[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 192 AND S. 208
RELATING TO
TAX TREATMENT OF FOREIGN INVESTMENT IN THE UNITED STATES

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON JUNE 25, 1979

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The bills described in this pamphlet (S. 192 and S. 208) have been scheduled for a hearing on June 25, 1979, by the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee.

These bills relate to the tax treatment of foreign investment in the United States. S. 192 (introduced by Senator Bumpers) would tax nonresident alien individuals and foreign corporations on all U.S. source capital gains, and S. 208 (introduced by Senator Wallop and others) would tax foreign investors on gains from the sale of U.S. farmland and other rural land.

The pamphlet first briefly summarizes the bills. This is followed by a discussion of present law and the issues involved, an explanation of the bill provisions, the effective dates, and the estimated revenue effects of the bills.

I. SUMMARY

S. 208 (Senator Wallop and Others)[1]

The bill would generally subject to U.S. tax the capital gains of foreign investors from the sale of farmland, land suitable for farming, or rural land. Under present law, such gains are generally not taxed unless they are effectively connected with a U.S. trade or business. The tax would be imposed at the rates generally applicable to U.S. taxpayers. The bill would not override U.S. tax treaty obligations.

S. 192 (Senator Bumpers)

The bill would generally tax the U.S. source capital gains of foreign investors from the sale of any capital assets. Under present law, such gains are generally not taxed unless they are effectively connected with a U.S. trade or business. The bill would not override U.S. tax treaty obligations.

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[1] The cosponsors are Senators Baker, Baucus, Bayh, Bellmon, Boren, Burdick, Cannon, Chiles, Church, Cochran, Cranston, Culver, Danforth, DeConcini, Domenici, Exon, Goldwater, Hart, Hatch, Hayakawa, Heinz, Hollings, Jepsen, Kassebaum, Leahy, Lugar, McClure, McGovern, Melcher, Morgan, Nelson, Sasser, Schmitt, Simpson, Steveus, Stone, Tower, Young, Zorinski, and Thurmond.

II. TREASURY REPORT

Section 553 of the Revenue Act of 1978 required the Treasury Department to conduct a study and analysis of the appropriate tax treatment of income from, or gain from the sale of, interests in U.S. property held by nonresident aliens and foreign corporations. The study was submitted to Congress on May 4, 1979. The Treasury report found that foreign persons rarely incur U.S. tax on their disposition of U.S. property holdings. The Treasury report recommends that modifications be made to certain specific statutory provisions which are utilized by foreign investors to avoid U.S. tax on capital gains derived from the disposition of U.S. real estate.

III. DESCRIPTION OF BILLS

A. Present Law and Issues

Present law

General

Under the Code, 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 withholding tax on the *gross* amount of certain passive income, such as rents, dividends, and interest, which are received from U.S. sources and are not effectively connected with a U.S. business. This withholding tax satisfies the taxpayer's U.S. income tax liability on the income. Capital gains not effectively connected with a U.S. business are 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, who are taxed at the flat rate of 30 percent on the gains.

Foreign investment in U.S. property

Whether a foreign investor in U.S. real estate is engaged in a U.S. trade or business 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 number of commercial buildings 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. 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 frequently exceed the entire economic income from the property. If the election is made, the taxpayer may reduce his gross income from the real property by the deductible expenses, such as depreciation, mortgage interest, and real property taxes and is taxed at the graduated rates which generally apply to U.S. taxpayers rather than paying 30 percent on his gross rental income. Often, the investor will pay no tax on the current income because depreciation, mortgage interest, real property taxes and other expenses exceed gross income. (This result would be the same if a U.S. person owned the property.) However, by making the election, the taxpayer will also subject 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.

Apart from the Code election, a number of planning techniques exist whereby a foreign investor may obtain the advantages of being taxed on current income from real property on a net basis. However, unlike the Code election, these techniques also offer the opportunity to avoid tax on the capital gain which would result on the sale of the property. Also, unlike the Code election, they may be employed on a property-by-property basis. For example, a foreign investor who is actually engaged in a U.S. real estate business will be taxed on current income from the property on a net basis (which might result in no current tax because of the allowable deductions). He may sell the property on an installment basis and receive most or all of the payments in years following the year of the sale. If he is not actually engaged in a U.S. trade or business in later years when the installment payments are received (and has not made the election to be treated as if he were), the gain would not be treated as effectively connected with a trade or business in the later years and would therefore go untaxed.

Secondly, 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 without the U.S., without recognition of gain. If the property he acquired in the exchange were outside the U.S., the gain he would recognize on the ultimate sale of the property received in the exchange would not be subject to U.S. tax. This would be the case whether the investor was actually engaged in a U.S. trade or business or had made the election to be so treated.

Other planning techniques may also be employed by investing in U.S. real property indirectly through a foreign holding company which either is actually engaged in U.S. business or makes the election. The holding company would be subject to tax on the income it receives from the property, but, as noted earlier, often there would be no taxable income on a current basis. Moreover, the corporation often could 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 often waived, on a reciprocal basis, under tax treaties between the United States and other countries. If the recipient of the income is entitled to such a treaty benefit, then income paid to him currently by the corporation would escape that U.S. tax. (Foreign investors frequently utilize U.S. treaties applicable to the Netherlands Antilles and British Virgin Islands, because the treaties contain the necessary waivers and because these jurisdictions impose low or no taxes on the income.)

The investors in the 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 sells the property and follows a plan of liquidation meeting certain requirements, the corporation will not be taxable on the gain under a general rule of the Code which exempts liquidating corporations from tax on gains from the sale of property (sec. 337). Moreover, the shareholders and security holders will generally not recognize a gain when they exchange their stock and securities in liquidation for the proceeds of the sale of the real property because, as foreign investors, they generally are not subject to U.S. capital gains tax. Even though the corporation is engaged in a U.S. trade or business, that business is not imputed to its investors. Since mere ownership or sale of stock is generally not a trade or business, the gains ordinarily would not be effectively connected with a U.S. business and thus would escape U.S. tax.

Second, if the investors instead sell their stock or securities, they would generally not be subject to tax on the gain for the same reasons that they would generally not recognize gain in a liquidation. Assuming that the sales price reflected the appreciated value of the real property, the purchaser of the corporation, even if a U.S. person, could then liquidate it without realizing a gain subject to U.S. tax because his basis in the stock for purposes of determining his gain on the liquidation would be his purchase price for the stock. He would also get a stepped-up basis for the real property equal to his purchase price for the stock.

Even if U.S. law were amended to subject these gains to tax, the treaty provisions waiving withholding on dividends and interest could be used to reduce the amount of gain. The corporation could borrow against appreciation in the value of the corporation's real property and pay out the proceeds as dividends (assuming adequate earnings and profits) or interest (in a reasonable amount). These current payments, if they escaped U.S. tax under the treaties, would reduce the net worth of the corporation and hence the capital gain realized on sale of the stock and securities or on liquidation.

Finally, some U.S. tax treaties (such as the treaties with the Netherlands Antilles and the British Virgin Islands) provide for a real property election similar to that in the Code, but the election may be made on a year-by-year basis. A foreign investor entitled to the benefits of such a treaty and not actually engaged in a U.S. business could use the treaty election to be taxed on a net basis in years prior to the year of sale. In that year, the taxpayer would not make the treaty election and would not be taxed on the gain on sale of the property because of the absence of a U.S. trade or business.

A number of U.S. tax treaties contain reciprocal provisions which prevent the United States from taxing certain types of U.S. source capital gains of foreign investors who are entitled to the treaty benefits. The Code provides that these treaty exemptions are to prevail if they require the exclusion from gross income of gains which the United States would otherwise tax.

Issues

The issue is whether, and to what extent, nonresident aliens and foreign corporations should be taxed on gains from the sale or exchange of U.S. property which now are not subject to U.S. tax. In particular, an issue is whether farmland, all real property, or all capital assets should be subject to tax. If Congress decides to tax foreign investors only on capital gains from U.S. real property or only from farmland, another question is whether taxes should be imposed on gains from stock or securities of corporations owning that property. Finally, if the provisions adopted would conflict with U.S. tax treaties, there is an issue as to whether the treaties should prevail over the legislation, be overridden by the legislation, or whether some period of time (e.g., 5 years) should be allowed for renegotiation of the treaties.

B. Description of S. 208

(Senator Wallop and Others)

Explanation of provisions

The bill would treat as effectively connected with a U.S. trade or business, and hence subject to U.S. tax, gain from the sale or exchange of real property located in the United States which is land used in farming, land suitable for use in farming, or land in a rural area.

Also taxable would be gain in excess of $3,000 for the taxable year from the sale or exchange of stock in a corporation, or interest in a partnership, trust, or estate, determined by the Treasury to be properly attributable to (i) the net unrealized appreciation in such land which is held by the corporation, partnership, trust, or estate and (ii) if the the foreign investor used a holding company and utilized the Code provision (sec. 337) allowing the corporation to sell the land and liquidate without recognizing the gain on the sale of the land, an amount equal to the gain realized (but not recognized) by the corporation on the sale of that property.

The gain would be taxed at the graduated rates applicable to U.S. taxpayers. Purchasers of the farmland or rural land (or stock or other interest if the real estate was held indirectly) would be required to withhold and pay over to the government an amount equal to 30 percent of the gain. The seller could obtain a refund of the difference between this and the amount due under the applicable U.S. tax rates by filing a refund claim.

However, no gain would be taxable under any of these provisions to the extent that any U.S. tax treaty requires that the gain not be included in gross income.

The bill also requires any corporation to file a report with the Treasury if 20 percent or more of the value of its assets at any time during the year is attributable to farm land, land suitable for farming, or rural land.

Effective date

The bill would apply with respect to sales and exchanges occurring after February 28, 1978.

Revenue effect

It is estimated that this bill could increase tax liabilities by up to $22 million at the 1979 level of gains. To the extent that U.S. tax treaties require certain gains to be excluded from gross income, there would be a corresponding reduction in the revenue gain.

C. Description of S. 192

(Senator Bumpers)

Explanation of provisions

The bill would provide that all U.S. source capital gains of foreign investors, whether from real property or personal property (such as stocks and securities), would be subject to U.S. tax. The bill leaves unchanged the rule that gains effectively connected with the conduct of a U.S. trade or business are generally taxed in the same manner of such gains of U.S. persons. However, the bill also would subject to tax all U.S. source capital gains (to the extent they exceed U.S. source capital losses) which are not effectively connected with a U.S. business. The bill would not, however, override U.S. tax treaties which would require the exclusion of such gains from gross income.

Effective date

The bill would be effective upon enactment.

Revenue effect

According to a very rough estimate in the Treasury report on taxation of all capital gains of foreign investors could increase tax liabilities by $276 million at the 1979 level of gains. This figure would be substantially reduced under S. 192 because a portion of the gains would be excluded from gross income as the result of U.S. tax treaties.