

# RECENT DEVELOPMENTS AFFECTING THE TAXATION OF PRIVATE EQUITY INVESTMENTS

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# A. PORTFOLIO INTEREST RULES

(Proposed Reg. Section 1.871-14(j), 1.881-2(a)(6), issued 6/13/2006)

- Section 871(h) provides an exception to the general rule that U.S. source interest received by a foreign taxpayer is subject to a 30% withholding tax for “portfolio interest” received by a nonresident individual or foreign corporation. The exception does not apply where the interest is received by a person owning the 10% or more of the combined voting power of the issuer, or, in the case of an issuer that is a partnership, of its capital or profits interest.
- The Proposed Regulations provide a long awaited clarification of the application of the 10% shareholder test where interest is paid to a partnership with foreign partners.

# A. PORTFOLIO INTEREST RULES (cont.)

- Previous guidance on this issue consisted of FSA issued in 1994 (1994 FSA Lexis 430, February 2, 1994) where the IRS also took an aggregate approach in a factual situation involving a Japanese partner in a Japanese general partnership that loaned funds to a U.S. company that owned U.S. real estate.
- The FSA concluded that the aggregate approach was applicable, because an entity approach would in effect attribute all of the partnership's equity interest in a borrower to each partner, which would be contrary to sections 318 and 871(h)(3)(C)(iii).
- Consistent with the earlier holding in the FSA, Prop. Reg. 1.871-14(g)(2)(ii)(B)(3) and the accompanying preamble clarify that the determination of whether the recipient owns 10% or more of the payor should apply at the foreign partner level to the nonresident individual or foreign corporation that is the beneficial owner of the income.

# A. PORTFOLIO INTEREST RULES (cont.)

- The Preamble notes that the IRS and Treasury do not believe that in enacting the 10-percent shareholder test, Congress intended for the test to be applied at the partnership level-such an interpretation would condition a foreign beneficial owner's entitlement to the portfolio interest exception on the ownership in the obligor held by either a person that is not a taxpayer (the partnership) or a person who is wholly unrelated to the beneficial owner (another partner in the partnership).
- The time for applying the test is the earliest of the following events:
  - When interest is distributed by the partnership to the foreign partner;
  - The date a nominee statement required under Section 6031(c) is mailed or provided to the foreign partner; or
  - The due date for furnishing the nominee statement. (Prop. Reg. 1.871-14(g)(2)(ii)(B)(3)(ii)).

# A. PORTFOLIO INTEREST RULES (cont.)

- The Treasury regulations are effective on or after the date they are finalized. Until then, practitioners can presumably rely on the reasoning of the FSA to support an aggregate approach to the 10% test.

## B. Section 704(b) and Substantiality of Partnership Allocations (Proposed Regulation Sec. 1.704-1(b)(2)(iii), issued 11/18/2005)

- Under Section 704(b), and the Treasury Regulations promulgated thereunder, a partnership's allocations must either have "substantial economic effect" or be made in accordance with each partner's interest in the partnership. A partnership agreement's allocations will not have substantial economic effect if:
  - (a) the after-tax economic consequences of at least one partner may be enhanced and
  - (b) no partner's after-tax economic consequences are substantially diminished, when compared to the consequences if the allocations were not contained in the partnership agreement.
- When determining the after-tax economic benefit or detriment to a partner, the interaction of the partnership's allocations with such partner's tax attributes are considered.

## B. Section 704(b) (cont.)

- In the preamble to Temporary Regulations issued on April 21, 2004 (TD 9121), the IRS and the Treasury Department indicated their concern that some partnerships were taking the position that, when determining if the economic effect of a partnership allocation is substantial, they do not need to consider the tax attributes of the owner of a partner resulting from the allocation.
- According to the IRS and the Treasury Department, this position is inconsistent with the policies underlying the substantial economic effect rules because it would allow a partnership to make tax-advantaged allocations if the tax advantages of the allocations accrue to an owner of a partner, instead of to the partner itself.
- The Proposed Regulations provide that the interaction of a partnership allocation with the tax attributes of owners of pass-through entities must be taken into account when testing for substantial economic effect.

## B. Section 704(b) (cont.)

- For this purpose, pass-through entities include partnerships, S corporations, trusts, certain controlled foreign corporations, and disregarded entities for federal tax purposes. However, at the moment, RICs and REITs are not included in the list of pass-through entities for these purposes.

## C. Section 409A in the Partnership Context

- Code Section 409A generally regulates “deferred compensation”, which is defined as a legally binding right of a service provider to receive payment from a service recipient in a year beyond the year in which the legally binding right arises. 409A generally regulates (i) the timing of elections to defer compensation, (ii) the times at which deferred compensation can be paid to the service provider, and (iii) the timing of changes to the time at which a deferred compensation payment is to be made.

## C. Section 409A (cont.)

- A “legally binding right” means that the service recipient does not have the right to unilaterally terminate or reduce the service provider’s right to payment. A legally binding right includes rights that are not yet vested. Thus, a right to a payment if certain performance goals are met is considered a legally binding right that will be deferred compensation subject to the rules of Section 409A.

## C. Section 409A (cont.)

- The proposed Treasury regulations issued under Code Section 409A provide generally that 409A may apply to an issuance of a partnership interest (including a profits interest) for services under the same principles that govern the issuance of stock. Proposed Treas. Regs. 1.409A-1, Preamble II.E., referring to IRS Notice 2005-1, Q&A 7.
- Payments covered by 707(a)(1) (partner acting in capacity other than as a partner) may also be subject to Section 409A. IRS Notice 2005-1, Q&A 7.

## C. Section 409A (cont.)

- If payments made to a partner that are guaranteed payments under Code Section 707(c) (i.e. determined without regard to the income of the partnership) are subject to Code Section 409A, unless they are paid within 2 ½ months following the later of the taxable year of the partner in which the partner obtained a legally binding right to such amounts, or if later, the taxable year in which the partner became vested in such amounts. IRS Notice 2005-1 Q&A 7 and Preamble II.E.

## C. Section 409A (cont.)

- The issuance of a profits interest for services that does not otherwise result in an inclusion in income will not be subject to 409A. IRS Notice 2005-1, Q&A 7. If, however, an issuance of a profits interest *would* result in an immediate inclusion in income (for example, if the profits interest were characterized as a payment made to a partner under 707(a)(1) other than in such partner's capacity as a partner), that also should not be subject to 409A, to the extent there has been no deferral of income. (See Prop. Treas. Regs. Section 1.409A-1(b)(1), which provides that a deferral of compensation occurs if a service provider has a legally binding right during a taxable year to compensation that is not includable in income in such year, and is payable in a later year.) To the extent the profits interest is subject to a substantial risk of forfeiture under Section 83, such interest should also not be subject to Section 409A. Prop. Treas. Regs. Section 1.409A-1(b)(6)(i).

## C. Section 409A (cont.)

- The issuance of a capital interest in connection with the performance of services under is treated the same as an issuance of stock, i.e. it is generally includible income to the service provider upon issuance. IRS Notice 2005-1, Q&A 7. Code Sections 61(a) and 83.

## C. Section 409A (cont.)

- If a fund manager waives fees in return for a “profits” interest, one issue is whether such an arrangement would be considered:
  - (A) a payment to a non-partner (or to a partner other than in its capacity as a partner), under 707(a)(1)) or a guaranteed payment to a partner under Section 707(c) and therefore subject to 409A as deferred compensation, or
  - (B) an issuance of a true profits interest that does not result in immediate inclusion in income and is not subject to 409A.
- Some managers limit the distributions that can be paid to the manager in connection with his profits interest to the partnership’s taxable income in order to bolster the argument that the manager is indeed a partner whose profits interest in a partnership is not subject to 409A.

# C. Section 409A (cont.)

## Prop. Treas. Reg. Section 1.409A-2(a)(i)

- Another issue that arises if section 409A does apply to the deferral (for example, if a partner's profits interest were a payment under 707(a)(1) or a guaranteed payment under Section 707(c), is when the election to defer the fees would have to be made to meet the requirements of 409A. In general, 409A requires an election to defer fees to be made before the "year" in which such fees are earned. For this purpose, the proposed regulations say that the "year" is generally the taxable year of the service provider (i.e. the manager). Prop. Treas. Reg. Section 1.409A-2(a)(i). In the case of a service recipient that has a non-calendar fiscal year, however, the "year" can also be the service recipient's fiscal year if the payments are based on the service recipient's fiscal year (not the calendar year) and the payments would, in the absence of a deferral election, be paid after the end of the fiscal year. Because the year of most partnerships is the calendar year, in most cases the "year" will be the service provider's taxable year. Prop. Treas. Reg. Section 1.409A-2(a)(5).

## C. Section 409A (cont.)

- Also, if any payment is subject to 409A as a deferral of compensation, it will escape characterization as a deferral of compensation under Section 409A as long as it is paid within the later of (i) 2 ½ months following the service provider's taxable year in which the right to such payment became vested, or (ii) 2 ½ months following the service recipient's taxable year in which the right to such payment became vested. Prop. Treas. Regs. Section 1.409A-1(b)(4)(i).

## C. Section 409A (cont.)

- Note, that under section 707(c) a partner does not take into income a guaranteed payment from a partnership until the partner's tax year which includes the end of the partnership year in which the payment was made. Treas. Reg. Section 1.707-1(c). This differs from the Rule of Preamble II.E requiring the inclusion in the partner's taxable year without regard to the partnership's taxable year.

It is possible that such a 707(c) guaranteed payment included in the partner's year includes the partnership's taxable year is not deferred compensation. Prop. Treas. Reg. Section 1.409A-1(b)(1).

- For example, a partnership with a June 30 fiscal year end makes a guaranteed payment in July 2004 to a partner with a calendar taxable year. Under the 707(c) regulations, the partner would take such item into income in 2005, since that is the partner's taxable year in which ends the partnership's year in which the payment was made. Would such payment be considered deferred compensation under 409A of Preamble II.E?

## C. Section 409A (cont.)

- There is nothing in the 409A guidance to suggest that clawbacks, or the method of allocating items of income, gain, loss, deductions or credits among partners are subject to Section 409A.

## D. Section 751(b) Partnership Distributions

- Notice 2006-14 (the “Notice”) proposes a new method with respect to implementing Section 751(b). Section 751(b) was enacted to preclude the use of partnerships as a means for obtaining capital gain treatment on unrealized ordinary income and appreciated inventory through severing the income rights from the partnership interests.

# D. Section 751(b) (cont.)

## Hypothetical Sale Method

- The Notice states that the IRS is considering issuing regulations that would replace the exchange provisions of current Section 751(b) regulations with a hypothetical sale of only unrealized receivables approach (the “Hypothetical Sale Method”). The Hypothetical Sale Method would require partnerships and their partners to compare (i) the amount of ordinary income that the partnership would recognize if the partnership's hot assets (including distributed assets) were sold for fair market value in a taxable transaction before the distribution with (ii) amounts that would be recognized in such a transaction after the distribution. If the amount of ordinary income that would be allocated to any partner (whether or not the distributee) is not reduced as a result of the distribution, Section 751(b) would not apply.

## D. Section 751(b) (cont.)

- In addition, the Hypothetical Sale Method would incorporate rules on the preservation of a partner's pre-distribution share of hot assets similar to those of Section 704(c) which preserve a partner's pre-contribution share of gain or loss. The Hypothetical Sale Method coupled with Section 704(c) principles reduces the frequency and complexity of the application of Section 751(b) by eliminating the deemed exchange of hot assets for cold assets and by preserving a partner's historic interest in hot assets, to the maximum extent possible.

# D. Section 751(b) (cont.)

## EXAMPLE 1

ABC is an equal partnership in which each of the partners has an outside basis and capital account balance of \$120. ABC purchases land for \$210, which appreciates to \$360, and accrues \$90 of unrealized receivables.

### ASSETS

	<u>Basis / Book</u>	<u>FMV</u>
Cash	150	150
Land	210	300
Receivables	0	90

	<u>Capital Accounts</u>	
	<u>Tax/Book</u>	<u>FMV</u>
A	120	180
B	120	180
C	120	180

ABC distributes \$90 to C, which reduces C's interest from 1/3 to 1/5.

## D. Section 751(b) (cont.)

**Under the current Section 751(b) regulation, the following tax consequences occur:**

1. Hypothetical Distribution: C is deemed to receive a current distribution of “hot assets” in the amount by which its interest in such assets has been reduced (*i.e.*, \$15 of unrealized receivables).
  - a) C has no gain or loss and takes a transferred basis in the receivables of \$0. Section 732(a)(1).
  
2. Section 751(b) Exchange: C is deemed to transfer the receivables to ABC in exchange for \$15 of cash.
  - a) C has an ordinary gain of \$15. (Amount realized of \$15 minus \$0 basis). See Section 735(a).
  - b) ABC takes a \$15 basis in the receivables that it acquires from C.
  
3. Non-Section 751(b) Distribution: C receives \$75 in cash.
  - a) C recognizes no gain or loss. C’s basis in its partnership interest is reduced to \$45.

## D. Section 751(b) (cont.)

### Result

- C has current recognition of \$15 of ordinary income from the deemed exchange of hot assets, the unrealized receivables for cash (which is part of the cold assets). ABC will have \$75 of ordinary income when the \$90 in receivables are realized (\$90-\$15 basis). C will recognize an additional \$15 of ordinary income (1/5 of \$75) at that time.

# D. Section 751(b) (cont.)

**Under Notice 2006-14, the following tax consequences occur:**

ABC's assets are revalued and capital accounts are increased to reflect each partners' share of unrealized appreciation.

Pre-Distribution Capital Account

Assets	Basis	Value	Capital	Basis	Value
Cash	\$150	\$150	A	\$120	\$180
Unrealized Receivables	\$0	\$90	B	\$120	\$180
Land	\$210	\$300	C	\$120	\$180
Total	\$360	\$540		\$360	\$540

Post-Distribution Capital Account

Assets	Basis	Value	Capital	Basis	Value
Cash	\$60	\$60	A	\$120	\$180
Unrealized Receivables	\$0	\$90	B	\$120	\$180
Land	\$210	\$300	C	\$30	\$90
Total	\$270	\$450		\$270	\$450

## D. Section 751(b) (cont.)

- Section 704(c) principles would require the partnership to allocate C's \$30 share of appreciation in the unrealized receivables to C when recognized by the partnership. Section 751(b) would not apply because C's pre-distribution share of ordinary income is fully preserved in C's capital account. This result occurs because Section 704(c) principles require a re-evaluation of the assets of ABC and preserve the allocation of historic built-in gain or loss for each partner.

# D. Section 751(b) (cont.)

## Hot Asset Sale Approach

- The Notice contemplates the addition of a "hot asset sale approach" to the Hypothetical Sale Method. Under the "hot asset sale approach," Section 751 would apply only to distributions that reduce any partner's share of the net unrealized appreciation in the partnership's hot assets. Such partner, whether or not the distributee, would be treated as receiving the relinquished hot assets in a deemed distribution, selling to the partnership the relinquished share immediately after the distribution, and recognizing ordinary income from the deemed sale. Under this approach, there would be no deemed exchange of hot assets for cold assets, and the need to identify cold assets to be exchanged or to construct a deemed distribution of cold assets would be eliminated. This is a significant improvement in simplifying the application of Section 751(b) and is consistent with the purpose of Section 751(b) to prevent the conversion of ordinary income at the partnership level to capital gain at the partner level. Thus, the sole focus of the Treasury Regulations should be on the reduction of a partner's interest in the ordinary income of assets of the partnership.

# D. Section 751(b) (cont.)

## Example 2

- A, B and C are partners in a partnership that holds inventory and capital assets, each with a basis of \$0 and a FMV of \$150. A is fully redeemed by a distribution of 2/3 of the capital asset.

### ASSETS

	<u>Basis / Book</u>	<u>FMV</u>
Inventory	0	150
Capital Assets	0	150

	<u>Capital Accounts</u>	
	<u>Tax / Book</u>	<u>FMV</u>
A	0	100
B	0	100
C	0	100

## D. Section 751(b) (cont.)

### **Under the current Section 751(b) regulations, the following tax consequences occur:**

1. Hypothetical Distribution: C is deemed to receive a distribution of its share of the inventory (FMV of \$50). C takes a \$0 basis in the inventory.
2. Section 751(b) Exchange: C is deemed to transfer the inventory deemed distributed (FMV of \$50) to ABC in exchange for capital assets with a FMV of \$50.
  - a) C has an ordinary gain of \$50. (Amount realized of \$50 minus \$0 basis). See Section 735(a). C takes a \$50 FMV basis in the capital asset.
  - b) ABC has a capital gain of \$50 (which is divided between B and C). (ABC has received inventory with a FMV of \$50 in exchange for capital assets in which it had a basis of \$0). ABC's basis in the inventory received from C is \$50. ABC's aggregate basis in its inventory is \$50.
3. Non-Section 751(b) Distribution: C receives a distribution in liquidation of its partnership interest comprised of \$50 (FMV) of ABC's capital assets.
  - a) C takes a \$0 basis in the capital assets received in the liquidation. C has a built-in capital gain of \$50 in the assets received in the distribution.

## D. Section 751(b) (cont.)

### Result

- C has current ordinary gain of \$50 and built-in capital gain recognition of \$50. ABC has current capital gain of \$50, built-in capital gain of \$50 and built-in ordinary income of \$100 for the inventory.

## D. Section 751(b) (cont.)

### **Under Notice 2006-14, the following tax consequences occur:**

1. Hypothetical Distribution: C is deemed to receive its share of inventory (FMV of \$50). C takes a \$0 basis in the inventory.
2. Section 751(b) Sale: C is deemed to sell the inventory deemed distributed to it (FMV of \$50) to ABC in exchange for \$50 of cash. C is deemed to contribute the \$50 of cash back to ABC as a capital contribution.
  - a) C has an ordinary gain of \$50. C's deemed contribution of the \$50 cash gives it a basis of \$50 in its partnership interest and increases its capital account.
  - b) ABC has no gain and takes a \$50 FMV basis in the inventory.
3. Non-Section 751(b) Distribution: C receives an actual distribution of the \$100 (FMV) of capital assets in complete liquidation of its partnership interest.
  - a) C takes a \$50 basis in the capital asset (corresponding to C's \$50 basis in its partnership interest).
  - b) ABC has a basis of \$0 in its \$50 of remaining capital assets.

# D. Section 751(b) (cont.)

## Result

- C has current ordinary income recognition of \$50 and built-in capital gain of \$50. ABC has built-in capital gain of \$50 and built-in ordinary income of \$100. Since C's share of the ordinary income property has been reduced to zero, he is deemed to have sold that share to ABC. There is no exchange of cold assets.

	751(b)		2006-14	
	Ordinary Income	Capital Gain	Ordinary Income	Capital Gain
A	50 (built-in)	50 (25 built-in)	50 (built-in)	25 (built-in)
B	50 (built-in)	50 (25 built-in)	50 (built-in)	25 (built-in)
C	50	50 (built-in)	50	50 (built-in)

*Issue*

\$50 of capital gain recognition allocable to ABC has been eliminated from taxation. A and B would recognize only \$50 of capital gain, whereas their shares of the capital gain would have been \$100 if ABC had sold all of its capital assets.

## D. Section 751(b) (cont.)

### Example 3

- Same as Example 2 except that ABC fully redeems C by a distribution of the inventory.

# D. Section 751(b) (cont.)

## Under current 751(b) regulations, the following tax consequences occur:

1. Hypothetical Distribution: C is deemed to receive its share of capital assets (FMV of \$50).
  - a) C takes a basis of \$0 in the capital assets.
2. Section 751(b) Exchange: C is deemed to transfer the capital assets received in the deemed distribution (FMV of \$50) to ABC in exchange for \$50 FMV of inventory.
  - a) C has a capital gain of \$50 on the exchange. (Amount realized of \$50 minus \$0 of basis). See Section 735(a). C takes a FMV basis in the inventory.
  - b) ABC has an ordinary gain of \$50 (which is divided between A and B). (ABC has received \$50 of capital assets in exchange for \$50 of ordinary assets in which it had a basis of \$0).
3. Non-Section 751(b) Distribution: C receives a \$50 (FMV) distribution of inventory in complete liquidation of its partnership interest.
  - a) C takes a \$0 basis in the inventory. C has ordinary built-in gain of \$50 in the inventory.
  - b) ABC has no gain or loss on the distribution. Section 731(b).

## D. Section 751(b) (cont.)

### Result

- C has \$50 of current capital gain recognition and \$50 of built-in ordinary income gain. ABC has \$50 of current ordinary income recognition, \$50 of built-in ordinary income and \$100 of built-in capital gain.

# D. Section 751(b) (cont.)

## Under Notice 2006-14, the following tax consequences occur:

1. Hypothetical Distribution: Because only \$50 of inventory remain, A and B have reduced their respective shares of “hot assets” by \$25 each. ABC is deemed to distribute the relinquished share of “hot assets.” (\$50 of inventory in which it has a \$0 basis) to A and B equally and each is treated as each selling \$25 of the hot asset to the partnership. A and B would each recognize \$25 of ordinary income. ABC’s basis in the distributed portion of the inventory would increase to \$50.
2. Section 751(b) Sale: A and B are deemed to sell the inventory deemed distributed (\$25 FMV of inventory to each) to ABC in exchange for \$25 each of cash. A and B each contribute \$25 of cash back to ABC.
  - a) A and B each have ordinary gain of \$25. (Amount realized of \$25 minus \$0 basis). See Section 735(a).
  - b) ABC has no gain and takes a \$50 FMV basis in the inventory.
3. Non-Section 751(b) Distribution: C receives an actual distribution of the \$100 of inventory.
  - a) C takes a \$0 basis in the inventory. Section 732(b).
  - b) If the partnership has a 754 election in effect, its basis in its remaining inventory is increased from \$50. Section 732(b)

# D. Section 751(b) (cont.)

## Result

- C has built-in ordinary gain of \$100. ABC has current ordinary income recognition of \$50 and built-in capital gain of \$150.

	751(b)		2006-14	
	Ordinary Income	Capital Gain	Ordinary Income	Capital Gain
A	50 (built-in)	50 (25 built-in)	25	75 (built-in)
B	50 (built-in)	50 (25 built-in)	25	75 (built-in)
C	50 (built-in)	50	100 (built-in)	0

### *Issue*

\$50 of ordinary income taxation has been shifted from ABC to C and \$50 of capital gain taxation has been shifted from C to ABC. Since C is not deemed to have sold any ordinary income assets to ABC, C's basis in his partnership interest remains at zero and therefore limits his basis in the inventory to zero. This result could be corrected by causing C to recognize \$50 of capital gain which would increase his basis in the inventory to \$50.

# E. The Foreign Tax Credit and the Technical Taxpayer Rule (Proposed Regulation 1.901-2(f))

- The general rule is that tax is considered paid by the person who has legal liability under foreign law for the tax.
- Foreign law is considered to impose such legal liability on the person who is required to take such income into account for foreign tax purposes even if another person has a sole obligation to remit the tax.
- A hybrid entity treated as a partnership for U.S. tax purposes and a corporation for foreign law purposes is legally liable under foreign law for foreign income tax imposed on the income of the entity. The owner of an entity that is disregarded for U.S. purposes is considered to have legal liability for tax imposed on the entity. In the case of a reverse hybrid treated as a corporation for U.S. purposes and a pass-through entity for foreign law purposes, tax is considered to be imposed on the combined income of the person and such reverse hybrid.

## E. The Foreign Tax Credit (cont.)

- However, if foreign tax is imposed on the combined income of two or more persons, foreign law is considered to impose legal liability on each such person for the amount of the tax that is attributable to such person's portion of the combined income, as determined generally under Treas. Reg. 1.901-2(f)(2)(iv) and foreign law. Treas. Reg. 1.901-2(f)(2)(i).

## E. The Foreign Tax Credit (cont.)

- Thus, if a foreign partnership and a foreign partner pay tax to a foreign country on a combined basis, the partnership will only be deemed to have legal liability for the amount of tax that is allocable to its portion of the combined income, as determined under foreign law. The regulations provide that each person's portion of the combined income shall be determined by reference to any return, schedule or other document that must be filed or maintained with respect to a person showing such person's income for foreign tax purposes, or if none exists, from the books of account regularly maintained by or on behalf of the person for purposes of computing its taxable income under foreign law. Treas. Reg. 1.901-2(f)(2)(iv)(A).

## E. The Foreign Tax Credit (cont.)

- If a hybrid partnership's U.S. taxable year closes for all partners due to a Section 708 termination, then foreign tax paid or accrued by the partnership shall be allocated between the terminating partnership and the new partnership under the principles of Treas. Reg. 1.1502-76(b) based on the respective portions of the taxable income of the partnership, as determined under foreign law, for the foreign taxable year that are attributable to the period ending on and the period ending after the last day of the terminating partnership's U.S. taxable year.

## E. The Foreign Tax Credit (cont.)

- Similarly, if as a result of a change in ownership during a hybrid partnership's foreign taxable year, the hybrid partnership becomes a disregarded entity and the entity's foreign taxable year does not close, foreign tax paid or accrued by the disregarded entity shall be allocated between the hybrid partnership and the owner of the disregarded entity under the principles of Treas. Reg. 1.1502-76(b).

# E. The Foreign Tax Credit (cont.)

## Example 3, from Tax Reg. 1.901-2(f)(6)

- A, a U.S. person, owns a bond issued by C, a non-U.S. person. A enters into a repo agreement with B, a U.S. person, in which A, in form, sells the bond to B, but agrees to repurchase the bond in five years for the same amount. Under the agreement, B is obligated to make payments to A equal to the amount of any interest paid by C to B. Under foreign law, the transaction transfers legal title to B, but under U.S. law, A remains the legal owner of the bond. The example provides that B is considered legally liable for the country X tax on payments of interest from C to B, because B is considered the owner of the interest income for country X purposes, even though A and not B recognizes the interest income for U.S. tax purposes.

# E. The Foreign Tax Credit (cont.)

## Example 6, from Tax Reg. 1.901-2(f)(6)

- A, a U.S. person, owns 100% of B a foreign entity treated as a corporation under foreign law and as a disregarded entity under U.S. law. B owns 100% of two foreign subsidiaries, C and D. Under foreign law, C and D file on a combined basis but their income or loss is attributed to and treated as the income or loss of B, and B has the sole obligation to pay income tax imposed with respect to the income of B, C and D. In year 1, B has taxable income of 100, C has taxable income of 200 and D has a net loss of 60, and under foreign law, B is considered to have 240 of taxable income resulting in an income tax of 72.

# E. The Foreign Tax Credit (cont.)

## Example 6, from Tax Reg. 1.901-2(f)(6)

- Because foreign law does not provide mandatory rules for allocating D's loss between B and C, D's loss is allocated pro rata between B and C in proportion to their income (20 to B and 40 to C). The 72 of tax is allocated pro rata between B, C and D in proportion to their income (24 to B ( $72 \times 80 / 240$ ) and 48 to C ( $72 \times 160 / 240$ ) Under Treas. Reg. 1.901-2(f)(3)(ii), A is considered to have legal liability for the 24 of foreign tax allocated to B.
- This example effectively reverses the result of *Guardian Industries v. Comm'r.*, 65 Fed. Cl. 50 (2005) ( U.S parent formed foreign subparent to hold a number of Luxembourg subsidiaries and checked the box to have foreign subparent treated as disregarded entity, held, foreign subparent liable for foreign taxes of entire affiliated group.)

# E. The Foreign Tax Credit (cont.)

## Example 7, from Tax Reg. 1.901-2(f)(6)

- A, a U.S. corporation, owns 95% of the voting power and value of C, a foreign entity in country Z treated as a corporation for U.S. tax purposes, but as a partnership under foreign law. B, a U.S. corporation, owns the remaining 5% of C. C has 500 of taxable income and under foreign law, A and B are required to take into account their respective shares of the taxable income of C which are 475 and 25 respectively. In addition A has 125 of other taxable income attributable to a PE in country Z. Country Z imposes a 30% tax on A's taxable income of 600 and a 7.5 tax on B's taxable income.

## E. The Foreign Tax Credit (cont.)

- Under Treas. Reg. 1.901-2(f)(2)(iii), the 180 of tax imposed on A is considered to be imposed on the combined income of A and C and must be allocated between A and C on a pro rata basis. C is considered to be legally liable for the 142.5 of tax imposed on A's 475 share of C's income ( $180 \times 475/600$ ) and A is considered to be legally liable for the 47.5 of tax imposed on A's 125 of income from its permanent establishment.
- The 7.5 of tax imposed on B is considered to be imposed on the combined income of B and C. However, since B has no other income on which income tax is imposed by country Z, under Treas. Reg. 1.901-2 (f)(2)(iii), the entire amount of such tax is allocated to and considered paid by C. A but not B is eligible to claim deemed paid taxes under Section 902(a) with respect to dividends paid by C. Additionally, the payments by A and B of taxes considered to be the legal liability of C under this section will be considered to be capital contributions.

## F. Tax Treatment of a loan by a CFC to a related foreign partnership where one or more partners are U.S. shareholders of the CFC

- The preamble to the recently proposed regulations under Section 954(i) requests comments regarding the application of Section 956 in the case of a loan by a CFC to a foreign partnership in which one or more partners are U.S. shareholders of the CFC.

## F. Tax Treatment of Loan by CFC (cont.)

- Sections 951 and 956 generally require each U.S. shareholder of a CFC to include in gross income any increase in the amount of the CFC's earnings that was invested in U.S. property in a particular quarter, to the extent such earnings were not previously included in a U.S. shareholder's income under Section 951. For this purpose, U.S. property generally includes tangible property located in the U.S., stock of a domestic corporation, obligations of a U.S. person that is related to the CFC (including certain pledges and guarantees) and rights to certain intangibles.

# F. Tax Treatment of Loan by CFC (cont.)

- Where the obligation is issued by a foreign partnership, the obligation is not issued by a U.S. person if the partnership is viewed as an entity, and not as an aggregate of its partners.
- Section 956 is designed to prevent a CFC from effectively paying a dividend to a U.S. shareholder through an investment of earnings in U.S. property.

# F. Tax Treatment of Loan by CFC (cont.)

- NYSBA has suggested that the general rule should be that such a loan does not automatically create Subpart F income because the foreign partnership is respected as an entity, subject to the abuse provisions set forth below. Situations where Subpart F treatment may be appropriate include situations where:
  - (i) a U.S. shareholder that is a partner in the foreign partnership receives the loan proceeds;
  - (ii) the loan would be treated under general U.S. tax principles (conduit, etc.) as made to a U.S. partner of the foreign partnership; or
  - (iii) one of the principal purposes for creating, organizing or funding the foreign partnership was to avoid the application of Section 956 with respect to the CFC.

## G. FINAL REGULATIONS UNDER SECTION 752 (TREATMENT OF CERTAIN LIABILITIES)

- On October 10, 2006, the IRS issued final regulations concerning when a partner may be treated as bearing the economic risk of loss for a partnership liability based upon an obligation of a disregarded entity.
- In effect, the final regulations convert certain recourse debt obligations of disregarded entities into nonrecourse liabilities for purposes of applying Section 752, which affects the basis a partner has in its partnership interest.
- If a partnership has a disregarded entity as a partner, the owner of the disregarded entity is treated as bearing the economic risk of loss of such disregarded entity only to the extent of the “net value of the disregarded entity.”
- The “net value of the disregarded entity” is the fair market value of all of the disregarded entity’s assets that may be subject to creditor’s claims under local law less its obligations except for those obligations requiring it to make a payment to the partnership with respect to partnership liabilities for which the disregarded entity bears the economic risk of loss.

## G. FINAL REGULATIONS UNDER SECTION 752 (TREATMENT OF CERTAIN LIABILITIES) (cont.)

- In general, the regulations under Section 752 provide a presumption of deemed satisfaction for purposes of determining the extent to which a partner has a payment obligation and bears the economic risk of loss. In such case, the liability is treated as a recourse liability of the partner bearing the risk of loss and all of the liability is allocated to that partner. This increases the partner's basis in its partnership interest.
- In the preamble to the Final Regulations, the IRS and the Treasury Department state that “apply[ing] the presumption of deemed satisfaction to a disregarded entity that shields the federal tax partner from liability for the entity's obligation would, in many cases, cause partnership liabilities that are economically indistinguishable from nonrecourse liabilities to be classified as recourse for purposes of Section 752. Applying the presumption of deemed satisfaction to disregarded entities would distort the allocation of partnership liabilities in those cases.”

## H. FINAL REGULATIONS CONCERNING THE ALLOCATION OF CREDITABLE FOREIGN TAX EXPENDITURES

- On October 19, 2006, the IRS issued final regulations under Section 704 of the Code concerning the allocation of creditable foreign tax expenditures (“CFTEs”). In general, CFTEs are foreign taxes paid or accrued by a partnership and eligible for credit under Code Section 901(a). CFTEs generally exclude foreign taxes deemed paid by a corporate partner under Section 902 or 960.
- The final regulations generally provide that allocations of CFTEs must be in proportion to the distributive shares of income to which the CFTEs relate. The income to which a CFTE relates is the net income in the “CFTE category” to which the CFTE is allocated and apportioned. A CFTE category is a category of net income attributable to one or more activities of the partnership. A CFTE category’s net income is its net income for U.S. federal income tax purposes. Income from separate activities is included in the same CFTE category only if the net income from such activities are allocated among the partners in the same proportions. In general, CFTEs are allocated to a CFTE category if the income on which the CFTE is imposed is in the CFTE category.
- These regulations were implemented, in part, to address the IRS’s growing concern over disproportionate allocations of CFTEs which cannot have “substantial economic effect.” For example, in a partnership with both U.S. and foreign partners, allocation of the CFTEs to only the U.S. taxable partners would not have substantial economic effect. The after-tax economic consequences to a foreign partner whose share of the tax expense is borne by a U.S. taxable partner will be enhanced while the after-tax economic consequences to the U.S. taxable partner may not be substantially diminished because the CFTE allocation will probably result in increased allowable foreign tax credit that reduces the U.S. tax the partner would otherwise owe.
- Since the allocation of CFTE’s cannot have substantial economic effect, they must be allocated in accordance with the partners’ interests in the partnership.
- Distributive shares of income must be established for each CFTE category under U.S. federal income tax rules.

## II. RULINGS

- A. Rescissions That Change An Entity's Tax Status
- B. Timely Filed Tax Return Requirement
- C. Substance Over Form in the Partnership Context
- D. Meaning of Partnership Liabilities

# A. Rescissions Changing Entity's Tax Status

- In many situations, a taxpayer may wish to unwind a transaction that changed an entity's tax classification – *i.e.*, an incorporation of a partnership, or a transfer of an interest in a disregarded entity that creates a partnership. The effects of such a rescission are not always clear.

# A. Rescissions Changing Tax Status (cont.)

- PLR 200613027 addressed whether a corporation, formed through a statutory conversion, that converted back into an LLC taxable as a partnership would be treated as a taxable liquidation or whether the rescission would be respected. The corporation had effected a statutory conversion in anticipation of an IPO, which as a result of “precipitous and unexpected deterioration in market conditions” was cancelled. The parties wanted to revert to a more tax efficient partnership structure and filed a certificate of conversion with the state authorities.
- The letter ruling respects the rescission, and treats the entity as a partnership for the entire taxable year. A failed rescission would have resulted in a taxable liquidation by the corporation, causing gain at both the corporate and shareholder level, followed by a Section 721 contribution of assets to the partnership.

# A. Rescissions Changing Tax Status (cont.)

- The letter ruling follows the general rule of Rev. Rul. 80-58 and *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940), which holds that where a valid rescission has occurred within the same tax year as the year as the transaction that is sought to be rescinded, the initial transaction will be unwound as of the date of the original transaction. If the taxable year of the original transaction has already passed, a subsequent rescission will be treated as a separate event, and the rescission will have its own tax consequences as a second transaction.

# A. Rescissions Changing Tax Status (cont.)

- Rev. Rul. 80-58, which involved the rescission of a sale of real property, required the positions of the relative parties to be restored to the positions they would have been in if the sale had never happened. Similarly, one of the representations required of the taxpayer in PLR 200613027 is that the “legal and financial arrangements among all of the parties were identical in all material respects to such arrangements prior to” the incorporation. Yet under the facts of the ruling, members of the management team redeemed stock that they had received as employee compensation, and these transactions were not rescinded. This may be explained by the fact that the employees were not “parties” to the transaction.

# A. Rescissions Changing Tax Status (cont.)

- See also PLR 200533002 (revocation of an S election could be reversed by rescinding the issuance of a class of preferred stock to three limited partnerships that wished to invest in the corporation).

## B. Timely Filed Tax Return Requirement

*Swallows Holding Ltd. v. Commissioner*, 126 T.C. 96 (Jan. 2006). A foreign corporate taxpayer need only file a true and accurate tax return in order to claim deductions against its U.S. taxable income – Section 882(c)(2) does not require that such return be timely filed, and therefore the timely filed requirement of the applicable regulations (1.884-4(a)(2)) is invalid.

## C. Substance Over Form in Partnership Context

- The Second Circuit ruled that a subsidiary of General Electric Corporation failed to create a partnership with two Dutch banks because the banks' investment looked more like debt than equity. *TIFD III-E Inc. v. U.S.* (better known as “*Castle Harbour*”), (CA 2 8/3/2006) 98 AFTR 2d, 2006-5616.

## C. Substance Over Form (cont.)

- Facts: A unit of General Electric (TIFD III-E) created an LLC (Castle Harbour) that was treated as a partnership for federal income tax purposes with two Dutch banks as partners. GE contributed cash, 63 fully tax depreciated airplanes and rents due on the airplanes. The Dutch partners contributed \$67.5 million to Castle Harbour and purchased \$50 million of GE's interest in Castle Harbour, bringing the total Dutch contribution to \$117.5 million, representing 18% of Castle Harbour's capital. The partnership agreement allocated 98% of Castle Harbour's operating income to the Dutch partners and effectively guaranteed that over eight years, the Dutch partners' interests would be almost entirely redeemed by partnership income, giving the Dutch partners a 9% return on their investment with very little risk.

## C. Substance Over Form (cont.)

Since the aircraft were fully depreciated for tax purposes, the taxable income allocated to the Dutch banks was greater than their book allocation by the amount of book depreciation. (The Dutch partners were insensitive to this book/tax difference since they paid no US taxes.) The IRS challenged this transaction on three grounds. First, the IRS argued that the transaction should be disregarded as a sham. Second, the IRS argued that the Dutch banks were not really partners for tax purposes and should not be allocated any partnership income. Finally, the IRS argued that the partnership allocations violated the “overall tax effect” rule of Code Section 704(b).

## C. Substance Over Form (cont.)

- In reversing the trial court's decision, the Second Circuit invoked a debt v. equity analysis, essentially asking whether the Dutch banks were lenders or partners. Of significance to the Second Circuit's decision was the fact that the banks would earn a heavily guaranteed fixed return and receive their principal back, with little possibility of gain or loss.

## C. Substance Over Form (cont.)

- Some view the opinion as incorporating corporate debt/equity analysis into the partnership arena, and representing that such analysis applies to characterize equity as debt or debt as equity just as in the corporate context. However, at recent panels, members of the IRS Chief Counsel's office expressed their view that this was not a debt v. equity case. They believe it is possible to find that a nominal partner is not a partner for tax purposes without finding that partner to be a lender. Thus, this case is more about exercising caution when structuring transactions where the tax benefits depend on the existence of a tax partnership since the IRS and the courts can invoke broad doctrines, such as substance over form, the business purpose test or the economic substance test, to find either that an alleged partner is not a partner for tax purposes or that a tax partnership is lacking.

## D. COLM PRODUCER, INC. V. U.S.

- On October 16, 2006, the Texas district court held that a partnership's obligation to close a short sale was a liability for purposes of Section 752 of the Code.
- In this case, a partnership executed a short sale of \$100 million of U.S. Treasury Notes ("T-Notes") and sold the T-Notes for \$102.5 million. The partnership was then sold for approximately \$1.8 million and the partners claimed a loss of approximately \$102.7 million. The partnership did not factor the obligation to replace the borrowed T-Notes in its cost basis nor did it include its relief from that obligation in its amount realized on the sale.
- The IRS disallowed the loss and the Texas district court agreed. The court explained that the term "liability" is not defined for purposes of Section 752 of the Code and refers to the ordinary meaning of the term. Curiously, the court does not cite Treas. Reg. Sec. 1.752-1(a)(4) which includes the obligation to close a short sale (i.e., to replace the borrowed T-Notes).
- Thus, the obligation to close the short sale was a Section 752 liability, which the partnership should have included in its amount realized from the sale of the partnership.
- The court further explains that the obligation to close the short sale is not a contingent liability excludable under Section 752 because the obligation is legally enforceable under local law. Also, the amount of the obligation is not contingent because at the time of the sale of the partnership, the partnership could determine its gain or loss on the short sale based on current market rates for T-Notes.

# III. Legislative Developments

- A. Rules on FIRPTA Distributions by REITs Prior to TIPRA Amendments
- B. Recent Legislation on Distributions by REITs
- C. Comments on Legislation
- D. Relevant Expected Future Guidance Based on 2006 Priority Guidance Plan

# A. Rules Prior to TIPRA Amendments

- a. To the extent attributable to gain from the sale or exchange of USRPIs, Section 897(h)(1) treats a distribution by a REIT to a foreign shareholder, as a sale or exchange by the foreign shareholder of a USRPI. This rule does not apply to a distribution by a REIT if stock is regularly traded on an established securities market and if the foreign shareholder did not own more than 5 percent of the class of publicly-traded stock.

Thus, for non-publicly traded REITs, a distribution of proceeds attributable to gain from the sale or disposition of a USRPI produces effectively connected U.S. source income. This would require the foreign shareholder to file a U.S. Federal income tax return.

## A. Rules Prior to TIPRA Amendments (cont.)

- b. Treasury Reg. Section 1.1445-8(c) requires the REIT to withhold at the rate of 35 percent on the amount of any distribution designated by the REIT as a capital gain dividend, or the largest amount that could be designated as a capital gain dividend under Section 857(b)(3)(c). Thus, even if no capital gain dividend is designated, the REIT is deemed to have designated an amount as such.
- c. Under Treasury Reg. Section 1.1445-1(f), the withholding under Section 1445 does not excuse a foreign person that disposes of a USRPI from filing a U.S. tax return with respect to the disposition.

## A. Rules Prior to TIPRA Amendments (cont.)

- d. The capital gain dividend under Section 857(b)(3)(C) cannot exceed its earnings and profits, its net capital gain for the year, or its taxable income. Shareholders treat a capital gain dividend as a long-term capital gain. If no capital gain dividend is designated, Section 857(b)(3)(D) allows a REIT to retain the capital gain on which the shareholders are taxed. The shareholders are allowed a credit for the amount of tax paid by the REIT on the deemed distribution. Thus, only one level of tax is imposed on the undistributed capital gain dividend.

## A. Rules Prior to TIPRA Amendments (cont.)

- e. Under Section 897(h)(2), gain from the sale of a domestically controlled REIT is not subject to U.S. tax as a USRPI. This rule applies whether or not the REIT is publicly-traded. To be domestically controlled, the value of the REIT stock held directly or indirectly by foreign persons must be less than 50 percent during the testing period. The testing period is the shorter of the period during which the REIT was in existence, or the 5 year period ending on the date of the disposition or distribution.

## A. Rules Prior to TIPRA Amendments (cont.)

- f. The difference between the Federal income tax treatment of a sale of a domestically controlled REIT on which no U.S. tax may be imposed as opposed to a distribution by a REIT which can result in a 35% tax withholding by the REIT on the entire capital gain dividend has encouraged foreign shareholders to sell their REIT shares prior to the ex-dividend date of a distribution and repurchase those shares after the distribution has been made. This technique is designed to convert a taxable capital gain distribution to a non-taxable gain from the sale of shares. As described below, Section 875(h)(5), as added by TIPRA, addresses this fact pattern.

## B. Recent Legislation on Distributions by REITS

- Overview. The changes made by Section 506 of TIPRA to the REIT provisions of the Code were designed to accomplish three basic goals. First, the amendments to Section 897(h)(1) clarify that intermediate distributions by tiers of REITs or RICS of gains from sales or exchanges of USRPIs retain their character as being subject to FIRPTA. Second, the addition of Section 897(h)(5) prevents foreign shareholders of domestically controlled REITs from entering into wash sale transactions to convert what would be a taxable dividend distribution into a tax-free gain from the sale of REIT shares. Finally, Section 1445(e)(6) was added to the Code to ensure that withholding is required on a distribution by a REIT or a RIC to the extent the distribution is treated as attributable to gain from the sale or exchange of a USRPI. See Joint Explanation of H.R. 4297 at 290. Although Treasury Reg. Section 1.1445-8 currently requires withholding by REITs, the statutory authority for the Treasury regulation is not clear.

## B. Recent Legislation (cont.)

- Section 897(h)(1) was amended to clarify that a look-thru rule applies to all intermediate distributions by including any distributions by and to any qualified investment entity. A qualified investment entity includes a REIT, and a RIC without regard to the publicly-traded exceptions.

## B. Recent Legislation (cont.)

- Section 897(h)(5) provides in pertinent part:
  - Treatment of certain wash sale transactions. (A) In general. If an interest in a domestically controlled qualified investment entity is disposed of in an applicable wash sale transaction, the taxpayer shall, for purposes of this section, be treated as having gain from the sale or exchange of a United States real property interest in an amount equal to the portion of the distribution described in subparagraph b) with respect to such interest which, but for the disposition, would have been treated by the taxpayer as gain from the sale or exchange of a United States real property interest under paragraph (1).
  - (B) Applicable wash sales transaction. For purposes of this paragraph –
    - (i) In general. The term “applicable wash sales transaction” means any transaction (or series of transactions) under which a nonresident alien individual, foreign corporation, or qualified investment entity –
      - (I) disposes of an interest in a domestically controlled qualified investment entity during the 30-day period preceding the ex-dividend date of a distribution which is to be made with respect to the interest and any portion of which, but for the disposition, would have been treated by the taxpayer as gain from the sale or exchange of a United States real property interest under paragraph (1), and
      - (II) acquires, or enters into a contract or option to acquire, a substantially identical interest in such entity during the 61-day period beginning with the 1st day of the 30-day period described in subclause (I)...

## B. Recent Legislation (cont.)

- The taxpayer must both sell the stock within the 30 day period and acquire the stock within the 61 day period which in effect means 30 days after the ex-dividend date. Note that no gain is required to be actually recognized on the sale, and the amount of the gain to be included is measured solely by the amount of the dividend distribution which would have been taxable under Section 897(h)(1). Finally, exceptions are provided for publicly-traded REIT or RIC stock where the taxpayer actually receives the distribution. Section 897(h)(5)(B)(iii) – (iv).
- Section 897(h)(5) also applies to substitute dividend payments and other similar payments. Section 897(h)(5)(B)(ii).

## B. Recent Legislation (cont.)

- Section 1445(e)(6) (added to the Code by Section 506(b) of TIPRA) provides as follows:
  - Distributions by regulated investment companies and real estate investment trusts. If any portion of a distribution from a qualified investment entity (as defined in section 897(h)(4)) to a nonresident alien individual or a foreign corporation is treated under section 897(h)(1) as gain realized by such individual or corporation from the sale or exchange of a United States real property interest, the qualified investment entity shall deduct and withhold under subsection (a) a tax equal to 35 percent (or, to the extent provided in regulations, 15 percent (20 percent in the case of taxable years beginning after December 31, 2010)) of the amount so treated.

## C. Comments on Legislation

- Several reasons are given for the statutory addition to specifically require withholding on REIT distributions attributable to the sale of USRPIs at 35 percent or 15 percent, as provided by Treasury Regulations.

The legislative history indicates that taxpayers may be taking the position that distributions by lower-tier REITs to an upper-tier REIT are not FIRPTA income in the hands of the upper-tier REIT and, therefore, can be distributed by the upper-tier REIT to its foreign shareholders free of FIRPTA withholding. The theory is that the upper-tier REIT is not a foreign person. Also, the legislative history indicates foreign taxpayers have been selling REIT shares before the distribution and buying back stock of that REIT shortly after the distribution. If the REIT is domestically controlled, the gain on the sale of the REIT shares is not subject to U.S. tax. Joint Explanation of H.R. 4297 at 290.

## C. Comments on Legislation (cont.)

- The legislative history notes that Treasury Regulations under Section 1445 already require FIRPTA withholding on distributions by REITs. Treas. Reg. Section 1.1445-8. However, it adds that no inference is intended regarding the Treasury regulations already in force. Joint Explanation of HR 4297 at 293.

## C. Comments on Legislation (cont.)

- The effective date for the Section 1445(e)(6) is curious because it is effective for taxable years of the REIT beginning after December 31, 2005, except that no amount is required to be withheld under Code Sections 1441, 1442 or 1445 with respect to any distribution before 5-17-2006 if such amount was not otherwise required to be withheld under any such Section as in effect before such amendments. Section 505(d) of TIPRA. The effective date provision would appear to question the validity of Treas. Reg. Section 1.1445-8 requiring REITs to withhold 35% on any distribution designated (or deemed designated) as a capital gain dividend. This rule appears to apply even if the capital gain dividend is not attributable to the sale or disposition of a USRPI.

## C. Comments on Legislation (cont.)

- No Treasury regulations have been promulgated under Section 897(h)(1) requiring withholding. Section 897(h)(1) is the substantive Code provision treating a distribution attributable to gain from the sales or exchanges of USRPIs as gain recognized by the foreign shareholder from the sale or exchange of a USRPI. In addition, the look-thru rule of Section 897(h)(1) treats the REIT as a partnership rather than a special type of corporation which makes deductible dividend distributions from earnings and profits. Finally, Section 1445(e)(6) refers to Section 897(h)(1) for purposes of measuring the gain, but no guidance exists under Section 897(h)(1) for measuring such gain or determining what portion of the distribution is treated as attributable to FIRPTA gain.

## C. Comments on Legislation (cont.)

- At least one commentator in a recent article has argued that Treasury Regulations Section 1.1445-8 are not supported by the statutory authority of Section 1445 and that Section 1445(e)(6), as added by the TIPRA, is not self-executing. See, Blanchard, “Is There FIRPTA Tax on REIT Distributions”, Tax Notes, September 18, 2006. The commentator notes the conflict between the look-thru provision of Section 897(h)(1) which treats a REIT like a partnership and the withholding regulations which treat the REIT as a corporation with a deduction for dividends paid. In particular, the computation of a capital gain dividend under the existing withholding rules of Treas. Reg. Section 1.1445-8(c)(2)(ii) is not consistent with the measure of gain contemplated by Section 897(h)(1) which arguably requires a look-thru to the recognized gain on the sale or exchange of each USRPI.

## D. Relevant Expected Future Guidance Based On 2006 Priority Guidance Plan

- Partnership Anti-Mixing Bowl Regulations under Sections 704 and 737 addressing the tax consequences of distributions of property following partnership mergers.
- Final Regulations under Section 704(b) regarding the allocation of foreign tax credits.
- Final Regulations under Section 704(b)(2) regarding whether the partnership allocations have substantial economic effect.
- Final Regulations under Section 707 regarding disguised sales.
- Guidance under Section 707(c) regarding guaranteed payments.

## D. Relevant Expected Future Guidance (cont.)

- Final Regulations under Sections 721 and 83 for partnership equity issued in connection with the performance of services.
- Final Regulations under Section 721 for the tax treatment of noncompensatory options and convertible instruments issued by a partnership.
- Proposed Regulations under Section 751 regarding unrealized receivables and inventory items of a partnership.

## D. Relevant Expected Future Guidance (cont.)

- Final Regulations under Section 752 where a general partner is a DRE.
- Final Regulations regarding the application of Section 1045 to certain partnership transactions.
- Guidance under Sections 704, 743 and 755 regarding the disallowance of certain partnership loss transfers.