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FOREIGN INVESTMENT IN UNITED STATES REAL ESTATE: CONGRESS ACTS TO REDUCE INCENTIVES

I. Introduction

The directional flow of international investment dollars has changed dramatically in the past decade. Historically, American corporations funneled their excess dollars into investment opportunities abroad which promised rates of return higher than those available at home. However, since the 1970s, with a relatively weak U.S. dollar, political unrest in Iran, Afghanistan, Poland, Libya and elsewhere, and with the notable growth of the "petrodollar", our country has witnessed a sharp increase in the flow of foreign funds into United States investment, including real estate.[1] This note will examine the statutory scheme governing foreign investment in U.S. real estate, explore the concept of tax treaties by which the United States contracts with other countries for mutual tax benefits, and finally will suggest planning ideas to be considered by foreign investors.

II. Statutory Framework

The Foreign Investors Tax Act (FITA)[2] provisions of the Internal Revenue Code and the new Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)[3] provisions compose the statutory rules governing the taxation of rentals from U.S. real property and gains realized from the sale or other disposition of such property by nonresident alien individuals[4] and foreign corporations.[5] The FITA provisions, which came into effect on January 1, 1967, were enacted partially to encourage foreign investment in

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1. For example, since 1975 Canadian real estate developers have invested nearly 25% of their assets, over $5 billion, in the United States. Contrast this with the early 1970s, when the Canadians' U.S. real estate portfolio was nearly zero. BARRON'S, October 20, 1980, at 11.

2. Pub. L. No. 89-809, 80 Stat. 1539 (1966). The FITA provisions referred to in this note can be found in §§ 861 through 896 of the Internal Revenue Code.

3. Omnibus Reconciliation Act of 1980 (Foreign Investment in Real Property Tax Act of 1980) Pub. L. No. 96-499, 94 Stat. 2682 (1980) (codified at I.R.C. §§ 897 and 6039c *as amended* at I.R.C. §§ 861(a)).

4. A "nonresident alien individual" is an individual who is not a citizen of the United States and is not a United States resident. Treas. Reg. § 1.871-2(a). *See generally* Langer, *When Does a Nonresident Alien Become a Resident for U.S. Tax Purposes?*, 44 J. TAX. 220 (1976).

5 A "foreign corporation" is a corporation not created or organized in the United States or under the laws of the U.S. or any state. I.R.C. §§ 7701(a)(4) and (5).

the United States.[6] FITA generally remained the basis for taxation of all U.S. source income of foreign investors until July 19, 1980. The new FIRPTA provisions apply to all gain or loss realized by a foreign investor from a sale or other disposition of a "United States Real Property Interest" (USRPI)[7] made after June 18, 1980. Although FITA continues to govern the taxation of rental and other income realized by a foreign investor while owning U.S. real property, this note will focus on the new FIRPTA rules which govern the taxation of gain or loss realized by a foreign investor from the sale or other disposition of a USRPI.

III. FIRPTA

FIRPTA substantially changed the taxation of foreign investors in U.S. real estate. Prior to its enactment, foreign corporations were able to avoid paying any federal tax on the sale of U.S. real estate, providing they carefully structured their ownership of the property. This could be accomplished in the following ways:

a. *Sale by foreign investor.* If a sale of U.S. real estate was made by a foreign corporation or by a nonresident alien individual who was in the United States less than 183 days during the year of the sale, the Internal Revenue Code imposed no tax on capital gains from the sale, provided the gains were not effectively connected with a U.S. trade or business.[8]
b. *Tax-free exchanges.* Foreign investors could trade their U.S. real estate for like-kind foreign real estate in a tax-free exchange. The investor would then be left with foreign real estate which would be free from U.S. taxation upon subsequent sale.[9]
c. *Installment sales.* Collections by foreign investors made in years following the installment sale were not subject to U.S. tax, provided

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6. The Senate Finance Committee Report stated that the two objectives of the FITA were:

> [I]mproving equity in the tax treatment of nonresident aliens and foreign corporations and providing, to the extent consistent with the first objective, increased incentives for investments by these persons and corporations in the United States.

S. REP. No. 1707, 89th CONG., 2d SESS., *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 4446, 4454.

7. The term USRPI is discussed in text accompanying notes at 29 *infra*. A lengthy definition can be found at I.R.C. § 897(c) (Law Co-op 1981).

8. I.R.C. §§ 871(a)(2), 882(a)(1). For a definition of "effectively connected income", *see* I.R.C. § 864(c).

9. I.R.C. § 1031.

the foreign investor was not engaged in a U.S. trade or business at any time during the year of collection.[10]

d. *Liquidation and sale.* A corporate owner of U.S. real estate that did not have an 80% corporate shareholder could adopt a plan of liquidation, sell its real estate without tax on the gain, and liquidate within 12 months.[11] The foreign investor shareholders were treated as having sold their stock and were not subject to tax.

e. *Sale of shares and liquidation.* The shares of a corporation owning U.S. real estate could be sold by the foreign investor to a U.S. corporate purchaser. As noted above, there was no tax on the sale. The purchaser could liquidate the acquired corporation and assign the purchase price to the assets received in liquidation, thus obtaining a stepped-up basis in the assets.[12]

Congress recognized that loopholes in the tax laws were encouraging foreign investment in U.S. real estate, most notably in farm property.[13] At one point, the Revenue Act of 1978 included provisions requiring taxation of foreign investors' gains from U.S. agricultural property and farmland.[14] Instead, the legislation as enacted directed a comprehensive Treasury Study of the problem.[15] The Treasury report was released in May, 1979,[16] inspiring Senate and House versions of the FIRPTA which were the basis of the bill finally reported out by the Conference Committee.[17] On December 5, 1980, President Carter signed the FIRPTA into law. Ironically, the FIRPTA as enacted does not prevent foreign investors from selling tax-free the shares of a foreign corporation that owns U.S. agricultural property.[18]

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10. I.R.C. § 453.

11. I.R.C. § 337.

12. I.R.C. §§ 332, 334(b)(2). *See* Zimmerman, *Foreign Investment in U.S. Real Estate — A New Set of Rules,* TAX ADVISER 324–25 (June 1981).

13. Support can be found for some of the rumors of extensive purchase of U.S. real property by foreign persons. *See, e.g.,* O'Donnel, *Drang Nach U.S.A.,* FORBES, July 7, 1980, at 82 (German investors believed to own about 40,000 square miles of U.S. farm properties). *See also* Green, *Foreign Investment in U.S. Real Estate: Analysis of the Data,* 6 INT'L. TAX J. 444 (1980).

14. Revenue Act of 1978, Pub. L. No. 95–600, 92 Stat. 2763 (1978).

15. Revenue Act of 1978, Pub. L. No. 95–600 § 553, 92 Stat. 2891 (1978).

16. U.S. Dep't of Treasury, Taxation of Foreign Investment in U.S. Real Estate (1979).

17. H.R. REP. NO. 96-1479, 96th CONG., 2d SESS. 186 (1980) (hereafter cited as Committee Report).

18. The purchaser can no longer liquidate the corporation to get a stepped-up basis, but that is not usually necessary with farmland, since it is non-depreciable and therefore creates no immediate need for a stepped-up basis.

FIRPTA attempts to tax the sale or other transfer of U.S. real property by nonresident aliens and foreign entities in a manner similar to that used to tax U.S. citizens on such dispositions. It has closed many of the loopholes perceived by Congress, including those outlined above. Essentially, FIRPTA taxes a foreign person's entire income from dispositions of U.S. real property interests (USRPI).[19] Such interests include dispositions of both direct interests in U.S. real property[20] and interests in U.S. corporations which have (or had) substantial interests in U.S. real property.[21]

A direct interest in real property includes any interest in real property located in the United States, including fee ownership and co-ownership, leasehold interest, and an option to acquire any such interest.[22] The explanatory material issued with the House bill states that "partial interests such as life estates, remainders, reversions, and rights of refusal in real property" would be treated as USRPIs.[23] Movable walls, furnishings, and "other personal property associated with the use of real property" are also considered to be USRPIs, presumably to ensure the inclusion of such items used in office buildings or hotels.

FIRPTA defines USRPI to include "any interest (other than an interest solely as a creditor)" in any United States corporation, unless the taxpayer establishes, in accordance with regulations to be prescribed by the Secretary of the Treasury, that the corporation was not a "United States real property holding corporation" (RPHC)[24] at any time during a defined period. The testing period used for this and other purposes in the Act is either the period after June 18, 1980 during which the taxpayer held the relevant interest, or the five-year period ending on the date of the relevant transaction (generally, the disposition of the interest), whichever is shorter.[25]

After defining USRPI so broadly, the statute excludes four categories of interest. First, if, on the date the interest is disposed of, the corporation holds no USRPI and has disposed of all the USRPI which it held during the testing period in transactions whereby the full amount of the corporation's gain was recognized, then the interest in the corporation will not be considered a USRPI.[26] Second, a class of stock regularly traded on an established securities

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19. I.R.C. § 897(c).
20. I.R.C. § 897(c)(1)(A)(i).
21. I.R.C. § 897(c)(1)(A)(ii).
22. I.R.C. § 897(c)(6)(A).
23. H.R. REP. NO. 7652, 96th CONG., 2d SESS. (1980).
24. *See* text accompanying notes 30–35 *infra*.
25. I.R.C. § 897(c)(1)(A)(ii).
26. I.R.C. § 897(c)(1)(B).

market is excluded from the definition of USRPI if it is held by a person who did not actually or constructively own more than five percent of that class of stock during the testing period.[27] Third, interests in domestically-controlled real estate investment trusts are not USRPIs.[28] Fourth, an interest in a corporation is not a USRPI if the corporation was never a U.S. real property holding company (RPHC) during the testing period.[29]

A corporation (foreign or domestic) is treated as an RPHC for the taxable year if the fair market value (FMV) of its USRPI is at least one half of the FMV of its USRPI plus the company's real property interests located outside the United States plus the FMV of any other assets used or held for use in a trade or business.[30] The statutory definition of RPHC is rampant with ambiguities. Most notably, a foreign seller is taxed on gain from the sale of an interest in a domestic corporation if it was an RPHC "at any time" within the testing period. Since the definition depends on relative fair market values, short-swing fluctuations in relative value can cause an entity to become a RPHC.[31] Apparently, a corporation meets the definition of RPHC if it satisfies the asset test on any one day during the relevant peirod.[32] Since the burden is on the corporation to prove that it is *not* an RPHC,[33] does this mean that the corporation must calculate for each day of the five-year period the relative values of its factory, patents, inventory, accounts receivable, trademarks, and goodwill? The FIRPTA does not address this problem. Perhaps the forthcoming Treasury regulations will clarify the parameters of the RPHC concept.[34]

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27. I.R.C. § 897(c)(3).

28. I.R.C. § 897(h)(2); *see* notes 58–62 and accompanying text *infra*.

29. I.R.C. § 897(c)(1)(A)(ii).

30. I.R.C. § 897(c)(2).

31. An example of extreme fluctuations in value can be seen in the New York office building market of the 1970s. *See* Hellman, "Towering Fiasco," *New York Times*, July 31, 1978 at 25. A corporation owning an interest in an office building in such a volatile market might well have fallen below the 50% line in one year and above it the next, with no changes in its actual holdings.

32. I.R.C. § 897(c)(1)(A)(ii).

33. *Id.*

34. The Treasury Regulations are authorized in I.R.C. § 897(e)(2). The means of calculating FMV of foreign property must also be determined, particularly where exchange rates between foreign currency and the U.S. dollar fluctuate.

Another issue regarding the definition of RPHC is whether "fair market value" includes the amount of any mortgages or whether it means only net value. Commentators seem to agree that Congress intended to mean gross value, *i.e.*, including any mortgages. *See, e.g.*, Klein, *An Analysis of the FIRPTA of 1980: How It Works*, 54 J. TAX'N 202, 203 (Apr. 1981).

In making the fifty percent computation for determining RPHC status, a flow-through concept is employed for controlled corporations. Stock ownership is ignored; instead, the parent company is treated as if it owned its pro rata share of each asset of the subsidiary. The pro rata share is determined using the FMV of the stock. If assets of the subsidiary are used in a trade or business, they will be considered so used by the parent. Control is considered to exist where fifty percent or more of the FMV of all classes of stock is held.[35]

Although the FIRPTA states that all gain or loss from "the disposition"[36] of a USRPI is taxed as effectively connected with a United States trade or business, the term is nowhere defined in the Act. Presumably, it includes sales or exchanges, except as otherwise governed by nonrecognition provisions. It would also include other transactions with respect to such shares which would be accorded sale or exchange treatment: the receipt of a distribution in partial or complete liquidation, the receipt of a distribution in redemption of shares accorded sale or exchange treatment, and the receipt of an interim distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the shares of the corporation.[37]

Broad guidelines are set out in FIRPTA which indicate that normal Code nonrecognition provisions will generally not apply to dispositions of real property by foreign investors. For example, although the Code provides that no gain or loss will be recognized in certain "like kind" exchanges of property (§ 1031), certain transfers of property to eighty percent controlled corporations (§ 351), certain transfers of property to partnerships (§ 721), certain corporate distributions of property (§ 332), and certain transfers occurring in the course of corporate reorganizations (§§ 354, 355, 361), FIRPTA denies to foreign investors the right to take advantage of these nonrecognition provisions unless the property received in exchange is an interest "the sale of which would be subject to taxation under (FIRPTA or the Code)."[38] This statutory provision means that a foreign investor will be able to exchange USRPI without tax (§ 1031) only if he receives USRPI in exchange. If he receives a foreign real property interest, the exchange would be taxable because any gain realized on the subsequent sale of the foreign real property would not be U.S. source income and therefore would not be subject to U.S. tax.[39]

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35. I.R.C. § 897(c)(5). Broad attribution rules apply in testing for the 50% ownership. I.R.C. § 897(c)(6)(C).

36. I.R.C. § 897(a)(1).

37. *See* Klein, *supra* note 34, at 203-04.

38. I.R.C. § 897(e).

39. *See* N.Y.U. 39th Ann. Inst. on Foreign Tax'n at § 30.02(19) (1981) (hereafter N.Y.U. Inst.).

FIRPTA also specifically limits the ability of a foreign corporation to distribute USRPI without recognizing gain, or to avail itself of the benefits of a § 337 one-year liquidation.[40] However, part of § 337 remains in effect, including nonrecognition of losses. This means that a foreign corporation planning to liquidate must sell its loss properties prior to adopting a plan of liquidation or must stretch the liquidation beyond the 12-month limit to ensure recognition of loss.[41]

The Secretary of the Treasury is authorized by FIRPTA to prescribe regulations which are "necessary or appropriate" to prevent the avoidance of federal income tax and to specify the extent to which the nonrecognition provisions shall apply to dispositions of USRPI.[42] Congress' intent is obviously to prevent foreign investors from moving otherwise taxable assets beyond the reach of FIRPTA.

As previously noted, FIRPTA seeks to impose tax on foreign investors in U.S. real property as if they were U.S. citizens, *i.e.*, as if all gains and losses from dispositions of USRPI were effectively connected with a United States trade or business.[43] Additionally, FIRPTA characterizes gain from the disposition of USRPI as derived from sources within the United States,[44] so that any foreign taxes paid by the foreign person may not be used to offset his federal income tax liability resulting from that gain.[45]

Most dispositions of USRPI held for more than 12 months will result in long-term capital gain.[46] However, ordinary income can result if the investor holds the property for sale to customers in the ordinary course of business,[47] if there is depreciation or investment credit to be recaptured,[48] or if the corporation is characterized as "collapsible."[49] FIRPTA allows the use of

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40. I.R.C. § 897(d).

41. Rev. Rul. 150, 1977-1 C.B. 88, approves the use of deliberate delay by a taxpayer in order to avoid application of I.R.C. § 337.

42. I.R.C. § 897(e)(2).

43. I.R.C. § 897(a).

44. I.R.C. § 861(a)(5).

45. *See* I.R.C. § 904(a). Query: would a foreign country grant a foreign tax credit for the United States income tax paid on a disposition of USRPI? What if the disposition was not structured to result in U.S. source income under the foreign country's laws? A double taxation problem can arise if the foreign investor's country does not allow a credit for U.S. taxes imposed by FIRPTA. *See* discussion of tax treaties in part IV of this note.

46. I.R.C. §§ 1221-22. Long term capital gain creates a 60% deduction so that only 40% of the gain is taxed.

47. I.R.C. § 1221(1).

48. I.R.C. §§ 1245, 1250, 47(a).

49. I.R.C. § 341.

losses from the operation of the property or from other U.S. trades or businesses to offset gain,[50] but the utility of these losses is restricted by the imposition of the minimum tax (§ 56) or the "alternative" minimum tax provided by FIRPTA.[51]

Gain realized on the disposition of stock in a foreign corporation generally would not be subject to tax under FIRPTA. However, the purchaser may not, as he could before FIRPTA, step-up his basis for the corporation's USRPI to reflect the price paid for the stock without incurring a U.S. tax when he liquidates the foreign corporation.[52] Presumably, where the basis of the underlying property is without tax significance, *e.g.*, non-depreciable farmland, the property will be left in the corporation, thereby deferring indefinitely the recognition of gain on the appreciated property. However, where basis is significant, a knowledgeable investor will now discount the price of the shares in a foreign holding company by an amount equal to the potential tax upon liquidation which would be attributable to the shares purchased or the loss of depreciation deductions that will occur if the corporation is not liquidated. In effect, U.S. income tax is thereby imposed upon the foreign seller. Likewise, as previously discussed,[53] gain realized by a foreign holding company on the disposition of a USRPI would be subject to recognition notwithstanding provisions such as sections 337 and 311. The amount of such gain, in the case of a distribution, would be an amount equal to the excess of the FMV of such interest over its adjusted basis.[54] These changes will preclude two techniques identified in the 1979 Treasury study[55] which had been used by foreign investors to avoid taxation on the disposition of a USRPI, *i.e.*, a sale of the property by the holding company pursuant to liquidation and a sale of shares in the holding company by the foreign investor.

If a foreign corporation has a U.S. permanent establishment *and* pursuant to a treaty the permanent establishment is protected by a nondiscrimination clause, then the foreign corporation may elect to be treated as a domestic corporation for the purposes of both taxation of dispositions of its USRPIs and the reporting requirements to be discussed below. The purpose of this provision is probably to forestall any arguments

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50. I.R.C. § 897(b).

51. I.R.C. § 897(a)(2)(A). FIRPTA establishes a 20% minimum tax on the lesser of the foreigner's alternative minimum taxable income or the individual's net U.S. real estate gain or $60,000.

52. I.R.C. § 897(d) and (e).

53. *See* text accompanying notes 38–41, *supra*.

54. I.R.C. § 897(d)(1).

55. *See* note 16 and accompanying text, *supra*.

that the rules imposed by FIRPTA discriminate against foreign corporations in violation of the nondiscrimination clauses in U.S. tax treaties. The election will be effective only if any conditions the Treasury may impose are accepted.[56] Once made, the election can be revoked only with the consent of the IRS.[57]

Taxation of a sale of shares by a foreign investor can be avoided by the use of a domestically controlled real estate investment trust[58] (REIT), because stock in such a trust is not considered to be a USRPI.[59] However, a distribution by any other REIT to a foreign person which is "attributable to gain from (the disposition of USRPI)" is treated as recognized by the foreign person from the sale or exchange of USRPI.[60] Prior to the enactment of FIRPTA, distributions by a REIT were generally treated as taxable dividends, except that "capital gains dividends"[61] were generally not subject to any tax in the case of a foreign shareholder.[62]

In addition to the many substantive changes, FIRPTA provides for extensive reporting requirements to identify foreign persons who directly or indirectly own interests in U.S. real estate. The requirements began for the period after June 18, 1980 and continue for each subsequent calendar year.[63] A domestic corporation must comply with the Act's reporting requirements if one or more if its shareholders is a foreign person and at *any* time during the calendar year or during any of the four immediately preceding calendar years the corporation was a U.S. RPHC.[64] Such a domestic corporation must report the name and address (if known by the corporation) of each foreign person who was a shareholder at *any* time during the calendar year. In addition, information regarding transfers of stock in the corporation to or from foreign

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56. Committee Report at 188. It is anticipated that one condition will be that none of the shareholders of the foreign corporation wishing to make the election have made a disposition of their stock, or, if such dispositions have been made, that taxes be paid as if the election had been in effect at the time of disposition.

57. I.R.C. § 897(i).

58. A "domestically controlled REIT" is a REIT in which less than half the value of the stock was held by foreign persons during the shortest of the period five years prior to the disposition, the period the REIT was in existence, or the period between June 19, 1980 and the date of disposition. I.R.C. § 897(h)(4)(B) and (D). In determining foreign ownership, both direct and indirect ownership are relevant, but no attribution rules are specifically enumerated.

59. I.R.C. § 897(h)(2).

60. I.R.C. § 897(h)(1).

61. I.R.C. § 857(b)(3)(B).

62. Rev. Rul. 244, 1969-1 C.B. 215.

63. I.R.C. § 1125(b).

64. I.R.C. § 6039C(a)(1)(B).

persons during the calendar year must be reported.[65] However, if the corporation's stock is regularly traded on an established securities market at all times during the calendar year, reporting is not required.[66] The penalty for failure to file a return by its due date is twenty-five dollars per day up to a maximum of $25,000, unless the failure can be shown to be due to reasonable cause and not to willful neglect.[67]

A foreign corporation, and every foreign or domestic partnership, trust, or estate, must file an information return if at any time during the calendar year it had a foreign interest holder, partner or beneficiary whose pro rata share of the entity's USRPI had a value which exceeded $50,000.[68] A foreign holder of an interest who fulfills this $50,000 requirement is defined as a "substantial investor."[69] The entity must report the name and address of each substantial investor, information concerning the entity's assets during the calendar year, and such other information as the Secretary prescribes.[70] An exception to the reporting requirement is provided "to any entity for the calendar year if such entity furnishes to the Secretary such security as the Secretary determines to be necessary to ensure that any tax imposed (by the Code) with respect to (USRPI) held by such entity will be paid."[71] Where a security agreement is reached with the IRS, the entity is not required to report the identity of the foreign persons holding interests in the entity.

Finally, every foreign person not otherwise required to file a return concerning a USRPI must file an information return if such person was not engaged in a trade or business in the United States at any time during the calendar year and holds, directly or by attribution from a partnership, trust,

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65. I.R.C. § 6039C(a)(1)(A).

66. I.R.C. § 6039C(a)(2).

67. I.R.C. § 6652(g). The due date is to be provided in the forthcoming Treasury Regulations.

68. I.R.C. § 6039C(b).

69. I.R.C. § 6039C(b)(4)(B).

70. I.R.C. § 6039C(b)(3).

71. I.R.C. § 6039C(b)(2). The Committee Report provides guidance as to the type of security that may be required. A recorded security interest in the real estate should be acceptable where it is guaranteed by a person from whom the IRS is reasonably certain it could collect the unpaid tax. Similar types of security may be considered adequate for a foreign corporation whose only asset is a tract of undeveloped U.S. real estate. However, where a foreign corporation is engaged in a U.S. trade or business and has a variety of U.S. assets, and where circumstances indicate that it is improbable that the foreign corporation would attempt to liquidate and remove its assets from the United States without satisfying its U.S. tax liability, the IRS may only require an undertaking by the foreign corporation to pay the tax in a closing agreement or similar agreement. *See* Committee Report, note 17, *supra*, at 191–92.

or estate or from a spouse or minor child, a USRPI whose fair market value at any time during the year equalled or exceeded $50,000.[72] This return must set forth the name and address of the foreign person, a description of the interests in USRPI he owned during the calendar year, and any other information prescribed by the Secretary. The penalty for the entity's failure to timely file the return is also twenty-five dollars per day up to a maximum of $25,000. An additional penalty of twenty-five dollars per day up to $25,000 is required where the entity fails to furnish the foreign investor with the required statement.[73]

IV. TAX TREATIES

The United States is a party to tax treaties with a number of countries. The general goal of these treaties is to avoid double taxation of people whose holdings and activities cross the national boundaries of the countries involved and who may be subject to tax claims by more than one country.

FIRPTA expressly overrides any contrary provisions in tax treaties to which the United States is a party, for dispositions of USRPIs taking place after the "treaty honeymoon" period ending December 31, 1984.[74] Before this date, the Treasury Department plans to renegotiate conflicting treaties in order to make them conform with FIRPTA. As an incentive to foreign negotiators, the effective date of the new treaties may be delayed for a maximum period of two years.[75]

If a foreign investor's home country has no tax treaty with the United States, or if the existing treaty has no favorable provisions regarding taxation of U.S. real estate income, some investors may choose to establish a holding structure in a third country which has a favorable tax treaty with the United States. Such investors should initially ensure that the treaty provisions are not limited to residents or citizens of the third country. Likewise, they should ensure that the U.S. taxing authorities will recognize the third country holding structure as the entity properly subject to tax on the USRPI in question. To counter any argument that the third country entity should be disregarded, investors should also seek to establish an adequate business prupose and "presence" of the entity in the third country.[76]

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72. I.R.C. § 6039C(c)(2).

73. *See* note 67, *supra*. Feder & Parker, *The Foreign Investment in Real Property Tax Act of 1980*, 34 TAX LAW. 545, 570 (1981).

74. I.R.C. § 1125(c).

75. *See* N.Y.U. Inst., *supra*, note 39, at § 30.03(8).

76. Ingemar Johansson v. United States, 336 F.2d 809 (5th Cir. 1964); *cf.* Rev. Rul. 23, 1975-1 C.B. 719.

In considering various tax treaties, there are several major provisions that foreign investors have sought in the past, and that are still important after FIRPTA. For example, a treaty provision limiting taxation to the country where the real estate is located remains a very desirable provision.

Additionally, in those cases where shares of a company owning U.S. real estate are held, a provision exempting capital gains from taxation would provide protection from the FIRPTA changes until December 31, 1984, or such other appropriate date as may be designated in a new treaty. Generally, no protection is provided for a direct investment in U.S. real estate.[77]

Prior to FIRPTA, a common method for investing in U.S. real estate was to use a Netherlands Antilles corporation. This was because of the benefits of the U.S. tax treaty and because of certain internal tax provisions in the Netherlands Antilles. Although capital gains tax can no longer be avoided, a Netherlands Antilles corporation still offers certain advantages:

1. No taxation by the Antilles on U.S. real estate income.
2. Waiver of U.S. tax on dividends and interest paid by the Antilles company to a non-U.S. citizen.
3. No Antilles tax on dividends and interest paid by the corporation to nonresidents.
4. No Antilles tax on gain on the sale of stock or liquidation of the corporation.
5. No gift or estate tax on transfer of the shares of an Antilles corporation.[78]

For planning purposes, it should be remembered that the U.S.-Netherlands treaty could be renegotiated and a FIRPTA effective date earlier than January 1, 1985 could be imposed.

V. PLANNING CONSIDERATIONS

FIRPTA has made significant changes in the approach that must be taken to minimize the overall tax burden on foreign investors in U.S. real estate. Below are several planning techniuqes that might be considered:

1. *Installment sales.* If a foreign investor already owns U.S. real estate, but the ownership is not structured to avoid capital gains tax, an

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77. Zimmerman, *supra*, note 12, at 332–33.

78. *Id.* at 332; *see also* Hussey & Berkson, *Taxation of Foreign Investors: A Transactional Analysis*, TAXES 1017, 1023 (Dec. 1980); Reiner & Aleb, *Foreign Investment in U.S. Real Estate: Interpreting the Statute*, INT'L TAX J. 357, 370 (June 1981).

installment sale should be considered. This is especially true if there is an operating loss carryover that can be used. When capital gain is realized, a taxpayer pays the lower of the capital gains tax on the entire gain, or the ordinary income tax on the gain less operating loss carryovers. As a result, no benefit is obtained from the loss carryovers when the capital gains tax is lower.[79] By distributing gain over several taxable years, the corporate taxpayer could benefit from the lower, graduated corporate rates which apply to the first $100,000 of net taxable income.[80]

2. *Shareholder leveraging loans.* As with U.S. shareholders, it is advisable for foreign shareholders in U.S. or foreign corporations to consider investing part of their funds as interest bearing debt, rather than as straight equity. The interest payments are deductible at the corporate level and any net operating losses of the corporation can be carried over, subject to certain restrictions, for five subsequent years.[81] Therefore, it is possible that this loss carryover could be used to offset gains realized by the company in the year it sells its U.S. property. The use of leveraging loans would increase the amount of loss carryover and maximize the possibility of their use to offset gain from the sale of the property. Any such leveraging loan should be structured in accordance with the new Treasury "debt/equity" Regulations[82] and the safe harbors provided therein. This will avoid "thin capitalization" problems and ensure interest deductibility at the corporate level.
3. *Partnership special allocation.* If a foreign investor forms a partnership with U.S. partners to develop or hold U.S. real estate, and the foreign partner has no other U.S. source income against which he can set off his allocable share of partnership deductions, it might be sensible to specially allocate such deductions to the U.S. partners. The IRS will uphold such an allocation if it has "substantial economic effect."[83] In evaluating this planning technique, the investor should ascertain whether he could use his share

79. Zimmerman *supra* note 12, at 333.

80. The corporate tax rates are: 17% of the first $25,000; 20% of second $25,000; 30% of third $25,000; 40% of fourth $25,000; and 46% of taxable income over $100,000. I.R.C. § 11.

81. I.R.C. § 172.

82. Treas. Reg. §§ 1.385.1 through 1.385-10 were to go into effect December 31, 1981. New regulations have recently been proposed with an effective date of June 30, 1982.

83. I.R.C. § 704(b); *see* Treas. Reg. § 1.704(b)(2); Rev. Proc. 22, 1974-2 C.B. 476.

of the partnership deductions or losses in his home country to reduce taxes on non-U.S. source income.[84]

4. *Sale of non-depreciable property.* A foreign investor owning undeveloped, non-depreciable property (*e.g.*, farmland) may be able to negotiate a tax-free sale of corporate stock which would be preferable to a taxable sale or distribution of the land by the corporation. The seller could accomplish this by offering the buyer a price concession that is less than the tax which the foreign corporation would have to pay upon a sale or distribution of the land. The buyer is not necessarily determined to get a high purchase price/basis because it would not generate any additional depreciation deductions. The buyer will have built-in tax liability,[85] but it can be deferred until the property is sold. The attractiveness of such a transaction can be determined by weighing the trade-off of future tax against current price concessions.

   In some instances, where both depreciable and non-depreciable property is being sold, it may be advisable to divide the property into land and improvements, with one corporation owning the improvements and the other owning and leasing the land to the first corporation. This type of arrangement could allow investors to take advantage of the different planning techniques available for depreciable and non-depreciable land.[86] Not all transactions would merit the time and complexity required to structure such a scheme, but in appropriate circumstances it should be evaluated as a planning alternative.

5. *Use of a foreign corporation.* The use of a foreign corporation or chain of corporations is the most common vehicle for foreign investment in U.S. real estate. It insulates the ultimate investor from U.S. gift and estate taxes, and, if properly structured, can preserve the investor's anonymity despite FIRPTA's rigorous reporting requirements.[87]

6. *Nationalization fail-safe devices.* If a foreign investor employs a corporation or other legal arrangement in a third country, he may have legitimate concern about the political stability of the third country or about the possibility of home country political emergencies. Several legal arrangements are available which may be

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84. N.Y.U. Inst. *supra* note 39, at § 30.05(8).

85. I.R.C. § 897(d).

86. *See* N.Y.U. Inst. *supra* note 39, at § 30.05(4).

87. *See* notes 63–73 and accompanying text, *supra; see also* Zimmerman *supra* note 12, at 332.

individually adapted to the investor in order to minimize the risks involved. For example, holding company "decanting" devices can be structured under which, upon the occurrence of political emergency, either the assets of the endangered corporation are shifted to a previously existing corporation with identical ownership organized in a safe jurisdiction, or the domicile of the endangered corporation is automatically shifted to a safe jurisdiction which will accept the entity as a legal entity domiciled there.[88] Alternatively, a trust may be established in the U.S. (or another safe jurisdiction) to hold title to the assets at all times. The occurrence of a specified political emergency would trigger a change in beneficiaries and in the trustee's role.[89]

7. *Election to be treated as a U.S. corporation.* For a foreign investor who plans to acquire depreciable property, it would be advantageous to operate through a U.S. corporation or through a foreign country whose treaty with the United States allows corporations to elect under FIRPTA to be treated as a U.S. corporation.[90] As discussed above,[91] the election may be made only if the foreign corporation has a permanent U.S. establishment and if the treaty provides that such an establishment "may not be treated less favorably than domestic corporations carrying on the same activities."[92] The benefit of electing to be treated as a U.S. corporation is that, although sales of the foreign corporation's stock would be subject to FIRPTA tax if the corporation was an RPHC, generally the electing corporation would not be subject to the Act's restrictions regarding nonrecognition provisions.[93] Therefore, the foreign investor could eventually recover his investment by utilizing, for example, a § 337 one-year liquidation through which the corporation would recognize no gain.

In summary, the former trend of providing tax incentives that encourage foreign investment in U.S. real estate has been abruptly curtailed by the 1980 Act. Prior to FIRPTA, a foreign investor could escape most, if not all, U.S. tax on U.S. real estate gains. After studying the problem for almost three years, Congress finally has taken strides to tax foreign investors in a

88. N.Y.U. Inst. *supra* note 39, at § 30.05(9).
89. *Id.*
90. I.R.C. § 897(i).
91. *See* text accompanying and preceding note 56 *supra*.
92. I.R.C. § 897(i).
93. *See* notes 38 to 41 and accompanying text *supra*.

manner similar to that used to tax U.S. citizens. In the ensuing months, the Treasury will be carefully scrutinizing the Act — searching for loopholes to be plugged by the directed Regulations.[94] Likewise, tax planners will be examining the provisions for methods of structuring new and innovative tax shelters for foreign investors.

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94. I.R.C. § 897(e)(2).