Foreign Investment in Real Property Tax Act of 1980

Richard Eigenbrode

Follow this and additional works at: https://repository.uchastings.edu/hastings_international_comparative_law_review

Part of the Comparative and Foreign Law Commons, and the International Law Commons

Recommended Citation

Available at: https://repository.uchastings.edu/hastings_international_comparative_law_review/vol5/iss3/6

This Article is brought to you for free and open access by the Law Journals at UC Hastings Scholarship Repository. It has been accepted for inclusion in Hastings International and Comparative Law Review by an authorized editor of UC Hastings Scholarship Repository.
Foreign Investment in Real Property
Tax Act of 1980

By Richard Eigenbrode*
B.A., Johns Hopkins University, 1973; J.D., Boston University, 1977; Associate, McCutchen, Doyle, Brown & Enersen, San Francisco.

I. INTRODUCTION

FIRPTA established a new regime for taxing foreign investors at progressive rates on the net gain realized on the disposition of

* This outline was prepared for Mr. Eigenbrode's presentation and was provided to all attendees.

II. DISPOSITION STRATEGIES UNDER PRIOR LAW

A. General. Prior to FIRPTA, a foreign investor was subject to U.S. tax on gain realized from the sale or exchange of capital assets including real property held for investment within the U.S. only if (a) the gain was “effectively connected” with the conduct by the investor of a U.S. trade or business, or (b) in the case of a nonresident alien individual (NRAI), if the NRAI was present in the U.S. for an aggregate of 183 days or more during the taxable year. I.R.C. §§ 871(a)(2), (b); 881-82. This rule remains in effect for sales or exchanges of capital assets not covered by FIRPTA.

B. Tax-free dispositions. A number of planning opportunities existed for tax-free dispositions of U.S. real property held for investment.

1. Installment sale. If the ownership of U.S. real property constituted a trade or business, a foreign investor could arrange an installment sale of the property with most or all of the gain realized in a later year in which the investor was not engaged in a U.S. business. See I.R.C. § 864(c)(1)(B); Treas. Reg. § 1.864-3(b), Ex. 1. Similarly, because the 183-day test is applied in the year in which the gain is realized, U.S. real estate held for investment by an NRAI could be sold on an installment basis under which the NRAI received payments in one or more subsequent years in which he was not physically present for 183 days or more. Treas. Reg. § 1.871-7(d)(2)(ii), (iv), Ex. 1.

2. “Like-kind” exchange. U.S. tax also could be avoided if a trade was made for other real property and the requirements of I.R.C. § 1031 were satisfied. Because this provision does not require that the property received in the exchange be located in the U.S., a foreign investor could receive foreign real estate in the exchange and not
recognize gain on the transaction. Cf. Rev. Rul. 68-363, 1968-2 C.B. 336. Gain realized on the later sale of the foreign exchange property would not be subject to U.S. tax because it would be foreign source. I.R.C. §§ 862(a)(5); 872(a); 882(b).

3. Sale of Stock. The holding and disposition of stock in a corporation generally does not constitute a trade or business. See I.R.C. § 864(b)(2)(A); Treas. Reg. § 1.864-2(c); compare Higgins v. Commissioner, 312 U.S. 212 (1941), with Moller v. United States, 2 U.S.C.C.R. No. 3 (Ct. Cl. 11/19/82) (involving domestic investors). Consequently, stock in a corporation holding U.S. real property could be sold tax-free in the U.S. by a foreign corporation or by an NRAI (unless he was present in the U.S. for 183 days or more both in the year of sale and in the year in which the gain was recognized). See Treas. Reg. § 1.871-7(d)(2)(i). Sale of such stock outside the U.S. would be foreign source and not subject to U.S. tax. I.R.C. § 862(a)(6); Treas. Reg. § 1.861-7.

4. Section 337 liquidation. A corporation holding U.S. real property could adopt a plan of complete liquidation pursuant to I.R.C. § 337, sell the property, and distribute its assets within twelve months. As a result, tax at the corporate level generally could be avoided, and the gain realized by the foreign investor on the distribution of the proceeds in exchange for the stock could be received tax-free.

C. Partially tax-free dispositions. Many bilateral income tax treaties contain substantially reduced withholding tax rates on dividends paid by a U.S. corporation to a resident of the treaty country. As a result, an in-kind distribution of U.S. real property to a foreign investor could be made at a nominal tax cost with the resulting step-up in basis. I.R.C. § 301(b), (d). A later sale of the property could be made at little or no gain.

III. SECTION 897—THE NEW RULES

A. General rule. Section 897 of the Internal Revenue Code does not impose a tax. Rather it defines certain gains which will be treated as “effectively connected” income under
I.R.C. §§ 871(b)(1) (relating to nonresident alien individuals) and 882(a)(1) (relating to foreign corporations). It provides that gain or loss:
—realized by an NRAI or foreign corporation (FC) (sometimes hereinafter referred to collectively as "foreign investors")
on the disposition after June 18, 1980, of
—a United States real property interest (USRPI)
is to be treated "as if" it were effectively connected with a
U.S. trade or business conducted by the taxpayer during
the taxable year of disposition. I.R.C. § 897(a)(1).

1. Taxation of FIRPTA gains and losses
   a. Effectively connected. Gains and losses recognized
      by a foreign investor under FIRPTA are taken into
      account with other effectively connected gains and
      losses realized by the foreign investor during the tax-
      able year in determining the foreign investor's net
      taxable income for the year.
   b. Character of gain or loss. FIRPTA does not alter
      the general rules for determining the character of
      gain or loss realized on the disposition of a USRPI;
      unless the interest constitutes a capital asset in the
      hands of the foreign investor, gain or loss recognized
      on its disposition will be taxable as ordinary income.
      Similarly, if the USRPI is a capital asset, but the
      normal depreciation recapture rules apply to a given
      disposition, part or all of the gain recognized may be
      taxed as ordinary income.
   c. Rates. FCs are taxed at progressive rates of between
      16% (15% for taxable years beginning in 1983) and
      46%, with a maximum 28% applicable to long-term
      capital gains. I.R.C. §§ 11, 1201(a). NRAIs are
      taxed at progressive rates of between 12% (11% for
      taxable years beginning in 1983) and 50%, with a
      maximum 20% applicable to long-term capital gains.
      I.R.C. §§ 1, 1202.
   d. Limitation on losses—NRAI. Section 897(b) limits
      the FIRPTA losses which may be taken into account
      by an NRAI in computing his net taxable income to
      those otherwise deductible under I.R.C. § 165(c),
      i.e., casualty or theft losses, losses incurred in a
FIRPTA

trade or business, or losses arising from transactions entered into for profit. Thus, e.g., a loss realized by an NRAI on the sale of a personal residence in the U.S. would not be available to offset other FIRPTA gains.

e. Alternative minimum tax—NRAI. The alternative minimum tax of I.R.C. § 55 also applies to FIRPTA gains realized by an NRAI. I.R.C. § 897(a)(2) modifies the computation of the alternative minimum tax under I.R.C. § 55(a)(1) by imposing a rate of not less than 20% on the lesser of:

1) the NRAI’s alternative minimum taxable income, as defined in I.R.C. § 55(b) for the taxable year; or

2) the NRAI’s “net U.S. real property gain” for the year.

For this purpose, net U.S. real property gain is the excess of gains over losses for the taxable year from dispositions of USRPIs. I.R.C. § 897(a)(2)(B).

f. Source rule. FIRPTA gains are treated as U.S. source income. I.R.C. § 861(a)(5).

2. Foreign investors. Dispositions of USRPIs by an NRAI (including a foreign trust or estate) and an FC are covered by FIRPTA. Dispositions by a partnership are treated as made by the partners.

a. Nonresident alien individual. An NRAI is an individual, including a foreign fiduciary, who is not a U.S. citizen and whose residence is outside the United States. Treas. Reg. §§ 1.871-2(a); 301.7701-5; 301.7701-6; 6a.897-1(k).

b. Foreign corporation. An FC is a corporation organized or created under the laws of a jurisdiction other than the U.S. or one of its states. I.R.C. § 7701(a)(4), (5); Treas. Reg. §§ 301.7701-5; 6a.897-1(f).

3. Disposition. The term is not defined by the statute but clearly is broader than the familiar “sale or exchange” concept. The temporary regulations provide that a disposition which is “not of a type that constitutes a realization event under any principal [sic] of federal income
taxation" is not taken into account for purposes of I.R.C. §§ 897 and 6039C. Treas. Reg. § 6a.897-1(i)(1). Thus, the gift of a USRPI by a foreign investor may be covered by FIRPTA if, e.g., the property is subject to liabilities in excess of basis. Treas. Reg. § 6a.897-1(i)(2). Certain dispositions are placed outside the net of I.R.C. § 897(a) if they are covered by certain nonrecognition provisions. See section IV.E., infra.

B. United States Real Property Interest

1. Definition. A USRPI is:

a. an “interest in real property” (other than solely as a creditor) located in the United States or in the U.S. Virgin Islands; or

b. any interest (other than solely as a creditor) in a domestic corporation, unless the foreign investor establishes that the corporation at no time during the “look-back period” was a United States real property holding corporation (USRPHC). I.R.C. § 897(c)(1)(A); Treas. Reg. § 6a.897-1(c).

1) United States. For this purpose, the “United States” includes only the States and the District of Columbia. I.R.C. § 7701(a)(9).

2) Real property

i) The temporary regulations provide that the term “real property” includes land and improvements (including structural components of buildings) and unharvested crops (including uncut timber). Treas. Reg. § 6a.897-1(b).

ii) A mine, well, or other natural deposit is also within the definition. I.R.C. § 897(c)(1)(A)(i). Local law definitions are not controlling. Treas. Reg. § 6a.897-1(b)(1). Local law definitions are not controlling. Treas. Reg. § 6a.897-1(b)(1). Movable walls, furnishings, and other personal property “associated with the use of the real property” are also considered real property for this purpose. I.R.C. § 897(c)(6)(B).

Personal property is considered “associated with
the use of real property” if its use is an “ordinary and necessary corollary” of the use of the real property. By contrast, personal property which has “dominant economic significance” in relation to the real property is not considered “associated.” For example, mining equipment is “associated,” while office equipment and harvested crops are not. The temporary regulations also provide that the determination of whether personal property is “associated” with certain real property will be made without regard to whether the same person owns both the personal and real property, or whether the personal property is disposed of at the same time as the real property. Treas. Reg. § 6a.897-1(b)(4).

3) Interest in real property. An interest in real property (other than solely as a creditor) includes:

   i) fee ownership and co-ownership of land or improvements thereon;

   ii) leaseholds of land or improvements thereon;

   iii) options to acquire land or improvements thereon; and

   iv) options to acquire leaseholds of land or improvements thereon. I.R.C. § 897(c)(6) (A).

The temporary regulations embellish the statutory definition by providing also that a time-sharing interest, life estate, remainder or reversionary interest in real property, or any right to share in the appreciation in value of, or in the gross or net proceeds or profits from the property (e.g., a shared appreciation mortgage), are considered interests for this purpose. Mineral production payments and rights to installment or deferred payments from the disposition of a real property interest are also considered interests in real property. Treas. Reg. § 6a.897-1(d)(3).

4) Interest solely as a creditor. Generally, an interest in real property or in a domestic corporation solely as a creditor does not qualify as a
USRPI. Moreover, such an interest in a corporation, partnership, estate or trust is not taken into account in determining whether a corporation is a USRPHC. See section III.C., infra. However, if a person has any interest in real property or in an entity other than solely as a creditor, all of his interests in such property or entity will be considered "non-creditor" interests. In making this determination, the constructive ownership rules of I.R.C. § 318(a) (as modified by I.R.C. § 897(c)(6)(C)) will apply. The temporary regulations also include an anti-abuse rule to prevent dispersion of creditor and non-creditor interests among related entities from circumventing the rule. Treas. Reg. § 6a.897-1(d)(1), (2).

5) Non-creditor interests in entities
   i) Corporations. A non-creditor interest in a corporation includes a stock interest, a right to share in the appreciation in value of a stock interest (e.g., through phantom stock or stock appreciation rights), a right to share in the appreciation in value of the corporation's assets or its gross or net proceeds or profits, and a right to convert or exchange an interest in the corporation as a creditor into a non-creditor interest. Treas. Reg. § 6a.897-1(d)(4).
   ii) Partnerships, trusts and estates. Rules similar to those provided for determining whether an interest in a corporation is a non-creditor interest are established for characterizing an interest in a partnership, estate or trust. Treas. Reg. § 6a.897-1(d)(5), (6).

2. Exceptions
   a. Interests in certain domestic corporations. A USRPI does not include an interest in a domestic corporation if at the date of disposition of the interest:
      1) such corporation did not own any USRPIs, and
2) all of the USRPIs held by it at any time during the look-back period (see section III.B.3., infra)
   i) were disposed of in transactions in which the full amount of the gain (if any) was recognized, or
   ii) ceased to the USRPIs because one or more subsidiaries disposed of all of their USRPIs in transactions in which all gain was recognized. I.R.C. § 897(c)(1)(B).

The temporary regulations provide that a foreign investor seeking to establish that a disposition of an interest in a domestic corporation is within the exception of I.R.C. § 897(c)(1)(B) must attach a statement to its U.S. income tax return for the year of disposition (even if the person had no income to report for the year). The statement must declare that the conditions for the exception are met on the date of disposition and must include information concerning the identity and disposition of all USRPIs held by the corporation during the look-back period, including the amount of any gain recognized on such disposition. The statement must be signed under penalty of perjury. Treas. Reg. §§6a.897-1(c), -2(k).

b. Regularly traded stock. A class of stock which is regularly traded on an established securities market does not qualify as a USRPI in the hands of a foreign investor if such person held no more than 5% of such class of stock at any time during the look-back period. I.R.C. § 897(c)(3).

   1) The statute does not define the term "established securities market." The Conference Committee Report accompanying the Omnibus Reconciliation Act, H.R. Rep. No. 1479, 96th Cong., 2d Sess. 111, 187 (1980) (hereinafter referred to as Conference Committee Report) refers only to "publicly traded stock." Under the temporary regulations, a domestic or foreign securities exchange which is registered under § 6 of the Securities Exchange Act of 1934 (15 U.S.C. § 78f), or a domestic over-the-counter market, will sat-
isfy the definition of an established securities ex-
change if information concerning the identity of
persons holding more than 5% of any class of in-
terests in the corporation is required to be sup-
plied to the SEC. Treas. Reg. § 6a.897-1(m).

2) In determining whether a foreign investor holds
more than 5% of a class of stock, the constructive
ownership rules of I.R.C. § 318(a) are applica-
table, except that “5 percent” is substituted for “50
percent” in paragraphs (2)(C) and (3)(C). I.R.C.
§ 897(c)(6)(C).

c. Domestically controlled REIT. Stock in a
“domestically controlled” real estate investment
trust (REIT) is not considered a USRPI.

1) A REIT is domestically controlled if, at all times
during the “testing period,” less than 50% in
value of the stock was held (directly or indi-
rectly) by foreign persons.

2) The testing period is the shorter of:
   i) the period beginning on June 19, 1980, and
      ending on the date the REIT shares are dis-
      posed of;
   ii) the five-year period ending on the date of
      disposition; or
   iii) the period during which the REIT was in
      existence. I.R.C. § 897(h)(2), (4).

3. Look-back period. As used in this outline, the term
“look-back period” means the shorter of:
   a. the period after June 18, 1980, during which the
      foreign investor held a USRPI; or
   b. the five-year period ending on the date of the
      disposition of such interest. I.R.C. § 897(c)(1)(A).

C. United States Real Property Holding Corporation

1. Definition. A corporation (domestic or foreign) is a
United States real property holding corporation
(USRPHC) if the fair market value of its USRPIs on
any applicable “determination date” equals or exceeds
50% of the sum of the fair market values of:
   a. its USRPIs;
b. its interests in real property located outside the U.S.; and

c. any other assets it uses or holds for use in a trade or business. I.R.C. § 897(c)(2).

Trade or business assets include property, other than real property, which is includible in inventory or held for sale to customers, depreciable property held for use in a trade or business, and certain livestock. Also included in the term are accounts receivable from the sale of such property or from the performance of personal services. However, cash and marketable securities and stock are not considered trade or business assets. Treas. Reg. § 6a.897-1(h).

If foreign real property, or trade or business assets, is acquired for the principal purpose of affecting the status of a corporation as a USRPHC, such assets will not be taken into account in the I.R.C. § 897(c)(2) computation. Treas. Reg. § 6a.897-2(f)(2).

(For purposes of this outline, the assets described in subparagraphs b. and c. supra are sometimes referred to collectively as “disqualifying assets.”)

2. Establishing non-USRPHC status

a. General. The determination of whether a given corporation is a USRPHC is relevant for several reasons. For example, unless an exception or non-recognition rule would apply, a foreign investor disposing of an interest in a domestic corporation would be required to recognize any gain realized if it did not establish that the corporation was not a USRPHC. In addition, such determination is important for purposes of determining whether another corporation holding an interest in a domestic or foreign corporation is itself a USRPHC. Finally, USRPHC status is also important for satisfying the reporting requirements under I.R.C. § 6039C. Treas. Reg. § 6a.897-2(a).

b. Requirement of schedules. In order to establish that gain or loss from the disposition of an interest in a domestic corporation is not subject to FIRPTA, a foreign investor must attach certain schedules to its U.S. income tax return for the year of disposition.
The schedules must supply detailed information concerning the USRPIs, foreign real property, and trade or business assets held and disposed of by the corporation during each year during the look-back period. The bases of such assets, as well as their fair market value on December 31 (or the date of disposition, if earlier), must also be supplied. Finally, calculation must be included demonstrating that the corporation was not a USRPHC on any applicable "determination date" during the year. The schedules may be prepared either by the foreign investor or by the corporation. Treas. Reg. § 6a.897-2(d).

c. Determination dates

1) The temporary regulations relax the statutory requirement that, for the purposes described above, a corporation not be a USRPHC at any time during the look-back period. Rather, it must be established only that the corporation was not a USRPHC on an applicable determination date during that period. The applicable determination dates for any calendar year are:

   i) December 31;

   ii) the day preceding the date on which the corporation disposes of a USRPI; and

   iii) the day preceding the date on which the corporation acquires an interest in foreign real estate or other assets used or held for use in the corporation’s trade or business during the year. An acquisition of trade or business assets will not trigger the occurrence of a determination date if, taking into account all prior acquisitions of such property during the year, the fair market value of the assets acquired is less than 1% of all such assets. Treas. Reg. § 6a.897-2(e)(1).

2) For a year in which a foreign investor disposes of an interest in a domestic corporation, the applicable determination dates are:

   i) the date on which the investor disposes of the interest; and
iii) any otherwise applicable determination date occurring prior to the date of such disposition. Treas. Reg. § 6a.897-2(e)(2).

3) Alternate valuation date. For purposes of determining whether a corporation is a USRPHC, any property retained by the corporation after an applicable determination date (other than December 31) may be taken into account at such date at its December 31 value (or its value at its disposition date, if earlier than December 31). Once an election is made to value property under this rule, the foreign investor must continue to value such property consistent with the election for any subsequent determination date during the year. Treas. Reg. § 6a.897-2(e)(3). See generally the examples at Treas. Reg. § 6a.897-2(e)(4).

3. Stock owned in another corporation

a. Controlling interest. For purposes of determining whether a corporation is a USRPHC, the manner in which any stock it holds in a second corporation is taken into account will depend on whether the first corporation owns a controlling interest in the second corporation. If it does, the stock of the second corporation is disregarded and the first corporation is treated as owning a proportionate share of each asset held by the second corporation under a look-through rule. The portion of each asset treated as owned by the first corporation is equal to the percentage of value of the second corporation’s stock held by the first corporation. I.R.C. § 897(c)(5)(A). See generally the examples at Treas. Reg. § 6a.897-2(i)(2).

1) The term “controlling interest” means 50% or more of the fair market value of all classes of stock of a corporation. I.R.C. § 897(c)(5)(B).

2) In determining whether a corporation owns a controlling interest in a second corporation, the constructive ownership rules of I.R.C. § 318(a) are applied, except that “5 percent” is substituted
for “50 percent” in paragraphs (2)(C) and (3)(C). I.R.C. § 897(c)(6)(C).

3) The first corporation takes into account not only its pro rata share of the USRPIs owned by the second corporation, but also its share of the second corporation’s disqualifying assets. Thus, an asset used or held for use by the second corporation in a trade or business will be treated as so used or held for use by the first corporation. I.R.C. § 897(c)(5)(A)(iii).

4) This look-through rule applies at each tier in a chain of corporations so long as the parent owns a controlling interest in the subsidiary. I.R.C. § 897(c)(5)(A). For example, if the second corporation owns a controlling interest in a third corporation, the second corporation would be considered as owning a proportionate share of each asset held by the third corporation, and, in turn, the first corporation would take into account its proportionate share of the third corporation’s assets treated as held by the second corporation. Treas. Reg. § 6a.897-2(i)(1).

5) The determination of what portion of the assets of a second corporation is deemed held by the first corporation, and the first corporation’s proportionate ownership of the second corporation’s stock is made on each of the applicable determination dates for determining whether the first corporation is a USRPHC. Treas. Reg. § 6a.897-2(i)(1).

b. Non-controlling interest. If a corporation holds less than a controlling interest in a second corporation, the value of the second corporation’s stock held by the first corporation is taken into account as a USRPI only if the second corporation is a USRPHC. See Treas. Reg. § 6a.897-2(i)(2), Ex. 3. If the second corporation is not a USRPHC, the value of the second corporation’s stock still may be taken into account in determining the first corporation’s disqualifying assets if such stock is used or
held for use by the first corporation in its trade or business.

c. Interest in foreign corporation. An interest in an FC will be treated as a USRPI (but only for purposes of determining whether another corporation is a USRPHC) unless it is established that the FC is not a USRPHC. Treas. Reg. § 6a.897-2(g).

4. Interests in partnerships, trusts, and estates

a. The rule here is identical to that which obtains under the "controlling interest" look-through rule described above. Thus, for purposes of determining whether a corporation is a USRPHC, assets (both USRPIs and disqualifying assets) held by a partnership, trust, or estate on an applicable determination date are treated as owned proportionately by its partners or beneficiaries. Assets used or held for use in a trade or business by the partnership, etc., are treated as so held by the partners or beneficiaries. Prior to its amendment by ERTA, only the USRPIs held by a partnership, estate or trust were treated as proportionately owned by the partners or beneficiaries. This look-through rule applies at each level of a chain of partnerships, trusts, or estates. I.R.C. § 897(c)(4)(B); Treas. Reg. § 6a.897-2(h)(1). See examples at Treas. Reg. § 6a.897-2(h)(2), (j).

b. The temporary regulations provide that a partner's proportionate interest in assets held by a partnership on any applicable determination date is equal to the ratio of the liquidation value of his interest in the partnership to the liquidation value of all interests on such date. For this purpose, the liquidation value of an interest is the amount of cash and the fair market value of other property, net of liabilities to persons holding interests in the partnership solely as creditors, which would be distributed to the holder of an interest upon liquidation of the partnership. Treas. Reg. §§ 6a.897-1(g)(2), -2(h)(1). Similarly, a beneficiary's proportionate interest in assets held by a trust or estate on any applicable determination date is equal to the ratio of the actuarial value of the beneficiary's interest in the cash and
other assets held by the entity, net of liabilities to persons holding interests in the entity solely as creditors, to the entire amount of cash and other assets held by the entity net of such liabilities on such date. The proportionate interest of a contingent beneficiary must be determined by reference to the actuarial value of the entire portion of the entity to which the beneficiary potentially may be entitled. Treas. Reg. §§ 6a.897-1(g)(3), -2(h)(1).

IV. TREATMENT OF CERTAIN DISPOSITIONS

A. Distributions by a foreign corporation

1. General. FIRPTA changes the general rule that a corporation is not taxed on gains realized upon the in-kind distribution of appreciated property to its shareholders. See I.R.C. §§ 311, 336. Under I.R.C.§ 897(d)(1)(A), an FC will be taxed on the excess of the USRPI’s fair market value as of the date of distribution over its adjusted basis.

2. Covered distributions. Distributions in connection with corporate liquidations and stock redemptions, as well as non-liquidating in-kind distributions, are covered by this rule.

a. Carryover basis exception. No gain is recognized by an FC on the distribution of a USRPI if:

1) the distributee shareholder receives a carryover basis in the USRPI (increased by the amount of any gain recognized on the distribution by the distributing corporation); and

2) at the time of its receipt, a subsequent disposition of the property by the distributee would be subject to U.S. tax. I.R.C. § 897(d)(1)(B).

The ERTA conferees illustrated the rule with the following example: Assume A, an NRAI, owns real estate through corporation B organized in country X. A contributes the stock of B to corporation C which is located in county Y. B thereafter liquidates under I.R.C. § 332. An existing treaty between Y and the U.S. enables C to dispose of the property free of U.S. tax. As a result, B is taxed under FIRPTA on the distribution to the extent the fair market value of the property at the time of the distribution exceeds B's adjusted basis in the property. ERTA Conference Report at 277.

b. Nonrecognition transaction exception. Gain realized by an FC on certain distributions of a USRPI also may not be recognized under future regulations promulgated by Treasury. I.R.C. § 897(d)(1)(B)(ii).

3. Section 337 is not available. Generally, an FC may not avoid recognition of gain on the sale or exchange of a USRPI by adopting a plan of complete liquidation under I.R.C. § 337 prior to the sale. I.R.C. § 897(d)(2).

  But see section V.D.2., infra.

4. Distributions to certain individual U.S. shareholders. Under I.R.C. § 897(d), a liquidating FC will recognize gain on the sale or distribution of appreciated USPRIs held by it, and U.S. individuals owning stock in the corporation might also recognize gain on receipt of their liquidating distributions under I.R.C. § 331. ERTA § 831(g) added new I.R.C. § 897(l) to provide relief to those U.S. citizens or residents who have owned stock in the FC continuously since June 18, 1980. The amendment relieves U.S. shareholders of the double tax burden by granting a credit against any tax imposed on them on the exchange of their stock upon liquidation. The credit is equal to the shareholder's proportionate share of the tax imposed on the FC on the sale or distribution of its USRPIs. ERTA Conference Report at 279-80.

5. Liquidation of FC where shares were acquired before November 26, 1980

  a. The problem. Under FIRPTA as it was reported by
the Senate Finance Committee on December 15, 1979, and the House Ways and Means Committee on June 18, 1980, an FC could have taken advantage of the tax-free liquidation provisions of the Code, but the foreign shareholders would have been taxed on the exchange of their stock. As finally enacted, I.R.C. § 897(d) provides that an FC will recognize gain on the sale or exchange of a USRPI, even if the sale otherwise would be tax-free under the nonrecognition liquidation provisions of the Code (except as the Treasury may provide by regulations). Thus, a U.S. person acquiring the stock of an FC from a foreign person between December 15, 1979, and November 26, 1980, could reasonably have expected that any tax, if any, due with respect to the unrealized appreciation of the USRPIs would have been borne by the foreign seller. The action of the FIRPTA conferees effectively shifted that burden to the acquiring shareholders. ERTA Conference Report at 279.

b. ERTA solution. However, if this election is made and an interest in the FC were treated as a USRPI, a foreign investor exchanging such interest for a liquidating distribution would be taxable under I.R.C. § 897(a) on any gain realized. Treas. Reg. § 6a.897-4(a).

c. The election under I.R.C. § 897(k) is made by filing a statement with the District Director, Foreign Operations District, Washington, D.C. (hereinafter referred to as the Foreign Operations Director), indicating that the requirements for such election are satisfied and disclosing information concerning the USRPIs held by the FC. The statement must be filed by the later of March 23, 1983, or 90 days after the FC first holds a USRPI. Once made, the election may not be revoked without the Commissioner's consent. Treas. Reg. §§ 6a.897-4(c), -3(f), (h). Thus, the FC can liquidate tax-free and the acquiring U.S. corporation can receive the USRPIs at a stepped-up basis. Notwithstanding such an election, a foreign shareholder selling stock in the FC will not be
treated as having disposed of a USRPI. I.R.C. § 897(k). An FC holding USRPIs and adopting a plan of liquidation under I.R.C. §§ 332 and 334(b)(2)(A) can elect to be treated as a domestic corporation for the period following June 18, 1980, if:

1) control of the FC was acquired by purchase within a twelve-month period; and

2) the first acquisition of its stock was made by the distributee corporation after December 31, 1979, and before November 26, 1980.

B. Sale of stock in an FC. Because stock in an FC is not a USRPI, a foreign investor is not subject to tax under FIRPTA on any gain realized on its sale or exchange. But see section V.D., infra. However, the FC's stock generally will not be very attractive to a potential U.S. buyer because, under the rules described in paragraph A. above, a liquidation of the corporation generally will trigger a tax on the appreciation in the USRPIs held by the FC.

C. Distributions by a domestic corporation

1. General. A foreign investor receiving a USRPI in an I.R.C. § 301 distribution form a domestic corporation will recognize income as under the pre-FIRPTA rules, but will not receive a fair market value basis in the USRPI. Instead, the basis of the USRPI in the hands of the foreign investor will not exceed its adjusted basis in the hands of the distributing corporation at the time of distribution, increased by (1) any gain recognized by the distributing corporation on the distribution, and (2) the amount of any U.S. tax paid by the distributee on such distribution. I.R.C. § 897(f).

2. Distributions by a REIT

a. General. Any distribution by a REIT to a foreign investor will, "to the extent attributable to gain from sales or exchanges by the REIT" of USRPIs, be taxable to the foreign investor as gain realized from the sale or exchange of a USRPI. I.R.C. § 897(h)(1).

b. Distribution by domestically controlled REIT. A domestically controlled REIT distributing a USRPI is required, under rules similar to those governing
distributions by FCs at section IV.A., supra, to recognize any gain to the extent of its "foreign ownership percentage." I.R.C. § 897(h)(3). A REIT's foreign ownership percentage is equal to the largest direct or indirect ownership of stock by foreign persons during the shorter of:

1) the period beginning on June 19, 1980, and ending on the date of distribution;
2) the five-year period ending on the date of distribution; or
3) the period during which the REIT was in existence. I.R.C. § 897(h)(4).

D. Sale of partnership, etc., interest

1. General. An interest in a partnership, estate or trust holding USRPIs does not qualify a USRPI. However, under regulations to be prescribed by the Treasury, any gain realized on the sale or exchange of such interest is, to the extent it is attributable to USRPIs held by the entity, treated as realized on the sale or exchange of a USRPI in the U.S. I.R.C. § 897(g).

2. Changes in interest in, or distributions from, a partnership, etc. The Treasury is directed to prescribe in regulations the extent to which changes in interests in, or distributions from, a partnership, trust, or estate are to be treated as sales of property at fair market value. I.R.C. § 897(e)(2)(B)(ii).

E. Application of the nonrecognition provisions

1. General. Pending the issuance of Treasury regulations, and except as limited by I.R.C. § 897(d), the nonrecognition provisions of the Code are to apply to dispositions of USRPIs, but only to the extent the property received would, if disposed of, be subject to tax under I.R.C. § 897(a). Thus, the interest received must be a USRPI. I.R.C. § 897(e)(1); Conference Committee Report at 188-89. For example, I.R.C. § 351 would apply to the contribution of a USRPI to a domestic corporation by a controlling shareholder, but not to a contribution of a USRPI to a foreign corporation. For this purpose, a "nonrecognition provision" is any Code pro-
vision for not recognizing gain or loss. I.R.C. § 897(e)(3).

Effect of treaty exemption. If a treaty would exclude gain on the disposition of the interest received from U.S. tax, an otherwise applicable nonrecognition provision will not apply. Conference Committee Report at 188-89.

2. Scope of Treasury regulations. The Treasury is to promulgate regulations providing the extent to which the nonrecognition provisions of the Code shall and shall not apply; such regulations are to be “necessary or appropriate to prevent the avoidance of federal income taxes.” I.R.C. § 897(e)(2). In addition, the regulations are to prescribe the extent to which transfers of property in reorganizations are to be treated as sales of property at fair market value. I.R.C. § 897(e)(2)(B)(i).

3. Contributions to capital. FIRPTA, as originally enacted, arguably permitted a foreign investor to avoid tax on the disposition of a USRPI by transferring it to an FC as a contribution to capital or paid in surplus under the rules of I.R.C. §§ 118 or 351. ERTA eliminated this ambiguity by adding I.R.C. § 897(j) to provide that, except as the Treasury may provide in regulations, a foreign investor will recognize gain in such circumstances to the extent the fair market value of the USRPI exceeds (1) its adjusted basis in the hands of the transferor plus (2) the amount of any gain recognized under any other Code provision by the transferor at the time of the transfer. ERTA Conference Report at 278-79.

V. EFFECT OF TREATIES

A. Grace period. Existing treaties which exempt gain realized by a foreign investor on the disposition of a USRPI will not apply after December 31, 1984. FIRPTA § 1125(c)(1).

B. Renegotiated treaties

1. If any treaty is renegotiated “to resolve conflicts between such treaty and the provisions of [I.R.C. § 897]” and is signed before January 1, 1985, the application of FIRPTA to a disposition of a USRPI which would be exempt under the old treaty is postponed to a
date not later than the date specified in the treaty (or accompanying exchange of notes), but in no event longer than two years after the new treaty is signed. FIRPTA § 1125(c)(2).

2. ERTA amendment. ERTA amended this provision to eliminate the ambiguity concerning its effect on treaties recently signed by the U.S. As amended, this provision makes clear that in order for the two-year rule to apply, the new treaty must have been signed on or after January 1, 1981. ERTA § 831(h). If a new treaty was signed before 1981, the old treaty will continue to apply until the earlier of the date the new treaty is ratified, or December 31, 1984. ERTA Conference Report at 280.

C. Treaty shopping. The delay in the effective date provisions was not intended to permit a foreign investor to rearrange existing U.S. real estate investments so as to come under a treaty which would exempt gain from the disposition of a USRPI from tax under FIRPTA. In the ERTA Conference Report, the conferees stated their belief that most such restructuring transactions were prohibited under the broad power given Treasury under I.R.C. § 897(e)(2) to adopt regulations to prevent tax avoidance. They felt compelled, however, to emphasize the point in order to “avoid any misunderstandings.” ERTA Conference Report at 281.

D. Election to treat FC as a domestic corporation

1. General. An FC holding USRPIs may elect to be treated as a domestic corporation only for purposes of I.R.C. §§ 897 and 6039C if, under a relevant treaty, it is entitled to nondiscriminatory treatment with respect to such interest. I.R.C. § 897(i)(1).

2. Significance. Thus, if an electing FC is a USRPHC, its stock will be a USRPI, and any gain realized by a foreign person on its sale or other disposition will be taxed under FIRPTA (unless an exception otherwise applies). See section III.B.2., supra. In addition, an FC electing such treatment would be entitled to distribute or sell USRPIs without recognizing gain to the extent permitted by the Code’s nonrecognition provisions. For example, it could adopt a plan of complete liquidation under I.R.C. § 337 so that gain on a sale of its USRPIs would
escape the corporate level tax under I.R.C. § 897(d)(2). However, because their shares would become USRPIs (in the absence of any available exception), the corporation's foreign shareholders would then be subject to tax on the gain realized on the receipt of liquidating distributions in exchange for their stock in the corporation. Treas. Reg. § 6a.897-3(a).

3. Conditions to the election

a. Generally, an election cannot be made if any interest in the FC is disposed of after the later of June 18, 1980, or the date on which the corporation first holds a USRPI. Treas. Reg. § 6a.897-3(b)(1). However, in the case of an interest disposed of before March 21, 1983, an election may be made, provided any U.S. tax is paid which would have been owed by the person disposing of the interest (notwithstanding any contrary treaty provision) if, prior to the disposition, the corporation had made the election. Treas. Reg. § 6a.897-3(b)(2). The required payment of tax must be made no later than the date of the election, but need not be made by the person who otherwise would have owed it; the FC, or any other person, may make the payment to the Foreign Operations Director. Treas. Reg. § 6a.897-3(c).

b. The corporation must agree that, while the election is in effect, it will not avail itself of the benefit of any treaty provision with respect to gain or loss realized on the disposition of a USRPI which would be taken into account under I.R.C. § 897(a). Treas. Reg. § 6a.897-3(b)(4), (d).

c. The information and consents required by Treas. Reg. § 6a.897-3(e) must be filed with the Foreign Operations Director. Treas. Reg. § 6a.897-3(b)(3).

d. An FC otherwise eligible to make an election under I.R.C. § 897(i) may not make the election if: (i) prior to its receipt of a USRPI, stock in the FC (or in any corporation above or below it in the same chain of ownership) was acquired in a transaction in which the transferee obtained a higher basis in the stock than its adjusted basis in the hands of the
transferor (e.g., by purchase); (ii) the full amount of gain realized by the transferor was not subject to U.S. tax; and (iii) the FC received the USRPI in a transaction (or series of transactions) in which gain was not recognized by reason of I.R.C. § 897(d)(1)(B) (e.g., in an I.R.C. § 334(b)(1) liquidation). Treas. Reg. § 6a.897-3(g)(1). See examples at Treas. Reg. § 6a.897-3(g)(2).

4. Manner and time of making election

a. An election under I.R.C. § 897(i) is made by filing a statement with the Foreign Operations Director which contains the information requested by Treas. Reg. § 897-3(e). Among other things, the statement must include: (i) the treaty provision under which the FC seeks nondiscriminatory treatment; (ii) detailed information concerning the USRPIs held by the corporation (including data on their acquisition, tax bases, and fair market values); (iii) a representation that no prior disposition of an interest in the corporation has occurred (except that, with respect to a pre-March 21, 1983, disposition, it must be demonstrated that the conditions imposed with respect to such a disposition have been satisfied); (iv) detailed information concerning the identity of all holders of non-creditor interests in the FC, the nature of their interest and its fair market value; and (v) information concerning any dispositions of interests in the corporation between related persons after December 31, 1979, and before June 19, 1980.

b. The statement filed with the Foreign Operations Director also must include a signed consent to the election by all holders of non-creditor interests in the corporation on the date of the election. Foreign interest holders also must agree that, while the election is in effect, they will not avail themselves of the benefit of any treaty provision with respect to gain or loss realized on their disposition of an interest in the corporation which would be taken into account under I.R.C. § 897(a). If a class of interest in the corporation is regularly traded on an established securities market, the consent and agreement need be
provided only by a person who holds or has held (actually or constructively) more than 5% of such class at some time during the look-back period. Treas. Reg. § 6a.897-3(e)(3).

c. An election by an FC in existence on or between June 19, 1980, and March 21, 1983, must be made by the later of March 21, 1983, or ninety days after the corporation first holds a USRPI. An election by an FC created after March 21, 1983, must be made no later than ninety days after the corporation first holds a USRPI. In either case, the period for which the election applies begins on the later of June 19, 1980, or the date the corporation first holds the USRPI. Treas. Reg. § 6a.897-3(f).

5. Revocability of election. Once made, the election may not be revoked without the Commissioner's consent. I.R.C. § 897(i)(2). Such consent will not be given if, during the period for which the election is in effect, the corporation has made any distribution of USPRIs in which the full amount of any gain realized by the corporation was not subject to U.S. tax. Treas. Reg. § 6a.897-3(h)(2).

6. Exclusive method of claiming nondiscrimination. As amended by ERTA, I.R.C. § 897(i) provides that the making of this election is the exclusive remedy of any FC which claims discrimination under any treaty for purposes of I.R.C. §§ 897 and 6039C. I.R.C. § 897(i)(4). If an FC is not permitted to make an election because the conditions prescribed at paragraph 3., supra, can not be satisfied, the nondiscrimination article of a treaty is not available with respect to I.R.C. §§ 897(a) and 6039C. Treas. Reg. § 6a.897-3(b).

VI. SOME PLANNING POSSIBILITIES UNDER FIRPTA

A. Avoidance of USRPHC status. The definition of a USRPI excludes stock in a domestic corporation if the value of its USRPIs does not equal or exceed 50% of the sum of the value of its USRPIs, foreign real property, and other assets used or held for use in a trade or business at any time during the look-back period. Accordingly, a foreign investor should carefully examine the asset mix of a U.S. corpora-
tion in which it is considering investing. Where the foreign investor is contemplating housing a U.S. real estate investment in a domestic corporation, consideration also should be given to contributing sufficient foreign real property, or other trade or business assets, to the corporation in order to avoid USRPHC status. But see Treas. Reg. § 6a.897-2(f)(2) (valid business purpose required). Care should be taken to ensure that USRPHC status does not inadvertently result, e.g., by first contributing or acquiring the U.S. real property. If USRPHC status obtains and sufficient disqualifying assets are subsequently contributed or acquired by the corporation, the I.R.C. § 897(c)(1)(A)(ii) taint will not be removed for five years, unless I.R.C. § 897(c)(1)(B) applies.

B. Disposition of interest in former USRPHC. If a domestic corporation is a USRPHC, the sale or exchange of its stock by an NRAI or FC will trigger the recognition of gain under FIRPTA. If it is necessary to dispose of such stock prior to the running of the look-back period, gain recognition under I.R.C. § 897(a) still can be avoided if all of the corporation's USRPIs have been disposed of in transactions in which the full amount of any gain was recognized. The absence of a de minimus rule can work a harsh result; thus, if at the date of disposition 99% of the fair market value of the USRPHCs assets are represented by disqualifying assets, the failure to dispose of the only remaining USRPI assets, representing only 1% of the corporation's value, in a taxable transaction will result in all the gain realized by the foreign investor being taxed under I.R.C. § 897. Query whether a liquidating corporation's previous disposal of its USRPIs in an installment sale in which part or all of the gain would be recognized in a year subsequent to that in which the stock is exchanged will satisfy the recognition requirement of I.R.C. § 897(c)(1)(B). The temporary regulations provide that such installment obligations are USRPIs, and I.R.C. § 453B would require recognition of gain by the corporation on their sale or distribution in liquidation.

C. Sale of stock in an FC. Even if an FC qualifies as a USRPHC, the sale of its stock in the U.S. at a gain generally will not be taxable in the hands of an FC or an NRAI (so long as his U.S. presence is less than 183 days during the year of disposition). However, because I.R.C. § 897(d) gen-
erally would require an FC to recognize gain on the sale or distribution of its USRPIs in a subsequent liquidation, the selling price for the stock may have to be discounted to reflect the inherent tax liability in the corporation’s USRPIs. Where the USRPIs are largely nondepreciable assets, e.g., farmland, the tax at the corporate level can be avoided because the buyer can forego liquidation. Of course, a buyer may prefer to purchase the land itself if it is unable to determine that the corporation has no undisclosed liabilities.

D. Treaty exemptions. The ERTA Conference Report clearly expresses the intent of Congress that foreign investors may not avoid the sweep of FIRPTA by rearranging their U.S. real estate investments to take advantage of favorable treaties prior to 1985. However, significant numbers of foreign investors holding U.S. real estate through domestic corporations may still take advantage of the favorable treatment accorded under treaties between their country of residence and the U.S. in disposing of stock in a USRPHC prior to 1985. For example, the Dutch, Swedish, Japanese, Belgian, and West German treaties exempt from U.S. tax gain realized by a resident (individual or corporate) of their respective countries from the sale of capital assets other than real estate if the taxpayer has no U.S. permanent establishment. The existing Canadian treaty exempts from U.S. tax gain on the sale of any capital asset, but only if the Canadian resident or corporation has no permanent establishment in the U.S. A foreign person contemplating a new investment in U.S. real estate should consider the use of a corporation formed in a country with a favorable treaty to benefit from the remaining grace period. For example, if the USRPI is held by a U.S. subsidiary of a Dutch parent, the U.S.-Netherlands treaty would permit gain on the disposition of the stock in the domestic corporation (whether by sale or in the context of an I.R.C. § 337 liquidation in which the USRPI is sold) to be excluded from U.S. tax. However, note that while foreign persons regularly utilize third country treaties with the U.S. to gain preferential tax treatment, the U.S. is pushing hard in its current treaty negotiations to cut off access to such benefits by non-residents of the treaty country.

E. Setoff of USRPI gains against other effectively connected
losses. Because other effectively connected losses of a foreign investor are netted against I.R.C. § 897(a) gains in computing the investor’s net U.S. taxable income, the sale of appreciated USRPIs might be postponed to a year in which other effectively connected losses could be utilized to shelter the gain.

F. Election to be treated as a domestic corporation. If an FC holds depreciable USRPIs with an adjusted tax basis which is lower than its shareholders’ basis in their stock, and a relevant treaty prohibits discrimination of the FC, an election under I.R.C. § 897(i) would permit the FC to sell the USRPIs pursuant to an I.R.C. § 337 plan of liquidation. As a result, the taxable gain would be limited to the lesser amount realized by the shareholders on their stock. However, an “(i)” election may not be advisable where a substantial portion of the gain in the FC is attributable to non-USRPI assets, since an election would result in the entire gain being taxable and not just that attributable to the USRPIs. Note that the temporary regulations greatly restrict the flexibility of the election: generally, it must be made at the time the FC first acquires a USRPI.

G. Going public. If a domestic corporation otherwise qualifies as a USRPHC, tax under FIRPTA on the sale or exchange of its stock by a foreign investor can be avoided if the stock is regularly traded on an established securities market and the foreign investor at no time during the look-back period held more than 5% of the stock. Generally, however, this will require a five year waiting period from the time the corporation goes public before a “more than 5%” foreign investor can dispose of his stock tax-free.

H. Sale of U.S. residence. A departing alien resident of the U.S. may inadvertently subject himself to tax under FIRPTA on the sale of his U.S. residence if the closing occurs after the time his U.S. residency ends, even if he reinvests in a foreign residence in a transaction covered by I.R.C. § 1034. Although the current real estate market may make it difficult, care should be taken to sell the property while the alien is still a U.S. resident, and reinvesting the proceeds in a new foreign principal residence within two years.
VII. REPORTING REQUIREMENTS

A. Domestic corporations and nominees

1. Domestic corporation

   a. General. If a domestic corporation has a foreign shareholder at any time during the calendar year and was a USRPHC during the year or at any time during the preceding four calendar years (but excluding any period prior to June 19, 1980), it is required to file Form 6659 with the IRS. I.R.C. § 6039C(a)(1); Treas. Reg. § 6a.6039C-2(a).

   b. Exceptions. Form 6659 need not be filed if:

   1) all classes of the corporation’s stock held by foreign persons during the year were regularly traded on an established securities market during the entire time held by foreign persons;

   2) the corporation has provided security to, and has in effect a security agreement with, the Foreign Operations Director; or

   3) with respect to all USRPIs held by it, the corporation would be exempt from filing a return. I.R.C. § 6039C(a)(2); Treas. Reg. § 6a.6039C-2(a). For this purpose a domestic corporation need not take into account an interest it holds in another entity which qualifies as a USRPI if the other entity has provided adequate security to the IRS with respect to all USRPIs which it holds. Treas. Reg. § 6a.6039C-5(f). See section VII.D., infra.

   c. Return information

   1) If known to the reporting corporation, the temporary regulations provide that the name, address and identifying number (if any) of any foreign person (or any nominee of any foreign person) who held an interest in the corporation on the last day of the calendar year must be disclosed on Form 6659, as well as information concerning, inter alia:

      i) the amount and types of interests in the corporation held by such persons;
ii) dispositions of interests in the corporation by such persons during the year;
iii) distributions of USRPIs to foreign persons;
iv) a description of all USRPIs held by the corporation; and
v) the identity of corporations in which the reporting corporation holds an interest which constitutes a USRPI. I.R.C. § 6039C(a)(1)(A); Treas. Reg. § 6a.6039C-2(b).

2) For this purpose, information is "known" to the corporation if it is included on its books and records or those of its agent, is known by its officers or directors, or is known by other employees who in the course of their employment have reason to know such information. Treas. Reg. § 6a.6039C-2(f).

2. REITs. While a foreign-controlled REIT must provide essentially the same information as a reporting corporation, a domestically-controlled REIT is subject to substantially less detailed reporting requirements. Treas. Reg. § 6a.6039C-2(c).

3. Nominees
   a. General. Unless one of the exceptions described below applies, a person (domestic or foreign) holding an interest on behalf of a foreign person in a corporation subject to the I.R.C. § 6039C(a) reporting requirements as a nominee must prepare and file Form 6659 with the IRS. The nominee must include all the information required by Treas. Reg. § 6a.6039C-2(b), and is required to obtain and supply any of such information not otherwise in its possession. Treas. Reg. § 6a.6039C-2(e)(1)(i). If a nominee does not know, or cannot obtain, the required information, it must provide security in accordance with Treas. Reg. § 6a.6039C-5. See section VII.D., infra.
   b. Reporting by corporation. If the corporation knows all the information required to be reported with respect to an interest held by a nominee, the corpora-
tion must file a Form 6659 with respect to such
interest and notify the nominee that it is not re-
quired to make a filing with respect to such interest.
If the corporation knows some, but not all, of the
information required to be supplied with respect to
such interest, it must file a partially completed Form

c. Exceptions. A nominee is not required to file Form
6659 with respect to an interest in a reporting corpo-
ration if:

1) it is notified by the corporation that it is not
required to make such a filing;

2) the nominee (or another nominee in a chain of
nominees) has provided adequate security to,
and has in effect a security agreement with, the
Foreign Operations Director;

3) with respect to the interest in the corporation
held by the nominee, the corporation has pro-
vided adequate security to, and has in effect a
security agreement with, the Foreign Operations
Director;

4) the nominee files with the IRS a completed
Form 6659 supplied by the beneficial owner
which the nominee is satisfied is complete; or

5) any exception described at section VII.A.1.b.,

d. Notice requirements

1) Domestic corporation. If a reporting
corporation does not know whether an owner of
record is a foreign person or a nominee for a for-

eign person, it must notify such owner that the
notice requirements of Treas. Reg. § 6a.6039C-
2(e) must be complied with if such record owner
is such a nominee. The notice must be given by
January 31 of the year following the calendar
year for which the return must be filed. For cal-
endar years 1980, 1981, and 1982, such notice
must be given by February 21, 1983. Treas.
Reg. § 6a.6039C-2(d); IR-83-7 (Jan. 10, 1983).
Unless otherwise known by the corporation, an
owner of bearer shares, or an owner of record with a foreign address, is presumed to be a foreign person. Treas. Reg. § 6a.6039C-2(g).

2) Nominee. Within twenty days of its receipt from a reporting corporation of a notice described at subparagraph d.1), supra, a nominee in a chain of nominees must notify the nominee above it that such nominee must file Form 6659 if that person holds an interest, directly or indirectly through other nominees, for a foreign beneficial owner. (A similar notice must be given by the latter nominee to any nominee above it within twenty days of its receipt of such notice from a nominee below it in the chain.) Within thirty days of its receipt of such notice from the reporting corporation, or from a nominee below it in a chain of nominees, a nominee must inform the corporation as to whether it is holding an interest in the corporation for a foreign beneficial owner or whether it has notified a nominee above it in a chain of nominees to file a Form 6659. A corporation or nominee which knows of its obligation to file must do so regardless of whether these notification procedures have been satisfied. Treas. Reg. § 6a.6039C-2(e)(1).

4. Publicly traded stock. Information with respect to stock in a corporation required to be reported on Form 6659 need not be included for any period during which the stock was of a class regularly traded on an established securities market. Similarly, notice to nominees and reporting corporations with respect to such stock need not be given if the stock was regularly traded on an established securities market for the entire year. Treas. Reg. § 6a.6039C-2(h).

5. Time and place for filing return. Form 6659 must be filed with the Philadelphia IRS Center not later than May 15 of the year succeeding the calendar year covered by the return. Returns for calendar years 1980, 1981, and 1982 must be filed no later than June 21, 1983. Returns with respect to Virgin Islands real property interests under I.R.C. § 6039C(f)(2) are filed with
the Virgin Islands Bureau of Internal Revenue. Treas. Reg. § 6a.6039C-1(c); IR-83-7.

B. Foreign corporations and other entities

1. General. Any FC, or any partnership, trust or estate (whether domestic or foreign), that has a “substantial investor in U.S. real property” on any applicable determination date during the calendar year must file a Form 6660 with the IRS. I.R.C. § 6039C(b)(1); Treas. Reg. § 6a.6039C-3(a).

2. Exceptions. A reporting entity need not file a Form 6660 if:
   a. it has provided adequate security to, and entered into a security agreement with, the Foreign Operations Director; or
   b. with respect to all USRPIs held by the entity, it would be exempt from filing under Treas. Reg. § 6a.6039C-5(f). Treas. Reg. § 6a.6039C-3(a). Thus, an entity need not take into account an interest it holds in another entity which qualifies as a USRPI if the other entity has provided adequate security to the IRS with respect to all USRPIs which it holds. See section VII.D., infra.

3. Substantial investor in U.S. real property
   a. A substantial investor is any foreign person who holds an interest in a partnership, trust or estate (whether domestic or foreign), or any person (domestic or foreign) who holds an interest in an FC, if, on any applicable determination date during the calendar year, the value of the person’s pro rata share of the entity’s USRPIs exceeds $50,000. In making this determination, interests held in an entity by a spouse or minor child of an individual are treated as held by the individual. I.R.C. § 6039C(b)(4)(B); Treas. Reg. § 6a.6039C-3(b).

1) Unless known to be otherwise by the entity, an owner of bearer shares, or an owner of record with a foreign address, is treated as a foreign person.

2) Interests held by a nominee are, in the absence
of contrary knowledge, treated as owned by a foreign person. Treas. Reg. § 6a.6039C-3(f).

b. Example. K, a domestic partnership, holds as its only asset a parcel of U.S. real property worth $101,000. D, a U.S. citizen, and F, an NRAI, are equal partners in K. Because the value of F’s pro rata share of K’s USRPIs is $50,500 (50% of $101,000), F is a substantial investor. Treas. Reg. § 6a.6039C-3(b)(2).

c. Indirect holdings. In determining whether an entity has substantial investors, USRPIs held by corporations, partnerships, trusts and estates are considered held proportionately by shareholders, partners, and beneficiaries, respectively. See Treas. Reg. § 6a.897-1(e). This rule is applied at each level of a chain of ownership, except that an entity’s pro rata share of USRPIs held by a corporation are disregarded unless the value of such pro rata share exceeds $50,000. I.R.C. § 6039C(b)(4)(C). In addition, the look-through rule does not apply with respect to stock in a corporation held by an entity if 1) it is of a class which is regularly traded on an established securities market; and 2) at no time during the look-back period did the entity hold more than 5% of such class. Treas. Reg. § 6a.6039C-3(c)(1). In a chain of ownership situation, each entity (other than a domestic corporation) treated as having a substantial investor must file Form 6660, unless an exception otherwise applies. See examples at Treas. Reg. § 6a.6039C-3(e)(2).

d. Determination dates. The applicable dates during the calendar year for determining whether an entity has substantial investors and whether a person is a substantial investor are:

1) December 31;

2) the date immediately preceding the date on which the entity disposes of a USRPI;

3) the date on which a foreign person with an interest in the entity (or any person, if the entity is a foreign corporation) disposes of an interest in the entity; and
4) if the entity is treated as holding a pro rata share of USRPIs held by another entity and such other entity disposes of a USRPI, the date immediately preceding such disposition. Treas. Reg. § 6a.6039C-3(d)(1).

e. Valuation methods. Generally, for purposes of determining the value of a person's pro rata share of USRPIs held by an entity, the fair market value of the property held by the entity on the applicable determination date must be used. Alternatively, if the property is retained after a determination date other than December 31, its fair market value as of December 31 (or the date of its disposition, if earlier) may be used for such earlier determination date. Once a valuation method is chosen, it must be used for all subsequent determination dates during the year and for all property with respect to which the determination is made. Treas. Reg. § 6a.6039C-3(d)(2).

4. Return information

a. In addition to disclosing the name, address and taxpayer ID number of each substantial investor in the entity during the calendar year, the entity reporting on Form 6660 must provide information concerning, *inter alia*:

1) the value of each substantial investor's pro rata share of USRPIs held by the entity on December 31 (or, in the case of a disposition of an interest in an FC by a substantial investor, on the date of disposition);

2) the amount and type of interest in the entity held by a substantial investor on December 31;

3) the USRPIs held by the entity on December 31, including their location, adjusted bases, and fair market values;

4) if the entity is a partnership, trust or estate, the USRPIs held by it on the date a substantial investor disposes of an interest in the entity;

5) the USRPIs distributed by the entity to a foreign person (and to a domestic person, if the entity is
an FC) during the year, including the date of distribution, the adjusted basis and fair market value of the interest, and the identity of the distributee (whether or not a substantial investor); 

6) dispositions of interests in a partnership, trust or estate during the year by a foreign person, including the transferor's identity, date of disposition, sales price (if any) or value of the interest (if the disposition is other than by sale), and, in the case of a disposition by a substantial investor, the value of the investor's pro rata share of USRPIs held by the entity on the date of disposition;

7) the identity of any other entity as to which the reporting entity is a substantial investor; and 

8) the identity of any domestic corporation in which the reporting entity holds an interest which qualifies as a USRPI. Treas. Reg. § 6a.6039C-3(e).

b. A reporting entity is required to obtain and supply any information requested by Form 6660 which it does not have, unless the entity has provided adequate security to, and has in effect a valid security agreement with, the Foreign Operations Director. The fact that stock of an FC is in bearer form, that an interest in an entity is held by a nominee, or that disclosure of ownership would violate a foreign secrecy law, does not constitute reasonable cause for failure to provide such information. Treas. Reg. § 6a.6039C-3(g).

5. Time and place for filing return. The filing requirements for Form 6660 are the same as those for Form 6659. See section VII.A.5., supra. Treas. Reg. § 6a.6039C-3(a).

6. Statements to substantial investors. Unless the entity has furnished adequate security to, and has in effect a security agreement with, the Foreign Operations Director, it must furnish a statement to all substantial investors no later than January 31 of the year following the year for which Form 6660 is filed. Statements for calendar years 1980, 1981, and 1982 must be furnished by
February 21, 1983. The statement must furnish the information described at sections VII.B.4.(1), (5), and (6), supra, which relates to the recipient of the statement. Treas. Reg. § 6a.6039C-3(h); IR-83-7 (Jan. 10, 1983).

C. Other foreign investors

1. General. If a foreign person (or a nominee on behalf of a foreign person), on any applicable determination date during the calendar year, holds USRPIs which at no time during the year were used by such person in a U.S. trade or business, such person must file a Form 6661 with the IRS if the value of such USRPIs on any applicable determination date was at least $50,000. I.R.C. § 6039C(c); Treas. Reg. § 6a.6039C-4(a).

2. Exceptions. Form 6661 need not be filed if:
   a. the foreign person is required to file a Form 6660 with respect to such non-business USRPIs;
   b. the foreign person has provided adequate security to, and entered into a security agreement with, the Foreign Operations Director with respect to such USRPIs; or
   c. with respect to such interests held through another entity, it would be exempt from filing under Treas. Reg. § 6a.6039C-5(f). See section VII.D., infra.

A foreign beneficiary of an estate or trust who is treated as owning a portion of the USRPIs held by such entity is not required to file a Form 6661 in respect of such interests if the actuarial value of no portion of his interests in the entity is definitely ascertainable. In such a case, the trustee or executor, rather than the beneficiary, must file a Form 6661 with respect to each such beneficiary, regardless of whether the trust or estate is also required to file a Form 6660. Treas. Reg. § 6a.6039C-4(a).

3. Indirect holdings. USRPIs held by a foreign person (or a nominee) include those held directly and indirectly in accordance with Treas. Reg. § 6a.897-1(e). Thus, USRPIs held by partnerships, trusts and estates are considered held proportionately by partners and beneficiaries, respectively. This rule is applied at each level in a chain of ownership. A foreign person is not treated as
owning a pro rata share of the assets held by a corporation in which it holds an interest. Interests held by a spouse or minor child of an individual are treated as held by the individual. Treas. Reg. § 6a.6039C-4(b).

4. Determination dates. The applicable dates during the calendar year for determining whether a person (or nominee) must file a Form 6661 are:
   a. December 31;
   b. the date of disposition by such person of a USRPI, or of an interest in an entity through which such person is treated as holding a pro rata share of USRPIs; and
   c. if an entity through which the person is treated as holding a pro rata share of USRPIs disposes of a USRPI, the date immediately preceding such disposition. Treas. Reg. § 6a.6039C-4(c)(1).

5. Valuation methods. For the valuation methods to be used in determining whether the value of USRPIs held by a foreign person (or nominee) on any applicable determination date is equal to or in excess of $50,000, see section VII.B.3.e., supra. Treas. Reg. § 6a.6039C-4(c)(2).

6. Return information. The information requested by Form 6661 includes:
   a. a description of USRPIs held by or on behalf of the foreign person on December 31 (other than those used in a U.S. trade or business), including their location, fair market values, date of acquisition, and the identity of any foreign person from whom the USRPIs were acquired;
   b. a schedule of all dispositions of USRPIs held by or on behalf of a foreign person during the year, including a description of the interests, their location (in the case of real or tangible USRPIs), fair market values, and adjusted bases in the hands of the person filing the return; and
   c. in the case of a disposition of a USRPI to a foreign person, the transferee’s identity, date of disposition, sales price (if any), and adjusted basis and fair mar-
ket value (in the case of a disposition other than a sale) of the property. Treas. Reg. § 6a.6039C-4(d).

7. Time and place for filing return. The filing requirements for Form 6661 are the same as those for Form 6659. See section VII.A.5., supra. Treas. Reg. § 6a.6039C-4(a).

D. Security arrangements

1. General. A person or entity otherwise required to file a Form 6659, 6660, or 6661 is excused from doing so if, for the calendar year for which the return is due, adequate security is provided to, and a security agreement is entered into with, the Foreign Operations Director covering the USRPIs which otherwise would be the subject of the return. The entering into a security agreement also relieves an entity of its obligation under I.R.C. § 6039C(b) to furnish a statement to substantial investors. Treas. Reg. § 6a.6039C-5(a). The temporary regulations liberalize the availability of the security arrangements which, under I.R.C. § 6039C(b), were limited to partnerships, estates, trusts, and FCs required to file an information return if they had a substantial investor in U.S. real property.

2. Advantage of security agreement. Entry into a security agreement with the IRS not only permits the person or entity required to file an information return to avoid disclosing the identity of its foreign beneficial owners, but also allows persons holding interests in the entity to disregard their pro rata share of the USRPIs covered by the agreement in determining their own obligation to file an information return with the IRS, but only if such persons receive written notification from the entity that a valid security agreement has been entered into. Treas. Reg. § 6a.6039C-5(f).

3. Amount of security

   a. General. The amount of security must be sufficient to secure payment of any tax liability arising under I.R.C. § 897(a) which might be imposed on the person or entity required to file the return, or on a foreign person holding an interest in the entity, with respect to the USRPIs held directly or indirectly by
such entity. Treas. Reg. § 6a.6039C-5(a). Generally, the amount of security would cover the excess of the aggregate “appraised fair market value” of all USRPIs held during the calendar year by the person or entity required to file the return over the aggregate of their adjusted bases, multiplied by the highest statutory income tax rate for long-term capital gain applicable to (i) the person or entity required to file the return, or (ii) the persons or entities holding an interest in the reporting entity (20% in the case of an individual; 28% in the case of a corporation), whichever is greater. Treas. Reg. § 6a.6039C-5(c).

b. Ceiling amount of security. The Foreign Operations Director may determine that a greater or lesser amount is appropriate to cover the tax which may be imposed, but the amount of security may not exceed the amount of tax which would be due if the excess of the aggregate appraised fair market value of all USRPIs held by the person or entity over the aggregate of their adjusted bases were multiplied by the highest statutory income tax rate for ordinary income applicable to (i) the person or entity required to file the return, or (ii) the foreign persons whose tax liabilities are to be secured under the security agreement (50% in the case of an individual; 46% in the case of a corporation). Treas. Reg. § 6a.6039C-5(c).

c. Appraised fair market value. For purposes of determining the required amount of security, the “appraised fair market value” of USRPIs means the value set by an “appraiser of competency” with regard to a particular property as of December 31 of the year for which a return is otherwise required. The appraisal must be made within sixty days of the close of the applicable calendar year. Appraisals made after sixty days of the close of such year will be accepted only if the Foreign Operations Director is satisfied that the person had good cause for not making a timely appraisal and the appraisal accurately represents the fair market value of the property at such December 31. With respect to security
agreements relating to calendar years 1980-82, the appraised fair market value of the USRPIs for each such year must be determined no later than March 21, 1983. Treas. Reg. § 6a.6039C-5(e).

4. Types of security. The IRS has absolute discretion to determine the type of security required. The temporary regulations provide a non-exclusive list of the types of security which the Foreign Operations Director may accept. They are:

a. recorded security interests in U.S. real property with sufficient priority to protect the Government's interest;

b. funds or other property placed in escrow;

c. letters of credit;

d. bonds executed with satisfactory surety;

e. evidence of binding voluntary withholding agreements which assure payment of tax on the disposition of a USRPI; and

f. binding agreement with an entity guaranteeing payment of the eventual income tax liability which may be owed by the entity (or any direct or indirect owner of the entity) if it:

1) is engaged in business in the U.S.;

2) has substantial assets in the U.S.;

3) satisfies the Foreign Operations Director that it will not be liquidated and that its assets will not be disposed of without payment of tax under FIRPTA; and

4) has sufficient assets to pay any such tax. Treas. Reg. § 6a.6039C-5(b).

5. Conditions for entering into security agreement. Before a security agreement will be entered into, the Foreign Operations Director must be satisfied that, with respect to the calendar year for which an information return is required, any income tax owed by:

a. the applicant, as to a disposition during such year of USRPIs with respect to which a return is required; and

b. any owner of an interest in the applicant, with
respect to a disposition during such year of an interest in the applicant;
either has been paid or will be paid by the date that such tax is due. Treas. Reg. § 6a.6039C-5(d).

6. Duration and renewal of security agreements

a. Duration. Generally, a security agreement is effective only for one calendar year. However, the IRS has the discretion to renew a security agreement for a two-year period. A security agreement covering 1981 may be extended by the Foreign Operations Director to cover 1980 if he is satisfied that the conditions for entering into a security agreement with respect to 1980 have been met. See section VII.D.5., supra.

b. Renewals

1) A security agreement may be renewed for a subsequent calendar year, but the amount of security must be adjusted to reflect any appreciation or depreciation in the USRPIs to be covered by the agreement as of the close of such subsequent year. Accordingly, the applicant must submit the appraised fair market values of such interests as of December 31 of such subsequent year. See section VII.D.3.c., supra.

2) If any USRPIs to be covered by the renewal agreement, or any interests in the entity renewing the agreement, were disposed of during the renewal year, the agreement will not be renewed unless the Foreign Operations Director is satisfied that any income tax liability with respect to such dispositions has been or will be paid by the date such tax is due. The IRS is permitted to accept a representation, made under penalty of perjury, by a responsible officer, general partner, or fiduciary of an entity that no USRPIs, and no direct or indirect interests in the entity, have been disposed of during such year in a transaction taxable under FIRPTA. Treas. Reg. § 6a.6039C-5(g).

c. Effect of violation or termination of security agreement
1) The security agreement may specify the actions the IRS may take with respect to the security if the terms of the agreement are violated, or if the agreement is not renewed.

2) If there is a violation of the agreement, any returns required with respect to the calendar year covered by the security agreement will be due on the later of the due date for such returns or the date thirty days from, and exclusive of, the date on which the violation first occurs. If the agreement is not renewed for a subsequent year, the person who entered into the agreement, and any other person who was exempt from filing a return because of the agreement, must file the required information returns for such subsequent year.

3) The security provided under the agreement will not be returned unless it is established that all persons required to file information returns with respect to the USRPIs covered by the agreement have done so, or have entered into new security agreements. The security also will not be released unless it is established that any required tax return is filed, and any tax due is paid, with respect to a USRPI covered by the agreement which was disposed of while the agreement was in effect. Any interest or other proceeds derived from the property serving as collateral under the agreement will be paid over to the property’s beneficial owner when the security is released, or as otherwise provided in the agreement. Treas. Reg. § 6a.6039C-5(g).

7. Application for security agreement
   a. An application for a security agreement, or a renewal of an agreement, is made to the Foreign Operations Director in Washington, D.C. and must be filed by January 30 of the year following the year for which a return otherwise would be required. Applications for calendar years 1980-82 must be filed by March 21, 1983. Treas. Reg. § 6a.6039C-5(h).
   b. Security agreements covering Virgin Islands real
property interests are entered into with the V.I. Bureau of Internal Revenue. Treas. Reg. § 6a.6039C-5(i).

E. Penalties

1. A penalty of $25 per day (up to a maximum of $25,000) is imposed for each day that a return or statement required to be filed or furnished under I.R.C. § 6039C(a) or (b) is delinquent. The $25 per day penalty also applies to foreign investors failing to file returns required under I.R.C. § 6039C(c), except that the maximum penalty cannot exceed the lesser of $25,000 or 5% of the aggregate fair market value of the USRPIs held by such person at any time during the year. I.R.C. § 6652(g); Treas. Reg. § 6a.6652(g)-1(a), (b).

2. The omission from a return of any required information constitutes a failure to file for this purpose. Moreover, each failure to supply a statement to a substantial investor as required under I.R.C. § 6039C(b)(3) constitutes a separate failure to file with respect to each substantial investor. Treas. Reg. § 6a.6652(g)-1(c)(2).

3. The penalty will not be imposed for the failure to file or furnish a return or statement if:
   a. a security agreement is entered into in lieu of making such a return or statement;
   b. such failure is shown to be due to reasonable cause and not due to willful neglect; or
   c. with respect to all USRPIs held by an individual, such individual’s spouse or parent has filed a return under I.R.C. § 6039C(c) with respect to the same property. Treas. Reg. § 6a.6652(g)-1(e).