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Taxation of Foreign Investors on Their Capital Gains from the Sale of United States Real Estate

All American citizens are subject to federal income tax on their income, regardless of whether or not they are residents of the United States when that income is earned or received and regardless of whether it is derived from foreign or domestic sources.[1] Similarly, resident aliens of this country are also taxed on their worldwide income.[2]

Until 1936, most of the capital gains on the sale or exchange of real estate held by the foreigners in this country were also subjected to the U.S. income tax. However, the tax laws have changed throughout the years so that under present law, non-resident aliens and foreign corporations making investments in this country oftentimes bear a much lighter tax burden for their capital gains on real estate than do our domestic investors. Notwithstanding this shift in tax policy, American citizens and resident aliens are generally taxed on their capital gains from real estate found abroad. That is, our decrease in taxation has not stopped foreign countries from taxing their foreign investors on a comparable scale with their domestic owners.[3] Hence, U.S. residents investing abroad are taxed by the foreign country where the subject property is located.

In order to determine whether the favorable tax treatment granted to foreign investors should be modified, the Revenue Act of 1978 required the Secretary of the Treasury to:

> Make a full and complete study and analysis of the appropriate tax treatment to be given to income derived from, or gain realized on, the sale of interests in

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[1]Treas. Reg. § 1.1-1(a)(3) (1971).

[2]Treas. Reg. § 1.871-1(a) (1966).

[3]REPORT BY THE TREASURY DEPARTMENT, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE, 96th Cong., Appendix B. BNA Background Materials, PS-175 (May 7, 1979).

United States property held by nonresident aliens or foreign corporations.[4]

The Act further required the Secretary to submit a final report of the study within six months from the date of the enactment of the Act.[5]

Four bills, described *infra*, have been proposed to alter the discriminatory tax treatment in favor of nonresident aliens and foreign corporations and against our resident aliens and citizens. Yet two years have passed since three of the bills were reported to the Senate as amended[6] and still no action has occurred.[7] A fourth bill was introduced two years ago and still remains in Committee.[8]

This paper will explore the various principles under which foreign investors have been taxed since 1934 by the United States, describe the basic contents of the congressional bills introduced to "cure" the loopholes existing under present law and relate to the reader why the proposed cures may not really ameliorate the problems.

As explained above, until 1936 the capital gains of both foreign and domestic taxpayers were subject to the United States income tax,[9] unless the foreign taxpayer was entitled to benefits under an income tax convention to which the United States was a party. In that event, he was taxed at the lesser treaty rate.

In 1936, the "force of attraction" method of taxation prevailed, providing that if a foreigner sets up an establishment in a country, he has brought himself within the taxability of that government for all profits derived therein. Thus, a distinction was drawn between foreigners engaged in and not engaged in business in the United States.[10] If engaged in business, all capital gains were taxed at graduated rates. If not engaged in business, the tax rates varied depending upon the amount of gross income and number of days he was present in the United States during the taxable year.[11]

In 1948, many countries became concerned with preventing the double taxation then existing under the myriad of national laws and income tax

[4]Pub. L. No. 95-600 at § 553(a).

[5]*Id.* at § 553(b).

[6]*See* note 46, *infra*.

[7]The *Commerce Clearing House Congressional Index* gave the status as of June 1982. Because Congress has been in adjournment for the past two weeks, it appears unlikely that further action has been taken since this time.

[8]*See* note 47, *infra*.

[9]*See* Revenue Act of 1934, Ch. 277, 48 Stat. 680, §§ 11, 12(b), 13(a), 212(a), 213 and 231(a). *See also* Revenue Act of 1921.

[10]*See* § 871 prior to 1966 amendments.

[11]If his gross income was less than $21,000 (Prior to Pub. L. No. 272 § 113(b)(1), the pertinent amount was $15,400. It was increased for 1964 to $19,000 and for years thereafter to $21,200 by Pub. L. No. 89-809, § 103(a)(1)), the nonresident alien who was physically present here for less than 90 days in the year was subject to a flat 30 percent (or lower treaty rate) on the net capital gains earned if he was present when the transaction occurred. If present ninety days or more, whether or not continuously, net capital gains were taxed at the 30 percent rate whether or not the taxpayer was in the United States when the transaction occurred. If the alien's income exceeded $21,200, the tax was levied at graduated rates if the tax was not less than 30 percent of the total income including capital gains. *See* §§ 871(a)(2), (b), 822 prior to 1966 amendments.

treaties which caused taxpayers engaging in economic activities in countries other than their own to be unable to determine their tax liabilities. Hence, the Organization of European Economic Cooperation was formed.[12] The "force of attraction" principle was abandoned in favor of the "effective connection" concept, premised on taxing a foreigner's profits in another country only if those profits were attributable to or effectively connected with a permanent establishment therein.[13]

In 1963, President Kennedy appointed the Fowler Task Force to develop programs to increase foreign investment in the securities of U.S. companies.[14] It was hoped that increased foreign investment would protect us from pressures imposed by great capital exports.[15] Eventually, the Fowler Task Force caused the adoption of the Foreign Investors Tax Act of 1966[16] (hereinafter referred to as FITA), an act designed to "provide for equitable treatment for foreign investment in the United States."

From 1966 through the present, the term *effectively connected* continues to serve to distinguish between the United States source business income of foreigners and the nonbusiness income of aliens engaged in business here.[17] Therefore, it is still indicative of the kind of foreign source income generated by the U.S. business activities of foreign taxpayers that will be subject to U.S. income tax.[18]

It is clear that U.S. citizens, whether they live in the United States or elsewhere, foreign individuals who are residents of the United States, U.S. corporations, trusts and U.S. estates will all be taxed on their worldwide income. Income derived outside the United States will be included in U.S. taxable income, but a dollar-for-dollar credit is provided for income taxes paid to foreign governments. However, the amount of the foreign tax credit cannot exceed the U.S. tax attributable to income derived outside the United States. Resident aliens are subject to tax on their capital gains as are U.S. citizens.[19]

Nevertheless, nonresident aliens[20] are not subject to any U.S. tax on capi-

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[12]J. Bialkin, *Nonresident Individuals—U.S. Income Taxation*, 340 BNA Tax Mgmt. 13 (1977).

[13]*Id.* at 15, *quoting* REPORT OF THE OECD FISCAL COMMITTEE at 80 (1963).

[14]*See* S. REP. No. 1797, 89th Cong., 2d Sess., U.S. CODE CONG. & AD. NEWS 4446, 4454 (1966).

[15]J. Bialkin, *supra* note 12, at 16.

[16]80 Stat. 154 (1966), Pub. L. No. 89-809.

[17]Section 864(c)(1), (3).

[18]Section 864(c)(4), (5).

[19]Regs. § 1.871-1(a). American citizens are taxed on all of their income from both foreign and domestic sources, regardless of whether they are U.S. residents when the income is earned or received. Regs. § 1.1(a)(3). Section 61 taxes income from whatever source derived.

[20]The term *nonresident alien* is not defined at all in the Internal Revenue Code. Regs. § 1.871-2(a) states that a nonresident alien is one whose residence is not within the United States and who is not a citizen of the United States. Aliens are presumed, by reason of the alienage, to be nonresidents. Regs. § 1.871-4(b). The determination of alien status is a question of fact determined by reference to the individual's intent, length and nature of stay in the United States. Regs. § 1.871-2(b). The definition of *resident alien* under the Immigration and Nationality Act does not govern for tax purposes. But for practical purposes almost every

tal gains from U.S. sources if they are present in the United States for less than 183 days during the taxable year, unless their gains are effectively connected with the conduct of a U.S. trade or business.[21] If present 183 or more days, and not effectively connected, their capital gains are taxed at a flat 30 percent rate with no deductions allowed.[22] If effectively connected, the capital gains are taxed at graduated rates and deductions are allowed.[23] Realization by a foreign corporation of long-term capital gains effectively connected with its U.S. trade or business for the year is subject to a tax of 28 percent.[24]

To determine whether U.S. source income, gains and losses are effectively connected with the conduct of a trade or business within the United States, one must consider whether it is derived from assets used in or held for use in the conduct of a trade or business or whether the trade or business activities were a material factor in the realization of the income, gains or losses.[25] The more substantial the investment, the more likely it is that the taxpayer will be considered engaged in a trade or business.[26]

Even if a foreign investor is not actually engaged in a trade or business, an election may be made to be treated as if so engaged with respect to all real property held for the production of income.[27] The taxpayer with rental income that has significant expenses associated with it may elect this option because the tax of up to 30 percent of the gross rentals could be greater than

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alien who is a resident for immigration purposes is probably also a resident for tax purposes. Thus, the claiming of tax benefits as a nonresident alien is inconsistent with one's status as a lawful permanent resident for immigration purposes. *See* Langer, *When Does a Nonresident Alien Become a Resident for United States Tax Purposes?* 44 J. TAX. 220, 222 (1976). Foreign corporations are those not created or organized in the U.S. or under the law of the United States or any State or Territory thereof. § 7701(a)(4) and (5).

[21]Regs. § 1.871-7(d). The nonresident alien not effectively connected with a trade or business is taxed only on U.S. source fixed or determinative annual or periodic income at the 30 percent withholding rate on the gross amount of passive income received. Therefore, no deductions are permitted on the income derived, including the § 1202 deduction for capital gains. Section 871(b). Sections 1441 and 1442 require the withholding of the 30 percent. The FITA effectively changed these sections to provide that no U.S. withholding tax is required in the case of any item of income effectively connected with the conduct of a U.S. trade or business. *See* a discussion of this and prior law in Sitrick, *New Rules on Withholding Payment of Tax on U.S. Income of Foreign Taxpayers*, 28 J. TAX. 110 (1968).

[22]Sections 864(c)(1)(B); Regs. § 1.864-3(a).

[23]Sections 1, 11.

[24]Sections 1231, 1201(a)(2) as amended by Revenue Act of 1978 at § 403(a). It will be subject to potential depreciation recapture under § 1250 and to potential minimum tax assessment on tax preferences. Sections 56, 57(a)(9)(B).

[25]Section 864(c)(2).

[26]*See* REPORT BY THE TREASURY DEPARTMENT, *supra* note 3, at PS-180.

[27]Sections 871(d) and 882(d) permit such elections. Generally, the election, once made and not modified for three years, remains in effect for all later years unless revoked with the IRS consent and in such a case, cannot be made again for five years. Regs. § 1.871-10(d)(1) and (2). But many income tax treaties permit a yearly election. *See* REPORT BY THE TREASURY DEPARTMENT, *supra* note 3 at Table 4-1.

the actual income received from it.[28] By electing the alternate net tax, the investor's gross income is decreased by such deductible expenses as depreciation, maintenance, mortgage interest and real property taxes. Hence, instead of a 30 percent tax on gross income, the net income is taxed at the normal graduated U.S. income tax rates. Yet by so electing, the taxpayer is also taxed on capital gains from the sale or exchange of the property.[29]

If an income tax treaty supersedes the Internal Revenue Code (hereinafter referred to as the Code) there might be less tax or even no tax levied because of the terms of the pertinent treaty.[30]

Thus, for all practical purposes, those individuals who are neither citizens nor residents of the U.S. and foreign corporations have three types of income:

1. Income, including capital gains, which is effectively connected with their U.S. trades or businesses, which can be offset by allowable deductions and which is taxed at the same progressive rates applied to U.S. citizens, residents and corporations;
2. Interest, rents, dividends and some other U.S. source income not effectively connected with the conduct of a U.S. trade or business, against which deductions are not allowed. This income is taxed at a flat 30 percent rate or less if the foreign investor resides in a country with which the United States has an income tax treaty. Therefore, U.S. source capital gain not effectively connected with the conduct of a trade or business is included here only if the nonresident alien is present in the United States for 183 or more days in the year in which the gain is realized; and
3. All other income, which is wholly exempt from U.S. income tax. Whether or not the first two types of income are ever taxed will depend upon the applicable tax treaty.

It is the opinion of this writer that these laws are sufficiently lenient to encourage foreign investment in our country. But as though this leniency were not enough to satisfy such nonresident aliens and foreign corporations, they have developed devices which permit them both the advantages of only being taxed on net current income from real property and of avoiding of tax on capital gains resulting from its sale. Although the utilization of such vehicles often requires expensive legal and accounting advice, it is frequently worthwhile financially because of the large tax benefit incentives.[31]

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[28] *See* Forry, *Planning Investments from Abroad in United States Real Estate*, 9 INT'L LAW 239, 243 and note 6 (1975). That is, the combination of building and maintenance expenses, mortgage payments and 30 percent tax will often exceed the cash flow from the property.

[29] That is, the election applied to all income from realty or interests therein, including capital gains upon the sale, whether or not otherwise taxable. Regs. § 1.871-10(b)(1) (1974).

[30] *See* §§ 894(a) and 7852(d).

[31] *See* REPORT BY THE TREASURY DEPARTMENT, *supra* note 3, at FN 18.

One example of a commonly used device is the following: The taxpayer will take the deductions when actually engaged in a trade or business and then sell the property when not in a trade or business. In such a case, there is no tax levied on the reported gain. To increase the attractiveness of this plan, since U.S. corporations and individuals may lessen the impact of the capital gains tax by receiving payments on an installment basis, if the taxpayer has not made the election for the year in which the bulk of the principal proceeds are received, the gain recognized in the years when they are received is not effectively connected so it goes untaxed.[32] Further, if the election was already made for that year, the taxpayer may even be able to revoke it.

Also, the taxpayer may decide to exchange the property for property of like kind. In that case, the only taxable gain is limited to the sum of money and the fair market value of other property not of like kind (i.e., "boot") received by the investor in the exchange.[33] If a fairly even trade is made, there is a good chance that there will be very little income tax from the exchange.

If the taxpayer exchanges his U.S. property for foreign property, no gain is recognized even if actually engaged in a U.S. trade or business or if the election was made. If the taxpayer then sells the foreign property, the sale is not effectively connected with a U.S. trade or business even if he is engaged in a trade or business. Therefore, the sale will be tax exempt.

If permitted by the applicable tax treaty, the individual may even choose not to make the election in a year in which tax-free capital gains from other property is expected.

Another very clever device is the indirect investment by the taxpayer in the property, as where it is made through a foreign holding company actually in a U.S. trade or business or one making the election. Such a holding company may eliminate any taxable income it has by paying deductible interest to its investors. Even though the dividends and interest paid by the foreign corporation getting most of its income from U.S. sources are subject to withholding taxes,[34] the taxes are often waived because of the applicable tax treaties.[35] A stockholder may then cause the corporation to sell the realty and liquidate within one year pursuant to Section 337, which exempts the liquidating company from tax on gains on the sale of property. The foreign investor-stockholder in this case will not be subject to the U.S.

[32]Regs. §§ 1.881-2(a)(4); 1.864-3(b)(1).

[33]Section 1031.

[34]If the stockholder provides the corporation with operating funds and it maintains the adequate debt to equity ratio required by Section 482 and the interest charges are at arms-length rates, they will be deductible by the corporation but subject to the withholding tax before it is paid to the stockholder.

[35]That is, many jurisdictions impose little or no taxes on the individual stockholders or the corporation itself and are "tax havens" for taxpayers. Hence, the U.S. treaties between Netherland Antilles and British Virgin Islands, jurisdictions which have treaties with waivers and with very low taxes on the income, are often used by foreign investors.

capital gains tax upon the exchange of stock in liquidation for the proceeds of sale as long as the gain is not effectively connected with his U.S. trade or business, provided that he is not present in this country for more than 182 days.[36] That is, although the stockholder realizes capital gain, it is realized in exchange for the stock and, therefore, tax exempt. In this manner, capital gain on the sale of U.S. real estate which should have been taxed is cleverly converted into tax exempt gain on the sale of corporate shares.

Of course, if present for 183 or more days, the stockholder may choose to just sell his stock outside the United States. By doing so, gain is not realized.[37]

If a foreign investor wishes to be treated as a resident of a certain country with which the United States has a treaty, all he has to do is establish a holding company there so that he gets the desired treaty-induced tax benefits while remaining a resident of a different country.

The real estate investment trust[38] offers similar advantages. It is not subject to federal income tax. Capital gain passed through to the foreign holders often escape income tax, since as a general rule, they are not "effectively connected income" for the investors. However, dividends paid by the trust to foreign stockholders are subject to the U.S. withholding tax.

The devices described above do not encompass the entire gamut of conceivable schemes to totally avoid taxation in a given year. The list is limited only by the imagination of clever tax planners.

Therefore, if we have not actually encouraged foreign investors in the past to circumvent the income tax which would otherwise be payable on their capital gains from sales or exchanges of realty situated in the United States, we have at least permitted it to occur with full knowledge of the financial consequences to our Treasury.[39] Our action or inaction, depending on how one looks at the situation, has been due to the fact that we have wanted to encourage foreign investment in this country.

However, the recent increase in U.S. real estate investments by nonresident aliens and foreign corporations has finally prompted Congress to question seriously the present tax laws which permit foreigners to utilize various schemes and devices similar to those detailed above, most of which are permissible and legitimate ones under our laws, to avoid paying capital gains tax on the income they realize from the sale of U.S. real estate. The substantial growth[40] of such investments by foreigners is due to such factors as

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[36]Sections 871(b), 871(a)(2). The mere ownership of stock is not a trade or business and the gains not effectively connected with the U.S. trade or business and so no tax is due. *See* § 864(b)(2); Regs. § 1.864-2(c).

[37]Regs. § 1.861-7(a) state that the sale of personalty outside the U.S. by a foreign investor who is not in a U.S. trade or business will not give rise to U.S. source income.

[38]Sections 856-58.

[39]S. Rep. No. 96-504, Part II details the revenue savings expected upon the passage of one of the proposed bills, H.R. 2297, which does not even cover many of the loopholes.

[40]Comprehensive statistics are not available for the amount of foreign investment in the United States in real estate. Most, but not all, sources agree that it has increased. *See* the

the devaluation of our dollar (which makes our land values less expensive when compared with those of other countries), the continuing economic strength of the United States and the desire by foreigners to make acquisitions of property in a politically stable country.[41] The expected capital gain, not income received from operations, may be the primary inducement for real estate investment by foreigners.[42]

As is often the case, the tax policy which had once prompted the enactment of certain laws and which had changed and then caused those laws to be disregarded had once again reversed itself. That is, we now seem to want to tax foreigners again, like we did before 1936. They are buying our land in large quantities and often not having to pay tax on the income they make when the land is sold.[43] Perhaps Congress, in passing the Revenue Act of 1978 described above, was really asking whether we should want to continue encouraging nonresident aliens and foreign corporations to pay little or no tax on money they earn as a result of their successful investments in the United States, to the financial detriment of this country's Treasury. That is, should the taxpayers of the United States continue to bear the burden of foreigners' good fortunes? It is the opinion of this writer that amendments to the Internal Revenue Code are long overdue.[44]

At least four bills have been introduced for this purpose.[45] H.R. 2297,

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conflicting statistical analyses at REPORT BY THE TREASURY DEPARTMENT, *supra* note 3, at PS-175, 176.

[41]Forry, *supra* note 28 at 239; Forst, *Federal Income Taxation of Foreign Investment in United States Real Estate*, 13 J. INT'L L. & ECON. 311 (1979).

[42]*See* REPORT BY THE TREASURY DEPARTMENT, *supra* note 3 at PS-178.

[43]J Bialkin, *supra* note 12 at 14.

[44]The Agricultural Foreign Investment Disclosure Act of 1978, Pub. L. No. 95-460, 182, 93 Stat. 1263, 7 U.S.C. § 3501, sought to decrease the potential for foreign investment in farmlands by creating a national reporting system requiring registration by the actual foreign owners of our farmland.

[45]S. 3414, 95th Cong., 2d Sess., 124 Cong. Rec. S. 13406 (1978) was attached to the Senate version of the Revenue Act of 1978. Through this bill, Senator Wallop proposed taxation on the capital gains received by foreign investors on the sale of agricultural land. The rationale was that exemption from capital gain taxation encouraged foreign investors to bid up the price of U.S. farmlands. The bill was dropped by the House-Senate Committee in favor of a provision requiring a Treasury study of patterns of foreign investment in U.S. real estate.

In addition, Treasury wanted to study the issue in relation to existing tax treaties.

Next, Senator Bumpers introduced S. 192, 96th Cong., 1st Sess., 125 Cong. Rec. § 431 (1979), amending § 871(a)(2) requiring identical capital gains treatment of foreign and domestic investors on the sale of a capital asset.

On January 24, 1979, Senator Wallop proposed S. 208, 96th Cong., 1st Sess., 125 Cong. Rec. § 555 (1979). Congressman Grassley introduced H.R. 3106. Both bills consider capital gain on the sale of land used in farming, land suitable for use in farming, land in rural areas, and shares in a corporation or an interest in a partnership, trust or estate, to the extent gain was greater than $3,000 and attributable to the unrealized appreciation in such land, or similar gain which a corporation had realized but elected not to recognize under § 337, to be effectively connected with a U.S. trade or business and, therefore, subject to U.S. capital gains tax. A purchaser of such agricultural land, corporate shares or partnership interests would be required to withhold a tax of 30 percent of the taxable gain. In turn, the taxpayer could file for a refund in the event of overpayment. Senator Wallop then accepted a Treasury recommendation that all gains from the sale of real estate, not just farmland gains, should be taxed. H.R.

H.R. 1318 and H.R. 1212[46] each seek to tax gains greater than $5,000 that are realized by foreign investors on the sale of U.S. real estate at the rate of 9⅓ percent. The cumulative effect is to subject such gains to a 28 percent rate of tax. H.R. 6007[47] proposes that gains from foreign investment in U.S. real estate be subjected to an income tax imposed at the same graduated rates as U.S. taxpayers would pay, with a 60 percent long-term capital gain deduction.

H.R. 2297, H.R. 1319 and H.R. 1212 add Section 897 to the Code, stating that either Section 871 (for individuals) or Section 882 (for corporations) is not to be considered where gain or loss is realized on the sale of U.S. real property interests if the difference between the gain and loss realized is greater than $5,000. Instead, a tax of 26 percent[48] of the excess of gains minus losses realized is imposed, unless that tax is less than the increase in the tax under Sections 871(b) or 879 tax.

Real property interest is defined by these bills as an interest in real property in the United States as well as any interest (other than an interest solely as a creditor) in any entity which is a real property holding organization (RPHO) during either the time the interest was held by the taxpayer or any of the five years before the date of sale. An RPHO is defined as any entity where 50 percent or more of the controlling interest is owned by or for ten or fewer people if U.S. real property constitutes 50 percent or more the fair market value of the organization's assets excluding cash or other readily marketable assets in excess of working capital. Constructive ownership is imposed. Certain returns must be filed by the RPHO if any part of the organization is owned by a nonresident alien. Failure to file may subject the RPHO to penalties.

Further, these bills add Section 1444 to the Code, requiring every purchaser of a U.S. real property interest from a foreigner to withhold a tax equal to the greater of 28 percent of the amount realized, the seller's maximum tax liability (the maximum amount the Secretary determines the seller could owe under Section 897 because of the disposition and any unsatisfied

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2297, H.R. 1319 and H.R. 1212 are considered the Wallop proposal. *See* WASH. T. REV. 4 (March 1980).

[46]H.R. 1212 was introduced on January 22, 1979 and H.R. 1319 on January 24, 1979. H.R. 2297 was introduced on February 8, 1979. The three bills passed the House on September 10, 1979, were introduced in the Senate on September 11, 1979, referred to the Senate Committee on Finance and reported as amended to the Senate on December 15 and 19, 1979. H.R. 1212 was introduced by Rep. Fuqua and reported by H. Rep. 96-378 and S. Rep. 96-532; H.R. 1319 was introduced by Rep. Akaka and reported by H. Rep. 96-376 and S. Rep. 96-499; H.R. 2297 was introduced by Rep. Duncan and reported by H. Rep. 96-377 and S. Rep. 96-504.

[47]This was introduced by Rep. Fisher on December 3, 1979 and marked up on December 5, 1979. It is still in Committee in the House and has not been reported yet.

[48]It appears that 28 percent is used because an individual U.S. taxpayer may deduct 60 percent of capital gain on the sale and pay tax on the other 40 percent. The maximum tax on ordinary income is 70 percent. Thus, the maximum effective tax rate on capital gains of an individual is 40 percent of 70 percent, or 28 percent. Long term capital gains of corporations are taxed at the lower of 25 percent or ordinary income. These are Pre-Recovery Act of 1981 calculations.

withholding obligations) or the fair market value of that part of the proceeds of the sale which are within the withholding agent's control. The seller and the seller's agent are required to notify the purchaser. No withholding is necessary if the seller gives the buyer a statement by the Secretary that the seller has reached an agreement with the Secretary for the payment of the tax or that the seller is exempt from Section 897 tax. In addition, no withholding is necessary if the property being acquired is a one-family residence, the seller realizes less than $150,000 and the buyer is buying it as his principal resident.

These three bills would be generally effective for sales or other dispositions of property occurring after December 31, 1979. However, to the extent that they would conflict with a U.S. treaty obligation, the effective date would not be until at least 1984.

H.R. 6007 amends Section 871(b) to provide that nonresident aliens engaged in a trade or business within the United States will be taxed (under Section 155 or 402(e)(1)) on their taxable income effectively connected with the conduct of a trade or business within the United States. If gain or loss attributable to the disposition of a U.S. real property interest is realized, the taxpayer will be treated as being engaged in a trade or business. That is, gross income will include only effectively connected income but gain or loss realized from the disposition of a U.S. real property interest will be recognized and treated as effectively connected. Similarly, the amended Section 882(a) provides that corporations engaged in trades or business within the United States will be taxed on their effectively connected income, which includes gain or loss attributable to disposition of a U.S. real property interest.

A U.S. real property interest is defined in a similar manner in H.R. 6007 as in the three other bills, although H.R. 6007 specifically designates stock as a real property interest. All interests in real property used in a trade or business as defined by Section 1231(b) of the Code and the pertinent Treasury regulations are not included as real property interests, unless those interests are used primarily for the production of rental, income from farming or gain from their sale. The definition of an RPHO is similar under all the bills, but the rules of constructive ownership differ. Although the withholding requirement of the three bills is reiterated in H.R. 6007, the latter bill exempts a buyer who is furnished a certification from the owner stating that the seller is a U.S. citizen or resident and a buyer where the acquisition of stock in a corporation occurs by an organized securities exchange from the said requirement. The filing of the return and imposition of penalties for failure to file are similar in all four of the bills.

By considering all capital gains on the sale of land as effectively connected with a U.S. trade or business, two of the frequently used tax avoidance methods are no longer possible. A foreign investor cannot avoid the tax by either making an installment sale or by not making the annual election to be taxed net of deductions. Similarly, by imposing a capital gains

tax on the sale of corporate shares, the gains upon liquidation of a holding company and those realized upon the sale of its stock, both presently untaxed, are subject to taxation.

Hence, the taxation methods described in the bills cure four of the basic tax loopholes. Nonetheless, foreign investors can still avoid income taxation by making exchanges of their U.S. property for foreign property of like kind and by the other devices discussed earlier, in addition to any other schemes which may be utilized.

Although taxing capital gains may be one way to close some loopholes, not taxing capital gains on the sale of corporate stock has many justifications. First and foremost, it is a vast departure from international norms,[49] so that politically speaking it may be a rash move, or at least an unsound one, in these unstable times. Next, the present exemption makes U.S. stock easier to sell on international markets. Of course, whether or not the stock of our country should be held by foreigners is an issue to be debated other than within the confines of this paper. Further, such taxation would be difficult to collect through audit or other enforcement procedures since not only are transfers of stock ownership frequently not recorded, they often do not even occur within the United States. To further muddy the waters, the present capital gains exemption can be seen as an offset for the denial of deductions on the income received before the transfer. Clearly this latter justification is inapplicable where a treaty supersedes the tax laws.

A possible solution to control the abuse without taxing capital gains on the sale of stock may be to amend the present corporation liquidation and reorganization rules so that these are no longer taxfree mechanisms, thus nipping the abuses in the bud rather than on a general level. When combined with a modification of the like kind exchange rules (perhaps including exchanges of U.S. property for foreign property of like kind in the "effectively connected" definition, thereby taxing the transfers when the exchanges of foreign property occur), it appears that the same taxable income would result without difficult enforcement and without creating political turmoil. If other abuses came into existence, as they undoubtedly will, the loopholes could be covered by an appropriate amendment. If necessary, the broader method of taxing capital gains on the sale of shares in corporations holding real estate could be enacted as proposed in the bills discussed above.

The five-year period before which treaties become ineffective to alter U.S. tax law is probably not long enough. A longer time lag for full effectiveness of the proposed bills appears to be necessary. It almost seems "unfair" to require foreign countries to modify their present means of doing business in the United States within such a short time since the negotiations necessary to amend the existing tax treaties will necessarily be lengthy and highly debated.

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[49]Report by the Treasury Department, *supra* note 3 at PS-176.

The H.R. 6007 method of simply amending Sections 871(b) and 882(a) is a more logical and organized approach than that offered by the combination of three bills. The new Section 897 added by the other three bills is ill-placed and easily overlooked by the innocent taxpayer. Naturally, all four bills are equally effective for the tax aware foreign investor. The $5,000 exemption granted by the three bills is a furtherance of inequity between foreign and domestic taxpayers, but the inequality is somewhat alleviated by the 28 percent tax imposed as a blanket rate even when the taxpayer is not one subject to the 70 percent tax bracket.[50]

The definition of *real property interest* under the three bills is broader and more inclusive than that given by H.R. 6007. However, the H.R. 6007 specific designation of stock as a real property interest is less ambiguous. This could be cured in the other bills by defining a real property interest as "any interest in real property in the United States, stock and other interest in an RPHO. . . ."

Further, the H.R. 6007 exemption for a buyer who is furnished a certificate from the owner stating that the seller is a U.S. resident or citizen is almost ludicrous. Any seller would be foolish not to furnish such a certificate, especially if that seller had no reason to feel he would have future dealings with the United States.

By not requiring withholding where the property acquired is a one-family dwelling to be used as a principal residence where the seller realizes less than $150,000, the imposition of penalties on innocent small-time purchasers is avoided. In addition, the exclusion is sensible because most foreign investors are purchasing expensive real estate like farms, office buildings and shopping centers, not residences.[51]

The proposed bills do not address themselves to Section 892 which, by providing that U.S. source income of foreign governments is tax exempt, excludes any long-term capital gain on real estate investments by such government from U.S. taxation. Although proposed regulations to Section 892 interpret this exemption as applicable only to noncommercial activities,[52] an amendment to the Code itself would be more appropriate. Because of the unstable political arena, it is possible that a blanket amendment would cause more unrest and ill feelings by foreign governments investing in our country. In that light, a quiet enactment of regulations may be the more acceptable method of taxation. However, the countries affected by the regulations are going to be just as aware of them as they would be of Code amendment and, therefore, the latter may be the most advantageous method to inform the foreign government of our country's clear-cut intention to tax the income it earns from real estate.

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[50]*See* note 48, *supra*.

[51]*See* Lindsey, *Foreign Investors Rush to Acquire U.S Property as Haven for Funds*, N.Y. Times, May 14, 1978 at 7, col. 2.

[52]Thereby, income from activities which generally constitute a trade or business within the U.S. would be taxed.

It is estimated that taxing gain on all U.S. real estate sold by foreign taxpayers would raise some $140 million of revenue.[53] However, the tax impact could be decreased markedly if foreign investors decreased their investments in our country because of the new tax laws or because the United States is not the politically stable country it was a few years ago.[54] Also, it is possible that if the economic security of the United States remains stable, the new tax laws will not deter foreign investment in this country if indeed foreigners invest here for other than tax-based reasons. In that event, our increased revenues could greatly exceed the estimated $142 million, especially when combined with inflation and rapid appreciation in real property valuation.

In conclusion, it is imperative that Congress do something to bridge the present inequities between foreign taxpayers not engaged in a trade or business and U.S. taxpayers. It appears that the passage of some bill taxing such capital gains is imminent.[55] The average purchases by foreigners are four times as large as those of domestic investors in terms of lot size. Further, more expensive land is being purchased by the nonresident aliens and foreign corporations than by our domestic purchasers.[56] The foreign investors will surely continue this trend unless a consistent tax is imposed on them. The proposed bills do offer many worthwhile solutions to several of the major problems with the present tax system while simultaneously creating sundry other potential problems such as burdens on domestic purchasers and problematic audit procedures. They do not impose penalties on foreigners nor do they necessarily discourage honest investment.

Therefore, if this writer had the choice between enacting either H.R. 6007 or the combination H.R. 2297, H.R. 1319 and H.R. 1212 or, in the alternative doing nothing, she would opt for the former choice. After all, the Code could always be amended again. In the meantime, the United States would at least be taxing its foreign investors on a more comparable scale with its own domestic investors than has been the case for the last forty-four years. Also, even though foreign investors could continue to circumvent the income tax on their capital gains from the sale of U.S. real estate by the use of some devices, Congress would have closed many of the available loopholes perpetuating tax avoidance found in the present Code.

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[53]Report by the Treasury Department, *supra* note 3 at PS-176.
[54]*See* note 9, *supra* and accompanying text.
[55]*See* WASH. T. REV. 4 (March, 1980).
[56]*See* REPORT BY THE TREASURY DEPARTMENT, *supra* note 3 at PS-177.