

the bank is the owner of the obligations or deposits and does not hold the obligations or deposits for, or use them in connection with, the conduct of a commercial banking function or other commercial activity by such bank. For purposes of this section and paragraph (i) of § 1.1441-4, obligations of the United States or of any agency or instrumentality thereof include beneficial interests, participations, and other instruments issued under section 302(c) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717). See 24 CFR part 1600 *et seq.*

(b) *Foreign central bank of issue.* (1) A foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such a bank is generally the custodian of the banking reserves of the country under whose law it is organized. See also paragraph (b)(5) of § 1.861-2.

(2) The exclusion granted by section 895 applies to an instrumentality that is separate from a foreign government, whether or not owned in whole or in part by a foreign government. For example, foreign banks organized along the lines of, and performing functions similar to, the Federal Reserve System qualify as foreign central banks of issue for purposes of this section.

(3) The Bank for International Settlements shall be treated as though it were a foreign central bank of issue for purposes of obtaining the exclusion granted by section 895.

(c) *Ownership of United States obligations or bank deposits.* The exclusion does not apply if the obligations or bank deposits from which the income is derived are not owned by the foreign central bank of issue. Obligations held, or deposits made, by a foreign central bank of issue as agent, custodian, trustee, or in any other fiduciary capacity, shall be considered as not owned by such bank for purposes of this section.

(d) *Commercial banking function or other commercial activity.* The exclusion applies only to obligations of the United States or of any agency or instrumentality thereof, or to bank deposits, held for, or used in connection

with, the conduct of a central banking function and not to obligations or deposits held for, or used in connection with, the conduct of commercial banking functions or other commercial activities by the foreign central bank.

(e) *Other exclusions.* See section 861(a)(1) (A) and (E) and § 1.861-2(b) (1) and (4), for special rules relating to interest paid or credited before January 1, 1977, on deposits and on similar amounts and for rules on interest derived from bankers' acceptances. For exemption from withholding under § 1.1441-1 on income derived by a foreign central bank of issue, or by the Bank of International Settlements, from obligations of the United States or of any agency or instrumentality thereof, or from bank deposits, see § 1.1441-4(i).

(f) *Effective date.* This section shall apply with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.85-1 (Revised as of January 1, 1972).

[T.D. 7378, 40 FR 45435, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975]

§ 1.897-1 Taxation of foreign investment in United States real property interests, definition of terms.

(a) *In general—(1) Purpose and scope of regulations.* These regulations provide guidance with respect to the taxation of foreign investments in U.S. real property interests and related matters. This section defines various terms for purposes of sections 897, 1445, and 6039C and the regulations thereunder. Section 1.897-2 provides rules regarding the definition of, and consequences of, U.S. real property holding corporation status. Section 1.897-3 sets forth rules pursuant to which certain foreign corporations may elect under section 897(i) to be treated as domestic corporations for purposes of sections 897 and 6039C. Finally, § 1.987-4 provides rules concerning the similar election under section 897(k) for certain foreign corporations in the process of liquidation.

(2) *Effective date.* The regulations set forth in §§ 1.897-1 through 1.897-4 are effective for transactions occurring after June 18, 1980. However, with respect to

all transactions occurring after June 18, 1980 and before January 30, 1985, taxpayers may at their option choose to apply the Temporary Regulations under section 897 (in their entirety). The Temporary Regulations are located at 26 CFR 6a.897-1 through 6a.897-4 (Revised as of April 1, 1983), and were originally published in the FEDERAL REGISTER for September 21, 1982 (47 FR 41532) and amended by T.D. 7890, published in the FEDERAL REGISTER on April 28, 1983 (48 FR 19163).

(b) *Real property*—(1) *In general.* The term “real property” includes the following three categories of property: Land and unserved natural products of the land, improvements, and personal property associated with the use of real property. The three categories of real property are defined in subparagraphs (2), (3), and (4) of this paragraph (b). Local law definitions will not be controlling for purposes of determining the meaning of the term “real property” as it is used in sections 897, 1445, and 6039C and the regulations thereunder.

(2) *Land and unserved natural products of the land.* The term “real property” includes land, growing crops and timber, and mines, wells, and other natural deposits. Crops and timber cease to be real property at the time that they are served from the land. Ores, minerals, and other natural deposits cease to be real property when they are extracted from the ground. The storage of severed or extracted crops, timber, or minerals in or upon real property will not cause such property to be recharacterized as real property.

(3) *Improvements*—(i) *In general.* The term “real property” includes improvements on land. An improvement is a building, any other inherently permanent structure, or the structural components of either, as defined in subdivisions (ii) through (iv) of this paragraph (b)(3).

(ii) *Building.* The term “building” generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment

houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Any structure that is classified as a building for purposes of section 48(a)(1)(B) and §1.48-1 shall be treated as such for purposes of this section.

(iii) *Inherently permanent structure*—(A) *In general.* The term “inherently permanent structure” means any property not otherwise described in this paragraph (b)(3) that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time. Property that is not classified as a building for purposes of section 48(a)(1)(B) and §1.48-1 may nevertheless constitute an inherently permanent structure. For purposes of this section, affixation to real property may be accomplished by weight alone.

(B) *Use of precedents under section 48.* Any property not otherwise described in this paragraph (b)(3) that constitutes “other tangible property” under the principles of section 48(a)(1)(B) and §1.48-1 (c) and (d) shall be treated for purposes of this section as an inherently permanent structure. Thus, for example, the term includes swimming pools, paved parking areas and other pavements, special foundations for heavy equipment, wharves and docks, bridges, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, permanently installed telephone and television cables, broadcasting towers, oil derricks, oil and gas pipelines, oil and gas storage tanks, grain storage bins, and silos. However, property that is determined to be either property in the nature of machinery under §1.48-1(c) or property which is essentially an item of machinery or equipment under §1.48-1(e)(1)(i) shall not be treated as an inherently permanent structure.

(C) *Absence of precedents under section 48.* Where precedents developed under the principles of section 48 fail to provide adequate guidance with respect to the classification of particular property, the determination of whether such property constitutes an inherently permanent structure shall be

made in view of all the facts and circumstances. In particular, the following factors must be taken into account:

(1) The manner in which the property is affixed to real property;

(2) Whether the property was designed to be easily removable or to remain in place indefinitely;

(3) Whether the property has been moved since its initial installation;

(4) Any circumstances that suggest the expected period of affixation (e.g., a lease that requires removal of the property upon its expiration);

(5) The amount of damage that removal of the property would cause to the property itself or to the real property to which it is affixed; and

(6) The extent of the effort that would be required to remove the property, in terms of time and expense.

(iv) *Structural components of buildings and other inherently permanent structures.* Structural components of buildings and other inherently permanent structures, as defined in § 1.48-1 (e)(2), themselves constitute improvements. Structural components include walls, partitions, floors, ceilings, windows, doors, wiring, plumbing, central heating and central air conditioning systems, lighting fixtures, pipes, ducts, elevators, escalators, sprinkler systems, fire escapes and other components relating to the operation or maintenance of a building. However, the term “structural components” does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the “sole justification” test provided by the preceding sentence even though it incidentally provides for the comfort of employees or serves to an insubstantial degree areas where such temperature or humidity requirements are not essential.

(4) *Personal property associated with the use of the real property—(i) In general.* The term “real property” includes movable walls, furnishings, and other personal property associated with the use of the real property. Personal prop-

erty is associated with the use of real property only if it is described in one of the categories set forth in subdivisions (A) through (D) of this paragraph (b)(4)(i). “Personal property” for purposes of this section means any property that constitutes “tangible personal property” under the principles of § 1.48-1(c), without regard to whether such property qualifies as section 38 property. Such property will be associated with the use of the real property only where both the personal property and the United States real property interest with which it is associated are held by the same person or by related persons within the meaning of § 1.897-1(i). For purposes of this paragraph (b)(4)(i), property is used “predominantly” in a named activity if it is devoted to that activity during at least half of the time in which it is in use during a calendar year.

(A) *Property used in mining, farming, and forestry.* Personal property is associated with the use of real property if it is predominantly used to exploit unsevered natural products in or upon the land. Such property includes mining equipment used to extract ores, minerals, and other natural deposits from the ground. It also includes any property used to cultivate the soil and harvest its products, such as farm machinery, draft animals, and equipment used in the growing and cutting of timber. However, personal property used to process or transport minerals, crops, or timber after they are severed from the land is not associated personal property.

(B) *Property used in the improvement of real property.* Personal property is associated with the use of real property if it is predominantly used to construct or otherwise carry out improvements to real property. Such property includes equipment used to alter the natural contours of the land, equipment used to clear and prepare raw land for construction, and equipment used to carry out the construction of improvements.

(C) *Property used in the operation of a lodging facility.* Personal property is associated with the use of real property if it is predominantly used in connection with the operation of a lodging facility. Property that is used in connection

with the operation of a lodging facility includes property used in the living quarters of such facility, such as beds and other furniture, refrigerators, ranges and other equipment, as well as property used in the common areas of such facility, such as lobby furniture and laundry equipment. Such property constitutes personal property associated with the use of real property in the hands of the owner or operator of the facility, not of the tenant or guest. A lodging facility is an apartment house or apartment, hotel, motel, dormitory, residence, or any other facility (or part of a facility) predominantly used to provide, at a charge, living and/or sleeping accommodations, whether on daily, weekly, monthly, annual, or other basis. The term "lodging facility" does not include a personal residence occupied solely by its owner, or a facility used primarily as a means of transportation (such as an aircraft, vessel, or a railroad car) or used primarily to provide medical or convalescent services, even though sleeping accommodations are provided. Nor does the term include temporary living quarters provided by an employer due to the unavailability of lodgings within a reasonable distance of a work-site (such as a mine or construction project). The term "lodging facility" does not include any portion of a facility that constitutes a nonlodging commercial facility and that is available to persons not using the lodging facility on the same basis that it is available to tenants of the lodging facility. Examples of nonlodging commercial facilities include restaurants, drug stores, and grocery stores located in a lodging facility.

(D) *Property used in the rental of furnished office and other work space.* Personal property is associated with the use of real property if it is predominantly used by a lessor to provide furnished office or other work space to lessees. Property that is so used includes office furniture and equipment included in the rental of furnished space. Such property constitutes personal property associated with the use of real property in the hands of the lessor, not of the lessee.

(ii) *Dispositions of associated personal property—(A) In general.* Personal prop-

erty that has become associated with the use of a real property interest shall itself be treated as a real property interest upon its disposition, unless either:

(1) The personal property is disposed of more than one year before the disposition of any present right to use or occupy the real property with which it was associated (and subject to the provisions of subdivision (B) of this paragraph (b)(4)(ii));

(2) The personal property is disposed of more than one year after the disposition of all present rights to use or occupy the real property with which it was associated (and subject to the provisions of subdivision (C) of this paragraph (b)(4)(ii)); or

(3) The personal property and the real property with which it was associated are separately sold to persons that are related neither to the transferor nor to one another (and subject to the provisions of subdivision (D) of this paragraph (b)(4)(ii)).

(B) *Personal property disposed of one year before realty.* A transferor of personal property associated with the use of real property need not treat such property as a real property interest upon disposition if on the date of disposition the transferor does not expect or intend to dispose of the real property until more than one year later.

However, if the real property is in fact disposed of within the following year, the transferor must treat the personal property as having been a real property interest as of the date on which the personalty was disposed of. If the transferor had not previously filed an income tax return, a return must be filed and tax paid, together with any interest due thereon, by the later of the date on which a tax return or payment is actually due (with extensions), or the 60th day following the date of disposition. If the transferor had previously filed an income tax return, an amended return must be filed and tax paid, together with any interest due thereon, by the later of the dates specified above. Such a transferor may be liable to penalties for failure to file, for late payment of tax, or for understatement of liability, but only if the transferor knew or had reason to anticipate

that the real property would be disposed of within one year of the disposition of the associated personal property.

(C) *Personalty disposed of one year after realty.* A disposition of real property shall be disregarded for purposes of subdivision (A)(2) of this paragraph (b) (4)(ii) if any right to use or occupy the real property is reacquired within the one-year period referred to in that subdivision. However, the disposition shall not be disregarded if such reacquisition is made in foreclosure of a mortgage or other security interest, in the exercise of a contractual remedy, or in the enforcement of a judgment. If, however, the reacquisition of the property is made pursuant to a plan the principal purpose of which is the avoidance of the provisions of section 897, 1445, or 6039C and the regulations thereunder, then the initial disposition shall be disregarded for purposes of subdivision (A)(2) of this paragraph (b)(4)(ii).

(D) *Separate dispositions of personalty and realty.* A transferor of personal property associated with the use of real property need not treat such property as a real property interest upon disposition if within 90 days before or after such disposition the transferor separately disposes of the real property interest to persons that are related neither to the transferor nor to the purchaser of the personal property. A transferor may rely upon this rule unless the transferor knows or has reason to know that the purchasers of the real property and the personal property—

(1) Are related persons; or

(2) Intend to reassociate the personal property with the use of the real property within one year of the date of disposition of the personal property.

(E) *Status of property in hands of transferee.* Personal property that has been associated with the use of real property and that is sold to an unrelated party will be treated as real property in the hands of the transferee only if the personal property becomes associated with the use of real property held or acquired by the transferee, in the manner described in paragraph (b)(4)(i) of this section.

(iii) *Determination dates.* The determination of whether personal property

is personal property associated with the use of real property as defined in this paragraph (b)(4) is to be made on the date the personal property is disposed of and on each applicable determination date. See § 1.897-2(c).

(c) *United States real property interest—(1) In general.* The term “United States real property interest” means any interest, other than an interest solely as a creditor, in either:

(i) Real property located in the United States or the Virgin Islands, or

(ii) A domestic corporation unless it is established that the corporation was not a U.S. real property holding corporation within the period described in section 897(c)(1)(A)(ii).

In addition, for the limited purpose of determining whether any corporation is a U.S. real property holding corporation, the term “United States real property interest” means an interest, other than an interest solely as a creditor, in a foreign corporation unless it is established that the foreign corporation is not a U.S. real property holding corporation within the period prescribed in section 897(c)(1)(A)(ii). See § 1.897-2 for rules regarding the manner of establishing that a corporation is not a United States real property holding corporation.

(2) *Exceptions and special rules—(i) Domestically-controlled REIT.* An interest in a domestically-controlled real estate investment trust (REIT) is not a U.S. real property interest. A domestically-controlled REIT is one in which less than 50 percent of the fair market value of the outstanding stock was directly or indirectly held by foreign persons during the five-year period ending on the applicable determination date (or the period since June 18, 1980, if shorter). For purposes of this determination the actual owners of stock, as determined under § 1.857-8, must be taken into account.

(ii) *Corporation that has disposed of all U.S. real property interests.* The term “United States real property interest” does not include an interest in a corporation which has disposed of all its U.S. real property interests in transactions in which the full amount of gain, if any, was recognized, as provided by section 897(c)(1)(B). See § 1.897-

2(f) for rules regarding the requirements of section 897(c)(1)(B).

(iii) *Publicly-traded corporations.* If, at any time during the calendar year, any class of stock of a domestic corporation is regularly traded on an established securities market, an interest in such corporation shall be treated as a U.S. real property interest only in the case of:

(A) A regularly traded interest owned by a person who beneficially owned more than 5 percent of the total fair market value of that class of interests at any time during the five-year period ending either on the date of disposition of such interest or other applicable determination date (or the period since June 18, 1980, in shorter), or

(B) [Reserved]

Separate non-regularly traded interests that were acquired in transactions more than three years apart shall not be cumulated pursuant to this rule. In determining whether a shareholder holds 5 percent of a class of stock in a corporation (or any other interest of an equivalent fair market value), section 318(a) shall apply (except that sections 318(a) (2)(C) and (3)(C) are applied by substituting the phrase “5 percent” for “50 percent”).

(iv) *Publicly traded partnerships and trusts.* If any class of interests in a partnership or trust is, within the meaning of §1.897-1(m) and (n), regularly traded on an established securities market, then for purposes of sections 897(g) and 1445 and §1.897-2 (d) and (e) an interest in the entity shall not be treated as an interest in a partnership or trust. Instead, such an interest shall be subject to the rules applicable to interests in publicly traded corporations pursuant to paragraph (c)(2)(iii) of this section. Such interests can be real property interests in the hands of a person that holds a greater than 5 percent interest. Therefore, solely for purposes of determining whether greater than 5 percent interests in such an entity constitute U.S. real property interests the disposition of which is subject to tax, the entity is required to determine pursuant to the provisions of §1.897-2 whether the assets it holds would cause it to be classified as a U.S. real property holding corporation if it were a corporation. The treatment of

dispositions of U.S. real property interests by publicly traded partnerships and trusts is not affected by the rules of this paragraph (c)(2)(iv); by reason of the operation of section 897(a), foreign partners or beneficiaries are subject to tax upon their distributive share of any gain recognized upon such dispositions by the partnership or trust. The rules of this paragraph (c)(2)(iv) are illustrated by the following example.

Example. PTP is a partnership one class of interests in which is regularly traded on an established securities market. A is a non-resident alien individual who owns 1 percent of a class of limited partnership interests in PTP. B is a nonresident alien individual who owns 10 percent of the same class of limited partnership interests in PTP. On July 1, 1986, A and B sell their interests in PTP. Pursuant to the rules of this paragraph (c)(2)(iv), neither disposition is treated as the disposition of a partnership interest subject to the provisions of section 897(g). Instead, A and B are treated as having disposed of interests in a publicly traded corporation. Therefore, pursuant to the rule of paragraph (c)(2)(iii) of this section, A's disposition of a 1 percent interest has no consequences under section 897. However, B's disposition of a 10 percent interest will constitute the disposition of a U.S. real property interest subject to tax by reason of the operation of section 897 unless it is established pursuant to the rules of §1.897-2 that the interest is not a U.S. real property interest.

(d) *Interest other than an interest solely as a creditor—(1) In general.* This paragraph defines an interest other than an interest solely as a creditor, with respect to real property, and with respect to corporations, partnerships, trusts, and estates. An interest solely as a creditor either in real property or in a domestic corporation does not constitute a United States real property interest. Similarly, where one corporation holds an interest solely as a creditor in a second corporation or in a partnership, trust, or estate, that interest will be disregarded for purposes of determining whether the first corporation is a U.S. real property holding corporation (except to the extent that such interest constitutes an asset used or held for use in a trade or business, in accordance with rules of §1.897-1(f)). In addition, the disposition of an interest solely as a creditor in a partnership, trust, or estate is not subject to sections 897, 1445, and 6039C. Whether an

interest is considered debt under any provisions of the Code is not determinative of whether it constitutes an interest solely as a creditor for purpose of sections 897, 1445, and 6039C and the regulations thereunder.

(2) *Interests in real property other than solely as creditor*—(i) *In general.* An interest in real property other than an interest solely as a creditor includes a fee ownership, co-ownership, or leasehold interest in real property, a time sharing interest in real property, and a life estate, remainder, or reversionary interest in such property. The term also includes any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property.

A loan to an individual or entity under the terms of which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property of the debtor or of a related person is, in its entirety, an interest in real property other than solely as a creditor. An interest in production payments described in section 636 does not generally constitute an interest in real property other than solely as a creditor. However, a right to production payments shall constitute an interest in real property other than solely as a creditor if it conveys a right to share in the appreciation in value of the mineral property. A production payment that is limited to a quantum of mineral (including a percentage of recoverable reserves produced) or a period of time will be considered to convey a right to share in the appreciation in value of the mineral property. The rules of this paragraph (d)(2)(i) are illustrated by the following example.

Example. A, a U.S. citizen, purchases a condominium unit located in the United States for \$500,000. A makes a \$100,000 down payment and borrows \$400,000 from B, a foreign person, to pay the balance of the purchase price. Under the terms of the loan, A is to pay B 13 percent annual interest each year for 10 years and 35 percent of the appreciation in the fair market value of the condominium at the end of the 10-year period. Because B has a right to share in the appreciation in value of the condominium, B has an interest other than solely as a creditor in

the condominium. B's entire interest in the obligation from A, therefore, is a United States real property interest.

(ii) *Special rule*—(A) *Installment obligations.* A right to installment or other deferred payments from the disposition of an interest in real property will constitute an interest solely as a creditor if the transferor elects not to have the installment method of section 453(a) apply, any gain or loss is recognized in the year of disposition, and all tax due is timely paid. See section 1445 and regulations thereunder for further guidance concerning the availability of installment sale treatment under section 453. If an agreement for the payment of tax with respect to an installment sale is entered into with the Internal Revenue Service pursuant to section 1445, that agreement may specify whether or not the installment obligation will constitute an interest solely as a creditor. If an installment obligation constitutes an interest other than solely as a creditor then the receipt of each payment shall be treated as the disposition of an interest in real property that is subject to section 897(a) to the extent of any gain required to be taken into account pursuant to section 453.

If the original holder of an installment obligation that constitutes an interest other than solely as a creditor subsequently disposes of the obligation to an unrelated party and recognizes gain or loss pursuant to section 453B, the obligation will constitute an interest in real property solely as a creditor in the hands of the subsequent holder. However, if the obligation is disposed of to a related person and the full amount of gain realized upon the disposition of the real property has not been recognized upon such disposition of the installment obligation, then the obligation shall continue to be an interest in real property other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(2)(ii)(A).

In addition, if the obligation is disposed of to any person for a principal purpose of avoiding the provisions of sections 897, 1445, or 6039C, then the obligation shall continue to be an interest in real property other than solely as a creditor in the hands of the subsequent holder subject to the rules of

this paragraph (d)(2)(ii)(A). However, rights to payments arising from dispositions that took place before June 19, 1980, shall in no event constitute interests in real property other than solely as a creditor, even if such payments are received after June 18, 1980. In addition, rights to payments arising from dispositions to unrelated parties that took place before January 1, 1985, and that were not subject to U.S. tax pursuant to the provisions of a U.S. income tax treaty, shall not constitute interests in real property other than solely as a creditor, even if such payments are received after December 31, 1984.

(B) *Options.* An option, a contract or a right of first refusal to acquire any interest in real property (other than an interest solely as a creditor) will itself constitute an interest in real property other than solely as a creditor.

(C) *Security interests.* A right to repossess or foreclose on real property under a mortgage, security agreement, financing statement, or other collateral instrument securing a debt will not be considered a reversionary interest in, or a right to share in the appreciation in value of or gross or net proceeds or profits generated by, an interest in real property. Thus, no such right of repossession or foreclosure will of itself cause an interest in real property which is otherwise an interest solely as a creditor to become an interest other than solely as a creditor. In addition, a person acting as mortgagee in possession shall not be considered to hold an interest in real property other than solely as a creditor, if the mortgagee's interest in the property otherwise constitutes an interest solely as a creditor.

(D) *Indexed interest rates.* An interest will not constitute a right to share in the appreciation in the value of, or gross or net proceeds or profits generated by, real property solely because it bears a rate of interest that is tied to an index of any kind that is intended to reflect general inflation or deflation of prices and interest rates (e.g., the Consumer Price Index). However, where an interest in real property bears a rate of interest that is tied to an index the principal purpose of which is to reflect changes in real property

values, the real property interest will be considered an indirect right to share in the appreciation in value of, or gross or net proceeds or profits generated by, real property. Such an indirect right constitutes an interest in real property other than solely as a creditor.

(E) *Commissions.* A right to payment of a commission, brokerage fee, or similar charge for professional services rendered in connection with the arrangement or financing of a purchase, sale, or lease of real property does not constitute a right to share in the appreciation in value of, or gross or net proceeds or profits of, real property solely because it is based upon a percentage of the purchase price or rent. Thus, a right to a commission earned by a real estate agent based on a percentage of the sales price does not constitute an interest in real property other than solely as a creditor.

However, a right to a commission, brokerage fee, or similar charge will constitute an interest other than solely as a creditor if the total amount of the payment is contingent upon appreciation, proceeds, or profits of the real property occurring or arising after the date of the transaction with respect to which the professional services were rendered. For example, a commission earned in connection with the purchase of a real property interest that is contingent upon the amount of gain ultimately realized by the purchaser will constitute an interest in real property other than solely as a creditor.

(F) *Trustees' fees, etc.* A right to payment of reasonable compensation for services rendered as a trustee, as an administrator of an estate, or in a similar capacity does not constitute a right to share in the appreciation in the value of, or gross or net proceeds or profits of, real property solely because the assets of the trust or estate include U.S. real property interests.

(3) *Interest in an entity other than solely as a creditor—*(i) In general. For purposes of sections 897, 1445, and 6039C, an interest in an entity other than an interest solely as a creditor is—

(A) Stock of a corporation;

(B) An interest in a partnership as a partner within the meaning of section 761(b) and the regulations thereunder;

(C) An interest in a trust or estate as a beneficiary within the meaning of section 643(c) and the regulations thereunder or an ownership interest in any portion of a trust as provided in sections 671 through 679 and the regulations thereunder;

(D) An interest which is, in whole or in part, a direct or indirect right to share in the appreciation in value of an interest in an entity described in subdivision (A), (B), or (C) of this paragraph (d)(3)(i) or a direct or indirect right to share in the appreciation in value of assets of, or gross or net proceeds or profits derived by, the entity; or

(E) A right (whether or not presently exercisable) directly or indirectly to acquire, by purchase, conversion, exchange, or in any other manner, an interest described in subdivision (A), (B), (C), or (D) of this paragraph (d)(3)(i).

(ii) *Special rules*—(A) *Installment obligations*. A right to installment or other deferred payments from the disposition of an interest in an entity will constitute an interest solely as a creditor if the transferor elects not to have the installment method of section 453(a) apply, any gain or loss is recognized in the year of disposition, and tax due is timely paid. See section 1445 and regulations thereunder for further guidance concerning the availability of installment sale treatment under section 453. If an agreement for the payment of tax with respect to an installment sale is entered into with the Internal Revenue Service pursuant to section 1445, that agreement may specify whether or not the installment obligation will constitute an interest solely as a creditor. If an installment obligation constitutes an interest other than solely as a creditor then the receipt of each payment shall be treated as the disposition of such an interest and shall be subject to section 897(a) to the extent that:

(1) It constitutes the disposition of a U.S. real property interest and

(2) Gain or loss is required to be taken into account pursuant to section 453. Such treatment shall apply to payments arising from dispositions of interests in a corporation any class of the stock of which is regularly traded on an established securities market,

but only in the case of a disposition of any portion of an interest described in paragraph (c)(2)(iii)(A) or (B) of this section. If the original holder of an installment obligation that constitutes an interest other than solely as a creditor subsequently disposes of the obligation to an unrelated party and recognizes gain or loss pursuant to section 453B, the obligation will constitute an interest in the entity solely as a creditor in the hands of the subsequent holder. However, if the obligation is disposed of to a related person and the full amount of gain realized upon the disposition of the interest in the entity has not been recognized upon such disposition of the installment obligation, then the obligation shall continue to be an interest in the entity other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(3)(ii)(A). In addition, if the obligation is disposed of to any person for a principal purpose of avoiding the provisions of section 897, 1445, or 6039C, then the obligation shall continue to be an interest in the entity other than solely as a creditor in the hands of the subsequent holder subject to the rules of this paragraph (d)(3)(ii)(A). However, rights to payments arising from dispositions that took place before June 19, 1980, shall in no event constitute interests in an entity other than solely as a creditor, even if such payments are received after June 18, 1980. In addition, such treatment shall not apply to payments arising from dispositions to unrelated parties that took place before January 1, 1985, and that were not subject to U.S. tax pursuant to the provisions of a U.S. income tax treaty, regardless of when such payments are received.

(B) *Contingent interests*. The interests described in subdivision (D) of paragraph (d)(3)(i) of this section include any right to a payment from an entity the amount of which is contingent on the appreciation in value of an interest described in subdivision (A), (B), or (C) of paragraph (d)(3)(i) of this section or which is contingent on the appreciation in value of assets of, or the general gross or net proceeds or profits derived by, such entity. The right to such a payment is itself an interest in the entity other than solely as a creditor,

regardless of whether the holder of such right actually holds an interest in the entity described in subdivision (A), (B), or (C) of paragraph (d)(3)(i) of this section. For example, a stock appreciation right constitutes an interest in a corporation other than solely as a creditor even if the holder of such right actually holds no stock in the corporation. However, the interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include any right to a payment that is (1) exclusively contingent upon and exclusively paid out of revenues from sales of personal property (whether tangible or intangible) or from services, or (2) exclusively contingent upon the resolution of a claim asserted against the entity by a person related neither to the entity nor to the holder of the interest.

(C) *Security interests.* A right to repossess or foreclose on an interest in an entity under a mortgage, security agreement, financing statement, or other collateral instrument securing a debt will not of itself cause an interest in an entity which is otherwise an interest solely as a creditor to become an interest other than solely as a creditor.

(D) *Royalties.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include rights to payments representing royalties, license fees, or similar charges for the use of patents, inventions, formulas, copyrights, literary, musical or artistic compositions, trademarks, trade names, franchises, licenses, or similar intangible property.

(E) *Commissions.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include a right to a commission, brokerage fee or similar charge for professional services rendered in connection with the purchase or sale of an interest in an entity. However, a right to such a payment will constitute an interest other than solely as a creditor if the total amount of the payment is contingent upon appreciation in value of assets of, or proceeds or profits derived by, the entity after the date of the transaction with respect to which the payment was earned.

(F) *Trustee's fees.* The interests described in subdivision (D) of paragraph (d)(3)(i) of this section do not include a

right to payment representing reasonable compensation for services rendered as a trustee, as an administrator of an estate, or in a similar capacity.

(4) *Aggregation of interests.* If a person holds both interests solely as a creditor and interests other than solely as a creditor in real property or in an entity, those interests will generally be treated as separate and distinct interests. However, such interests shall be aggregated and treated as interests other than solely as a creditor in their entirety if the interest solely as a creditor has been separated from, or acquired separately from, the interest other than solely as a creditor, for a principal purpose of avoiding the provisions of section 897, 1445, or 6039C by causing one or more of such interests to be an interest solely as a creditor. The existence of such a purpose will be determined with reference to all the facts and circumstances. Where an interest solely as a creditor has arm's-length interest and repayment terms it shall in no event be aggregated with and treated as an interest other than solely as a creditor. For purposes of this paragraph (d)(4), an interest rate that does not exceed 120 percent of the applicable Federal rate (as defined in section 1274(d)) shall be presumed to be an arm's-length interest rate. For purposes of applying the rules of this paragraph (d)(4), a person shall be treated as holding any interests held by a related person within the meaning of § 1.897-1(i).

(5) *"Interest" means "interest other than solely as a creditor."* Unless otherwise stated, the term "interest" as used with regard to real property or with regard to an entity hereafter in the regulations under sections 897, 1445, and 6039C, means an interest in such real property or entity other than an interest solely as a creditor.

(e) *Proportionate share of assets held by an entity—(1) In general.* A person that holds an interest in an entity is for certain purposes treated as holding a proportionate or pro rata share of the assets held by the entity. Such proportionate share must be calculated, in accordance with the rules of this paragraph, for the following purposes.

(i) In determining whether a corporation is a U.S. real property holding corporation—

(A) A person holding an interest in a partnership, trust, or estate is treated as holding a proportionate share of the assets held by the partnership, trust, or estate (see section 897-2(e)(2)), and

(B) A corporation that holds a controlling interest in a second corporation is treated as holding a proportionate share of the assets held by the second corporation (see § 1.897-2(e)(3)).

(ii) In determining reporting obligations that may be imposed under section 6039C, the holder of an interest in a partnership, trust, or estate is treated as owning a proportionate share of the U.S. real property interests held by the partnership, trust, or estate.

(2) *Proportionate share of assets held by a corporation or partnership*—(i) *In general.* A person's proportionate or pro rata share of assets held by a corporation or partnership is determined by multiplying—

(A) The person's percentage ownership interest in the entity, by

(B) The fair market value of the assets held by the entity (or the book value of such assets, in the case of a determination pursuant to § 1.897-2(b)(2)).

(ii) *Percentage ownership interest.* A person's percentage ownership interest in a corporation or partnership is the percentage equal to the ratio of (A) the sum of the liquidation values of all interests in the entity held by the person to (B) the sum of the liquidation values of all outstanding interest in the entity. The liquidation value of an interest in an entity is the amount of cash and the fair market value of any property that would be distributed with respect to such interest upon the liquidation of the entity after satisfaction of liabilities to persons having interests in the entity solely as creditors. With respect to an entity that has interests outstanding that grant a presently-exercisable option to acquire or right to convert into or otherwise acquire an interest in the entity other than solely as a creditor, the liquidation value of all interests in such entity shall be calculated as though such option or right had been exercised, giving effect both to the payment of any consideration required to exercise the option or right

and to the issuance of the additional interest.

The fair market value of the assets of the entity, the amount of cash held by the entity, and the amount of liabilities to persons having interests solely as creditors if determined for this purpose on the date with respect to which the percentage ownership interest is determined.

(iii) *Examples.* The rules of this paragraph (e)(2) are illustrated by the following examples.

Example 1. Corporation K's only assets are stock and securities with a fair market value as of the applicable determination date of \$20,000,000. K's assets are subject to liabilities of \$10,000,000. Among K's liabilities are a \$1,000,000 loan from L, under the terms of which L is entitled, upon payment of the loan principal, to a profit share equal to 10 percent of the excess of the fair market value of K's assets over \$18,000,000, but only if all other corporate liabilities have been paid. K has two classes of stock, common and preferred. PS1 and PS2 each own 100 of the 200 outstanding shares of preferred stock. CS1 and CS2 each own 500 of the 1,000 outstanding shares of common stock. Each preferred shareholder is entitled to \$10,000 per share of preferred stock upon liquidation, subject to payment of all corporate liabilities and to any amount owed to L, but before any common shareholder is paid. The liquidation value of L's interest in K, which constitutes an interest other than an interest solely as a creditor, is \$1,200 (\$1,000,000 principal of the loan to K plus \$200,000 (10 percent of the excess of \$20,000,000 over \$18,000,000)). The liquidation value of each of PS1's and PS2's blocks of preferred stock is \$1,000,000 (\$10,000 times 100 shares each). The liquidation value of each of CS1's and CS2's blocks of common stock is \$3,900,000 [\$20,000,000 (the total fair market value of K's assets)—\$9,000,000 (liabilities to creditors other than L)—\$1,200,000 (L's liquidation value)—\$2,000,000 (PS1's and PS2's liquidation value)] times 50 percent (the percentage of common stock owned by each). The sum of the liquidation values of all of the outstanding interests in K (i.e., interests other than solely as a creditor) is \$11,000,000 [\$1,200,000 (L's liquidation value)+\$2,000,000 (PS1's and PS2's liquidation values)+\$7,800,000 (CS1's and CS2's liquidation values)]. Each of CS1's and CS2's percentage ownership interests in K is 35.5 percent (\$3,900,000 divided by \$11,000,000). Each of PS1's and PS2's percentage ownership interests in K is 9 percent (\$1,000,000 divided by \$11,000,000). L's percentage ownership interest in K is 11 percent (\$1,200,000 divided by \$11,000,000).

Example 2. A, a U.S. person, and B, a foreign person are partners in a partnership the only asset of which is a parcel of undeveloped land located in the United States that was purchased by the partnership in 1980 for \$300,000. The partnership has no liabilities, and its capital is \$300,000. A's and B's interests in the capital of the partnership are 25 percent and 75 percent, respectively, and A and B each has a 50 percent profit interest in the partnership. The partnership agreement provides that upon liquidation any unrealized gain will be distributed in accordance with the partners' profit interest. In 1984 the partnership has no items of income or deduction, and the fair market value of its parcel of undeveloped land is \$500,000. In 1984 the percentage ownership interest of A in the partnership is 35 percent [the ratio of \$100,000 (the liquidation value of A's profit interest in 1984) plus \$75,000 (the liquidation value of A's 25 percent interest in the partnership's \$300,000 capital) to \$500,000 (the sum of the liquidation values of all outstanding interests in the partnership)]. The percentage ownership interest of B in the partnership in 1984 is 65 percent [the ratio of \$325,000 (B's \$100,000 profit interest plus his \$225,000 capital interest) to \$500,000]

(3) *Proportionate share of assets held by trusts and estates*—(i) *In general.* A person's proportionate or pro rata share of assets held by a trust or estate is determined by multiplying—

(A) The person's percentage ownership interest in the trust or estate, by

(B) The fair market value of the assets held by the trust or estate (or the book value of such assets, in the case of a determination pursuant to § 1.897-2(b)(2)).

(ii) *Percentage ownership interest*—(A) *General rule.* A person's percentage ownership interest in a trust or an estate—is the percentage equal to the ratio of:

(1) The sum of the actuarial values of such person's interests in the cash and other assets held by the trust or estate after satisfaction of the liabilities of the trust or estate to persons holding interests in the trust or estate solely as creditors, to (2) the entire amount of such cash and other assets after satisfaction of liabilities to persons holding interests in the trust or estate solely as creditors. For purposes of calculating this ratio, the fair market value of the trust's or estate's assets, the amount of cash held by the trust or estate, and the amount of the liabilities to persons having interests solely as

creditors is determined on the date with respect to which the percentage ownership interest is determined. With respect to a trust or estate that has interests outstanding that grant a presently-exercisable option to acquire or right to convert into or otherwise acquire an interest in the trust or estate other than solely as a creditor, the liquidation value of all interests in such entity shall be calculated as though such option or right had been exercised, giving effect both to the payment of any consideration required to exercise the option or right and to the issuance of the additional interest. With respect to a trust or estate that has interests outstanding that entitle any person to a distribution of U.S. real property interests upon liquidation that is disproportionate to such person's interest in the total assets of the trust or estate, such disproportionate right shall be disregarded in the calculation of the interest-holders' proportionate share of the U.S. real property interests held by the entity. For purposes of determining his own percentage ownership interest in a trust, a grantor or other person will be treated as owning any portion of the trust's cash and other assets which such person is treated as owning under sections 671 through 679.

(B) *Discretionary trusts and estates.* In determining percentage ownership interest in a trust or an estate, the sum of the definitely ascertainable actuarial values of interests in the cash and the other assets of the trust or estate held by persons in existence on the date with respect to which such determination is made must equal the amount in paragraph (e)(3)(ii)(A)(2) of this section. If the amount in paragraph (e)(3)(ii)(A)(2) of this section exceeds the sum of the definitely ascertainable actuarial values of the interests held by persons in existence on the determination date, the excess will be considered to be owned in total by each beneficiary who is in existence on such date, whose interest in the excess is not definitely ascertainable and who is potentially entitled to such excess. However, such excess shall not be considered to be owned in total by each beneficiary if the discretionary terms of the trust or estate were included for

a principal purpose of avoiding the provisions of section 897, 1445, or 6039C by causing assets other than U.S. real property interests to be attributed in total to each beneficiary. The rules of this paragraph (e)(3) are illustrated by the following example.

Example. A, a U.S. person, established a trust on December 31, 1984, and contributed real property with a fair market value of \$10,000 to the trust. The terms of that trust provided that the trustee, a bank that is unrelated to A, at its discretion may retain trust income or may distribute it to X, a foreign person, or to the head of state of any country other than the United States. The remainder upon the death of X is to go in equal shares to such of Y and Z, both foreign persons, as survive X. On December 31, 1984, the total value of the trust's assets is \$10,000. On the same date, the actuarial values of the remainder interests of Y and Z in the corpus of the trust are definitely ascertainable. They are \$1,000 and \$500, respectively. Neither the income interest of X nor of the head of state of any country other than the United States has a definitely ascertainable actuarial value on December 31, 1984. The interests of Y and Z in the income portion of the trust similarly have no definitely ascertainable actuarial values on such date since the income may be distributed rather than retained by the trust. Since the sum of the actuarial values of definitely ascertainable interests of persons in existence (\$1,500) is less than \$10,000, the difference (\$8,500) is treated as owned by each beneficiary who is in existence on December 31, 1984, and who is potentially entitled to such excess. Therefore, X, Y, Z, and the head of state of any country other than the United States are each considered as owning the entire \$8,500 income interest in the trust. On December 31, 1984, the total actuarial value of X's interest is \$8,500, and his percentage ownership interest is 85 percent. The total actuarial value of Y's interest in the trust is \$9,500 (\$1,000 plus \$8,500), and his percentage ownership interest is 95 percent. The total actuarial value of Z's interest is \$9,000 (\$500 plus \$8,500), and his percentage ownership interest is 90 percent. The actuarial value of the interest of the head of state of each country other than the United States is \$8,500, and his percentage ownership interest is 85 percent.

(4) *Dates with respect to which percentage ownership interests are determined.* The dates with respect to which percentage ownership interests are determined are the applicable determination dates outlined in § 1.897-2 or in regulations under section 6039C.

(f) *Asset used or held for use in a trade or business*—(1) *In general.* The term “asset used or held for use in a trade or business” means—

(i) Property, other than a U.S. real property interest, that is—

(A) Stock in trade of an entity or other property of a kind which would properly be included in the inventory of the entity if on hand at the close of the taxable year, or property held by the entity primarily for sale to customers in the ordinary course of its trade or business, or

(B) Depreciable property used or held for use in the trade or business, as described in section 1231(b)(1) but without regard to the holding period limitations of section 1231(b), or

(C) Livestock, including poultry, used or held for use in a trade or business for draft, breeding, dairy, or sporting purposes, and

(ii) Goodwill and going concern value, patents, inventions, formulas, copyrights, literary, musical, or artistic compositions, trademarks, trade names, franchises, licenses, customer lists, and similar intangible property, but only to the extent that such property is used or held for use in the entity's trade or business and subject to the valuation rules of § 1.897-1(o)(4), and

(iii) Cash, stock, securities, receivables of all kinds, options or contracts to acquire any of the foregoing, and options or contracts to acquire commodities, but only to the extent that such assets are used or held for use in the corporation's trade or business and do not constitute U.S. real property interests.

(2) *Used or held for use in a trade or business.* An asset is used or held for use in an entity's trade or business if it is, under the principles of § 1.864-4(c)(2)—

(i) Held for the principal purpose of promoting the present conduct of the trade or business,

(ii) Acquired and held in the ordinary course of the trade or business, as, for example, in the case of an account or note receivable arising from that trade or business (including the performance of services), or

(iii) Otherwise held in a direct relationship to the trade or business.

In determining whether an asset is held in a direct relationship to the trade or business, consideration shall be given to whether the asset is needed in that trade or business. An asset shall be considered to be needed in a trade or business only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business if, for example, the asset is held for the purpose of providing for future diversification into a new trade or business, future expansion of trade or business activities, future plant replacement, or future business contingencies. An asset that is held to meet reserve or capitalization requirements imposed by applicable law shall be presumed to be held in a direct relationship to the trade or business.

(3) *Special rules concerning liquid assets*—(i) *Safe harbor amount.* Assets described in paragraph (f)(1)(iii) of this section shall be presumed to be used or held for use in a trade or business, in an amount up to 5 percent of the fair market value of other assets used or held for use in the trade or business. However, the rule of this paragraph (f)(3)(i) shall not apply with respect to any assets described in paragraph (f)(1)(iii) of this section that are held or acquired for the principal purpose of avoiding the provisions of section 897 or 1445.

(ii) *Investment companies.* Assets described in paragraph (f)(1)(iii) of this section shall be presumed to be used or held for use in an entity's trade or business if the principal business of the entity is trading or investing in such assets for its own account. An entity's principal business shall be presumed to be trading or investing in assets described in paragraph (f)(1)(iii) of this section if the fair market value of such assets held by the entity equals or exceeds 90 percent of the sum of the fair market values of the entity's U.S. real property interests, interests in real property located outside the United States, assets otherwise used or held for use in trade or business, and assets

described in paragraph (f)(1)(iii) of this section.

(4) *Examples.* The application of this paragraph (f) may be illustrated by the following examples:

Example 1. M, a domestic corporation engaged in industrial manufacturing, is required to hold a large current cash balance for the purposes of purchasing materials and meeting its payroll. The amount of the cash balance so required varies because of the fluctuating seasonal nature of the corporation's business. In months when large cash balances are not required, the corporation invests the surplus amount in U.S. Treasury bills. Since both the cash and the Treasury bills are held to meet the present needs of the business, they are held in a direct relationship to that business, and, therefore, constitute assets used or held for use in the trade or business.

Example 2. R, a domestic corporation engaged in the manufacture of goods, engages a stock brokerage firm to manage securities which were purchased with funds from R's general surplus reserves. The funds invested in these securities are intended to provide for the future expansion of R into a new trade or business. Thus, the funds are not necessary for the present needs of the business; they are accordingly not held in a direct relationship to the business and do not constitute assets used or held for use in the trade or business.

Example 3. B, a federally chartered and regulated bank, is required by law to hold substantial reserves of cash, stock, and securities. Pursuant to the rule of paragraph (f)(2) of this section, such assets are presumed to be held in a direct relationship to B's business, and thus constitute assets used or held for use in the trade or business. In addition, B holds substantial loan receivables which are acquired and held in the ordinary course of its banking business. Pursuant to the rule of paragraph (f)(1)(iii) of this section, such receivables constitute assets used or held for use in the trade or business.

(g) *Disposition.* For purposes of sections 897, 1445, and 6039C, the term "disposition" means any transfer that would constitute a disposition by the transferor for any purpose of the Internal Revenue Code and regulations thereunder. The severance of crops or timber and the extraction of minerals do not alone constitute the disposition of a U.S. real property interest.

(h) *Gain or loss.* The amount of gain or loss arising from the disposition of the U.S. real property interest shall be determined as provided in section 1001 (a) and (b). Such gain or loss shall be

subject to the provisions of section 897 (a) and (b), unless a nonrecognition provision is applicable pursuant to section 897 (d) or (e) and regulations thereunder. Amounts otherwise treated for Federal income tax purposes as principal and interest payments on debt obligations of all kinds (including obligations that are interests other than solely as a creditor) do not give rise to gain or loss that is subject to section 897(a). However, principal payments on installment obligations described in §§ 1.897-1(d)(2)(ii)(A) and 1.897-1(d)(3)(ii)(A) do give rise to gain or loss that is subject to section 897(a), to the extent such gain or loss is required to be recognized pursuant to section 453. The rules of paragraphs (g) and (h) are illustrated by the following examples.

Example 1. Foreign individual C has an undivided fee interest in a parcel of real property located in the United States. The fair market value of C's interest is \$70,000, and C's basis in such interest is \$50,000. The only liability to which the real property is subject is the liability of \$65,000 secured by a mortgage in the same amount. C transfers his fee interest in the property subject to the mortgage by gift to D. C realizes \$15,000 of gain upon such transfer. As a transfer by gift constitutes a disposition for purposes of the Code, and as gain is realized upon that transfer, the gift is a disposition for purposes of sections 897, 1445, and 6039C and is subject to section 897(a) to the extent of the gain realized. However, section 897(a) would not be applicable to the transfer if the mortgage on the U.S. real property were equal to or less than C's \$50,000 basis, since the transfer then would not give rise to the realization of gain or loss under the Internal Revenue Code.

Example 2. Foreign corporation Y makes a loan of \$1 million to domestic individual Z, secured by a mortgage on residential real property purchased with the loan proceeds. The loan agreement provides that Y is entitled to receive fixed monthly payments from Z, constituting repayment of principal plus interest at a fixed rate. In addition, the agreement provides that Y is entitled to receive a percentage of the appreciation value of the real property as of the time that the loan is retired. The obligation in its entirety is considered debt for Federal income tax purposes. However, because of Y's right to share in the appreciation in value of the real property, the debt obligation gives Y an interest in the real property other than solely as a creditor. Nevertheless, as principal and interest payments do not constitute gain under section 1001 and paragraph (h) of this section, and both the monthly and final payments received by Y are considered to con-

sist solely of principal and interest for Federal income tax purposes, section 897(a) shall not apply to Y's receipt of such payments. However, Y's sale of the debt obligation to foreign corporation A would give rise to gain that is subject to section 897(a).

(i) *Related person.* For purposes of sections 897, 1445, and 6039C, persons are considered to be related if they are partners or partnerships described in section 707(b)(1) of the Code or if they are related within the meaning of section 267 (b) and (c) of the Code (except that section 267(f) shall apply without regard to section 1563(b)(2)).

(j) *Domestic corporation.* The term "domestic corporation" has the same meaning as set forth in section 7701(a) (3) and (4) and § 301.7701-5. For purposes of sections 897 and 6039C, it also includes a foreign corporation with respect to which an election under section 897(i) and § 1.897-3 or section 897(k) and § 1.897-4 to be treated as domestic corporation is in effect.

(k) [Reserved]

(l) *Foreign corporation.* The term "foreign corporation" has the meaning ascribed to such term in section 7701(a) (3) and (5) and § 301.7701-5. For purposes of sections 897 and 6039C, however, the term does not include a foreign corporation with respect to which there is in effect an election under section 897(i) and § 1.897-3 or section 897(k) and § 1.897-4 to be treated as a domestic corporation.

(m) *Established securities market.* For purposes of sections 897, 1445, and 6039C, the term "established securities market" means—

(1) A national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f),

(2) A foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and

(3) Any over-the-counter market. An over-the-counter market is any market reflected by the existence of an inter-dealer quotation system. An inter-dealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are

prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.

(n) [Reserved]

(o) *Fair market value*—(1) *In general.* For purposes of sections 897, 1445, and 6039C only, the term “fair market value” means the value of the property determined in accordance with the rules, contained in this paragraph (o). The definition of fair market value provided herein is not to be used in the calculation of gain or loss from the disposition of a U.S. real property interest pursuant to section 1001. An independent professional appraisal of the value of property must be submitted only if such an appraisal is specifically requested in connection with the negotiation of a security agreement pursuant to section 1445.

(2) *Method of calculating fair market value*—(i) *In general.* The fair market value of property is its gross value (as defined in paragraph (o)(2)(ii) of this section) reduced by the outstanding balance of any debts secured by the property which are described in paragraph (o)(2)(iii) of this section. See § 1.897-2(b) for the alternative use of book values in certain limited circumstances.

(ii) *Gross value.* Gross value is the price at which the property would change hands between an unrelated willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. Generally, with respect to trade or business assets, going concern value should be used as it will provide the most accurate reflection of such a price. However, taxpayers may use other methods of valuation if they can establish that such method will provide a more accurate determination of gross value and if they consistently apply such method to all assets to be valued. See subdivisions (3) and (4) of this paragraph (o) for special rules with respect to the valuation of leases and of intangible assets.

(iii) Debts secured by the property. The gross value of property shall be reduced by the outstanding balance of debts that are:

(A) Secured by a mortgage or other security interest in the property that is valid and enforceable under the law of the jurisdiction in which the property is located, and

(B) Either (1) Incurred to acquire the property (including long-term financing obtained in replacement of construction loans or other short-term debt within one year of the acquisition or completion of the property), or (2) otherwise incurred in direct connection with the property, such as property tax liens upon real property or debts incurred to maintain or improve property.

In addition, if any debt described in this paragraph (o)(2)(iii) is refinanced for a valid business purpose (such as obtaining a more favorable rate of interest), the principal amount of the replacement debt does not exceed the outstanding balance of the original debt, and the replacement debt is secured by the property, then the gross value of the property shall be reduced by the replacement debt. Obligations to related persons shall not be taken into account for purposes of this paragraph (o)(2)(iii) unless such obligations constitute interests solely as a creditor pursuant to the provisions of paragraph (d)(4) of this section and unless the related person has made similar loans to unrelated persons on similar terms and conditions.

(iv) *Anti-abuse rule.* The gross value of real property located outside the United States and of assets used or held for use in a trade or business shall be reduced by the outstanding balance of any debt that was entered into for the principal purpose of avoiding the provisions of section 897, 1445, or 6039C by enabling the corporation to acquire such assets. The existence of such a purpose shall be determined with reference to all the facts and circumstances. Debts that a particular corporation routinely enters into in the ordinary course of its acquisition of assets used or held for use in its trade or business will not be considered to be entered into for the principal purpose of avoiding the provisions of section 897, 1445, or 6039C.

(3) *Fair market value of leases and options.* For purposes of sections 897, 1445, and 6039C, the fair market value of a

leasehold interest in real property is the price at which the lease could be assigned or the property sublet, neither party to such transaction being under any compulsion to enter into the transaction and both having reasonable knowledge of all relevant facts. Thus, the value of a leasehold interest will generally consist of the present value, over the period of the lease remaining, of the difference between the rental provided for in the lease and the current rental value of the real property. A leasehold interest bearing restrictions on its assignment or sublease has a fair market value of zero, but only if those restrictions in practical effect preclude (rather than merely condition) the lessee's ability to transfer, at a gain, the benefits of a favorable lease. The normal commercial practice of lessors may be used to determine whether restrictions in a lease have the practical effect of precluding transfer at a gain. The fair market value of an option to purchase any property is, similarly, the price at which the option could be sold, consisting generally of the difference between the option price and the fair market value of the property, taking proper account of any restrictions upon the transfer of the option.

(4) *Fair market value of intangible assets.* For purposes of determining whether a corporation is a U.S. real property holding corporation, the fair market value of intangible assets described in § 1.897-1(f)(1)(ii) may be determined in accordance with the following rules.

(i) *Purchase price.* Intangible assets described in § 1.897-1(f)(1)(ii) that were acquired by purchase from a person not related to the purchaser within the meaning of § 1.897-1(i) may be valued at their purchase price. However, such purchase price must be adjusted to reflect any amortization required by generally accepted accounting principles applied in the United States. Intangible assets acquired by purchase shall include any amounts allocated to goodwill or going concern valued pursuant to section 338(b)(3) and regulations thereunder. Intangible assets acquired by purchase shall not include assets that were acquired indirectly through an acquisition of stock to which sec-

tion 338 does not apply. Such assets must be value pursuant to a method described in subdivision (ii) or (iii) of this paragraph (o)(4).

(ii) *Book value.* Intangible assets described in § 1.897-1(f)(1)(ii) (other than goodwill and going concern value) may be valued at the amount at which such assets are carried on the financial accounting records of the holder of such assets, provided that such amount is determined in accordance with generally accepted accounting principles applied in the United States. However, this method may not be used with respect to assets acquired by purchase from a related person within the meaning of § 1.897-1(i).

(iii) *Other methods.* Intangible assets described in § 1.897-1(f)(1)(ii) may be valued pursuant to any other reasonable method at an amount reflecting the price at which the asset would change hands between an unrelated willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. However, a corporation that uses a method of valuation other than the purchase price or book value methods may be required to comply with the special notification requirements of § 1.897-2(h)(1)(iii)(A).

(p) *Identifying number.* The "identifying number" of an individual is the individual's United States social security number or the identification number assigned by the Internal Revenue Service (see § 301.6109-1 of this chapter). The "identifying number" of any other person is its United States employer identification number.

(Approved by the Office of Management and Budget under control number 1545-0123)

(Sec. 897 (94 Stat. 2683; 26 U.S.C. 897), sec. 6011 (68A Stat. 732; 26 U.S.C. 6011) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 7999, 49 FR 50693, Dec. 31, 1984; 50 FR 12530, Mar. 29, 1985, as amended by T.D. 8113, 51 FR 46626, Dec. 24, 1986; T.D. 8198, 53 FR 16217, May 5, 1988; T.D. 8657, 61 FR 9343, Mar. 8, 1996; 61 FR 14248, Apr. 1, 1996; T.D. 9082, 68 FR 46082, Aug. 5, 2003]