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Bruce Zagaris

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# INVESTMENT BY NONRESIDENT ALIENS IN UNITED STATES REAL ESTATE

BRUCE ZAGARIS\*

*The author reviews the current increased activity in and attractiveness of investment in United States real estate by non-resident aliens. The article discusses the various favorable and unfavorable aspects of such investment with emphasis on American and foreign tax laws, as well as other restrictions. Questions are raised and pitfalls are anticipated with awareness as the goal rather than a definitive answer to every question. The author concludes by discussing treaties and how their use can work to the substantial benefit of the foreign investor.*

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## I. WHY INVEST IN UNITED STATES REAL ESTATE?

Recent economic events have provided the impetus for an increasing amount of foreign investment in United States real estate. A recent study<sup>1</sup> points out several reasons for this development. The most common example is the large influx of investment funds by oil-exporting nations.<sup>2</sup> Since speculation in land has always been a legitimate investment goal in America, much of that surplus finds its way over here. In general, the liberal philosophy embodied in United States law with regard to conveyance and purchase of land is a further aid to the growth of foreign investment in United States real estate. Except where specifically prohibited by statute,<sup>3</sup> aliens have been permitted to own land in America since the 19th century.

This article will analyze alien investment in United States real estate primarily from the viewpoint of the investor. The prospective investor's main concerns may be summarized as follows: What are the United States land laws which could affect a foreigner's investment? What are the United States tax implications—income, estate, and gift? What other legal complications will arise from the obligations in the investor's own country? This article also will deal

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1. F. MORRISON & K. KRAUSE, STATE AND FEDERAL LEGAL REGULATION OF ALIEN AND CORPORATE LAND OWNERSHIP AND FARM OPERATION, UNITED STATES DEP'T OF AGRIC. ECON. REP. NO. 284 (1975) [hereinafter cited as ALIEN LAND OWNERSHIP].

2. *Id.* at 2.

3. 3 AMERICAN LAW OF PROPERTY § 12.69 (A.J. Casner ed. 1974).

with the interactions of various legal systems within the context of international real estate transactions. As a concluding note, the potential impact of a changing public policy concerning foreign investment will be discussed.

## II. PROPERTY LAWS RELATING TO FOREIGN INVESTMENT

Under our federal system, foreign investors may be subject to both federal and state regulation. In the United States, land law primarily is within the domain of the states. Therefore, the first concern will be state restrictions on alien ownership.

A total of twenty-one states have no restrictions on alien ownership of land.<sup>4</sup> Seven states have a general prohibition against alien ownership.<sup>5</sup> The remaining states either have so-called "major" restrictions, such as limitation on the acreage which a nonresident alien may own,<sup>6</sup> or "minor" restrictions, such as prohibitions against ownership by "enemy aliens," or the alternative requirements that alien owners be "friends."<sup>7</sup> The latter restrictions have very little, if any, practical effect at the present time.

The United States Constitution places limitations on the reach of state regulation when applicable. In addition, since treaties and executive agreements are the "supreme law of the land,"<sup>8</sup> the effect is that they also will superede any conflicting state laws.<sup>9</sup>

The United States has become a party to various agreements with many countries which authorize aliens to become engaged in enumerated businesses within this country and to lease land necessary for the operation of those businesses.<sup>10</sup> The United States, however, does reserve the right under most of these treaties to limit or exclude alien "exploitation" of land and natural resources.<sup>11</sup>

An important clause contained in many of these treaties is the "most-favored-nation" clause. Under such a clause, an alien from a contracting nation has the right to be treated on an equal basis

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4. ALIEN LAND OWNERSHIP, *supra* note 1, at 15.

5. *Id.*

6. *Id.* at 19.

7. *Id.*

8. U.S. CONST. art. VI, cl. 2.

9. *E.g.*, United States v. Pink, 315 U.S. 203 (1942) (executive agreement); Missouri v. Holland, 252 U.S. 416 (1920) (treaty).

10. *E.g.*, Treaty of Friendship, Commerce and Navigation, Oct. 29, 1954, United States-Germany, [1956] 7 U.S.T. 1839, T.I.A.S. No. 3593.

11. *Id.* at 1849-50.

with the most favored aliens operating in the United States. Since, as mentioned previously, the United States has a vast array of treaties with many nations, these clauses in and of themselves may provide significant rights pertaining to, for example, mining, inheritance, and other special arrangements.<sup>12</sup>

As far as the United States Constitution itself is concerned, the equal protection clause of the fourteenth amendment contains the most far-reaching restriction on state power. It provides: "nor shall any state . . . deny to any person within its jurisdiction the equal protection of the law."<sup>13</sup> This clause effectively precludes all forms of state discrimination.

A second constitutional doctrine further limits state regulation. Due process of law<sup>14</sup> requires that state legislation must have a legitimate rational basis so as to justify state action.<sup>15</sup>

Another significant constitutional limitation concerns foreign relations. Necessarily, federal power is plenary in this area.<sup>16</sup> The states may not interfere in foreign relations where the nation acts as a single and indivisible unit. In the past, states have interfered by singling out one foreign nation for favorable or unfavorable treatment.<sup>17</sup> As foreign investment in United States real estate becomes more significant, such action should no longer be permissible due to classification as "incidental" in its effect on foreign relations.<sup>18</sup>

Although the Constitution gives Congress the power to regulate international economic relations through the commerce clause,<sup>19</sup> Congress has not chosen to exercise its authority. This silence, combined with the traditional occupation of this field by state law, amounts to implicit recognition and acceptance of state authority.<sup>20</sup>

At present, there is a dearth of specific federal restrictions on alien ownership of land in the United States. What law there is on the subject only applies in certain limited cases. For example, the Trading with the Enemy Act of 1917<sup>21</sup> restricts ownership and pro-

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12. ALIEN LAND OWNERSHIP, *supra* note 1, at 34.

13. U.S. CONST. amend. XIV § 1.

14. *Id.*

15. *E.g.*, *Sei Fujii v. State*, 38 Cal. 2d 718, 242 P.2d 617 (1952).

16. *Zschernig v. Miller*, 389 U.S. 429 (1968).

17. *Clark v. Allen*, 331 U.S. 503 (1947).

18. ALIEN LAND OWNERSHIP, *supra* note 1, at 27-28.

19. U.S. CONST. art. I, § 8.

20. ALIEN LAND OWNERSHIP, *supra* note 1, at 29-30.

21. *See* 50 U.S.C. app., § 1-39, 41-44 (1970).

vides for the seizure and administration of the property of alien enemies.<sup>22</sup> Also, the Foreign Assets Control Regulations<sup>23</sup> subject assets of foreign nationals of countries listed therein to the control of the Treasury Department. The alien retains technical "ownership" of the property but is forbidden to transact any business with reference to it.

There also are federal laws regulating the use of public land.<sup>24</sup> Generally, these laws deal with the issuance of grazing permits, mining leases, licenses, and homesteads to citizens and certain types of corporations. An alien investor in ranch land would be at a serious disadvantage, for example, if there was no reasonable assurance that a grazing permit would be issued. Under the Taylor Grazing Act,<sup>25</sup> permits are issued to citizens or aliens who are in the process of becoming citizens. Federal law concerning exploitation of minerals is very complex. In general, most minerals are subject to exploitation, development, and production by private investors. However, different rules govern depending upon the kind of mineral, its location, and the type of federal land.<sup>26</sup>

Once an alien investor has considered the applicable land laws which have a bearing upon his investment, he must investigate the tax implications—both federal and state—before determining the feasibility of such an investment. Of course, the legal complications which might arise due to obligations which exist with regard to the investor's relationship with his own country cannot be overlooked.

### III. UNITED STATES TAX IMPLICATIONS FOR REAL ESTATE INVESTMENT

#### A. *Introduction: Federal Tax Consequences with Regard to Property Investments*

Principally, three different federal tax consequences can be occasioned by an alien investing in United States real estate: income tax, estate tax, and gift tax. This discussion is directed at nonresident aliens. A threshold determination to be made in any tax question concerning an alien is whether such individual is considered a

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22. *Id.* § 6.

23. 31 C.F.R. pt. 500 (1976).

24. See PUBLIC LAND LAW REVIEW COMMISSION, HISTORY OF PUBLIC LAND LAW DEVELOPMENT (1968).

25. 43 U.S.C. § 315 (1970).

26. ALIEN LAND OWNERSHIP, *supra* note 1, at 41-42.

resident or nonresident alien for United States tax purposes. The United States tax consequences of the two classifications are dramatically different. A resident alien is taxed on his income from both United States and foreign sources.<sup>27</sup> Similarly, he is subject to the estate<sup>28</sup> and gift<sup>29</sup> taxes on both United States and foreign situs property. The nonresident alien is generally taxed only on his income from United States sources.<sup>30</sup> He is subject to estate<sup>31</sup> and gift<sup>32</sup> taxation on property located in the United States.

For income tax purposes, there is no definition of the term "nonresident alien" in the Internal Revenue Code. The regulations define residence in a general manner, emphasizing the alien's intent as to the length and nature of his stay.<sup>33</sup> There is a rebuttable presumption that an alien, by reason of his alienage, is presumed to be a nonresident alien.<sup>34</sup> A nonimmigrant alien present in the United States for less than one year is presumed to be a nonresident alien, in the absence of exceptional circumstances.<sup>35</sup> The determination of residence is a factual inquiry requiring a consideration and weighing of all factors.<sup>36</sup>

Residence or domicile for the estate and gift taxes is something more than residence for income tax purposes.<sup>37</sup> Domicile requires actual physical presence in a certain locality plus the intention to make it a fixed and permanent home.<sup>38</sup> It is interesting to note that an alien may be deemed a resident alien for income tax purposes,

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27. Treas. Reg. § 1.1-1(b) (1956).

28. I.R.C. § 2001(a); Treas. Reg. § 20.2033-1(a) (1963).

29. I.R.C. §§ 2501(a), 2511(a).

30. I.R.C. § 871. Under certain very limited circumstances, the nonresident alien may be subject to income taxation of foreign source income. I.R.C. § 864 (c)(4).

31. I.R.C. §§ 2101, 2103.

32. I.R.C. §§ 2501, 2511.

33. Treas. Reg. § 1.871-2(b) (1957).

34. Treas. Reg. § 1.871-4 (1957).

35. Rev. Rul. 66-76, 1966-1 C.B. 296.

36. Rudolf Jellinek, 36 T.C. 826 (1961). For a review of some of these factors see William E. Adams, 46 T.C. 352 (1966).

37. Treas. Reg. § 20.0-1(b) states:

A resident decedent is a decedent who, at the time of his death, had his domicile in the United States. . . . A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

38. Estate of Julius Bloch-Sulzberger, 6 T.C.M. (CCH) 1201 (1947).

but a nonresident alien for the estate tax.<sup>39</sup>

The method of income taxation of nonresident aliens and foreign corporations depends on whether or not the taxpayer is engaged in a United States trade or business. The Internal Revenue Code does not define what constitutes the carrying on of a trade or business. The determinative factor is whether regular management decisionmaking and operating control is carried on in the United States.<sup>40</sup>

A nonresident alien or foreign corporation which has United States source rents, interest, dividends, and other periodical income which are not effectively connected<sup>41</sup> with a United States business is taxed at a flat 30 percent rate on such income.<sup>42</sup> The tax is imposed on gross income with no allowance for deductions or exemptions.<sup>43</sup> Gains on the sale of capital assets located in the United States which are not deemed effectively connected income are taxed at the flat 30 percent rate only if the nonresident alien is present in the United States for 183 days or more in the calendar year of sale.<sup>44</sup>

The 30 percent tax on gross rents may be particularly burdensome if the real property does not have a cash flow great enough to cover such tax. Generally, only income from rental real property subject to a net lease or rents on unimproved real estate will be considered as not derived from a trade or business.<sup>45</sup> To avoid this problem, sections 871(d) and 882(d), and certain treaties permit such income to be taxed at regular rates on a net basis after deduction of related expenses. These relief provisions are analyzed further in a subsequent portion of this article.

If a nonresident alien or foreign corporation engages in a United

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39. Estate of Jan Willens Nienhuys, 17 T.C. 1149 (1952), acq. 1952-1 C.B. 3.

40. For a discussion of the case law in the area see Garelik, *What Constitutes Doing Business Within the United States by a Nonresident Alien Individual or a Foreign Corporation*, 18 TAX L. REV. 423 (1963).

41. Such periodical income, described in I.R.C. §§ 871(a)(1) and 881(a), may be taxed at the regular income tax rates provided for in I.R.C. §§ 1 or 11 if it is effectively connected with the conduct of a trade or business within the United States. I.R.C. §§ 871(b) and 882. I.R.C. § 864(c) states that such income will be deemed effectively connected if "derived from assets used in or held for use in the conduct of such trade or business, or . . . the activities of such trade or business were a material factor in the realization of the income, gain, or loss."

42. I.R.C. §§ 871(a)(1), 881(a).

43. I.R.C. §§ 873(a), 882(c).

44. I.R.C. § 871(a)(2). It should be noted that if a foreign corporation has United States source capital gains, such income will not be taxed under § 882 unless it is effectively connected.

45. See Evelyn Neill, 46 B.T.A. 197 (1942).



States trade or business—for example, by ownership of an apartment project—then net income which is effectively connected with such business is taxed at regular tax rates.<sup>46</sup> A nonresident alien's capital gains which are deemed to be effectively connected income—for example, gain resulting from the sale of the apartment project—are taxed at a maximum rate of 25 percent on the first \$50,000 of such income and 35 percent thereafter.<sup>47</sup> In addition, the minimum tax provisions provide that an amount equal to one-half of the net capital gain is treated as a tax preference item.<sup>48</sup> The aggregate of a taxpayer's tax preference items in excess of the greater of \$10,000 or one-half of his income taxes is taxed at a flat rate of 15 percent.<sup>49</sup> The combination of the minimum tax plus the regular tax can therefore boost the maximum effective tax rate on capital gains to approximately 40 percent. A tax of 30 percent is imposed on United States source effectively connected capital gains of a foreign corporation.<sup>50</sup>

Due to the fact that federal income tax laws favor certain types of real estate investments, the foreign investor should be made aware of the beneficial tax provisions. For example, when investment is in multiple residential dwellings (i.e., apartments), accelerated depreciation is available as a deduction.<sup>51</sup> This would allow an investor to realize quickly a positive cash flow due to the fact that large amounts of depreciation supply ample leverage to counterbalance, and perhaps eliminate, income earnings which ordinarily would be taxable.

Other mechanisms are available to defer income tax liability. Two common methods are tax-free "like-kind" exchanges and installment sales. In a "like-kind" exchange, real property owners exchange parcels of investment property. Even though the equity may be increased substantially, a tax on such exchanges is due only in the event that cash is realized in addition to the exchanged property. Tax is deferred until income is realized.<sup>52</sup> By pyramiding these

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46. I.R.C. §§ 871(b), 882.

47. I.R.C. §§ 871(b)(1), 1201(b), 1202.

48. I.R.C. § 57(a)(9)(a).

49. I.R.C. § 56.

50. I.R.C. §§ 882(a)(1), 1201(a). The minimum tax provisions, as applied to a corporation's capital gains, are somewhat different than those for individuals, producing a substantially smaller tax. See §§ 56(a)(c) and 57(a)(9)(B).

51. I.R.C. § 167(b).

52. I.R.C. § 1031(a).

exchanges, an investor has the possibility of an indefinite tax deferral.

A tax deferral can also be realized through use of installment sales. If within the first year following a sale the vendor receives no more than 30 percent of the purchase price, he is able to spread recognition of gains over many years.<sup>53</sup> A potential purchaser also is at an advantage in that he may be able to purchase, for example, \$100,000 worth of real estate with a substantially reduced initial outlay of cash.

It should also be noted by the potential investor that the tax consequences will vary according to whether the investment is in unimproved property or income-producing and acquired for development property.

### B. *Investment in Unimproved Property*

#### 1. DIRECT OWNERSHIP BY A NONRESIDENT ALIEN

Direct ownership of real estate by the foreign investor provides the least complicated way to structure investment in unimproved property which is held for appreciation and subsequent sale. Besides individual ownership, property may be held directly in a tenancy in common or in a joint tenancy.

If several natural persons join in the investment, their respective goals will determine which of the available forms of ownership will be chosen. If property is held by the investors as tenants in common, the interest will pass to the investors' heirs upon death, and not to the other investors. If, on the other hand, ownership is held in the form of a joint tenancy, the property will pass to the surviving investors upon the death of one of them. Other forms of ownership are available in the various jurisdictions.<sup>54</sup>

If the foreign investor realizes a capital gain from the sale of the property, his American income tax consequences may be very favorable. A nonresident alien's capital gain will be tax-free if: (1) the gain is not effectively connected with the conduct of a trade or business carried on within the United States by the individual (i.e.,

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53. I.R.C. § 453; Treas. Reg. § 1.453-1(a), (c) (1976).

54. Forry, *How to Structure Foreign Investments in U.S. Real Estate*, in 2 P-H TAX IDEAS ¶ 24,013.7; Forry, *Planning Investments from Abroad in U.S. Real Estate*, 9 INT'L LAW. 239 (1975).

it is not "effectively connected income");<sup>55</sup> and (2) the individual is not present in the United States for 183 days or more during the taxable year in which the sale occurs.<sup>56</sup>

In the event that any investor also has improved real property in the United States or property acquired for development, the unimproved property should be kept separate. This is necessary since improved or development property will fall into the category of "effectively connected income."<sup>57</sup>

Since the foreign investor receives tax-free treatment of capital gains, he is not allowed to take deductions for real estate taxes, interest, or other carrying charges. Generally, these deductions are allowed only to the extent that they are allocated to "effectively connected income."<sup>58</sup>

## 2. PARTNERSHIPS

When two or more foreign investors are involved, an alternative form of investment is formation of an American or foreign partnership. Under United States tax law, a partnership only exists as a conduit, with all tax consequences falling upon the partners as individuals. In other words, the entire amount of the partnership earnings, whether distributed or not, is taxed to the partners.<sup>59</sup>

Although the tax treatment is essentially the same under the partnership form as it is under direct ownership, some important considerations come into play if a partnership is contemplated. For example, there is always the danger that if the partnership has too many corporate characteristics it will be treated as a corporation for tax purposes.<sup>60</sup>

Additionally, one should be aware that every partner is deemed to act for all the others insofar as tax treatment is concerned. In other words, if one of the partners should act in such a way so as to categorize the property income as "effectively connected income," when a sale is attempted, such treatment applies to all of the partners.<sup>61</sup>

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55. I.R.C. § 871(a)(2).

56. *Id.*

57. Jan Casimir Lewenhaupt, 20 T.C. 151, *aff'd*, 221 F.2d 227 (9th Cir. 1955).

58. I.R.C. §§ 873, 882(c).

59. I.R.C. § 701.

60. Treas. Reg. § 301.7701-2 (1976).

61. I.R.C. § 875.

It also should be noted that, within the scope of the business, one partner may act to bind all other partners and that each partner is liable for the debts of the organization. Finally, for state law purposes, the death, insanity, or withdrawal of any partner generally will bring the partnership to an end.<sup>62</sup>

### 3. LIMITED PARTNERSHIPS

In the situation where a partnership is desired, but one or more of the partners wants to limit his liability, the limited partnership form may be used.<sup>63</sup> In exchange for limited liability, the "limited" partners cannot participate in the management of the property. This function is carried on by the "general" partners.

One possible combination would be to establish a limited partnership in the United States with a foreign corporation acting as a limited partner. Foreign investors could then purchase stock in the corporation which in turn would distribute its share of the partnership income in the form of dividends to the foreign investors.<sup>64</sup>

### 4. FOREIGN CORPORATIONS

An interest in unimproved property located within the United States can be acquired through formation of a foreign corporation. Profits from any subsequent sale of such unimproved property, if not connected with a trade or business, should be exempt from federal income taxation.<sup>65</sup> Distribution of dividends by the corporation may be taxed at reduced rates or exempted from federal income taxation if there is a tax treaty in operation between the United States and the foreign state in question. In addition, investment through a foreign corporation may serve to insulate the investor from United States estate and gift taxes.

As mentioned previously, certain states have restricted access to investment in United States real estate for corporations formed outside of this country. The investor cannot overlook this point in selecting the conduit for his funds.

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62. Note that the tax laws do not follow state laws for determination of termination. See I.R.C. §§ 706(b), 708(b).

63. Forry, *How to Structure Foreign Investments in U.S. Real Estate*, *supra* note 54, at ¶ 24,411.

64. *Id.*

65. See, I.R.C. §§ 881, 882.

It has already been shown that there is a distinct difference in tax consequences when land is treated as "effectively connected" with a trade or business. Accordingly, different treatment is accorded land which is unimproved as opposed to improved. The same investor can make use of a foreign corporation to segregate improved from unimproved property, and investments which are "effectively connected" with a trade or business from investments which are not so connected.

#### 5. AMERICAN CORPORATIONS

To the foreign investor who has already established himself in the United States, formation of a United States corporation may be a suitable, and readily available, means of investment. Again the tax consequences, as in other areas, are of primary importance in making the decision.

As a general proposition, the foreign investor who already has a considerable amount of American-based income may be able to work under a lower tax rate when using the corporate form. Besides the tax consequences, other benefits, such as limited individual liability, arising from the use of a United States corporation should be considered.<sup>66</sup>

#### 6. TRUSTS

One of the most flexible means of holding and managing real property is through use of an irrevocable living trust. The grantor who creates the trust would be the foreign investor. The trust estate (comprised of the United States real estate) is established in a deed of settlement or a trust agreement which would provide for management by a trustee. This trustee is subject to the usual fiduciary obligations.

The trust estate is usually divided into two parts: principal or corpus, and income. Income from operation of the corpus (real estate) is taxed only once even though distributed to beneficiaries (the foreign investors). This is due to the fact that the trust can deduct that portion of the income which is distributed to beneficiaries in arriving at the trust's taxable income.<sup>67</sup> The balance of the trust's

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66. O. BOYD, *ATLAS' TAX ASPECTS OF REAL ESTATE TRANSACTIONS* 7 (5th ed. 1971).

67. I.R.C. §§ 641, 651, 661.

income, the amount distributed, is taxed under rates applicable to the single individual.<sup>68</sup> There is a danger, however, if a trust is used for the benefit of a group and has the characteristics of a corporation. In that event, the trust can be treated as a corporation for tax purposes.<sup>69</sup>

Since the classification of earnings for tax purposes depends upon the same considerations previously discussed,<sup>70</sup> it may prove beneficial to segregate any property with "effectively connected income" from other property. Again, this may be accomplished through formation of yet another trust or a corporation. In addition, in order to receive the advantages of investing as a nonresident alien, the trust should have a foreign situs.<sup>71</sup>

The most common purpose for using trusts in common law jurisdictions has been to distribute assets outside the scope of estate taxation and other regulations. Since the trustee utilized in our situation will ordinarily be a professional, the trust estate should be managed efficiently and in accordance with instructions written into the trust agreement. Through a careful wording of the agreement, the foreign investor-grantor still may be able to modify the disposition, management, and administration of the assets held under the trust.<sup>72</sup>

Although United States tax laws with regard to trusts are generally favorable, it should be noted that they are quite complex. The tax treatment may vary because of the peculiar wording of the trust instrument.<sup>73</sup>

The trust's acquisition of the status of nonresidency, where United States citizens are investors, has major tax impacts. For example, an equalization tax may become due on the transfer of appreciated securities, and a gift tax may accrue on the transfer of other property to the trust. Tax on income to the American beneficiary may be deferred until distribution.<sup>73.1</sup> There are other possi-

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68. I.R.C. §§ 652, 662.

69. Treas. Reg. § 301.7701-2 (1965).

70. See, e.g., section III, B, 1, *supra*.

71. Duffy & Ferguson, *The Use of Foreign Trusts*, in *FOREIGN TRUSTS IN INTERNATIONAL PLANNING* 35, 39 (1974).

72. Kanter, *Some Reasons for Use of Irrevocable Common Law Trusts in Common Law and Civil Law Countries*, in *FOREIGN TRUSTS IN INTERNATIONAL PLANNING* 7, 9-11 (1974).

73. See, e.g., *Special Clauses for Deed Settlement*, in *FOREIGN TRUSTS IN INTERNATIONAL PLANNING* 21 (1974).

73.1. Recent changes in the 1976 Tax Reform Act should be noted. See Pub. L. 94-455 §§ 1013-15, 90 Stat. 1520 (1976). See also, Dale & Ferguson, *Foreign Trusts*, in M. FERGUSON

bilities where American investment is combined with foreign investment.<sup>74</sup>

## 7. JOINT VENTURES

The corporation and the general partnership are the two forms of joint ventures usually used. The joint venture can be very useful since it consists of combining within one entity a nonresident alien or a foreign corporation with other foreign investors or with a United States investor.<sup>75</sup> The amount, or extent, of participation varies according to the investment and income goals of the various participants.

An example of this proposition is in the situation where a non-resident owns unimproved property situated within the United States which is wanted for development. A joint venture can be formed between the American developer and the foreign investor with the entity purchasing, at arms-length value, the property in question, or with the joint venture's issuance of stock in exchange for the property.<sup>76</sup>

If the investor is more desirous of an established minimum annual return on his investment after a certain period of time, the joint venture may be formed by exchanging the property for interest-bearing obligations. In fact, the notes can be secured by the property itself. In this situation, there is a 30 percent withholding tax. There are methods to minimize this through some of the methods yet to be described.<sup>77</sup>

In the event that one or more of the ventures is a foreign or domestic corporation which in turn is owned by an American citizen or resident, caution should be exercised so as to avoid the joint venture's being classified as a "personal holding company." If the joint venture is classified as such, penalty taxes may be incurred by the joint venture.<sup>78</sup>

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& V. ZONANA THE TAX REFORM ACT OF 1976 689-729 (P.L.I. No. 104, 1976).

74. Duffy & Ferguson, *supra* note 71, at 41-47. See also Ferguson, *U.S. Income Tax Considerations of Deferred Payment Sales to Foreign Situs Trusts*, in *FOREIGN TRUSTS IN INTERNATIONAL PLANNING* 57 (1974).

75. See generally Forry, *How to Structure Foreign Investments in U.S. Real Estate*, *supra* note 54, at ¶ 24,410-11.

76. *Id.* at ¶ 24,411.

77. *Id.*

78. I.R.C. §§ 541-65. Generally, a personal holding company is a corporation meeting certain stock ownership requirements and having substantial passive income.

C. *Investments in Income-Producing Property and Property Acquired for Development*

1. DIRECT OWNERSHIP BY A NONRESIDENT ALIEN

The rate at which a nonresident alien investor in United States real estate is taxed is largely determined by whether or not income to the investor from his United States investment is income which is "effectively connected" with a United States trade or business. In determining whether rents, dividends, interest, and other fixed or determinable periodic income<sup>79</sup> and capital gains are treated as "effectively connected," the investor must consider whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of such a trade or business, or whether the activities of such trade or business were a material factor in the realization of the income, gain, or loss.<sup>80</sup> All other United States source income is treated as "effectively connected."<sup>81</sup> Where income is treated as "effectively connected," the net amount of income is subject to taxation at regular graduated rates.<sup>82</sup> Income which is treated as not "effectively connected" is subject to a flat 30 percent tax on gross income.<sup>83</sup> No deductions for depreciation, interest, or other expenses are allowed.<sup>84</sup>

Income from a United States trade or business is considered "effectively connected." Therefore, income-producing property which has "effectively connected income" includes rental income from an office building, an apartment building, or a shopping center. Sales proceeds from property which is developed and held for sale by investors are also treated as "effectively connected" and taxed on a net basis at the ordinary rates paid by United States residents.<sup>85</sup>

The activities of a United States agent can be attributed to a foreign investor and thereby trigger categorization as a trade or business. In *Jan C. Lewenhaupt*,<sup>86</sup> a foreign investor in American

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79. See I.R.C. § 871(a)(1).

80. I.R.C. § 864(c)(2).

81. I.R.C. § 864(c)(3).

82. I.R.C. § 871(b).

83. I.R.C. § 871(a)(1).

84. I.R.C. § 873(a).

85. I.R.C. § 871(b). See Forry, *How to Structure Foreign Investments in U.S. Real Property*, *supra* note 54, at ¶ 24,403-04.

86. 20 T.C. 151, *aff'd*, 221 F.2d 227 (9th Cir. 1955).



real property hired a resident agent to manage, acquire, and dispose of property. The agent was given broad powers of attorney which included the power to buy, sell, lease, or mortgage the real estate, as well as to conduct other financial affairs for the foreign investor in the United States. Included in the management activities of the agent were: leasing properties, making leases, collecting rent, maintaining financial records, supervising repairs, paying taxes and mortgage interest, and insuring the properties. The court found that these activities were "considerable, continuous, and regular" and therefore constituted engaging in a trade or business within the United States.<sup>87</sup>

In the event that little or no business activity is carried on in the United States by the foreign investors or their resident agents, the income may not be deemed "effectively connected income." This treatment has resulted, for instance, where a long term lease for the property in question provided that all maintenance and other activities and costs were to be the responsibility of the tenant rather than of the foreign owners.<sup>88</sup> It often is extremely undesirable that property produce rental or other fixed income since the income will incur a withholding tax of up to 30 percent of the gross amount without any deductions. The effect is that the tax often will equal or exceed the net income from the property.<sup>89</sup> To avoid this problem, an election can be made to have the income from non-trade or business real estate treated as "effectively connected" and thus taxed on a net basis after deductions.

*Example:* Olaf Kyrkannen, a non-resident alien, owns two pieces of property in America. Property 1 is under net lease to a single tenant and therefore not deemed to be a trade or business. Property 2 is managed continuously by a property management company which collects rents and provides services for the tenants with regard to maintenance and upkeep. Therefore, Kyrkannen is engaged in a United States trade or business with respect to this property. If he elects to treat Property 1 income as "effectively connected" with a trade or business, Kyrkannen can obtain substantial tax savings, as shown in this illustration:

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87. *Id.* at 163.

88. Evelyn Neill, 46 B.T.A. 197 (1942).

89. I.R.C. §§ 871(a), (d), 882(d); Rev. Rul. 552, 1973-2 C.B. 226.

	<u>Property 1</u>	<u>Property 2</u>	<u>Combined</u>
Gross Rents	\$150,000	\$150,000	\$300,000
Expenses (Interest)	20,000	50,000	70,000
Depreciation	80,000	150,000	230,000
Taxable Income (Loss)	\$ 50,000	\$(50,000)	\$ -0-
Tax without election — 30% of \$150,000			
Gross Rents	\$ 45,000	-0-	\$ 45,000
Tax with election on combined taxable income assuming no other U.S. Income			
			\$ -0-

There are two types of elections which may be made — under the Internal Revenue Code<sup>90</sup> or pursuant to a treaty.<sup>91</sup> The Code election, once made, can only be revoked with Internal Revenue Service permission,<sup>92</sup> which is rarely granted. Therefore, when Property 1 is sold, the capital gain on the sale will be subject to taxation as “effectively connected income”<sup>93</sup> even though the nonresident alien is not present in the United States for the requisite 183 days.<sup>94</sup> The treaty election avoids this problem. If the nonresident alien is a citizen of a country which has a treaty with the United States providing for an election to have income from real property taxed on a net basis,<sup>95</sup> then such election may be made annually and is thus not binding in subsequent tax years. If the treaty election is not made in the year of sale and the nonresident alien owner is not present in the United States for 183 days, then the gain on sale will not be taxed.

90. I.R.C. § 871(d). A foreign corporation can elect under I.R.C. § 882(d).

91. See, e.g., Protocol Modifying Convention on Double Taxation of Income, Oct. 23, 1963, United States-Netherlands, art. X, [1964] 15 U.S.T. 1900, T.I.A.S. No. 5665; Convention on Taxes on Income, July 28, 1967, United States-France, art. 5, para. 3, [1968] 19 U.S.T. 5280, T.I.A.S. No. 6518.

92. I.R.C. § 871(d)(1).

93. I.R.C. §§ 864(c), 871(b). It should be noted that the election applies to all real property and cannot be made on a property-by-property basis.

94. I.R.C. § 871(a)(2).

95. See, e.g., treaties, *supra* note 91. If the nonresident alien is not a citizen of a country which has such a treaty, he may still form a corporation in a treaty country in order to purchase the property. This will accomplish the same result.

## 2. PARTNERSHIPS

Since, for tax purposes, partners receive the same tax treatment as the partnership, the discussion concerning "effectively connected income" and elections<sup>96</sup> is applicable to partnerships.

## 3. LIMITED PARTNERSHIPS

A limited partnership in which a United States corporation participates as general partner and manager along with foreign investors and United States investors as limited partners is often used to invest in income-producing property.<sup>97</sup> A management contract regulates the general partners' duties and compensation. The participation of limited partners can consist of a mixture of stock and equity depending upon the international tax treatment.<sup>98</sup>

## 4. FOREIGN CORPORATIONS

The use of a foreign corporation for holding income-producing property can have various tax consequences depending upon how it is organized and operated. It often is recommended where a primary goal is the avoidance of estate tax.<sup>99</sup>

The tax consequences of using a foreign corporation for income-producing property, however, are not as favorable as in the case of unimproved property. Assuming that the income of the foreign corporation from the property consists of "effectively connected income," it incurs United States taxation at a rate which may be higher than the rates which would be payable by the individuals if they received the income directly. In addition, profits will be taxed twice before they reach the foreign shareholders—once at the corporate level<sup>100</sup> and again due to withholding taxes when dividends are paid.<sup>101</sup> Accumulation of funds is not a viable alternative since a

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96. Treas. Reg. 1.871-10(d)(3) (1974) requires the partners, rather than the partnership, to make the Code election to treat real property income as effectively connected with a United States business.

97. Forry, *How to Structure Foreign Investments in U.S. Real Estate*, *supra* note 54, at ¶ 24, 411.

98. See, e.g., the use of Netherlands Antilles treaty, section V, A, 2, *infra*, *How to Combine a Partnership and Corporation to Invest in U.S. Real Estate*, 3 U.S. TAXATION OF INTERNATIONAL OPERATIONS, ¶ 5.2 (No. 5, March 12, 1975).

99. See text accompanying notes 124 and 125 *infra*.

100. I.R.C. § 882.

101. I.R.C. §§ 871(a)(1)(A), 1441.

"substantial accumulated earnings tax" may be imposed if American profits are accumulated in excess of the reasonable business needs of the corporation.<sup>102</sup> The investor may mitigate the impact of these provisions through careful tax planning.

In order to avoid the problem of double taxation, the investor might, on arms length terms, loan money to the corporation. So long as the corporation maintains an adequate debt-to-equity ratio, the interest payments made to the investor should be deductible against the corporation's United States income.<sup>103</sup> These interest payments will still be subject to withholding taxes.<sup>104</sup>

The 30 percent withholding tax to which the gross amount of dividends and interest is subject may make the arrangement unpalatable to foreigners. The withholding tax applies according to the following rule: If at least one-half of the foreign corporation's gross income for the latest three taxable years is "effectively connected income," the same proportion of any dividends or interest paid by the corporation will be subject to a United States withholding tax of 30 percent of the gross amount paid.<sup>105</sup> Many tax treaties, however, reduce dividend withholding rates to at least 15 percent and interest withholding rates to 5-10 percent, or exempt them entirely. The hardship of the withholding tax may be further mitigated if the investor takes advantage of the special treatment extended to Netherlands Antilles Corporations.<sup>106</sup>

Another way in which the burden of the withholding tax may be lightened is through the sale of stock for a profit. The "effectively connected income" flowing from this sale is taxed at the regular graduated rates. Where these rates are below 30 percent a tax saving will result. The impact of "effectively connected" treatment, where the appropriate rate is higher than 30 percent, can be reduced by interposing an intermediate holding subsidiary. This technique can be combined advantageously with others yet to be described.<sup>107</sup>

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102. I.R.C. § 531.

103. I.R.C. §§ 163(a), 385.

104. I.R.C. § 1441(b).

105. I.R.C. §§ 861(a)(1)(C), 861(a)(1)(D), 861(a)(2)(B), 871(a)(1).

106. The treaty provides that dividends and interest paid by a Netherlands Antilles corporation to a recipient other than a United State person are exempt from United States income taxation. See section V, A, 2, *supra*.

107. M. EDUARDES-KER, INTERNATIONAL TAX STRATEGY 14-17 (1973).

## 5. UNITED STATES CORPORATIONS

Foreign investors can form a United States corporation in order to own income-producing property. The United States identity may be advantageous in working with governmental agencies and American businesses. However, different tax impacts, many of which are negative, are derived from the use of an American corporation<sup>108</sup> as opposed to a foreign corporation.

Rental income will be taxed on a net basis at the rates ordinarily applicable to any domestic corporation. These rates are generally higher than those a nonresident alien would pay if he received the income directly. Any dividend received from the United States corporation will incur a withholding tax of 30 percent of the gross amount paid. As previously mentioned, an additional penalty tax may be assessed if profits are excessively accumulated.<sup>109</sup> However, it should be remembered that many United States income tax treaties reduce, and some eliminate the withholding tax on dividends and interest payments.

If income-producing property is sold, capital gains will generally result to the American corporation.<sup>110</sup> This gain will be taxable at the ordinary corporate gain rate of 30 percent. Any distributions of the sales proceeds to foreign shareholders will be subject to an additional withholding tax of 30 percent unless a lesser rate is set by treaty.<sup>111</sup>

In some cases, foreign shareholders may want to sell their shares in the United States corporation. Unless the shares are held primarily for sale to customers in the ordinary course of trade or business, or the corporation is treated as a "collapsible corporation," capital gains treatment should result.<sup>112</sup> A collapsible real estate corporation is one which is formed or utilized primarily for the construction of a building, the purchase of property, or the holding of stock in a corporation which does the foregoing, with a view to the sale or exchange of the stock by their shareholders before the corporation realizes any substantial part of the net income from

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108. Forry, *Planning Investments from Abroad in U.S. Real Estate*, *supra* note 54, at 245.

109. I.R.C. § 531.

110. I.R.C. §§ 1245 and 1250 require recapture of the excess of accelerated depreciation over straight-line depreciation as ordinary income.

111. I.R.C. §§ 871(a)(1), 1441.

112. I.R.C. § 1221.

the property. The classification of a corporation as a collapsible corporation was introduced into the tax code to preclude the conversion of ordinary income into long term capital gains. If a corporation is deemed to be a collapsible corporation, gain realized by shareholders is treated as ordinary income.<sup>113</sup>

Another alternative may be to sell the property and liquidate the corporate investment pursuant to a twelve month plan of liquidation.<sup>114</sup> This will not result in income tax at the corporate level except for the recapture of accelerated depreciation taken by the United States corporation on the property. This alternative is not available with a collapsible corporation, nor if at least 80 percent of the United States common stock is owned by another corporation.<sup>115</sup>

## 6. TRUSTS

Since a trust is treated, for income tax purposes, similarly to a single individual, its earnings on investments in income-producing property will be subject to the same considerations as those for direct ownership as discussed previously. It also should be noted that if a trust becomes a partner in a partnership which is engaged in a trade or business in the United States, the trust will have "effectively connected income."<sup>116</sup>

Additional considerations exist. A trust may want to segregate its earnings; and if management of unimproved and improved property is involved, it may become important to segregate the situs of the trust for the place of interpretation from the situs of the place of administration. For instance, to qualify as a Netherlands Antilles resident and take advantage of the United States-Netherlands Antilles tax convention (to be discussed later in this article), a trust established under New Hebrides law can be moved for trusteeship and administration to the Netherlands Antilles.<sup>117</sup> Since trusts are often used by individuals with diverse holdings and investment goals, specific arrangements may depend upon nonproperty goals.

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113. I.R.C. § 341; Treas. Reg. § 1.341-1, -2(a) (1976).

114. I.R.C. § 337.

115. Forry, *How to Structure Foreign Investments in U.S. Real Estate*, *supra* note 54, at ¶ 24.407.

116. I.R.C. § 875.

117. Kanter, *supra*, note 72, at 14.

## 7. JOINT VENTURES

The chief advantage of joint ventures with either United States or foreign investors is that they can be structured in different ways according to investment goals of various investors. Joint ventures with American or foreign investors, for instance, can be used when income-producing property is involved to allocate a larger portion of the excess deductions, perhaps in exchange for services performed by the United States partner or foreign investment goals of the foreign investor.<sup>118</sup> This arrangement is favorable to the foreign investor who does not have other "effectively connected income" against which to apply its share of excess deductions.

## 8. REAL ESTATE INVESTMENT TRUSTS

The real estate investment trust (REIT) is an unincorporated United States trust which is not subject to American income tax on its income distributed to its shareholders.<sup>119</sup> To qualify as a REIT, a trust must meet certain organization, gross income, and asset requirements. Foreign investors will incur a withholding tax on the dividends paid by the REIT out of its ordinary income. However, capital gains distributions are not usually "effectively connected income," and should therefore be generally received taxfree.<sup>120</sup>

### D. *United States Estate and Gift Taxation of Nonresident Aliens*

If real property situated in the United States and owned by a nonresident alien passes to a member of his family or is transferred or donated by him, the property will be subject to federal estate and gift taxation. Because of its impact on lifetime and estate planning, the tax consequences of ownership of the property should be considered prior to purchase. The complexity of estate and gift taxation in this area requires expertise both in the making of gifts and in the drafting of wills. The following discussion provides an outline of the initial considerations for the nonresident alien who contemplates the purchase of real property situated in the United States.

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118. Forry, *How to Structure Foreign Investments in U.S. Real Estate*, *supra* note 54, at ¶ 24,410-11.

119. I.R.C. § 857(b).

120. Forry, *Planning Investments from Abroad in U.S. Real Estate*, *supra* note 54, at 250.

## 1. ESTATE TAX

United States real property which is included in the estate of a nonresident alien at the time of his death is subject to federal estate taxation.<sup>121</sup> Other interests in real property subject to estate taxation include equity investments in real property situated in the United States,<sup>122</sup> and mortgage investments if the mortgagor is a person within the United States (i.e., a citizen or resident of the United States, a domestic partnership, a domestic corporation, or an estate or trust with a situs within the United States).<sup>123</sup>

The stock of a domestic corporation which owns United States real property, owned by a foreign investor, will be included in the investor's gross estate.<sup>124</sup> If the property is owned by a foreign corporation, however, the stock of that corporation will not constitute part of the investor's gross estate for federal tax purposes.<sup>125</sup>

In an attempt to attract the foreign investor, Congress has applied a lower tax rate to the estate of this investor than to the estate of the United States citizen or resident. The new tax rate schedule<sup>126</sup> for the estates of nonresident aliens is as follows:

<u>Taxable Estate</u>	<u>Tax Equals</u>
Not over \$100,000	6% of taxable estate
Over \$100,000 but not over \$500,000	\$6,000 plus 12% of excess over \$100,000
Over \$500,000 but not over \$1,000,000	\$54,000 plus 18% of excess over \$500,000
Over \$1,000,000 but not over \$2,000,000	\$144,000 plus 24% of excess over \$1,000,000
Over \$2,000,000	\$384,000 plus 30% of excess over \$2,000,000

Formerly, no estate tax return had to be filed for a nonresident alien whose gross estate did not exceed \$30,000.<sup>127</sup> Now, "equivalent

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121. I.R.C. §§ 2101, 2103.

122. Feinschreiber & Feinschreiber, *Foreign Investment in U.S. Real Estate: The Federal Tax Considerations*, 3 REAL ESTATE L.J. 144, 150 (1974).

123. I.R.C. § 861(a)(1).

124. I.R.C. § 2104(a).

125. Treas. Reg. 20.2105-1(f) (1963).

126. I.R.C. § 2101.

127. I.R.C. § 6108(a)(2); Treas. Reg. § 20.6091-1(b) (1958).



exemption" tables must be consulted due to the vast 1976 tax reform.<sup>128</sup>

There are aspects of the federal estate taxation scheme, however, which work to the detriment of the foreigner. A nonresident alien formerly received an exemption of \$30,000, as opposed to \$60,000 for the United States citizen or resident. The rationale for the lower exemption was that a nonresident alien's gross estate which is subject to federal estate taxation represents only a portion of his total estate.<sup>129</sup> Now, the exemptions have been replaced by a unified estate and gift tax credit.<sup>130</sup> A nonresident alien is not entitled to the marital deduction which permits a United States citizen to transfer, free of taxation, up to one-half of his adjusted gross estate or \$250,000 if higher, to his spouse upon his death. Further, the credit for his state death taxes is limited,<sup>131</sup> charitable contributions are defined differently,<sup>132</sup> and the availability of other deductions is restricted.<sup>133</sup>

An additional burden is suffered by the survivors due to the imposition of a state estate tax on the real property. Although the rates are substantially lower than the federal estate tax rates, and a credit is allowed to partially offset the federal tax, state estate taxes should not be overlooked. It also should be noted that a special restrictive scheme applies to former United States citizens who have expatriated to avoid taxes.<sup>134</sup>

## 2. GIFT TAXES

A nonresident alien who makes a gift of real property situated in the United States is subject to federal gift taxation. According to the old law, gifts of intangible property with United States situs (i.e., corporate stock or mortgages) were subject to federal gift taxation if the alien was engaged in an American trade or business. Now, these gifts are exempt from gift tax, regardless of whether or not the

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128. Tax Reform Act of 1976 §§ 2001(a), (c), adding I.R.C. § 2010 and amending § 6018(a).

129. H.R. REP. NO. 1450, 89th Cong., 2d Sess. 46 (1966).

130. Tax Reform Act of 1976 §§ 2001(a), (c), adding I.R.C. § 2010 and amending § 6018 (a).

131. I.R.C. § 2102(b).

132. I.R.C. § 2106(a)(2).

133. I.R.C. § 2106(a)(1).

134. I.R.C. § 2107.

alien is doing business in the United States.<sup>135</sup>

The gift tax is imposed upon the donor of the gift.<sup>136</sup> The donee pays neither a gift tax nor an income tax,<sup>137</sup> but if the gift tax is not paid when due, the donee will be held liable for the tax up to the value of the gift.<sup>138</sup> Gift tax liability is computed quarterly. The same rates apply to the nonresident alien as to the United States citizen or resident. Nonresident aliens may avoid gift taxes by using foreign corporations as vehicles for ownership of United States investments and gifting the stock in the corporation.<sup>139</sup>

#### IV. INTERNATIONAL TAX ISSUES

Consequences encountered outside of the United States, especially in the alien's country of residence, domicile, or citizenship must be examined. The following factors are paramount: nontax barriers such as currency restrictions; methods of avoiding double taxation in the alien's own country; and the estate and inheritance taxes due on American real estate.

##### A. *Currency Restrictions*

Currency restrictions and exchange controls are used increasingly to regulate national balances of payments. Some forms may hinder investment in the United States. For example, Sweden requires governmental approval of transfers of money to other countries. In other nations, laws may require the repatriation of profits, capital or both.<sup>140</sup> In the United Kingdom a nondomiciliary resident is taxed only on income derived from United Kingdom sources or on income remitted to the United Kingdom, but he must also offer earnings received in a nonsterling currency for sale to a bank in the United Kingdom under their Exchange Control Act of 1947. A partial alleviation of this burden is given by treating payments remitted within three months as not having been remitted for tax purposes.<sup>141</sup>

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135. I.R.C. §§ 2501(a)(2), 2511(a).

136. I.R.C. § 2502(d); Treas. Reg. § 25.2502-2 (1958).

137. I.R.C. § 102.

138. I.R.C. § 6324(b).

139. Treas. Reg. 25.2511-3(b)(3)(ii).

140. M. EDWARDES-KER, *supra* note 107, ch. 17 at 13 (1973).

141. B. SPITZ, *INTERNATIONAL TAX PLANNING* 41-42 (1972) (other requirements must also be met).

## B. *Double Taxation and Its Relief*

### 1. THE OCCURRENCE OF DOUBLE TAXATION

Two types of double taxation can be identified in connection with investment in international real estate—juridical and economic.<sup>142</sup> Juridical double taxation arises in a case in which the same person is taxed with respect to the same income by two different sovereign jurisdictions. For example, a citizen of West Germany, in absence of tax relief provisions, may be subject to income tax from his ownership interests in real estate in the United States via the source principle and in West Germany by way of the principle of domicile.<sup>143</sup>

Economic double taxation can occur in several ways, and commonly occurs where income flows through multiple transactions. For example, a parent company in West Germany may receive dividends from a subsidiary investing in real estate in the United States, the subsidiary may be taxed on its profits in the United States, and the dividends representing distributed profits may be taxable in the United States and West Germany. Profits and dividends are treated as different objects,<sup>144</sup> though the income has simply flowed from one entity to another.

Another example of economic double taxation is where taxing authorities treat the same international transaction differently. For instance, a real estate development company in the United States may receive marketing services from one of its sister companies in Switzerland. In most cases, the marketing fees are deductible by the American company. However, if the fees are disproportionately high when compared to the services provided, they may be considered nondeductible taxable dividend distributions in the country of the payor.<sup>145</sup>

The extent of double taxation depends on various factors: whether taxation is based on residence, domicile or nationality; the source of the income; the nature of the transaction or operation; and the relationship of the parties.

Residence, domicile, and nationality may be controlling factors in the decision to invest in American real estate. Sweden taxes all

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142. See *id.* at 24-36.

143. *Id.* at 24-25.

144. *Id.* at 34.

145. See I.R.C. § 482.

residents on income from world-wide sources.<sup>146</sup> This is similar to the United States tax on all citizens for their world-wide income. In the United Kingdom, taxpayer categories are neither ample nor nondiscriminatory: a domiciliary resident is taxed and surtaxed on income from sources within and without the country; a nondomiciliary resident generally is taxed only on income from domestic sources, or on income from foreign sources which is remitted to the United Kingdom.<sup>147</sup>

The source of income may determine the international tax consequences of some transactions, especially since some countries impose taxes only on a territorial basis. The territorial principle, common in Latin America, applies in Venezuela, Panama, and Costa Rica. In these countries residents pay an income tax only on their earnings from sources within the country. They are not taxed in their country of residence on income which they may derive from abroad. Many countries, however, now tax income on a world-wide basis.<sup>148</sup>

The nature of the transaction may determine whether earnings are subject to tax and whether expenses are deductible from the taxable base. In many countries, the critical difference is between income and capital gains.<sup>149</sup> Other distinctions are among the forms of entities, such as individuals, partnerships, corporations, and resident or nonresident trusts.<sup>150</sup>

The relationship between the parties may determine whether an item is included in the taxable bases as well as determining the rate of tax. In most countries inheritance tax on distributions within a family is kept low.<sup>151</sup> Also, in many countries special provisions apply to parent and subsidiary, or otherwise related enterprises. This may facilitate intercorporate dividends.<sup>152</sup> Sometimes losses of associated companies may be deductible. The amount of share participation may determine the tax consequences in the case of holding companies. In a number of tax treaties, dividends and interests

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146. M. NORR, C. SANDELS, N. HORNHAMMAR, *THE TAX SYSTEM IN SWEDEN* 71 (1972).

147. See A. SUMPTION, *TAXATION OF OVERSEAS INCOME AND GAINS* (2d ed. 1975).

148. M. LANGER, *HOW TO USE FOREIGN TAX HAVENS* 6 (1975).

149. B. SPITZ, *supra* note 141, at 14.

150. *Id.* at 11-12. See generally P. ANDERSON, *TAX PLANNING OF REAL ESTATE* 1-10 (6th ed. 1970); M. EDWARDES-KER, *supra* note 107, ch. 17 at 2-4,

151. B. SPITZ, *supra* note 141, at 14-16.

152. *Id.* at 15.

incur a reduced withholding tax where a company of one contracting state controls more than a certain percentage of a company within the other contracting state.<sup>153</sup> In other cases, related enterprises may be subject to anti-avoidance provisions or special provisions may enable tax authorities to disregard or reallocate transactions which are not deemed to have been made at arms-length.

Taxation of corporations and their shareholders varies. The most usual system is the "classical system"; corporations pay corporate tax on their profits and the shareholders pay individual tax on the dividends they receive. Many countries give relief from this double taxation, either at the corporate tax level or to the shareholders. In the "dual" or "split" rate system (i.e., the system used in Germany and in Austria), the rate of corporate tax on distributed profits is lower than the rate on undistributed profits. Under the "imputation system" (i.e., the "avoir fiscal" used in France), shareholders are granted a credit for part of the corporate tax paid.<sup>154</sup>

## 2. RELIEF FROM DOUBLE TAXATION

Two types of double taxation relief are afforded the nonresident alien investor. The first method is through a bilateral tax treaty. The second method is through domestic legislation in the absence of a treaty.<sup>155</sup>

### a. Treaty Relief

The substantial majority of countries whose domiciliaries invest in United States real estate have concluded treaties with the United States which provide for relief from double taxation. Where these treaties exist, they prevail over unilateral provisions concerning relief from double taxation.<sup>156</sup>

Although there are general principles of treaty relief, in dealing with any particular case it is essential to examine the specific treaty involved. The tax consequences, as set forth in a particular bilateral treaty, will depend upon how the income is characterized in the treaty. Some of the countries with which the United States has

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153. *Id.* See generally 69b *Cahiers de Droit Fiscal International* (1964).

154. B. SPITZ, *supra* note 141, at 35-36.

155. See, e.g., A. SUMPTION, *supra* note 147, at 148.

156. I.R.C. § 894(a); see B. BITTKER & L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS 410-11 (1968).

concluded treaties are OECD<sup>157</sup> members who have adopted some uniform principles for treating various taxable categories.<sup>158</sup>

In any given situation, even before establishing additional planning mechanisms, an investor's income from real property may be classified into one of the following categories: (1) income from immovable property; (2) income in the form of dividends from a United States corporation engaged wholly or partly in investments in United States real estate; (3) income from earnings and dividends from a foreign entity engaged wholly or partly in American real estate investments; (4) gains from the sale of capital assets such as stock; or (5) income from debts, mortgages, and loans which finance real estate investments in the United States.

The first category includes capital gains and income derived from immovable property. This category is typically defined as "income from real property and royalties in respect of the operation of mines, quarries, or other natural resources. . . ."<sup>159</sup> This does not include interest derived from mortgages and bonds secured by real property. All treaties entered into by the United States give the right to tax immovable property to the nation in which the property is located. Hence, the United States is given the right to tax real property located within its borders. The principle that the country in which the situs exists should tax property is long-standing and is also followed by the OECD Draft Convention.<sup>160</sup> The practical consequence is that if a United States double taxation treaty exists, a nonresident alien owning property directly as an individual is subject to the United States taxation. Another provision included in the immovable property article of some of the United States income tax conventions gives a resident or entity the right to elect to be taxed on a net basis as if he were engaged in a trade or business.<sup>161</sup>

Although the OECD Draft Convention explicitly includes "in-

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157. Organization for Economic Cooperation and Development. The members of OECD are: Austria, Belgium, Canada, Denmark, England, France, West Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, and the United States.

158. See OECD, DRAFT DOUBLE TAXATION CONVENTION (1963).

159. See, e.g., Convention on Double Taxation, July 28, 1967, United States-France, art. V, para. 1, [1968] 19 U.S.T. 5280, T.I.A.S. No. 6518.

160. OECD, *supra* note 158, art. 6 at 45, commentary on art. 6 at 78 (1963).

161. See, e.g., Convention on Double Taxation, March 30, 1955, United States-Italy, art. IX, para. 2, [1956] 7 U.S.T. 2999, T.I.A.S. No. 3679. The importance of this provision can be understood by referring to section III, C, *supra*.

come derived from the direct use, letting or use in any other form of immovable property,"<sup>162</sup> income derived from rental property is, in many treaties, not included in the definition.<sup>163</sup> The result is that income from this property may be subject to tax at graduated ordinary income rates. In fact, upon signing the first OECD Draft Convention, the United States has reserved its position concerning the imputation of income to the exemption from tax for immovable property.<sup>164</sup> This reservation corresponds to case law holding that where rentals from real property result from a nonresident's being "engaged in a trade or business," the nonresident is not entitled to reduced dividends withholding. Hence, it seems that the issue of taxation of income from rental property turns on whether a nonresident alien is engaged in a trade or business.

Where a nonresident alien is not engaged in a trade or business in the United States, his tax rate on dividend income paid by United States corporations has been reduced by treaty from 30 percent, provided by section 871(a)(1) of the Internal Revenue Code, to 15 percent. Minor variations of this provision exist from treaty to treaty.<sup>165</sup>

Income in the third category, a nonresident alien's dividend income from a foreign entity engaged in American real estate investment, is not subject to United States taxation. The exception is where the foreign entity does business through a permanent establishment in the United States. If the entity is within that exception, provisions concerning immovable property and income from a permanent establishment settle the tax. When the entity is a corporation remitting dividends, that tax will be subject to a reduced rate of withholding.

The fourth category, capital gains realized by nonresident aliens and foreign entities, is exempt from taxation in the United States, under most United States Treaties, except in limited cases.<sup>166</sup> In recent years, the Senate Foreign Relations Committee has nullified the exemption by adding reservations to such treaty

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162. OECD, *supra* note 158 at art. 6, para. 3 (1963).

163. See, e.g., Protocol Modifying the Convention on Double Taxation, Sept. 17, 1965, United States-Germany, art. IX, [1965] 16 U.S.T. 1875, T.I.A.S. No. 5920.

164. B. BITTKER & L. EBB *supra* note 156, at 482.

165. See, e.g., Convention on Double Taxation, July 22, 1954, United States-Germany, art. VI, [1954] 5 U.S.T. 2768, T.I.A.S. No. 3133.

166. *Id.* art. IX, para. 1.

provisions. In any event, a nonresident alien cannot claim the exemption, where it does exist, when a capital asset is sold and it has a connection with a trade or business.<sup>167</sup> The taxation of capital gains, therefore, depends upon the specific treaty provision and the particular circumstances involved.

The fifth category, income derived by a nonresident alien from debts, mortgages, and loans which finance real estate, is ordinarily subject to United States withholding tax at the 30 percent rate, but often is reduced or exempted by treaties. Sometimes, however, interest which is connected with real estate will not receive either reduction or an exemption.<sup>168</sup>

After finding the appropriate category within which the transaction may fit, reference must be made to the methods used to give tax relief in the nation which has agreed to limit taxation.

#### b. Double Taxation Relief at the Domestic Level

In the event that the investor's country of domicile or nationality has not entered into a double taxation convention with the United States which applies to the specific situation, the investor can make use of unilateral relief which is usually contained in the domestic legislation of his own country. It is difficult to generalize concerning this legislation. An essential consideration is whether the exemption or credit method is followed. It may also be important to ascertain whether the unilateral relief provisions cover state and local government taxes, since land owned by nonresident aliens often incurs such a tax. In order to illustrate how the unilateral mechanism operates, three different systems, those used in the Netherlands, West Germany, and Belgium, will be described. These cases are hypothetical since these countries have signed tax treaties with the United States.

In the Netherlands, tax is imposed upon world-wide income. Relief is provided under the following conditions: (1) when no treaties or other measures are applicable; and (2) when the income is from specified sources; and (3) when the foreign country levies an income tax. If all of the above criteria are met, relief is available

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167. B. BITTKER & L. EBB, *supra* note 156, at 458-59.

168. I.R.C. §§ 861(a)(1)(D), 871(a)(1)(A), 881(a)(1); see B. BITTKER & L. EBB, *supra* note 156, at 449.



through a proportional reduction in Dutch taxation in accordance with the following formula:

$$\frac{\text{amount of tax reduction}}{\text{Dutch tax on total}} = \frac{\text{foreign income}}{\text{total income}}$$

Therefore, total income of Dutch taxpayers is reduced by the income attributable to the foreign source income. The relief for individual taxpayers does not provide a full exemption for foreign source income since the progressive rate of individual income tax applied to domestic and foreign tax amounts to a higher tax rate on the domestic income than would have been imposed if there had been no foreign income. In the Netherlands, this problem does not exist for companies since they are not subject to graduated taxes.<sup>169</sup>

In order to receive unilateral tax relief, it is necessary that foreign source income be taxed by the state in which the income has been earned. "Taxed," however, means that the company is subject to tax, not that tax actually has been paid on the foreign income in question.<sup>170</sup>

In West Germany, resident taxpayers can avail themselves of at least three potential domestic law mechanisms: tax credits, deductions, and a flat rate.

Credit may be taken by resident taxpayers for income taxes corresponding to German individual or corporate income tax with the limitations set forth below. The foreign tax credit can be used only for income from countries with which Germany does not have a tax treaty, although a limited credit may be taken under certain treaty circumstances. The maximum amount of credit per country is as follows:

$$\text{credit} = \frac{(\text{corporate income tax}) \times (\text{foreign source income})}{\text{total income}}$$

Full credit may not be realized due to certain restrictions. For instance, the credit may be used only for national and not for state or

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169. [1976] THE TAXATION OF PRIVATE INVESTMENT INCOME (INT'L BUREAU FISCAL DOCUMENTATION) NETHERLANDS.

170. *Id.* For a more detailed discussion, see Bouwsma, *Unilateral Relief from Double Taxation in the Netherlands*, 23 BULL. FOR INT'L FISCAL DOCUMENTATION 407 (1969); *A Comparative Analysis of the Classical Dual Rate, and Imputation Taxation Systems and An Examination of the Corporate Tax Systems in Belgium, France, Germany, Italy, The Netherlands, and The United Kingdom*, 12 EUROPEAN TAX pt. I at 112, 125-29 (1972).

local taxes. Foreign income taxes are creditable only insofar as they do not exceed the German income tax on the same income. Any excess foreign tax credit cannot be used.

An indirect foreign tax credit may be taken by a resident parent company with a foreign subsidiary. The subsidiary must have derived income out of which dividends are distributed from active conduct of business or from another subsidiary engaged in such operations. Dividends distributed by foreign second tier subsidiaries can be taxed as if they had been distributed directly to the parent company.<sup>171</sup>

The second method of domestic relief from double taxation is through deductions. A resident may deduct foreign income tax on foreign source income which is also taxable in Germany if he does not qualify for a credit. Therefore, those faced with foreign, state, and local income taxes are granted some relief from double taxation.<sup>172</sup>

The third method involves a flat rate taxation of certain business income. In the event that a resident has business income from a permanent establishment, participates in a foreign unincorporated association, or invests in a foreign commercial entity, he may request a flat rate of corporate or individual tax of 25 percent instead of the foreign tax credit. Where the resident does not qualify for the foreign tax credit or where the foreign income tax rate is low, this provision may be beneficial. Flat rate taxation is generally allowed only in exceptional circumstances.<sup>173</sup>

In Belgium, resident corporations doing business at home and abroad are subject to Belgium taxation on their world-wide income. Unilateral relief is granted to resident corporations in the form of a reduced tax rate on foreign income. The net foreign income is included in the tax base, but the Belgian tax on this foreign income is reduced by 75 percent. This reduction applies to: (1) profits earned abroad which are subject to a foreign tax; (2) income from foreign real estate earned by a foreign entity related to a Belgian company, if it was not subject to foreign tax; and (3) income from foreign real estate of a Belgian company whether or not it was sub-

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171. THE TAXATION OF COMPANIES IN EUROPE (INT'L BUREAU FISCAL DOCUMENTATION) GERMANY ¶ 351 (Supp. 9, Sept. 1975).

172. *Id.* ¶ 352.

173. *Id.* ¶ 353.

ject to a foreign tax.<sup>174</sup>

The Netherlands unilateral provisions illustrate what is called in the next section "exemption with progression" while German provisions illustrate the "ordinary credit" method.

### 3. THE IMPORTANCE OF THE EXEMPTION AND CREDIT METHODS

It is now appropriate to move from the application of treaty and domestic methods of providing relief to an assessment of the two principal legal mechanisms used to avoid double taxation, the exemption method and the credit method. Both of these mechanisms have been incorporated into unilateral and treaty provisions. The extent to which a nonresident alien investor in United States real estate can avoid double taxation depends upon which of these methods is employed by his home country.

The exemption method can take two different forms, the "full exemption" form and the "exemption with progression" form. When the "full exemption" method is used, the total gross income attributable to investments in real property located within the United States is excluded by the home state from its computation of taxable income. When the "exemption with progression" system is used, the taxpayer receives the same exemption as it would under the "full exemption" scheme. However, here, the home state reserves the right to consider the United States source income for the purpose of determining the tax rate to be imposed on the remaining income. Thus, although the investor receives an exemption for part of his gross income, he probably incurs a tax rate increase on his taxable income.

When conventions entered into between OECD countries have employed either of the exemption methods, the home state usually has reserved the rights accruing to it under the "exemption with progression" scheme.

When either of the exemption methods is utilized, if the United States tax is lower than the domestic tax, the taxpayer has an advantage over the credit method. If the United States tax is higher, the result is the same as under the credit method.<sup>175</sup>

A nation using the credit method imposes a tax on the basis of

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174. *Id.* BELGIUM ¶¶ 254-56 (Supp. 12, Mar. 1976).

175. OECD DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL, Commentary on art. 23 A, 145-47 (1963).

the taxpayer's total income, including the income from another state, and then allows a deduction from its own tax for any tax paid in that other country. There are different forms of the credit method. Under the "ordinary credit" form, the deduction allowed by the state of residence is limited to an amount that does not surpass that part of its own tax appropriate to the income from the other state (e.g., Germany, Sweden and Italy). Under the "full credit" form (e.g., Japan), the state of residence allows a deduction of the total amount of tax paid in the United States, the source country. Another form of the credit system is where the state of residence limits the deduction to an amount not exceeding the tax which it would have derived on that income if the taxpayer had no other income.<sup>176</sup>

OECD countries in which the credit method applies have usually followed the ordinary credit method in their bilateral treaties. As mentioned previously, the credit method is often not as advantageous to the foreign investor as the exemption method. Under the credit system, if the United States tax is lower than the domestic tax, the result is the same as if the United States income had been the domestic income. In the other case, where the United States tax is higher than the domestic tax, there is an additional burden to the extent of the difference. This result is the same under the exemption method.

In the case in which a foreign investor from a country which employs the exemption method invests in unimproved American real estate for which he receives capital gains treatment, he will avoid a tax at both ends.

### C. *Estate and Gift Taxes*

Since estate (or inheritance taxes on the Continent) and gift taxes may constitute an important factor in an investor's decision to invest in United States real property, their effect should be considered. The effect of estate and gift taxation may be determined by either unilateral or treaty provisions.

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176. *Id.* Commentary on art. 23 B, at 147-50.

## 1. ESTATE TAX

### a. Treaties

The United States has become a party to twelve estate tax treaties and two gift tax treaties.<sup>177</sup> Several uniform principles are present throughout these treaties. One such principle provides that:

The contracting State imposing tax in the case of a deceased person, who, at the time of his death, was domiciled . . . or was a citizen [of such a country], shall allow against its tax . . . a credit for the amount of tax imposed by the other contracting State with respect to property situated in such other contracting State and included for tax purposes by both States.<sup>178</sup>

Of particular importance is the uniform application of this type of provision to "real"<sup>179</sup> or "immovable" property.<sup>180</sup> Thus, if an investor who is both domiciled in, and a citizen of, Norway invests in real property situated in the United States, he may expect that upon his death Norway will levy an estate tax and then, pursuant to the convention, provide a credit to offset any double taxation.

One further point bears mentioning. Unlike the OECD countries, the United States does not restrict its individual states from imposing estate or inheritance taxes on property transferred at death.<sup>181</sup> However, incidents of international double taxation created by such state taxes are eliminated by the allowance of a corresponding credit on the federal estate tax return.

### b. Domestic Legislation

In countries where a bilateral treaty is not in force, domestic tax law may exclude from death taxes immovable property that is situated in a foreign country. Some examples serve to illustrate the fact that there is a split in the law.

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177. [1976] TAX TREATIES (CCH) 19.

178. CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON ESTATES AND INHERITANCES, JUNE 13, 1949, UNITED STATES-NORWAY, [1951] 2 U.S.T. 2353, T.I.A.S. No. 2358, art. V, para. 1.

179. *Id.* art. III, para. 2(a).

180. *Cf.* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Gifts, May 14, 1953, United States-Australia, art. III, para. 1(a) [1953] 2 U.S.T. 2264, T.I.A.S. No. 2879.

181. See OECD, DRAFT DOUBLE TAXATION CONVENTION ON ESTATES AND INHERITANCES, Commentary (1966).

France, Belgium, Australia,<sup>182</sup> and Mexico<sup>183</sup> are among the countries which exclude foreign situs property from the estates of their domiciliaries. In France, the imposition of inheritance tax is determined by two factors: the domicile of the deceased and the situs of the property. The residence or the citizenship of the beneficiary is never relevant. If the deceased is domiciled in France, the inheritance tax will be assessed on his entire estate, with the exception of real property and movable property physically located outside of France at the time of his death. If the decedent, at the time of his death, was outside of France, only those assets situated in France would be subject to French inheritance tax. Hence, United States real estate should always remain beyond the scope of the French estate tax.<sup>184</sup> Similarly, in Belgium, if the decedent is not domiciled in Belgium at the time of his death, his gross estate includes only his real property in Belgium. If however, the decedent was domiciled or had his wealth in Belgium at the time of his death, his gross estate for inheritance purposes includes all property, whether situated in Belgium or abroad.<sup>185</sup>

Some countries, such as Japan<sup>186</sup> and Ireland,<sup>187</sup> extend the scope of estate taxation to property owned by their domiciliaries. In Colombia, extension of estate tax jurisdiction to all property, wherever located, applies to Colombian nationals, regardless of domicile. The same is true of an alien residing in Colombia at the time of his death.<sup>188</sup> In 1962, the United States expanded its jurisdiction for estate tax purposes to include foreign situs property. Foreign real estate is now includible in the gross estate of an American citizen or resident who dies on or after July 1.<sup>189</sup>

## 2. GIFT TAX

The creation of an inter vivos trust constitutes one of the most effective mechanisms to circumvent United States federal estate tax

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182. W. BRUDNO, *WORLD TAX SERIES: TAXATION IN AUSTRALIA* 69 (1958).

183. H. GRUMPPEL AND H. MARGIN, *WORLD TAX SERIES: TAXATION IN MEXICO* 73 (1957).

184. Killius, *Recognition of Trusts in European Countries*, in *SECOND WORLD TAX HAVENS CONFERENCE PAPERS*; Seminar Services S.A., 1 Passage Perdonnet, 1000 Lausanne 4, Switzerland (monograph).

185. Inheritance Tax Code, art. 48 (Belg.), as modified by Royal Decree of April 18, 1976.

186. JAPANESE MINISTER OF FINANCE, *AN OUTLINE OF JAPANESE TAXES* 108 (1975).

187. [1976] *DOING BUSINESS IN EUROPE-IRELAND* (CCH) ¶ 25,101.

188. *WORLD TAX SERIES: TAXATION IN COLOMBIA* 152 (G. Eder & J. Chommie eds. 1964).

189. Revenue Act of 1962, Pub. L. No. 87-834, § 18(b) 76 Stat. 1052.

on real estate. Such a transfer, however, may have possible gift tax consequences, including multiple taxation. One tax may be imposed by the United States and another by a domicile or native country. More importantly, there are presently only two conventions in force, with Australia and Japan, providing for the practical elimination of such multiple taxation.<sup>190</sup> The pattern is identical in both conventions—the state in which the taxpayer-investor is domiciled or resides gives a credit which offsets an effective double tax caused by the United States' imposition of a similar tax on real property situated therein.

The formation of inter vivos trusts, and especially foreign trusts, constitutes the most common method of transferring property during one's lifetime. Therefore, it is useful to look at the taxation of both the creation of and the income from these trusts. This will be accomplished from the standpoint of three countries: France, Germany, and Italy. This analysis summarizes an article written by Dr. Juergen Killius.<sup>191</sup>

The creation of an inter vivos trust receives favorable tax treatment in France and Italy, while in Germany it is likely to be treated unfavorably. In France, no gift tax is incurred upon the formation of an inter vivos trust either by a resident or a national of France, or by a nonresident, provided that the deed by which the trust is created is unclear as to the additional requirement that the property contributed to the trust be located outside of France. At the time of the death of the settlor, however, the gifts made before his death must be included in his estate and, therefore, inheritance taxes may be imposed.<sup>192</sup> In Italy, no tax would be imposed upon the creation of an inter vivos trust abroad.<sup>193</sup> In Germany the transfer of property to an inter vivos trust created by a resident may be fully subject to German gift tax, since it is likely to be classified as the equivalent of a "family foundation fund."<sup>194</sup>

The taxation of income from an inter vivos trust also receives

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190. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Gifts, *supra* note 180; Convention for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates, Inheritances and Gifts, April 16, 1954, United States-Japan, [1955] 1 U.S.T. 113, T.I.A.S. No. 3175.

191. Killius, *supra* note 184.

192. *Id.*

193. *Id.*

194. *Id.*

favorable treatment in France and Italy, but usually incurs a tax in Germany. In France, the beneficiaries of a trust, if they are domiciled in France, are taxed on the income from the trust which is assimilated into income from foreign securities, and therefore is not eligible for the "avoir fiscal" relief against corporate tax which ordinarily accompanies the receipt of dividends in France. Beneficiaries are taxed regardless of whether the income is distributed since they are deemed to have control over such income. If the recipient, however, is of foreign citizenship and pays in his country of citizenship a tax which is similar to the French progressive income tax, he will be exempt from taxation in France. If a recipient is only a resident in France, but not a domiciliary, he will not be taxed even if he is a French citizen because the trust is deemed to be foreign source income.<sup>195</sup> In Italy, residents' income obtained from foreign trusts is not subject to tax unless it is actually distributed.<sup>196</sup> In Germany, the inter vivos trust is most likely to be taxed as a family foundation. The family foundation is subject to unlimited German income tax liability if the founder is a resident, even though its principal place of management or its statutory seat is outside of Germany. If the founder is not a resident, the German tax will be applied to the German resident beneficiary's proportionate share in the income of the foundation.<sup>197</sup>

In some countries, a net worth tax is imposed upon the assets of individuals and corporations. In Germany, the net worth tax is limited in principle to only the legal owner of the property. Where the beneficiary of a trust can be considered the real owner of the property from an economic point of view, he can be taxed. Also, the trust property may be attributed to a resident beneficiary for purposes of the net worth tax. In this event, any property located within the United States would be exempt from German net worth tax under Article XIV A(1) of the United States-German Tax Treaty.<sup>198</sup>

## V. ADDITIONAL PLANNING MECHANISMS

There are, of course, additional planning mechanisms. For example, the investor may make use of a third "low-tax" country as

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195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*



the situs of his investment, or he may create a foreign trust, or a combination thereof. In this connection, the investor must be aware of anti-avoidance laws which place a limit on the mechanisms available.

### A. *Use of Tax Havens*

#### 1. IN GENERAL

In the event that a nonresident alien or entity is unable to avoid double taxation through normal channels, or in the event that he wishes to minimize domestic taxes or to coordinate United States real estate investments with other investments, he may make use of a tax haven.<sup>199</sup> The availability of any such haven depends upon two considerations. The investor must consider the tax laws of his residence and the federal tax laws applicable to American real estate investments.

A foreign trust or corporation located within a tax haven is advantageous where the domestic tax is not levied until income is repatriated. In this situation, earnings can be accumulated and taxes can be deferred until such time as the investor (i.e., the trust or corporation) distributes funds to beneficiaries or shareholders. This system is particularly inviting for a resident of the United Kingdom. In the case of individual taxpayers, Britain follows a "remittance basis" system. Income is taxed only if it is brought back into the country while the source of such income remains in existence.

Although companies located within tax havens can serve as intermediaries for channeling funds to the United States for real estate investment purposes, the tax impacts still are numerous. This requires that, in transactions involving more than a simple sale of unimproved property, a country with advantageous treaty provisions be used. In effect, this excludes all "havens" with the exception of the Netherlands Antilles.

#### 2. NETHERLANDS ANTILLES

Nonresident aliens have invested in American real estate through entities based in the Netherlands Antilles for many years

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199. See generally M. LANGER, *supra* note 148.

now. Investors with these connections in the Netherlands Antilles are the beneficiaries of an extremely beneficial tax treaty between that country and the United States. The Netherlands Antilles has entered into additional tax treaties with the Netherlands, Surinam, Denmark, Norway, and the United Kingdom and has entered into negotiations with Japan.<sup>200</sup>

The Netherlands Antilles enjoys autonomy with respect to its external affairs despite the fact that it is a part of the Kingdom of the Netherlands. Although the Netherlands Antilles is likely to attain its independence within the next decade, the favorable tax laws should remain in existence. In fact, its government recently announced that it does not intend to introduce a dividend tax.<sup>201</sup>

It should be kept in mind that the Netherlands Antilles is a civil law country. Therefore, it is not recommended as a situs for trusts since it lacks common law jurisprudence. This situation could be remedied by the Netherlands Antilles' enacting a trust law based upon common law principles, perhaps one similar to the Louisiana law.<sup>202</sup>

Nevertheless, the United States-Netherlands Antilles tax treaty and the Antilles tax laws provide major legal incentives for its use as a conduit for investment in American real estate. Most foreign investments emanating from the Netherlands Antilles are made by formation of an Antilles corporations known as a Naamloze Vennootschap (N.V.). Shares of an N.V. may be either registered, or, in order to satisfy an investor's desire for anonymity, made out to bearer. The shares may be issued to individual investors or to foreign entities.<sup>203</sup> Some highlights of the tax consequences are set forth herein.

In structuring initial ownership of property by an N.V., the potential seller of the land or a shareholder in the N.V. may have already realized capital gains. The extent of the gain or appreciation, however, should be limited to fair market value if the seller and the N.V. are related parties. Capital gains realized on "arms-length" sales should constitute a tax free capital gain to the seller.<sup>204</sup>

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200. *Id.* at 187.

201. *Id.* at 187-88.

202. *Id.* at 188.

203. *Id.* at 189-91.

204. Treas. Reg. § 1.482-2(e) (1976).

To finance the investment and potential development of the property, loans may be procured by the N.V., and any interest paid will be deductible. Any loans from related parties should be at arms-length interest rates.

No United States withholding tax is imposed on interest paid by the N.V. or on dividends paid to the N.V. shareholders, unless the recipient is a United States citizen, resident, or corporation.<sup>205</sup> If the N.V. does not develop the property and merely holds it for subsequent resale, the accrued capital gains tax should not apply because of the seller's status as a nonresident alien. If, on the other hand, the property is developed and rental income is the result, the N.V. can elect to be taxed on this income on a net basis for a period of years and still receive a tax free capital gain upon eventual sale of the real estate.<sup>206</sup>

Within the Antilles, further favorable tax results are obtained. By virtue of the Treaty, income from American real estate is not subject to the Antilles income taxes.<sup>207</sup> In addition, the Antilles does not impose any gift, estate, or inheritance taxes upon transfer or inheritance of N.V. stock by individuals or their successors.<sup>208</sup>

When disposing of the investment, several options are available to the nonresident investor. As mentioned previously, the simplest method is to buy and hold unimproved real estate until long term capital gains can be realized on sales by the N.V. to third parties. Previously mentioned planning mechanisms, such as a like-kind exchanges or installment sales, can also be used to defer taxes. The nonresident shareholder can sell his shares in the N.V. and avoid capital gain taxes, if he is not present in the United States for 183 days or more in the year of sale.<sup>209</sup>

As another alternative, the N.V. can sell the property and then liquidate itself pursuant to a 12-month plan of liquidation if the

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205. Convention with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, United States-Netherlands, art. XII, 62 Stat. 1757 (1948), T.I.A.S. No. 1855.

206. Convention on Double Taxation: Taxes on Income, Oct. 23, 1963, United States-Netherlands, art. X, [1964] 15 U.S.T. 1900, T.I.A.S. No. 5665, *amending* Convention, *supra* note 205.

207. Convention on Double Taxation: Taxes on Income, Dec. 30, 1965, United States-Netherlands, art. V, [1966] 17 U.S.T. 896, T.I.A.S. No. 6051, *amending* Convention, *supra* note 205.

208. ALGEMENE BANK NEDERLAND N.V., TAXATION IN THE NETHERLANDS ANTILLES: A TENTATIVE SURVEY (3d ed. 1973).

209. I.R.C. § 871(a)(2).

plan is adopted before closing on the sale of the property. No United States income tax will be imposed upon the N.V. itself, except to recapture any accelerated depreciation already taken by the N.V. on its property.<sup>210</sup> There is no income tax at the shareholder level either, provided he is not present in the United States for 183 days or more.<sup>211</sup> The investor should be aware that other alternatives must be used in cases where the N.V. is deemed a collapsible corporation or where 80 percent or more of the N.V. is owned by another corporation.<sup>212</sup>

As previously mentioned, the N.V.'s gains from the sale of real property will be free from Antilles taxes. This also applies to the shareholders as to income derived from the distribution at the N.V.'s liquidation. Of course, the N.V. must meet the statutory requirements for liquidating corporations in the Netherlands Antilles, and it must also meet the provisions of its own tax laws.<sup>213</sup>

### B. *Use of Foreign Trusts*

The utility of foreign trusts, not widely known outside of common law jurisdictions, for investment in United States real estate warrants additional discussion. This article only mentions some of the important concepts and issues in order that the investor may be able to foresee possible problems.

Besides providing a method of realizing estate planning goals, the use of a trust allows for effective management and beneficial tax results. Examples of two types of individuals who may profit from the use of foreign trusts to diversify assets through investment in United States real estate are:

*Example A:* Rio Caracas, a South American engaging in business activities dealing with foreign currencies, may use a Cayman trust to defer repatriation of funds and effect retention in foreign exchange. Simultaneously, he can combine this with an estate plan under professional management which would transfer assets gradually within his family outside of the scope of local estate tax laws and without the risk of use of bearer shares by a nonfiduciary.

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210. I.R.C. §§ 337, 1250.

211. I.R.C. § 871(a)(2).

212. I.R.C. § 337(c).

213. Netherlands Antilles, Profits Tax Ordinance, art. 14A (undated).

*Example B:* Franz Geneve, a Swiss citizen with business investments in various parts of the world including shipping, manufacturing, art, and securities investments, may wish to use a New Hebrides trust utilizing banking facilities there to effect a base holding trust. In conjunction with this, he could use, for example, a Panamanian company for his shipping, or a Hong Kong company for manufacturing. This allows for gradual development of these assets outside the scope of Swiss death duty laws of descent.

In both of these examples, United States real estate could be added as a complementary investment.

For the family with world-wide investments, the advantage lies in its flexibility which permits fragmentation as well as movement of the situs for administration and interpretation purposes. For instance, in example B Franz may use the Netherlands Antilles administration for American real estate investment while retaining the New Hebrides base for other investments. Common law jurisdictions which can be used as a trust situs are Australia, the Bahamas, Bermuda, Canada, Cayman Islands, Hong Kong, New Hebrides, the United Kingdom, and the United States. There also are some non-common law countries which have various trust laws, including Nahu, St. Lucia, Panama, and Mexico.<sup>214</sup> Establishment of trusts in non-common law countries, however, can be risky since these countries lack a body of decisions to define and protect the intended benefits of trust creation. Statutory regulations alone can be inadequate as safeguards in this area.<sup>215</sup>

Conflict of laws rules may determine whether, and to what extent, a foreign trust can be utilized successfully. Since trusts are virtually unknown in civil law countries, problems with the recognition of a trust may arise in three areas: (1) the validity and enforceability of the creation and administration of an inter vivos trust; (2) the validity and treatment of a testamentary trust; and (3) the standing and status of a trustee with respect to the trust property.<sup>216</sup> The taxation of trusts and their beneficiaries is a further consideration, and, on this latter point, the discussion of gifts in the international tax section should be noted.

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214. Kanter, *supra* note 72, at 13.

215. *Id.*

216. Killius, *supra* note 184.

### C. Anti-Avoidance Measures

Recently, countries have taken measures to counter both tax evasion (the fraudulent, unlawful escape of tax) and tax avoidance (the unethical, and sometimes unlawful, escape from taxation). Naturally, these measures may limit the availability of additional planning mechanisms. The measures come in two main forms—unilateral provisions and bilateral conventions. Due to the wide range of techniques, only the more salient ones will be highlighted.

The French employ a technique which has a potentially significant impact on investment in United States real estate. Any direct investment abroad requires approval of the French Investment Control Department if the investment exceeds one million francs in one year or relates to holding, investment, portfolio, financing, or financial companies.<sup>217</sup> As a further control, it is common in France to require a permit in order to obtain the benefit of a special tax status, often related to foreign dealings.<sup>218</sup> Government approval also is required for foreign investments in Sweden, the United Kingdom, and Finland.

One of the first European countries to embark upon anti-avoidance legislation was the United Kingdom. The legislation enacted was intended to prevent British residents from avoiding income tax by transferring assets in such a way as to rechannel income to persons residing or domiciled outside the United Kingdom.<sup>219</sup>

The most common anti-avoidance provision used in European countries provides that there must be a "commercial purpose" behind any transaction. For instance, in the Netherlands, the *fraus legis* applies in cases where a taxpayer uses an unusual method where a more normal method would result in a higher tax. In France, an "abuse of rights" provision applies to tax avoidance transactions without a commercial purpose. In Germany and Luxembourg, an "abuse of forms of legal structures in civil law" denies effect to certain types of tax avoidance transactions.<sup>220</sup>

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217. Goldsmith, *Anti-Avoidance Measures in France*, in TAX HAVENS AND MEASURES AGAINST TAX EVASION AND AVOIDANCE IN THE EEC 19 (J.F.A. Jones ed. 1974).

218. *Id.*

219. Jones, *Anti-Avoidance Measures in the United Kingdom*, in TAX HAVENS AND MEASURES AGAINST TAX EVASION AND AVOIDANCE IN THE EEC 54 (J.F.A. Jones ed. 1974).

220. Jones, *Foreward* to TAX HAVENS AND MEASURES AGAINST TAX EVASION AND AVOIDANCE IN THE EEC at xii (J.F.A. Jones ed. 1974).

In 1973, Belgium enacted anti-avoidance measures to prevent fraud and international tax evasion. Essentially, where funds are transferred by a Belgian taxpayer to a company established in a country whose tax system is significantly more advantageous than that of Belgium, the taxpayer has the burden of proving that the funds were transferred in genuine transactions and that they do not exceed "normal limits."<sup>221</sup>

In some countries, anti-avoidance legislation is directed at unremitted earnings of foreign intermediary companies. In Germany, the unremitted income of resident taxpayers can be taxed if: (1) the taxpayer owns, directly or indirectly, a majority of the shares or the voting power of the intermediary; (2) the intermediary is subject to foreign tax at a rate of less than 30 percent; (3) income is passive; and (4) income from the intermediary exceeds 10 percent of the taxpayer's total income.<sup>222</sup>

In some cases, legislation has focused on retaining the right to tax a citizen on his world-wide income *after* he has emigrated. The United States tax code, for example, provides that a citizen who becomes a nonresident to avoid federal income, estate, or gift taxes will be taxed in a special fashion if the tax liability computed is greater than the normal liability of a nonresident alien.<sup>223</sup> German legislation, enacted in 1972, subjects certain German citizens who move to a "low tax" country to taxation for ten years after emigration if the citizen continues to have substantial economic ties with Germany.<sup>224</sup>

The second main method of combatting tax evasion and avoidance is through the use of tax treaties. The treaties often contain general provisions enabling authorities to exchange information and also include measures for dealing with specific problems.<sup>225</sup> The information exchange includes data indicating payments of dividends and interest to all payees whose addresses are listed as being in the other country.<sup>226</sup>

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221. M. LANGER, *supra* note 148, at 112.

222. Heining, *Anti-Avoidance Measures in Germany*, in *TAX HAVENS AND MEASURES AGAINST TAX EVASION AND AVOIDANCE IN THE EEC* 36-39 (J.F.A. Jones ed. 1974).

223. I.R.C. § 877.

224. Heining, *supra* note 222, at 34-35.

225. van Horn, *Anti-Avoidance Measures in Tax Treaties*, in *TAX HAVENS AND MEASURES AGAINST TAX EVASION AND AVOIDANCE IN THE EEC* 65 (J.F.A. Jones ed. 1974).

226. See, e.g., OECD DRAFT CONVENTION ON INCOME AND CAPITAL, art. 26 (Jan.-Feb. 1976).

Some tax treaties contain specific provisions against avoidance of income tax on earnings derived from foreign situs real property. In some instances, countries customarily using the exemption method will use the credit method under a treaty. For example, under the German-Spanish Tax Treaty, Germany applies the credit method to income from immovable property situated in Spain.<sup>227</sup>

A simple method of combatting avoidance would be to refuse to conclude tax treaties with "havens."<sup>228</sup> As mentioned previously, the United States-Netherlands Antilles treaty is a notable exception.

An important trend in anti-avoidance law has been increased cooperation within the EEC. In April 1976, the EEC Commission issued a proposal providing for automatic exchange of information by tax authorities when certain triggering conditions exist. The directive assumes importance, however, for the trend toward multi-lateral cooperation which it represents, rather than its substantive importance.<sup>229</sup>

#### D. *Use of Tax Treaties*

Tax treaties can be used as a double-edged sword to avoid taxation. Their proper use offers an investor a vast array of channels through which to steer investment in American real estate.<sup>230</sup> The following example is illustrative of some of the many possibilities.

If a resident of France wishes to invest in United States income-producing property through a corporation engaged in an American trade or business, and if he wishes to further minimize the 15 percent withholding tax under the United States French Tax Treaty, he could use a Netherlands holding company to form a Netherlands Antilles corporation to make the investment. This arrangement makes possible the following: zero withholding of dividends according to the United States-Netherlands Antilles Tax Treaty; 3 percent, possibly zero, Netherlands Antilles do-

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227. van Horn, *supra* note 225, at 70.

228. *Id.* at 72.

229. EEC Commission, *Proposal for a Council Directive Concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation*, in OFFICIAL JOURNAL OF THE EUROPEAN COMMUNITIES No. C9412 (Apr. 27, 1976).

230. Bischel, *How to Use Tax Treaties in International Tax Planning*, in [1974] U.S. TAXATION OF INTERNATIONAL OPERATIONS (P.H.) ¶ 7511; M. EDWARDES-KER, *supra* note 107, at 10-12.



mestic tax on dividends if a favorable ruling is obtained from the tax authorities; elimination of taxation on such dividends under the Netherlands-Netherlands Antilles Tax Treaty; no taxation on the holding company pursuant to Netherlands law; 5 percent maximum tax on intercorporate dividends under the French-Netherlands Tax Treaty.

Of course, this planning mechanism would need sufficient earnings to justify its establishment.

It also should be noted that tax treaties may be used in combination with foreign trusts. A foreign trust situated in a country which is a party to a tax treaty with the United States should be entitled to the treaty benefits. When income is distributed to beneficiaries, the status of the beneficiaries should govern their qualification for treaty benefits.

## VI. INVESTIGATIONS BY THE UNITED STATES CONGRESS

As a result of federal legislation enacted in 1974, the Secretary of Commerce has been directed to carry out a study of direct foreign investment in the United States. Included in the interim report, published in the Spring of 1976, is a report prepared by the Economic Research Service drawing upon materials from academic personnel across the country concerning various aspects of foreign land ownership. The study examines the major institutional, legal, economic, and informational issues related to foreign investment in American real estate and contains the following recommendations:

(1) While the comprehensive study of long run economic, social, and political impacts of such investment is being conducted the present policy of limited federal restrictions on alien ownership of land, without preemption of state restrictions, should be continued.

(2) The reporting of investment transactions to a federal agency should be required, so that the extent, location, values, and uses of all real property owned by nonresident alien individuals and entities, including beneficial as well as nominal owners, can be evaluated.

(3) States should be encouraged to require local governments to maintain systematic records of alien ownership for analysis by the federal government.

(4) A system should be designed for collecting and processing information on real property more efficiently at a reduced cost.

This emphasis on collecting and analyzing information can be traced to the findings that no mechanisms currently exist to measure the extent of alien ownership. The collection of information presumably is a prerequisite to further action on controlling alien investment in United States real estate.<sup>231</sup>

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231. G. WUNDERLICH, FOREIGN INVESTMENT IN U.S. REAL ESTATE: SUMMARY CONCLUSIONS, AND RECOMMENDATIONS, UNITED STATES DEP'T OF AGRIC. REPORT 365 (June 1976).