VIRGINIA TAX REVIEW

ARTICLES

PREFACE — *Edwin S. Cohen*

THE PARTNERSHIP CAPITAL FREEZE: INCOME, ESTATE, AND GIFT TAX CONSIDERATIONS — *William F. Nelson*

GOVERNMENT ACCESS TO INDEPENDENT ACCOUNTANTS' TAX ACCRUAL WORKPAPERS — *Mortimer Caplin*

THE FORMULATION OF FEDERAL TAX POLICY THROUGH LITIGATION — *M. Carr Ferguson*, *Leonard J. Henzke, Jr.*

OBSERVATIONS ON THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT OF 1980 — *Fred Feingold*, *Herbert H. Alpert*

NOTES & COMMENTS

THE INCOME TAX TREATMENT OF INTEREST-FREE LOANS

Estate of Levine v. Commissioner AND TREASURY REGULATION SECTION 1.1001.2: TOWARD A COMPREHENSIVE APPLICATION OF THE *Crane* RULE.

Xerox Corp. v. United States AND THE INVESTMENT TAX CREDIT: WHEN IS PROPERTY USED BY THE GOVERNMENT?

RCA Corp. v. United States: THE TAXATION OF INCOME FROM FUTURE SERVICES

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OBSERVATIONS ON THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT OF 1980

*Fred Feingold & Herbert H. Alpert**

THROUGH a variety of mechanisms, foreign taxpayers often have been able to avoid U.S. income tax liability on gains attributable to the disposition of interests in U.S. real property.[1] The Foreign Investment in Real Property Tax Act of 1980[2] (Act), which adds sections 897[3] and 6039C[4] to the Internal Revenue Code and amends several other Code provisions,[5] was intended to restrict severely the ability of foreign taxpayers to avoid U.S. tax liability on gain derived from the disposition of interests in U.S. real property. First, the new rules provide that gains and losses derived from the sale or exchange of U.S. real property interests are to be taken into account under the operative taxing provisions "as if" they were effectively connected with a U.S. trade or business.[6] Second, interests in certain corporations holding realty are treated, for purposes of the Act, as if they were interests in U.S. real property.[7] Third, certain of the rules relating to the basis of transferred assets are modified so that, in certain circumstances, the basis of such assets

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[1] A number of methods are discussed in a U.S. Treasury report submitted to Congress on May 14, 1979. *See* U.S. TREASURY DEP'T, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE (1979) (mandated by Revenue Act of 1978, Pub. L. No. 95-600, § 553, 92 Stat. 2763).

[2] Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, §§ 1121-1125, 94 Stat. 2682 (1980) [hereinafter cited as the Act]. The recently enacted Economic Recovery Tax Act of 1981, Pub. L. No. ___, § 831, ___ Stat. ___ (1981), amends certain provisions of the Act. This article was written prior to the publication of such amendments and, therefore, does not reflect the changes made by the new law.

[3] I.R.C. § 897.

[4] *Id.* § 6039C. *See generally* notes 134-51 *infra* and accompanying text.

[5] The Act also amends § 861(a)(5) of the Code to provide as follows:

> (5) Dispositions of United States Real Property Interest—Gains, profits and income from the disposition of a United States real property interest (as defined in section 897(c)).

I.R.C. § 861(a)(5). It is not entirely clear why this change was made. The change eliminates any possibility of a § 906 foreign tax credit on a transaction covered by § 897, and thus, double taxation may result. *See id.* § 906(b)(1).

[6] *See id.* § 897(a)(1).

[7] *See id.* § 897(c)(1)(A)(ii), (B).

carries over to the transferee.[8] Fourth, nonrecognition rules otherwise applicable are overridden in certain cases.[9] Finally, the Act provides that section 897 will override any conflicting treaty provisions after December 31, 1984, or, in certain circumstances, within two years thereafter.[10] While consideration had been given to the collection of the tax imposed by the Act through a withholding mechanism, the Act leaves enforcement of its provisions to detailed reporting requirements. Any tax liability imposed under the Act, therefore, need not be withheld from sales proceeds.[11]

In most instances, the new rules will ensure that gains attributable to appreciation in U.S. realty will be subject to tax. In certain cases, however, the Act is somewhat broader than may have been necessary to achieve this purpose. There likely will be instances where gains not attributable to appreciation in the value of U.S. realty will be caught by the all-or-nothing approach applied to sales of shares in domestic corporations. In other cases, the same appreciation may be taxed twice because of the new basis rules. In still other cases, gains attributable to U.S. realty may not be taxed in the United States either because of a conflicting treaty provision or because the property is held through a foreign corporation the shares of which can be sold without confronting the new rules.

This article discusses these and other statutory provisions affected by the enactment of the Act, as well as some of the collateral problems raised by section 897. Finally, a brief overview of the relatively complicated reporting requirements is provided.

I. Prior Law

Prior to the Act, a foreign taxpayer generally was not subject to U.S. income tax on gain realized from the sale or exchange of interests in real property located in the United States, unless the gain was "effectively connected" with a U.S. trade or business.[12] Thus, a foreign taxpayer could have avoided tax liability on the gain from a sale of a direct interest in real property, if the foreign taxpayer's

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[8] *See id.* § 897(f); Act, *supra* note 2, § 1125(d).

[9] *See* I.R.C. § 897(d), (e).

[10] *See* Act, *supra* note 2, § 1125(c). *See also* note 70 *infra* and accompanying text.

[11] *See* I.R.C. § 6039C. *See generally* notes 134-51 *infra* and accompanying text.

[12] *See* I.R.C. §§ 864, 871, 881, 882. Nonresident aliens are taxable on U.S. source capital gains if they are present in the United States 183 days or more during the taxable year. *See id.* § 871(a)(2).

holding of the property did not constitute a U.S. trade or business.[13] If the holding did constitute such a trade or business, the foreign taxpayer could have minimized U.S. tax liability by selling the property on the installment basis and deferring a substantial portion of the payments to years in which the taxpayer was not engaged in a U.S. trade or business.[14] If the taxpayer held the property through a single-purpose corporation, he could have avoided U.S. tax liability by selling the stock of the corporation, because gain from the sale of such stock ordinarily would not be effectively connected income.[15] Furthermore, a purchaser of the shares of the corporation could obtain a stepped-up basis in the assets of the corporation pursuant to the basis provisions applicable to liquidations.[16] Other possibilities also existed prior to the Act for the avoidance of a tax on appreciation in value to the date of the transaction, including the use of section 337 to avoid recognition of gain on the sale of realty held by a corporation where the sale was made pursuant to a plan of complete liquidation,[17] and the distribution consisted of appreciated real property or the shares of a corporation owning such property.[18]

II. The Statutory Scheme

A. Deemed Effectively Connected Income

The Act does not purport to change the general principles governing the taxation of nonresident aliens and foreign corporations.[19] Rather, it provides the statutory basis for imposing a tax on foreign persons realizing gains from the disposition of "United States real property interests" by providing that all gains and

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[13] *See* I.R.C. § 864(c)(2); Treas. Reg. § 1.864-3(b), ex. 1 (1972).

[14] *See* Treas. Reg. § 1.864-3(b), ex. 1 (1972).

[15] *See id.* § 1.864-4(c), *amended*, T.D. 7332, 1975-1 C.B. 204.

[16] *See generally* I.R.C. § 334(a), (b)(2). Upon liquidation of the corporation, certain "recapture" items would give rise to taxable income under §§ 1245 and 1250. *See id.* §§ 1245(b)(3), 1250(d)(3).

[17] *See id.* § 337.

[18] *See id.* § 301(b)(1)(D), (d)(3). Section 301(b)(1)(D) provides that the amount distributed by a corporation to a shareholder that is a foreign corporation will be the amount of the money received plus the fair market value of other property received if such distribution to the foreign corporation is not effectively connected with a U.S. trade or business of that foreign corporation. *See id.* § 301(b)(1)(D). Section 301(d)(3) provides that the basis of the property in the hands of such distributees will be its fair market value. *See id.* § 301(d)(3).

[19] *See* note 12 *supra*.

losses from the disposition of such interests are to be taken into account "as if the taxpayers were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business."[20] By deeming the foreign taxpayer to be engaged in a U.S. trade or business and gains and losses of foreign taxpayers to be "effectively connected," a foreign taxpayer becomes subject to U.S. tax liability thereon by virtue of the applicable operative provisions.[21]

The Act does not affect the rate of U.S. income tax applicable to effectively connected gains or losses. Thus, if a disposition of U.S. realty results in a long-term capital gain, the lower tax rates applicable to such capital gains still apply. In the case of nonresident alien individuals, however, section 897(a)(2)(A) imposes an additional alternative minimum tax of twenty percent on the lowest of the following: (1) the individual's alternative minimum taxable income under section 55(b)(1), (2) the individual's net U.S. real property gains for the taxable year, or (3) $60,000.[22] While the Act does not affect the manner in which actual effectively connected gains are treated under the general rules, one obvious effect of section 897(a)(1) is to preclude the possibility of avoiding tax liability by deferring, until a year in which the taxpayer is no longer actually engaged in a U.S. trade or business, the time when a gain must be reported for U.S. tax purposes.[23] Less clear are the effects of characterizing the foreign taxpayer realizing the gain or loss as engaged in a U.S. trade or business. For example, because foreign entities are deemed by section 897(a) to be engaged in a U.S. trade or business, the source of interest and dividend payments from such entities may be affected.[24]

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[20] *See* I.R.C. § 897(a)(1).

[21] *See* note 12 *supra*.

[22] *See* I.R.C. § 897(a)(2)(A). Section 897(a)(2)(B) defines net U.S. real property gain as the excess of gains from the dispositions of U.S. real property interests over the losses from dispositions of such interests. *See id.* § 897(a)(2)(B).

[23] *See* note 13 *supra*.

[24] Dividends from a foreign corporation can be U.S. source income under § 861 only if 50% or more of its gross income from all sources for a three-year period was effectively connected with a U.S. trade or business. *See* I.R.C. § 861(a)(2)(B). Interest paid by a foreign corporation engaged in a U.S. trade or business can be U.S. source income if during the preceding three years 50% or more of its gross income was effectively connected with a U.S. trade or business. *See id.* § 861(a)(1)(D). A similar problem arises under the statutory net

B. United States Real Property Interests

Under section 897, gain or loss realized by a foreign taxpayer from the disposition of a "U.S. real property interest" (USRPI) is subject to U.S. tax.[25] A USRPI is defined as (1) a direct interest in real property, including an interest in a mine, well, or other natural deposit,[26] or (2), with certain exceptions, any interest, other than solely as a creditor,[27] in a domestic corporation that meets the definition of a "U.S. real property holding corporation" (USRPHC).[28] The definition does not include interests in foreign corporations.[29] Therefore, gain derived from the disposition of shares in foreign corporations would not be taxable under the Act. As discussed below, however, other changes have been made to existing law in order to ensure that appreciation in value of a USRPI held by a foreign corporation will be taxed.

With certain exceptions, a domestic corporation is a USRPI if at any time during the measuring period it was a USRPHC. This measuring period is the shorter of the five-year period antedating the date of the disposition of the USRPI, or the period after June 18, 1980.[30] A USRPHC is any corporation in which the fair market

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election afforded by §§ 871(d) and 882(d). *See id.* §§ 871(d), 882(d). *Compare* Treas. Reg. § 1.871-10(c) (1974) *with id.* § 1.861-2(b)(3)(iii), T.D. 7378, 1975-2 C.B. 272.

[25] *See* I.R.C. § 897(a).

[26] *See id.* § 897(c)(1)(A)(i). Interests in real property include fee ownership, co-ownership, leaseholds of land or improvements, options to acquire land or improvements and options to acquire leaseholds. *See id.* § 897(c)(6)(A). Real property also includes personal property associated with the use of real property. *See id.* § 897(c)(6)(B). Furthermore, real property is to have the meaning it has under the U.S. Treasury's model income tax convention. *See* H.R. Rep. No. 1479, 96th Cong., 2d Sess. 186 (1980), *reprinted in* [1980] U.S. Code Cong. & Ad. News 9963, 10028. The model U.S. income tax convention generally provides that real property is to be defined by resort to local law. *See* United States Treasury Model Convention, art. 6(2), 1 Tax Treaties (CCH) ¶ 153 (1977). Whether this provision means that the law of the state in which the property is situated will control, or that federal law will govern if it conflicts with state property law, is not certain.

[27] It is unclear whether the regulations will treat "hybrid instruments" that are classified as debt under Treas. Reg. §§ 1.385-5 or 1.385-6(c) as an interest in a corporation "solely as a creditor."

[28] *See* I.R.C. § 897(c)(1)(A)(ii).

[29] *See id.* § 897(c)(2). The term "USRPHC" is not restricted to U.S. corporations and thus may apply to foreign corporations as well. *See id.* Whether a foreign corporation is or has been a USRPHC, however, is relevant only if the U.S. corporation owns less than a "controlling interest" in a foreign corporation. In such a case, the status of the foreign corporation as a USRPHC would be relevant in determining whether the U.S. corporation is a USRPHC. *See id.* § 897(c)(4)(A).

[30] *See id.* § 897(c)(1)(A)(ii)(I), (II).

values of its USRPI's at any time equal or exceed fifty percent of the sum of the fair market values of its USRPI's, its interests in real property located outside the United States, and any other assets used or held for use in a trade or business.[31]

In determining whether a corporation is a USRPHC, the following rules govern: First, USRPI's held by a partnership, trust, or estate are treated as owned proportionately by its partners or beneficiaries;[32] and, second, if a corporation owns fifty percent or more in value of all of the outstanding stock in another corporation (*i.e.*, a "controlling interest"), the "controlling" corporation is treated as holding a pro rata share of each of the assets of the other corporation.[33] If the stock owned in the other corporation is less than a controlling interest, then the value of the stock is taken into account, provided that the noncontrolling interest is in a domestic corporation that is a USRPHC or the stock is held for use in a trade or business.[34] The size of the interest can make a material difference when the other corporation has substantial liabilities, because liabilities are taken into account indirectly in valuing a noncontrolling interest, but are irrelevant in the case of a controlling interest.[35]

There are, however, exceptions to the relatively broad definition of a USRPI. First, shares of any class of stock regularly traded on an "established securities market" are treated as a USRPI only in the case of a person who at any time during the applicable measuring period held more than five percent of such class.[36] Thus, in many instances, portfolio investors in securities of U.S. corporations that are regularly traded need not be concerned with the tax imposed by the Act.

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[31] *See id.* § 897(c)(2).

[32] *See id.* § 897(c)(4)(B).

[33] *See id.* § 897(c)(5).

[34] *See id.* § 897(c)(2)(B).

[35] *See id.* It should be noted that the denominator for the fifty-percent test does not necessarily include a corporation's total assets. For example, a corporation's investments in mortgages or securities are not taken into account, unless the corporation is in the business of lending.

[36] *See id.* § 897(c)(3). In applying the percentage ownership test, however, § 897(c)(6)(C) provides that the attribution rules under § 318(a) will apply with "5 percent" substituted for "50 percent" at § 318(a)(2)(C) and (3)(C). *See id.* § 897(c)(6)(C). Presumably, the regulations will attempt to restrict the term "established securities market" to markets established within the United States and to markets established elsewhere that meet similar standards.

Second, an interest in a corporation is not a USRPI if two conditions are satisfied: First, the corporation must hold no USRPI's on the date of disposition of the interest in that corporation; and second, all of the USRPI's held by the corporation during the previous five years must have been disposed of in transactions in which the full amount of gain was recognized.[37] Unless the regulations adopt some type of *de minimus* rule, this exception may have limited application because of the broad definition of USRPI. For example, assume that a corporation disposes of all its appreciated USRPI's in transactions giving rise to gain recognition. The corporation will not qualify for the exception if it thereafter leases office space, because the leasehold will qualify as a USRPI.

The impracticality of the second exception highlights a problem built into the definition of a USRPI. The test for determining whether an interest in a domestic corporation constitutes a USRPI is whether at any time during the previous five years it was a USRPHC.[38] Moreover, a corporation is a USRPHC if at any time fifty percent or more of its real estate and operating assets consist of USRPI's.[39] These rules may subject foreign investors in U.S. corporations to tax on gain that is not attributable to appreciation of U.S. realty. On the other hand, appreciation in U.S. realty may be sheltered because operating assets held directly or indirectly by the corporation may prevent the corporation from being classified as a USRPHC. For example, suppose that a newly formed domestic corporation acquired a small factory on January 1, 1981, and began manufacturing operations on the same day. Since on January 1, 1981, the factory was U.S. realty and comprised fifty percent or more of the corporation's assets, the corporation qualifies as a USRPHC. As a result, if the corporation's foreign shareholders sell its shares within the five-year period, they will be subject to U.S. taxation on the entire gain, even if the factory had not increased in value and the entire gain was attributable to assets other than realty. Thus, one should consider carefully whether real estate should be held by the same corporation that holds manufacturing or other types of assets.

The statute presumes that every domestic corporation is a

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[37] *See id.* § 897(c)(1)(B).
[38] *See* note 30 *supra* and accompanying text.
[39] *See* note 31 *supra* and accompanying text.

USRPHC unless the taxpayer establishes, in a manner to be prescribed by regulation, that the corporation's ownership of USRPI's did not meet the fifty-percent test. This presumption is particularly troublesome in light of the literal requirement that the fifty-percent test be applied on a daily basis.[40] While in many cases it should be clear whether the test is met, there likely will be many cases raising valuation issues, and it is unclear whether the domestic corporation will have the burden of obtaining daily appraisals. One can only hope that the regulations will adopt a more reasonable approach, perhaps creating a presumption that a corporation not meeting the test on the last day of its year did not meet the test any day of the year. In addition, special rules could be provided in the case of acquisitions or dispositions during the year.

Three special rules are provided for real estate investment trusts (REIT's).[41] Like the case of a mutual fund, the distributed income of an REIT is taxed to the shareholders rather than to the REIT. To the extent that this distributed income consists of gains from the sale or exchange of USRPI's, the distributed income will retain, under the Act, such character in the hands of foreign shareholders.[42] With respect to sales of interests in an REIT, the Act distinquishes between those REIT's that are "domestically controlled"[43] and those that are not. The former are specifically excluded from the definition of USRPI's;[44] the latter are subject to the general rules described above. Thus, a foreign shareholder will be subject to tax liability on the sale of his shares in an REIT if and only if the REIT is domestically controlled. On the other hand, the rules are reversed in the case of a distribution in kind of a USRPI. If the REIT making the distribution is domestically controlled, the REIT will recognize gain on the distribution of a USRPI to the extent of the "foreign ownership percentage." An

[40] *See id.*

[41] Whether or not incorporated, an REIT by definition is considered a domestic corporation for tax purposes. *See* I.R.C. § 856.

[42] *See id.* § 897 (h)(1). Under this section, any distribution by an REIT to a nonresident alien individual or a foreign corporation is treated, to the extent attributable to gain from the sale or exchange of a USRPI by the REIT, as gain recognized by such nonresident alien individual or foreign corporation from the sale or exchange of a USRPI. *See id.*

[43] A "domestically-controlled REIT" is a real estate investment trust in which less than 50% in value of its stock is held directly or indirectly by foreign persons during the "testing period." *See* I.R.C. § 897(h)(4)(A)-(B).

[44] *See id.* § 897(h)(2).

REIT that is not domestically controlled is not subject to this rule.[45] The basis for the difference in treatment presumably is that, in the latter case, gains derived by foreigners from the sale of the shares of a non-domestically-controlled REIT that constitute USRPI's will be taxable under section 897, while, in the former case, they will not. Indeed, in the case of liquidating distributions, this dichotomy may produce rough justice. It is less clear why this is necessary in the case of nonliquidating distributions, given the new basis rules contained in section 897(f).[46]

C. *USRPI's Held by Foreign Corporations*

Under prior law, it was often possible to avoid U.S. tax liability on gain attributable to U.S. realty by selling shares of a corporation owning the realty.[47] This device is no longer useful with regard to U.S. corporations, because the definition of a USRPI includes the shares of a domestic corporation that qualifies as a USRPHC.[48] However, gains from the sale or exchange of stock of foreign corporations are not subject to U.S. tax under the Act, even if the foreign corporation's assets were wholly U.S. real property.

To deter the use of foreign corporations for tax avoidance purposes in this context, section 897 alters the application of subchapter C to foreign corporations. While under existing law a corporation generally is not required to recognize gain or loss on the distribution of appreciated property either as an ordinary distribution,[49] or in liquidation,[50] section 897 modifies these provisions with respect to foreign corporations that distribute USRPI's. Sec-

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[45] *See id.* § 897(h)(3). Section 897(h)(3) provides that the rules of § 897(d) apply to the "foreign ownership percentage" of any gain. Section 897(d) provides that foreign corporations are taxed on the distribution of appreciated USRPI's. *See id.* § 897(d); note 51 *infra* and accompanying text. The "foreign ownership percentage" is that percentage of the stock of the REIT that was held directly or indirectly by foreign persons at the time during the testing period when the ownership of stock by foreign persons was greatest. *See* I.R.C. § 897(h)(4)(C).

[46] *See id.* § 897(f). In general, § 897(f) provides that if a domestic corporation makes a nonliquidating distribution of a USRPI to a nonresident alien individual or a foreign corporation, the distributee takes a basis that does not exceed the basis of the distributor in such property, increased by any gain recognized by the distributing corporation and by any tax paid by the distributee in connection with such distribution. *See id.*

[47] *See* notes 12-18 *supra* and accompanying text.

[48] *See* I.R.C. § 897(c)(1)(A)(ii).

[49] *See id.* § 311.

[50] *See id.* § 336.

tion 897(d)(1)(A) specifically requires that foreign corporations recognize gain on the distribution of a USRPI regardless of the character of the distribution.[51] This provision does not apply, however, where the distributee takes a carryover basis in the USRPI distributed.[52] Losses are not recognized, and it appears that a loss on one asset may not be used to offset gain on another.[53] Thus, a stockholder of a foreign corporation can obtain a step-up in the basis of the underlying assets on liquidation, but, under section 897(d), only at the cost of a corporate level tax to the extent of the gain attributable to its USRPI's. Finally, section 897(d)(2) makes section 337 inapplicable to the sale or exchange of USRPI's by a foreign corporation.[54]

D. *Special Election of Certain Foreign Corporations*

If a foreign corporation has a permanent establishment in the United States, and a treaty nondiscrimination article applies to prevent the United States from taxing such permanent establishment at a higher rate than a domestic corporation carrying on similar operations,[55] the foreign corporation may elect under section 897(i) to be treated as a domestic corporation for purposes of section 897.[56] As a result of the election, a foreign corporation may distribute or sell USRPI's without recognizing gain to the extent nonrecognition is permitted under Code provisions other than section 897.[57] Any foreign person disposing of shares of the electing foreign corporation, however, becomes subject to U.S. tax under section 897(a).[58]

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[51] *See id.* § 897(d)(1)(A). Treaty provisions barring a U.S. tax liability on dividend distributions to foreign persons, such as article XII of the U.S.-Netherlands Treaty, will not prevent the imposition of tax on the distributing corporation. *See* Convention with Respect to Taxes on Income, Apr. 29, 1948, United States-Netherlands, art. XII, 62 Stat. 1757, T.I.A.S. No. 1855, 2 TAX TREATIES (CCH) ¶ 5803 [hereinafter cited as United States-Netherlands Income Tax Treaty].

[52] *See* I.R.C. § 897(d)(1)(B).

[53] *See id.*

[54] *See id.* § 897(d)(2).

[55] *See, e.g.,* United States Treasury Model Income Tax Convention, art. 24(1), 1 TAX TREATIES (CCH) ¶ 153 (1977).

[56] *See* I.R.C. § 897(i). The election is revocable only with the consent of the Treasury. *See id.* § 897(i)(2).

[57] *See, e.g., id.* §§ 311, 336, 337, 351, 1031.

[58] *See id.* § 897(a)(1), (c)(1)(A)(ii).

Notwithstanding the potential tax liability under section 897(a), an election under section 897(i) may prove advantageous in several respects. First, if the foreign corporation is to be liquidated and the gains attributable to the USRPI's held by the foreign corporation exceed the gains attributable to the shares of the corporation, the election will result in tax liability only on the sale or exchange of the shares. Second, it is possible that an electing foreign corporation that holds highly appreciated USRPI's may not qualify as a USRPHC. For example, assets other than USRPI's in that corporation or in other controlled corporations may exceed fifty percent of the value of the corporation. Thus, sale of the shares of the corporation or its liquidation after an election would not be subject to tax under section 897(a). Absent the election, liquidation of the corporation would generate a corporate level tax on the gain attributable to the USRPI's of the corporation.[59] Third, if the foreign corporation is owned by one or more residents of countries that have treaties with the United States that exempt capital gains from U.S. tax, a section 897(i) election may insulate the gain from U.S. taxation until such treaty provisions are overridden by section 897.[60]

Although the statutory language appears to require such results, the election is "subject to such conditions as may be prescribed by the Secretary."[61] It is possible that conditions imposed by the regulations will negate some or all of the advantages noted above. For example, it is unlikely that the regulations will permit an election to be made after the shares of a foreign corporation have been sold, unless satisfactory arrangements are made for the payment of the tax which would have been due on the disposition had the election been in effect.[62]

E. Nonliquidating Distributions of USRPI's by Domestic Corporations

Under existing law, nonliquidating distributions in kind by a

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[59] Absent the election, a purchaser seeking a stepped-up basis for the assets of the foreign corporation would liquidate the corporation. Under § 897(d), however, the corporation would then be required to recognize gain. *See id.* § 897(d).

[60] *See* notes 115-16 *infra* and accompanying text.

[61] *See* I.R.C. § 897(i)(3).

[62] *See* H.R. Rep. No. 1479, *supra* note 26, at 188. Retroactive elections may be permitted in cases where transactions occurred prior to the date of the Act. *See id.*

corporation to a foreign taxpayer generally will be treated as a distribution in an amount equal to the fair market value of the property being distributed.[63] This rule has two effects: First, it increases the amount of the distribution that can be a dividend; and, second, it increases the distributee's cost basis in the property distributed to its fair market value. Thus, it is sometimes possible for a domestic corporation to distribute appreciated property to a foreign shareholder at relatively little tax cost (taking into account the rate of tax applicable to dividend distributions as may be reduced by tax conventions) and still give the distributee an increased basis for U.S. tax purposes.

The Act forecloses this tax planning device with respect to distributions of USRPI's by domestic corporations. Section 897(f) provides that a foreign distributee of a USRPI takes a basis in the property that shall not exceed the distributing domestic corporation's basis in the property, increased by any gain recognized by the distributing corporation on such distribution and by any U.S. tax paid by the distributee on such distribution.[64] Section 897(f) does not appear to change the rules under section 301(b) as to the amount of the distribution.

No similar rule applies to liquidating distributions of domestic corporations, presumably because foreign shareholders are subject to tax on any gain realized on the exchange of their shares under section 897(a). In some cases, however, an ordinary distribution in kind by a domestic distribution will have the same effect as a liquidating distribution. For example, if all or part of the distribution exceeds the earnings and profits of the corporation, the amount distributed in excess of the earnings and profits first reduces the distributee's basis in the shares of the domestic corporation and then is treated as gain from the disposition of property.[65] No similar rule applies to distributions from foreign corporations because a distribution by foreign corporations of USRPI's is taxable to the extent of the gain attributable to the USRPI's.[66] The following examples illustrate the operation of these principles.

First, assume that *D*, a domestic corporation, is wholly owned

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[63] *See* I.R.C. § 301(b)(1)(D). *See also* note 18 *supra*.
[64] *See* I.R.C. § 897(f).
[65] *See id.* § 301(c)(3)(A).
[66] *See id.* § 897(d)(1)(A). *See also* note 51 *supra* and accompanying text.

by *F*, a foreign corporation. *F* is resident in a country that does not have a tax treaty with the United States. *D* owns several appreciated parcels of real estate and is a USRPHC. *D*'s shares thus are USRPI's. *F*'s basis in the shares of *D* is $1,000. *D* has no current or accumulated earnings and profits. *D* distributes parcel A with a basis of $2,000 and a fair market value of $11,000 to *D* on the date of distribution. *F* will realize a gain of $1,000, which is effectively connected with a U.S. trade or business, because the amount distributed of $2,000, which is the adjusted basis to *D* of parcel A, exceeds *F*'s basis in *D* by $1,000. Assuming *D* is not a collapsible corporation,[67] *F* will pay a tax of $280. *F*'s basis in parcel A will be $2,280, which is the sum of *D*'s basis in the property plus the taxes paid by *F* with respect to the distribution. Were *F* to later sell parcel A while it was worth $11,000, it would incur a taxable gain of $8,720.

If *D* were a foreign corporation, it would have incurred a $2,520 tax liability (*i.e.*, 28% of $9,000) on the first distribution, but *F* probably would have obtained a fair market value basis of $11,000 in the distributed property under section 301(d)(4). Thus, *F* would not incur a second tax on the same gain on a subsequent sale. Further, if *D* were a foreign corporation, it might be able to use its other operations to shelter part of the gain without affecting the step-up in basis to *F*.

As a second example, assume that *D* had earnings and profits of $11,000 and that, apart from the Act, the dividend of parcel A would not be income which is effectively connected with the conduct of a U.S. trade or business by *F*. In such circumstances, the amount of *F*'s dividend would be $11,000 under section 301(b)(1)(D). Prior to the enactment of the Act, *F*'s basis in parcel A would have been equal to the amount distributed under section 301(d)(3) or $11,000.

Section 897 does not alter the characterization of *F*'s dividend, as non-effectively-connected dividend income. Section 897(f), however, does provide that F's basis in parcel A would not exceed *D*'s basis in parcel A ($2,000) plus the amount of any tax paid by *F* on the distribution. If we assume *F* paid a $3,300 tax, computed at a thirty percent rate under section 881(a), *F*'s basis in parcel A would be $5,300 and a subsequent sale by *F* of parcel A, at a time

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[67] *See* I.R.C. § 341.

it is worth $11,000, would yield a gain of $5,700, which would subject *F* to tax under section 897. It should be noted that the upward adjustment in *F*'s basis for parcel A depends on whether it pays a tax on the dividend it receives. Thus, a reduced rate of tax applicable in the case of certain tax treaties would have the effect of diminishing *F*'s basis in parcel A.

As a final example, assume that *D* had earnings and profits of $6,000. In that case, *F* would receive a dividend of $6,000 and thus would incur a tax liability of $1,800 at the thirty percent rate, a return of basis of $1,000, and on the assumption that a pro rata portion of *D*'s adjusted basis in parcel A is used up by virtue of the dividend portion of the distribution, *F* would have no gain subject to tax under the Act as effectively connected income. *F*'s basis in parcel A would appear to be $3,800, calculated as follows:

(a) Portion of basis to *D* of parcel A allocable to dividend 6,000/11,000 x 2,000	$ 1,091.08
(b) Balance of D's basis in parcel A	908.92
(c) Total	$ 2,000.00
(d) Amount of nondividend distribution under § 301(b)(1)(D)	$ 908.92
(e) Basis of *F* in *D* shares	1,000.00
(f) Gain on distribution	-0-
(g) Tax on dividend, 30% x 6,000	$ 1,800.00
(h) Basis of parcel A to *F* ((c)+(g))	$ 3,800.00

If however, no portion of *D*'s adjusted basis in parcel A is allocated to the dividend portion of the distribution, then *F* would appear to have a gain of $1,000, subject to section 897(a), in addition to the dividend of $6,000. In such a case, *F*'s basis in parcel A would be increased by the tax paid on the gain. While the proper method of allocation is an issue that may arise in situations not covered by the Act, and probably should be dealt with by regulation under section 301, the Act increases the opportunity for the issue to surface.

In order to achieve tax results similar to the situation where *D* is a foreign corporation, *F* would have to liquidate *D*. Such a step, however, would increase the gain realized by *F* on the liquidation if other assets in *D* were distributed in the liquidation. To avoid this result, each parcel of U.S. realty could be kept in separate subsidiaries with no common U.S. parent. The use of such a device, how-

ever, would preclude filing consolidated returns for U.S. tax purposes.[68] It also would not solve the problem for existing arrangements. In any event, whether gain on the liquidation of a wholly-owned U.S. subsidiary by a foreign corporation would be recognized would depend on the application of sections 367(a)[69] and 897(e).[70]

F. USRPI's Held by Partnerships, Trusts, and Estates

Under section 897(g), the amount of money and the fair market value of property received by a foreign person in exchange for all or part of its interest in a partnership, trust, or estate is treated as an amount received from the sale or exchange in the United States of USRPI's held by the partnership, trust, or estate.[71] The interplay between the rules and existing law is not always clear.

1. Partnership Distributions of USRPI's

The Act does not provide specific rules for the treatment of gain or loss realized by a partnership on the sale or exchange of a USRPI. Under existing law, if a partnership sells or exchanges a USRPI and realizes gain or loss, each partner is required to report separately his distributive share of such gain or loss.[72] Section 897 merely serves to characterize such gain or loss at the partnership level as effectively connected income in order to ensure that a foreign partner is subject to U.S. tax liability on his distributive

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[68] A group of corporations must have a common U.S. parent corporation to be able to file consolidated returns. *See id.* § 1504(a)(2), (b)(3).

[69] *Id.* § 367(a). Section 367(a) provides that certain nonrecognition provisions do not apply to certain transactions between U.S. and foreign corporations absent a ruling by the Secretary that concludes that one of the principal purposes of the transaction is not tax avoidance. In this regard, interesting questions arise as to how the Treasury will apply the ruling policy under § 367(a) where the property transferred is a USRPI. If only USRPI's are being transferred, and if there is a carryover basis under § 334(b)(1), there is arguably more justification for a favorable ruling. *See id.* § 897(e); note 92 *infra* and accompanying text.

[70] I.R.C. § 897(e). Section 897(e)(1) provides that nonrecognition provisions will continue to apply only in the case of a transfer of a USRPI for an interest the sale of which would be subject to tax.

[71] *See id.* § 897(g).

[72] *See id.* § 702(a). Section 702(a) provides that each partner will take into account separately his distributive share of the partnership's gain or loss from the sale of capital assets. *See id.*

share.[73]

A partnership distribution of property other than money to a partner is not generally a taxable event to the partnership or the partner.[74] In the case of a nonliquidating distribution, a partner takes a basis in the distributed property equal to the partnership's basis in the property.[75] In the case of a liquidating distribution, a partner takes a basis in the distributed property equal to the partner's basis in his partnership interest.[76]

Section 897(g) does not immediately alter these rules.[77] The Act also authorizes the issuance of regulations to determine the extent to which changes in interests in, or distribution from, a partnership are to be treated as sale of property at fair market value.[78] If a partnership holding USRPI's makes a non-pro rata distribution to a foreign partner of money or property other than a USRPI, it is possible that the regulations will treat USRPI's as a separate category of assets analogous to the treatment of unrealized receivables and substantially appreciated inventory items under section 751.[79] If the section 751 analogue is pursued, the regulations may treat the distribution as if the foreign partner received his prorata share of the USRPI's and then exchanged the USRPI's for the portion of the money or property that he actually received.

It may be necessary to broaden the regulations to cover situations where a partnership has only U.S. corporations as its members. An interest of a foreign taxpayer in a U.S. corporation is a USRPI if, at any time during the measuring period, the U.S. corporation was a USRPHC.[80] In determining whether a domestic corporation is a USRPHC, consideration is given to the portion of the assets of the corporation that are USRPI's.[81] Because assets held by a partnership are treated as being held proportionately by its members, a non-pro rata distribution from a partnership may sufficiently alter the composition of the assets of its domestic corpo-

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[73] *See id.* § 897(a)(1).
[74] *See id.* § 732(a).
[75] *See id.*
[76] *See id.* § 732(b).
[77] *See* note 71 *supra* and accompanying text.
[78] *See* I.R.C. § 897(g).
[79] *Id.* § 751.
[80] *See id.* § 897(c)(2).
[81] *See id.*

rate partners to affect their status as USRPHC's. On the other hand, it is possible for the regulations to adopt a less complicated approach. For example, a domestic corporation would remain a USRPI if it was a USRPHC at any time within a five-year period immediately preceding the date of the disposition of the interest.[82] Given the broad spectrum of transactions that section 897 specifically affects, the five-year waiting period may be a sufficient deterrent to manipulation to avoid further complication through expansion of the scope of the present section 751(b).

2. *Trust Distributions*

Foreign trusts and estates generally are treated in the same manner as nonresident aliens for purposes of U.S. income taxation.[83] Under regulations to be promulgated, such entities probably will be subject to U.S. tax on any gain realized from the sale of a USRPI to the same extent that a domestic trust or estate would be subject to tax. Thus, a current distribution of such gain would entitle the trust or estate to a deduction equal to the gain so that no tax would be imposed on the trust or estate on such gain.[84] The beneficiary receiving the current distribution, however, is subject to U.S. tax on the gain as if such beneficiary had received the income directly.[85]

Non-grantor trusts that are not required to distribute gains currently, and that in fact do not do so, are subject to tax on the gain. When the income is distributed, it is taxed to the beneficiary pursuant to complicated "throwback" rules:[86] Under these rules, an "accumulation distribution"[87] by a foreign trust to a nonresident alien or a foreign corporation attributable to long-term capital gain on a USRPI retains its character as such, but a similar accumulation distribution to a U.S. person does not.[88] Thus, U.S. benefi-

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[82] *See id.*

[83] *See* B. W. Jones Trust v. Commissioner, 46 B.T.A. 531, 535 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943); Rev. Rul. 60-181, 1960-1 C.B. 257.

[84] *See* I.R.C. §§ 643(a)(3), 651(a), 661(a).

[85] *See id.* §§ 652(a), 662(a).

[86] *See id.* §§ 665-668. *See generally* Batt, *Taxation of Trust Distributions in Excess of Current Income—The "Throwback Rule"*, 27 N.Y.U. INST. TAX. 265 (1969).

[87] *See* I.R.C. § 665(b).

[88] *See id.* §§ 643(a)(6)(C), 667(e). While the Act did not introduce these rules, it increases the opportunities for their application.

ciaries of foreign trusts may have a greater tax burden on accumulation distributions than foreign beneficiaries of foreign trusts with respect to USRPI gains realized by the trust. Because capital gains generally are excluded from the "distributable net income" of domestic trusts,[89] an accumulation distribution in excess of "undistributed net income"[90] made by a domestic trust with capital gains in a prior year will not result in U.S. taxation of either U.S. or foreign beneficiaries. An accumulation distribution, however, will result in U.S. taxation to the extent of undistributed net income.[91]

G. *Effect of the Act on Certain Nonrecognition of Gain Rules*

To ensure that USRPI's are not exchanged tax-free for assets that are not subject to taxation under the Act, section 897(e)(1),[92] pending the issuance of regulations,[93] provides that nonrecognition rules apply for purposes of section 897 only in the case of an exchange of a USRPI for an interest the sale of which would be subject to tax under the Code as modified by tax treaty.[94] A number of issues arise with respect to the application of the general rule provided by section 897(e)(1). First, gain from the sale or exchange of property other than USRPI's usually is not taxable to foreign taxpayers under sections 871 and 882.[95] For example, assume that in a section 351 exchange,[96] a domestic corporation that is a USRPHC issues debt securities, in addition to shares, in exchange for a USRPI and that the ownership of such securities represents an interest in the issuing corporation solely as a creditor. It is unclear how section 897(e)(1) would apply if the USRPI were exchanged partially for an interest the sale of which would be subject to taxation under the Code, and partially for an interest the sale of

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[89] *See id.* § 643(a)(3).

[90] *See id.* § 665(a).

[91] *See id.* §§ 666-667.

[92] *Id.* § 897(e)(1).

[93] *See id.* § 897(e)(2).

[94] *See id.* § 897(e)(1). The Conference Report provides that for purposes of § 897(e)(1) any treaty modifications of the Code under §§ 894 and 7852(d) are taken into account. *See* H.R. Rep. No. 1479, *supra* note 26, at 188-89.

[95] *See* note 11 *supra* and accompanying text.

[96] I.R.C. § 351(a). This section provides nonrecognition treatment to persons who exchange property for the stock or securities of a corporation, provided that the persons transferring the property are in control of the corporation immediately after the exchange. *See id.* § 351(a).

which would not be subject to taxation. Analogous problems arise in the formation of a partnership where one partner contributes USRPI's and another partner contributes cash or other property, with both partners receiving partnership interests in exchange.[97] would appear to be overridden by section 897(e)(1). In these cases, the regulations possibly will seek to tax only the portion of the gain represented by the property other than USRPI's that has been received, effectively treating such other property as "boot."

Second, the most obvious application of section 897(e)(1) to exchanges involving domestic corporations will be to those exchanges of USRPI's where the property received consists of shares of a U.S. corporation that is either (1) a non-USRPHC on the date of the exchange,[98] (2) a publicly traded corporation, with respect to which, taking into account the shares received on the exchange, the transferor owns less than five percent in value of a class of shares regularly traded on an established market,[99] or (3) a domestically controlled REIT.[100]

Third, where gain to a foreign taxpayer on the disposition of property received in exchange for a USRPI would not be taxed by the United States due to treaty exemptions,[101] gain would be recognized under section 897(e)(1), even if it was intended that the shares not be disposed of until after December 31, 1984. On this date, the provisions of section 897 override any conflicting treaty exemptions and thus subject these interests to U.S. taxation.[102] This problem could be alleviated if the determination of whether the property received in the exchange is subject to U.S. taxation could be made in light of the facts and circumstances at the time of the exchange, or if the transferor entered into a closing agreement pursuant to which any disposition of the shares of the USRPHC before December 31, 1984 would be taxable in the United States.

Fourth, where a foreign taxpayer makes a like-kind exchange of

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[97] *Id.* § 721(a). Section 721(a) provides that no gain or loss will be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. *See id.*

[98] *See* note 28 *supra* and accompanying text.

[99] *See* note 36 *supra* and accompanying text.

[100] *See* notes 43-46 *supra* and accompanying text.

[101] *See* note 94 *supra*.

[102] *See* note 115 *infra* and accompanying text.

a USRPI for real estate located abroad, section 897(e)(1) would preclude nonrecognition treatment under section 1031,[103] because foreign taxpayers normally are not subject to U.S. tax on the disposition of real estate located abroad. If a U.S. corporation, however, exchanged U.S. real estate for foreign real estate or for shares in a U.S. corporation that was not a USRPHC, the exchange would not be affected by section 897(e)(1), and, therefore, any applicable nonrecognition provision would continue to apply. In this situation, a foreign shareholder of the U.S. corporation could sell his shares without incurring a U.S. tax liability when the U.S. corporation ceases to be a USRPHC.[104] The U.S. corporation, alternatively, could distribute the acquired shares or the foreign real estate pursuant to section 301 and avoid the section 897(f) basis rules.[105]

Fifth, it is unclear whether the draftsmen of section 897(e)(1) contemplated situations where, because of otherwise applicable nonrecogniton provisions, the transferee of the USRPI would have taken a carryover basis under section 362(a)[106] and thus would be subject to U.S. tax on the existing appreciation attributable to the USRPI on its subsequent disposition had section 897(e)(1) not required immediate recognition of gain. For example, if a foreign taxpayer contributes a USRPI to a domestic corporation that is not a USRPHC in exchange for stock in that corporation in a transaction otherwise qualifying for nonrecognition treatment under section 351, section 897(e)(1) requires the foreign taxpayer to recognize gain on the exchange. It appears to be irrelevant for purposes of section 897(e)(1) that the corporate transferee would obtain a carryover basis in the USRPI if gain was not recognized on the contribution.

H. Related Party Transactions

A two-step rule is provided for transactions in USRPI's occur-

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[103] I.R.C. § 1031. Section 1031 provides nonrecognition treatment for exchanges of "like-kind" property. *See id.*

[104] *See id.* §§ 861(a)(5), 871(a)(1), 882(a).

[105] *See* notes 64-66 *supra* and accompanying text.

[106] I.R.C. § 362(a). Section 362(a) provides that a corporation's basis in property received pursuant to § 351 or pursuant to a capital contribution will be the same as the basis of the property in the hands of the transferor.

ring between related parties after December 31, 1979.[107] A related-party transaction is defined as a disposition of a USRPI to a related person as defined in section 453(f)(1).[108] Under section 453(f)(1), a related person is any person whose stock would be attributed under section 318(a)[109] to the person first disposing of the property.[110] If the transaction is between related parties, the basis of the USRPI in the hands of the related transferee is reduced to the extent that gain was not taxed to the seller under the provisions relating to the taxation of effectively connected income, because either (1) the disposition occurred before June 19, 1980, or (2) the gain was exempt from tax under applicable treaty provisions.[111]

The obvious purpose of this provision is to prevent the avoidance of section 897 otherwise possible because of the step-up in basis that would result if a taxpayer transferred USRPI's to a related party in a transaction in which realized gain was recognized but was not subject to tax. Unfortunately, in some cases, the language used literally will require downward adjustments in basis that could not have been intended; in other cases, step-ups will continue to be permitted. For example, an otherwise tax-free reorganization[112] between related domestic corporations owned by non-U.S. persons that occurred between January 1 and June 18, 1980, might lead to surprising results where the consideration received consists of shares in a domestic corporation that was not a USRPHC. In this case, had the transaction occurred after June 18, 1980, the general nonrecognition of gain rules would be overridden by section 897(e)(1). Thus, any gain realized on the transaction would be "nontaxed gain," because the transaction occurred prior to June 19, 1980. As a consequence, the transferee's basis in the property transferred would require downward adjustment by the amount of the gain realized. In the case posited, the basis to the transferee absent this provision would be a carryover basis. If this

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[107] *See* Act, *supra* note 2, § 1125(d).

[108] I.R.C. § 453(f)(1). This section was recently enacted by the Installment Sales Revision Act of 1980, Pub. L. No. 96-471 § 2(a), 94 Stat. 2247 (1980).

[109] I.R.C. § 318.

[110] *See id.* § 453(f)(1).

[111] *See* Act, *supra* note 2, § 1125(d). Gain not taxed for either of these reasons is called "nontaxed gain" for the purpose of § 1125(d) of the Act. *See id.*

[112] *See* I.R.C. §§ 354, 355, 356, 358, 362, 368.

provision were applied literally, the transferee's basis would be reduced below the basis of the transferor. Thus, while it appears that the provision was intended merely to require a downward adjustment equal to a basis step-up where gain is recognized, the statutory language may not yield that result.

Similarly, under section 871(a)(2), a nonresident alien individual is taxable on capital gains from U.S. sources if he is present in the United States for 183 days or more during his taxable year. This section generally applies only if the capital gains are not effectively connected with a U.S. trade or business. If section 871(a)(2) were to apply to gain from a disposition made before June 19, 1980 to a related person, such gain also might be taxable under section 897. Thus, the same gain might be taxed twice.

On the other hand, situations may arise where the adjustment to basis will not be made at all, even though there has been a step-up in basis. For example, assume a U.S. corporation is owned entirely by a foreign resident who is entitled to a treaty exemption from U.S. tax liability on gain from the sale or exchange of capital assets. If the U.S. corporation were to be liquidated, the shareholder apparently would obtain a basis for the assets distributed equal to the fair market value, even though the shareholder's gain on liquidation would be exempt from tax liability under a treaty.[113] This result seems required, because the relevant gain appears to be the appreciation in value of the assets distributed, which goes untaxed to the distributing corporation by reason of section 336[114] and not by reason of a treaty, so that there would be no "nontaxed gain." While the shareholder's gain on his stock would be "nontaxed gain" so that section 1125(d) of the Act would adjust the basis of these shares in the hands of the liquidating corporation, such adjustment would not have any significance because the shares would be retired after the liquidation. It is conceivable that, notwithstanding this literal application of the statute, the Service might consider applying the provision more broadly by adjusting the basis of the USRPI's transferred to the shareholder in liquidation. If,

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[113] The proceeds of liquidation are not taxed under §§ 871(b)(1) and 882(a) because such proceeds normally are characterized as gain from the exchange of capital assets under § 331. *See id.* § 331. U.S. source capital gains generally are not taxed to foreign taxpayers. *See* note 12 *supra*.

[114] *See* I.R.C. § 336.

however, the provision is applied, in this manner new problems may arise. For example, if a domestic corporation that qualifies as a USRPHC makes a section 301 distribution of U.S. realty and the basis adjustment under section 1125(d) of the Act applies, it is not clear how such an adjustment would affect the new basis rules under section 897(f).

III. Treaty Override

The Act will override conflicting treaty provisions after December 31, 1984.[115] If an existing treaty is renegotiated and signed before 1985, but is not ratified until after December 31, 1984, the existing treaty may continue to apply for up to two additional years, depending on the provisions of the renegotiated treaty or accompanying exchanges of notes.[116] The United States presently is a party to several treaties that provide an exemption from U.S. tax liability on gain derived from a sale or exchange of a capital asset if the gain is not attributable to a U.S. permanent establishment.[117] The exemption generally does not extend to real property located in the United States.[118] This limitation, however, normally does not negate the application of an otherwise applicable capital-gain treaty exemption. If such a provision exists, it would exempt a

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[115] *See* Act, *supra* note 2, § 1125(c).

[116] *See id.* § 1125(c)(2). Indeed, the proposed Canadian Treaty was negotiated in anticipation of the new rules under § 897. *See* Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, United States-Canada, art. XIII, 1 Tax Treaties (CCH) ¶ 1301 (unratified).

[117] *See, e.g.*, Convention for the Avoidance of Double Taxation, July 9, 1970, United States-Belgium, art. XIII, 23 U.S.T. 2764, T.I.A.S. No. 7463, 1 Tax Treaties (CCH) ¶ 587 [hereinafter cited as United States-Belgium Income Tax Treaty]; Convention with Respect to Taxes on Income and Property, July 28, 1968, United States-France, art. XII, 19 U.S.T. 5280, T.I.A.S. No. 6518, 1 Tax Treaties (CCH) 2803 [hereinafter cited as United States—France Income Tax Treaty]; Convention for the Avoidance of Double Taxation, July 22, 1954, United States-Germany, art. IXA, 5 U.S.T. 2768, T.I.A.S. No. 3133, 1 Tax Treaties (CCH) ¶ 3033; United States-Netherlands Income Tax Treaty, *supra* note 51, art. XI; Income Tax Convention, Mar. 4, 1942, United States-Canada, art. VIII, 56 Stat. 1399, T.S. No. 983, 1 Tax Treaties (CCH) ¶ 1203 [hereinafter cited as United States-Canada Income Tax Treaty]. Certain U.S. treaties contain no such exemption. *See, e.g.*, Convention for the Avoidance of Double Taxation, Dec. 31, 1975, United States-United Kingdom, art. 8, _ U.S.T. _, T.I.A.S. No. 9682, 2 Tax Treaties (CCH) ¶ 8103A [hereinafter cited as United States-United Kingdom Income Tax Treaty].

[118] *But cf.* United States-Canada Income Tax Treaty, *supra* note 117, art. VIII (capital gains from sale of real property exempt from U.S. taxation).

disposition of a USRPI by a foreign taxpayer.[119]

Current treaties also generally provide an exemption from U.S. tax liability on "industrial and commercial profits" not attributable to a U.S. permanent establishment.[120] Under certain U.S. treaties, the term "industrial and commercial profits" does not include income from real estate or gains derived from the disposition of real estate.[121] In other treaties, this exclusion is limited to cases in which the income is not attributable to a U.S. permanent establishment.[122] Finally, certain U.S. treaties which deal specifically with income and gains attributable to real property are silent on the issue of whether such income may constitue business profits.[123]

Gains derived from the disposition of shares in a USRPHC that is a USRPI may fall within a capital-gains or a business-profits treaty provision, or may not fit squarely within any provision of the relevant treaty. Determining the applicable treaty provision becomes even more difficult where there is a disposition of shares in a collapsible corporation.[124] A "strict constructionist" may argue that "capital asset" means property other than certain specific types of property enumerated in section 1221.[125] While shares held for sale in the ordinary course of business are not capital assets under section 1221, there is no similar exception for shares in a collapsible corporation.[126] It therefore has been suggested[127] that

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[119] *See* H.R. Rep. No. 1479, *supra* note 26, at 186.

[120] *See, e.g.*, United States-Belgium Income Tax Treaty, *supra* note 117, art. VII; United States-France Income Tax Treaty, *supra* note 117, art. VI; United States-Netherlands Income Tax Treaty, *supra* note 51, art. III; United States-United Kingdom Income Tax Treaty, *supra* note 117, art. 7.

[121] *See, e.g.*, United States-Netherlands Income Tax Treaty, *supra* note 51, art. III(5); United States-Belgium Income Tax Treaty, *supra* note 117, art. VI(5)(b).

[122] *See, e.g.*, United States-France Income Tax Treaty, *supra* note 117, art. VI(6); United States-United Kingdom Income Tax Treaty, *supra* note 117, art. 7(7).

[123] *See, e.g.*, Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, May 24, 1951, United States-Switzerland, art. II(1)(h), 2 U.S.T. 1751, T.I.A.S. No. 2316, 2 Tax Treaties (CCH) ¶ 7404; United States-Netherlands Income Tax Treaty, *supra* note 51, art. III, *extended*, Extention to Netherlands Antilles of Operation of Convention of Apr. 29, 1948, June 24-Nov. 10, 1955, United States-Netherlands, 6 U.S.T. 3703, T.I.A.S. No. 3367, 2 Tax Treaties (CCH) ¶ 5832A.

[124] *See* I.R.C. § 341. *See generally* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.01 (1979).

[125] I.R.C. § 1221. This section defines the term "capital asset" by exclusion. *See id.*

[126] *See id.*

[127] *See* B. Bittker & J. Eustice, *supra* note 124, ¶ 17.07, at 17-17 n.44.

Issues analogous to those raised by capital gains exemptions in tax conventions occur with

the disposition of the shares in a collapsible corporation is a "sale of a capital asset." Under this approach, a capital gains exemption under a relevant convention would apply to gains on the disposition of shares in a collapsible corporation. This approach, however, would be at odds with U.S. internal law treatment,[128] in general,[129] and with the Service's rulings.[130] These rulings hold that amounts "treated as" capital gains under section 402 will qualify for the capital gains exemption afforded under the existing Canadian treaty.[131] The implication of these rulings is that it is the domestic tax treatment as capital gains or as ordinary income that will control the application of the capital gains treaty provisions. On the other hand, it may be possible to argue that these rulings merely confer a benefit where, under domestic law, there is capital gains treatment and that they do not intend to restrict the application of the treaty where applicable by its terms.

In an appropriate case, consideration might also be given to the argument that, while a collapsible gain is not a capital gain, it should be included in the term business profits and exempt under an applicable treaty business-profits provision.[132] Under this inter-

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respect to the application of § 864(c)(3) to gains from the sale of shares in collapsible corporations. The legislative history of § 864(c)(3) states that gains from the sale of "capital assets" are not included in the provision. *See* H.R. REP. No. 1450, 89th Cong., 2d Sess. 61 (1966). Thus, § 341 gain arguably would not be within § 864(c)(3), even though such gain is ordinary, because the underlying stock is a capital asset.

[128] Under certain provisions of the Code, gains derived from the sale or exchange of property that is not a capital asset are "considered as gains" from the sale of a capital asset. For example, under § 1231, the gain recognized on the sale or exchange of depreciable property is treated as gain from the sale or exchange of a capital asset. *See* I.R.C. § 1231. On the other hand, certain Code provisions provide that the gains derived from the sale or exchange of capital assets will be taxed as ordinary income. Thus, gain from the sale of shares held for more than one year in a collapsible corporation is treated as ordinary income under § 341. *See id.* § 341. The issue then is whether capital gains treaty provisions are to be interpreted as being applicable only to gains that are considered capital gains under the Code or whether the provisions apply with respect to the gain derived from the alienation of shares otherwise meeting the test of a capital asset regardless of whether such gain receives capital gains treatment under U.S. internal law.

[129] *See id.* § 1231.

[130] *See, e.g.,* Rev. Rul. 58-247, 1958-1 C.B. 623; Rev. Rul. 58-248, 1958-1 C.B. 621.

[131] *See generally* S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS ¶ IX/15D, at IX-255 (1966).

[132] In some cases there will be further problems with this approach. Consider Article III of the Netherlands Treaty. Under Article III(5) of that treaty, industrial and commercial profits are defined as "income derived from the active conduct of a trade or business," other than certain specific types of income dealt with elsewhere in the treaty, including capital

pretation, all income of an enterprise not dealt with separately qualifies automatically as business profits. Certain income, however, could fall between the cracks because it is not covered by any treaty provision. Under the U.K. treaty, income not dealt with would result in an exemption.[133]

Given the different possible results depending on the applicable treaty provision, it is difficult to speculate how the Service will approach the issue, especially because it appears possible for a court to reach either conclusion. While this problem suggests interesting questions of interpretation, given the rules for related party transactions and that all treaty exemptions on gain otherwise subject to the tax under the Act will be overidden by December 31, 1984 (or possibly by up to two additional years thereafter), it is probable that the issue will arise less frequently than otherwise might be expected.

IV. Reporting Requirements and Enforcement Procedures

The Act does not provide any withholding requirements, primarily because there was not enough time to consider a comprehensive mechanism for withholding tax that would not unduly disrupt the U.S. real estate market.[134] This omission does not mean, how-

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gains. *See* United States-Netherlands Income Tax Treaty, *supra* note 51, art. III (5). The quoted language was inserted in 1967. *See* Supplementary Convention Modifying Convention of Apr. 29, 1948, Dec. 30, 1965, art. II, United States-Netherlands, 17 U.S.T. 896, T.I.A.S. No. 6051, 2 Tax Treaties (CCH) ¶ 5856C. The treaty did not contain a definition of industrial and commercial profits prior to that time, but the regulations promulgated thereunder did. *See* Treas. Reg. § 505.104(d), T.D. 5778, 1950-1 C.B. 92 (promulgated as Treas. Reg. § 7.853(d)). That definition did not contain any mention of the "active conduct" requirement, and no mention is made in the legislative history of the 1967 treaty that a change was intended. Thus, while it is arguable that the active conduct phraseology merely reflects the truism that all income of an industrial or commercial enterprise would be derived from the active conduct of such business (except perhaps income dealt with under the separate provisions), a contrary argument can be made that the phrase "active conduct" is a limitation. *See* United States-Netherlands Tax Treaty, *supra* note 51, art. III(5).

[133] Under the U.K. treaty, if a collapsible gain were not a capital gain, it would be exempt either because it was business profits or income not dealt with. If such gain were treated as capital gain, however, the gain would obtain no exemption under the treaty. *See* United States-United Kingdom Income Tax Treaty, *supra* note 117, art. 22. *See also* Income Tax Treaty, Feb. 18, 1981, United States-British Virgin Islands, art. 21, _ U.S.T. _, T.I.A.S. No. _, 1 Tax Treaties (CCH) ¶ 1003 (unratified). *Cf.* United States-Canada Income Tax Treaty, *supra* note 116, arts. XIII, XXII (capital gains of Canadian taxpayer generally exempt from U.S. taxation).

[134] *See* H.R. Rep. No. 1479, *supra* note 26, at 189-90.

ever, that additional pressure will not be exerted to include a withholding mechanism in future legislation, especially if a self-assessment approach in an international context yields an unsatisfactory level of compliance. The difficulty of enforcement probably was a factor in the decision not to impose tax liability on the sale of shares in a foreign corporation. Whether the level of compliance will be higher in the case of the sale of shares in a U.S. corporation remains to be seen. Nevertheless, it now appears that if withholding rules are adopted in the future, they will apply prospectively.[135] The tax imposed by the Act is "enforced" only through comprehensive reporting requirements.

Section 6039C imposes three separate annual reporting requirements.[136] First, every U.S. corporation that had at least one foreign person as a shareholder during a calendar year and that was a USRPHC at any time during such year or at any time during the preceding four calendar years, must file a return disclosing the name and address of each foreign person who was a shareholder at any time during the year, to the extent such information is "known by the corporation," and such information with respect to transfers of stock in the corporation to or from foreign persons during the year as may be prescribed by regulations.[137] Publicly traded corporations are exempt from this filing requirement.[138] If a nominee holds stock in a U.S. corporation for a foreign person and the foreign person has not supplied the U.S. corporation with the information described above, the nominee must file a return.[139]

Second, entities other than U.S. corporations that have a "substantial investor" in U.S. real property during the calendar year must file a return for the calendar year disclosing the name and address of each "substantial investor," and information with respect to the assets of the entity as the regulations may prescribe.[140] A "substantial investor" is defined as a foreign person whose pro rata share of USRPI's held by the entity had a fair market value exceeding $50,000.[141] If the reporting entity is a foreign corpora-

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[135] *Id.* at 190.
[136] *See* I.R.C. § 6039C.
[137] *See id.* § 6039C(a)(1).
[138] *See id.* § 6039C(a)(2).
[139] *See id.* § 6039C(a)(3).
[140] *See id.* § 6039C(b)(1).
[141] *See id.* § 6039C(b)(4)(B)(i).

tion, the term "substantial investor" includes both foreign and domestic persons.[142] Thus, the identity of both U.S. and foreign persons investing in the foreign corporation must be disclosed. For purposes of determining the amount of the foreign person's interest in USRPI's, if the entity is a "substantial investor" in a U.S. or foreign corporation, the entity's pro rata share of the corporation's USRPI's are taken into account. The inclusion is required whether or not the corporation was a USRPHC, and whether or not the entity's interest in the corporation was a "controlling interest."[143] The reporting entities are required to furnish each of their "substantial investors" with annual statements reflecting the investor's share of USRPI's held directly or indirectly by the entity.[144] Under this provision, reporting generally is required of substantial investors regardless of the degree of attenuation of ownership.

A highly unusual provision makes this second reporting requirement inapplicable if security is furnished to the Service "to ensure that any tax imposed by chapter 1 . . . with respect to United States real property interests held by such entity will be paid."[145] It is unclear what kind of security the Service will consider adequate.[146] This provision may enable the identity of a nonresident alien shareholder in a foreign corporate parent of a foreign corporate owner of a USRPI to remain undisclosed because there would be no tax to secure. It is unlikely that the regulations will allow such an interpretation.

Third, any foreign taxpayer who held USRPI's having a fair market value exceeding $50,000 at any time during the calendar year, and who was not engaged in trade or business in the United States at any time during such year, must file an annual informa-

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[142] *See id.* § 6039C(b)(4)(B)(ii).

[143] *See id.* § 6039C(b)(4)(C).

[144] *See id.* § 6039C(b)(3).

[145] *See id.* § 6039C(b)(2).

[146] The Conference Report indicates that, in the case of a foreign corporation whose only asset is undeveloped U.S. realty, the Service might require a recorded security interest in the real estate. *See* H.R. Rep. No. 1479, *supra* note 26, at 191. How this will work in practice is unclear. Such a recorded security interest might violate the terms of an existing first lien or at least make it difficult for the corporation to finance development of the property. The Service presumably would agree to subordinate its lien to any development financing, but probably would not agree to subordinate its lien to the proceeds of a financing not going into the property. *See id.* at 191. The Conference Report also indicates that a guarantee by a person from whom the Service could be reasonably certain that it could collect the unpaid tax may also serve as a security interest. *See id.*

tion return.[147] This return must disclose the name and address of the foreign person, and a description of the USRPI's held by the foreign person during the year.[148] This requirement may also apply to foreign entities that are exempt from the requirement applicable to foreign corporations, partnerships, trusts, and estates either because they provided adequate security to the Service or because they have no "substantial investors."

In addition to other penalties that may be imposed under section 7203,[149] section 6652(g) imposes a penalty for each failure to file a return required by section 6039C on the prescribed date.[150] The penalty is twenty-five dollars per day per return, not to exceed $25,000.[151]

V. Summary

The Act represents a comprehensive revision of the rules regarding the taxation of foreign investors in U.S. real property. Because of the complexity of the approach taken, particularly with regard to the modification of the nonrecognition rules under section 897, even the simplest transaction may require careful study before its U.S. tax implications under the new legislation become clear. In many cases, it will be difficult to predict accurately the U.S. tax consequences until regulations are promulgated. Furthermore, because the Act is retroactive, all transactions completed since the beginning of 1980 in which there has been foreign participation should be reviewed in light of the Act. Finally, the reporting requirements contained in the Act, effective June 18, 1980, will add to the administrative burden already imposed upon tax professionals and their clients.

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[147] *See* I.R.C. § 6039C(c)(2).

[148] *See id.* 6039C(c)(1).

[149] *Id.* § 7203. This section imposes various criminal penalties for willful failure to file a return, supply information, or pay tax. *See id.*

[150] *See id.* § 6652(g).

[151] *See id.* § 6652(g)(2)-(3). In the case of a return required by § 6039C(c), a further limitation restricts the amount of the penalty to five percent of the aggregate fair market value of the USRPI's owned by the foreign person at any time during the year. *See id.* § 6652(g)(3)(B).