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Part III - Administrative, Procedural, and Miscellaneous

Announcement of rules to be included in final regulations under Sections 897(d) and (e) of the Code

Notice [XXXX-XX]

PURPOSE

This notice announces that the Internal Revenue Service (IRS) and the Treasury Department (Treasury) will issue final regulations under sections 897(d) and (e) of the Internal Revenue Code (Code) that set forth and, to the extent described in this notice, revise, the current rules under sections 1.897-5T and 1.897-6T of the temporary income tax regulations and Notice 89-85, 1989-2 C.B. 403, regarding certain transactions involving the transfer of U.S. real property interests (USRPI), as defined in section 897(c)(1) of the Code. When issued, the regulations will revise the rules of Notice 89-85 and Temp. Treas. Reg. § 1.897-5T(c)(4) relating to inbound asset reorganizations described in section 368(a)(1)(C), (D), or (F) to take into account statutory mergers and consolidations described in section 368(a)(1)(A). The final regulations will also revise the rules of Temp. Treas. Reg. § 1.897-6T(b)(1) to take into

account foreign-to-foreign statutory mergers and consolidations described in section 368(a)(1)(A) and to create two additional exceptions that provide a foreign corporation with nonrecognition treatment on its transfer of a USRPI in certain foreign-to-foreign asset reorganizations. The final regulations will also incorporate a revised version of the stock disposition rule of Temp. Treas. Reg. § 1.897-6T(b)(1)(iii). Finally, the final regulations will eliminate~~not incorporate~~ the conditions required for nonrecognition treatment specified in Temp. Treas. Reg. § 1.897-6T(b)(2). The portion of the final regulations that will address distributions, transfers, or exchanges occurring in the context of a statutory merger or consolidation described in section 368(a)(1)(A) will generally apply to distributions, transfers, or exchanges occurring on or after January 23, 2006. Final regulations regarding the additional exceptions to be added to Temp. Treas. Reg. § 1.897-6T(b)(1) (except as applicable to exchanges in section 368(a)(1)(A) reorganizations), the changes to the stock disposition rule of Temp. Treas. Reg. § 1.897-6T(b)(1)(iii), and the removal of the conditions in Temp. Treas. Reg. § 1.897-6T(b)(2) will apply to distributions, transfers, or exchanges occurring on or after [**INSERT DATE THAT NOTICE IS ADVANCE DROPPED**]~~;~~. ~~h~~However, taxpayers may choose to ~~consistently~~ apply these regulatory changes to all dispositions, transfers, or exchanges occurring before [**INSERT DATE NOTICE IS ADVANCE DROPPED**] during any taxable year that is not closed by the period of limitations, provided they do so consistently.

BACKGROUND

Under section 897(a), the disposition of a USRPI by a nonresident alien individual or a foreign corporation is taxable as effectively connected income under section 871(b)(1) or section 882(a)(1), respectively, as if the taxpayer were engaged in a trade or business within the United States during the taxable year and the gain or loss were effectively connected with the trade or business.

Section 897(c)(1) generally defines a USRPI to include any interest (other than an interest solely as a creditor) in any domestic corporation, unless the taxpayer establishes that such corporation was not a U.S. real property holding corporation (USRPHC) at any time during the shorter of the period the taxpayer held such interest or the 5-year period ending on the date of the disposition of such interest. Under section 897(c)(2), a USRPHC is defined as any corporation if the fair market value of its USRPIs equals or exceeds 50-percent of the sum of the fair market value of (i) its USRPIs, (ii) its real property interests located outside of the United States, and (iii) any of its other assets used or held for use in a trade or business.

Under section 897(d)(1), except to the extent provided in regulations, gain is recognized by a foreign corporation on the distribution (including a distribution in liquidation or redemption) of a USRPI in a ~~distribution~~ transaction that otherwise qualifies for nonrecognition under the Code. Section 897(d)(2) provides that gain is not recognized under section 897(d)(1) if either: (i) at the time of the receipt of the distributed property, the distributee would be subject to taxation on a subsequent disposition of the distributed property, and the basis of the distributed property in the

hands of the distributee is not greater than the adjusted basis of such property before the distribution, increased by the amount of gain (if any) recognized by the distributing corporation; or (ii) nonrecognition treatment is provided for in regulations prescribed by the Secretary under section 897(e)(2). Temp. Treas. Reg. § 1.897-5T provides rules, exceptions, and limitations regarding section 897(d) distributions in the context of sections 332, 355, and 361. See Temp. Treas. Reg. § 1.897-5T(c)(2), (3), and (4). Notice 89-85 announced rules that would revise the application of certain of the exceptions set forth in the temporary regulations. As relevant to the changes announced in this notice, the provisions of those regulations and Notice 89-85 are discussed below.

Subject to the rules of section 897(d) and any regulations issued under section 897(e)(2), section 897(e)(1) provides that any nonrecognition provision will apply only in the case of an exchange of a USRPI for an interest the sale of which would be taxable under Chapter 1 of the Code. Under section 897(e)(2), Treasury has authority to prescribe regulations providing the extent to which nonrecognition provisions shall apply to transfers of USRPIs.

Pursuant to section 897(e)(2), Temp. Treas. Reg. § 1.897-6T(a)(1) states the general rule of section 897(e) and imposes certain requirements for nonrecognition. Among other things, that regulation provides that except as otherwise provided in Temp. Treas. Reg. §§ 1.897-5T and -6T, any nonrecognition provision applies to a transfer by a foreign person of a USRPI on which gain is realized only to the extent that

the transferred USRPI is exchanged for a USRPI which, immediately following the exchange, would be subject to U.S. taxation upon its disposition, and the transferor complies with the filing requirements of Temp. Treas. Reg. § 1.897-5T(d)(1)(iii). Temp. Treas. Reg. § 1.897-6T(b) provides exceptions to this rule for certain exchanges in foreign-to-foreign nonrecognition transactions. The exceptions described in Temp. Treas. Reg. § 1.897-6T(b) are discussed below in the context of the changes announced by this notice to such provisions.

The IRS and Treasury issued final regulations on January 23, 2006, concerning statutory mergers and consolidations described in section 368(a)(1)(A). See T.D. 9242, I.R.B. 2006-7 (February 13, 2006). Treasury Decision 9242 provides a revised definition of the term "statutory merger or consolidation" that permits transactions effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation. Further, that regulation generally applies to transactions occurring on or after January 23, 2006. Prior to the issuance of T.D. 9242, temporary regulations defined a statutory merger or consolidation as including only transactions effected pursuant to the laws of the United States or a State or the District of Columbia.

DISCUSSION

The IRS and Treasury have determined that the rules of Notice 89-85, and Temp. Treas. Reg. §§ 1.897-5T(c) and 1.897-6T(b) should be revised to reflect the recently issued regulations under section 368(a)(1)(A). This action is necessary because Notice

89-85 and the temporary regulations did not contemplate statutory mergers or consolidations under foreign or possessions law as qualifying under section 368(a)(1)(A). In addition, the IRS and Treasury believe that certain other changes to the scope of the rules under § 1.897-6T are appropriate. Accordingly, this notice announces that the IRS and Treasury will issue final regulations under sections 897(d) and (e) that generally incorporate the rules of Temp. Treas. Reg. §§ 1.897-5T and-6T and Notice 89-85, except as described below.

1. Revision to the rules of Temp. Treas. Reg. § 1.897-5T(c)(4) relating to inbound asset reorganizations

Section 1.897-5T(c)(4) of the temporary regulations applies the rules of section 897(d) to certain distributions of stock of a USRPHC by a foreign corporation under section 361(c)(1). Under the temporary regulations, a foreign corporation that transfers property to a domestic corporation (that is a USRPHC immediately after the transfer) in an exchange under section 361(a) or (b) pursuant to a reorganization under section 368(a)(1)(C), (D) or (F) must recognize gain under section 897(d)(1) and Temp. Treas. Reg. § 1.897-5T(c)(4)(i) when it distributes the stock of the USRPHC to its shareholders under section 361(c). Sections 1.897-5T(c)(4)(ii) and (iii) provide an exception and a limitation to this gain recognition.

In Notice 89-85, the IRS and Treasury announced that the exception and the limitation set forth in Temp. Treas. Reg. § 1.897-5T(c)(4)(ii) and (iii) would be replaced by a new exception. The new exception provides that recognition of gain will not be required on the distribution under section 361(c)(1) of the stock of the USRPHC under

Temp. Treas. Reg. § 1.897-5T(c)(4)(i) if the foreign corporation pays an amount equal to any taxes that section 897 would have imposed upon all persons who had disposed of interests in the transferor foreign corporation (or a corporation from which such assets were acquired in a transaction described in section 381) after June 18, 1980, as if it were a domestic corporation on the date of each such disposition, and if the conditions of Temp. Treas. Reg. § 1.897-5T(c)(4)(ii)(A) and (C) (relating to the distributee being subject to tax on a subsequent disposition and certain filing requirements) are met. Other requirements relating to the time and manner of payment of tax and interest are also set forth in the notice. The revisions announced in Notice 89-85 generally apply to all distributions of stock under Temp. Treas. Reg. § 1.897-5T(c)(4) occurring after July 31, 1989.

The IRS and Treasury have determined that when final regulations are issued, inbound statutory mergers and consolidations described in section 368(a)(1)(A) (including such reorganizations by reason of 368(a)(2)(D) or (E)) will be subject to the same rules set forth in Temp. Treas. Reg. § 1.897-5T(c)(4) and Notice 89-85 that apply to other inbound asset reorganizations. Comments are ~~requested~~ requested on the scope and application of these rules.

2. Revisions to the rules of Temp. Treas. Reg. §1.897-6T

(a) Revision to the rules of Temp. Treas. Reg. § 1.897-6T(b)(1)(ii) to take into account statutory mergers and consolidations described in section 368(a)(1)(A)

As noted above, Temp. Treas. Reg. § 1.897-6T(a)(1) generally provides that any

nonrecognition provision shall apply to a transfer by a foreign person of a USRPI only to the extent that the foreign person receives a USRPI in such exchange. Pursuant to the regulatory authority of section 897(e)(2) of the Code, Temp. Treas. Reg. § 1.897-6T(b)(1) and (2) provide exceptions to the rule of Temp. Treas. Reg. § 1.897-6T(a)(1) for certain foreign-to-foreign reorganizations and certain exchanges under section 351 where a foreign person transfers a USRPI for stock in a foreign corporation. These exceptions require that (1) the transferee's subsequent disposition of the transferred USRPI be subject to U.S. income taxation in accordance with Temp. Treas. Reg. § 1.897-5T(d)(1)~~,~~; (2) the filing requirements of § 1.897-5T(d)(1)(iii) be satisfied~~,~~; (3) one of the five conditions set forth in paragraph (b)(2) ~~to~~ exists~~,~~; and (4) the exchange ~~to~~ takes one of the three forms of exchange described in paragraph (b)(1).

Temp. Treas. Reg. § 1.897-6T(b)(1)(ii) describes one of the three permissible forms of exchange referenced above. That paragraph describes an exchange by a foreign corporation pursuant to section 361(a) or (b) in a reorganization described in section 368(a)(1)(C), where there is an exchange of the transferor corporation stock for the transferee corporation stock (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) under section 354(a) and the transferor corporation's shareholders own more than fifty percent of the voting stock of the transferee corporation (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) immediately after the reorganization. The fifty percent limitation is intended to restrict this exception to reorganizations described in section

368(a)(1)(C) that are basically internal restructurings.

The IRS and Treasury have determined that when final regulations are issued, foreign-to-foreign statutory mergers and consolidations described in section 368(a)(1)(A) (including such reorganizations by reason of section 368(a)(2)(D)) will be subject to the same rules set forth in Temp. Treas. Reg. § 1.897-6T(b)(1)(ii) that apply to foreign-to-foreign reorganizations described in section 368(a)(1)(C) (including parenthetical C reorganizations). The exception for statutory mergers and consolidations described in section 368(a)(1)(A) will also be limited to internal restructurings. Further, the final regulations will provide that in determining whether the fifty~~50~~ percent requirement set forth in § 1.897-6T(b)(1)(ii) is met where the transferee corporation owns more than ~~50~~fifty- percent of the transferor corporation before a reorganization under section 368(a)(1)(A) or 368(a)(1)(C) [(e.g., an upstream reorganization)] , the share~~h~~olders of the transferee corporation before the reorganization (that continue to be shareholders of the transferee corporation after the reorganization) will be treated as shareholders of the transferor corporation before the reorganization to the extent of their indirect interest in the stock of the transferor corporation (owned by the transferee corporation) before the reorganization. Accordingly, when issued, the final regulations will provide that gain shall not be recognized where an exchange is made by a foreign corporation pursuant to section 361(a) or (b) in a reorganization described in section 368(a)(1)(A) (including such reorganization by reason of section 368(a)(2)(D)); there is an exchange of the transferor corporation stock for the transferee corporation stock (or the stock of

the transferee corporation's parent in the case of a reorganization by reason of section 368(a)(2)(D)) under section 354(a); immediately after the reorganization, the transferor corporation's shareholders own more than 50-fifty percent of the voting stock of the transferee corporation (or the transferee corporation's parent in a reorganization by reason of section 368(a)(2)(D)); and the other requirements of § 1.897-6T(b)(1) (as modified by this notice) are satisfied.

(b) Additional exceptions to be added to the rules of Temp. Treas. Reg. § 1.897-6T(b)(1)

The IRS and Treasury have determined that when final regulations are issued, the rules of Temp. Treas. Reg. § 1.897-6T(b)(1) will be expanded to include two additional exceptions. Those exceptions will apply only in certain foreign-to-foreign statutory mergers and consolidations described in section 368(a)(1)(A) (including such reorganizations by reason of section 368(a)(2)(D)) and foreign-to-foreign reorganizations described in section 368(a)(1)(C) (including parenthetical C reorganizations). Accordingly, the new exceptions to be incorporated in the final regulations will revise the rules of §1.897-6T(b)(1) to provide that such foreign-to-foreign reorganizations will be excepted from the general gain recognition rule of Temp. Treas. Reg. § 1.897-6T(a)(1) provided that the other requirements set forth in § 1.897-6T(b)(1) are met. The two additional exceptions apply where an exchange is made by a foreign corporation pursuant to section 361(a) or (b) in a reorganization described in section 368(a)(1)(A) (including a reorganization by reason of section 368(a)(2)(D)) or

pursuant to section 368(a)(1)(C) (including parenthetical C reorganizations); there is an exchange of the transferor corporation stock for the transferee corporation stock (or the transferee corporation's parent in the case of a reorganization by reason of section 368(a)(2)(D) or a parenthetical C reorganization) under section 354(a); and either:

- stock in the transferor corporation (including a predecessor corporation in a transaction described in section 381(a)) would not be a USRPI at any time within the five ~~5-~~year period ending on the date of the reorganization if the transferor corporation were a domestic corporation; or
- prior to the exchange, and with respect to the transferee corporation after the exchange, the stock of the transferor corporation and transferee corporation are regularly traded under Treas. Reg. § 1.897-1(n) and Temp. Treas. Reg. § 1.897-9T(d)(1) and (2) on an established securities market under § 1.897-1(m) (1) and (2) and, in the case where the transferor corporation would have been a USRPHC at any time within the five ~~5-~~year period ending on the date of the reorganization if the transferor corporation had been a domestic corporation, no foreign shareholder of the transferor corporation owned (directly or indirectly) a more than five ~~5-pp~~ercent interest in the transferor corporation at such time.

(c) Revision to the rules of Temp. Treas. Reg. § 1.897-6T(b)(1)(iii) relating to foreign-to-foreign section 351 and section 368(a)(1)(B) reorganizations

As discussed above, Temp. Treas. Reg. § 1.897-6T(b)(1) contains exceptions to the general rule provided in Temp. Treas. Reg. § 1.897-6T(a)(1) if one of three forms of

exchange occurs and certain other requirements are met. Specifically, Temp. Treas. Reg. § 1.897-6T(b)(1)(iii) provides a foreign person with nonrecognition treatment if the foreign person exchanges stock in a USRPHC under section 351(a) or section 354(a) in a reorganization described in section 368(a)(1)(B), and, immediately after the exchange, all of the stock of the transferee corporation (or the stock of the transferee corporation's parent in the case of a parenthetical B reorganization) is owned in the same proportions by the same nonresident alien individuals and foreign corporations that immediately before the exchange owned the stock of the USRPHC. However, if any of the stock in the foreign corporation received by the individual or corporate transferor in the exchange is disposed of within three years from the date of its receipt, then the transferor must recognize that portion of the realized gain with respect to the stock of the USPRHC for which the foreign stock disposed of was received.

The IRS and Treasury have determined that the final regulations will revise the three year period in Temp. Treas. Reg. § 1.897-6T(b)(1)(iii) to one year.

(d) Removal of the conditions set forth in Temp. Treas. Reg. § 1.897-6T(b)(2)

As discussed above, to come within an exception to Temp. Treas. Reg. § 1.897-6T(a)(1), not only must an exchange be described in Temp. Treas. Reg. § 1.897-6T(b)(1), but it must also satisfy one of the five conditions set forth in Temp. Treas. Reg. § 1.897-6T(b)(2). The IRS and Treasury have determined that the conditions of Temp. Treas. Reg. § 1.897-6T(b)(2) are no longer necessary. Accordingly, the final regulations will eliminate the conditions required for nonrecognition treatment specified

in Temp. Treas. Reg. § 1.897-6T(b)(2). ~~Accordingly, the final regulations will not incorporate Temp. Treas. Reg. § 1.897-6T(b)(2).~~

COMMENTS

Written comments on issues addressed in this notice may be submitted to the Office of Associate Chief Counsel International, Attention: Margaret Hogan (Notice 2006-XXXX), room 4567, CC:INTL:B04, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to Notice.Comments@m1.irscounsel.treas.gov Comments will be available for public inspection and copying.

EFFECTIVE DATE

Final regulations to be issued incorporating the guidance set forth in this notice regarding exchanges occurring in the context of a statutory merger or consolidation described in section 368(a)(1)(A) will generally apply to distributions, transfers, or exchanges occurring on or after January 23, 2006. Final regulations regarding the additional exceptions to be added to Temp. Treas. Reg. § 1.897-6T(b)(1) (except as applicable to section 368(a)(1)(A) transactions), the change~~s~~ to the stock disposition rule of ~~T~~Temp. Treas. Reg. § 1.897-6T(b)(1)(iii), and the removal of the conditions in Temp. Treas. Reg. § 1.897-6T(b)(2) will apply to distributions, transfers, or exchanges occurring on or after [**INSERT DATE THAT NOTICE IS ADVANCE DROPPED**]~~;~~. However, taxpayers may choose to apply these regulatory changes to all dispositions, transfers, or exchanges occurring before [**INSERT DATE NOTICE IS ADVANCE**

DROPPED] during any taxable year that is not closed by the period of limitations, provided they do so consistently. however, taxpayers may choose to consistently apply these regulatory changes to all dispositions, transfers, or exchanges occurring before [**INSERT DATE NOTICE IS ADVANCE DROPPED**] during any taxable year that is not closed by the period of limitations.

Prior to the issuance of the final regulations, taxpayers may rely on the guidance contained in this notice. Taxpayers applying this notice, however, must do so consistently with respect to all transactions within its scope.

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. § 3507) under control number 1545-[0902]. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The rules of this notice will apply to a foreign corporation distributing stock of a USRPHC to its shareholders pursuant to an inbound asset reorganization or a foreign corporation transferring a USRPI to another foreign corporation pursuant to an asset reorganization and will require such foreign corporations to satisfy the filing requirements of Temp. Treas. Reg. § 1.897-5T(d)(1)(iii), as modified by Notice 89-57,1989-1 C.B. 698. The specific collections of information are contained in Temp. Treas. Reg. §§ 1.897-5T(c)(4)(ii)(C) and 1.897-6T(b)(1). These filing requirements

notify the IRS of the transfer and enable it to verify that the transferor qualifies for nonrecognition and the transferee will be subject to U.S. tax on a subsequent disposition of the USRPI. Generally, they may be satisfied by: (1) filing the information statement required by § 1.897-5T(d)(1)(iii); (2) filing a notice of nonrecognition to the IRS in accordance with the provisions of Treas. Reg. § 1.1445-2(d)(2); or (3) filing a withholding certificate in accordance with the requirements of Treas. Reg. § 1.1445-3. The collections of information are required in order to obtain the benefit of the nonrecognition provisions. The likely respondents are businesses.

The estimated total annual reporting and/or recordkeeping burden is 500 hours. The estimated annual burden hour per respondent and/or recordkeeper is 1 hour. The estimated number of respondents and/or recordkeepers is 500. The estimated frequency of response is occasional.

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

EFFECT ON OTHER DOCUMENTS

Notice 89-85, 1989-2 C.B. 403 is amplified.

DRAFTING INFORMATION

The principal author of this notice is Margaret A. Hogan of the Office of Associate Chief Counsel (International). For further information regarding this notice

contact Ms. Hogan at (202) 622-3860 (not a toll-free call).