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Foreign Investors Real Property Tax Act: Historical Perspective and Critical Evaluation

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FOREIGN INVESTORS REAL PROPERTY TAX ACT: HISTORICAL PERSPECTIVE AND CRITICAL EVALUATION

WILLIAM D. METZGER

I. INTRODUCTION

For many years, the complicated interplay of rules dealing with the taxation of gain from the sale of United States real estate allowed foreign investors tax advantages far greater than those enjoyed by their domestic counterparts. The beginning of the end of that era in tax law can be traced back to the Revenue Act of 1978, which required that the Treasury Department conduct a study and analysis of the uneven tax treatment.

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1. STAFF OF JOINT COMM. ON TAXATION, 96th CONG., 1ST SESS., DESCRIPTION OF PROPOSALS RELATING TO THE TAX TREATMENT OF FOREIGN INVESTMENT IN THE UNITED STATES 2 (Joint Comm. Print 1979) (reporting to members of the House Ways and Means Committee a Treasury Department finding that foreign persons rarely incur United States tax on the disposition of United States real estate) [hereinafter cited as DESCRIPTION OF PROPOSALS].


3. Id. § 553, 92 Stat. 2891 (codified at I.R.C. § 7801 (Supp. V 1981) (note)). The 1978 Act directed the Secretary of Treasury to “make a full and complete study and analysis of the appropriate tax treatment to be given to income derived from, or gain realized on, the sale of interests in United States Property held by nonresident aliens or foreign corporations.” Id. The study, Taxation of Foreign Investment in U.S. Real Estate, was completed May 4, 1979 pursuant to requirements of the 1978 Act. UNITED STATES DEPT OF THE TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE (1979) [hereinafter cited as TREASURY STUDY].

Legislative change in the area of foreign investment in United States real property
It is not surprising that Congress ordered this inquiry. Many Americans perceived there to be massive foreign investment in the United States, and press reports supported that view. Congress was disturbed by the magnitude of foreign investment and enacted a law requiring all foreigners, owning or renting United States farm land under long-term leases, to register such holdings with the Government. A study of the taxation of foreign investors was a logical consequence of public and congressional concern. A tax study was the necessary first step toward elimination of a tax incentive which Congress feared was encouraging massive foreign investment in United States real estate.

The study, *Taxation of Foreign Investment in U.S. Real Estate*, was submitted by the Secretary of Treasury to Congress on May 4, 1979. While admitting to the unavailability of comprehensive statistics, the Secretary clearly took issue with the newspaper accounts which suggested a rapid growth of foreign investment in United States real estate. The study cited statistics, specifically with respect to agricultural land, that were prepared by the United States General Accounting Office (GAO). This data demonstrated that during 1977 and the first half of 1978, foreigners purchased about two percent of the total acreage sold during that period, and the acreage had an estimated value of about four percent of the total value of such land sold.

By the time that the House Ways and Means Committee consid-

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7. Early Congressional debate expressed concern that the tax incentive was also bidding up the price of United States farmland by foreign investors. *TREASURY STUDY*, supra note 3, at 47.

8. *TREASURY STUDY, supra* note 3.

9. *Id.* at 2, 5.

10. *Id.* at 7, 9 (citing *UNITED STATES GENERAL ACCOUNTING OFFICE, FOREIGN OWNERSHIP OF U.S. FARMLAND, MUCH CONCERN, LITTLE DATA* (1979)).

ered its tax proposals in October, 1979, congressional alarm over the intensity of foreign investment had subsided. The description of the various proposals for legislative change, prepared for the Ways and Means Committee by the Joint Committee on Taxation staff, referred in its background material to a GAO report. This report discussed both the magnitude of foreign investment in United States agricultural land and the competitive disadvantage afforded United States investors as a result of the ineffective taxation scheme on foreign investors. When Congress eventually enacted a solution to the problem of uneven taxation treatment on the disposition of United States real estate, the legislators justified the changes only on the grounds that there was a need for equitable tax treatment between foreign and United States investors. The legislators, however, went on to express the affirmative view that the changes were not intended to discourage foreign investment in the United States.

Although the study effectively diffused congressional concern as to the magnitude of foreign investment in the United States and, thus, the need for statutory modification of the tax rules on those grounds, it demonstrated the sharp variance in tax treatment between foreign and domestic investors in United States real estate. Foreign investors were enjoying the same tax advantages on earnings from United States real estate as were their domestic counterparts, but at the same time were able to avoid tax on any gain realized on the disposition of those investments. Furthermore, this avoidance could be accomplished in any one of several ways. Congress perceived such a disparity of treatment as unfair to both non-residents, who lacked the counsel or incentive to avoid the tax, and to United States citizens and residents, who were not afforded the

13. See generally Description of Proposals, supra note 1.
14. Id. at 2 (citing United States General Accounting Office, Foreign Investment in U.S. Agricultural Land—How It Shapes Up (1979)).
15. The report found eight percent of the total acreage sold during an eighteen month period in one hundred forty-eight counties in ten states was purchased by foreign investors. Id.
16. Id.
17. See supra note 3.
19. Id.
20. See supra text accompanying notes 9-11.
22. Id. at 46.
23. Id. at 30-32.
24. The costs associated with the avoidance technique of using a foreign holding
chance for tax avoidance. Congress attempted to deal directly with those several opportunities for tax avoidance by enacting the Foreign Investment in Real Property Tax Act of 1980 (the Act).

While the Act in balance deals effectively with the problem of the uneven tax treatment of investment in United States real estate, it is not without problems. With respect to some situations, the Act's solution is less than complete. In other situations, the Act's response to a problem differs depending on the place of incorporation of the taxpayer, a condition within the investor's control. At times, neither the language employed by the Act nor an explanation of the committee reports is specific enough to prevent significant interpretative questions from arising. Probably the most notable deficiency of the Act, however, is its failure to require withholding of tax as a means of enforcing its provisions.

This article first discusses the United States tax treatment of foreigners generally and the pre-Act withholding and taxation scheme with respect to foreign investment in United States real estate. Then follows a discussion of the several ways in which foreign investors were, before the Act, able to avoid tax on the disposition of United States real estate and a critical evaluation of the Act's response to those avoidance methods. Finally, a discussion of the Act's enforcement provisions and a general discussion of withholding of tax on nonresidents is provided.

II. UNITED STATES TAXATION OF FOREIGNERS

Essentially, foreigners who are residents of the United States are taxable in the same manner as United States citizens. Foreigners who are nonresidents of the United States, including foreign corporations, are subject to tax only on that income effectively-connected with a trade or business in the United States and on fixed or determinable annual or periodical income from United States sources.
The taxation scheme for each of these broad categories of income, however, is quite different. The income of a nonresident effectively-connected with a United States trade or business is taxed generally in the same manner as if it were earned by a United States resident or United States corporation.\textsuperscript{34} The other type of income is subject to a flat rate of tax on gross income.\textsuperscript{35}

Although nonresidents with income subject to United States tax are generally required to file a tax return, as are United States citizens and residents,\textsuperscript{36} the tax collector obviously faces a very difficult compliance problem with respect to persons not physically present in the United States. The traditional response to that problem has been to establish a system of withholding of tax at the source of income generated by nonresidents.\textsuperscript{37} Withholding, however, is generally made inapplicable in the case of income effectively-connected with a trade or business in the United States,\textsuperscript{38} both because the compliance problem is less severe and because such income is not taxed at a flat rate. On the other hand, nonresidents who are not engaged in a trade or business in the United States and whose entire United States income is subject to withholding at source, need not file a tax return in the United States.\textsuperscript{39} In such cases, the withholding tax becomes the only tax due and collected.

\section*{III. Income and Gains From United States Real Estate}

\subsection*{A. Withholding and Taxation Scheme Prior to the Act}

Income from real property situated in the United States can take the form of either proceeds from the current use or exploitation of the property,\textsuperscript{40} or gain from the sale or other disposition of the property.\textsuperscript{41} Rents derived from the lease of real property and royal-

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{36} Treas. Reg. § 1.6012-1(b)(1), T.D. 7670, 1980-1 C.B. 160, 164.
\item\textsuperscript{37} I.R.C. §§ 1441, 1442 (1976).
\item\textsuperscript{38} I.R.C. § 1441(c)(1) (1976); see also infra note 279.
\item\textsuperscript{40} Rents and royalties are taxable under either Code section 871(a)(1) (1976) or section 871(b) (1976 & Supp. V 1981).
\item\textsuperscript{41} Capital gains are taxable under either Code section 871(a)(2) (1976) or section 871(b) (1976 & Supp. V 1981).
\end{enumerate}
\end{footnotesize}
ties derived from mines or other natural deposits are generally subject to withholding under chapter 3.\textsuperscript{42} Gain derived from the sale of property, however, is not subject to withholding.\textsuperscript{43}

Rents and royalties must be United States sourced in order to be subject to withholding,\textsuperscript{44} and are United States sourced if the property is situated in the United States.\textsuperscript{45} None of the tax treaties to which the United States is a party exempts real property rental and royalty income from taxation, and less than one-half of the treaties reduce the rate of tax on such income.\textsuperscript{46}

Withholding is not required, however, in cases where real property income is effectively-connected with the conduct of a trade or business within the United States.\textsuperscript{47} Since such income is sure to satisfy the “effectively-connected” test,\textsuperscript{48} the real test of qualification for relief from the withholding rules is whether the activity can be classified as a trade or business.\textsuperscript{49} Although neither the statute nor the regulations specifically define “trade or business,” case law has developed clear guidelines that narrow the inquiry to an examination of the level of the property owner's activity.\textsuperscript{50} Thus, mere ownership of rented property, coupled with passive receipt of rental income, is insufficient to rise to the level of a trade or business.\textsuperscript{51} Payment of incidental expenses for the collection of the rental income will not change that result.\textsuperscript{52} A brief presence in the United States in order to supervise the negotiation of long-term leases, even though the visit involved the making of significant decisions, does not infuse the transaction with sufficient activity to render it a trade or business.\textsuperscript{53} The activity of the owner, either directly or through an agent, must be considerable, continuous, and regular in order to

\textsuperscript{44} Treas. Reg. § 1.1441-3(a) (1956).
\textsuperscript{46} United States Dep't of the Treasury, Withholding of Tax on Non-Resident Aliens and Foreign Corporations 15 (Table 1) (1980).
\textsuperscript{48} Treas. Reg. § 1.864-4(c) (1972); Treasury Study, supra note 3, at 24.
\textsuperscript{51} Lewenhaupt v. Commissioner, 20 T.C. 151, 163 (1953), aff’d, 221 F.2d 227 (9th Cir. 1955) (per curiam).
\textsuperscript{52} Herbert v. Commissioner, 30 T.C. 26 (1958) (payment of insurance, taxes and mortgage).
\textsuperscript{53} Rev. Rul. 73-522, supra note 50.
constitute a trade or business. The trade or business status of the nonresident is determined annually. It is, therefore, subject to manipulation from year to year depending upon the nonresident's ability to increase or decrease his commercial activity with respect to the property.

If the real property income is subject to chapter 3 withholding, tax must be withheld at the rate of thirty-percent of the gross income generated. Because real estate rental can incur very high operating expenses, a tax on gross income might translate into a high effective tax rate on net income or even eclipse net income. For this reason, Congress has provided elections to nonresidents, allowing them to have certain real property income treated as effectively-connected with the conduct of a trade or business in the United States. The election has the immediate effect of relieving the real property income of the withholding requirements.

Although nonresidents may elect out of the withholding requirements on gross realty income, the significance of the election lies in its effect on the method of taxation of the nonresident. The election has the effect of treating realty income as effectively-connected with the conduct of a United States trade or business. Thus, the income becomes subject to the graduated tax rates applicable to United States citizens and residents, rather than to the flat rates applicable to income not connected with a United States trade or business. As such, the income subject to tax is net income rather than gross income. The ability to take related deductions before subjecting income to tax may result in substantial savings to the tax-

54. 20 T.C. at 163.
60. Treas. Reg. § 1.871-10(c)(1) (1974); Id. § 1.1441-4(a)(1), T.D. 6908.
61. Net income is taxed on a progressive basis as opposed to gross income which is taxed at a flat rate. See infra notes 62-65 and accompanying text.
payer, especially in the early years of the business operation.  

From an investment standpoint, however, the appreciation in value of real property in the United States is probably more significant than the rents that can be derived from the property. Under United States tax rules, tax is not due on this appreciation until the property is sold or otherwise disposed. When tax is due, it is generally computed at favorable rates since the gain is likely to be classified as capital gain.

Although capital gains from United States sources are generally not subject to withholding under chapter 3, nonresident aliens are potentially subject to tax on such gains under either one of two statutory methods. If the gain is not effectively-connected with the conduct of a United States trade or business, a flat thirty-percent tax is imposed on the net capital gain for the year, provided that the nonresident taxpayer actually is present in the United States for 183 days or more during that year. If the gain is effectively-connected with the conduct of a United States trade or business, it is subject to the same tax that applies to United States citizens, regardless of the nonresident taxpayer’s presence in the United States. Thus, while capital gains of a nonresident that are effectively-connected with a United States trade or business are subject to United States tax, capital gains not so effectively-connected are likely to be exempt from United States tax.

Therefore, with respect to income and gains from United States

67. See id. at 18.
69. Id. § 1231 (1976 & Supp. V 1981). The property must be held for at least one year. If depreciation on the property were taken at an accelerated rate, that is, faster than under the straight-line method, then a portion of the gain on disposition will be denied capital gain treatment under I.R.C. § 1250 (1976 & Supp. V 1981). Beginning in 1981, gain from the disposition of nonresidential real estate will be denied capital gain treatment to the full extent of prior depreciation deductions unless the straight-line method is elected. Id. § 1245(a)(1) (West 1982).
70. See supra note 43 and accompanying text.
72. Id. § 871(a)(2) (1976). This rule applies only to individuals. Id.
74. Foreign corporations are not subject to the tax if the gain is not effectively connected income. Individuals can avoid the tax by disposing of the property only in a year in which they were not present in the United States for longer periods than they were present in the United States. I.R.C. § 871(a)(2) (1976).
real property before the Act, the nonresident could generally have anticipated either of two possible taxation schemes: (1) A flat thirty-percent tax on gross rentals or royalties coupled, in all likelihood, with an exemption from tax on the gain from the disposition of the property;75 or (2) a graduated tax on net rental or royalty income coupled with a capital gains tax on the gain from the disposition of the property.76 Each scheme had one relatively more favorable tax rule than the other. Scheme One allowed an exemption from tax on gain when the property was disposed of and Scheme Two allowed deductions before subjecting current income to tax. Congress seemed content with these alternative taxing schemes77 in spite of the ability of a nonresident to elect out of Scheme One into Scheme Two at will.78 The concern of Congress, however, was the possibility of nonresidents utilizing Scheme Two during years in which the property was generating rent or royalty income and then utilizing Scheme One in the year the property was disposed.79 This selective use of the most favorable rule from each of the alternate systems was probably always beyond congressional intent,80 although not always beyond tax law.81

As previously stated,82 achieving net income taxation on rental and royalty receipts from real property is completely within the nonresident's control. Electing effectively-connected income status for current income, however, generally subjected gain on the disposition of the property to the same status83 and the consequent capital gains taxation.84 The tax challenge for the nonresident, therefore, involved finding a method to break the otherwise necessary link between effectively-connected current income and effectively-

75. See supra text accompanying notes 64, 74.
76. See supra text accompanying notes 63, 65, 73.
78. Id.
80. The legislative history indicates that the election to treat income from the real estate as effectively connected cannot be revoked unless the Commissioner consents and that gains on the disposition of the real estate are covered by the election. There is no discussion of the impact of any treaties. S. REP. NO. 1707, supra note 57, at 26-27, reprinted in 1966 U.S. CODE CONG. & AD. NEWS 4471-72.
81. TREASURY STUDY, supra note 3, at 46.
82. See supra note 59 and accompanying text.
83. See supra note 73 and accompanying text; infra note 99 and accompanying text.
84. See supra note 69 and accompanying text.
connected capital gains. At least five effective methods for a nonresident to break the link, thereby avoiding tax on gain from the disposition of United States realty, existed when Congress became interested in the problem.

B. Methods of Tax Avoidance on the Disposition of Real Estate and the Act’s Response

The tax avoidance methods available to a foreign investor identified by Congress were as follows: (1) An annual treaty election to treat real property income as effectively-connected income; (2) the sale of stock in real estate holding companies; (3) the tax-free liquidation of a real estate holding company; (4) some like-kind exchanges of United States real estate; and (5) an installment sale of the United States real estate. Although the Act’s provisions, designed to deal with each of these methods, are quite complex, the basic thrust of the statutory change is twofold. First, the Act treats all dispositions of United States real property interests (USRPI) after June 18, 1980, by a nonresident alien individual or foreign corporation, as giving rise to gain or loss. The gain or loss is then treated as if it were effectively-connected with the conduct of a United States trade or business. In this regard, the Act employs a broad defini-

85. See supra note 79 and accompanying text.
87. Id.
90. Id.
93. I.R.C. § 897(a)(1) (Supp. V 1981). Since a nonresident alien’s gains from the disposition of USRPI are treated as effectively connected income, those gains are taxed the same as if they were incurred by a United States resident. Id. § 871(b)(1) (1976 & Supp. V 1981). As such, only gains net of effectively connected losses are subject to tax,
tion of United States real property interests.\textsuperscript{94} Second, the Act overrides the Internal Revenue Code (the Code)\textsuperscript{95} and, eventually, the treaty nonrecognition provisions\textsuperscript{96} with respect to these otherwise

and then are eligible for favorable capital gain treatment. For a nonresident, however, all foreign source income (other than that specifically treated as if it were effectively connected income, \textit{id.} \S 864(c)(4)(B) (1976 \& Supp. V 1981)) and non-effectively connected United States source income are outside the graduated tax base. Because of a perceived less harsh tax treatment for nonresidents on the disposition of USRPI's under these rules, the Act imposed a special tax on nonresident alien individuals with net United States real property gain for the taxable year. See H.R. Conf. Rep. No. 1479, supra note 92, at 186, reprinted in 1980 U.S. Code Cong. \& Ad. News 5968. In such cases, the alternative minimum tax rates, I.R.C. \S 55 (Supp. V 1981), amended by TEFRA, Pub. L. No. 97-248, \S 201(a), 96 Stat. 411, were raised to a minimum level of twenty percent of alternative minimum taxable income, to the extent of such net United States real property gain. H.R. Conf. Rep. No. 1479, supra note 92, at 186-87, reprinted in 1980 U.S. Code Cong. \& Ad. News 5969.

The Tax Equity and Fiscal Responsibility Act of 1982 increased the alternative minimum tax rate to a flat twenty-percent rather than a split ten-twenty percent rate. I.R.C. \S 897(a)(2) (Supp. V 1981), amended by TEFRA, Pub. L. No. 97-248, \S 201(c)(6), 96 Stat. 419-20. While the rate of tax is thus no longer harsher in these situations, the effective base of the tax remains broader since no exemption amount applies to these foreign investors.

94. I.R.C. \S 897(c) (Supp. V 1981). The definition is broad enough to include the following direct interests in United States real property: fee ownership, co-ownership, easements, options, rights of refusal, mineral royalties, life estates, remainders, reversions, and certain personal property associated with the use of real property such as movable walls and furnishings. H.R. Rep. No. 1167, supra note 18, at 513, reprinted in 1980 U.S. Code Cong. \& Ad. News 5876. Furnishings such as antiques and works of art, however, are not included where their value is not dependent on their functional use. Similarly, personal property such as office equipment or livestock is not included where such property has dominant economic significance in relation to the underlying real estate. Temp. Treas. Reg. \S 6a.897-1 (Sept. 20, 1982). In addition, the statute includes organizations (corporations, partnerships, trusts) that hold substantial United States real property interests, that is, at least fifty percent by fair market value of all its real estate holdings and trade or business assets are United States real property interests. H.R. Rep. No. 1167, supra note 18, at 513, reprinted in 1980 U.S. Code Cong. \& Ad. News 5876.


Congress was sensitive to the prospect of foreign investors attempting to structure their investments in a way that would avoid the effect of the Act until 1985. The delay of the treaty override could provide such an opportunity, for example, for a foreign investor
tax-free dispositions.

1. Annual Treaty Election

The most direct way to break the current income-capital gains link discussed above\(^97\) is to make the election to treat real property income as effectively-connected income applicable during the years rental or royalty income was being generated, but inapplicable during the year the property was sold.\(^98\) Under the Code election, this course of action is beyond the control of the nonresident because once the election is made, it remains in force until termination is allowed by the Commissioner of Internal Revenue.\(^99\) Under many of our treaties, however, this election is made on an annual basis.\(^100\) Thus, in the year of sale of the real estate, the nonresident could effectively revoke\(^101\) the election and thereby subject the gain on sale to non-effectively-connected tax treatment\(^102\) and thus probable exemption.\(^103\) If the investor were a resident of a country having no tax treaty with the United States, or one having a treaty without an annual election provision, he could establish a corporation in a country having one and allow the corporation to own the United States real estate, thereby taking advantage of the treaty election.\(^104\)

While under current law the treaty election may still be used to treat otherwise non-effectively-connected current income as if it were effectively-connected,\(^105\) the revocation of the election in the year of sale of the United States realty will no longer be effective to avoid

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\(^97\) See supra text accompanying note 85.

\(^98\) Effectively connected income status would allow the nonresident to be taxed on a net income basis on the current income. Non-effectively connected income status would in all likelihood exempt any gain on disposition from taxation. See supra text accompanying notes 63-64, 71-74.


\(^100\) Of the fifty-three treaties outstanding at the time of the Treasury Department study, thirty-seven contained annual net basis elections. Treasury Study, supra note 3, at 38-41 (Table 4-1).

\(^101\) Since the election is an annual one, the nonresident would simply not affirmatively make the election in the year of sale. The election is made by disclosing an appropriate statement on taxpayer’s income tax return. For an example of such a statement, see Rev. Rul. 174, 1977-1 C.B. 414.

\(^102\) This assumes that the business activity of the nonresident is insufficient in the year of sale to qualify it as a trade or business. See supra text accompanying notes 50-56.

\(^103\) See supra text accompanying notes 71-74.

\(^104\) Treasury Study, supra note 3, at 31.

\(^105\) See supra note 99.
effectively-connected capital gains because the Act mandates such treatment on all such sales.\(^{106}\) The annual election, therefore, when coupled with the new law, produces a situation that is the functional equivalent of the Code election under prior law.\(^{107}\)

Assuming that the Code election was a carefully bargained compromise to deal with the problem of taxation of real estate income on a gross basis, the annual treaty election was clearly an overgenerous departure and one that had to be rectified.\(^{108}\) Although the Act’s response in taxing the gain in all cases was broader than necessary,\(^{109}\) such treatment is not without justification. Thus, under the provisions of the model income tax treaty used by the United States and by most western nations, the primary right of taxation on gains from the sale or other disposition of realty is enjoyed by the country in which the realty is situated.\(^{110}\)

The Act’s solution, however, is not without problems. While its approach prevents discordant treatment between the two alternative taxing schemes discussed above\(^{111}\) by eliminating the prior effectiveness of the annual treaty election, it creates the same discordant treatment in other circumstances. Thus, in cases where the nonresident’s real estate activity does not rise to the level of a trade or business,\(^{112}\) the Code will now demand a flat-tax on the gross income derived from current operations,\(^{113}\) followed by a capital gains tax on the disposition of the property.\(^{114}\) Of course, the availability of the Code election to treat the current income as effectively-connected

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107. See supra text accompanying notes 82-84.
109. See supra text accompanying notes 75-78.
110. United States Model Income Tax Treaty, art. 13(1), 1 TAX TREATIES (P-H) ¶ 1019 (May 17, 1977) (the most recent draft of the United States Model Income Tax Treaty contains the same provision, id. ¶ 1022 (June 16, 1981)); The Organization for Economic Cooperation and Development (O.E.C.D.) Model Double Taxation Convention on Income and on Capital, art. 13(1), 1 TAX TREATIES (P-H) ¶ 1017 (1977). Thus, while both the country of situs of the property and the country of residence of the taxpayer, the seller of the property, can tax the gain on the disposition of the property, the scheme of the model treaties is to allow only the situs country the unrestricted right to retain the tax as the other country allows a tax credit for the tax paid to the situs country. United States Model Income Tax Treaty, art. 23(1), 1 TAX TREATIES (P-H) ¶ 1019; O.E.C.D. Model Double Taxation Convention on Income and Capital Gain, art. 23B(1), 1 TAX TREATIES (P-H) ¶ 1017.
111. See supra text accompanying notes 105-07.
112. See supra note 102.
114. Id. § 897(a)(1) (Supp. V 1981); see supra note 69.
income transfers to nonresidents the authority to prevent such treatment. Because of the high deductions generally associated with the use or holding of productive real estate, and because under the Act gain on the disposition of the property will be taxed regardless of whether the election is made, the election is likely to be utilized liberally. There may be, however, years in which a tax of thirty-percent on gross income is less than a progressive tax on net income. This may occur, for example, in the later years of operation when tax deductions may be small and taxable income may be high. The Code's effectively-connected election, once made to reduce tax in the early years, guarantees similar effectively-connected treatment in later years. For this reason, the annual treaty election may remain an important device in United States real estate investment for nonresidents, as it allows them the flexibility of choosing either the flat-tax on gross income or a progressive tax on net income on an annual, as opposed to investment-long basis. Because the Act eventually overrides treaty provisions only for the purpose of protecting the tax on the disposition of the real estate, annual treaty elections should remain effective for this purpose. For that reason, it would be advisable for the Treasury Department to consider renegotiation of annual elections in conjunction with its congressionally inspired negotiation of other provisions.

2. Sale of Stock in Real Estate Holding Company and Distribution of Other Entities

Where an annual treaty election was not available, real estate holding companies were utilized to avoid capital gains tax in either

116. The election will prevent the flat tax on gross income, but at the price of a progressive tax on net income. See supra text accompanying notes 61-65.
117. See supra note 57 and accompanying text.
119. Id. § 871(a)(1) (1976).
121. See supra text accompanying note 83.
122. If the effectively connected election becomes unattractive for any particular year after it is made, only the treaty election allows the nonresident to “elect out” for that year. See supra notes 99, 101. In addition, only the treaty election allows effectively connected determination to be made on a property-by-property basis rather than on all-U.S. property basis. H.R. REP. NO. 1167, supra note 18, at 509, reprinted in U.S. CODE CONG. & AD. NEWS 5872.
124. Id. § 1125(c)(2), 94 Stat. 2690.
of two ways under prior law. The most direct way was for the nonresident to sell his stock in the corporation rather than sell the real estate directly. While gain on the sale of the real estate may have been effectively-connected income and therefore subject to the capital gains tax, gain on the sale of the stock would most likely not be effectively-connected and therefore almost certainly exempted from tax. Although stock in a corporation owning United States realty was probably less marketable than the realty itself, the Code allowed a relatively painless mechanism for the purchaser to eliminate the corporate intermediary.

The Act provides a bifurcated response to this problem; a response depending upon whether the holding company is domestic or foreign. With respect to stock in a United States corporation, or a foreign corporation that has elected to be treated as a domestic

127. I.R.C. § 871(b) (Supp. V 1981); see supra note 73 and accompanying text.
129. See supra notes 71-74 and accompanying text.
130. The corporation may have liabilities, some of which may be unknown, which the purchaser is not interested in acquiring. See 2 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation 539 (2d ed. 1980). In addition, there are several potential tax problems which would not be encountered if the real estate were purchased directly. The most immediate of these which would be a continuation of the real estate's basis in the hands of the corporation. Id.
132. Although the term “stock” does not include the interest of a creditor, it does include convertible debt. H.R. Rep. No. 1167, supra note 18, at 514, reprinted in 1980 U.S. Code Cong. & Ad. News at 5877.
133. United States real estate holding companies were used twice as frequently as foreign real estate holding companies in 1974. Treasury Study, supra note 3, at 12-13 (Tables 2-4, 2-5).
corporation,\textsuperscript{134} the Act simply reverses the prior rule, which gener­
ally treated the gain on the sale of the stock as not effectively-con­
nected income.\textsuperscript{135} The Act, in effect, looks through the corporate
shell and treats ownership of the stock as ownership of the underly­
ing United States real property interest held by the corporation.\textsuperscript{136}

For administrative convenience, the new rule applies only to corpo­
rations that held substantial interests in United States real estate\textsuperscript{137}

\begin{itemize}
\item \textsuperscript{134} See infra note 161.
\item \textsuperscript{135} I.R.C. § 897(a)(1)(C) (Supp. V 1981).
\item \textsuperscript{137} This requirement is basically satisfied if United States real property interests
account for at least one half of the corporation's fair market value at any time during the
period described below. See infra note 136. While the statute would literally require the
taxpayer to show that the value of USRPI was lower than one half the corporation's
value at each moment during the testing period before being excepted from these rules,
the temporary regulations take a more practical view. Under the temporary regulations,
the taxpayer must supply schedules showing appropriate valuations on the last day of the
calendar year and at other significant intervals. Temp. Treas. Reg. § 6a.897-2(b), (d), (e)
(Sept. 20, 1982). While this approach significantly lessens the potential burden on the
taxpayer, it invites manipulation of asset holdings around the critical dates. For that
reason, the regulations allow acquisitions for the principal purpose of affecting these
rules to be disregarded. \textit{Id.} § 6a.897-2(f)(2).

Technically, the statute excepts from these “look-through” rules any domestic cor­
poration which was not at any time during that period a United States Real Property
Holding Corporation (USRPHC). It then defines a USRPHC as a corporation in which
the fair market value of its United States real property interests equals or ex­
ceds 50 percent of . . . the fair market value of . . . its United States real
property interests [plus] its interests in real property located outside the United
States, plus . . . any other of its assets which are used or held for use in a trade
or business.

I.R.C. § 897(c)(2) (Supp. V 1981). Thus, unless one half of the corporation's assets were
composed of United States real property interests, the corporation will not be considered
to be a USRPHC and thus disposition of an interest therein will not be subject to tax
under the Act as such interest is not a United States real property interest.

In order to determine a domestic corporation's level of United States real property
interests for these purposes, broad attribution rules have been provided. See I.R.C.
§ 897(c)(4)-(5) (Supp. V 1981). Thus, such interests held by a partnership, trust or estate
will be considered owned proportionately by a corporate partner or beneficiary. Temp.
Treas. Reg. § 6a.897-2(h) (Sept. 20, 1982). Similarly, such interests held by another cor­
poration, foreign or domestic, will be attributed back to a related corporation under
either of two sets of rules which depend upon whether the related corporation "controls,"
that is, holds at least fifty percent by fair market value of all classes of stock in that other
corporation. \textit{See id.} § 6a.897-2(i) (Sept. 20, 1982). For purposes of determining control,
the attribution rules of Code section 318 (1976) as modified for this purpose, are em­
ployed. I.R.C. § 897(c)(6)(C) (Supp. V 1981). The Act had originally attributed only the
USRPI held by partnerships, trusts or estates back to the corporate partner or benefici­
ar, without consideration of the proportionality of such holding by that non-corporate
entity. Such one sided attribution was probably not intended by the drafters and was
changed in 1981 to provide for attribution of all assets held by the non-corporate entity
for purposes of determining whether a corporation is a USRPHC. In further clarification
of its original intent, Congress specified in 1981 that these same rules were to apply to
during a prescribed period. In addition, the new rule is inapplicable to stock regularly traded on an established securities market if held by a small investor obviously to prevent discouraging portfolio foreign investment in the United States market.

Treatment of the sale of stock in this circumstance as if it were the sale of the underlying United States realty itself is necessary, of course, to protect the taxation scheme devised by the Act. It is also an effective mechanism through which to eliminate the obvious loophole that developed under prior law, in which a nonresident could avoid taxation simply by interposing a corporate facade between himself and an otherwise effectively-connected sale of realty. Although the Act provides for circumstances in which these new rules will not apply and, thus, opportunities for tax avoidance, such opportunities seem to be reasonably limited and, in any event, are appropriate to effectuate other congressional goals. If abuses develop, however, especially with respect to the definition of corporations included within the above rules, Congress should be

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138. I.R.C. § 897(c)(1)(A)(ii) (Supp. V 1981). The period is basically five years, with measurement commencing as of the date of disposition of an interest in the corporation held no United States real property interests and any such holdings during the period described below, see infra note 138, were disposed of in taxable transactions or ceased to be United States real property interests by reason of the application of this exception to another corporation. I.R.C. § 897(c)(1)(B) (Supp. V 1981). These rules also apply to holdings in Virgin Islands real estate or holdings by Virgin Islands Corporations. See infra note 148.


140. I.R.C. § 897(c)(3) (Supp. V 1981). For these purposes a small investor is a person who held no more than five percent of the class of stock actually disposed of at any time during the period previously described. See supra note 138. For purposes of determining whether the five percent test has been satisfied, modified section 318 attribution rules are employed. I.R.C. § 897(c)(6)(C) (Supp. V 1981).


142. Id.

143. See supra notes 126-29 and accompanying text.

144. For example, the rules apply only to a corporation which is, or has been within the last five years, a USRPHC. See supra notes 137-38. Small investors are also excluded. See supra note 140.

145. See supra notes 137, 140 and accompanying text.

146. These "look-through" rules apply only to a corporation in which a substantial
willing to make reasonable adjustments.\textsuperscript{147}

With respect to stock in a foreign corporation, other than a Virgin Island corporation to which special rules apply,\textsuperscript{148} the response is less direct. The Act does not attempt to change the prior rule in this proportion of its holdings consisted of United States real property interests at any time during the five year period. \textit{See supra} note 137. Thus, the corporation could, for example, build up its foreign real estate interest for five years and then sell its stock. A less than five year period can be effective under the proposed regulations, but will be subject to challenge if done principally for manipulative purposes. \textit{Id.}

\textsuperscript{147}. For example, in such cases a rule could be provided that taxes the corporation to the extent of its United States real property interests. The Act's treatment of gain on the disposition of an interest in a partnership, trust, or estate by a foreigner employs just such a proportionate tax rule. \textit{See infra} note 162.

\textsuperscript{148}. Under the so-called "mirror tax system," Virgin Islands corporations pay income tax to the Virgin Islands under tax rules which are read as if the names "Virgin Islands" and "United States" are substituted for one another in the Code. Such payment satisfies any United States tax otherwise imposed on such corporations. 48 U.S.C. \textsection 1642 (1976 & Supp. V 1981).

While the mirror tax and the Act's original definition of USRPI as real property interests located in the United States were effective in dealing with the situation where a Virgin Islands corporation owned Virgin Islands real estate, it did not seem to be effective in situations where a Virgin Islands corporation owned United States real estate. For example, if foreign investors set up a Virgin Islands corporation which held substantial interests in Virgin Islands real estate, the mirror tax would have required tax on the disposition of interests in the corporation under rules parallel to the situation where a United States corporation held such interests in United States real estate. The language of the statute, however, literally applied only where the location of the real estate and place of incorporation of the corporate holder coincided. That is, to be a USRPHC under section 897(c)(2) the corporation had to have substantial holdings in real estate located in the United States. Holding the mirror up to the statute, in order to be a Virgin Islands real property holding corporation (VIRPHC), the corporation had to have substantial holdings in real estate located in the Virgin Islands. Thus, holdings of United States real estate by the Virgin Islands corporation would not be subject to the real property holding corporation rules with the result that tax could have been avoided in the Virgin Islands. Since satisfaction of its tax obligation to the Virgin Islands, (even if the tax obligation was zero), satisfied any tax obligation to the United States, the provisions of the Act could have been circumvented. To prevent this and other lack of coordination problems created by the interplay of the Act and the mirror tax, Congress amended the Code to provide that a USRPI include an interest in real property located in the Virgin Islands as well as the United States. \textit{ERTA, Pub. L. No. 97-34, \textsection 831(a), 95 Stat.} 352 (codified at I.R.C. \textsection 897(c)(1)(A)(i) (Supp. V 1981)). Thus, for example, a Virgin Islands corporation owning substantial interests in United States real estate will be subject to the USRPHC rules. H.R. CONF. REP. No. 215, 97th Cong., 1st Sess. 276, \textit{reprinted in} 1981 U.S. CODE CONG. & AD. NEWS 365-66.

Under the ERTA amendment, the tax must be paid to and returns filed with, the jurisdiction in which the underlying interest in real property is located or, in the case of a sale of an interest in a real property holding corporation, to the jurisdiction of the incorporation. By making gains from the disposition of a USRPI which is located in the Virgin Islands non-United States sourced, \textit{ERTA, Pub. L. No. 97-34, \textsection 831(a), 95 Stat.} 352 (codified at I.R.C. \textsection 897(c)(1)(A)(i) (Supp. V 1981)), the amendment allowed United States persons paying tax to the Virgin Islands to receive a foreign tax credit.
circumstance and continues to allow non-effectively-connected treatment of sales of such stock. A nonresident investor remains able, after the Act, to avoid any direct United States taxation on the disposition of United States real estate through utilization of a foreign corporation. The Act, however, preserves the gain, and thus the future taxability, in the foreign corporation itself. That is, any gain element in the United States real estate continues after the sale of the stock because the corporation's basis in the real estate before the sale remains the same after the sale. At the time that the real property interest is distributed, the gain is triggered under the Act.

150. See supra notes 126-29 and accompanying text.
151. Id.
152. The Code initially preserves the gain element, see infra note 153, and the Act then insures against tax-free distribution, see infra note 154.
153. See 2 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, supra note 130, at 539.

The Act provided an exception to these rules where the distributee's basis in the distributed USRPI is carryover basis, increased by any gain recognized by the distributing corporation on the distribution. I.R.C. § 897(d)(1)(B) (Supp. V 1981). While this exception allowed a foreign subsidiary to distribute its United States real property interests tax-free to its foreign parent, the foreign parent would then be subject to taxation on its disposition of such interests under Code section 897. In such cases, the corporation would be no better off than if it had originally incorporated as a foreign corporation owning United States real property interests. Congress became concerned with the ability of certain foreign investors to avoid tax in this case where, for example, the foreign parent was incorporated in a country with which the United States had a treaty containing a provision allowing the foreign parent to dispose of the United States real property interest tax-free. Congress therefore amended the statute to provide as an additional requirement, that the distributee, measured as of the time of receipt of the property, needed to be subject to tax on its distribution of the property. ERTA, Pub. L. No. 97-34, § 831(c), 95 Stat. 353 (codified at I.R.C. § 897(d)(1)(B) (Supp. V 1981)). Thus, in the case described above, the exception would not apply until the treaty provision is overruled. H.R. CONF. REP. NO. 215, supra note 96, at 277, reprinted in 1980 U.S. CODE CONG. & AD. NEWS at 366-67. In addition, Congress specifically provided the Secretary of Treasury with regulatory authority to allow nonrecognition provisions to apply where tax avoidance is absent. Id., reprinted in 1980 U.S. CODE CONG. & AD. NEWS 366.

Congress also grandfathered the tax-free liquidation of a foreign corporation in certain cases. A foreign corporation acquired by a United States corporation between De-
The prior painless mechanism for the purchaser to eliminate the corporate intermediary has thus been removed.  

While the Act has successfully injected pain into this method of tax avoidance on the disposition of United States real estate, the pain is not nearly as sharp as in the case of a domestic holding company. This dual standard is unfortunate. If outright reversal of the prior rule is an appropriate response to the problem created by a domestic holding company, then an equal response in the case of a foreign holding company would appear to be equitable. The Act's preservation of the gain in the real estate, and its limitation on the purchaser's ability to undo that preservation in any fashion other than by unleashing that gain in a taxable transaction, will undoubtedly depress the value of the stock of the company holding the real estate. Although this will result in some cost to the nonresident shareholder on its sale, the cost may well be far less than the tax that would otherwise be due if the purchaser does not quickly liquidate the corporation. Of course, policing the sale of stock in a foreign corporation by a nonresident is more difficult than policing such a sale of stock in a domestic corporation. Thus, the Act's dual standard may be the only practical solution to this problem. However, the same treatment is required in the case of foreign corpora-

December 31, 1979 and November 26, 1980, may elect tax-free liquidation treatment under I.R.C. § 334(b)(2) (1976). ERTA, Pub. L. No. 97-34, § 831(g), 95 Stat. 354 (codified at I.R.C. § 897(k) (Supp. V 1981)). Such treatment will allow the avoidance of tax to the distributing corporation under I.R.C. § 897(d) (Supp. V 1981), and will also allow a step-up in basis in the United States real estate in the hands of the United States corporate purchaser. H.R. CONF. REP. NO. 215, supra note 96, at 279, reprinted in 1981 U.S. CODE CONG. & AD. NEWS 368. The election can be easily made and is subject to no conditions. Temp. Treas. Reg. § 6a.897-4. The reason for this exception from taxation under the Act's taxing scheme is that the original Senate and House bills would have imposed the tax on the foreign shareholders in this case and not on the foreign corporation. Thus, until the conferees shifted the tax burden to the foreign corporation itself, a purchaser of the corporation would have had every expectation that tax-free liquidation and basis step-up would have been possible, even after the Act's enactment. For a related relief provision for individual purchasers of foreign stock, see infra note 176.

155. See supra note 131. The potential for a tax-free liquidating distribution has been eliminated by the Act in these circumstances. See supra note 154.

156. See supra notes 132-37 and accompanying text.

157. Id.

158. See supra note 154.

159. This result occurs because the tax liability is deferred until the occurrence of a taxable transaction. This deferral significantly reduces the impact of the tax liability, see Surrey, The Tax Reform Act of 1969—Tax Deferral and Tax Shelters, 12 B.C. IND. & COM. L. REV. 307, 310 (1971), and the longer the deferral, the more significant the reduction. Here, the investor, as owner of the corporation, has control over the timing of the distribution.

tions electing under the Act to be treated as domestic corporations for purpose of Code section 897. The Act also provides special, but analogous rules for distributions of interests in partnerships, trusts, estates, and real estate investment trusts, possessing

161. I.R.C. § 897(i) (Supp. V 1981). Under the Act, foreign corporations that had a permanent establishment in the United States, and were protected by treaties against less favorable treatment than domestic corporations carrying on the same activities, were allowed to make an election to be treated as a domestic corporation for the purposes of these rules. Id. Because some taxpayers were apparently claiming an inability to make this election as formulated by the Act, the provision was reworked to clearly provide that any foreign corporation owning aUSRPI, and protected against discriminatory treatment, under a treaty could make the election. ERTA, Pub. L. No. 97-34, § 831(d) 95 Stat. 353 (codified at I.R.C. § 897(1) (Supp. V 1981)). Congress also reaffirmed its original intent that this election was to provide the exclusive remedy against claims of discriminatory treatment by the operation of Code section 897 or section 6039(C). H.R. Conf. Rep. No. 215, supra note 96, at 278, reprinted in 1981 U.S. Code Cong. & Ad. News 367. The election can be revoked only with the consent of the Secretary of the Treasury. The election is effective only if all the shareholders consent and specifically agree to tax that under the Act even if such taxation was prohibited by treaty. For stock traded on an established market, no consent need be secured from five percent or smaller shareholders. Id.

The temporary regulations provide, after a long phase-in period, a relatively short period (ninety days) after the acquisition of a USRPI in which the foreign corporation can make the election. Temp. Treas. Reg. § 6a.897-3(f) (Sept. 20, 1982). The rules for qualification are also tightly drawn. Id. § 6a.897-3.

The sale of stock in a foreign corporation which has made such an election will be taxable to the nonresident seller under the deemed effectively connected rules of Code section 897(a). Id. § 6a.897-3(a)(3). See supra notes 132-47 and accompanying text discussing the sale of stock in a domestic real estate holding company.


163. Generally, income from a real estate investment trust (REIT) is taxed on a "pass through" basis to its distributee shareholders rather than to the REIT itself. I.R.C. §§ 856-860 (1976 & Supp. V 1981). Under the Act, the pass through treatment is retained for distributions to foreign shareholders which are attributable to gain from the sale or exchange of USRPIs by the REIT. Id. § 897(h)(1) (Supp. V 1981). As such, foreign distributees are treated as if they sold or exchanged the USRPI directly and thus are taxable under the general rule of Code section 897. Id. § 897(a)(1) (Supp. V 1981).

With respect to the sale of an interest in a REIT, the Act employs a bifurcated treatment depending upon whether or not the REIT is domestically controlled; that is, one in which less than fifty percent of its stock was held by foreigners for, generally, the last five years. Id. § 897(h)(4) (Supp. V 1981). By specifically excluding from the definition of USRPI any interest in a domestically controlled REIT, the Act allows the sale of such an interest by a foreign person to avoid its taxation scheme. Id. § 897(h)(2) (Supp. V 1981); H.R. Conf. Rep. No. 1479, supra note 92, at 188, reprinted in 1980 U.S. Code Cong. & Ad. News 5971. Distributions of USRPIs by such domestically controlled REITs will be taxable to the REIT, however, to the extent of its foreign ownership percentage. I.R.C. § 897(h)(3) (Supp. V 1981). Because non-domestically controlled REITs are not specifically excluded from the definition of USRPI, a foreigner's sale of an interest therein will be subject to tax under the rules discussed above. See supra note 162.
USRPI's.

3. Tax-Free Liquidation of Real Estate Holding Company

If the sale of the company were to prove too difficult, there was another method available to the nonresident, allowing him the opportunity to sell the real estate directly. Under this method, the corporation would sell the real estate after it had adopted a plan of complete liquidation\(^{164}\) and would then distribute the proceeds to the nonresident shareholder in exchange for his stock.\(^{165}\) While the gain on the sale by the corporation might have been income effectively-connected with its United States trade or business,\(^{166}\) it was received tax-free under the Code if the corporation liquidated in a prescribed fashion.\(^{167}\) The distribution of the sale proceeds by the corporation to the nonresident shareholder in exchange for his stock was generally a taxable transaction to the shareholder,\(^{168}\) although they usually proved to be tax-free to a nonresident\(^{169}\) since neither the ownership of the stock nor infrequent sales of stock were sufficient to establish a United States trade or business.\(^{170}\) Without a United States trade or business, the effectively-connected rules would not apply to the nonresident's gain on the exchange of stock,\(^{171}\) with the almost certain result that the gain would be exempt from tax.\(^{172}\)

As in the case of the sale of stock in a real estate holding company,\(^{173}\) the Act's response to this problem is bifurcated. If the liquidated corporation were a United States corporation, then receipt of the liquidation proceeds in exchange for the nonresident's stock

\(^{164}\) I.R.C. § 337(a) (1976); Treas. Reg. § 1.337-2(b) (1955).
\(^{166}\) Treas. Reg. § 1.864-4(c) (1972).
\(^{169}\) Code section 331(a)(1) treats the distribution as proceeds received from the sale of stock. Sale of stock by a nonresident shareholder is taxable in the United States only under limited circumstances. See infra note 172.
\(^{170}\) Treas. Reg. § 1.864-2(c) (1968).
\(^{172}\) See supra notes 73-76 and accompanying text.
\(^{173}\) See supra notes 125-63 and accompanying text.
would be a taxable transaction since the stock itself is treated, in this
circumstance, as a United States real property interest.\textsuperscript{174} Thus, re-
ceipt of the liquidation proceeds presents a taxable transaction to the
nonresident shareholder.\textsuperscript{175} In situations where the liquidated cor-
poration is a foreign corporation, the Act prevents it from selling the
real estate in a nontaxable fashion\textsuperscript{176} and, thus, gain will result to the
corporation on the sale of its real estate.\textsuperscript{177} Thus, regardless of
where the corporation is established, gain will now result immedi-
ately on the sale under this previously effective method of tax avoid-
ance.\textsuperscript{178} The location in which the corporation is established is im-
portant, however, since it is determinative of the person upon whom
the tax burden falls.\textsuperscript{179} Thus, corporate location will continue to be
an important tax-planning consideration.\textsuperscript{180} This distinction in the
identification of the taxpayer, based upon place of incorporation,
necessarily places some flexibility in the hands of the nonresident

\footnotesize{\textsuperscript{174} I.R.C. § 897(c)(1)(A)(ii) (Supp. V 1981); see supra notes 132-41 and accompa-
nying text.}
\footnotesize{\textsuperscript{175} I.R.C. § 897(a) (Supp. V 1981), amended by TEFRA, Pub. L. No. 97-248,
§ 201(a), 96 Stat. 411-19.}
\footnotesize{\textsuperscript{176} Id. § 897(d)(2) (Supp. V 1981). In 1981 Congress enacted a limited exception
to this denial of tax-free sale at the foreign corporate level. In cases where a United
States individual owns stock in a foreign corporation which holds United States real
estate, tax would be imposed at both the corporate and shareholder levels as a result of a
twelve month liquidation. See infra note 177. For foreign shareholders, the “second” tax
would almost surely not apply. See supra notes 168-70 and accompanying text. Thus,
the main thrust of the Act’s provision was to insure the imposition of one tax on the
appreciation in the United States real estate. As for United States shareholders, the Act
would have imposed two taxes had Congress decided to allow a credit to the United
States shareholder in an amount (after his proceeds from the liquidation were grossed-up
by that amount) equal to the proportionate part of the tax imposed on the corporation
because of Code section 897(d) against the tax imposed on the surrender of his stock.
1981)). The relief provision applies, however, only to shareholders who have continu-
ously held such stock since June 18, 1980. Thus, although the double tax burden still
exists for United States persons buying such stock after that effective date, no relief is
offered to such persons. For a related relief provision for United States corporate pur-
chasers, see supra note 154.}
\footnotesize{\textsuperscript{177} I.R.C. §§ 61(a)(3), 1001(c) (1976). Before the Act, Code section 337
would have prevented taxation at the corporate level in appropriate cases. See supra notes 164-
67 and accompanying text.}
\footnotesize{\textsuperscript{178} See supra notes 174-77.}
\footnotesize{\textsuperscript{179} If the corporation is domestic, the tax burden falls upon the shareholder. See
supra note 175. If the corporation is foreign, the tax burden falls upon the corporation.
See supra notes 176-77.}
\footnotesize{\textsuperscript{180} The choice of the appropriate foreign person to tax will turn upon a projec-
tion of which one will be in a lower tax bracket at the time of the disposition of the real
estate.}
4. Like-Kind Exchange

Another option open to the nonresident was to engage in a "like-kind" exchange. Under the Code, if business or investment property were exchanged for business or investment property of a like-kind, the tax due on any gain realized on the transfer was deferred until the newly acquired property was disposed of in a taxable manner. As a result the nonresident could have exchanged ownership of his United States real property for ownership of foreign real property of like-kind and incurred no tax on the transaction. Case law allowed this scheme to be effective even if the purchaser of the United States realty had recently acquired the foreign realty solely for the purpose of engaging in the tax-free exchange.

The Act's response to this problem is to delegate to the Secretary of the Treasury the authority to prescribe applicable rules in the form of regulations. These rules will determine when and to what extent the Code's nonrecognition rules, of which like-kind exchanges are only one, would apply to dispositions of foreign investments in United States real estate.

The blanket application of the like-kind exchange rules and other nonrecognition provisions to nonresident aliens and foreign corporations was always unsound. Although the specific policy reasons for the enactment of the various nonrecognition provisions may vary, they generally represent situations in which the continuity of the underlying investment has been changed more in form than in substance. The policy reasons represent basic congressional decisions in favor of postponing the tax on admittedly realized gain until

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181. This statement is especially true as the place of incorporation is completely within the control of the nonresident. If United States tax status turned upon a less arbitrary standard, as it does in many other countries, for example, place of effective management, the rule would be less troublesome. TREASURY STUDY, supra note 3, at 22-23.


183. I.R.C. § 1031(a) (1976). If non-like-kind property is also received on the exchange, gain is recognized to that extent. Id. § 1031(b) (1976).


a more appropriate time.\textsuperscript{188} The precise basis computation mechanisms always enacted in conjunction with the nonrecognition provisions attests to congressional intent that those provisions merely defer, and not forgive, eventual taxation.\textsuperscript{189} Although forgiveness of the tax is always a possibility when the tax is originally deferred, that result should be allowed to occur only as a result of deliberate congressional design.\textsuperscript{190} Use of the source rules to accomplish that result hardly measures up to such a standard.\textsuperscript{191}

When appreciated United States real estate is exchanged for foreign real estate of a like-kind, the gain realized on the exchange is clearly United States source gain.\textsuperscript{192} Prior to the Act, the Code allowed deferral of tax on the gain until the foreign real estate was disposed of in a taxable transaction.\textsuperscript{193} At that time, the entire gain on the disposition of the foreign real estate would be non-United States taxable since the gain was non-United States sourced.\textsuperscript{194} The assumption behind this statutory rule appears to be that the entire gain recognized on the sale is sourced in the foreign country in which the property is situated. Of course, with respect to the portion of the gain attributable to appreciation in value of the foreign real estate while owned by the taxpayer, that assumption is true. With respect to the portion of the gain attributable to the appreciation in

\begin{enumerate}
\item \textsuperscript{190} See, e.g., I.R.S. § 1014 (1976 & Supp. V 1981). This section allows heirs to take property at an income tax basis equal to its fair market value, and thus exempts all tax on the untaxed appreciation in such property. If the decedent held property that carried a lower-than-value basis because of a prior nonrecognition transaction in which tax had been deferred, that property also could be inherited with a stepped-up-to-market-value basis. In such cases, the prior deferral of tax would be transmuted into a forgiveness of tax. Congressional intention to provide for this result cannot be doubted as a recent attempt to change that result was repealed before it became effective. Crude Oil Windfall Profits Tax Act of 1980, Pub. L. No. 96-223, § 401, 94 Stat. 299-301 (1980); S. Rep. No. 394, 96th Cong., 2d Sess. 124-25, reprinted in 1980 U.S. Code Cong. & Ad. News 410, 530-31.
\item \textsuperscript{191} While Congress has clearly designated that non-United States sourced income not be taxed to a nonresident, the combination of Code section 1031 deferral and section 871 exemption on non-United States sourced income is much less calculated than the combination of that same deferral combined with a section 1014 exemption.
\item \textsuperscript{193} Id. § 1031 (1976).
\end{enumerate}
value of the United States real estate carried over to the foreign real estate by means of the basis provisions, however, the assumption is not true. That portion of the gain represents an increase in wealth clearly sourced in the United States. The disposition of the foreign real estate is merely the triggering event that measures the appropriate time to end the deferral and does not affect the character or source of the gain. Even assuming the validity of this analysis, the practical problems associated with its enforcement would be insurmountable. If the nonresident had no contacts with the United States at the time of disposition of the foreign real estate, the likelihood of his reporting the transaction in the United States would be very remote. Even if the nonresident retained contacts with the United States at the time of the disposition, the functional inability of the Internal Revenue Service (IRS) to discover facts indicating that the disposition of the foreign realty occurred would certainly provide a disincentive to reporting the gain, especially if the gain were not otherwise taxable to the nonresident.

Practicality certainly demands that the tax not be deferred in this situation. Indeed, the rule ought to be just the opposite: Nonrecognition should be allowed only in cases where collection of the

195. For example, assume N exchanged United States real estate which it had purchased for fifty dollars for foreign real estate at a time when each was worth seventy-five dollars. If the exchange qualified as like-kind under Code section 1031(a), no gain would have been recognized at that time. Assume further that N later sold the foreign real estate for one hundred thirty-five dollars. Since under section 1031(d) N's basis in the foreign real estate is fifty dollars, N's gain on the sale is eighty-five dollars, all of which is considered to be foreign sourced. See supra note 194. It is clear, however, that the foreign real estate appreciated in value by only sixty dollars and that the other twenty-five dollars of gain recognized on the sale is attributable to the appreciation in value of the United States real estate that was allowed to be disposed of tax-free.

196. The contrary argument indicates that the basis mechanism preserves the gain not recognized in the exchange of the original property by building into the new property an equal amount of gain. While the reason for building in that gain is obviously to account for the gain not taxed on the original property, the statutory mechanism is content with allowing that gain to escape taxation altogether as long as the potential gain on the new property has been increased. In such circumstances, all the gain belongs to the new property.

197. Also, rules would have to be worked out to cover cases where the original property appreciated in value and the new property depreciated in value before the sale, and vice versa. The question would have to be answered as to whether United States source gain should be allowed to be offset by foreign source loss, and vice versa, in these types of transactions.

198. Some countries impose no tax on the gain from the sale of property. See Treasury Study, supra note 3, at 60 (appendix B).

199. Deferral in this situation will almost always be elevated to an exemption. See supra note 194 and accompanying text. The problem created by nonrecognition provisions as applied to nonresidents is not new. Analogous concerns were raised with respect
tax would not be in greater jeopardy after the transaction than before. The Act seems to recognize such a position because it provides that, until appropriate regulations are promulgated, nonrecognition will continue to apply only to exchanges where the property received is property "the sale of which would be subject to taxation under [the Code]."²⁰⁰

The construction of the statute is less than clear. Gain from the sale of any property would be subject to taxation under the Code if held by the proper person, such as a United States citizen.²⁰¹ Although the Committee reports offer no additional enlightenment, it would be unthinkable for a court to apply such a construction since it would render the entirety, of an otherwise restrictive clause, meaningless. Undoubtedly, the hypothetical sale to which the section refers is one in which the nonresident alien individual or foreign corporation disposed of the original interest in United States real property.²⁰² Read in this light, the acquisition of like-kind foreign real estate would no longer justify deferral and exemption,²⁰³ since the source of any gain upon its disposition would preclude taxation in the United States,²⁰⁴ if held by a nonresident.²⁰⁵

If the individual had, by the time of the sale, acquired United States residence or citizenship, the sale "would be subject to taxation under [the Code]."²⁰⁶ Again, without assistance from legislative history, it is reasonable to expect that such a statutory construction would be rejected by the courts.²⁰⁷ Proper construction of the statutory language requires an evaluation of the individual's status as of the time of the exchange. This is not to say, however, that determination of the applicability of the statute should always turn upon the actual facts extant at the time of the exchange, that is, a deemed sale immediately after the exchange. For example, assume that a nonresident owns stock in a "United States Real Property Holding Corporation" (USRPHC)²⁰⁸ and exchanges it in a nonrecognition to tax-free transfers of property to foreign corporations, a problem which found a solution in Code section 367 (1976).

²⁰³. See supra note 194 and accompanying text.
²⁰⁷. Otherwise, the restrictive clause would be rendered meaningless. See supra text accompanying notes 201-02.
²⁰⁸. See supra note 137.
transaction for stock in a corporation not so classified. The immediate sale of the acquired stock by the nonresident "would be subject to taxation under [the Code]" if sold in the United States. The existence of either of these contingencies at the time of original exchange will, of course, not guarantee their existence at the time of disposition of the acquired stock. Furthermore, their existence or absence is within the control of the nonresident. Since deferral should apply only in cases where guarantees are present, that is, where the sale of acquired stock would be subject to taxation under any circumstances, the nonrecognition provisions should not apply in this case either.

The only situation that apparently lends itself to both continuity of investment and a guarantee of future tax subjectivity is one in which the property received in exchange for a United States real property interest is, itself, a United States real property interest. The regulations, therefore, should be interpreted to allow nonrecognition of gain to apply only upon receipt by a nonresident of a U.S.R.P.I.

In 1981, Congress included the transfer of a U.S.R.P.I. to a foreign corporation, as a contribution to capital or as paid-in surplus, within these rules. For the same reasons as discussed above, the regulations should allow nonrecognition in this situation sparingly.

5. Installment Sales

The situations discussed above dealt with cases in which the rental or royalty income could be treated as effectively-connected with the conduct of a United States trade or business under an election made by the nonresident. In cases involving income that was actually effectively-connected, the uncoupling of capital gains on disposition from effectively-connected status could have been ac-

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210. This is especially true with respect to the sale of personal property where source is determined according to the place of sale. Treas. Reg. § 1.861-7(a) (1957).
212. See supra text accompanying notes 199-200.
213. The Committee Report contains language inviting, but not demanding, a contrary approach: "These regulations may, under appropriate circumstances and conditions, provide for nonrecognition even where the taxpayer does not receive in the exchange a U.S. real property interest." H.R. REP. No. 1167, supra note 18, at 512, reprinted in 1980 U.S. CODE CONG. & AD. NEWS 5875.
214. ERTA, Pub. L. No. 97-34 § 831(f), 95 Stat. 354 (codified at I.R.C. § 897(j) (Supp. V 1981)). In effect, the transfer is treated as a taxable exchange since the gain is measured as the difference between the fair market value of the U.S.R.P.I. and its adjusted basis in the hands of the transferor.
215. See supra note 59.
complished in a different manner. As previously stated,\textsuperscript{216} the determination whether a nonresident is engaged in a United States trade or business is made annually. Thus, if in the year of sale the activities of the nonresident were insufficient to qualify the real property for trade or business status,\textsuperscript{217} the non-effectively-connected rules would apply for that year.\textsuperscript{218} Of course, that determination is a factual one and would necessarily involve a great deal of uncertainty. What is certain, however, is that the year of sale marked the last year of potential trade or business status for that real estate activity.\textsuperscript{219} Thus, if the nonresident could postpone recognition of the gain from the sale of the real estate to a year or years after the year of sale, and during which the nonresident is not engaged in a United States trade or business,\textsuperscript{220} the result will be income not effectively-connected although it would have been so treated if recognized in the year of sale.\textsuperscript{221} One easy method of accomplishing this postponement is for the nonresident to report income under the installment sales provision under Code section 453.\textsuperscript{222} Basically, the installment sales provision taxes the gain proportionally as the sale proceeds are received.\textsuperscript{223}

If no proceeds are received in the year of sale, then none of the gain is taxed that year\textsuperscript{224} and, thus, total "uncoupling" with the effectively-connected rules was accomplished.\textsuperscript{225} As stated above,\textsuperscript{226} the degree of activity of the nonresident in the year of sale is no longer relevant to the question of taxation on the disposition of real property interests as the Act automatically provides for satisfaction of the effectively-connected test.

The phenomenon of changing the taxable effectively-connected characterization to a nontaxable non-effectively-connected one by merely postponing payment to the next tax year obviously could not

\textsuperscript{216} \textit{See supra} note 55.
\textsuperscript{217} \textit{See supra} notes 50-54 and accompanying text.
\textsuperscript{218} \textit{See supra} notes 71-74 and accompanying text.
\textsuperscript{219} \textit{Id.} \S 1.864-3 (1972).
\textsuperscript{220} \textit{Id.} \S 1.871-8(c)(1) (1960).
\textsuperscript{221} \textit{Id.} \S 1.864-3 (1972).
\textsuperscript{223} \textit{Id.} \S 453(c) (Supp. V 1981).
\textsuperscript{224} \textit{Id.} The statute, as amended by the Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980), provides for application of the installment sales provision even in cases where a single lump-sum payment is received, as long as it is received in a taxable year subsequent to the year of sale. Temp. Treas. Reg. \S 15A.453-1(b)(1).
\textsuperscript{225} \textit{See supra} note 221.
\textsuperscript{226} \textit{See supra} text accompanying note 95.
withstand a comprehensive overhaul of the system. As with the like-kind exchange rules noted earlier, the installment sales rules are designed to postpone tax until a more convenient time—here, when the cash proceeds from the sale are actually received—and not to forgive the tax. The Act's treatment of the disposition as effectively-connected is an efficient and simple solution to this problem since it allows taxation on the gain recognized from the disposition whenever the proceeds are received.

IV. ENFORCEMENT PROVISIONS UNDER THE ACT

A. Introduction

Effectively defining the disposition of investment real estate by a foreigner as a taxable transaction was only one-half the challenge of the Act. Insuring a proper mechanism for the collection of the tax on the transaction is as important as insuring the taxability of the transaction itself. To that end, the Act has imposed new enforcement provisions while, at the same time, spurning the traditional method of imposing a withholding requirement.

B. Reporting Requirements

The Act's method of enforcing these provisions employs reporting requirements, which are substantial as to degrees of coverage and a penalty for noncompliance. Basically, the Act requires disclosure of all foreign persons holding a substantial USRPI. Reporting is required of any foreign person holding an interest at any time during the year in a domestic corporation that was an USRPSC at any time during the current or preceding four years, unless the corporation's stock was regularly traded on an established securities market at all times during the calendar year. Reporting

227. See supra text accompanying note 183.
228. See supra notes 188-91 and accompanying text.
230. See supra notes 71-74 and accompanying text.
231. See infra notes 232-41 and accompanying text.
232. See infra notes 242-50 and accompanying text.
234. Id. § 6652(g) (Supp. V 1981).
235. The required disclosure includes the name and address of the foreign investor and such other information as the Secretary of the Treasury may prescribe in regulations. Id. § 6039C(a)(1)(A) (Supp. V 1981).
is also required of any foreign person holding a substantial indirect investment in United States real property through a foreign corporation, domestic or foreign partnership, or trust or estate.\textsuperscript{238} For these purposes, a substantial indirect investment includes a pro rata share of the USRPI held by the entity at any time during the calendar year which is in excess of fifty-thousand dollars.\textsuperscript{239} The Act allows the avoidance of these reporting requirements, however, by furnishing the Secretary of the Treasury with adequate security to insure payment of the tax,\textsuperscript{240} a requirement that undoubtedly can be simply satisfied with a bond. Finally, any foreign person not otherwise required to file a return is required to do so if such person did not engage in a United States trade or business during the calendar year and held a substantial USRPI at any time during the year.\textsuperscript{241} The penalty for failure to make a required return is twenty-five dollars for each day that the failure continues, up to certain limits,\textsuperscript{242} but does not apply if the failure is due to reasonable cause and not to willful neglect.

C. Withholding

The Act does not require any withholding on gains from the disposition of a USRPI. Members of the Senate Finance Committee proposed the implementation of withholding on several occasions.\textsuperscript{243} In its original formulation, withholding would have been required only in cases where the purchaser had actual knowledge of the seller’s foreign status.\textsuperscript{244} If the seller, or seller’s agent had reason to believe that the seller might be a foreign person, both would have

\textsuperscript{238} I.R.C. § 6039C(b) (Supp. V 1981). For a determination as to when a foreign person holds such an indirect interest, see Temp. Treas. Reg. § 6a.897-1 (Sept. 20, 1982).


\textsuperscript{241} I.R.C. § 6039C(c) (Supp. V 1981).

\textsuperscript{242} I.R.C. § 6652(g) (Supp. V 1981). The maximum amount of the penalty is twenty-five thousand dollars or, in the case of a foreign person required to file under § 6039C(c), see \textit{supra} text accompanying note 240, the lower of twenty-five thousand dollars or five percent of the value of such person’s real estate investments for the year. I.R.C. § 6652(g)(3)(B) (Supp. V 1981).

\textsuperscript{243} See \textit{infra} note 247.

\textsuperscript{244} H.R. CONF. REP. NO. 1479, supra note 92, at 189, reprinted in 1980 U.S. CODE CONG. & AD. NEWS 5972.
been required to so notify the purchaser.\textsuperscript{245} In addition, exceptions were provided for the sale of single family residences up to certain valuations, for stock sold on an established securities market, or cases in which arrangements were made with the Treasury for the payment of the tax.\textsuperscript{246} In conference, the Senate conferees modified these provisions in several respects, including relieving the seller's agent from the responsibility of notifying the purchaser of the seller's foreign status if the agent relied in good faith upon the seller's statement that he was either not foreign or that he had notified the purchaser of his status.\textsuperscript{247}

Having failed in its attempt to enact a withholding provision on such gains as part of the original Act, the Senate again tried in each of the following two years to amend the Code to that effect.\textsuperscript{248} The substance of the amendment was basically the same as that proposed originally in conference and, presumably for the same reasons, failed again on each occasion.\textsuperscript{249}

The failure of Congress to impose this traditional and historic safeguard casts serious doubt on the effectiveness of the Act. A system of withholding has always been considered to be a necessary and integral part of the taxation scheme applicable to nonresidents.\textsuperscript{250} The existing system, withholding income prior to its exit from the United States, is sophisticated and workable. The system can be easily adapted to gains on the disposition of United States real estate.\textsuperscript{251}

V. IRC Solution to Taxing Nonresident Aliens on Income "Earned" Within the United States

A. Persons Required to Withhold

Under the statutory scheme, an agent is appointed to withhold and collect tax on the nonresident's income. The withholding agent, usually the last person to have control over the earnings prior to its dispersal to the nonresident alien, is defined as "any person required

\textsuperscript{245}  Id.
\textsuperscript{246}  Id.
\textsuperscript{247}  Id.
\textsuperscript{250}  See supra text accompanying note 37.
\textsuperscript{251}  See infra notes 286-94.
to deduct and withhold any tax" under chapter 3 of the Code. This definition is broad enough to encompass any foreign or domestic individual, partnership, trust, estate, association, or corporation. Therefore, any person who makes a payment of, or has the control, receipt, custody, or disposal of any item of income subject to withholding is a withholding agent. The fact that chapter 3 of the Code does not require a tax to be withheld from such items of income does not relieve the payor from his classification as a withholding agent.

The duty to withhold income persists regardless of the capacity of the withholding agent. The classification of a person as a withholding agent imposes liability for the payment of the tax whether or not he actually withholds that amount.

B. Persons Subject to Withholding Rules

Chapter 3 withholding applies to two types of payees: certain foreign persons receiving income which is subject to withholding;
and persons receiving interest on certain tax-free covenant bonds.\textsuperscript{259} The foreign persons subject to chapter 3 withholding are foreign partnerships, foreign corporations, and nonresident alien individuals.\textsuperscript{260} Foreign corporations include foreign private foundations, although special rules apply.\textsuperscript{261} A partnership or a corporation is classified as foreign if it is not created or organized in the United States or under the laws of the United States or of any state.\textsuperscript{262} The term "nonresident alien individual," however, is not easily classified. Under the Treasury Regulations, a nonresident alien individual is described as an individual "whose residence is not within the United States, and who is not a citizen of the United States."\textsuperscript{263} Therefore, the crucial test is in establishing residence and the difficult cases revolve around the subjective determination of the residence of an alien temporarily present in the United States. The residence of an alien is determined by that individual's intentions with regard to the length and nature of his stay. An individual is considered a resident of the United States if he is other than a transient, if he lives in the United States, and has no definite intention as to the length of his stay; or if he plans an extended, although not permanent, stay to accomplish the purpose for which he came to the United States, even though he intends to return to his domicile abroad when that purpose has been achieved.\textsuperscript{264}

Initially, an alien is presumed to be a nonresident merely by

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\item[259.] \textit{Id.} § 1451 (1976). This provision applies only to tax-free covenant bonds or similar obligations issued by corporations before January 1, 1934. In such cases, the corporation must withhold on payments made to both residents and nonresidents. Treas. Reg. § 1.1451-1 (1960).
\item[260.] \textit{Id.} § 1441(a) (1976); Treas. Reg. § 1.1441-1, T.D. 7385, 1975-2 C.B. 298, 304. An alien who is a resident of Puerto Rico is considered a nonresident alien individual for purposes of withholding under Code section 1441(e) (1976), even though he is generally taxed in the same fashion as United States residents. \textit{Id.} § 876 (1976). A resident of the Virgin Islands is, however, exempt from withholding since he is required to pay a tax determined under United States standards to the Treasury of the Virgin Islands. Treas. Reg. § 1.1441-4(d), T.D. 6922 (1967). \textit{See supra} note 148.
\item[261.] Treas. Reg. § 1.1443-1(b)(1) (1956). Gross investment income paid to a private foundation created under the laws of a foreign country or a United States possession is subject to Chapter 3 withholding. The tax withheld is the four percent excise tax imposed by Code section 4948(a) (1976). Payments to foreign corporations, which would be tax exempt if organized under the laws of the United States, are exempted from withholding on all but their unrelated business income. Treas. Reg. § 1.1443-1(a)(2), T.D. 7229, 1973-1 C.B. 265, 291.
\item[263.] Treas. Reg. § 1.871-2(a) (1957).
\item[264.] Treas. Reg. § 1.871-2(b) (1957).
\end{itemize}
reason of his alienage.\textsuperscript{265} If the alien's stay is limited to a definite period by the immigration laws, nonresidence is again presumed.\textsuperscript{266} Similarly, presence in the United States for less than one year gives rise to a presumption of nonresidence.\textsuperscript{267} Notwithstanding any of these presumptions, however, proof of an intention to acquire United States residence or citizenship will establish residence for tax purposes.\textsuperscript{268} Once United States residence is established, it is retained until it is abandoned and the alien actually departs from the United States.\textsuperscript{269}

C. \textit{Income Subject to Withholding}

The definition of income subject to withholding is initially very broad: "The gross amount of fixed or determinable annual or periodical income."\textsuperscript{270} The long list of items within this definition is subject to many exceptions. Chapter 3 imposes several preliminary requirements before any income may be subject to withholding.

First, the payment must be of an income item which is specifically included within the definition of gross income. Thus, items specifically excluded from the definition of gross income of a nonresident alien individual,\textsuperscript{271} or foreign corporation,\textsuperscript{272} are not subject to withholding.\textsuperscript{273}

Second, withholding is required only on income derived from sources within the United States.\textsuperscript{274} Thus, Code sections 861-64,

\begin{itemize}
\item \textsuperscript{265} Treas. Reg. 1.871-4(b) (1957). This presumption, however, can be overcome. Rev. Rul. 611, 1969-2 C.B. 150, provides a presumption of residence in cases where the alien stays in the United States for one year or more. Adams v. Commissioner, 46 T.C. 352, 362 (1966) (ownership of a home in Florida where the alien spent 40 weeks per year and where her children went to school was sufficient to establish United States residence since she "was assimilated into . . . the community").
\item \textsuperscript{266} Treas. Reg. § 1.871-2(b) (1957).
\item \textsuperscript{268} Brittingham v. Commissioner, 66 T.C. 373 (1976), aff'd, 598 F.2d 1375 (5th Cir. 1979) (the court found United States residence where the alien's stay was limited by immigration laws); see also Treas. Reg. § 1.871-4(c) (1957).
\item \textsuperscript{270} Treas. Reg. § 1441-2(a)(1), T.D. 6873 (1966).
\item \textsuperscript{271} The following items are excluded from withholding: (1) earnings derived from ships and aircraft of a foreign country which provides a reciprocal exclusion; (2) compensation of certain nonresident aliens participating in certain exchange or training programs; and (3) interest on certain government bonds by residents of the Ryukyu Islands or Trust Territory of the Pacific Islands. I.R.C. § 872(b) (1976).
\item \textsuperscript{272} Id. § 883 (1976) provides a parallel exclusion to item (1), see supra note 270, and also excludes earnings of a foreign railroad in certain cases on a reciprocal basis.
\item \textsuperscript{274} I.R.C. § 1441(a) (1976); Treas. Reg. § 1.1441-3(a), T.D. 6500 (1960).
\end{itemize}
dealing with determination of the source of income, becomes relevant in the withholding area. For example, services performed in the United States generally result in United States source income regardless of where the contract is made, where the payment takes place, or where the employer resides.\textsuperscript{275} Chapter 3 does not, however, require a United States employer who contracts in the United States for the performance of services overseas, to withhold tax compensation payments since such payments are considered non-United States sourced income.\textsuperscript{276}

Third, no withholding is required\textsuperscript{277} if the income, other than for personal services, is effectively-connected with the conduct of a trade or business in the United States,\textsuperscript{278} and is includable in the nonresident alien's gross income for the taxable year.\textsuperscript{279} The lack of withholding in this circumstance is compensated for by a graduated rate of tax imposed on such income.\textsuperscript{280} To claim an exemption from withholding in such cases, the payee need only file an appropriate

\textsuperscript{277} I.R.C. § 1441(c) (1976).
\textsuperscript{278} Id. § 864(b), (c) (1976).
\textsuperscript{279} Id. §§ 871(b), 882(a) (1976 & Supp. V 1981).
\textsuperscript{280} Pre-1967 law basically provided that if a nonresident alien was engaged in a trade or business within the United States at any time during the taxable year, all the United States source income of such alien would be subject to the graduated rates of tax applicable to United States residents. S. REP. NO. 1707, supra note 57, at 23, reprinted in 1966 U.S. CODE CONG. & AD. NEWS at 4468. The rule became known as the "force of attraction" principle as it taxed both business and nonbusiness income of the alien in the same fashion. If the alien was not engaged in a trade or business within the United States, appropriate United States source income was subject to the flat thirty percent rate of tax. Id. at 22, reprinted in 1966 U.S. CODE CONG. & AD. NEWS 4467. For individuals with such income in excess of $21,200 for the year, the rate was the higher of thirty percent or the regular United States rates applicable to individuals. Id. at 22-23, reprinted in 1966 U.S. CODE CONG. & AD. NEWS 4467-68. In 1966, the force of attraction principle was repealed because it effectively deterred foreign persons operating businesses in the United States from making investments in the United States and foreign investors from establishing trades or businesses in the United States. Id. at 23, reprinted in 1966 U.S. CODE CONG. & AD. NEWS 4468.

The Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539, divided a nonresident alien's income into two categories: (1) gross income effectively connected with the conduct of a United States trade or business and (2) other gross income from United States sources. The first category, business income, is subject tax at normal domestic rates after allowable deductions. I.R.C. § 871(b) (1976 & Supp. V 1981). The second category, investment income, is subject to the flat thirty percent rate. I.R.C. § 871(a) (1976). Since a nonresident alien can now be taxed on United States source income under both the graduated and the flat rates of tax in the same year, the concept of "effectively connected" income (basically income derived from a United States trade or business) was enacted to divorce the nonresident alien's business income from his invest-
form with the withholding agent.\textsuperscript{281}

Finally, if income is paid to a United States citizen or resident, the payee need only prove his United States citizenship or residence to be exempted from chapter 3 withholding.\textsuperscript{282} A limited type of exemption is also afforded to certain foreign partnerships and foreign corporations upon a showing that the withholding requirements of chapter 3 would impose an undue administrative burden for a particular taxable year.\textsuperscript{283}

Under the statutory scheme, chapter 3 withholding is imposed at the flat rate of thirty-percent of the gross amount of such income.\textsuperscript{284} This statutory amount, however, is subject to a reduction in the rate of withholding where payment is made to residents of countries which have entered into a tax treaty with the United States.\textsuperscript{285} In order to secure the reduced treaty rate, the payee of income which is otherwise subject to withholding generally is required to file an appropriate form with his withholding agent.\textsuperscript{286}

Thus, fixed or determinable annual or periodical income paid to a nonresident which is United States sourced and is not effectively-connected with the conduct of a United States trade or business is

\textsuperscript{281} Treas. Reg. § 1.1441-4(a)(2), T.D. 6908 (1966); see I.R.S. Form 4224.

\textsuperscript{282} Treas. Reg. § 1.1441-5, T.D. 6908 (1966). As stated above, the withholding provisions apply only to persons who are not citizens of, nor residents in, the United States. See supra text accompanying notes 257-62. Thus, a withholding agent is relieved from the liability for withholding, see supra note 251, when the payee has claimed United States residence or when partnerships or corporations have claimed in writing not to be foreign. Such a claim is generally accomplished by filing I.R.S. Form 1078 with the withholding agent.

\textsuperscript{283} Treas. Reg. § 1.1441-4(f)(1), T.D. 6908 (1966). The entity must have engaged in a trade or business in the United States for at least part of the taxable year. The Director of International Operations must be convinced that the imposition of the administrative burden is "undue" and that exemption will not jeopardize the collection of the tax. The regulations indicate that the exemption is intended to apply in situations where it is difficult to determine which portions of payments received by the payee are effectively connected. \textit{Id.}

\textsuperscript{284} I.R.C. § 1441(a) (1976). The rate is fourteen percent when the amounts are received by participants in certain exchange or training programs. \textit{Id.}

\textsuperscript{285} Treas. Reg. § 1.1441-6(a) (1971).

\textsuperscript{286} Treas. Reg. § 1.1441-6(a), T.D. 7157 (1971). The regulation, as prescribed by T.D. 7157, supercedes all prior filing requirements required by the regulations under the various tax treaties, even though those regulations were not correspondingly amended. Therefore, the appropriate form is Form 1001 for all treaty partners.
subject to withholding unless specifically exempt by the Code or a tax convention.

D. Withholding Rules as Applied to USRPI Gains

Withholding is not required on the disposition of a USRPI because the gain is not classified as fixed or determinable annual or periodical income and because effectively-connected income is generally exempted from the withholding requirement. If withholding were required, the seller would be the person subject to the withholding and the purchaser would be the logical withholding agent.

The Senate Finance Committee's imposition of a withholding requirement would have taken the form of a new Code section to provide specific rules for withholding on gains defined in the Act. The new provision would not have been inconsistent with the existing withholding scheme. Withholding is generally not required on gains from the disposition of property by a foreigner because such gain is likely to be exempt from United States tax. Where the gain is not exempt from tax, significant United States contacts, in the form of presence or activity, mitigate the need for withholding as an enforcement provision. Gains under the Act, however, are always subject to tax, and are so regardless of presence and even in cases of minimal activity. With no mitigating factors to temper the general rule of withholding, a specific provision for withholding under the Act would be consistent with the IRC withholding scheme.

VI. Conclusion

With the help of an extremely informative Treasury study, the Act has accomplished its goal of basically equating the tax treatment of foreign and domestic investors in United States real estate. The basic equalizing measure was to make the appreciation in value

287. See supra notes 33, 269.
288. See supra notes 38, 276-80.
289. See supra note 257.
290. See supra note 253 and accompanying text.
291. See supra note 242 and accompanying text.
293. See supra notes 71-74 and accompanying text.
294. See supra notes 36-39 and accompanying text discussing the "effectively connected" exemption from withholding.
295. See supra notes 92-93 and accompanying text.
296. See supra note 3 and accompanying text.
of United States real estate investment taxable to the foreign investor.\textsuperscript{297} In two of the five defined abuse situations,\textsuperscript{298} annual treaty election and installment sales, the change was direct and sensible. The ability to elect inconsistent tax treatment on the different phases of the investment permitted by the annual treaty election was unfair and directly contrary to the norm established by the election under the Code.\textsuperscript{299} While the Act eliminated the major inequity generated by the annual election, the potential for inconsistent treatment on the same investment remains and should be eliminated by revoking the annual election altogether.\textsuperscript{300}

Delaying the imposition of tax on installment sales from the time of the sale to the time when the proceeds are actually received is a generally harmless and acceptable rule unless the delay converts an otherwise taxable transaction into a nontaxable one.\textsuperscript{301} With respect to nonresidents, the effectively-connected rules have just such an effect because of their focus on the nonresident's activity in the year the proceeds are received rather than in the year the real estate is sold.\textsuperscript{302} The new rule prescribed by the Act solves that problem with respect to sales of real estate and real estate interests.\textsuperscript{303} The installment sales rule as applied to nonresidents outside the real estate area should be similarly changed in those cases where the proceeds would have been taxed if received in the year of sale.

As with the installment sales rule, the generally accepted like-kind exchange rule of tax delay becomes unacceptable in the case of nonresidents.\textsuperscript{304} Unlike the all-inclusive taxation scheme on United States residents, nonresidents escape United States taxation on non-United States sourced gains\textsuperscript{305} and the combination of the like-kind exchange and source rules had often turned tax delay into tax forgiveness.\textsuperscript{306} The intent of the Act clearly is to undo that state of affairs, but at the same time to preserve the like-kind exchange, non-recognition, and contribution to capital rules for nonresidents in appropriate situations.\textsuperscript{307} The Act delegates to the Treasury the

\begin{footnotes}
\item[297] See supra notes 92-96 and accompanying text.
\item[298] See supra notes 87-91 and accompanying text.
\item[299] See supra notes 97-103 and accompanying text.
\item[300] See supra notes 111-24 and accompanying text.
\item[301] See supra notes 220-21 and accompanying text.
\item[302] See supra notes 222-23 and accompanying text.
\item[303] See supra note 226 and accompanying text.
\item[304] See supra notes 182-85, 193-94 and accompanying text.
\item[305] See supra note 31 and accompanying text.
\item[306] See supra notes 193-94 and accompanying text.
\end{footnotes}
authority to define these appropriate situations and it should exercise that authority sparingly. 308

Incorporated real estate investments presented Congress with the most difficult situation to deal with. The treatment accorded such investments by the Act represents clear compromises with respect to tough enforcement of the Act's taxation provisions on the one hand and practicalities of general enforcement of tax rules and an unwillingness to interfere with certain stock investments by nonresidents on the other. 309 In this area the Act's rules are complex, but are generally fair and workable. It is in this area that Congress should be most willing to tinker with the Act's provisions if unintended abuse situations develop. 310

The most troublesome shortcoming of the Act by far is its failure to enact an appropriate withholding mechanism. 311 While the creation of an elaborate withholding system to protect the provisions of the Act would hardly seem justified, the failure to utilize such a system which is already in place is wasteful. 312 This seems to be the view of the Senate Finance Committee, but not of the House Ways and Means Committee. 313 It is likely that the House members were reluctant to force withholding agent status on United States citizens solely by virtue of their purchase of United States real estate. 314 Although all United States citizens suffer the risk of potential withholding agent status and liability, 315 real estate purchases expand the parameters of that risk greatly because of their frequency and high purchase price. Such considerations, however, fly in the face of the established system of withholding. Placing comprehensive tax provisions on the books without effective enforcement provisions 316 invites noncompliance and an overall undermining of our self-assessment tax system.

Since the Act directs its attention to dispositions of United States real estate, perhaps Congress could improvise in this instance. For example, a procedural provision could be enacted which would

308. Id.; see supra note 213 and accompanying text.
309. See supra notes 144-45 and accompanying text.
310. See supra note 147 and accompanying text.
311. See supra note 249 and accompanying text.
312. See supra note 250 and accompanying text.
313. See supra note 242 and accompanying text.
315. See supra note 251 and accompanying text.
allow IRS to file a notice of potential federal tax liability on any real estate identified under the Act’s disclosure provisions. Such a notice would have the effect of putting a cloud on the title to the property and force the foreign seller to come to terms with the IRS before effectuating a sale of the property. Such a procedure would impede the free flow of real estate to some extent, but would apply only in a limited number of cases and effectively impose burdens on only foreign sellers rather than imposing risks on all United States real estate purchasers. It also would be no more burdensome than similar provisions already enacted by states with respect to insuring satisfaction of their estate tax levies. The absence of any withholding provision to complement the provisions of the Act is a serious miscalculation by the Act’s drafters. This miscalculation should not be left unattended much longer.