STEPHEN A. MIHALY*

Tax Treatment of Gains Realized by Foreigners on Sale of U.S. Real Property

The Foreign Investment in Real Property Tax Act of 1980 became law when on December 5, 1980, the President signed the Omnibus Reconciliation Act of 1980, passed by Congress a few days earlier.[1] The basic purpose of the law is to assure that foreigners disposing of their interests in U.S. real property would be subject to the same capital gain tax which is imposed on U.S. persons.

This new law reverses the rule and practice which was in effect for more than 40 years, ever since 1936, under which nonresident alien individuals or foreign corporations[2] did not in fact have to pay any U.S. tax on sale or other disposition of U.S. real property. If the foreign investor was not "engaged in a trade or business" in the United States, it was clear that the U.S. capital gain tax did not apply.[3] Even if the foreign investor was engaged in U.S. trade or business and the gain derived from the sale of U.S. real property was "effectively connected" with such trade or business, there were at least five, relatively easy, methods of avoiding the imposition of tax on gain realized from sale or other disposition of U.S. real property by foreigners. If we add to this that foreign investors seldom incurred any U.S. tax in connection with the operation of the real property in this country (mainly because of deductions for depreciation and interest), the new result was that they were able to invest large amounts of monies in U.S. real property, derive a good benefit from the operation of such property and realize

*Mr. Mihaly is a law student and member of the American Bar Association (LSD).

[1]The Foreign Investment in Real Property Tax Act of 1980 (Tax Act) is contained in Subtitle C of Title XI of the Omnibus Reconciliation Act of 1980 (Omnibus Act).

[2]Hereinafter sometimes collectively referred to as "foreign investor."

[3]Sections 871(a) and 882(a) of the IRC, prior to their amendment by the Tax Act. Capital gains were subject to tax only in the exceptional case when the nonresident alien individual was present in the United States for at least 183 days in the taxable year.

substantial gains on its subsequent sale and pay no tax to the U.S. government at any time in connection with such operations and investments. This tax treatment placed foreigners at a distinct advantage as compared with U.S. persons who would have to pay at least the capital gain tax on gain realized from the sale of property.

The law as finally passed by Congress is somewhat less far-reaching than the original proposals contained in bills passed earlier in 1980 separately by the House and Senate. Both bills would have taxed the gain realized by foreigners even if the gain would have been realized from the sale of stock of a foreign corporation as long as at least 50 percent of the assets of the foreign corporation consisted of "U.S. real property interests." In the final version of the law, Congress has retreated from such original position. The law does not impose tax on gain realized by foreigners from sale or other disposition of stock of a foreign corporation even if the foreign corporation's only asset were a U.S. real property. Also, the stringent withholding provisions which were originally contained in the Senate version of the bill have been deleted from the law as enacted. The absence of withholding provisions could make the enforcement of the new provisions questionable in certain situations. Perhaps to compensate for the dropping of withholding provisions and giving up on taxing the gain realized by foreigners from sale of stock of a foreign corporation (owning U.S. real properties), the new law contains far-reaching provisions requiring the filing of tax returns by a large number of foreigners in which they will have to report to the IRS their interests in U.S. real properties.

The new rules will change significantly the overall tax planning and structuring of investments by foreigners in U.S. real property. Because of the known sensitivity on the part of many foreigners to disclose the actual or beneficial ownership in various foreign entities, the new reporting requirements will also have significant impact on the overall tax planning. Attorneys and other professionals advising foreigners investing in U.S. real property will have to be well versed with these new provisions.

Sale or Other Disposition of U.S. Real Property by Foreign Investors

If the foreign investor sells the U.S. real property, the gain realized from such sale will be subject substantially to the same tax treatment as would apply in case of a sale by a U.S. person (U.S. individual or corporation, respectively).[4] Assuming that the property was held for at least one year, the gain would be subject to capital gain tax. If the seller is a corporation, the present rate of capital gain tax is 28 percent. If the seller is an individual, he can exclude 60 percent of the gain and pay ordinary income tax on the remaining 40 percent of gain. Assuming that the individual is in the top, 70 percent, income tax bracket, the effective rate of his tax would be 28

[4]These provisions are contained in the new § 897 of IRC. See § 1122 of Omnibus Act.

percent (70 percent of 40 percent). If the individual is in a lower tax bracket, the effective rate of his tax could be substantially lower than 28 percent.

Thus, these taxes will now be imposed on a foreign investor even if the foreign person is not engaged in U.S. trade or business and the gain realized upon the sale of U.S. real property is not "effectively connected" with such trade or business. The capital gain tax will be imposed without regard to whether the foreign investor is engaged in U.S. trade or business. Moreover, if the seller is a nonresident alien individual, he is subject to a minimum tax of at least 20 percent of the gain.[5]

If the seller is a foreign corporation, it would have to pay the capital gain tax even if it were involved in a section 337 liquidation. Section 897(d)(2) states expressly that "Section 337 shall not apply to any sale or exchange of a United States real property interest by a foreign corporation."

The tax applies not only in case of a sale, but also in case of any other "disposition." However, transfer of property by way of inheritance or gift would not trigger the tax since no amount would be realized as a result of such disposition.[6]

U.S. real property includes interest in a mine, well, or other natural deposits,[7] fee ownership and co-ownership of land or improvements, leaseholds of land or improvements, options to acquire land or improvements and options to acquire leaseholds of land or improvements. It also includes moveable walls, furnishings, and other personal property associated with the use of the real property involved.[8]

Sale or Other Disposition of Stock of U.S. Corporation Holding U.S. Real Property

Gain realized by a foreign investor from sale or other disposition of stock of a U.S. corporation is taxed in the same manner as gain derived from the sale or other disposition of the U.S. real property itself, provided that at least 50 percent of the assets of the U.S. corporation consists of interest in U.S. real property. This follows from Section 897(c)(1) which defines the term "United States real property interest" as including not only interest in U.S. real property, but also any interest in a U.S. corporation unless such

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[5]§ 879(a)(2)(A). Since this minimum tax may be higher than the tax that would be imposed on a U.S. individual, this rule could be in conflict with the provision contained in the "nondiscrimination" article of an income tax treaty, in which case the provision of the income tax treaty would prevail through December 31, 1984, or until the treaty is amended to avoid the conflict, whichever occurs first. *See* § 1125 of the Omnibus Act. For example, Article 7(1) of the Convention for the Avoidance of Double Taxation between the United States and Japan (March 8, 1971), 23 U.S.T. 967, T.I.A.S. No. 7365, provides as follows: "A citizen of a Contracting State who is a resident of the other Contracting State shall not be subjected in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof."

[6]*See* Senate Finance Committee Report No. 96-504 to Accompany H.R. 2297, 96th Congress, 1st Session 8.

[7]§ 897(c)(1)(B)(i).

[8]§ 897(c)(6)(A) and (B).

U.S. corporation is not, and was not at any time during a five-year period prior to the sale of stock of the U.S. corporation, a "United States real property holding corporation" (RPHC). A U.S. corporation is an RPHC if at least 50 percent of the fair market value of its assets consists of interests in U.S. real property. For this purpose, the assets to be considered include only the interest in U.S. real property, real property interests outside the U.S. and other assets which are used or held for use in trade or business. Thus, bank deposits, marketable securities or other assets which are readily marketable, and are not actually used or held for use in a trade or business by the corporation, would have to be disregarded in determining whether the corporation is an RPHC.

Thus, whether a U.S. corporation will be treated as an RPHC will depend on the fair market value of its assets, and particularly on the fair market value of its interests in U.S. real property. Yet, the statute does not explain how the fair market value of the assets should be determined, and particularly whether mortgages or other liabilities imposed on the assets should be considered in determining its fair market value. For example, let us assume that a U.S. corporation owns machinery, equipment and other business assets (not U.S. real property) with a fair market value of $300,000 (and subject to no outstanding liabilities) and it also owns a piece of U.S. real property with a fair market value of $500,000, subject to a mortgage of $400,000 (so that the corporation's investment in the real property is only $100,000). Would the fair market value of U.S. real property be determined on the gross fair market value, disregarding the $400,000 mortgage, in which case the fair market value of U.S. real property would be $500,000 and the corporation would be an RPHC (since more than 50 percent of the fair market value of its assets would consist of U.S. real property), or would the fair market value of U.S. real property be determined on the basis of equity investment in such property (i.e., by reducing the gross value of the property by the mortgage), in which case the fair market value of U.S. real property would be only $100,000 and the corporation would not be an RPHC (since less than 50 percent of the fair market value of its assets would consist of U.S. real property)? Since there is no indication in the statute that the fair market value of the asset could be reduced with the amount of mortgages or other liabilities imposed on the particular asset, it must be assumed that the gross values (unreduced by liabilities) must be used, in which case, of course, the above mentioned corporation would be treated as an RPHC.

However, even if the U.S. corporation was an RPHC during the five-year period prior to the sale or other disposition of its stock by the foreign investor, the sale of its stock would nevertheless not trigger tax liability if at the time of the sale or disposition of such stock by the foreign investor, the U.S. corporation did not in fact hold any U.S. real property interests and it has disposed of all of its U.S. real property interests in transactions in which the full amount of the gain was recognized.

The foreign investor will be subject to U.S. capital gain tax no matter how small the interest held by such person in the U.S. corporation is. Thus, the tax consequence would apply even if only 1 percent of the stock of the U.S. corporation would be held by a foreigner and such foreigner would sell his 1 percent stock interest to any person. The only exception to this rule applies when the stock of the U.S. corporation is publicly traded in which case the tax would be imposed on the foreign shareholder only if he has held more than 5 percent of the stock of the corporation.[9]

If the foreign investor sells the stock of a U.S. corporation which is an RPHC, he will be subject to U.S. tax with respect to all gain realized from such sale and not only with respect to a pro rata share of the gain attributable to appreciation in the fair market value of the U.S. real property held by such U.S. corporation. Thus, the foreign investor could be subject to tax even if there has been no appreciation in the fair market value of the U.S. real property at all and the gain realized from the sale of stock of the U.S. corporation is due to other business operations of the U.S. corporation or other factors. This is in contrast with the tax treatment of gain realized by foreign investor from sale or disposition of his interest in a partnership, trust or estate, since, as will be seen, in such a case the foreign investor is subject to U.S. tax only with respect to gain attributable to appreciation in the fair market value of U.S. real property held by such entities.

Sale or Other Disposition of Interests in Partnerships, Trusts, and Estates

The foreign investor having an interest in a partnership, trust or estate, will be subject to U.S. capital gain tax on sale or other disposition of his interest in such entities to the extent that the gain represents his pro rata share of appreciation in the value of U.S. real property interests of the entity involved. This rule applies whether the partnership, trust or estate is a U.S. or foreign entity.

Again, it makes no difference whether the entity, if foreign, has been engaged in U.S. trade or business.[10] Thus, even if the partnership is a foreign partnership and the foreign investor sells his interest in such foreign partnership, he will have to pay U.S. capital gain tax on that portion of the gain which is represented by his pro rata share of appreciation in the value of U.S. real property interests held by the partnership. It should be noted that, unlike in the case of U.S. corporations, there is no 50 percent rule here: for example, the sale of an interest in a foreign partnership would trigger the tax even though U.S. real property interests would constitute less than 50 percent of the total assets of the partnership.

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[9] § 897(c)(3).
[10] § 897(g).

Interests in Real Estate Investment Trusts

Distributions by a real estate investment trust (REIT) to a foreign shareholder are treated as gain on the sale of U.S. real property to the extent of the shareholder's pro rata share of the net capital gain of the REIT.

In addition, gain derived by the foreign shareholder from sale of stock of REIT is also subject to tax, unless the REIT is "domestically controlled," i.e., more than 50 percent in value of its stock is held by U.S. persons.

Sale or Other Disposition of Stock of Foreign Corporation Holding U.S. Real Property

The Tax Act does not subject gains realized by foreign shareholders from the sale or other disposition of stock of a foreign corporation, even if such corporation is used exclusively for the purpose of holding U.S. real properties. This is in marked contrast with the provisions of the House Bill and the Senate Bill which made no distinction between foreign and U.S. corporations as long as at least 50 percent of the assets of the corporation consisted of U.S. real property interests. It is also in marked contrast with the tax treatment of any other, direct or indirect, form of ownership of U.S. real property interests by foreigners. The sale or disposition of any directly held U.S. real property interests, stock of U.S. corporations and interests in U.S. and foreign partnership, trusts and estates, would all trigger the tax. Only gain realized from sale or other disposition of stock of a foreign corporation will continue to remain immune from such tax treatment.

To compensate for this failure to tax foreign shareholders selling their stock interest in foreign corporations, the law imposes a tax on the foreign corporation itself at the time of any distribution by such corporation of a U.S. real property interest. The foreign corporation is required to recognize, at the time of such distribution, the gain in an amount equal to the excess of the fair market value of the distributed U.S. real property interest over the adjusted basis of the foreign corporation in such property. All distributions are taxable, whether they are in form of dividends or in form of a distribution in liquidation or redemption. The only exception applies when the distributee acquires a carry-over basis in the distributed property. In addition, Section 337 is made inapplicable to any foreign corporation selling or exchanging a U.S. real property interest, so that gain realized by the foreign corporation from sale or exchange from its U.S. real property interest will be taxable to the foreign corporation even if it would be involved in a section 337 liquidation.[11]

If the foreign corporation has a permanent establishment in the U.S. and is entitled to a nondiscriminatory treatment on the basis of an existing income tax treaty, the foreign corporation may make an election to be treated as a U.S. corporation for purposes of Section 897.[12] Normally, such

[11] § 897(d).

[12] And also for purposes of § 6039C relating to reporting obligation. § 897(i).

election would be required to be made before the first sale or other disposition of stock of the foreign corporation which would be taxable if the corporation would be treated as a U.S. corporation had the election been made before such disposition.

New Source of Income Rule

The Tax Act introduces a new source of income rule[13] according to which gain derived from the disposition of U.S. real property interest will be considered U.S. source income. Thus, for example, gain derived by a resident and citizen of the United Kingdom from sale of his interest in a U.K. partnership (holding U.S. real property interests) to another U.K. resident citizen will constitute U.S. source income even though the entire transaction involving the sale of the partnership interest takes place in London. The practical consequence of this rule will be that the taxpayer (the U.K. selling partner) will not be allowed credit against his U.S. tax liability for whatever U.K. taxes he may have to pay on such gain. If, under such circumstances, the foreign tax rules would allow credit for the U.S. tax only if the gain would be deemed to be from U.S. sources and would treat the gain as being derived from U.S. sources only if the sales transaction (and perhaps the negotiations) takes place in the U.S. (which is likely to be the foreign tax rule), it might be advisable to arrange for the closing (and, if necessary, negotiations) of the sales transaction (sale of U.S. real property, sale of shares of an RPHC or sale of interest in a foreign or U.S. partnership or in a foreign or U.S. trust) in the United States in order to create U.S. source income for purposes of the foreign tax rules and thus enable the foreign investor to at least obtain credit for the U.S. taxes against the taxes he may have to pay to his own country.

Nonrecognition Rules

Section 897 grants broad powers to the IRS to prescribe regulations describing the extent to which nonrecognition rules will, or will not, apply under the new law. Pending issuance of such regulations, the nonrecognition provisions of the IRC will apply only in case of an exchange of a U.S. real property interest for an interest the disposition of which would be taxable under the IRC (as modified by any income tax treaty).[14] Thus, under these new rules, and until regulations will be promulgated by the IRS, the foreign investor could exchange the U.S. real property for another U.S. real property under Section 1031 since the gain that he would derive from subsequent sale of the second U.S. real property, would be taxable to him under Section 897. However, he could not exchange the U.S. real property for foreign real property and he could not transfer the U.S. real property to a foreign corporation since the subsequent sale of the foreign real property,

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[13]§ 1124 of the Omnibus Act, introducing a new § 861(a)(5) of the IRC.
[14]§ 897(d).

in the first case, or the sale of stock of the foreign corporation, in the second case, would not be taxable to him. Also, it seems that a Dutch corporation could not transfer a U.S. real property to a U.S. corporation controlled by it since the gain that would be realized by the Dutch corporation from subsequent sale of stock of the U.S. corporation could escape the tax under Section 897 under the provisions of the existing income tax treaty between the United States and the Netherlands.[15]

No Withholding Obligation

The Senate Bill would have imposed the obligation on the person purchasing U.S. real property interest from a foreign investor to withhold the tax imposed on the foreign investor. The seller and his agent, including his attorney, would have been required to notify the purchaser of the fact that the seller was a foreign person.

The House conferees were concerned that such withholding provisions would have disrupted the U.S. real estate market and exposed U.S. buyers or U.S. agents of foreign sellers of U.S. real estate to unreasonable tax liability. As a result, the withholding provisions have been dropped from the final version of the bill. However, there is an indication in the Conference Report that the advisability of introducing the withholding provisions may be reconsidered by Congress in the future.[16]

Information Reporting

The Tax Act introduces a new Section 6039C of the IRC which contains three different reporting requirements.

1. All U.S. corporations which are RPHCs, or which were RPHCs at any time during the preceding four years, are required to file annual returns with the IRS, setting forth the name and address (if known by the corporation) of each foreign shareholder, information regarding transfers of stock in the corporation by such foreign shareholders and other information that may be required by regulations. This obligation exists even if only a very small stock interest (such as 1 percent) is held in the RPHC by a foreign investor. However, U.S. corporations with publicly traded stock are exempt from this reporting obligation.[17]

2. All other entities, namely foreign corporations and domestic and foreign partnerships, trusts and estates, must file annual returns setting forth the name and address of each foreign person who is a "substantial investor in U.S. real property" and such other information as may be required by regulations.[18] A person will be considered a "substantial investor" if his

[15]Article XI of the income tax treaty between the United States and Netherlands.
[16]Conference Report to Accompany H.R. 7765, H.R. REP. No. 96-1479, 96th Cong., 2d Sess. 190.
[17]6039C(a).
[18]6039C(b).

pro rata share of U.S. real property interests held by such entity exceeds $50,000 at any time during the calendar year. If the entity is a foreign corporation, "substantial investor" includes not only a foreign investor, but also a U.S. person.

In determining whether the pro rata share of the person's beneficial interest in U.S. real property held by the entity exceeds $50,000, the entity's pro rata share of any U.S. real property interest held by any other such entity in which the first entity holds a beneficial interest, and interests in the first entity held by the person's family (spouse and minor children), must also be taken into account. Thus, for example, if a Panamanian corporation owns all of the stock of a Netherlands Antilles company which in turn owns real property in the U.S., and the Panamanian corporation is considered a "substantial investor in U.S. real property" (which would be the case if the fair market value of U.S. real property owned by the Netherlands Antilles company exceeds $50,000), the assets of the Panamanian corporation would be deemed to include 100 percent of the U.S. real property interests held by the Netherlands Antilles company.[19] Wealthy foreign investors often use a long chain of corporations and other entities to hold various businesses and real properties throughout the world, including the United States. Such structure could now prove to be detrimental since all of the entities involved in the chain might be compelled to file returns with the IRS until the chain reaches the final beneficial foreign owner. This would be so even though the various foreign corporations in the chain would own substantial assets abroad or would be involved in substantial business operations, other than real estate, in the United States or abroad. The original bills would have imposed the reporting obligation only if the U.S. real property interests represented at least 40 percent of the total real property and business assets of the foreign (or U.S.) corporation. This requirement has been deleted in the final version of the bill as enacted and thus returns would now have to be filed by all of such foreign entities no matter how small the percentage of their overall assets in in the form of U.S. real property interests, as long as the beneficial interest of the foreign owner in U.S. real property interests exceeds $50,000.

A reporting obligation exists only if there is a "substantial investor." A person will be deemed to be a "substantial investor" only if his pro rata share of U.S. real property interests held by the entity exceeds $50,000. The statute does not explain what is meant by "fair market value" of U.S. real property interests, and particularly whether such fair market value must be determined by considering the mortgage or other liabilities imposed on such property. For example, let us assume that the foreign investor owns all of the stock of a Netherlands Antilles company which owns a piece of U.S. real property with a fair market value of $100,000, but subject to a mortgage of $60,000, so that the foreign investor paid only $40,000 for the

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[19] 6039C(b)(4)(C).

stock of the Netherlands Antilles company and the Netherlands Antilles company used such funds to make the down payment on the U.S. real property. Is the foreign investor's share of U.S. real property interest held by the Netherlands Antilles company $100,000 (based on fair market value of the property, unreduced by mortgage), in which case the reporting obligation would apply, or is the fair market value of his share of U.S. real property interest held by the Netherlands Antilles company only $40,000 (based on net equity value, reflecting the mortgage), in which case the Netherlands Antilles company would not have to file the return with the IRS? Like in connection with the analogous question arising in determining whether the fair market value of U.S. real property interests equals or exceeds 50 percent of the fair market value of total assets of a U.S. corporation (and thus in determining whether such corporation must be treated as an RPHC), it must be assumed that gross values must be used, i.e., that mortgages or other liabilities can not be applied in reducing the fair market value of U.S. real property interests for this purpose.

The entity required to make such return is also required to furnish each "substantial investor" with a statement showing the name and address of the entity, the substantial investor's pro rata share of U.S. real property held by the entity and such other information as may be required by regulations.

The entity may be exempted from reporting obligations if it will furnish the IRS with such security as the IRS will determine to be necessary to assure that any U.S. tax that may become due with respect to U.S. real property interest held by such entity will in fact be paid.

3. Finally, if the foreign person owns a U.S. real property interest directly and is not required to file the return under Section 6039C(b) (point 2 above), and the fair market value of the U.S. real property interest held by him is at least $50,000 at any time during the year, he must file a return with the IRS setting forth his (or its) name and address, description of all U.S. real property interest held at any time during the calendar year and such other information as required by regulations.[20] This requirement would apply, for example, if a resident and citizen of Ireland owns a piece of real property in the U.S. which has a fair market value of at least $50,000.

A penalty of $25 a day is imposed for failure to file a tax return or to furnish a statement to a "substantial investor," but the penalty can not exceed $25,000 a year (or in the case of a failure by a foreign person to report his directly owned United States real property interest under Section 6039C(c), 5 percent of the aggregate fair market value of U.S. real property interest held by such person).

Retroactive Effect

The new rules are retroactive in three different ways:

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[20]§ 6039C(c).

1. They apply to all sales or other dispositions occurring after June 18, 1980.

2. Assuming that the sale or disposition occurs after June 18, 1980, all gain is subject to the new tax, even if it reflects appreciation in U.S. real property that occurred prior to June 18, 1980. Thus, if the foreign investor had purchased the U.S. real property in 1960 for $1,000,000 and the property has appreciated in value to $6,000,000 by June 18, 1980, and then the foreign investor sold the property for $6,000,000 on June 20, 1980, he would be subject to the new tax on the entire gain of $5,000,000.

3. Finally, if the foreign investor made a disposition of U.S. real property to a related person in a nontaxable transaction after December 31, 1979, no stepped-up basis would be allowed with respect to such disposition. "Related person" is defined[21] by reference to Section 453(f)(1) of the IRC,[22] meaning any person whose stock would be attributed under Section 318(a) to the person making the disposition of the property.[23] Thus, if the foreign investor transferred the U.S. real property to his Dutch corporation on January 1, 1980, such transfer would not result in a stepped-up basis.

Effect of Income Tax Treaties

The new capital gain tax will not be imposed to the extent that this would be in conflict with the provision of a U.S. income tax treaty until January 1, 1985 (or until the income tax treaty is amended to avoid conflict with the new U.S. tax provisions if such amendment occurs prior to January 1, 1985). After January 1, 1985, the new statutory provisions will prevail, notwithstanding any contrary provision in the income tax treaty.

One particularly important provision contained in an existing U.S. income tax treaty which is in conflict with the new rules is the provision contained in Article XI of the income tax treaty between the United States and Netherlands which provides, in effect, that a Netherlands resident or corporation is exempt from U.S. tax on capital gains (other than gain from sale of real property). Thus, if a Netherlands corporation owns the stock of a U.S. subsidiary, it could sell the stock of such U.S. subsidiary and the gain realized by it from such sale would not be subject to U.S. tax even though the U.S. corporation would be engaged exclusively in U.S. real estate business. Such tax treatment will remain in effect until December 31, 1984, or until such income tax treaty is amended if this occurs prior to December 31, 1984.[24]

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[21]§ 1125(d) of Omnibus Act.

[22]Introduced by Section 2 of the Installment Sales Revision Act of 1980.

[23]Except that for this purpose a person holding an option to acquire stock of the corporation will not be considered as owning the stock of such corporation.

[24]Similar provision is contained in Article VII of the income tax treaty between the United States and Canada, except that such provision is broader since it exempts from U.S. tax even gains realized by Canadian residents and corporations from sale of U.S. real property.

Impact on Tax Planning

The new law does not affect in any way the U.S. tax treatment of income derived by foreign investors from operation of U.S. real property. It changes only the U.S. tax treatment of gain realized from sale or other disposition of U.S. real property interests by foreign investors. However, much of the tax planning in the past did concentrate on avoiding the imposition of U.S. capital gain tax upon the disposition of U.S. real property interests by foreign investors. Thus, the new rules will have a profound impact on structuring of foreign investments in U.S. real property.

1. With one notable exception, the various "loopholes" which were available in the past to avoid U.S. capital gain tax on sale or other disposition of U.S. real property will no longer be available. This can be seen by briefly reviewing the five principal methods which were used in the past to accomplish such result.

a. Payments on installment obligations were not taxable if received in a year when the foreign investor was not engaged in a U.S. trade or business.[25] Thus, if the foreign investor sold U.S. real property in a taxable year on installment and then withdrew from U.S. business, the installment payments received in subsequent years were free from U.S. tax. Under the new law, this technique will not be available since the tax treatment of foreign investor will no longer depend on whether the foreign investor is engaged in U.S. trade or business.

b. It was possible for the foreign investors to adopt a plan of complete liquidation under Section 337 for the foreign (or domestic) corporation and in connection with such liquidation the corporation was able to sell the U.S. real property free from any tax. This technique will no longer be available. Even if the corporation selling the U.S. real property would be a foreign corporation, Section 337 would no longer be available to make the gain realized by the foreign corporation from sale of U.S. real property tax-exempt.[26]

c. The foreign investor could simply sell the stock of the corporation which owned the U.S. real property and the gain realized from such sale was exempt from U.S. tax provided that the foreign investor was not engaged in U.S. trade or business (and provided further that the non-resident alien was not physically present in the United States for at least 183 days during the taxable year). Insofar as the sale of stock of a U.S. corporation which is an RPHC is concerned, this treatment will no longer apply since gain realized from sale of stock of such U.S. corporation will be subject to U.S. capital gain tax even if the selling foreign investor is not engaged in U.S. trade or business.

d. The foreign investor could exchange his U.S. real property for foreign property of a like kind. The exchange qualified under Section 1031.

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[25]Reg. § 1.871-8(c)(2), Example 2.
[26]§ 897(d)(2).

The subsequent sale of foreign real estate by the foreign investor was not subject to U.S. tax. Since Section 1031 is a "nonrecognition provision," it would not apply under the new law if the foreign investor would intend to exchange his U.S. real property for a foreign property of a like kind. Thus, the foreign investor would be subject to U.S. capital gain tax on the gain realized from such exchange.

e. If the operation of the U.S. real property did not constitute engaging in U.S. trade or business (for example, the property was leased on a triple net lease basis) and the foreign owner (such as a Netherlands Antilles company) was entitled to use the so-called treaty election to pay U.S. tax on net tax basis,[27] the foreign investor could first use the treaty election to pay U.S. tax on net tax basis (normally resulting in no actual tax liability because of deductions of depreciation, interest and other expenses) and then skip the election in the year of sale. Since the foreign investor was not engaged in U.S. trade or business in the year of sale, gain realized from sale of the property was not subject to tax. This is no longer true under the new law since the foreign investor is subject to U.S. tax even if he is not engaged in U.S. trade or business at all.

2. One exception, where the loophole has not been closed completely, but only partially, exists with respect to foreign corporations. The foreign investor will continue to be able to operate a U.S. real property through a foreign corporation and then sell the stock of such corporation without having to pay the U.S. capital gain tax. It is true that, under the new rules, the buyer will not be able to liquidate the foreign corporation in order to obtain a stepped-up basis in the U.S. real property under Section 334(a) or Section 334(b)(2). However, the foreign investor might very well find a foreign buyer who would be interested in purchasing the stock of the foreign corporation since the acquisition of a stepped-up basis in the U.S. real property might be less important to such foreign purchaser than to a U.S. buyer, partly since the foreign purchaser may not need a tax shelter from operation of the U.S. real property if he or it has taxable income from U.S. sources against which such tax shelter could be used. This would be the case to an even greater extent if the U.S. real property owned by the foreign corporation consists of farmland or other nondepreciable assets.

The favorable tax treatment granted by the new law to foreign corporations is likely to further encourage the use of such corporations in structuring investments by foreign investors in U.S. real property. The use of a foreign corporation for such purpose has the advantage of avoiding U.S. estate taxes which would be imposed on the foreign investor if he would own the U.S. real property directly or if he would own directly the stock of a U.S. corporation[28] and avoiding costly and time-consuming ancillary pro-

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[27] Article X of the U.S.-Netherlands Antilles income tax treaty.
[28] § 2104(a) of the IRC.

bate proceedings in the U.S. Using a foreign corporation, the foreign investor has a better chance to avoid the 30 percent U.S. withholding tax on dividend and interest payments (by causing the corporation to derive more than 50 percent of its gross income from sources outside the United States. In addition, it can be expected that as long as the extremely favorable provisions presently contained in the income tax treaty between the United States and Netherlands Antilles, exempting from U.S. withholding tax dividend and interest payments made by a Netherlands Antilles company to a foreign person, will remain in effect, it may continue to be preferable to use Netherlands Antilles companies to acquire and operate U.S. real properties.[29]

3. If the foreign investor would plan to sell his interest in the U.S. real property prior to January 1, 1985, to a buyer who would want to obtain a stepped-up basis in the property, he should consider using a Dutch corporation with a U.S. subsidiary for such purpose. Normally, the so-called Dutch sandwich technique is used for this purpose. The foreign investor incorporates a Netherlands Antilles corporation which incorporates a wholly owned Dutch corporation which incorporates a wholly owned Dutch corporation which incorporates a wholly owned U.S. subsidiary and the U.S. real property is acquired by the U.S. corporation. By using this technique, the Dutch corporation will be able to sell the stock of the U.S. subsidiary, the purchaser will be able to liquidate the U.S. corporation and obtain a stepped-up basis in the U.S. real property equal to the purchase price paid and the entire transaction will not trigger any U.S. tax as long as the sale will occur prior to January 1, 1985 or the effective date of an amendment of Article XI of the income tax treaty between the United States and the Netherlands (which presently exempts from U.S. capital gain tax any gains derived by a Dutch resident or corporation from sale of a capital asset other than real property), if such amendment occurs prior to January 1, 1985.

Of course, the Dutch sandwich technique is a viable option only if the so-called substantial participation exemption treatment can be obtained under the laws of the Netherlands, usually in form of a favorable ruling from the Dutch government, to assure that gain realized by the Dutch corporation from sale of the stock of its U.S. subsidiary (and any dividends it may receive from such subsidiary) will be completely exempt from Dutch taxes also.[30]

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[29]The U.S. Treasury Department is presently negotiating with the government of the Netherlands Antilles in order to replace the present income tax treaty with a new treaty. Treasury Department News Release, June 18, 1980. There is a good possibility that Article XII of the present treaty, exempting dividends and interest payments made by the Netherlands Antilles company to foreign persons from the U.S. withholding tax, will be replaced or amended before the end of 1981.

[30]For further discussion of the exact tax treatment of the Dutch sandwich arrangement, *see* HUSSEY II & BERKSON, TAXATION OF FOREIGN INVESTORS: A TRANSACTIONAL ANALYSIS, (Taxes, December, 1980), p. 1017, on pp. 1023-24, and ELLIS & JUCH, THE PARTICIPATION EXEMPTION IN THE NETHERLANDS, Kluwer, 1977.

4. In the future, it may be even less advisable than in the past to use foreign partnerships, trusts or estates to hold U.S. real property since under the new law gain realized from the sale or other disposition of interest in such entities will also be subject to U.S. tax. However, such entities, as well as U.S. partnerships, trusts and estates, could still be preferable in a particular situation as compared with the holding of U.S. real property through a U.S. corporation since in the case of a sale or other disposition of an interest in partnership, estate or trust, the foreign investor is subject to U.S. capital gain tax only on his pro rata share of the gain attributable to appreciation in U.S. real property, while in the case of sale of stock of a U.S. corporation which is an RPHC, the entire gain derived by the foreign shareholder from sale of such stock is subject to tax.

5. Finally, the stringent and cumbersome reporting requirements introduced by the new law will also have significant impact on structuring of foreign investments in U.S. real property. In most cases, it is unlikely that the foreign investor would desire to unnecessarily disclose a long chain of corporations and other entities through which he conducts operations in different parts of the world, which he would have to do if such entities would also be used to hold interests in U.S. real properties. Therefore, it is more likely that if the foreign investor will realize that his identity may have to be disclosed in any event, he will prefer to use the simplest structure, namely usually a foreign corporation (to acquire the U.S. real property) the stock of which would be held directly by him.