



**STRUCTURING  
FOREIGN  
INVESTMENT  
IN  
U.S. REAL ESTATE**

**W. Donald Knight, Jr.**

**Kluwer Law and Taxation Publishers**

Copyright 1982 © by Kluwer Law and Taxation Publishers

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without permission in writing from the publisher.

Requests for permission to make copies of any part of the work should be mailed to:

Kluwer Law and Taxation Publishers  
Post Office Box 23  
7400 GA Deventer  
The Netherlands

Printed in the United States of America

U.S. Library of Congress Catalog Number 82-083809  
ISBN No. 90T2752006

with love  
to  
JANE, CATHERINE and JENNIE

### *Acknowledgements*

Portions of Part I of this book appeared in a paper which the author presented to the 39th Annual New York University Institute on Federal Taxation and which was included in the Proceedings of the Institute published in 1981. These portions appear here with the permission of the Institute.

Portions of Part IV of this book appeared in a paper by the author which was published in the March, 1981 issue of *The International Business Lawyer*, the journal of the International Bar Association's Section on Business Law. These portions appear here with the permission of that journal.

*My Gratitude*

And love to my Mother.

To Jane, Catherine and Jennie, for their love and understanding — particularly needed during this project.

To some of the many who contributed their time and their considerable talent, energy, enthusiasm and expertise: William J. Wilkins, Kenneth Kraft, Robert Banta and George Lanier.

To my long-suffering partners and associates at King & Spalding.

To my excellent secretary Susan Whittaker and to the fine staff of the Word Processing Department at King & Spalding.

To Darby Printing Company, Atlanta, particularly Bill Darby and Jean Fincher.

To Kluwer Law and Taxation Publishers, particularly Fritz Hasselblad.

W. Donald Knight, Jr.  
Atlanta — December, 1982

*About the Author:*

**W. Donald Knight, Jr.**, is a partner in the law firm of King & Spalding (Atlanta, Georgia and Washington, D.C.) and is head of the firm's International Department. He has written on matters of taxes and international law for numerous publications (including The New York University Institute on Federal Taxation, The International Business Lawyer, The Journal of Taxation, Tax Management International Journal, and Recht der Internationalen Wirtschaft). Mr. Knight has spoken on those subjects in the United States and abroad, at seminars sponsored by the International Fiscal Association, The International Bar Association, The American Law Institute/American Bar Association, The New York University Institute on Federal Taxation, The University of Miami Law School, The Practising Law Institute, The World Trade Institute and others.

# TABLE OF CONTENTS

	<u>Page</u>
<b>INTRODUCTION .....</b>	<b>3</b>
<b>PART I</b>	
<b>THE TAX CONSIDERATIONS IN STRUCTURE PLANNING</b>	
<b>CHAPTER 1:</b>	
<b>THE "GROUND RULES" OF THE INTERNAL REVENUE CODE: RENTAL INCOME</b>	
<b>[1.01] Classification of Foreign Investors .....</b>	<b>11</b>
<b>[1.02] U.S. Taxation of the Income of Foreign Investors Before the FITA: The "Force of Attraction" Principle .....</b>	<b>13</b>
<b>[1.03] The Foreign Investors Tax Act .....</b>	<b>14</b>
<b>[1.04] The Pivotal Question of Whether Income is Effectively Connected with a U.S. Trade or Business of the Foreign Investor .....</b>	<b>15</b>
<b>[1.05] U.S. Trade or Business .....</b>	<b>17</b>
<b>[1.06] The "Effectively Connected" Concept .....</b>	<b>20</b>
<b>[1.07] Code Regimen for Taxation of "Non-Effectively Connected" Rentals .....</b>	<b>22</b>
<b>[1.08] Code Regimen for Taxation of Effectively Connected Rentals .....</b>	<b>23</b>
<b>[1.09] Election by Foreign Investor to Treat U.S. Real Property Rental Income as Effectively Connected Income .....</b>	<b>24</b>
<b>[1.10] The Significance of the "Non-Cash" Depreciation (Cost Recovery) Deduction .....</b>	<b>27</b>
<b>[a] Summary of the Old Depreciation System as         to Real Property .....</b>	<b>28</b>
<b>[b] Summary of the ACRS System .....</b>	<b>30</b>
<b>[c] Recapture Upon Sale of Property Subject to         ACRS .....</b>	<b>31</b>
<b>[d] Example of Cost Recovery Producing Tax-         Free Cash Flow .....</b>	<b>33</b>
<b>[e] Foreign Investor Use of Tax Losses Limited         to Sheltering Other Effectively Connected         Income .....</b>	<b>34</b>
<b>[f] Example of Impact of Recapture on ACRS         Property .....</b>	<b>34</b>
<b>[g] Choosing the Optimum Method of Cost         Recovery .....</b>	<b>36</b>



	<u>Page</u>
[1.11] Net Operating Losses of Non-Trade or Business Foreign Investors .....	37
<b>CHAPTER 2:</b>	
<b>THE “GROUND RULES” OF THE INTERNAL REVENUE CODE: SALES AND OTHER DISPOSITIONS</b>	
[2.01] Background of the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) .....	44
[2.02] The FIRPTA Regimen for Taxation of Gains from Sale or Other Disposition of “United States Real Property Interests” .....	49
[a] Taxation of Foreign Investor Real Property Gains under the FITA .....	49
[b] The Operative Tax Rule of the FIRPTA .....	51
[c] Types of Dispositions Taxable Under the FIRPTA .....	53
[2.03] Tax Rates Applicable to Gains from United States Real Property Interests .....	54
[2.04] Tax on United States Real Property Interests Applicable to Net Gains .....	60
[a] The FIRPTA Tax and Net Gains .....	60
[b] The FIRPTA Tax and Operating Losses of Non-Trade or Business Foreign Investors .....	62
[2.05] United States Real Property Interests .....	62
[a] The FIRPTA Definition of Interest in Real Property .....	63
[b] The FIRPTA Definition of Real Property ....	65
[c] Disposition of an Interest in a Partnership, Estate or Trust .....	69
[2.06] United States Real Property Holding Corporations .....	71
[a] The “Asset Mix” Test .....	72
[b] The “Look Through” Rules and the “Asset Mix” Test .....	73
[c] The “Look Through” Rules for Controlled Corporations .....	73
[d] Constructive Ownership Rules and “Controlling Interests” .....	74
[e] Non-Controlled RPHCs .....	74
[f] The “Look Through” Rules for Partnerships, Trusts and Estates .....	76
[2.07] Interests in a RPHC Solely as a Creditor .....	77
[2.08] FIRPTA Taxation of Sale of Non-Creditor Interest in a RPHC .....	79

	<u>Page</u>
[2.09] Exceptions to FIRPTA Taxation of Sale of Non-Creditor Interest in a RPHC .....	79
[a] The “Regularly Traded Stock” Exception ....	80
[b] The “Cleansed Entity” Exception .....	81
[2.10] Practical Problems Inherent in the RPHC Rules	82
[2.11] The FIRPTA Treatment of Foreign Corporations .....	84
[a] Sales of Stock; Corporate Level Tax on Distributions of United States Real Property Interests .....	84
[b] Exceptions to the FIRPTA Corporate Level Tax on Distributions of United States Real Property Interests .....	87
[c] Liquidation of Foreign Corporations Acquired During Gestation of the FIRPTA	89
[d] Tax Treatment of Pre-FIRPTA U.S. Shareholder upon Liquidation of a Foreign Corporation .....	91
[e] FIRPTA Election To Be Treated as a Domestic Corporation .....	94
[2.12] Distributions of U.S. Real Property Interests by U.S. Corporations .....	94
[2.13] Coordination of the FIRPTA and Code Nonrecognition Provisions.....	96
[a] General FIRPTA Provisions as to Nonrecognition .....	96
[b] FIRPTA Denial of Nonrecognition on Contributions to Capital of Foreign Corporations .....	100
[2.14] FIRPTA Effect on “Second Tier” U.S. Withholding Tax .....	101
[2.15] Real Estate Investment Trusts: Special FIRPTA Rules .....	102
[2.16] Enforcement of the FIRPTA Tax .....	105

### CHAPTER 3: THE EFFECT OF TAX TREATIES ON THE CODE GROUND RULES

[3.01] Real Estate Income Treaty Provisions.....	112
[a] Rental Income .....	112
[b] Real Estate Capital Gains .....	115
[c] Treaty Net Basis Elections .....	118
[3.02] Treaty Provisions Regarding Capital Gains from Property Other than Real Estate .....	121

	<u>Page</u>
[a] Treaty Protection of Gain from Sale of RPHC Stock .....	121
[b] Sale of Shares of a “Collapsible” RPHC .....	122
[c] Sale of an Interest in a Partnership, Trust or Estate .....	123
[d] Treaty Effects on the FIRPTA Rule as to REIT Capital Gain Distributions .....	124
[3.03] Dividend Income Treaty Provisions .....	126
[3.04] Interest Income Treaty Provisions .....	126
[3.05] Industrial and Commercial Profits Treaty Provisions .....	127
[3.06] Treaty Effects on Taxes Other Than Income Tax .....	132
[3.07] Using Third Country Treaties: “Treaty Shopping” .....	132
[a] Establishment of a Holding Company in an “Offshore” Treaty Country .....	132
[b] Growing U.S. Opposition to “Treaty Shopping” .....	133
[c] Avoidance of “Sham” Treaty Country Corporation .....	137
[3.08] Relationship of the FIRPTA with Tax Treaties: The “Treaty Honeymoon” Period .....	138
[3.09] Foreign Corporation FIRPTA Election to Be Treated as a U.S. Corporation .....	140
[a] Treaty Non-Discrimination Provisions and the FIRPTA Election .....	140
[b] Foreign Corporations Which Can Make the FIRPTA Election .....	144
[c] Conditions to a Foreign Corporation’s Making the Election .....	148
[d] Procedure for Making the Election .....	151
[e] Effect of Making the Election .....	152
[f] Tax Advantages of the Election .....	152
[g] Interrelationship of the Election, the Source of Income Rules and the Foreign Tax Credit Provisions .....	154
[h] Whether the Election Can Be Made After 1984 .....	156
[3.10] Related Party Transactions .....	157
[3.11] The Prospect for Post-FIRPTA Treaty Renegotiation: Learning from the Recently-Signed U.S.-Canada Treaty .....	159

**CHAPTER 4:  
LEGAL STRUCTURE ALTERNATIVES**

[4.01]	Direct Holding .....	165
[4.02]	Trusts .....	167
	[a] Domestic Trusts .....	167
	[b] Foreign Trusts .....	169
[4.03]	Partnerships—Domestic or Foreign .....	170
[4.04]	Corporations .....	173
	[a] Domestic Corporations .....	173
	[b] Foreign Corporations .....	176
	[c] Special U.S. Taxation of Corporations Used to Avoid Shareholder Level Tax .....	178
[4.05]	Real Estate Investment Trusts .....	181
[4.06]	Foreign Pension Plans .....	184

**CHAPTER 5:  
SPECIAL TAX PLANNING TECHNIQUES**

[5.01]	General Observations: Tax Planning After the FIRPTA and the ERTA .....	194
[5.02]	“Treaty Honeymoon” Period Stock Sales .....	198
	[a] Sales of Stock of a U.S. RPHC Under Protection of a General Treaty Capital Gains Article .....	198
	[b] Converting an Existing Holding Structure Into an “Open-Faced Dutch Sandwich” .....	201
[5.03]	The “Canadian Conversion” .....	202
[5.04]	Passing the RPHC “Asset Mix” Test .....	205
[5.05]	Shareholder Leveraging Loans .....	208
[5.06]	Realization of Gain at the Shareholder Level ...	213
	[a] Stock Sales Versus Corporate Level Sales: The Non-Depleted Basis of Stock .....	213
	[b] Realization of Gain at the Shareholder Level: The Favorable Rate Differential for Individual Shareholders .....	214
[5.07]	Planning Techniques Using the Code Section 897(i) Election .....	215
	[a] Realization of Gain at the Shareholder Level .....	216
	[b] Dispositions Where the Electing Foreign Corporation Is Not a RPHC .....	217
	[c] Tax-Free Exchange for Foreign Property ....	218
	[d] The Two Tier Technique to “Cleanse” a Purchased Foreign Corporation of Its Inherent FIRPTA Tax Liability .....	219

	<u>Page</u>
[e] Use of Code Section 351 for Estate Tax Planning.....	223
[5.08] Sale of Stock of Land-Holding Foreign Corporation .....	224
[5.09] Income Spreading Techniques.....	225
[5.10] Use of Netherlands Antilles Corporations .....	227
[5.11] Use of Hybrid Legal Entities.....	231
[5.12] Partnership Special Allocations .....	233
[5.13] Like Kind Exchanges for Foreign Real Property in Certain Cases .....	234
[5.14] Collapsing Pre-FIRPTA Multiple Corporations to Achieve “Consolidation” .....	236
[5.15] Use of “Twin” Corporations to Hold Real Property Separate From Otherwise Related Personalty .....	238

## CHAPTER 6: UNITED STATES ESTATE, GIFT AND GENERATION- SKIPPING TAXES

[6.01] The U.S. Estate Tax .....	242
[a] Gross Estate .....	243
[b] Deductions Used to Determine Taxable Estate .....	247
[c] Application of Rates to Taxable Estate .....	247
[d] Credits Used to Determine Tax Due .....	248
[6.02] The U.S. Gift Tax .....	249
[a] Taxable Transfers .....	250
[b] Exclusions and Deductions Used to Determine “Taxable Gifts” .....	250
[c] Application of Rates to Taxable Gifts .....	251
[6.03] The Tax on Generation-Skipping Transfers .....	252
[a] Generation-Skipping Transfers.....	253
[b] Subtractions of Exemptions and Deductions .....	254
[c] Application of Tax Rates .....	254
[d] Credits Subtracted to Determine Tax Due...	255
[6.04] Estate and Gift Tax Treaties.....	256
[6.05] Observations on Estate and Gift Tax Planning .....	256
[a] The Lack of Consistency Among the Estate, Gift and Generation-Skipping Taxes .....	256
[b] The Conflicts Between U.S. Income and Estate Tax Planning .....	258
[c] Interrelationship of U.S. Estate Tax and Home Country Death Tax .....	259

**CHAPTER 7:**

**STATE AND LOCAL TAX CONSIDERATIONS**

[7.01]	State and Local Income Taxes .....	261
[7.02]	State and Local Ad Valorem Taxes .....	262
[7.03]	State Inheritance and Estate Taxes .....	263
[7.04]	Effect of Tax Treaties on State Taxation .....	264

**PART II**

**TRANSFER OF OWNERSHIP OF U.S. REAL  
PROPERTY**

**AT THE DEATH OF A FOREIGN INVESTOR**

**CHAPTER 8:**

**TRANSFER OF OWNERSHIP OF U.S. REAL PROPERTY  
UNDER A "HOME COUNTRY" OR "U.S." WILL**

[8.01]	Impact of Conflict of Laws Rules on International Estates .....	268
[8.02]	Transfer of Ownership of U.S. Real Property at Death of Individual Foreign Investor Who Dies Intestate .....	270
[8.03]	Transfer of Ownership of U.S. Real Property of Foreign Investor Who Has a Will .....	272
[8.04]	Transfer of Ownership of U.S. Real Property Under a Foreign Investor's Home Country Will .....	274
	[a] Probate of a Will and Administration of an Estate .....	274
	[b] Place of Probate .....	276
	[c] Requirements for Admission of a Will to Probate .....	276
[8.05]	Transfer of Ownership of U.S. Real Property Under a Separate "U.S. Will" Devising a Foreign Investor's U.S. Real Property .....	278

**CHAPTER 9:**

**PLANNING TECHNIQUES TO AVOID  
U.S. PROBATE OF A WILL**

[9.01]	Concurrent Property Interests .....	284
[9.02]	Use of Foreign Property-Holding Entities .....	285
[9.03]	Inter Vivos Trusts .....	286

**PART III  
FEDERAL DISCLOSURE LAWS WITH RESPECT  
TO FOREIGN INVESTMENTS IN U.S. REAL  
ESTATE**

<b>CHAPTER 10: INTRODUCTION TO FEDERAL DISCLOSURE LAWS WITH RESPECT TO FOREIGN INVESTMENTS IN U.S. REAL ESTATE .....</b>	<b>293</b>
--	------------

<b>CHAPTER 11: RESPONDING TO FOREIGN DIRECT INVESTMENT: CURRENT FEDERAL DISCLOSURE LAWS FROM AN HISTORICAL PERSPECTIVE</b>	
<b>[11.01] Background of Foreign Direct Investment in U.S. Real Estate .....</b>	<b>299</b>
<b>[11.02] Congressional Responses to Foreign Direct Investment in U.S. Real Estate.....</b>	<b>303</b>
<b>[a] The Foreign Investment Study Act of 1974</b>	<b>303</b>
<b>[b] The International Investment Survey Act of         1976 .....</b>	<b>305</b>
<b>[c] The Agricultural Foreign Investment         Disclosure Act of 1978 .....</b>	<b>306</b>
<b>[d] The Foreign Investment in Real Property         Tax Act of 1980 .....</b>	<b>307</b>
<b>[11.03] The Evolving U.S. Policy Concerning Foreign Direct Investment in U.S. Real Estate .....</b>	<b>308</b>

<b>CHAPTER 12: DISCLOSURE OF REAL ESTATE INVESTMENTS UNDER THE INTERNATIONAL INVESTMENT SURVEY ACT OF 1976</b>	
<b>[12.01] Scope of the IISA .....</b>	<b>312</b>
<b>[a] Introduction .....</b>	<b>312</b>
<b>[b] Study of Feasibility of System to Monitor         Foreign Investment in U.S. Real Estate.....</b>	<b>313</b>
<b>[c] "Direct Investment": Real Estate Within         Scope of the IISA Survey Authority .....</b>	<b>315</b>
<b>[12.02] Statutory Framework for Direct Investment Surveys .....</b>	<b>317</b>
<b>[a] The IISA as a Mere Framework: The Broad         Discretion of the Executive Branch .....</b>	<b>317</b>
<b>[b] Confidentiality of Data Reported Under the         IISA .....</b>	<b>319</b>
<b>[c] Penalties for Failure to Comply with IISA         Requirements .....</b>	<b>319</b>

	<u>Page</u>
[12.03] Rules and Reporting Requirements: Preserving Investor Anonymity.....	321
[a] Reporting Rules Issued Under the IISA .....	321
[b] Reporting Requirements: Report Forms Initially Issued Under the IISA .....	323
[c] Reporting Requirements: 1979 Amendments .....	324
[d] Structuring Approaches After 1979 Amendments .....	325
[e] Reporting Requirements After 1981 Amendments to the IISA Rules .....	329
[12.04] Existing Reporting Forms Under the IISA.....	332
[a] Acquisition Reporting Forms .....	333
[b] Periodic Reporting Forms .....	336
[12.05] IISA Confidentiality Protections .....	338
[a] General Limitations on Public Disclosure....	338
[b] Interagency Access to Information Gathered Under the IISA .....	343
[c] Foreign Government Access to Information Gathered Under the IISA .....	344
[12.06] Other Developments Under the IISA .....	345
[12.07] Conclusion .....	348

**CHAPTER 13:  
DISCLOSURE REQUIREMENTS OF THE AGRICULTURAL  
FOREIGN INVESTMENT DISCLOSURE ACT OF 1978**

[13.01] Scope of Reporting Requirements.....	350
[a] Persons Subject to the AFIDA: The Definition of “Foreign Person”.....	351
[b] Investments Covered by the AFIDA: The Definition of “Any Interest” .....	355
[c] Property Covered by the AFIDA: “Agricultural Land”.....	357
[13.02] Information Which Must Be Reported by First Tier Owners .....	359
[13.03] Tracing Ownership .....	360
[13.04] Investigative Powers of the Secretary of Agriculture.....	361
[13.05] Penalties for Failure to Report .....	362
[13.06] Public Disclosure of Reports .....	363
[13.07] Preservation of Foreign Investor Anonymity Under the AFIDA.....	365
[13.08] Conclusion .....	369



**CHAPTER 14:**

**THE FIRPTA DISCLOSURE REQUIREMENTS**

<b>[14.01]</b>	<b>Summary of the FIRPTA Disclosure Requirements .....</b>	<b>371</b>
<b>[14.02]</b>	<b>U.S. Corporation Annual Return .....</b>	<b>375</b>
<b>[14.03]</b>	<b>Non-U.S. Corporation Entity Annual Return .....</b>	<b>378</b>
	<b>[a] Substantial Investor in U.S. Real Property .....</b>	<b>378</b>
	<b>[b] Substantial Investor Attribution Rules .....</b>	<b>380</b>
	<b>[c] Attribution Through Corporate Holdings .....</b>	<b>380</b>
	<b>[d] Attribution From Partnerships, Trusts, Estates and Certain Family Members .....</b>	<b>382</b>
	<b>[e] Effect of the FIRPTA Substantial Investor Attribution Rules .....</b>	<b>383</b>
	<b>[f] Information Required to Be Disclosed in the Return .....</b>	<b>383</b>
	<b>[g] Avoiding Disclosure by Furnishing Security to the IRS .....</b>	<b>384</b>
<b>[14.04]</b>	<b>Disclosure Statements to Substantial Investors .....</b>	<b>387</b>
<b>[14.05]</b>	<b>Passive Direct Investor Annual Return .....</b>	<b>387</b>
<b>[14.06]</b>	<b>Preservation of Investor Anonymity Under the FIRPTA .....</b>	<b>389</b>
<b>[14.07]</b>	<b>Penalties for Failure to File FIRPTA Returns ...</b>	<b>391</b>

**PART IV**

**“FAILSAFE” LEGAL STRUCTURES TO PROTECT  
U.S. ASSETS OF FOREIGN INVESTORS**

**CHAPTER 15:**

**STRUCTURES TO PROTECT U.S. ASSETS AGAINST  
THE EFFECTS OF FOREIGN POLITICAL EMERGENCIES**

<b>[15.01]</b>	<b>Areas of Concern Addressed by Political Emergency Structures .....</b>	<b>397</b>
	<b>[a] Protection of the U.S. Investment Against a “Home Country” Expropriation .....</b>	<b>398</b>
	<b>[b] Protection of the U.S. Investment Against Expropriation by a Country in Which an Offshore Holding Company Is Organized ...</b>	<b>398</b>
	<b>[c] Preservation of the U.S. Investment During Confusion Resulting from Political Emergency .....</b>	<b>399</b>
	<b>[d] Protection of the U.S. Investment Against United States “Freezing” or “Vesting” of Assets .....</b>	<b>399</b>