SHOP TALK

Do Taxpayers Still Need to Sell Domestically Controlled REIT Shares to Avoid FIRPTA?

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@kattenlaw.com, and Richard M. Lipton, Suite 5000, 300 East Randolph Street, Chicago, Illinois 60601, Richard.Lipton@bakermckenzie.com.

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Samuel Grilli of Baker McKenzie, a previous contributor to Shop Talk, writes us regarding one particular practical implication of a recently released Policy Statement on the Treasury and IRS's guidance process, including regulations, revenue rulings, revenue procedures, notices, and announcements.

On March 5, 2019, the Department of the Treasury issued a "Policy Statement on the Tax Regulatory Process" in which Treasury and the IRS clarified and affirmed "their commitment to sound regulatory practices." The three-page statement has five sections entitled: (I) Commitment to Notice-and-Comment Rulemaking; (II) Limited Use of Temporary Regulations; (III) Proper Scope of Subregulatory Guidance Documents; (IV) Limit on Notices Announcing Intent to Propose Regulations; and (V) General Provision.

Ironically, the release of the Policy Statement has been met with confusion by the tax practitioner community. (See, e.g., Jonathan Curry, "Treasury's Regulatory Course Correction Confounds Observers," 162 Tax Notes 1366 (03/18/2019)). There has been active deliberation over how much the statement is really promising to change, as well as its practical implications. One particular question concerning the practical impact of the Policy Statement involves liquidating distributions of a domestically controlled real estate investment trust (REIT).

Section I of the statement begins with an affirmation by Treasury and the IRS: "The best practice for agency rulemaking is the notice-and-comment process established by the Administrative Procedure Act (APA)." Accordingly, Treasury and the IRS "as a matter of sound regulatory policy" reaffirm in Section I their commitment to "using the notice-and-comment process for interpretive tax rules published in the Code of Federal Regulations."

Section II includes a commitment by Treasury and the IRS to include a statement of good cause when issuing any future temporary regulations. Even when there is good cause, the Policy Statement points out, there are limitations to its use: proposed regulations must be simultaneously issued with temporary regulations, and the latter must expire within three years of issuance. This is statutorily mandated by **Section 7805(e)** . These limitations ensure that, even where good cause justifies immediate action without notice and comment, any resulting final regulations will be subject to notice and comment.

The proper scope of revenue rulings, revenue procedures, notices, and announcements, which are published in the Internal Revenue Bulletin (subregulatory guidance) is the subject of Section III of the Policy Statement. There are a number of potential benefits arising from subregulatory guidance, provided that "proper limits are observed," an important caveat since such guidance does not have the force and effect of law. However, such guidance has in the past had the *practical* force and effect of law because tax practitioners generally are quite reluctant to advise a taxpayer to take a path that runs contrary to such guidance. This is even more so when subregulatory guidance carries with it the threat of regulations retroactive to the date of such notice, which is often the case. As readers can imagine, this has a significant chilling effect on taxpayer behavior.

An example of such subregulatory guidance which immediately springs to mind (there are others) is **Notice 2007-55, 2007-2 CB 13, 6** /13/2007. In this notice, the IRS alerted taxpayers that they intended to challenge an assertion by any foreign taxpayer that liquidating REIT distributions were not subject to tax under the Foreign Investment in Real Property Tax Act of 1980, as amended (FIRPTA). In general, the disposition of a U.S. real property interest (USRPI) by a foreign person is subject to U.S. federal income tax, withholding tax, and tax return filing obligations under FIRPTA.

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There are special FIRPTA rules providing for look-through treatment of certain REIT distributions. Generally, and subject to exceptions, any distribution by a REIT to a foreign person, to the extent attributable to gain from sales or exchanges by the REIT of USRPIs, is treated as gain recognized by such foreign person from the sale or exchange of a USRPI, and, thus, subject to U.S. federal income tax under FIRPTA. (See **Section 897(h)(1)**). Taxpayers had been taking the position (in the view of many, the better position) that the rules providing for look-through treatment did not apply to distributions in complete liquidation of a REIT, an especially strong position with respect to a domestically controlled REIT (DCREIT) under **Section 897(h)(4)(B)** given the exemption from FIRPTA for a sale of shares in a DCREIT provided in **Section 897(h)(2)** . The basis for this position is that a REIT liquidation is deemed for federal income tax purposes to be treated as a sale or exchange of the REIT shares pursuant to

Section 331 . The liquidating proceeds are treated as payment to the REIT shareholder in exchange for a deemed disposition of the REIT shares.

Treasury and the IRS did not like this position. Treasury and the IRS declared their intention in **Notice 2007-55** to issue regulations that would "clarify the correct interpretation of these provisions." The future regulations would provide that distributions subject to look-through treatment under FIRPTA include liquidating distributions attributable, in whole or in part, to gain from the sale or exchange of a USRPI by a REIT. The result of such future regulations would mean that foreign shareholders of a DCREIT generally would be taxable on distributions under FIRPTA, even though they could sell their DCREIT shares free of FIRPTA tax. Treasury and the IRS declared that those future regulations would retroactively apply to distributions occurring on or after the date of the notice, June 13, 2007.

As a result of **Notice 2007-55** , tax practitioners have practically been compelled to advise certain foreign DCREIT shareholders to actually undertake a sale of DCREIT shares upon exit, rather than an asset sale followed by a liquidation of the DCREIT, in order to ensure application of the DCREIT exception to FIRPTA. This causes a number of complicated business and tax issues.

First, a sale of REIT shares is generally much more complicated than a direct asset sale because the transaction involves the purchase and sale of a taxable entity instead of a piece of real estate. This can often lead to a reduction in the purchase price, or the imposition of additional indemnity obligations upon the seller of the REIT shares, in contrast to what could have been achieved from a direct asset sale.

Second, since a REIT may not be closely held under the "5&50" test (see **Sections 856(a)(6)** and **856(h)**), many active purchasers of real estate are excluded from the potential purchaser pool because they are closely held and are therefore not REIT-eligible purchasers. There are more issues, but this suffices to demonstrate the point that the requirement to sell DCREIT shares is not usually viewed favorably from an economic or transactional standpoint.

The chilling effect on taxpayer behavior which has resulted from **Notice 2007-55** perfectly illustrates how subregulatory guidance can serve as a convenient end run around notice-and-comment rulemaking. This is why Section IV of the Policy Statement really caught my attention.

Section IV discusses the practice of publishing notices announcing the intention to issue proposed regulations. These notices describe the scope and content of the intended proposed regulations, invite comments, and encourage a dialogue with taxpayers regarding the content of future proposed regulations before they are proposed. Sometimes notices state that taxpayers may rely on the notice in taking tax positions on upcoming tax returns. But what about the scope and effect of a notice that is not taxpayer-friendly, such as **Notice 2007-55** , which aimed to put a damper on taxpayer activity that the IRS did not like?

At some unreasonable point in time after its issuance, it becomes problematic for there to be a notice stating that proposed regulations will be issued with retroactive effect, without Treasury and the IRS actually having to issue regulations that go through the notice-and-comment process established by the

APA. Such so-called "Zombie Notices" preclude taxpayers from ascertaining what is and will be the actual law applicable to their situation, to their detriment and disadvantage in violation of the notice-and-comment process established by the APA. The IRS is not allowed to purposefully avoid the requirements set forth by the APA to its unfair advantage over taxpayers-that is an impermissible abuse of discretion!

Treasury and the IRS acknowledge part of this reality regarding notices in Section IV of the Policy Statement which states:

> Failure to promulgate regulations previewed in notices on a timely basis can cause confusion or uncertainty for taxpayers. To limit the uncertainty that these situations may create, the Treasury Department and the IRS will include a statement in each future notice of intent to issue proposed regulations stating that if no proposed regulations or other guidance is released within 18 months after the date the notice is published, taxpayers may continue to rely on the notice but, until additional guidance is issued, the Treasury Department and the IRS will not assert a position adverse to the taxpayer based in whole or in part on the notice.

Future notices will have something like a soft-expiration date. This is akin to saying that future zombies will continue to exist and roam, but we promise that after 18 months they will no longer bite you! It is certainly an improvement in regulatory practice to have a clear 18-month soft-expiration date placed on such notices, but the notices will continue to linger around indefinitely in the tax ether. Such notices, like toothless zombies, will likely continue to cause uncertainty, confusion, and concern, unless revoked if no regulations are timely issued.

What about prior notices? Notwithstanding the prospective nature of the announcements in the Policy Statement, regulatory principles require that at some point Zombie Notices should lose

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the practical force and effect of law. (A similar argument can be made as to the weight given to stale proposed regulations (issued prior to the effective date of **Section 7805(e)**). See, e.g., Shop Talk, "Do Old Proposed Regulations Never Die?," **91 JTAX 60 (July 1999)** ; *The Brook, Inc.,* TCM 1985-614.) There is a strong argument that **Notice 2007-55** has exceeded its legal life span. It has been almost 12 years since this notice was published and no regulations have been issued. None have even been proposed. Surely the same important regulatory principles which led Treasury and the IRS to publicly promise an 18-month shelf life for future notices should also apply to past notices.

Treasury and the IRS assert in Section V that the Policy Statement is not intended to, and does not, create any right or benefit, substantive or procedural, enforceable at law or in equity, by any party against the United States, its departments, agencies, or entities, its officers, employees, or agents, or any other person.

However, taxpayers already have rights under the APA. If the IRS did issue regulations pursuant to **Notice 2007-55** retroactive to June 13, 2007, a taxpayer would have a strong argument that a reviewing court should not uphold the retroactive effect of such regulations. It would not be easy for the IRS to argue in court for a 12-year retroactivity period, when it has now promised an 18-month period for future notices. If temporary regulations must expire within three years, then for how long should the mere threat of regulations in a notice last? Presumably, less than three years.

Moreover, since the IRS stated in **Notice 2007-55** that further regulations were needed to clarify the applicable tax rules, one could infer that the requirements of the law under the relevant statutory and regulatory provisions are, at the very least, debatable. A taxpayer could construe **Notice 2007-55** as an admission by the IRS that there is a potential gap in FIRPTA, one which requires regulations to plug, if not a statutory amendment. In fact, there was such a subsequent statutory amendment in the Protecting Americans from Tax Hikes Act of 2015, which amended **Section 897(c)(1)(B)** to provide that the "cleansing exception" (disposition of all USRPIs in taxable transactions) would not apply to turn off USRPI status of REIT shares. This was viewed as an inappropriate result because a sale of foreign-controlled REIT shares is subject to tax under FIRPTA. The case is significantly different for foreign shareholders of a DCREIT, who are not relying on this cleansing exception to FIRPTA tax, because the shares of a DCREIT are not USRPIs.

In the wake of the Policy Statement, tax practitioners can and should start to reconsider whether they still have to advise foreign DCREIT shareholders in applicable circumstances to undertake an actual sale of DCREIT shares in order to avoid FIRPTA tax. Even better, the IRS should declare the full and complete legal termination and expiration of **Notice 2007-55** .

We thank Sam for sharing his insights. As always, we welcome our readers' comments.

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