



TaxNewsFlash

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Application of the FIRPTA regularly traded exception to stock held by partnerships (Chief Counsel legal advice memo)

The IRS today publicly released a legal advice memorandum* (from the Office of the Chief Counsel) regarding the application of exception under section 897(c)(3) to stock held by partnerships.

*Legal advice memoranda are signed by executives in the National Office of the Office of Chief Counsel and issued to Internal Revenue Service personnel who are national program executives and managers. The memoranda are issued to assist IRS personnel in administering their programs by providing authoritative legal opinions on certain matters, such as industry-wide issues. The memoranda cannot be used or cited as precedent.

Read [AM 2023-003](#) [PDF 143 KB] (released May 19, 2023, and dated May 12, 2023)

Facts presented in the memorandum

- PRS is a partnership in which each partner is allocated a proportionate share of all items of PRS's income and loss in accordance with its partnership agreement.
- CORP, a domestic corporation, is a United States real property holding corporation ("USRPHC"), within the meaning of section 897(c)(2), at all times during the relevant holding period and has a single class of stock outstanding.
- CORP's stock is regularly traded on an established securities market within the meaning of section 897(c)(3).
- NRA, a nonresident alien individual, owns a 25% interest in the capital and profits of PRS.
- The other partners of PRS are United States citizens, unrelated to NRA.

Situation 1: PRS holds 8% of the outstanding stock of CORP. NRA owns no stock of CORP, directly or constructively, aside from its ownership of CORP stock through its interest in PRS. PRS disposes of all

of its CORP stock. Gain is recognized on the disposition of the CORP stock and is allocated proportionately to each of PRS's partners, including NRA.

Situation 2: PRS holds 4% of the outstanding stock of CORP. In addition to the ownership of CORP stock that NRA holds through its interest in PRS, NRA directly holds 4.5% of the outstanding stock of CORP. NRA disposes of, and recognizes gain on, all of the CORP stock that it holds directly.

Section 897(a) generally provides that a foreign corporation's or a non-resident alien individual's gain or loss on the disposition of a "United States Real Property Interest" ("USRPI") is treated as gain or loss that is effectively connected to a United States trade or business, making such gain or loss subject to United States income tax.

A USRPI is any interest in real property located in the United States or the Virgin Islands and any non-creditor interest in a domestic corporation that is (or was during certain holding periods) a USRPHC. A USRPHC is a corporation whose relevant assets are primarily USRPIs (50% or more by fair market value).

A non-creditor interest in a domestic corporation that is a USRPHC generally is not treated as a USRPI, if any class of stock of the domestic corporation is regularly traded on an established security market (the "regularly traded exception"). The regularly traded exception does not apply to a person who holds more than 5% of the class of regularly traded stock.

Ownership for Foreign Investment in Real Property Tax Act (FIRPTA) purposes includes direct ownership and includes ownership through certain constructive ownership rules that adopt a modified version the section 318(a) ownership rules. A partnership is treated as a person for purposes of FIRPTA.

Neither the FIRPTA statutory language nor the related Treasury regulations provides specific guidance on whether the regularly traded exception is applied at the partnership level or at the partner level. This issue is raised in Situation 1 of the memorandum.

IRS conclusion

- In Situation 1, because PRS holds 8% of the stock of CORP, the regularly traded exception does not apply. Therefore, the stock is considered a USRPI with respect to any foreign partner of PRS and, when PRS disposes of its stock of CORP, NRA is allocated its allocable share of the gain recognized on the disposition. Under section 897(a), NRA's gain on the disposition is effectively connected income.
- In Situation 2, NRA holds 4.5% of the stock of CORP directly. Due to the section 318(a)(2)(A) attribution rules, NRA is also treated as holding NRA's proportionate share of stock held by PRS. Therefore, NRA is treated as indirectly owning an additional 1% of the stock of CORP (i.e., 25% of PRS's 4% of the CORP stock). Because NRA is treated as holding a total of 5.5% of the stock of CORP under section 897(c)(3), when NRA disposes of its stock of CORP, the stock is considered a USRPI and NRA's gain recognized on the disposition is effectively connected income under section 897(a).

The IRS in Situation 1 of the memorandum provides its first public interpretation of an issue that has been debated since the 1980 enactment of FIRPTA: whether the regularly traded exception applies at the partnership level or at the partner level. The IRS's interpretation of the provision applies entity theory partnership taxation to resolve the issue, which is not a taxpayer favorable interpretation because PRS holds over 5% of CORP. This makes the regularly traded exception inapplicable to its partners and makes NRA subject to United States income tax on its allocable share of the gain attributable to the disposition of CORP.

Under the alternate aggregate theory partnership taxation, NRA (not PRS) is the owner of CORP for purposes of the regularly traded exception. NRA in Situation 1 under aggregate theory holds only 2% of CORP ($.25 \times .08 = .02$), which would mean that the regularly traded exception applies to NRA's holding of CORP stock, making NRA's share of the gain of the disposition not subject to United States income tax.

Some taxpayers might have implemented certain structures and have taken certain positions based on the application of aggregate theory partnership taxation to the regularly traded exception. As a result of the memorandum, some taxpayers might want to review certain structures and certain positions to reassess the position and to consider making related changes.

The analysis and conclusion in Situation 2 is a straightforward application of the relevant attribution rules, but the example might illustrate a trap for the unwary because the aggregation of interests making the regularly traded exception inapplicable to all shares owned by a person is not necessarily obvious. Some taxpayers might want to consider instituting control measures to avoid inadvertently rendering the regularly traded exception inapplicable to their holdings in certain domestic corporations.

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