TAX PLANNING: FOREIGN INVESTMENT IN UNITED STATES REAL PROPERTY

William H. Newton, III*

I. INTRODUCTION

For the first time, foreign investors\textsuperscript{1} are subject to taxation on gain from disposition of United States real estate. Previously, this gain for most foreign investors had escaped taxation entirely.\textsuperscript{2} Now taxation is triggered due to the Foreign Investment in Real Prop-

\textsuperscript{*} Associated with the firm of Kimbrell, Hamann, Jennings, Womack, Carlson & Kniskern in Miami, Florida, U.S.A.; Adjunct professor of law in the Master's of Tax Program of the University of Miami.

\textsuperscript{1} The term "foreign investors" for this analysis is specially defined. It refers to both non-resident alien individuals and foreign corporations. A nonresident alien is an individual whose residence is not in the United States and who is not a United States citizen. Treas. Reg. § 1.871-2(a) (1960). See also W. NEWTON, INTERNATIONAL ESTATE PLANNING 3-4 ([Shepard's/ McGraw-Hill] 1981) (defining residence and citizenship). A foreign corporation is one not domestic. I.R.C. § 7701(a)(5). The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the laws of the United States or of any State. I.R.C. § 7701(a)(4). The United States for this purpose is defined as the 50 states and the District of Columbia. Id. § 7701(a)(9).

\textsuperscript{2} Taxation resulted only in two limited circumstances. First, the physical presence of a nonresident alien in the United States for 183 days or more during the taxable year triggered taxation of all capital gains. I.R.C. § 871(a)(2). The rate of taxation was 30% without the allowance of deductions. Id. The impact of the 183-day rule could be avoided by placing capital assets within the structure of a foreign corporation. I.R.C. § 881. Second, if in the year of sale operation of real property by either a nonresident alien or foreign corporation rose to the level of a United States trade or business, or was deemed to rise to that level, all gain resulting from the sale was taxed as effectively connected income. I.R.C. §§ 871(b), 882. The rates of taxation were the same progressive rates applicable to United States taxpayers. Id.

A series of techniques were available to avoid both the 183-day rule and the effective connection of gains. These included:

1. The sale of realty by either a foreign or domestic holding corporation pursuant to an I.R.C. § 337 liquidation coupled with distribution of the proceeds to the ultimate foreign investor.
2. An installment sale.
3. A like-kind exchange of United States realty for foreign situs realty.
4. The sale of realty in a year when the 183-day rule was not satisfied and the gain was not effectively connected.
5. The sale of stock in a foreign or domestic holding corporation in a year when the 183-day rule was not satisfied and the gain was not effectively connected.

Although taxation is now the general rule, the Acts do provide important planning opportunities. These opportunities often are clear and unequivocal, but occasionally they may be accentuated by ambiguity. Thorough analysis and understanding of these opportunities is essential in order to minimize taxation and promote tax planning.

II. TREATMENT OF GAIN

The Acts are designed to place gain derived by foreign investors for disposition of a United States real property interest (USRPI) on a parity with that of similarly situated domestic investors. The approach is to treat the foreign investor as engaged in an artificial United States trade or business. Gain derived from disposition

The effect was to place foreign investors at a competitive advantage over their domestic counterparts. Id. In the absence of taxation, foreign investors could afford to pay more for United States real estate, thus artificially bidding up the price. Id.


The effective date of both Acts is June 19, 1980. See I.R.C. § 897 (note) and 1981 Amendment § 831(i). Dispositions occurring on or subsequent to that date are subject to their scope. Id. See also notes 136 through 138 and accompanying text infra (effective date for overriding treaties). A special basis adjustment applies to dispositions of United States real property interests between related persons after December 31, 1979. See Foreign Investment in Real Property Tax Act § 1125(d). See also I.R.C. § 453(f)(1) (defining related person). The adjustment reduces the basis of the transferred property in the hands of the transferee by the amount of any nontaxed gain. Foreign Investment in Real Property Tax Act § 1125(d).

USRPI is a condensation of the term "United States real property interest." See I.R.C. § 897(c)(1)(A).

With one exception, the effect is to equalize the rates of taxation between domestic and foreign investors. The exception applies only to nonresident aliens. I.R.C. § 897(a)(2). Their effectively connected gain is subject to a 20% minimum tax. The rationale for this distinction between nonresident aliens and United States citizens or residents is that the latter will ordinarily have other income in addition to capital gain from the disposition of realty. See H.R. Rep. No. 1479, 96th Cong., 2d Sess. 186-87 (1980). In contrast, a nonresident alien may have no other income to push him into higher progressive rates. Id. The 20% minimum tax is inapplicable to foreign corporations, which continue to be subject to a flat 28% rate on long term capital gain. I.R.C. §§ 11, 1201. See also notes 109 through 125 and accompanying text infra (tax rates—impact on investment vehicle).

This approach is not novel. Foreign students and trainees may also be treated as engaged in a United States trade or business irrespective of whether they were actually so engaged. I.R.C. § 871(e).
of the property is deemed to be effectively connected with the conduct of that trade or business.\(^7\)

### III. Definition of USRPIs

A USRPI is defined to include two separate property classifications. They are: (1) interests in United States or United States Virgin Islands situs real property, and (2) interests in domestic corporations that are characterized as United States real property holding corporations (USRPHCs).\(^8\) Interests in foreign corporations are excluded from the definition of a USRPI.\(^9\)

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\(^7\) Effectively connected gain is aggregated with other gain which is effectively connected in setting the appropriate tax rate. Fixed or determinable, annual or periodic income (hereinafter referred to as fixed-determinable income) is not included in the computation. Instead, it is taxed separately and in the absence of treaty, is subject to a flat 30% rate without benefit of deductions. I.R.C. §§ 871(a), 881.

Treatment of gain from disposition of a USRPI as effectively connected does not result in similar treatment of rental income derived from real property not disposed of during the taxable year. If not effectively connected, rental income will be taxed as fixed-determinable income. It will be treated as effectively connected if an actual United States trade or business exists with respect to operation of the real property held for rental, or the Code or treaty election is exercised to have the property so treated. Id. §§ 871(d), 882(d).

\(^8\) I.R.C. § 897(c)(1)(A). USRPHC is a condensation of the term “United States real property holding corporation.”

The term “United States real property interest” is a misnomer. In addition to realty, it includes property ordinarily classified as personalty. This is reflected in the definition of a USRPI by inclusion of interests in domestic corporations which constitute USRPHCs. Id. § 896(c)(1)(A)(ii). Interests in corporations are ordinarily classified as personalty irrespective of underlying assets. See W. NEWTON, INTERNATIONAL ESTATE PLANNING 4-55 ([Shepard’s/McGraw-Hill] 1981). Apart from interests in domestic corporations, United States situs real property is defined to include personal property associated with the use of property. I.R.C. § 897(c)(6)(B). See also notes 19 through 33 and accompanying text infra (property classifications). Due to the inclusion of personal property within its scope, the definition of a USRPI is broader than the definition of real property used for the net basis Code election. I.R.C. §§ 871(d), 882(d).


The tax on the gain from the sale of real property can often be avoided by transferring the ownership of the property to a corporation and selling the shares of the corporation rather than the real property directly. If the corporation is foreign with respect to the country where the real property is located, gain on the sale of its shares is almost invariably beyond the scope of a country’s tax law. If it is a domestic corporation and a substantial holding is sold, several countries assert jurisdiction to tax. See U.S. DEPT OF TREAS., Taxation of Foreign Investment in U.S. Real Estate 61, May, 1979. If a foreign corporation exercises the I.R.C. § 897(1) election to be treated as a domestic corporation, a disposition of its shares will become subject to taxation. See I.R.C. § 897(i). See also notes 143 through 149 and accompanying text infra (election to be treated as domestic corporation).
A. Interests in United States or United States Virgin Islands Situs Real Property

An interest in United States or United States Virgin Islands situs real property requires that the foreign investor hold the requisite degree of ownership in real property as defined by the Acts. Existence of the necessary ownership and property classifications is geared to state, not federal law.

1. Ownership Classifications

Ownership classifications specifically enumerated in the Acts are: (1) free ownership and co-ownership, (2) leaseholds, and (3) options. These classifications are preceded by the word "included." Thus, unenumerated classifications are implicit. This interpretation is supported by the legislative history, which states that ownership includes easements, royalties, and partial interests such as life estates, remainders, reversions, and rights of refusal in real property.

Whether other ownership classifications are included requires comparison with those specifically enumerated. If sufficiently analogous, unenumerated classifications should also be included. A contract for sale of realty, although not specifically enumerated, is an example. The purchaser holds equitable title and the seller holds bare legal title. In contrast, the purchaser of an option, an enumerated classification, holds neither equitable nor legal rights. Because a contract for sale reflects more ownership rights than the enumerated classification, it is implicitly covered.

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10 I.R.C. § 897(c)(6). The real property must be located in rather than outside the United States. I.R.C. § 7701(a)(9). The requisite degree of ownership must be held at the time disposition occurs. I.R.C. § 897(c).
12 I.R.C. § 897(c)(6)(A).
13 Id.
15 See, e.g., Bissell v. Heyward, 96 U.S. 580 (1877); Lewis v. Hawkins, 90 U.S. 119 (1874). See also 77 AM. JUR. 2d Vendor and Purchaser § 317 (1975). Bare legal title is held as security for the purchase money. Aycock Bros. Lumber Co. v. First Nat'l Bank, 54 Fla. 640, 45 So. 501 (1907). On payment the seller is required to convey legal title to the purchaser. Id.
16 See I.R.C. § 897(c)(6)(A).
18 The interest of the purchaser in a contract for sale does not rise to fee simple ownership. However, his interest is classified as real property and the seller's interest is deemed to be personalty. 77 AM. JUR. 2d Vendor and Purchaser § 317 (1975).
2. Property Classifications

Property classifications specifically enumerated in the Acts that give rise to a USRPI are: (1) land, (2) mines, (3) wells, or (4) natural deposits. Again, the word "including" indicates the implicit coverage of other unenumerated classifications. The legislative history of the Acts states that the term "real property" has the same meaning as given in the model income tax treaty of the United States Treasury Department.

The model treaty defines realty in terms of immovable property. Immovable property is a characterization ordinarily limited to Civil Law jurisdictions. It differs from realty by the inclusion of chattels real, which ordinarily are treated as personalty.

Real property as defined in the Acts includes associated personal property. A requirement is that there be some realty with which

A mortgage at Common Law was regarded as a conveyance of realty. United States v. Commonwealth Title Insurance and Trust Co., 193 U.S. 651 (1904). The modern trend is to treat a mortgage as a security or lien for performance of an obligation. Id. Thus, a mortgage is ordinarily characterized as personal property. See, e.g. Sheldon v. Sill, 49 U.S. (9 How.) 441 (1850). But see Fair v. Commissioner, 91 F.2d 218 (3d Cir. 1937) (three hypotecas [mortgages without accompany bond] classified as immovable property in Cuba held to be realty for federal estate tax). To the extent a mortgage is strictly security for an obligation it should not be regarded as an interest in real property. See also I.R.C. § 897(c)(1)(A)(ii) (excluding from the scope of a USRPI an interest in a USRPHC held solely as a creditor). If there is equity participation coupled with a security interest, the issue becomes clouded. At some point the equity interest may be of sufficient magnitude to override creditor status and an interest in real property will arise.

Immovable property includes property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

The term 'immovable property' shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

U.S. DEPT OF TREAS., Model Income Tax Treaty, art. 6, para. 2, (1976) reprinted in 1 TAX TREATIES (CCH) ¶158. Because the United States has no internal law defining immovable property, that term is ordinarily taken to mean real property. See, Technical Explanation by the Treasury Department of the United States Netherlands Estate Tax Convention, 2 TAX TREATIES (CCH) ¶5896.


Inclusion of personal property raises an issue as to division between personal property associated with and that not associated with realty. Resolution may depend in part on the degree of affixation and whether the overall purchase price relates to the personalty such that title passes in conjunction with that of the underlying realty.
the personal property can become associated.\textsuperscript{26} If there is no realty under the applicable state law, but only personalty, a USRPI cannot exist. This distinction is illustrated by the doctrine of equitable conversion, which is based upon the constructive conversion of realty into personalty.\textsuperscript{27} Thus, real property which is to be converted into cash is automatically deemed personal property.\textsuperscript{28} Conversion may be by inter vivos or testamentary instrument.\textsuperscript{29} The time of conversion is established when there is an unequivocal, mandatory direction to convert the property from realty to personalty.\textsuperscript{30} On ultimate disposition, no realty exists, only personalty.

In practice, the theoretical result does not always materialize. The doctrine of equitable conversion has been declared ineffective where its application violates public policy.\textsuperscript{31} Whether a violation would result were the Acts rendered inoperable depends upon the state law governing the transaction.\textsuperscript{32} The uncertainty of the effectiveness of the doctrine coupled with a general undesirability of mandating

\textsuperscript{26} This requirement is expressly embodied in I.R.C. § 897(c)(B): "Real property includes associated personal property.—The term 'real property' includes movable walls, furnishings, and other personal property associated with the use of the real property." (emphasis supplied).

An exception exists only for interests in domestic corporations characterized as USRPHCs. I.R.C. § 897(c)(A)(ii). Corporate interests are ordinarily classified as personalty in their entirety irrespective of underlying assets. See also notes 34 through 41 and accompanying text infra (interests in domestic corporations).

\textsuperscript{27} Equitable conversion is based on the maxim that equity regards as done that which ought to be done. Trotter v. Van Pelt, 144 Fla. 517, 198 So. 215 (1940). See also 18 C.J.S. Conversion § 2 (1963). The doctrine has application in reclassification of property for conflict of laws. See W. Newton, International Estate Planning 2-10, 2-11, 2-14 ([Shepard's/McGraw-Hill] 1981).

\textsuperscript{28} Trotter v. Van Pelt, 144 Fla. 517, 198 So. 215 (1940).

\textsuperscript{29} A separation agreement between husband and wife may effect an inter vivos conversion. Christy v. Christy, 44 N.Y.S.2d 579 (1943). A will may trigger a testamentary conversion. Given v. Hilton, 95 U.S. 591 (1877).

\textsuperscript{30} There must ordinarily be a mandatory direction to convert, irrespective of all contingencies and independent of all discretion. See, e.g., In re Morris' Will, 197 Misc. 322, 97 N.Y.S.2d 740 (1949); In re Matous' Estate, 53 Misc. 2d 255, 278 N.Y. 2d 70 (1967).

The Acts are not triggered unless there is disposition of a USRPI. I.R.C. § 897(a)(1). For a disposition to occur there must be realization of gain. I.R.C. § 1001. See also notes 61, 62, and accompanying text infra (dispositions of USRPIs). A mere gratuitous transfer by will or trust instrument does not ordinarily result in gain realization. But see Rev. Rul. 636, 1970-2 C.B. 158 (gain realized on gift of realty subject to mortgage in excess of donor's basis).


\textsuperscript{32} Controlling law is that of the state in which the realty is situated. Clarke v. Clarke, 178 U.S. 186 (1900). See also 27 Am. Jur. 2d Equitable Conversion § 2 (1966).
B. Interests in Domestic Corporations

A USRPI includes interests in domestic corporations that constitute USRPHCs. If so characterized, the full amount of gain on disposition is subject to taxation. There is no allocation between USRPIs and non-USRPIs held by the corporation. If not so characterized, there is no taxation on disposition, even though the corporation otherwise holds USRPIs.

An important exclusion from the definition arises where a domestic corporation has disposed of all its USRPIs in taxable transactions in which the full amount of gain was recognized. This provides a means of cleansing the corporation of its taxable taint. Cleansing the corporation is especially appropriate if appreciation is due primarily to non-USRPIs. In this event, if the shares were

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34 I.R.C. § 897(c)(1)(A)(i). The interest will constitute a USRPI if the domestic corporation was a USRPHC at any time during the "tax taint period." Id. The period cannot exceed five years. It is the shorter of the: (1) period the foreign investor held the interest after June 18, 1980, or (2) five-year period ending with disposition of the interest.
35 A domestic corporation is presumed to be a USRPHC. Id. The burden of proving otherwise rests on the foreign investor. The legislative history suggests the burden may be carried where the corporation files a voluntary return with information establishing it is not a USRPHC. See H.R. REP. No. 1479, 96th Cong., 2d Sess. 190 (1980). This approach is satisfactory if the foreign investor is in control of the corporation such that the investor can cause the return to be filed. Otherwise, there should be a return for voluntary filing of information by the foreign investor. In any event, if the burden is not carried, the full amount of gain is subject to taxation.
36 Disposition of an interest in a foreign corporation is subject to taxation only if the foreign corporation has exercised the election to be treated as a domestic corporation. I.R.C. § 897(i). Excluded from the definition of USRPI are interests in domestic corporations held solely as a creditor. Id. I.R.C. § 897(c)(1)(A)(ii). Whether the proposed regulations for distinguishing between debt and equity promulgated under I.R.C. § 385 will be adopted, or even if adopted, will also apply to I.R.C. § 897, is unclear.
37 This is in contrast with the pass-through treatment accorded partnerships, trusts, and estates. I.R.C. § 897(g). Money or property received by a foreign investor in exchange for the investor's partnership, trust, or estate interest is, to the extent attributable to a USRPI, treated as received from sale or exchange of the USRPI. Id. See also notes 93 through 96 and accompanying text infra (dispositions of USRPIs: partnerships, trusts, and estates).
38 I.R.C. § 896(c)(1)(B). The exception also applies if the domestic corporation ceased to be a USRPI due to application of I.R.C. § 897(c)(1)(B) to one or more other corporations. Id.
39 If the conditions of the exception are met, taxation will not result even if disposition occurs during the tax taint period. I.R.C. § 897(c).
40 This could occur where a USRPHC holds both United States and foreign situs realty as its only assets and the foreign situs realty has appreciated, while the United States situs realty has not.
transferred, the full amount of gain would be taxed, although the non-USRPIs contributed primarily to appreciation. Rather than transferring shares, the USRPHC should first dispose of all its USRPIs. In the absence of appreciation, taxation does not result. In addition, the domestic corporation will have been cleansed of USRPHC status. Thus, its shares do not constitute a USRPI and may be disposed of without imposition of tax.

1. USRPHCs

Any domestic or foreign corporation may constitute a USRPHC. A foreign corporation is so characterized only for the purpose of determining whether a domestic corporation which holds foreign corporation stock is itself a USRPI. Only domestic corporations which constitute USRPHCs may be USRPIs. Foreign corporations cannot be so characterized.

A USRPHC is any corporation in which the value of USRPIs equals or exceeds that of foreign situs realty and assets used or held for use in a trade or business. Borrowing against corporate assets may

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39 The corporation must dispose of all its USRPIs, not merely enough to bring it below the 50% level such that it is no longer a USRPHC. I.R.C. § 897(c)(1)(B). Because an installment sale results in deferral rather than nonrecognition of gain, it will qualify for the exception. I.R.C. § 453.

40 If amounts distributed are characterized as dividends or interest, a foreign investor protected by a treaty will incur little or no withholding. This characterization is not automatic. A payment is treated as a dividend only to the extent of earnings and profits. I.R.C. §§ 316, 897(f). See also notes 89 through 92 and accompanying text in fraud (dispositions by domestic investors). Otherwise, the excess distribution reduces the basis of the stock and additional amounts are treated as gain from the sale or exchange of property. I.R.C. § 302(c). Treatment as a sale or exchange will result in taxation under the Acts if the distribution is made by a USRPHC. Because an investment in United States situs realty held for rental may produce de minimus earnings and profits, this may not be an infrequent occurrence. Furthermore, a distribution otherwise classified as interest may not be so treated if the creating instrument is recharacterized as equity instead of debt. See, e.g., I.R.C. § 385.

41 An exception from classification as a USRPI exists for any class of stock regularly traded on an established securities market. I.R.C. § 897(c)(3). The foreign investor must not hold more than 5% of the class during the tax taint period. Id. An established securities market includes any national securities exchange and any over-the-counter market. Cf. I.R.C. § 453(f)(2); Treas. Reg. § 1.453-3(d)(4) (1972). Whether a foreign exchange may constitute an established securities market is unresolved.

42 See notes 56 and 59 and accompanying text in fra (interests in foreign corporations).

43 I.R.C. § 897(c)(2). Theoretically, if at any point during the tax taint period the value of USRPIs equals or exceeds this level, a USRPHC will exist. I.R.C. § 897(c)(1)(A)(ii). The Commissioner by regulation may adopt a more pragmatic approach requiring a single annual valuation. Valuation, especially where assets are located in foreign jurisdictions, may prove complex. Further clarification is necessary in the criteria for gauging trade or business assets. For valuation purposes, I.R.C. § 897(c)(2) refers to "fair market value," which implies that gross rather than net values are employed. The effect is to include property at its full value irrespective of an
diminish net worth so that any amount realized on a subsequent stock sale is correspondingly reduced. During the interim, borrowed amounts could be paid as interest or dividends.\textsuperscript{44} If the shareholder of the domestic corporation is protected by an income tax treaty, withholding could be \textit{de minimus}.

An existing USRPHC may be recharacterized to avoid that status,\textsuperscript{45} by purchasing sufficient foreign situs realty as trade or business assets to insure that their fair market value exceeds that of the USRPIs. Funds to make the purchases may be obtained either through direct loans from or contributions to capital by the foreign investor.\textsuperscript{46} An alternative is for the USRPHC to use funds that it borrows against its own assets to purchase additional property rather than diminishing net worth through interest or dividends.

2. \textit{Corporate Ownership Interests}

Ownership interests which one corporation holds in another may affect the status of the first as a USRPHC. The extent of the effect depends upon: (1) whether it is a controlling interest,\textsuperscript{47} and (2) the assets held by the second corporation. If control does exist, the value of the stock is ignored in gauging whether the controlling corporation is itself a USRPHC.\textsuperscript{48} Instead, the assets of the controlled cor-

\textsuperscript{44} See note 40 \textit{supra} (treatment of distributions as dividends or interest).
\textsuperscript{45} The tax taint period still has application. I.R.C. \textsection 897(c)(1A)(ii). The preferable approach is to avoid USRPHC status at the outset, on formation of the corporation, rather than relying on recharacterization. Once USRPHC status attaches, it is retained irrespective of subsequent fluctuations in valuation for the full taint period. If recharacterization is necessary, the full five year taint period must expire before USRPHC status is removed. \textit{But see} I.R.C. \textsection 897(c)(1)(B) and (c)(2) (exclusion and exception from USRPI status).
\textsuperscript{46} Caution must be exercised to insure that the debt interest is not recharacterized as equity. Cf. I.R.C. \textsection 385(b)(3) (the ratio of debt to equity of the corporation is one factor which may be considered in determining whether a debtor-creditor or corporation shareholder relationship exists).
\textsuperscript{47} A controlling interest in ownership of 50\% or more of all classes of stock in the controlled corporations. I.R.C. \textsection 897(c)(5)(B). Constructive ownership rules apply for determining whether the requisite control exists. \textit{Id.} I.R.C. \textsection 897(c)(6)(C).
\textsuperscript{48} I.R.C. \textsection 897(c)(5). Though a foreign corporation cannot be a USRPI, it may be classified as a USRPHC. Classification as a USRPHC may be important for two reasons. First, it may determine whether a domestic corporation is a USRPI. \textit{Id.} Second, it may play a role in gauging the extent of taxation on a foreign corporation's exercise of the election to be taxed as a domestic corporation. I.R.C. \textsection 897(i). \textit{See also} notes 143 through 149 and accompanying text \textit{infra} (income tax treaties). If the foreign corporation was a USRPHC, it will continue to be so during the entire tax taint period. Exercise of the election during this period will cause the corporation to be treated as a USRPI even though it was no longer a USRPHC when the election was exercised. The status of the controlled corporation as a USRPHC is immaterial.
poration are imputed to the controlling corporation in proportionate amounts, based on the fair market value of the stock interest of each asset of the controlled corporation. USRPIs, foreign situs realty, and trade or business assets are treated as proportionately owned by the controlling corporation. Imputation continues through the chain of successive corporation ownership.49

In contrast, if control does not exist, the extent to which the stock interest held in a second corporation is taken into account depends upon whether the second corporation is itself a USRPHC.50 If so, the full value of the stock interest held by the first corporation is treated as a USRPI. There is no allocation between USRPIs, foreign situs realty, or trade or business assets. The full value of the stock is added to other USRPIs in determining whether the first corporation is a USRPHC.

In the event the second corporation is not a USRPHC, the stock interest does not enhance the value of USRPIs held by the first corporation. USRPIs held by the second corporation are not taken into account. If the stock is characterized as a trade or business asset51 it is taken into account and diminishes the prospect that the first corporation will be a USRPHC.

3. Partnerships, Trusts, and Estates

In gauging the existence of a USRPHC, full pass-through treatment is accorded assets held by a partnership, trust, or estate.52 This means that USRPIs, foreign situs realty, and trade or business assets are treated as owned proportionately by the partners or beneficiaries.53

The effect is illustrated by comparing ownership through a partnership, trust, or estate with ownership through a corporation. If

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49 I.R.C. § 896(c)(5)(B).
50 The second corporation can be either domestic or foreign. I.R.C. § 896(c)(4)(A).
51 Characterization of assets as trade or business may depend on the motivation for initial acquisition or continued retention of the stock. Rev. Rul. 40, 1958-1 C.B. 275 concludes that stocks, bonds and securities purchased in the regular course of business solely to obtain inventory are not capital assets. See also Treas. Reg. § 1.537-3(b) (1960) (minority shareholders interests treated as part of parent corporation’s business).
52 I.R.C. § 896(c)(4)(B).
53 Id. Prior to the Economic Recovery Tax Act of 1981, I.R.C. § 897(c)(4)(B) referenced only “United States real property interests . . . .” not foreign situs realty and trade or business assets. This raised the potential argument that the latter were not accorded pass-through treatment.

Pass-through treatment is also accorded partnerships, trusts, and estates on disposition of USRPIs. I.R.C. § 897(g). See also notes 93 through 96 and accompanying text infra (dispositions of USRPIs: partnerships, trusts, and estates).
control exists, no form is preferred over the others, as pass-through treatment is accorded irrespective of the form of ownership.\textsuperscript{54}

In contrast, in the absence of control, form governs over substance. Ownership should be in the form of a corporation if USRPIs do not reach the fifty percent threshold level, and in the form of a partnership, trust, or estate if USRPIs equal or exceed this level.\textsuperscript{55}

C. \textit{Interests in Foreign Corporations}

Disposition of an interest in a foreign corporation does not trigger section 897.\textsuperscript{56} Instead, taxation ordinarily will result on disposition of a USRPI by a foreign corporation.\textsuperscript{57} Disposition of a USRPI might be appropriate for two reasons.\textsuperscript{58}

First, a prospective purchaser may prefer a direct disposition to avoid unknown or contingent liabilities of the seller. A simple purchase of assets readily accomplishes this objective, as the seller is left with its own liabilities. A stock acquisition may indirectly give rise to unknown or contingent liabilities. Although liabilities of the acquired corporation are neither assumed by nor are they the direct responsibility of the purchaser, the purchaser does bear responsibility if the sale price is excessive or the acquired corporation has unknown or undisclosed liabilities. A USRPI held by a foreign corporation is an example of a contingent liability. The liability is equal to the difference between the fair market value and the adjusted basis of the USRPI. Disposition of an interest in a foreign corporation, as opposed to disposition of a USRPI by a foreign corporation, merely defers ultimate taxation. Theoretically, the corporate interest may be transferred free of tax an infinite number of times to a series

\textsuperscript{54} The controlling corporation is deemed to own a proportionate amount of USRPIs, foreign situs realty, and trade or business assets. I.R.C. § 896(cX5).

\textsuperscript{55} If USRPIs do not reach the 50% level, those USRPIs which are held by the corporation do not enhance the value of USRPIs held by the corporate owner. Where the 50% threshold is reached, the full stock interest held by the corporate owner is deemed to be a USRPI. Thus, in this latter event, ownership should be through a partnership, trust, or estate to afford pass-through treatment to underlying assets.

\textsuperscript{56} USRPI does not include interests in foreign corporations. I.R.C. § 897(cX1XA). See also H.R. Rep. No. 1479, 96th Cong., 2d Sess. 187 (1980). This is so even if the foreign corporation is characterized as a USRPHC. I.R.C. § 897(cX4XA).

\textsuperscript{57} The nonrecognition provisions are typically rendered inapplicable. I.R.C. §§ 897(d), (e). \textit{But see} I.R.C. § 897(dX1XB) (exception for carryover basis). See also notes 63 through 78 and accompanying text \textit{infra} (recognition of gain).

\textsuperscript{58} The status of the corporation as collapsible is not ordinarily an issue on disposition of stock in a foreign corporation. I.R.C. § 341. This is because the collapsible provisions preclude long term capital gain treatment but do not result in the conclusion that the transferred asset is not a capital asset. I.R.C. § 341(a).
of different foreign investors. During the interim, with appreciation of the USRPI and depreciation of its basis, potential tax liability will be increasing. The effect is the creation of a secondary market of discounted, foreign corporate stock.

The second reason for a foreign corporation to dispose of a USRPI is to obtain a step-up in basis. This is appropriate especially where the USRPI consists of depreciable assets such as buildings held for rental. To recoup a depreciable basis, disposition is necessary in order to trigger the taxation of gain with resultant increase in basis.\textsuperscript{9}

The purchaser of stock in a foreign corporation must take steps to guard against contingent liabilities such as substantially appreciated, low-basis USRPIs. These include:

1. carefully reviewing the balance sheet to determine the existence of USRPIs,
2. requiring personal warranties or an indemnification agreement from the seller,
3. withholding part of the purchase price,
4. insisting on an escrow arrangement in which part of the purchase price is placed in escrow as security, or
5. providing for final audit of the seller's books just prior to closing, but deferring transfer of consideration until a subsequently scheduled second closing date.

If a contingent liability is discovered, an appropriate discount should be made in the purchase price.

\section*{IV. DISPOSITIONS OF USRPIs}

The "disposition" of a USRPI is the taxable event which triggers section 897.\textsuperscript{10} Even though a disposition does occur, taxation will not result unless there is both realization and recognition of gain.

\textsuperscript{9} Taxation results due to inability of the foreign corporation to claim nonrecognition. I.R.C. §§ 897(d), (e). The need for a step-up is diminished if the USRPI is comprised of nondepreciable assets such as farmland. The effect is to promote stock transfer with the resultant deferral of the pent-up gain. This result is somewhat anomalous since the initial impetus for the Acts was Congressional concern over foreign purchases of farmland. \textit{See U.S. DEPT OF TREAS., Taxation of Foreign Investment in U.S. Real Estate}, May 1979. The Acts may well accelerate that pace by causing a refocussing of foreign investment from depreciable USRPIs to farmland. In any event, a step-up is essential if the purchaser intends to use the nondepreciable raw land for development purposes.

\textsuperscript{10} I.R.C. § 896(a)(1). The Acts do not define the term "disposition." Other Code provisions have specified that it includes a sale, exchange, distribution, or transmission of property. \textit{See I.R.C. § 453(d) (1969).}
Gain, even if realized, is not subject to taxation unless also recognized. Furthermore, gain if both realized and recognized may be minimized by offsetting the gain against losses and utilizing the most beneficial tax rates.

A. Recognition of Gain

The nonrecognition provisions have a limited scope with respect to the distribution of a USRPI. The first limitation, under I.R.C. section 897(d), applies only to foreign corporations and precludes nonrecognition in connection with distributions by a foreign corporation. In addition, the nonrecognition provisions of section 337 are rendered inapplicable.

An exception to the first limitation arises where the shareholder who receives the distributed property is subject to taxation on subsequent disposition and takes a carryover basis in the property.

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61 See I.R.C. § 1001(b) (defining amount realized as the sum of any money plus the fair market value of any property received). The requirement that there be realization of gain ordinarily removes gifts, gratuitous transfers, from the scope of § 897. See Treas. Reg. 25.2511-1(c) (1973). An exception arises if a gift is tantamount to a sale or exchange. This could occur where a gift of realty is subject to a mortgage in excess of the donor's basis. In this event, Rev. Rul. 626, 1970-2 C.B. 158 holds that the donor is taxed on the excess amount. See also Estate of Levine, 72 T.C. 780 (1979), aff'd, 634 F.2d 12 (2d Cir. 1980).

62 Gain which is realized is ordinarily subject to recognition. I.R.C. § 1001(c). Despite this general rule, the Code does contain a number of important provisions authorizing nonrecognition of gain. See, e.g., I.R.C. §§ 267(d), 311(a), 332, 336, 337, 351, 371(a), 374(a), 501(a), 51(a)(b)(5), 721, 731, 1031, 1033, 1038, 1039, 1071, and 1081. The effect is to preclude ultimate recognition until some future date or the occurrence of some future event.

63 I.R.C. §§ 897(d), (e). The approach is to require recognition "... notwithstanding any other provision of this chapter..." Id. I.R.C. § 897(d)(1)(A). See also I.R.C. § 896(c)(3) (defining a nonrecognition provision as one for not recognizing gain or loss). The limitations apply expressly to Code nonrecognition provisions. I.R.C. §§ 897(d), (e). Judicial nonrecognition may not be affected by these limitations. See, e.g., General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935) (authorizing the nonrecognition subsequently embodied in I.R.C. § 311(a)(2)). See also B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 7-50 (4th ed. 1979) (judicial nonrecognition). Furthermore, even limitations such as Code nonrecognition may raise complex issues under the nondiscrimination clause of income tax treaties. See notes 142 through 146 and accompanying text infra.

64 I.R.C. § 897(d).

65 This includes distributions in liquidation and redemption. Id.

66 I.R.C. § 897(d)(2). Prior to the Acts, I.R.C. § 337 was the primary section providing a technique for avoiding taxation of capital gain. Section 337 continues to be available for domestic corporations, even those with foreign shareholders. If the interests held by the shareholders are USRPIs, taxation will result on exchange of the liquidation proceeds for the corporate stock. But see notes 154 through 158 and accompanying text infra (income tax treaties may provide exemption).

67 I.R.C. § 896(d)(1)(B). The requirement that there be taxation on subsequent disposition was added by the Economic Recovery Tax Act of 1981. Congress sought to block any attempt by an existing foreign investor to rearrange his investment to take advantage of a treaty
this event nonrecognition is available. The Commissioner has further authority to prescribe by regulation the extent to which nonrecognition may apply in other situations.68

The second limitation is broader than the first. It provides:

Except to the extent otherwise provided in subsection (d) and paragraph (2) of this subsection, any nonrecognition provision shall apply for purposes of this section to a transaction only in the case of an exchange of a United States real property interest for an interest the sale of which would be subject to taxation under this chapter.69

Both nonresident aliens and foreign corporations are implicitly subject to this limitation, but beyond this its scope is not entirely clear.70

Literally, it authorizes nonrecognition only where a USRPI is exchanged for an interest otherwise subject to taxation. An example is a section 351 transfer of a USRPI to a domestic corporation. In the absence of treaty, nonrecognition71 is allowed because the stock of the corporation is an interest subject to taxation. In contrast, a section 351 transfer of a USRPI to a foreign corporation would not qualify for nonrecognition since foreign corporation stock is exempt from taxation.

A like-kind exchange provides further illustration. Foreign investors which exchange domestic realty for other like-kind domestic realty are entitled to nonrecognition.72 On the other hand, an ex-
change of domestic for foreign realty is denied the same treatment.\textsuperscript{73} If a nonresident alien becomes a United States resident,\textsuperscript{74} however, an exchange of domestic for foreign realty under section 1031 could be allowable.\textsuperscript{75}

Transfers to a foreign corporation either as paid-in surplus or contributions to capital may also result in recognition of gain.\textsuperscript{76} The amount of gain recognized is equal to the fair market value of the property less the sum of its adjusted basis plus any gain otherwise subject to recognition on the transfer.\textsuperscript{77} Nevertheless, the Commissioner has authority to prescribe by regulation the extent to which nonrecognition may be allowed.\textsuperscript{78}

B. Deferral of Gain

Even if both realized and recognized, gain may be deferred from immediate taxation. The primary method of deferral of taxation on disposition of a USRPI is the installment sale.\textsuperscript{79} Gain from the sale

\textsuperscript{73} Foreign realty does not constitute an interest "... the sale of which would be subject to taxation. ..." I.R.C. § 897(e)(1). Despite the general rule precluding nonrecognition, the foreign investor may be entitled to the protection of a treaty nondiscrimination clause. See notes 142 through 146 and accompanying text infra. In this event, nonrecognition may continue to be available. Id.

\textsuperscript{74} A nonresident alien could become a United States resident through the act of physical presence in the United States coupled with the intent to remain. See W. Newton, International Estate Planning 3-7 (Shepard's/McGraw-Hill 1981). A nonresident alien could also become a United States resident through exercise of the special elections provided by I.R.C. §§ 6013(g), (h). Id. at 3-60.

\textsuperscript{75} At a subsequent time when nonresident alien status is again acquired, the realty theoretically could be sold without triggering I.R.C. § 897. During the period of residency, the individual would be taxed on worldwide income. I.R.C. §§ 1(a), 11(a), 61(a). See also Treas. Reg. § 1.1-1(b) (1974).

In the event the nonresident alien has clothed himself with domestic status to avoid the impact of § 897, the Commissioner may have authority to curb nonrecognition by regulation. I.R.C. § 897(e)(2). See also note 69 supra. One approach would be for the Commissioner to adopt a step transaction mechanism by requiring that the property be held for a specific period of time prior to disposition.

\textsuperscript{76} I.R.C. § 897(i).

\textsuperscript{77} Id.

\textsuperscript{78} Id.

\textsuperscript{79} I.R.C. § 453. The Acts delimit the extent to which a foreign investor can claim Code nonrecognition provisions. I.R.C. §§ 897(d)(1), (e). Historically, an installment sale has been viewed as providing deferral rather than nonrecognition of gain. See, e.g., I.R.C. § 1001 (distinguishing between an installment sale and recognition of gain). This distinction is expressly embodied in § 897(e)(3) which defines the term "nonrecognition provision" as "any provision of this title for not recognizing gain or loss."

The fact that an installment sale retains viability on disposition of a USRPI is fully supported by the legislative history. The principle reason for the adoption of the 20% minimum tax on nonresidents was the concern that an installment sale could be used to spread the
is treated as effectively connected and subjected to taxation only in the year payments are ultimately received. This defers taxation by spreading the gain over a series of taxable years. Timing the installment payment to its receipt coinciding with that of other effectively connected income may prevent bunching of income and result in reduced rates of taxation. Furthermore, if the receipt of gain occurs in a taxable year in which effectively connected losses are also incurred, those losses, to the extent they may be utilized, can further reduce the rate of taxation.

The ultimate shareholders of a foreign corporation owning United States situs realty may prefer direct receipt of installment payments rather than allowing payments to be made to the corporation. This is readily accomplished if the property is held by a domestic corporation, as it may couple the sale with a section 337 liquidation. Distribution of an installment obligation in a section 337 liquidation does not trigger taxation of the entire gain due under the obligation. Instead, the shareholders report the gain as payments as the obligations are received. That gain will be subject to the appropriate tax rate, depending on whether the shareholder is taxed as a corporation or an individual.

Much United States situs realty presently is held by foreign rather than domestic corporations. For shareholders of these corporations, direct receipt of the installment payments may not be feasible. Section 337 nonrecognition is expressly inapplicable to foreign corporations. Unless gain over a period of years at reduced rates. I.R.C. § 897(a)(2). As the legislative history states:

Since any other U.S. source investment income and all foreign source income of the foreign investor would not be taken into account, the rate of tax on the U.S. real estate gains of foreign investors (particularly if an installment sale were used to spread the gain over several years) (emphasis supplied) would generally be lower than that imposed on U.S. investors in similar circumstances.


* I.R.C. § 897(a)(1). Prior to the Acts, the installment sale was the primary technique for avoiding, rather than merely deferring, taxation. Because gain from the sale is treated as effectively connected when ultimately received, this avenue of tax avoidance is no longer available.

* See notes 97 through 108 and accompanying text infra.

* This approach may be preferable for a number of reasons: (1) convenience, (2) avoiding annual fees for maintaining the foreign corporation, and (3) maximizing the potential of crediting the United States tax against any foreign tax otherwise due.

* The limitation on nonrecognition under I.R.C. § 337 extends only to foreign, not domestic corporations. I.R.C. § 897(d)(2).

* I.R.C. § 453(B)(d)(2). Distribution of an installment obligation in a transaction, other than one to which either I.R.C. § 332 or § 337 applies, triggers taxation of the entire gain, including the deferred portion. I.R.C. § 453(B)(a).

* See note 5 supra (rates of taxation for individuals and corporations).

* I.R.C. § 897(d)(2).
the foreign corporation is entitled to exercise the section 897(i) election, direct disposition of the installment obligation will trigger taxation of the entire amount of the obligation. The effect is to require the corporation to remain in existence for the entire payout period in order to obtain deferred taxation.

C. Dispositions by Domestic Investors

Dispositions of USRPIs by domestic investors ordinarily are not affected by section 897. An exception to this general rule exists if a domestic corporation distributes a USRPI to a foreign investor as a dividend. The exception equates the adjusted basis of the transferred property with the adjusted basis prior to distribution. The adjusted basis is increased only by the sum of the gain recognized and the tax paid by the foreign shareholder on receipt. This reserves the inherent tax liability in the USRPI for the shareholder. An analogous exception for payment of the indebtedness of a domestic corporation to its foreign investor shareholders is unnecessary. Although the withholding rate on interest would be diminished substantially if the foreign investor could claim the protection of an income tax treaty, the domestic corporation on distribution will realize gain to the extent the value of the appreciation of the USRPI exceeds its adjusted basis. Taxation is avoided if the indebtedness is repaid with cash or nonappreciated USRPIs.

D. Dispositions of USRPIs: Partnerships, Trusts, and Estates

The disposition by way of exchange of an interest in a partnership,
trust, or estate is subject to section 897. For this purpose, the partnership, trust, or estate is treated as a pass-through entity. Its status as domestic or foreign is immaterial. Money or property received by the foreign investor in exchange for his interest in the partnership, trust, or estate is treated, to the extent attributable to a USRPI, as received from sale or exchange of the USRPI.

In contrast with partnerships, trusts, and estates, interests in domestic corporations are not accorded pass-through treatment. If a domestic corporation constitutes a USRPI, the full amount of gain on disposition is taxed. There is no allocation between USRPIs and non-USRPIs held by the corporation.

The effect of these provisions is to encourage ownership through a domestic corporation if its USRPIs do not reach the 50% threshold level. In this event, disposition of stock in the domestic corporation escapes taxation in its entirety. Where the value of USRPIs equals or exceeds the 50% threshold, the pass-through treatment of a partnership, trust, or in the event of death, an estate, is preferred.

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92 I.R.C. § 897(g). See also I.R.C. § 897(h). (Special rules for REITs). Literally, § 897 does not treat gain derived from the disposition of a USRPI by a partnership, trust, or estate as effectively connected. See I.R.C. § 897(a)(1) (covering only dispositions by nonresident alien individuals and foreign corporations). This result is not affected by I.R.C. § 897(g). That section, by its terms, is directed only to dispositions of interests in partnerships, trusts, and estates. I.R.C. § 897(c)(4), which is applied only to determine the existence of a USRPHC, does not fill this gap. See notes 52 through 55 and accompanying text supra.

The absence of an express reference to the taxation of dispositions of USRPIs by a partnership does not pose a problem. A partnership may be treated as an aggregate of individuals rather than an entity. I.R.C. § 702. In computing gain or loss, a sale or exchange of property by a partnership is imputed to and deemed to be effected separately by the partners. I.R.C. § 702(a)(3).

This analysis does not extend directly to trusts and estates. Instead, they are deemed to be taxable entities separate from either the grantor or beneficiaries. I.R.C. §§ 641(a); 7701(a)(1), (14). They are taxed separately on retained or accumulated income. I.R.C. §§ 661-64. The disposition of a USRPI by a trust or estate in which the gain is to be accumulated should be treated as a separate transfer by the trust or estate. See Maximov v. United States, 373 U.S. 49 (1963). Trusts and estates are also treated as separate entities for purposes of the 183-day physical presence test. Rev. Rul. 621, 1968-2 C.B. 286.

Nevertheless, a trust or estate is treated as an individual for computation of its tax liability. I.R.C. § 641(b). Furthermore, the term “resident alien” for purposes of § 871 includes nonresident alien fiduciaries of trusts and estates. Treas. Reg. § 1.871-2(a) (1960). Thus, it would seem that disposition of a USRPI by a trust or estate is covered by I.R.C. § 897.

* See also I.R.C. § 897(c)(4)(B) (pass-through treatment afforded partnerships, trusts, and estates in gauging USRPHC status).

* I.R.C. § 897(g).

* A domestic rather than a foreign corporation should be used. Domestic corporations can liquidate under I.R.C. § 337. Foreign corporations are unable to do so even if not characterized as a USRPHC. I.R.C. § 897(d)(2).
E. Disposition of USRPIs: Offsetting Gain with Losses

Gain derived by a foreign investor from disposition of a USRPI is treated as effectively connected with the conduct of an artificial trade or business.\(^7\) The gain may be minimized by offsetting losses. The losses may arise in the same taxable year in which the gain was generated or an entirely different year. Losses which arise in a different taxable year may be carried back to prior years or forward to subsequent years as net operating losses.\(^8\) In the case of a corporation, net operating losses may not be utilized to offset capital gain generated through application of the 28% alternative tax.\(^9\)

Outright ownership of real property by the foreign investor\(^10\) requires that the losses be connected with a United States trade or business.\(^11\) The trade or business with which the losses are connected need not be that from which the gain ultimately arises.

Deductions which trigger losses from real estate are those for mortgage interest, property taxes, and depreciation. They may be applied to offset either rental income or gain from disposition of a USRPI. If in a particular year deductions exceed income, a loss is generated which may be carried back to a prior year and, to the extent that it can be utilized, forward to subsequent taxable years.

This provision encourages generation of excess loss deductions. One approach which can enhance potential net operating loss is to maximize the interest deduction by using borrowed funds to finance real property acquisitions.\(^12\) Furthermore, if a corporation is used

\(^7\) I.R.C. § 897(a)(1).

\(^8\) I.R.C. § 172(a). The net operating loss is carried back to the three taxable years preceding the year of loss. I.R.C. § 172(b)(1)(A). It is applied in the earliest of those taxable years to which it can be carried. I.R.C. § 172(b)(2). The loss is carried forward until exhausted or through the fifteen taxable years following the year of loss. I.R.C. § 172(b)(1)(B).


\(^10\) United States situs real property owned outright by a nondomiciliary decedent will be included in his gross estate for federal estate tax. Treas. Reg. §20.2104-1(a)(1) (1974). In contrast, if real property is purchased through a foreign corporation, neither the realty nor the foreign corporate stock is ordinarily includable. Treas. Reg. §20.2105-1(f) (1974). The decision as to inclusion requires comparison of estate tax rates with the income tax rates applicable on disposition of a USRPI. See I.R.C. §1.2101(a). Furthermore, at the death of the nondomiciliary there is deemed to be a change of taxpayers, and the loss carryovers do not transfer to the estate. Rev. Rul. 175, 1974-1 C.B. 52.


\(^12\) Borrowing against realty held by a domestic corporation which constitutes a USRPI may sufficiently diminish net worth such that the amount realized on a subsequent stock sale is correspondingly reduced. The borrowed amounts may be paid as dividends or interest. See, note 40 supra.
to make the investment, funds may be advanced by the shareholders in the form of a loan rather than a contribution to capital.\textsuperscript{105} For shareholders protected by treaty, the withholding rate on interest payments may be substantially diminished or totally eliminated.\textsuperscript{104}

Losses may arise independently of the USRPI whose disposition generated the effectively connected gain.\textsuperscript{105} It is required simply that they be connected with some United States trade or business. This could result from independent investment in other USRPIs which constitute a trade or business. An illustration is oil and gas property. The foreign investor would be a limited partner.\textsuperscript{106} If the partnership which holds the USRPI is engaged in a trade or business, the foreign investor, although a limited partner, is also deemed to be engaged in a trade or business.\textsuperscript{107} Losses generated by the partnership are treated as connected with the trade or business, and they may be applied to offset gain derived from the ownership, operation, or disposition of a separate USRPI.\textsuperscript{108}

F. Tax Rates: Impact on Investment Vehicle

Investment in United States situs realty ordinarily has been through a foreign corporation. Title to the investment may be held through an intermediate corporation.\textsuperscript{109} A foreign corporation organized in a treaty jurisdiction may be able to claim reduced withholding rates on dividends and interest. Furthermore, for estate taxation, stock in a foreign corporation is treated as foreign situs property even though the corporation owns United States situs realty.\textsuperscript{110}

\textsuperscript{103} But see I.R.C. §385 (criteria for distinguishing between debt and equity).

\textsuperscript{104} Recharacterization of the underlying instrument as equity rather than debt will cause payments to be treated as dividends, not interest. See I.R.C. §385. See also note 40 supra (treatment of dividends). Loss generated at the corporate level also will be correspondingly reduced.

\textsuperscript{105} I.R.C. §§873(a), 882(c)(1)(A).

\textsuperscript{106} A limited partner is liable for obligations of the partnership only to the extent of his capital contribution.

\textsuperscript{107} I.R.C. §875(1). See Donroy, Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962).

\textsuperscript{108} The "at risk" rules require that deductible partnership losses for specifically enumerated activities be based on recourse rather than non-recourse financing. I.R.C. §465(b). These activities expressly include the exploration and exploitation of oil and gas resources. I.R.C. §456(c)(1)(D).

\textsuperscript{109} The intermediate corporation may be domestic rather than foreign. An intermediate domestic corporation may be able to claim advantages unavailable to a foreign corporation holding United States situs realty outright. See, e.g., notes 82 through 88 and accompanying text supra.

Neither the stock nor the realty is subject to estate tax.\(^{111}\)

Although these advantages continue, taxation of gain on disposition of a USRPI by a foreign corporation raises potential difficulties. The maximum rate of taxation on long term capital gain of corporations continues at 28%,\(^{112}\) and the minimum tax or tax preferences may increase this rate by approximately 1.67%.\(^{113}\) In contrast, however, the Economic Recovery Tax Act of 1981 reduces the maximum rate of tax on long term capital gain of individuals from 28 to 20%.\(^{114}\)

In the event title to a USRPI is held directly by a foreign corporation with a nonresident alien individual as shareholder, the 20% rate nevertheless may be available. It is required that the corporation be entitled to exercise the section 897(i) election such that it can be treated as a domestic corporation entitled to liquidate under section 337. The higher corporate rate will apply if this condition is not met.

To obtain long term capital gain treatment, it is essential that the foreign investor hold the USRPI for one year.\(^{115}\) Otherwise, the higher progressive rates applicable to short term capital gain will be effective.\(^{116}\) If the foreign investor holds a USRPI in the form of stock in a domestic corporation, it is necessary to insure that the

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\(^{111}\) The gift tax would also be inapplicable. This is because all transfers of intangible personal property are expressly excluded from gift taxation. I.R.C. §2501(a)(2). Since the exclusion applies to all intangible personal property, even a gift of stock in a domestic corporation would not be taxed. Id.

\(^{112}\) I.R.C. §§111, 1201.

\(^{113}\) I.R.C. §56.

\(^{114}\) I.R.C. §§1, 1202(a). The §56 minimum tax does not increase the 20% rate for individuals since long term capital gain is not treated as an item of tax preference for purposes of that tax. I.R.C. §57(a). The §55 alternative minimum tax, imposed in lieu of regular tax liability for individuals to the extent it is greater, is also limited to a maximum 20% rate. I.R.C. §55(a).

\(^{115}\) I.R.C. §1222(3). The one year period may be shortened by treaty. See, e.g., Income Tax Treaty, Jan. 1, 1947 (as amended), United States—Netherlands, art. XI, para. 3(b), reprinted in 2 Tax Treaties (CCH) 15815 [hereinafter cited as Netherlands art. XI] (six months). The Netherlands treaty covers those capital assets representing USRPIs held in domestic corporations but not United States situs realty held outright. Id. art. XI, para. 1. See also notes 154 through 158 and accompanying text infra (treaty exemptions for capital gain).

\(^{116}\) Foreign investors are concerned with the holding period of capital assets only because the Acts treat gain derived from disposition of a USRPI as effectively connected. I.R.C. §897(a)(1). This means that the foreign investor's gain is taxed in the same fashion and subject to the same rates as gain for domestic taxpayers. I.R.C. §§871(c), 882. Prior to the Acts, capital gain was treated as effectively connected only if it bore the requisite factual nexus with the United States trade or business. I.R.C. §864(c)(2).
latter not be collapsible under section 341. A safe harbor from the collapsible rules is afforded if corporate assets are held three (3) years or more.\footnote{117}{I.R.C. §341(b)(3). The extent to which §341 applies to capital assets exempted by treaty is unresolved. Compare I.R.C. §341(a) with Netherlands art. XI.}

Depending on the value of the taxable estate, the estate tax rate applicable to estates of nondomiciliary decedents\footnote{118}{See W. Newton, International Estate Planning 3-66 (Shepard's/McGraw-Hill 1981) (defining United States domiciliary).} may be less than the income tax rate. These rates are:

<table>
<thead>
<tr>
<th>Value of Estate</th>
<th>Estate Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $100,000</td>
<td>6% of such amount</td>
</tr>
<tr>
<td>Over $100,000 but not over $500,000</td>
<td>$6,000, plus 12% of excess over $100,000</td>
</tr>
<tr>
<td>Over $500,000 but not over $1,000,000</td>
<td>$54,000, plus 18% of excess over $500,000</td>
</tr>
<tr>
<td>Over $1,000,000 but not over $2,000,000</td>
<td>$144,000, plus 24% of excess over $1,000,000</td>
</tr>
</tbody>
</table>
| Over $2,000,000          | $384,000, plus 30% of excess over $2,000,000\footnote{119}{A USRPI consisting of stock in a domestic corporation is also subject to estate tax. I.R.C. §2104(a); Treas. Reg. §20.2104-1(a)(5) (1974).}

The value of the taxable estate may be reduced by any non-recourse indebtedness imposed against the property.\footnote{120}{I.R.C. §2101(d).} If United States situs realty is owned outright by a nonresident alien who is also a non-domiciliary, the property will be subject to estate tax.\footnote{121}{See Estate of Harcourt Johnstone v. Commissioner, 19 T.C. 44 (1952). See also Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940).} In addition, the property will obtain a step-up in basis equal to its fair market value at the applicable valuation date.\footnote{122}{See W. Newton, International Estate Planning 3-7, 3-66 (Shepard’s/McGraw-Hill 1981) (distinguishing between residence and domicile).} To the extent of the step-up, income taxation is avoided. Also, the property can be transferred without realization of gain to the extent of the step-up.\footnote{123}{I.R.C. §2103; Treas. Reg. §20.2103-1 (1974). A USRPI consisting of stock in a domestic corporation is also subject to estate tax. I.R.C. §2104(a); Treas. Reg. §20.2104-1(a)(5) (1974). I.R.C. §1014.}
Whether this approach should be adopted depends on the overall objectives of the nonresident. If he merely intends to own a second home in the United States without additional investment, the approach discussed should be given consideration. In any event, computation of the taxable estate and comparison of the applicable rate with that which would be imposed for income tax purposes is essential.

V. SOURCE OF INCOME

Taxation of USRPIs has resulted in modification of the Internal Revenue Code source of income rules. Those rules expressly define United States source income as including gain from disposition of a USRPI. In the absence of modification, stock in a domestic corporation which constitutes a USRPI could be transferred with title to the stock passing outside the United States. Gain derived on disposition may be classified as foreign rather than United States source income.

Classification of gain from disposition of a USRPI as United States source income also affects the source of income rules for interest and dividends. Interest and dividends paid by a domestic corporation are considered United States rather than foreign source income if 20% or more of the corporation's gross income is derived from United States sources for the three years preceding the year
of payment.  

Disposition of a USRPI by a domestic corporation which previously would have generated foreign source income may now be applied in reaching the 20% threshold.

Whether this approach applies to interest and dividends paid by a foreign corporation is not entirely clear. In this connection, interest and dividends are treated as United States source income if 50% or more of the foreign corporation's gross income during the preceding three year period was effectively connected with the conduct of a United States trade or business.  

A foreign corporation, on disposition of a USRPI, is deemed to be engaged in a United States trade or business. The gain derived is treated as effectively connected with the artificial trade or business. Section 897 expressly extends to sections 871(b)(1) and 882(a)(1). Only if this treatment implicitly extends to the source of income rules will payment of interest and dividends by a foreign corporation be affected.

VI. FOREIGN TAX CREDIT

Foreign investors may be entitled to claim a credit for foreign taxes imposed on effectively connected income resulting from disposition of a USRPI. Nonresident aliens may claim the credit if the jurisdictional nexus for the foreign tax is one other than citizenship or residence. For foreign corporations, the jurisdictional nexus for the foreign tax must be one other than the creation or organization of the corporation in the foreign jurisdiction.

An illustration is a foreign jurisdictional nexus that is based on

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129 I.R.C. §§ 861(a)(1)(B), (C); 861(a)(2)(A). Interest paid by a resident alien individual is subject to this same treatment. I.R.C. §§ 861(a)(1)(B), (C).

130 I.R.C. §§ 861(a)(1)(D), 861(a)(2)(B). If less than 50% of the foreign corporation's gross income was effectively connected, interest and dividends are classified as foreign source income. Id.

131 The election to treat rental income derived from real property as effectively connected is analogous. I.R.C. §§ 871(d), 882(d). Exercise of this election does not cause the foreign investor to be engaged in a United States trade or business. Id. Nevertheless, Treas. Reg. § 1.861-2(b)(3)(iii) (1972) treats this gain as effectively connected for the source of income rules.

132 I.R.C. § 906. The credit extends to all foreign source, effectively connected income. Id. United States source, effectively connected income may be credited only if the requisite jurisdictional nexus was applied by the foreign country. Id. This treatment extends to dispositions of all USRPIs because they generate United States, not foreign source, effectively connected income. I.R.C. § 861(a)(5). See also notes 130, 131 and accompanying text supra (issue as to extension of effectively connected treatment beyond I.R.C. §§ 871(b)(1) and 882(a)(1)). The credit is unavailable for any foreign tax not imposed on effectively connected income. I.R.C. § 906(b)(3). The amount of the credit is subject to the overall limitation. I.R.C. §§ 906(b)(2), 904.

133 I.R.C. § 906(b)(1)(A).

the source of the income. This situation could occur, for example, where title to stock in a domestic corporation which constitutes a USRPI passes in the foreign jurisdiction. If that jurisdiction taxes the gain based on the source, double taxation will occur. The impact of double taxation is alleviated when the United States allows the foreign investor to credit the amount of foreign tax paid against the United States tax liability resulting from the disposition.

VII. INCOME TAX TREATIES

Income tax treaties may modify the ground rules of the Internal Revenue Code for taxation of gain on disposition of a USRPI. The Acts expressly limit the scope of these modifications. The limitation is to become applicable after December 31, 1984. At that time, all treaties are to be rendered inapplicable to the extent that they require an exemption from or reduction of tax imposed by section 871 or section 822 on gain described in section 897. The treaties continue beyond the December 31, 1984 deadline in all other respects. Thus, treaty provisions authorizing no exemption from or reduction of taxation may retain vitality. On their face, treaty source of income rules and nondiscrimination clauses appear to qualify.

135 Income tax treaties may contain consistent source rules which diminish the double taxation impact. See notes 139 through 141 and accompanying text infra.


In the case of tax treaties, Congress has adopted two provisions designed to avoid the existence of conflict. The first provision, I.R.C. § 7852(d), precludes application of conflicting Code provisions to any treaty obligation already in effect when the 1954 Code was adopted. The second, I.R.C. § 894(a), specifies that all income, to the extent required by any treaty, is not to be included in gross income but is to be exempt from taxation. This provision, in contrast with I.R.C. § 7852(d), is not frozen to any one point in time, but applies to all subsequently ratified treaties.

137 Foreign Investment in Real Property Tax Act of 1980. Pub. L. No. 96-499, § 1125(c)(1), 94 Stat. 2682, 2690 (although included in the Act, this section is not part of the Code). The cutoff date extends to tax treaties generally, not merely those protected by I.R.C. §§ 7852(d) and 894(a). See Foreign Investment in Real Property Tax Act § 1125(c)(1) (referring to §§ 894(a) and 7852(d) and "... any other provision of law ..."). See also H.R. REP. No. 1479, 96th Cong., 2d Sess. 193 (1980). Special treatment applies to those treaties renegotiated before 1985. See Foreign Investment in Real Property Tax Act § 1125(c)(2).

138 Source of income rules merely distinguish between income from sources within and income from sources outside the United States. See note 126 supra. These rules provide consistent source treatment for purposes of the foreign tax credit. See note 135 and accompanying text supra. Detailed source of income rules appear in a number of tax treaties. See, e.g., Income Tax Treaty, Jan. 1, 1957, United States—Austria, art. II, para. 2, reprinted in 1 Tax
Treaty source of income rules often provide that gain from the sale of personal property (whether tangible or intangible) is treated as arising within that contracting state in which the sale occurs. This represents an important modification of the Internal Revenue Code source rules. These rules treat gain from disposition of all USRPIs as United States source income. Foreign investors entitled to the protection of treaty source rules may be able to transfer stock in a domestic corporation which constitutes a USRPI, with title passing in the foreign jurisdiction. Gain from the sale of stock, as personal property, may then be classified as foreign rather than United States source income.

Treaty nondiscrimination clauses may affect the extent to which nonrecognition provisions can be delimited in connection with disposition of a USRPI. To the extent United States citizens and residents are entitled to nonrecognition, foreign investors protected by a nondiscrimination clause have a viable argument that the clause precludes discrimination by authorizing continued nonrecognition.

TREATIES (CCH) ¶505 [hereinafter cited as Austria]; Income Tax Treaty, Jan. 1, 1952, United States—Finland, art. 6, reprinted in 1 TAX TREATIES (CCH) ¶2657 [hereinafter cited as Finland]; Income Tax Treaty, May 7, 1975, United States—Iceland, art. 6, reprinted in 1 TAX TREATIES (CCH) ¶3709 [hereinafter cited as Iceland]; Income Tax Treaty, July 9, 1972, United States—Japan, art. 6, reprinted in 1 TAX TREATIES (CCH) ¶4393F [hereinafter cited as Japan]; Income Tax Treaty, Jan. 1, 1964, United States—Luxembourg, art. XVII, reprinted in 1 TAX TREATIES (CCH) ¶5320 [hereinafter cited as Luxembourg]; Income Tax Treaty, Dec. 3, 1971, United States—Norway, art. 24, reprinted in 2 TAX TREATIES (CCH) ¶6077 [hereinafter cited as Norway]; Income Tax Treaty, Jan. 9, 1970, United States—Trinidad and Tobago, art. 5, reprinted in 2 TAX TREATIES (CCH) ¶7614 [hereinafter cited as Trinidad and Tobago].

Treaty nondiscrimination clauses are designed to preclude a contracting state from imposing more onerous taxes on taxpayers from the other contracting state than it imposes on its own taxpayers. A nondiscrimination clause is contained in most United States income tax treaties. See, e.g., Norway, art. 25, ¶6078; Income Tax Treaty, Jan. 1, 1974, United States—Poland, art. 21, reprinted in 2 TAX TREATIES (CCH) ¶7024 [hereinafter cited as Poland]; Trinidad and Tobago, art. 6, ¶7614.


The protection of treaty nondiscrimination clauses is limited by section 897(i). This provision allows foreign corporations falling within its scope to elect to be treated as domestic corporations.\textsuperscript{143} To claim the election, the foreign corporation must hold a USRPI and be entitled to protection against discrimination.\textsuperscript{144} Due to the availability of the election, a foreign corporation's claim of discrimination due to the absence of nonrecognition is obviated.\textsuperscript{145} However, the Acts provide no corresponding election for nonresident alien individuals. Thus, if protected by a nondiscrimination clause, they may be able to assert continued nonrecognition.\textsuperscript{146}

A claim for nonrecognition will exist for those foreign investors otherwise subject to the second nonrecognition limitation.\textsuperscript{147} This limitation curtails nonrecognition except where a USRPI is exchanged for an interest "... the sale of which would be subject to taxation under this chapter."\textsuperscript{148} The legislative history indicates that the quoted language precludes nonrecognition if a USRPI is exchanged for an interest which is not taxed because of a treaty exemption.\textsuperscript{149} In this event, if the foreign investor is not entitled to exercise the section 897(i) election, the investor may be able to claim protection under the nondiscrimination clause.

Even to the extent treaties do provide an exemption from or reduction of tax, that exemption or reduction is rendered inapplicable only where it extends to tax imposed by section 871 or section 882 on gain described in section 897.\textsuperscript{150} To the extent a treaty provides an exemption or reduction of tax imposed by other Internal Revenue Code provisions, its application again is allowed to continue. Other taxes, which if covered by treaty may continue to provide exemptions or reductions, include the minimum tax on tax prefer-
ences,\textsuperscript{151} the accumulated earnings tax,\textsuperscript{152} and the personal holding company tax.\textsuperscript{153}

Treaties continue to be effective until December 31, 1984, even to the extent that they provide an exemption from or reduction of tax specified in the Acts.\textsuperscript{154} In the interim, therefore, treaty exemptions from or reductions of tax continue. This is especially important due to the exemptions for capital gain provided in a number of treaties.\textsuperscript{155} With the exception of the Canadian treaty, capital gain resulting from an outright sale of real property is not exempt under treaties in force. The Canadian treaty exempts direct dispositions of all capital assets including outright sales of realty.\textsuperscript{156}

Treaty capital gain exemptions provide tax planning opportunities. One approach is to establish a corporation in the foreign treaty jurisdiction which owns 100\% of the stock of a domestic USRPHC. The URPHC can sell its realty in a section 337 liquidation without recognition of gain. The treaty exempts the exchange of the liquidation proceeds for domestic corporation stock.\textsuperscript{157} In structuring the transaction, caution must be exercised to determine the tax impact in the foreign treaty jurisdiction. Many foreign tax rates may be substantially in excess of what the United States tax would have been.\textsuperscript{158} Furthermore, it may be necessary to utilize a second foreign corporation in a separate jurisdiction in order to exempt the gain from taxation on distribution to the ultimate nonresident alien individual shareholder.

\textbf{VIII. CONCLUSION}

The general rule taxing foreign investors on gain from the disposition of a USRPI is clearly mandated. Within the context of that general rule, a number of important tax planning opportunities do exist. Failure to exercise those opportunities could be very expensive through the loss of tax savings. In order to exercise these opportunities properly, it is essential that the transaction be structured correctly at the outset.

\textsuperscript{151} I.R.C. \S\S 55-58.
\textsuperscript{152} I.R.C. \S\S 531-537.
\textsuperscript{153} I.R.C. \S\S 541-547.
\textsuperscript{154} Foreign Investment in Real Property Tax Act \S 1125(c)(1), \textit{supra} note 137.
\textsuperscript{155} See, e.g., Canada, art. VIII; Netherlands, art. XI.
\textsuperscript{156} Real property held for rental may be subject to I.R.C. \S 1231 rather than being strictly classified as a capital asset.
\textsuperscript{157} The treaty must be analyzed to determine the impact, if any, of the collapsible corporation provisions. I.R.C. \S 341.
\textsuperscript{158} The rate in Canada is 50\%. In the Netherlands it may approach 48\%. If a “participation exemption” is obtained, the Netherlands capital gains tax may be avoided.
Once the investment has occurred, restructuring will be impossible. The small expense incurred in properly tailoring the transaction will be well worth the tax savings which result on ultimate disposition of the USRPI.