[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 1915

RELATING TO

TAX TREATMENT OF FOREIGN INVESTMENT IN U.S. REAL PROPERTY

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON JUNE 19, 1984

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on S. 1915 (introduced by Senator Goldwater) on June 19, 1984. S. 1915 would repeal the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) which generally taxes gains of foreign investors on the disposition of U.S. real properly interests.

This pamphlet, prepared in connection with the hearing, has four parts. The first part is a summary. The second part provides background information on U.S. taxation of foreign investors and describes the provisions of FIRPTA. Part three describes the provisions of S. 1915. Finally, part four discusses certain issues raised by the bill.

I. SUMMARY

Present Law

Foreign investors who are not engaged in the conduct of a U.S. trade or business and who, therefore, are not normally taxed on a net basis may elect to be taxed on the income from U.S. real property investment on a net basis (Code secs. 871(d) and 882(d)). Often, as a result of the election, a foreign investor will pay no tax on the income because deductible expenses exceed income.

Before the enactment of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), capital gains of foreign investors on the disposition of U.S. real property interests were not subject to U.S. income tax unless the gains were effectively connected with a U.S. trade or business or the foreign investor was an individual present in the United States 183 days or more during the year. Foreign investors could use a number of planning techniques to avoid U.S. tax on U.S. real property gains, even when the net basis taxation election had previously been made.

In general, FIRPTA subjects to U.S. tax all gains of nonresident aliens and foreign corporations on the disposition of U.S. real property interests. This is accomplished by treating all gains and losses of foreign investors on the disposition of U.S. real property interests as if they are effectively connected with a U.S. trade or business of the foreign investor. Net gains on such dispositions are generally taxable to foreign investors at the same graduated capital gains rates that apply to gains of U.S. persons on the disposition of real property interests. In the case of individual foreign investors, tax is imposed at a minimum rate of 20 percent of net property gains (or 20 percent of alternative minimum taxable income, if less).

"U.S. real property interests" include certain interests in U.S. real property holding corporations (U.S. RPHCs). Gains on the disposition of foreign corporate stock, however, are not subject to tax under FIRPTA. Instead, FIRPTA, with certain exceptions, taxes foreign corporations on the distribution of appreciated U.S. real property interests to their shareholders (and on the sale of such interests in connection with their liquidation). However, if a foreign corporation holds a U.S. real property interest and, under any U.S. treaty obligation, is entitled to nondiscriminatory treatment with respect to that interest, then the foreign corporation may elect in accordance with certain rules to be treated as a U.S. corporation for FIRPTA purposes.

FIRPTA also taxes certain dispositions of interests in partnerships, trusts, and estates, certain distributions of real estate investment trusts (REITs) and certain contributions to capital.

FIRPTA authorizes the Secretary of the Treasury to prescribe regulations providing the extent to which nonrecognition rules of the Code will (or will not) apply to override its provisions. Beginning in 1985, FIRPTA generally will prevail over any conflicting U.S. treaty provisions remaining in effect.

FIRPTA contains reporting requirements to identify when taxable transactions have occurred, but the deadlines for compliance with these requirements have been postponed by the Internal Revenue Service, pending the issuance of final regulations. To simplify the administration of FIRPTA and to insure collection of the tax imposed, the Senate has voted several times to impose withholding on dispositions of U.S. real property interests by foreign investors. As of the date of printing of this pamphlet, the House and Senate conferees on H.R. 4170 had agreed to a modified withholding proposal.

S. 1915

S. 1915 would repeal FIRPTA. Under the bill, gains of foreign investors on the disposition of U.S. real property interests would not be subject to U.S. income tax unless, as before FIRPTA, the gain is effectively connected with a U.S. business or is realized by a nonresident alien individual who was present in the United States 183 or more days during the year. The repeal of FIRPTA would be effective for dispositions made in taxable years beginning after 1983 and for returns for calendar years beginning after 1983.

II. BACKGROUND AND PRESENT LAW

Taxation of Foreign Persons Generally

Under the Code, U.S. persons are taxed on their worldwide income. Nonresident aliens and foreign corporations engaged in a U.S. trade or business are generally taxed on the U.S. source income of that business in the same manner, and at the same rates, as U.S. persons. However, their foreign source income not connected with that business is not taken into account in determining the applicable rates of U.S. tax.

In contrast, the U.S. source income of a nonresident alien or foreign corporation which is not effectively connected with a U.S. business is generally subject to a different tax regime. The Code provides that a foreign individual or corporation is ordinarily subject to a 30-percent tax on the *gross* amount of certain passive income such as dividends and interest, which is received from U.S. sources and is not effectively connected with a U.S. business. This tax, which is collected by means of withholding, generally satisfies the taxpayer's U.S. income tax liability on the income. This tax is often reduced by income tax treaty.

Prior to the enactment of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), capital gains not effectively connected with a U.S. business were not subject to any U.S. income tax, except in the limited situation of nonresident individuals who were present in the United States 183 days or more during the year.

Non-FIRPTA Taxation of Foreign Investment in U.S. Real Property

Whether a foreign investor in U.S. real property is engaged in a U.S. trade or business and, thus, is taxable on income from his investment on the same basis as a U.S. person, depends on all the facts and circumstances. For example, a foreign investor who enters into a single long-term net lease (under which the lessee is responsible for operation of the property and pays the expenses) probably would not be engaged in a U.S. trade or business, whereas a taxpayer who owns and manages a commercial building would be so engaged.

If a foreign taxpayer is not actually engaged in a U.S. trade or business, he is permitted under the Code to elect to be treated as if he were so engaged with respect to all his real property held for the production of income (Code secs. 871(d) and 882(d)). This election is provided because rental income, unlike other types of passive income, ordinarily has associated with it significant expenses. Therefore, a tax equal to 30 percent of the gross rentals could exceed the entire economic income from the property. If the election is made, the foreign taxpayer may reduce his gross income from the real property by deductible expenses, such as depreciation, mortgage interest, and real property taxes. The taxpayer is then taxed on the net income at the graduated rates that generally apply to U.S. taxpayers. Often, as a result of the election, the foreign investor will pay no tax on the current income because expenses exceed gross income. (This result would be the same if a U.S. person owned the property.) By making the election, however, the taxpayer also—in theory—subjects himself to U.S. tax on any capital gains from the sale or exchange of the property. The election, once made, is binding on the taxpayer in all subsequent years unless consent to revoke it is obtained from the Internal Revenue Service.

FIRPTA effectively eliminated a number of planning techniques whereby a foreign investor could avoid tax on the capital gain that resulted on the sale of a U.S. real property interest, even after having obtained the advantage of being taxed on current income from the real property interest on a net basis.

First, a foreign investor who is actually engaged in a U.S. real estate business and is, therefore, taxed on current income from the property on a net basis may sell the property on the installment basis and receive most or all of the payments in years following the year of the sale. Prior to FIRPTA, if the investor were not actually engaged in a U.S. trade or business in later years when the installment payments were received (and had not made the election to be treated as if he were), the gain would not have been treated as effectively connected with a trade or business in the later years and would therefore have gone untaxed.

Second, prior to FIRPTA, a foreign investor could generally exchange his U.S. real property held for productive use or investment for other property of a like kind, whether within or outside the United States, without recognition of gain. If the property acquired in the exchange were outside the United States, the gain recognized on the ultimate sale of the property received in the exchange also would not be subject to U.S. tax.

Third, a taxpayer could obtain the benefits of current taxation on a net basis and exemption from tax on the gain on ultimate sale by investing in U.S. real property indirectly through a foreign holding company which either was actually engaged in U.S. business or made the election. Such a holding company is subject to tax on the income it receives from the property, but, as noted earlier, there may often be no taxable income on a current basis. Also, the corporation may be able to reduce or eliminate its taxable income by paying deductible interest to its investors. Ordinarily, dividends and interest paid by a foreign corporation deriving most of its income from U.S. sources are subject to U.S. withholding taxes. However, these taxes are sometimes waived on a reciprocal basis under tax treaties between the United States and other countries.

Before FIRPTA, the investors in such a foreign holding company could avoid U.S. tax on the gain from the sale of the property by either of two methods. First, if the corporation sold the property and followed a plan of liquidation meeting certain requirements, the corporation was not taxable on the gain under a general rule of the Code that exempts liquidating corporations from tax on gains from the sale of property (sec. 337). Moreover, the shareholders and security holders generally were not taxable when they exchanged their stock and securities in liquidation for the proceeds of the sale of the real property because, as foreign investors, they generally were not subject to U.S. capital gains tax. While the corporation was engaged in a U.S. business, its business was not imputed to its investors under the Code. Mere ownership or sale of stock is generally not a trade or business. Ordinarily, therefore, the gains were not effectively connected with a U.S. business and thus escaped U.S. tax.

Alternatively, if the foreign holding company investors instead sold their stock or securities, they generally were not subject to tax on the gain for the same reasons that they generally did not recognize gain in a liquidation. Assuming that the sales price reflected the appreciated value of the real property, the purchasers of the stock, even if U.S. persons, could then liquidate the corporation without realizing gain subject to U.S. tax because their basis in the stock for purposes of determining gain on the liquidation was their purchase price for the stock.

Fourth, some U.S. tax treaties (such as the existing income tax treaty with the Netherlands Antilles) provide a more liberal net basis taxation election for real property income than the Code—these treaties permit an election to be made on a year-by-year basis without restriction. A foreign investor entitled to the benefits of such a treaty and not actually engaged in a U.S. business can use the treaty election to be taxed on a net basis in years prior to the year of sale. In the year of sale, the investor is free under these treaties not to make the treaty election. Prior to FIRPTA, by not making the election in that year, the investor avoided tax on the gain on the sale of the property because of his lack of a U.S. business.

Fifth, a number of existing U.S. tax treaties contain reciprocal provisions that prohibit the United States from taxing certain types of U.S. source capital gains of foreign investors who are entitled to treaty benefits. While these provisions reciprocally exempting capital gains generally do not apply with respect to real estate (that is, they do not restrict either country from taxing gains on sales of its real estate derived by residents of the other), they generally apply with respect to stock in real estate holding corporations. Prior to FIRPTA, these treaty provisions prevented U.S. tax tax on disposition of some U.S. real property interests.

FIRPTA

In general

Congress passed FIRPTA (Code secs. 897, 6039C, and 6652(g)) in November 1980 as part of the Omnibus Reconciliation Act of 1980. FIRPTA generally taxes nonresident aliens and foreign corporations on gains on the disposition of U.S. real property interests. Tax is imposed regardless of whether the gain is effectively connected with a U.S. trade or business or the seller was present in the United States. FIRPTA contains reporting requirements to identify when taxable transactions have occurred.

Congress made a number of technical amendments to FIRPTA in the Economic Recovery Tax Act of 1981. The discussion below incorporates these (and subsequent) technical amendments.

Amount of tax

Gains and losses of foreign investors on the disposition of U.S. real property interests generally are treated under FIRPTA as if they are effectively connected with a U.S. trade or business of the foreign investor. Thus, net gains are generally taxable to foreign investors at the same U.S. graduated capital gains rates that apply to gains of U.S. persons. However, in the case of individual foreign investors, tax is imposed at a minimum rate of 20 percent of net property gains (or 20 percent of alternative minimum taxable income, if less).

Effectively connected losses reduce the gain subject to tax. Losses attributable to the U.S. real property from years prior to the year of sale are generally allowed as deductions against the foreign investor's effectively connected U.S. gross income (including gains from real property sales) when the foreign investor makes the Code election to be taxable on a net basis on its U.S. real property income.

Definition of U.S. real property interest

FIRPTA taxes gains on the disposition of interests in real property (including interests in mines, wells, or other natural deposits) located in the United States or the Virgin Islands. The term "interest in real property" includes fee ownership and co-ownership of land or improvements, easements, and options, to acquire leaseholds of land or improvements thereon. Moreover, the term includes partial interests such as life estates, remainders, reversions, and rights of refusal in real property. Proposed Treasury regulations provide that the term includes any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, U.S. real property (Prop. Treas. Reg. sec. 1.897(c)).

Movable walls, furnishings, and other similar personal property associated with the use of real property are considered real property for purposes of FIRPTA.

U.S. real property interests also include certain holdings in U.S. real property holding corporations, discussed below.

U.S. real property holding corporations (U.S. RPHCs)

A. U.S. RPHC is any corporation the fair market value of whose U.S. real property interests is at least 50 percent of the sum of the values of its (1) U.S. real property interests, (2) interests in foreign real property, and (3) other assets used or held for use in the trade or business during the taxable year. Any interest in a corporation (whether foreign or domestic), other than an interest solely as a creditor, is treated as a U.S. real property interest unless the taxpayer establishes that the corporation was at no time a U.S. RPHC during the period after June 18, 1980 (the general effective date of FIRPTA) during which the taxpayer held the interest, or the five years preceding the disposition of the interest, whichever is shorter ("five-year base period").

In determining whether a corporation is a U.S. RPHC, a corporation that is a partner in a partnership takes into account its proportionate share of all assets of the partnership. Thus, for example, the corporate partner counts its proportionate share of the foreign real estate of the partnership. The same rules apply to trusts and estates in which a corporation has an interest and to a chain of successive partnerships, trusts or estates in which a corporation has an interest. Look-through rules also apply to a controlling interest held by a corporation in another corporation, with respect to assets held downward through the chain of ownership. For these purposes, a controlling interest is 50 percent or more of the fair market value of all classes of stock of the second corporation.

In general, gains from the disposition of an interest in a U.S. RPHC are subject to tax. However, no tax is imposed on the sale of publicly traded corporate stock by an investor who, throughout the five-year base period, owned five percent or less of the class of stock sold. FIRPTA also does not tax gains on the disposition of stock in a foreign corporation.

Foreign corporations

As indicated above, FIRPTA generally taxes foreign corporations on gains on the disposition of U.S. real property interests, but does not tax shareholders of foreign corporations on gains on the disposition of their stock.

Under a special rule, FIRPTA generally taxes foreign corporations on the distribution (whether or not in liquidation) to their shareholders of appreciated U.S. real property interests and on the sale of such interests in connection with their liquidation. Tax generally is imposed in these cases notwithstanding any nonrecognition provision of the Code.

Gain is not recognized by a foreign corporation on a distribution of appreciated U.S. real property, however, if the distributee takes a carryover basis in the property and, at the time of receipt of the property, the distributee would be subject to tax on a subsequent disposition of the property. Gain is also not recognized by a foreign corporation on a distribution of appreciated U.S. real property if nonrecognition is provided under regulations (authorized by FIRPTA) regarding the application of Code nonrecognition rules to transactions otherwise subject to FIRPTA (discussed below).

If a foreign corporation holds a U.S. real property interest and, under any treaty obligation of the United States, is entitled to nondiscriminatory treatment with respect to that interest, then the foreign corporation may elect to be treated as a U.S. corporation for purposes of FIRPTA. The election may be revoked only with the consent of the Secretary. The election may be made only if all shareholders of the corporation at the time of the election consent to the election and specifically agree that any gain from the disposition of the interest after June 18, 1980, which would be taken into account under the legislation, will be taxable even if such taxation would not be allowed under a treaty to which the United States is a party. If a class of stock in a foreign corporation is traded on an established securities market, then the consent need only be made by a person who held more than five percent of that class of stock. The Internal Revenue Service has proposed additional rules governing the making of the election (See Prop. Treas. Reg. secs. 1.897-3 and 1.897-4).

The election to be treated as a domestic corporation is the exclusive remedy for any person claiming discriminatory treatment because of FIRPTA.

As amended by the Economic Recovery Tax Act of 1981, FIRPTA provides U.S. shareholders of a foreign corporation holding U.S. real property interests that adopts a plan of complete liquidation with a credit against any tax imposed on them on the surrender of their stock. The credit is available to U.S. shareholders who acquired their stock before the general effective date of FIRPTA and have held it continuously since. The credit equals the U.S. shareholder's proportionate share of the tax imposed on the liquidating foreign corporation on the distribution or liquidation-related sale of its U.S. real property interests. This credit effectively prevents the imposition of FIRPTA tax at both the corporate and shareholder levels in connection with the complete liquidation of a foreign corporation holding appreciated U.S. real property interests. The credit insures that a complete liquidation of a foreign corporation, like a complete liquidation of U.S. corporation, will be taxed at one level only under FIRPTA.

Partnerships, trusts, and estates

Gain of a foreign investor on the disposition of an interest in a partnership, trust, or estate is subject to tax under FIRPTA to the extent that the gain represents the investor's pro rata share of appreciation in the value of U.S. real property interests of the entity.

REITs

Distributions to foreign shareholders by a real estate investment trust (REIT) are treated as gains on the sale of U.S. real property to the extent of the shareholder's pro rata share of the net capital gain of the REIT on the disposition of U.S. real property interests. In the case of REITs controlled by U.S. persons, sales of the REIT shares by foreign shareholders are not subject to tax (other than in the case of distributions by the REIT).

Contributions to capital

Except to the extent otherwise provided in regulations, gain is recognized by a foreign investor under FIRPTA on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid in surplus or as a contribution to capital. The gain equals the fair market value of the property transferred over the adjusted basis of the property and any other gain recognized by the transferor.

Nonrecognition rules

FIRPTA authorizes the Secretary to prescribe regulations providing the extent to which nonrecognition rules of the Code will (or will not) apply to override its provisions. Regulations have not yet been issued. Pending the issuance of regulations, nonrecognition provisions generally apply, but only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code (as modified by any treaty pursuant to Code secs. 894 and 7852(d)).

FIRPTA also authorizes the Secretary to prescribe regulations providing the extent to which transfers of property in reorganizations and changes in interests in (or distributions from) a partnership, trust, or estate are to be treated as sales at fair market value. Regulations have not yet been issued.

Reporting requirements and penalties for noncompliance

FIRPTA provides for enforcement of the tax on foreign investors through a system of information reporting designed to identify foreign owners of U.S. real property interests.

Reporting by U.S. RPHCs

U.S. corporations that are or, at any time during the preceding four years, were U.S. real property holding corporations (U.S. RPHCs) and that have one or more foreign shareholders at any time during the calendar year are required to file annual returns setting forth the name and address (if known by the corporation) of each foreign shareholder. The annual returns must also set forth any information with respect to transfers of stock in the corporation by foreign shareholders, as well as any other information, that the Secretary may prescribe. Any nominee holding stock in a U.S. corporation on behalf of a foreign person who does not furnish the above information is required to file such a return instead. No reporting with respect to publicly traded stock is required.

Proposed Treasury regulations provide that a domestic corporation whose stock is not publicly traded, any interest in which is known by the corporation to be held by a foreign person, must determine each December 31 (and on the acquisition or disposition of certain property) whether it is a U.S. RPHC (Prop. Treas. Reg. sec. 1.897-2(h)). When such a domestic corporation determines that it is not a U.S. RPHC, it must attach a statement to that effect to its income tax return for the year. The proposed regulations further provide that such a domestic corporation must, within 30 days after receipt of an inquiry from a foreign person holding an interest in it, inform that person whether his interest constitutes a U.S. real property interest and whether the corporation has submitted a statement to the Internal Revenue Service indicating that it is not a U.S. RPHC.

Reporting by foreign corporations and partnerships, trusts, and estates

Foreign corporations and partnerships, trusts, and estates (whether foreign or domestic) are required to file annual returns setting forth the name and address of each foreign person (and each U.S. person as well in the case of foreign corporations required to make a return) who has a substantial indirect investment in U.S. real property through the entity. The annual returns must also set forth such information with respect to the assets of the entity and such other information as the Secretary may prescribe. For this purpose, a person has a substantial indirect investment in U.S. real property through an entity if the person's pro rata share of the U.S. real property interests held by the entity exceeded

$50,000 at any time during the calendar year. In determining a person's pro rata share of the U.S. real property interests held by an entity, the entity must look through to the assets of any corporation in which the entity has an interest. U.S. real property interests held by a partnership, trust, or estate are treated as owned proportionately by the partners or beneficiaries. U.S. real property interests held by the spouse or a minor child of an individual are treated as owned by the individual.

Any entity required to make a return is also required to furnish each foreign person (and each U.S. person as well in the case of a foreign corporation required to make a return) holding a substantial indirect investment in U.S. real property through the entity a statement showing the name and address of the entity, the substantial indirect investor's pro rata share of the U.S. real property held by the entity, and such other information as the Secretary shall prescribe.

These reporting requirements do not apply to an entity for any calendar year in which the entity furnishes the Internal Revenue Service such security as the Service determines to be necessary to ensure that any U.S. tax with respect to U.S. real property interests held by the entity will be paid.

Reporting by certain other foreign investors

A separate reporting requirement applies to foreign investors owning U.S. real property who are not foreign corporations or partnerships, trusts, or estates required to report under the provision described immediately above. Where such a foreign investor did not engage in a trade or business in the United States at any time during the calendar year and held U.S. real property interests worth $50,000 or more at any time during the year, the foreign investor is required to file a return setting forth his name and address, a description of all U.S. real property interests held at any time during the calendar year, and such other information as the Secretary may prescribe.

In determining whether a foreign investor held U.S. real property interests worth $50,000 or more, a foreign partner or beneficiary of a trust or estate is treated as owning a proportionate share of the U.S. real property interests held by the entity. Also, U.S. real property interests held by the spouse or a minor child of a foreign investor are treated as owned by the foreign investor.

U.S. interest versus Virgin Islands interest

An investor taxed under FIRPTA is required to pay the tax and file the necessary returns with the United States in the case of interests in real property located in the United States, and with the Virgin Islands in the case of interests in real property located in the Virgin Islands. Sale of an interest, other than solely as a creditor, in a U.S. RPHC of the United States is subject to tax in the United States while sale of an interest in a U.S. RPHC of the Virgin Islands is subject to tax in the Virgin Islands.

Penalties for noncompliance

For each failure to file a return containing the information required by the above information reporting requirements or to furnish a required statement to a substantial indirect investor of its pro rata share of the U.S. real property interests held by an entity, a penalty is imposed of $25 for each day during which the failure continues, unless it is shown that the failure is due to reasonable cause and not to willful neglect. In the case of U.S. RPHCs, and of partnerships, trusts, estates, and foreign corporations through which there is substantial indirect investment in U.S. real property, the maximum penalty is $25,000 per calendar year. In the case of other investors subject to the reporting requirements, the maximum penalty for a calendar year is the lesser of $25,000 and five percent of the aggregate fair market value of the U.S. real property interests held by the investor at any time during the year.

Postponement of reporting requirements

Temporary and proposed regulations pertaining to the substantive and reporting provisions of FIRPTA were published in September 1982 (47 F.R. 41532 and 47 F.R. 41581). In April 1983, the Internal Revenue Service postponed the reporting requirements for 1980, 1981, and 1982 until after the issuance of final regulations. This postponement applied to all reporting-related deadlines including the deadline for applying for a security agreement in lieu of reporting. The Service decided to delay the reporting requirements rather than require immediate compliance with regulatory provisions that might be changed in response to public comment. In February 1984, the Service postponed the reporting requirements for 1983. The postponement of the reporting-related deadlines does not affect the obligation to file an income tax return if one is required or to pay any liability arising under FIRPTA.

In November 1983, the Service issued new proposed regulations pertaining to the substantive provisions of FIRPTA that supersede the proposed substantive regulations issued in September 1982 (48 F.R. 50751). The Service has not yet issued final regulations pertaining to the reporting provisions of FIRPTA.

Effective date

FIRPTA generally applies to dispositions after June 18, 1980. However, until January 1, 1985, gain generally is not taxed under FIRPTA to the extent required by treaty obligations of the United States. On and after January 1, 1985, FIRPTA generally will prevail over any conflicting treaty provisions remaining in effect except in certain situations where a treaty is renegotiated to resolve conflicts between the treaty and FIRPTA, and a new treaty is signed in 1981, 1982, 1983, or 1984. In that event, the delay in the effective date can be extended in the new treaty or in an accompanying exchange of notes beyond January 1, 1985, specifically for a period of up to two years after the signing of the new treaty. This two-year period is intended to permit the Senate adequate time to consider the new treaty.

The delayed effective date provision is intended to benefit only foreign investors who were residents on the date FIRPTA became effective of a country whose existing income tax treaty with the United States conflicts with FIRPTA. No benefit is intended for foreign investors who, after that date, rearrange their investment so as to come under such a treaty.

No step-up in basis is allowed with respect to a disposition of a U.S. real property interest to a related party (within the meaning of Code section 453(f)(1)) after December 31, 1979 in a transaction not otherwise taxed under FIRPTA either because it occurred on or before June 18, 1980 or was exempt from tax under a U.S. treaty obligation.

Congressional Efforts to Implement Withholding

FIRPTA presents compliance problems. Since the tax is not due until a tax return is filed after the end of the year, a foreign person can sell his U.S. real estate, take the proceeds out of the United States, and since he is beyond the jurisdiction of the United States, not pay U.S. tax on the sale. Moreover, through nominees and foreign corporations established in tax havens, he may be able to reinvest these untaxed proceeds back in the United States.

In addition, the FIRPTA information reporting system, as interpreted in temporary and proposed Treasury regulations (47 F.R. 41532 and 47 F.R. 41581), is cumbersome. As indicated above, the information reporting requirements of FIRPTA have been postponed by the Internal Revenue Service for 1980 through 1983, pending the issuance of final regulations with respect to those reporting requirements. The Internal Revenue Service has had difficulty developing these regulations; it has not yet issued final regulations, so no information reporting is now required.

To simplify the administration of FIRPTA, and to insure collection of the tax imposed, the Senate version of the FIRPTA legislation included a provision requiring withholding by purchasers of U.S. real estate, where a U.S. real property interest is acquired from a foreign investor. The conference on the 1980 legislation dropped this withholding provision. The Senate voted again in 1981, 1982, 1983, and 1984 to impose withholding on sales of U.S. real property interests by foreign investors. In 1981 and 1982, the conference committee did not agree to withholding. No conference was held on the 1983 legislation because the tax bill reported by the House Ways and Means Committee did not reach a vote in the House. As of the date of printing of this pamphlet, the conferees on the 1984 legislation (H.R. 4170) had agreed to a modified withholding proposal.

III. EXPLANATION OF THE BILL

Repeal of FIRPTA

S. 1915 would repeal the provisions of the Code (secs. 897, 6039C, and 6652(g)) added by FIRPTA that subject nonresident aliens and foreign corporations to tax on gains from dispositions of U.S. real property interests, and impose information reporting requirements in connection with such dispositions. Under the bill, such gains would no longer be subject to U.S. income tax unless, as before FIRPTA, they are effectively connected with a U.S. business or are realized by a nonresident alien individual who was present in the United States 183 or more days during the year.

Effective Date

The amendments made by the bill would apply to dispositions made in taxable years beginning after December 31, 1983 and to returns for calendar years beginning after December 31, 1983.

IV. ISSUES

Equity

One of the principal reasons cited by Congress in 1980 for the enactment of FIRPTA was that it was important to establish equity of tax treatment of U.S. real property between U.S. and foreign investors.[1] U.S. investors generally are taxable at graduated capital gain rates on all sales of U.S. real property interests. Prior to FIRPTA, foreign investors were taxable on sales of such interests only when their gains were effectively connected with a U.S. business or the investor was an individual who was present in the United States 183 days or more during the year. Most other types of passive income (e.g., rents, interest, and royalties) from U.S. sources paid to foreign investors generally are not exempt from U.S. tax. Prior to FIRPTA, foreign investors could obtain both the advantage of being taxed on current income from a U.S. real property interest on a net basis and the advantage of paying no U.S. tax on the eventual disposition of the property interest.

Proponents of FIRPTA contended that the ability of foreign investors to avoid capital gains tax on U.S. real estate dispositions put U.S. investors at a competitive disadvantage.[2] The differential treatment of U.S. and foreign owners of U.S. real estate arguably violated the principle of "horizontal" equity, i.e., that similarly situated taxpayers be subject to similar tax rules.

FIRPTA was also viewed as promoting international parity in the taxation of real property investments by foreigners. The tax codes of other countries generally subject U.S. investors to tax on capital gains realized on real property investments in those countries: A Treasury Department study of the tax treatment of foreign real estate investment in the United States found in 1979 that ". . . nearly all other industrial countries, and virtually all of the developing countries for which the information is readily available, tax nonresidents on capital gain from the disposition of real property located in the country as well as on gains derived from business activity there." [3]

Advocates of FIRPTA repeal, however, argue that U.S. tax laws frequently violate the principle of treating similarly situated U.S. and foreign investors in a similar manner, and that it is unclear whether FIRPTA produces a more equitable result. The 1979 Treasury study cited included an analysis of a hypothetical investment in U.S. farmland which showed that if certain foreign investors

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[1] See H. Rep. No. 1167, 96th Cong., 2d Sess. 511 (1980).

[2] A General Accounting Office (GAO) study concluded in 1979 that, ". . . [E]limination of the tax advantage foreign investors have would remove a factor that may be preventing potential U.S. purchasers from competing effectively with potential foreign purchasers." See GAO, *Foreign Investment in U.S. Agricultural Land—How it Shapes Up*, (July 30, 1979), p. iii.

[3] Treasury Department, *Taxation of Foreign Investment in U.S. Real Estate*, (May 1979), p. 60.

were subject to a FIRPTA-type tax on capital gains, they would bear a heavier tax burden than similarly situated U.S. investors. The Treasury study found that the U.S. tax system tends to discriminate against foreign investments in assets which, as a result of debt financing or tax preferences, generate tax losses: If a foreign investor has no other effectively connected U.S. income, these tax losses would, to the extent that they are carried forward, result in no current reduction in tax liability. The Treasury study concluded that,

> Some differences (e.g., treatment of capital gains, taxation limited to effectively connected and specified other U.S. income) favor foreign taxpayers, others (e.g., treatment of losses, number of exemptions) favor domestic taxpayers. Whether foreign taxpayers are better or worse off than domestic taxpayers when all the differences are considered together depends on the circumstances of a particular investment and investor. (p. 51).

Some advocates of FIRPTA repeal have also questioned the legislation's equity effect on the ground that capital gains in assets other than real property, such as bonds and listed securities, are not generally subject to U.S. tax. They allege that FIRPTA was not intended to improve the equity of the U.S. tax system but instead to deter foreign investment in U.S. real estate.

Enforceability

Another issue is the extent to which FIRPTA can be adequately enforced. Under its information reporting requirements, tax and returns are not due until after the end of the year. While most practitioners believe that the vast majority of foreign investors will pay their U.S. tax, some foreign investors might sell their U.S. real property, take the proceeds out of the United States before the end of the year, and not pay the tax due. Also, the information reporting requirements have not yet gone into effect; the Internal Revenue Service has postponed their application pending the issuance of final regulations. The Service has had difficulty in developing the regulations. A withholding system might simplify the administration of FIRPTA and insure collection of the tax more effectively than information reporting alone. In 1980, 1981, and 1982, withholding proposals were approved by the Senate but rejected by the House-Senate Conferences. As of the date of the printing of this pamphlet, however, the House and Senate conferees on H.R. 4170 had agreed to a modified withholding proposal.

Foreign Demand for U.S. Real Property

FIRPTA imposes tax on capital gains realized by foreign investors on U.S. real property investments in situations where, prior to FIRPTA, tax might have been avoided. Consequently, FIRPTA lowers the prospective after tax rate of return on foreign investments in U.S. real property which is likely to reduce foreign demand. Thus, FIRPTA tends to reduce the aggregate (i.e., domestic plus foreign) demand for U.S. real property and, therefore, lower its price. This hurt U.S. real estate owners whose asset values may be diminished.

While the enactment of FIRPTA may have reduced the demand for U.S. real property, the following factors suggest that the overall magnitude of such an effect is negligible. First, although the data are incomplete, foreign investment appears to constitute only a small portion of total investment in U.S. real property. The Department of Agriculture estimates that foreigners own 1.1 percent of the privately owned agricultural land in the United States.[4] A General Accounting Office (GAO) study found that, from January 1977 through June 1978, only 4 percent of the agricultural land sold in 10 States was purchased by foreign investors. Data from the department of Commerce covering new plant and equipment investment, but excluding land, show that foreign investment amounted to 7.2 percent of total U.S. nonfarm expenditures for new plant and equipment in 1981.[5] Although there is no definitive data, it would appear that foreign investment amounts to less than 10 percent of U.S. real property investment. Thus, if the enactment of FIRPTA caused foreign real property investment demand to decline by, for example, 20 percent, the effect on aggregate real property investment demand would be below 2 percent.

Second, the GAO's informal survey of foreign buyers' purchase motives suggested that confidence in the U.S. political and economic system, a desire to hedge against inflation and devaluation in foreign currencies, and the low price and high availability of land were at least as important as tax considerations in the decision to invest in the United States.

Trade Balance

Currently, the United States follows a policy of flexible exchange rates under which the market is allowed to set the value of the dollar relative to other currencies based on supply and demand, rather than having the government attempt to peg the value of the dollar at a particular level. In a regime of flexible exchange rates, net capital inflows strengthen the dollar. A stronger dollar reduces the dollar price of imports into the United States and makes our exports more expensive to foreign purchasers. Thus, a stronger dollar tends to reduce exports and increases imports. Consequently, if repeal of FIRPTA increases net foreign investment in the United States, there is likely to be additional dollar appreciation, and a decline in net exports. Thus, the benefits of increased foreign real property investment in the United States attributable to FIRPTA repeal might be offset by reduced income and employment in the exporting and import-competing sectors of the economy. However, as discussed in the previous section, it is unlikely that the foreign demand for U.S. real property investment is very sensitive to tax considerations. Furthermore, real estate investment constitutes only a small portion of total foreign investment in the United States. Commerce Department data show that *direct* foreign investment in the United States (that is, plant, equipment, land, and in-

[4] U.S. Department of Agriculture, *Foreign Ownership of U.S. Agricultural Land Through December 31, 1983,* (April 1984).
[5] U.S. Department of Commerce, *Survey of Current Business,* (November 1983).

ventories only) amounted to less than 12 percent of *total* foreign investment in the United States in 1982–83. Thus, repeal of FIRPTA would likely have only a negligible effect on net foreign investment in the United States and the U.S. balance of payments.

Revenue Impact

Although repeal of FIRPTA is likely to cause only a negligible increase in foreign investment in U.S. real estate, the loss in revenue to the U.S. Treasury would be significant, especially in view of the large current and projected Federal budget deficit. In 1979, the Treasury Department estimated that the revenue increase associated with a FIRPTA-type tax would be approximately $226 million for 1979. The annual loss in revenue were FIRPTA repealed today would probably exceed this amount because of inflation and greater foreign investment in U.S. real property.

Based on the analysis of foreign demand for investment in U.S. real property that appears above, it is unlikely that the reduction in tax resulting from FIRPTA repeal would significantly increase the level of foreign investment.

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