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THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT OF 1980

Lisa B. Petkun, Esquire*

I. Background

For a number of years foreign investors were able to invest in real property located in the United States and to avoid, to a great extent, the payment of United States income tax on the operating income from the property and on the gain realized upon the disposition of the property.[1] However, with the enactment of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[2] the ability of foreigners to avoid the United States tax on gains realized upon the sale of real property located in the United States has been greatly circumscribed. To accomplish this result FIRPTA added to the Internal Revenue Code a section of enormous complexity, section 897, and also added section 6039C, which imposes reporting requirements on certain corporations and individuals.[3] Conforming changes were made to other Code sections.[4] This article will describe the more significant substantive provisions of FIRPTA and point out certain of the issues that need to be resolved.

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1. _See_ Hudson, _Capital gains taxation of foreigners' investments in U.S. real property_, 67 A.B.A. J. 1366 (1981).

2. Pub. L. No. 96-499, 94 Stat. 2682 (1980), _amended by_ Pub. L. No. 97-34, 95 Stat. 352 (1981), _codified at_ 26 U.S.C. §§ 861, 897, and 6039C (Supp. IV 1980). [hereinafter "26 U.S.C." will be referred to as "I.R.C."] For treatment of the legislative history, _see_ Olsen, _Analysis of the Foreign Investment in Real Property Tax Act of 1980_, 7 INT'L TAX J. 262 (Apr. 1981).

3. I.R.C. §§ 897 and 6039C.

4. I.R.C. §§ 55, 165, 301, 318, 337, 453, 861, 871, 882, 894, 897, 4986, 4992, 6429, and 6652.

II. Previous Law

Before the enactment of FIRPTA, a foreign investor was subject to United States income taxation on the gain realized from the sale or exchange of real estate located in the United States only if the gain was "effectively connected" with an United States trade or business in which the investor was engaged during the year the gain was realized.[5] In the case of a nonresident alien individual, if the individual was present in the United States for 183 days or more during the year, the individual's capital gains from United States sources were subject to tax.[6] Although the mere ownership of one piece of real property subject to a net lease would not cause the foreign investor to be engaged in an United States trade or business,[7] in most instances the investor's activities extended beyond this level such that he was engaged in a trade or business in the United States. The manner in which a foreign investor, by using perfectly legitimate means, could avoid United States income tax upon the disposition of United States real property interests prior to FIRPTA had become fairly standardized and quite well-known. The principal methods included:[8]

1. Selling the real estate on the installment method under section 453. Principal payments on the buyer's note which were received in years when the foreign investor was no longer engaged in an United States trade or business were free of United States tax.[9]

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5. I.R.C. §§ 864(b), 864(c), 871, and 882.
6. I.R.C. § 871(a)(2).
7. *See*, *e.g.*, Herbert v. Commissioner, 30 T.C. 26 (1958).
8. *See* Ranzal, *Foreign Investment in U.S. Real Property*, 51 CERTIFIED PUB. ACCOUNTANTS J. 9, 10-11 and Hudson, *supra*, at 1366 and 1368.
9. Treas. Reg. §§ 1.864-3(a) and 1.864-3(b), Ex. 1 (1982).

2. Holding the real estate in a domestic or foreign corporation and selling the stock of the corporation, rather than the underlying real property. The gain realized on the sale of the stock usually would not constitute "effectively connected" income.[10] In addition, the buyer could liquidate the corporation without being subject to taxation and obtain a basis in the corporation's assets equal to the buyer's purchase price for the stock.[11]

3. Holding the real estate in a corporation and causing the corporation to adopt a plan of complete liquidation under section 337, sell its assets, and liquidate in one year. The sale by the corporation would be tax-free under section 337 and, even though the foreign shareholders would realize gain on the liquidation, the gain would be treated as the gain from the sale or exchange of stock and not subject to United States income tax because it would not be effectively connected income.[12]

4. Exchanging the real estate in the United States for foreign real estate in a like-kind exchange under section 1031.[13]

5. Holding the real estate in a partnership or a trust, and selling the interest in the entity in a transaction consummated outside the United States. Since the gain from the sale would constitute foreign source income, it would not be subject to United States tax.[14]

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10. Treas. Reg. § 1.864-4(c) (1982).
11. I.R.C. §§ 331, 332, 334(a), and 334(b)(2).
12. I.R.C. §§ 331 and 337.
13. I.R.C. § 1031.
14. I.R.C. §§ 864(c)(4)(A) and 861(a)(6); Treas. Regs. § 1.861-7 (1982).

III. Enactment of FIRPTA

In the late 1970's there arose a perception that the ability of foreigners to avoid the United States income tax stimulated investment in real property in the United States, primarily farm property, thus driving up prices to the disadvantage of American farmers. Moreover, the ability of foreign investors to own real estate in the United States for extended periods and then sell it free of United States tax on the gain was viewed as unfair tax avoidance. These factors coalesced to cause the passage of FIRPTA.

The Senate and House versions differed in two significant respects. The Senate bill imposed a tax at a minimum rate of twenty-eight percent and required every buyer of real estate in the United States or of an interest in an entity owning mostly real estate in the United States to withhold twenty-eight percent of the sales price. These two provisions were not contained in the House bill, which formed the basis of the Bill that was finally reported out by the House and Senate Conference Committee.[15]

IV. Provisions of FIRPTA

A. Overview

FIRPTA does not alter the basic principles governing the taxation of nonresident aliens and foreign corporations. Rather, it provides that all gains and losses from dispositions of certain interests are treated as effectively connected with an United States trade or business, and that the

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15. H.R. Conference Rep. No. 1479, 96th Cong., 2nd Sess. ___, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 5871, 5968.

foreign investors disposing of such interests is deemed to be engaged in an United States trade or business. Thus, the foreign investor is subject to income tax at regular United States rates.[16] FIRPTA becomes effective for dispositions occurring after June 18, 1980.[17]

Basically, FIRPTA taxes the gain or loss realized with respect to two kinds of dispositions: (A) dispositions by nonresident alien individuals and foreign corporations of the following three types of interests: (i) direct interests in real property located in the United States; (ii) interests in domestic corporations which hold substantial interests in real property located in the United States; and (iii) interests in foreign and domestic partnerships, trusts or estates, to the extent the assets of these entities consist of property set forth in (i) or (ii); and (B) dispositions by foreign corporations of property described in (i) or (ii), including distributions as dividends, liquidating distributions, stock redemptions, or a section 337 liquidation. Finally, FIRPTA taxes certain distributions by real estate investment trusts.[18]

Some of the present United States income tax treaties contain provisions that permit capital assets to be disposed of free of tax. FIRPTA permits these treaty provisions to override FIRPTA, but only until December 31, 1984.[19]

B. Analysis of FIRPTA

The touchstone for taxation under section 897(a) is a "disposition". The term "disposition" includes transactions

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16. I.R.C. § 871(b).
17. Section 1125 of FIRPTA.
18. I.R.C. §§ 897(c)(1)(A)(i), 897(c)(1)(A)(ii), 897(g), 897(d), and 897(h).
19. I.R.C. §§ 894 and 7852; section 1125(c)(1) of FIRPTA.

other than sales and exchanges, including, in the case of corporations, liquidations and dividends, and in the case of individuals, possible gifts and bequests.[20] Section 897(a)(1) restricts taxation to gains and losses realized by a nonresident alien individual or a foreign corporation, but fails to mention the treatment of foreign trusts and estates.[21]

C. U.S. Real Property Interest

Section 897(a)(1) provides that a taxable event occurs upon the disposition of an United States real property interest ("RPI"). This term includes direct interests in real property in the United States and indirect interests by ownership in certain domestic corporations.[22]

D. Direct Interest in Real Property

The first category of RPI is "real property," which is statutorily defined to include: mines, wells and other natural deposits, fee ownership and co-ownership of land or improvements, leasehold interests, and options to acquire land or leasehold interests; and movable walls, furnishings, and other personal property associated with the use of real property.[23]

Until the promulgation of regulations, it is unclear how the latter class of property will be interpreted. It could include, for example, equipment used in strip mining,

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20. See I.R.C. §§ 861(a)(5) and 897(c); Klein, An Analysis of the Foreign Investment in Real Property Tax Act of 1980: How it Works, 54 J. TAX'N 202, 203-204 (Apr. 1981).
21. I.R.C. § 897(a)(1).
22. I.R.C. § 897(c).
23. I.R.C. §§ 897(c)(k)(A)(i), 897(c)(6)(A), and 897(c)(6)(B). For more detail on property classification, see Newton, Foreign Investment in United States Real Property, 34 TAX EXECUTIVE 12-13 (Oct. 1981).

a large press used in a factory, and hotel beds and sheets. In determining what property is to be classified as real property, the Conference Committee has stated its intention to incorporate the definition of real property that is used in the United States Treasury's Model Income Tax Treaty. The definition used in the Model Treaty is quite broad, and includes, for example, livestock and equipment used in agriculture and forestry.[24] It is likely that the regulations will include as real property such intangible assets as contracts of sale, life and remainder interests, and easements.

One very important uncertainty that exists with respect to the statutory definition of real property is whether a real estate mortgage constitutes real property. If it does, as discussed below, an interest in an entity such as a savings and loan association whose assets consist primarily of such mortgages will constitute a RPI, and thus will be subject to United States tax upon the disposition of the interest.

E. Indirect Interest in Real Property

The second category of RPI is any "interest," other than an interest solely as a creditor, in a domestic corporation, unless the taxpayer establishes, in accordance with regulations to be prescribed, that the corporation was not an United States real property holding corporation ("RPHC") during the "testing period".[25] Although the term "interest" is not defined in the Code, the only form of interest in a RPHC that is excluded is an interest solely as a creditor. Thus it is likely that interests in a RPHC will include warrants

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24. See Joint Explanatory Statement of the Committee of Conference (1980 U.S. CODE CONG. & AD. NEWS 5968) and Art. 6 (2) of United States Model Income Tax Treaty (May 17, 1977). See also Reiner and Alef, Foreign Investment in U.S. Real Estate: Interpreting the Statute, 7 INT'L TAX J. 357, 358-359 (June 1981).

25. I.R.C. § 897(c)(1)(A)(ii).

and options to acquire stock, contracts to acquire stock, preferred stock, and debt instruments with equity kickers or rights of conversion. Under existing authorities and under the section 385 regulations certain debt instruments may be characterized as stock and hence constitute an "interest" in a corporation.[26]

The "testing period" is the shorter of the five-year period preceding the date of disposition of the RPI or the period after June 18, 1980.[27] The term RPHC includes any corporation, domestic or foreign, it, at any time during the testing period, the fair market value of its RPIs was fifty percent or more of the sum of the fair market values of the following: the corporation's RPIs real property located outside the United States and any other assets used or held for use in a trade or business.[28] To determine whether a corporation is a RPHC, therefore, it is necessary to determine the "fair market value of an interest in" certain of its assets.

At the present time there is no guidance provided as to whether a corporation's "interest in" property subject to a mortgage is the property's full fair market value or only the corporation's equity in the property. Nor is any guidance given to indicate whether the fact that the mortgage is recourse or nonrecourse should make a difference. Similarly, it is unclear as to which assets owned by a corporation are considered as "used or held for use" in a trade or business. The ability to count such items as accounts receivable, cash, and inventory may be significant in making the computation

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26. I.R.C. § 385; Treas. Reg. §§ 1.385-2 through 1.385-10 (1982).

27. I.R.C. § 897(c)(1)(A)(ii); see also Klein, supra, at 202.

28. I.R.C. § 897(c)(2).

and may tip the balance, one way or the other, in a close case.

Although a foreign corporation can be characterized as a RPHC, the disposition of its stock by a foreign investor is not subject to United States tax because only an interest in a domestic corporation is a RPI. The classification of a foreign corporation as a RPHC becomes significant only for the purpose of determining whether a domestic corporation which owns its stock is a RPHC.[29]

In determining whether a corporation is a RPHC, special "look through" rules are used with respect to interests in other entities.[30] RPIs owned by a partnership, trust or estate are treated as owned proportionately by the entity's partners or beneficiaries.[31] However, there is no "look through" rule for other assets of a partnership, trust or estate. Thus, the foreign real property or other business property held by such an entity cannot be counted in examining the assets owned by the entity's United States partners or beneficiaries.

As concerns the corporate ownership of interests in other corporations, FIRPTA provides that if a parent corporation owns a "controlling interest" in a subsidiary, the parent is deemed to hold a pro rata share of each asset of the subsidiary, equal to the parent's percentage ownership, by value, of the stock of the subsidiary.[32] For this purpose a "controlling interest" is fifty percent or more of the

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29. I.R.C. § 897(c)(4)(A).

30. For more on "look through" rules, see Klein, supra, at 203.

31. I.R.C. § 897(c)(4)(B).

32. I.R.C. § 897(c)(5)(A)(ii); see also Feder, Planning Under the Foreign Investment in Real Property Tax Act of 1980, 59 TAXES 81, 84-85 (Feb. 1981).

fair market value of all classes of the corporation's stock.[33] This provision could be interpreted as requiring ownership of fifty percent or more of the value of each class of stock or fifty percent or more of the aggregate fair market value of all classes of stock. In making the calculation, the attribution rules of section 318 apply with the modification that the ownership of stock is attributed both from a corporation to shareholders that own five percent of its stock and from shareholders who own five percent of the stock of the corporation to the corporation.[34]

Both the non-"tainted" assets held by the corporation and the RPIs held by the corporation are taken into account by its corporate shareholder. This differs from the rule with respect to the attribution of assets from a trust or partnership to its beneficiaries or partners, which requires that the beneficiary or partner only take into account the entity's RPIs. The corporate "look through" rule applies to a chain of corporations, provided that a controlling interest is owned in the subsidiary corporation.

The rule for the attribution of assets held by a corporation is computed differently if one corporation owns less than a controlling interest in another corporation. In that event, the entire fair market value of the stock of the owned corporation is used in determining whether the corporate shareholder is a RPHC, provided that the noncontrolling interest is in a corporation that itself is a RPHC.[35] In other words, the fair market value of a noncontrolling stock interest in a PRHC is characterized in the hands of the

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33. I.R.C. § 897(c)(5)(B); <u>see</u> Reiner and Alef, <u>supra</u>, at 364.

34. I.R.C. §§ 318 and 397(c)(6)(C).

35. I.R.C. § 897(c)(5).

corporate shareholder as a RPI, but if the owned corporation is not a RPHC its stock does not enter into the determination of the corporate shareholder's status as a RPHC. When a noncontrolling interest is owned, the liabilities of the corporation are taken into account indirectly since the shareholders include the fair market value of the corporation's stock. When a controlling interest is owned, however, liabilities are irrelevant since the corporate shareholder is treated as owning a pro rata share of the corporation's assets.[36]

There are several exceptions to the fairly broad definition of a RPI. One exception is for an interest in a corporation if the corporation was never a RPHC during the testing period.[37]

Another exception exists for certain shares of stock of publicly-held corporations. A class of stock that is regularly traded on an "established securities market" is not a RPI in the case of a person who, at any time during the testing period, did not own, actually or constructively, more than five percent of that class of stock.[38] In making the determination of the percentage of ownership, the constructive ownership rules of section 318 apply with the modification that stock is attributed both from a corporation to five percent shareholders and from five percent shareholders to a corporation.[39] Therefore, a foreign investor with a portfolio that includes regularly-traded stock in domestic corporations should not be affected by FIRPTA.

Another exception covers a corporation that has disposed of its RPIs. To fall within this exception, the

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36. I.R.C. § 897(c)(5)(A)(ii).
37. I.R.C. § 897(c)(5)(A)(ii).
38. I.R.C. § 897(c)(3).
39. I.R.C. § 897(c)(6)(C) and 318(a).

corporation cannot hold any RPIs on the date the interest in the corporation is disposed of and the corporation must have disposed of all RPIs which it owned during the testing period in transactions in which the full amount of the corporation's gain was recognized.[40] In many circumstances it may be difficult for a corporation to meet this exception, since if, on the date that its stock is disposed of, it holds even one RPI, no matter how small in value, the corporation's stock will constitute a RPI. If a corporation sells its assets on the installment basis under section 453, the gain will not be fully recognized until the obligation has been fully paid, and thus the exception would not be applicable until that time.[41] If a mortgage on the sale of an interest in real property is itself a RPI, the exception would not be applicable for a corporation which took back such a mortgage until the mortgage was fully paid.

The fact that FIRPTA presumes that every domestic corporation is a RPHC and places the burden on the corporation to establish that it is not a RPHC may present valuation problems for many corporations. Under FIRPTA, a corporation is a RPHC if its assets meet the fair market value test on even one day of the testing period.[42] This suggests that constant monitoring of values is required, a task that is extremely burdensome and highly impractical. Moreover, a corporation could become a RPHC merely as a result of an unforeseen shift in values. For example, if a corporation's non-real estate assets suffer a short-term decline in value, the corporation could become a RPHC.

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40. I.R.C. § 897(c)(1)(B).
41. I.R.C. § 453.
42. I.R.C. § 897(c)(2).

F. Treatment of Foreign Corporations Holding RPIs

The disposition of stock in a foreign corporation, even if the only assets of the foreign corporation are parcels of real property in the United States, is not subject to tax under FIRPTA.[43] Even though the foreign corporation may be a RPHC, section 897(c)(1)(A)(ii) provides that only stock in a domestic corporation can be a RPI. This does not mean, however, that FIRPTA has left a loophole. Rather than taxing the sale of stock in foreign corporations holding real property in the United States, FIRPTA restricts the ability of foreign corporations to transfer RPIs without recognizing gain. Because of these rules, it is assumed that the purchaser of the stock of such a foreign corporation will pay a lower price to take into account the corporation's inchoate tax liabilities. This pricing adjustment, if it occurs, will result in imposing the United States income tax on the seller indirectly.

A corporation generally can distribute appreciated property to its shareholders as an ordinary distribution or in liquidation without being required to recognize gain.[44] FIRPTA alters this result by imposing United States tax on a foreign corporation with respect to distributions of appreciated RPIs, whether in liquidation or as an ordinary dividend distribution.[45] Gain will be recognized to the distributing corporation in an amount equal to the excess of the fair market value of the property at the time of distribution over its adjusted basis. An exception to this gain recognition

43. I.R.C. § 897(c)(1)(A); see Olsen, supra, at 276-277.
44. I.R.C. §§ 311 and 336.
45. I.R.C. § 897(d)(1)(A).

rule is provided whenever the recipient takes a carryover basis in the RPI that is distributed by the foreign corporation. This exception would apply to a parent company's liquidation of a subsidiary under section 332.[46] FIRPTA also makes section 337 inapplicable to the sale or exchange of RPIs by a foreign corporation.[47] These rules prevent a buyer of the stock of a foreign corporation from obtaining a stepped-up basis in the underlying assets of the corporation without paying United States tax attributable to the appreciation in the corporation's RPIs.

To provide relief from the application of these rules, a special election is provided for a foreign corporation which has a permanent establishment in the United States. This election can be utilized, however, only if there is an applicable tax treaty nondiscrimination provision which precludes the United States from taxing the corporation at a higher rate than the rate of tax for a domestic corporation carrying on similar operations.[48] In that case, a foreign corporation may elect to be treated as a domestic corporation. By making the election, the foreign corporation is able to distribute RPIs without tax using the usual nonrecognition provisions of the Code. The price to be paid for making the election is that the disposition of the shares of a corporation which has made the election will subject the foreign shareholders to United States tax under section 897(a).

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46. I.R.C. §§ 897(d)(1)(B) and 332.
47. I.R.C. §§ 897(d)(2) and 337.
48. I.R.C. § 897(i)(1); see Reiner and Alef, supra, at 376-377.

G. In-Kind Distributions of RPIs by Domestic Corporation

Generally, an in-kind property distribution to a non-corporate shareholder, including a foreign shareholder, is treated as a distribution in an amount equal to the fair market value of the distributed property.[49] The shareholder receives a basis in the property stepped-up to the property's fair market value on the date of distribution.

Previously, although the dividend was subject to United States tax, if there was a foreign shareholder the rate of United States withholding tax on the dividend may have been reduced by the terms of an applicable tax treaty, thus resulting in the foreign shareholder receiving property with a stepped-up basis at little tax cost. These rules are altered by FIRPTA. A foreign shareholder who receives a distribution of a RPI as a dividend is required to take a carryover basis in the property. The basis is increased by the gain recognized by the corporation, if any, and by the United States tax paid by the foreign shareholder.[50]

H. Non-Recognition Rules

An easy way to avoid the provisions of FIRPTA would have been for a foreign investor to exchange his RPIs in a non-taxable exchange for assets that are not subject to tax under FIRPTA. To preclude this result, FIRPTA drastically reduces a foreign investor's ability to utilize the Code's non-recognition rules. Specifically, FIRPTA provides that the non-recognition rules do not apply to a transaction involving a RPI unless the taxpayer receives in exchange an interest,

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49. I.R.C. § 301(b)(1)(A).
50. I.R.C. § 897(f)(A) and (B).

the sale of which would be taxable under FIRPTA or other provisions of the Code, as modified by an applicable tax treaty.[51]

Applying the rule to an obvious case, a foreign investor can exchange a RPI without being subject to tax in a section 1031 like-kind exchange only if a RPI is received in exchange.[52] Probably the most significant application of section 897(e)(1) is its preclusion of a foreign investor's ability to receive the tax benefits associated with an otherwise fully or partially tax-free reorganization exchange. For example, a merger of a domestic corporation with another domestic corporation ordinarily is tax-free. However, if the disappearing corporation is a RPHC and the surviving corporation is not a RPHC, then the stock in the survivor received by the foreign investor will not be a RPI. This would cause the foreign investor to become subject to United States income tax on the exchange. A reorganization in which a RPHC is acquired by a foreign corporation would be taxable to a foreign shareholder, since a RPI will have been disposed of and the property received in exchange will not be a RPI. Similarly, an exchange by a foreign investor of a RPI where the property received consists of shares of a domestic corporation that is a publicly-traded corporation (if the foreign investor owned less than five percent in value of the class of shares regularly traded on an established market) would be subject to tax.

Along the same lines, section 351 will apply when a foreign investor transfers a RPI only if the transferee corporation is a domestic RPHC.[53] This application of section 351

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51. I.R.C. § 897(e)(1).
52. I.R.C. § 1031.
53. I.R.C. § 351.

raises the question of the effect of an otherwise non-taxable exchange in which a domestic RPHC issues property, the sale of part of which would be subject to United States tax and part of which would not be. This would occur, for example, in a section 351 exchange where a foreign investor who transferred a RPI to RPHC received in exchange a debt instrument and stock in the RPHC. The sale of the debt instrument (an interest solely as a creditor) should not be subject to tax whereas the sale of the stock would be.

I. Effect of Treaties

The United States currently is a party to several income tax treaties which prevent the United States from taxing foreign investors on the gain from the disposition of capital assets. Although Congress is able to enact statutes that override the treaty obligations of the United States, in enacting FIRPTA Congress provided a limited period for treaties to prevail. In a situation where gain realized by a foreign investor would not be subject to United States tax as a consequence of a treaty provision, the treaty will prevail until December 31, 1984.[54] If an existing treaty is renegotiated and signed before 1985 but is not ratified until after December 31, 1984, the treaty may continue to apply for up to two additional years, depending on the provisions of the renegotiated treaty.[55]

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54. Section 1125(c) of FIRPTA. *See* Olsen, *supra*, at 282-288. For an explanation of the "Dutch Sandwich" or "Dutch Open Face Sandwich," *see* Reiner and Alef, *supra*, at 374-376 and Parks and Clement, *Using Commodity Straddles to Circumvent FIRPTA*, 7 INT'L TAX J. 449, 449-453 (Aug. 1981).

55. Section 1125(c)(2) of FIRPTA; *see also* Feder, *supra*, at 86-91.

J. Transactions Between Related Persons

Special provisions exist for transactions involving RPIs which occur between "related persons" after December 31, 1979. A "related person" transaction is defined as a disposition of a RPI to a "related person," as that term is defined in section 453(f)(1).[56] Pursuant to section 453(f)(1), a related person is any person whose stock would be attributed under section 318(a) to the person who first disposed of the property. In the case of a disposition of a RIP to a related person, the basis of the RPI in the hands of the transferee is reduced by the amount of gain realized that is not subject to federal income tax because either: (1) the transaction occurred before June 19, 1980, or (2) a treaty provision exempts the gain from tax.[57] The purpose of the related person rule is to prevent section 897 from being avoided as a result of the step-up in basis that would result when a taxpayer transferred a RPI to a related person and the gain was recognized but not subject to tax.

K. Calculation of Tax

FIRPTA imposes federal income tax on a foreign investor as if all his gains or losses realized from dispositions of RPIs were effectively connected with an United States trade or business.[58] Consequently, tax is imposed as though the foreign investor were an United States taxpayer. Additionally, any gain realized from the disposition of a RPI is treated as United States source gain, and any foreign taxes paid cannot offset the foreign investor's income tax liability

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56. Section 1125(d) of FIRPTA; I.R.C. § 453(f)(1).
57. Section 1125(d)(2)(A) and (B) of FIRPTA.
58. I.R.C. § 897(a)(1) and (2).

resulting from the gain.[59]

Whether the gain will be ordinary or capital, long or short-term, will depend on the holding period and the nature of the property involved.[60] Other Code provisions apply, such as depreciation recapture and "collapsible" corporation rules.[61] Losses that are incurred in other United States trades or businesses in the year of sale may be used to offset any gains that are made taxable by reason of section 897.

In the case of nonresident alien individuals, the alternative minimum tax is modified so that the lowest bracket of income subject to the tax is taxed at twenty percent rather than at the ten percent rate set forth in section 55 (a)(1)(A).[62] Another special rule permits losses to be taken into account under section 897 only if the loss would be taken into account under section 165(c).[63]

L. Partnerships, Estates and Trusts

FIRPTA provides that the proceeds of a sale or exchange of an interest in a partnership or estate by a foreign investor will, to the extent attributable to RPIs, be taxes as an amount received from the sale or exchange of a RPI. FIRPTA also authorizes the promulgation of regulations concerning situations in which changes in interests in, and distributions by, a partnership, trust or estate will be treated as sales of property at fair market value.[64]

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59. I.R.C. §§ 164, 165(c), and 897(b); see Reiner and Alef, supra, at 359.
60. I.R.C. §§ 1221 and 1231.
61. I.R.C. §§ 1245, 1250, and 341.
62. I.R.C. §§ 55(a)(1)(A) and 897(a)(2).
63. I.R.C. § 897(b).
64. I.R.C. §§ 897(g) and 897(e)(2)(B)(ii).

Under existing law, if a partnership sells or exchanges RPIs and realizes a gain or loss, each partner is required to report separately his distributive share of such gain or loss.[65] A foreign partner's share of gain or loss from the sale of RPIs by a foreign or domestic partnership will be treated as if the partner himself had sold the RPI and will be subject to federal income tax.

Foreign trusts and estates generally may be treated identically with nonresident aliens for purposes of United States income taxation.[66] When regulations are promulgated, it is likely that these entities will be subject to United States tax on any gain realized from the sale of a RPI to the same extent that a domestic trust or estate would be subject to tax. If the trust or estate distributed the gain on a current basis, it would be entitled to a deduction equal to the gain and no tax would be imposed on the trust or estate. However, the beneficiary who received the distribution would be subject to United States tax on the gain as if such beneficiary had received the income directly, since the trust acts as a "conduit" for such gain.[67]

M. Real Estate Investment Trust

Three rules are provided for real estate investment trusts ("REITs").[68] Generally, the distributed income of a REIT is taxed to its shareholders rather than to the REIT.[69] Before the enactment of FIRPTA, REIT distributions generally were treated as dividends except that "capital gain dividends"

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65. I.R.C. § 702(a) and (b).
66. *See* Rev. Rul. 60-181, 1960-7 C.B. 257.
67. I.R.C. §§ 651(a) and 661(a); 652(a) and 662(a). For a more elaborate discussion, *see* Klein, *supra*, at 204-205.
68. "Real estate investment trust" is defined in I.R.C. § 856(a).
69. I.R.C. § 856(a)(3) and 857.

were generally not subject to any tax in the case of a foreign shareholder. FIRPTA provides that all distributions by a REIT to a foreign investor that are attributable to gain from the disposition of a RPI are treated as gain recognized by the foreign investor from the sale or exchange of a RPI.[70]

With respect to sales of interests in a REIT, FIRPTA distinguishes between "domestically-controlled" REITs and REITs that are not "domestically-controlled". A "domestically-controlled" REIT is specifically excluded from the definition of a RPI.[71] For this purpose, a REIT is domestically-controlled if, at all times during the test period, less than fifty percent in value of its stock was held directly or indirectly by foreign persons.[72] The principal effect of this provision is to permit a foreign person to dispose of stock in a domestically-controlled REIT without imposition of United States income tax.

In the case of an in-kind distribution of a RPI by a domesticaly-controlled REIT, FIRPTA provides that the REIT will recognize gain on such distribution to the extent of its "foreign ownership percentage."[73] If this provision had not been included, a distribution received by a foreign shareholder might be treated either as a dividend (possibly taxed at a low withholding tax rate pursuant to an applicable tax treaty) or as a distribution deemed to result in gain from the sale or exchange of stock in the REIT, which gain would be exempt from United States tax under section 897 (h)(2).[74]

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70. I.R.C. § 897(h)(1).
71. I.R.C. § 897(h)(2).
72. I.R.C. § 897(h)(4)(B).
73. I.R.C. §§ 897(d)(1) and 897(h)(3).
74. _See_ Klein, _supra_, at 205-206.

N. Reporting Requirements

Section 6039C imposes three separate annual reporting requirements. First, every domestic corporation which was a RPHC at any time during the testing period and that had at least one foreign person as a shareholder during a calendar year must file a return disclosing certain information.[75] The corporation must provide the name and address of each foreign person who was a shareholder at any time in the year, to the extent such information is known by the corporation, and also must provide information regarding tranfers of stock to or from foreign persons during the calendar year.[76] Publicly-traded corporations are exempt from the filing requirements.[77]

Every foreign corporation, and every foreign or domestic partnership, trust, or estate, is required to file an information return if any time during the calendar year it had a "substantial investor".[78] A "substantial investor" is defined as a foreign person whose pro rata share of RPIs held by the entity had a fair market value exceeding 50,000 dollars.[79] The name and address of each "substantial investor" must be supplied, as well as information with respect to the assets of the entity, as the regulations may prescribe.[80] If the reporting entity is a foreign corporation, the term "substantial investor" includes both foreign and domestic persons.[81] The entity also must advise each substantial

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75. I.R.C. § 6039C(a)(1); see Olsen, supra, at 289-291 and Reiner and Alef, supra, at 370-374.
76. I.R.C. § 6039C(a)(1)(A).
77. I.R.C. § 6039C(a)(2).
78. I.R.C. § 6039C(b)(1); for an example, see Klein, supra, at 206.
79. I.R.C. § 6039C(b)(4)(B)(1).
80. I.R.C. § 6039C(b)(4)(B)(i).
81. I.R.C. § 6039C(b)(4)(B)(i).

investor of his pro rata share of the entity's RPIs.[82] The reporting requirement is inapplicable to any entity for the calendar year if the entity furnishes to the Internal Revenue Service ("IRS") such security as the IRS determines to be necessary to ensure that any tax imposed by the Code with respect to RPIs held by the entity will be paid.[83]

Lastly, every foreign investor must file an information return if the RPIs owned by the investor had a fair market value exceeding 50,000 dollars at any time during the calendar year and the investor was not engaged in any trade or business in the United States.[84] This return must disclose the name and address of the foreign investor, and a description of the RPIs held by the investor.[85]

In addition to other penalties that may be imposed, section 6652(g) imposes a penalty for each failure to file a return required by section 6039C. The penalty is twenty-five dollars per day per return, not to exceed 25,000 dollars.[86]

V. Conclusion

FIRPTA is a comprehensive overhaul of the rules regarding the United States taxation of foreign investment in real property in the United States. These rules are highly complex and require that every real property transaction in the United States involving a foreign investor be analyzed carefully.[87] Undoubtedly many of the uncertainties contained in the law will be resolved when regulations are promulgated.

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82. I.R.C. § 6039C(b)(2).
83. I.R.C. § 6039C(b)(2).
84. I.R.C. § 6039C(c)(2).
85. I.R.C. § 6039(c)(1).
86. I.R.C. § 6652(g)(2) and (3).
87. For examples of applications of the Act, <u>see</u> Olsen, <u>supra</u>, at 278-282.