

IRS Challenges Claims that Certain Capital Gain Dividends Received by Foreign Government Investors from REITs or RICs are Not Subject to US Tax

June 21, 2007

On June 13, 2007, the Internal Revenue Service (IRS) issued Notice 2007-55 to alert taxpayers that it intends to (i) challenge claims that capital gain dividends paid to foreign government investors by qualified investment entities (QIEs), where such dividends are attributable to gain on the sale of US real property interests (USRPIs), are not subject to US federal income tax and (ii) issue regulations to clarify the rules concerning such dividends.

Background

Under Section 892 of the Internal Revenue Code of 1986, as amended (the “Code”), certain categories of income earned by foreign governments are excluded from gross income and, therefore, not subject to US federal income tax. These income categories include dividends from, and capital gains with respect to investments in the United States in stocks, bonds, or other domestic securities. Code Section 892 does not apply to income derived from the conduct of any commercial activity (whether within or without the United States), income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or income derived from the disposition of any interest in a controlled commercial entity.

Under Code Section 897, gain or loss recognized from the disposition of a USRPI by a nonresident alien individual or a foreign corporation is subject to US federal income tax as if such gain were effectively connected with the conduct of a trade or business in the United States during the taxable year. A USRPI includes both (i) an interest in real property located in the United States or the Virgin Islands and (ii) any interest (other than solely as a creditor) in a domestic corporation that is a United States real property holding corporation (a “USRPHC”). A USRPHC is any corporation where the fair market value of its USRPIs equals or exceeds 50 percent of the total fair market value of its USRPIs, its interests in real

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

Under Code Section 897(h)(1), a distribution by a QIE (a QIE is either a real estate investment trust (REIT) or a regulated investment company (RIC)) to a nonresident alien individual or foreign corporation that is attributable to gain from the sale or exchange by the QIE of a USRPI (i.e., a capital gain dividend) is treated as gain recognized by such nonresident alien individual or foreign corporation from the sale or exchange of a USRPI. Thus, such distributions are taxable under Code Section 897. Under Treasury regulation section 1.897-9T(e), a foreign government investor is treated as a foreign corporation for purposes of Code Section 897.

Treasury regulation sections 1.897-9T(e) and 1.1445-10T(b) provide that a foreign government is subject to US federal income tax under Code Section 897 (and withholding of such tax under Code Section 1445) on the disposition of a USRPI, “except to the extent specifically otherwise provided in the regulations issued under section 892.”

Treasury regulation section 1.892-3T(a)(1)(iii) provides that gain realized by a foreign government from the disposition of a USRPI (other than stock in a USRPHC) is *not exempt* from US federal income tax under Code Section 892. Gain derived by a foreign government from the disposition of an interest in a USRPHC, however, is exempt from US federal income tax, provided the USRPHC does not constitute a controlled commercial entity.

Notice 2007-55

In Notice 2007-55, the IRS noted that some foreign governments (and withholding agents on their behalf) have taken the position that capital gain dividends paid by REITs are not subject to tax under Code Section 897, but rather are

dividends exempt from US tax by virtue of Code Section 892. The IRS described a typical investment as follows:

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

With respect to distributions from the REIT (including distributions in liquidation) that are attributable to gain from the sale or exchange of a USRPI (other than an interest in a USRPHC), the IRS understands that foreign governments (or the relevant withholding agents) have asserted that such distributions from the REIT are exempt from taxation (and withholding) under Code Section 892. Further, the IRS understands that foreign governments (or the relevant withholding agents) have also asserted that Code Section 897(h)(1) does not apply in any event to liquidating distributions from the REIT.

In the IRS's view, Code Section 897(h)(1) treats any distribution by a QIE to a foreign corporation as gain recognized by the foreign corporation (which includes a foreign government for this purpose) from the disposition of a USRPI to the extent that the distribution is attributable to gains from sales or exchanges by the

QIE of USRPIs. To the extent such gain (if recognized directly by the investor) would be subject to US federal income tax under Code Section 897 and to withholding under Code Section 1445(e), the capital gain dividend should be similarly taxed.

Accordingly, the IRS announced in Notice 2007-55 that it will issue regulations clarifying that capital gain dividends received by a foreign government (including distributions in liquidation) from a QIE that are attributable to gain from sales or exchanges by the QIE of a USRPI (other than an interest in a USRPHC, the gain from the sale of which would not be subject to tax in the hands of a foreign government in any event) are not exempt from taxation or withholding under Code Section 892. It is important to note that any such regulations issued by the IRS will be effective for distributions occurring on or after June 13, 2007 (i.e., the date Notice 2007-55 was released). Further, it is our view that redemptions of REIT stock, to the extent that the REIT must dispose of assets in order to fund the redemption, are likely to be subject to these regulations as well.

Furthermore, emphasizing that the regulations it will issue on this point will merely clarify existing law, the IRS also announced in Notice 2007-55 that it will challenge any assertion (presumably for capital gain dividends paid prior to June 13, 2007) that Code Section 892 exempted from US federal income tax distributions from a QIE that are treated under Code Section 897(h)(1) as gain recognized by a foreign government from the sale or exchange of a USRPI (other than an interest in a USRPHC).

If you have questions, we would be pleased to provide additional details about Notice 2007-55 or advice about how Notice 2007-55 might affect your business or practice. For more information, please contact any of the attorneys listed below or any member of our Transactional Tax Practice group.

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