REPORT #600

TAX SECTION

New York State Bar Association

Report on the Temporary and Proposed Regulations
Under Sections 897(d) and (e) and certain
Related provisions

By the Committee on U.S. Activities of Foreign Taxpayers

January 16, 1989

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Tax REPORT #600

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January 17, 1989

Temporary and Proposed Regulations under
Sections 897td) and (el and Certain Related
Provisions

Dear Commissioner Gibbs:

I enclose our report on the Temporary and Proposed Regulations under Sections 897 (dl and (e) and certain related provisions. The report was prepared by our Committee on U.S. Activities of Foreign Taxpayers. The principal draftsman of the report was Stanley I. Katz. Jeffrey B. Samuels and Kenneth R. Silberqleit contributed to the drafting of certain sections. Harry Hives, Bob Kaplan, Edward A. Kotite, John E. McDermott, Kevin Rowe, Sidney Smolowitz, William Tatlock and Kirk W. Wallace participated in the preparation of the report. Helpful comments were also received from Arthur A. Feder and Lee S. Parker.

The report includes analysis and recommendations on: the definition of "non qualifying consideration" and the rules which should govern recognition of gain on receipt of such property in exchange for a U.S. real property interest ("USRPI”) ; the treatment of inbound reorganizations; certain Treaty related issues - particularly the treatment of Article XIII(9) of the U.S.-Canada Treaty; the rules governing recognition of gain and certain related matters in § 332 liquidations and certain § 355 distributions; the treatment of contributions of USRPI to partnerships; the treatment of stock of a "former USRPHC"; the application of § 1034 to non-resident aliens; the availability of the § 897(i) election; the rules governing when a class of interests is to be regarded as regularly publicly traded; and certain aspects of foreign - to-foreign transfers of USRPI.

The Tax Section of the New York State Bar Association hopes this report will be useful to you in preparing final regulations

Sincerely,

Herbert L. Camp

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Tax Report #600

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NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on the Temporary and Proposed Regulations under Sections 897(d) and (e) and Certain Related Provisions

by the Committee on U.S. Activities of Foreign Taxpayers

January 16, 1989

NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on the Temporary and Proposed Regulations under Sections 897(d) and (e) and Certain Related Provisions*

January 16, 1989

1. Introduction.

On May 5 , 1988 the Internal Revenue Service published Temporary and Proposed Regulations under §§897(d) and (e) of the Code. These regulations also include certain provisions under §367(e)(2), relating to distributions, after the repeal of General Utilities ("post-G.U. Repeal"), to a foreign 80% shareholder in a 5332 liquidation. The publication also included certain regulations under §897 (and conforming amendments to regulations under §1445) which relate to the treatment of certain partnership interests and amend the existing final §897 regulations with respect to the §897(i) election, aspects of the treatment of publicly traded interests in a domestic

* This report was drafted principally by Stanley I. Katz. Jeffrey B. Samuels and Kenneth R. Silbergleit contributed to the drafting of certain sections. Harry Hives, Bob Kaplan, Edward A. Kotite, John E. McDermott, Kevin Rowe, Sidney Smolowitz, William Tatlock and Kirk W. Wallace participated in the preparation of the report. Helpful comments were also received from Arthur A. Feder and Lee S. Parker.

corporation which is a United States real property holding corporation (a "USRPHC") and some ancillary definitions. This report comments on these regulations (the "Regulations").

The legislative history of FIRPTA, and the structure and language of the relevant Code sections, give substantial guidance as to when otherwise applicable non-recognition is to be denied or limited in the case of a foreign person's disposition of a United States real property interest ("USRPI"), The purpose of FIRPTA, as stated in the House Committee Report,[*] was:

> To establish equity of tax treatment in U.S. real property between foreign and domestic investors, The Committee does not intend by the provisions of Title IX to impose a penalty on foreign investors or to discourage foreign investors from investing in the United States.

The grant of regulatory power pursuant to which the §§897(d) and (e) regulations are issued is embodied in 5897(e)(2) which, in relevant part, provides:

The Secretary shall prescribe regulations (which are necessary or appropriate to prevent the avoidance of Federal income taxes) providing –

(A) The extent to which non-recognition provisions shall and shall not apply for purposes of this section....

[*] H. R. Rep. No. 1167, 96th Cong., 2d Sess. (1980).

We are concerned that, in some central respects, the Regulations would require recognition of gain by foreign taxpayers in circumstances in which, or to a degree to which, such recognition is neither necessary nor appropriate to preventing the avoidance of Federal income tax. Four such general instances may usefully be highlighted in this introduction, since they have a pervasive import on the Regulations.

First, where a foreign person exchanges a USRPI in a transaction which would otherwise qualify for non-recognition, the Regulations would permit non-recognition only if, or to the extent that, the property received in exchange is also a USRPI. The explicit wording of the Code would permit such non-recognition provided that the interest (whether or not a USRPI) received in exchange is subject to U.S, income taxation on a subsequent disposition, and the legislative history clearly states that, pending regulations, that general legislative rule was to prevail.

Second, as their general rule, the Regulations would treat such non-qualifying property received in exchange as "boot" (though, in certain specific instances, they would apply a more limited "proportionate recognition" rule). This rule would generally result in recognition of an amount of gain in excess of that which would be required to prevent the possible avoidance of Federal income taxes.

Third, the Regulations impose recognition on a foreign distributee in certain 5332 liquidations of, or 5355 distributions by, a USRPHC (or §897(i) electing foreign corporation) solely with respect to non-USRPI received in the distribution. This appears to be an attempt to tax the value of the stock of the distributing corporation attributable to non-USRPI. The rules adopted by the Regulations to implement this purpose would frequently result in a tax liability where no potential U.S. tax would be avoided were full non-recognition permitted, and they do result in a set of complex, ungeneralizable, and we think indefensible, rules of recognition with respect to certain §332 and §355 distributions.

Fourth, the Regulations would require recognition of gain by the distributing or transferor foreign corporation in certain §332 liquidations, §355 distributions, and inward reorganizations, essentially as a surrogate for shareholder tax on possible prior sales of the stock of that foreign corporation. Clearly, FIRPTA does not tax sales of stock of a foreign corporation. Use (particularly retroactive use) of the regulatory power to impose a surrogate tax on such sales is questionable. In our view, it is beyond question that the regulatory power should not be used to create recognition at the level of the distributing foreign corporation in the general case, when no potential tax liability is being avoided, on the grounds that in some such cases it might be justified as a surrogate tax for prior sales of stock of the foreign corporation,

A further troublesome feature of these Regulations is that they seem to have been devised with s mind almost exclusively to closely held entities and to businesses or investments consisting predominantly, or exclusively, of U.S. real property. While the principal concern of the Regulations must be preventing the avoidance of Federal income tax in such cases, more thought must be given to their potential effect on widely held entities, or on foreign owned U.S. businesses which include USRPI but not as the principal element of the business. Thus, for example, the four aspects highlighted above could have a particularly unfair effect where the entity is not closely held and/or the U.S. business is not primarily U.S. real estate, and the prospective limitation on availability of the §897(i) election is of particular concern once such broader effect is considered.

Section 2 of this report itemizes our main recommendations, Section 3 provides a more expanded analysis and discussion.

2. Summary of Recommendations,

2.1 General Rule for Exchanges.

The Regulations provide that a foreign person's exchange of a USRPI shall qualify for otherwise applicable non-recognition treatment only if the property received in exchange is also a USRPI. This is contrary-to the explicit wording of the Code, and its retroactive application is contrary to the explicit statement of the Conference Committee Report. Both retroactively and prospectively, the general rule should follow the Code in permitting non-recognition on an exchange of a USRPI for an interest the subsequent disposition would be subject to income tax under the Code (as by any treaty pursuant to sections 894 and 7852(d)).

2.2 Rule of Recognition on Receipt of Non-Qualifying Property.

We will use the term "Non-Qualifying Property" to refer to property which is received in exchange for a USRPI and which would qualify for non-recognition treatment but for the recognition required pursuant to §897(e)(l). In their general rule, the Regulations would treat Non-Qualifying Property received in exchange for a USRPI as "boot," together with any cash or property which is "boot" for purposes of the applicable general Code non-recognition provision. This treatment results in recognition of an amount of gain generally in excess of that which would be justifiable on the grounds of preventing possible avoidance of Federal income tax, or consistent with equitable treatment of United States and foreign investors. An alternative "proportionate recognition" of gain rule -- essentially requiring that the foreign transferor of the USRPI recognize a proportion of the gain realized on the transferred USRPI equal to the proportion of the fair market value of the Non-Qualifying Property received to the fair market value of the total property received in exchange -- appears sufficient to prevent the avoidance of Federal income tax, and is more consistent with equitable treatment of United States and foreign investors. The proportionate recognition rule should be adopted as the general rule governing recognition with respect to Non-Qualifying Property received in an exchange. (The regulations do adopt a "proportionate recognition" rule to determine the gain recognized by a distributee in a pre-General Utilities ("G.U.") Repeal 5332 liquidation of a corporation the stock of which is a USRPI. If such distributee recognition is to be required at all in final regulations, we think a "gain preservation" rule of recognition, applying Non-Qualifying Property first against distributor earnings and profits and distributee basis for its distributor stock would be more appropriate.)

2.3 Inbound Reorganizations.

On a reorganization of a foreign corporation into a USRPHC, the Regulations would override 5354 to require that the transferor foreign corporation recognize gain with respect to its actual, or deemed, distribution of the transferee USRPHC's stock, to the extent of any excess of its "inside" basis for such USRPHC stock over its distributee shareholders' "outside" basis for the stock with respect to which such USRPHC stock is distributed, (The transferee USRPHC's basis for its acquired property would be unaffected by this transferor recognition.) This would result in required recognition of gain notwithstanding the fact that full non-recognition would have allowed no tax avoidance possibility and that, subsequent to the reorganization, the transferor corporation's shareholders are more, not less, subject to the U.S. taxing jurisdiction.

For such inbound reorganizations post-G.U. Repeal, §354 should continue to apply without limitation to permit non-recognition to the transferor corporation. For such inbound reorganizations prior to G.U. Repeal: (a) recognition of gain by the transferor corporation should be required, if at all, only if the transferee USRPHC subsequently disposed of the transferred USRPI in a transaction to which pre-G.U. Repeal §§336 or 337 applied; and (b) the amount of gain the transferor corporation is required to recognize should be limited to the lesser of (x) the gain realized by such transferor corporation with respect to USRPI transferred to the transferee USRPHC, or (y) any excess of transferor's shareholders' allocable "outside" basis for their transferor stock over transferor's "inside" basis for the USRPHC stock distributed,

In our view, the regulatory power should not be used to attempt to impose recognition at the level of the transferor corporation in inbound reorganizations as a surrogate for United States tax on past sales or exchanges of its stock. If, nonetheless, the Treasury remains convinced that such a purpose is valid and can be implemented without overruling non-recognition in the general case, the recognition required should be carefully limited, in circumstances and amount, to only that appropriate to such "surrogate" taxation.

2.4 Treaty Protection.

A transferor's, transferee's, or distributee's qualification for the benefits of Article XIII(9) of the United States-Canada Income Tax Treaty should not be treated as a limitation of the extent to which the transferor, transferee or distributee is subject to United States taxation on a subsequent disposition of the property received. The Regulations should also explicitly provide that Reg. 51.897-6T(c)(3) does not apply to Article XIII(9).

2.5 Section 332 Liquidations.

We present, in 3.5.1 below, a table which, we think, shows that the provisions of the Regulations with respect to §332 liquidations are an uncoordinated set of rules which produce indefensible comparative results in the different cases.

2.5.1 Liquidations of USRPHCs or Electing Foreign Corporations.

The following general rule should be adopted. In the case of §332 liquidations of a USRPHC or a foreign corporation which has an effective §897(i) election, except as required under general Code provisions: (a) the liquidating corporation should recognize no gain with respect to USRPI distributed; (b) recognition by the liquidating corporation with respect to non-USRPI distributed should be limited to that required under §367(a), for pre-G.U. Repeal liquidations, and under §367(e)(2), for post-G.U. Repeal liquidations; and (c) there should be no distributee recognition.

2.5.2 Section §332 Liquidations of Foreign Corporations.

We question the justifiability of the special recognition rule of §1.897-5T(c)(2)(ii)(B) (essentially requiring the liquidating foreign corporation to recognize full gain on USRPI distributed if any "toll charge" would have been payable on a §897(i) election made at the time of adoption of the plan of liquidation). If such a rule is to be retained, the amount to be recognized by the liquidating corporation should be limited to the allocable part of the "toll charge."

The step transaction rules of general U.S. tax law should suffice to govern a transfer of stock of a foreign corporation to a domestic corporation under §351 or in a B-reorganization and subsequent §332 liquidation of the foreign corporation. If Reg, §1.897-5T(b)(3)(v) is intended to step the transactions in circumstances where the general step transaction rule would not do so, it raises problems where the transferors include U.S. persons and/or the property of the foreign corporation includes non-USRPI.

2.6 Section 355 Distributions by a USRPHC.

The proposed rule treating a foreign transferee as exchanging a proportionate part of its distributor stock when a USRPHC distributes stock of a foreign corporation or non-USRPHC should be dropped. The sole reason for this rule appears to be to immediately tax that part of the potential gain on distributor stock which may be attributable to non-USRPI as though the stock were sold. The business purpose requirements of §355, as supplemented by any regulations promulgated under §367(e)(1), should be sufficient to protect against a principal tax avoidance purpose.

2.7 Contributions of USRPI to a Partnership,

In general, no gain should be recognized by a foreign person on transfer of a USRPI to a partnership if, or to the extent that, the transferor's subsequent disposition of the partnership interest received in exchange would be subject to U.S. taxation (whether by reason of §897(g) or otherwise). Furthermore, such a transfer of USRPI to a partnership should generally qualify for non-recognition to the full extent provided by 5721. To prevent any possibility of the avoidance of U.S. federal income taxation, regulations under §897(g) should ensure that, on a sale or other taxable disposition of the partnership interest prior to the disposition by the partnership of the contributed USRPI, the foreign contributor partner would recognize, as gain subject to §897(a), the full amount of the gain that was inherent in the contributed property on the date of its contribution.

2.8 Treatment of Stock of a "Former USRPHC".

Regs. §§1.897-5T(b)(iv)(A), 1.897-6T(a)(4) and 1.897-6T(a)(l) distinguish stock of a "former USRPHC" from other USRPI. This distinction, and the resultant immediate recognition with respect to former USRPHC stock, may well be appropriate for purposes of applying §367(e)(2) to a domestic distributor in a post-G.U. Repeal §332 liquidation, provided that it applies to all such domestic distributors regardless of whether their stock is a USRPI. We think the general distinction, and resultant accelerated recognition, more questionable in the other cases - i.e,, in applying §§897(e)(l) and (2) to a foreign person's exchange (or deemed exchange) of a USRPI for stock of a former USRPHC in a transaction to which §§351, 362 or 355 applies. The rule adopted would accelerate recognition even if the USRPI given in exchange is stock of a former USRPHC. As the general rule, for purposes of such applications of 5 897(e)(l), it would be fairer, and more consistent with the exchange provisions of FIRPTA and these Regulations, to generally treat stock of a former USRPHC like other USRPI in determining whether immediate non-recognition applies, and to provide that where stock of a former USRPHC is received in such an exchange for a USRPI, it shall remain a USRPI in the hands of the exchanging foreign person for five years or, if less, the period for which the USRPI given in exchange would have remained a USRPI in its hands.

2.9 Section 1034 "Rollover" by a Non-Resident Alien ("NRA").

The rule which will, prospectively, deny non-recognition under 51034 to an outward move of a principal residence by an NRA is inconsistent with the existing law on a similar outward move by a resident alien who will subsequently cease to be resident. Further consideration should be given to whether such inequitable treatment is appropriate, particularly in light of the fact that, under the rules of §7701(b) determining when an alien present in the U . S . is a resident alien and when such residency terminates, its incidence would likely be relatively arbitrary and frequently dependent on whether or not the alien is guided by careful U.S. tax advice. If it is to be retained, regulations must ensure that an NRA is given a cost basis for his U.S. principal residence.

2.10 Section 897(i) Elections

The prospective limitation of the availability of the §897(i) election to a foreign corporation which would be a USRPHC were it domestic is, in our view, contrary to the statutory language, the legislative history, and the purpose of this election, The general availability of the election without any such limitation appears particularly important if certain other provisions -- e.g., limitation of qualifying consideration, or the general treatment of inbound reorganizations, are to be retained. We can see no clear justification for the proposed limitation and think that it should be withdrawn.

2.11 Publicly Traded Interests.

(i) It should be made clear (a) that Reg. 51.897-9T(d)(l) has no relevance to the determination of whether a class of interests is considered to be regularly traded on a domestic market, and (b) that any class of interests of a domestic corporation which is considered to be regularly traded on a domestic market will always be treated as regularly traded for purposes of any purchases and sales on a foreign market.

(ii) We can see no apparent rationale for Reg. §1.897-9T(d)(l)(ii)(B). Moreover, as proposed it appears difficult to implement or monitor. How could one ever know that a corporation does not fall afoul of the 50% ownership criterion of that paragraph?

(iii) In appropriate circumstances, it should be possible to seek and obtain a ruling pursuant to which, notwithstanding any provisions of 51.897-9T(d), a class of stock traded on a foreign exchange will be considered to be regularly traded.

(iv) The rule governing when interests in a domestic corporation traded on a domestic exchange will be considered to be regularly traded may need restatement since, in its present form, its terms appear applicable only to OTC trading.

2.12 Foreign-to-Foreign 5351 Transactions.

There appear to be good arguments for loosening the restrictions on the circumstances in which non-recognition will be accorded a transfer of a USRPI in a foreign-to-foreign 5351 transaction (or B reorganization). Consideration should be given to permitting: (i) non-recognition transfers of USRPIs other than stock of USRPHCs; (ii) some differences between the ownership of the USRPIAJSRPHC before the transfer and of the foreign corporation after the transfer; and (iii) some flexibility in transferring the stock of the foreign corporation between related entities during the three-year period following the §351 transaction (or B reorganization).

3. Discussion.

3.1 The General Rule for Exchanges.

The wording of section 897(e)(1) of the Code is clear and unambiguous:

> IN GENERAL. - Except to the extent otherwise provided in subsection (d) and paragraph (2) of this subsection, any non-recognition provisions shall apply for purposes of this section to a transaction only in the case of an exchange of a United States real property interest for an interest the sale of which would be subject to taxation under this chapter.

Had Congress intended to generally limit qualifying consideration to USRPI, as these Regulations do, it could, and would, have used the words "under this section" rather than "under this chapter." Moreover, the Conference Committee Report implicitly further emphasized this distinction by replacing language in the prior House Report which was ambiguous in this respect* with a clear statement of the intended meaning of "under this chapter."

> The Secretary would be authorized to prescribe regulations providing the extent to which non-recognition rules would, or would not, apply under the bill. Pending the issuance of these regulations, non-recognition provisions of the Code, would apply, but only in the case of an exchange of a United States real property interest for an interest the disposition of which would be taxable under the Code (as modified by any treaty pursuant to Sections 894 and 7852(d)).**

The wording of the Code section and the above explicit statement of the Conference Committee report establish that this rule governing the determination of the consideration that may be received in exchange for a USRPI without recognition of gain or loss may not retroactively be narrowed by regulation, Thus, for example, a foreign person with no treaty protection may not retroactively be rendered taxable, even in part, on a transfer of a USRPI to a partnership engaged in a trade or business in the United States if all gain on a subsequent disposition of

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* See: H. R. Rep,, supra, at 512.

** H. R. Conf. Rep, No. 1479, 96th Cong., 2d Sess. 188 (1980).

the partnership interest received in exchange would have been taxable as income effectively connected with a U.S. trade or business.

While the Treasury has the power to prospectively limit the range of qualifying consideration, we find it difficult to see how any such limitation could be justified as necessary or appropriate to preventing the avoidance of Federal income tax. This is particularly so given the substantial extension, in §864(c)(7), of the period for which gain on property held for use in a U.S. trade or business remains subject to U.S. Federal income taxation. If the Treasury is indeed concerned about any particular remaining avoidance possibilities, it should address them specifically. Subject to any such specific provisions, the general rule should remain that non-recognition shall apply to exchanges of a USRPI for an interest the sale of which would be subject to taxation under the Code.

3.2 The Rule Governing Recognition of Gain on Receipt of Non-Qualifying Property.

Pursuant to Reg, §1.897-6T(8), Non-Qualifying Property received in exchange for a USRPI would generally be treated as "boot." Gain with respect to the USRPI transferred would thus be recognized to the extent of allocable "boot," including

Non-Qualifying Property, received in the exchange.*

Consider the following example: A foreign person transfers a parcel of U.S. real estate with an adjusted basis of 600 and fair market value 1,000, in a 5351 transaction, to a new United States corporation for 500 of stock and a 500 long term note which qualifies as a security for purposes of 5351. The stock is a USRPI. Assume that the security, while generally meriting non-recognition treatment under United States tax law, would be an interest solely as a creditor and is not otherwise connected with the transferor's United States trade or business, Thus, it would not be subject to United States tax on a subsequent disposition and, accordingly, would be Non-Qualifying Property under any reasonable interpretation of §897(e)(l). The rule adopted would treat the security as "boot", resulting in recognition by the transferor of its full 400 gain realized. As shown below, this resultant gain recognition exceeds that required to prevent the foreign transferor's avoidance of U.S. income taxation and penalizes a foreign transferor relative to a U.S. person in like circumstances. The rule adopted in the Regulations is a "gain acceleration" rule.

* The statement of the rule in Reg. 51.897-6T(a)(8)(i) does not allow for the possibility that certain USRPI received -- e.g., convertible debt -- may, in certain cases, be "boot" under the applicable Code provision.

An alternative "gain preservation" rule would, initially, appear to better satisfy the two disiderata of continuing to permit non-recognition for transactions in which it is generally appropriate under United States tax law while preventing avoidance of United States taxation of gain inherent in the transferred USRPI, The amount of Non-Qualifying Property received would first be applied to reduce transferor's post-exchange basis for the USRPI received. Any excess over such basis of the amount of Non-Qualifying Property received would give rise to gain recognition. Thus, in the above example, no gain would be recognized on the exchange, and, thereafter, the transferor would hold the 500 USRPI received with 100 basis and the 500 securities received with full 500 basis. The transferee corporation would hold the transferred USRPI with a 600 carryover basis, In sum, the full gain inherent in the transferred USRPI would remain subject to U.S. tax at both transferor and transferee levels. We think that there is much to be said for such a rule. However, while it would preserve for U.S. taxation the full amount of the built-in gain on the transferred interest, it would not preclude a deferral of gain recognition by such a foreign transferor relative to a U.S, transferor in like circumstances, since the foreign transferor could subsequently dispose of the securities free of U.S. tax.

Compare the treatment of a U.S. transferor in like circumstances. After the exchange the U,S, transferor would hold the stock, worth 500, with 300 basis and the securities, worth 500, with 300 basis. A subsequent disposition of the securities would result in the recognition of 200 gain, and 200 of additional gain would remain to be recognized on a subsequent disposition of the stock.

A foreign transferor would be in the same position immediately after the exchange as a U.S. transferor after the non-recognition exchange and subsequent recognition of gain on disposition of the securities if a "proportionate recognition" rule were to be adopted. Such a rule would provide that a foreign transferor receiving Non-Qualifying Property in exchange for a USRPI is to recognize a proportion of the gain realized on the transfer of the USRPI equal to the ratio of the value of the Non-Qualifying Property received to the value of the total property received in exchange for such USRPI,[*] The amount of gain so recognized with respect to Non-Qualifying Property received is to be allocated to increase the post-exchange basis of such Non-Qualifying Property (as determined under 5358 without regard to

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[*] Equivalently, treat as "boot" the proportion of the Non-Qualifying Property received in exchange for a USRPI equal to the ratio of the gain realized on the transfer of the USRPI to the fair market value of that USRPI.

this provision) or, equivalently, the Non-Qualifying Property may be treated as "boot" for purposes of §358. In the above example, the foreign transferor would thus recognize 200 of gain and, after the exchange, would hold the USRPI, worth 500, with basis 300, and the securities, worth 500, with full 500 basis. No further gain would remain to be recognized on subsequent disposition of the securities, and 200 of gain would be recognized, and subject to U.S. tax, on subsequent sale of the stock. The transferor's position is identical to that of the U.S. transferor which has disposed of its securities. The rule allows no possibility of avoidance of U.S. Federal income tax,

This property of the "proportionate recognition" rule is general -- not an accident of the particular example.* Moreover, it generalizes directly to such a transaction in which both "boot" and Non-Qualifying Property are received in part exchange for the USRPI -- i.e., recognize that proportion

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* Let V denote the value of the USRPI transferred, B, its basis and N the value of the Non-Qualifying Property received. Under the general provisions of 5358 (without regard to any recognition pursuant to §897(e)(1)) the transferor's basis for the Non-Qualifying Property received is N x B/V. Thus, the gain which would be recognized on a subsequent disposition of the Non-Qualifying Property is equal to N(V - B)/V, which is a statement of the "proportionate recognition" rule. Where "boot" is received, the equivalent statement of both gain to be recognized with respect to the Non-Qualifying Property received and the "proportionate recognition" rule is N(V - B - boot)/(V - boot),

of any realized gain remaining unrecognized after boot is considered, equal to the ratio of the value of the Non-Qualifying Property to the value of the total property, excluding boot, received in exchange for the transferred USRPI,*

The present Regulations do adopt a "proportionate recognition" rule for purposes of determining the amount of gain recognized by a distributee foreign shareholder in certain 5332 liquidations and §355 distributions by USRPHCs (and certain other corporations). In the case of such §332 liquidations, the basis adjustment with respect to Non-Qualifying Property received by the foreign distribute does not work satisfactorily, since the transferee's basis with respect to the distributed property is a carryover, or modified carryover, basis, rather than a §358(a) transferred, or modified transferred, basis. If, indeed, such a requirement of distributee recognition in §332 liquidations is to be retained in final Regulations (we think it should not be -- see 3.5.1 below) a "gain preservation" rule of recognition might be more appropriate in those special cases. For §897(e)(l) in general, however, the "proportionate recognition" rule is the

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* Equivalently, treat as "boot" the proportion of the Non-Qualifying Property received equal to the ratio of (a) the gain realized less boot received, to (b) the value of the transferred USRPI less boot received.

appropriate rule. It prevents the deferral or avoidance of U.S, federal income tax and, to the maximum extent consistent with that requirement, preserves the non-recognition deemed appropriate under general U.S. tax law and equitable treatment of U.S. and foreign transferors of U.S. real property interests.

3.3 Inbound Reorganizations.

The treatment in these Regulations of inbound C, D and F Reorganizations of a foreign corporation (particularly Reg. 51,897-5T(c)(4) and examples there under) appears to have aroused more public comment than any other aspect of the Regulations (indeed probably more than all other aspects combined). These provisions are particularly important in light of the impetus given by Congress to domesticate a foreign corporation's United States business, in enacting the Branch Profits Tax and related provisions, The response is further attributable to the inappropriateness and inequity of the resulting recognition of gain in most, if not all, cases, and to the mechanistic nature of the underlying statutory analysis.

Consider the following examples:

> Example 1: In 1980 foreign shareholder(s1 ("FS") subscribed 300 for the stock of a foreign corporation ("FC"), which FC immediately used to purchase parcel P of U.S. real property. By the beginning of 1987, P has appreciated to a fair market value of 600. FS's basis for the FC stock remains 300, but FC's adjusted basis for P is

100, reflecting the depreciation deductions allowed with respect to P. In 1987, FC domesticates into domestic corporation DC, a USRPHC, to avoid Branch Tax.

Regardless of whether this domestication takes the form of a corporate continuance under U.S. State law, with no actual transfer or exchange of any sort by FC or FS, of an FS exchange of FC stock for DC stock followed by liquidation of FC into DC, or of an exchange by FC of its property for DC stock and a subsequent liquidation of FC, these Regulations (in accord with the Service's position published in Rev. Ruls. 87-66, 1987-2 C.B. 168 and 88-25, 1988-16 I.R.B. 8) would deem it to take the form of (i) a transfer by FC of all its property to DC in exchange for stock of DC, followed by (ii) a liquidating distribution by FC of its DC stock.

Pursuant to the Regulations, while the exchange by FC of P for USRPHC stock would be tax-free, under 55361 and 897(e)(l), FC would recognize 200 of gain on its distribution, or deemed distribution, of the transferee stock to its shareholders. Notwithstanding FC's recognition of gain, DC would hold P with a 100, carryover, basis. Under §358(a), FS would have a 300, transferred, basis for the DC stock received in exchange for its FC stock.

Thus, as a result of the inbound reorganization (which may have involved no more than a corporate continuance) FC has recognized 200 gain, the full pre-reorganization built in gain on P remains subject to U.S. corporate tax, and FS, previously not subject to U,S, tax on a disposition of its corporate stock, is now potentially subject to such tax, Moreover, in this example, FC's gain recognition is ultimately attributable solely to its permitted depreciation deductions, Indeed, in general, under these Regulations, a foreign corporation which has taken depreciation deductions with respect to its transferred property will seldom, if ever, be permitted non-recognition of gain realized on an inward reorganization, At Least some part of the amount recognized will generally be attributable to its depreciation.

> Example 2: FS has 300 basis for its FC stock. FC owns and operates a U.S. business which includes no USRPI. FC's basis for such U.S. business assets is 100 and the fair market value of the business is 600, (The relevant magnitudes are, thus, identical to those in Example 1.) FC's business is acquired by a new U.S. subsidiary of DC, the, non-publicly traded, parent of a U.S, consolidated group, solely in exchange for DC voting stock. DC is a 'USRPHC. FC liquidates, distributing the DC stock to FS, The transaction constitutes an inbound C Reorganization.

The result, under these Regulations, is identical to that in Example 1. FC recognizes 200 gain, DC takes a carryover basis in the acquired business properties and, after the transaction, FS is subject to U,S. tax on its acquired DC stock. While the example is, admittedly, an extreme case, it highlights three additional general points.

First, the amount of gain required to be recognized by the transferor corporation, pursuant to the Regulations, bears no necessary relationship to gain, if any> realized by such transferor with respect to USRPI transferred (or deemed transferred) to the domestic transferee in the inbound reorganization. In the extreme case, the transferor would be required to recognize gain even if no USRPI, or no appreciated USRPI, are transferred. In general, the gain subject to recognition would include all gain realized with respect to any appreciated non-USRPI transferred.[*]

Second, the example emphasizes that a §897(i) election may not be available as a possible remedy for such discriminatory taxation. In the extreme case, it would not be available because the transferor owned no USRPI. More commonly, it might not be available because there is no applicable treaty or, under these Regulations, because the

[*] If FC is a Canadian corporation, it should be protected from U.S. taxation of such gain realized with respect to transferred non-USRPI, under the Business Profits and non-discrimination provisions of the current, post-FIRPTA, U.S.-Canada treaty. It may be arguable that, notwithstanding the general FIRPTA override of treaties, similar protection should continue to apply under the corresponding provisions of other treaties, at least where the transferor has no actual, even transitory, ownership of the DC stock.

transferor foreign corporation, were it domestic, would not be a USRPHC.

Third, the example emphasizes that the substance of any inbound reorganization is two exchanges: (i) a transfer of FC's properties to DCI which may appropriately be viewed as an exchange of such properties for DC stock (and any other relevant property) and (ii) an inward exchange by FS of its FC stock for stock of DC (and, where relevant, other property). The shareholder exchange is generally not subject to U,S. tax (other than possible dividend taxation with respect to "boot" received) if the shareholder is foreign, since it involves no disposition of property subject to U.S. taxation. In the case of a U.S. shareholder, that exchange is governed by 5354. The actual or deemed exchange by FC of its properties can have tax import under §357(c) and it is probably appropriate that it should continue to be given effect for purposes of applying §897(e)(l). Contrary to the substance of an inbound reorganization as two such exchanges, the Regulations (following the earlier analysis of Rev. Rul. 87-66, 1987-2 C.B. 168) give determinative import to the transitory ownership (or deemed ownership) of DC stock by FC, and its deemed distribution of that stock, events which have no economic significance and no analytical significance in other current applications of the relevant reorganization provisions, We do not think that, absent regulations, the applicable statutory provisions would compel such recognition of gain by the reorganizing foreign corporation. First, FC's transitory ownership, and distribution, of USRPHC stock may be solely the result of Revenue Rulings (which, so far as we are aware, simply provide that inbound reorganizations will be so recast, without further reason or justification). Second, assuming that such transitory ownership is actual, or that the recasting is compelled, it is questionable whether 5§897(d)(l) and (2) apply to the subsequent distribution, or deemed distribution, of that stock. Applicability of §897(d) is not compelled by the statutory language, which refers to a "distribution (including a distribution in liquidation or redemption)", and the clear (albeit implicit) purpose of §§897(d)(l) and (2) -- to override distributor non-recognition in circumstances where failure to do so would result in the removal from the U,S. taxing jurisdiction of built-in gain on the distributed USRPI -- strongly suggests that §897(d) should not be read to apply in an inbound reorganization in which, given full non-recognition, all the built-in gain on USRPI previously owned and transferred by the transferor FC would remain fully subject to U.S. taxation, Third, even if §897(d) is potentially applicable to such reorganizations, it is surely within the scope of the Service's ruling authority to determine that it does not apply in the case of a transitory ownership and distribution which has no economic significance. Finally, even if the relevant statutory provisions lead inexorably to the conclusion that the transferor corporation recognizes gain, regulations should override such required recognition and continue to permit non-recognition if, and to the extent that, such non-recognition would allow no tax avoidance possibilities.

In the two examples presented above, full non-recognition would permit no tax avoidance possibility. All gain on USRPI transferred by FC would remain fully subject to tax in the hands of the transferee domestic corporation and, in addition, as a result of the reorganization, FS's gain on its stock is rendered subject to U.S. taxation under §897(a)

We are aware of two grounds (absent in our above examples) upon which it has been argued that the gain recognition imposed by the Regulations is justifiable as necessary or appropriate to prevent the possible avoidance of U.S. federal income taxation.

If, before GU Repeal, FC transferred appreciated USRPI to DC in an inbound reorganization, DC might, thereafter, have disposed of such transferred USRPI in a liquidation qualifying under pre-GU Repeal 5337, In that case, the gain subject to U.S. tax would have been limited to FS's gain recognized with respect to its DC stock, and the post-liquidation owner of of the USRPI would hold that USRPI with a stepped-up basis. U,S. taxation of any excess of FC's gain realized on its inward transfer of the appreciated USRPI over FS's gain subsequently recognized with respect to the transferee stock would have been permanently avoided. The point is well taken. However, it does not justify the general requirement of recognition imposed by the Regulations, even for such a pre-GU Repeal inbound reorganization. First, as emphasized by our Example 2 above, the potential tax avoidance would be limited to any excess of gain realized by FC with respect to USRPI transferred over FS's potential gain on the transferee stock. A corresponding limitation should be imposed on any FC gain recognition required by the Regulations. Second, the tax avoidance possibility raised is essentially that resulting from the possibility that a U.S. transferee or distributee of a USRPI may, in the relevant sense, not be subject to taxation on a subsequent disposition of that USRPI because of the availability of pre-GU Repeal §336 or §337. That possibility is addressed in Reg, 51.897-5T(d)(l), which, in substance, provides that the foreign distributor shall not be required to recognize gain for this reason unless the U.S. distribute subsequently disposed of the transferred USRPI in a transaction to which pre-GU Repeal 53336 or 337 applied. There appears no good reason why a similar provision should not apply to pre-GU Repeal inbound reorganizations.

We understand that the Treasury may take the view that there is a second, more general, justification for the exercise of the regulatory power to require transferor recognition in an inbound reorganization - viz. that such recognition is appropriate if, and to the extent that, the excess of FS's outside basis for FC stock over FC's inside basis for its USRPI is attributable to a step up of that shareholder basis resulting from foreign persons' past sales of FC stock which would have been subject to U.S. taxation had FC been domestic. The corporate tax so imposed by regulation would thus serve as a surrogate for U.S. tax on such past shareholder sales,

We find it difficult to understand how a foreign person's sale of the stock of a foreign corporation, which is explicitly outside the scope of FIRPTA, can be regarded as the "avoidance" of U.S, Federal income tax. The U.S. has explicitly limited its taxing jurisdiction under FIRPTA to USRPI, including stock of certain U.S. corporations and certain electing foreign corporations, but excluding stock of foreign corporations. (Furthermore, in the case of Canada, it has negotiated and concluded a post-FIRPTA treaty which explicitly precludes U.S. taxation of sales of stock of a Canadian corporation.) This explicit limitation of the scope of FIRPTA both cedes sole taxing jurisdiction with respect to such sales of foreign corporation stock to the country of residence of the shareholder or corporation and provides one consideration which, together with others, such as foreign taxation, limits of U.S. estate and gift taxation and the economics of selling corporate stock rather than the underlying property (including the likely discount on such stock sales) legitimately determine the economic decisions of both sellers and purchasers. We think it questionable to attempt to impose by regulation an indirect, surrogate, tax with respect to such prior stock sales that FIRPTA would not tax directly, to be borne by subsequent owners of the stock (and, possibly, by many shareholders who have long held their stock without sale or exchange). It is particularly questionable to do so retroactively, with respect to prior transfers of the foreign corporation stock which seller, purchaser (and continuing shareholders) had every reason to believe would have no U.S. tax consequences.

An alternative formulation of this reason for requiring corporate transferor recognition by regulation might, initially, appear more appealing. This justification would be by reference to the §897(i) election. Congress provided the §897(i) election as the sole remedy to a foreign treaty country resident against the contravention by FIRPTA of the applicable treaty non-discrimination provisions. Under the regulations governing §897(i), payment is required on election of an amount equal to the U.S. tax, if any, that would have been payable had the electing foreign corporation been domestic, on foreign persons' sales of the electing corporation's stock within the shortest of three prior time periods specified in such regulation, (For convenience, we have previously referred to this payment as the §897(i) "toll charge" and shall continue to do so herein.) The argument would thus be that, since such a toll charge is required if a foreign corporation is to be allowed FIRPTA treatment as a domestic corporation, no form of domestication of a foreign corporation should be permitted on terms more favorable than the §897(i) election,

We think such an argument misconceived and unpersuasive. First, it ignores the particular reason for the absolute necessity of the §897(i) "toll charge". The main reason was that, absent such a toll charge, the election could have been used, prior to G.U. Repeal, to "drive a coach and horses" through FIRPTA. The foreign corporation stock would be sold, after which the election would be made and the electing corporation be liquidated under §336 or §337, so providing total avoidance of U,S. taxation and a full step up of the appreciated USRPI to the purchaser. Thus the toll charge, and the renouncing of shareholder treaty protection, was absolutely necessary. It may well be that even absent that necessity the toll charge would have been imposed on the grounds that non-discriminatory treatment under FIRPTA of a foreign corporation relative to a U.S. corporation required equivalent FIRPTA treatment of the corporation and its shareholders from the time that the corporation first acquired USRPI (though this reason would not be fully consistent with the limited lookback period, the requirement that shareholder treaty protection be renounced, and the fact that the election does not have retroactive effect with respect to prior USRPI transfers by the electing corporation). Second, the §897(i) toll charge is elective -- every shareholder must consent. The charge is not necessarily levied on the foreign corporation -- indeed the regulations explicitly provide for a step-up in basis for a present shareholder's payment with respect to the charge. Where the charge is borne by the corporation, it could generally only be so with the consent of all its shareholders. The proposed surrogate corporate tax, by contrast, would be borne indiscriminately by all shareholders, without consent. Third, while domestication of a foreign corporation of necessity ensures subsequent treatment as domestic for purposes of FIRPTA, it carries with it the entire panoply of the other consequences of domestication, including foreign tax consequences, and all U.S. income, estate, and gift tax consequences. It is simply not analogous to an election to have a foreign corporation treated equivalently to a domestic corporation for the limited purposes of FIRPTA. Finally, it would be anomalous indeed if the §897(i) election, provided by Congress as a remedy to treaty residents for the discriminatory consequences of the FIRPTA statute as enacted, became a reason for imposing, by regulation, further discriminatory treatment on a domesticating foreign corporation which is not required by the statute and not justifiable by reason of any possible avoidance of the tax imposed by the statute.

In sum, in our view, provided that the possibility of tax avoidance by means of a pre-G.U. Repeal domestication is precluded, an inbound reorganization allows no possibility of tax avoidance and the Regulations should, accordingly, permit full non recognition.

Even if the Treasury continues to believe that surrogate taxation of prior sales of stock of the foreign transferor is a valid purpose of regulation under §§897(d) and (e), it must be clear that the corporate transferor recognition imposed in these Regulations is indiscriminate and ill fitted to implementing that purpose. As shown earlier, the Regulations would require recognition of gain attributable to depreciation, and to any appreciated non-USRPI transferred, regardless of whether any relevant prior stock sales occurred. (Similarly, such recognition could be attributable to prior dividend distributions on which the shareholders were subject to U.S. tax.) Furthermore, these Regulations would impose, or increase, corporate gain recognition, in situations where the shareholder basis is stepped up by events or transactions which would have given rise to no U.S. tax had the foreign corporation been domestic and/or to no toll charge had it made a §897(i) election--e.g. step-up on death of a shareholder, pre-FIRPTA sales, sales prior to the "toll charge" look back period, sales of stock of an FC which would not be a USRPHC were it domestic, and any sales by U.S. shareholders which may already have been taxed.

3.4 Treaty protection.

3.4.l Article XIII(9) of the U.S,-Canada Treaty.

Pursuant to Regs. 551.897-5T(d)(2) and1.897-6T(a)(9), the provisions of Article XIII(9) of the U.S.-Canada Treaty ("Paragraph 9") are to be given effect in limiting the gain recognized pursuant to 5897 and regulations there under. However, Paragraph 9 is also explicitly cited, in Reg. §1.897-5T(d)(l) as the example of a treaty provision which reduces, but does not entirely eliminate, U.S. taxation of gain on a subsequent disposition. (So far as we are aware, it is the only provision of any U.S. treaty which could have this effect.) By reason of this latter Regulation, a Canadian person which, in a transaction which would otherwise qualify for full non-recognition, exchanges a USRPI solely for a USRPI with respect to which it would qualify for Paragraph 9 protection on a subsequent disposition, or distributes a USRPI to a Canadian distributee which will qualify for Paragraph 9 protection on a subsequent disposition, would be required to recognize a portion of the gain realized on the USRPI exchanged or distributed.

The Regulations give no indication of why such recognition should be required. It appears entirely inappropriate, since no possible avoidance of U,S. tax could result were full non-recognition permitted. Essentially this is because the exchanging person, or distributee, can qualify for the protection of Paragraph 9 on a subsequent disposition of the property received only if, and to the extent that, in the case of an exchange of a USRPI, such exchanging person qualified for such protection with respect to the interest transferred, or in the case of a distribution, the Canadian distributor qualified for such protection with respect to the interest distributed. The partial recognition required by the Regulations thus requires that a qualifying Canadian transferor or distributor recognize gain in circumstances in which a foreign person with no treaty protection would incur no recognition, notwithstanding the fact that allowing non-recognition to the Canadian transferor or distributor would permit no avoidance of U.S. taxation. Not only is such a protected Canadian person's recognition of gain thus unjustifiably accelerated, but in many, if not all, cases the overall effect would be to deny some part of the limitation of U.S. taxation of gain accorded by Paragraph 9 -- i,e., the gain subjected to U.S. tax on the exchange or distribution plus the gain so taxable on a subsequent disposition would exceed the amount of the gain subject to U,S. tax pursuant to Paragraph 9 if the interest distributed or exchanged were instead initially sold in a fully taxable transaction. The remainder of this section substantiates and illustrates these points.

In general, Paragraph 9 limits the U.S. taxation of a Canadian resident's gain on an alienation of a USRPI which (a)

Is a capital asset, (b) was not part of the business property of a U.S. permanent establishment at September 26, 1980, and (c) which, on or after September 26, 1980, was owned only by Canadian residents and was transferred, if at all, only in "non-recognition transactions. " For this purpose, a non-recognition transaction includes any transaction which, without regard to §§897(d) and (el of the Code, would qualify as a non-recognition transaction under the Code. The effect of Paragraph 9, as stated in the treaty, is that:

> The amount of the gain which is liable to tax in the [U.S] in accordance with this Article shall be reduced by the proportion of the gain attributable on a monthly basis to the period ending December 31 [I9841 or such greater portion of the gain as is shown to the satisfaction of the [U.S.] competent authorities to be reasonably attributable to that period.

The Treasury Department's technical explanation of the treaty[*] (the "Technical Explanation") includes an expansive treatment of Paragraph 9 which, inter alia: (a) states that Paragraph 9 will apply to transactions notwithstanding section 1125(c) of FIRPTA; and (b)explicitly provides that "the amount of gain which is reduced by reason of the application of Paragraph 9 is not to be treated for U.S. tax purposes as an

[*] Treasury Department technical explanation of the Convention Between the United States of America and Canada With Respect to Taxes signed on September 26, 1980 as amended by protocols signed on June 14, 1983 and March 28, 1984.

amount of 'non taxed gain' under section 1125(d)(2)(B) of FIRPTA where that section would otherwise apply."

Consider the following examples. In each case, the Canadian resident owning the USRPI at the start of the transaction described purchased it on December 31, 1979, held it continuously since that date and transfers it, in the relevant transaction on December 31, 1987. The transferring Canadian resident qualifies for the protection of Paragraph 9 with respect to its disposition. The value of the USRPI at the time of disposition, is 900 and the initial transferor's adjusted tax basis for it is 100. (We assume that the transferor cannot, or does not, establish a December 31, 1984 value ("fresh start basis") in excess of that which would result under the proration of gain rule of the treaty.)

> Example 1: The Canadian resident owning the USRPI is a wholly-owned Canadian subsidiary ("CanSub") of a Canadian corporation ("Parent") It distributes the USRPI to Parent in a 5332 liquidation.

This is Example 4 of the Technical Explanation. Paragraph 9 applies to CanSub1s distribution, and therefore to Parent's subsequent disposition. Parent succeeds to CanSub1s holding period for Paragraph 9 purposes so that, under the Regulations, only 3/8 of the distributed property will be treated as subject to U.S. taxation on a subsequent disposition by Parent. Thus, CanSub would be required to recognize 5/8 of the gain realized on the distributed USRPI. Given the applicability of Paragraph 9, 187,5 (i.e. 3/8 x 5/8 x 800) of CanSub's gain realized would be taxed. Pursuant to Reg. §1.897-5T(c)(l), which limits the step-up in basis to distributor's gain recognized "(and subject to U.S. income taxation)," Parent's basis on a subsequent disposition would be 287.5. Thus, on an immediate subsequent sale, the U.S. would tax a further 230 of gain. Overall, the U.S. would have taxed 517.5 of gain, in contrast to the 300 so taxable had CanSub simply sold its property in a taxable sale. Had CanSub been permitted full non-recognition, Parent's gain subject to U.S. tax on a subsequent sale would have been the full 300. No tax avoidance could have resulted from full non-recognition on the distribution.

In this case, the overall result -- U.S. taxation of gain in excess of that permitted under Paragraph 9 -- is a necessary result of the limitation of distributee's basis by Reg. §1.897-5T(c)(l). There appears no justifiable reason for this limitation, Moreover, it directly contravenes the explicit statement in the Technical Explanation that the amount of gain reduced by reason of Paragraph 9 is not to be treated for U.S. tax purposes as "non-taxed gain" under Section 1125(d)(2)(B) of FIRPTA. Even assuming that distributee's basis were not so restricted by the Regulations, the required partial recognition of gain by a distributor or transferor might still give rise to overall recognition in excess of that permitted under Paragraph 9 on a single taxable disposition. This is true not only in the case of the §332 distribution discussed in this example, but in the case of all the distributions and exchanges to which such partial recognition might apply by reason of Paragraph 9 protection on a subsequent disposition, Further detailed analysis of why this is so is beyond the scope of this report - essentially it is because it is by no means clear that the interaction of application of Paragraph 9 to a partial recognition transaction and the Code provisions determining basis will be such as to result in the appropriate post-partial-recognition basis.*

> Example 2: The Canadian resident, C, transfers the USRPI to a new U,S, corporation, which is a USRPHC, in a §351 transfer solely in exchange for stock of the transferee.

This is Example 3 in the Technical Explanation. If permitted full non-recognition, C's gain subject to U.S. tax on an immediate subsequent disposition of the USRPHC stock would be identical to that which would have been subject to U.S. tax

* The underlying issues are whether Paragraph 9 applies to limit gain realized or recognized, and how provisions of the Code then apply to determine the post-recognition Basis. Determinative resolution of these issues remains for treaty regulations, or appropriate rulings,

if it had sold the transferred USRPI in a taxable sale. The U.S. transferee would have a 100 carryover basis for the transferred USRPI and would be subject to U.S. taxation on the full 800 potential gain without regard to Paragraph 9, Notwithstanding, the Regulations would treat 562.5 of the USRPHC stock received as boot and 211 of gain recognized would be taxed. Gain recognition is clearly accelerated, without any possible justification by reason of potential tax avoidance had full non-recognition been permitted. (If transferor's basis for the stock received is less than 662.5, the accelerated partial recognition would again result in overall U.S. taxation, on the exchange and subsequent disposition, in excess of that permitted by Paragraph 9 on a single taxable disposition.)

> Example 3: C is a Canadian corporation which domesticates into a USRPHC by corporate continuance or D reorganization,

In this case, notwithstanding the fact that the domestic transferee is fully taxable on a subsequent disposition of the property, C would, under these Regulations, be twice required to partially recognize gain realized -- once on its exchange, or deemed exchange, for USRPHC stock which is not fully subject to U.S. taxation on a subsequent disposition and again on the actual or deemed distribution of that stock. (Furthermore, such partial recognition on the latter distribution would not be limited by excess of shareholder "outside" over transferor "inside" basis,) This, notwithstanding the fact that given full non-recognition, the domestic transferee would be fully subject to U.S. tax, without reference to Paragraph 9, and C's shareholders would be entitled to Paragraph 9 protection only with respect to the same proportion of gain on the transferee stock as C was entitled to with respect to its transferred USRPI.

Example 4: C is an Ontario corporation which is continued under the Canadian federal statute.

Absent Paragraph 9, this transaction would qualify for full non-recognition under Reg, §1,897-6T(b), In this case, if Paragraph 9 applies to C's deemed transfer, it is not clear whether non-recognition is available in any part. If it is available at all, the Regulations would require recognition of gain with respect to 5/8 of the property deemed transferred, notwithstanding the fact that essentially nothing has happened which could reasonably be regarded as having any U.S. tax relevance.

In Conclusion:

(i) Qualification for the protection afforded by Paragraph 9 should not be treated as a reduction, restriction, or limitation of the extent to which a disposition is, or a subsequent disposition would be, subject to U.S. income taxation for any purposes of §§897(d) and (e) or regulations thereunder.

(ii) Reg. §1.897-6T(c)(3), which implements Section 1125(d)(2)(B) of FIRPTA, should be amended to explicitly provide that it does not apply to a reduction of gain subject to U.S. tax pursuant to Paragraph 9. This exclusion is mandated by the explicit provision to that effect in the Technical Explanation.

3.4.2 Other Treaty Issues.

(i) It is not clear that there is any statutory or other authority for limiting to Articles XIII(9) and XXX(5) (as is done in Regs. §§1.897-5T(d)(2) and -6T(a)(9)) the provisions of the new Canadian Treaty which shall have effect for purposes of §§897(d) and (e) and regulations thereunder.

(ii)A treaty issue is raised by Reg, 1.897-5T(a)(3)(iv)(B), relating to §332 liquidations of an electing foreign corporation (See P.52 below).

3.5 Section 332 Liquidations.

The chart on the next page schematically displays the rules in the Regulations governing §332 liquidations, These are complex, defy generalization, and produce anomalous results -- e.g., possible partial double taxation on a pre-G.U. repeal liquidation, no double taxation on a similar post-Repeal liquidation; probable double taxation on a liquidation of' an electing foreign corporation, and no double taxation on a similar liquidation of a (domestic) USRPHC.

3.5.1. §332 Liquidations of Domestic or Electing Foreign Corporations.

Apart from the special treatment, in Case IV, of stock of a "former USRPHC," the Regulations consistently retain full non-recognition in all cases, at both distributor and distributee levels, with respect to the distribution of USRPI in a §332 liquidation of a USRPHC, "former USRPHC" or §897(i) electing foreign corporation. This is so regardless of whether the shareholder's gain potential on the stock was greater than it will be on the distributed USRPI. This rule seems correct. The sole statutory basis for distributor recognition would be §367(e)(2), as amended by the 1986 Act, and such recognition should clearly not be required under that provision, since the distributed USRPI necessarily remains fully subject to U.S. taxation. There is no direct statutory basis for imposing distributee recognition, and no good reason for requiring such recognition by regulation, since the gain on the underlying U.S. real property is fully preserved for U.S. taxation and §332 non-recognition is fully consistent with the FIRPTA scheme (c,f. §897(c)(2)(B)).

The differences in required distributee recognition under §897(e)(2) thus relate solely to non-USRPI distributed in the §332 liquidation. Neither the Regulations, nor any statements of the Treasury or Service of which we are aware, give any explanation of the reasons why distributee recognition of gain should be required at all, why in some cases and not in

332 Liquidations

Circumstances of Liquidation	Distributor Recognition	Distributee recognition	Distributee's Basis
I ##G.U. reperal: Liquidation of USRPHC* into ### under §§332, 334(b)(1) ## 336. [Presumably also applies to liquidation of ##97(i) electing FC under ## circumstances]	No recognition w.r.t. USPRI. Recapture on non-Uspri to extent, if any, required by §367(a).	Recognizes, under §897(e)(1), the proportion of gain realized on stock allocable (in FMV terms) to non-USPRI received. No additional recognition by reason of §367(a) after December 31, 1984.	C/o for USRPI. For non-USRPI, c/o plus allocable share (proportionate to gain potential of asset) of gain recognized on stock, but to maximum of FMV.
II ## g.u. REPEAL: Liquidation of USRPHC* into ## UNDER §§332, 334(B)(2)	None	Recognizes, under §897(e)(1), gain on stock to extent of excess of FMV of non-USRPI over their allocable §334(b)(2) basis.	§334(b)(2) basis for USRPI. For non-USRPI, §334(b)(2) basis plus allocable share (proportionate t gain potential of assets) of recog- nized gain on stock, to maximum of FMV.
III. ## G.U. repeal: Liquidation of USRPHC* into ## under §§332,337(a), ## (e)(2)	No recognition w.r.t. USRPI. Recognize gain, under §367(e)(2), w.r.t. stock of former USRPCH and, except as provided in §367(e)(2) regs. w.r.t. non-USRPI.	No recognition.	C/o for USRPI: C/o plus gain recognized "and subject to U.S. taxation" w.r.t. stock of former USRPHC" ans non-USRPI.
IV. ## G.U. repeal: Liquidation of §897(i) ##ecting FC into FC	No recognition w.r.t. USRPI. Recognizes gain, except as provided in §367(e)(2) regs. w.r.t. non-USRPI.	Recognizes, under §897(e)(1), the portion (in FMV terms) of gain on the stock allocable to non-USRPI which will not be used in a U.S. trade or business(or PE, if treaty protected).	C/o for USRPI. For non-USRPI, c/o [query whether increased for distri- butor recognition] plus allocable distributee gain (allocated proportionately to gain potential) to maximum of FMV.
V. Liquidation of FC into FC:	Recognizes gain w.r.t. USRPI if §897(d)(2) requirements not met. W.r.t. non-USRPI, presumably, NO RECOGNITION pre G.U. repeal, and §367(e)(2) controls post G.U. repeal.	None	
VI. Liquidation of FC into ## mestic corporation:	W.r.t. USRPI, gain generally recognized unless §897(d)(2) requirements are met. If §897(i) election, at time of adoption of plan of liqui- dation, would require payment by reason of transfer of the stock of FC 5 years before distribution of USRPI in §332 Liquidation, distributor recognizes gain w.r.t. the USRPI distributed.	Presumably §367(b) conrols.	

Key to Abbreviations:
C/o - Carryover
FC - Foreign corporation
FMV - Fair market value
G.U. - General utilities
w.r.t. - with respect to

* Also applies to such liquidation of "former USRPHC."

others, and why the particular recognition rules adopted should have been chosen.

Consider first Case I -- a pre-G.U. Repeal liquidation of a USRPHC, former USRPHC or a foreign corporation with an effective §897(i) election, under §§332, 334(b)(1) and 336. Pursuant to Reg. §1.897-5T(3)(ii), the distributee would be required to recognize, under §897(e)(l), the proportion of its gain realized with respect to the distributor stock equal to the ratio of the fair market value of non-USRPI received in the distribution to the fair market value of total property so received. The gain recognized would be allocable to increase the basis only of non-USRPI received, but not in excess of their fair market values.

If distributee recognition in such §332 liquidations is to be retained in final regulations, three of the problems raised by the above rules should be avoided by appropriate amendment of the Regulations. '

First, as discussed in 3.1 above, §897(e)(l) should generally not apply to require recognition with respect to an exchange of a USRPI for a non-USRPI which is subject to U.S. taxation on a subsequent disposition, and we can see no reason why a different rule should apply for a §332 liquidation,

Second, the allocation of distributee gain recognized solely to increase the basis of non-USRPI, but not in excess of their fair market values, could frequently give rise to recognition of gain with no corresponding basis step-up. This is because the amount of gain recognized would bear no necessary relationship to the amount, if any, of distributor gain realized with respect to distributed non-USRPI -- consider, for example, a liquidating corporation which distributes only appreciated USRPI and cash. If such distributee recognition is to be required, it would be appropriate to increase the basis of the USRPI distributed by the amount of any gain recognized by distributee in excess of that allocated to increase basis of non-USRPI.

Third, the "proportionate recognition" of gain rule adopted is inappropriate. We can see no reason why any recognition should be required with respect to that part of the distribution of non-USRPI which would have constituted a dividend had it been distributed prior to the liquidation. Nothing in FIRPTA, or in the fact that the distributor is a USRPHC, would have affected the taxability of such a dividend, and there appears no good reason why FIRPTA regulations should impose recognition on that amount when it could have been received by distributee without recognition in any other §332 liquidation. Furthermore, recognition with respect to any additional amounts of non-USRPI received in distribution should be limited to the amount in excess of stock basis -- i.e., that which in an immediate pre-liquidation distribution would have given rise to recognized taxable gain under §301(c)(3) and

§897(a). In sum, if distributee recognition were to be retained at all, a "gain preservation" rule would be that appropriate, limiting recognition of gain to the excess, if any, of the value of non-USRPI distributed over the sum of: (a) current and accumulated earnings and profits of the distributor, and (b) distributee basis for distributor stock.

The fundamental issue, however, is why distribute recognition should be required at all. It cannot consistently be justified on grounds of preserving for U.S. taxation any excess of shareholder gain with respect to stock over distributor gain with respect to property distributed, since the proposed recognition is independent of any such difference, and full non-recognition is permitted, notwithstanding such possible difference, where solely USRPI are distributed and in the case of other §332 liquidations, Nor can it be justified simply by reason of the technical applicability of §897(e)(l), since the Regulations clearly find it appropriate to permit full distributee non-recognition in similar post-G.U. Repeal §332 liquidations. Any possible reason for requiring distributee recognition must thus somehow be bound up with the sole distinguishing difference between such pre- and post-G.U. Repeal liquidations -- viz., the fact that, post-G.U. Repeal, §367(e)(2) may apply to require distributor recognition of gain realized on certain appreciated non-USRPI distributed.

One is thus left to seek some reasonable justification for the required distributee recognition in the implicit view that it is appropriate to overrule §332(a), pursuant to §897(e)(l), to require distributee recognition with respect to non-USRPI received in a §332 liquidation of a USRPHC, but not where the distributor is potentially subject to U.S. taxation on its distribution of appreciated non-USRPI (whether or not any such distributed non-USRPI are in fact appreciated or any such tax is in fact imposed). We find it difficult to make sense of such a view. Requiring distributee recognition, in a §332 liquidation, under §897(e)(l) is suspect. While there is certainly a distributee exchange of stock for the distributed property, the substance of the transaction is a non-recognition distribution -- as clearly emphasized by the general Code determination of distributee's basis by reference to distributor's basis for the distributed property, rather than by reference to the basis for the exchanged stock.

The only possible distributee avoidance of FIRPTA tax, if full non-recognition were permitted, would be with respect to any excess of gain on the USRPHC stock over that on the underlying distributed property. This "avoidance" is clearly irrelevant under FIRPTA, so far as USRPI are distributed. It would also have been entirely irrelevant under FIRPTA, if distributor disposed of all its USRPI in taxable transactions(§897(b)(3)(ii)). Under the Regulations, it would, furthermore, be irrelevant if the non-USRPI are potentially subject to distributor recognition under a provision which has no relationship to FIRPTA and the application of which is entirely independent of whether the distributing entity is or is not a USRPHC. The potential taxability of USRPH C stock was required under FIRPTA to preclude avoidance of taxation on the underlying USRPI by means of a stock sale. It was necessary for this reason to extend U.S. taxing jurisdiction to stock of domestic corporations the value of which are predominantly attributable to USRPI. However, this does not constitute any explicit or implicit intent to subject to U.S. taxation appreciation of non-USRPI solely by reason of the fact that they may be owned by a USRPHC. Indeed, the structure of FIRPTA indicates the contrary (as evidenced, inter alia, by the irrelevance of shareholder basis, and/or non-USRPI, in the circumstances pointed to above). Much less should it constitute a reason for overriding §332 and creating the complexity, and anomalies of result, of the diverse rules adopted in these Regulations with respect to §332 liquidations.

The effect of the Regulations' imposition of distributee recognition with respect to pre-G.U, Repeal §332 liquidations is, essentially, to retroactively impose a shareholder level tax as a sort of surrogate for §367(e)(2) for periods prior to the time that that provision took effect under the Code. Moreover, such taxation, imposed under §897(e)(l), which has a purpose quite different from §367(e)(2), would bear no necessary relationship to any tax which would be incurred at the distributor level under the latter provision, Gain recognition might well be required with respect to non-appreciated USRPI, as well as with respect to any appreciated USRPI which would not have been taxable under §367,

In sum, we can see no defensible reason for imposing distributee recognition with respect to non-USRPI received in a pre-G.U. Repeal §332 liquidation of a domestic corporation.

The requirement (under Reg. §1.897-5T(a)(3)(iv)(B)) of such distributee recognition in the case of a post-G.U. Repeal §332 liquidation of a foreign corporation which has an effective §897(i) election, where no such recognition would be required on a similar liquidation of a (domestic) USRPHC, appears unjustifiable. In making the election, the corporation and its shareholders consent to an increase of the U.S. taxing jurisdiction, renounce treaty protection, and may pay a "toll charge". Once made, such election is irrevocable without the consent of the Secretary. The effect of the election under the Code, and under regulations hitherto, is, without reservation, FIRPTA treatment of the corporation and its shareholders, identical to that accorded a domestic corporation. A subsequent, and indeed retroactive, introduction by Regulation of a distinction between FIRPTA treatment of such a corporation and its shareholders and that accorded a domestic corporation and its shareholders would appear to be a breach of faith. At the very least, it should not be done without an absolutely clear and compelling reason. We have searched in vain for any clear reason, let alone a compelling one. Absent these Regulations, FIRPTA treatment of §332 liquidation of such an electing foreign corporation and a similar domestic corporation would be identical. The only possible difference in their overall U.S. tax treatment would thus have to be attributable to possible differences in the application of §367(e)(2). There is no obvious reason why regulations under §367(e)(2) should make distinctions between 5332 liquidation into a foreign corporate 80% shareholder of a U.S. corporation, on the one hand, and of a foreign corporation, on the other. But if they do so, it would presumably be for good reasons germane to §367(e)(2). Any other possible differences in U.S. taxation of the distributor could be attributable only to treaty limitation of U.S. taxation of gain recognized by the foreign distributor with respect to certain appreciated non-USRPI. It does not appear justifiable for the U.S. to override the non-discriminatory treatment provided by the §897(i) election to tax indirectly under §897(e)(l) appreciation of non-USRPI that it cannot tax directly by reason of a treaty obligation, and, in addition, to sweep into such distributee recognition non-USRPI which may already have been taxed to the distributor under §367(e)(2) as well as any unappreciated non-USRPI.

3.5.2 §332 Liquidations of Foreign Corporations.

The general rules relating to §332 liquidations of a foreign corporation appropriately implement 5§897(d)(l) and (2) and the applicable provisions of §367. However, the two special "anti-avoidance" rules raise significant issues.

(a) Req. §1.897-5T(c)(2)(ii)(B): Pursuant to this section, a foreign corporation liquidating, under §332, into a U.S, corporation would be required to recognize all gain with respect to USRPI distributed in such liquidation if any amount of "toll charge" would have been payable on a §897(i) election made at the time of the liquidation by reason of any sale of the liquidating corporation's stock within the five years prior to the distribution. Since no statutory provision would directly require such recognition, it is imposed under the regulatory power of §897(e)(2), as "necessary or appropriate to prevent the avoidance of Federal income tax."

We discussed, at some length, on pages 30 to 35 above, whether sales of stock of a foreign corporation, or "avoidance" of the §897(i) "toll charge", should, for this purpose, be regarded as a relevant "avoidance" of Federal income taxation. We concluded that they should not, Even if the Treasury persists in the contrary view, the treatment proposed in this Regulation would be indiscriminate and punitive. First, the triggering §897 toll charge may relate to an acquisition other than by the distributee U.S. corporation, or predecessors of shareholders from which it purchased. Second, and of significantly more general importance, the corporate recognition required could vastly exceed any toll charge which would have been payable on an election at the time of adoption of the plan of liquidation. Admittedly, in many cases, this latter consequence could be avoidable by having such an election actually made prior to the liquidation. However, this may not be possible if there remain non-consenting outside shareholders, if there is no suitable applicable treaty (or if the present Regulations continue to apply and at that time the foreign corporation would no longer be a USRPHC were it domestic). In any case, requiring such an actual election to avoid an unjustifiable disastrous consequence would put an unjustifiable premium on alert and sophisticated tax advice. In our view, if the recognition rule is to be retained at all, gain recognized with respect to distributed USRPI should be limited to the toll charge that would have been payable with respect to stock owned by the 80% distributee.

(b) Reg. §1.897-5T(b)(3)(v): The step transaction rule proposed in this regulation appears intended to be stronger and more definite than that applicable under general U.S. tax law. If so, it raises problems. How is it to apply when there are multiple transferors, some of which are not foreign, in the first §351 or §368(a)(l)(B) step? Is it to apply, and if so how, for purposes of application of Code provisions other than

FIRPTA and with respect to non-USRPI owned by the transferred foreign corporation? Particularly n light of these issues, it is not clear why it is not sufficient to rely on the step transaction rules of general U.S. tax law for FIRPTA purposes,

3.6 Section 355 Distributions by a USRPHC,

Under Reg. §1.897-6T(a)(4) a foreign distribute receiving stock of a corporation which is not a USRPHC in a §355 distribution by a corporation the stock of which is a USRPI would be "considered as" having exchanged a proportionate part of its distributor stock for the controlled corporation stock distributed. It would, therefore, under these Regulations, recognize gain, but not loss, under §897(e)(l).

Since there is no disposition of a USRPI, and no deemed exchange under any other provision of the Code, §897(a) would not apply on the face of the statute. The rule is promulgated solely under the regulatory power of §897(e)(2). As such, it surely ought not to have retroactive effect. Furthermore, we do not believe it justifiable as. "necessary or appropriate to prevent the avoidance of federal income tax." The purpose, and effect, appears to be to impose immediate shareholder recognition with respect to the portion of gain on distributor stock allocated to non-USRPI owned by the distributing corporation. The issue is very similar to that of imposing distributee recognition with respect to non-USRPI received in a §332 liquidation, discussed in 3.5.1 above. We think that our argument and conclusion there that such recognition is of very questionable consistency with the structure and intent of FIRPTA apply equally in this §355 case, with the additional force that, in this latter case, there is no statutory provision, which, on its face, would require recognition. Furthermore, (i) business purpose for the transaction, and the fact that it is not principally a device for the distribution of earnings and profits, must be established to qualify it for §355 non-recognition treatment, and (ii) §367(e)(l) has been enacted by Congress as the general provision under which such outbound §355 distributions are to be treated.

In light of the above, we believe that this Regulation should be withdrawn. If there is, indeed, any significant possibility of avoidance of FIRPTA taxation by means of a §355 distribution which would not be adequately dealt with under the above general Code provisions and does not relate solely to the fact that non-USRPI are being withdrawn from a USRPHC, it should be addressed specifically, not by a blanket provision requiring recognition by foreign distributees in such 5355 distributions.

3.7 Contributions of USRPI to a Partnership.

Reg. §1.897-6T(a)(3) states that it would apply to the transfer of a USRPI to a partnership and that such a transfer would qualify for non-recognition treatment only to the extent that the disposition of the partnership interest would be subject to U.S. taxation by reason of §897(g).

As discussed in 3.1 above, we believe that such non-recognition must be permitted under §721 if, and to the extent that, a subsequent disposition of the partnership interest received in exchange would be subject to U,S. income taxation, regardless of whether this is by reason of §897(g) or otherwise. More generally, in our view the contribution by a foreign partner of a USRPI to a partnership should qualify for non-recognition of gain to the full extent provided by §721. Section 704(c) ensures that, upon an ultimate sale of the USRPI by the partnership, the foreign partner would be allocated the full amount of the gain that was inherent in the property on the date of its contribution to the partnership. In addition, the regulations under §897(g) could ensure that the foreign partner would recognize such gain on a sale or other taxable disposition of its partnership interest prior to the disposition of the USRPI by the partnership, The concept would be analagous to the share of inside basis rules of §743. For example, under Reg. §1743-l(b)(2), a partner's share of the adjusted basis of partnership property for purposes of §743 is determined by taking into account the effect of §704(c).

Under the §897(g) regulations, without regard to whether §743 would apply to the transfer of the partnership interest (i.e., whether or not a §754 election is in effect), upon the sale of partnership interest by a foreign partner, the gross consideration should be allocated on a fair value basis among the assets of the partnership. To the extent the amount allocated to any asset exceeds the foreign partner's share of the partnership's basis for such asset, the foreign partner would have gain which, in the case of gain allocable to any partnership USRPI, would be subject to U.S. tax.* Any §1445

* Reg. §1.897-7T(a) provides inter alia, that for purposes of §897(g), an interest in a partnership in which, directly or indirectly, 50% or more of the value of the gross assets consists of USRPIs and 90% or more of the value of the gross assets consists of USRPIs plus any cash or cash equivalents, shall be treated as a USRPI only to the extent that the gain is "attributable to U.S. real property interests (and not cash, cash equivalents or other property)." Notice 88-72, I.R.B. 1988-27 (June 10, 1988) clarifies that a similar rule applies in the case of a sale of an interest in a non-50/90 partnership (i.e., the foreign partner is taxable only on any gain "attributable to a USRPI" of the partnership). Looking to the partner's share of inside basis is the most logical way of determining to which assets the gain is attributable. However, the reference in Reg. §1.897-7T to cash and cash equivalents in the parenthetical quoted above is disturbing if it implies that gain on a sale could be attributable to cash. The reference to cash (which can never have a basis less than its face amount) may imply that the amount of gain attributable to underlying assets of the partnership will be determined by allocating the gain on the sale of the partnership interest among the assets of the partnership in accordance with the relative fair values of such assets without regard to the basis of such assets or the partner's share of such basis. We believe that such a straight fair market value allocation would not be appropriate in determining the amount of a partner's gain which is attributable to USRPIs.

withholding tax obligation of a purchaser could be determined on a gross basis without regard to the seller's share of the partnership's basis for its assets. See Reg, §1.1445-llT(d).

3.8 Treatment of Stock of a "Former USRPHC"

We understand the term "stock of a former U.S. real property holding company", which is used but not formally defined in the Regulations, to refer to stock of a corporation which is not currently a USRPHC, but which stock is a USRPI by reason of the fact that the corporation was a USRPHC at some time during the shorter of (a) five years, or (b) the period since June 18, 1980 that the taxpayer held such stock.

Pursuant to Reg, §1,897-5T(b)(3)(iv)(A), a USRPHC or former USRHPC would recognize gain, under § 367(e)(2), on its distribution of stock of a former USRPHC to a foreign parent in a post-G.U. Repeal §332 liquidation. Furthermore, although the term "former USRPHC" is not explicitly used, gain would be recognized under §§897(e)(l) and/or (e)(2): (i) pursuant to Reg. 1.897-6T(a)(4), by a foreign shareholder of a USRPHC or former USRPHC on receipt of stock of a former USRPHC in a §355 distribution; or (ii) under Reg. 1.897-6T(a)(l), by a foreign transferor of USRPI in a §351 or §361 exchange to a corporation which, immediately after the exchange, is a former USRPHC,

The distinction between stock of a former USRPHC and other USRPI for purposes of §367(e)(2), so requiring recognition by the liquidating domestic corporation with respect to the former but not the latter, is justifiable if, in general, the same distinction is to be made in applying §367(e)(2) to any such liquidation of a domestic corporation (whether or not its stock is a USRPI). The domestic transferor would indefinitely have been subject to U.S. tax on the distributed stock and it is thus probably not inappropriate to the purpose of § 3 6 7 (e) (2) to treat the period of less than five years in which the stock will remain subject to U.S. taxation in the hands of the distributee as insufficient for permitting non-recognition by a domestic distributor,

The Regulations do not distinguish between stock of a former USRPHC and other USRPI for purposes of applying §367(e)(2) to a §332 liquidation of a foreign corporation (though, absent explicit §367(e)(2) regulations treating that case, it is not certain what position the Treasury will ultimately take). We think that such a distinction would be inappropriate in this latter case, provided that it is clear that the distributee succeeds to distributor's holding period for purposes of continuing to classify the distributed interest as stock of a former USRPHC.

As discussed in 3.6 above, we think the distribute recognition under §1.897-6T(a)(4) inappropriate. Recognition, if any, should be at the distributor level under §367(e)(l), Furthermore, it should be noted that the present Regulations would impose such accelerated distributee recognition even if the distributing corporation is itself a "former USRPHC" -- indeed, in the extreme case, even if the controlled former USRPHC the stock of which is distributed owns all the USRPI then directly or indirectly owned by the distributor, Similarly, Reg. §1.897-6T(a)(l) would impose recognition on a §351 or §361 transfer of stock of a former USRPHC to a former USRPHC .

Further consideration should be given to whether the acceleration of recognition under §897(e)(l) which results from distinguishing stock of a former USRPHC from other USRPI is necessary or appropriate, We think it would be fairer, and more consistent with FIRPTA and the other exchange provisions of these Regulations, to treat any potential avoidance problems posed by stock of a former USRPHC by permitting non-recognition where a foreign person receives stock of a former USRPHC in non-recognition exchange for a USRPI, and ensuring that such former USRPHC stock remains a USRPI for five years or, if less, the period for which the USRPI given in exchange would have remained a USRPI.

3.9 Application of Section 1034 to Non-Resident Aliens.

Regulation §1.897-6T(a)(5) would, prospectively, deny §1034 "rollover" treatment to the sale by a non-resident alien ("NRA") of a U.SB principal residence and purchase, within the relevant time period, of a foreign principal residence. It would also condition the applicability of §1034 to an NRA's sale of one, and subsequent purchase of another, U.S. principal residence on the timely filing of a return and payment of tax with respect to the sale if the subsequent purchase is not effected by the due date for such filing, and on the subsequent filing of an amended return with respect to the year of the sale

This rule with respect to an NRA is directly contrary to that which prevails for resident aliens and U.S. citizens. Section 1034 applies to a resident alien's sale of a U.S. principal residence and subsequent purchase of a foreign principal residence even where it is clear that the Seller's status as U.S. resident will terminate and a subsequent sale of the the foreign principal residence will not be subject to U.S. taxation (see, Rev. Rul. 71-495, 1971-2 C.B. 311; §1034 applied to sale of U.S. residence by a resident alien citizen of Norway who returned permanently to Norway after the sale and within one year purchased a Norwegian principal residence. See also Rev. Rul. 54-611, 1954-2 C.B. 159; §1034 applies to an outward "rollover" by a U.S. citizen).

The denial of §1034 "rollover" treatment to an outward move by an NRA would be particularly punitive if the NRA does not have a cost basis for his U,S. principal residence. Under current law it appears that this would frequently be the case, by reason of the applicability of 51034 to the NRA's sale of his foreign principal residence on moving to the U.S. It is clear that §1034 rollover treatment is mandatory, not elective, (see, e.g. Reg. §1.1034-11, it applies regardless of the location of either residence (see the two Revenue Rulings cited above) and we know of no grounds for concluding that it does not thus apply to an inward move by an NRA.

Even assuming that the NRA were assured a cost basis for the U.S, principal residence, it would remain highly questionable to deny rollover treatment on an outward move of an NRA when such rollover treatment is permitted a resident alien in exactly like circumstances. Such a difference in treatment would not be consistent with the stated purpose of FIRPTA to "establish equity of tax treatment in U.S. real property between foreign and domestic investors." Moreover the impact of such a denial of the §1034 rollover would be relatively arbitrary, and would frequently depend on whether or not sophisticated U.S. tax advice was available, Two effects of §7701(b), enacted in the 1984 Act, are that (a) continued status as an NRA is generally not consistent with any lengthy period of continuous presence in the United States (other than for certain "exempt" individuals such as diplomats, employees of international organizations, students or trainees), and (b) the rules governing the start and termination of the period for which an alien is a U,S, resident alien, while definite, 'are highly technical. Thus, whether an alien would be required to recognize gain on an outward move of his principal residence would frequently depend on whether or not he is an "exempt individual" for the §7701(b) presence tests and/or on whether he is well advised (or lucky) as to the timing of the sale of his U.S. residence relative to the timing of his termination of U.S. residency.

3.10 The Section 897(i) Election.

Regulation §1.897-8 prospectively limits the availability of a §897(i) election to a foreign corporation which qualifies as a U.S. real property holding corporation as defined in §1.897-2(b)(l) - i.e., to a corporation the stock of which would be a USRPI were it domestic. Neither the Regulations, nor any statement by the Treasury or the Service of which we are aware, gives any reason, or justification, for this limitation.

In our view, the statute and legislative history are clear. Any foreign corporation which owns a USRPI and is entitled to non-discrimination treatment with respect to that USRPI under any treaty obligation of the U.S. is entitled to the election. Congress amended §897(i) in 1981 to emphasize just that fact:

> The amendment makes clear that under section 897(i), any foreign corporation may make an election to be treated as a domestic corporation for purposes of section 897 of the Code and the related reporting requirements if the corporation owns a U.S. real property interest and, under any treaty obligation of the United States, the foreign corporation is entitled to non-discriminatory treatment with respect to that interest.

It is surely questionable whether the regulatory power granted the Secretary in §897(i)(3)(B) can reasonably be read as permitting so fundamental a limitation of the statutory election. Even assuming the regulation to be valid, its appropriateness must be questioned. It has the effect of entirely denying any remedy against discriminatory treatment under FIRPTA to a foreign corporation engaged in a U.S. trade or business which is not primarily, or at least in major part, a U.S, real estate business.

3.11 Publicly Traded Interests.

Regulation §1.897-9T leaves some ambiguity as to whether, and if so how, its paragraph (d)(l) applies to a class of interests traded on a domestic securities market. We understand the intent to be that (a) §1.897-9T(d)(l) has no relevance to determining whether a class of interests traded on a domestic market is to be considered to be regularly traded, and (b) that interests of any class which is considered to be regularly traded on a domestic market will be considered regularly traded for purposes of transactions on any established foreign securities market, without regard to §1.897-9T(d)(l),

Even as so limited in potential scope, §1.897-9T(d)(l)raises some significant issues:

(i) We are puzzled by Reg. §1.897-9T(d)(l)(ii)(B)which provides that:

> If at any time during the calendar quarter one hundred or fewer persons own 50% or more of the outstanding shares of a class of interests, such class shall not be considered to be regularly traded for purposes of sections 897, 1445 and 6039C. Related persons shall be treated as one person for purposes of this paragraph (d)(l)(ii)(B).

Related person does not appear to be clearly defined for this purpose. However, the provision would presumably apply in the situations in which(a) the corporation is a 50% subsidiary of another corporation (query if the parent is publicly traded?), (b) the corporation is 50% owned by a family, or (c) the corporation is being taken private and at some time during the quarter the 50% has been acquired and the remainder is tendered for on the market. We cannot see why, in any of these cases, a seller of the stock which at all times owned less than 5% should be made subject to FIRPTA taxation and the purchaser should be subject to a §1445 withholding obligation. In other cases in which the 50% concentration of ownership is not readily evident, the provision appears impossible of monitoring or implementation. How can anyone know whether 50% of a class of stock is owned by one hundred or fewer persons treating related persons as one? .Conversely, how can anyone ever know that a class of stock does not fall afoul of that criterion? If taken literally, this provision would appear to leave every purchaser and every seller at risk with respect to every trade of stock of a domestic corporation on a foreign market.

(ii) We cannot assess whether the requirements of Paragraphs (A) and (B) of Reg. §1.897-9T(d)(l)(i) are reasonable. We have no idea, for example, of what percentage of classes of stock of corporations traded on U,S, exchanges would regularly fulfill these requirements. It is clear that regular monitoring would be required, and no provision is made for notification or publication of the results to enable trading to take place without FIRPTA risk or obligation where these requirements are satisfied, The third (paragraph (C)), reporting requirement for a class of stock to be considered regularly traded appears to present an even more insuperable problem in any case where the class is not registered pursuant to Section 12 of the Securities Exchange Act. In that case the corporation would be required to provide the stipulated information as to its ownership and related matters with its federal income tax return. Thus, whether the stock is to be treated now as regularly traded is apparently made dependent on the corporation's satisfying its reporting obligation at some future date.

(iii) There is a clear conflict between, on the one hand, the very practical reasons for exempting portfolio sales of publicly traded stock from FIRPTA taxation, and all sales of such stock from FIRPTA withholding, and the resultant need for clarity and certainty, and, on the other hand, the evident concern of these regulations with the possibilities of avoidance, or evasion, of FIRPTA taxation or withholding through the publicly traded stock exceptions. Provided that it is made absolutely clear that a class of interests of a domestic corporation which is considered to be regularly traded on a domestic market will always be treated as regularly traded for purposes of purchases and sales on any foreign market, the scope of Reg. §1.897-9T(d) would appear to be limited and its evident principal concern with limiting possibilities of avoidance or evasion, even at a likely cost of some impracticability for genuine portfolio sales, is probably justified. However, the two paragraphs discussed above should be carefully reconsidered, and, in addition, consideration should be given to adding a provision empowering the Secretary, in appropriate cases, to issue an advance ruling, with a stipulated period of validity, pursuant to which, notwithstanding any provisions of Reg. §1.897-9T(d), a class of stock traded on a foreign exchange will be considered to be regularly publicly traded.

3.12 Foreign-to-Foreign §351 Transactions.

Reg. §1.897-6T(b) provides rules under which a foreign person may transfer a USRPI to a foreign corporation in exchange for stock without recognizing gain if certain requirements are met. The requirements are much stricter in the case of §351 transactions (and B reorganizations) than in the case of C, D and F foreign-to-foreign reorganizations. In particular, (i) the USRPI must be stock in a USRPHC, (ii) ownership of the foreign corporation after the exchange must be identical to the ownership of the USRPHC before the exchange, and (iii) the stock of the foreign corporation received in the exchange must be retained for at least three years.

It is not clear why these more stringent requirements are imposed in the case of a §351 exchange or B reorganization. The following arguments for loosening the restrictions should be considered:

(i) It is not apparent why the transfer of a USRPI which is not stock of a USRPHC presents any greater possibility of abuse than does the transfer of stock of a USRPHC. In the case of a C, D or F foreign-to-foreign reorganization, the tax-free transfer of a USRPI other than stock of a USRPHC is permitted.

(ii) The requirement that stock ownership be identical appears to be too restrictive. For example, if foreign person A and foreign person B each owned 50% of the stock of USRPHC, A could not transfer his USRPHC stock to a wholly-owned foreign corporation in exchange for stock without recognizing gain (since A would own 100% of the transferee foreign corporation but owned only 50% of the stock of USRPHC). Arguably, there should be no triggering of gain where there is no change in the indirect beneficial ownership of the

USRPI by the ultimate foreign shareholders, In fact, some shift in beneficial ownership should probably be permitted. (Consider the 50% shift in ownership permitted by Reg. §1.897-6T(b)(l)(ii) in the case of C reorganizations.) Consideration should be given to permitting transfers of USRPHC stock within a controlled group of corporations (as defined in §1563(a), but substituting "50%" for "80%") in Section 351 exchanges or B reorganizations without triggering gain.

(iii) The three-year retention requirement should arguably be liberalized to permit transfers of stock of the foreign corporation where there is no shift in the ultimate beneficial ownership of the USRPI (or no greater shift than would be permitted under the previous paragraph at the time of the §351 transaction). Again, gain should not be triggered where the stock is transferred within a controlled group of corporations.

3.13 Miscellaneous Other Comments.

3.13.1 Reg, §1.897-5T(d)(iii).

The list of items to be set forth in the document attached to a return is presented conjunctively. This has apparently led some commentators on the Regulations to conclude that the waiver of treaty protection and irrevocable agreement to subsequent U.S. taxation, denoted as item (HI on that list, is a necessary requirement for any non-recognition treatment. We understand from a discussion with a draftsman of the

Regulations that this was certainly not intended. It should be clarified that such waiver and agreement is pertinent only where it is required for non-recognition treatment pursuant to the applicable substantive Regulations.

3.13.2 Reg. §1.897-6T(c)(2).

We can see no conceivable authority under §897 for promulgating this provision. It deals with a foreign person's transfer of a z - U S R P I and with the taxation of a U.S. corporation, both of which are outside the jurisdiction of §897. It should be withdrawn.