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U.S. Taxation of U.S. Real Estate Owned by Nonresident Aliens And Foreign Corporations

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U.S. TAXATION OF U.S. REAL ESTATE OWNED BY NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

ROBERT B. ALEXANDER, JR.*

I. NONRESIDENT ALIEN INDIVIDUAL'S INCOME TAX	651
A. <i>Real Property Capital Gains</i>	651
B. <i>Real Property Ordinary Income</i>	653
C. <i>Real Property Investment Income</i>	654
D. <i>Election to Have Real Property Income Treated as "Effectively Connected"</i> <i>Business Income</i>	655
II. FOREIGN CORPORATIONS' INCOME TAX	656
A. <i>Real Property Capital Gains</i>	656
B. <i>Real Property Ordinary Income</i>	657
C. <i>Real Property Investment Income</i>	657
D. <i>Election to Treat Real Property Income as Income Connected with U.S.</i> <i>Business</i>	658
E. <i>Meaning of "Effectively Connected"</i>	658
F. <i>Definition of a Foreign Corporation</i>	661
G. <i>Controlled Foreign Corporations</i>	661
III. OTHER INCOME TAX CHANGES AND TAX FACTORS IN REAL ESTATE INVESTMENTS AND OPERATIONS	662
A. <i>The Foreign Tax Credit</i>	662
B. <i>Withholding at Source</i>	663
C. <i>Source of Income</i>	663
D. <i>Treaties</i>	664
E. <i>Foreign Country with Community Property Laws</i>	666
F. <i>Investment Credit</i>	667
G. <i>Depreciation</i>	667
H. <i>Recapture of Depreciation</i>	668
I. <i>Depletion</i>	669
J. <i>What Constitutes Conducting a Trade or Business Within the U.S.</i>	669
K. <i>Tax-Free Exchanges of Like Property</i>	670
L. <i>How to Postpone Tax on the Sale of Real Property</i>	670
M. <i>Sales and Leasebacks</i>	671
IV. ESTATE TAX	671
A. <i>Reduction in U.S. Estate Tax</i>	671
B. <i>Other Changes</i>	673
C. <i>Credit for State Death Taxes</i>	674
V. GIFT TAX	674
A. <i>Application to Real Property</i>	674
B. <i>Exemption from Gift Tax for Certain Gifts</i>	674
C. <i>Annual Gift Tax Exclusion of 3,000 Dollars and No Returns Required in</i> <i>Most Cases</i>	675

On November 13, 1966, the President signed the Foreign Investors Tax Act of 1966,¹ which completely revised the income, estate and gift tax rules on taxation of nonresident aliens and foreign corporations.

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1. 80 Stat. 1539 (1966) [hereinafter cited as the Act], in *United States Code Congressional and Administrative News* 5778 (1966) [hereinafter cited as *Cong. & Adm. News*].

The Senate Finance Committee Report² stated that the two objectives of the bill are:

[I]mproving equity in the tax treatment of nonresident aliens and foreign corporations and providing, to the extent consistent with the first objective, increased incentives for investments by these persons and corporations in the United States.

I. NONRESIDENT ALIEN INDIVIDUAL'S INCOME TAX

A. *Real Property Capital Gains*

In the case of a nonresident alien's net capital gains on real property in the U.S. which are not "effectively connected" with the conduct of a trade or business within the U.S., there is no U.S. tax, unless he has been present here for at least 183 days during the taxable year.

For purposes of applying the 183 day test an alien will be treated as being on a calendar year basis unless he has previously established a different taxable year. The requirement of the prior law which taxed capital gains when the alien was physically present in the U.S. at the time of realization was eliminated. The Senate Report³ provides:

In the case of capital gain, it was the opinion of your committee and the House that the present rule that taxes a nonresident alien if present in the United States when the gain is realized is an arbitrary rule which constitutes only a trap for the unwary. Also, your committee agrees with the House view that the exclusion for nonresident aliens not present in the United States for 90 days during a year should be extended to a period of 183 days. The 183-day period more closely parallels the general rule applied by most of the industrialized countries of the world. . . .

In the case of a nonresident alien's net U.S. source capital gains (other than those specifically included in the list as taxable at the 30-percent rate) which are not effectively connected with the conduct of a trade or business within the United States, the bill provides that no U.S. tax is to be imposed unless the nonresident alien has been present in the United States for at least 183 days during the taxable year. . . .

The amended statute⁴ provides:

Sec. 871. *Tax on Nonresident Alien Individuals.*

(a) *Income not connected with United States business—*
30% Tax.—

2. S. REP. NO. 1707, 89th Cong., 2d Sess. (1966) [hereinafter cited as the Senate Report], in *Cong. & Adm. News* 6190, 6198.

3. Senate Report, in *Cong. & Adm. News* 6212-13, 6214.

4. INT. REV. CODE OF 1954. [hereinafter cited as the Code] § 871, as amended by § 103 of the Act, in *Cong. & Adm. News* 5788.

(1) *Income other than capital gains.*—There is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a non-resident alien individual as—

(A) interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other fixed or determinable annual or periodical gains, profits, and income. . . .

Capital gains are not “fixed or determinable annual or periodical gains, profits, and income” as these terms are used in section 871. The regulations⁵ provide that “income derived from the sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income.” Thus, the exemption from the U.S. income tax for real property capital gains which are not connected with a U.S. business, unless the nonresident alien has been present at least 183 days in the U.S. during the taxable year is explained.

There is extensive discussion of the meaning of “effectively connected” below. The term “nonresident alien individual” is defined in the regulations⁶ as “an individual whose residence is not within the United States, and who is not a citizen of the United States.” A resident alien has substantially the same income tax liabilities as a citizen. “Residence” is defined in the regulations⁷ as follows:

An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

5. Treas. Reg. § 1.1441-2(a)(3) (1956), as amended, T.D. 6873, 1966 INT. REV. BULL. No. 8, at 11, and Treas. Reg. § 1.871-7(b)(2)(i) (1957), as amended, T.D. 6841, 1965-2 CUM. BULL. 200, which refers to Treas. Reg. § 1.1441-2(a)(3) (1956).

6. Treas. Reg. § 1.871-2(a) (1957).

7. Treas. Reg. § 1.871-2(b) (1957).

If a nonresident alien is present in the United States 183 days or more, a tax of 30 per cent on his net capital gains on real property in the U.S. (not connected with a U.S. business) will apply whenever during the year the gain was realized. As to capital gains not connected with a U.S. business, amended section 871(a)(2) provides:

(2) *Capital gains of aliens present in the United States 183 days or more.*—In the case of a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year, there is hereby imposed for such year a tax of 30 per cent of the amount by which his gains, derived from sources within the United States, from the sale or exchange at any time during such year of capital assets exceed his losses, allocable to sources within the United States, from the sale or exchange at any time during such year of capital assets.

But, if the nonresident alien is engaged in a trade or business in the U.S. and the capital gain is "effectively connected" with his business, it will be taxed without regard to the 183 day presence rule. Amended section 871(b)(1), with regard to income connected with a U.S. business, provides:

A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 or 1201(b) on his taxable income which is effectively connected with the conduct of a trade or business within the United States.

Therefore, it can be seen from the rules set forth above that the U.S. largely exempts capital gains of foreigners where the gains arise in this country.

B. *Real Property Ordinary Income*

If a nonresident alien individual's income from U.S. realty (including gains on sale) is from a trade or business in the U.S., the tax is at regular rates (under section 1) with proper deductions (including depreciation), or at reduced rates (under section 1201(b)). Section 871(b)(1) applies.

The regular rates on ordinary income begin at 14 per cent and progress considerably higher. In determining taxable income to which is applied the regular or reduced rates of sections 1 or 1201(b), gross income includes only gross income which is connected with a business within the U.S.

The reduced rates are explained as follows. Depreciable property used in the trade or business and real property used in the trade or business may be sold or exchanged at a gain after being held for more

than six months; the net gain will be considered a capital gain under section 1231, but any net loss will not be considered a capital loss—such loss being given ordinary loss treatment, unless such depreciable property or real property is inventory or “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” in which case the gain would not be treated as a capital gain. Thus, the reference to section 1201(b) in section 871(b)(1). Therefore, when the nonresident alien is engaged in a trade or business within this country and a capital gain is “effectively connected” with such business, he will be given regular rate taxation on real estate sold from his inventory or from that held “primarily for sale to customers,” but he will be given capital rate treatment under sections 1231 and 1201(b) on certain “section 1231” real estate and depreciable property sold which is used in the trade or business, as in the case of U.S. individuals.

C. Real Property Investment Income

Section 871(a) makes it clear that if a nonresident alien individual's income from U.S. realty is not from U.S. business nor “effectively connected” therewith, the 30 per cent tax applies to gross rent and interest (and certain dispositions of timber, coal or iron ore under section 631(b) or (c)). This is so even though he may be engaged in a business here and thus have other U.S. ordinary income taxed at regular rates. That is, the regular rates are applicable to business income of an alien doing business here, but the 30 per cent maximum applies to nonbusiness investment income, for example, gross rents not “effectively connected” with his U.S. business.

For example, a nonresident alien conducts a mercantile business here, and has some unrelated real estate or stock investments. The mercantile business income will be taxed at regular rates. The rental or dividend income on the real estate or stock investments, if not “effectively connected,” will not be aggregated with the mercantile income and will be taxed separately at 30 per cent or lower treaty rate. Capital gain on the sale of the real estate or stock investment, if not “effectively connected,” would not be taxed (unless in U.S. at least 183 days in year gain realized and then at 30 per cent); capital gain, if “effectively connected,” is taxed as provided in sections 1 and 1201(b) pursuant to amended section 871(b)(1) as noted above.

The new law continues the 30 per cent (or lower treaty) tax on the gross amount of specific types of passive or investment income of aliens not doing business here, but eliminates the application of regular rates where income exceeds 21,200 dollars. That is, 30 per cent is the maximum tax no matter how great the investment income. These changes in existing law are explained by the Senate Report.⁸

8. Senate Report, in *Cong. & Adm. News* 6212.

*D. Election to Have Real Property Income Treated as
"Effectively Connected" Business Income*

The nonresident alien individual is given an election to have his income treated as "effectively connected" business income, because it is sometimes difficult to tell which classification applies under the rules above (*i.e.*, ordinary income regular rate; the 30 per cent tax on U.S. source investment income; the 30 per cent tax on U.S. source capital gains when present over 183 days; section 1 or 1201(b) rate on "effectively connected" capital gains, or no capital gains tax). The reason for this new section 871(d) is explained in further detail below. The election is to be made in such manner as regulations may provide and is binding for all later years unless the Commissioner permits revocation. If revoked, a new election cannot be made for five years without the consent of the Internal Revenue Service.

The election provided for in section 871(d) is illustrated by the following example from the Ways and Means Committee Report:⁹

Example.—A, a nonresident alien individual, owns two parcels of real estate located in the United States. One parcel is improved with an office building which *A* has leased on a long-term, net-lease basis. The other parcel is unimproved and is held for investment purposes. During the taxable year 1967, *A* is at no time present in the United States or engaged in trade or business within the United States. In 1967, *A* elects to have the income from the improved real estate treated as income which is effectively connected with the conduct of a trade or

Your committee agrees with the House that the present tax treatment of nonresident aliens is unnecessarily complicated and also makes arbitrary distinctions based upon the size of the individual's income and whether or not the individual has a trade or business in the United States which may be wholly unrelated to the specific income in question. The bill has retained the rule of present law which provides that U.S. trade or business income of nonresident aliens is subject to the regular individual income tax rates. However, other income is to be subject to the regular rates only if it is effectively connected with the U.S. trade or business. U.S.-source fixed or determinable income of nonresident aliens which is not so connected is to be subject to a flat 30-percent rate (or lower treaty rate). This removes the arbitrary rule of present law which would vary the treatment of investment income depending upon whether the individual has an unrelated trade or business in the United States.

The flat 30-percent rate of tax in the case of certain nonresident aliens has been applied under present law, and is continued under the bill, because the United States does not have jurisdiction over all of such an individual's income. These taxpayers are not allowed the deductions that are available to U.S. citizens and the 30-percent rate is considered an appropriate effective rate in such cases. In addition, it has been found in practice that only a small amount of tax has been collected as a result of imposing the graduated rates. It is also thought that applying the uniform flat rate with respect to income not effectively connected with a trade or business in the United States would tend to encourage investment here by foreigners. To the extent this occurs, there will, of course, be an improvement in our balance of payments.

9. Technical explanation in the Ways and Means Report from House Report 1450 of the Committee on Ways and Means, dated April 26, 1966, adopted by reference by the Senate Finance Report accompanying H.R. 13103 [hereinafter cited as the Ways and Means Committee Report], in H.R. REP. No. 1450, 89th Cong., 2d Sess. 87-89 (1966).

business within the United States. *A* has no other income from United States sources during the taxable year. In determining his income subject to tax under section 1 of the Code, *A* is allowed any deductions which are allowable under amended section 873; and for such purposes deductions attributable to such real property and to the income therefrom is to be treated as connected with the conduct of a trade or business within the United States. In 1968, *A* sells the unimproved parcel of real estate held for investment, the election under section 871(d) still being in effect. Any gain realized from such sale, and *A*'s income for the year from the rental property, are subject to tax under section 1 or 1201(b). If such sale is at a loss, the loss will be treated as a capital loss which is deductible under amended sections 873(a) and 1212(b) of the Code.

II. FOREIGN CORPORATIONS' INCOME TAX

A. *Real Property Capital Gains*

A foreign corporation not doing business in this country will not be taxed on its U.S. source net capital gains on real property in the U.S. A foreign corporation doing business here will be taxed on capital gains on real property in the U.S. only if "effectively connected" with that business.¹⁰ The new statute provides:

Sec. 882. Tax on Income of Foreign Corporations Connected With United States Business.

(a) Normal Tax and Surtax.—

(1) Imposition of tax.—A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11 or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

The Ways and Means Committee Report¹¹ explains sections 881 and 882 as follows:

Gains from the sale or exchange of a capital asset (other than amounts to which amended section 881(a)(2) and (3) applies) are subject to tax only if they are received by a foreign corporation which is engaged in trade or business within the United States at some time during the taxable year for which the tax is being determined and are effectively connected with the conduct of a trade or business within the United States. . . .

10. Code § 881(a), as amended by § 104(a) of the Act, in *Cong. & Adm. News* 5798; *Treas. Reg.* § 1.1441-2(a)(3) (1956), as amended, T.D. 6873, 1966 INT. REV. BULL. No. 8, at 11, and *Treas. Reg.* § 1.881-2(b) (1957), as amended, T.D. 6841, 1965-2 CUM. BULL. 200, which refers to *Treas. Reg.* § 1.1441-2(a)(3); § 882(a)(1), as amended by § 104(b) of the Act, in *Cong. & Adm. News* 5798.

11. H.R. REP. No. 1450, 89th Cong., 2d Sess. 87-89 (1966).

Paragraph (1) of the section 882(a) provides that a foreign corporation which is engaged in trade or business within the United States at any time during the taxable year in respect to which the tax is being determined is also subject to the regular corporate tax imposed by section 11 or 1201(a) on its taxable income (whether derived from sources within or without the United States) which is effectively connected with the conduct of a trade or business within the United States. . . .

[I]ncome from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States is taxable under section 881 of the code, as amended by section 4(a) of the bill, if such income is described in section 881(a). Any such income which is not described in section 881(a), such as almost all capital gains, is not subject to U.S. income tax.

B. Real Property Ordinary Income

If a foreign corporation's income from U.S. realty (including gains on sale) is from a trade or business in this country the tax is at regular rates (under section 11) with proper deductions (including depreciation), or at reduced rates (under section 1201(a)). Section 882(a)(1), quoted above, makes this clear.

C. Real Property Investment Income

If a foreign corporation's income from U.S. realty is not "effectively connected" with its U.S. business, even though it may be engaged in a business here and thus have other U.S. business income, the 30 per cent tax applies to gross rents and interest.¹²

12. § 881. Tax on Income of Foreign Corporations Not Connected With United States Business.

(a) *Imposition of Tax.*—There is hereby imposed for each taxable year a tax of 30 per cent of the amount received from sources within the United States by a foreign corporation as—

(1) interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income, . . .

The Senate Report, *Cong. & Adm. News* 6222, explains new sections 881 and 882 as follows:

Your committee's and the House bill, both in the case of nonresident aliens and in the case of foreign corporations, provides a consistent pattern of taxation. Nonresident aliens and foreign corporations will be taxed at the regular income tax rates in the case of income which is effectively connected with a U.S. trade or business. In the case of nonresident alien individuals and foreign corporations with U.S. source fixed or determinable income which is not effectively connected with a U.S. trade or business, a flat 30-percent rate is applied. . . .

One of the principal changes resulting from this new classification in the case of foreign corporations is that investment income which is not related to a trade or business carried on in the United States will be taxed at the flat 30-percent rate (or lower treaty rate) rather than at the regular corporate rate. This does away with the arbitrary distinction which exists under present law which makes the rate of tax, a flat 30 percent or regular rate, turn on the presence or absence of a trade or business in the United States which may be wholly unrelated to the investment income.

D. *Election to Treat Real Property Income as
Income Connected with U.S. Business*

The new law gives the foreign corporation an election to have its income treated as "effectively connected" business income. Due to the difficulty of determining the classification applicable (*i.e.*, regular rate on ordinary income, 30 per cent rate on U.S. source investment income applicable to gross rents, section 11 regular rate or section 1201(a) reduced rate on capital gains "effectively connected," or no capital gains tax), an election has been granted and can be made in such manner as described in Section I. D., *supra*.¹³ The Senate Report¹⁴ explains the reason for the provision as follows:

Under the [prior law] . . . one foreigner may be taxed on investment income at the regular individual or corporate rates while another, with an identical portfolio investment, is taxed on his investment income at the flat 30-percent (or lower treaty) rate. The difference in treatment arises from the fact that one is engaged in business in the United States and the other is not, even though the investment portfolio of the former is wholly unrelated to his U.S. business. Your committee agrees with the House that it is neither equitable nor logical for this substantial difference in tax treatment of investment income to depend on the presence or absence of an unrelated business. In addition, the Presidential Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities has pointed out that the present scheme deters foreign businessmen operating in the United States from investing in the United States, and also deters foreigners already investing in the United States from commencing a trade or business here. . . .

To meet both types of problems described above the bill provides for the taxation of nonresident aliens and foreign corporations at the regular U.S. graduated individual rates or corporate rates on their income which is effectively connected with the conduct of a trade or business within the United States. . . .

E. *Meaning of "Effectively Connected"*

Amended section 864,¹⁵ relating to definitions, states:

In determining whether income from sources within the United States of the types described in section 871(a)(1) or section

Under the bill all U.S. source investment income (fixed or determinable income) of foreign corporations which is not effectively connected with a trade or business in the United States will be taxed at a flat rate. However, all investment income effectively connected with a U.S. trade or business will be taxed in the same manner as other income of that trade or business, and in the same manner as similar income of a domestic corporation.

13. Code § 882(d), as amended by § 104(b) of the Act, in *Cong. & Adm. News* 5799.

14. Senate Report, in *Cong. & Adm. News* 6207.

15. Code § 864(c)(2), as amended by § 102(d) of the Act, in *Cong. & Adm. News* 5786.

881(a) or whether gain or loss from sources within the United States from the sale or exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether—

(A) the income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business, or

(B) the activities of such trade or business were a material factor in the realization of the income, gain, or loss.

In determining whether an asset is used in or held for use in the conduct of such trade or business or whether the activities of such trade or business were a material factor in realizing an item of income, gain, or loss, due regard shall be given to whether or not such asset or such income, gain, or loss was accounted for through such trade or business.

The Senate Report¹⁶ elaborates further in explaining the meaning of “effectively connected”:

In the case of investment and other fixed or determinable income and capital gains from U.S. sources the income is to be treated as effectively connected with a U.S. business if the income is derived from assets used or held for use in the conduct of a U.S. business or if the activities of the U.S. business are a material factor in the realization of the income. All other types of U.S. source income are to be considered to be effectively connected if there is a U.S. business. . . .

The income of nonresident aliens which is effectively connected with a U.S. business is to be taxed at the regular graduated rates applicable to individuals and all income not so connected is to be taxed at a flat 30 per cent rate (or lower treaty rate). U.S. source capital gains of a nonresident alien not engaged in business in the United States are to be taxed only if the alien was in the United States for 183 days or more during the year. Deductions are allowable only to the extent allocable to income which is effectively connected to a U.S. business. Also, an election is provided which allows an alien to treat income from real property as U.S. business income in order to take deductions allocable to it. . . .

In determining whether periodical income such as interest, dividends, rents, wages, and capital gains is effectively connected with the conduct of a trade or business within the United States two principal factors are to be taken into account. First, is the income derived from assets used or held for use in the conduct of a trade or business in the United States? Thus, for example, are the assets being held for future, or remittant, use

16. Senate Report, in *Cong. & Adm. News* 6191-2, 6208.

in the business? In this regard, particular attention will be given to the relationship between the asset and the needs of the business. Second, were the activities of the trade or business a material factor in the realization of the income? Thus, in the case of this second factor, is there an immediate relationship between the income in question and the U.S. business activities of the foreign corporation? Also to be taken into account in weighing the relationship of the investment income to the trade or business, but not to be a controlling factor by itself, is whether or not the assets or income are accounted for through the U.S. trade or business. . . .

U.S. source income of the passive type (interest, dividends, rents), normally taxed under the 30 per cent rule or as capital gain or loss, may be "effectively connected" (and thus taxed at graduated rates as a part of business income) if it is derived from assets used in the business or if the activities of the business are a material factor in producing the income. All other U.S. source income of a foreign corporation doing business here is "effectively connected." In short, whether this passive income is "effectively connected" business income is a question of fact. The accounting treatment of the assets and income will be a material, but not conclusive, factor.

For example, dividends from corporation stock or rents from real estate, purchased and held to insure a source of supply, normally would be "effectively connected" and taxed as business income. Likewise for gain or loss on the sale of the stock or real estate. But, dividends from the stock or rents from real estate in which surplus funds are invested probably would not be; the dividend or rents would be taxed under the 30 per cent rule (because dividends and rents are a type of income specifically taxed under that rule). However, capital gain on the sale of the stock or real estate would not be taxed at all (because such income, if not "effectively connected," is not one of such types taxed to corporations).

The provisions of amended sections 864 and 882 and the meaning of "effectively connected" may be illustrated by the following example from the Ways and Means Committee Report:¹⁷

During the taxable year, the foreign corporation *M* maintains a branch sales office in the United States and by reason of its activities therein is engaged in business within the United States. The income which is effectively connected with the business carried on through such sales office is derived from sources within the United States. Corporation *M* also owns stock in a domestic corporation, and, by reason of the application of new section 864(c), the dividends on such stock, and a capital gain

17. H.R. REP. NO. 1450, 89th Cong., 2d Sess. 89-90 (1966).

derived from the sale of a part of the stock, are not effectively connected with the conduct of a trade or business within the United States. The tax under Section 11 of the Code is imposed on the taxable income which is effectively connected with the business carried on through such sales office, determined after allowance of all deductions connected with income which is effectively connected with the conduct of the trade or business within the United States. The tax of 30 percent is imposed under section 881 on the gross amount of the dividend income. The gain realized from the sale of the stock is not subject to U.S. income tax.

Foreign source income will be "effectively connected" with the U.S. business only if the corporation has an office or other fixed place of business here to which the income is attributable. Furthermore, only certain limited types of income can be "effectively connected," such as royalties from intangibles.¹⁸

F. Definition of a Foreign Corporation

The existing regulation states:

Foreign corporations are divided into two classes, namely, non-resident foreign corporations and resident foreign corporations. A nonresident foreign corporation is a foreign corporation which is not engaged in a trade or business within the U.S. at any time during the taxable year. A resident foreign corporation is a foreign corporation which, at some time during the taxable year, is engaged in a trade or business within the U.S.¹⁹

The statute²⁰ defines "foreign" by stating: "The term 'foreign' when applied to a corporation or partnership means a corporation or partnership which is not domestic;" and it also defines "domestic": "The term 'domestic' when applied to a corporation or partnership means created or organized in the United States under the law of the United States or of any state or territory."

G. Controlled Foreign Corporations

It is to be noted that foreign corporations controlled (generally by over 50 per cent of the voting power) by U.S. shareholders, and referred to as "controlled foreign corporations," are being included within this article only limitedly. Such U.S. shareholders (individuals or corporations) have a limited amount of the income included within their income in certain cases. If a foreign corporation is a "controlled foreign corporation" every U.S. shareholder who owns 10 per cent or more of the

18. Senate Report, in *Cong. & Adm. News* 6208-09.

19. Treas. Reg. § 1.881-1 (1960).

20. Code § 7701.

voting power must include in his gross income his pro rata share of the corporation's subpart F income²¹ for that year. "Subpart F income" means certain income derived from the insurance of U.S. risks and the "foreign base company income" which consists of certain "foreign base company sales income" (profits from personal property sales) and certain "foreign base company services income" (income relating to services performed for a "related person"). The purpose here is to deny U.S. tax deferral, for example, where a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country outside the U.S. primarily to obtain a lower rate of tax for the service income.²² There are special rules for the treatment of earnings invested in the U.S. There are also special rules under section 1248,²³ which, in general, apply if a U.S. person (individual or corporation) sells or exchanges stock or receives a distribution treated as such. The tax imposed by section 1248, treating gain on the disposition of stock in a foreign corporation as dividend income to the extent attributable to earnings accumulated in taxable years of the foreign corporation beginning after December 31, 1962, applies irrespective of the nature of the income accumulated.

III. OTHER INCOME TAX CHANGES AND TAX FACTORS IN REAL ESTATE INVESTMENTS AND OPERATIONS

Not included within the scope of this article are a number of other ways of acquiring, holding and disposing of real property, for example, through the use of partnerships, limited partnerships, syndicates, trusts, real estate investment trusts, cooperatives and condominiums, all with their special tax ramifications and advantages. There are a few special distinctions in regard to the taxability of each of these, for example, the law applicable to the taxability of resident trusts even though the beneficiaries are nonresident aliens. The new law has also made changes exempting certain foreign corporations owned by nonresident aliens from the personal holding company tax.

A. *The Foreign Tax Credit*

The foreign tax credit sections 901-905 govern the allowance of the foreign tax credit. These sections provide that income taxes levied by a foreign country and taxes imposed in lieu of these taxes may be credited against U.S. income taxes when properly paid or accrued. The new law makes several changes. Taxes imposed by the foreign country of source, domicile, or residence on income "effectively connected" with a U.S. trade or business will be allowed as a foreign tax credit to the non-

21. Subparts F and G of Part III, Subchapter N of Chapter 1 of the Code; §§ 951-64 and 970-72 of the Code.

22. S. REP. No. 1881, 87th Cong. 2d Sess. 84 (1962).

23. Code § 1248.

resident alien or foreign corporation.²⁴ The credit is subject to the "per-country" or "over-all" limitation,²⁵ and in applying such limitation only "effectively connected" income is to be taken into account. The credit will be allowed only against U.S. tax on "effectively connected" income; in other words, it will not be allowed against any 30 per cent (or lower treaty) tax imposed on nonbusiness investment income. If a foreign corporation receives dividends from its foreign subsidiary and they are "effectively connected," it may credit taxes of the foreign subsidiary²⁶ as though the recipient corporation were a domestic corporation.

Aliens residing in the U.S. are taxed substantially as U.S. citizens, but are allowed the foreign tax credit only if the country of nationality allows a similar credit to U.S. citizens. In the future, the credit will be denied only if the President finds it in the public interest to do so and the foreign country refuses to grant the U.S. citizens a credit on request. A parallel change has been made in the estate tax credit for foreign death taxes.

B. *Withholding at Source*

Withholding at 30 per cent (or lower treaty basis) has been required of payers of certain kinds of income (interest, rents, dividends, etc.) to nonresident alien individuals. Beginning in 1967, withholding will not be required (except as to wages) if the income is "effectively connected" with the payee's U.S. business.²⁷ It is expected that regulations will permit the payer to rely on a certification by the payee that the income is "effectively connected." The Treasury, by regulation, may require withholding on wages under the regular withholding system in lieu of the 30 per cent rate. Also, nonresident aliens with "effectively connected" income become subject to the estimated tax requirements. Income paid to foreign corporations will be exempt from withholding if "effectively connected." Even if not, the Treasury, by regulation may exempt provided that collection of the 30 per cent tax on such income is not jeopardized. At present, withholding agents file returns and remit the withheld tax annually on March 15th of the following year. The Treasury is given authority to require more current compliance and will probably do so in the same manner as returns and payments for domestic withholding.

C. *Source of Income*

A nonresident alien or foreign corporation is taxed only on income from sources within the U.S., except for foreign source income "effectively connected" with a taxpayer's U.S. business.²⁸ (The new Act made

24. Code § 906, as amended by § 106 of the Act.

25. Code § 904.

26. Code § 902.

27. Code § 1442, as amended by § 104 of the Act.

28. Code § 861, as amended by § 102 of the Act.

several changes in the source of income rules in a limited area with regard to interest on bank deposits and dividends.)

Interest received by a nonresident alien or foreign corporation on a mortgage on U.S. real property from a nonresident alien or foreign corporation will not be U.S. source income, unless "effectively connected," and therefore will not be taxed by the U.S., since the source of interest income depends on the country of residence of the payer or obligor.²⁹

Thus, even though gains, profits and income from the sale (as distinguished from interest income) of real property located in the U.S. are treated as income from sources within the U.S., since the situs of the real property is in the U.S. and determines the source, note that under the rules above capital gains upon the sale of such U.S. real property owned by nonresident aliens and foreign corporations are usually not taxed by the U.S. (regardless of the residence of the buyer).

D. *Treaties*

Complementing the foreign tax credit are the foreign tax treaties. Although treaties are becoming more numerous, the credit still remains the principal factor in reducing double taxation. Typically, the treaties provide credit for certain specified foreign taxes. Normally, the treaties relieve nonresident aliens and foreign corporations from U.S. tax on certain income items and gain exemptions or reductions in foreign income taxes levied on the foreign income of U.S. citizens, residents, or domestic corporations.

The Act provides that any contrary treaty provisions shall take precedence over the amendments made by the Act, unless the effect is to deny a benefit granted by the Act. For example, if a treaty provides that a foreign corporation is subject to a U.S. tax only on U.S. source income, no foreign source income will be taxed under the "effectively connected" rule. As another example, some treaty benefits are denied if the foreign corporation has a permanent establishment here. For the purpose of applying treaty benefits to income not "effectively connected," the corporation's U.S. business will not be deemed a permanent establishment.

The Ways and Means Committee Report³⁰ explains income affected by treaty by the following example:

M, a corporation organized in foreign country *Z*, is engaged in business in the United States through a permanent establishment (for example, an office or a place of management)

29. A. C. Monk & Co., 10 T.C. 77 (1948); Code §§ 861(a)(1), (5), 862, 871, 881 and 882 as amended by §§ 102-104 of the Act.

30. H.R. REP. NO. 1450, 89th Cong. 2d Sess. 99 (1966).

located therein. The United States and country *Z* are parties to an income tax convention. The convention provides that the United States will tax at a 15-percent rate dividends received from sources within the United States by a corporation of country *Z* not having a permanent establishment in the United States. Corporation *M* receives dividends from a domestic corporation all of whose income is from U.S. sources. The dividends are not effectively connected with the conduct of *M* corporation's business in the United States. The gross dividends are taxable under amended section 881, but the tax may not exceed the treaty rate of 15 percent. If the dividends were effectively connected with the conduct of *M* corporation's business in the United States, they would be taxable under section 882(a) after allowance of the dividends received deduction under section 243 of the code.

The grant of more favorable tax treatment to foreign persons may reduce the incentive of foreign governments to negotiate treaties under which they grant concessions to U.S. persons. To retain negotiation leverage, the Act³¹ provides that the President may proclaim that residents and corporations of a foreign country shall be taxed without regard to the amendments made by this or later Acts if he finds: (1) the taxes the foreign country imposes on U.S. citizens and corporations are more burdensome than U.S. taxes on residents and corporations of the foreign country; (2) the foreign country has not remedied this situation although requested to do so; and (3) it is in the public interest to apply pre-1967 tax rules to the residents and corporations of such foreign country.

Typical treaty provisions³² may provide that income from real property situated in one of the contracting States (*e.g.*, the U.S.), including gain derived from a sale of such real property, may be taxed by that State, even though the treaty may exempt gains derived from the sale of other types of capital assets except when the person deriving the gain has a permanent establishment in the U.S. and such gain is "effectively connected" with such permanent establishment. Thus, the exemption from the U.S. capital gains tax on real property sales made by nonresident aliens and foreign corporations exists by virtue of the U.S. Code sections discussed *supra* in IA and IIA which largely exempt capital gains of foreigners.

The modification of the U.S.-German treaty indicates that the U.S. is joining European thinking on the mobility of investment; that the

31. Code § 896, added by Act § 105(b).

32. For example, Protocol With the Federal Republic of Germany, Oct. 19, 1965, T.I.A.S. No. 5920; as to income exempt under treaty see Code § 894; see also *A Topical Comparison of U.S. Income Tax Conventions*, U.S. Congress, Joint Committee on Internal Revenue Taxation, prepared for the Senate Committee on Foreign Relations, November 1, 1960; DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS, UNITED NATIONS, INTERNATIONAL TAX AGREEMENTS (1948-1964).

U.S. is changing on the taxation of business income; that the U.S. refuses to change on the international implications of other types of tax systems which, for example, tax retained earnings at a high rate while taxing distributed earnings at a lower rate to encourage public buying of corporate shares and companies to seek expansion capital in the market. The Protocol reflects the U.S. change in internal policy in the direction of the European position which separates a nonresident taxpayer's investment income from his business income into portions "attributable" and not "attributable" to a permanent establishment.

A firmly rooted tax treaty policy concept is that business profits are not taxable at the source unless the enterprise realizing them maintains a permanent establishment in the source country. The Protocol with Germany completely revised the definition of a permanent establishment, clarifying and liberalizing the amount of business activities which an enterprise may carry on in a country before a permanent establishment is deemed to exist. One significant addition, for example, is the term "place of management." The revision of the definition will permit trading operations to achieve a far greater penetration of the source country without paying taxes than was possible under the existing treaty. Specifically carved out of the revised definition is a fixed place of business used for the storage, display or delivery of goods. Apparently salesmen may be employed to take orders for the trading operation, so long as final acceptance is reserved to the home office and the salesmen do not have the power to bind it to contracts.

The treaty modification with Germany foretold and presented the change in U.S. policy, now confirmed in the Foreign Investors Tax Act of 1966, toward a more liberal source-country tax treatment for foreign investors. The treaty's elimination of the "force of attraction" and the method of applying the "attribution" rule for taxing the business profits of an enterprise maintaining a permanent establishment, as well as the exemption of certain capital gains and all income of charitable organizations, point in this direction. Thus, the U.S. law moves in the direction of the European systems, responding to a shift in economic power. The German treaty and U.S. internal law reflect concepts entirely new to Americans, such as "attribution" of profits, "effective connection" of investment income to a permanent establishment, and "place of management." The Treasury Department has thus shown that it believes in strong liberalization of international trade.

E. Foreign Country with Community Property Laws

A U.S. citizen married to a nonresident alien and residing in a foreign country with community property laws previously has been sub-

ject to U.S. taxes on his or her share of the community income, even though earned solely by the alien spouse. This was thought to be unfair. Therefore, for years following 1966, the spouses may elect³³ to have their income, for U.S. tax purposes, treated largely as follows: (1) earned income will be considered the income of the spouse who earned it; thus, if the alien husband earned it all, no part will be taxed to the U.S. citizen wife; (2) trade or business income will be considered to be the income of the husband, unless the wife is the manager of the business; (3) community income derived from separate property will be the income of the spouse who owns the property; (4) other community income will be treated as the applicable foreign law provides; thus if each spouse owns half, the U.S. citizen spouse will be taxed on half the income.

F. *Investment Credit*

Generally, 7 per cent of "qualified investment" in new and used depreciable property (except buildings and their structural components) may be subtracted from tax liability.³⁴

The credit does not reduce basis and thus does not limit the total depreciation allowance. Examples to which the tax credit applies are tangible personal property which may be contained in, attached to, or located outside of a building such as production machinery, elevators and escalators, printing presses, transportation and office equipment, refrigerators, display racks and shelves, testing equipment, signs, hydraulic lifts, gasoline pumps and tanks; and, when used as an integral part of manufacturing, production or extraction, the property definition is broadened to encourage such activities and the credit applies to such items as docks, railroad tracks, bridges, furnaces, pipelines, and fences. Included also are certain waterwells, silos, trees and groves. Thus, it can be seen that many items associated closely with real property and improvements are given the tax benefits of the investment credit.

G. *Depreciation*

The faster depreciation writeoffs on depreciable realty constructed or acquired between October 10, 1966, and December 31, 1967 (paralleling the temporary limited suspension period of the investment credit) have been reduced. Under the suspension, the faster writeoff methods ("200% declining balance" or "sum-of-digits") can never be used for buildings costing over 50,000 dollars and their structural components. But, the "150% declining balance" and the "straight-line" method are

33. Code § 981, added by Act § 105(e).

34. Code §§ 38, 46, 47 and 48, as amended by Pub. L. No. 89-800, 80 Stat. 1508 (1966), in *Cong. & Adm. News* 5742.

still available. And many items discussed above in IIIF, which are not a part of a building or one of its structural components, continue to qualify for the faster depreciation methods even though they are suspension period property.

When building a new warehouse, factory or the like, the cost of land improvements may be recoverable through depreciation even though not actually part of the physical structure. For example, although the cost of general grading of the land is not depreciable, the expenses of digging, grading, and removing soil for "the proper setting of the buildings and roadways" can be written off. The reason is that they are "directly associated" with such improvements and are part of the depreciable cost of construction.³⁵ Other examples are grading and graveling a private road to provide customers with access to a store and warehouse; tunnel under public road between two business buildings; plank road and filling in and grading of land on which a new lumber yard was to be built; and, the cost of landscaping and shrubbery on business property.

If property is being purchased, the purchaser can include the amount of any borrowed money used to finance the purchase as a part of his cost basis for the purpose of computing his allowance for depreciation. Although only a part of the money put up to pay for the property is his, he is entitled to take for his cost basis the entire price paid, including both the money put up by him and by his mortgagee. Thus a substantial portion of the gross income from the property may be received by the purchaser as a tax free allowance for depreciation. The purchaser is placed in the position of being able to increase his equity in the property by paying off the mortgage debt out of the moneys attributed to the depreciation allowance. Obviously he can increase his equity in the property much faster than if he were required to make his payments out of taxable income. The owner's price for this privilege is the payment of interest, an expense normally deductible. These are additional reasons for the current popularity of real estate investment as a vehicle for building up capital values.

H. *Recapture of Depreciation*

In the case of buildings and structural components, if held over ten years there is no recapture of depreciation on sale. The gain attributable to the land is separated out of the total gain. The stepped up part of depreciation on buildings (*i.e.*, the amount in excess of straight-line depreciation), however, is recaptured as ordinary income,³⁶ but, the applicable percentage of recapture, if any, goes down, generally 1 per

35. Rev. Rul. 265, 1965-2 CUM. BULL. 52.

36. Code § 1250, as amended by Pub. L. No. 89-800, 80 Stat. 1508 (1966), in *Cong. & Adm. News* 5742.

cent per month during the ten-year holding period. Personalty has a separate rule.³⁷

I. Depletion

The income from extracting minerals, oil and gas, other natural deposits and timber is generally ordinary income subject to percentage depletion or cost depletion in the hands of the owner of an economic interest. The law thus recognizes that capital is consumed in the process of extraction, and the deduction is intended as compensation for the exhaustion of assets consumed in the production of income through severance. By an outright sale the owner may receive capital gains for his interest. Owners of coal, iron ore and timber receive special capital gains benefits (*e.g.*, an election to treat the cutting of timber as a sale at capital gains rates). The percentage deduction in the case of oil and gas wells is allowable on the basis of $27\frac{1}{2}$ per cent of the gross income from the property, limited to 50 per cent of the taxable income from the property, and is deductible even though the entire cost of the property has been recovered through prior deductions. The rates of percentage depletion vary, for example, from 23 per cent in the case of sulfur and uranium, to 15 per cent for certain metals and clay, to 10 per cent for sodium chloride, and 5 per cent for sand and gravel.

J. What Constitutes Conducting a Trade or Business Within the U.S.

The mere ownership of real property in the United States by a non-resident alien individual or foreign corporation does not in itself constitute engaging in trade or business within this country.³⁸ Since the decision of the Supreme Court in *Higgins v. Commissioner*,³⁹ it is settled law that the mere management of investments and the collection of rents and interest therefrom is insufficient to constitute the carrying on of a trade or business. The case of *Elizabeth Barbour*⁴⁰ illustrates passive management of a nonresident alien's real property in the U.S. by taxpayer's attorneys. The Tax Court there held that the activities of the taxpayer and her agents in respect to management of her real estate did not constitute the carrying on of a trade or business.

However, management activities, through an agent, with respect to parcels of real estate, have been held to constitute the engaging in a trade or business within the meaning of section 211(b) of the 1939 Code, where the activities were beyond the scope of mere ownership of real

37. Code § 1245, as amended by Pub. L. No. 89-800, 80 Stat. 1508 (1966), in *Cong. & Adm. News* 5442.

38. G.C.M. 18835, 1937-2 CUM. BULL. 141.

39. 312 U.S. 212 (1941).

40. 13 P-H Tax Ct. Mem. 241 (1944).

property, or the receipt of income from real property. The activities were considerable, continuous and regular.⁴¹

It is noted that the case law in the previous paragraphs, when applied to the various rules set forth herein, must be viewed in context with the use of such terms as "effectively connected" and "permanent establishment;" thus, certain real property income not heretofore considered generated by or related to a trade or business may hereafter be "effectively connected" with the income from a trade or business and taxed as business income in certain limited cases under the rules set forth herein. The new law makes it clear that trading in the U.S. in stocks, securities or commodities directly or through a resident agent or broker is not a trade or business.⁴² This rule will apply even if the resident broker or agent has discretionary authority. However, a dealer in stock or securities and an investment company having its principal office in the U.S. are not within the rule; whether or not they are in business here will depend on all the facts.

K. *Tax-Free Exchanges of Like Property*

Owners of real property held for investment or held for use in trade or business have the privilege of deferring the potential gain to be realized upon a disposition of the property by exchanging it for another parcel of real property "of a like kind."⁴³

Thus, an owner of business real estate which is worth more than its basis may exchange the property for another parcel of business real estate without paying a tax on the gain represented by the excess of the value over basis. Similarly, a farmer may exchange his farm or ranch for another farm or ranch and qualify the exchange as a tax-free transaction. The same benefits are extended to owners of apartments who exchange their interest in one apartment for an interest in another.

The benefits of a tax-free exchange are expressly denied to owners of real property held for sale to customers in the ordinary course of business,⁴⁴ or to owners of property used for residential purposes (for example, as a home).⁴⁵

L. *How to Postpone Tax on the Sale of Real Property*

The seller of real property on a time payment sale may postpone the payment of any tax due on the gain for as long as possible by report-

41. Jan Casimir Lewenhaupt, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955). See also Code § 1237 wherein the section recognizes the right of an owner of property who is not otherwise a dealer to engage in a limited amount of subdivision work without, by that fact, converting himself into a dealer no longer qualifying for capital gain treatment.

42. Code § 864, as amended by § 102(d) of the Act.

43. Code § 1031(a).

44. *Ibid.*

45. I.T. 1587, II-I CUM. BULL. 26 (1923).

ing his gain, if he receives not more than 30 per cent of the total sales price in the year of sale, on the installment basis.⁴⁶ All the gain to be realized under such a sale will be postponed until the year or years in which installment payments are received.

M. *Sales and Leasebacks*

An owner of property may sell it, converting its value into cash, lease it back from the purchaser, and yet be in a position to enjoy the continued use of it. Thus, investment property may be purchased with a built-in tenant, namely the seller. And, because the lease is normally executed contemporaneously with the sales agreement, the buyer will know exactly what his return on his investment will be. The factor of deductibility of rent becomes increasingly important as the owner exhausts his allowance for depreciation on the property. By transferring the property to a new owner (which can be a corporation in which seller owns part of the stock), a new basis for depreciation is created in the hands of the purchaser. Thus, some of the benefit of the new allowance for depreciation may in effect inure to the benefit of the seller in a lesser rental.

Some of the advantages of the so-called ABC transaction, frequently used in the oil and gas field for the purpose of financing the acquisition of an interest in productive oil and gas property, may be applicable to aid in financing the acquisition of real estate.

IV. ESTATE TAX

The estate of a nonresident alien is subject to the U.S. estate tax only on real property situated in the United States at the time of his death.⁴⁷ (The estate of a resident alien is subject to a similar estate tax liability as is a citizen's. The test for determining residence for estate tax purposes is more rigid than the test used for income tax purposes.)

A. *Reduction in U.S. Estate Tax*

Certain changes have been made to encourage foreign investment in the U.S. The Ways and Means Committee Report⁴⁸ states:

These . . . measures are designed to accord approximately the same tax treatment in the case of the estate of a nonresident alien as is accorded a similar-sized estate of a citizen eligible for a marital deduction.

46. Code § 453.

47. Code § 2103 defines gross estate as follows:

For the purpose of the tax imposed by section 2101, the value of the gross estate of every decedent nonresident not a citizen of the United States shall be that part of his gross estate (determined as provided in section 2031) which at the time of his death is situated in the United States.

48. H.R. REP. NO. 1450, 89th Cong. 2d Sess. 4-5 (1966).

Before the new Foreign Investors Tax Act of 1966, a foreign estate was subject to heavier taxes than a domestic estate, because only a 2,000 dollar exemption was allowed and no marital deduction was allowed. The Ways and Means Committee Report⁴⁹ gives the reasons for increasing the exemption and establishing a new rate schedule, which were designed to encourage foreign investment in the U.S. as follows:

[T]he estate of a nonresident alien is likely to pay heavier taxes on its U.S. assets than would be true in the case of the estate of a U.S. citizen of similar size. Your committee believes that this is not appropriate. In addition, it has been suggested to your committee that the high U.S. estate tax on the U.S. assets of a nonresident alien tends to discourage foreign persons from investing in the United States. Any increase in foreign investment in this country which may be brought about by this change will, of course, have a favorable effect on this country's balance of payments.

In view of the considerations set forth above, your committee believes that the taxation of the U.S. estates of nonresident aliens should be reduced to more closely equate with the taxation of the estates of U.S. citizens. The bill therefore establishes a new schedule of graduated estate tax rates applicable to nonresident aliens which will impose a tax on the U.S. estates of these persons in an amount which is generally equivalent to the tax imposed on an estate of similar value of a U.S. citizen with the maximum marital deduction.

The estate tax exemption is increased from 2,000 dollars to 30,000 dollars.⁵⁰

A new tax rate schedule⁵¹ for estates of nonresident decedents not citizens of the U.S. provides:

49. H.R. REP. No. 1450, 89th Cong. 2d Sess. 42 (1966).

50. H.R. REP. No. 1450, 89th Cong. 2d Sess. 46 (1966). The Ways and Means Committee Report explains:

Presumably the basis for having a lower exemption for nonresident aliens than citizens and residents is that they typically have only a portion of their estate in the United States and therefore should have only a portion of the exemption allowed citizens and residents. Your committee also agrees that this justifies a lesser exemption for nonresident aliens but the minimal estate tax exemption presently allowed is so low as to place an unreasonable and inequitable tax burden on the estates of nonresident aliens. The exemption level your committee concluded was reasonable for nonresident aliens was \$30,000, or half that allowed in the case of citizens. This is high enough to make filing of returns unnecessary in the case of relatively small investments here. This level of exemption was also selected in conjunction with the rates made applicable to nonresident aliens . . . to assure approximately the same level of tax burdens for a nonresident alien as in the case of citizens of the United States eligible for the marital deduction. . . .

The bill amends the code to provide that the estate of a nonresident not a citizen is allowed to deduct a \$30,000 exemption in computing the taxable estate. The exemption which the estate of a resident of a U.S. possession to which the special rule applies is allowed, under your committee's amendment, is to be the greater of \$30,000 or the proportion of the \$60,000 exemption allowable under present law.

51. Code § 2101, as amended by § 108(a) of the Act, in *Cong. & Adm. News* 5818.

Taxable Estate:	Tax:
Not over \$100,000	5% of the taxable estate
Over \$100,000 but not over \$500,000	\$5,000 plus 10% of excess over \$100,000
Over \$500,000 but not over \$1,000,000	\$45,000 plus 15% of excess over \$500,000
Over \$1,000,000 but not over \$2,000,000	\$120,000 plus 20% of excess over \$1,000,000
Over \$2,000,000	\$320,000 plus 25% of excess over \$2,000,000

No estate tax return will be required for a nonresident alien unless the gross U.S. estate exceeds 30,000 dollars. If the estate is in excess of this 30,000 dollar limitation, form 706NA is required and is filed with the Office of the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225.⁵²

The following table compares the effective rates for estates of nonresident aliens provided by the new schedule with U.S. citizens with the marital deduction (10 per cent of gross estate deducted for funeral and other expenses). The rates for U.S. citizens without the marital deduction are considerably higher.

U.S. Gross Estate:	Effective Rate of Estate Tax:	
	Nonresident Alien	U.S. Citizen with marital deduction
\$2,000		
\$10,000		
\$30,000		
\$60,000	2.0	
\$100,000	3.0	
\$500,000	7.4	8.0
\$1,000,000	10.1	11.1
\$5,000,000	17.8	16.9
\$10,000,000	20.6	21.2

B. Other Changes

The Act also contains provisions applicable to citizens who expatriate to avoid taxes and provisions to protect the bargaining leverage of this country in negotiating estate tax treaties, since the unilateral reduction of the estate tax rates may have the effect of making it more difficult to negotiate these treaties. The Ways and Means Committee Report⁵³ explains the reasons for these provisions as follows:

Under present law, the foreign tax credit for income, etc., or death taxes are allowable to an alien who is a resident of the United States (or Puerto Rico) only if the foreign country of

52. Code § 6018; Treas. Reg. § 20.6091-1 (1958), as amended, T.D. 6600, 1962-1 CUM. BULL. 164.

53. H.R. REP. No. 1450, 89th Cong., 2d Sess. 38-39 (1966).

which the alien is a citizen or subject, in imposing its income, etc., or death taxes, allows a similar credit to citizens of the United States residing in such country. . . .

It has been called to the attention of your committee that present law acts to deny the credit to alien residents of the United States who are citizens of countries which may be following foreign policies which are adverse to the United States. Such countries may be unconcerned as to our tax treatment of refugees from their country who become residents of the United States. The fact that the United States may deny a credit to refugees from their country, in fact, might encourage them not to provide a foreign tax credit or exemption in their laws for any residents of their country who may be U.S. citizens. Your committee believes that the denial of the credit to such persons under these circumstances is unjustified and, therefore, has amended present law so as to allow these persons the foreign tax credit unless the President finds that so doing is not in the public interest.

The Act also provides that benefits granted by the Act shall not be denied by a treaty, but all other treaty provisions take precedence over amendments made by the Act.

C. *Credit for State Death Taxes*

Estates of nonresident aliens are allowed the credit against U.S. estate taxes for state death taxes. A special limitation will restrict the credit in certain cases.⁵⁴

V. GIFT TAX

A. *Application to Real Property*

The gift tax applies to real property of a nonresident alien donor situated in the United States, whether or not he is in business in this country.⁵⁵ (The gift tax also applies to personal property in the U.S.)

B. *Exemption from Gift Tax for Certain Gifts*

A gift by a nonresident alien of intangible property (e.g., corporate stock) with a U.S. situs, which has under old law been subject to U.S. gift tax if the alien was engaged in a U.S. trade or business, will no longer incur the gift tax whether or not he is in business in the U.S. The Ways and

54. Code § 2102, as amended by § 108(b) of the Act, in *Cong. & Adm. News* 5818.

55. Code § 2511; Treas. Reg. § 25.2511-1 (1958), as amended, T.D. 6542, 1961-1 CUM. BULL. 420; Treas. Reg. § 25.2511-2 (1958); Treas. Reg. § 25.2511-3 (1958), as amended, T.D. 6542, 1961-1 CUM. BULL. 420; Code § 2502 imposes a U.S. Gift tax, for example, of \$112.50 on a taxable gift of \$5,000 (\$3,000 each year for each donee is excluded in computing the amount of the taxable gift); \$375 on a \$10,000 taxable gift; \$1,200 on a \$20,000 taxable gift; and \$5,250 on \$50,000.

Means Committee Report⁵⁸ explains this change and reduction in the gift taxes of nonresidents not citizens as follows:

Under . . . present law a gift of intangible property having a U.S. situs by a nonresident alien who is engaged in trade or business in the United States is subject to the U.S. gift tax.

In practice this rule has proved to be impossible to enforce, since there is no practical way for the Internal Revenue Service to find out when these gifts are made. Moreover, it does not occur to many nonresident aliens that these transfers are subject to U.S. gift tax. Thus the revenue significance of this provision is minimal.

For the above reasons your committee's bill amends present law to provide that gifts of intangible property by nonresident aliens are not to be subject to the U.S. gift tax.

*C. Annual Gift Tax Exclusion of 3,000 Dollars and
No Returns Required in Most Cases*

Gift tax liability is computed on the basis of the calendar year. Any individual who makes a gift during the calendar year of any future interest in real property, regardless of the amount, or a present interest in excess of the annual individual exclusion of 3,000 dollars,⁵⁷ is required to file a return on form 709 not later than April 15th of the following year.⁵⁸ The return is required even though, because of the use by the donor of part or all of his specific exemption of 30,000 dollars,⁵⁹ no gift tax is payable. However, except as otherwise provided in a tax convention between the U.S. and another country, a donor who was a nonresident and not a citizen of the U.S. at the time the gift or gifts were made is not entitled to this specific exemption.⁶⁰

If the donor is a nonresident and has a principal place of business located in an Internal Revenue district, the gift tax return should be filed with the District Director of that District. If the nonresident donor does not have a principal place of business located in an Internal Revenue district, the gift tax return should be filed with the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225.⁶¹

56. H.R. REP. NO. 1450, 89th Cong., 2d Sess. 49 (1966).

57. Code § 2503.

58. Code § 6019; Treas. Reg. § 25.6019-1 (1958).

59. Code § 2521.

60. Treas. Reg. § 25.2521-1 (1958).

61. Treas. Reg. § 25.6091-1 (1958).