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An Analysis of the Temporary Regulations Under FIRPTA: Part II

The Regulations provide an entirely new set of nonrecognition rules, which sometimes conflict with the statutory provisions.

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The long awaited Regulations under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) provide detailed and somewhat surprising rules applicable to corporate transfers that otherwise qualify for nonrecognition treatment. Rules governing certain partnership transfers are also provided.

Interaction of FIRPTA and Section 367

As was previously discussed, Section 897(d)(1) may overide the otherwise applicable nonrecognition rules that apply to distributions of a U.S. real property interest (USRPI) made by certain foreign corporations.[1] Similarly, Section 897(e)(1) generally overrides otherwise applicable nonrecognition rules where a foreign person exchanges a USRPI for property that would not be subject to tax in the hands of the foreign person. In determining whether nonrecognition treatment is otherwise applicable, a number of other Code provisions must be considered. In particular, Sections 367(a) and (e) must be considered in connection with an "outbound" transfer involving a USRPI (an "outbound" transfer is one in which the transferor is a U.S. person and the recipient is a foreign corporation[2]).

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Section 367(a)(1) generally provides that if a U.S. person transfers property to a foreign corporation, the foreign corporation will not be considered a corporation for purposes of determining the amount of gain that must be recognized by the U.S. person.[3]

EXAMPLE: A U.S. person transfers appreciated property to a wholly owned foreign corporation in exchange for its shares. Even though gain ordinarily would not be recognized under Section 351, gain *will* be recognized if Section 367(a)(1) treats the foreign corporation as an entity other than a corporation.

Section 367 interacts with FIRPTA in the context of several different corporate transactions. Section 332 liquidations involving a foreign parent and a U.S. subsidiary are considered below.

Pre-*General Utilities* repeal. Prior to the repeal of *General Utilities,* Section 367(a)(1) had little significance in a liquidation to which Section 332 applied. Although Section 332 was one of the nonrecognition transactions covered by Section 367 (a)(1), nonrecognition was provided to a liquidating U.S. corporation under former Section 336, which applied regardless of whether the shareholder was considered to be a corporation[4]; and Section 367(a)(1) did not (and still does not) trigger gain recognition to a *foreign* person.[5] (On the other hand, FIRPTA may subject a foreign corporate shareholder to U.S. tax if stock of a domestic U.S. real property holding corporation (USRPHC) is exchanged by the foreign corporation for property that would not subject such foreign corporation to U.S. tax on a subsequent sale of the property received. This rule, in Section 897 (e)(1), is discussed in greater detail below.)

Section 367(e) was added in 1984 to close this "loophole" in Section 367(a) by providing a mechanism to prevent the outbound tax-free distribution of appreciated property to a foreign corporation in a Section 332 liquidation. As originally enacted, however, Section 367(e) was to apply to trigger gain to a liquidating U.S. corporation only to the extent provided in Regulations (which, if issued, were to apply only prospectively).[6] If gain were triggered to the U.S. corporation under Section 367 (e), the foreign corporate shareholder presumably could have avoided any otherwise-applicable tax triggered by FIRPTA as a result of the application of Section 897(c)(1)(B).[7]

Post-*General Utilities* repeal. As a result of the overall repeal of the *General Utilities* doctrine, the "loophole" in Section 367(a)(1) disappeared automatically, but Section 367 (e) was not repealed. In fact, Congress, in TRA '86, strengthened it.

After the repeal of *General Utilities,* the nonrecognition rule of Section 337(a) does not apply if there is no 80% corporate distributee in a

Section 332 liquidation. Since Section 367(a)(1) ignores the corporate character of a foreign corporation, after the repeal of *General Utilities* that section would make Section 332 inapplicable, and Section 336(a) would require recognition of gain by the liquidating U.S. corporation. As amended in 1986, however, Section 367(e)(2) now generally provides that in the case of a liquidation described in Section 332, unless otherwise provided by Regulation, the nonrecognition rule contained in Section 337 does not apply to any corporation where the 80% distributee is a foreign corporation.

There are several differences between the application of Sections 367 (a)(1) and 367(e)(2) to a Section 332 liquidation. In particular, Section 367(a)(1) still applies only to transfers of property by a domestic corporation, whereas Section 367(e)(2) applies to liquidations of either domestic or foreign corporations. Furthermore, until Regulations are promulgated under Section 367(e)(2), none of the statutory exceptions to the application of the harsh Section 367(a)(1) rule apply under Section 367(e)(2).[8] It is also troublesome that, as a technical matter, in the absence of Regulations, both Sections 367(a)(1) and (e)(2) mandate recognition of gain by any liquidating corporation with an 80% foreign corporate shareholder.[9]

In *Notice* 87-5, IRB 1987-3, 7, the IRS announced that Regulations to be promulgated under Section 367(e)(2) would provide that the recognition rule of Section 367(e)(2) will not apply to a Section 332 liquidation of a foreign corporation into another foreign corporation (a "foreign-to-foreign" Section 332 liquidation),[10] except with respect to the distribution of USRPIs or property used in a U.S. trade or business. *Notice* 87-5 also stated that the treatment of distributions of USRPIs will be governed by Section 897(d).[11] Temp. Reg. 1.897-5T(c)(2)(ii)(A) confirms that Section 367(e)(2) will not affect the application of Section 337(a) to the distribution of most USRPIs in a foreign-to-foreign Section 332 liquidation (at least where the subsidiary is not an electing foreign corporation).[12]

A liquidating U.S. corporation is required to recognize gain under Section 367(e)(2) on the distribution of a USRPI that is stock of a U.S. corporation which had been, but which no longer is, a USRPHC.[13] No gain is required to be recognized on the distribution of other USRPIs. While the issue of whether recognition will be required under Section 367(e)(2) on the distribution of property other than USRPIs is reserved for future Regulations, in the absence of Regulations to the contrary the statute mandates recognition.[14]

In the case of a liquidation of an electing foreign corporation[15] into a foreign parent corporation under Section 332 after 7/31/86, different rules apply. Under Temp. Reg. 1.897-5T(b)(3)(iv)(B), the electing foreign corporation is *not* required to recognize gain under Section 367 (e)(2) on the distribution of any USRPI, whether or not the USRPI is stock of a former USRPHC, perhaps because an electing foreign corporation is treated as a *foreign* corporation under Section 367(e)(2) and *Notice* 87-5. As in the case of a liquidating domestic corporation, however, the treatment under Section 367(e)(2) of gain realized on the distribution of non-USRPIs is reserved for future Regulations.

No apparent reason exists for the seemingly more liberal treatment of liquidating electing foreign corporations under Section 367(e)(2). However, a foreign 80% distributee of an electing foreign corporation may be subjected to more onerous U.S. tax treatment under the Temporary Regulations than a similarly situated foreign corporate shareholder of a liquidating U.S. corporation. This difference in treatment is discussed further below.

Availability of Other Nonrecognition Rules

Section 897(e)(1) provides that, except as otherwise provided in Section 897(d) or under Regulations under Section 897(e)(2), any nonrecognition provision applies for purposes of Section 897 only in an exchange of a USRPI for an interest the sale of which would be "subject to tax" under the Code. Thus, like Section 897(d), Section 897(e)(1) operates only where nonrecognition is pro-

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[1] See Feingold and Glicklich, "An Analysis of the Temporary Regulations under FIRPTA: Part I," 69 JTAX 262 (October 1988) ("Part I").

[2] In connection with transfers to other foreign entities, see Sections 1491, 1492.

[3] An exception in Section 367(a)(3)—which is not relevant in transactions to which FIRPTA may apply—is provided for transfers of property by a U.S. person to a foreign corporation for the latter's use in an active trade or business outside the U.S. This exception would be limited by pending Section 367(a)(5), as proposed in the Miscellaneous Revenue/Technical Corrections Bills of 1988, H.R. 4333/S.2238, 100th Cong., 2d Sess., Section 106(e)(13)(A).

[4] An "outbound" Section 332 liquidation that did not qualify for an exception to Section 367(a)(1) could have triggered "recapture" to the liquidating corporation.

[5] Several letter rulings seemed to miss the significance of the application of Section 336. See, e.g., Ltr. Ruls. 8524049 and 8524090.

[6] To date, no Regulations have been issued under that section, except perhaps Temp. Reg. 1.897-5T.

[7] See Part I at 69 JTAX 264, fn. 16.

[8] Compare to Section 367(e) as in effect before TRA '86.

[9] Compare current Section 367(a)(5) with Section 367(e)(2).

[10] No reference is made to Section 367(a); but see Section 367(a)(5). With respect to foreign-to-foreign liquidations, see Temp. Reg. 7.367(b)-5. See also Section 337(d)(2) (Regulations are to be promulgated which provide for the appropriate coordination of Section 337 with the rules relating to the taxation of foreign corporations and their shareholders). As noted above, Section 897(d) ordinarily does *not* override Section 337(a) nonrecognition treatment accorded to the distribution of USRPIs in a foreign-to-foreign Section 332 liquidation. Section 897(d)(2); Temp. Reg. 1.897-5T(c)(2)(i). Gain may have to be recognized, however, under Temp. Reg. 1.897-5T(c)(2)(ii)(B) (an inbound liquidation occurring within five years from the date of acquisition by a U.S. corporation of the shares of a foreign corporation).

[11] For purposes of Section 367, an electing foreign corporation is still a foreign corporation. Therefore, a Section 332 liquidation of either a non-electing or an electing foreign corporation into either a non-electing or an electing foreign corporation would be subject to the same rules under Section 367(e)(2) but not to Section 367(a)(1). Under FIRPTA, of course, before the repeal of *General Utilities*, a Section 332 liquidation of a foreign corporation into an electing foreign corporation raised a "subject to tax" issue under Section 897(d)(2)(A), as discussed in Part I.

vided elsewhere in the Code in connection with the transfer by a foreign person (not including an electing foreign corporation) of a USRPI. Accordingly, if the property transferred by a foreign person is not a USRPI, Section 897(e)(1) has no application. Section 897(e)(1) also is not applicable where gain must otherwise be recognized on the exchange under any other provision.[16]

If property received in an exchange would *not* meet the subject-to-tax test, Section 897(e)(1) overrides any otherwise-applicable nonrecognition rule unless nonrecognition is otherwise permitted either under Section 897(d) or Regulations under Section 897(e)(2). The subject-to-tax test that applies under Section 897(e)(1) is the same as that considered in connection with the discussion of the first requirement under Section 897(d)(2).[17]

While Section 897(e)(1) would appear to allow a USRPI to be exchanged for property other than USRPIs (*e.g.,* U.S. business property) without the recognition of gain as long as the transferee would be "subject to tax" on a subsequent sale or exchange of the property, the general rule set forth in Temp. Reg. 1.897-6T(a)(1) states that a USRPI may *only* be exchanged for *another* USRPI! This Regulation apparently conflicts with the statute.[18] The drafters of the Temporary Regulations may not have intended to create this conflict. For example, the Temporary Regulations in certain places provide that U.S. business property other than USRPIs may qualify for nonrecognition treatment under Section 897(e)(1)[19]; in still other places, the Temporary Regulations appear to ignore the subject-to-tax requirement entirely.[20]

As noted in the first part of this article,[21] Section 897(e)(2) grants to the IRS broad authority to prescribe Regulations deemed necessary (to prevent avoidance), which provide the extent to which nonrecognition provisions will apply for purposes of Section 897 and the extent to which transfers of property in reorganizations will be treated as sales at fair market value. Thus, if after applying Sections 897(e)(1) and (d)(2) a statutory nonrecognition rule would apply, a Regulation promulgated under Section 897(e)(2) may still prevent it from applying. On the other hand, a Regulation under Section 897(e)(2) may *permit* an otherwise-applicable nonrecognition rule to apply (in whole or in part) even if the requirements of Section 897(e)(1) or 897(d)(2) are not met.

Section 332 Liquidations

As previously noted, Section 897(e)(1) is potentially applicable to the foreign corporate shareholders of a liquidating domestic or electing foreign USRPHC.[22] In either case, the foreign shareholders would be subject to U.S. tax on gain realized on the liquidation but for Section 332 (a nonrecognition provision), and the foreign corporation would be exchanging a USRPI (*i.e.,* shares of the liquidating subsidiary) for the property received in the liquidation.

Pre-*General Utilities* repeal. Under Section 897(e)(1), gain would be recognized to the foreign parent to the extent it received property not subject to tax on a subsequent disposition. Under Temp. Reg. 1.897-5T(b)(3)(ii), this rule is applied to liquidations of U.S. subsidiaries occuring prior to the effective date of *General Utilities* repeal. The Temporary Regulations provide that the amount of gain that must be recognized by the foreign parent is determined by multiplying the gain realized by a fraction, the numerator of which is the fair market value of property other than USRPIs[23] received in the exchange and the denominator of which is the fair market value of all the property distributed. The Regulations do not specify whether or how liabilities assumed (or taken subject to) are to be treated for this purpose.

The basis to the distributee of the assets other than USRPIs received in the liquidation is increased (but not above their fair market value) by the gain recognized. Since the Temporary Regulations do not provide for any basis adjustment for USRPIs received, they will often have the effect of taxing appreciation attributable to USRPIs more than once. In fact, this double tax will result whenever appreciated USRPIs and less-appreciated non-USRPI property (*e.g.,* cash) are distributed in the liquidation.

EXAMPLE: USC, a domestic USRPHC, is liquidated on 1/1/86. On that date, USC owned a USRPI with a zero adjusted basis and a fair market value of $1,500. USC also had cash of $1,000 and no liabilities.

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12 See also Temp. Reg. 1.897-5T(b)(3)(ii).

13 Temp. Reg. 1.897-5T(b)(3)(iv)(A). Presumably, the reason for requiring recognition of gain on the distribution of stock of a former USRPHC is that such property would not be a USRPI in the hands of the distributee. See Section 897(c)(1)(A)(ii)(I). In any event, this rule requires a determination under Section 897(c)(2) as of the date of distribution. The Temporary Regulation provides for a basis adjustment which should avoid double taxation. However, Section 367(a)(1) is not even mentioned. The authors assume that a reference to Section 367(e)(2) in the Temporary Regulations was also intended to be a reference to Section 367(a)(1).

14 See Notice 87-5, IRB 1987-3, 7, and H. Rep't No. 99-841, 99th Cong., 2d Sess. II-202 (1986). The foreign parent corporation is not required to recognize *any* gain on the liquidation. See discussion below.

15 That is, a corporation that elects under Section 897(i) to be treated as a U.S. corporation solely for purposes of FIRPTA (including FIRPTA reporting and FIRPTA withholding purposes). See Part I at 69 JTAX 263.

16 See Section 337(d)(2).

17 See Part I at 69 JTAX 265.

18 See Sections 864(c)(6) and (7), added by TRA '86.

19 See, e.g., Temp. Reg. 1.897-5T(b)(3)(iv)(B) (first sentence) (but query why the Regulation uses "and" rather than "or").

20 See Temp. Reg. 1.897-5T(b)(3)(iv)(A).

21 See, e.g., 69 JTAX at 266-268.

22 Prior to the effective date of the repeal of General Utilities, Section 897(e)(1) also applied to a foreign electing shareholder under Section 333. See Temp. Reg. 1.897-5T(b)(6).

23 As noted above, this limit to property constituting a USRPI is consistent with Temp. Reg. 1.897-6T(a)(1), but it may be inconsistent with the language of Section 897(e)(1), which would *permit* nonrecognition if U.S. business property were received.

24 Other rules might also be considered. Compare Sections 338(b), 1060 and 755.

25 As noted previously, such a corporation may have to recognize gain under Sections 367(a)(1) and (e)(2).

26 No special rule is provided for electing foreign corporations prior the repeal of General Utilities. Therefore, such corporations are treated under FIRPTA like any domestic corporation. See Section 897(i)(l); Temp. Reg. 1.897-5T(b)(4).

USC's sole shareholder was FPC, a foreign corporation, which had a basis in its USC shares of $1,000. FPC's total gain is $1,500. FPC's recognized gain would be $600, calculated as follows:

$$\frac{1500 \times 1000}{2500} = 600$$

Under the Temporary Regulations and Section 334(b)(1), FPC's basis in the USRPI received would be zero, even though FPC recognized gain of $600. On a subsequent disposition of the real property, that $600 gain would again be subject to tax.

This problem could be solved by allowing FPC to adjust its basis in the USRPI. Where property other than USRPIs or cash is distributed, the solution might be either to increase the basis of the non-USRPI first (to its fair market value) and any excess could be added to the basis of the USRPI. Alternatively, the basis of all property with built-in appreciation could be increased in proportion to the fair market value of each item of property.[24]

Post-*General Utilities* repeal: liquidating U.S. corporation. Where a U.S. corporation liquidates after the effective date of *General Utilities* repeal, Temp. Reg. 1.897-5T (b)(3)(iv)(A) provides that the foreign parent need not recognize any gain, regardless of the relative amounts of USRPIs distributed, and whether or not the foreign parent would be subject to tax on a subsequent disposition of the property received from the U.S. subsidiary.[25]

Post-*General Utilities* repeal: liquidating electing foreign corporation. Still another rule is provided with respect to the recognition of gain to a foreign parent corporation after the repeal of *General Utilities* in the case of a Section 332 liquidation of an electing foreign corporation.[26] With respect to such transactions, Temp. Reg. 1.897-5T(b)(3)(iv)(B) provides that gain must be recognized by the foreign parent corporation equal to its gain realized multiplied by a fraction. The numerator is the amount of the fair market value of the nonqualified property; for this purpose nonqualified property includes all non-USRPIs that are not U.S. business assets. The denominator is the combined fair market values of all the properties received in the liquidation. As in the case of the liquidation of a U.S. corporation before *General Utilities* repeal, no rule is provided for liabilities assumed (or taken subject to). The Temporary Regulations provide that in this situation, the appropriate basis-adjustment rules for any USRPIs and U.S. business assets received are to be provided in Regulations promulgated under Section 367(e)(2)! (The basis to the distributee of properties other than USRPIs and U.S. business assets is the distributing corporation's basis, plus any gain recognized by the *distributee* with respect to the receipt of such property, with a fair market value ceiling.)

Other Transactions Subject to Section 897(e)(1)

With the exception of certain foreign-to-foreign exchanges and multiple-property transfers, discussed below, the general "subject-to-tax" rule applies to other nonrecognition exchanges of a USRPI by a foreign person. Thus, gain is required to be recognized by the foreign person to the extent that nonqualified property is received. The Temporary Regulations consider anything other than fully taxable USRPIs to be nonqualified property!

Section 355 spin-offs. In the case of a spin-off by a domestic or an electing foreign USRPHC with foreign shareholders, under Section 897(e)(1) and Temp. Reg. 1.897-6T (a)(4), the distribution is treated as an exchange of stock in the distributing corporation for stock of the previously controlled corporation. If stock of the controlled corporation is not a USRPI in the hands of the foreign recipient, gain is required to be recognized by the recipient.

Partnership interests, etc. Under FIRPTA, interests in partnerships, trusts or estates are not USRPIs unless such interests are considered to be interests in real property. As defined in Reg. 1.897-1(d)(2), such an interest includes "any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, the real property." This implies that a partnership interest in a partnership owning a USRPI (or an interest in a similar trust or estate) might be a USRPI at least in part. Other provisions of the FIRPTA Regulations strongly imply, however, that an interest in a partnership (or in a trust or estate) is not a USRPI.[27]

Related to the issue of whether an interest in a partnership owning USRPIs is a USRPI is whether (and to what extent) (1) gain must be recognized on the transfer of a USRPI to a partnership in exchange for a partnership interest, and (2) gain from the disposition of a partnership interest is to be treated as gain from the disposition of USRPIs owned by the partnership. Regulations were to be promulgated under Section 897(g) to indicate the extent to which amounts received in exchange for an interest in a partnership, trust or estate would be considered attributable to a disposition of a USRPI. Until the issuance of the new Temporary Regulations in May 1988, most practitioners probably took the position that a contribution of a USRPI by a foreign person to a partnership did *not* trigger gain to the foreign transferor under Section 897(e)(1). This suggested that a foreign person would be "subject to tax" on a subsequent disposition of a partnership interest.

Temp. Regs. 1.897-7T and 1.1445-11T now provide that an interest in a partnership that meets a "50/90" test (*i.e.*, 50% of the value of its gross assets consist of USRPIs and 90% of the value of the gross assets consist of USRPIs and cash or cash equivalents) is subject to the following rules:[28]

1. The interest will be treated entirely as a USRPI for Section 1445 withholding purposes (effective for dispositions occurring after 6/6/88).[29]

2. Effective after 6/6/88, gain recognized on a disposition of the interest will be treated as gain ("attributable gain") from the disposition of a USRPI to the extent the gain is attributable to a USRPI.[30] However, no rules are provided for

determining the amount considered so attributable. Apparently each foreign transferor is required to demonstrate the extent to which gain is *not* attributable to USRPIs.[31]

These rules implied that before 6/7/88, an interest in a partnership was not a USRPI and that gain from the disposition of any such interest was not subject to FIRPTA. If that were the case, however, a pre-6/7/88 contribution of an appreciated USRPI to a partnership, and certain liquidating exchanges involving a corporation that owned a partnership interest, would have been subject to tax under Sections 897(e)(1) or 367(e)(2)[32] because the partnership interest would not have been a USRPI.

This confusion was addressed by the IRS in *Notice* 88-72, IRB 1988-27, 26. There, the IRS announced that Section 897(g) was not dependent on the issuance of Regulations, and that gain realized on the disposition by a foreign person of a partnership interest (or an interest in a trust or estate) is subject to FIRPTA to the extent such gain is attributable to a USRPI. Thus, it appears that, even prior to 6/7/88, such gain was subject to the substantive provisions of FIRPTA (apparently without regard to whether a *de minimis* threshold, such as the "50/90" test, had been met). Presumably, this view will be reflected in any revised Regulations under Section 897(g). It is still not clear, however, whether after 6/6/88 attributable gain is to be subject to the substantive provisions of FIRPTA only if the 50/90 test is met.[33]

Multiple-asset exchanges. Where nonqualifying property is received in exchange for a USRPI, the underlying principle under Section 897(e)(1) is that realized gain will be recognized to the extent thereof.[34] Where a USRPI *and* other property are exchanged for both a USRPI and other property, a determination must be made as to the amount of nonqualifying property that is considered received in exchange for (1) the transferred USRPI and (2) the other property.

To determine the amount of the nonqualifying property received for a USRPI in such multiple-property exchanges, the Temporary Regulations adopt a "fractionalized" approach.[35] Under this approach, the amount of nonqualifying property (including cash) considered to be received in exchange for a USRPI is determined by multiplying the fair market value of all the nonqualifying property received by the "real property fraction." The numerator is the fair market value of the USRPIs transferred in the exchange and the denominator is the fair market value of all properties transferred.[36] This approach tends to accelerate gain attributable to the USRPIs, which will provide an incentive to attempt to separate transfers of USRPIs from transfers of other property.

Exceptions to Recognition Rule

Under Section 897(e)(1), discussed above, gain ordinarily would be recognized on the exchange by a foreign person of a USRPI for stock of a foreign corporate transferee (or for stock of a foreign corporation in control of the foreign-corporate transferee involved in the exchange). Temp. Reg. 1.897-6T(b) provides certain exceptions to this rule, however, under Section 897(e)(2). In order to come under one of these exceptions, the transferor must satisfy the "procedural requirements" noted in the first part of this article, the transfer must be in one of three approved forms (described below), and one of five additional conditions (designed to assure that the FIRPTA tax will ultimately be paid) must be met.[37]

The types of approved transfers are as follows:

1. D or F reorganizations in which the shareholders of the transferor foreign corporation exchange (or are considered to exchange) their shares of stock of the transferor for shares of stock of the transferee under Section 354.

2. C reorganizations, provided that the transferor corporation's shareholders own more than 50% of the voting stock of the transferee corporation (or, if shares of its parent are received, more than 50% of that voting stock) after the exchange.

3. Section 351 exchanges or B reorganizations in which stock of a domestic USRPHC is transferred, provided that the transferee corporation (or its parent) is owned by foreign persons in the same proportions[38] as the stock of the USRPHC was owned immediately before the exchange. If the shares of the foreign corporation received in the exchange are sold by the recipient within three years, however, a proportionate amount of the gain must be recognized.

In addition, one of the following five conditions must be met:

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27 See Reg. 1.897-1(d)(3)(i)(B). See also Section 897(c)(4)(B) and Reg. 1.897-1(e)(2) (USRPIs held by partnerships are attributed to the partners for purposes of determining whether a corporation is a USRPHC). Former Regs. 1.1445-5(c)(2)(i) and 1.1445-5(b)(8)(iv) had provided that until Regulations were adopted under Section 897(g), withholding was not required on the transfer of a partnership interest.

28 The Temporary Regulations do not indicate when the 50/90 test is to be determined. Presumably, it is to be determined at the time of (or perhaps immediately before or after) a relevant transaction. But see Temp. Reg. 1.1445-11T(d)(2)(i) (buyer of a partnership interest may rely on a statement from a partnership dated as much as 30 days before the transfer).

29 Temp. Reg. 1.897-11T(b).

30 Temp. Reg. 1.897-7T(b).

31 Temp. Reg. 1.1445-11T(d)(1).

32 See Section 386(a) (as to distributions).

33 Compare Temp. Regs. 1.897-7(a) and (b) with Notice 88-72, IRB 1988-27, 26.

34 Temp. Reg. 1.897-6T(a)(8).

35 See Temp. Reg. 1.897-6T(a)(8)(ii). (*Cf* Rev. Rul. 85-164, 1985-2 CB 117 (holding period and basis of shares issued in exchange for multiple properties under Section 351).

36 Temp. Reg. 1.897-6T(a)(8)(ii)(A).

37 See Temp. Reg. 1.897-6T(b)(1).

38 This may preclude formation of a foreign holding company to own shares of a domestic USRPHC previously owned by a foreign person unless that person owned 100% of the interests in the domestic USRPHC or unless all the other holders of interests in the domestic USRPHC participate in the exchange. Perhaps the Temporary Regulations should be made more flexible by allowing a taxpayer to transfer shares of a domestic USRPHC as long as the ultimate beneficial interests in the domestic USRPHC are not changed. This could be accomplished by applying certain attribution rules (see e.g., Section 318) to determine the ultimate beneficial ownership of a domestic USRPHC.

39 Such a transfer would be tax-free only if it occurred after 5/5/88.

1. Each of the interests received or exchanged in a transferor or transferee corporation would not be a USRPI if they were domestic corporations. (Thus, non-real estate companies may be reorganized.)

2. The transferee corporation (and its parent, if its stock is issued in a reorganization) is incorporated in a treaty country, the treaty has an exchange-of-information provision, and *all* treaty benefits are waived by the transferee (and the parent corporation if its stock is issued).[39]

3. The transferee (and its parent if its stock is issued in a reorganization) is a "qualified resident" (within the meaning of Section 884(e)) of the country in which it is incorporated.

4. Both the transferee (and its parent if its stock is issued in a reorganization) and the transferor are incorporated in the same treaty country, and the treaty has an exchange-of-information provision. (The parties need not be bona fide residents of such treaty country, and need not waive any treaty benefits.)

5. Both transferee and transferor are incorporated in the same foreign country and the transaction is incidental to an F reorganization.

Under these foreign-to-foreign rules, for example, in most circumstances, a Panamanian corporation owning only a USPRI could not reorganize into a Bahamian corporation without paying a tax, even though the reorganization would—if tax free—not adversely affect the amount of gain on any USRPI that ultimately would be subject to tax in the U.S. The policy reason for limiting which types of foreign-to-foreign exchanges will be allowed nonrecognition treatment under Section 897 (e)(2) is not apparent. These special rules illustrate, however, that the Treasury is in some cases willing to allow transfers of USRPIs which preserve the amount of gain that ultimately will be subject to U.S. tax.

Conclusion

Charged with developing rules to apply under an ever-changing Code to transactions spanning back nearly eight years and forward for perhaps a longer period of time, the drafters of the new Temporary FIRPTA Regulations may have produced as good a product as could be expected under the circumstances. It might have been more useful, however, if the energy devoted to this project had been devoted instead to conforming FIRPTA to the realities of the world after *General Utilities* repeal. Had such energy been harnessed and directed toward such a goal, today's FIRPTA could have been dramatically simplified. □

QBU ACCOUNTING METHODS EXPLAINED

Qualified business units (QBUs) that use the dollar as their functional currency (FC) are required to compute profit and loss or E&P using the dollar approximate separate transactions method of Temp. Reg. 1.985-3T. *Notice* 88-101, IRB 1988-36, 49, offers guidance on the use of this method. In addition, new Temporary Regulations (TD 8220, 8/25/88) detail the profit and loss method that must be used by QBUs that do not use the dollar as their FC. (See "Temp. Regs. Determine Functional Currency," 68 JTAX 194 (September 1988).) *Notice* 88-102, IRB 1988-36, 50, explains the weighted average exchange rates.

Separate transactions method. According to *Notice* 88-101, a QBU uses the separate transactions method for its first taxable year beginning after 1986 by determining the dollar and hyperinflationary currency basis of its assets acquired before 1987, the dollar and hyperinflationary amount of its liabilities incurred before 1987, and retained earnings at the end of its last taxable year beginning before 1987. Hyperinflationary currency is the currency of any country where there is cumulative inflation of at least 100% for a specified 36-calendar month period.

Use of the separate transactions method entails the following:

1. Compiling a profit and loss statement in the QBU's hyperinflationary currency.

2. Adjusting the profit and loss statement to comply with U.S. accounting and tax rules.

3. Translating the hyperinflationary currency shown on the adjusted statement into dollars.

4. Adjusting the resulting dollar profit and loss or E&P to reflect the amount of currency gain or loss.

Currency gain or loss is the dollar amount of retained earnings at the end of the taxable year, adjusted for distributions made during the year, minus the total dollar amount of retained earnings at the end of the preceding taxable year and the dollar profit (or plus the dollar loss) for the taxable year. Generally, the dollar amount of retained earnings is the aggregate dollar basis of the QBU's assets on its balance sheet, less the aggregate dollar amount of liabilities on its balance sheet.

Rules for CFCs. If an eligible QBU was a controlled foreign corporation (CFC) for its last taxable year beginning before 1987 and had a significant event (described in Reg. 1.964-1(c)(6)) in a taxable year beginning before 1987, its hyperinflationary currency adjusted basis in assets acquired before 1987 and its hyperinflationary currency amount of liabilities incurred before 1987 is the basis determined under Reg. 1.964-1(e) prior to translation under Reg. 1.964-1(e)(4). The dollar adjusted basis in such assets and the dollar amount of such liabilities is the adjusted basis or the amount determined under Reg. 1.964-1(e) after translation under Reg. 1.964-1(e)(4).

Foreign corporations other than eligible QBUs must compute hyperinflationary currency and dollar adjusted basis in assets acquired and hyperinflationary currency and dollar amount of liabilities incurred in taxable years beginning before 1987, as well as the dollar amount of retained earnings at the beginning of the first taxable year beginning after 1986, in accordance with Temp. Reg. 1.985-3T.

Net worth branches. An eligible QBU that is a branch of a U.S. person and used a net worth method of accounting for its last taxable year beginning before 1987 determines its hyperinflationary currency adjusted basis of assets and hyperinflationary currency amount of liabilities under Temp. Regs. 1.989(c)-1T(c) and (d). The dollar adjusted basis in the as-

sets and the dollar amount of such liabilities are the adjusted basis and amount used in determining final net worth under Temp. Reg. 1.989(c)-1T (b)(2)(i).

The dollar amount of retained earnings at the beginning of the QBU's first taxable year after 1986 equals final net worth as determined under Temp. Reg. 1.989(c)-1T(b)(2)(i), less the aggregate amount of reserves (other than reserves out of current or accumulated E&P) and the amount of paid-in capital on the balance sheet.

Profit and loss method. According to Temp. Reg. 1.987-1T(b), QBUs that have an FC other than the dollar and that used a profit and loss method of accounting for their last taxable year beginning before 1987 must calculate exchange gain or loss on their remittances occurring in taxable years beginning before 1987. Section 987 provides that exchange gain or loss is determined on a remittance of post-'86 QBU earnings (the previously unremitted earnings of the QBU, as adjusted according to U.S. generally accepted accounting and tax principles, for taxable years beginning after 1986). Exchange gain or loss is also determined on a remittance in excess of post-'86 earnings.

A taxpayer must assign its unremitted QBU earnings and capital (as measured in FC) to two pools, one consisting of post-'86 QBU earnings and the other consisting of the sum of pre-'87 equity (*i.e.*, earnings and capital) and post-'86 capital (the EQ pool). A remittance is deemed to emanate first from post-'86 earnings and second from the EQ pool. The exchange gain or loss on a remittance from the EQ pool is determined by comparing the current dollar value of the remittance to its historical dollar basis. Generally, such gain or loss is recognized in the year of the remittance.

Five-step method. Under Temp. Reg. 1.987-1T(b)(1), the first step is to calculate the beginning EQ pool. This equals the FC adjusted basis of the branch's assets less the FC amount of the branch's liabilities at the end of the taxpayer's last taxable year beginning before 1987. The EQ pool is then increased for capital contributions made after 1986 and decreased by certain remittances.

Next, the branch's beginning dollar equity pool ($E) is determined, under Temp. Reg. 1.987-1T(b)(2). Generally, this is the dollar amount of all the branch's profits for taxable years beginning before 1987, plus the total dollar amount of all capital contributions to the branch during that period, less the dollar amount of all the branch's losses reported on the taxpayer's returns for such years, and the total dollar basis of all remittances made by the branch during that period.

The $E pool is then increased by capital contributions made after 1986

and decreased by certain remittances. Next, a determination is made of the pools from which remittances are drawn, in accordance with Temp. Reg. 1.987-1T(b)(3).

The dollar basis of a remittance of EQ is then calculated, using a formula detailed in Temp. Reg. 1.987-1T(b)(4). Finally, the exchange gain or loss on the remittance of EQ is calculated, under Temp. Reg. 1.987-1T(b)(5). Temp. Regs. 1.987-1T(c) and (d) set out the rules for determining the FC adjusted basis of branch assets and liabilities acquired in taxable years beginning before 1987.

Computing exchange rates. According to *Notice* 88-102, the weighted average exchange rate referred to in Sections 989(b)(3) and (4) (for amounts included in income under Sections 951(a), 551(a) and 1293(a), and for QBUs) is the simple average of the daily exchange rates (determined by reference to a qualified source of exchange rates, as defined in Reg. 1.964-1(d)(5)) for the taxable year. □

NEW DECISIONS

Backdated promissory note was not a commission. (TC)

Export, taxpayer's subsidiary, elected DISC status. Export reported income attributable to commissions from the taxpayer, although the commissions were not paid within 60 days after the close of Export's taxable year. In lieu of payment, the taxpayer gave Export a promissory note created more than 60 days following the close of Export's taxable year, but backdated. The IRS determined the note was not a valid export asset, so that Export did not qualify as a valid DISC.

Held: For the Commissioner. The note was neither a producer's loan nor a commission payable. Even if the note qualified as a commission, it was not an export asset because it was not timely created. *Rocky Mountain Associates Int'l, Inc.,* 90 TC No. 79.

Calculation of foreign tax credit determined. (TC)

Taxpayers were members of an oil partnership that acquired concessions in Libya. In exchange for the right to extract oil, the taxpayers were to pay fees and royalties. Subsequently, Libya required companies operating under license to increase the posted price of oil, and the taxpayers and other companies agreed to resist these demands by decreasing production. After this agreement, Libya began nationalizing the oil interests, and under the mutual agreement the taxpayer received back-up Persian Gulf crude oil to substitute for the Libyan oil. In calculating its foreign tax credit, the taxpayer used the per-country limitation and sourced the income derived from the sales of back-up crude to Libya. The Service disallowed a carryover of Libyan credits to the tax year at issue and issued a notice of deficiency.

Held: For the Commissioner. Under the passage of title rule of Reg. 1.861-7, the income derived from sales of the back-up crude oil was properly sourced in the Persian Gulf nations rather than Libya. Income from personal property is generally sourced to the country where all right, title and interest transferred. Here, both a purchase and sale of the back-up crude occurred. The taxpayer's argument that the oil was derived, at least indirectly, from its ownership of Libyan wells is without merit since the income from the sale of the back-up crude had no connection with the taxpayer's explorations, ownership or operation of oil wells in Libya. *Hunt,* 90 TC No. 84.

Foreign income exclusion denied. (TCM)

Taxpayer was employed as a mechanical technician in Angola. After working for six-week periods, he had four weeks off, at which time he returned to a residence he maintained in Florida. In Angola, he lived on his employer's work compound and rarely ventured out. He claimed that his wages were subject to the foreign earned income exclusion under Section 911(a).

Held: For the Commissioner. Taxpayer's tax home was the U.S., not Angola. He had few contacts in Angola and no bona fide residence there, but maintained significant contacts in the U.S. and returned there when off duty. *James,* TCM 1988-266; similarly, *Howe,* TCM 1988-277.

Interest on damage award taxable. (CA)

Taxpayer, a nonresident alien, received damages from a U.S. bank for conversion of his shares in a foreign mutual fund, the income of which was not taxable by the U.S. Taxpayer also received interest on the award, which he contended was not taxable. The district court held for taxpayer.

Held: Reversed. The prejudgment interest is taxable income from a U.S. source under Section 861. It does not assume the tax-free status of the mutual fund's income. *Iglesias,* CA-2, 6/1/88.

Income of U.K. reserve funds exempt from U.S. taxation. (Rev. Rul.)

Section 892(a)(1) exempts from income the income of foreign governments received from U.S. investments. The United Kingdom Superannuation Act of 1972 (Act) permits local governments in England, Wales and Scotland to establish investment reserves to provide retirement benefits to government employees. The IRS has ruled that Section 892(a)(1) applies to the county councils that maintain such reserve funds. Income earned by these funds from investments in the U.S. is exempt under Section 892 and is not subject to withholding under Section 1441 or Section 1442. *Rev. Rul.* 88-7, IRB 1988-4.