NEW YORK CITY BAR

COMMITTEE ON TAXATION OF BUSINESS ENTITIES

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February 5, 2016

The Honorable Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: New York City Bar Association Report Requesting Guidance on Application of the FIRPTA Exception for Publicly Traded Stock in the Partnership Context

Dear Assistant Secretary Mazur and Commissioner Koskinen:

On behalf of the New York City Bar Association, as reported by the Committee on Taxation of Business Entities, I am pleased to submit this Report requesting guidance on application of the FIRPTA exception for publicly traded stock in the partnership context.

The Internal Revenue Code generally subjects foreign persons to tax on gains from the sale of United States real property interests, including stock in a United States real property holding corporation. There is an exception pursuant to which stock of a publicly traded corporation is a United States real property interest only in the case of a foreign person owning more than a specified percentage of such stock.

Neither the statute nor Treasury Regulations, however, specifies whether the ownership threshold under the publicly traded stock exception is determined at the partnership level or at the partner level. In the interests of bringing clarity to the law, we respectfully request that new guidance be issued that addresses this issue.

The Committee specifically requests that guidance be issued which provides that the ownership test is applied at the partner level and not at the partnership level. Such clarification would eliminate the current uncertainty, would mirror similar look-through provisions in other related areas of the tax law, such as the portfolio interest rules, and would be consistent with recent legislation aimed at encouraging investment in U.S. real property and infrastructure. The proposed guidance can be implemented through Treasury Regulations.

We would be pleased to discuss any questions you may have regarding our Report. Please contact the undersigned at (212) 880-9828 or via e-mail at pgross@kkwc.com if you would like to discuss.

Very truly yours,

Philip S. Gross
Chair

Enclosure

THE NEW YORK CITY BAR ASSOCIATION
COMMITTEE ON TAXATION OF BUSINESS ENTITIES

REPORT PROPOSING GUIDANCE CLARIFYING THE APPLICATION OF THE FIRPTA RULES TO CERTAIN PUBLICLY TRADED STOCK OWNED BY A PARTNERSHIP

February 5, 2016

This report, which is submitted on behalf of the New York City Bar Association by its Committee on Taxation of Business Entities, discusses whether a partnership should be looked through for purposes of applying an exception to the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") rules for certain publicly traded stock, as set forth in Section 897(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code").[1] This report proposes that the IRS clarify that Section 897(c)(3) requires a "look-through" approach as applied to partnerships that would test the applicable ownership threshold according to each partner's proportionate interest in the publicly traded corporation.[2]

I. Introduction

In general, foreign persons are subject to tax on the disposition of interests in U.S. real property, including certain interests in domestic corporations the majority of the assets of which consist of U.S. real property interests. An exception provides that shares in a publicly traded corporation are considered U.S. real property interests only in the case of a person who owns more than a specified percentage of such stock (at any time during a specified testing period). Where publicly traded shares are held by a partnership, however, the Code and the regulations are silent on whether the ownership test is a partnership-level determination or a partner-level determination.

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[1] Unless otherwise indicated, all "Section" and "IRC §" references are to the Internal Revenue Code of 1986, as amended, and all "Treasury Regulation Section" and "Treas. Reg. §" references are to Treasury Regulations promulgated thereunder.

[2] This report was prepared by the Committee on Taxation of Business Entities of the New York City Bar Association. The authors of the report are Philip S. Gross and Justin J.R. Reda. Helpful comments were provided by John Barrie, Jill Darrow, Sheldon Elefant, Steve Foley, Alan Kravitz, Mark Stone, Alan Tarr, and Jeffrey Uffner.

We believe such determination should be made at the partner level. We believe such a "look-through" approach is implied by the preamble to the final regulations, would be more consistent with the treatment of partnerships in analogous contexts, and would eliminate uncertainty that may inhibit investment in infrastructure and other U.S. real estate.

II. Proposal

Regulations or other guidance should be issued clarifying that, where an entity (whether domestic or foreign) treated as a partnership for federal tax purposes owns shares of a publicly traded corporation, the relevant percentage ownership of such shares for purposes of the "Publicly Traded Stock Exception" set forth in Section 897(c)(3) is determined at the partner level. Any such guidance should apply to both dispositions by a partnership of publicly traded stock and dispositions by a foreign partner of interests in a partnership holding publicly traded stock.

III. Ambiguity Under Current Law

The disposition of an interest in U.S. real property ("USRPI") by a foreign person is generally subject to tax in the United States under Section 897, which was enacted by the Foreign Investment in Real Property Tax Act of 1980 (collectively, with Treasury Regulations promulgated pursuant to authority granted thereunder, "FIRPTA"). USRPIs generally include any interest (other than solely as a creditor) in any domestic corporation that is (or, during a specified testing period of up to five years, was) a United States real property holding corporation ("USRPHC").[3] A USRPHC is any U.S. corporation if the fair market value of its USRPIs equals or exceeds 50% of the total value of (i) its USRPIs, (ii) its interests in real property located outside the United States, and (iii) any other of its assets that are used or held for use in a trade or business.[4] However, pursuant to the Publicly Traded Stock Exception, stock that is regularly traded on an established securities market is considered to be a USRPI only if the regularly traded interest is owned by a person who beneficially owned (directly or constructively) more than five percent (or, in the case of stock of a real estate investment trust, more than ten percent) of that class of stock at any time during the applicable testing period.[5]

The Code provides that a slightly modified version of the constructive ownership rules set forth in Section 318 applies to determine whether any person holds more than the permissible percentage of a class of stock.[6] However, the Code does not expressly provide which person is

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[3] IRC § 897(c)(1)(A)(ii).

[4] IRC § 897(c)(2).

[5] IRC §§ 897(c)(3) and (k)(1)(A); Treas. Reg. § 1.897-1(c)(2)(iii).

[6] *See* IRC §§ 897(c)(6)(C) and (k)(1)(A).

the relevant beneficial owner of the publicly traded shares for purposes of the Publicly Traded Stock Exception in the partnership context.

IV. Discussion

The Regulations Suggest Look-Through Treatment Was Intended

Although the statute refers to any "person" who owns publicly traded stock, which term generally includes partnerships,[7] as noted below, the Treasury Regulations clarify that the relevant ownership for purposes of the Publicly Traded Stock Exception is beneficial ownership. Whereas the concept of beneficial ownership is not explicitly addressed within FIRPTA, other areas of the tax law contain rules suggesting that partners are the beneficial owners of partnership property.[8]

The preamble to the Treasury Regulations issued under Section 897 states that the final regulations extend the Publicly Traded Stock Exception to interests in publicly traded partnerships and publicly traded trusts.[9] In addition, the preamble acknowledges the resulting parity of treatment among publicly traded entities, stating that the FIRPTA issues motivating the Publicly Traded Stock Exception are common to all publicly traded entities.[10] However, in describing how the provision applicable to publicly traded partnerships and trusts would apply, the preamble concludes, "Thus, *only foreign persons holding a greater than five percent interest will be subject to section 897* on sale of their interests."[11]

Because partnerships are not "subject to" income tax,[12] the description of FIRPTA reaching "only foreign persons holding a greater than five percent interest" would seem to necessarily link the ownership threshold under the Publicly Traded Stock Exception with the taxpayers subject to FIRPTA on the disposition. In the case of publicly traded stock owned by a partnership, that concept means looking through to each partner's direct and constructive ownership interest in the publicly traded corporation. Indeed, if the ownership threshold is

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[7] IRC § 7701(a)(1). But note that the same statutory use of the word "person" did not prevent look-through application under the portfolio interest rules as discussed below.

[8] *See, e.g.*, Treas. Reg. §§ 1.1441-1(c)(6)(ii)(B) (providing that partners of a foreign partnership are the beneficial owners of income paid to the foreign partnership) and 1.871-14(g)(3), discussed *infra*.

[9] *See* T.D. 7999 (Jan. 1, 1985).

[10] *Id.*

[11] *Id.* (emphasis added). The regulations have not been amended to take into account the recent enactment of Section 897(k)(1)(A), which increases the ownership threshold to ten percent in the case of stock of a real estate investment trust.

[12] IRC § 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter.").

measured at the partnership level, foreign partners in a domestic partnership that owns publicly traded stock may be subject to tax under FIRPTA even though there is no *foreign* person that owns a greater than five percent (or, if applicable, ten percent) interest in the publicly traded corporation. The quoted language is similarly applicable in the context of a foreign partner's disposition of a partnership interest, as a partnership-level determination could subject such partner to tax under FIRPTA even though the transferor never owned a greater than five percent (or, if applicable, ten percent) interest in the publicly traded corporation.

A regulation or ruling that specifically identifies each foreign partner in a partnership as the "person" whose percentage ownership determines application of the Publicly Traded Stock Exception would clarify the result intended by Treasury in finalizing the relevant regulations.

Consistency Within FIRPTA

Other FIRPTA provisions are given look-through treatment in the partnership context. First, Section 897(g) expressly adopts an aggregate approach for partnerships that hold USRPIs and have foreign partners. It would be consistent with these aggregate principles to adopt a look-through approach for purposes of the Publicly Traded Stock Exception as well.

Furthermore, in addressing an issue perhaps most analogous to the ownership determination under the Publicly Traded Stock Exception, the Service issued a private letter ruling suggesting that the determination of whether a qualified investment entity is domestically controlled within the meaning of Section 897(h)(4)(B) requires looking through partnerships and other flow-through entities not subject to tax.[13] Similarly, Section 897 provides that a corporate partner looks through to a proportionate share of a partnership's assets in determining whether such partner is a USRPHC.[14] Relatedly, FIRPTA yields to other exemption provisions that are calculated on the basis of a partner's proportionate — and not the partnership's aggregate — ownership levels. For example, disposition of 100% of the shares of a USRPHC by a domestic partnership owned equally by three Section 892 investors is not subject to tax under FIRPTA, because the USRPHC is not considered a controlled commercial entity with respect to any of the partners.[15]

More broadly, the taxability of transfers under Section 897 should be a partner-level determination pursuant to partnership tax principles. For example, a disposition of USRPIs by a foreign partnership is subject to FIRPTA only to the extent the resulting gain is allocated to

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[13] *See* I.R.S. Priv. Ltr. Rul. 200923001 (Feb. 26, 2009) (holding that the domestic control inquiry terminates with domestic corporations based on the representation that such corporations were taxable corporations for U.S. federal income tax purposes and not "flow-through" entities).

[14] IRC § 897(c)(4)(B).

[15] *See* Treas. Reg. § 1.892-3T(b), *Example (1)*.

foreign partners of the partnership. Taxability under FIRPTA is therefore determined according to the circumstances of the individual partners, not the partnership through which such partners are invested.

It is unclear what, if any, policy considerations underlying the Publicly Traded Stock Exception would be served by applying an inconsistent approach where shares of a publicly traded corporation are held by a partnership. If taxation under FIRPTA in the partnership context generally reproduces results that would apply if assets held by the partnership were held proportionately by its partners, publicly traded shares attributable to the investments of domestic partners, who are not subject to FIRPTA, should not preclude a foreign partner from qualifying for the Publicly Traded Stock Exception. Further, and perhaps even more of an odd result, because Section 318 provides for attribution from partners to partnerships,[16] a foreign partner in a partnership with aggregate shareholdings that would normally qualify for the Publicly Traded Stock Exception could become subject to FIRPTA tax where a domestic partner's shareholdings held outside the partnership are attributed to the partnership and cause the partnership's shareholdings to exceed the applicable ownership threshold.

Similar Guidance Issued Under the Portfolio Interest Rules

Significantly, in an analogous situation, the Service has issued regulations, Treas. Reg. Section 1.871-14(g)(3)(i), clarifying that look-through treatment applies to partnerships in a very similar context outside of FIRPTA. For purposes of determining whether a partner receiving interest through a partnership is a 10-percent shareholder for whom such interest would not be exempt under the portfolio interest rules, Treas. Reg. Sec. 1.871-14(g)(3)(i) explicitly provides that the ownership test be applied only at the partner level and not at the partnership level.[17] In other words, interest paid by a domestic corporation or partnership to a partnership qualifies as portfolio interest to a foreign partner and thus is not subject to a 30% withholding tax if the foreign partner does not own (and is not deemed to own) 10% or more of the borrower. It does not matter if the lender partnership owns 10% or more of the borrower.

In our view, the requested proposal would bring the Publicly Traded Stock Exception in line with the other specific provisions of FIRPTA that treat the partners of a partnership as the relevant beneficial owners of shares and other assets held by the partnership. Such clarification would also be consistent with the general principle of partnership taxation—that taxability is determined at the partner level—which is echoed elsewhere in the FIRPTA rules. Finally, our proposal would mirror similar clarifying guidance issued in analogous contexts, including the 10-percent shareholder test under the portfolio interest rules.

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[16] *See* IRC § 318(a)(3)(A).

[17] Treas. Reg. § 1.871-14(g)(3).

Uncertainty for Taxpayers Discourages Capital Investment

A partnership-level ownership limit for purposes of the Publicly Traded Stock Exception creates an artificial impediment to capital investment. Citing the expansive definition of "person" in Section 7701 to include partnerships,[18] and in the absence of specific guidance to the contrary, practitioners generally take the view that the test is conducted at the partnership level. (Some practitioners, however, may take the position that the test is conducted at the partner level, while other practitioners may not be aware of this issue.) As a result, investment partnerships are discouraged from holding a greater than five percent (or, in the case of a real estate investment trust, ten percent) stake in a publicly traded company which is, or could be deemed to be, a USRPHC (either currently or during the applicable testing period). The ambiguity in the current law also creates uncertainty for withholding agents, resulting in further economic distortion.

Removing this obstacle to investment in U.S. real estate and infrastructure aligns with recent legislation aimed to increase investment in infrastructure and U.S. real estate markets. In the Protecting Americans From Tax Hikes Act of 2015 (the "PATH Act"),[19] several provisions were enacted to increase foreign investment in U.S. infrastructure.[20]

V. Implementation of Our Proposal

Our proposed clarification would be simple to implement. As in the case of the analogous look-through principle applied to the determination of 10-percent shareholders in the portfolio interest context, regulations could be issued that specify that, where a partnership owns stock of a corporation that is regularly traded on an established securities market, the percentage threshold set forth in Section 897(c)(3), as modified where applicable by Section 897(k)(1), is applied at the partner level.

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[18] IRC § 7701(a)(1) defines "person" to include partnerships.

[19] Pub. L. No. 114-113.

[20] *See* PATH Act, §§322-324.