

II. Exemption for Capital Gains Derived by Foreign Investors*

RECOMMENDATION

BE IT RESOLVED, That the American Bar Association urges Congress to continue the exemption for capital gains derived by foreign investors on sales of stock of U.S. corporations (other than U.S. real property holding corporations), so as not to burden foreign direct investment in the United States with a second level tax not imposed on U.S. individual investors similarly situated.

REPORT

Legislation has been proposed in each of the two preceding Congresses that would have imposed federal income tax on dispositions of stock in U.S. corporations by foreign investors, subject to an exemption for owners of less than 10-percent of the U.S. corporation. Although not yet proposed this year, it is foreseeable that the measure will be reintroduced. To date, the United States has generally followed a principle, shared by the other industrialized nations, that capital gains are to be taxed based on the residence of the seller.

The principal impact of the new tax would be on foreign individuals who own U.S. businesses or property through a corporate form. In fact, foreign individuals selling an interest in a closely held U.S. corporation would face a double tax: the U.S. corporation would have paid a corporate tax on its income, and the investor would now have to pay a capital gains tax on the increase in value of his interest. By comparison, an individual U.S. investor may use an "S" corporation (unavailable to nonresident aliens) or a limited partnership, to limit personal liability in real estate or other business ventures, while paying only the individual federal income tax rate of 31%. If such tax is enacted, this disparity may increase the perception of discrimination against foreign investors and discourage legitimate and desirable foreign investment in the United States.

1. Current Law

Historically, the United States has not imposed income tax on capital gains derived by foreign investors unless effectively connected with the conduct of a U.S. trade or business. Internal Revenue Code Section 871(a)(2) imposes a capital gains tax for aliens present in the United States 183 days or more during

*This Recommendation and Report was adopted by the House of Delegates in February 1992. Credit for this Recommendation and Report goes to the International Taxation Committee, Bruce Zagaris, chair, and in particular to committee member Jonathan Warner, who worked on this resolution.

a taxable year, and Section 897, enacted in 1980 by the Foreign Investment in Real Property Tax Act (FIRPTA), taxes foreign investors' gains derived from U.S. real property interests, including dispositions of stock in U.S. real property holding companies.

Most foreign investors have structured their non-portfolio U.S. investments with the current estate tax in mind. The U.S. estate tax applies to foreign decedents at the same rates applicable to U.S. decedents, but with a credit equivalent only to a \$60,000 exemption, compared to a credit for U.S. decedents equivalent to a \$600,000 exemption. In addition, the unlimited marital deduction is generally unavailable to foreign decedents.

This estate tax anomaly has led foreign individuals to structure their ownership of U.S. businesses and property through use of a foreign holding company, which in turn typically owns some or all of a U.S. corporation because of branch tax concerns. This approach avoids the U.S. estate tax burden for foreign individuals. Under present law, upon disposition of the underlying investment, the U.S. corporation may be liquidated without further U.S. tax; this results in only a single level of U.S. tax, albeit at corporate rates. Alternatively, the stock of the U.S. corporation may be sold without U.S. tax, but the tax liability of the corporation remains and is reflected in the purchase price of the stock. Stock in a U.S. real estate holding corporation is subject to tax on sale or liquidation unless the underlying U.S. real property interest has been disposed of in a taxable transaction.

2. Proposed Legislation

The 1990 proposed version of Section 899 (H.R. 4308 and S. 2410) would have treated all gains or loss from disposition of stock in a corporation by a 10% shareholder, whether a nonresident alien individual or foreign corporation, as effectively connected income derived from a U.S. source. The tax rate was to be the individual or corporate tax rate otherwise applicable, with a minimum tax rate specified for nonresident alien individuals based on the minimum tax rate for U.S. individual taxpayers. The tax was to be enforced through a withholding system on gross income realized, similar to that of Code Section 1445 for real estate transactions.

As proposed, Section 899 would not have overridden treaties. Most U.S. income tax treaties preclude taxation of capital gains, but there are several exceptions, including the treaties with the United Kingdom and Japan. Further, where an applicable treaty exempts capital gains, the proposed tax would have treated liquidating gains and redemption gains as dividends to the extent of earnings and to the extent consistent with the treaty.

3. Potential Discouragement of Foreign Investment

The international investment arena today offers a number of tax-favored investments providing economic return at least as great as direct investment in

U.S. real estate or other U.S. commercial activity. It would be delusive to assume that foreign individual investors will continue to seek out U.S. investments if U.S. tax policy were to impose effective tax rates that would be viewed as excessive, if not flatly discriminatory. Particularly when a foreign individual compares a potential 54.5% or 56.5% income tax rate to the 31% rate readily available to a comparable U.S. individual investor, it becomes increasingly difficult to justify the U.S. as a destination for direct investment. Since the proposed tax violates the international norm that capital gains are to be taxed based on the residence of the seller, not the location of the asset, international investors would be more likely to seek investments in countries that honor the established principle of exempting capital gains of foreign investors.

Ironically, although the proposed tax is motivated by a concern that large foreign corporations are not paying a "fair share" of U.S. tax, large foreign corporations will not be as affected as individual foreign investors, because of treaty exemptions and because there simply are fewer dispositions of U.S. companies by major foreign corporations, as compared with foreign individuals. Direct investment by foreign individuals is perceived to be smaller in scale and less controversial than the widely reported acquisitions of large U.S. companies by foreign multinational corporations.

The proposed tax would be directed primarily at U.S. *direct* investments by foreign individuals. Portfolio investment would be largely exempted from the proposed tax by the 10% threshold. While this may be advantageous to certain sectors of the economy, such diversion would contradict tax neutrality and the historic freedom of investment choice.

In sum, the proposed law will not effectively address the problem of large foreign corporations paying a "fair share" of U.S. tax. It will unduly impact the foreign individual investor. It will unnecessarily discourage foreign investment in the United States—which could adversely impact economic growth, interest rates and U.S. jobs.

Respectfully submitted,
Gerold W. Libby
Chairman
Section of International Law
& Practice

November, 1991