Vol 32 No.

Selected U.S. Tax Developments

Editor: Sidney I. Roberts*

FIRPTA—AN OVERVIEW OF THE NEW PROPOSED REGULATIONS

Fred Feingold

New regulations have been proposed under FIRPTA that substantially modify certain of the rules contained in the existing temporary regulations and as a result require a reconsideration of their effect on a number of transactions.

I. INTRODUCTION

Section 897 of the Internal Revenue Code[1] ("Code") is not a tax imposing provision. Rather, it characterizes certain actual and deemed gains and losses as "effectively connected" with the conduct of a U.S. trade or business and further considers such trade or business to have been carried on in the United States. Once so characterized, sections 871(b) and 882(b) take over and provide the basis for taxation.

The gains and losses that are characterized as "effectively connected" are those relating to the disposition of "United States real property interests" ("USRPIs"). Accordingly, it is the term USRPI that is the underpinning of the statutory scheme. Section 897(c) uses that term as well as a number of other similar terms, each with a somewhat different meaning. Furthermore, certain of the terms used depend on other terms for their meaning. Thus, section 897(c)(1)(A) defines the term USRPI as including, among other things, "interests in real property" located in the United States or the Virgin Islands. Section 897(c)(6)(A) describes the phrase "interest in real property" without defining the term and section 897(c)(6)(B) illustrates items that are included within the term "real property," a term that itself is not defined in the statute. Other similar terms used in section 897 include "interest,"[2] "an interest other than an interest solely as a creditor," and although not expressly used, by implication, "an interest solely as a creditor."[3]

---

*Messrs. Roberts, Feingold, and Weiss are partners of Roberts & Holland, New York, New York and Washington, D.C.

[1]Unless otherwise indicated, all references to sections in the text are to sections of the Internal Revenue Code of 1954, as amended ("IRC").

[2]See IRC section 897(c)(1)(A)(ii).

[3]See Prop. Reg. section 1.897-1(d)(1).

In addition, section 897(c)(2) defines the term "United States real property holding corporation" ("USRPHC") by reference to the percentage of its relevant assets that constitute USRPIs. To determine whether a corporation is a USRPHC, other terms become critical, including "controlling interest,"[4] "percentage ownership interest,"[5] "fair market value,"[6] and "assets which are used or held for use in a trade or business."[7] Finally, for the purpose of determining whether an interest in a corporation is a USRPI, the terms "regularly traded"[8] and "established securities market"[9] are important as well.

On September 21, 1982, the first instalment of regulations to be issued under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") was published both as proposed and as temporary regulations (the "temporary regulations").[10] They deal with the terms used in section 897 and also cover reporting requirements under section 6039C. On November 3, 1983, new regulations were proposed under section 897[11] (the "proposed regulations"), superseding the portion of the regulations that had been proposed on September 21, 1982 that deal with section 897. Although the earlier temporary regulations continue to remain in effect, it appears likely that they will be replaced by the new proposed regulations as they may be amended.

This article will describe certain of the more significant provisions of the proposed regulations and their effect on the application of section 897. It will not, however, attempt to discuss the intricacies of section 897,[12] except as may be required to illustrate the proposed regulations.

---

[4]IRC section 897(c)(5)(B).

[5]See the discussion in part IV of this article under the heading "The Percentage of the Assets of Entities That Is Includible."

[6]IRC sections 897(c)(2)(A) and 897(c)(5)(B).

[7]IRC section 897(c)(2)(B)(iii).

[8]IRC section 897(c)(3).

[9]Ibid.

[10]For a discussion of the September 21, 1982 regulations, see Herbert H. Alpert, "The Foreign Investment in Real Property Tax Act: The New Regulations," in *Report of Proceedings of the Thirty-fourth Tax Conference,* November 22-24, 1982 (Toronto: Canadian Tax Foundation, 1983), 754-73; see also Alan R. Johnson, "The Initial FIRPTA Regulations" (Spring 1983), 36 *Tax Lawyer* 713-49.

[11]The proposed regulations deal only with sections 897(a), (c), (i), and (k). Thus, while they modify certain of the definitions in the temporary regulations that are applicable for sections 897 and 6039C, as well as provide new rules for the making of the section 897(i) and section 897(k) elections, they do not cover other substantive areas under section 897. For example, no rules have as yet been proposed under sections 897(d) (relating to distributions of USRPIs by foreign corporations), 897(e) (relating to the effect of certain "nonrecognition" transactions), 897(f) (relating to distributions of USRPIs by domestic corporations), 897(g) (relating to the sale of interests in partnerships, trusts, and estates), 897(h) (relating to REITs), section 897(j) (relating to the contribution of a USRPI to the capital of a foreign corporation by a non-U.S. person), or section 1125(d) of the Foreign Investment in Real Property Tax Act of 1980 (relating to an adjustment in basis for certain transactions between related persons). In this connection, the introductory material to the proposed regulations advises that further regulations under section 6039C are expected to be issued once consideration of comments regarding the proposed regulations is completed. Presumably, the Internal Revenue Service also will propose regulations under the substantive provisions enumerated above sometime thereafter.

[12]Nor will this paper discuss the section 897(k) election. For a discussion of sections 897 and

(Continued on next page

Since the operation of section 897 is dependent to a great extent on terms of art, emphasis will be placed on the significance of the meanings assigned in the proposed regulations to the terms of art used in section 897 with particular focus on changes in those meanings from the earlier temporary regulations. During the course of the discussion, the exceptions to USRPI classification will be examined. The discussion also will cover what a USRPHC is and how one establishes that, whatever a USRPHC is, what has been sold is not an interest in a corporation that was a USRPHC during the relevant period. Finally, because it does not appear to be of immediate concern to Canadians, the section 897(i) election will be touched upon just briefly.

II. DEFINITIONS RELATING TO THE TERM USRPI

An Interest (Other Than Solely as a Creditor)

The term "interest" is used throughout section 897, either alone or coupled with other words such as "other than solely as a creditor," "in real property" ("real property"), etc. To understand the significance of the usage of the term "interest," it must be remembered that there is a distinction drawn between "property" and the rights relating thereto. It is the latter that is the "*interest*." Further distinctions are drawn between "interests in 'real property' " and "interests in entities."As discussed below under the heading "Interest in an Entity," the latter distinction is of considerable significance. However, it is not always clear where to draw the line between an interest in "real property" and an interest in an "entity."

The term "interest" is itself defined[13] by reference to what it is not: it is not a right to property "solely as a creditor." (For convenience, the term "interest other than solely as a creditor" will be referred to herein as an "interest.") This implies that an "interest" ordinarily does not include a "straight" loan whether or not secured by a mortgage on "real property." Apart from that, the term "interest" appears to encompass any direct or indirect ownership right to property or its fruits, including specifically any right to share in the appreciation in value and the gross or net proceeds or profits therefrom.[14]

Both the temporary and proposed regulations provide that an obligation giving to the holder thereof the direct or indirect right to share in the value of, or the gross or net proceeds or profits generated by, an "interest" of the debtor or a

---

[12]Continued. . .

6039C, see Fred Feingold and Herbert H. Alpert, "Observations on the Foreign Investment in Real Property Tax Act of 1980 (1981), 1 *Virginia Tax Review* 105-00; Herbert H. Alpert, "The Co-ordination Between the New Canada-U.S. Treaty and the U.S. Foreign Investment in Real Property Tax Act," in this feature (July-August 1981), 29 *Canadian Tax Journal* 558-61.

[13]See Prop. Reg. section 1.897-1(d)(5).

[14]For example, with respect to real property, it includes a fee ownership or leasehold interest in real property and a time-sharing interest in real property as well as a life-estate, remainder interest, or reversionary interest in such property. See Prop. Reg. section 1.897-1(d)(2)(i). But it does not include the right to a brokerage commission arising from a sale of an interest in real property or a right to a payment of reasonable compensation for services rendered as a trustee. See Prop. Reg. section 1.897-1(d)(2)(ii)(E) and (F).

related person is in its entirety an "interest,"[15] whether or not the loan would be regarded in whole or in part as debt for other U.S. federal income tax purposes. Notwithstanding this, and as a departure from the temporary regulations, the proposed regulations provide that the right to a production payment described in section 636 (which, subject to certain limitations, may be measured by the income to be derived from "real property") does not constitute an "interest" in "real property."[16]

The effect of including what would be regarded as debt for other tax purposes as an "interest" is somewhat limited. As is discussed under part IV of this article, "The USRPHC Definition," in the case of an "interest" in "real property" and certain "interests" in entities, a corporation owning the debt would have to take into account its fair market value in the numerator of the testing formula for USRPHC status. In addition, were a foreign holder to sell a debt that constituted an "interest" and a USRPI at a gain, the gain would be characterized as effectively connected income under section 897(a).

Significantly, characterization of a debt as an "interest" in general or as an "interest" in "real property" in particular does not change the nature of the income earned with respect to the debt. Amounts that otherwise are characterized as interest for U.S. federal income tax purposes continue to be so characterized. The proposed regulations not only expressly adopt this view,[17] but they also may go even further: by providing that amounts otherwise treated for U.S. federal income tax purposes as principal and interest payments on debt obligations of all kinds (including obligations that are "interests") do not give rise to gain or loss that is subject to section 897(a), the proposed regulations appear to permit a holder of a debt instrument, in part contingent upon appreciation of an "interest" in "real property" or in an entity the "interests" of which are USRPIs, to retain his debt instrument until maturity and thereby avoid section 897(a). Moreover, the avoidance would appear to be possible even in the case of a corporate obligation that is a capital asset in the hands of a foreign holder; ordinarily, the amount received by the holder upon retirement of such debt is treated as an amount received in exchange for the debt.[18] If the amount treated as in exchange for a debt gives rise to gain or loss, it would appear that, in the absence of the special rule contained in the proposed regulations that excludes such gain or loss from the application of section 897(a), the gain or loss could be subject to section 897(a). Thus, in the absence of this special rule, there could be a distinction between corporate debt and noncorporate debt,[19] with the former treated worse than the latter. It does not appear that any such distinction is intended, although it should be noted that the two examples used in the proposed regulations illustrate only the case of noncorporate debt.[20]

---

[15]See Temp. Reg. section 6a.897-1(d)(3)(i) and Prop. Reg. section 1.897-1(d)(2)(i).

[16]Compare Temp. Reg. section 6a.897-1(d)(3)(i) with Prop. Reg. section 1.897-1(d)(2)(i).

[17]See Prop. Reg. section 1.897-1(h).

[18]IRC section 1232(a).

[19]To which, and apart from debt issued by any government or political subdivision thereof, IRC section 1232(a) is not applicable.

[20]See Prop. Reg. section 1.897-1(h), Examples (1) and (2).

Interest Solely as a Creditor

The term "interest solely as a creditor" is itself not defined. It seems clear, however, that this term is reserved for obligations with no payments that are contingent. Moreover, the right to a security interest in property does not convert an obligation that is not otherwise an "interest" into an "interest."[21] Interest or principal that varies with an index that is intended to reflect general inflation will not be considered contingent, but it would be so considered if the purpose of the index is to reflect "real property" values.[22] Thus interest pegged to the prime lending rate is *not* contingent, but an interest rate that varies with an index of rental rates for commercial buildings in a particular area is likely to be considered contingent.

Under the temporary regulations, if a lender or a person related to him also has an equity position in the borrower or the "real property," the two rights are aggregated and both are treated as "interests."[23] The proposed regulations reach this result *only* if the two rights were separated for the principal purpose of avoiding the provisions of section 897 or 6039C. Moreover, under the proposed regulations, in no event will the rights be aggregated if the loan carries with it arm's length interest and repayment terms.[24] What terms will be considered to be arm's length are not discussed. Nor is a safe-harbour rule provided.

Instalment Obligations

Both under the temporary and the proposed regulations, an obligation that, under the rules noted above, would be viewed as an interest solely as a creditor is to be regarded as an "interest" if it represents a right to instalment or other deferred payments to which section 453 applies arising from the disposition of an "interest."[25] Under the temporary regulations, there appears to be a distinction between instalment and other deferred payment rights arising from the disposition of "interests" in "real property" and those arising from "interests" in USRPIs other than "interests" in "real property," with the former included as an "interest" and the latter literally not so included. The proposed regulations have no such distinction, including as "interests" both the former and the latter, provided they arose from dispositions occurring after June 18, 1980.[26] Thus, under the proposed regulations, in the event instalment reporting of a right to an instalment payment arising from the disposition of an "interest" in an entity is appropriate, then such right also is an "interest" in the entity.

---

[21]Prop. Reg. section 1.897-1(d)(2)(ii)(C).

[22]Prop. Reg. section 1.897-1(d)(2)(ii)(D).

[23]Temp. Reg. section 6a.897-1(d)(2)(i).

[24]Compare Treas. Reg. section 1.482-2(a)(2) with section 1.483-1(c). See also Article 11(5) of the Proposed United States Model Income Tax Convention, reprinted in CCH, *Tax Treaties*, at paragraph 158.

[25]Assuming an election out of instalment treatment has not been made. See Temp. Reg. section 6a.897-1(d)(3)(i) and Prop. Reg. sections 1.897-1(d)(2)(ii)(A) and 1.897-1(d)(3)(ii)(A).

[26]Compare Prop. Reg. sections 1.897-1(d)(2)(ii)(A) and 1.897-1(d)(3)(ii)(A) with Temp. Reg. section 6a.897-1(d)(3)(i).

Including an instalment obligation arising from the disposition of an "interest" within the term "interest" will have the effect of counting such "interest" for the purpose of determining USRPHC status, provided the "interest" disposed of was a USRPI, and will also affect reporting requirements. Although, by its inclusion, any gain or loss arising from the disposition of an obligation that is an "interest" which is a USRPI is expressly made subject to section 897(a), this would have appeared to have been the result in any case.[27]

Real Property

While the term "real property" is central to an understanding of no less than four other terms used in section 897(c), it is not defined in the statute. The temporary regulations define "real property"[28] as including land and improvements such as buildings and other inherently permanent structures, as well as the structural components thereof. Also included as "real property" are mines, wells, and other natural products. Moreover, as required by the statute itself, personal property associated with the use of "real property" is included as "real property."

The proposed regulations define the term "real property" as including three, and only three, categories of property—namely, land and severed natural products of the land, improvements, and personal property associated with the use of "real property."

Little need be said regarding the definition of land other than that local law property rules do not control for purposes of determining what is "real property."[29] With regard to natural products of the land, growing crops, timber, and natural deposits retain their character as "real property" until severed or extracted, but once so severed or extracted, they cease to be "real property."[30] In addition, the term "improvements" has now been clarified by Proposed Regulation section 1.897-1(b)(3) so that property meeting the test of other tangible property within the meaning of section 48(a)(1)(B) and Treasury Regulation section 1.48-1(d) will qualify, as will buildings and other inherently permanent structures as defined in Treasury Regulation section 1.48-1(e)(2), whether or not such property will otherwise constitute machinery for purposes of Treasury Regulation section 1.48-1(c).

Under the proposed regulations, personal property can be associated with the use of "real property" only if the personal property is tangible personal property.[31] Second, for personal property to be associated with the use of "real property," both the personal property and the associated "real property" must be held by the same person or a related person.[32] Third, for the personal property to be associated with the use of "real property," the personal property must

---

[27]See IRC section 453B(a).

[28]Temp. Reg. section 6a.897-1(b); see also H.R. Rep. no. 1479, 96th Cong., 2d Sess. 186 (1980).

[29]Prop. Reg. section 1.897-1(b)(1); see also H.R. Rep. no. 1479, supra, at n. 12.

[30]Prop. Reg. section 1.897-1(b)(2).

[31]Prop. Reg. section 1.897-1(b)(4)(i).

[32]Ibid. For the definition of related person, see Prop. Reg. section 1.897-1(i).

be used (a) in mining, farming, or forestry; (b) in the improvement of "real property;" (c) in the provision of furnished office or other work space; or (d) in the operation of a lodging facility. In the latter case, the personal property will be associated only in the hands of the owners or operators of the facility, not in the hands of the tenant or guest.

As a further limitation, the proposed regulations provide that personal property that had been associated with the use of "real property" will cease to be so associated one year after

- the removal of the personal property from the "real property" with which it is associated provided it is not relocated there or associated with other "real property" held by the same or a related person, or
- the disposition of all present rights to use or occupy the "real property" with which it is associated to an unrelated party, or
- the termination of the use of the "real property" with which it is associated.

Once personal property is no longer associated with "real property," it will not be considered "real property."[33]

Interest in Real Property

The term "interest in real property" means almost any property right in or to "real property" other than solely as a creditor. Thus section 897(c)(6)(A) defines an "interest in real property" as including fee ownership and co-ownership of land and improvements thereon, leaseholds of land or improvements thereon, and options to acquire such "interests in real property." Section 897(c)(1)(A)(i) further provides that an "interest in real property" includes an "interest" in a mine, well, or other natural deposit. As will be seen below, certain "interests in an entity" also may be "interests in real property."

Interest in an Entity

Whether a right in an entity is an "interest in an entity" or an "interest in real property" is of considerable significance. For example, an "interest" in a domestic corporation is a USRPI unless it can be established that at no time during the relevant period was the domestic corporation a USRPHC[34] or one of three exceptions applied to that "interest."[35] In the case of a foreign corporation, an "interest" therein could be viewed as a USRPI solely for the limited purpose of treating another entity owning such "interest" as a USRPHC.[36] However, an "interest in real property" located in the United States or the Virgin Islands is always a USRPI.

Whether a right in a partnership, trust, or estate constitutes an "interest" therein is also significant. First, amounts received by a non-U.S. person in exchange for all or a part of an "interest" in such entity will, to the extent attri-

[33]Prop. Reg. section 1.897-1(b)(4)(ii).

[34]IRC section 897(c)(1)(A)(ii).

[35]See IRC sections 897(c)(1)(B), 897(c)(3), and 897(h)(2).

[36]IRC section 897(c)(4)(A).

butable to USRPIs owned by the entity, be considered an amount received from the sale or exchange of such property.[37] Second, when issued, the regulations under section 897(e) may provide that a change of an "interest" in a partnership, trust, or estate is to be viewed as a sale or exchange of property at fair market value.[38] Third, section 897(c)(4)(B) provides that, for purposes of determining whether any corporation is a USRPHC, holders of only certain types of "interests" in partnerships, trusts, and estates (that is, partners or beneficiaries thereof) are treated as holding a proportionate share of the assets of such entity.[39]

The temporary and proposed regulations provide a list of what constitutes an "interest in an entity." Thus, to no one's surprise, stock in a corporation, a partnership "interest," and an "interest" in a trust or estate as a beneficiary or owner appears on the list. Interestingly, the temporary regulations provide that an "interest" that is, or would under U.S. tax principles be viewed as, stock is an "interest" in a corporation,[40] whereas the proposed regulations provide that only stock is to be so viewed.[41] In the light of the change in language, it appears possible that purported debt in a corporation that is recharacterized as equity under section 385 would not be viewed as an "interest" if the debt represented a right that was an "interest" solely as a creditor. In this connection, the introductory material to the proposed regulations states that "whether an interest constitutes 'debt' or 'equity' for purposes of other Code sections is irrelevant to a determination of whether an interest is 'other than solely as a creditor' within the meaning of sections 897 and 6039C, as the two terms serve different purposes."[42] For example, a stock appreciation right is treated as an "interest" in a corporation even though the holder is not a stockholder.[43] Similarly, a right to convert into stock a debt that is an interest solely as a creditor is an "interest" in the corporation even though the conversion right is not currently exercisable.[44] It is also possible, however, that the quoted language means only that debt characterization under the Code does not control for purposes of section 897, leaving open the possibility that equity characterization under, for example, section 385 would control.

---

[37]IRC section 897(g). It is not clear whether the purpose of this language is merely to characterize the gain or loss on a sale of an "interest" in the entity as gain or loss from the disposition of a USRP or whether it was intended that there would be a complete look-through for purposes of determining the nature of the gain. This issue could be of considerable significance, for example, in a situation where the sale of the asset owned by the entity would not give rise to capital gain, but the sale of the "interest" in the entity would. Compare IRC sections 741 and 751 with 897(g). A similar issue could also arise under section 897(h)(1). It is to be hoped that the issue will be dealt with in the regulations under these sections.

[38]IRC section 897(e)(2)(B)(ii).

[39]Prop. Reg. section 1.897-2(e)(2) expands this to include the holder of any "interest" in such entity. See the discussion in part IV of this article under the heading "Indirect Ownership of Assets of Controlled Corporations and Other Entities."

[40]Temp. Reg. section 6a.897-1(d)(4)(i).

[41]Prop. Reg. section 1.897-1(d)(3)(i)(A).

[42]See also Prop. Reg. section 1.897-1(d)(1).

[43]Prop. Reg. section 1.897-1(d)(3)(ii)(B).

[44]Prop. Reg. section 1.897-1(d)(3)(i)(E).

If a debt instrument carries with it a right to share in the appreciation in value of an entity or its assets, or in the gross or net proceeds or profits of the entity, it is an "interest in an entity," whether or not the debt would be considered to be debt when tested under the principles of section 385.[45] Such an "interest" may also be an "interest in real property" if the contingent right relates to the value of "real property" owned by the entity, or the gross or net proceeds derived from "real property" owned by the entity, but it would not appear to be so considered if the contingent right relates only to the "interest in an entity." For example, a stock appreciation right, although an "interest in an entity," would not also appear to constitute an "interest in real property" even though the assets of the corporation consisted entirely of "real property." Similarly, a right to net income of a corporation would not appear to be converted from an "interest" in the corporation to an "interest in real property" merely because the entity owned only "real property," but a right to share in the net income of "real property" of a corporation would appear to qualify both as an "interest in real property" and as an "interest" in the corporation.

An option to acquire an "interest in an entity" would appear to constitute an "interest" therein,[46] but not an "interest in the real property" owned by the entity. The right to receive a royalty for the use of intangibles is expressly excluded from being an "interest in an entity."[47] While this exclusion by its terms is broad enough to encompass royalties that are calculated at least in part by net receipts, this may not turn out to be the result in an egregious case, and in any event such a right may be an "interest in real property" if calculable by reference to the net receipts of "real property." Also excluded is a right to a commission and to reasonable trustee fees.[48] Of course, an interest solely as a creditor is excluded: indeed, by definition, that is not an "interest" at all. Instalment obligations arising from the disposition of an "interest" in an entity are treated as "interests in an entity."[49]

III. CERTAIN INTERESTS IN CORPORATIONS EXCEPTED FROM CLASSIFICATION AS USRPIs.

A USRPI includes an "interest in real property" as well as an "interest" in a domestic (and for certain limited purposes an "interest" in a foreign) corporation, unless it can be established that the corporation was not a USRPHC during the relevant period. Discussed below are three exceptions to the classification as a USRPI of an "interest" in a corporation that was a USRPHC.

Publicly Traded Corporations

A class of stock in a corporation which is "regularly traded" on an "established securities market" is not a USRPI if held by a 5 per cent or less holder of such

---

[45]Prop. Reg. section 1.897-1(d)(3)(ii)(B).

[46]Prop. Reg. section 1.897-1(d)(3)(i)(D).

[47]Prop. Reg. section 1.897-1(d)(3)(ii)(C).

[48]See Prop. Reg. sections 1.897-1(d)(3)(ii)(D) and (E).

[49]See the discussion in part II of this article under the heading "Real Property."

stock,[50] but any other "interest" in the corporation could be a USRPI if, on the date it was acquired, its fair market value is greater than 5 per cent of the fair market value of the regularly traded class of stock of the corporation with the lowest fair market value.[51]

While the temporary regulations do not provide a separate definition for the term "regularly traded," they define the term "established securities market."[52] Under the temporary regulations, an established securities market is one that is registered under section 6 of the Securities and Exchange Act of 1934 or is a domestic over-the-counter market, provided information concerning persons holding more than 5 per cent of any class of interest is required to be reported to the Securities and Exchange Commission. In no event, however, could an "interest" be considered to be regularly traded over an established securities market under the temporary regulations by reason of being traded on a foreign securities exchange not registered under section 6 of the Securities Exchange Act.

The proposed regulations take a completely different and much more liberal view. First, under the proposed regulations, a class of stock traded on an established securities market is considered to be regularly traded if the class of stock is regularly quoted by brokers or dealers making a market in such stock, and is presumed to be regularly traded if there is a total of 500 or more shareholders.[53] Second, an "established securities market" includes not only a national securities exchange registered under section 6 of the Securities and Exchange Act, but also any over-the-counter market as well as any foreign national securities exchange that is officially recognized, sanctioned, or supervised by governmental authority.[54] There is no requirement that information regarding a more than 5 per cent holder of any class be reported to the Securities and Exchange Commission or any comparable foreign agency.

Although this exception will have its greatest application to shares in domestic corporations (which for this purpose includes shares in a foreign corporation in respect of which an election under section 897(i) is in effect), it also can apply to shares in a foreign corporation. Interests in a foreign corporation are excluded from being USRPIs with respect to any gain or loss derived from their disposition. Such interests may, however, be USRPIs for the limited purpose of determining whether any corporate holder thereof is a USRPHC.[55]

Interests in Real Estate Investment Trusts (REITs)

An "interest" in a real estate investment trust ("REIT") that is domestically controlled is not a USRPI,[56] but a distribution by a REIT, whether or not

[50] IRC section 897(c)(3). Certain attribution rules apply for this purpose.

[51] Prop. Reg. section 1.897-1(c)(2)(ii).

[52] Temp. Reg. section 6a.897-1(m).

[53] Prop. Reg. section 1.897-1(n).

[54] Prop. Reg. section 1.897-1(m).

[55] IRC section 897(c)(4)(A).

[56] IRC section 897(h)(2).

domestically controlled, to a foreign person to the extent attributable to gain from sales or exchanges by the REIT of USRPIs would be viewed as gain recognized by the foreign person from the sale or exchange of a USRPI.[57] If a REIT were to sell an "interest" in a partnership that owned "real property," it appears that any gain derived therefrom literally would not fall under this rule because an "interest" in a partnership is not a USRPI unless the "interest" in the partnership was also an "interest in real property."[58] Moreover, it appears that non-U.S. persons may acquire "interests" in domestically controlled REITs (as distinguished from "interests in real property" owned by such REITs) and avoid section 897(a) altogether with respect to such "interests."

Disposition of All USRPIs

An "interest" in a corporation will not be regarded as a USRPI if, at the time of the disposition of the "interest," the corporation held no USRPIs and all USRPIs held by the corporation during the relevant period were disposed of in a transaction in which the full amount of gain, if any, was recognized.[59] The obvious intention of this provision is to permit a non-U.S. person to avoid a second tax once a U.S. corporation owning USRPIs has incurred a tax on the full amount of the appreciation in any USRPI it holds.

This exception does not apply if the corporation has any USRPIs at the time of the disposition of an "interest" in the corporation; even a leasehold interest covering office space used by the corporation counts for this purpose. The proposed regulations address this by inserting a *de minimis*[60] rule, which does not appear to accomplish very much. It provides that a lease for a term of one year or less at prevailing market rates (and which may include an option to renew for a period of one year or less at the prevailing market rate at the time of renewal) will not be counted as a USRPI for this purpose, provided the leased property *is* used by the corporation in the conduct of a trade or business in the United States. No apparent reason exists for the requirement that the leased property be used in a trade or business (for example, if the leased property were held for the production of income, it would not appear to qualify), nor is it apparent why the trade or business must be in the United States (for example, if the leased property were used to carry on a foreign trade or business, the exception does not appear to apply). In addition, the use of the term "prevailing market rate" raises yet another issue: is it the prevailing rate at the inception of the lease (as appears to be the case in a renewal situation) or at the time of the disposition of

---

[57]IRC section 897(h)(1). As noted previously, it is not clear whether this language is intended to treat the shareholder as having made the sale made by the REIT or merely to characterize the gain as gain from the sale of a USRPI.

[58]This will be determined by reference to the terms of the partnership agreement. A cross-reference in section 897(c)(4) to section 897(h)(1) may be required to remedy what appears to be a defect in the statute. Additional cross-references may also be required in sections 897(f), 897(g), and 897(j) to cure similar problems. Quaere whether the defect can be cured by regulation. See IRC section 897(i)(1)(A) and Prop. Reg. section 1.897-3(b)(1) (last sentence). The defect exists if a partnership is to be viewed as an entity except as otherwise provided in the statute or in the regulations. Whether such an assumption was intended is unclear.

[59]IRC section 897(c)(1)(B).

[60]See Prop. Reg. section 1.897-2(f)(2).

the "interest" that is to be taken into account? In a particular case, of course a problem with regard to the term of a lease or the rent thereunder may be solvec by renegotiation, provided the other party is willing to cooperate.

Even assuming the leasehold problem is avoided, the exception is not likel to apply if the corporation disposed of any of its USRPIs in transactions quali fying for instalment reporting and is holding the instalment paper at the time o the disposition of an "interest" therein. As noted previously, the instalmen obligation is to be treated as an "interest" and consequently as a USRPI. Thi obstacle would be surmounted if the corporation were to dispose of its instal ment paper in order to trigger the deferred gain before any disposition of a "interest" in the corporation.

IV. THE USRPHC DEFINITION

A corporation is a USRPHC if the "fair market value" of its USRPIs equals o exceeds 50 per cent of the fair market values of (1) its USRPIs, (2) its "interest in real property" located outside the United States, and (3) any other assets tha are used or held for use in a trade or business.[61] All other assets of a corporatio are disregarded. In calculating whether this test has been met, a proportionat part of the fair market value of the assets of certain lower-tier entities is take into account.

Assets Used in a Trade or Business

The temporary regulations provide that assets that are used or held for use in trade or business ("business assets") include property other than "real prop erty" that fits within four separate categories—namely, inventory, depreciabl personal property without regard to its holding period, livestock,[62] an accounts receivable from the sale of any of the foregoing or from the perfor mance of services.[63] The temporary regulations exclude from classification a "business assets": cash, marketable securities, or an option or contract t acquire stock, securities, or commodities that constitute a capital asset to th holder. Thus, under the temporary regulations, cash could never be part of th "business assets" whether or not held for use in the business. Nor could a loa receivable that arose in the course of carrying on a banking, finance, or simila business or any nondepreciable business asset, such as goodwill and going con cern value, constitute a "business asset."

The proposed regulations take a more realistic approach. First, the first thre categories of property listed as includible in "business assets" under the tem porary regulations are also includible as "business assets" under the propose regulations.[64] To this list is added goodwill and going concern value (provide it is purchased from an unrelated party); patents; inventions; formulas copyrights; literary, musical, or artistic compositions; trademarks; trad

[61]IRC section 897(c)(2).

[62]Temp. Reg. section 6a.897-1(h)(1).

[63]Temp. Reg. section 6a.897-1(h)(2).

[64]Prop. Reg. section 1.897-1(f)(1)(i).

names; and any other similar intangibles[65] *to the extent used in a trade or business*. While an account receivable acquired as a result of a sale of depreciable personal property may constitute a "business asset" if held for use in a trade or business, it is not automatically so considered. Rather, cash, stocks, securities, and receivables are included to the extent used in a trade or business.[66]

Assets will be considered used in a trade or business if, in accordance with the principles of Treasury Regulation section 1.864-4(c)(2) (the "asset-use" test),[67] the assets are held for the principal purpose of promoting the trade or business, are acquired and held in the ordinary course of the trade or business, or are otherwise held in a direct relationship to the trade or business.[68] For example, cash held to pay for the purchase of materials or for payroll will be considered to have a direct relationship to a trade or business, but cash held to finance future expansion will not be so considered.[69]

Fair Market Value

Neither the statute nor its legislative history states what was intended by the use of the term fair market value ("FMV"). Presumably, it was intended that the term FMV would be given its ordinary meaning—that is, the price at which a property would change hands between an unrelated buyer and seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Under such a definition, FMV generally means the gross purchase price without deduction for any liabilities to which the property may be subject.[70] Were this definition of FMV to be used, liabilities generally would not be an offset against the gross price at which the property would change hands.[71]

While the temporary regulations adopt the approach suggested above,[72] the proposed regulations deviate somewhat from this approach. Under the proposed regulations,[73] the general rule is that "gross value" is to be used and that appraisals are not required. There is an exception to the use of gross value, albeit with an important flaw. The proposed regulations provide that the gross value of the property is to be reduced by the outstanding balance of debts that are secured by the property, but only if (1) the proceeds of the debt were used to purchase or improve the property, and (2) the debt is secured either by (a) a properly

---

[65]Prop. Reg. section 1.897-1(f)(1)(ii).

[66]Prop. Reg. section 1.897-1(f)(1)(iii).

[67]The cited regulation has a specific cross-reference to Treas. Reg. section 1.864-4(c)(5), which provides special rules applicable to taxpayers conducting a banking, financing, or similar business. It is not clear whether the special rules contained in Treas. Reg. section 1.864-4(c)(5) are intended to be applicable for purposes of determining whether an asset is a "business asset."

[68]Prop. Reg. section 1.897-1(f)(2).

[69]Compare Examples (1) and (2) of Prop. Reg. section 1.897-2(f)(3).

[70]See *Crane v. Commissioner*, 331 U.S. 1 (1947).

[71]See the discussion regarding "controlling interests" in part IV of this article under the heading "Indirect Ownership of Assets of Controlled Corporations and Other Entities."

[72]Temp. Reg. section 6a.897-1(n).

[73]Prop. Reg. section 1.897-1(o).

recorded and enforceable purchase money mortgage on the property, (b) a purchase money security interest in personal property that is valid and enforceable pursuant to state law, or (c) a mechanic's, materialman's, or similar security interest in real or personal property arising from the rendering of services or the providing of materials in connection with the improvement of property.

Consider the case of a developer that obtains a construction loan secured by a mortgage on land and improvements allowing the borrower to draw down on the loan in order to pay architects, contractors, and suppliers of materials. If the borrower is doing what it is supposed to do—that is, paying for work and materials with the funds borrowed (indeed, the lender may be doing it for the borrower)—it may well be that either no mechanic's or materialman's security interest would arise or that, if it did arise, it would be satisfied as soon as the work was completed. There would, however, be a construction mortgage loan, the proceeds of which went to improve the property. Nevertheless, the construction mortgage loan does not appear to be a mechanic's or materialman's lien and unless such a construction mortgage loan were to fit under the "purchase money" exception, it would not qualify even though the proceeds were used to improve the property. For the same reason, a permanent mortgage loan that replaces a construction loan would not appear to qualify. Similar problems would arise whenever a purchase money mortgage were refinanced—for example, to obtain a lower interest rate or to extend the date of maturity. One can only wonder whether any of this was intended.

Presumably, in order to prevent abuses from developing, the proposed regulations provide that any debt owed to a related person does not count; that is, it can never be netted against gross value regardless of whether the debt was incurred on arm's length terms.[74] Under certain circumstances, the general rule precluding the netting of liabilities may be subject to abuse by taxpayers with results adverse to the fisc. For example, a corporation holding substantial USRPIs might attempt to avoid USRPHC status by incurring debt to acquire an "interest" in foreign "real property" for the principal purpose of avoiding the provisions of section 897. To forestall such tactics, the proposed regulations provide a further anti-abuse rule. Under that rule, the gross value of assets held outside the United States and of "business assets" is to be reduced by the outstanding balance of debts entered into for the principal purpose of avoiding the provisions of sections 897 and 6039C.[75] In determining whether a bad purpose exists, it is stated that all facts and circumstances are to be considered but that debts routinely entered into in the course of a trade or business are not to be considered entered into for the proscribed principal purpose.

The proposed regulations also provide rules for determining the FMV of certain types of assets. Thus the FMV of a leasehold "interest in real property" generally will be equal to the discounted value (at an appropriate discount rate) of the bargain element in the lease over its remaining term. However, a leasehold "interest" will have no value if it cannot be assigned.[76] Although

[74]Prop. Reg. section 1.897-1(o)(2)(iii).

[75]Prop. Reg. section 1.897-1(o)(2)(iv).

[76]Prop. Reg. section 1.897-1(o)(3).

assets generally are to be valued on a going concern basis, the value of goodwill and "going concern value" is to be equal to the price paid therefor if paid to an unrelated person. In other cases, goodwill and going concern value are to have no value. If other intangible assets are purchased from an unrelated person, they may be valued by reference to their purchase price or book value. In other cases, such assets may be valued on some other reasonable valuation method. If the purchase price method is used, the purchase price is to be amortized in accordance with generally accepted accounting principles.

Indirect Ownership of Assets of Controlled Corporations and Other Entities

Section 897(c)(5)(A)(i) provides that a corporation (the "parent") holding a "controlling interest" in another corporation (the "controlled corporation") shall not include the *stock* of the "controlled corporation" as an asset for the purpose of determining whether the "parent" is a USRPHC. This is because section 897(c)(5)(A)(ii) provides that a portion of each of the assets held by the "controlled corporation" is treated as held by the "parent." No mention is made in either the statute or the temporary regulations[77] of what happens to "interests" other than stock held in the "controlled corporation" by the "parent." The proposed regulations provide, however, that, for the purpose of determining whether the "parent" is a USRPHC, all "interests" held by the "parent" in a "controlled corporation" are to be disregarded.[78]

A "controlling interest" means 50 per cent or more of the FMV of all classes of stock of the corporation.[79] Literally, an "interest" in a corporation that is not stock is not taken into account for the purpose of determining whether one corporation has a "controlling interest" in another.[80] Thus, for example, a stock appreciation right would not appear to be taken into account for purposes of determining whether a "controlling interest" exists; however, if a "controlling interest" exists, all "interests" in a corporation, including a right or option to acquire an "interest" in the corporation, are taken into account for the purpose of determining a person's "percentage ownership interest,"[81] a term that is relevant for the purpose of determining the portion of the assets of a "controlled corporation" that are considered as owned by the "parent."

For purposes of determining whether a corporation is a USRPHC, section 897(c)(4)(B) provides that a partner of a partnership and beneficiary of a trust or estate must also include a proportionate share of each asset held by the partnership, trust, or estate, as the case may be. Although "interest" holders in partnerships, trusts, or estates, other than partners or beneficiaries, are not required by the literal terms of the statute to include, for purposes of determin-

---

[77]See Temp. Reg. section 6a.897-2(i)(1)(i).

[78]Prop. Reg. section 1.897-2(e)(3)(iii).

[79]IRC section 897(c)(5)(B). With certain modifications, section 318 constructive ownership rules apply for this purpose; IRC section 897(c)(6)(C).

[80]Prop. Reg. section 1.897-2(e)(3); compare Prop. Reg. section 1.897-1(e)(2).

[81]Prop. Reg. section 1.897-1(e)(2)(ii). See the discussion in part IV of this article under the heading "The Percentage of Assets of Entities That Is Includible."

ing whether they are USRPHCs, any portion of the assets of the entity, the proposed regulations expressly so include such other "interest" holders.[82]

Not only is a portion of each asset held by a "controlled corporation" or partnership, trust, or estate included as an asset of the "parent" or, in the case of a partnership, trust, or estate, as an asset of an "interest" holder therein, but also any "business asset" held by a lower-tier entity retains its character as a "business asset" when considered as owned by a higher-tier entity.[83] In the case of a chain of entities, the indirect ownership rules are applied successively up the chain.

The Percentage of the Assets of Entities That Is Includible

Section 897(c)(5)(A)(ii) provides that the portion of each asset of a "controlled corporation" that is considered owned by the "parent" is equal to the percentage of the FMV of the stock of the "controlled corporation" held by the "parent." Thus, if corporation P owned 90 per cent of the only class of shares in corporation C, it would be considered to own 90 per cent of the FMV of each asset owned by C. Moreover, this literally would appear to be true regardless of whether there were outstanding other "interests" in C that were held by third parties. A similar result also could obtain under the literal terms of the statute with respect to "interests" in partnerships, trusts, or estates. Both the temporary and the proposed regulations, however, adopt a rule that requires that all "interests" in a corporation, partnership, trust, or estate are to be taken into account for purposes of determining the appropriate percentage of the FMV of assets of the entity that is includible.[84]

By including all "interests," a rule had to be evolved for determining how to allocate among different types of "interests." The rule that emerged in the temporary regulations and that also is contained in the proposed regulations compares the percentage of liquidation values represented by "interest" holders. The liquidation value of an "interest" is the amount of cash and FMV of any property that would be distributed with respect to such "interest" upon liquidation, after satisfaction of liabilities to persons having interests solely as creditors.

Consider the case of C, a "controlled corporation" with two classes of stock outstanding. Class A is common stock with no par value. Class B is preferred stock entitling the holders thereof to a fixed annual return, plus a preference on liquidation equal to 115 per cent of the par value of the preferred stock. Assume there is $1,000,000 par value of Class B preferred stock outstanding, all of which is owned by Z corporation. Further assume there are outstanding 1,000 shares of Class A common stock, all of which is owned by P corporation, as well as liabilities constituting interests solely as a creditor aggregating $1,000,000 and an "interest" in the form of a right entitling the holder to 25 per cent of the proceeds of liquidation after deducting only the aforementioned liabilities, but tha

---

[82]Prop. Reg. section 1.897-2(e)(2).

[83]IRC sections 897(c)(5)(A) and 897(c)(4)(B).

[84]See Temp. Reg. section 6a.897-1(g) and Prop. Reg. section 1.897-1(e).

such right is payable only after payment of the amounts due the preferred stockholders. C's balance sheet on a liquidation basis is as follows:

Assets	$11,000,000
Liabilities	1,000,000
Liquidation right	2,500,000
Preferred shares	1,150,000
Common shares	6,350,000
	$11,000,000

P's "percentage ownership interest" in C would be 63.5 per cent. Although Z's "percentage ownership interest" in C would be 11.5 per cent, since Z does not have a "controlling interest" in C, it need not include any portion of C's assets. But unless Z can establish that C was not a USRPHC during the relevant period or unless another exception applies, it must treat the preferred stock of C as a USRPI.

To complicate matters further, assume C also had outstanding options to acquire another 1,000 shares of Class A common stock requiring the payment of $1,000,000 to exercise the options, that Z held those options, and that those options were presently exercisable. Further assume Z also held the liquidation right in C. In order to compute the respective liquidation values, an option that is presently exercisable is assumed to have been exercised.[85] If the option had been exercised, C's liquidation balance sheet would look like this:

Assets	$12,000,000
Liabilities	1,000,000
Liquidation right	2,750,000
Preferred shares	1,150,000
Common shares	7,100,000
	$12,000,000

P's "percentage ownership interest" in C would be equal to 3.55/11 or 32.27 per cent and Z's "percentage ownership interest" in C would be equal to 7.45/11 or 67.73 per cent. Although P has a "percentage ownership interest" of less than 50 per cent in C, and Z has a "percentage ownership interest" greater than 50 per cent, it appears that both P and Z would be considered to own a "controlling interest" in C. Z would be considered to own a "controlling interest" in C because section 318 would attribute to Z stock over which it has a presently exercisable option. P also would be considered to have a "controlling interest" since, for the purpose of determining whether P has a "controlling interest," there does not appear to be any rule similar to that for treating an option of a third party as having been exercised. If Z had actually exercised the option, however, Z would have a "controlling interest" in C, but P no longer would.

If, in the above illustration, the FMV of the assets were equal only to $2,150,000 without regard to the exercise of the option, it is unrealistic to

[85]Prop. Reg. section 1.897-1(e)(2)(ii).

assume that the option would be exercised. Indeed, were it to be exercised, Z would be paying $1,000,000 for common stock worth $231,250 (that is, 50 per cent of $462,500).

	Assume exercise of option	*Assume non-exercise of option*
FMV of assets	$3,150,000	$2,150,000
Liabilities	1,000,000	1,000,000
Liquidation rights	537,500	-0-
Preferred shares	1,150,000	1,150,000
Common shares	462,500	-0-
	$3,150,000	$2,150,000

Nevertheless, the proposed regulations require that presently exercisable options be considered to have been exercised for purposes of computing a "parent's" "percentage ownership interest" without regard to the likelihood of their exercise, with the result that, in the case illustrated, P would have a "percentage ownership interest" in C of approximately 10.75 per cent (that is, $231,250/($3,150,000 —$1,000,000)) rather than zero (that is, 0/$1,150,000). Quaere the result in a case where the FMV of the assets are equal to or less than the liabilities.

Calculating liquidation values in the partnership context no doubt will be more difficult particularly because of the greater variety of arrangements that are possible.[86] One type of arrangement that appeared to catch the eye of the draftsmen was one in which one partner is entitled to a disproportionate share of USRPIs upon liquidation. The temporary regulations provide that such an arrangement would be disregarded pursuant to regulations to be promulgated under section 897(g).[87] The proposed regulations adopt this approach, albeit without a cross-reference to section 897(g), not only for partnerships but also for corporations as well as trusts and estates.[88]

In calculating the "percentage ownership interest" in a "nongrantor" trust or an estate that is not discretionary, rules identical to those applicable to corporations and partnerships generally apply, except that instead of liquidation values, actuarial values are used.[89] However, the rules relating to discretionary trusts and estates are somewhat more complex. In the case of a discretionary trust or estate, two calculations must be made. First, there must be a calculation of the definitely ascertainable actuarial values of all "interests" of persons in existence on the "determination date" (the "calculable sum"). If the "calculable sum" equals the amount that would be available after satisfaction of liabilities to persons holding interests solely as creditors (the "available sum"), the rule for nondiscretionary trusts and estates applies. If, however, the "available sum" exceeds the "calculable sum," the excess will be considered as

---

[86]A relatively simple case is illustrated by Prop. Reg. section 1.897-1(e)(2)(iii), Example (2).

[87]Temp. Reg. section 6a.897-1(g)(2)(i).

[88]Prop. Reg. sections 1.897-1(e)(2)(ii) and 1.897-1(e)(3)(ii).

[89]Prop. Reg. section 1.897-1(e)(3)(ii).

owned by each beneficiary (1) who is in existence on the determination date, (2) whose interest in the excess is not definitely ascertainable, and (3) who is potentially entitled to such excess.

Under this rule, every existing member of a class of potential beneficiaries must include the full amount of the excess of the "available sum" over the "calculable sum" in determining its "percentage ownership interest" in the trust unless such beneficiary were included for a principal purpose of avoiding the provisions of sections 897 or 6039C. Both the temporary and proposed regulations illustrate the application of this principle by providing that a trust for the benefit of X, Y, and in the discretion of Z, an independent trustee, the heads of state of every country other than the United States, each such head of state must take into account the excess sum in determining his "percentage ownership interest."[90] Although it is difficult to think of a case more clearly deserving of consideration as an illustration of the wrong purpose for including beneficiaries, its very inclusion as an example in the proposed regulations casts a doubt on the issue.

V. ESTABLISHING THAT AN INTEREST IN A CORPORATION IS NOT A USRPI

An "interest" in a corporation[91] is a USRPI unless the taxpayer can establish that at no time during the "relevant period"—that is, the shorter of the periods (1) after June 18, 1980 to the date the taxpayer disposed of the "interest" in the corporation, and (2) the five-year period ending on the date of disposition of the "interest"—was the corporation a USRPHC.[92] Read literally, a taxpayer could not meet his burden unless he could establish that during each day during the "relevant period," the corporation did not meet the asset test of being a USRPHC. It would be possible, of course, to draw the inference that a corporation was not a USRPHC at any time if it could be shown that it was not a USRPHC at certain times. The temporary and the proposed regulations adopt procedures under which a corporation is not to be considered a USRPHC at any time during the "relevant period" if it was not a USRPHC at what is referred to as the "applicable determination dates."

Applicable Determination Dates

Under the temporary regulations, the "applicable determination dates" are as follows: (1) December 31 of each year during the "relevant period"; (2) each date immediately preceding the date of a disposition of a USRPI or acquisition

---

[90]See Temp. Reg. section 6a.897-1(g)(3)(ii), Example, and Prop. Reg. section 1.897-1(e)(3)(ii)(B), Example.

[91]In the case of a foreign corporation, an "interest" therein can be a USRPI only for the limited purpose of determining whether another corporation is a USRPHC; IRC section 897(c)(4)(A).

[92]IRC section 897(c)(1)(A)(ii). In addition, for the purpose of determining whether another corporation is a USRPHC, an "interest" in a corporation will not be a USRPI if it is owned by another corporation that owns a "controlling interest" in the first corporation; IRC section 897(c)(5)(A)(i). Nor will it be considered a USRPI if one of the statutory exceptions apply to that "interest." See IRC sections 897(c)(1)(B), 897(c)(3), and 897(h)(2).

of an "interest" in foreign "real property" or "business assets" by the corporation, any "controlled corporation" as well as any partnerships, trusts, or estates in which it has an "interest"; and (3) the date a foreign person disposes of an "interest" in a U.S. corporation, but the date of an acquisition of a USRPI does not give rise to an "applicable determination date" under the temporary regulations. Although the acquisition of inventory and livestock is expressly excluded as an event giving rise to an "applicable determination date," an "applicable determination date" arises from the acquisition of other "business assets" unless the FMV of the acquired "business assets" is not greater than 1 per cent of the total FMV of all such "business assets." The one comfort provided is that retained assets need be valued only on the December 31 following the "applicable determination date."

The principal problem with the approach taken by the temporary regulations is the number of potential "applicable determination dates." The proposed regulations generally follow the pattern of the temporary regulations. There are, however, considerable differences, which presumably were intended to alleviate the burden to some extent. Whether they have done so is somewhat doubtful.

The proposed regulations[93] provide for the following "applicable determination dates": (1) as in the case of the temporary regulations, each December 31; (2) unlike the case of the temporary regulations, which focussed on the date preceding dispositions of USRPIs and the dates preceding acquisitions of "interests" in foreign "real property" and "business assets," the proposed regulations provide that the date that is relevant is the date of acquisition of a USRPI or disposition of an "interest" in foreign "real property" or "business assets" by the corporation, any "controlled corporation," and any partnership, trust, or estate in which it has an "interest." Unlike the rule provided in the temporary regulations, under the proposed regulations, the date of disposition of an "interest" in the corporation is *not* an "applicable determination date."

As in the case of the temporary regulations, the disposition of "business assets" (other than inventory and livestock) may give rise to an "applicable determination date" if the magnitude of the "business assets" reaches a certain threshold referred to as the "limitation amount." Under the proposed regulations, however, the threshold varies with the percentage of all assets the corporation is considered to hold that consist of USRPIs. The following table describes the "limitation amount" that is generally applicable.[94]

Percentage of FMV of assets consisting of USRPIs	*Limitation amount %*
Less than 25%	10
From 25% up to but not equalling 35%	5
35% or greater	2

[93]See Prop. Reg. section 1.897-2(c).

[94]Prop. Reg. section 1.897-2(c)(2)(iii). Where a corporation is not a USRPHC under the presumption relating to book value of assets, the limitation amount is 10 per cent; Prop. Reg. section 1.897-2(c)(2)(iii)(D).

In computing whether the "limitation amount" has been reached, all dispositions during a year are aggregated. Once the "limitation amount" has been reached, so too has an "applicable determination date." Then the process starts over.[95]

Applicable Procedure

Under the temporary regulations,[96] a foreign person disposing of an "interest" in a domestic corporation is required to file a tax return to which must be attached schedules showing that, on all the "applicable determination dates" during the "relevant period," the corporation was not a USRPHC. These schedules must also be attached with respect to lower-tier domestic and foreign corporations that are not "controlled corporations." If a return is not filed or if the schedules are not attached, the temporary regulations appear to provide that the statutory burden of the taxpayer cannot otherwise be met. Thus, whether or not the corporation actually has any USRPIs during the "relevant period" is relevant only if a return is filed and if the schedules are attached. It is unclear, however, whether a late filed return would qualify.

This approach has both disadvantages and advantages. The principal disadvantage is that foreign persons disposing of "interests" in domestic corporations would be required to file a tax return even where it is clear that the corporation was never a USRPHC. Thus the filing of an income tax return would be required in any case where there was a disposition of an "interest" in a domestic corporation and an exception to characterization of such "interest" as a USRPI was not clearly evident regardless of whether a tax return was otherwise required to be filed.

Another disadvantage to the approach is the difficult burden placed on the foreign person. Given the number of potential "applicable determination dates," it would be difficult in many cases and impossible in others for a foreign person holding an "interest" in a domestic corporation to obtain the necessary information. Moreover, since the temporary regulations do not impose a requirement on domestic corporations to cooperate with foreign "interest" holders, in many cases there would be no practical way for a foreign person to obtain the information.

The advantage with the approach taken is that it is consistent with a self-assessment system. The foreign "interest" holder makes the determination based on the best information he can obtain and reports the information and the determination on his tax return. If the Internal Revenue Service ("IRS") disagrees, it can propose a deficiency, and the foreign "interest" holder generally need not pay the proposed deficiency (unless he chooses to do so) until he has had his day in court.

The proposed regulations adopt completely different procedures with new advantages and disadvantages. Under the proposed regulations, a domestic corporation (other than a domestically controlled REIT and a corporation any

[95]Prop. Reg. section 1.897-2(c)(iii).

[96]Temp. Reg. section 6a.897-2(b), (e), and (d).

class of stock of which is regularly traded on an established securities market at any time during the year) must determine whether it was a USRPHC at the "applicable determination dates" if it knows that any "interest" therein is held by a foreign person.[97] Since "interests" in domestically controlled REITs are excluded from being USRPIS, no purpose would be served by requiring such a corporation to make the determination. The same cannot, however, be said for all "interests" in corporations any class of stock of which is regularly traded on an established securities market, because only certain "interests" therein and only with respect to certain holders thereof are excluded from constituting USRPIS. Thus there will be "interest" holders in such corporations that are potentially subject to the provisions of section 897(a) who will not be able to obtain the benefit of the corporation's determination unless the corporation were voluntarily to make the determination.[98]

If a domestic corporation determines that it was a USRPHC on any of the "applicable determination dates" during the calendar year, it must comply with the requirements of section 6039C(a). If, however, the corporation determines that it was not a USRPHC on any "applicable determination date" during its taxable year, it must notify the IRS by attaching a statement to that effect to its tax return for the year. For taxable years ending after June 18, 1980 for which a return was filed before the date of publication of final regulations, the statement must be delivered separately to the IRS office where its most recent tax return was filed no later than the date that is three months after the date of publication of final regulations.

The statement must be made under penalty of perjury and must be signed by a responsible officer of the corporation. It must contain the name, address, place of incorporation and identifying number of the corporation, the last date, if ever, after June 18, 1980 that the corporation qualified as a USRPHC, and a statement that the corporation has determined that it was not a USRPHC on any "applicable determination date" during the taxable year. The calculations upon which the determination is made need not be included and no official form is prescribed.[99]

A corporation that attached such a statement to its return and thereafter attains USRPHC status on an "applicable determination date" must deliver a notification of change of status to the IRS within 30 days of such "applicable determination date." Finally, a corporation that determines that "interests" therein ceased to be USRPIS during the course of its taxable year *may* (but apparently is not required to) notify the IRS of that fact.

Assume that closely held domestic corporation C was first formed and became operational on January 1, 1984 and that it has a calendar taxable year-end. Further assume that C determined that at no "applicable determination date" in 1984 was it a USRPHC. As a result, if C knows that it has any foreign "interest" holder, it is required to attach a statement to the effect that it was not

---

[97]Prop. Reg. sections 1.897-2(h)(1)(i) and 1.897-2(h)(3).

[98]It should be noted that this will always be true in the case of a foreign corporation. See Prop. Reg. section 1.897-2(h)(2).

[99]Prop. Reg. section 1.897-2(h)(1)(ii).

a USRPHC at any time during 1984 to its 1984 income tax return, which we will assume is filed on September 15, 1985 because of an applicable extension.

Suppose, however, that on January 1, 1985, C acquires a USRPI of sufficient value to make it a USRPHC on that "applicable determination date." If C is required to notify the IRS that starting with the January 1, 1985 "applicable determination date" it is a USRPHC, it must do so within 30 days of that date. Is C so required? Apparently not, because, since it has not yet filed its 1984 return, it has never previously informed the IRS that it was not a USRPHC.[100] Is C still required to attach a statement to its 1984 tax return advising that it was not a USRPHC during 1984? There appears to be no rule that would allow it not to do so. Thus the IRS must wait until the 1985 tax return is filed to learn of a change. But all that the IRS will see on that return is that there is no statement similar to that which was included on the 1984 return.

A foreign person disposing of an "interest" in a domestic corporation must ascertain from the corporation whether an "interest" therein was a USRPI as of the date of disposition.[101] If the corporation informs the foreign person within the period for filing a U.S. tax return that the "interest" was not a USRPI and that it has filed the required statement with the IRS, the foreign person has met the burden of establishing that the corporation was not a USRPHC at any time during the "relevant period." If, however, the corporation either does not inform the foreign person that the "interest" was not a USRPI or does not inform the foreign person that it filed the required statement with the IRS, the "interest" is presumed to be a USRPI. Thus, even if the domestic corporation has determined it was not a USRPHC, that would not be sufficient to change the burden. It also must certify this determination to the IRS and as well inform the foreign person requesting the information that it in fact certified the information.

To some extent, this leaves a foreign "interest" holder at the mercy of the domestic corporation in which he holds an "interest." However, unless a domestic corporation is exempted from the requirement of making determinations,[102] it must within 30 days of the receipt of an inquiry from a foreign "interest" holder therein inform the foreign person whether the "interest" constitutes a USRPI and, if not, whether the corporation has notified the IRS as required.[103] Such a determination can be made in part on the basis of the prior determinations that the domestic corporation was required to make over the "relevant period." If it made no such determination because it did not know any foreign person held an "interest" therein or because no foreign person held an "interest" therein, the corporation has up to 90 days to make the determination and deliver a response to the foreign person. If the determination is that the corporation was not a USRPHC for any year, it must so inform the IRS within the 90-day period.

---

[100]Prop. Reg. section 1.897-2(h)(1)(ii).

[101]Prop. Reg. section 1.897-2(g)(1)(i).

[102]See supra, note 104.

[103]Prop. Reg. section 1.897-2(h)(1)(iv).

Three additional requirements are imposed on domestic corporations required to make determinations. First, if a corporation computes the value of intangibles other than by reference to their purchase price or book value, it must submit a supplementary statement.[104] Second, a corporation wishing to avail itself of the presumption against classification as a USRPHC[105] must submit a supplementary statement if it is engaged in or is planning to engage in the trade or business of mining, farming, forestry, the buying and selling or developing of real property, or leasing real property.[106] Third, a domestic corporation that must make a determination of its status and that holds an "interest" in another corporation (whether domestic or foreign) other than a "controlling interest," must ascertain the status of the other corporation from that corporation.[107] There is, however, no requirement that the other corporation respond to a request of a domestic corporation. Thus, if the other corporation does not inform the first corporation that the "interest" is not a USRPI and that it has filed a statement to that effect with the IRS (either because it was required to do so or because it voluntarily did so), the "interest" will be presumed to be a USRPI.

In any case where a person's "interest" in a corporation is presumed to be a USRPI because it has not received the appropriate notification from the corporation, the person may request the assistance of the Director of the Foreign Operations District in making a determination that the "interest" is not a USRPI. This assistance may be requested only if a request had been made of the corporation prior to 90 days before the date for filing a return. If the Director cannot make a determination, he must so notify the person requesting assistance. In that case, the proposed regulations provide that the person requesting assistance will have the opportunity to establish to the satisfaction of the Director that the "corporation is not a USRPHC."[108] Of course, the relevant determination is whether the corporation was a USRPHC at any time during the "relevant period," and one must assume that the use of the imprecise language will be corrected.

Significantly, if the foreign transferor cannot establish to the satisfaction of the Director that the "interest" is not a USRPI, the tax that would be due as a result of any gain arising from the disposition of the "interest" being considered "effectively connected" must be paid with the filing of its tax return. If the Director subsequently determines that the "interest" was not a USRPI and so notifies the foreign person, a refund is possible. This rule, however, appears to apply only to the case where a request for assistance was properly made to the Director. In all other cases, it appears that the taxpayer has not met his burden of proof and that there is no right to a later determination. It is not clear whether this is intended.

---

[104]Prop. Reg. section 1.897-2(h)(1)(iii)(A).

[105]See the discussion in part V of this article under the heading "Presumption That a Corporation Is Not a USRPHC."

[106]Prop. Reg. section 1.897-2(h)(1)(iii)(B).

[107]Prop. Reg. section 1.897-2(g)(2).

[108]Prop. Reg. section 1.897-2(g)(1)(ii).

Thus a foreign "interest" holder in a domestic corporation comes out better in some ways under the proposed regulations and worse in others. The foreign "interest" holder need not file a return or fill out detailed schedules if he can get the appropriate cooperation of a domestic corporation in which he has an "interest." Rather, all that needs to be done is to make a timely request of the domestic corporation as to its status and as to whether it informed the IRS that it was not a USRPHC for each "applicable determination date" included in the "relevant period." In making the request, the foreign "interest" holder will have to advise the domestic corporation of the "relevant period," since it obviously could vary depending on the holding period for the "interest."

Problems may arise if the domestic corporation does not respond or if it responds unfavourably in circumstances where the foreign "interest" holder has reason to believe it should have responded favourably. If the domestic corporation does not respond at all, at least the foreign "interest" holder has the opportunity to obtain the assistance of or otherwise convince the Foreign Operations District that the "interest" was not a USRPI. If the domestic corporation responds unfavourably, it appears, pursuant to the literal terms of the proposed regulations, that the foreign "interest" holder has no right to request assistance or submit contrary information. One can only hope that in practice a foreign "interest" holder will be given the opportunity to present evidence regardless of the response received from the domestic corporation. Unfortunately, it appears that at least in the case where the foreign "interest" holder did not timely request the information from the domestic corporation, the Director will have no authority to assist or even look at information concerning the status of the corporation. Moreover, it may well be that in such a case, the foreign "interest" holder may have no defence to an assessment. A better approach may well be to allow the foreign "interest" holder to submit information with a return if a favourable response has not been received, regardless of whether information was requested on a timely basis.

Presumption That a Corporation Is Not a USRPHC

Obviously, there will be many cases where a corporation clearly would not be a USRPHC. To avoid requiring a corporation to consider values in these cases, the proposed regulations create a presumption that a corporation is not a USRPHC on any "applicable determination date" if on such date the total book value of the USRPIs of the corporation is 25 per cent or less of the aggregate book values of the assets used in determining whether a corporation is a USRPHC.[109] Book value means the value used on the financial accounting records of the corporation provided they are kept in accordance with generally accepted accounting principles.

The presumption thus created may, however (would you believe), be rebutted conclusively merely by the IRS notifying the corporation that it cannot rely on this presumption. Presumably, the IRS must adopt a standard that must be met before it can advise a corporation that it cannot rely on the presumption. Whether the IRS is aware of this and, if so, what that standard will be, is kept from us at least for now.

[109]Prop. Reg. section 1.897-2(b)(2).

VI. THE SECTION 897(i) ELECTION

An "interest" in a foreign corporation is treated both better and worse than an "interest" in a U.S. corporation under section 897. An "interest" in a foreign corporation is treated better because section 897 does not treat the gain (or loss) on the disposition of such an "interest" as effectively connected with the conduct of a U.S. trade or business, regardless of whether the foreign corporation was a USRPHC at any time during the "relevant period." As a consequence, a foreign person disposing of an "interest" in a foreign corporation is not likely to be subject to U.S. tax on any gain realized on the disposition.[110] To compensate for this benefit, holders of "interests" in foreign corporations are made to bear the worse treatment accorded to foreign corporations under section 897: section 897 mandates that certain "nonrecognition" provisions generally applicable to corporations either are not applicable to foreign corporations or are applicable to foreign corporations only under certain conditions.[111]

In certain cases, worse treatment accorded a foreign corporation might violate a "nondiscrimination" article of a tax or other treaty to which the United States is a party. Were a foreign corporation entitled to nondiscriminatory treatment under a treaty, it conceivably would have the best of both worlds (that is, it would be treated no worse than a U.S. corporation in the case of sales, exchanges, and/or distributions of USRPIs owned by the corporation, and as well as a foreign corporation with respect to dispositions of "interests" therein). Of course, this result could have been prevented by Congress in a number of different ways. For example, Congress could have enacted a provision that would specifically override any treaty obligation that could be construed as requiring a foreign corporation to be treated as well as a U.S. corporation for purposes of section 897. This action would have had the effect of violating a nondiscrimination provision of a treaty insofar as it conflicted with the discrimination built into section 897. Alternatively, Congress might have provided that a foreign corporation otherwise entitled to nondiscriminatory treatment under an applicable treaty could obtain that treatment only if it elects to be treated no better or worse than a U.S. corporation is treated under section 897, without imposing other conditions not particularly relevant to the taxation of the electing corporation—for example, by not requiring an "interest" holder to waive treaty benefits. Adopting neither approach in its entirety, Congress instead emerged with section 897(i).

Section 897(i) provides in part that, if a foreign corporation holds a USRPI and is entitled to nondiscriminatory treatment with respect to that USRPI, it may "elect to be treated as a domestic corporation" (hereafter the "I" election) for purposes of section 897 (and section 6039C, but for no other purpose) provided that two conditions are met. First, with the exception of "interest" holders described in section 897(c)(3), all "interest" holders therein not only must consent to the I election but also must agree that the gain (no mention is made of losses), if any, from the disposition of an "interest" in the electing corporation,

---

[110]Prop. Reg. section 1.897-2(e)(1). Also the distribution of a USRPI by a foreign corporation is not subject to the basis rules of section 897(f). See also IRC section 897(k).

[111]See IRC sections 897(d), (e), and (j).

which gain would be taken into account under section 897(a) as effectively connected income, will be subjet to U.S. tax regardless of any conflicting tax treaty provision. Second, conditions to be prescribed by regulation must be met. Section 897(i) further provides that the I election is to be the exclusive remedy for any person claiming discriminatory treatment with respect to the operation of section 897.[112]

In order for a foreign corporation to make an I election, it must waive the benefit of any treaty with respect to the disposition of any USRPI during the period the I election is in effect.[113] Second, it must agree to be taxed as though it were a domestic corporation on the gain, if any, arising from the disposition of a USRPI and other property received in exchange therefor in a nonrecognition transaction. Significantly, it is not required to agree to be subject to U.S. tax on the disposition of property other than USRPIs and property exchanged therefor.[114]

In order for the I election to be effective, all "interest" holders in an electing corporation[115] must waive rights they may have to treaty benefits with respect to gain or loss arising from the disposition of an "interest" in the electing corporation. In addition, all "interest" holders in an electing corporation must consent to the I election. Information concerning "interest" holders must either be furnished to the IRS together with the I election or, if a security agreement is in effect or has been applied for, may be available for inspection by the IRS.[116]

Perhaps the most significant contribution of the proposed regulations to the utilization of the I election is that they do not impose any arbitrary deadlines for making the I election. An I election may be made at any time before the first disposition of an "interest" in the electing foreign corporation and, if certain conditions are met, even thereafter.[117] By permitting an I election to be made at any time, the proposed regulations afford foreign corporations and their "interest" holders the opportunity to compare the results that would be obtained absent an I election with the results achieved by an I election. Moreover, this comparison need not be made until all the relevant facts are in.

An I election would generally be effective from the date made, although it can be made effective from an earlier date. In certain cases, allowing a retroactive election may achieve a desired result but there could be others where abuses will develop. Some safeguards obviously are needed.

---

[112]IRC section 897(i)(4).

[113]Prop. Reg. section 1.897-3(c)(2).

[114]Prop. Reg. section 1.897-3(c)(3).

[115]Other than those entitled to the benefits of sections 897(c)(3) or 897(c)(1)(B).

[116]See Prop. Reg. section 1.897-3(c)(4)(i) and (ii). However, shy "interest" holders who have sought a security agreement may be able to live with the potential disclosure required because of an I election by insulating themselves with an intermediate tier of foreign corporations.

[117]Prop. Reg. section 1.897-3(d)(1) and (2). Treas. Reg. section 6a.897-3(f), as originally issued, required that the I election be made within 90 days of the date the electing corporation first held or was considered to hold a USRPI. The temporary regulations were later amended to provide that the last date for making the election is the date established by the final regulations.

Significantly, once effective, an I election remains so for the life of the corporation, unless revoked with consent.[118] Consent generally will be given to a revocation if there have been no distributions of USRPIs while the I election was in effect. If there were distributions of USRPIs, a consent generally will be given if there is a payment of an amount equal to the tax that would have been due if the I election were not in effect on the date of the distribution, if the person receiving the distribution is subject to tax on a subsequent disposition thereof, or if the corporation was subject to U.S. tax on the full amount of the appreciation of the USRPIs that were distributed.

Unlike Article XXV(5) of the pending income tax treaty between Canada and the United States, the existing income tax convention does not have a provision that would entitle a Canadian corporation to nondiscriminatory treatment, and therefore section 897(i) does not appear to be of immediate concern to Canadians. For this reason, many of the intricacies of the proposed regulations that deal with the I election were not discussed in this article.

---

[118]Prop. Reg. sections 1.897-3(d)(1) and 1.897-3(f)(1).

PROPOSED TAX LEGISLATION HAS AN IMPACT ON MANY AREAS OF INTERNATIONAL CONCERN

Stanley Weiss

The U.S. Congress is considering a number of tax proposals that could have a significant impact on Canadians investing or doing business in the United States. This article briefly summarizes the proposed legislation.

A number of legislative proposals relating to international tax issues were introduced in Congress last year and, although no significant tax legislation was adopted at year-end, many of these proposals are likely to be taken up again in the next session. Since some of them, if enacted, could have a significant impact on Canadians investing or doing business in the United States, it might be useful to note very briefly the amendments currently pending. Of course, the proposals may be further amended in the course of legislative developments.

Most of the proposed changes are reflected in H.R. 4170, a bill reported out by the House Ways and Means Committee and optimistically named the Tax Reform Act of 1983.[1] The bill does not provide for systematic modification of the U.S. rules for the taxation of foreign persons and activities, but offers a hodgepodge of amendments affecting their tax treatment. One group of provisions would drastically reduce the cost recovery or depreciation deductions for property leased to most foreign users and would eliminate the investment credit for property subject to such leases.[2] Under existing law, the credit may be

---

[1]H.R. 4170, 98th Cong., 1st Sess. (1983).

[2]Ibid., Title I.

available for certain foreign use property, such as U.S.-documented vessels.[3] Similar, less onerous provisions are contained in S. 2062, which was reported out as part of its budget reconciliation package by the Senate Budget Committee.[4] H.R. 4170 and S. 2062 also include provisions to prevent tax avoidance through the use of U.S.-controlled offshore commodities funds. These provisions would extend the accumulated earnings tax to such funds and treat gain realized from the sale of their stock as ordinary income rather than capital gains to the extent of their accumulated profits.[5] The tax straddle rules also would be amended to prevent their avoidance by having a foreign corporation hold one leg of a commodities straddle.[6]

H.R. 4170 contains a number of proposed amendments in the foreign area for which there are no Senate counterparts. The House bill seeks to provide a more objective definition of residence for use in determining whether an alien is a resident or nonresident of the United States for U.S. tax purposes.[7] Rules also are included relating to the tax treatment of certain community property income in the case of nonresident alien individuals.[8] The foreign personal holding company provisions would be amended to eliminate the attribution of ownership from nonresident alien family members and to prevent taxpayers from interposing foreign entities between themselves and their foreign corporations to avoid an inclusion of income under these provisions.[9] A new mechanism would be provided to avoid double taxation through the application of both the foreign personal holding company rules and the Subpart F rules while assuring that tainted income would be taxable in full under one or the other of these two sets of provisions.[10]

H.R. 4170 also would modify existing law to ensure that corporate earnings reflected in dividend treatment to the seller when stock of a foreign corporation is sold will not again be treated as giving rise to dividend income when distributions are made to the purchaser of the shares.[11] This bill also would require that, where the stock of a foreign corporation and a domestic corporation is stapled or paired, the foreign entity be taxed as though it were a domestic company.[12] Certain changes are proposed as well in the treatment of foreign oil-related income[13] and in the classification of certain foreign currency contracts as

---

[3]IRC, section 48(a)(2)(B).

[4]S. 2062, 98th Cong., 1st Sess., Part IV (1983).

[5]Supra footnote 1, sections 804-805; supra footnote 4, sections 113-114.

[6]Supra footnote 1, section 806; supra footnote 4, sections 111-112.

[7]Supra footnote 1, section 451. See the earlier discussion of this in this feature, Herbert H. Alpert and Fred Feingold with the assistance of Ross Macdonald, "Proposal Before Congress to Define U.S. Resident Status" (September-October 1983), 31 *Canadian Tax Journal* 853-62.

[8]Supra footnote 1, section 452.

[9]Ibid., section 453.

[10]Ibid., section 455.

[11]Ibid., section 454.

[12]Ibid., section 456.

[13]Ibid., section 612.

regulated futures contracts subject to taxation on a marked-to-market basis, taking into account unrealized gains or losses at year-end.[14]

S. 2062 would replace the current FIRPTA reporting rules with a withholding tax system, requiring that a portion of the sale price be withheld by the buyer or any agent involved in the transaction where the seller is a foreign person.[15] An exemption would be provided where the buyer is to use the property as his principal residence and it is purchased for not more than $200,000.[16] There is no House counterpart to these withholding tax provisions and the House still may be opposed to them.[17]

The proposed Foreign Sales Corporation Act, H.R. 3810/S. 1804, which is intended to replace the domestic international sales corporation or DISC rules, also contains provisions relating to the tax treatment of offshore factoring.[18] Under these provisions, the loss deduction claimed by a U.S. company selling accounts receivable on a discounted basis to its controlled foreign subsidiary would not be affected.[19] But any income realized by the foreign corporation from collection of the receivables would be treated as interest income for purposes of Subpart F and the foreign personal holding company rules.[20] In addition, the purchase of U.S. receivables would be treated as an investment in U.S. property and taxed as a constructive dividend by the foreign subsidiary to the extent of its accumulated earnings.[21] While H.R. 4170 does not deal with offshore factoring directly, it does contain a provision precluding the recognition of losses on sales between related entities that could eliminate the loss deductions to the U.S. parent generated by these transactions.[22]

Bills also have been introduced to provide an exemption from withholding tax for interest paid to foreign investors on portfolio indebtedness,[23] to suspend permanently the application of Treasury Regulations section 1.861-8 concerning the allocation of research and development expenses to foreign income,[24] to provide for a 15-year foreign tax credit carryforward,[25] to provide for the use of carryovers on a first-in first-out (FIFO) basis,[26] and to provide a domestic loss recapture rule akin to the present foreign loss recapture provision.[27] Legislation

[14]Ibid., section 622.

[15]Supra footnote 4, section 116; S. Rep. no. 98-300, 98th Cong., 1st Sess., 129-132 (1983).

[16]Ibid.

[17]S. Rep. no. 98-300, supra footnote 15, 129. (Despite Senate passage, the Conference Committee has twice failed to impose withholding.)

[18]H.R. 3810, 98th Cong., 1st Sess. (1983); S. 1804, 98th Cong., 1st Sess., section 2(c) (1983).

[19]Ibid.

[20]Ibid.

[21]Ibid.

[22]Supra footnote 1, section 492; H.R. Rep. no. 98-432, 275-277 (1983).

[23]H.R. 4029, 98th Cong., 1st Sess. (1983); S. 1557, 98th Cong., 1st Sess. (1983).

[24]H.R. 1887, 98th Cong., 1st Sess. (1983); S. 654, 98th Cong., 1st Sess. (1983).

[25]H.R. 3140, 98th Cong., 1st Sess., section 3 (1983); S. 1584, 98th Cong., 1st Sess., section 3 (1983).

[26]Ibid.

[27]H.R. 3140, supra, section 2; S. 1584, supra, section 2.

also has been introduced to grant an election to deduct foreign taxes imposed on construction contract services performed in the United States for use in a foreign country.[28]

Other proposals would tighten the rules of section 367 relating to the transfer of appreciated property abroad;[29] impose recapture on the "decontrol" of a controlled foreign corporation;[30] extend ordinary income section 1248 treatment to "hot" assets—that is, to assets whose sale would give rise to Subpart F income or would result in ordinary income if taxable to the corporation in the United States;[31] and require the use of the lower of the overall or "per country" foreign tax credit limitation.[32]

Congress's failure to enact any of the above proposals should not be construed as a sign that there is little likelihood of their eventual enactment. Indeed, there are strong indications that some of the proposals, such as those included in H.R. 4170, will be considered shortly after Congress reconvenes in late January 1984.[33] Consequently, people who might be affected by any of the proposed changes should keep abreast of legislative developments in the international tax area during the new congressional session.

---

[28]S. 1550, 98th Cong., 1st Sess. (1983).

[29]Staff of Senate Committee on Finance, *The Reform and Simplification of the Income Taxation of Corporations,* 98th Cong., 1st Sess. (Senate Print 98-95, 1983).

[30]Ibid.

[31]Ibid.

[32]"Provisions of Pease-Gephart-Moody-McHugh Amendment," *Daily Tax Report* (Washington, D.C.: Bureau of National Affairs, October 25, 1983), at G-10 to G-14.

[33]"Tax Legislation: Congress Winds Down Without Tax Bill, But Further Consideration Planned for 1984," *Daily Tax Report* (Washington, D.C.: Bureau of National Affairs, November 18, 1983), at G-3.