Foreign Investment in U.S. Real Estate Symposium - Real Estate Finance - An Emphasis on Texas Law.

Stephen P. Jarchow
FOREIGN INVESTMENT IN U.S. REAL ESTATE

STEPHEN P. JARCHOW*

I. Historical Perspective .................................. 1069
   A. The Origin ........................................ 1069
   B. The Modern Era .................................. 1071
   C. Recent Congressional Concern .................... 1072
II. The Objectives of Foreign Investors ................. 1075
   A. The Informational Gap ............................ 1075
   B. Investment Considerations ........................ 1078
III. Representing the Foreign Investor .................. 1081
   A. Investment Consultants ............................ 1081
   B. Legal Consultants ................................ 1082
   C. The Contract of Purchase ......................... 1083
   D. State Filings ...................................... 1084
   E. Use of a Netherlands Antilles Corporation ...... 1085
   F. Reporting and Disclosure Requirements ............ 1086
IV. U.S. Taxation of Foreign Investment ................. 1089
   A. Taxation Under the Internal Revenue Code ....... 1089
   B. Treaty Taxation .................................... 1091
   C. Transfer Taxation of Foreign Investors .......... 1094
   D. Tax Implications of Utilizing Various Entities .. 1094
   E. The New Legislation—The Foreign Investment Act .. 1097
V. Conclusion ............................................. 1102

I. HISTORICAL PERSPECTIVE

A. The Origin

Traditionally, the regulation of foreign investment in the United States has been characterized by both flexibility and restraint. Just as the American colonies were the product of foreign investment,

* B.B.A., M.S., J.D., University of Wisconsin. Associate, Partner, Lincoln Property Company, Las Vegas, Nevada.

1069
the thirteen original states economically were dependent upon such investment.\(^1\) Aware of this dependency, the new American government was anxious to establish creditworthiness in the eyes of European investors. This was necessary in order to maintain a favorable climate for investment.\(^2\)

Alexander Hamilton generally is considered the first American hero of foreign investment.\(^3\) Viewing it as an essential catalyst for the economic development of the fledgling nation, Hamilton expressed disgust at his colleagues who questioned whether such investment might be the first step to re-colonization.\(^4\) Notwithstanding such opposition, Hamilton's views ultimately prevailed. During the eighteenth and nineteenth centuries, foreign capital was an important factor in the financial maturation of the United States.\(^5\)

Real estate was a popular area of direct foreign investment. Those accustomed to the limited realty available in Europe were enthralled by the seemingly endless expanses of the American west. In fact, land was a valuable commodity utilized by Americans to purchase European expertise and goods.\(^6\)


2. Even though the Revolutionary War had been fought recently with the British, there was a particular sensitivity to resolving British claims quietly. In fact, the Jay Treaty with England provided that the United States would compensate the British for property seized or destroyed and debts unpaid as a result of the war. See Borchard, Introduction to Gatherings, International Law and American Treatment of Alien Enemy Property VII (1940).


4. It has been suggested that Hamilton's championing of the cause was in part motivated by personal investment interests. See id. at 253-54; Shriner, Alexander Hamilton As A Promoter, 15 Americana 120 (1921).

5. See North, International Capital Flows and the Development of the American West, 16 J. Econ. Hist. 493 (1956). In fact, most significant American industrial and agricultural development during the nineteenth century had at least a modicum of foreign financing. See Boorstein, Foreign Investments In America, 2 Editorial Research Reports 571 (1974). It is estimated that Europeans made two-thirds of the new investment in American railroads during the 1880's. Interestingly enough, the Louisiana Purchase in 1803 was funded with a loan of $11.25 million from England, France, and the Netherlands.

6. For example, the Texas government granted an English company a three million acre parcel of Texas land in payment for erecting the capitol building in Austin. See J. Danning, Studies in International Investment 171 (1970); Boorstein, Foreign Investments in America, 2 Editorial Research Reports 572-73 (1974). The British were involved heavily in the American cattle business. In the 1880's at least 18 companies were registered in Great Britain to engage in American ranching. Various European nobility and entrepreneurs sought with mixed success to create baronial estates in the American West. See Boorstein, Foreign Investments in America, 2 Editorial Research Reports 571 (1974).
B. The Modern Era

World War I was a major turning point in the foreign investment saga. In order to satisfy their wartime needs for American products, the European creditor countries disposed of a large portion of their accumulated U.S. investments. At the same time, loans to the European Allies moved vast sums of American capital to Europe. As a result, within a few years America's role shifted from debtor to creditor nation, a position it has not relinquished to date.

As the years passed, the attitudes of the U.S. populace toward foreign investment gradually changed. Foreigners and foreign investment fell prey to political attack. Antagonism toward foreign ownership of land led to the passage of the Alien Land Law of 1887, prohibiting aliens from owning land in federal territories. During World War II the United States invoked the Trading with the Enemy Act in order to seize the assets of German and Japanese nationals and governments. After the war a Foreign Claims Settlement Commission was established to adjudicate claims arising out of these seizures. Unfortunately, in many respects, the history of this process is a distressing commentary on the American bureaucratic mentality.

Following World War II, the trend shifted and the United States seemed to support the free flow of international investment. United States interest in overseas investment grew significantly. As a result, the United States entered into a series of bilateral agreements designed to encourage international investment and trade by providing mutual assurances of fair treatment and protection of foreign investors and traders.

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8. See id.


12. See Niehuss, Foreign Investment in the U.S.: A Review of Governmental Policy, 16
In the 1960's, the United States developed problems with a balance of payments deficit. Consequently, it took cautious steps to limit outflow of capital and to encourage inflow of capital. One of these measures was the imposition of the Interest Equalization Tax, an excise tax on purchases of foreign securities by U.S. citizens. The Act was designed to discourage foreign utilization of the U.S. equity market. In addition, a presidential task force was appointed to propose means of encouraging the sale of U.S. securities in foreign capital markets.

In the early 1970's, prices of U.S. corporate securities were depressed and the value of the dollar had declined in international exchange markets. Consequently, U.S. securities and real estate became bargains for foreign investors. At the same time, foreigners were holding substantial amounts of U.S. dollars due to dollar outflows in prior years. Foreign investments in the United States began to rise markedly, a phenomenon which attracted a great deal of public attention.

C. Recent Congressional Concern

The House Subcommittee on Foreign Economic Policy held informal hearings in early 1974 on the subject of direct foreign investment in the United States. Representatives of business and farm organizations, state development agencies, financial institutions, the academic community, and the executive branch of the U.S. government testified. In addition, striking increases in the price of oil implemented by the OPEC nations led to a flurry of


FOREIGN INVESTMENT

congressional hearings and legislative proposals in the mid-1970's.¹⁶

The various hearings highlighted the absence of adequate information concerning the extent, nature, and effects of foreign investment. As a result, Congress directed the Commerce and Treasury Departments to conduct studies of foreign direct and portfolio investment.¹⁷ Reports of the completed studies were submitted to Congress in 1976.¹⁸

In 1975, the President established an interdepartmental Committee on Foreign Investment in the United States.¹⁹ One function of the committee was to monitor foreign investment in the United States. To accomplish this, the committee was vested with responsibility for initiating legislative and regulatory action, presumably in an effort to offset a rash of ad hoc legislative and regulatory proposals promulgated in response to the pressures of particular constituencies.²⁰

Congress enacted the International Investment Survey Act of 1976 (Survey Act)²¹ to provide "clear and unambiguous authority for the President to collect information on international investment and to provide analyses of such information to the Congress, the executive agencies and the general public."²² The Survey Act expressly declares that it is not intended "to restrain or deter foreign investment in the United States or United States investment abroad."²³ Pursuant to the Act, benchmark surveys of foreign


¹⁷. See Foreign Investment Study Act of 1974, Pub. L. No. 93-479, 88 Stat. 1450. Prior to this Act, section 5(b) of the Trading with Enemy Act and section 8 of the Bretton Woods Agreement Act provided the authority to collect international investment data.


¹⁹. See Exec. Order No. 11858, 3 C.F.R. 990 (1976). This committee has been subjected to recent criticism for its relative inaction. See COMMITTEE ON GOVERNMENT OPERATIONS, TWENTIETH REPORT ON THE ADEQUACY OF THE FEDERAL RESPONSE TO FOREIGN INVESTMENT IN THE UNITED STATES (Aug. 1, 1980).


²². Id. § 1301(b).

²³. Id. § 1301(c).
direct and portfolio investment in the United States and United States direct investment abroad must be conducted at least once every five years, plus data collection must be maintained on a continuing basis.24

The particular sensitivity of various groups to the prospect of foreign investment in U.S. agriculture spurred the enactment of the Agricultural Foreign Investment Disclosure Act of 1978 (AFIDA).25 This Act requires any foreign person who acquires or transfers any interest, other than a security interest, in agricultural land to report the transaction to the Agricultural Department. The Agricultural Department has the responsibility of analyzing the reported information and periodically advising Congress and the President of the results.26

On August 1, 1980, a House Government Operations subcommittee released a study stating the total value of foreign-owned or influenced businesses and property in the United States at the end of 1979 approached $350 billion—roughly double the 1974 level.27 The study concluded that increased foreign investment threatens the U.S. economy and jeopardizes U.S. self-sufficiency and security. In addition, the report charged that the Treasury Department is carrying out a secret agreement between the United States, Saudi Arabia, and Kuwait preventing the disclosure or interagency sharing of information relating to Middle East OPEC country-by-country investments in the United States.28 This startling study

26. See id. A report by the General Accounting Office examined the extent of foreign investment in U.S. agricultural land and concluded that of the three million acres purchased within the 18 month period studied, foreign investors purchased approximately 8%. It also found that foreign investors buying U.S. real property had tax advantages, involving primarily capital gains, not available to U.S. citizens. See General Accounting Office, Foreign Investment in U.S. Agricultural Land—How It Shapes Up (July, 1979). The Treasury Department issued a report that indicated in 1977 and 1978 foreigners were purchasing U.S. agricultural land at a rate of 560,000 acres per year, constituting approximately 2% of the acreage sold in that period. The average foreign purchase was 1,141 acres, almost four times as large as the overall U.S. average of 308 acres. The average purchase by a foreign buyer was worth almost $1.1 million which is six to seven times as large as the average domestic purchase. See Department of the Treasury, Taxation of Foreign Investment in U.S. Real Estate (May, 1979).
28. See id.
FOREIGN INVESTMENT

set the stage for the enactment of the Foreign Investment in Real Property Tax Act of 1980 (Foreign Investment Act).\(^\text{29}\) The new legislation is examined later in this article.

II. THE OBJECTIVES OF FOREIGN INVESTORS

A. **The Informational Gap**

Innumerable articles and press accounts have addressed foreign presence in U.S. real estate investment.\(^\text{30}\) A discussion of this subject, however, is difficult. Despite the data-gathering mechanisms introduced by various legislation, there is little official or reliable published information setting forth the details of U.S. real estate transactions in general. Likewise, there is a significant lack of data concerning the activities of foreign investors. Notwithstanding inadequate data collection systems, the complex ownership structures characteristic of large real estate transactions preempt intelligible conclusions.

Available information concerning foreign investment is the product of individual experiences with transactions involving foreign investors. The information that follows is the result of personal experience, as well as extensive discussions with institutional and individual investors whose observations and parameters for investment may be considered representative.\(^\text{31}\)

While the hysteria concerning foreign investment in U.S. real estate seems misplaced, the foreign investor clearly has had a significant impact on the U.S. real estate market, particularly on the forces of supply and demand.\(^\text{32}\) The addition of substantial foreign


\(^{30}\) See generally Abrutyn, United States: Investment in United States Real Estate by Non-resident Aliens, Individuals and Foreign Corporations, Tax MANAGEMENT INT'L J. 77 (Sept. 1977); Bell, Foreign Investments in U.S. Properties, 8 REAL EST. REV. 56 (1978); Sturm, Taxation of the Foreign Investor in the United States, 55 TAXES 542 (1977).

\(^{31}\) Client confidences prevent a completely candid assessment of the extent and nature of foreign investment activities. Conversations with attorneys who represent foreign investors reflect a similar hesitancy to be too detailed or to disclose too much on the subject.

\(^{32}\) Although foreign investment comprises less than 1% of the value of domestic realty, its sheer volume is substantial and pervasive. It is reported that foreign real estate holdings exceed $1 billion in Dade County, Florida and include more that $200 million worth of office buildings in downtown Houston and at least 13 of the largest downtown buildings in Los Angeles. See Committee on Government Operations, Twentieth Report on the Adequacy of the Federal Response to Foreign Investment in the United States 18
demand has had a predictable effect on prices and yields.33

Canadian investors are probably the most significant group of foreigners engaged in the active development of U.S. real estate. The Separatists’ movement in Quebec, the general antidevelopment attitude of the Canadian bureaucracy, high price of Canadian labor, rent controls, antispeculation taxes, and high transfer taxes on properties purchased by non-Canadians have in many instances made the development of real estate in Canada undesirable. These factors, combined with the shortage of development real estate in Canada, caused a number of Canadian real estate companies to look for U.S. real estate development opportunities some time ago. Expansion into U.S. real estate is viewed as a logical investment strategy for many Canadian development companies which are familiar with the U.S. political structure, laws, and real estate. Noteworthy is that Canadian developers are some of the largest in North America and their operations generally are well financed and of high quality.34

British investors have been well-known to U.S. property owners since the American Revolution. Traditionally, British investors have backed a number of major U.S. developers with varying success. In recent years, the rapid growth of British pension funds has spurred renewed demand for a variety of investments including real estate. Further, a number of British individuals have made significant U.S. investments in an effort to escape adverse United

(Aug. 1, 1980). Foreigners also have significant investments in New York City real estate. See Jackson, Foreign Investors Love New York, 10 REAL EST. REV. 55 (1980). The Commerce Department’s Office of Foreign Investment identified 158 foreign purchases of U.S. real estate in 1978. Of that number 112 purchases were reported to have been sold for $1.1 billion. See DEPARTMENT OF THE TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE (May, 1979). These survey results reflect a “hit and miss” review of the pervasive foreign real estate holdings in the United States.

33. The opportunities to invest in quality real estate are limited. The absence of adequate supply to satisfy the domestic demand creates a steadily increasing price structure for real estate with resultant declining yields. Demands made by foreign investors further inflate this pricing structure.

34. See Chiles, Who Owns Texas? TEXAS MONTHLY, June, 1980, at 122. Significant Canadian developers in the United States include: Cadillac Fairview, Ltd.; Rostland Corporation; Daon Development Corporation; Genstar, Ltd.; Kinwest Development; Concert Developments, Ltd.; Campeau Corporation; United Management Ltd. of Calgary; Waron Developments, Inc. of Toronto; N.B. Cook Corporation; Block Brothers Development, Inc.; Wycliffe International, Inc.; Olympia & York Development, Ltd.; Bramela Ltd. of Toronto; and Oxford Development Group, Ltd. In addition, a constant stream of Canadian individuals have made extensive passive investments in U.S. real estate.
FOREIGN INVESTMENT

Kingdom political developments, higher taxation, labor problems, perceived socialist pressures, and currency restrictions. Germans have been investing in U.S. real estate for well over a century. German investors purchase U.S. real estate primarily because their tax laws favor real estate investment abroad and the German currency regulation does not inhibit foreign investment. Wealthy individuals transacting business through family-owned enterprises characterize most German investors. Some investments, however, are made through large blind pool funds which are among the most substantially capitalized in the world.

Holland's large banks and massive pension funds of international conglomerates have been active in the purchase of foreign real estate for many years. It is difficult, however, to determine how much U.S. real estate is actually owned by Dutch residents because many other foreign investment vehicles are incorporated and organized in the Netherlands and Netherlands Antilles as a result of the favorable tax treaties those countries have with the United States.

The dramatic increases in oil prices gradually have shifted a great deal of the world's wealth to the Arab countries of Saudi Arabi, Kuwait, Iran, Oman, and the United Arab Emirates. To avoid adverse publicity and scrutiny, many Arab investors have

35. Large state owned pension funds including British Airways Pension Fund, Staff Superannuation Funds of the British Post Office, Electricity Supplies Nominees of the United Kingdom, British Rail, and the Coal Industry Nominees are among the most active British investors in U.S. real estate. Large trust companies and a number of wealthy individuals also are significant British investors.

36. Recently, German investors acquired One Shell Plaza and Pennzoil Place in Houston, Texas.

37. It is possible for Germans to aggressively structure certain transactions under the U.S.-German Income Tax Treaty so as to avoid both German and U.S. taxation.

38. Significant German investors in U.S. real estate include the Frederick Flick Group, Volkswagen of America, the Lennorff Group, the Werner Otto Group, and the Quants. German investors often are represented by German banks and real estate advisory firms.

39. The traditional structuring of foreign investment in U.S. real estate utilizes a Netherlands Antilles corporation. Recent tax legislation and possible renegotiation of the U.S.-Netherlands Treaty which extends to the Netherlands Antilles makes it necessary to reconsider some basic investment premises. For example, some advisers are considering a so-called "sandwich structure" involving both Netherlands Antilles and Netherlands corporations. Notwithstanding such changes, it is likely that the Netherlands and Netherlands Antilles will continue to play a significant role in international financing and real estate transactions. A more thorough discussion of structuring a Netherlands Antilles corporation is presented later in this article.
conducted their investment transactions through a complicated network of foreign banks and through domestic banks such as Bank of America, J. P. Morgan, Chase Manhattan, Citicorp, Manufacturers Hanover Trust, Morgan Guaranty Trust, and Chemical Bank. The banking networks most recently used by Arab investors are the UBAF Arab-American Bank and the newly formed Arab Banking Corporation.40 Thus far, Arab financiers have been prudent and conservative in their investment activity. While most Arab investments are fairly well camouflaged, it is clear that Arab investors have significant holdings in U.S. real estate, including farmlands.41

B. Investment Considerations

An analysis of the increased interest of foreign investors in U.S. real estate must consider the impact of world political and economic conditions. Although the foreign investor has been involved in U.S. real estate for at least 100 years, the increased Communist presence in a number of the middle-European countries undoubtedly spurred the pace of foreign involvement during the mid-1970's.42 As a result, the criteria for a great deal of foreign investment was a desire to invest quickly in assets not likely to decline in value rather than careful selection of assets having the potential for appreciation. Characterized as "flight capital," such investment in the United States caused an aberration in the marketplace. Recently, however, there has been a conversion by foreign investors to more conventional standards for evaluation of real estate investment.

The phenomenon of inflation, as well as its perception by investors, also has had an effect on the real estate marketplace. The foreign investor, in many respects, has been light years ahead of his American counterpart in developing an investment philosophy centered upon the desire to hold long-term investments with better than average inflation resistance. This attitude is the result of ex-

40. The Arab Banking Corporation may be a mechanism which will afford middle eastern interests effective control of the world's capital markets. See Arab Banks Grow, BUSINESS WEEK, Oct. 6, 1980, at 70.
42. Notwithstanding the political turmoil resulting from our Watergate experience, most foreign investors view the American political system as one of the most stable in the world.
experience with periods of inflation significantly affecting many of the free-world economies during the twentieth century. The two principal concepts reflecting this attitude within the overseas real estate market are the absence of long-term mortgages at fixed interest rates and the indexing of various types of tenant leases.43

While the property characteristics of a typical foreign investment are similar to American investment, the differences should not be ignored. As previously noted, the most important characteristic for a property to have, as far as the foreign investor is concerned, is the ability to withstand erosion in value from inflation. To possess this characteristic an income-producing property must have the ability to adjust its rental income on a regular basis and to pass along to its tenants increases in operating expenses. This characteristic is absent in the long term net lease which is the type of investment that has dominated the real estate investment portfolios of most domestic financial institutions.44

The foreign investor has developed significant interests in shopping centers and certain types of office and industrial properties. The characteristic of a shopping center attractive to many foreign investors is the standard form of tenant lease which calls for rental payments determined in part by the sales volume of the merchant. Certain office buildings and industrial properties also provide for the ability periodically to escalate rental income, but in a different manner than the shopping center. The mechanisms commonly used in the office building are the “step” rent and short lease terms.45 While this procedure provides some protection against in-

43. See Schulweis, Foreign Investment in United States Real Estate, in 38 NYU Fed. Tax. Inst. 15-1 (1980). Long-term mortgages in Europe typically have five or ten year maturities, imposing personal liability as well as being secured by a lien on the related real estate. Consequently, it is interesting to observe the reactions of shock and disbelief of many foreign investors when initially learning of the standard practice of U.S. financial institutions to make twenty and thirty year nonrecourse, fixed interest rate mortgages. This phenomena is changing, however, due to the current condition of U.S. financing markets, resulting in U.S. real estate transactions being structured similar to traditional European arrangements. See generally Barton & Morrison, Equity Participations Between Institutional Lenders and Real Estate Developers, 12 St. Mary's L.J. 929 (1981).

44. See Roulac, Commitment of Foreign Capital to U.S. Real Property: Rationale, Objectives and Investment Processes, in ABA Section of Real Prop., Prob. & Tr. L. Conf. on Foreign Investment in U.S. Real Est. (Aug. 14, 1979). Long-term net leases providing for rentals to remain constant and for the tenant to pay all expenses are characteristic of most domestic financial institution's investment portfolios.

45. The step rent does what its name implies—periodically increases the tenant’s rent
flation, it obviously is less effective than the so-called "percentage" rent used in shopping centers.

The foreign investor appears to be a student of American demographic trends and increased emphasis on quality of life. Such lifestyle analysis, coupled with the foreign investor's preference for the viability of major cities, has led him to concentrate his investment activity in the half-dozen largest metropolitan areas and the major markets in the Sun Belt.46

The most dramatic differences in investment philosophy between the foreign and domestic investor are evident in the areas of yield expectation, degree of third-party financial leverage, and the emphasis on tax benefits and burdens. During the 1960's and early 1970's, the foreign investor acquired a reputation for paying the highest price for property, thereby altering the price structure for many segments of the real estate marketplace. Several reasons account for the foreign investor performance. As a result of his long-term experience with inflation, he was accustomed to relatively low investment yields in his homeland investments. He traditionally evaluated his return as being partially attributable to current cash yields which often are quite low, and partially to the increase in value which real estate undergoes over an investment span of centuries. Upon entering the U.S. market, he merely anticipated the same pricing structure. The foreign investor also had a desire to establish himself as an accepted element in the U.S. marketplace and was willing to pay the price of admission. Consequently, it was advantageous for American sellers of real estate to seek out the foreign investor. Furthermore, the foreign investor often was not well represented and was taken advantage of by his agents and intermediaries.

It should be noted that the foreign investor's yield parameters have undergone an evolutionary phase during the past ten years. As the foreign investor has gained greater experience in dealing in the American market and has adjusted his previous investment parameters to be more in line with conventional standards established by U.S. investors, his yield expectations, while still considerable low, are no longer markedly different from his American counterparts. In addition, the quality of representation is now a

46. See Heineman, Pursuing the Foreign Investor, 10 Real Est. Rev. 44 (1980).
significant consideration for the foreign investor. Similarly, as the foreign investor gained experience and confidence, the traditional U.S. concept of leverage—incurring third party debt to finance the purchase of property—has played a more pervasive role in transactions with foreign investors.

Income tax considerations always prevail in evaluating real estate investments. The foreign investor’s reactions to tax considerations take different forms based upon whether the foreign investor has undertaken the investment on his own or has associated with a joint venture including a U.S. taxpaying participant. A solely owned investment by a foreign investor is usually structured to minimize the imposition of U.S. income tax but not necessarily to maximize income tax losses. An investment taking the form of a joint venture with a U.S. taxpayer, however, changes its thrust to accommodate the needs of the U.S. participant for utilizing tax losses from the transaction. Conflicts may arise with respect to tax perspectives and needs which must be taken into account when structuring a particular transaction. Tax considerations are discussed later in this article.47

III. REPRESENTING THE FOREIGN INVESTOR

A. Investment Consultants

Real estate is a local business, practiced most successfully by professionals who are familiar with the economics, demographics, and customs of a particular area. Just as it is difficult to invest successfully on a national scale without good local representation, it is inadvisable to attempt international investing without competent local representation. While some foreign investors directly seek real estate brokers as a source of investment opportunities, most sophisticated foreign investors establish relationships with reputable advisors or consultants, or attempt to organize their own operations.48 The nature of the U.S. advisor, his reputation, and his relationship with the foreign investor often influences the deci-

47. The Foreign Investment Act may prompt some foreign investors for the first time to use investment tax structures resulting in the realization of tax losses.

48. European institutional money primarily is represented by U.S. affiliates of European real estate advisory firms and in limited instances, by U.S. investment or commercial banking firms. A number of international consultants also focus on foreign investment in U.S. real estate.
sion to invest or not, and how the transaction will be structured.

B. Legal Consultants

The lawyer, representing a foreign investor, is faced with special problems arising out of that relationship. Since communication is difficult and distances are great, it is essential not to take anything for granted. Further, it is important to understand and appreciate the foreigner's perceptions and salient concerns.

Often, the first contact a lawyer has with a foreign investor is through an intermediary such as a real estate broker or an investment advisor. The cautious attorney should obtain from the foreign client written instructions establishing the authority of the intermediaries. The lawyer should clarify who his client is, as well as insure that the fiduciary relationship between himself and his client is articulated clearly. Additionally, in order for the lawyer to structure a transaction properly, the nationality of the real party in interest should be ascertained.49

The lawyer's role in representing the foreign investor is multifaceted. The foreign investor, engaged for the first time in a transaction in the city in which the U.S. lawyer is located, usually relies on the lawyer for recommendations as to banking and accounting relationships. Functioning beyond his representative capacity, the lawyer often coordinates the activities of a number of advisors and professionals.

The lawyer should realize that time allowed for obtaining signatures, approving documentation, and providing funds must be lengthened considerably in light of the distances separating the parties to a transaction. In addition, complex currency transfers by foreign banks may be necessary in order to provide funds for a closing in the United States.

Many times the foreign investor is not present for either the execution of a contract of sale or the closing documents. On such occasions, the lawyer may be asked to act on behalf of the foreign investor pursuant to a power of attorney. In these instances, the lawyer should obtain detailed, written instructions from the for-

49. Intelligent tax planning requires knowledge of the investor's nationality. A lawyer also must be cognizant of potential currency law violations. The extent of a U.S. lawyer's ethical and legal responsibilities concerning violations of foreign law is a controversial and difficult subject.
A lawyer, who is not qualified to give international tax advice, should so advise the foreign client and arrange to have properly qualified tax counsel involved in the transaction from its inception. Because of the complex tax considerations and other complications which arise in a foreign transaction, a lawyer almost always spends more time in closing a transaction for a foreign investor than is normal for a U.S. investor. Pragmatically, that should be taken into account in discussing fees with the foreign client.

C. **The Contract of Purchase**

The contract of purchase should cover matters which a careful real estate lawyer would cover on behalf of a U.S. investor. Particular attention should be paid to representations and warranties obtained from the seller as to the condition of improvements, potential violations of laws, ordinances or regulations, pending assessments, and current status of notes, liens, and leases affecting the property. The lawyer should insure that the representations and warranties survive the closing of the transaction for a sufficient period of time to allow an absentee foreign investor the opportunity to become acquainted with any defects in the purchased property and to pursue appropriate recourse. In addition, the contract should provide for the delivery of notices by telex to the foreign investor and by an appropriate medium to his lawyer.

The contract of purchase should include a representation and warranty to the effect that neither the property being purchased nor any portion thereof has been utilized for agricultural purposes within five years prior to the date of the contract and a covenant that no such use will be made of the property or any portion thereof from the date of the contract through the date of closing. This is necessary in order to avoid or be cognizant of any requirement to file a report under the Agricultural Foreign Investment Disclosure Act of 1978.51

Problems may be encountered in obtaining funds in a timely

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50. Market conditions and other business factors dictate the lawyer's ability to obtain appropriate representations and warranties.
manner as a result of transfers from foreign banks. The contract specifically should provide, therefore, for payment of the cash portion of the purchase price in a manner that can be accomplished by wire transfer or by check drawn on the lawyer's trust account. Without such an advance agreement, the attorney representing the foreign investor could find himself at the closing without sufficient funds and the foreign investor in breach of his obligation on the required closing date.

Texas presently does not restrict foreign ownership of real property. A Texas lawyer representing foreign investors in other states should ascertain by inquiring of local counsel and/or independent investigation whether any possible restrictions are imposed in those states. The lawyer also may ask the local title company about the availability of "alien ownership" endorsements which give affirmative assurance against the foreign investor's title being affected adversely as a result of the foreign ownership status.52

D. State Filings

In order to have the right to transact business in Texas, a corporation chartered pursuant to the laws of another country must obtain a certificate of authority.53 A foreign corporation transacting business in Texas without a certificate of authority is liable for fees and franchise taxes which it would have paid if properly qualified.

52. Many states have no restrictions on alien ownership of real property. Restrictions imposed by some states include: (1) prohibiting the outright ownership of land by aliens with occasional exceptions for aliens residing within the state or the United States; (2) limiting amounts of land permitted to be acquired or the length of time during which aliens can hold lands; and (3) restricting ownership only with respect to aliens who are "enemies" of the United States. Although many states impose the same restrictions upon both foreign corporations and alien individuals, some statutes permit the corporate form or a land trust to be used to avoid restrictions imposed on individuals. Those states which do have separate restrictions on foreign corporations may restrict domestic corporations in which aliens hold stock. The foreign investor also should be aware that several states have enacted laws substantially restricting corporations from engaging in agricultural activities. See generally Aronst, The Virginia Land Trust—An Overlooked Title Holding Device for Investment, Business and Estate Planning Purposes, 30 WASH. & LEE L. REV. 73 (1973); Morrison, Limitations on Alien Investment in American Real Estate, 60 MINN. L. REV. 621 (1976); Nellis, Foreign Investment in United States Real Estate: Federal and State Laws Affecting the Foreign Investor, in ABA SECTION OF REAL PROP., PROB. & TR. L. CONFERENCE ON FOREIGN INVESTMENT IN U.S. REAL ESTATE (Aug. 14, 1979); Note, Foreign Direct Investment in United States Real Estate, 28 U. FLA. L. REV. 491 (1976).

53. See TEX. BUS. CORP. ACT ANN. art. 801.A (Vernon 1980).
In addition, a non-qualifying foreign corporation is required to forfeit an amount not less than $100 nor more than $5,000 for each month or fraction thereof it transacted business in Texas without a certificate. Foreign corporations whose names are unavailable and foreign partnerships must file assumed name certificates.

Every domestic and qualified foreign corporation must pay a franchise tax equal to $4.25 per $1,000, or fractional part thereof, applied to the assessed value for county ad valorem tax on the real and personal property owned by the corporation in Texas. Such taxation of a foreign corporation could be substantial since there is no provision for deduction of mortgages from the value of the property. To avoid the corporate franchise tax, it is sometimes suggested that a partnership be formed to hold legal and equitable title to the real property with two foreign corporations owning the partnership interests. While this approach may work for corporations acting as limited partners, its success is less clear for corporate general partners. Designating such general partners as non-managing partners may be helpful in this regard.

E. Use of a Netherlands Antilles Corporation

Under U.S. tax law the use of a Netherlands Antilles corporation (N.V.) is a beneficial foreign investment vehicle in many instances, due to the favorable tax treaty between the United States and the Netherlands which has been extended to the Netherlands Antilles. Furthermore, foreign investors can achieve a degree of

54. See id. art. 818.C.
57. “N.V.” stands for the words “Naamloze Venootschap.”
58. A N.V. is formed by contacting counsel or a trust company in the Netherlands Antilles, usually in Curacao. A list of appropriate Netherlands Antilles counsel may be obtained by contacting the Netherlands Antilles Economic Mission, 30 Rockefeller Plaza, Suite 3327, New York, New York 10020. If the foreign investor wishes to designate a particular name for the corporation, at least four weeks are required from the time of initial contact with counsel in Curacao before the corporation will be in a position to acquire property and conduct business. A N.V. may issue either bearer shares which are transferred by taking possession of the certificates evidencing the shares, or registered shares which are in the name of the owner and transferred by assignment document. Bearer shares may be issued only when capital equal to at least the par value of the shares has been paid. Registered shares may be issued upon the payment of capital in an amount equal to a minimum of 10%
anonymity through the use of a N.V. or other off-shore corporation. Assuming that a N.V. is the best vehicle for a foreign investor's tax purposes, the lawyer must consider the requirements of forming the N.V. and closing a real estate transaction when a N.V. is either the purchaser or a partner in a purchasing partnership. It is essential that the lawyer representing a N.V. indicate its existence to the title company very early in the transaction. Corporate documentation should be furnished well in advance of closing to the title company and any lender involved in the transaction. The lawyer representing a N.V. also should receive an opinion from a Netherlands Antilles counsel stating that the N.V. is duly incorporated, validly exists in good standing, and has the requisite power to close the transaction and perform other appropriate actions.

F. Reporting and Disclosure Requirements

Many foreign investment clients express a desire for anonymity. This desire may be for the simple purpose of protecting the privacy of the investor or, in some instances, may be based on a fear of either political or legal reprisals in the foreign investor's home country. The identity of an ultimate beneficial owner effectively may be shielded through the use of bearer shares issued by a N.V. corporation and sent from Curacao to a bank in Switzerland or elsewhere. The Foreign Investment Act, however, may make such anonymity illegal.

The Agricultural Foreign Investment Disclosure Act of 1978 of the par value of each share issued. Despite the fact that there is no legal requirement regarding minimum capitalization, the Ministry of Justice can refuse to approve a N.V. if the size of the authorized capital does not appear to be adequate in light of the purposes of the corporation as expressed in the incorporation documents. As of the date of this article, a N.V. must have a current minimum equity capitalization of $30,000 in order to engage in the real estate business. See generally Glast, Foreign Investment in Texas and Representing Foreign Investors, in ADVANCED REAL ESTATE L. COURSE (May 1980); Richards, Real Estate Counsel, Contract and Closing for the Foreign Investor, in ABA SECTION OF REAL PROP., PROB. & TR. L. CONFERENCE ON FOREIGN INVESTMENT IN U.S. REAL ESTATE (Aug. 14, 1979).

59. The corporate documentation required is similar to that required of a Texas corporation, including: (1) corporate resolutions authorizing the transaction to be closed and specifically authorizing the appointment of an attorney-in-fact if a power of attorney is to be utilized at closing; (2) a copy of the deed of incorporation of the N.V. translated in English by a sworn translator; and (3) a certificate of good standing.
FOREIGN INVESTMENT

(AFIDA), for example, requires any foreign person acquiring or transferring any interest, other than a security interest, in U.S. agricultural lands to file a report of ownership with the Secretary of Agriculture within ninety days after the acquisition or transfer. Failure to file an AFIDA report or submission of a misleading or false report results in a penalty equal to 25% of the fair market value of the interest in the agricultural land. Reports filed must be available for public inspection at the Department of Agriculture in Washington D.C. within ten days of their filing.

Similarly, the International Investment Survey Act of 1976 (Survey Ac) may cause foreign investors to lose their anonymity. The Survey Act requires a report be filed with respect to every business enterprise in which foreign persons, as individuals or as affiliates, have an interest equalling 10% or more. A foreign person or corporation investing only as a limited partner is not required to file a report. While the Survey Act provides for maintaining confidentiality of the information obtained, such assurance is of little comfort to the foreign investor desiring anonymity.

Department of Commerce, Form BE-15 requires an annual report be filed for each parcel of U.S. real property in which a 10% or greater interest is owned by a foreign person or U.S. affiliate during a calendar year. Forms BE-13A, 13B, and 14 must be filed within forty-five days following acquisition of a 10% or greater interest in any parcel of U.S. real estate by a foreign person or U.S. affiliate. If the business enterprise acquired is real property, the beneficial owner of the real property must file Form BE-13A as well as Form BE-607, an "Industry Classification Questionnaire." In addition, the foreign parent which is not the parent of a subsidiary corporation, but rather the holder of real property since real property has been defined as a business enterprise, must file Form

62. Id.
64. 15 C.F.R. § 806.15(f) (1980).
65. Id. § 806.15(g)(3)-(4).
66. Id. § 806.15(g)(1)(3)(i).
BE-13B. A foreign corporation which buys real estate in the U.S. must file Form BE-13A as the beneficial owner of the real property constituting the business enterprise and Form BE-13B as the foreign parent of the business enterprise—the real property.

Form BE-14 reports are to be filed by any U.S. person, including intermediaries, real estate brokers, business brokers, and brokerage houses assisting or intervening in the sale to, or purchase by, a foreign person of an interest which would be required to be reported on Form BE-13A or BE-13B. This requirement apparently does not include attorneys merely giving structuring or tax advice. As such, Form BE-14 need not be filed if either Form BE-13A or BE-13B is filed with regard to the transaction. In addition, any U.S. person who enters into a joint venture structured as a general or limited partnership with a foreign person to create a U.S. business enterprise must file Form BE-14 unless Form BE-13A or BE-13B is filed or is not required. Failure to file may result in civil penalties, injunctive relief, and imprisonment of up to one year for an individual or an officer, director, or agent of a corporation.

Furthermore, the Foreign Bank Secrecy Act requires any person physically transporting, mailing, or shipping currency or other monetary instruments which, by definition include securities in bearer form, into or out of the United States, to report such occurrence to the United States Treasury through the Bureau of Customs on IRS Form 4790. This filing requires name, address, nationality, passport number, and country. A recipient or shipper by mail apparently may include a U.S. attorney.

Finally, extremely large real estate transactions involving two or more companies may fall within the Hart-Scott-Rodino Act requiring filings with the Antitrust Division of the United States Justice Department and the Federal Trade Commission. This notification must be made if one company has consolidated assets or

67. Id. § 806.15(g)(3)(ii).
68. Id. § 806.15(g)(3).
69. Id. § 806.15(g)(4).
70. Id. § 806.15(g)(4)(B).
71. Id. § 806.15(g)(4)(B).
72. Id. § 806.6.
annual sales of one hundred million dollars or more and the other company has consolidated assets or annual sales of ten million dollars or more, and the acquisition exceeds fifteen million dollars in value or 15% of the stock or assets of the acquired company. If the notification is required the real estate purchase may not be closed until thirty days after the filing.

IV. U.S. TAXATION OF FOREIGN INVESTMENT

The United States allows foreign individuals to invest in U.S. property directly or through foreign or U.S. corporations, foreign or domestic trusts, partnerships, or real estate investment trusts (REITS). This section reviews the traditional tax patterns for structuring foreign investment in U.S. real estate and examines the new legislation affecting this area.

A. Taxation Under the Internal Revenue Code

Under the Internal Revenue Code (Code), domestic corporations, domestic trusts, and resident individuals are taxed in the United States on their worldwide income.75 Foreign corporations, foreign trusts, and nonresident alien individuals are taxed on their U.S. source income, not their foreign source income.76 Generally, the source of income is deemed to be the place where the income is earned.77 Once it is determined that income has an U.S. source, the income is taxed on a net basis—net of available deductions related to the earning of such income, including depreciation. See id. §§ 61, 167.

75. See I.R.C. §§ 1, 11. Domestic corporations, domestic trusts, and resident aliens investing directly or through partnerships are taxed on their worldwide income on a net basis—net of available deductions related to the earning of such income, including depreciation. See id. §§ 61, 167.
76. See id. § 871. Not all U.S. source income is taxed. See id. § 101.
77. See id. § 861. Examples of U.S. source income include: (1) compensation for services performed in the United States unless the services are performed by a nonresident alien temporarily in the United States not more than 90 days during the taxable year, and the amount earned is less than $3,000, and services are performed for a foreign employer or a foreign branch of a domestic employer, see id. § 861(a)(3); (2) rental or royalty income from property located in the United States, see id. § 861(a)(4); (3) gains from the sale of real property located in the United States, see id. § 861(a)(5); (4) gains from the sale of personal property when title passes in the United States, see id. § 861(a)(6); (5) interest income when the obligor resides in the United States unless it can be shown that less than 20% of the obligor's gross income for a three-year period was from U.S., see id. § 861(a)(1); and (6) dividend income from domestic corporations unless it can be shown that less than 20% of the corporation's gross income for a three-year period prior to the declaration of dividends was from U.S. sources, see id. § 861(a)(2). It should be noted that interest income will be deemed proportionate to the U.S. sources when the obligor is a foreign corporation and
U.S. taxation thereof depends on the income's classification as either income derived from an U.S. trade or business, income effectively connected with an U.S. trade or business, or income not effectively connected with an U.S. trade or business.  

Income derived from an U.S. trade or business is defined as income earned by a foreign investor who has considerable, continuous, or regular business activities in the United States or performs personal services within the United States for a domestic employer. Foreign individuals operating an U.S. trade or business are taxed on a net basis at graduated rates under the same general rules that an U.S. individual would be taxed on similar income. Foreign corporations and trusts are taxed on income derived from an U.S. trade or business under the same general rules as a comparable U.S. taxpayer.  

Income effectively connected with an U.S. trade or business is determined by applying one of two tests: the “assets use” test and the “business activity” test. Under the assets use test it must be determined whether the income in question was derived from assets used or held for use in the conduct of an U.S. trade or business. Under the business activity test it must be determined whether the activities of the U.S. trade or business were a material factor in the realization of income. The Code taxes income effectively connected with an U.S. trade or business in the same manner as income from an U.S. trade or business.  

more than 50% of its gross income is effectively connected with a U.S. trade or business. The U.S. source portion is equal to the proportion of the corporation’s “effectively connected” gross income to total gross income. See id. § 861(a)(1)(c). Dividends from foreign corporations, however, will be deemed U.S. source income proportionately if more than 50% of the corporation’s gross income is effectively connected with a U.S. trade or business. As with interest income, the U.S. source portion is the proportion of the corporation’s effectively connected gross income to total gross income. See id. § 861(a)(2)(B).  

78. See id. § 872.  
79. See id. § 864(b). Examples of income derived from a U.S. trade or business include income from products manufactured in the U.S., active rental operations of a U.S. apartment building, and continuous conduct of a U.S. banking business.  
80. See id. §§ 872-873.  
81. See id. § 882.  
82. See id. § 864(c)(2)(A).  
83. See id. § 864(c)(2)(B).  
Income not effectively connected with an U.S. trade or business constitutes all U.S. income of a foreign investor not otherwise defined as income effectively connected with or derived from an U.S. trade or business. Non-effectively connected income characterized as "fixed or determinable annual or periodical gains, profits, and income" is subject to a 30% withholding tax on the gross amount of income. While income such as interest, dividends, and salaries are considered "fixed or determinable annual or periodical gains," capital gains are not so considered. As a result, non-effectively connected capital gains are not taxable by the United States, unless they constitute gains of a nonresident alien present in the United States for 183 or more days in the year of sale.

The Code permits a taxpayer to elect to be taxed on a net basis for realty income. This election eliminates uncertainty about the income's tax status and avoids the undesirable flat rate withholding taxation of gross income. A net basis election for realty income, however, extends to all real property income, including capital gains which might otherwise have escaped taxation, and all U.S. real property income presently held or acquired in the future. In addition, such an election applies to other types of non-rental income such as royalties from mines or wells, and certain gains from the sale of timber.

B. Treaty Taxation

Taxation under the Code constitutes a set of unilateral rules for taxing the income of the foreign investor. Taxation under income tax treaties, on the other hand, is the result of a bilateral agreement between two countries. Treaty benefits are available only to residents of a foreign treaty country and to legal entities of the treaty country. Domestic entities owned by foreign investors normally cannot claim treaty benefits. A foreign investor can choose between taxation of U.S. source income under the applicable treaty

85. See I.R.C. § 864(c).
86. See id. § 871(a)(1).
87. See id. § 871(a)(1)(A).
89. See I.R.C. §§ 871(d)(1), 882(d)(1).
90. See Treas. Reg. § 1.871-10(b)(1).
or the Code. Influential in this decision is the fact that treaty taxation is generally more favorable to the foreign investor.92

While treaty provisions vary, it is possible to generalize about some of their more salient provisions. Wages and salaries from services performed in the United States by a treaty beneficiary usually are exempt from U.S. taxation if an individual is present in the United States less than 183 days and services are performed for a resident or company of the foreign treaty country.93 Typically, industrial or commercial profits of a treaty beneficiary are exempt from U.S. taxation unless the profits are from an U.S. trade or business operating through a permanent establishment.94 A foreign investor has a permanent establishment if he conducts active and continuous business operations through a U.S. office or other fixed place of business in the United States or through an U.S. agent.95

Most treaties provide for a reduced rate of or total exemption from U.S. taxation on U.S. source interest income, unless the income is effectively connected with an U.S. trade or business through a permanent establishment. Similarly, U.S. source dividends paid to a treaty country recipient are subject to a reduced rate of U.S. withholding tax unless the income is effectively connected with an U.S. trade or business through a permanent establishment. Treaty provisions often exempt certain outgoing dividends and interest paid by certain foreign entities from U.S. taxation, thereby overriding U.S. rules.96

It is difficult to set forth accurate generalizations about treaty provisions governing income from realty. A few treaties state that


94. “U.S. trade or business” generally has the same meaning as under the Code. See I.R.C. § 864(b).

95. See Williams, Permanent Establishment in the United States, 22 Tax. Law. 277 (1976).

96. When treaty provisions do not apply, dividends and interest paid by a foreign entity to non-U.S. recipients are subject to the 30% withholding tax when the foreign entity has a specific amount of U.S. source effectively connected income. See I.R.C. §§ 861(a)(1)(C)-(D); 861(a)(2)(B).
the United States may tax rental income up to 15% unless the rental property constitutes a U.S. permanent establishment. Other treaties provide that the country in which real estate is located (the situs country) may tax rental income according to its own rules. Some treaties provide that capital gains may be taxable by the situs country, yet expressly exclude U.S. real estate. Others give the exclusive right to tax real estate capital gains to the situs country. A few old treaties exempt capital gains completely from U.S. taxation unless the investor maintains a permanent establishment in the United States.

Often treaties allow a foreign investor to make a net basis election on his U.S. source real estate income not effectively connected with an U.S. permanent establishment. Most treaty elections are annual, which in the past has allowed net basis taxation for the operating years of the net lease real estate, and exemption from taxation in the year of sale by simply not electing net basis in that year. This planning device has been fairly well preempted, however, by the Foreign Investment Act.97

Foreign investors often establish a holding company structure in a third country having a tax treaty with the United States. This is desirable when a foreign investor's home country has no treaty with the United States or a treaty with comparably unfavorable provisions. Third country entities, however, are subject to close scrutiny by the IRS. Unless an adequate business purpose is established, the IRS may totally disregard the entity or attribute the actions of the third country entity to the foreign investor, claiming the existence of an agency relationship.98 Therefore, the foreign investor must be careful to give the third country entity significant

98. Great prominence in international finance has been given to the term “tax haven,” specifically referring to a country which imposes little or no tax on income earned domestically or in foreign countries. Foreign investors in U.S. real estate prefer structuring holding companies in tax havens which also are covered by treaty provisions allowing local entities realizing certain forms of income in the U.S. to mitigate the tax effect. In addition, a tax haven may be used to avoid limitations imposed on nationals by many economically troubled countries, including currency exchange restrictions and foreign investment regulations. In recent years the IRS has attempted to minimize the use of tax havens, most notably with its “Project Haven” which used covert activities to attack such use of a Bahamian bank. See Gordon, Tax Havens and Their Use By United States Taxpayers—An Overview (Jan. 12, 1981) (A Report to the Commissioner of Internal Revenue).
independent existence apart from himself.

C. Transfer Taxation of Foreign Investors

Foreign investors are subject to U.S. gift tax on transfers by gifts of “real and tangible personal property situated in the United States.”\(^9\) Thus, U.S. gift taxation does not reach gifts of stock in foreign or domestic corporations made by foreigners because stock is considered intangible property. The United States has gift tax treaties with very few countries. As with income tax treaties, the gift tax treaties provide an alternative scheme of gift taxation which alleviates double taxation of gifts.\(^10\)

The United States taxes the foreign investor’s estate on the value of property situated in the U.S. in which the foreign investor has an interest at the time of his death.\(^11\) This includes both U.S. realty and shares of stock in domestic corporations.\(^12\) Noteworthy is that stock in a foreign corporation is not considered situated in the United States and is not included in the estate.\(^13\) The situs of a partnership interest is considered to be the country where the partnership conducts its business. The United States has estate tax treaties with several nations, providing alternative methods of taxation designed to alleviate double taxation of estates.

D. Tax Implications of Utilizing Various Entities

U.S. real estate can be owned in a variety of different formats, each having distinct tax ramifications. The most common devices are direct holdings, domestic or foreign corporations, domestic or foreign trusts, partnerships, and real estate investment trusts.

Foreign investors can hold title to U.S. property directly and be taxed on income according to its classification under the Code or applicable treaty. U.S. source income derived and effectively connected with an U.S. trade or business is taxed on a net basis at the graduated rates which apply to U.S. individuals. Income not effectively connected is taxed on a gross basis at a flat 30\% rate. When the individual is a treaty beneficiary, the treaty may reduce the

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100. See id. § 894.
101. Id. § 2033; see id. §§ 2031, 2033.
102. See id. § 2031.
U.S. rate of taxation on U.S. income. In addition, U.S. property is subject to U.S. estate and gift taxes; direct ownership can force probate of the foreign investor's will with its accompanying expense, delay, and difficulty.

Domestic corporations owned by foreigners are taxed on their worldwide income at the regular corporate rates. Dividends or interest paid to foreign investors holding shares of domestic corporations are taxed to the extent of earnings and profits at a rate of 30% or lower treaty rate, collected by withholding at the source. Structuring part of the investor's return as interest reduces tax at the corporate level.

Prior to the enactment of the Foreign Investment Act a foreign investor not engaged in a U.S. trade or business had three primary tax-free techniques for disposing of domestic corporate property. First, he could sell the stock within or without the United States since capital gains resulting therefrom generally are not taxable by the United States. Second, he could arrange for the corporation to exchange property for other "like kind" property. The third possibility involved having the corporation sell substantially all of its assets and liquidate under section 337 of the Code. This special liquidation provision enables a corporation to avoid the corporate level tax and distribute its assets in a transaction which would be treated like a tax-free sale of stock by the foreign shareholder. A variety of other techniques utilizing the Code and treaties also were available in certain circumstances. The Foreign Investment Act, however, has preempted these alternatives for most foreign owned domestic corporations holding primarily U.S. real estate.

Foreign corporations are taxed under the Code on their source income according to the appropriate categorization. Alternatively, foreign corporations may be able to utilize appropriate

105. See I.R.C. § 337.
Dividends or interest paid by the corporation to foreign investors may be subject to withholding tax at a rate of 30% or a lower treaty rate when the outgoing dividend and interest rules apply. Prior to the enactment of the Foreign Investment Act the three methods of tax-free disposition of property discussed above were equally applicable to foreign corporations. Significant is that stock of a foreign corporation owned by an individual foreign investor still is not subject to U.S. estate or gift taxes.

The accumulated earnings tax and the personal holding company tax are penalty taxes intended to discourage the use of a corporation to avoid shareholder taxation. While these taxes potentially could apply to foreign or domestic corporations with foreign shareholders, they would not be imposed when dividends are exempted by treaty. The personal holding company tax does not apply to foreign corporations wholly owned by non-resident aliens. Domestic corporations owning real estate can avoid the personal holding company tax by insuring that net rental income exceeds 50% of other net income or by making certain dividend distributions.

Trusts are taxed in the United States according to their classification as foreign or domestic. This classification is made on the basis of a multiple factor test, including: country of creation of the trust; situs of the trust property; nationality of the trustee, grantor, and beneficiaries; and place of trust administration. An initial inquiry in dealing with foreign or domestic trusts is whether the grantor has retained so much control over the income or corpus of the trust that the trust effectively may be ignored for tax purposes. If a grantor trust exists, U.S. tax consequences generally are similar to those imposed when property is held directly.

In regular domestic trusts, the foreign beneficiaries are taxed on amounts of income required to be distributed currently and in

108. See id. § 894.
109. See id. §§ 881(a), 894.
110. See id. §§ 531, 541. Specially, tax is imposed on a corporation formed or used to accumulate earnings thereby avoiding tax on dividends.
111. See id. § 542(c)(5).
112. See id. § 541.
113. See B.W. Jones Trust, 46 B.T.A. 531 (1942).
the future under the provisions of the trust. Tax on the remainder is charged to the trust. Domestic trusts can be used to obtain deductions not otherwise available to foreign beneficiaries because beneficiaries are taxed only on distributable net income. Income distributed to beneficiaries retains its original character; thus, non-effectively connected capital gains are not taxed.\textsuperscript{116}

Foreign investors may be concerned about the possibility of nationalization of their U.S. investments by their home country. A U.S. grantor trust is one technique which may be used to improve a foreigner's position for avoiding expropriation. These trusts usually are formed as revocable trusts until the time of political emergency when they become irrevocable.

Foreign and domestic, general or limited partnerships are basically taxed under U.S. law in the same manner as their U.S. counterparts. The partnership itself does not pay U.S. tax, rather, each partner is treated as the recipient of his proportionate share of income with each item retaining its original character.\textsuperscript{116} If the partnership is engaged in an U.S. trade or business or maintains a permanent establishment, the partners will be so deemed. Thereafter, each partner's U.S. tax is determined according to the applicable U.S. law or treaty.\textsuperscript{117}

Real estate investment trust (REITS)\textsuperscript{118} are not liable for U.S. tax as long as all ordinary income and capital gains are distributed each year. Taxable income is determined on a net basis; therefore, the REIT is not required to distribute depreciation-sheltered cash to avoid taxation. Dividends from a REIT which are not effectively connected with the trade or business of foreign shareholders are subject to the 30\% withholding tax or applicable lower treaty rate.

E. The New Legislation—The Foreign Investment Act

As illustrated above, the pace of foreign investment in U.S. real estate has increased substantially. Paralleling this growth is a strong belief that U.S. tax advantages available to the foreign investor create unfair competition in the U.S. real estate market-

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\textsuperscript{115.} See id. §§ 651-652, 661-662, 671.
\textsuperscript{116.} See id. § 701.
\textsuperscript{117.} See id. §§ 701-702, 704, 875; Rev. Rul. 73-522, 1973-2 C.B. 226.
\textsuperscript{118.} A REIT is an electing organization taxable as a corporation which invests primarily in real estate and meets certain technical requirements. See I.R.C. §§ 856-859.
place. Beginning in 1978, Congress considered legislation dealing with foreign investment in real estate. Finally, on December 5, 1980, President Carter signed into law the Foreign Investment in Real Property Tax Act of 1980 (Foreign Investment Act) which created new Internal Revenue Code sections 897 and 6039C. The intent of the Foreign Investment Act is to tax nonresident aliens and foreign corporations on the disposition of U.S. real property.

1. Definitions. In order to understand the Foreign Investment Act, it is necessary to consider the definitions of several new terms.

a. United States Real Property Holding Corporation (RPHC). A RPHC is any foreign or domestic corporation having a fair market value in its United States Real Property Interests (RPI) equal to 50% or more of the fair market value of the sum of all RPIs, interests in foreign real estate, and other assets used or held for use in a trade or business—collectively referred to as “qualifying assets.” For purposes of this computation a corporation cannot include the fair market value of any passive investment other than real property interests. There is one exception to this rule. If the corporation owns a controlling interest in another corporation it must include in the fair market value of its assets a proportionate share of the fair market value of all the qualifying assets of the controlled corporation. Controlling interest means 50% or more of the fair market value of all classes of stock of the corporation, as determined by certain attribution rules.

b. United States Real Property Interest (RPI). RPI means any interest in real property located in the United States. Further, RPI means any interest, other than solely as a creditor, in a domestic corporation which is a RPHC or was a RPHC during the shorter of: (a) the five year period prior to the date of disposition,
or (b) the period since June 18, 1980, during which the taxpayer held the interest. The definition specifically excludes interests in a number of corporations qualifying as RPHCs, including certain corporations the stock of which is regularly traded on an established securities market and is held by holders of less than 5% of the class of stock listed.

c. Interest in Real Property. This term includes fee ownership and co-ownership of, leaseholds of, options to acquire, and options to acquire leases on land or improvements thereon.124 "The term 'real property' includes movable walls, furnishings, and other personal property associated with the use of real property."125

2. Relevant Provisions. Essentially, the Foreign Investment Act provides that all dispositions of a RPI by a nonresident alien or a foreign corporation are treated as effectively connected with an U.S. trade or business—taxable in the U.S. after appropriate deductions.126 Such dispositions by a partnership, trust, or estate are treated as proportionate dispositions by the partners or beneficiaries.127

Under the Foreign Investment Act, any distribution of a RPI by a foreign corporation resulting in the shareholder's receipt of a stepped-up basis in the distributed assets is taxable to the corporation to the extent the fair market value exceeds the corporation's basis in the assets.128 Effectively eliminated is the traditional procedure of having a foreign corporation sell real estate, then liquidate under section 337 and distribute the proceeds to the shareholders with no gain recognized by the shareholders.129 The corporation now must recognize the gain on sale or distribution of the assets to the shareholders, including dividends, distributions in liquidation, and redemptions.

124. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2684 (to be codified in I.R.C. § 897 (c)(6)(A)).
125. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2684 (to be codified in I.R.C. § 897 (c)(6)(B)).
126. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2682 (to be codified in I.R.C. § 897 (a)(1)).
127. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2684 (to be codified in I.R.C. § 897 (c)(4)(B)).
128. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2685 (to be codified in I.R.C. § 897 (d)(1)).
129. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2685 (to be codified in I.R.C. § 897 (d)(2)).
In general, foreign corporations must treat any gains on the disposition of a RPI as effectively connected with an U.S. trade or business in the same manner as they currently treat other effectively connected income. Nonresident aliens are subject to new rules for treating gains and losses on the disposition of a RPI in relation to their alternative minimum tax.

The law applies to dispositions after June 18, 1980. The reporting requirements under new section 6039C apply to 1980 and subsequent calendar years. Any disposition of a RPI after December 31, 1979, between related parties which is exempt from taxation under the Foreign Investment Act, results in a reduction of basis of the RPI in the hands of the distributee.

The Foreign Investment Act does not supersede contrary treaty provisions during the period ending either December 31, 1984, or two years from the date of any new treaty signed before January 1, 1985. In order for this provision to apply, there must be a direct conflict with a tax treaty. Noteworthy is that the traditional techniques for avoidance of tax on gain by Netherland Antilles corporations engaged in effectively connected rental activity are based upon provisions of the Internal Revenue Code rather than provisions of the Tax Treaty. The delayed effective date for the Foreign Investment Act, therefore, does not appear to assist most Netherland Antilles corporations engaged in real estate activity.

There are a number of reporting requirements imposed by the Foreign Investment Act. Any domestic corporation which is not publicly traded and which is, or was at any time during the four prior calendar years, a RPHC must file a report if the corporation has any foreign shareholders. If the stock of the foreign corpora-

130. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2682 (to be codified in I.R.C. § 897 (a)(1)).
131. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2682 (to be codified in I.R.C. § 897 (a)(2)).
135. Id. Pub. L. No. 96-499, § 1122(c), 2690-91.
137. Id. Pub. L. No. 96-499, § 1123(a), 94 Stat. 2688 (to be codified in I.R.C. § 6039C (a)(2)).
138. Id. Pub. L. No. 96-499, § 1123(a), 94 Stat. 2687 (to be codified in I.R.C. § 6039C (a)(1)).
tion is held by a nominee who refuses to divulge the required information to the corporation, the nominee must file the report.139

Any foreign corporation, partnership, trust, or foreign or domestic estate having a foreign person as shareholder, partner, or beneficiary whose pro rata share of all RPIs in the entity exceeds $50,000 in value, must file a separate report. When the reporting entity is a foreign corporation, it also must submit a report for any domestic person whose pro rata share of all RPIs exceeds $50,000. These returns must be filed with the IRS and a copy of the information contained in the return provided to the individual named in the return.140

Any foreign person including corporations, partnerships, trusts, and estates, owning directly more than $50,000 worth of RPIs and not otherwise required to file a return as an entity with a substantial investor, must file a return.141 For purposes of determining the $50,000 value, RPIs held by a partnership, estate, or trust are deemed to be owned proportionately by its partners or beneficiaries. RPIs owned by an individual's spouse or minor child, moreover, are deemed owned by the individual.142

The penalty for failure to file these returns is $25 a day up to a maximum of $25,000 for each return. The penalty for a foreign person cannot exceed 5% of the fair market value of the person's RPIs.143

It is extremely difficult to plan investment techniques at this time due to the absence of regulations. Furthermore, after all the hearings and legislative proposals, it is interesting to note the structure and language of the Foreign Investment Act are somewhat awkward, which raises the possibility that further changes or classifications in the Act might be forthcoming.

Significant when planning a real estate transaction for a foreign investor is the applicability of various nonrecognition provisions of

139. Id. Pub. L. No. 96-499, § 1123(a), 94 Stat. 2688 (to be codified in I.R.C. § 6039C (a)(2)).
140. Id. Pub. L. No. 96-499, § 1123(a), 94 Stat. 2688 (to be codified in I.R.C. § 6039C (b)).
141. Id. Pub. L. No. 96-499, § 1123(a), 94 Stat. 2689 (to be codified in I.R.C. § 6039C (c)).
142. Id. Pub. L. No. 96-499, § 1123(a), 94 Stat. 2689 (to be codified in I.R.C. § 6039C (e)(1)).
143. Id. Pub. L. No. 96-499, § 1123(a), 94 Stat. 2689-90 (to be codified in I.R.C. § 6039C (g)).
the Internal Revenue Code. The Foreign Investment Act has clearly eliminated the application of section 337 of the Code to foreign corporations selling U.S. real estate.144 There is a provision in the Foreign Investment Act providing that nonrecognition provisions shall apply so long as the asset for which a RPI has been exchanged would be subject to taxation under the Act upon sale.145 This would appear to preclude tax deferral by exchanging U.S. real property for foreign real property.

One planning possibility is to hold real property in a foreign corporation and sell the stock of the corporation. As a result, the gain would be locked into the corporation. Therefore, it is likely the stock would sell at a discount from the fair market value of the property thereby reflecting the capital gains tax which must eventually be paid. When the purchaser is intending to hold the property for an extended period, such a transaction profitably might be structured.

A domestic corporation owning sufficient foreign property, preventing qualification as a RPHC, also could be used. The stock of the corporation would be owned by the foreign person. When the property is sold, the foreign person would sell the stock. This would not be a sale of a RPI and, therefore, not subject to the Foreign Investment Act. The buyer would liquidate the corporation and receive the U.S. and foreign property as liquidating distributions. The foreign property then could be sold back to the foreign person or to a third party. Utilization of a tax treaty which would mandate a result contrary to the Foreign Investment Act is yet another possibility.

V. CONCLUSION

The legal and political status of foreign investment in U.S. real estate is in a state of flux. While the hysteria regarding a foreign takeover of U.S. natural resources, including real estate, seems misplaced, better information gathering clearly is in order. The Foreign Investment Act seems to be an appropriate, albeit clumsy, first step. Undoubtedly, extensive foreign investment in U.S. real

144. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2685 (to be codified in I.R.C. § 897 (d)(2)).
145. Id. Pub. L. No. 96-499, § 1122(a), 94 Stat. 2685 (to be codified in I.R.C. § 897 (e)(1)).
estate will continue, in part because of its inherent economic value, but also because inventive minds will develop investment structures designed to minimize current and future unfavorable tax treatment.