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## Income Taxation—Disposition of Investment in United States Real Property—Enactment of I.R.C. §897

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# Income Taxation– Disposition of Investment in United States Real Property– Enactment of I.R.C. §897

John D. Lyons

## **Abstract**

The purpose of this Recent Development is to explain the effects of section 897 in terms of the problems it was designed to remedy. Part I will explore the methods that were used in the past by non-resident aliens and foreign corporations to avoid the payment of capital gains tax on the disposition of real property held in the United States. Part II will examine the newly implemented section 897 to determine how it will be applied and whether it is likely to achieve the goal of equal tax treatment for domestic and foreign investors on the disposition of United States real property.

INCOME TAXATION—DISPOSITION OF INVESTMENT IN UNITED STATES REAL PROPERTY—*Enactment of I.R.C. § 897.*

Continued economic growth and political stability have traditionally attracted foreign investment in United States real property.<sup>1</sup> The rate of this investment has steadily increased in recent years,<sup>2</sup> causing United States taxpayers to complain that federal tax laws unduly favored foreign investors.<sup>3</sup> The Internal Revenue Code (Code) previously exempted from capital gains taxation those foreign corporations and non-resident aliens not engaged in a United States trade or business.<sup>4</sup> Furthermore, foreign investors not entitled to the exemption were able to conduct their transactions so as to avoid taxation of capital gains.<sup>5</sup> In a recent review of federal tax laws as they affect foreign investors, the House Committee on Finance identified four ways in which foreign investors avoided paying capital gains taxes, and noted that other schemes might exist.<sup>6</sup>

On December 5, 1980, President Carter signed the Omnibus Reconciliation Act of 1980,<sup>7</sup> which, among many other provisions,<sup>8</sup> created section 897 of the Internal Revenue Code.<sup>9</sup> Section 897,

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1. Arthur Anderson & Co., *International Investment In U.S. Real Estate* ii (1979). The United States has been very liberal in allowing foreign investors to purchase commercial, agricultural, and residential property. Apart from its proven record of profitability, United States real property has provided a hedge against worldwide inflation and a secure investment for those whose countries are tending toward socialism. *Id.*

2. See generally *New Realities: A Survey of the Commercial Real Estate Market in the United States*, *ECONOMIST*, Feb. 7, 1981, insert after 56.

3. Rankin, *Reforms Sought on Real Estate*, *N.Y. Times*, Aug. 26, 1980, at D2, col. 1.

4. The Revenue Act of 1936, ch. 90, § 211, 49 Stat. 1648. See generally O'Dell, *Foreign and Domestic Tax Consequences of International Real Estate Investment*, 7 *INT'L TAX J.* 99 (1980).

5. SENATE COMM. ON FINANCE, 96TH CONG., 2D SESS., *REPORT ON REVENUE INCREASES 5* (Comm. Print 1980) [hereinafter cited as *FINANCE COMMITTEE REPORT*].

6. *Id.* at 6-8. The devices utilized by foreign investors included installment sales, see notes 27-30 *infra* and accompanying text; like-kind exchanges, see notes 31-35 *infra* and accompanying text; liquidation, see notes 46-49 *infra* and accompanying text; and sale of shares, see notes 50-53 *infra* and accompanying text.

7. Pub. L. No. 96-499, 94 Stat. 2599 (1980).

8. See, e.g., *id.* § 201, (school lunch and child nutrition programs), § 701, (veteran's program), §§ 1001-1026, (other security act programs; unemployment compensation).

9. *Id.* §§ 1121-1125, (codified at I.R.C. § 897). Section 897 retroactively applies

entitled Disposition of Investment in United States Real Property (Act), was designed to equalize the taxation of domestic and foreign investors on the disposition of real property<sup>10</sup> by imposing capital gains tax on non-United States citizens, and by closing the loopholes which allowed foreign investors to avoid capital gains taxation.<sup>11</sup> Sponsors of this measure hoped that such equal tax treatment would prevent foreign investors from outbidding United States investors due to tax exemptions.<sup>12</sup> At the same time, they sought to avoid placing a tax on foreign investors so onerous that it would provide a disincentive to foreign investment in the United States, and thereby negatively affect the balance of payments.<sup>13</sup>

The new tax treatment of gain from the sale of United States real property by foreign investors will affect millions of acres of land and billions of dollars in assets.<sup>14</sup> The purpose of this Recent Development is to explain the effects of section 897 in terms of the problems it was designed to remedy. Part I will explore the methods that were used in the past by non-resident aliens and foreign corporations to avoid the payment of capital gains tax on the disposition of real property held in the United States. Part II will examine the newly implemented section 897 to determine how it will be applied and whether it is likely to achieve the goal of equal tax treatment for domestic and foreign investors on the disposition of United States real property.

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to all dispositions made after June 18, 1980. I.R.C. § 897(c)(1)(A)(ii)(I). Nations with operative tax treaties, however, may not be affected until January 1, 1985. Memorandum of David Brockway, Deputy Counsel on International Taxation of the Congressional Joint Committee on Taxation, Foreign Investment in Real Property Tax Act of 1980, at 14 (Jan. 1981) (internal memorandum on file with the *Fordham International Law Journal*) [hereinafter cited as Brockway Memorandum].

10. FINANCE COMMITTEE REPORT, *supra* note 5, at 6; O'Dell, *supra* note 4, at 100.

11. See generally I.R.C. § 897.

12. *Taxation of Foreign Investors Direct and Indirect Ownership of Property in the United States: Hearings of the House Comm. on Ways and Means*, 96th Cong., 1st Sess. 38-40 (1979) (statement of Sen. Wallop).

13. *Id.* at 63-65 (statement of John Sann).

14. Green, *Foreign Investment in U.S. Real Estate: Analysis of the Data*, 6 INT'L TAX J. 444, 445 (1980).

**I. TAXATION ON DISPOSITION OF FOREIGN  
INVESTMENT IN UNITED STATES REAL PROPERTY  
PRIOR TO ENACTMENT OF SECTION 897**

**A. The "Trade or Business" Exemption**

Prior to the enactment of section 897, tax treatment of foreign investors depended on whether or not they were engaged in a United States trade or business.<sup>15</sup> Non-resident aliens and foreign corporations engaged in a United States trade or business were taxed on their income from that business at the same rates and in the same manner as United States entities.<sup>16</sup> Non-resident aliens and foreign corporations not engaged in a United States trade or business were subject to a thirty percent withholding tax on gross

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15. See, e.g., I.R.C. §§ 871-872 (individuals); §§ 881-882 (corporations). The Code and the Treasury Regulations provided detailed guidelines for making this determination. *Id.* §§ 864(b), 871(d), 882(d); Treas. Reg. § 1.864-2 (1975); *id.* § 1.864-4 (1974); *id.* § 1.864-5 (1972). Nevertheless, the courts tended to make their findings on a case-by-case basis, analyzing the nature and extent of the foreign investor's contacts with the United States. See, e.g., *Comm'r v. Spermacet Whaling & Shipping Co.*, 281 F.2d 646 (6th Cir. 1960) (no United States trade or business); *United States v. Balanovski*, 236 F.2d 298 (2d Cir. 1956), *cert. denied*, 352 U.S. 968 (1957) (United States trade or business); *Lewellyn v. Pittsburgh B. & L.E.R. Co.*, 222 F. 177 (3d Cir. 1915) (no United States trade or business). See generally Garelik, *What Constitutes Doing Business Within the United States by a Non-Resident Alien Individual or Foreign Corporation*, 18 TAX L. REV. 423 (1963). Professors Bittker and Eustice offer the following explanation:

It is clear that the entire business operation need not be centered in the United States. The difficult question is how much of the business functions must be located here to create a U.S. business situs. Relevant factors in determining the extent of economic penetration in the United States for this purpose are (a) location of production activities; (b) location of management (i.e., direction and control of the enterprise); (c) location of distribution activities (e.g., storage of goods, solicitation of orders, advertising and promotion, clerical functions, showroom and samples, credit functions, etc.); and (d) location of such other business functions as purchasing, financial activities, research, servicing of products, transportation, and the like. Moreover, the type of business (extractive, manufacturing, trading, service) is a factor since some ventures such as mining or manufacturing are inherently local in character. Finally, the taxpayer's formal structure (parent-subsidiary corporations, brother-sister corporations, or separate branches or divisions of a single corporation) has an important bearing on this question.

B. BITTKER & J. EUSTICE, *FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 17.02 (4th ed. 1979).

16. I.R.C. §§ 871(b), 864(c); Treas. Reg. § 1.864-4 (1974). The foreign source income that is not connected with a United States business is not included in gross income. I.R.C. § 871(b)(2).

amounts received as passive income, such as rents, dividends, interest, and royalties from United States sources.<sup>17</sup> This tax, however, was often reduced or even eliminated by provisions in reciprocal tax treaties.<sup>18</sup> Consequently, foreign investors were generally taxed at reduced rates unless engaged in a United States trade or business.<sup>19</sup>

With respect to real property held for the production of income, the Code further provided that foreign investors could elect to be treated as if engaged in a trade or business.<sup>20</sup> This election was especially beneficial for owners of rent-producing property because of the significant expenses involved in such ownership.<sup>21</sup> By making the election, the foreign investor could reduce the taxable gross income realized from the real property by deducting the expenses attributable to the real estate operations,<sup>22</sup> such as depreciation, mortgage interest, and property taxes.<sup>23</sup> The foreign investor was then taxed on net income and could take advantage of graduated tax rates.<sup>24</sup>

### B. *Avoidance of Capital Gain Taxation*

In response to this pattern of taxation, foreign investors developed several methods to gain the benefits of the Code election

17. I.R.C. §§ 871(a), 881(a), 1441. As to interest, an exception exists for original issue discount as defined in § 1232(b). *Id.* §§ 871(a)(1)(A), 881(a)(1)(A).

18. B. BITTKER & J. EUSTICE, *supra* note 15, ¶ 17.03; *see* I.R.C. § 894(a). For examples of such treaties, *see* note 45 *infra*.

19. I.R.C. §§ 871(a)(2), 881(a). Also, non-resident aliens who were present in the United States for 183 days or more during a taxable year were taxed at a flat rate of 30% on their gains. *Id.* § 871(a)(2).

20. *Id.* §§ 871(d), 882(d).

21. FINANCE COMMITTEE REPORT, *supra* note 5, at 5-6. Also, in situations where the tax was not reduced by treaty, the 30% withholding tax could easily exceed the income of the property. *Id.*; *see* notes 17-18 *supra* and accompanying text.

22. I.R.C. § 162.

23. Hollingsworth & Banks, *Foreign Investment in U.S. Real Estate: An Analysis of Code-Treaty Interactions*, 52 J. TAX. 38, 38 (1980). Such an election often left the investor with no current tax liability due to the allowable deductions. *See* I.R.C. §§ 871(a), 881(a), 1441.

After the election the foreign investor was subject to taxation on gains from any property held within the United States. *Id.* §§ 871(d), 882(d). The election remained in effect unless the government consented to its revocation. *Id.* This requirement prevented a foreign investor from revoking the election in the year that the property was sold in order to avoid capital gains taxation. *See* Treas. Reg. § 1.871-10(d) (1974).

24. Under the graduated rate structures of the Code, taxpayers "graduate" into higher tax brackets as their income increases. *See* I.R.C. §§ 1, 11.

while avoiding the capital gains tax which would normally result from the sale of property.<sup>25</sup> Furthermore, foreign investors were able to achieve this advantage on a property-by-property basis.<sup>26</sup>

### 1. Installment Sales

Foreign investors in a United States trade or business dealing in real estate are taxed on the current income from the property on a net basis.<sup>27</sup> Code section 453(b) enables real estate investors to dispose of property in a given year and to realize the gain from this disposition in future years.<sup>28</sup> In order to avoid capital gains taxation on the sale of their property, foreign investors would use an installment sale structured so that most of the payments would be received in years after the sale.<sup>29</sup> The installment payments received during these years were not subject to capital gains taxation because they were not effectively connected with a United States trade or business.<sup>30</sup>

### 2. Like-Kind Exchanges

A foreign investor can exchange his United States real property for foreign property of a "like-kind" without recognition of gain.<sup>31</sup> Code section 1031 utilizes a substituted basis method<sup>32</sup> and requires that the property being exchanged be held either for productive use in a trade or business or for investment.<sup>33</sup> If the property acquired in the exchange was not within the United States, the gain realized on a subsequent sale of the acquired property was not subject to United States tax.<sup>34</sup> This included cases where the

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25. FINANCE COMMITTEE REPORT, *supra* note 5, at 6.

26. *Id.*

27. I.R.C. §§ 871(b), 864(c); Treas. Reg. § 1.864-4 (1974).

28. I.R.C. § 453; Giljum, *Installment Sales*, 48-4th TAX MNGM'T (BNA) A-1. When the taxpayer uses a deferred payment plan, Code § 483 provides that interest earned on the amount withheld will be taxed as ordinary income.

29. See Treas. Reg. § 1.864-3(a) (1972).

30. *Id.* § 1.871-7 (1974).

31. I.R.C. § 1031(a). "Like-kind" refers to the characteristics of the properties exchanged. The exchange of similar properties held for productive use in a trade or business is a like-kind exchange, and no gain or loss will be recognized. *Id.* Code § 1031(a), is an exception to the general rule of section 1002 that gain or loss will be recognized on the sale or exchange of property.

32. *Id.* § 1031(d). Section 1031(d) is an exception to the general rule that the basis of property shall be the cost of such property, not including any amounts paid for real property taxes. See *id.* § 1012.

33. *Id.* § 1031(a).

34. See FINANCE COMMITTEE REPORT, *supra* note 5, at 6.

investor was engaged in a United States trade or business or had made a Code election.<sup>35</sup>

### 3. Real Property Holding Organizations

Non-resident aliens and foreign corporations are permitted to invest in a real property holding organization (RPHO).<sup>36</sup> Such an organization can engage in a United States trade or business,<sup>37</sup> or choose to make the Code election.<sup>38</sup> RPHO's are subject to tax on their income<sup>39</sup> but are able to deduct trade or business expenses,<sup>40</sup> thereby greatly reducing current taxable income. Taxable income can be further reduced by capitalizing the RPHO with debt-financed obligations<sup>41</sup> rather than equity financing, and then deducting the interest payments made to investors.<sup>42</sup>

Dividends and interest payments made by the RPHO are taxed as income to foreign investors, and normally subject to a thirty percent withholding tax.<sup>43</sup> This tax, however, may be waived by the provisions of reciprocal tax treaties,<sup>44</sup> thus enabling foreign investors to avoid that portion of United States tax on income paid by the RPHO. Two of the treaties most often utilized are reciprocal tax treaties with the Netherlands Antilles and the British Virgin Islands.<sup>45</sup>

35. *Id.*; see notes 20-24 *supra* and accompanying text.

36. FINANCE COMMITTEE REPORT, *supra* note 5, at 6.

37. See I.R.C. §§ 864(b), 871(d), 882(d); Treas. Reg. §§ 1.864-2 (1975), 1.864-4 (1974), 1.864-5 (1972).

38. I.R.C. §§ 871(d), 882(d).

39. FINANCE COMMITTEE REPORT, *supra* note 5, at 6.

40. I.R.C. § 162.

41. *Id.* § 163.

42. *Id.*

43. *Id.* §§ 871(a), 881(a), 1441; see text accompanying note 15 *supra*.

44. I.R.C. § 894(a); see note 18 *supra*. Treaty provisions will take precedence over the Code for purposes of United States taxation. Hollingsworth & Banks, *supra* note 23, at 39. See also Breacker, *Relationship of and Conflicts Between Income Tax Treaties and the Internal Revenue Code*, 24 TAX EXECUTIVE 175 (1971); Shockery, *Income Tax Treaties Administrative and Competent Authority Aspects*, 402 TAX MNGM'T (BNA) (1979).

45. Protocol on Double Taxation, United States-Netherlands, signed Oct. 23, 1963, and entered into force with respect to the United States Sept. 28, 1964, 15 U.S.T. 1900; T.I.A.S. 5665; 521 U.N.T.S. 377; Convention on Double Taxation, United States-United Kingdom, signed April 16, 1945, and entered into force with respect to the United States July 25, 1946, 60 Stat. 1377; T.I.A.S. 1546; 6 U.N.T.S. 189. These treaties are favored by foreign investors because they contain the necessary waivers or reductions, and because these jurisdictions impose little or no taxes on the income. FINANCE COMMITTEE REPORT, *supra* note 5, at 7.

Code section 337 provides, with some exceptions, that corporations which adopt a plan of complete liquidation and implement it within a twelve-month period shall not recognize gain or loss from the sale or exchange of their property.<sup>46</sup> An RPHO can thus avoid taxation on the gain from the sale of property by adopting such a plan of liquidation. Foreign investors, however, were also able to avoid taxation on the exchange of their stock for the proceeds of this liquidation.<sup>47</sup> This was true even if the RPHO was engaged in a trade or business because the business is not imputed to its investors.<sup>48</sup> Since foreign investors were not engaged in a United States trade or business by virtue of owning stock in the RPHO, their gains on the exchange were not taxed.<sup>49</sup>

Similarly, foreign investors could sell their stock in an RPHO and not be taxed on the gain.<sup>50</sup> In situations where the purchasers wished to liquidate the corporation, they too could avoid capital gains taxation. Purchasers of the corporation would obtain a basis for their stock equal to the current corporate net worth,<sup>51</sup> thereby enabling them to liquidate the corporation without any further capital gains tax.<sup>52</sup> The purchasers would additionally receive a stepped-up basis for the real property distributed in the liquidation equal to its fair market value.<sup>53</sup>

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46. I.R.C. § 337. See generally Silverstein, *Section 337 and Liquidation of the Multi-Corporate Enterprise*, 16 N.Y.U. INST. FED. TAX. 429 (1958); Note, *Tax Free Sales in Liquidation Under Section 337*, 76 HARV. L. REV. 780 (1963); Rock, *Corporate Liquidations Under Section 337*, 18-5th, TAX MNGM'T (BNA) (1975). For the purposes of § 337, the term "property" does not include inventory, I.R.C. § 337(b)(1)(A), or installment obligations, *id.* § 337(b)(1)(B), (C). These items are excluded from the definition of property because § 337 was designed to aid a liquidating corporation in winding up sales. B. BITTKER & J. EUSTICE, *supra* note 15, ¶ 11.65.

47. This avoidance of taxation was contrary to the general rule that amounts distributed in complete liquidation of a corporation are taxable to the shareholders as capital gains. See I.R.C. § 331(a)(1).

48. *Whipple v. Comm'r*, 373 U.S. 193 (1963) (expenses incurred in connection with a trade).

49. I.R.C. §§ 864(c)(1)(B), 871(b)(2); Treas. Reg. §§ 1.864-2 (1975), § 1.864-4 (1974), § 1.864-5 (1972). The only gain that might have been recognized was depreciation recapture under § 1250.

50. I.R.C. § 871(b)(2).

51. *Id.* § 1012.

52. *Id.* § 331(a)(1). It should be noted that under § 334(b)(2) a parent corporation can liquidate a subsidiary without recognizing any gain.

53. *Id.* § 334(a). The advantage of receiving a stepped-up basis is that a higher basis reduces the taxable gain on the subsequent sale of the property. See *id.* § 1001(a).

## II. THE EFFECT OF SECTION 897

## A. General Rule

Section 897 now subjects foreign investors to new provisions which regulate their disposition of investment in United States real property. Section 897 is structured according to a general rule that foreign investors will be taxed on their gains whether or not they are engaged in a United States trade or business.<sup>54</sup> All gains and losses from such dispositions of United States real property are now to be treated as if the taxpayer were effectively connected with such trade or business.<sup>55</sup> The result has an equalizing effect, as foreign investors will now be taxed in the same manner as United States investors on the disposition of United States real property.<sup>56</sup>

The Act allows the aggregation of gains and losses from the disposition of United States real property within a taxable year in order to determine whether taxable income exists, and in what amount.<sup>57</sup> A limitation exists, however, on the type and quality of losses which the individual investor can realize. These losses are to be governed by section 165(c) of the Code,<sup>58</sup> which provides that taxpayers cannot deduct the losses that arise from the voluntary disposition of property which was not held for a trade, business, or investment purpose.<sup>59</sup>

Section 897 imposes a minimum tax of twenty percent on the United States real property gains of nonresident alien individuals.<sup>60</sup> This special minimum tax on individual foreign investors is necessary because the graduated tax rates would otherwise be lower for the foreign taxpayer than for the United States taxpayer in a similar situation. This discrepancy would occur because calculation of the foreign investors's tax rate would not include his foreign source in-

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54. *Id.* § 897(a).

55. *Id.* § 897(a)(1)(B).

56. Brockway Memorandum, *supra* note 9, at 1. Individuals will be subject to the graduated rate structure under § 1, with the 60% capital gains deduction of § 1202. Corporations are subject to the corporate tax rates from 17-46% with the 28% alternative for long-term capital gains under Code § 11. *Id.* at 1.

57. I.R.C. § 897(a).

58. *Id.* § 897(b).

59. *Id.* § 165(c). An example would be a loss on the sale of a personal residence.

60. *Id.* § 897(a)(2)(A).

come<sup>61</sup> or his United States investment income,<sup>62</sup> thereby placing him in a lower tax bracket.<sup>63</sup>

This minimum tax will apply to all dispositions of interests in real property in the United States.<sup>64</sup> Included as interests in real property are fee ownerships and co-ownerships of land, improvements on such land, and options to acquire land or leaseholds of land and improvements thereon.<sup>65</sup> The real property interest extends to movable walls, furnishings, and personal property which are associated with the use of the real property.<sup>66</sup>

### B. *Installment Sales*

In the past, foreign investors were able to avoid liability for capital gains tax on the disposition of United States real property by receiving installment payments in years after the sale<sup>67</sup> when the foreign investor was not effectively connected with a United States trade or business.<sup>68</sup> Implementation of Code section 897 prevents use of the installment sales method by the foreign investor as a scheme to avoid capital gains tax. Section 897 effectively treats foreign investors as if they are engaged in a United States trade or business during the taxable year, and as if such gain or loss on the disposition of United States real property were effectively connected with such trade or business.<sup>69</sup> The foreign investor will now pay capital gains tax on each installment payment that is received, as these payments are now treated as if they are still connected with a United States trade or business.<sup>70</sup>

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61. *Id.* § 871(b)(2).

62. *See, e.g., id.* § 897(c)(3) (income derived from stock regularly traded on an established securities market).

63. *Id.* § 864(c)(1)(B); Brockway Memorandum, *supra* note 9, at 2.

64. I.R.C. § 897(c)(1). Real property is defined to include wells and other natural deposits located within the United States. *Id.* § 897(c)(1)(A)(i).

65. *Id.* § 897(c)(6)(A). An issue that has not been resolved by statute or by legislative history is whether a mortgage will be considered an interest in real property.

Presumably a straight mortgage without any equity participation would not constitute an interest in real property for purposes of the act, but presumably there is also some point at which a lender's equity in the property becomes significant enough that the mortgage will be considered to be an interest in real property.

Brockway Memorandum, *supra* note 9, at 3.

66. I.R.C. § 897(c)(6)(B).

67. *See* notes 27-30 *supra* and accompanying text.

68. *See* Treas. Reg. § 1.871-7 (1974).

69. I.R.C. § 897(a)(1).

70. *Id.*

### C. *Like-Kind Exchanges*

Prior to the enactment of section 897, the foreign investor was able to convert a taxable United States real property interest into a non-taxable foreign interest by making a like-kind exchange.<sup>71</sup> The nonrecognition provisions<sup>72</sup> of section 897 prevent this tax avoidance scheme by permitting tax-free like-kind exchanges of United States real property only where the property received in the exchange is property the sale of which would be subject to United States taxation under the Code.<sup>73</sup> Consequently, the foreign investor can utilize a tax-free like-kind exchange and temporarily avoid taxation only when the real property received in the exchange is "tainted" with eventual United States taxation.<sup>74</sup> If the foreign investor enters into a like-kind exchange of his United States real property for real property not subject to United States taxation, then the gain or loss on the United States real property must be recognized and taxed at the time of the exchange.<sup>75</sup>

### D. *Investments in United States Real Property through Corporations*

The Act sets out detailed provisions<sup>76</sup> that will effectively impose United States tax on the disposition of a foreign investor's interest in United States real property which is held indirectly by a corporation.<sup>77</sup> These provisions were created in direct response to tax plans which enabled the investor to avoid United States tax on the disposition of real property by liquidation or sale of shares in a corporation.<sup>78</sup> The operation of section 897 will differ depending

71. *Id.* § 1031; see notes 31-35 *supra* and accompanying text.

72. I.R.C. § 897(e).

73. *Id.* § 897(e)(1).

74. *Id.*

75. This concept is similar to the depreciation recapture provision in section 1245. The Internal Revenue Service is authorized to prescribe regulations that may override the nonrecognition provision and provide the extent to which like-kind exchanges can qualify for nonrecognition treatment. *Id.* § 897(e)(2). An alternative approach would have been to design the nonrecognition provision to "taint" the newly exchanged property regardless of its proximity to United States tax jurisdiction. This approach, however, might have created a problem with collection of the tax if the foreigner is not within the jurisdiction of the United States.

76. See generally *id.* § 897.

77. Brockway Memorandum, *supra* note 9, at 4. Section 897 also contains provisions for taxation of interests in real property held by partnerships, trusts, and estates which will not be discussed in this Recent Development.

78. See notes 36-53 *supra* and accompanying text.

upon the type of organization and plan which is utilized by the foreign investor.

When a foreign investor has an interest in a *United States corporation* that holds United States real property, the tax will be levied on the foreign investor, rather than on the corporation, at the time the foreign investor disposes of his interest in the corporation.<sup>79</sup> Although this section applies only to United States RPHO's,<sup>80</sup> a foreign corporation can make a special Code election to be treated as a domestic corporation.<sup>81</sup>

When the United States real property is held by a *foreign corporation*, section 897 will tax the foreign corporation, rather than the foreign investor, when the foreign corporation disposes of its United States real property interest.<sup>82</sup> The tax on the disposition of the United States real property interest will be levied regardless of whether or not the foreign corporation is an RPHO.<sup>83</sup>

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79. Brockway Memorandum, *supra* note 9, at 4. This result is achieved by refining the definition of "taxable interest" in a United States RPHO. An interest in a United States real property is now defined to include any interest (other than an interest solely as a creditor) in any United States corporation, unless the foreign investor can establish that the corporation was not, at any time after June 18, 1980, a United States RPHO during the previous five years. I.R.C. § 897(c)(1)(A)(ii).

80. A United States corporation will be considered a United States RPHO under section 897 if the fair market value of its interests in United States real property equals or exceeds 50% of the sum of the values of its (1) United States real property interests; (2) interests in real property located outside the United States; plus (3) any other of its assets which are used or held for use in a trade or business. *Id.* § 897(c)(1)(B).

81. *Id.* § 897(i). This election was created because United States corporations are permitted tax-free liquidations and other advantages to which the foreign corporation is no longer entitled. *Id.* § 897(d)(1)(A). This binding election can only be made in situations where United States tax treaties grant that corporations may not be treated less favorably than domestic corporations carrying on the same activities. *Id.* § 897(i)(1)(B). Furthermore, this election is only available to corporations which fall under §§ 897 and 6039(c).

Shareholders resident in countries having treaties with the United States which exempt gains on share sales will, for the period the treaties remain in effect, be able to avoid any tax on the disposition of their interests. Even if a treaty exemption is not available, the election may be advantageous in some circumstances—e.g., where the shareholder's marginal rate would be lower than the corporation's or where the corporation would not be an [RPHO].

Brockway Memorandum, *supra* note 9, at 8.

82. I.R.C. § 897(d)(1)(A). An exception to this rule exists when there is a carryover basis. *Id.* § 897(d)(1)(B).

83. Brockway Memorandum, *supra* note 9, at 7.

### 1. Liquidation

Prior to the enactment of Code section 897, a domestic corporation could sell its United States real property tax-free by adopting a plan of complete liquidation pursuant to the provisions of section 337. Foreign investors could also escape capital gains tax on the exchange of their stock for the proceeds of the liquidation because they were not engaged in a United States trade or business.<sup>84</sup> Under Code section 897, the domestic corporation can still utilize section 337 to escape taxation at the corporate level, but foreign investors will be taxed on the appreciation in value of their shares of stock in the liquidating corporation at the capital gains rate<sup>85</sup> usually imposed on United States citizens and residents.<sup>86</sup> This result is achieved because the foreign investor's gain on the liquidation is deemed to be effectively connected with a United States trade or business.<sup>87</sup>

Foreign corporations are barred by section 897 from liquidating under section 337 on any sale or exchange of a United States real property interest.<sup>88</sup> The foreign corporation will now be taxed on any such disposition in an amount equal to the excess of the fair market value of such interest over its adjusted basis.<sup>89</sup> This

84. See notes 46-49 *supra* and accompanying text.

85. I.R.C. § 1.

86. *Id.* § 871(a)(2).

87. *Id.* § 897(a)(1). Foreign investors will not be taxed if the corporation was formerly an RPHO which had previously disposed of all its United States real property interests in transactions taxable to the corporation. *Id.* § 897(c)(1)(B).

88. *Id.* § 897(d)(2).

89. *Id.* § 897(d)(1)(A). The tax on the liquidation of real property by a foreign corporation will apply even if there are United States shareholders of the foreign corporation.

Thus, U.S. buyers of foreign corporations owning U.S. real property interests will have to discount the purchase price to reflect the locked-in tax liability if they purchase stock rather than assets.

While this approach will permit a deferral of U.S. tax as compared to situations where the property is held through a U.S. corporation, it will greatly simplify the imposition of the tax on foreign investors and will minimize substantially the conflicts with foreign governments concerning extra-jurisdictional application of U.S. law. The development of a secondary market in foreign [RPHO] stock in order to defer the liquidation tax will be limited by (a) the fact that the stock price will be discounted by buyers to reflect factors such as the built-in tax liability with respect to the U.S. real property held by the foreign [RPHO]; (b) in the case of a foreign [RPHO] owning developed property, the inability to step-up the basis for depreciation purposes, and (c) the general reluctance of buyers to be exposed to the potential of undisclosed liabilities of the target company, notwithstanding

approach effectively prevents avoidance of capital gains tax since the foreign corporation must now recognize gain on all distributions.<sup>90</sup>

## 2. Disposition of Shares

Previously, a foreign investor could hold real property through shares in a corporation and avoid paying capital gains tax on the sale of the shares. Purchasers of the shares could also avoid capital gains taxation by liquidating the corporation after receiving a stepped-up basis in the stock.<sup>91</sup> Section 897 prevents tax avoidance through sale of shares in a domestic RPHO as the foreign investor is now taxed on any disposition of investment in United States real property as if he were engaged in a trade or business within the United States during the taxable year.<sup>92</sup> The foreign investor will now be taxed on the gain realized at the time the shares are sold.<sup>93</sup>

### CONCLUSION

Section 897 was enacted with the overall goal of equalizing the taxation of domestic and foreign investors on the disposition of United States real property. Achievement of this goal was attempted by taxing foreign investors on their gains whether or not they are engaged in a United States trade or business, and by instituting a twenty percent minimum tax on the United States real property gains of foreign investors, non-recognition rules, and controls over domestic and foreign RPHO's. It presently appears that section 897 has equalized the standing of these taxpayers, but the effects of this addition to the Code cannot be fully appraised until the corresponding Treasury Regulations are issued and implemented.

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these factors, it can be expected that the tax deferral and other advantages will be significant enough that use of a foreign corporation to obtain those advantages will be advisable in many situations.

Brockway Memorandum, *supra* note 9, at 7.

90. *Id.*

91. See notes 50-53 *supra* and accompanying text.

92. I.R.C. § 897(a)(1).

93. An exception exists for portfolio investors in publicly traded corporations. If any class of stock of a corporation is regularly traded on an established securities market, this stock shall be treated as a United States real property interest only in the case of a person who at some time held more than 5% of the class of stock. *Id.* § 897(c)(3).

