

(C) A description of the U.S. real property interest received in an exchange;

(D) A declaration signed by an officer of the corporation that the distributing foreign corporation has substantiated the adjusted basis of the shareholder in its stock if the distributing corporation has nonrecognition or recognition limitation under paragraph (c) (3) or (4) of this section;

(E) The amount of any gain recognized and tax withheld by any person with respect to the distribution or transfer;

(F) Identification by name and address of the distributee or transferee, including the distributee's or transferee's taxpayer identification number (if any);

(G) The treaty and article (if any) under which the distributee or transferor would be exempt from U.S. taxation on a sale of the distributed U.S. real property interest or the U.S. real property interest received in the transfer; and

(H) A declaration, signed by the distributee or transferor or its authorized legal representative, that the distributee or transferor shall treat any subsequent sale, exchange, or other disposition of the U.S. real property interest as a disposition that is subject to U.S. taxation, notwithstanding the provisions of any U.S. income tax treaty or intervening change in circumstances.

A person who has provided or filed a notice described in § 1.1445-2(d)(2)(iii) or § 1.1445-5(b)(2)(ii) in connection with a transaction may satisfy the requirement of this paragraph (d)(1)(iii) by attaching to his return a copy of that notice together with any information or declaration required by this subdivision not contained in that notice.

(2) *Treaty exception to imposition of tax.* If gain that would be currently recognized pursuant to the provisions of this section or § 1.897-6T is subject to an exemption from (or reduction of) U.S. tax pursuant to a U.S. income tax treaty, then gain shall be recognized only as provided by that treaty, for dispositions occurring before January 1, 1985. For dispositions occurring after December 31, 1984, all gain shall be recognized as provided in section 897 and

the regulations thereunder, except as provided by Articles XIII (9) and XXX (5) of the United States-Canada Income Tax Convention or other income tax treaty entered into force after June 6, 1988.

With regard to Article XXX (5) of the Income Tax Treaty with Canada, see, Rev. Rul. 85-76, 1985-1 C.B. 409. With regard to basis adjustments for certain related person transactions, see, § 1.897-6T(c)(3).

(3) *Withholding.* Under sections 1441 and 1442, as modified by the provisions of any applicable U.S. income tax treaty, a corporation must withhold tax from a dividend distribution to which section 301 applies to a shareholder that is a foreign person, if the dividend is considered to be from sources inside the United States. For a description of dividends that are considered to be from sources inside the United States, see section 861(a)(2). Under section 1445, withholding is required with respect to certain dispositions and distributions of U.S. real property interests.

(4) *Effect on earnings and profits.* With respect to adjustments to earnings and profits for gain recognized to a distributing corporation on a distribution, see section 312 and the regulations thereunder.

(e) *Effective date.* Except as otherwise specifically provided in the text of these regulations, this section shall be effective for transfers, exchanges, distributions and other dispositions occurring after June 18, 1980.

[T.D. 8198, 53 FR 16217, May 5, 1988; 53 FR 18022, May 19, 1988]

§ 1.897-6T Nonrecognition exchanges applicable to corporations, their shareholders, and other taxpayers, and certain transfers of property in corporate reorganizations (temporary).

(a) *Nonrecognition exchanges—(1) In general.* Except as otherwise provided in this section and in § 1.897-5T, for purposes of section 897(e) any nonrecognition provision shall apply to a transfer by a foreign person of a U.S. real property interest on which gain is realized only to the extent that the transferred U.S. real property interest is exchanged for a U.S. real property interest which, immediately following the

exchange, would be subject to U.S. taxation upon its disposition, and the transferor complies with the filing requirements of paragraph (d)(1)(iii) of § 1.897-5T. No loss shall be recognized pursuant to section 897(e) or the rules of this section unless such loss is otherwise permitted to be recognized. In the case of an exchange of a U.S. real property interest for stock in a domestic corporation (that is otherwise treated as a U.S. real property interest), such stock shall not be considered a U.S. real property interest unless the domestic corporation is a U.S. real property holding corporation immediately after the exchange. Whether an interest would be subject to U.S. taxation in the hands of the transferor upon its disposition shall be determined in accordance with the rules of § 1.897-5T(d)(1).

(2) *Definition of “nonrecognition” provision.* A “nonrecognition provision” is any provision of the Code which provides that gain or loss shall not be recognized if the requirements of that provision are met. Nonrecognition provisions relevant to this section include, but are not limited to, sections 332, 351, 354, 355, 361, 721, 731, 1031, 1033, 1034 and 1036. For purposes of section 897(e), sections 121 and 453 are not nonrecognition provisions.

(3) *Consequence of nonapplication of nonrecognition provisions.* If a nonrecognition provision does not apply to a transaction, then the U.S. real property interest transferred shall be considered exchanged pursuant to a transaction that is subject to U.S. taxation by reason of the operation of section 897. See, however, § 1.897-5T (d)(2) with respect to the treaty exceptions to the imposition of tax. If a U.S. real property interest is exchanged for an interest the disposition of which is only partially subject to taxation under chapter 1 of the Code (as modified by the provisions of any applicable U.S. income tax treaty), then any nonrecognition provision shall apply only to the extent that the interest received in the exchange would be subject to taxation under chapter 1 of the Code, as modified. For example, the exchange of a U.S. real property interest for an interest in a partnership will receive nonrecognition treatment pursuant to sec-

tion 721 only to the extent that a disposition of the partnership interest will be subject to U.S. taxation by reason of the operation of section 897(g).

(4) *Section 355 distributions treated as exchanges.* If a domestic corporation, stock in which is treated as a U.S. real property interest, distributes stock in a foreign corporation or stock in a domestic corporation that is not a U.S. real property holding corporation to a foreign person under section 355(a), then the foreign person shall be considered as having exchanged a proportionate part of the stock in the domestic corporation that is treated as a U.S. real property interest for stock that is not treated as a U.S. real property interest.

(5) *Section 1034 rollover of gain—(i) Purchase of foreign principal residence.* A nonresident alien individual shall not be entitled to nonrecognition under section 1034 on the sale of a principal residence when the new principal residence acquired is not a U.S. real property interest.

(ii) *Purchase of U.S. principal residence.* A nonresident alien individual who sells his principal residence that is a U.S. real property interest and, within a period beginning two years before the date of such sale and ending on the date (with extensions) of filing his income tax return for the taxable year of the sale of the principal residence, purchases and uses another U.S. real property interest as a principal residence, shall, to the extent provided by section 1034, not recognize gain on the sale of the principal residence. If the individual has not purchased another U.S. real property interest as a principal residence at the time of the filing of the return for the year of sale, the individual must file a timely income tax return for the year of sale without claiming the benefit of section 1034. If the individual subsequently purchases another U.S. property interest as a principal residence that otherwise qualifies under section 1034 after the due date of the income tax return for the year of the sale of the principal residence and before a date that is two years after the sale of the principal residence, the individual may then apply section 1034 by filing an amended income tax return for the year of the sale

of the principal residence and claim a refund. A nonresident alien may not claim the benefits of section 1034 unless such individual files a complete and timely income tax return with the appropriate forms for the year of the sale of the principal residence. The rules of this paragraph (a)(5)(ii) shall first apply to the sale of principal residences after June 6, 1988.

A nonresident alien individual who sells his principal residence that is a U.S. real property interest on or before June 6, 1988 shall, to the extent provided by section 1034, not recognize gain on the sale of the principal residence if the new principal residence is a U.S. real property interest.

(6) *Determination of basis.* If a nonrecognition provision applies to the transfer of a U.S. real property interest pursuant to the provisions of this section, then the basis of the property received in the exchange shall be determined in accordance with the rules generally applicable with respect to such nonrecognition provision. Similarly, the basis of the exchanged property in the hands of the transferee shall be determined in accordance with the rules that generally apply to such transfer.

(7) *Examples.* The rules of paragraphs (a) (1) through (6) of this section may be illustrated by the following examples. In each instance, the filing requirements of paragraph (d)(1)(iii) of § 1.897-5T have been satisfied.

Example 1. (i) A is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. A owns Parcel P, a U.S. real property interest, with a fair market value of \$500,000 and an adjusted basis of \$300,000. A transfers Parcel P to DC, a newly formed U.S. real property holding corporation wholly owned by A, in exchange for DC stock.

(ii) Under paragraph (a)(1) of this section, A has exchanged a U.S. real property interest (Parcel P) for another U.S. real property interest (DC stock) which is subject to U.S. taxation upon its disposition. The nonrecognition provisions of section 351(a) apply to A's transfer of Parcel P.

(iii) Under paragraph (a)(6) of this section, the basis of the DC stock received by A is determined in accordance with the rules generally applicable to the transfer. A takes a \$300,000 adjusted basis in the DC stock under the rules of section 358(a)(1).

Example 2. (i) A is a citizen and resident of Country F who is stationed in Washington, DC as a full-time employee of an international organization. A sells his principal residence in Washington, and in the same taxable year A purchases another principal residence in Washington. The cost of the new residence exceeds the adjusted sales price of the old residence.

(ii) Under section 7701(b), A is a nonresident alien for U.S. tax purposes, and is subject to taxation under section 897(a). Under paragraphs (a)(1) and (5)(ii) of this section, A is considered to have exchanged a U.S. real property interest (the old principal residence) for another U.S. real property interest (the new principal residence) which is subject to U.S. taxation upon its disposition. The nonrecognition and basis provisions of section 1034(a) apply to A.

Example 3. If in *Example 2*, A had instead purchased a new principal residence in Country F, there would be an exchange of a U.S. real property interest for property that is not a U.S. real property interest. Under paragraph (a)(5)(i) of this section, A would recognize gain under section 897(a) on the disposition of the old principal residence.

Example 4. (i) B is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. B owns stock in DC1, a U.S. real property holding corporation. In a reorganization qualifying for nonrecognition under section 368(a)(1)(B), B exchanges the DC1 stock under section 354(a) for stock in DC2, a U.S. real property holding corporation.

(ii) A does not recognize any gain under paragraph (a)(1) of this section on the exchange of the DC1 stock for DC2 stock because there is an exchange of a U.S. real property interest (the DC1 stock) for another U.S. real property interest (the DC2 stock) which is subject to U.S. taxation upon its disposition.

Example 5. (i) C is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. C owns all of the stock of DC, a U.S. real property holding corporation. The fair market value of the DC stock is 500x, and C has a basis of 100x in the DC stock.

(ii) In a transaction qualifying as a distribution of stock of a controlled corporation under section 355(a), DC distributes to C all of the stock of FC, a foreign corporation that has not made a section 897(i) election. C does not surrender any of the DC stock. The FC stock has a fair market value of 200x. After the distribution, the DC stock has a fair market value of 300x.

(iii) Under the rules of paragraph (a)(4) of this section, C is considered to have exchanged DC stock with a fair market value of 200x and an adjusted basis of 40x for FC

stock with a fair market value of 200x. Because the FC stock is not a U.S. real property interest, C must recognize gain of 160x under section 897(a) on the distribution. C takes a basis of 200x in the FC stock. C's basis in the DC stock is reduced to 60x pursuant to section 358(c).

Example. (i) A is an individual citizen and resident of Country F. F has an income tax treaty with the United States that exempts gain from the sale of stock, but not real property, by a resident of F from U.S. taxation. In 1981, A transferred Parcel P, an appreciated U.S. real property interest, to DC, a U.S. real property holding corporation, in exchange for DC stock. A owned all of the stock of DC.

(ii) Under the rules of paragraph (a)(1) of this section, A must recognize gain on the transfer of Parcel P. Even though there is an exchange of a U.S. real property interest for another U.S. real property interest, there is gain recognition because the U.S. real property interest received (the DC stock) would not have been subject to U.S. taxation upon a disposition immediately following the exchange. A may not convert a U.S. real property interest that was subject to taxation under section 897 into a U.S. real property interest that could be sold without taxation under section 897 due to a treaty exemption.

Example 7. (i) A, a nonresident alien, organized FC1, a Country W corporation in September 1980 to invest in U.S. real property. FC1's only asset is Parcel P, a U.S. real property interest with a fair market value of \$500,000 and an adjusted basis of \$200,000. The FC1 stock has a fair market value of \$500,000 and A's basis in the FC1 stock is \$100,000. The United States does not have a treaty with Country W.

(ii) A, organized FC2, a Country W corporation in July 1987. FC2 organized DC in August 1987. Pursuant to a plan of reorganization under section 368 (a)(1)(C), FC1 transfers Parcel P to DC in exchange for FC2 voting stock. As a result of the transfer, DC is a U.S. real property holding corporation wholly owned by FC2. The FC2 stock used by DC in the acquisition had been transferred by FC2 to DC as part of the plan of reorganization. FC1 distributes the FC2 stock to A in exchange for A's FC1 stock.

(iii) FC1's exchange of Parcel P for the FC2 stock under section 361(a) is a disposition of a U.S. real property interest. FC1 must recognize gain of \$300,000 under section 897(e) and paragraph (a)(1) of this section on the exchange because the FC2 stock received in exchange for Parcel P is not a U.S. real property interest.

(iv) Under section 362(b), DC takes a basis of \$500,000 in Parcel P. FC2 takes a basis of \$500,000 in the DC stock. A takes a basis of \$100,000 in the FC2 stock under section 358(a)(1). Section 897(d) and paragraph (c)(1) of § 1.897-5T do not apply to FC1's distribu-

tion of the FC2 stock because the FC2 stock is not a U.S. real property interest.

Example 8. (i) The facts are the same as in *Example 7*, except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in § 1.897-3(b)(2). FC1, but not FC2, makes a valid section 897(i) election prior to the transaction.

(ii) FC1's transfer of Parcel P to DC in exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section because FC1 made an election under section 897(i). DC takes a basis of \$200,000 in Parcel P under section 362(b).

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is not subject to the section 897(d) and paragraph (c)(1) of § 1.897-5T because FC1 made an election under section 897(i).

(iv) A must recognize gain on the exchange under section 354(a) of the FC1 stock for the FC2 stock. A exchanged a U.S. real property interest (the FC1 stock) for an interest which is not a U.S. real property interest (the FC2 stock). A recognizes gain of \$400,000. Under section 1012, A takes a \$500,000 basis in the FC2 stock.

Example 9. (i) The facts are the same as in *Example 7* except that the United States has a treaty with Country W that entitles FC1 and FC2 to nondiscriminatory treatment as described in § 1.897-3(b)(2). FC2, but not FC1, makes a valid section 897(i) election prior to the transaction.

(ii) FC1's exchange of Parcel P for the FC2 stock under section 361(a) is a disposition of a U.S. real property interest. FC1 does not recognize any gain under section 897(e) and paragraph (a)(1) of this section because there is an exchange of a U.S. real property interest (Parcel P) for another U.S. real property interest (the FC2 stock). DC takes a basis of \$200,000 in Parcel P under section 362(b). FC2 takes a basis of \$200,000 in the DC stock.

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is subject to section 897(d) and paragraph (c)(1) of § 1.897-5T. Because A takes a basis of \$100,000 in the FC2 stock under section 358(a) (which is less than the \$200,000 basis of the FC2 stock in the hands of FC1), and A would be subject to U.S. taxation under section 897(a) on a subsequent disposition of the FC2 stock, FC1 does not recognize any gain under paragraph (c)(1) of § 1.897-5T due to the statutory exception of paragraph (c)(2)(i) of that section, provided that FC1 complies with the filing requirements of paragraph (d)(1)(C) of § 1.897-5T.

(iv) Since, the FC1 stock was not a U.S. real property interest, its disposition by A in the section 354(a) exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section.

Example 10. (i) The facts are the same as in *Example 7*, except that the United States has a treaty with Country W that entitles FC1

and FC2 to nondiscriminatory treatment as described in § 1.897-3(b)(2). FC1 and FC2 made valid section 897(i) elections prior to the transactions.

(ii) FC1's transfer of Parcel P to DC in exchange for FC2 stock is not subject to section 897(e) and paragraph (a)(1) of this section because FC1 made an election under section 897(i). DC takes a basis of \$200,000 in Parcel P under section 362(a). FC2 takes a basis of \$200,000 in the DC stock.

(iii) FC1's distribution of the FC2 stock to A in exchange for the FC1 stock is not subject to section 897(d) and paragraph (c)(1) of § 1.897-5T because FC1 made an election under section 897(i).

(iv) A does not recognize any gain on the exchange of the FC1 stock for the FC2 stock under section 354(a). Under paragraph (a)(1) of this section, there is an exchange of a U.S. real property interest (FC1 stock) for another U.S. real property interest (FC2 stock). A takes a basis of \$100,000 in the FC2 stock under section 358(a).

(8) *Treatment of nonqualifying property*—(i) *In general.* If, under paragraph (a)(1) of this section, a nonrecognition provision would apply to an exchange but for the fact that nonqualifying property (cash or property other than U.S. real property interests) is received in addition to property (U.S. real property interests) that is permitted to be received under paragraph (a)(1) of this section, then the transferor shall recognize gain under this section equal to the lesser of—

(A) The sum of the cash received plus the fair market value of the nonqualifying property received, or

(B) The gain realized with respect to the U.S. real property interest transferred. However, no loss shall be recognized pursuant to this paragraph (a)(8) unless such loss is otherwise permitted to be recognized.

(ii) *Treatment of mixed exchanges.* In a mixed exchange where both a U.S. real property interest and other property (including cash) is transferred in exchange both for property the receipt of which would qualify for nonrecognition treatment pursuant to paragraph (a)(1) of this section and for other property (including cash) which would not so qualify, the transferor will recognize gain in accordance with the rules set forth in subdivisions (A) through (C) of this paragraph (a)(8)(ii).

(A) *Allocation of nonqualifying property.* The amount of nonqualifying

property (including cash) considered to be received in exchange for U.S. real property interests shall be determined by multiplying the fair market value of the nonqualifying property received by a fraction ("real property fraction"). The numerator of the fraction is the fair market value of the U.S. real property interest transferred in the exchange. The denominator of the fraction is the fair market value of all property transferred in the exchange.

(B) *Recognition of gain.* The amount of gain that must be recognized, and that shall be subject to U.S. taxation by reason of the operation of section 897, shall be equal to the lesser of:

(1) The amount determined under subdivision (A) of this paragraph (a)(8)(ii), or

(2) The gain or loss realized with respect to the U.S. real property interest exchanged.

(C) *Treatment of other amounts.* The treatment of other amounts received in a mixed exchange shall be determined as follows:

(1) The amount of nonqualifying property (including cash) considered to be received in exchange for property (including cash) other than U.S. real property interests shall be treated in the manner provided in the relevant nonrecognition provision. Such amounts shall be determined by subtracting the amount determined under subdivision (A) of this paragraph (a)(8)(ii) from the total amount of nonqualifying property received in the exchange.

(2) The amount of qualifying property considered to be received in exchange for U.S. real property interests shall be treated in the manner provided in paragraph (a)(1) of this section. Such amount shall be determined by multiplying the total fair market value of qualifying property received in the exchange by the real property fraction described in subdivision (A) of this paragraph (a)(8)(ii).

(3) The amount of qualifying property considered to be received in exchange for property other than U.S. real property interests shall be treated in the manner provided in the relevant nonrecognition provision. Such amount shall be determined by subtracting the amount determined under subdivision

(2) of this paragraph (a)(8)(ii)(C) from the total fair market value of qualifying property received in the exchange.

(iii) *Example.* The rules of paragraph (a)(8)(ii) of this section may be illustrated by the following example.

Example. (i) A is an individual citizen and resident of country F. Country F does not have an income tax treaty with the United States. A is the sole proprietor of a business located in the United States, the assets of which consist of a U.S. real property interest with a fair market value of \$1,000,000 and an adjusted basis of \$700,000, and equipment used in the business with a fair market value of \$500,000 and an adjusted basis of \$250,000. A decides to incorporate the business, and on January 1, 1987, A transfers his assets to domestic corporation DC in exchange for 100 percent of the stock of DC, with a fair market value of \$900,000. In addition, A receives a long term note (constituting a security) from DC for \$600,000, bearing arm's length interest and repayment terms. DC has no assets other than those received in the exchange with A. Pursuant to section 897(c)(2) and § 1.897-2, DC is a U.S. real property holding corporation. Therefore, the stock of DC is a U.S. real property interest. Assume that the note from DC constitutes an interest in the corporation solely as a creditor as provided by § 1.897-1(d)(4) of the regulation. A complies with the filing requirements of paragraph (d)(1)(iii) of § 1.897-5T.

(ii) Because the note from DC would not be subject to U.S. taxation upon its disposition, it is nonqualifying property for purposes of determining whether A is entitled to receive nonrecognition treatment pursuant to section 351 with respect to his exchange of the U.S. real property interest. Thus, A must recognize gain in the manner provided in paragraph (a)(8)(ii) of this section. Pursuant to paragraph (a)(8)(ii)(A), the amount of nonqualifying property received in exchange for the real property interests is determined by multiplying the fair market value of such property (\$600,000) by the real property fraction. The numerator of the fraction is \$1,000,000, the fair market value of the real property transferred by A. The denominator is \$1,500,000, the fair market value of all property transferred by A. Thus, A is considered to have received \$400,000 of the note in exchange for the real property ($\$600,000 \times \frac{\$1,000,000}{\$1,500,000}$). Pursuant to paragraph (a)(8)(ii)(B), A must recognize the lesser of the amount initially determined or the gain realized with respect to the U.S. real property interest. Therefore, A must recognize the \$300,000 gain realized with respect to the real property.

(iii) Pursuant to paragraph (a)(8)(ii)(C) of this section, A is considered to have received

\$200,000 of the note in exchange for equipment ($\$600,000$ [total value of note received] minus $\$400,000$ [portion of note received in exchange for real property]), \$600,000 of the stock in exchange for real property ($\$900,000$ [total value of stock received] times $\frac{\$1,000,000}{\$1,500,000}$ [proportion of property exchanged consisting of real property]), and \$300,000 of the stock in exchange for equipment ($\$900,000$ [total value of stock received] minus $\$600,000$ [portion of stock received in exchange for real property]). All three amounts are entitled to nonrecognition treatment pursuant to section 351.

(iv) Pursuant to paragraph (a)(2) of this section, A's basis in the stock and note received and DC's basis in the U.S. real property interest and equipment will be determined in accordance with the generally applicable rules. The \$400,000 portion of the note received in exchange for the real property interest is other property. Pursuant to section 358(a)(2), A takes a fair market value (\$400,000) basis for that portion of the note. Pursuant to section 358(a)(1), A's basis in the property received without the recognition of gain (the DC stock and the other portion of the note) will be equal to the basis of the property transferred (\$950,000 [\$700,000 basis of U.S. real property interest plus \$250,000 basis of equipment]), decreased by the fair market value of the other property received (\$400,000 portion of the note), and increased by the amount of gain recognized to A on the transaction (\$300,000). Thus, A's basis in the stock and the nonrecognition portion of the note is \$850,000 ($\$950,000 - \$400,000 + \$300,000$). Under § 1.358-2(b)(2) of the regulations, the \$850,000 is allocated between the stock and the nonrecognition portion of the note in proportion to their fair market values. A takes a basis of \$697,000 in the DC stock ($\$850,000 \times \frac{\$900,000}{\$1,100,000}$). A takes a basis of \$153,000 in the nonrecognition portion of the note ($\$850,000 \times \frac{\$200,000}{\$1,100,000}$). A's basis in the note is \$553,000 ($\$400,000 + \$153,000$). DC's basis in the property received from A will be determined under section 362(a). DC takes a basis of \$1,000,000 in the real property interest (A's basis of \$700,000 increased by the \$300,000 of gain recognized by A on it). DC takes a basis of \$250,000 in the equipment (A's basis of \$250,000).

(9) *Treaty exception to imposition of tax.* If gain that would be currently recognized pursuant to the provisions of this section is subject to an exemption from, or reduction of, U.S. tax pursuant to a U.S. income tax treaty, then gain shall be recognized only as provided by that treaty for dispositions occurring before January 1, 1985. For dispositions occurring after December 31, 1984, all gain shall be recognized as

provided in section 897 and the regulations thereunder, except as provided by Articles XII (9) and XXX (5) of the United States-Canada Income Tax Convention or other income tax treaty entered into after June 6, 1988. In regard to Article XXX (5) the Income Tax Treaty with Canada, see, Rev. Rul. 85-76, 1985-1 C.B. 409.

(b) *Certain foreign to foreign exchanges*—(1) *Exceptions to the general rule.* Notwithstanding the provisions of paragraph (a)(1) of this section and pursuant to authority conferred by section 897(e)(2), a foreign person shall not recognize gain, in the instances described in paragraph (b)(2) of this section, on the transfer of a U.S. real property interest to a foreign corporation in exchange for stock in a foreign corporation, but only if the transferee's subsequent disposition of the transferred U.S. real property interest would be subject to U.S. taxation, as determined in accordance with the provisions of § 1.897-5T(d)(1), if the filing requirements of paragraph (d)(1)(iii) of § 1.897-5T have been satisfied, if one of the five conditions set forth in paragraph (b)(2) exists, and if one of the following three forms of exchange takes place.

(i) The exchange is made by a foreign corporation pursuant to section 361(a) in a reorganization described in section 368(a)(1) (D) or (F) and there is an exchange of the transferor corporation stock for the transferee corporation stock under section 354(a); or

(ii) The exchange is made by a foreign corporation pursuant to section 361(a) in a reorganization described in section 368(a)(1)(C); there is an exchange of the transferor corporation stock for the transferee corporation stock (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) under section 354(a); and the transferor corporation's shareholders own more than fifty percent of the voting stock of the transferee corporation (or stock of the transferee corporation's parent in the case of a parenthetical C reorganization) immediately after the reorganization; or

(iii) The U.S. real property interest exchanged is stock in a U.S. real property holding corporation; the exchange qualifies under section 351(a) of section

354(a) in a reorganization described in section 368(a)(1)(B); and immediately after the exchange, all of the outstanding stock of the transferee corporation (or stock of the transferee corporation's parent in the case of a parenthetical B reorganization) is owned in the same proportions by the same nonresident alien individuals and foreign corporations that, immediately before the exchange, owned the stock of the U.S. real property holding corporation.

If, however, a nonresident alien individual or foreign corporation which received stock in an exchange described in subdivision (iii) of this paragraph (b)(1) (or the transferee corporation's parent) disposes of any of such foreign stock within three years from the date of its receipt, then that individual or corporation shall recognize that portion of the gain realized with respect to the stock in the U.S. real property holding corporation for which foreign stock disposed of was received.

(2) *Applicability of exception.* The exception to the provisions of paragraph (a)(1) provided by paragraph (b)(1) shall apply only if one of the following five conditions exists.

(i) Each of the interests exchanged or received in a transferor corporation or transferee corporation would not be a U.S. real property interest as defined in § 1.897-1(c)(1) if such corporations were domestic corporations; or

(ii) The transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in a foreign country that maintains an income tax treaty with the United States that contains an information exchange provision; the transfer occurs after May 5, 1988; and the transferee corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) submit a binding waiver of all benefits of the respective income tax treaty (including the opportunity to make an election under section 897 (i)), which must be attached to each of the transferor and transferee corporation's income tax returns for the year of the transfer; or

(iii) The transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B

or C reorganization) is a qualified resident as defined in section 884(e) and any regulations thereunder of the foreign country in which it is incorporated; or

(iv) The transferee foreign corporation (and the transferee corporation's parent in the case of a parenthetical B or C reorganization) is incorporated in the same foreign country as the transferor foreign corporation; and there is an income tax treaty in force between that foreign country and the United States at the time of the transfer that contains an exchange of information provision; or

(v) The transferee foreign corporation is incorporated in the same foreign country as the transferor foreign corporation; and the transfer is incident to a mere change in identity, form, or place of organization of one corporation under section 368(a)(1)(F).

For purposes of any election by a transferee foreign corporation (or the transferee corporation's parent in the case of a parenthetical C reorganization) to be treated as a domestic corporation under section 897(i) and § 1.897-3 where the exchange was described in subdivisions (i) or (ii) of paragraph (b)(1) of this section, any prior dispositions of the transferor foreign corporation stock will be subject to the requirements of § 1.897-3(d)(2) upon an election under section 897(i) by the transferee foreign corporation (or the transferee corporation's parent in the case of a parenthetical C reorganization).

(3) *No exceptions.* No exception to recognition of gain under paragraph (a)(1) of this section is provided for the transfer of a U.S. real property interest by a foreign person to a foreign corporation in exchange for stock in a foreign corporation other than as provided in this paragraph (b). Thus, no exception is provided where—

(i) Such exchange is made pursuant to section 351 and the U.S. real property interest transferred is not stock in a U.S. real property holding corporation; or

(ii) Such exchange is made pursuant to section 361(a) in a reorganization described in section 368(a)(1) that does not qualify for nonrecognition of gain under this paragraph (b). With regard

to the treatment of certain foreign corporations as domestic corporations under section 897(i), see §§ 1.897-3 and 1.897-8T.

(4) *Examples.* The rules of paragraph (b)(1) and (2) of this section may be illustrated by the following examples. In each instance, the filing requirements of paragraph (d)(1)(iii) of § 1.897-5T have been satisfied.

Example 1. (i) FC is a Country F corporation that has not made a section 897(i) election. FC owns Parcel P, a U.S. real property interest, with a fair market value of \$450x and an adjusted basis of 100x.

(ii) FC transfers Parcel P to FS, its wholly owned Country F subsidiary, in exchange for FS stock under section 351 (a). FS has not made a section 897(i) election. Under the rules of paragraph (a)(1) of this section, FC must recognize gain of 350x under section 897 (a) because the FS stock received in the exchange is not a U.S. real property interest. No exception to the recognition rule of paragraph (a)(1) is provided under this paragraph (b) for a transfer under section 351 (a) of a U.S. real property interest (that is not stock in a U.S. real property holding corporation) by a foreign corporation to another foreign corporation in exchange for stock to the transferee corporation.

Example 2. (i) FC is a Country F corporation that has not made a section 897(i) election. FC owns several U.S. real property interests that have appreciated in value since FC purchased the interests. FP, a Country F corporation, owns all of the outstanding stock of FC. Country F maintains an income tax treaty with the United States.

(ii) For valid business purposes, FC transferred substantially all of its assets including all of its U.S. real property interests to FS in 1989 under section 361(a) in a reorganization in exchange for FS stock. FS is a newly formed Country F corporation that is owned by FC. The transfer qualifies as a reorganization under section 368(a)(1)(D). FC immediately distributes the FS stock to FP in exchange for the FC stock and FC dissolves. FP has no gain or loss on the exchange of the FC stock for the FS stock under section 354(a).

(iii) Under the rules of paragraph (b)(1)(i) of this section, FC does not recognize any gain on the transfer of the U.S. real property interests to FS under section 361(a) in the reorganization under section 368(a)(1)(D) because FS would be subject to U.S. taxation on a subsequent disposition of the interests, as required by paragraph (b)(1) of this section; there is an exchange of stock under section 354(a), as required by paragraph (b)(1)(i); and FC and FS are incorporated in Country F which maintains an income tax treaty

with the United States, as required by paragraph (b)(2)(iv).

(5) *Contributions of property.* A foreign person that contributes a U.S. real property interest to a foreign corporation as paid in surplus or as a contribution to capital (including a contribution provided in section 304(a)) shall be treated, for purposes of section 897(j) and this section, as exchanging the U.S. real property interest for stock in the foreign corporation.

(c) *Denial of nonrecognition with respect to certain tax avoidance transfers—*

(1) *In general.* The provisions of § 1.897-5T and paragraphs (a) and (b) of this section are subject to the rules of this paragraph (c).

(2) *Certain transfers to domestic corporations—*

(i) *General rule.* If a foreign person transfers property, that is not a U.S. real property interest, to a domestic corporation in a nonrecognition exchange, where—

(A) The adjusted basis of such property transferred exceeded its fair market value on the date of the transfer to the domestic corporation;

(B) The property transferred will not immediately be used in, or held by the domestic corporation for use in, the conduct of a trade or business as defined in § 1.897-1(f); and

(C) Within two years of the transfer to the domestic corporation, the property transferred is sold at a loss;

then, it will be presumed, absent clear and convincing evidence to the contrary, that the purpose for transferring the loss property was the avoidance of taxation on the disposition of U.S. real property interests by the domestic corporation. Any loss recognized by the domestic corporation on the sale or exchange of such property shall not be used by the domestic corporation, either by direct offset or as part of a net operating loss or capital loss carryback or carryover to offset any gain recognized from the sale or exchange of a U.S. real property interest by the domestic corporation.

(ii) *Example.* The rules of paragraph (c)(2)(i) of this section may be illustrated by the following example.

Example. A is an individual citizen and resident of country F, which does not have an income tax treaty with the U.S. On Janu-

ary 1, 1987, A transfers a U.S. real property interest with a basis of \$100,000 and a fair market value of \$600,000 to domestic corporation DC in exchange for all of the stock of DC. On October 20, 1987, A transfers stock of a publicly traded domestic corporation with a basis in his hands of \$900,000 and a fair market value of \$500,000, in exchange for additional stock of DC. The stock of the publicly traded domestic corporation does not constitute an asset used or held for use in DC's trade or business. If DC sells the stock of the publicly traded domestic corporation before October 20, 1989 and recognizes a loss, the loss may not be used to offset any gain recognized on the sale of the U.S. real property interests by DC.

(3) *Basis adjustment for certain related person transactions.* In the case of any disposition after December 31, 1979, of a U.S. real property interest to a related person (within the meaning of section 453(f)(1)), the basis of the interest in the hands of the person acquiring such interest shall be reduced by the amount of any gain which is not subject to taxation under section 871(b)(1) or 882(a)(1) because the disposition occurred before June 19, 1980 or because of any treaty obligation of the United States. If a foreign corporation makes an election under section 897(i), and the stock of such corporation was transferred between related persons after December 31, 1979 and before June 19, 1980, then such stock shall be treated as a U.S. real property interest solely for purposes of this paragraph (c)(3).

(4) *Rearrangement of ownership to gain treaty benefit.* A foreign person who directly or indirectly owns a U.S. real property interest may not directly or indirectly rearrange the incidents of ownership of the U.S. real property interest through the use of nonrecognition provisions in order to gain the benefit of a treaty exemption from taxation. Such nonrecognition will not apply to the foreign transferor. The transferor will recognize gain but not loss on the transfer under section 897(a).

(d) *Effective date.* Except as specifically provided otherwise in the text of the regulations, paragraphs (a) through (c) shall be effective for transfers, exchanges and other dispositions occurring after June 18, 1980. Paragraph

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(a)(5)(ii) of this section shall be effective for exchanges and elections occurring after June 6, 1988.

[T.D. 8198, 53 FR 16224, May 5, 1988; 53 FR 18022, May 19, 1988]

§ 1.897-7T Treatment of certain partnership interests as entirely U.S. real property interests under sections 897(g) and 1445(e) (temporary).

(a) *Rule.* Pursuant to section 897(g), an interest in a partnership in which, directly or indirectly, fifty percent or more of the value of the gross assets consist of U.S. real property interests, and ninety percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents shall, for purposes of section 1445, be treated as entirely a U.S. real property interest. For purposes of section 897(g), such interest shall be treated as a U.S. real property interest only to the extent that the gain on the disposition is attributable to U.S. real property interests (and not cash, cash equivalents or other property). Consequently, a disposition of any portion of such partnership interest shall be subject to partial taxation under section 897(a) and full withholding under section 1445(a). For purposes of this paragraph, cash equivalent means any asset readily convertible into cash (whether or not denominated in U.S. dollars) including, but not limited to, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments.

(b) *Effective date.* Section 1.897-7T shall be effective for transfers, exchanges, distributions and other dispositions occurring after June 6, 1988.

[T.D. 8198, 53 FR 16228, May 5, 1988]

§ 1.897-8T Status as a U.S. real property holding corporation as a condition for electing section 897(i) pursuant to § 1.897-3 (temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that if and when adopted as a final regulation, will be added to paragraph (b) of § 1.897-3. Paragraph (b) of this section would

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then appear as paragraph (b)(4) of § 1.897-3.

(b) *General conditions.* The foreign corporation upon making an election under section 897(i) (including any retroactive election) must qualify as a U.S. real property holding corporation as defined in paragraph (b)(1) of § 1.897-2.

(c) *Effective Date.* Section 1.897-8T shall be effective as of June 6, 1988, with respect to foreign corporations making an election under section 897(i) after May 5, 1988.

[T.D. 8198, 53 FR 16229, May 5, 1988]

§ 1.897-9T Treatment of certain interest in publicly traded corporations, definition of foreign person, and foreign governments and international organizations (temporary).

(a) *Purpose and scope.* This section provides a temporary regulation that, if and when adopted as a final regulation will be added as new paragraphs (c)(2)(iii)(B), (k), (n) and (q) of § 1.897-1. Paragraph (b) of this section would then appear as paragraph (c)(2)(iii)(B) of § 1.897-1. Paragraph (c) of this section would then appear as paragraph (k) of § 1.897-1. Paragraph (d) of this section would then appear as paragraph (n) of § 1.897-1. Paragraph (e) of this section would then appear as paragraph (q) of § 1.897-1.

(b) Any other interest in the corporation (other than an interest solely as a creditor) if on the date such interest was acquired by its present holder it had a fair market value greater than the fair market value on that date of 5 percent of the regularly traded class of the corporation's stock with the lowest fair market value. However, if a non-regularly traded class of interests in the corporation is convertible into a regularly traded class of interests in the corporation, an interest in such non-regularly traded class shall be treated as a U.S. real property interest if on the date it was acquired by its present holder it had a fair market value greater than the fair market value on that date of 5 percent of the regularly traded class of the corporation's stock into which it is convertible. If a person holds interests in a corporation of a class that is not regularly traded, and subsequently acquires