108th Cong. section 2(c)(36); Tax Simplification Act of 2002, H. R. 5166, 107th Cong. section 101(c)(41); Individual Tax Simplification Act of 2001, H. R. 2529, 107th Cong. section 303(b)(18); S. 492, 107th Cong. section 1(b)(19) (2001); Alternative Minimum Tax Repeal Act of 2001, H. R. 437, 107th Cong. section 2(c)(38); Family Values Tax Relief Act of 2001, H. R. 275, 107th Cong. section 5(b)(20); Tax Ease and Modernization Act – Part I, S. 2642, 106th Cong. section 101(b)(19) (2000); Family Values Tax Relief Act of 2000, H. R. 3612, 106th Cong. section 5(b)(20); Alternative Minimum Tax Repeal Act of 1999, H. R. 2364, 106th Cong. section 2(b)(29); Tax Equity Preservation Act of 1999, H R. 1561, 106th Cong. section 2(b)(20); Individual Tax Simplification Act of 1999, H. R. 1420, 106th Cong. section 303(b)(19); Alternative Minimum Tax Repeal Act of 1997, H. R. 162, 105th Cong. section 2(b)(27); Alternative Minimum Tax Repeal Act of 1995, H. R. 1142, 104th Cong. section 2(b)(27).

Original Section 897(c)

Section 897(c) described two categories of USRPIs: (1) direct interests[15] in real property[16] located within the U.S.,[17] and (2) shares or other non-debt interests in a "United States real property holding company" (USRPHC).[18]

A USRPHC was defined as any domestic corporation in which the fair market value of its USRPIs constituted at least 50% of the value of its total assets—excluding assets other than real property interests, unless such assets were used in a trade or business—at any point during the shorter of: (1) the five-year period prior to such disposition, and (2) the taxpayer's holding period (the 897(c) testing period).[19] A domestic corporation's interest in a foreign subsidiary will be treated as a USRPI for these purposes if the foreign subsidiary meets the above test to be treated as a USRPHC.[20]

In determining whether a domestic corporation should be classified as a USRPHC, the corporation was treated as holding its proportionate share of any USRPIs held indirectly through either a partnership, trust, or estate (each a flow-through entity).[21] Similarly, the corporation was treated as holding its proportionate interest in any USPRIs held by a subsidiary corporation at least 50% of which was owned by such domestic corporation (a controlled subsidiary). Unlike the look-through rule for flow-through entities, however, non-U.S. real property interests and assets used in the controlled subsidiary's trade or business were also attributed to the parent corporation.[22]

Section 897(c) provided two exceptions from the definition of a USRPHC: (1) the "FIRPTA cleansing exception" for any corporation that had disposed of all of its USRPIs[23] held during the 897(c) testing period in one or more taxable transactions;[24] and (2) the "897(c) regularly-traded exception" for any corporation whose stock was regularly traded on an established securities market, unless the relevant holder held more than 5%[25] of the outstanding stock in such class at any point during the 897(c) testing period.[26]

USRPI Amendments

The definition of direct USRPIs under Section 897(c) was expanded in 1981 to include real property located within the Virgin Islands. This amendment was necessary because the Virgin Islands operate under a unique "mirror system" vis-à-vis the U.S. pursuant to which, despite the fact that the Virgin Islands are a U.S. territory, residents of the Virgin Islands are not subject to U.S. taxation under the Code; instead, they are subject to Virgin Islands taxation under a modified version of the Code in which all references to the U.S. are replaced with the Virgin Islands, and vice versa.[27]As a result, it was possible for a non-U.S. individual or corporation to avoid the application of the FIRPTA rules by holding USRPIs through a Virgin Islands corporation.[28] For example, the "mirrored" FIRPTA rules only treated real property interests located within the Virgin Islands as USRPIs, and therefore a Virgin Islands corporation could hold interests that would otherwise be treated as USRPIs under FIRPTA without being treated as a USRPHC.[29]

For purposes of determining whether a domestic corporation is a USRPHC, Section 897(c) was expanded in 1981 to treat a corporation as holding its proportionate share of all non-USRPI assets indirectly held through a flow-through entity, as well as attributing to such corporation any trade or business in which those assets are used.[30] Absent these amendments, and because the determination as to whether a domestic corporation is a USRPHC does not take into account assets that are neither real property interests nor used in such corporation's trade or business, a domestic corporation holding no assets other than an interest in a flow-through entity that held one or more USRPIs would have automatically been treated as a USRPHC, without regard to the other assets held by such flow-through entity.[31] Similarly, this legislation applied the look-through rule for flow-through entities to assets held indirectly through a chain of two or more flow-through entities, in order to ensure that a domestic corporation would not be able to avoid USRPHC treatment by holding USRPIs through a tiered-partnership structure.[32]

FIRPTA Cleansing Exception Amendments

In 2015, Section 897(c) was amended to exclude from the FIRPTA cleansing exception any corporation, including any predecessor corporation, that was treated as either a REIT or regulated investment company (RIC)[33] at any point during the 897(c) testing period.[34] This exclusion was needed in light of the fact that REITs

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[15] These included fee ownership, co-ownership, leaseholds, and certain options. Section 897(c)(6)(A).

[16] These included movable walls, furnishing, and other associated personal property. Section 897(c)(6)(B).

[17] Section 897(c)(1)(A)(i) (amended 1981).

[18] Section 897(c)(1)(A).

[19] Sections 897(c)(1)(A)(ii), (c)(2).

[20] Section 897(c)(4)(A).

[21] Section 897(c)(4)(B) (amended 1981).

[22] Section 897(c)(5). Stock in a controlled subsidiary was excluded from the domestic parents' assets for purposes of calculating whether such parent was a USRPHC. Section 897(c)(5)(A)(i). These rules regarding controlled subsidiaries were effective only to the extent that the Treasury issued regulations issued thereunder. Such regulations were published in final form in 1984. See Regs. 1.897-1(e), Reg. 1.897-2(e)(3).

[23] These included any interests in USRPHCs, unless all such USRPHCs separately qualified for the FIRPTA cleansing exemption. Section 897(c)(1)(B)(ii)(II).

[24] Section 897(c)(1)(B) (amended 2015).

[25] Determined after the application of a modified version of the constructive ownership rules of Section 318(a). Section 897(c)(6)(C).

[26] Section 897(c)(3).

[27] Staff of the Joint Committee on Taxation, "General Explanation of the Economic Recovery Tax Act of 1981," (Joint Comm. Print JCS-71-81, 1981), 369, www.jct.gov/publications.html?func=select&id=9. Although not explicit, in this context the statute must be referring to the U.S. Virgin Islands, as opposed to the British Virgin Islands or Spanish Virgin Islands.

[28] *Id*. at 369-70.

[29] *Id*.

[30] Section 897(c)(4)(B). These rules regarding attribution from flow-through entities were effective only to the extent that the Department of Treasury issues regulations issued thereunder. Such regulations were published in final form in 1984. See Reg. 1.897-1(e), Reg. 1.897-2(e)(2).

[31] See Staff of the Joint Committee on Taxation, Note 27, *supra* at 371.

[32] Section 897(c)(4)(B).

[33] A domestic corporation that is either a REIT or a RIC is referred to as a "qualified investment entity" or "QIE" for purposes of FIRPTA. The general rules regarding QIEs are contained in Section 897(h). See Notes 68-76, *infra,* and accompanying text.

[34] Section 897(c)(1)(B)(iii).

[35] See Section 561.

and RICs largely are able to avoid paying entity-level taxation on their taxable dispositions by distributing the proceeds from such disposition to shareholders and offsetting their taxable income through the use of a "dividends paid" deduction.[35] Accordingly, if a REIT were to dispose of a USRPI in a taxable transaction and make a liquidating distribution to its non-U.S. shareholder without incurring any entity-level tax, allowing such shareholder to benefit from the FIRTPA cleansing exception on the subsequent disposition of its shares in the REIT effectively would permit the non-U.S. shareholder to avoid U.S. tax on its indirect disposition of a USRPI.[36]

Excluding QIEs from the FIRPTA cleansing exception had been included in seven previous legislative proposals prior to 2015. Six of those seven proposals differed slightly from what was enacted in 2015, in that the FIRPTA cleansing exception was only disallowed if the relevant corporation was a QIE at the time when USRPHC status was determined, rather than at any point during the 897(c)(1) testing period. The seventh was identical to what was ultimately enacted later in the year.

Unsuccessful USRPI Amendments

A proposed amendment in 2004 would have excluded from the USRPI definition any interests in, or assets held by, investment partnerships[37] that met certain qualifications.[38] In particular, this exclusion would have applied if, during the relevant testing period,[39] the partnership: (1) had an adjusted tax basis in any USRPIs that did not exceed 10% of its aggregate adjusted tax basis in all of its assets;[40] (2) was widely held, such that no non-U.S. person held (directly or indirectly) 10% or more of the interests in the partnership; and (3) was domestically controlled.[41]

A second amendment, introduced in five different proposed bills, would have added a new exclusion from the USRPI definition under Section 897(c) for any interests in a REIT indirectly held through a "qualified shareholder," unless an investor in the qualified shareholder held (directly or indirectly) more than 10% of the interests in the underlying REIT.[42] Each of these bills defined the term "qualified shareholder" as including any entity: (1) that would be eligible for a reduced rate of withholding on ordinary dividends paid by a REIT under an income tax treaty with the U.S., even if such entity held more than 10% of the stock of such REIT, and (2) whose principal class of interests are regularly traded on a recognized stock exchange. Two of these bills additionally provided that, if prong (1) above were not satisfied, such entity still would be treated as a qualified shareholder if the entity were eligible for benefits under an income tax treaty with the U.S. and would have been, absent this exclusion from the USRPI definition, classified as a USRPHC at any time during the five-year period ending on the date of disposition or distribution of shares in the underlying REIT.[43] One of the bills similarly provided that, if prong (1) above were not satisfied, such entity still would be treated as a qualified shareholder if it were a corporation (other than an entity taxed analogously to a REIT) engaged primarily in the trade or business of operating or managing real estate entities or assets.[44] These three bills that provided an expanded definition of "qualified shareholder" also required that such qualified shareholder maintain records identifying holders of greater than 10% of its regularly-traded interests. A modified version of these rules ultimately was enacted in 2015, although it was included as part of new Section 897(k) rather than as a modification of Section 897(c).

A third proposed amendment, included in three separate bills, would have added a new exclusion to the USRPI definition for certain "mitigation bank" credits earned in connection with the restoration, establishment, enhancement or preservation of a wetland, stream, or other aquatic resource.[45]

Unsuccessful USRPC Amendments

A proposed amendment in 2010 would have removed entirely the USRPHC rules from Section 897(c), such that the definition of a USRPI would be limited to direct interests in real property located within the U.S.[46]

Unsuccessful FIRPTA Section 897(c) Regularly-Traded Exception Amendments

Another amendment, introduced in six different proposed bills, would have amended Section 897(c) to increase the ownership threshold under the Section 897(c) regularly-traded exception from 5% to 10% in the case of any domestic corporation that is a REIT.[47] This change

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36 See S. Rep't No. 114-25, pt. II(B)(6) at 17 (2015).

37 An investment partnership is generally defined as any partnership that has never been engaged in a trade or business and substantially all of the assets of which consist of passive assets such as cash, shares, notes and certain derivative contracts. See Section 731(c)(3)(C)(i).

38 H. Rep't. 3829, 108th Cong. section 1(a) (2004).

39 The shorter of: (1) the five-year period prior to such disposition, and (2) the existence of the partnership.

40 For purposes of determining the ownership of interests in the partnership, a look-through rule would have applied in respect of beneficiaries of any pension trust holding an interest in such partnership.

41 Applying the same test applicable to QIEs under Section 897(h)(4)(B). See text accompanying Note 57, *infra*.

42 Real Estate Investment and Jobs Act of 2014, H. Rep't. 5487, 113th Cong. section 2(a)(3); Real Estate Investment and Jobs Act of 2013, H. Rep't 2870, 113th Cong. section 2(a)(3); Real Estate Investment and Jobs Act of 2013, S. 1181, 113th Cong. section 2(a)(3); Real Estate Investment and Jobs Act of 2011, S. 1616, 112th Cong. section 2(a)(3); Real Estate Jobs and Investment Act of 2011, H. Rep't. 2989, 112th Cong. section 2(a); Real Estate Jobs and Investment Act of 2010, H. Rep.'t 5901, 111th Cong. section 2(a)(3) (prior to Senate amendments).

43 Real Estate Investment and Jobs Act of 2013, S. 1181, 113th Cong. section 2(a)(3); Real Estate Investment and Jobs Act of 2011, S. 1616, 112th Cong. section 2(a)(3).

44 Real Estate Investment and Jobs Act of 2013, H. Rep't. 2870, 113th Cong. section 2(a)(3).

45 Wetlands Conservation Investment Act of 2011, H. Rep't. 2058, 112th Cong. section 3(a); Wetlands Conservation Investment Act of 2011, S. 664, 112th Cong. section 3(a); Wetlands Conservation Investment Act of 2009, S. 2876, 111th Cong. section 3(a).

46 Real Estate Revitalization Act of 2010, H. Rep't. 4539, 111th Cong. Section 2(a).

47 Real Estate Investment and Jobs Act of 2014, H. Rep't. 5487, 113th Cong. Section 2(a)(2); Real Estate Investment and Jobs Act of 2013, H. Rep't 2870, 113th Cong. section 2(a)(2); Real Estate Investment and Jobs Act of 2013, S. 1181, 113th Cong. section 2(a)(2); Real Estate Investment and Jobs Act of 2011, S. 1616, 112th Cong. section 2(a)(2); Real Estate Jobs and Investment Act of 2011, H. Rep't. 2989, 112th Cong. section 2(a); Real Estate Jobs and Investment Act of 2010, H. Rep't. 5901, 111th Cong. section 2(a)(2) (prior to Senate amendments).

ultimately was made in 2015, although it was enacted as part of new Section 897(k) rather than as a modification of Section 897(c).

Original Section 897(d)

Section 897(d) required a non-U.S. corporation to recognize gain on the distribution of an appreciated USRPI, in an amount equal to the fair market value of the USRPI at the time of distribution over such corporation's adjusted tax basis.[48]

There was an exception from the general rule requiring gain recognition if the recipient's adjusted tax basis in the distributed USRPI did not exceed the sum of the distributing corporation's adjusted tax basis of such USRPI immediately prior to the distribution, plus any gain recognized by such distributing corporation (giving such recipient a carry-over tax basis).[49]

Section 897(d) also provided that the nonrecognition rule of Section 337 did not apply to any sale or exchange of a USRPI by a foreign corporation.[50]

Gain Nonrecognition Amendments

In 1981, the exception to the general rule requiring gain recognition under Section 897(d) for recipients who receive a carry-over tax basis was modified to require that such recipient must be subject to tax on a subsequent disposition of the USRPI.[51] Further, a second exception was added in respect of any transaction for which nonrecognition treatment was provided for pursuant to Section 897(e)(2), which in turn provided authority to the Treasury to issue regulations modifying any nonrecognition provisions if necessary in order to prevent tax avoidance.[52] The intent of this latter amendment was to clarify that, in addition to having the power to disallow nonrecognition to combat tax avoidance, the Treasury also had the authority to waive FIRPTA taxation in respect of transactions where tax avoidance was not present.[53]

Prior to 1986, Section 337 permitted a domestic corporation to make a distribution to its corporate shareholders without incurring entity-level taxation, provided that such distribution was pursuant to a plan of complete liquidation.[54] Absent the exclusion in Section 897(d), a USRPHC could dispose of its USRPIs tax-free and distribute the proceeds to a foreign corporation under Section 337, thereby escaping FIRPTA taxation. In 1986, Section 367 was amended such that a liquidating distribution to a foreign shareholder was no longer exempt from entity-level taxation under Section 337.[55] Because the potentially abusive scenario described above was no longer available, the exception from FIRPTA for Section 337 was unnecessary and Section 897(d)(2) therefore was repealed.

Original Section 897(h)

Section 897(h) provided that a cash distribution made by a REIT to a non-U.S. individual or corporation, to the extent attributable to gain on a corresponding disposition of an underlying USRPI (a USRP gain distribution), was treated as gain from the disposition of a USRPI (the 897(h) look-through rule).[56]

Notwithstanding the fact that shares in a REIT (as interests in a USRPHC) ordinarily would be treated as USRPIs, Section 897(h) provided that shares in a REIT would not be treated as USRPIs if, at all times during the shorter of: (1) the five-year period prior to the relevant disposition or distribution, and (2) the existence of the REIT (the 897(h) testing period), non-U.S. persons held, by value, less than 50% of the shares in such REIT (making it domestically-controlled).[57] Accordingly, shares in a domestically-controlled REIT generally could be disposed of without triggering FIRPTA taxation. If a domestically-controlled REIT distributed a USRPI, however, such REIT was required to recognize a portion of any unrealized gain[58] on such USRPI equal to the greatest percentage of stock in the REIT held by non-U.S. persons at any point during the 897(h) testing period, unless the recipient of such distribution obtained a carry-over tax basis[59] in such USRPI.[60]

Regularly-Traded Exception Amendments

In 2004, an exception was added to the 897(h) look-through rule for any USRP gain distributions that were paid: (1) in respect of shares of a REIT that are regularly traded on an established securities market within the U.S., and (2) to a shareholder that did not hold more than 5% of such class of shares at any time during

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[48] Section 897(d)(1)(A).

[49] Section 897(d)(1)(B) (amended 1981). The Treasury was authorized to provide additional exceptions to the general rule requiring gain recognition ("Except to the extent otherwise provided in regulations…."). Temporary regulations to this end were published in 1988. See Temp. Reg. 1.897-5T(c).

[50] Section 897(d)(2) (amended 1986).

[51] Section 897(d)(1)(B).

[52] *Id.* Temporary regulations pursuant to Section 897(e)(2) were published in 1988. See Temp. Reg. 1.897-6T(b).

[53] See Staff of the Joint Committee on Taxation, Note 27, *supra* at 371.

[54] Section 337(a) (amended 1986).

[55] Section 367(e).

[56] Section 897(h)(1) (amended 2004).

[57] Sections 897(h)(2), (h)(4)(B).

[58] The amount of unrealized gain was equal to the fair market value of the USRPI at the time of distribution over the REIT's adjusted tax basis. See Section 897(d)(1).

[59] See text accompanying Note 49, *supra*.

[60] Sections 897(h)(3), (h)(4)(C), (d)(1) (amended 1981).

[61] Section 897(h)(1).

[62] *Id.*

[63] See Notes 68-69, *infra,* and accompanying text.

[64] Staff of the Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 108th Congress," (Joint Comm. Print JCS-5-05, 2005), 303 n. 536, available at www.jct.gov/publications.html?func=select&id=9.

[65] Section 897(h)(1).

[66] *Id*.

[67] See Notes 74-76, *infra,* and accompanying text.

[68] Section 897(h)(4)(A)(i).

[69] Staff of the Joint Committee on Taxation, Note 64, *supra*, at 286-87.

[70] Cf. Notes 777-81, *infra,* and accompanying text.

[71] Section 897(h)(4)(A)(i)(II).

[72] Section 897(h)(4)(A)(ii).

[73] Section 897(h)(4)(A).

[74] Section 897(h)(1).

[75] See Staff of the Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 109th Congress," (Joint Comm. Print JCS-1-07, 2007), 298, www.jct.gov/publications.html?func=select&id=9.

[76] *Id.*

[77] *Id.*

[78] Section 897(h)(5).

[79] Section 897(h)(5)(B)(i).

[80] Section 897(h)(5)(B), flush language.

the tax year of such distribution (the 897(h) regularly-traded exception).[61] In 2005, this testing period was changed from the relevant tax year to the one-year period ending on the date of the USRP gain distribution.[62] Despite the fact that the 2004 legislation introducing the 897(h) regularly traded exception also expanded the 897(h) look-through rule to include USRP gain distributions by RICs,[63] the 897(h) regularly-traded exception was intentionally drafted to address only USRP gain distributions made by REITs.[64] This disparity between REITs and RICs was eliminated in 2006, when the 897(h) regularly-traded exception was amended to include USRP gain distributions from qualifying RICs as well.[65]

The 897(h) regularly-traded exception was also narrowed in 2006 to apply solely to USRP gain distributions received by a non-U.S. individual or corporation.[66] The practical application of this amendment was in the context of tiered QIEs,[67] such that an upper-tier QIE could not utilize the 897(h) regularly-traded exception in order to "cleanse" a USRP gain distribution received from a lower-tier QIE and thereby avoid FIRPTA taxation upon a corresponding distribution by the upper-tier QIE to a non-U.S. individual or corporation.

RIC Amendments

The 897(h) look-through rule was expanded in 2004 to include USRP gain distributions made by RICs in addition to REITs, by means of the new defined term "qualified investment entity" (QIE) that consisted of all REITs and RICs.[68] As well as aligning the FIRPTA treatment of RICs and REITs, this change was part of a larger set of reforms intended to place non-U.S. investors in RICs in the same position as if they had held the underlying securities directly, and therefore discourage the movement of mutual funds offshore.[69]

This 2004 legislation did not contain any limitations on which RICs would be treated as QIEs, however, which created a peculiarity: a RIC could be subject to the 897(h) look-through rule, yet if less than 50% of the value of its assets consisted of USRPIs, FIRPTA would not apply to a disposition of shares in the RIC. Because of this disparity in treatment, a holder of shares in such a RIC could enter into a wash sale in order to avoid beneficial ownership of the RIC at the time when a USRP gain distribution was paid, thereby avoiding the application of the 897(h) look-through rule.[70] This potentially abusive scenario was addressed retroactively in 2006, such that a RIC needed to qualify as a USRPHC—disregarding for purposes of this determination the exception for domestically-controlled QIEs and the 897(h) regularly-traded exception—in order to be treated as a QIE subject to the 897(h) look-through rule.[71]

The 2004 legislation that applied the 897(h) look-through rule to RICs included a sunset provision, stating that RICs would no longer be treated as QIEs after 12/31/07.[72] This sunset provision was amended in 2006 to provide that, even after the expiration of the general provision treating a qualifying RIC as a QIE, such RIC would still be treated as a QIE for purposes of applying the 897(h) look-through rule to any distribution made by the RIC that is attributable to a USRP gain distribution received by the RIC from an underlying REIT. Beginning in 2008, the expiration date of the sunset provision was extended to 12/31/09, 12/31/11, 12/31/13, and 12/31/14. This sunset provision was removed entirely in 2015, thereby permanently applying the 897(h) look-through rule to qualifying RICs.[73]

Tiered QIE Amendments

Section 897(h) was amended in 2006 to expand the 897(h) look-through rule to capture USRP gain distributions received by QIEs.[74] This change was needed because the 897(h) look-through rule technically only applied to distributions that were: (1) attributable to "sales or exchanges *by the qualified investment entity* of United States real property interests" (emphasis added), and (2) received by a QIE to a non-U.S. individual or corporation.[75] Accordingly, if a distribution by an upper-tier QIE to a non-U.S. individual or corporation were attributable to the disposition of a USRPI by a lower-tier QIE subsidiary, neither the distribution by the upper-tier QIE (which did not satisfy (1), above) nor the distribution by the lower-tier QIE to the upper-tier QIE (which did not satisfy (2), above) would be subject to the 897(h) look-through rule, thereby allowing non-U.S. individuals and corporations to indirectly dispose of USRPIs without triggering FIRPTA taxation.[76]

Wash Sales Amendments

Section 897(h) was amended in 2006 to prevent a holder of shares in a domestically-controlled QIE from circumventing the application of the 897(h) look-through rule by disposing of such shares shortly before the payment of a USRP gain distribution, then reacquiring substantially identical shares soon thereafter (a wash sale).[77] If a non-U.S. individual, non-U.S. corporation, or QIE enters into a wash sale that meets the requirements below, and unless the 897(h) regularly-traded exception otherwise would have applied to the USRP gain distribution, the 897(h) look-through rule will apply to the relevant holder as if the wash sale had not occurred.[78]

For these wash sale rules to apply, the disposition must occur as part of one or more transactions during the 30-day period preceding the ex-dividend date of a USRP gain distribution, and the subsequent acquisition must occur no later than 30 days after the relevant ex-dividend date.[79] A holder will also be treated as having reacquired identical shares if it entered into an option to acquire, or a related party to such holder acquired, such shares.[80] Finally, a substitute payment made under a securities lending transaction or a sale-repurchase transaction that is equivalent to a USRP gain distribution is treated as the payment of a USRP gain distribution for these purposes.[81]

Domestic Control Amendments

In 2015, Section 897(h) was amended to provide administrative relief in determining whether a QIE is a "domestically controlled" QIE, such that shares in a QIE that are regularly traded on an established securities market in the U.S. will be treated as held by a U.S. person by default unless: (1) the holder

owned at least 5% of the relevant class of shares in the QIE at any point during the 897(h) testing period, or (2) the QIE has actual knowledge that the holder is a foreign person.[82]

A similar set of default rules was added in 2015 in respect of tiered QIEs,[83] wherein any shares in a lower-tier QIE that are held by an upper-tier QIE will be treated as: (1) held by a U.S. person, if the upper-tier QIE is domestically controlled; (2) held by a non-U.S. person, if the upper-tier QIE is not domestically-controlled but either its shares are regularly traded on an established securities market or it is a RIC that issues redeemable securities; or (3) if neither (1) nor (2) applies, held by U.S. and/or non-U.S. persons proportionate to the ownership of the upper-tier QIE (after applying these default rules to the upper-tier QIE, if applicable).[84] These default rules were intended to resolve potential uncertainty in determining whether a QIE is domestically controlled and acknowledge that it may be impracticable for certain publicly-traded QIEs to identify their smaller shareholders. [85]

A predecessor version of these default rules had been proposed in four earlier bills; the only substantive difference was that, under those earlier proposals, shares in a lower-tier QIE were always treated as held by a non-U.S. person unless the parent was a domestically-controlled QIE.[86]

Technical Amendments

The 897(h) regularly-traded exception as introduced in 2004 referred to a regularly-traded "REIT" rather than a "real estate investment trust."[87] Perhaps surprisingly, the term REIT is not defined anywhere in the Code and, although such term previously had been defined under Section 897(h), the definition was removed in 2004 when the term "qualified investment entity" was introduced.[88] Accordingly, a technical correction was necessary in order to address this point, and so the term "REIT" was replaced with "real estate investment trust" in 2005.[89]

The default ownership rules added to Section 897(h) in 2015 in respect of tiered QIEs required a determination to be made as to whether the upper-tier QIE is domestically controlled.[90] A technical amendment was made in 2015 to clarify that a RIC will be treated as an upper-tier QIE for purposes of determining whether a lower-tier REIT is a domestically-controlled QIE under the default rules.[91]

Unsuccessful Look-Through Rule Amendments

In connection with a proposal to repeal of the USRPHC rules, a bill introduced in 2010 would have modified the 897(h) look-through rule to treat any distribution from a QIE that is attributable to gain on the disposition of an underlying USRPI as an ordinary dividend, rather than as the indirect disposition of a USRPI.[92] Similarly, any liquidating distribution would be treated as an ordinary dividend to the extent attributable to the disposition of an underlying USRPI, except that the amount of such dividend would not exceed the amount of gain that such shareholder otherwise would recognize under Section 331.[93]

A series of bills would have imposed a limitation on the 897(h) look-through rule,[94] such that certain corporate distributions that are treated as a sale or exchange of shares under Section 301(c)(3), Section 302, or Section 331 would not be subject to the 897(h) look-through rule. This proposed amendment would have overridden the Service's position that liquidating distributions and similarly-treated distributions are captured by the 897(h) look-through rule.[95]

Unsuccessful Regularly-Traded Exception Amendments

A series of proposed bills would have increased the ownership threshold under the 897(h) regularly-traded exception in respect of REITs from 5% to 10%, and would have added an exclusion from the 897(h) look-through rule for distributions by a REIT to a "qualified shareholder"[96] that held less than 10% of the stock in such REIT.[97]

NOTES

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

82 Section 897(h)(4)(E).

83 See Notes 74-76, *supra,* and accompanying text.

84 Section 897(h)(4)(E).

85 See, S. Rep't No. 114-25, pt. II(B), at 12 (2015).

86 Real Estate Investment and Jobs Act of 2013, H. Rep't. 2870, 113th Cong. section 2(c); Real Estate Investment and Jobs Act of 2013, S. 1181, 113th Cong. section 2(c); Real Estate Investment and Jobs Act of 2011, S. 1616, 112th Cong. section 2(c); Real Estate Jobs and Investment Act of 2011, H. Rep't. 2989, 112th Cong. section 2(c).

87 Section 897(h)(1).

88 See Note 68, *supra,* and accompanying text.

89 Section 897(h)(1).

90 See Note 84, *supra,* and accompanying text.

91 Section 897(h)(4)(A)(ii).

92 Real Estate Revitalization Act of 2010, H. Rep't. 4539, 111th Cong. section 2(b).

93 Although not explicit, presumably this rule was intended to apply only to liquidating distributions *by a QIE*.

94 Real Estate Investment and Jobs Act of 2013, H. Rep't. 2870 113th Cong. section 2(b)(4); Real Estate Investment and Jobs Act of 2013, S. 1181, 113th Cong. section 2(b)(4); Real Estate Investment and Jobs Act of 2011, S. 1616, 112th Cong. section 2(b)(4); Real Estate Jobs and Investment Act of 2011, H. Rep't. 2989, 112th Cong. section 2(b).

95 Notice 2007-55, 2007-27 IRB 13.

96 See Notes 42-44, *supra*, and accompanying text.

97 Real Estate Investment and Jobs Act of 2013, H. Rep't. 2870, 113th Cong. section 2(b)(1)-(3); Real Estate Investment and Jobs Act of 2013, S. 1181, 113th Cong. section 2(b)(1)-(3); Real Estate Investment and Jobs Act of 2011, S. 1616, 112th Cong. section 2(b)(1)-(3); Real Estate Jobs and Investment Act of 2011, H. Rep't. 2989, 112th Cong. section 2(b); Real Estate Jobs and Investment Act of 2010, H. Rep't. 5901, 111th Cong. section 2(b) (prior to Senate amendments).

98 Section 897(i)(1) (amended in 1981).

99 Section 897(i)(3) (amended in 1981) ("...subject to such other conditions as the Secretary may prescribe by regulations..."). Treasury regulations thereunder were published in 1984. See Reg. 1.897-3.

100 Section 897(i)(2).

101 "Taxation of Foreign Investor Direct and Indirect Ownership of Property in the United States" (hearing before the H. Comm. on Ways and Means, 10/29/79, Serial 96-43, statement of Hon. Donald C. Lubick, Assistant Sec'y for Tax Policy, Dep't of the Treasury).

102 Staff of the Joint Committee on Taxation, "General Explanation of the Economic Recovery Tax Act of 1981," (Joint Comm. Print JCS-71-81, 1981), 372-73, www.jct.gov/publications.html?func=select&id=9.

103 Section 897(i)(1).

104 Section 897(i)(4).

105 Section 897(i)(3).

106 See Note 25, *supra*.

107 Section 897(i)(3), flush language.

108 Real Estate Revitalization Act of 2010, H. Rep't. 4539, 111th Cong. section 2(c) (2010).

Original Section 897(i)

Section 897(i) permitted a non-U.S. corporation to elect to be treated as a U.S. corporation for purposes of FIRPTA, provided that such corporation: (1) had a permanent establishment within the U.S. pursuant to the terms of a relevant double taxation treaty, and (2) under such treaty, the corporation's permanent establishment was entitled to nondiscriminatory treatment as compared with U.S. corporations carrying on the same activities.[98] This election was subject to any conditions required by regulations[99] and, once made, it was irrevocable unless consent were to be given by the Treasury.[100]

Treaty Amendments

When FIRPTA was originally promulgated, the U.S. had entered into 46 tax treaties then in force, each of which included a nondiscrimination clause.[101] Section 897(i) was intended to ensure that FIRPTA was not in conflict with those nondiscrimination clauses by permitting non-U.S. corporations to be treated as U.S. corporations for FIRPTA purposes. Absent this election, a U.S. corporation could dispose of a USRPI without recognizing gain pursuant to nonrecognition provisions (e.g., as part of a complete liquidation), whereas a non-U.S. corporation would be subject to tax under FIRPTA on a similar disposition.[102] In 1981, the requirement that the non-U.S. corporation must maintain a permanent establishment within the U.S. that was entitled to treaty protection was removed, instead requiring only that the non-U.S. corporation must hold a USRPI and be entitled to nondiscriminatory treatment under a tax treaty with respect to such interest.[103] This change was necessary in order to avoid discriminatory treatment with respect to non-U.S. corporations that did not maintain a permanent establishment within the U.S. but were nevertheless subject to taxation under FIRPTA on the disposition of a USRPI. Section 897(i) was also amended at that time in order to stipulate that the election to be treated as a U.S. corporation for purposes of FIRPTA is the exclusive remedy for any person claiming discriminatory treatment under a relevant tax treaty.[104]

Consent Amendments

In 1981, prior to the issuance of regulations pursuant to Section 897(i)(3), Section 897(i) was amended to provide that all holders of interests in the non-U.S. corporation, other than interests solely as a creditor, must approve the election to be treated as a domestic corporation for FIRPTA purposes.[105] This rule was relaxed in the case of a corporation whose shares are regularly traded on an established securities market, such that only the consent of holders of greater than 5% of such shares during the shorter of: (1) the five-year period prior to such election, and (2) the taxpayer's holding period, determined after the application of the constructive ownership rules under Section 897(c),[106] was necessary in order to effectuate the election.[107]

Unsuccessful Repeal Efforts

One failed proposal would have repealed Section 897(i) in its entirety, in connection with a full repeal of the USRPHC rules.[108]

Conclusion

Although FIRPTA was untouched by the recent tax reform, the same cannot be said for the international tax landscape under the Code. Most notably, the shift from a worldwide tax regime to a territorial system has already raised numerous questions in the market and created planning opportunities for U.S. multinational companies. What these changes portend for the FIRPTA rules is unclear, however, and the answer may only come once the dust of repatriation and restructuring has settled. One thing that is clear, however, is that non-U.S. investors will still have to navigate the waters of FIRPTA, at least until the waves of tax reform return. ●