TAXATION OF FOREIGN INVESTMENT IN THE UNITED STATES

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

S. 192

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO EQUALIZE THE TAX TREATMENT OF DOMESTIC AND FOREIGN INVESTORS

S. 208

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO SUBJECT FOREIGN INVESTORS TO THE CAPITAL GAINS TAX ON GAIN FROM THE SALE OF REAL PROPERTY SITUATED IN THE UNITED STATES

JUNE 25, 1979

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

50-150 O WASHINGTON : 1979 HG 96-29

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TAXATION OF FOREIGN INVESTMENT IN THE UNITED STATES

MONDAY, JUNE 25, 1979

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY,
COMMITTEE ON FINANCE,
Washington, D. C.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd, Dole, Packwood, Wallop, and Chafee.

[The press release announcing this hearing and the bills S. 192 and S. 208 follow:]

[Press Release, May 14, 1979]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON TAXATION OF FOREIGN INVESTMENT IN UNITED STATES

Senator Harry F. Byrd, Jr., Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, today announced that the Subcommittee will hold a hearing on taxation of foreign investors on June 25, 1979.

The hearing will be held in Room 2221, Dirksen Senate Office Building, beginning at 9:30 a.m.

Under present law, foreign investors are generally not taxable on capital gains when they sell U.S. property. Internal Revenue Code and existing treaty provisions bear upon this result. In the Revenue Act of 1978, Congress requested a Treasury Department study and recommendations on this subject. The report, "Taxation of Foreign Investment in U.S. Real Estate," was recently submitted to Congress.

The following Senate bills, of general application, have been introduced on taxing foreign investment in the United States.

S. 208, introduced by Senator Malcolm Wallop on behalf of himself and 36 co-sponsors, which would tax foreign investors on gains from the sale of U.S. farmland and other rural land, and

S. 192, introduced by Senator Dale Bumpers, which would tax nonresident alien individuals and foreign corporations on all U.S. source capital gains.

Witnesses who desire to testify at the hearings should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, by no later than the close of business on June 14, 1979.

Legislative Reorganization Act.—Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statement must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Subcommittee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written Testimony.—Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by July 14, 1979, to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

96TH CONGRESS
1ST SESSION

S. 192

To amend the Internal Revenue Code of 1954 to equalize the tax treatment of domestic and foreign investors.

IN THE SENATE OF THE UNITED STATES

JANUARY 23 (legislative day, JANUARY 15), 1979

Mr. BUMPERS introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to equalize the tax treatment of domestic and foreign investors.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 871(a)(2) is deleted and a new section 871(a)(2) is added as follows:

"(2) In the case of a nonresident alien individual, there is hereby imposed a tax as provided by section 1201(b) upon the amount by which his gains, derived from sources within the United States, from the sale or exchange of capital assets at any time during the taxable year, exceed his losses allocable to sources within the United States, from the sale or exchange at any time during such year of capital assets. Such gains and such losses shall be determined without regard to section 1202 (relating to deduction for capital gains) and such losses shall be determined without the benefits of the capital loss carryover provided in section 1212. Any gain or loss which is taken into account in determining the tax under paragraph (1) of this subsection or subsection (b) shall not be taken into account in determining the tax under this paragraph.".

(b) That section 881(a) is amended by deleting the word "and" at the end of subparagraph 3(c), by adding the word "and" at the end of paragraph (4) and by adding new paragraph (5) as follows:

"(5) gains described in section 1222(11),".

96TH CONGRESS
1ST SESSION

S. 208

To amend the Internal Revenue Code of 1954 to subject foreign investors to the capital gains tax on gain from the sale of real property situated in the United States.

IN THE SENATE OF THE UNITED STATES

JANUARY 24 (legislative day, JANUARY 15), 1979

Mr. WALLOP (for himself, Mr. BAKER, Mr. BAUCUS, Mr. BAYH, Mr. BELLMON, Mr. BURDICK, Mr. CANNON, Mr. CHURCH, Mr. COCHRAN, Mr. CRANSTON, Mr. CULVER, Mr. DANFORTH, Mr. DECONCINI, Mr. DOMENICI, Mr. EXON, Mr. GOLDWATER, Mr. HART, Mr. HATCH, Mr. HAYAKAWA, Mr. HEINZ, Mr. HOLLINGS, Mr. JEPSEN, Mrs. KASSEBAUM, Mr. LUGAR, Mr. MCCLURE, Mr. MCGOVERN, Mr. MELCHER, Mr. MORGAN, Mr. NELSON, Mr. SASSER, Mr. SCHMITT, Mr. STEVENS, Mr. STONE, Mr. TOWER, Mr. YOUNG, Mr. ZORINSKY, and Mr. THURMOND) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to subject foreign investors to the capital gains tax on gain from the sale of real property situated in the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

I—E●

SECTION 1. TAXATION OF NONRESIDENT ALIENS, ESTATES, TRUSTS, PARTNERSHIPS, AND FOREIGN CORPORATIONS ON GAINS FROM THE SALE OF FARM LAND AND OTHER RURAL LAND IN THE UNITED STATES.

(a) GAIN FROM SALE OF FARMLAND TREATED AS EFFECTIVELY CONNECTED INCOME.—Paragraph (2) of section 871(b) of the Internal Revenue Code of 1954 (relating to determination of gross income of nonresident alien individuals which is connected with United States business) and paragraph (2) of section 882(a) of such Code (relating to determination of taxable income of foreign corporations which is connected with United States business) are each amended to read as follows:

"(2) DETERMINATION OF TAXABLE INCOME.—In determining taxable income for purposes of paragraph (1)—

"(A) gross income includes only gross income which is effectively connected with the conduct of the trade or business within the United States, and

"(B) there shall be treated as gross income which is effectively connected with the conduct of a trade or business within the United States—

"(i) gain from the sale or exchange of real property located in the United States which is—

"(I) land used in farming (as defined in section 180(b)),

"(II) land suitable for use in farming (as defined in section 182(c)(2)), or

"(III) land in a rural area (within the meaning of paragraph (7) of section 306(a) of the Consolidated Farm and Rural Development Act (7 U.S.C. 1926(a)(7)), and

"(ii) that portion, in excess of $3,000 for the taxable year, of the gain from the sale or exchange of stock in a corporation, or interest in a partnership, trust, or estate determined by the Secretary to be properly attributable to—

"(I) the net unrealized appreciation in land described in clause (i) which is held by such corporation, partnership, trust, or estate, and

"(II) in the case of the sale or exchange of stock in a corporation, an amount equal to the gain, if any, realized by such corporation on the sale of property described in this paragraph which was not recognized by that corporation under section 337.".

(b) WITHHOLDING OF TAX.—

(1) NONRESIDENT ALIEN INDIVIDUALS.—The first sentence of section 1441(b) of such Code (relating to withholding of tax on nonresident aliens) is amended by inserting "gains subject to tax under section 871(b)(2)(B)" after "section 871(a)(1)(D),".

(2) FOREIGN CORPORATIONS, PARTNERSHIPS, ESTATES, AND TRUSTS.—Subsection (a) of section 1442 of such Code (relating to withholding of tax on foreign corporations) is amended—

(A) by striking out "and" immediately after "881(a)(4),", and

(B) by inserting "and the reference in section 1441(b) to section 871(b)(2)(B) shall be treated as referring to section 881(a)(2)(B)," after "sections 881(a) (3) and (4)".

SEC. 2. REPORTS BY FOREIGN CORPORATIONS HOLDING UNITED STATES FARM AND OTHER RURAL PROPERTY.

(a) IN GENERAL.—Subpart A of part III of subchapter A of chapter 61 of the Internal Revenue Code of 1954 (relating to information concerning persons subject to special provisions) is amended by inserting after section 6039B the following new section:

"SEC. 6039C. INFORMATION CONCERNING CERTAIN HOLDINGS OF UNITED STATES PROPERTY BY FOREIGN CORPORATIONS.

"Every corporation, 20 percent or more of the value of the assets of which at any time during the taxable year is attributable to land described in section 882(a)(2)(B)(i), shall make a return for the taxable year setting forth such information, as the Secretary may by regulation prescribe for the purpose of enforcing sections 871 and 882. Any return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012.".

(b) CLERICAL AMENDMENT.—The table of sections for such subpart is amended by inserting after the item relating to section 6039B the following item:

"Sec. 6039C. Information concerning certain holdings of United States property by foreign corporations.".

SEC. 3. EFFECTIVE DATE.

The amendments made by this Act shall apply with respect to sales and exchanges occurring after February 28, 1978.

Senator BYRD. The committee will come to order.

The subcommittee today will consider measures designed to make the capital gains tax treatment of foreign investors equivalent to the taxation of Americans. S. 208, introduced by the Senator from Wyoming, Mr. Wallop, and cosponsored by 36 other Senators, requires that foreign investors pay a capital gains tax upon the sale of American agricultural land.

S. 192, sponsored by the Senator from Arkansas, Mr. Bumpers, imposes a capital gains tax upon the sale of any capital asset held by a foreign investor.

Last year in the Revenue Act of 1978, the Senate approved a measure similar to S. 208 which Senator Wallop and 52 other cosponsors introduced. In the conference, the conferees agreed to a study of this very important measure.

In May of 1979, the Treasury Department issued a report pursuant to the Revenue Act of 1978. These hearings today will focus upon the Treasury report and consider recommendations for future congressional action.

Senator WALLOP. Mr. Chairman?

Senator BYRD. Senator Wallop, do you have a statement?

Senator WALLOP. I do have a statement and I also have one from Senator Bayh which he asked be made a part of the record.

Senator BYRD. Yes.

[The statement of Senator Birch Bayh follows:]

PREPARED STATEMENT OF SENATOR BIRCH BAYH

Thank you, Mr. Chairman. I commend you on holding these hearings, the strong bipartisan sponsorship that this bill has received from some 40 of our colleagues clearly shows that the Nation is eager for the type of legislation we are examining here. I hope that the passage of this bill into law will mark the initial step in legislative efforts to protect American farmers from the economic power of wealthy outside investors.

As a cosponsor of S. 208, I, of course, strongly urge its passage. But I question whether it goes far enough toward slowing foreign investment in farmland. With all the difficulties facing the independent American farmer, I strongly believe that foreign speculators should be banned from investing in our farmland. The slight benefit to out Nation in the international balance of payments is far outweighed by the detrimental effects of land inflation, land concentration and the ecological abuse of prime farmland by foreign investors seeking nothing more than a quick return on their money.

Of course it would be rash to try to pin the entire blame on foreigners for the raging land inflation in our country, but there is little question that such purchases have fueled the price rise in specific localities. Armed with an exemption from our capital gains taxes and a charter of incorporation from such tax-exempt countries as the Netherlands Antilles, foreign buyers can pay up to 50 percent more for farmland than the American farmer and still reap the same financial return. In Georgia, a spot check by the GAO found that foreign buyers were paying from $150-$2,000 more per acre of agricultural land than domestic buyers. The passage of S. 208 would ease the crunch on our farmers caused by land prices which have been pushed far above those justified by the potential agricultural return on the land.

The figures on the amounts of land owned by foreigners are quite misleading. Foreigners are sound investors; they purchase only prime farmland with easy access to market transportation. Moreover, the figures themselves are so divergent as to be almost useless—the American Real Estate Exchange, the Nation's largest realtor to foreign clients, estimates that foreign buyers were behind 40 percent of U.S. land sales in 1977 and as high as 60 percent of the sales in some areas like California. On the other hand, a study earlier this year by the USDA claimed that foreigners were involved in only 2.25 percent of farmland purchases from January 1977 through June 1978. Experts I have spoken with believe that the results of the New Foreign Agricultural Investment Disclosure Act will settle few of these discrepancies due to the foreign buyers' use of front purchasers, dummy corporations, and other hidden devices. But most disturbing, regardless of the precise amount of land presently held by foreigners, is the obvious trend. As the dollar continues to sink on foreign markets and as political instability abroad threatens established wealth, American farmland will remain a continually more attractive investment. There is no doubt that we will see increased alien purchases of farmland, perhaps our Nation's most precious natural resource.

My colleagues in the Senate should not, however, allow the more politically attractive target of foreign investment to turn our heads from the most serious threat to the family farms of the United States—absentee and corporate investment by concentrations of domestic wealth. It is a much more difficult problem to deal with; our legislative efforts will be challenged by the very wealth and power that is causing hundreds of farms to close down each week and making it almost impossible for a young man or woman to get a start in farming.

In May of this year, I chaired hearings before the Judiciary Committee Subcommittee on Antitrust and Monopoly on S. 334, the Family Farm Antitrust Act of 1979. This bill would limit investment in farmland by large concentrations of domestic wealth, ban foreign speculation in U.S. farmland and establish an annual registration system for wealthy owners of agricultural land. At the hearings, rural sociologists and local farm leaders praised the bill as a valuable start toward a new American agricultural policy designed to protect the family farm and prevent the monopolization of the $150 billion food industry by large conglomerates. Another day of hearings will be held on July 17 at which time the subcommittee will hear from representatives of the four major farm organizations and from prominent agricultural economists.

I am excited about both these pieces of legislation. The 96th Congress will have performed a great service to the farmers and consumers of our Nation if it passes both bills. I urge my colleagues to carefully study S. 208 and S. 334. I think you will come to the same conclusions as I, that the Nation can no longer afford to ignore the increasing absentee control of our Nation's vital agricultural lands.

Senator WALLOP. Mr. Chairman, first let me thank you for holding these hearings. I think the issue of foreign investment in the United States has drawn the attention of the public and other committees of Congress. I am pleased that the Senate Finance Committee is taking the time to take a closer look at the tax questions involved in this important issue.

The Senate is already familiar with the tax problems associated with foreign investment and there is no doubt regarding the sentiments in Congress toward the taxation of foreign investors in U.S. real property. Last year 52 Senators cosponsored an amendment to the Revenue Act of 1978 which would tax foreign investors on capital gains from the sale of U.S. farmlands. The amendment was dropped in conference with the House but the understanding and sentiments toward this issue have greatly changed since last year.

As we will hear from my good friend from Iowa, Congressman Charles Grassley, there is strong support in the House of Representatives for taxing foreign investors on capital gains from the sale of U.S. farmland.

Interest in the foreign investment issue stems in part from the recent size and rate increase of foreign investments in the United States. The Commerce Department's Office of Foreign Investment in the United States identified 158 foreign purchases of U.S. real estate in 1978 valued at $1.1 billion. And in 1977 and 1978, foreign investors were purchasing U.S. agricultural land at a rate of 560,000 acres per year.

A recent Treasury study indicates that the average farm purchase by a foreign buyer was worth about $1.1 million, which is six to seven times as high as the average domestic purchase.

More information on the extent of foreign ownership of U.S. real estate will soon be available when the GAO completes a study that was requested by the Senate Agricultural Committee.

I would like to commend Senator Talmadge for requesting this investigation and thank him for his suggestion that the GAO study be made part of the record for this hearing.

[The material referred to follows:]

CHAPTER 3

NATIONALITIES AND TAX ADVANTAGES

OF FOREIGN PURCHASERS

The 224 foreign purchases of agricultural land in the review counties during the 18-month period involved 173 foreign purchasers. They were affiliated with at least 30 different foreign countries. In some cases, we were unable to identify the specific country involved. In other cases, the investors-of-record were actually firms owned by individuals or firms from other countries. Although most purchasers' agents or attorneys were very helpful in providing ownership information, some would not go beyond admitting that the purchasers were European or foreign and some refused to provide any information on the subject.

FOREIGN AFFILIATIONS OF PURCHASERS OF AGRICULTURAL LAND IN REVIEW COUNTIES

The foreign affiliations of the 173 purchasers-of-record are shown in the following table.

	Acres purchased		Transactions	
Foreign affiliation	Number	Percent of total (note f)	Number	Percent of total (note f)
Netherlands Antilles	89,860	36.2	52	23.2
Belgium	34,792	14.0	3	1.3
West Germany	22,989	9.3	30	13.4
France	12,665	5.1	11	4.9
Switzerland	11,825	4.8	12	5.4
Europe (country not identified)	8,467	3.4	11	4.9
Austria	8,428	3.4	1	0.4
Canada	8,269	3.3	39	17.4
Venezuela	7,967	3.2	1	0.4
Great Britain	6,583	2.7	6	2.7
Liechtenstein	6,582	2.7	3	1.3
Netherlands	5,842	2.4	10	4.5
Mexico	5,190	2.1	4	1.8
Switzerland, West Germany, and Canada (note a)	5,179	2.1	3	1.3
Singapore	2,755	1.1	1	0.4
Luxembourg	2,641	1.1	1	0.4
Sweden	2,452	1.0	2	0.9
Hong Kong	1,547	0.6	3	1.3

Foreign affiliation	Acres purchased Number	Acres purchased Percent of total (note f)	Transactions Number	Transactions Percent of total (note f)
Italy	922	0.4	3	1.3
Bahamas	578	0.2	4	1.8
Liechtenstein, Panama, Canada, and Switzerland (note b)	355	0.1	4	1.8
Cayman Islands	214	0.1	1	0.4
Iran	213	0.1	3	1.3
Japan	202	0.1	1	0.4
Philippines	197	0.1	3	1.3
Denmark	153	0.1	1	0.4
Australia	107	(d)	2	0.9
Panama	95	(d)	1	0.4
South Africa	90	(d)	1	0.4
Japan and France (note c)	86	(d)	1	0.4
India	78	(d)	1	0.4
Spain	64	(d)	1	0.4
Taiwan	59	(d)	1	0.4
Turkey	38	(d)	1	0.4
Indonesia	26	(d)	1	0.4
Country unknown	636	0.3	1	0.4
Total	248,146	e/100.0	224	e/100.0

a/Foreign-owned partnership comprised of German, Swiss, Canadian, and U.S. citizens.

b/Foreign-owned corporation comprised of Panamanian, Liechtenstein, Swiss, and Canadian citizens.

c/Foreign-owned corporation comprised of Japanese and French citizens.

d/Less than 0.1 percent.

e/Numbers do not add due to rounding.

f/Percentages based on projected data could differ.

Some of the countries and territories listed above are known as tax havens because residents of and firms incorporated in these areas have particularly attractive tax advantages regarding their investments in the United States. These so-called tax havens include the Netherlands Antilles, Switzerland and Liechtenstein. While we did not inquire further into the ownership of the Swiss and Liechtenstein investors, we did obtain additional information on the Netherlands Antilles purchasers.

One of our purposes in following up on the ownership of the Antillean purchasers was to determine whether concerns expressed by various individuals and sources that Arab interests may be buying U.S. agricultural land were well-founded. As the following section shows, we did not obtain any information showing that Arab interests were involved in any of the Antillean purchasers.

Purchases by Netherlands Antilles corporations

As the table on pages 20 and 21 shows, Netherlands Antilles purchasers bought more acreage than any other foreign purchasers--89,860 acres, or 36.2 percent. These purchasers accounted for 45 of the 173 purchasers-of-record. The Netherlands Antilles--two groups of islands in the West Indies--are part of the Kingdom of the Netherlands. The islands are covered by an income tax treaty with the United States under which Netherlands Antilles corporations are entitled to certain tax benefits with respect to income derived from sources within the United States. (See pp. 31 and 32.)

It is very difficult to determine the true ownership of Antilles corporations. Antillean law allows shareholders of investment corporations to remain anonymous. This is advantageous to owners who may desire anonymity for various reasons. The president of a large real estate exchange which functions as a clearinghouse for foreign investors looking for U.S. property told us, for example, that investors from some foreign countries frequently buy property through Swiss banks and large law firms and incorporate in offshore tax havens such as the Netherlands Antilles. He said that such purchasers usually do not publicize their investments in countries other than their own because of possible legal repercussions of their countries' currency control laws.

Through the cooperation of agents and attorneys for Antillean corporations and other sources, we obtained information on the nationality, but not identity, of most of the corporations' owners. The Antillean firms that bought the most acreage (60 percent of the 89,860 acres bought by Antillean firms) were owned by Swiss and Belgian investors, as shown on the following page.

Residence and/or nationality of owners	Purchases by Netherlands Antilles corporations: Acres: Number	Acres: Percent of all foreign purchases	Transactions: Number	Transactions: Percent of all foreign purchases
Switzerland	28,181	11.4	5	2.2
Belgium	25,488	10.3	3	1.3
Italy	12,096	4.9	8	3.6
France, Italy, or West Germany (note a)	10,603	4.3	15	6.7
Liechtenstein	4,772	1.9	1	0.4
Netherlands	4,313	1.7	6	2.7
Hong Kong	1,247	0.5	2	0.9
Spain	479	0.2	1	0.4
Europe (country not identified)	459	0.2	1	0.4
Country unknown	2,222	0.9	10	4.5
Total	89,860	b/36.2	52	b/23.2

a/The agent who represented the 11 Netherlands Antilles corporations that made these 15 purchases told us that each corporation was owned by an individual, family, or group of friends from either France, Italy, or West Germany. He would not associate any corporation with a particular country.

b/Numbers do not add due to rounding.

Combining the results of this analysis with the data in the table on pages 20 and 21 shows that six Belgian purchasers actually bought the most agricultural land--60,280 acres, or 24.3 percent--with Swiss purchasers being second--40,006 acres, or 16.1 percent. A revised ranking of the foreign affiliations of the purchasers buying more than 1,000 acres of U.S. agricultural land is shown on the next page.

Foreign affiliation	Acres purchased Number	Acres purchased Percent of total	Transactions Number	Transactions Percent of total
Belgium	60,280	24.3	6	2.7
Switzerland	40,006	16.1	17	7.6
West Germany	22,989	9.3	30	13.4
Italy	13,018	5.2	11	4.9
France	12,665	5.1	11	4.9
Liechtenstein	11,354	4.6	4	1.8
France, Italy, or West Germany	10,603	4.3	15	6.7
Netherlands	10,155	4.1	16	7.1
Europe (country not identified)	8,926	3.6	12	5.4
Austria	8,428	3.4	1	0.4
Canada	8,269	3.3	39	17.4
Venezuela	7,967	3.2	1	0.4
Great Britain	6,583	2.7	6	2.7
Mexico	5,190	2.1	4	1.8
Switzerland, West Germany, and Canada	5,179	2.1	3	1.3
Country unknown	2,858	1.2	11	4.9
Hong Kong	2,794	1.1	5	2.2
Singapore	2,755	1.1	1	0.4
Luxembourg	2,641	1.1	1	0.4
Sweden	2,452	1.0	2	0.9

The Netherlands Antilles corporations bought agricultural land in six States (Arkansas, California, Georgia, Illinois, Montana, and Texas). Most of the land they purchased was in Montana (52,900 acres), California (26,356 acres), and Texas (7,029 acres). These purchases accounted for more than half of the total acres of foreign-bought agricultural land in the review counties in Montana and California and almost half of the acres purchased in Texas.

--Of the seven Netherlands Antilles corporations which purchased the 52,900 acres in Montana, three were Belgian-owned firms which bought 25,488 acres and four were Swiss-owned firms which bought the other 27,412 acres.

--Thirty-two Netherlands Antilles corporations purchased the 26,356 acres in California. Of these, 8 were Italian-owned firms which bought 12,096 acres and 11 were German, French, or Italian-owned firms (we had no further breakdown) which bought 10,603 acres. We could not identify the nationalities of the owners of nine other corporations that bought 1,182 acres. The owners of the remaining four corporations were from Hong Kong or Europe.

--Two Netherlands Antilles corporations purchased the 7,029 acres in Texas. One, a Netherlands-owned firm, bought 2,257 acres; the other, a Liechtenstein-owned firm, bought 4,772 acres.

Ownership of the Netherlands Antilles firms which bought agricultural land in the other three States was as follows:

	Acres
Arkansas:	
One Spanish-owned firm	479
Georgia:	
One Netherlands-owned firm	1,509
One firm--owner's nationality unknown	1,040
Total	2,549
Illinois:	
One Netherlands-owned firm	547

Foreign affiliations of purchasers by State

The greatest numbers of different nationalities were represented by foreign purchasers in 4 of the 10 States--Arkansas, California, Georgia, and Washington. A listing, by State, of the countries and purchased acreage follows. (For this listing, the owners of the Netherlands Antilles corporations are included according to their country of residence or nationality.)

State and foreign affiliation	Foreign purchases Acreage	Percent of total
Arkansas:		
West Germany, Canada, and Switzerland	5,179	42
Luxembourg	2,641	22
Netherlands	2,374	19
West Germany	960	8
Switzerland	500	4
Spain	479	4
France	168	1
Total	12,301	100
California:		
Italy	12,254	27
France, West Germany, and Italy (note a)	10,603	23
Liechtenstein	6,582	14
Europe	3,398	7
West Germany	3,324	7
Hong Kong	2,794	6
Canada	2,020	4
Country unknown	1,182	3
Switzerland	1,016	2
Belgium	620	1
Bahamas	578	1
Mexico	350	(b)
Cayman Islands	214	(b)
Netherlands	172	(b)
Iran	133	(b)
Panama	95	(b)
India	78	(b)
Spain	64	(b)
Taiwan	59	(b)
Great Britain	46	(b)
Turkey	38	(b)
Total	45,620	c/100

State and foreign affiliation	Foreign purchases Acreage	Percent of total
Georgia:		
France	10,004	23
Austria	8,428	19
Europe	5,528	13
West Germany	4,416	10
Great Britain	3,253	8
Switzerland	3,047	7
Singapore	2,755	6
Sweden	2,452	6
Country unknown	1,676	4
Netherlands	1,509	4
Australia	107	(b)
South Africa	90	(b)
Total	43,265	c/100
Illinois:		
Netherlands	818	56
Italy	637	44
Total	1,455	100
Iowa:		
West Germany	302	42
Great Britain	272	37
Denmark	153	21
Total	727	100
Kansas:		
West Germany	5,264	64
France	2,493	31
Switzerland	332	4
Iran	80	1
Total	8,169	100
Montana:		
Belgium	59,660	62
Switzerland	27,412	28
Venezuela	7,967	8
West Germany	1,160	1
Canada	30	(b)
Total	96,229	c/100

State and foreign affiliation	Foreign purchases Acreage	Percent of total
Pennsylvania:		
Great Britain	3,012	68
West Germany	1,302	29
Italy	127	3
Total	4,441	100
Texas:		
West Germany	6,261	38
Liechtenstein	4,772	29
Netherlands	4,514	27
Switzerland	1,086	7
Total	16,633	c/100
Washington:		
Switzerland	6,613	34
Canada	6,219	32
Mexico	4,840	25
Netherlands	768	4
Switzerland, Panama, Canada, and Liechtenstein	355	2
Japan	202	1
Philippines	197	1
France and Japan	86	(b)
Indonesia	26	(b)
Total	19,306	c/100
Total	248,146	

a/No breakout by specific country.

b/Less than 1 percent.

c/Numbers do not add because of rounding.

TAX INCENTIVES FOR FOREIGN INVESTMENT IN U.S. AGRICULTURAL LAND

Foreign investors who buy U.S. real property, including agricultural land, have certain U.S. tax advantages not available to U.S. citizens who may wish to invest in that same property. We did not obtain information on the extent to which any taxes required to be paid to the foreign country involved may offset the advantages available to foreign investors under U.S. tax laws and regulations.

The key determinant for U.S. income tax purposes is whether or not U.S. source income derived from the foreign source investment capital is considered to be effectively connected with a U.S. trade or business. This problem is discussed in a recent Treasury Department report 1/ on the tax treatment of income from, or gain or loss realized on the sale of, an interest in U.S. property owned by nonresident aliens and foreign corporations.

Under U.S. law, if a nonresident alien or foreign corporation purchases U.S. real property and operates the property as a business, income derived from the investment (including capital gains) is taxed by the United States on a net basis and at rates applicable to U.S. taxpayers.

Capital gains realized by nonresident aliens and foreign corporations on the sale of U.S. investment property are not subject to U.S. tax if such gains are not "effectively connected" with a U.S. trade or business. Ordinary, "non-effectively connected" income from the investment property is taxed on a gross basis (without allowable business deductions) at a flat rate of 30 percent or at a lower rate if permitted by a tax treaty between the United States and the foreign country. With respect to ordinary income, the difference between a tax based on gross income and a tax based on that same income less allowable deductions can be substantial. If a foreign investor is not engaged in a U.S. trade or business, the investor may elect to have income from the U.S. investment property (such as payments

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1/"Taxation of Foreign Investment in U.S. Real Estate," Department of the Treasury, May 4, 1979. A summary of this report was included in a Joint Committee Print on Tax Treatment of Foreign Investment in the United States, prepared for the use of the Senate Committee on Finance by the staff of the Joint Committee on Taxation, June 22, 1979.

received under a sharecropping or lease arrangement) taxed on a net basis as if it were effectively connected with a U.S. trade or business. This election is usually irrevocable if made under the Internal Revenue Code. It is annual if made under the Netherlands Antilles treaty.

The Treasury report concluded that, although most foreign investment in U.S. real estate either constitutes a U.S. trade or business or, at the election of the taxpayer, is taxed as if it were, foreign investors rarely incur a capital gains tax on the sale or disposition of their property holdings. The evidence is that foreign taxpayers are adept at using the various planning techniques available under present law which allow them to avoid the capital gains tax. Some of these techniques are as follows:

1. Foreign investors who are engaged in a U.S. trade or business may sell their U.S. real property on an installment basis and postpone receiving most or all of the payments until later years when they are no longer engaged in a trade or business. Any gain attributable to the payments in the years after the sale is not treated as effectively connected with a trade or business and therefore is not taxed.

2. Foreign investors may generally exchange U.S. real property held for productive use or investment for other property of a like kind, without recognizing any capital gain. If the property acquired in the exchange is located outside the United States, the capital gain realized on the subsequent sale of that property would not be subject to U.S. tax.

3. Foreign investors may invest in U.S. real estate through a real estate holding company incorporated outside the United States and avoid paying a capital gains tax on the sale of the real estate by the company or on the sale of the stock of the company by the foreign investor. One of the following two planning techniques would ordinarily be used.

   First, if the real estate holding company sells the property and liquidates within 1 year, distributing the sales proceeds to the foreign shareholders, the capital gain realized by the company is not recognized for U.S. tax purposes.

Also, the shareholders would generally not be taxed on the gain when they exchanged their stock in liquidation for the sales proceeds of the real property because the shareholders are not considered to have been engaged in a U.S. trade or business by reason of their stock ownership.

Second, if the foreign investors sell their stock in a foreign real estate holding company which owns U.S. real estate, they are not subject to U.S. tax on the gain realized since the sale of the stock does not give rise to U.S. source income.

4. Many U.S. tax treaties with foreign countries permit foreign investors who are not engaged in a U.S. trade or business, but who elect to have their U.S. real estate income taxed on a net basis, to revoke that election in the year in which the real estate is sold. This means that with proper planning, foreign investors can elect to have income from their U.S. investment taxed on a net basis while the investment increases in value, and then revoke the election in the year they sell their land to avoid paying a capital gains tax.

The Netherlands Antilles tax treaty

Firms and individuals doing business through the Netherlands Antilles have the following tax advantages regarding their investments in the United States.

--The Antilles profits tax on business income earned in the United States by Antilles firms is generally imposed at an effective rate of only 2 or 3 percent.

--The Antilles has no estate, gift, or inheritance tax and no tax on capital gains, dividends, interest, or Antilles-source investment income paid to nonresidents.

--The Antilles tax treaty with the United States allows for reduced U.S. taxes on income not connected with a U.S. trade or business by allowing foreign investors to elect annually whether to have the income taxed net of deductions.

--The Antilles allows residents of other countries to incorporate in the Antilles and thereby take advantage of its tax treaty provisions with the United States. Consequently, investors from countries that have no tax treaties with the United States or whose tax treaties do not provide for an annual net basis election can substantially reduce their taxes on income and capital gains from their U.S. investments by incorporating in the Antilles and making the net basis election.

--The Antilles allows its corporations to keep secret the identity of their shareholders. This makes it possible for investors from other countries that may have strict laws limiting investment of capital in foreign countries to circumvent such restrictions by incorporating in the Antilles.

Further details on the taxation of foreign investments in U.S. agricultural land and other real estate are discussed in the Treasury report.

SUMMARY AND CONCLUSIONS

Various individuals and sources have expressed concern that Arab interests may be buying U.S. agricultural land. We did not find this to be the case although we recognize that we did not probe beyond the nationality of the first level of ownership except in the case of the Netherlands Antilles firms. Most of the foreign-bought acreage was bought by Western European purchasers. The motives and other information regarding these purchases are discussed in the next four chapters.

The largest acreage of foreign-bought agricultural land was purchased by Netherlands Antilles firms which appear to have distinct tax advantages over U.S. purchasers. Other foreign purchasers also may have tax advantages in their U.S. property investments. Without considering any possible broader implications of such action, we believe that elimination of tax advantages available to foreign, but not U.S., investors would eliminate one of the factors that may be inhibiting potential U.S. purchasers from effectively competing with potential foreign purchasers of U.S. land. The Department of the Treasury favors elimination of these tax advantages to foreign investors. According to Treasury's report, taxing capital gains on the sale of U.S. agricultural land alone would raise U.S. Treasury revenues by an estimated $22 million in 1979; taxing capital gains on all U.S. real estate sold by foreign taxpayers would raise Treasury revenues by $142 million. The report states that the balance of payments impact of such action cannot be estimated with any precision but would probably be relatively small.

Two bills introduced in the 96th Congress (S. 208 and H.R. 3106) would generally subject to U.S. tax the capital gains of foreign investors from the sale of farmland, land suitable for farming, or rural land. Another bill (S. 192) would tax nonresident alien individuals and foreign corporations on their capital gains on all U.S. property--real estate, stocks, bonds, and so forth. Hearings were held on S. 208 and S. 192 in June 1979.

Senator WALLOP. There is much information left uncovered regarding the nature and extent of foreign investment in the United States. This committee cannot concern itself with the wide range of issues surrounding foreign investment nor can we effectively judge the desirability of foreign investment in real estate at this time.

I certainly will not contend that foreign investments in farmlands or real estate either harm or benefit the U.S. economy. I argue that there is no reason to provide foreign investors a tax break or incentive denied our own citizens.

The exemption from capital gains taxation is a strong incentive to invest in U.S. real estate. The incentive only increases as land prices rise, pushing farmland prices out of reach of the American farmer. It is a leverage which is neither needed nor desired.

The May 1979 Treasury study on "The Taxation of Foreign Investments in the United States" indicates that taxing capital gains on the sale of U.S. real property is fully consistent with international practice and that the United States is unusual by not taxing such gains.

There are strong economic arguments against providing a tax incentive for foreign investors in U.S. real estate. Unlike securities, land is a limited commodity and the growing foreign interest in U.S. land has only added to the rate of farmland appreciation. There is no reason to provide a tax incentive for foreigners to invest in such a precious, limited resource. It creates an ideal climate for speculation which only adds to the investment's attraction and the rate of inflation to domestic investors.

I am confident that today's hearing will shed further light on the foreign investment issue and that Congress will act this year to end the capital gains tax advantage for foreign investors.

Senator BYRD. Thank you, Senator Wallop.

Senator Packwood, do you have a statement?

Senator PACKWOOD. I have no statement.

Senator BYRD. The committee is pleased to have the distinguished senior Senator from Arkansas, Mr. Bumpers, as a witness today. Senator Bumpers has introduced one of the two pieces of legislation which is being considered by this committee.

I welcome Senator Bumpers, and you may proceed as you wish.

STATEMENT OF HON. DALE BUMPERS, U.S. SENATOR FROM THE STATE OF ARKANSAS

Senator BUMPERS. First of all, I thank the committee for holding these hearings.

The large number of cosponsors for Senator Wallop's proposal, S. 208, and for my proposal, S. 192, demonstrates the Senate's recognition of the problem, so I will not belabor the point.

Suffice it to say that there are ample incentives, such as the overall political and economic stability of this country to induce investments in this country without adding further incentives of tax treatment that actually favors foreign investors over American citizens. The current tax laws provide such an incentive, and it ought to be removed.

I agree with the statement which Senator Wallop made when he introduced S. 208 and he said that "there is no reason to provide foreign investors with a tax incentive denied our own people" and that this issue presents important questions of "equity and confidence in our tax laws."

I could not agree more that it is unfair to allow foreigners to escape any taxation on the sale of agricultural lands while Americans pay.

The same logic which requires that taxation applies equally well to require that foreigners be taxed on capital gains arising from all their American investments. My proposal goes further than Senator Wallop's to provide for that.

Senator Wallop's proposal recognizes that the transfer of stock may be the equivalent to the transfer of land itself, so it devises a method for determining when that occurs. That device will no doubt be examined during these hearings.

Because my proposal would automatically embrace the transfer of stock, there is no need to determine whether a transfer of stock is really a taxable transfer of land.

If either my proposal or Senator Wallop's is adopted, it is possible that taxing the transfer of stock could lead to some tax evasion when the stock is held by nonresident aliens. That possibility, however, must be distinguished from the necessity to impose the tax itself, and this committee should not be deterred by possibilities of evasion. Instead, it should devise a means of curtailing any evasion, as I am confident that it can.

These hearings may also reveal that there are potential conflicts with tax treaties. On this subject, the tax treaties must yield. Regardless of the investment advantage which treaties might secure for Americans investing abroad, they cannot be allowed to dictate a domestic tax policy which discriminates against American citizens investing in American property.

Since these hearings are aimed at eliminating the disparity between the taxation of domestic investment by foreigners and by Americans, they should examine the possibility that foreigners would still enjoy a considerable advantage, even if their capital gains are taxed, because they would be taxed at very low levels.

Such a situation could arise; for example, if foreigners generally have no taxable ordinary income, while an American citizen's capital gains would be taxed on top of his ordinary income at a higher rate. If these hearings reveal that such a disparity would result, then some device, such as the minimum tax or simply a flat rate of tax, should be used to reduce it. It should not serve the purposes of either my proposal or Senator Wallop's to eliminate the discriminatory law and allow the actual discrimination to continue.

Finally, I must confess that I suspect that my proposal may not go far enough, because it may still be possible for foreign owners of American land to avoid taxes by selling the produce of that land at less than its market value to a related entity located abroad. That produce would then be incorporated into a finished product without ever being taxed.

Such a practice would equally discriminate against domestic producers. Section 482 may well be designed to forestall such a practice, but, as a practical matter, it may not be sufficient for the task.

Therefore, I urge this committee to use these hearings to examine whether such a practice is occurring and to determine whether section 482 is adequate to end it.

Senator BYRD. Thank you, Senator Bumpers.

What is the basic difference between your bill and Senator Wallop's bill?

Senator BUMPERS. Senator Wallop's bill covers agricultural lands and he has a provision there to allow the Secretary, I believe, some discretion in determining whether a stock transfer may be considered the equivalent of a land transfer. Mine attempts to get at both.

I admit, Mr. Chairman, I think that almost everybody would agree that foreigners buying and selling land in this country certainly ought to pay the same capital gains rate that the American citizens pay. When you go beyond that and start trying to tax transfers of stock, it immediately gets a little sticky.

For example, a German citizen may hold stock in IBM. He can sell it to another German citizen, or a French citizen, and presumably he would pay tax in his country on that, but would pay none in this country.

Senator BYRD. As I visualize it, while you would prefer your proposal, you also support Senator Wallop's proposal?

Senator BUMPERS. You are precisely right, Mr. Chairman.

Senator BYRD. Thank you.

Senator Packwood?

Senator PACKWOOD. I am a bit confused. Would you tax all foreign investment in this country at the same rates that we tax domestic investment?

Senator BUMPERS. Senator Packwood, that is a question that I, probably, just on the face of it, I would say that probably not, but I would use reciprocity as the determining feature.

In other words, if our tax treaties, any tax treaty that we may have with another country, provides for what I consider to be discrimination against an American citizen investing in their country where they enjoy an advantage and investing in this country, then that tax treaty just as inequity, it is very difficult to determine.

In my opinion, those treaties ought to be revised so all citizens of countries who do reciprocate are treated equally.

Senator PACKWOOD. I was not thinking of the treaties.

Senator BUMPERS. Foreign investment in banks, for example.

Senator PACKWOOD. Where the tax on the investment, is called withholding tax.

Senator BUMPERS. What?

Senator PACKWOOD. We went through this debate 2 years ago; in banks where foreign investors make deposits, the investors pay no withholding tax.

Senator BUMPERS. Yes.

Senator PACKWOOD. The argument is, of course, that it attracts capital to this country. My question is this: Is there any validity to the argument that we should give preference to foreign investment in this country because it will attract capital we would not otherwise attract?

Senator BUMPERS. To tell you the truth, when you consider the depressed value of the dollar, I think that is probably, right now, at least, plus the political stability of this country which most people found attractive, particularly from underdeveloped countries, the OPEC nations. I think those are sufficient incentives, maybe.

But still, there is a great deal of international competition for capital and Japan and Germany and the United Kingdom and other developed countries are competing for that same capital and when they are providing incentives that we are not, they also have fairly stable political and economic systems that are fairly attractive to these people.

You know, Bob, I honestly—when this debate occurred 2 years ago, the bankers in this country, as you know, just went ape, and with very good reason. Most of them were holding prestigious deposits from these countries and they could see the outflow of that capital with terrible business consequences to those banks.

I think we got into the debate at that time as to whether those banks ought to be able to reveal the amount of foreign holdings they have, foreign investment in the bank. That amount—for example, Saudi Arabia has invested in Chase Manhattan. I can certainly understand Chase's reluctance to reveal a figure like that because that is a revelation of a client privilege that we do not normally require of anybody else.

I tell you, I have not firmly fixed my mind on that, because of that. There are $600 billion, Eurodollars, Petrodollars, or whatever name you want to give to all those dollars we have spent abroad for many purposes, floating around the world.

Obviously, if they dump all of that money in this country at the same time, if everybody decides to come home and invest that $600 billion at one time, the inflation rate that would result, in my opinion, would sink our ship.

So we have to balance all of that. It is a synergistic thing.

It occurs to me that Senator Wallop's bill and my bill on the issue of agricultural lands does address one of the more egregious and visible discriminatory laws.

Senator PACKWOOD. Thank you.

Senator BYRD. Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman.

Senator Bumpers, neither your bill nor mine proposes to override U.S. tax treaties, but would you be in favor of a tax treaty override provision if it were necessary to carry out the intention of either one?

Senator BUMPERS. I almost said that in my testimony but I will be frank with you. That troubles me a little bit.

I think treaties ought to be handled on a case by case basis, rather, but in this case, on agricultural lands, yes, absolutely.

Senator WALLOP. Thank you.

Senator BUMPERS. Mr. Chairman, if I may make one other observation, we tried to design a bill about 6 months ago with little luck and I forget exactly where the embryo of the idea was, but as you know, a foreign agricultural investor can come to this country and buy—well, I do not mind calling names. Let's take Lichtenstein, which buys 10,000 acres of land in southwest Arkansas and 10,000 acres of land in Texas, which adjoins it, down near Texarkana.

They are good citizens, as far as I know. I am just using them as an example.

They can grow anything they want to there, and I believe, conceivably—you might ask the Secretary about this—let us say they are raising soybeans on that 20,000 acres of land and the cost of growing those beans is precisely, or virtually, the same as it is for an American farmer growing the same number of acres of soybeans, yet there can be a parent company, let's say back in Lichtenstein, that can harvest those beans, as far as I know, ship them back to the parent company in Lichtenstein and no taxable transfer takes place.

If they file a tax return in this country on that sale, they could simply show that the sales price was some deflated price to cover the cost of production.

If it cost them $5 a bushel to produce those beans, they could sell them for $5 a bushel to the parent corporation. The parent corporation can sell them in Europe for $10 a bushel and realize a $5 profit in Europe where there is no profit derived here and the United States gets no tax from that.

You can see, when you have 20,000 acres of land taken out, where those kinds of transactions can occur. Our tax base is seriously eroded every time there is a foreign purchase of agricultural lands from another standpoint. Do I make that point clear?

That may not be as simple as I suggested here. We have been trying to design a bill to cover that and I have not been able to do it.

Senator BYRD. That is my question. As I visualize it, Senator Wallop's bill does not cover the situation which you outlined.

Senator BUMPERS. Mine does not, either. I just throw that out because I covered that in the last paragraph of my testimony. It is another place where I hope the staff of this committee would look into the possibilities of redressing that.

Senator WALLOP. It certainly is another place where it is obvious that we do not need to design a further inducement to invest in American farmland. There are inducements enough.

Senator BUMPERS. You are absolutely right. Constitutionally, I do not think we can prohibit—the Supreme Court has ruled that citizenship includes aliens so when it comes to alienation of property, I doubt that constitutionally we are ever going to be able to prohibit foreigners from buying land in this country unless we amend the Constitution, but what we have been doing, we have been giving tax incentives to invest.

The whole purpose of Senator Wallop's and my bill and the other hundreds of others that have been introduced in the House is to remove those incentives and create disincentives.

Thank you very much, Mr. Chairman.

Senator BYRD. Thank you very much, Senator Bumpers. You made many good points.

The next witness will be the distinguished Congressman from Iowa, Mr. Charles E. Grassley.

We are glad to have you again before this committee, Congressman Grassley.

Representative GRASSLEY. Thank you, Senator.

Senator BYRD. It is always good to see you.

STATEMENT OF HON. CHARLES E. GRASSLEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Representative GRASSLEY. I appreciate working with you on doing away with the carryover basis. Hopefully we can get that job done here, too.

Senator BYRD. I hope so. I appreciate your strong support in the House.

Representative GRASSLEY. Mr. Chairman, Senator Packwood, Senator Wallop, members of the committee generally, I appreciate the opportunity to be with you this morning. I have introduced a bill similar to the one Senator Wallop introduced, so similar I guess I could say there are only a few technical differences.

You passed a bill last year. We had a bill introduced last year. However, we did not get hearings on it in the House. We have 172 cosponsors in the House which shows overwhelming support in the House for it, at least in the matter of introduction.

I feel we will get hearings. We have been promised hearings by one of the Ways and Means subcommittees. No date has been set yet at this point.

The point was first made by the Senator from Arkansas as for the reason for this bill—equity. Sentaor Wallop and I zero in on farmland. The question can legitimately be raised as to why just agricultural land as to all real estate. That is a legitimate question, one that at this point I am not prepared to respond to completely, but there is an overemphasis of foreign investment in this country on agricultural land, at least as agriculture relates to the total economy in this country.

Last year foreign investors invested $800 million in U.S. farmland, according to a Brussels-based European investment research center.

This constituted 30 percent of foreign direct investment in the United States.

There is one example where Dutch interests paid $5.7 million for what I know as Green Hill Farms, one of Oregon's agricultural holdings. In 1977, foreign interests purchased large tracts of land, including 12,000 acres in Illinois, 10,000 in Texas, 23,000 in Wyoming.

There are obvious reasons why U.S. farmlands are attractive to foreign investments. One, they desire an opportunity to diversify investments and, of course, in America there is the rapidly appreciating farmland price that is encouraging to investors overseas.

And, of course, that is a more favorable price for U.S. farmland, compared to farmland in Western Europe and Japan.

At various times, particularly a year ago—and maybe now there is a new trend setting in—there is a favorable currency exchange rate for some foreign investors allowing the purchase of U.S. property at what I consider to be a considerable discount.

Another advantage is the stability of the U.S. investment situation compared to that in other countries and lastly, and the purpose of our bill, there are sizable capital gains tax incentives for investments, particularly as it relates to our relationships with foreign investors because of certain tax treaties we have.

The avoidance of a capital gains tax can make a significant difference in the amount of foreign investment that a foreign investor is willing to pay for land. Research done by the Economic Research Service of the USDA, Working Paper No. 47, will tell you that if there is an appreciation of 8 percent in farmland, a foreign investor could economically pay 14 percent to 15 percent more for the farmland because of the exemption from capital gains.

If farmland would appreciate 10 percent, a foreign investor would be willing to pay, or could have an advantage of paying, between 5.6 to 24 percent more than a domestic farmer because of the capital gains exemption.

So we get down to the basic point, the basic point, one of equity for American farmers. We cannot do as we did for the carryover basis. That may be the sort of tax advantage that foreigners have in buying farmland in this country is a detriment to keeping the family farmer young and passing onto the next generation the family farm institutions.

We could also argue that quite obviously we should not have this unfair competition. Most of this I think has been—I do not know whether unknown, but at least not discussed by people—until a year ago, because of what Congressman Noland of Minnesota and I did in the House and what Senator Talmadge did in the Senate to bring attention to foreign investment in this country, and we did get a bill passed requiring foreigners who do invest in farmland in America, because heretofore there had been no registry of such land so we did not know what the total investment was.

There were a few State laws that required that investment, but only three or four State laws were really adequate to report the total investments, just in those States, so this bill was passed.

We will not know until October 6 when certain deadlines on that legislation are reached as to just exactly what that total investment is.

During our debate of that bill last year, and hearings on the bill, and probably also in the Senate, there did come out evidence of the unequal treatment of American farmers, or any Americans investing in agricultural land, as compared to what advantage certain foreigners have under the tax treaties of our country and hence our bill, and the rapid passage of the same bill by the Senate. Even though 100 House Members last year signed a letter to the conferees working on that tax bill, we were still not able to get the House conferees to go along with the Senate conferees on that point.

We hope now, with these hearings and with hearings that are coming up in the House, with 172 Members sponsoring it in the

House, and with what I think is close to a majority, or more than a majority of the Senate interested in this issue, we will be able to bring the proper attention and obviously get the votes to pass the bill. Maybe better yet, encourage the proper Cabinet-level agencies in the administrative branch of Government to negotiate the treaties so that American citizens who want to invest do not have this disadvantage.

I would like to call to your attention, in closing, to the chart over here that was prepared by the Library of Congress, the Joint Committee on Taxation, and an agency in the IRS, that will tell you about a citizen of a foreign country who, under the tax treaties that we have with the Netherlands Antilles, could invest in farmland and, through proper election at the right time, avoid paying any capital gains that an American citizen investing in the same land over the same period of time would end up paying a $400,000 capital gains tax.

I think that lays it out, as clearly as anything can, of the necessity for this legislation, or at least a necessity for the Cabinet-level agencies to renegotiate these treaties.

If there are any questions, I would be glad to answer them.

Senator BYRD. Thank you, Congressman Grassley.

You represent a farming and agricultural area. Do you feel that most of the farmers in your congressional district, and in Iowa, for that matter, would favor the legislation being considered today?

Representative GRASSLEY. No doubt about it. In fact, when you tell them of the tax advantages that foreigners have in buying farmland compared to what American citizens might have, they cannot even believe that such a situation like that would exist, that a country's government, established to protect American citizens and to give equal treatment, that we could allow a situation like this to exist. More importantly, how could it ever have been done in the first place.

Senator BYRD. Thank you, sir.

Senator Packwood?

Senator PACKWOOD. I have no questions.

Senator BYRD. Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman.

I want to welcome you here this morning and thank you very much for the support that you have given us on the other side because I think we are going to need it, although the inclination on both sides is clearly to address the problems identified in our bills.

In your State of Iowa, would you say that the concern over foreign investment in agricultural land is of temporary interest, or that the farmers will continue to be troubled?

Representative GRASSLEY. At least for the last 6 or 8 years, it has been a prime interest. It led to the legislature 3 or 4 years ago passing one of the better State laws on the registration of foreign ownership of farmland.

The tax problems, even though they are not as well known, just the general question of who owns how much land, is still equally important but just has not gotten the attention at this point.

Senator WALLOP. Do you perceive any interest in your State in applying this tax to all real estate, as opposed to just farmland, or is that not a topic?

Representative GRASSLEY. Again, I think the most interest is in the farmland. I, quite frankly, have not made up my mind on that point entirely and I guess I would like to leave myself open to dialogue on that point.

If there is some way that our bill, zeroing in just on agricultural land, is very difficult to substantiate because of the narrowness of it, then quite obviously, as a matter of fairness and equity, we would want to expand it. But when I consider 30 percent of foreign investment zeroing in on agriculture in this country based on this institute in Brussel's study, that is where I want to zero in and that is the main interest in the United States, in my State, and Senator Talmadge's study of the interest in the agricultural reporting bill that was passed last year led us in this direction.

Maybe our opening up the issue for the first time causes legitimately the expansion of the discussion of that point. I think we ought to look at it. I do not think that we ought to do anything to hinder the passage of this bill, because there might be some doubt that maybe we should not make it all-encompassing, because I think, quite frankly, that there has been adequate evidence laid out here that we at least need it for the agricultural segment of our investment economy.

Senator WALLOP. I think it fair to say, speaking for myself—and by the nature of your bill, perhaps for you to—that none of us have in mind launching an attack on the portfolio security of foreign investors. We are addressing a problem here more specific than capital gains generally, investments and stocks, for instance, that are necessarily going to be in the French area of this argument.

I compliment you on your chart, particularly the demonstration of the $400,000 differential potential between a foreign investor and an American investor. It is easy to see what that does to the escalation of the rate of inflation in American farmland.

I think that is one of the most important reasons to pursue this.

Representative GRASSLEY. Senator, let me comment on the responsible approach of our legislation, as well as the bill that was passed last year on reporting of farmland. It is hard for me to even go home and justify to citizens, although I have to do it, because this is the responsible, statesmanlike approach, that all we should do at this point is to bring about equity in taxation and only bring about the reporting of farmland. Most of the people back home that I talk to—and maybe you can argue that their thinking on this subject is not as sophisticated as it ought to be—they think there ought to be laws right now passed banning foreign ownership of farmland.

You know, we should not be making decisions like that in the Congress until we get the facts. We do not have those facts yet. Quite obviously, I do not think we ought to ban foreign ownership anyway, but we need to have the facts there so that we can make a more intelligent decision.

Out of this research has come a very unequitable situation that is unjustifiable. I think this is one responsible follow-up that we can pursue.

I thank you.

Senator BYRD. Senator Dole?

Senator DOLE. I want to thank Congressman Grassley for his leadership in his area. Washington has had a lot of farmers here in the last couple of years. In addition to prices, this has been one of their primary complaints. This has been a complaint many of the farmers who came on their tractors have called to my attention as a member of the Agriculture Committee. As you indicated, Senator Talmadge did provide leadership, along with others of us in the Agriculture Committee—I am looking ahead at the next witness's statement the administration suggests, the approach may be too narrow.

Certainly Congressman Grassley, has provided strong leadership and being as close to Iowa as Kansas is, I know of your concern for rural areas.

I appreciate your statement. I hope that we can do something very quickly.

Thank you.

Senator BYRD. The charts that you have presented, Congressman Grassley, are excellent charts and, without objection on the part of the committee, those charts will be included in the record.

[The material referred to follows:]

	PURCHASE OF U.S. FARM LAND	OPERATION OF THE U.S. FARM AND TAX CONSEQUENCES		SALE OF U.S. FARM LAND AND TAX CONSEQUENCES	
		U.S. INCOME TAXES	NETHERLAND ANTILLES (N.A.) AND OTHER FOREIGN INCOME TAXES	U.S. INCOME TAXES	NETHERLAND ANTILLES (N.A.) AND OTHER FOREIGN INCOME TAXES
U.S. CITIZEN & TAXPAYER OWNS A U.S. CORPORATION. U.S. CORPORATION BORROWS $900,000 FROM U.S. BANK.	U.S. CORPORATION PURCHASES U.S. FARM LAND. DEBT $900,000 EQUITY 100,000 COST $1,000,000 DEBT TO U.S. BANK WITH 10% MORTGAGE. $90,000 INTEREST PAYMENT ANNUALLY.	GROSS RENTAL INCOME $100,000 INTEREST EXPENSE <90,000> OPERATING EXPENSES <10,000> TAXABLE INCOME $ 0 U.S. TAXES $ 0 THE U.S. CORPORATION OPERATES THE FARM DIRECTLY. THE FARMER IS THE OWNER OF THE U.S. CORPORATION. $90,000 INTEREST PAYMENT TO U.S. BANK IS TAXED @ 48% ($43,200) AS BANK INCOME.	NOT APPLICABLE SINCE ONLY U.S. CITIZEN AND U.S. CORPORATION ARE INVOLVED.	LAND SELLING PRICE $2,000,000 BASIS (COST) <1,000,000> CAPITAL GAIN $1,000,000 U.S. TAX <400,000> NET PROFIT $600,000 CAPITAL GAINS TAX RATE IS APPROXIMATED AT 40%.	NOT APPLICABLE SINCE U.S. CORPORATION.
FOREIGN CITIZEN OWNS A FOREIGN CORPORATION WHICH IS PARENT OF A NETHERLANDS ANTILLES (N.A.) CORPORATION, 100% OWNED SUBSIDIARY. FOREIGN PARENT INVESTS $100,000 IN N.A. SUBSIDIARY & LOANS NETHERLANDS ANTILLES SUBSIDIARY $900,000 @ 10%.	NETHERLAND ANTILLES CORPORATION PURCHASES U.S. FARM LAND. DEBT $900,000 EQUITY 100,000 COST $1,000,000 DEBT IS TO FOREIGN PARENT CORPORATION WITH INTEREST @ 10% PER YEAR, OR $90,000.	GROSS RENTAL INCOME $100,000 INTEREST EXPENSE <90,000> OPERATING EXPENSES <10,000> TAXABLE INCOME $ 0 U.S. TAXES $ 0 NETHERLAND ANTILLES CORPORATION RENTS FARM LAND TO U.S. FARMERS WHO OPERATE FARM AND PAY RENT. NETH. ANTILLES CORP. MAKES ANNUAL ELECTION TO BE TAXED ON NET BASIS AND CAN DEDUCT INTEREST PAYMENTS OF $90,000. THIS AVOIDS 30% TAX ON GROSS RENTAL INCOME.	THERE IS NO TAXABLE INCOME AND THUS NO NETHERLANDS ANTILLES CORPORATE INCOME TAX. INTEREST OF $90,000 PAID BY NETH. ANTILLES SUBSIDIARY TO FOREIGN PARENT CORPORATION IS NOT SUBJECT TO N.A. TAX BECAUSE OF TAX TREATIES WITH EUROPEAN COUNTRIES.	LAND SELLING PRICE $2,000,000 BASIS (COST) <1,000,000> CAPITAL GAIN $1,000,000 U.S. TAX $ 0 NET PROFIT $1,000,000 CAPITAL GAINS ARE EXEMPT FROM U.S. TAXES BECAUSE OF SECTION 881 OF THE 1954 INTERNAL REVENUE CODE WHICH EXEMPTS FOREIGN CORPORATION NOT ENGAGED IN TRADE OR BUSINESS FROM CAPITAL GAINS TAX ON SALE OF PROPERTY. N.A. CORPORATION ELECTS UNDER ARTICLE X OF N.A. TAX TREATY TO BE TAXED ON GROSS INCOME BASIS AND THIS ENABLES THE CORPORATION TO QUALIFY UNDER SECTION 881 FOR THE EXEMPTION FROM CAPITAL GAINS SINCE NOT ENGAGED IN TRADE OR BUSINESS.	NO CAPITAL GAINS TAX FOR N.A. REAL ESTATE COMPANIES ON SALE OF FOREIGN PROPERTIES. ALTERNATE METHOD TO REALIZE CAPITAL GAIN ON LAND: FOREIGN PARENT COULD SELL STOCK OF THE NETHERLANDS ANTILLES SUBSIDIARY. TITLE TO LAND WOULD REMAIN IN N.A. SUBSIDIARY. FOREIGN PARENT WOULD PROBABLY PAY NO CAPITAL GAINS TAX TO COUNTRY IN WHICH IT RESIDES.

Senator BYRD. Thank you.
[The prepared statement of Mr. Grassley follows:]

REMARKS OF CONGRESSMAN CHARLES GRASSLEY OF IOWA

Thank you, Mr. Chairman, for allowing me the opportunity to testify this morning in support of S. 208. Senator Wallop and I co-authored similar legislation in the 95th Congress. Unfortunately, the Senate-passed bill was eliminated in the tax conference, despite the fact that over 100 members of Congress endorsed the Senate language in a letter to the House conferees.

This year, we are in a better position, since 172 members of Congress have cosponsored our bill. The Ways and Means Committee has also indicated their willingness to hold hearings on the bill although no specific date has been set as yet.

I do not intend to testify this morning as an expert on tax law. However, as a primary author of the Agricultural Foreign Investment Act of 1978, I became very aware of one fact. That is that no one in government or otherwise has any idea how much foreign investment there is in farmland or real estate in general for that matter. I believe the Treasury Department confirmed my conclusions in their recent report to the Congress on foreign investment in farmland.

I certainly do not want to leave this committee with the impression that the Grassley-Wallop bill is the final solution to this difficult subject. Although I will not be able to stay to hear the rest of the witnesses, a member of my staff will inform me of the suggestions made here today. I intend to keep an open mind, especially with regard to the Treasury Department's suggestion that the bill be expanded to include all real estate. However, I am concerned that this might lessen the chances for the bill's passage if it were misinterpreted by certain interest groups as an attempt to somehow keep foreign investment out of the United States. On the contrary, I would to see as many American dollars repatriated to this country as quickly as possible.

However, and I think that this is the central concern of both Senator Wallop and I, it should not be done at the expense of the American farmer or any American for that matter. I do not think our tax treaties and statutes should place a foreign investor in a more competitive position to purchase a piece of farmland than an American farmer or investor. Especially when the American happens to be a young farmer attempting to buy his own land. Simply stated, it boils down to being a matter of equity for the American farmer.

The chart that I have brought with me today illustrates that an American farmer cannot effectively compete for available farmland. It compares a foreign investor who incorporates in the Netherlands Antilles for the purpose of investing in farmland in the United States with an American farmer subject to our tax laws. The bottom line of the chart is that with the same amount of investment, the foreign investor who takes advantage of a loophole in our tax treaty with the Netherlands Antilles and our own tax statutes, will end up after the sale of the farm with $400,000 more in his pocket than the American. This fact allows the foreign investor to outbid the American investor because he knows that he can avoid paying any capital gains tax when he sells the farm. I commend the Chairman and Senator Wallop for tackling this difficult problem, especially at a time when our balance-of-payments may be adversely affected if the wrong decision is made. Thank you. I would be glad to answer any questions that the committee might have.

Senator DOLE. May I put a statement in the record?
Senator BYRD. Yes.
Senator DOLE. I will not read it. I will just put it into the record, but it is a good statement.
Senator BYRD. I am sure it is.
[The prepared statement of Senator Dole follows:]

STATEMENT OF SENATOR BOB DOLE

In recent years, foreign ownership of U.S. property has increased. In some portions of rural America, farmers are alarmed that passive foreign investors are needlessly bidding up the price of property. The property may be removed from the production of agriculture products which, in the long run, will prove to be detrimental to this country.

Mr. Chairman, nonresident aliens and certain foreign corporations are subject to different tax treatment than our own citizens. These advantages may be contributing to the growth of foreign ownership of U.S. property. While I recognize the need to recycle money through the international system, we must be careful. In 1977, and the first half of 1978, nonresident aliens were purchasing agricultural lands at a rate of 560,000 acres per year. In a recent report by the Treasury Department, the value of foreign purchases of U.S. land was approximately $560 million, or 4 percent of the total value of agricultural land sold in 1977. The average size of the foreign purchases is almost 4 times that of the U.S. overall average. There is some evidence to be concerned.

Under present law, capital gains realized by nonresident aliens and foreign corporations are not subject to U.S. tax unless they are "effectively connected with a U.S. trade or business." This must change. As a cosponsor of the bill introduced by Senator Wallop, I support his efforts to remove the tax advantage to the foreign investor and preserve the integrity of American farm lands.

Mr. Chairman, I look forward to the comments of the witnesses today. However, it is my hope that the full committee and the Senate could expeditiously consider this very important piece of legislation.

Senator BYRD. The next witness will be the Honorable Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy.

I am glad to have you, Mr. Lubick.

Mr. LUBICK. Thank you, Mr. Chairman.

With me are Tom Horst, Chief International Economist, and Stanley Longbein, of the Office of International Tax Counsel. They are the principal authors of our report on taxation of foreign investment in U.S. real estate.

With your permission, I would like to insert my prepared statement and a copy of the report in the record.

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. LUBICK. I would like to associate myself with Senator Dole's statement. I have not seen it, but with his usual perspicacity, I know I will agree with it.

Our report describes the opportunities and possibilities for manipulation in connection with foreign ownership of real estate. Basically, there are a couple of principles that you should bear in mind.

Capital gains of nonresident aliens are taxed, by and large, only if they are effectively connected with the conduct of a U.S. trade or business. If they are not connected with a trade or business, then they are not taxed under the U.S. Internal Revenue Code when realized by a nonresident alien.

On the other hand, ordinary real estate operating income, such as farming income or rental income, is taxed at U.S. rates, if it is effectively connected, U.S. rates applicable to domestic taxpayers, and if it is not effectively connected, however, it is subject to a flat 30-percent rate on gross.

Ordinarily, this means that it is more desirable to be effectively connected with a trade or business in the United States during the time of operation of that business because a 30-percent rate of tax is usually much higher than the normal U.S. rates where all of the deductions applicable to real estate are available.

On the other hand, when the time comes for disposition of the property, because there is taxation, if effectively connected, foreign taxpayers prefer the opposite side of the coin and find ways to shift from being effectively connected income to noneffectively connected income.

And our report indicates that there are many ways in which this goal of having both sides of the coin can be achieved.

Senator Wallop's bill would go after this problem by making agricultural land subject to taxation at capital gains rates when disposed of by a foreign investors, and he has expressed the concern that we have an especially attractive situation for foreign investors driving up the price of real estate and affecting the ability of independent U.S. farmers to remain economically viable in light of this competition for land.

Our report in chapter 2 shows the inadequacy of our statistics, but suggests that there have been some recent accumulations of evidence which show a trend not reflected in the statistics which are somewhat out of date. It is our position that all the arguments advanced in favor of Senator Wallop's bill apply equally to all real estate.

We believe that gain recognized by nonresident alien investors in U.S. real estate ought to be taxable. We would apply that rule to all real estate, because, first of all, real estate has a situs in the United States. It is located here. It is regarded in the U.S. Internal Revenue Code as gain from sources within the United States.

Under our source rule, gain from the sale of real estate is U.S. source income.

As has been pointed out, it is in accordance with international conventional practice to tax real estate at the situs. On the other hand, we find the Senator Bumpers' bill by taxing the gain on shares of stock, general investment assets, goes too far.

We do not believe that the present rules ought to be changed except in the limited circumstance when necessary to end abuse, to protect the rule of Senator Wallop's bill, to deal with incorporated real estate companies.

We do not very well see how you can tax real gain on the sale of real estate and permit the seller the day before he sells it to put it into a real estate holding company and then sell off the shares. That is sending an invitation in large, bold letters to avoid the rule that you have decided is desirable.

We do think, however, that we ought not to tax gain generally on the sale of shares. We think that has very serious balance of payments implications. It is not an area where there has been manipulation as there has been in the case of real estate rules being taxed as a U.S. taxpayer currently and then switching over to being not effectively connected with a U.S. trade or business.

There are capital formation reasons that we are concerned with to encourage investment generally in shares, so we would draw the line as between real estate generally and shares of stock with the exception that, in order to protect the real estate rule, we will have to deal with the real estate situation where the real estate is in an incorporated holding company.

We are not concerned with the sale of real estate where you have a plant in connection with a big operating manufacturing business. That is incorporated.

Therefore, we would not go so far as Senator Wallop does to tax any corporation on the attributable portion of real estate gain to the sale of shares.

Instead, we have set up a tax which we think will solve his particular problem and deal with the abuse cases. We would say that where either 50 percent of the income of a corporation for a 3-

year period is real property income, such as farming income and rental income, or if 90 percent of the assets of that corporation, exclusive of cash certificates of deposit and other assets that could be pumped in to change the ratio, if those are real property assets and if most of the stock, more than half of the stock, is owned by 10 or fewer nonresident aliens, then we think the sale of shares ought to be regarded as a sale of real estate and we would apply U.S. capital gains rates to that transaction.

Now, the principal problem that has been touched on in Senator Wallop's bill, and which we are concerned with, is one of enforcement. If you have the sale of real estate, it is reasonably easy to enforce. You could, perhaps, put a lien on the real estate and make sure that certain requirements are satisfied.

When you deal with the sale of shares, it is a little more difficult because those assets are, of course, movable assets.

Senator Wallop's bill suggests that the purchaser who pays over the purchase price ought to withhold the usual 30-percent rate of gross withholding on a payment to a nonresident alien and the problems which we see are, first, that the purchaser may not know the identity of the seller, whether he is a foreign person; he may not know what his gain is, and there may be some heavy overtaxation because the gross amount of the purchase price may not mean that there is a substantial gain; and, indeed, there are also the circumstances where you have a purchaser being a foreign person himself, and we cannot get hold of one foreigner selling to another foreigner.

Therefore, we would build on Senator Wallop's proposal and try to impose some obligations on the seller to overcome those problems. We would require the seller to disclose his identity or that of the real party at interest. We would require him to disclose the information necessary to calculate the amount due to avoid overwithholding, and we would provide some backup liability on the corporation if shares are traded without payment of tax.

We would look forward to working with the committee in getting protective rules to deal with that situation.

One final point, and that is, we believe that it is important, because of the nature of our treaty obligations which represent the combination of law and arduous negotiations over a period of time, that we not lightly override these obligations, and therefore, we would suggest, since many of our treaty partners are anxious and willing to enter into negotiations with us to arrive at an accommodation in this area that where every provision of the bill, as finally enacted, does conflict with a treaty, that we have a reasonable period of time to renegotiate these treaty obligations so that we can handle the process of international relations on a smooth basis.

I will be pleased to answer any questions that you may have.

Senator BYRD. Thank you, Mr. Secretary.

Let me ask you this. If an American citizen invests in farmland in Canada and sells it and makes a profit, what is the tax consequences of such a transaction?

Mr. LUBICK. The Canadians have already gone this route that we are suggesting. Under the Canadian tax law, gains of nonresidents from the disposal of real property, are subject to Canadian tax in the same way as taxable capital gains of Canadian residents.

It is essentially a taxation of half the gain at ordinary rates, and they define real property interest as including shares of Canadian corporations where the nonresident shareholder owns at least 25 percent of the shares of any class of stock of the corporation.

We have suggested a somewhat narrower test which we think might be, nevertheless, appropriate and would control the abuse.

They also have a system to deal with the collection of tax in that situation, two alternative methods. One, that the nonresident proposing to make a sale, the seller, may report the contemplated transaction to the Minister of Inland Revenue, indicating the expected purchaser and identification of the property to be disposed of, the anticipated proceeds, his basis, and he is required to remit either 25 percent of the anticipated gain or furnish some acceptable security.

The Minister then gives him a certificate that permits a sale as far as the purchaser is concerned without any obligation on his part. On the other hand, if the seller has not filed a report, the parties may nevertheless conclude the transaction. The seller has to file an information return with about the same information.

Senator BYRD. At any rate, how would you sum it up?

Mr. LUBICK. They do have a procedure and we could take a look at that when we go to mark up the bill.

Senator BYRD. The Canadian procedure is very similiar to what Senator Wallop proposes, not the procedure for collection, but the tax?

Mr. LUBICK. Yes.

I should point out that we have a convention with Canada that overrides that particular legislation as far as U.S. sellers are concerned, but basically we could model ourselves, with some variation, on the Canadian experience.

Senator BYRD. Let me see if I can summarize your view on these two bills. You feel that Senator Bumpers' bill goes too far?

Mr. LUBICK. Yes.

We think at this time, with our needs for capital formation and our needs for orderly markets and our needs for balance of payments that, in effect, there is no manipulation in respect to ordinary share ownership; that we ought not to try to tax gain on all shares.

We think that this is a real property problem. As a matter of fact, under our existing source rules, gain from the sale of shares is sourced, where it takes place, and Senator Bumpers' bill applies to capital gains from sources within the United States and it would be very easy to avoid the impact of the bill simply by making a sale outside of the United States.

On the other hand, with real property we have a situs in the United States. We think it is appropriate to tax gain from the sale of real property in the United States and we would deal with the incorporated personal holding company type of corporation by applying the same rules with respect to those shares.

Senator BYRD. The Treasury Department favors Senator Wallop's bill, with certain modifications?

Mr. LUBICK. Yes. We would expand it to cover all real estate, not just agricultural real estate, and we would beef up the enforcement mechanism to put some obligations on the seller as well as on the purchaser.

Senator BYRD. Can you tell us how much foreign investment there is in the United States, how much of that is in real estate and how much of the real estate is in farmland?

Mr. LUBICK. Those are the figures that we indicate in our report which are very shadowy. The material that we generally have—if you have a copy of our report, it is on page 6—we have some figures. We have a number here from distribution. We have some 1974 statistics which we think are perhaps not accurately reflective of the problem and it shows total assets owned by foreigners for all industries, $174 billion of which real estate is $4.2 billion; and of that $4.2 billion, you see the property, plant and equipment account, net of mortgage liabilities at $2.6 billion and the property alone at $621 million.

We are not able to break it down between agricultural and nonagricultural real estate.

Yes, we do. On the top of page 9, we have an estimate on acreage which foreigners own 3 million acres of the estimated 1 billion total acreage of U.S. agricultural land in 1978.

Senator BYRD. Am I correct, then, according to your figures foreigners have total investments in the United States of $174 billion?

Mr. LUBICK. That is 1974. It has doubtless increased substantially since that time.

Senator BYRD. Of that $174 billion, $4.2 billion is in real estate?

Mr. LUBICK. Those are the 1974 amounts.

Senator BYRD. You cannot break that down between farmland and nonfarmland, but you have another figure showing 3 million acres of farmland?

Mr. LUBICK. Yes. That is a comparatively recent figure. It is based upon the GAO study, June 12, 1978, which estimates foreigners owning 3 million acres out of the estimated 1 billion total acres.

Senator BYRD. Of the total of $4.2 billion in real estate, if that is a 1974 figure, now, 5 years later, it probably has substantially been increased above that amount.

Mr. LUBICK. Yes. As indicated on page 9 of our report, the average size of farm purchase was almost four times as large as the overall U.S. average of 308 acres, and then we assume that foreigners are purchasing somewhat more expensive land than domestic purchasers.

The implication is that the average purchase by the foreign buyer was worth about $1.1 million, six or seven times as large as the average domestic purchase.

We think that represents a rather serious trend.

Senator BYRD. Assuming Senator Wallop's proposal were adopted by the Congress, would that require a negotiation of any treaties?

Mr. LUBICK. About half of our treaties, about 15 treaties—and 2 of the most important ones, of course, are Canada and Germany that would be involved.

Senator BYRD. They would need to be renegotiated, would they?

Mr. LUBICK. Yes.

Senator BYRD. Is there a provision for opening renegotiations?

Mr. LUBICK. As to both of those, there are provisions, standard provisions, for reopening. It so happens that we, at the present time, are engaged in comprehensive negotiations with both those countries so that it could be put right into the context of the existing negotiations.

Senator BYRD. You touched on this, but I am not clear as to your position. As a practical matter, can the Treasury Department successfully collect a capital gains tax from a foreign investor?

Mr. LUBICK. There are always going to be difficulties, in particular with the incorporated real estate. We have made the best effort we can, we think. Just because there are difficulties we do not want to throw up our hands and say we will not try. Then you might as well not enact the original provision.

But if we place obligations on the corporation with respect to corporate-owned real estate, we think we have a reasonable prospect of doing a decent job of enforcement.

We are not going to get 100 percent, but we do not in very many areas.

Senator BYRD. Of the total investments of foreigners in real estate, what is the breakdown between office buildings and apartment buildings and raw land?

Mr. LUBICK. If I can call your attention to the table on page 55 of the green report, we have some information that will give you some clues. I do not think that it is a direct answer to your question, but we have some revenue estimates as to what the tax consequences would be of foreign capital gains by assets sold and you will notice we talk about assets sold in 1979 we are estimating $150 million of agricultural land and commercial real estate, $1 billion, so the amount in investment and commercial real estate, nonagricultural, we think is very substantially in excess of the investment in agricultural land.

Senator BYRD. Senator Wallop?

Mr. LUBICK. Now, that is the turnover. I do not know if the ratio of continued ownership approximates the ratio of turnover or not. There might be a tendency, for example, to hold one class or the other longer. I just do not know the answer to that.

Senator BYRD. Thank you.

Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman.

I want to thank you, Mr. Lubick, for the support and interest of the Treasury Department. One thing, Mr. Chairman, that is potentially different, at least in my mind, about foreign real estate investment, particularly in land versus regular portfolio investment in stocks and bonds and that kind of thing, is the leverage that can be achieved through the ordinary means of purchasing, which is borrowing. As you well know, you can acquire most farmlands for a 29-percent downpayment. In fact, most sellers of farmland would prefer that, in terms of their own tax consequences.

The gains are achieved on American capital, so in terms of encouraging foreign investment and tax formation in this country, this would not happen with farmland. Very likely any repatriated gains would be net capital outflow to the country greater than just the gains in American capital.

Mr. Lubick, I think that we will be able to work together on this problem.

Let me ask you a question concerning the issue of overriding international treaties. The Treasury report on taxation of foreign investments contends that there should be considerably less international objection to a prospective override of the treaties coupled with a sufficient time lapse of reciprocal international agreements on shares will be negotiated.

That statement suggests that the Treasury feels it could negotiate agreements on a limited taxation of corporate shares, in this instance, shares in landholding companies, and carry out the provisions of the bill without causing sizable disruption.

Mr. LUBICK. We do believe that we have had some discussions with our counterparts in foreign countries. After all, what you are suggesting is not very much at variance with their normal practice, so we would expect to be able to renegotiate the treaties.

Senator WALLOP. Have any of our tax treaty partners expressed official concern over these potentials?

Mr. LUBICK. We have not heard any concern expressed. I may point out that, since our statutory policy has been one of exemption, we have been generally offering exemption in our treaties without any resistance, obviously, from the other side, or at least trying to get them to get exemption.

Our policy has been the opposite of what we would like to see.

Senator WALLOP. Are you at all familiar with why the annual election provision was put into the treaty with the Netherlands Antilles and into other treaties in the first place?

Mr. LUBICK. Apparently it has its genesis in an ancient provision in our statutory law. That was a very old treaty and it was probably picked up from that.

The statutory law was changed in the Foreign Investors Act of 1966, but the Netherlands Antilles Treaty antedates that statutory change.

Senator WALLOP. How long has Treasury been aware of the loophole that has developed?

Mr. LUBICK. Apparently, we have been aware of our great and liberal generosity to the rest of the world for a very long time. I would like to point out that the election is not even a major loophole. There are a number of others which we discussed in the report.

We have been aware of this whole problem for a considerable period of time.

Senator WALLOP. Would the provisions of this bill tend to address that problem?

Mr. LUBICK. Yes.

Senator WALLOP. The ones you suggest?

Mr. LUBICK. Yes.

We drafted and attached to my statement a copy of principles we would suggest that we think would deal with the problem.

Senator WALLOP. You suggest that a reasonable period of time to negotiate these treaties would be welcome. Could you give us an idea of how long that would be?

Mr. LUBICK. Five years or so. The treaty process, unfortunately, is slow. We are slow in negotiating and I would like to point out that the Senate is perhaps an equally guilty partner in the ratification process.

I look forward to your early vote on the six treaties that have been reported out by the Foreign Relations Committee, and there are a number of others that have been there for some time.

It would be very helpful if we could get this whole process moved along, at least voted up or down one way or the other so we knew where we stand.

Senator WALLOP. One of the things I noted, as a junior member of the minority party, was that I am rarely consulted as to the flow of legislation, treaties or otherwise.

Mr. LUBICK. I am sure Senator Dole, who is frequently consulted, would give you his ideas.

Senator BYRD. Senator Dole?

Senator DOLE. If you could find one of those treaties that you wanted badly enough to tack on carryover basis——

Mr. LUBICK. I was going to disassociate myself from Congressman Grassley's hortatory remarks to Senator Byrd. I am glad to find myself in agreement with you, Senator Dole, on so many issues, and perhaps you will see the light on that one too, after a little while.

Senator DOLE. I just hope that you will.

Perhaps, the report answers the question. Can we identify which particular groups have been purchasing the property?

Mr. LUBICK. We do have some information in the report. I believe the largest investment came from Canada, if I recall.

If you would look on page 8, we have the largest number of transactions in 1978 coming from Canada. You will notice that there are a number from the Netherlands and the Netherlands Antilles that might lead one to suspect that they are not, indeed, acquisitions by nationals of those particular sovereign nations.

Then comes the United Kingdom and West Germany down with a significant number of transactions.

Senator DOLE. I have been handed an article called, "Takeover: The Secret Arab Strategy To Buy America." I do not know whether you have read that particular article.

Apparently the Arabs are not in the top five, at least in this report.

Mr. LUBICK. I do not know if they are going through the Netherlands Antilles. It could very well be coming through there.

I do not expect they are coming through Canada.

Senator BYRD. If Senator Dole would yield, according to your table, there is no appreciable buying of real estate by the OPEC countries. I was under the impression there had been.

Mr. LUBICK. Senator, I would like to caution you. We are not suggesting that we have the information necessary to draw conclusions. We are dealing with some transactions here which were identified. These are direct investments.

One could form a U.S. corporation to acquire the real estate and the share ownership could very well be not known or in the hands of nominees, so there are many ways to achieve secrecy and avoid actual, precise knowledge of who the ultimate beneficial owner is.

Senator DOLE. The United Kingdom, does it include the British Virgin Islands?

Mr. LUBICK. I do not believe so, Senator Dole. We would have a separate entry in that score.

Senator DOLE. Could you explain the term "tax haven countries," and which are the principal ones?

Mr. LUBICK. A tax haven country would be a country which would impose little or no tax on a nonresident of that country who is engaging in a transaction in our country or some third country and, of course, the treaty countries to which you have been alluding are very popular tax haven jurisdictions.

Switzerland is a popular tax haven jurisdiction. Lichtenstein. There are a number of others.

Senator DOLE. Where has most of the farmland been purchased?

Mr. LUBICK. We do not have any idea.

Senator DOLE. One other question. When somebody moves into an area and pays a high price for a certain piece of land, it has an impact on every other piece of land in that area.

Also, the question has been raised whether the nonresidence continues to be used for farm purchases and whether or not the commodities produced were to ship back to that country.

Mr. LUBICK. It is my understanding that the Department of Agriculture is preparing a study in this area. We hope they will be able to gather some of this data for us.

We think we can move ahead of Senator Wallop's proposal because we think it is soundly grounded conceptually. We do not see any particular reason to delay.

It is consistent with sound tax theory.

Senator DOLE. Thank you.

Senator BYRD. Thank you, Secretary Lubick.

[The prepared statement of Mr. Lubick and the Treasury report follow:]

STATEMENT OF THE HONORABLE DONALD C. LUBICK,
ASSISTANT SECRETARY FOR TAX POLICY

I am pleased to have the opportunity today to discuss the Administration's views on the appropriate tax treatment of capital gains on the sale of U.S. property. We first became aware of dissatisfaction with our present law during Senate consideration of the Revenue Act of 1978. The Treasury asked for and received six months time to prepare a study and make appropriate recommendations to the Congress. Because the Report was submitted to the Congress in early May, and because my time this morning is limited, I would like to submit the Report for the record and summarize only its principal findings. Under present law, the United States does tax capital gain of foreign taxpayers -- nonresident alien individuals and foreign corporations -- if such gain is effectively connected with a U.S. trade or business. Most foreign investment in U.S. real estate either constitutes a U.S. trade or business or, at the election of the taxpayer, is being taxed as if it were.

The problem with present law is that a well advised foreign taxpayer can avoid our capital gains tax upon the sale of his U.S. real estate, even though that real estate has been used in a U.S. trade or business. The Report notes five methods of achieving that unintended result; other ways may also be available. The Report indicates the sorts of changes in present law we believe would be appropriate to limit these opportunities for tax avoidance; I would like to set forth a more detailed proposal this morning.

Let me begin with the scope of the Administration's proposal which is described more fully in an attachment to my statement. A striking difference between S.208 and S.192 is that S.208 would change present law as it applies only to agricultural and rural land, whereas the S.192 bill would apply to all U.S. property -- real estate, stock, bonds, and so forth. In the Administration's view, present law should be changed as it applies to all real estate. That is to say, we believe that the scope of S.203, agricultural and rural land, is too narrow, and that of S.192, all property, is too broad. Let me explain why.

B-1687

As noted above, present law distinquishes between capital gain which is effectively connected with a U.S. trade or business, and capital gain which is not. I see no reason to question that basic distinction. The problem highlighted in our Report is the manipulation of that distinction to avoid capital gains tax on real estate which has been used in a trade or business. This manipulation appears to be a problem in real estate generally, not just with respect to agricultural land. On the other hand, such manipulation does not appear to be a significant factor in the case of foreign investment in manufacturing or other non-real-estate industries. Accordingly, our proposal is structured to limit present abuses, rather than to make more fundamental changes in the way we tax foreigners investing in the United States.

As to our specific recommendations for change, we would take the same general approach as that in S.208. We do think, however, that S.208 could be improved upon in two respects. The first concerns the manner in which gain from the sale of corporate shares is taxed when such gain is attributable to the appreciation in value of agricultural land, or real property, held by the corporation. The second concerns the means for collecting and enforcing the taxes imposed. Let me address these two questions in turn.

First, the question of the taxation of gain on shares. Under S.208, a nonresident alien or foreign corporation is subject to taxation on the sale of shares in any corporation, or interest in any partnership, trust, or estate, to the extent the gain is attributable to unrealized appreciation on farmland, or to gain not recognized to the corporation pursuant to the special provisions of section 337 of the Internal Revenue Code. The Secretary of the Treasury is to "determine" what part of any share gain is attributable to the corporation's real property holdings, but the statute is not clear whether the Secretary will have authority to issue "legislative" type regulations in this area.

In our view, this approach is both too narrow and too broad. It is too broad in that, potentially at least, it reaches a whole host of transactions which do not raise the kind of problems this legislation aims at resolving. Under this approach, for instance, a foreign person who held shares of a public corporation -- even a U.S. public corporation -- would be liable for tax on the sale of its shares, if the corporation held U.S. farmland which bore unrealized appreciation. This would embroil the Treasury in a highly complex administrative task of devising rules for determining the amount of gain on the shares of any corporation were attributable to appreciation on farmland, or, if the scope of the bill is widened, appreciation on all real property. It would also create a very complicated, perhaps impossible, enforcement task of trying to find all transactions by foreign persons in shares of U.S. companies when the companies held U.S. farmland, or real property. Equitable enforcement would probably be impossible to achieve, and any attempt at it would in all likelihood have the effect of disrupting investment by foreign persons in all U.S. equity securities, to the detriment of our efforts to stabilize our balance of payments position and to promote capital formation in the economy.

Moreover, I do not think this approach is required by the basic objective of the bill in taxing shares. That objective, in our understanding, is to ensure that foreign persons are not able to avoid capital gains taxes on farmland, or real estate, by the simple expedient of placing the realty in a corporation and selling the shares. The central concern of this legislation is with the "real estate holding company" -- the closely held company the preponderant portion of whose assets constitute the realty which the foreign person would hold directly, but for the capital gains tax on real estate.

Accordingly, we believe that the tax on shares imposed by the legislation should be limited to real estate holding companies, and, moreover, that the tax should apply to all gain on such shares, not simply that attributable to unrealized appreciation of land. Such a tax would be at once much simpler to administer and enforce, and more carefully tailored to meet the essential objectives of the legislation. The Administration's proposal limits the tax to holding company shares and extends it to all gain on such shares.

We would also recommend enforcement provisions different from those in S.208. Section 1(b) of the bill makes the taxation of these gains dependent upon the ordinary "withholding" method for taxing the income of foreign persons. This approach presents three problems.

1. A purchaser of real estate, and still more of shares in a company, may not know the true identity of the seller. In the real estate industry, it is commonplace for transactions to be effected through nominees; shares of closely held companies may be so traded as well; and in trades of shares of public companies, a purchaser only very rarely

knows the party from whom he makes his purchase. Therefore, it is impossible for a purchaser, who has a withholding liability, to know whether the seller is a foreign person. While there is existing statutory authority to relieve such a purchaser of liability, there is insufficient authority to compel a seller to disclose his identity. Thus, the Treasury in these circumstances would have means of relieving purchasers of unfair burdens, but only at the expense of effective and equitable enforcement of the tax.

2. The withholding obligation is geared to the "gain" derived by the seller, and to the tax due on that gain. But there is no way for a purchaser to know how much gain a seller derives on a sale, and still less to know how much tax is due on the gain. The ordinary withholding obligation is 30 percent (or some lower figure stipulated by tax treaty) of a gross amount of a payment, which ordinarily constitutes income to the full amount of the payment. This is true, for instance, where the payment is a payment of interest, dividends, or royalties. But where the payment is a purchase price, a large part of it, indeed in many cases all of it, may not be capital gain -- it is simply return of capital. And even if the amount of gain is known, the amount of tax may not be determinable. It must be emphasized in this context, that this legislation contemplates "net basis" income taxes, by treating the gains as effectively connected income. Thus, a seller may have deductions, or other capital losses, to offset against gains realized. It is impossible for a purchaser to know these circumstances, and the proposed legislation sets forth no mechanism for giving him the power to apprise himself of them.

3. The proposed legislation does not deal with the fact that many of the purchasers involved, the "withholding agents" under the legislation, may themselves be foreign persons. Withholding taxes are imposed because collecting tax from foreign persons is very difficult once the income to which the tax attaches is out of the country. Withholding taxes contemplate that in the ordinary case the income will be paid by a U.S. person with U.S. assets subject to lien, attachment, or the like, in the event of nonpayment. But in the situation addressed by this legislation, the purchaser may

> often himself be a foreign person. This problem becomes particularly acute in the case of a sale of shares in a holding company, since the person involved may keep evidence of the shares outside the country, may have no assets in the country, and may himself never appear in the country.

The Administration's proposals are designed to give the Treasury tools for overcoming this variety of problems. With respect to the first, the proposal requires that a seller disclose the identity of the real party in interest to the purchaser, so that the withholding agent may determine himself whether there exists a legal obligation to withhold. With respect to the second, the proposal permits a seller to disclose the information necessary to a purchaser to determine the amount of tax due, so that the purchaser will know the extent of his withholding obligations. If the seller chooses not to do this -- our proposal permits him this choice -- the purchaser is required to withhold the maximum amount the tax may be, 28 percent of the purchase price. With respect to the third problem, the proposal establishes a device for imposing a backup liability on a corporation or other entity whose shares are traded without proper payment of tax. This provision would ensure that the IRS would have the power to collect the tax from some party which, after the transaction, continued to hold title to property located within the United States territory.

We recognize that these enforcement proposals are in some respects, far reaching. We nevertheless believe that they are necessary to ensure effective enforcement of the kind of taxes this legislation contemplates, whether those taxes are limited to agricultural land, or are extended to all real property.

Let me comment on the relationship of present statutes and proposed changes to our bilateral tax treaties. The United States presently has in force bilateral tax treaties with 38 foreign countries and 8 overseas territories. Two of those treaties would preclude taxation of capital gain from the sale of U.S. real estate when such gain was not attributable to a "permanent establishment" in the United States. Approximately one half of the treaties contain articles exempting residents of the treaty country from U.S. taxation on capital gain on the sale of corporate shares. All the treaties contain non-discrimination articles which would, for example, prevent the United States from imposing a tax applicable to corporations owned by residents of the treaty country, but not to corporations owned by U.S.

taxpayers. In the absence of specific statutory provisions overriding these treaty provisions, the treaties take precedent over present and future tax statutes.

The process of negotiating and ratifying a tax treaty is long and arduous. This process would be rendered all the more difficult, if not altogether impossible, if the United States were to begin overriding specific treaty provisions a foreign country had negotiated in good faith. However, most of our treaty partners are sympathetic to considering treaty changes necessary to prevent tax evasion and unintended tax avoidance. Accordingly, we are opposed to any statutory changes which would immediately override our tax treaty obligations, but are willing to contemplate provisions which would allow the Treasury sufficient time to implement appropriate modifications in those treaties before statutory changes became effective.

In closing, let me say that it is far easier to see what is wrong with present law and others' proposals for change than it is to formulate specific alternatives. The proposal set forth in the attachment to my statement is not the Administration's final view of how difficult issues should be resolved. Rather, our proposal, like others will help focus the discussion of the appropriate shape of final legislation. We look forward to continuing work with the Congress in formulating mutually satisfactory legislation.

PROPOSAL FOR TAXING CAPITAL GAIN ON NONRESIDENT ALIENS' AND FOREIGN CORPORATIONS' INTERESTS IN UNITED STATES REAL PROPERTY

(1) A "United States real property interest" would be defined as an interest in real property situated within the United States; shares of any foreign-controlled United States real property corporation; and an audit in any United States real property partnership or any United States real property trust.

(2) A "foreign-controlled United States real property corporation (or partnership or trust)" would be defined as a corporation (or partnership or trust) which met the following two tests:

(a) either

(i) more than 50 percent (50%) of the gross income of such corporation, partnership or trust during the three-year period ending with the taxable year preceding that for which the status of the corporation, partnership or trust is to be determined, or for such other period as is applicable, was derived from commercial, agricultural, or residential rentals from U.S. real property, from the sale of agricultural products produced on U.S. land held by the corporation, partnership or trust, or from gains from the sale of a "United States real property interest"; or

(ii) more than 90 percent (90%) of the assets of such corporation, partnership or trust (exclusive of cash, amounts on deposit in a financial institution, marketable securities, accounts or notes receivable, or other readily marketable assets, in excess of a reasonable amount of working capital) constitute "United States real property interests." For this purpose, the term "United States real property interests" shall not include real property used in a trade or business as described in section 1231(b), except that such term shall in any event include: (a) real property used in a trade or business the primary object of which is to earn income of a kind described in paragraph (i) above; and (b) any real property located in the United States which is --

(I) land used in farming (as defined in section 180(b) of the Code);

(II) land suitable for use in farming (as defined in section 182(c)(2)); or

(III) land in a rural area (within the meaning of paragraph (7) of section 306(a) of the Consolidated Farm and Rural Development Act (7 U.S.C. 1926(a)(7)); and

(b) at any time during the taxable year more than fifty percent (50%) of the value of the outstanding stock of the corporation (or, in the case of a partnership or trust, of the capital or income interest) is owned, directly or indirectly, by or for not more than ten (10) individuals who are nonresident aliens.

(3) Capital gain realized by any nonresident alien or foreign corporation, trust, or estate on the disposition of a United States real property interest would be treated as income effectively connected with the conduct of a United States trade or business. Any nonresident alien or foreign corporation or foreign trust or estate which realized such gain would be deemed to be engaged in a United States trade or business.

(4) Any purchaser of a United States real property interest would be required to obtain from the seller and to file with the IRS a statement declaring the identity of the beneficial owner of the property sold; and declaring whether that party was a foreign corporation or nonresident alien. If such person is a nonresident alien or foreign corporation, such statement could, at the election of the seller, indicate the amount of gain to be realized by the person on the sale. In the event the statement does indicate such an amount, the purchaser would be required to withhold tax at a rate of 28% of such amount. In the event the statement did not indicate such an amount, or if no statement were filed upon the basis of which the purchaser could determine that the seller was not a nonresident alien or foreign corporation, the purchaser would be required to withhold tax at a rate of 28% of the sale price. The purchaser would be subject to all sanctions imposed by the present Code upon withholding agents.

(5) Every foreign-controlled United States real property corporation, partnership, or trust would be required to file an annual information return indicating the assets

it held which constituted United States real property interests, and showing the extent of its ownership by nonresident aliens, foreign corporations, trusts or estates. Each foreign-controlled United States real property, corporation, partnership, or trust would be required to show the ownership of any person or entity which owned directly or indirectly, 5% or more of any class of its shares (or in the case of a partnership or trust, of the capital or income interest), and the ownership of any person which owned, directly or indirectly, 5% or more of the shares of (or interests in) any such person. Such returns would be required to identify the ultimate beneficial owners of any of the shares of the corporation (or interest in the trust or partnership) held in any entity owning 5% or more of the corporation, partnership, or trust. The return would be required to indicate all changes in ownership which occurred during the taxable year, which involved a person who at any time during the year owned, directly or indirectly, more than 5% of the shares of the corporation (or interest in the partnership or trust) including changes which occurred as a result of transactions in interests in entities which owned, directly or indirectly, the shares of the corporation, partnership, or trust. The corporation, partnership, or trust would be required to attach a proof of payment of tax with respect to all dispositions of interests in the corporation, partnership, or trust by any nonresident alien or foreign corporation which owned, directly or indirectly, 5% or more of the shares of the corporation at any time during the taxable year.

In the absence of proof of payment of tax with respect to any such transaction, the corporation, partnership, or trust will be liable for a tax in an amount of 28% of the difference between the proportionate share of the excess of the fair market value of any United States real property interests held by the corporation, partnership, or trust at the time of the transaction, over the aggregate basis of such interests in the hands of the corporation, partnership, or trust with an appropriate step-up in basis to the corporation, partnership, or trust. Such liability will be abated in the event of subsequent payment of the tax. If the corporation, partnership, or trust fails to supply proof of stock ownership, it will be liable for a tax equal to 28% of the difference between the aggregate fair market values of any U.S. real property interests it holds at the end of the year in question, over the aggregate basis of such interests in its hands, attributable to the shares the ownership of which the corporation, partnership, or trust fails to identify. This liability too, is subject to abatement in the event of subsequent identification of the beneficial owners of the corporation, partnership, or trust.

(6) Section 1031 would be amended to provide that property, the gain from the disposition of which would not be considered effectively connected with a United States trade or business would not be considered to be similar in kind and use to property the gain from the disposition of which would be so considered.

(7) To the extent that the application of any of the above provisions would be inconsistent with any obligation of the United States under any double taxation convention, such provisions would not take effect until five years after the effective date of the provision. The Treasury Department would be authorized to negotiate executive agreements to modify any income tax treaty with which any of the above provisions would be inconsistent.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

AUG 10 1979

Dear Mr. Chairman:

I have received a copy of a letter dated July 30, 1979, addressed to the Finance Committee from Marshall J. Langer, supplementing Mr. Langer's testimony before your Subcommittee on the subject of taxing capital gains realized upon sales of U.S. real property. I would very much appreciate it if the comments in this letter were considered a supplement to my testimony of June 25, 1979, on that same subject, and included in the record of the Subcommittee's hearings.

Mr. Langer's letter is critical of the Administration's proposal with respect to the tax treatment of capital gains on the sale of U.S. property by foreigners. In my testimony I noted that "it is far easier to see what is wrong with present law and others' proposals for change than it is to formulate specific alternatives. The proposal set forth in the attachment to my statement is not the Administration's final view of how difficult issues should be resolved. Rather, our proposal, like others, will help focus the discussion of the appropriate shape of final legislation."

Mr. Langer's criticisms of the Administration's proposal essentially break down into four groupings: a suggestion that legislation should be confined to capital gains realized on sales of "farmland and unimproved rural land"; a suggestion that complexities and other aspects of our proposal will deter investment in the United States; a contention that our proposal will not be effective; and a series of essentially technical comments dealing with alleged anomalies and "loopholes" in the proposal.

The argument that, apart from investments in farmland, there is no reason to equalize the tax treatment of foreigners and U.S. persons investing in real property is without merit. U.S. real property generally, not just U.S. farmland, has appreciated in value rapidly over recent years. The same tax planning techniques which presently allow foreign investors to escape capital gains taxation on farmland apply just as well to other real property. As Mr. Langer has testified, foreigners invest in all types of U.S. real property, and not just farmland.

Mr. Langer argues that if capital gain on sales of real property are taxed to a foreigner as they would be to a U.S. person, consistency requires that tax treatment be similarly equalized for other U.S. income, such as interest, earned by foreigners. This is not right. In fact, the logic of this position would lead to the conclusion that since the United States at present does not generally tax foreigners on capital gains realized on sales of U.S. real property, it should not tax foreigners on United States source dividend income either.

The difficulty here is with Mr. Langer's starting point: contrary to his unstated premise, there is substantial basis for distinguishing among the types of income on which nonresidents are taxed. As a matter of international tax policy, there are few items of income to which a country is generally accorded so strong a claim to source basis taxation as capital gains realized on sales of its real property. The present United States posture of not generally taxing at source capital gains on sales of U.S. real estate is much more generous than the position of most countries of the world. And many countries which have statutory rules for taxing capital gains realized on sales of real property have more liberal rules for source basis taxation of foreigners on items such as interest or the sale of portfolio securities.

Mr. Langer also contends that the Administration's proposal will deter foreign investment in the United States. But as I just mentioned, most other countries tax sales of real property at source. Our proposal will therefore not place the United States in an unattractive competitive position. Moreover, there is a great appeal to investments in United States real property, as domestic investors have perceived; our unusual generosity toward foreigners would not seem necessary. Canadian experience with legislation similar to our proposal suggests that such taxation need not impede the smooth functioning of real estate markets.

Mr. Langer also suggests that the annual information return requirement in our proposal would be "obnoxious" to many foreign investors and is susceptible to "large-scale cheating." Be that as it may, there are substantial policy reasons for ascertaining the identity of those persons who own our real property. We are, of course, amenable to any suggestions that would help to forestall cheating.

Mr. Langer further suggests that the aspect of our proposal that would tax capital gains on sales of real property holding companies is unnecessary. It is hardly surprising, however, that in Mr. Langer's experience foreign buyers of U.S. real property have traditionally preferred to purchase the property itself rather than shares in a real property holding company. Today, capital gains realized on the sale of United States real property is generally not taxable to foreigners. The purpose of including provisions governing sales of shares in real property holding companies is to obviate avoidance possibilities which would become significant if the United States began to tax capital gains on sales of the property itself. Mr. Langer's experience with the present tax rules provides no assurance that avoidance possibilities would not be exploited under new rules.

Treasury carefully considered Mr. Langer's alternative suggestion that entitlement to a step-up in basis be eliminated when a real property holding company is liquidated. Our conclusion was that such a provision would not be effective with respect to individual purchasers of shares. We are certainly prepared to consider this option further if it can be shown that provisions can be adopted to eliminate the tax advantage of real property holding companies owned by foreigners.

Mr. Langer also argues that our proposal "won't work" because it does not deal with publicly held foreign corporations, real estate holding companies whose U.S. real property is not income-producing, or companies a majority of whose shares are not owned by foreigners. We tend to doubt that these particular cases negate the basic proposal, because it has not been shown that they are feasible on a widespread basis. Certainly there are precedents in the tax laws for limiting similar provisions to closely held companies and to companies whose ownership by the target class is 50 percent or less. Delineating the proper scope of legislative change as applied to corporations owning U.S. real property is, however, difficult, and we are happy to consider expanding the proposal to cover the cases cited by Mr. Langer.

Mr. Langer also objects to the exclusion of shares of a company whose real property was used in a trade or business other than real estate. Of course, sales of such property are already subject to tax in the United States. With respect to the sale of shares of a holding company owning real property used in a non-real estate trade or business, we believe the approach taken in our proposal is the correct one. We believe a distinction should be made between the case where United States real property is incidental to an operating business, and the case where the investment is primarily in the real property itself.

Several of Mr. Langer's technical points, such as his objection to the term "land in a rural area," can be addressed, if necessary, in the drafting process. Our proposal was not intended as statutory language.

Finally, Mr. Langer objects to the withholding mechanism in the Treasury proposal. He prefers a requirement of a tax clearance certificate showing that the tax had been adequately provided for. It is not clear to us how the tax clearance mechanism would be significantly less burdensome than the withholding mechanism, but it may have other advantages; we are willing to consider this idea further.

In conclusion, several of Mr. Langer's points warrant further analysis, but his leap from these relatively minor matters to a suggestion that legislative action in this area should be limited to farmland or unimproved rural land is wholly unwarranted. We recognize the difficulties inherent in taxing capital gains realized on shares of real property holding companies, but we do not see any other practical alternative for ensuring that a law designed to tax capital gains on the sale of United States real property will not be nullified through the formation of such holding companies. We do not believe that our proposal will seriously discourage foreign investment in United States real property. We reiterate that we are prepared to work with the Subcommittee and others in perfecting the various proposals that have been made on this subject, and to rectify the favoritism toward foreigners that has characterized this area of our tax laws.

Sincerely,

Donald C. Lubick

Donald C. Lubick
Assistant Secretary
(Tax Policy)

The Honorable
Harry F. Byrd, Jr.
Chairman, Subcommittee on
Taxation and Debt Management
Senate Finance Committee
Washington, D.C. 20510

Taxation of Foreign Investment in U.S. Real Estate

50-150 0 - 79 - 5

THE SECRETARY OF THE TREASURY
WASHINGTON

MAY 4 1979

Dear Mr. Chairman:

Section 553 of Public Law No. 95-500, the "Revenue Act of 1978," required the Treasury Department to conduct a study and analysis of the appropriate tax treatment of income from, or gain on the sale of, interest in United States property held by nonresident aliens and foreign corporations. The Secretary is required to transmit a report of the results of this study, together with the recommendations of the Department, within six months of the date of enactment of the Act.

Pursuant to these provisions, I hereby submit a report entitled "Taxation of Foreign Investment in U.S. Real Estate."

Under present law, capital gains realized by nonresident aliens and foreign corporations are not subject to U.S. tax unless they are "effectively connected" with a U.S. trade or business. The Treasury Report finds that, while most real property holdings of foreign persons is used in a U.S. trade or business, foreign persons rarely incur capital gains tax on the disposition of their U.S. property holdings. The Report identifies various ways in which the capital gains on real estate, which would ordinarily be taxable, can be converted into capital gain on some other asset, which would not. The principal means by which this is accomplished is through a real property holding company, and converting gain realized on disposition on the "effectively connected" property into gain realized on disposition of the shares, which is not deemed "effectively connected."

The Treasury does not believe that taxing capital gain on the sale of corporate shares is desirable or practical. But to prevent unintended tax avoidance, the Treasury recommends modifying certain specific statutory provisions under which foreign taxpayers convert taxable gain on real estate into nontaxable gain. The Report describes certain steps which may be taken in this regard. The Treasury plans to work with the Congress and with other agencies of the Government in developing formal legislative proposals in this area.

I am sending an identical letter to Senator Russell B. Long, Chairman of the Committee on Finance.

Yours very truly,

WM Blumenthal

W. Michael Blumenthal

The Honorable
Al Ullman, Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Enclosure

Table of Contents

List of Figures and Tables

Chapter 1 - Introduction and Summary*

This Report was prepared pursuant to section 553 of the Revenue Act of 1978, which stated:

SEC. 553. STUDY OF TAXATION OF NONRESIDENT ALIEN REAL ESTATE TRANSACTIONS IN THE UNITED STATES

(a) STUDY.--The Secretary of the Treasury shall make a full and complete study and analysis of the appropriate tax treatment to be given to income derived from, or gain realized on, the sale of interests in United States property held by nonresident aliens or foreign corporations.

(b) REPORT.--The Secretary of the Treasury shall submit to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a final report of its study, together with its recommendations, no later than 6 months from the date of enactment of this Act.

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* This Report seeks to describe and analyze present U.S. law for taxing income from, and capital gain on the sale of, U.S. real estate. The Report does not purport, however, to take a position or resolve any ambiguities in the interpretation of existing statutes, regulations, revenue procedures, and so forth. The Report cannot and should not be relied upon by taxpayers or the Internal Revenue Service in resolving pending or future determinations of taxpayers' liability for U.S. tax.

Chapter 2 summarizes available statistics on the nature and extent of foreign investment in U.S. real estate.* Chapter 3 describes taxation of foreign investment income under present U.S. statutory law; Chapter 4 explains how U.S. statutory law is modified by existing tax treaties. Chapter 5 describes and analyzes proposals to change the statutory treatment of foreign taxpayers' capital gains on the sale of U.S. real estate.

The statistics presented in Chapter 2 suggest that foreign investors own a small percentage of U.S. real estate generally or of farmland in particular. Both Commerce and Agriculture Department statistics indicate that foreigners own less than one half of one percent of U.S. agricultural land; previously unpublished statistics based on 1974 tax returns indicate that total receipts of foreign and foreign-controlled corporations whose primary U.S. operations were real estate represented approximately 3 percent of the total receipts of all real estate corporations in the United States. Comparable statistics for individuals and partnerships are unavailable. Although press clippings and other sources indicate that such investment has been growing rapidly over the last five years, hard statistical evidence documenting this trend is simply unavailable.

Tax return data also indicate that real estate investors, domestic and foreign, often report losses on their U.S. tax returns. Real estate ventures are frequently

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* The term, "real estate", as used here means land and its improvements, and buildings and their structural components. "Foreign investors" are individuals who are neither U.S. citizens nor resident in the United States, corporations chartered under foreign laws, foreign governments, and foreign trusts and estates. "Foreign Investment in U.S. real estate" includes not only direct ownership by a foreigner of U.S. real estate, but also ownership of an interest in a U.S. corporation, partnership, trust or estate whose assets consist primarily of U.S. real estate. A foreign investor may buy U.S. real estate for his own use in a non-real-estate business (e.g., a manufacturer's plant), for lease to some other user, or merely for a non-income-producing investment. This Report, however, is concerned only with real estate which is leased or held for investment.

A Glossary of these and other terms is appended to the Report.

undertaken by partnerships, rather than by corporations, because losses offset other income earned by partners. Although most foreign corporations and shareholders of foreign-controlled U.S. corporations investing in U.S. real estate come from Canada, the United Kingdom and other industrialized countries, a substantial minority listed addresses in the Bahamas, the Netherlands Antilles and other western hemisphere countries.

The specific rules under which foreign investors are taxed by the United States on income and capital gain from U.S. real estate are complex, but their essential features can be described simply. Individuals who are neither citizens nor residents of the United States and foreign corporations have, for U.S. tax purposes, three types of income:

- Income, including capital gains, which is effectively connected with a U.S. trade or business. This income can be offset by allowable deductions and is taxed at progressive rates under the same general rules as those applicable to U.S. citizens, residents or corporations.

- Interest, dividends, rents and certain other U.S.-source income not effectively connected with a U.S. trade or business, against which no deductions are allowed and which is taxed at a flat rate of 30 percent (less for certain items for residents of countries with which the United States has a tax treaty in force). U.S.-source capital gain not effectively connected with a U.S. trade or business is included in this category only in the exceptional case of a nonresident alien who is present in the United States for 183 days or more in the year in which such gain is realized.

- All other income, which is exempt from U.S. tax.

Foreign investors ordinarily prefer to have rental income from U.S. real estate considered effectively connected with a U.S. trade or business so as to qualify for deductions. Under statutory law, a foreign taxpayer who does not have such a trade or business may simply elect to have U.S. real property income taxed as if it were.

When real estate is sold, a foreign investor can avoid U.S. tax on his capital gain only if such gain is not effectively connected with a U.S. trade or business. Although statutory law does not intend that capital gain on assets used in a trade or business escape taxation, Chapter 3 identifies five ways (there may well be others) of achieving that result under present rules. Four of those ways depend only on a careful use of existing statutes, the fifth requires a treaty provision, but would be ineffective without the statutory exemption for capital gains on real estate not used in a trade or business.

Chapter 4 describes in greater detail the ways in which tax treaties modify U.S. statutory law. Although a substantial portion of foreign investment in U.S. real estate comes from or through foreign countries with which the United States has a tax treaty, the analysis of available statistics and relevant law suggests that statutory rules, not treaty modifications of those rules, allow foreign investors to avoid U.S. taxes on real estate income and capital gains.

Chapter 5 describes and analyzes proposals to treat all capital gain derived directly or indirectly from U.S. real estate as effectively connected with a U.S. trade or business and, thus, subject to U.S. tax. Analysis of a hypothetical investment in U.S. farmland suggests that under present law a foreign investor bears a lighter U.S. tax burden than a domestic investor does, but would bear a heavier burden if his capital gain were subject to tax. Taxing capital gain on the sale of U.S. real property would be fully consistent with international practice; indeed, the United States is somewhat unusual in not presently taxing such gain.

Taxing part or all of the capital gain on the sale of shares in a corporation owning U.S. real estate would, however, be a departure from international norms. A tax on the capital gain on the sale of shares is, moreover, difficult to enforce. A careful analysis of the specific steps a foreign investor must go through to avoid U.S. capital gains tax suggests that present abuses might be curtailed by modifying the rules relating to "like kind exchanges" of property, corporate liquidations and reorganizations, and so forth, rather than assessing a tax on the sale of corporate shares.

Taxing capital gain on the sale of U.S. agricultural land alone would raise U.S. Treasury revenues by an estimated $22 million in 1979; taxing capital gain on all U.S. real estate sold by foreign taxpayers would raise Treasury revenues by $142 million. The balance of payments impact of the proposal cannot be estimated with any precision, but would probably be relatively small.

Chapter 2 - Statistical Background

I. Introduction

This chapter summarizes available evidence on foreign investment in U.S. real estate generally and agricultural land in particular. Although all statistics could be improved, those pertaining to foreign investment in U.S. real estate should be approached with more than the usual caution. Under generally accepted accounting practices, assets are usually valued at historical cost; this practice may substantially understate fair market value or replacement cost of assets like U.S. real estate whose prices have been inflating rapidly. Moreover, statistical coverage of large investors tends to be better than that of small investors; the typical real estate investment is small by comparison to that in other industries. Finally, the most recent comprehensive Commerce Department and Internal Revenue Service statistics pertain to 1974. Newspaper accounts suggest that foreign investment in U.S. real estate has been growing rapidly in the last five years, but comprehensive statistics are simply unavailable.

II. Commerce Department and Other Non-Tax Statistics

The most recent benchmark census by the Department of Commerce of total foreign direct investment in the United States was based on 1974 data; results from that survey are summarized in Table 2-1. The Commerce Department statistics exclude U.S. affiliates* whose total assets and total annual revenues were both less than $100,000; assets are stated at book value (usually based on original cost) and net of depreciation (buildings and equipment are depreciated for reporting purposes in financial statements and tax returns, but land is not).

Table 2-1 indicates that total assets of U.S. affiliates of foreign investors had book value of $174 billion in 1974. Property, plant and equipment (net of depreciation) had book value totaling $29 billion; property alone (i.e. land and improvements) was valued at $4.7 billion. Property, plant and equipment includes not only real estate leased to other users, but also such assets used by a U.S. affiliate in a

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* According to Commerce Department definitions, a U.S. affiliate of a foreign investor is a U.S. branch of a foreign corporation or a U.S. corporation at least 10 percent of whose equity is owned by foreign investors.

Table 2-1

Assets, Liabilities & Net Worth
of U.S. Affiliates 1/ of Foreign Companies
(Millions of Dollars)

	All Industries	Real Estate
Year End 1974		
Total Assets 2/	174,272	4,245
Property, Plant and Equipment (Net)	29,366	2,601
Property (Net)	4,733	621
Total Liabilities	134,165	3,387
Long Term	20,865	2,273
Net Worth	40,107	858

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Office of Tax Analysis

Source: U.S. Department of Commerce, Foreign Direct Investment in the United States, Volume 2: Benchmark Survey, 1974, (April 1976).

1/ Includes U.S. Companies of which at least 10 percent of the equity was owned by foreigners.

2/ All assets stated at book value net of depreciation. Accumulated depreciation was equal to $4,523 million in total of which $327 million was in real estate.

business other than real estate. Foreign affiliates whose primary industry was real estate reported assets worth $4.2 billion, of which $2.6 billion represented property, plant and equipment, and $621 million property alone. Property, plant and equipment of real estate affiliates increased by 20 percent between 1973 and 1974. The Commerce Department also estimated that foreign-owned affiliates owned 1.1 million acres of U.S. agricultural land at the end of 1974.

The Commerce Department's Bureau of Economic Analysis updates certain benchmark statistics with annual sample surveys: the most recent survey indicates that net foreign investment (i.e., assets less liabilities) in the U.S. real estate industry decreased by $20 million between 1976 and 1977.* This finding, which is hard to reconcile with press accounts, may reflect book losses reported by existing investments and inadequate coverage of new investment. A different picture of new investment is provided by the Commerce Department's Office of Foreign Investment in the United States (OFIUS), which prepares annual tabulations of foreign purchases of U.S. property as reported in the press--see Table 2-2. OFIUS clippings identified 158 foreign purchases of U.S. real estate in 1978; the 112 purchases for which a price was reported amounted to $1.1 billion. Several of the larger purchases reflected in Table 2-2 were by Canadian developers. Purchases through the Netherlands Antilles (and, to a lesser extent, the Netherlands and the United Kingdom) may have been by corporations owned by residents of third countries.

The available statistics describing foreign investment in U.S. agricultural land are more current than those for U.S. real estate generally. According to a recent report by the General Accounting Office, foreigners owned an estimated three tenths of one percent of the land in the counties surveyed; if those counties are typical of the United States as a whole, foreigners owned 3 million acres (as compared to the Commerce Department estimate of 1 million acres as of

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* William K. Chung and Gregory C. Fouch, "Foreign Direct Investment in the United States, 1977," Survey of Current Business, U.S. Department of Commerce, Washington, D.C., August 1978, Tables 13 and 14.

Table 2-2

1978 Foreign Investments in the U.S. Real Estate Industry
Identified from Press Clippings by the Office of Foreign Investment
in the United States

Country of Parent*	Number of Transactions	Number with Money Given	Total Purchases (in millions)	Percent of Total
Canada	55	38	$564.5	51.3
Netherlands	12	9	131.6	12.0
Netherlands Antilles	12	9	28.3	2.6
United Kingdom	9	7	81.4	7.4
West Germany	15	10	79.7	7.2
Total	158	112	1,101.0	

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*The source of 10 transactions was not identified.

Comments:

1) There were 13 transactions with value in excess of $25 million accounting for 62.0 percent of the total investment identified. They were mainly by Canadian developers.

2) Only 20 transactions are definitely identified as involving a farm or ranch. There is therefore not much overlap with the purchases identified by the Department of Agriculture.

1974) of the estimated one billion total acres of U.S. agricultural land in 1978.* In 1977 and the first half of 1978, foreigners were purchasing U.S. agricultural land at a rate of 560,000 acres per year, which constituted about 2 percent of the acreage sold in that period. Assuming that foreigners purchased agricultural land worth $1,000 per acre (as opposed to the U.S. national average of $591 per acre),** the value of foreign purchases was approximately $560 million, or 4 percent of the total value of agricultural land sold in 1977. Finally, the average size of foreign purchase, 1,141 acres, was almost four times as large as the overall U.S. average of 308 acres. That difference, combined with the assumption that foreigners purchase somewhat more expensive land than domestic purchasers, implies that the average purchase by a foreign buyer was worth about $1.1 million, six-to-seven times as large as the average domestic purchase. This difference may be attributable, at least in part, to the fact that foreigners are typically making large, first-time purchases, whereas many domestic buyers are presumably making marginal additions to existing holdings.

III. Tax Return Statistics

Tables 2-3, 2-4 and 2-5 present tax return statistics on real estate operations by domestic and foreign investors in 1974 or 1975. Table 2-3 is based on all corporations (foreign or domestic), partnerships and sole proprietors (including farm landlords) whose primary industry is U.S. real estate, and all other individuals reporting income or

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* U.S. General Accounting Office, Foreign Ownership of U.S. Farmland, Much Concern, Little Data, June 12, 1978. This material can also be found in the Report to the General Accounting Office, in Foreign Investment in United States Agricultural Land, published by the U.S. Senate Committee on Agriculture, Nutrition and Forestry, (January 1979).

** Available statistics do not indicate the average price per acre of land purchased or owned by foreign investors. Evidence does suggest, however, that foreign investment tends to be concentrated in agricultural land of higher than average value. Because the price of prime U.S. farmland may substantially exceed $1,000 per acre, this Report has assumed that foreign-owned farmland was worth $1,000 per acre on average. Experts at the Department of Agriculture agree that this estimate is reasonable.

Table 2-3

Selected Balance Sheet and Income Statement Items
by Type of Return and Selected Industry
(Money Amounts are in Millions of Dollars)

Type of Return and Selected Industry	Number of Returns	Total Assets	Depreciable Assets (Net)	Land	Mortgages Notes and Bonds Payable	Total Receipts	Total Deductions	Taxes Paid	Interest Paid	Depreciation	Net Income	Deficit
CORPORATIONS 1/												
Lessors of buildings	166,985	$62,833	$34,145	$11,792	$5,185	$14,394	$5,737	$2,022	$2,898	$2,010	$1,710	$927
Lessors of mining, oil, and similar property	784	549	171	54	48	227	140	15	14	12	88	2
Lessors of railroad and other property	6,183	1,754	466	739	106	219	179	24	43	26	63	23
Real estate investment trusts	325	14,705	2,919	961	4,978	1,429	1,849	65	899	81	74	514
Corporations	174,277	79,841	37,701	13,546	10,317	16,269	15,782	2,126	3,854	2,129	1,935	1,466
PARTNERSHIPS WITH BALANCE SHEETS 2/												
Lessors of buildings	215,923	117,877	84,177	19,131	98,803	20,121	23,754	2,847	7,744	5,135	1,768	5,401
Other Lessors	21,772	4,808	546	3,421	2,445	363	413	50	155	49	131	181
Partnerships with Balance Sheets	237,695	122,685	84,713	22,552	101,248	20,484	24,167	2,897	7,899	5,184	1,899	5,582
Corporations and partnerships with balance sheets	411,972	202,526	122,414	36,098	111,565	36,753	39,949	5,023	11,753	7,313	3,834	7,048
ALL PARTNERSHIPS 2/												
Lessors of buildings	260,635	n/a	n/a	n/a	n/a	20,858	24,478	2,956	7,904	5,308	1,909	5,530
Other Lessors	32,349	n/a	n/a	n/a	n/a	527	494	65	160	59	222	189
Partnerships	292,984	n/a	n/a	n/a	n/a	21,485	24,972	3,021	8,064	5,367	2,131	5,719
Corporations and Partnerships	467,261	n/a	n/a	n/a	n/a	37,754	40,754	5,147	11,918	7,496	4,066	7,185
SOLE PROPRIETORS 2/												
Lessors of buildings	29,684	n/a	n/a	n/a	n/a	906	955	103	248	185	97	146
Other Lessors	34,817	n/a	n/a	n/a	n/a	83	117	18	24	28	22	56
Farm landlords	360,610	n/a	n/a	n/a	n/a	2,879	1,466	236	83	102	1,526	113
Sole proprietors	425,111	n/a	n/a	n/a	n/a	3,868	2,538	357	355	315	1,645	315
Corporations, partnerships, and sole proprietors	892,372	n/a	n/a	n/a	n/a	41,622	43,292	5,504	12,273	7,811	5,711	7,500
INDIVIDUALS REPORTING INCOME OR LOSS FROM REAL ESTATE 3/	1,176,287	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	975	1,095
All returns	2,067,659	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	6,686	8,595

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Office of Tax Analysis

1/ Source: Internal Revenue Service, Corporation Source Book of Statistics of Income, 1975.

2/ Source: Internal Revenue Service, Statistics of Income - 1975, Business Income Tax Returns.

3/ Source: Internal Revenue Service, Statistics of Income - 1975, Individual Income Tax Returns.

n/a Not available

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losses from real estate.* Because many of the rules for taxing the real estate income of domestic persons also apply to foreign persons, data from domestic tax returns provide important information. Table 2-3 documents an important aspect of real estate investment: losses are more often reported on tax returns than net income. For corporations, partnerships, farm landlords, sole proprietors and individuals, total deficits amounted to $8.6 billion, and total net income was $6.7 billion. Unlike other industries, where the corporate form predominates, real estate investment is most commonly undertaken by partnerships; total receipts of real estate partnerships amounted to $20.5 billion, as contrasted to the $14.4 billion of such receipts by real estate corporations. Real estate investors often prefer partnerships because under U.S. tax laws losses flow through to the partners and may shelter the partners' other income from taxation.**

Table 2-4 is based on the 1974 tax returns of U.S. real estate corporations 50 percent or more of whose equity was owned by foreign persons; Table 2-5 presents comparable statistics for foreign real estate corporations with income effectively connected with a U.S. trade or business. Taken together, these tables provide further insight into the nature and extent of foreign ownership of U.S. real estate:

- The $373 million in total receipts of these two types of corporation taken together equals approximately 3 percent of the total receipts of all U.S.

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* A farm landlord is an individual filing Form 4835 reporting gross farm rental income and expenses, but not "materially participating" in the operation or management of a farm. Such landlords typically provide land to a farmer in exchange for a share of farm production. A sole proprietor is an individual who included with his Form 1040 either Schedule C (Profit or Loss from Business or Profession) or Schedule F (Farm Income and Expenses). Other individuals are those who included with their Form 1040 Schedule E (Supplemental Income Schedule) and reported rental income.

** Losses flow through to the shareholders of Subchapter S corporations, but the restrictions on such corporations (e.g., 15 or fewer shareholders, none of whom may be a foreign individual or taxpayer, the need to make a unanimous election, the restriction to a single class of stock) may make this form unattractive to real estate investors.

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Table 2-4

Selected Income Statement and Balance Sheet Items of
Domestic Corporations Engaged in Real Estate and Owned 50 Percent
or more by a Foreign Entity by Country of Address of Foreign Owner, 1974
(Money Amounts in Millions of Dollars)

Country	Number of Returns	Total Assets	Depreciable Assets (Net)	Total Receipts	Total Deductions	Net Income	Deficit
All geographic areas	760	$2,110	$1,198	$311	$363	$7	$60
Canada	294	470	255	64	77	1	14
Latin America	78	90	30	11	15	*	5
Panama, excluding Canal Zone	13	44	21	4	7	*	4
Peru	55	13	1	2	2	-	*
All other Latin America	10	33	8	5	6	*	1
Other western hemisphere	85	236	154	29	36	1	8
Bahamas	34	102	70	8	12	-	5
All other western hemisphere (includes Netherlands Antilles)	51	133	84	21	24	1	3
Europe	53	287	115	40	44	3	8
Luxembourg	16	24	16	2	3	-	1
Switzerland	3	3	3	1	1	-	*
United Kingdom	25	155	108	26	29	1	4
West Germany	4	69	32	8	6	3	*
All other Europe	5	36	*	3	6	-	1
Africa	3	15	2	3	3	*	-
Liberia	3	15	2	3	3	*	-
Asia	93	141	49	19	25	1	7
OPEC countries	9	23	18	2	5	-	2
Japan	71	82	12	15	18	1	4
All other Asia	13	36	19	2	2	*	*
Australia	24	11	5	22	21	*	-
Country not stated	129	844	613	121	135	*	14

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Source: Unpublished Internal Revenue Service tabulations.

* Less than $500,000

Table 2-5

Foreign Corporations Engaged in U.S. Trade or Business
whose Principal Industry was Real Estate,
by Country of Incorporation, 1974
(Money Amounts in Million of Dollars)

Country	Number of Returns	Total Receipts	Total Deductions	Net Income	Deficit
All geographic areas	347	$62	$78	$3	$20
Canada	74	13	15	*	3
Latin America	65	6	6	*	1
Panama, excluding Canal Zone	60	5	6	*	1
All other Latin America	5	*	*	*	*
Other western hemisphere (includes Netherlands Antilles)	138	36	48	2	14
Europe	39	5	4	1	*
Liechtenstein	10	1	1	*	*
United Kingdom	6	4	3	1	*
West Germany	16	*	*	*	*
All other Europe	17	*	*	*	*
Africa and Asia	13	1	2	*	1
Australia	7	1	1	*	*

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* Less than $500,000

real estate corporations and 1 percent of such receipts by U.S. real estate corporations and partnerships. This $373 million does not include rental income of foreign individuals, trusts or estates owning U.S. real estate in their own names or holding an interest in a U.S. real estate partnership.*

- Foreign owners of U.S. real estate corporations most often listed addresses in Canada, Western Europe (especially the United Kingdom), and other western hemisphere countries (especially the Bahamas and, to a lesser extent, the Netherlands Antilles). Foreign corporations investing directly in U.S. real estate are, by contrast, predominantly from other western hemisphere countries.
- Foreign investment in U.S. real estate through U.S. corporations is much larger than direct ownership by foreign corporations ($311 million vs. $62 million in business receipts). Both types of corporations are typically reporting tax losses, rather than positive income.

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* A nonresident alien with income effectively connected with a U.S. trade or business (e.g., real estate) is required to file a U.S. tax return, Form 1040NR. However, the Internal Revenue Service does not presently compile statistics based on Form 1040NR. All Forms 1040NR are excluded from the I.R.S. tabulations based on Form 1040 filed by U.S. citizens and resident aliens.

Chapter 3 - U.S. Statutory Law

I. Taxation of U.S. Individuals and Corporations

A. Ordinary Income and Loss

To appreciate how the United States taxes foreigners, it is necessary to understand how the United States taxes its own citizens, residents, corporations and other entities. U.S. citizens, whether living in the United States or in a foreign country, foreign individuals who are resident in the United States, U.S. corporations, U.S. trusts and U.S. estates are all taxed on their worldwide income. Deductions are allowed for most ordinary and necessary costs of earning income and for other specifically enumerated expenses. Losses from one activity can be offset against income from other activities. Individuals may either itemize deductions, or claim a standard deduction (zero bracket amount),* and may exempt $1,000 for themselves, each qualifying dependent, and on account of blindness or age over 65 years. Income derived outside the United States is included in U.S. taxable income, but a dollar-for-dollar credit is provided for income taxes paid to foreign governments.**

The allowance of deductions and the consolidation of income and losses are particularly important to real estate investors. Rental income from real estate can be reduced by operating expenses (utilities, maintenance, etc.), insurance, property taxes, mortgage interest and, in the case of buildings, depreciation. Because most readers are familiar with the first four items, only the fifth, depreciation, needs to be described in any detail.

Because buildings and equipment may depreciate in value on account of wear and tear, obsolescence, etc. necessary to the production of income, a deduction is allowed for

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* As of 1979, the zero bracket amount is $3,400 for married individuals filing jointly, $1,700 for married individuals filing separately, and $2,300 for unmarried individuals.

** The amount of the foreign tax credit cannot, however, exceed the U.S. tax attributable to income derived outside the United States.

depreciation. Under U.S. tax accounting rules, the depreciation deduction is not, however, based on the actual gain or loss in the market value of the property (so called economic depreciation). Rather, the depreciation allowance is calculated so that the aggregate of amounts set aside, plus the salvage value at the end of the estimated useful life of the depreciable property, will equal the cost or other basis of the property. Under this approach, calculation of the depreciation allowance depends on the depreciation base and the estimated useful life of the investment. Under the statute, taxpayers choose a particular method for amortizing the base over the estimated useful life.

No depreciation can be taken with respect to land. For buildings, the depreciation base generally equals the original cost of acquiring the property less the cost attributable to the land. The owner estimates the useful life of the building according to the type of construction, the age of the building when acquired, and other "facts and circumstances". Under the straight-line method, depreciation deductions are taken in equal annual installments over the useful life of the investment. U.S. law, however, specifically allows accelerated methods of depreciation as follows:

Table 3-1

Accelerated Depreciation Methods*
Expressly Permitted for Real Estate Property
Under U.S. Tax Law

Type of Property	Method of Depreciation
Land	No Depreciation Permitted
New Rental Housing	200 percent declining balance, sum of the years digits, or other accelerated method
Used Rental Housing (with remaining useful life of 20 or more years)	125 percent declining balance
New Commercial Property	150 percent declining balance
Used Commercial Property	Straight-line only

* These different methods are best illustrated with a numerical example. Suppose a building cost $1 million, had an estimated useful life of 50 years. Under the straight-line methods, the investor could claim a depreciation deduction of $20,000 (one fiftieth of $1 million) in each of the fifty years (assuming the building had no salvage value). Under the 200 percent declining balance method, he could claim a deduction of $40,000 in the first year (two fiftieths of $1 million), $38,400 in the second year (two fiftieths of $960,000, the original base less the first year's depreciation), etc. The 150 percent or 125 percent declining balance is the same as the 200 percent declining balance method, except the fraction is 150 percent or 125 percent, respectively, of the straight-line fraction. Under the sum-of-the-years-digits method, one first totals the digits from 1 to 50 and obtains the sum, 1275. In the first year, the depreciation deduction equals 50/1275, or 3.92 percent, of the depreciation base; in the second year, the depreciation deduction equals 49/1275, or 3.84 percent, of the depreciation base, etc. In the early years of an investment, the sum-of-the-years-digits method produces a result closely approximating the 200-percent-declining balance method.

Taxpayers are permitted to make certain switches in the method of depreciation. For new rental housing, for example, the most rapid depreciation would be achieved by using the 200 percent declining balance method for the first three years and then switching to the sum-of-the-years-digits method. Taxpayers may, subject to certain conditions, change from any declining balance method of depreciation to any other method without express IRS permission. Once a taxpayer has changed to a straight-line method, however, IRS consent is required to change to any other method.

Under the accelerated methods, higher depreciation in the early years of an investment is offset by lower depreciation in the later years. Accelerated depreciation allows an investor to postpone the recognition of income and, thus, defer his tax payments. This makes investment in real estate more attractive than it would otherwise be under a straight-line method.

As shown in Table 2-3, real estate deductions typically exceed rental income and result in losses for tax purposes. Losses shown on real estate investments can offset income from other activities in computing a taxpayer's total taxable income, "sheltering" such other income from taxation. This tax-shelter feature makes real estate investment particularly attractive to individuals whose high income would otherwise place them in a high tax-rate bracket.

B. Capital Gain

Over the last two decades, U.S. real estate has appreciated rapidly in value. Indeed, the expected capital gain, not the operating income, has become the primary non-tax inducement to real estate investment. Because real estate is ordinarily held for more than one year, this section will describe only the tax treatment of long-term capital gain. When real estate is sold, a U.S. taxpayer treats any gain up to the amount of prior "excess depreciation" as ordinary income* and the balance, if any, as capital gain.** Under

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* The recapture rule for real estate is more generous than for other depreciable assets. If other assets are sold, the seller must treat any gain up to the amount of all prior depreciation, not just the excess over the straight-line amount, as ordinary income and the balance, if any, as capital gain.

** For example, suppose an investor purchased a property for $1 million and had claimed total depreciation deductions of $500,000. Had the investor used straight-line rather than accelerated depreciation, his total depreciation deductions would have been $400,000. If the property is sold for $2 million, his net gain realized for tax purposes would be $1,500,000. He must, however, treat $100,000, the excess of accelerated over straight-line depreciation, as ordinary income. The remaining $1,400,000 is capital gain. If the property was held for more than one year, he may deduct an amount equal to 60 percent of the capital gain, or $840,000. Thus, his net taxable income is $660,000 ($100,000 plus 40 percent of $1,400,000).

the new provisions of the Revenue Act of 1978, an individual may deduct an amount equal to 60 percent of capital gain on the sale of this property and pay tax on the remaining 40 percent. With a maximum tax rate of 70 percent on ordinary income, the maximum effective rate on capital gain of individuals is 28 percent (40 percent of 70 percent).

An individual with substantial long-term gain may be affected by the alternative minimum tax. Alternative minimum taxable income as defined by the Revenue Act of 1978, equals taxable income plus the long-term capital gains deduction plus certain adjusted itemized deductions. Alternative minimum taxable income is taxed at progressive rates; the highest rate, 25 percent, applies to alternative minimum taxable income in excess of $100,000. The individual's income tax liability equals the higher of the tax computed under the ordinary rules and the tax computed under the alternative minimum tax rules.

An unmarried individual with no ordinary income or itemized deductions, and who claims no tax credits, but who has long-term capital gain of at least $108,000, but less than $214,000, would pay by the alternative minimum tax. As a consequence, the marginal rate of taxation of his capital gain within this bracket would be raised to 25 percent. Because the only credit allowed against the alternative minimum tax is a foreign tax credit (the computation of which is specially controlled by the alternative minimum tax rules), the alternative minimum tax provisions impinge most heavily on individuals with substantial deductions for long-term capital gains (or adjusted itemized deductions) and tax credits, such as the investment tax credit, not allowed against the alternative minimum tax.

Individuals do not recognize capital gain on the sale of a principal residence provided a new principal residence is acquired within 18 months. And, an individual who is at least 55 years old may elect once in his lifetime to exclude $100,000 on the sale of a principal residence.

Long-term capital gains of corporations are taxed without any special deduction either as ordinary income or at a flat rate of 28 percent, whichever produces a lower amount of tax.

Corporations and individuals may lessen the impact of the capital gains tax if the purchaser spreads payment over two or more years. If the seller requires payment of less than 30 percent in the year of sale, he may defer recognition of his capital gain in accordance with the schedule of payments. For example, if a buyer makes a down payment of 25 percent of the purchase price and agrees to pay off the balance in three annual installments of 25 percent (plus appropriate interest), the seller can recognize 25 percent of total net gain with each payment.

C. Taxation of Partnerships

A partnership is not a taxable entity under U.S. law; rather, each partner in determining his own tax includes his distributive share of the partnership's taxable gross income and of certain other specified items of gain, loss, income, deduction or credit. U.S. law provides that a partner's distribution share of any item of income, loss, deduction or credit is to be determined by the partnership agreement, unless the agreement contains no provision determining a partner's distributive share, or unless the applicable provision lacks "substantial economic effect."

Appendix C describes a hypothetical example of a partnership between a domestic and a foreign taxpayer. By allocating the tax losses to the domestic investor, who is not limited in his ability to offset such losses against other U.S. income, and allocating only capital gain to the foreign investor, who may be exempt from U.S. tax on such gain under present U.S. law, both investors may obtain higher after-tax returns than could either one investing separately.

II. Taxation of Nonresident Aliens and Foreign Corporations

A. Introduction

A nonresident alien or foreign corporation has three types of income for U.S. tax purposes:

1. Income, including capital gain, effectively connected with a U.S. trade or business. This type of income can be offset by allowable deductions and is taxed generally according to the same rules and rates as those applicable to the income of U.S. citizens or corporations.

2. Certain other income having a U.S. source, which is taxed at a flat rate of 30 percent (or at a lower rate if a tax treaty applies), and against which no deductions are allowed. This category includes:

a. interest, dividends, rents and certain other items of income or gain which are of U.S. source, but which are not effectively connected with the active conduct of a U.S. trade or business.

b. an individual's capital gain on U.S. property, but only in the exceptional case of the non-resident alien who is present in the United States for more than 183 days in the year in which the gain is realized.

3. All other income, which is exempt from U.S. taxation, whether of U.S. source or not.

This section describes how the residence of an alien individual is determined for U.S. tax purposes, how the income or capital gains of nonresident aliens, foreign corporations, foreign trusts and foreign estates is allocated among the three types enumerated above, and how each type of income is taxed.

B. When is a Foreigner a Resident of the United States for Income Tax Purposes?

Because a foreign individual's U.S. tax liability may be substantially affected by whether he is or is not considered a U.S. resident for U.S. tax purposes, the criteria for determining residence are important. The Internal Revenue Code itself provides no explicit standards. Regulation 1.871-2(b), however, does provide standards:

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

in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

An alien who has been in the United States for less than a year is presumed under I.R.S. regulations not to be a resident for tax purposes. The burden of proof falls on the individual or the Internal Revenue Service, as the case may be, to rebut the presumption of nonresidence. This may be done by examining the following factors:

Visa - Some visas under which foreigners enter the United States allow the individuals to take up residence, but others do not. The type of visa does not govern for tax purposes, but legal residents under U.S. immigration laws would usually be residents for tax purposes.

Length of Stay - The longer a foreigner remains in the United States, the more likely it becomes that he or she will be deemed a resident for tax purposes. Foreigners staying in the U.S. for more than one year are presumed by the I.R.S. to be residents for tax purposes.

Other Factors - Owning a home or condominium, signing a long-term apartment or office lease, maintaining bank and charge accounts, registering a car or getting a driver's license, and joining a church or club in the United States are evidence of U.S. residence.

Aliens wishing to avoid having a U.S. residence for tax purposes generally enter the U.S. on temporary visas, limit the length of any one stay in the United States, and so forth, while those wishing to establish residence do the opposite.

The dividing line between taxation as a U.S. person and taxation as a foreign person is much simpler and more automatic in the case of a corporation than in that of an individual. The United States regards the place of incorporation as determinative; an entity incorporated in the United States is domestic, while all others are foreign. This rule, which has the obvious virtue of simplicity, may also be subject to manipulation: investors who wish to be taxed under the rules applicable to foreign corporations incorporate outside the United States; those who prefer the rules applicable to domestic corporations incorporate in one of the fifty States or the District of Columbia. Countries other than the United States often look to the place of "effective management," rather than (or in addition to) the place of incorporation, in determining the tax status of corporations. Like the U.S. residence rules for individuals, the place of effective management rules for corporations depend on the facts and circumstances of individual cases and differ from one country to another.

C. When is a Nonresident Alien or a Foreign Corporation Engaged in a Trade or Business Within the United States?

Although the concept of having a U.S. trade or business is critical to U.S. taxation of a foreign investor's income, the Internal Revenue Code provides little explicit guidance for making this determination. The performance of personal services within the United States is, with one limited exception, a U.S. trade or business; trading in securities or commodities through an independent agent by a foreigner for his own account is not. In the case of real estate, whether a foreign investor has a U.S. trade or business is usually determined by the following factors:

- Size of the Investment: The more substantial the investment, the more likely the person will be considered to be engaged in a U.S. trade or business.

- Terms of a Lease: A lessor with a long-term net lease to a single tenant under which the lessee assumes responsibility for paying maintenance and operating costs, insurance, property taxes or mortgage interest has been considered not engaged in a U.S. trade or business. The shorter the lease, the greater the share of the costs incurred by the owner, rather than the tenant, and the more numerous the tenants, the more likely it becomes that the lessor will be deemed to be engaged in a U.S. trade or business.

- Nature of the Property: Leasing unimproved land, including agricultural land, has been considered not to be a U.S. trade or business.

- Personal Use: If a house or condominium is used by the owner and rented out only occasionally, the investor is considered not to have a U.S. trade or business.

If a partnership as an entity is considered to be engaged in a U.S. trade or business, so too will be all partners. The Internal Revenue Code also provides that a foreign beneficiary of trust or estate will be considered engaged in a U.S. trade or business if the trust or estate is engaged in a U.S. trade or business.

D. What Income is Effectively Connected with a U.S. Trade or Business?

If a nonresident alien or foreign corporation is considered to be engaged in a U.S. trade or business, the income which will be considered effectively connected with the U.S. trade or business consists of three types:

- Interest, dividends, rents and other such U.S.-source income, plus capital gains or losses, if the income is derived from assets used in (or held for use in) the conduct of a U.S. trade or business, or if the trade or business activities were a material factor in the realization of such income.

- All other U.S. source income (e.g., income derived from goods sold in the United States).

- Certain foreign source income attributable to the U.S. trade or business.

To take an obvious example, suppose a foreign corporation or non-resident alien owned U.S. real estate and was considered by the nature of its investment to be engaged in a U.S. trade or business. Rental income from that real estate would be considered effectively connected with the U.S. trade or business, as would U.S.-source interest income on cash balances maintained to pay property taxes and meet other expenses of the U.S. trade or business. However, if the corporation also earned U.S.-source interest on long-term bonds which were not held for use in the conduct of its U.S. trade or business, this latter income might not be effectively connected with the U.S. trade or business.

E. Election to have Real Property Income Taxed on Net Basis

Even if a foreigner is not otherwise engaged in a U.S. trade or business and would consequently not be entitled to any deductions, he may elect to have his real property income taxed net of deductions. Real property income includes income from, or capital gain on the sale of, real estate, rents or royalties from mines, wells or other natural resource deposits, and capital gain from the sale of timber, coal and iron ore. The difference between a tax of 30 percent on gross rental income and a tax on that same income less all allowable deductions can be substantial.

The disadvantage of making the net election allowed by statute is that capital gain on the sale of the real estate will generally also be considered effectively connected with the elected U.S. trade or business and thereby lose what might otherwise be tax-exempt status. Under section 871(d), an election, once made, cannot be revoked without permission of the Internal Revenue Service. Foreigners typically resolve this dilemma by making an election and finding some other way to avoid the capital gains tax.

F. Treatment of Foreign Taxpayers versus Domestic Taxpayers

Income effectively connected with a U.S. trade or business of a foreign taxpayer is generally taxed by the United States according to the same rules and rates as those applicable to comparable U.S. taxpayers. There are, however, certain exceptions to this general rule:

- A foreigner's losses effectively connected with a U.S. trade or business cannot be used to offset U.S.-source interest, dividends, and other income not effectively connected with a U.S. trade or business.

- A nonresident alien can claim only one personal exemption. Additional exemptions cannot be claimed for dependents or on account of the individual's age or blindness.

- A nonresident alien must itemize deductions--that is, he cannot claim the standard deduction, or zero-bracket amount. Apart from the charitable contributions, deductions are generally limited to those allocable to income effectively connected with the U.S. trade or business.

- A nonresident alien cannot file a joint return with his spouse.* Not only will he be subject to the harsher limitations and schedules applicable to married individuals filing separate returns, but he cannot limit his tax on personal services income (wages and salary, etc.) to the otherwise applicable maximum rate of 50 percent.

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* If a nonresident alien is married to a U.S. citizen or resident, the nonresident alien may elect to join his or her spouse in filing a joint return. If this election is made, the nonresident alien individual is treated as a resident for U.S. tax purposes, and thus the married couple is taxable on their combined worldwide income.

- A nonresident alien may not elect, nor join with others in electing, to have a U.S. corporation in which he is a shareholder taxed according to the rules of Subchapter S. The Subchapter S rules allow a U.S. corporation with 15 or fewer shareholders to elect not to pay tax provided its shareholders include a proportionate share of the corporation's income or loss in their own taxable income.

G. Taxation of Interest, Dividends, Rent and Other Income Not Effectively Connected with a U.S. Trade or Business

The preceding discussion describes the taxation of income which is effectively connected with a U.S. trade or business or, in the case of real property income, which the foreign investor elects to be taxed as if it were. The United States also taxes U.S.-source "interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed and determinable, annual or periodical gains, profits and income" which are earned by foreigners, but which are not effectively connected with a U.S. trade or business. No deductions are allowed against such income and, in the absence of a tax treaty, the rate of tax is 30 percent. As Table 3-2 indicates, however, the rate is reduced, often substantially, for residents of foreign countries with which the United States has a tax treaty.

The withholding rate on rent from real estate investment is often not reduced by treaty and, where it is reduced, is lowered only to 15 percent. Moreover, mortgage interest, property taxes, operating expenses, and depreciation cannot be deducted from rental income in determining the amount of the tax.* The disallowance of all deductions serves as a powerful incentive for foreigners to elect to be taxed as if they were engaged in trade or business, if they otherwise would not be.

H. Taxation of Capital Gains of Foreign Investors

Foreign investors may under certain circumstances be taxable in the United States on capital gains derived from sales of U.S. real estate. Capital gains which are effectively connected with a U.S. trade or business are taxable

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* If such expenses are paid by a tenant under the terms of a net lease, such expenses are added to the net lease payment made to the foreign owner in computing the base to which the withholding tax is applied.

under the same rules and at the same rates as are applicable to U.S. taxpayers. Capital gains which are considered not to be effectively connected are tax exempt, except for a foreign individual who, though not a resident of the United States, is present in the United States for more than 183 days in the year in which the gain is realized.

The historical evolution of U.S. taxation of capital gain on the sale of U.S. property may help explain why the tax applies only to gain effectively connected with a U.S. trade or business or gain of a nonresident alien present in the United States for more than 183 days. The Revenue Act of 1921 specifically included capital gain on the sale of real property located in the United States in the income of a nonresident alien subject to U.S. tax; the Revenue Act of 1934 added capital gains from the sale of personal property, which includes stocks, bonds and other financial assets.* Under these statutes, nonresident alien and foreign corporations were taxable in the U.S. on a net basis. The Revenue Act of 1936 introduced the method of taxing foreign persons not engaged in U.S. business on a flat rate basis. Section 211 of that Act limited the U.S. tax on a nonresident alien or foreign corporation who was not engaged in a U.S. trade or business and who did not maintain an office or place of business in the United States to 10 percent of his U.S. source dividends, interest, rents, wages, salaries, annuities, and periodical gains, profits and income. It did not subject capital gains to the flat rate tax. The House Report offered the following explanation for this change:

> In section 211, it is proposed that the tax on a nonresident alien not engaged in a trade or business in the United States and not having an office or place of business therein, shall be at the rate of 10 percent on his gross income from interest, dividends, rents, wages, and salaries and other fixed and determinable income. This tax (in the usual case) is collected at the source by withholding as provided for in section 143. Such a nonresident will not be subject to the tax on capital gains, including gains from hedging transactions, as at present, it having been found impossible to effectually collect this latter tax. It is believed that this

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* Since 1921, U.S. citizens and residents have been required to include capital gain on the sale of real property, corporate shares and other capital assets.

Table 3-2 Withholding Tax Rates on Income Other Than Compensation for Personal Services Under Chapter 3, Internal Revenue Code, and Income Tax Treaties

Income code number			2	3	5			6	7	9	10	11	12	13	14
Country of residence of payee					Interest on tax-free covenant bonds — Bonds issued before Jan. 1, 1934			Dividends paid by a				Copyright royalties			
Name	Code	Interest paid by U.S. obligors general	Interest on real property mortgages	Interest paid to a controlling foreign corporation	If obligor assumes over 2% of tax	If obligor assumes 2% or less of tax	Maturity date extended on or after 1/1/34 and obligor assumes over 27 1/2% of tax	U.S. corporation general	U.S. subsidiary to foreign parent corporation	Capital gains	Industrial royalties	Motion pictures and television	Other	Real property income and natural resources royalties	Pensions and annuities
Antigua	AC	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Australia	AS	30	30	30	2	30	27 1/2	15	15	30	30	30	0	30	0
Austria	AU	0	30	0	0	0	0	15	5	30	0	10	0	30	0
Barbados	BB	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Belgium	BE	15	15	15	2	15	15	15	15	0	0	30	0	30	0
Belize (British Honduras)	BH	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
British Virgin Islands	VI	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Burundi	BY	15	15	15	2	15	15	15	15	30	0	0	0	30	0
Canada	CA	15	15	15	2	15	15	15	15	0	15	15	0	15	0
Denmark	DA	0	0	0	0	0	0	15	5	30	0	0	0	30	0
Dominica	DO	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Falkland Islands	FA	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Finland	FI	0	0	0	0	0	0	15	5	0	0	0	0	30	0
France	FR	10	10	10	2	10	10	15	5	0	5	0	0	30	0
Gambia	GA	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Germany, Fed. Rep. of	GE	0	0	0	0	0	0	15	15	0	0	0	0	30	0
Greece	GL	0	0	30	0	0	0	30	30	30	0	30	0	30	0
Grenada	GR	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Iceland	IC	0	0	0	0	0	0	15	5	0	0	30	0	30	0
Ireland	EI	0	0	30	0	0	0	15	5	30	0	0	0	15	0
Italy	IT	30	30	30	2	30	27 1/2	15	5	30	0	0	0	30	0
Jamaica	JM	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Japan	JA	10	10	10	2	10	10	15	10	0	10	10	10	30	0
Luxembourg	LU	0	30	0	0	0	0	15	5	30	0	0	0	30	0
Malawi	MI	0	0	30	0	0	0	15	5	30	0	0	0	15	0
Montserrat	MH	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Netherlands	NL	0	0	0	0	0	0	15	5	0	0	0	0	30	0
Netherlands Antilles	NA	0	30	30	0	0	0	15	5	30	0	0	0	30	0
New Zealand	NZ	30	30	30	2	30	27 1/2	15	5	30	30	0	30	30	30
Nigeria (before 1979)	NI	30	30	30	2	30	27 1/2	15	5	30	0	0	0	15	0
Norway	NO	0	0	0	0	0	0	15	10	0	0	30	0	30	0
Pakistan	PK	30	30	30	2	30	27 1/2	30	15	30	0	30	0	30	0
Poland	PL	0	0	0	0	0	0	15	10	0	10	10	10	30	30
Romania	RO	10	10	10	2	10	10	10	10	0	15	10	10	30	0
Rwanda	RW	15	15	15	2	15	15	15	15	30	0	0	0	30	0

St. Christopher-Nevis-Anguilla	SC	30	30	30	2	30	27 1/2	[c,h]15	[b,c,h]5	30	[c,h]0	[c,h]0	[c,h]0	[c,h]15	[e]0
St. Lucia	ST	30	30	30	2	30	27 1/2	[c,h]15	[b,c,h]5	30	[c,h]0	[c,h]0	[c,h]0	[c,h]15	[e]0
St. Vincent	VC	30	30	30	2	30	27 1/2	[c,h]15	[b,c,h]5	30	[c,h]0	[c,h]0	[c,h]0	[c,h]15	[e]0
Seychelles	SE	30	30	30	2	30	27 1/2	[c,h]15	[b,c,h]5	30	[c,h]0	[c,h]0	[c,h]0	[c,h]15	[e]0
Sierra Leone	SL	30	30	30	2	30	27 1/2	[c,h]15	[b,c,h]5	30	[c,h]0	[c,h]0	[c,h]0	[c,h]15	[e]0
South Africa	SF	30	30	30	2	30	27 1/2	30	30	30	30	30	30	30	30
Sweden	SW	[h]0	[h]0	[h]0	[h]0	[h]0	[h]0	[h]15	[b,h]5	[h]0	0	0	0	30	[e]0
Switzerland	SZ	[h]5	[h]5	[h]5	2	[h]5	[h]5	[h]15	[b,h]5	30	[h]0	[h]0	[h]0	30	[e]0
Trinidad & Tobago	TD	30	30	30	2	30	27 1/2	30	30	30	[g]15	30	[g]0	30	[c,h]0
Union of Soviet Socialist Republics	UR	[o]0	30	30	2	30	27 1/2	30	30	[p]0	0	0	0	30	30
United Kingdom[k]	UK	[g]0	[g]0	[g]0	[g]0	[g]0	[g]0	[g]15	[g]15	[c,g]0	[g]0	[g]0	[g]0	[c,h]15	[e]0
Zaire	CG	[h]15	[h]15	[h]15	[g]0	[h]15	[h]15	[h]15	[h]15	30	[h]0	[h]0	[h]0	30	[e]0
Zambia	ZA	[c,h]0	[c,h]0	30	[c,h]0	[c,h]0	[c,h]0	[c,h]15	[b,c,h]5	30	[c,h]0	[c,h]0	[c,h]0	[c,h]15	[e]0
Other countries	......	30	30	30	2	30	27 1/2	30	30	30	30	30	30	.30	30

[a] No U.S. tax is imposed upon a dividend paid by a U.S. corporation which has less than 20% of its gross income from U.S. sources for the 3-year period preceding the declaration of such dividend. (See section 861(a)(2)(A) of the Internal Revenue Code.)

[b] The reduced rate applies to dividends paid by a subsidiary to a foreign parent corporation having the required percentage of stock ownership. In some cases, the income of the subsidiary must meet certain requirements (e.g. a certain percentage of its total income must consist of income other than dividends and interest).

[c] The exemption or reduction in rate applies only if the recipient is subject to tax on such income in the country of residence. Otherwise a 30 percent rate applies. In the case of Canada, this requirement applies to intercorporate dividends only.

[d] Exemption does not apply to U.S. Government (Federal, State, or local) pensions and annuities; 30% rate applies to such pensions and annuities.

[e] The treaty exemption applicable to U.S. source capital gains includes capital gains under section 871(a)(2) if received by a nonresident alien present in the U.S. for a period not exceeding 183 days. (182 days for Belgium.)

[f] Includes alimony

[g] Under the treaty the exemption or reduction in rate does not apply if the recipient has a permanent establishment in the United States and the property giving rise to the income is effectively connected with such permanent establishment. Notwithstanding the treaty, if the income is not effectively connected with the conduct of a trade or business in the United States by the recipient, such recipient will be deemed not to have a permanent establishment in the United States under section 894(b), I.R.C.

[h] Under the treaty the exemption or reduction in rate does not apply if the recipient is engaged in the conduct of a trade or business in the United States through a permanent establishment located in the United States. However, if the income is not effectively connected with the conduct of a trade or business in the United States by the recipient, such recipient will be deemed not to have a permanent establishment in the United States for the purpose of applying the reduced treaty rate to the item of income concerned. Section 894(b), I.R.C.

[i] Bangladesh has not indicated that it wishes to assume the responsibilities or exercise the rights of the United States—Pakistan income tax treaty.

[j] Exemption is not available when paid from a fund, under an employees' pension or annuity plan, contributions to which are deductible under the tax laws of the United States in determining taxable income of the employer.

[k] Yemen has not indicated that it wishes to assume the responsibilities or exercise the rights of the United States—United Kingdom income tax treaty.

[l] Exemption from or reduction in rate of tax not applicable in the case of income of holding companies entitled to special tax benefits under the laws of Luxembourg.

[m] Exemption does not apply to gains from the sale of real property; 30% rate applies to such sales.

[n] The exemption or reduced rates applicable to U.S. source dividends, interest, industrial, and literary royalties do not apply when these items are paid to a Netherlands Antilles investment or holding company entitled to special tax benefits under Netherlands Antilles law and owned by persons or corporations not resident in the Netherlands.

[o] The exemption applies only to interest on credits, loans, and other indebtedness connected with the financing of trade between the U.S. and the U.S.S.R. It does not include interest derived from the conduct of a general banking business.

[p] The exemption only applies to gains from the sale or other disposition of property acquired by gift or inheritance.

exemption from tax will result in additional revenue from the transfer taxes and from the income tax in the case of persons carrying on the brokerage business.**

In subsequent years, Congress eliminated the provision that a foreign taxpayer which had a U.S. office or fixed place of business, but which was not "engaged" in U.S. business, would be taxable on a net basis. The flat rate of taxation on interest, dividends, and other income of taxpayers not engaged in a U.S. trade or business was gradually increased, and the special rule for capital gains of nonresident aliens present in the United States for 90 and then 183 days were added. Also, in 1966 the distinction between effectively connected income and not effectively connected income of taxpayers who were engaged in a U.S. trade or business was introduced. But the exemption for capital gains of foreign corporations and nonresident aliens not engaged in a U.S. trade or business has remained since 1936.

To avoid capital gains taxation under present law, the foreign investor must find a way of severing any connection between the gain and the (actual or deemed) U.S. trade or business which qualified him for taking deductions against his operating income. At present, at least five such ways are available:

1. A foreigner who <u>is</u> engaged in trade or business (and thus has made no election to be so taxed) may make an installment sale and postpone receiving payment until after the end of the year in which the property was sold. Under the installment sale rules, the gain is recognized in proportion to the amount of the installment payment (see p. above). Although an <u>election</u> to be taxed as if engaged in trade or business cannot be revoked, the <u>actual determination</u> in the absence of an election is made anew each year. So although a foreign investor may have been engaged in trade or business, he would no longer be in trade or business when most or all the gain is reported.

2. Suppose the foreign resident owned the real estate through a holding company, the company sold the real estate and was liquidated within a year, and its assets (e.g., the proceeds from the sale of the real estate)

** U.S. Congress. House. Committee on Ways and Means. Revenue Bill of 1936. 74th Cong. 2nd Sess. H. Rept. 2475 (1936) were distributed to shareholders. Under section 337 of the Internal Revenue Code, a corporation, if it pursues the liquidation according to certain proscribed steps, will not recognize such a gain for tax purposes. While the shareholders must recognize the capital gain, that capital gain is considered to be realized in exchange for their stock. Because stock ownership does not per se constitute a trade or business, the capital gain is tax exempt. The holding company, not its shareholder(s), is engaged in a U.S. trade or business. In short, capital gain on the sale of U.S. real estate, which would have been taxable, is converted into capital gain on the sale of corporate shares, which may well be exempt.

3. The same result would be obtained if the foreign shareholders sold their shares in the holding company. Capital gain on the sale of shares is generally tax exempt. The buyer could liquidate the holding company and recognize no capital gain; the only gain the liquidated company would recognize would be the amount of its prior "excess depreciation" and any similar items subject to recapture.

4. If the foreign investor exchanges his U.S. property for foreign property "of a like kind," his taxable gain is limited to the cash or other "boot" received as part of the overall exchange. Thus, a foreign investor could exchange his U.S. real estate (and cash and other "boot," if necessary) for foreign real estate and, as long as he receives no "boot," pay no capital gains tax. The foreign real estate he purchases may have been recently acquired for this specific purpose by his trading partner. If he then turns around and sells the foreign real estate, that gain will not be effectively connected with a U.S. trade or business and, thus, will be exempt from U.S. tax.

5. As discussed in Chapter 4, many of our tax treaties permit a foreigner who is not engaged in a U.S. trade or business, but who elects to have his real estate income taxed as if it were, to revoke that election in the year in which the real estate is sold. (Under our statutory law, the net election cannot be revoked without the special permission of the I.R.S.) A foreigner who is not a resident of a country with which the United States has a tax treaty providing for such an annual election can establish a holding company in a country, such as the Netherlands Antilles or the British Virgin Islands, with which we have a tax treaty permitting an annual election.

No doubt there are other avenues for avoiding U.S. taxation of capital gains. Although these methods require careful tax planning, the substantial value of foreign investments in U.S. real estate would usually justify the added legal and accounting costs of such planning.*

III. Investments by Foreign Governments

Section 892 of the Internal Revenue Code provides that:

> The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

The Internal Revenue Service and Treasury Department have recently proposed regulations interpreting the section 892 exemption as applying only to non-commercial income. Income from "commercial activities" would, however, be taxable. According to the proposed regulations, "commercial activities" would include:

- activities that would and generally constitute a "trade or business within the United States"

- obtaining or holding "net leases" on property.

Thus, under the proposed regulations income earned by foreign governments from U.S. real estate would be taxable in the same way as if it were earned by a foreign corporation.

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* Knowledgeable practitioners suggest that the use of a Netherlands Antilles or other foreign holding company, a common tax avoidance device, is worth the legal and accounting costs only for investments of $250,000 or more. As noted in Chapter 2, the size of the average foreign purchase of U.S. farmland is $1 million.

IV. Federal Estate and Gift Taxation

The United States taxes the estates and gifts of aliens resident in the United States in the same manner as it taxes those of U.S. citizens. However, the definition of residence for estate and gift taxes differs from that for income tax purposes. For estate and gift tax purposes, an alien's residence is his domicile, his permanent home to which he ultimately intends to return. Thus, an alien who was present in the United States with no definite plans as to the length of his stay, but with the ultimate intention of some day returning to a foreign domicile, would be resident for income tax purposes, but not for estate tax purposes. Likewise, an alien not present in the United States and with no definite plans as to the length of his stay outside the United States, but with a definite intention to return some day to a domicile in the United States, would be a resident for estate tax purposes, but not for income tax purposes. To avoid needless confusion in this Report, an alien who is resident in the United States for estate and gift tax purposes will be referred to as a domiciled alien.

The estates of U.S. citizens and domiciled aliens are subject to U.S. estate tax upon the value of all property "real and personal, tangible or intangible" owned by the individual at the time of his death. Such individuals qualify for a credit against the tax of $47,000, which effectively exempts approximately $175,000 of property from estate tax.

Similarly, the gifts of U.S. citizens and domiciled aliens are subject to U.S. gift tax upon the value of all gifts made by (not to) the individual. The estate and gift taxes imposed upon such persons are "integrated" under the Tax Reform Act of 1976; that is to say, the amounts of gift and estate tax are computed at the same rate, and prior gifts made by an individual are included for the purpose of determining the bracket of, or rate of tax imposed upon, any subsequent gift or upon the individual's estate. The $47,000 "unified" credit may be claimed against any gift until the amount an individual may claim has been exhausted; once an individual has claimed part of this credit against a gift tax due, the amount he may claim against the tax on a subsequent gift or upon his estate is reduced by a corresponding amount.

Aliens not domiciled in the United States are subject to estate taxes only upon property situated within the United States. The existing statute does not define what property is situated within the United States, except with respect to certain limited classes of property. The Estate and Gift Tax Regulations provide that real property located within the United States is deemed to be situated within the United States for the purpose of the estate tax imposed upon non-resident aliens. The Internal Revenue Code itself provides that stock issued by a foreign corporation is deemed to be property situated without the United States for these purposes. The Estate and Gift Tax Regulations provide that shares of stock issued by a domestic corporation are treated as property within the United States.

The rate of tax imposed upon the taxable estates of non-domiciled decedents is substantially lower than that imposed upon domiciled or citizen decedents. The initial rate is 6%, and the highest 30%, compared to a range of 18% to 70% applicable to the estates of domiciled and citizen decedents. Aliens not domiciled in the United States are entitled, however, to a lower amount as a credit against estate tax; they may claim a credit of only $3,600, which is the equivalent of exempting $60,000 of property from tax.

Aliens not domiciled in the United States are subject to U.S. gift taxes only on <u>tangible</u> property situated within the United States. <u>Real estate</u> is considered tangible property. Gifts of tangible property situated in the United States by nondomiciled aliens are taxed according to the same rules and rates as are gifts of all property by U.S. citizens and domiciled aliens; prior gifts of tangible U.S. property are reflected in the computation of U.S. estate tax on U.S. property of a deceased alien not domiciled in the United States.

In summary, aliens not domiciled in the United States can avoid federal estate taxes by holding U.S. real estate through a foreign corporation and federal gift taxes through a foreign or a domestic corporation.* For this reason, estate and gift taxes do not appear significantly to impede foreign investment in U.S. real estate, but they do affect the legal form in which that investment occurs.

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* The United States presently has in force estate or estate and gift tax conventions with 13 countries. One such convention (Netherlands) and two conventions signed, but not yet in force (the United Kingdom and France), provide that shares in a U.S. corporation can be excluded from the taxable U.S. estate of an alien domiciled in the treaty country.

Chapter 4 - Tax Treaties

Chapter 3 describes the manner in which foreign persons investing in United States real estate minimize the taxation of income derived from their United States real estate investment. The methods of achieving tax minimization described in Chapter 3 are the products of provisions of U.S. statutory law; they are not primarily the product of double taxation conventions (treaties) in force between the U.S. and other countries.

Double taxation conventions do, however, play a role in the manner in which the income derived by foreign persons from U.S. real estate investments is taxed. In particular, U.S. conventions with certain "tax haven" jurisdictions appear to be exploited by some foreign persons resident outside these jurisdictions, who can gain certain advantages by "structuring" their U.S. real estate investments "through" the tax haven jurisdiction. Although the tax savings achieved by these devices are, in the case of real estate, small in comparison to the tax savings which result from the operation of U.S. statutory law, the opportunities for achieving them may nonetheless affect the design of foreign investments in the United States.

The operation and impact of the conventions may be very difficult for non-experts to understand when studying arrangements whereby foreign persons invest in U.S. real estate. Limited improvements in the manner in which income from foreign investment in U.S. real estate is taxed might be made by modifications of existing U.S. double taxation arrangements, even though a major change in the general pattern of taxing this income cannot be achieved through the treaty process. For these two reasons, this chapter is devoted to analyzing the use of tax conventions by foreign persons investing in U.S. real estate.

I. Tax Conventions Generally

The United States is a party to 26 conventions in force for the elimination of double taxation and the prevention of fiscal evasion with respect to taxes on income or on income and capital. These conventions are applicable to 38 independent nations, and eight territories of other nations. These conventions are always bilateral.

The general purpose of income tax conventions is to avoid double taxation of income where persons resident in (or corporations organized in) one country derive income in a second country. The principal means by which this is achieved is through reciprocal concessions of taxing jurisdiction by the two states signatory to the convention.

These concessions regulate which state--the state of residence or the source state--has the primary right to tax with respect to particular classes of income. For instance, a double taxation convention may provide that the state where real property is located has the primary right to tax the income derived from the property, or that royalty income from one state shall be exempt from tax in that state. The former example is an instance where the primary right to tax is allocated to the source state, the latter where the right to tax is allocated to the state of residence. As these examples indicate, the reciprocal concessions embodied in a double taxation convention are ordinarily defined according to types of income.

Double taxation conventions therefore avoid double taxation only by means of provisions under which the signatory states relinquish taxing rights. Conventions do not in themselves purport to impose taxes in the contracting states. The provisions of double taxation conventions are self-executing under U.S. law; that is, they operate to limit provisions of domestic law inconsistent with the convention without implementing legislation expressly overriding domestic law. International treaties or conventions which purported to impose any tax not otherwise imposed under domestic law would not be self-executing under U.S. constitutional law; that is, the tax involved could not be imposed without implementing legislation adopted by both houses of Congress according to constitutionally prescribed procedures for the adoption of revenue laws. For these reasons, deficiencies in U.S. statutory law which permit any class of income to escape taxation cannot be corrected by treaty. Thus, if it is perceived that the present pattern of taxation contains unwarranted gaps in the taxation of income derived from foreign investment in U.S. real estate, those gaps must be filled by statute. They cannot be filled by bilateral treaties.

In accordance with the method of double taxation conventions generally, U.S. conventions involve two sets of concessions by the U.S. With respect to some categories of income, the U.S. agrees to accord the primary right to tax to the source state. U.S. conventions achieve this by requiring the United States to allow a credit for taxes paid to the other country in an amount not to exceed the U.S. tax which would otherwise be imposed upon the income in question. Second, the United States agrees to reduce or eliminate its tax upon persons resident in (or corporations organized in) the treaty partner on their income from investment or business in the United States. It is these latter provisions which are relevant to the taxation of foreign investment in U.S. real estate.

The object of convention provisions reducing or prohibiting U.S. taxation of described categories of U.S. income is to reduce U.S. tax on income in circumstances where the income is subject to taxation by the state of the recipient's residence (or citizenship). Two provisions of the United States model income tax convention illustrate this point.* Paragraph 6 of Article 4, governing the determination of residence under income tax conventions, provides that if the treaty partner taxes its residents only when income is remitted (rather than when it is earned), the relief from U.S. taxes mandated under the conventions is required only to the extent that the income involved is actually remitted. In a similar vein, Article 16 (Investment and Holding Companies) of the model treaty provides that any reductions mandated by the conventions in withholding taxes on dividends, interest, and royalties will not apply to holding companies owned by third country residents if the tax imposed on such income by the treaty partner generates substantially less tax than would be imposed on other business profits in that country.

Most U.S. double taxation conventions in force do not contain these or parallel provisions, primarily because they were negotiated before the positions embodied in the U.S. model had been fully developed. The model was issued in 1977. Most U.S. treaties were signed and ratified before that; the largest number were signed and ratified in the late 1940's and early 1950's.

Various provisions of double taxation conventions may be of concern to foreign investors in U.S. real estate. Table 3-2 above described the withholding rates applicable under the various treaties to interest, dividends, rents and royalties. Real estate investors may make the election under the statute to be taxed on a net basis on their rental income, however, and this tends to limit the application of withholding rates with respect to rental income.

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* The U.S. model income tax treaty reflects the preferred position of the United States in tax treaty negotiations. If a foreign country does not have a copy of the model treaty, the U.S. Treasury provides an advance copy to facilitate treaty negotiations. Thus, the model treaty is, in essence, the starting offer of the U.S. Treasury in tax treaty negotiations.

Table 4-1 below summarizes provisions of U.S. conventions in force or signed with respect to matters which are of particular relevance to real estate investors. The Table shows the following:

- Most tax conventions signed before 1970 allow residents of the other contracting state to elect on an annual basis to have real property income offset by deductions when the foreign resident has no "permanent establishment"* in the United States. These provisions give these residents rights substantially broader than those enjoyed by residents of other countries, who to receive "net basis" treatment must make an election revocable only with I.R.S. consent. Most conventions signed since 1970 do not provide for an annual election.

- Most conventions waive the U.S. withholding taxes on interest and dividends paid by foreign corporations earning a majority of their income from a United States business. (As explained more fully below, this waiver of the "second withholding" taxes is of greatest significance to a company holding U.S. assets, incorporated in the treaty country, but owned by third country residents). However, most conventions signed since 1970 do not waive the second withholding tax on interest payments which the foreign investor has deducted in calculating his U.S. taxable income. Under present treaty policy, the United States will agree to waive its second withholding taxes on dividends and interest only if the treaty partner imposes comparable withholding taxes.

- In many cases, the United States has agreed generally to exempt residents of the treaty partner from taxation on capital gain from the sale of U.S. property. In all but two cases, however, the exemption does not apply to real estate (i.e., the treaty does not preclude taxation of capital gain on the sale of U.S. real estate). The two exceptions to this rule, Canada and the United Kingdom,

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* A "permanent establishment" is a treaty concept and is defined in general to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on. In general, having a "permanent establishment" implies as high or higher a "permanent establishment" implies as high or higher level of economic involvement as the statutory concept of having a trade or business. In the particular case of real estate, the two notions are largely synonymous.

TABLE 4-1

Selected Provisions of U.S. Income Tax Treaties
Affecting Foreign Ownership of U.S. Real Property

Country	Date of signature of treaty or most recent protocol (P)	Annual net basis election	Waiver of U.S. second dividend tax	Waiver of U.S. second interest tax	Treatment of capital gains in U.S.: General source exemption	Exceptions to source country exemption: real property	Exceptions to source country exemption: P.E. or fixed base property	Exceptions to source country exemption: 183 day presence in source state	Exceptions to source country exemption: other
Antigua 1/	1958	x	x	x					
Australia	1953	x	x 2/						
Austria	1956	x	x	x					
Barbados 1/	1958	x	x	x					
Belgium	1970		x	x 10/	x	x	x	x	
Belize 1/	1958	x	x	x					
British Virgin Islands 1/	1958	x	x	x					
Burundi 3/	1959	x							
Canada	1966(P)	x	x	x	x		x		
Denmark	1948	x							
Dominica 1/	1958	x	x	x					
Egypt 4/	1975			x 10/	x	x	x	x	
Falkland Islands 1/	1958	x	x	x					
Finland	1970				x	x	x	x	
France 5/	1978(P)	x		x 10/	x	x	x	x	x 6/
Gambia 1/	1958	x	x	x					
Germany	1965(P)	x	x	x	x	x	x	x	
Greece	1950	x	x	x					
Grenada 1/	1958	x	x	x					
Hungary 4/	1979			x	x	x	x		
Iceland	1975		x	x 10/	x	x	x	x	
Ireland	1949	x	x	x					
Israel 4/	1975		x	x 10/	x	x	x	x	x 7/
Italy	1955	x	x	x					
Jamaica 1/	1958	x	x	x					
Japan	1971		x	x 10/	x	x	x	x	
Korea 4/	1976		x	x 10/	x	x	x	x	
Luxembourg	1964	x	x	x					

cont.

TABLE 4-1

(Continued)

Selected Provisions of U.S. Income Tax Treaties
Affecting Foreign Ownership of U.S. Real Property

Country	Date of signature of of treaty or most recent protocol(P)	Annual net basis election	Waiver of U.S. second dividend tax	Waiver of U.S. second interest tax	Treatment of capital gains in U.S.: General source exemption	Exceptions to source country exemption: real property	P.E. or fixed base property	183 day presence in source state	other
Malawi 1/	1958	x	x	x					
Montserrat 1/	1958	x	x	x					
Morocco 4/	1977		x	x 10/	x	x	x	x	x 6/
Netherlands	1965(P)	x	x	x	x	x	x	x 8/	
Netherlands Antilles 9/	1963(P)	x	x	x					
New Zealand	1948	x	x						
Norway	1971		x	x 10/	x	x	x	x	
Pakistan	1957		x						
Philippines 4/	1976			x 10/	x	x	x		
Poland	1974			x 10/	x	x	x	x	
Romania	1973			x 10/	x	x	x	x	
Rwanda 3/	1959	x							
St. Christopher, Nevis & Anguilla 1/	1958	x	x	x					
St. Lucia 1/	1958	x	x	x					
St. Vincent 1/	1958	x	x	x					
Seychelles 1/	1958	x	x	x					
Sierra Leone 1/	1958	x	x	x					
Sweden	1963(P)				x	x	x		
Switzerland	1951	x	x 2/	x 2/					
Trinidad & Tobago	1970	x		x 10/					
Union of South Africa	1950(P)	x							
U.S.S.R.	1973								
U.K. - present treaty	1966(P)	x	x	x	x		x	x	
U.K. - proposed treaty 4/	1979(P)		x	x 10/					
Zaire 3/	1959	x							
Zambia 1/	1958	x	x	x					

Office of the Secretary of the Treasury
Office of Tax Analysis

TABLE 4-1

Selected Provisions of U.S. Income Tax Treaties
Affecting Foreign Ownership of U.S. Real Property

Footnotes

1/ 1958 extension of U.K. treaty as in effect at that time.

2/ Payments are exempt from U.S. tax only if paid to residents of the other country.

3/ 1959 extension of Belgian treaty as in effec' at that time.

4/ Signed but not yet in force.

5/ The 1978 protocol is signed but not yet in force.

6/ Country of situs of real property may tax gain on sale of shares or similar interests in real property cooperative or corporation whose assets consist principally of that property.

7/ A U.S. resident is taxable by Israel on gain from the alienation of shares in a real estate holding company. A protocol which is not yet signed will make this provision reciprocal.

8/ Source right to tax applies only if asset is held less than 6 months.

9/ 1955 extension of Netherlands treaty as then in effect, as amended by a 1965 protocol.

10/ Though the U.S. does not preserve the precise form and scope of the second interest tax, it does retain the right to tax interest paid by a resident of the other State if the payor has a P.E. in the U.S. in connection with which the indebtedness was incurred, and which bears the interest.

tax their residents' capital gain from the sale of U.S. real estate at rates comparable to those applicable to U.S. citizens or corporations.**

II. Conduit Countries

A. Netherlands Antilles

Although most recent conventions contain provisions designed to limit benefits under the convention to individuals and corporations taxable in the treaty country, some of the older conventions do not contain adequate protection against this result. These conventions may be used by third-country residents using a holding company incorporated in the treaty country (or territory). In addition to the legal tax advantages derived from the careful use of a holding company, the third country resident may wish to conceal his investment from tax, foreign exchange, or other authorities in his home country or in the United States. Third-country residents may be able to achieve this objective by "structuring" investments "through" some of the countries with which the U.S. has double taxation conventions in force.

The most important of the "conduit" countries is the Netherlands Antilles. The United States signed a double taxation convention with the Netherlands in 1948. In 1955, the U.S. and the Netherlands executed a protocol to this convention making the provisions of the convention applicable to the Netherlands Antilles. In 1963, the U.S. and the Netherlands executed a protocol to the convention which modified the application to the Antilles of the dividend, interest, and royalty withholding articles. In 1966, the U.S. and the Netherlands executed a protocol to the convention which modified the application of the provisions of the convention. The 1963 protocol does not apply to the Netherlands, and the 1966 protocol does not apply to the Netherlands Antilles.

The Netherlands Antilles has no estate, gift or inheritance tax, no tax on capital gains, and no withholding taxes on dividends, interest or other payments to non-residents. In calculating income subject to the Netherlands Antilles corporation tax, a holding company can deduct operating expenses, property taxes, mortgage interest and depreciation. The Antilles does not permit deductions for accelerated depreciation as generous as those permitted by U.S. law,

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** The new U.K.-U.S. treaty which has been signed, but is not yet in force, contains no exemption from source-country tax on capital gains.

however, so that a company may in certain circumstances be unable to show a tax loss for Antilles profits tax purposes even when it shows such a loss for U.S. income tax purposes. But even where this occurs, the income shown in the Antilles will usually be taxed only at 2-3 percent rates in the Antilles. Under Antilles law active business income earned by an Antilles corporation outside the Antilles, and rental investment income earned by certain holding companies outside the Antilles are taxed at one-tenth the otherwise applicable tax rates. A final advantage of an Antilles holding company is that the Netherlands Antilles allows corporations to issue bearer shares, which assures the confidentiality of ownership.

The U.S.-Netherlands Antilles treaty modifies U.S. or Netherlands Antilles law in three ways of significance to real estate investors:

1. First, and most critically, dividends and interest paid by a Netherlands Antilles company are exempt from the U.S. "second withholding" taxes. The United States applies a withholding tax not only to dividends and interest paid by a U.S. corporation (unless more than 80 percent of the corporation's gross income is foreign source), but also to a portion of dividends and interest paid by a foreign corporation if 50 percent or more of the foreign corporation's gross income (e.g., rent) is effectively connected with a U.S. trade or business.* The purpose of this "second withholding" tax is to limit the disparity in U.S. tax treatment of a U.S. and a foreign corporation with a trade or business in the United States.

   As a consequence of a treaty waiver of the "second withholding" taxes, interest on a mortgage financing a U.S. real estate investment can be paid tax free by a holding company. Suppose, for example, that a foreigner had $1 million which he wished to invest in U.S. real estate. Rather than investing directly, he may establish a Netherlands Antilles holding company to which he advances $250,000 as equity. The holding company may then buy the U.S. real estate, advancing the $250,000 equity contribution as a down payment and arranging for a $750,000 mortgage held directly or through a financial

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* The fraction of a dividend or interest payment by a foreign corporation to which the U.S. withholding tax applies is the ratio of gross income effectively connected with a U.S. trade or business to worldwide gross income of the corporation.

intermediary by the company's own shareholder. Assuming the Netherlands Antilles company is not too thinly capitalized, the mortgage interest payments will be deductible in computing the holding company's taxable income in the United States. Even though the interest is payable to a foreign mortgage holder, the Netherlands Antilles convention exempts that interest from the U.S. "second withholding" tax. As noted above, the Netherlands Antilles itself imposes no withholding tax. That portion of the foreigner's total return on his $1 million U.S. real estate investment which the mortgage interest represents thereby escapes U.S. income tax.

2. Under the Netherlands Antilles convention, the election to be taxed on net, rather than gross, income from real estate which is not attributable to a trade or business conducted through a "permanent establishment" can be made (and thus revoked) annually. A Netherlands Antilles company which does not have a permanent establishment can therefore deduct substantial expenses (e.g., operating costs, property taxes, insurance premiums, mortgage interest and, where applicable, depreciation) while the property produces rental income, and then, by not making the election in the year the property is sold, pay no tax on the capital gain. (Under U.S. statutes, this election cannot be revoked without the special permission of the Internal Revenue Service).

3. The convention also provides that income from real estate and interest on real estate mortgages are taxable only in the country where the real estate is located (the United States in this instance). The Netherlands Antilles interprets this article to exempt the U.S. real estate income of a Netherlands Antilles company from Netherlands Antilles income tax (which, in any event, would have been minimal because of the allowance of deductions and the preferential rates of taxation for foreign business income and holding companies' foreign rental income).*

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* This interpretation of the convention is not inevitable. In the reciprocal case - of a U.S. corporation deriving income from Antilles real estate - the U.S. does not interpret the convention as precluding the right of the U.S. to tax the income, by virtue of a provision of the convention reserving each state's right to tax its own nationals as though the convention had not come into effect.

British Virgin Islands

The income tax convention between the U.S. and the British Virgin Islands is an extension of a 1945 convention between the U.S. and the United Kingdom. A 1959 protocol extended the 1945 convention and its subsequent protocols to 20 jurisdictions which at the time were United Kingdom dependencies. In 1966, the U.S. and U.K. executed a protocol to the 1945 convention. This protocol does not apply to the British Virgin Islands or the other territories to which the 1945 convention was extended. In 1975, the U.S. and U.K. signed a convention which when it takes effect would replace the 1945 convention. Three protocols to the new 1975 convention have been signed, but neither the convention nor the protocols have been ratified. The new convention would not apply to the territories to which the 1945 convention was extended.

A foreign investor can reach the same favorable results by establishing a holding company in the British Virgin Islands as it can via the Netherlands Antilles. Like the Netherlands Antilles treaty, the British Virgin Islands treaty exempts a holding company from the U.S. "second withholding" tax on dividends and interest and allows the company to elect on an annual basis to be taxed in the U.S. as if it were engaged in a U.S. trade or business. The British Virgin Islands does impose a corporate income tax of 15 percent; deduction for operating expenses, interest, property taxes, and depreciation are allowed; and a taxpayer may claim a credit for income tax paid to a foreign government. More importantly, income is taxed only if it is remitted to the British Virgin Islands. This means that if income is never deposited in or otherwise paid over to the British Virgin Islands, it is not taxable in the British Virgin Islands. The "remittance" basis of the BVI tax law plays the same role in the use of the BVI for these purposes as is played by statutory favored treatment in the Netherlands Antilles. Like the Netherlands Antilles, the British Virgin Islands has no estate, gift, inheritance, capital gains tax, nor withholding taxes on dividends and interest paid to non-residents. Although bearer shares are not allowed, a foreign investor may conceal his ownership by having a nominee register as the shareholder in the BVI.

Chapter 5 - Analysis and Conclusions

I. Summary of Relevant Tax Provisions

Income effectively connected with a U.S. trade or business earned by a nonresident alien or a foreign corporation is taxed under generally the same rules as those applicable to a U.S. citizen or corporation, respectively. Much foreign investment in U.S. real estate constitutes a U.S. trade or business; that which does not may, at the election of the foreign investor, be taxed as if it were. Allowable deductions often equal or exceed rental income; losses, rather than positive income, are reported for tax purposes.

If a foreign taxpayer engaged in a U.S. trade or business by reason of a real estate investment sold such U.S. real estate, the gain would ordinarily be effectively connected with the trade or business and taxable in the United States. Present law, however, offers a careful foreign investor several ways of reclassifying the gain as not effectively connected with a U.S. trade or business, and as a consequence, ordinarily exempt from U.S. tax. The ways of avoiding U.S. capital gains tax identified in this Report were:

1. An installment sale.

2. An exchange for foreign property of a like kind.

3. Sale of the property by a holding company, coupled with a complete liquidation of the company within one year.

4. Sale of the shares of a holding company (the new owner can liquidate the company with minor tax consequences and gain a stepped-up basis in the property).

5. Under a tax treaty, revoking an election to be taxed on a net, rather than a gross, basis.

Although any one of these methods of avoiding capital gains tax may not work or not work well in some cases, the methods are numerous and varied enough that one or more would usually be available. Although the role of tax treaties, especially the U.S.-Netherlands Antilles treaty, has been highlighted in public discussion, the opportunities for avoiding capital gains tax derive largely from U.S. statutes, rather than U.S. treaties.

II. Legislative Proposals

A proposal by Senator Wallop to tax the capital gain on the sale of agricultural land was included in the Senate version of the Revenue Act of 1978. Apart from tax equity between domestic and foreign taxpayers, the primary concern expressed in the Senate debate was that exemption from capital gain taxation encouraged foreign investors to bid up the price of U.S. farmland. Because neither the House of Representatives nor the Treasury had had an opportunity to consider the proposal carefully, the House-Senate conference committee decided to delete the proposal, but to ask the Treasury to prepare this Report.

In January 1979, Senator Wallop introduced S. 208, a bill substantially similar to the bill the Senate passed in 1978. Essentially the same bill, H.R. 3106, was introduced in the House of Representatives by Congressman Grassley; both bills have broad, bipartisan support. Under each bill, capital gain on the sale of:

- land used in farming, suitable for use in farming, or in a rural area; and

- shares in a corporation or an interest in a partnership, trust or estate, to the extent gain was in excess of $3,000 and attributable to the unrealized appreciation in such land (or similar gain which a corporation had realized, but elected not to recognize, under section 337)

would be considered effectively connected with a U.S. trade or business and, therefore, subject to U.S. capital gains tax. The purchaser of affected agricultural land, corporate shares or partnership interests would be required to withhold tax equal to 30 percent of a foreign investor's taxable gain. (The taxpayer could file for refund of an overpayment.) H.R. 3106 would override tax treaties five years after its date of enactment, S. 208 would not.

If capital gains on the sale of land were always considered effectively connected with a U.S. trade or business, a foreign owner could not avoid tax by making an installment sale and deferring recognition of the gain or by failing to make an annual election to be taxed net of deductions. Thus, two of the tax avoidance methods noted above would not work. If capital gains on the sale of corporate shares (to the extent such gains were attributable to unrealized gain on agricultural land) were also considered effectively connected, two other methods described above for avoiding capital gains tax would presumably not work either: the gain upon liquidation of a holding company, or the sale of such a company's shares. Although S. 208 would not affect exchanges for foreign property of like kind, such exchanges could be easily covered by an appropriate amendment.

III. Impact of Capital Gains Taxation on a Hypothetical Investment

The burden of the U.S. capital gains tax depends on how rapidly property appreciates in value, how long the property is held, and other features of specific cases. No hypothetical example can convey the diversity of circumstances to be found in actual cases. Carefully constructed examples can, however, put proposals for change into a clearer economic perspective. The particular example summarized in this section and described more fully in Appendix C proceeds on the hypothesis that an investor purchases unimproved agricultural land for $1 million, $800,000 of which is obtained from a conventional, 40-year mortgage carrying interest of 10 percent per annum. For ten years, the investor receives $50,000 in annual rent and pays out $10,000 each year in property taxes and other actual expenses. With mortgage payments of approximately $82,000 per year, the investment has a pre-tax cash outflow deficit of $42,000 per year. After ten years, the investor sells the property for $2.9 million (this amount is derived from the average rate of appreciation for all U.S. farmland from 1968 to 1978).

The cash-flow profile of such an investment for a domestic and a foreign investor are depicted in Figure I. Each investor would have to put up $200,000 initially and $42,000 in each subsequent year. Figure I depicts the accumulated amounts invested; funds which are spent or received after a period of years are measured by their present (or discounted) value to adjust for the time value of money.* Present values allow meaningful comparisons between payments and receipts occurring in different years.

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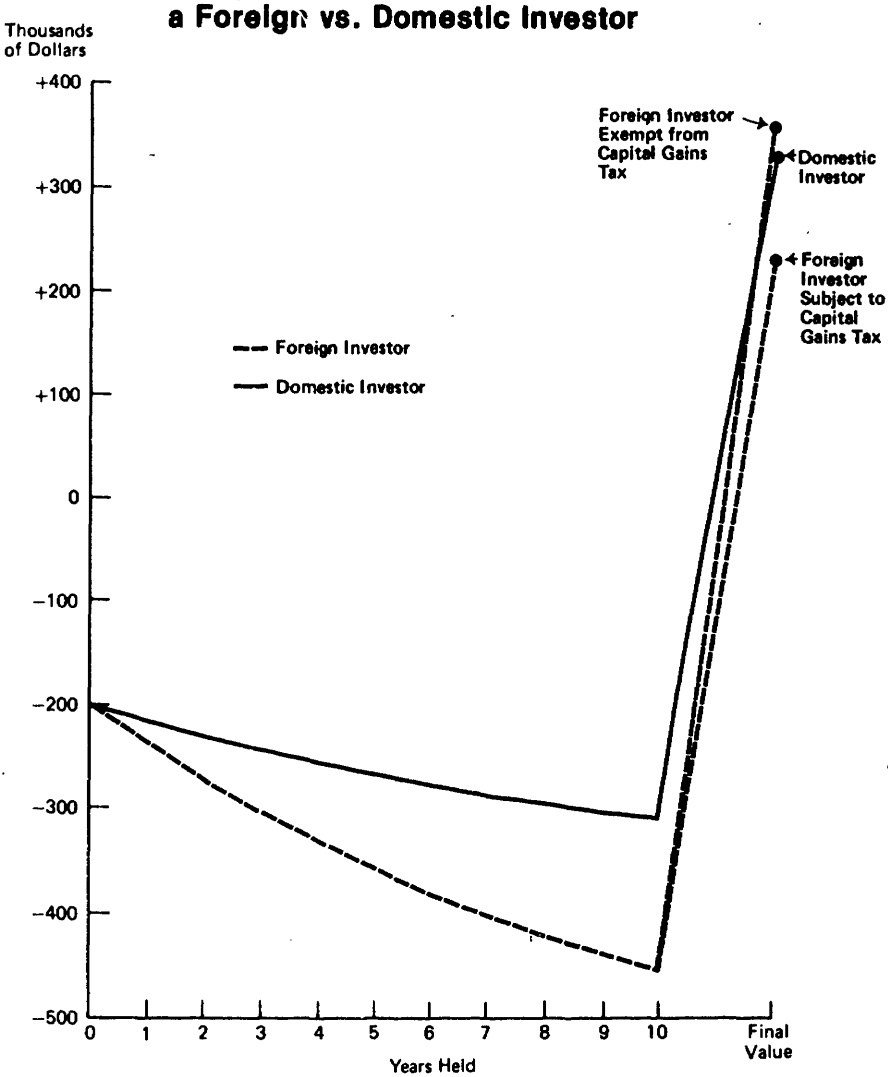
* For example, the present value of the $10,000 in property taxes and other expenses payable at the end of the first year is $9,091 (assuming a 10 percent discount rate). That is to say, if the investor put $9,091 in a bond maturing in one year and paying interest of 10 percent, he could pay the $10,000 tax with the proceeds when the $9,091 bond matured.

Figure 1: Present Value of Accumulated Cash Flow from a Hypothetical Investment in U.S. Farmland to a Foreign vs. Domestic Investor



Because this hypothetical investment requires additional cash inputs in every year, the accumulated cash flow depicted in Figure I declines steadily over the ten-year life of the investment. Note that the accumulated present value of cash payout by the domestic investor is less than that by the foreign investor. This difference reflects an assumption that a domestic investor can use the tax losses generated by this investment to shelter other income from U.S. taxation,* but that the foreign investor has no other U.S. income which can be similarly sheltered. That is to say, real estate investment is assumed here to provide a tax shelter for a domestic investor, but to have no such shelter value for a foreign investor. Needless to say, there may be cases in which a foreign investor can take advantage of such shelter value.

When the real estate is sold and the mortgage principal paid off, each investor is left with net proceeds of $2.1 million, a substantial return on his cash outlays over the prior ten years. Our hypothetical example assumes that the foreign investor can avoid paying U.S. capital gains tax. The domestic investor must, however, pay ordinary income tax on 40 percent of his capital gain (which, in turn, equals his $2.9 million in gross proceeds less his basis in the property, $1 million). The tax, which amounts to $343,000, exceeds the tax savings from his prior real estate losses, even when both amounts are converted to their present values. Thus, the real estate investment generates a higher return to the foreign investor than to the domestic investor.

The foreign investor in this example does somewhat better than the domestic investor because, under the assumptions which underlie the example, the *de facto* exemption from capital gains tax is worth more than the ability to shelter income other than real estate income from taxation. The net advantage of the foreign investor would be larger if he could use the real estate losses to shelter other income from taxation *and* avoid paying capital gains taxation. In fact, a foreign investor may have the best of both worlds in at least three different ways:

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* Because real estate investment often attracts wealthy investors, the domestic investor is assumed to be in a 60 percent marginal tax bracket.

- The losses may offset other effectively connected income.

- If the real estate is held by a foreign-controlled U.S. corporation, the real estate losses can offset other U.S. income whether or not such income would be considered effectively connected if earned by a foreign corporation. Table 2-4 indicated that U.S. companies, not foreign companies, were in 1974 the primary corporate form for foreign investment in U.S. real estate.

- A partnership agreement between a domestic and foreign investor might be structured to allocate all the losses to the former and only capital gain to the latter. In an example given in Appendix C, the hypothetical investment is undertaken by a domestic-foreign partnership obtains a higher rate of return than that obtained by either partner investing separately. A partnership agreement may allow a foreign investor to derive indirectly some benefit from real estate losses allocated to a domestic partner.

Thus, the assumption that the foreign investor derives no benefit from real estate losses is probably too strong, and the net tax advantage of a foreign investor compared to a domestic investor is larger than that calculated above and depicted in Figure I.

This conclusion--that a foreign investor bears a lighter tax burden than a domestic investor--would be reversed if the foreigner were taxable on his capital gain. In the hypothetical example described in Appendix C and depicted in Figure I, a foreign investor who can make only limited use of his real estate losses, but is taxable on his capital gain, is worse off than a domestic investor who can make better use of the real estate losses.

The results reached in the hypothetical case are, we repeat, sensitive to the underlying assumptions about the rate of capital appreciation, the extent to which the initial investment is financed with borrowed money, the tax bracket of the investor, the rate of discount and so forth. The main point is that the differential treatment of capital gains is one of several differences in the way the United States taxes foreign versus domestic taxpayers. Some differences (e.g., treatment of capital gains, taxation limited to effectively connected and specified other U.S. income) favor foreign taxpayers, others (e.g., treatment of losses, number of exemptions) favor domestic taxpayers. Whether foreign taxpayers are better or worse off than domestic taxpayers when all the differences are considered together depends on the circumstances of a particular investment and investor.

IV. Policy Issues in Taxing Capital Gains from the Sale of Real Estate

A. Tax Policy Considerations

In considering U.S. taxation of foreigners on their U.S. source capital gains, a critical issue is tax equity--a foreign investor with more than a minimal presence in the United States should not bear a lighter tax burden than a comparable domestic investor. United States real estate arguably represents, in and of itself, a presence that is more than minimal. This conclusion has, in fact, wide international acceptance. Section 1 of Article 13 (Capital Gains) of the O.E.C.D. model income tax treaty provides:

> Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in the other State.

Appendix B to this Report summarizes other countries' rules for taxing capital gain on the sale of domestic real property by foreign owners. As shown there, virtually all countries tax such gain using the same rules as those applicable to domestic owners. The U.S. exemption for gain on real property not effectively connected with a U.S. trade or business is unusual by international standards.

Countries' tax practices differ widely, however, in taxing capital gain on the sale of shares in a corporation holding real property. As noted above, several of the methods for avoiding U.S. capital gains tax on the sale of real estate involve the use of holding companies. As Appendix B indicates, some countries attempt to tax such gains; others do not.

The U.S. exemption of a foreign taxpayer's capital gains on the sale of corporate shares has at least three justifications:

- Compliance. A tax on capital gains on the sale of corporate shares and other securities is difficult to collect because transfers of ownership are usually not recorded (as opposed to transfers of real estate, which are) and can and frequently do take place outside the United States. Such a tax could only be effectively enforced through measures that would seriously burden the overall market in such securities. These measures are not desirable, nor would it be desirable to enact a tax that cannot be effectively enforced.

- Gross vs. Net Taxation. Dividends, interest and other income on financial assets are taxed without the benefit of deductions unless such income is effectively connected with a U.S. trade or business (in which case deductions are allowed, but capital gains are subject to tax). Exemption from capital gains taxation may be seen as an offset, roughly, for the prior denial of deductions from such income;

- Balance of Payments. The exemption from capital gains tax makes domestic securities easier to sell on international markets.

Taxing capital gains on the sale of corporate shares would not be justified by general international practice and would, in fact, run contrary to U.S. tax treaties. Such a tax would not affect the sale of shares by residents of countries with a current treaty exemption (see Table 4-1 above).

Then, it makes considerable sense to draw a line between capital gains on the sale of assets used in a U.S. trade or business and capital gains on the sale of shares. The next issue, however, is whether the rules for distinguishing effectively connected and non-effectively connected gains should be so easily manipulable. The abuse highlighted in this Report is the conversion of capital gains on real estate which had been used in a U.S. trade or business (by election, if not in fact) into capital gains on the sale of shares.

This, in turn, suggests that an appropriate and effective remedy may focus on one or more steps in the various processes by which gains which should be taxable are converted into tax-exempt gains. For example, in the case of a "like kind" exchange, it may be easier to impose a tax when U.S. property is exchanged for foreign property than when the foreign property is subsequently sold. Similarly, it may be difficult to impose a tax on the sale of corporate shares of a holding company, but it appears possible to deny the new owner an all but tax-free liquidation and step-up in basis.

In contemplating changes in statutory law, our treaty obligations to other countries must be taken into account. As noted in Table 4-1, approximately half of the treaties currently in force would preclude a U.S. tax on capital gains from the sale of shares by residents of the treaty country. These treaty obligations could be overridden, but doing so would tend to make it far more difficult to obtain satisfactory treaties in the future. On the other hand, there should be considerably less international objection to a prospective override of the treaties, coupled with a sufficient time lag so that reciprocal international agreements on limited taxation of shares can be negotiated.

B. Economic Impact of Taxing Foreign Investors' U.S. Capital Gains

The rate at which foreign-owned assets typically appreciate in value or the length of time they are held can only be surmised. Table 5-1 below presents exceedingly rough estimates of the potential gain in U.S. Treasury revenues from taxing foreigners' capital gains on U.S. agricultural land, all other real estate, and all U.S. property (including stocks, bonds and other financial assets). The first column indicates that the U.S. Treasury might have gained up to $276 million from subjecting all U.S. property to be sold by foreigners in 1979 to the capital gains tax. This additional tax would represent approximately 12 percent of the estimated value of U.S. property sold by foreigners in 1979. Taxing capital gain on agricultural land only would yield an estimated $22 million, on all real estate $142 million.

Like all revenue estimates, those in Table 5-1 take no account of behavioral adjustments lessening the impact of the tax. Foreign investors might, for example, hold their investments for longer periods of time. The extent to which their aggregate investment in the United States would be reduced if capital gains were subject to U.S. tax is virtually impossible to predict. Aggregate purchases by foreigners of U.S. real property in 1979 will probably be less than $5 billion, and a substantial fraction of that will be financed with mortgages from U.S. lenders. Statistical analysis of the U.S. balance of payments behavior suggests, moreover, that long-term foreign investment in the United States depends more on the growth of the U.S. economy than on changes in the current rate of return on U.S. investment.* This

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* See Richard Berner, Peter Clark, Howard Howe, Sung Kwak and Guy Stevens, "Modeling the International Influences on the U.S. Economy," International Finance Discussion Paper 93, Board of Governors, U.S. Federal Reserve Bank, Washington, D.C. 1978. This analysis found that rates of return variables had no statistically significant impact on the rate of foreign investment in the United States. This particular finding was not specifically reported in the summary discussion cited here, but was obtained by the Treasury Department from the authors of the Federal Reserve Board study.

Table 5-1

Revenue Estimates for the Taxation
of Foreign Capital Gains

Investment	1979 Revenue (million $)	Assets Sold (millions)	Tax as a Percent of Sales Value
Agricultural Land	22	$ 150	14.7
Commercial Real Estate	120	1,000	12.0
Stocks and Direct Investment	134	1,100	12.2
Total	276	2,250	12.3

Office of the Secretary of the Treasury
Office of Tax Analysis

April 10, 1979

Assumptions made in revenue estimate:

1. Five percent of farmland and 10 percent of commercial real estimate turn over each year;

2. Foreigners are taxed at the rate of 24 percent, reflecting a 60 percent marginal tax rate and a 60 percent exclusion of long term capital gains from taxation;

3. The ratio of gain to basis is 1.5 for farm property and 1 for commercial property.

statistical result accords well with the common observation that foreigners invest in U.S. real estate as a hedge against economic and political uncertainty overseas and not because of a small differential between the rate of return on U.S. real estate and that on foreign property.

APPENDIX A

Glossary

Foreign Investment: Foreign investment is the gross value of assets in the U.S. owned directly and indirectly by foreign individuals and corporations. These are ordinarily stated at historical cost net of depreciation. This definition of foreign investment differs from the balance of payment definition. The balance of payment definition is based on net equity inflow, retained earnings of U.S. subsidiaries of foreign shareholders, and total earnings of U.S. branches of foreign corporations. As a consequence, the balance of payments measure does not reflect property whose acquisition was financed with borrowed funds or non-income cash flow (e.g., depreciation allowances).

Real Estate Investment: Real estate investment is land and buildings leased to other users or held purely for investment. It does not include land and buildings used by an investor in some other, non-real-estate, trade or business.

Agricultural Land: Agricultural land is land used for farming, including agriculture, forestry, and timber production. It also includes idle land if its last use was for agricultural production within the past 5 years.

Foreign Individual: An individual who is neither a U.S. citizen nor a U.S. resident.

Residence: An alien actually present in the U.S. who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. If he lives in the U.S. and has no definite intention as to his stay, he is a resident. An alien whose stay in the U.S. is limited to a definite period of time by the immigration laws is not a resident except in exceptional circumstances.

Domicile: A domicile is acquired by living in a locality with the intent to make it a fixed and permanent home. To change domicile two conditions must be satisfied: (1) residence must be changed (2) there must be an intention to remain at the new residence permanently.

Corporation: A corporation is defined to be any association which is taxed as a corporation under the Internal Revenue Code. The essential features of a corporation are associates (shareholders), an objective of carrying on business and dividing the gain therefrom, continuity of life, centralization of management, limited liability, and free transferability of interests.

Foreign Corporation: A foreign corporation is a corporation which is not organized under the federal laws of the United States or the laws of the fifty states or the District of Columbia.

Trust: A trust is an arrangement created either by a will or an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries. Generally speaking, an arrangement will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Estate: The property and debts of a decedent.

Partnership: A partnership is a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Internal Revenue Code of 1954.

Permanent Establishment: Permanent establishment is a concept used in U.S. tax treaties to determine the way in which business income is taxed. While the precise definition varies from treaty to treaty, generally a permanent establishment means a fixed place of business through which the business or an enterprise is wholly or partly carried on.

Trade or Business Within the U.S.: Whether or not a nonresident alien is engaged in a trade or business is a basic distinction used in the U.S. statutory law to determine tax treatment and is a lower threshhold of activity than the maintenance of a "permanent establishment" concept used in tax treaties. A U.S. trade or business includes any business operation in the U.S. involving the sale of services, products, merchandise, in the ordinary course of business. It also, with minor exceptions, includes the performance of personal services.

<u>Effectively Connected Income</u>: Income effectively connected with a trade or business in the U.S. includes income from personal services performed in the U.S., income derived from the active conduct of a trade or business in the U.S., and income derived from assets used in, or held for use in, the conduct of a trade or business in the U.S.

<u>Capital Gains</u>: Capital gains are gains from the sale or exchange of a capital asset or an asset whose tax treatment is the same as a capital asset. Assets which do not receive capital gains treatment include stock in trade or other property included in inventory or held for sale to customers.

<u>Basis</u>: Basis, which is used in determining the amount of capital gains, generally means the cost of the asset plus improvements less applicable depreciation, amortization, and depletion. If stock is sold, basis is also reduced by the amount of nontaxable distributions prior to the sale.

<u>Depreciation</u>: Depreciation, for tax purposes, is a deduction allowed for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or property held for the production of income. The allowance does not apply to land, inventory, stock in trade, and personal assets. The allowance permitted for tax purposes does not depend on the actual decline in the market value of the asset over time.

<u>Excess Depreciation</u>: Excess or "additional depreciation" is the excess of the accumulated deduction for depreciation over the amount that would have been taken under the straight line method. The straight line method allows a fixed annual deduction over the estimated useful life of the asset.

APPENDIX B

Taxation of Real Property Gains of Nonresidents: Some International Comparisons

I. General Observations

The United States taxes nonresidents on gains derived from ("effectively connected" with) a U.S. business activity. But otherwise, a nonresident is exempt from U.S. tax on gain from the disposition of assets in the United States unless physically present in the United States for more than 183 days in the year the gain is realized.

Such a broad exemption of capital gains of nonresidents is unusual. The United Kingdom apparently taxes the capital gains of nonresidents only if derived from business assets in the United Kingdom. But nearly all other industrial countries, and virtually all of the developing countries for which the information is readily available, tax nonresidents on capital gains from the disposition of real property located in the country as well as on gains derived from business activity there. A smaller number also tax gains derived by nonresidents on the sale of a "substantial" holding of shares in domestic corporation (with "substantial" typically defined as 25 percent or more of the outstanding shares). And a few tax any sale of shares or other rights when the underlying assets are real property.

Thus, in terms of its intended reach, U.S. law is generous in the treatment of capital gains of nonresidents. However, at the practical level, nonresidents may be able to escape tax on gains realized from the disposition of real property in other countries, despite the broader scope of their laws. This can result if exemption is granted for gains on assets held longer than a specified number of years, or because of difficulties of enforcing the tax.

In the simplest case, where an individual owner of a piece of land sells it and transfers the title accordingly, some countries exempt the gain from tax if the property was held for a specified number of years. Capital gains of domestic residents are usually taxed at lower rates than ordinary income and may be completely exempt if property is held for a sufficient length of time. The same tax benefits are generally available to nonresidents if they satisfy the conditions of realizing long-term gains.

The tax on the gain from the sale of real property can often be avoided by transferring the ownership of the property to a corporation and selling the shares of the corporation rather than the real property directly. If the corporation is foreign with respect to the country where the real property is located, gain on the sale of its shares is almost invariably beyond the scope of a country's tax law. If it is a domestic corporation and a substantial holding is sold, several countries assert jurisdiction to tax. However, enforcement may be difficult, especially if both the buyer and seller are nonresidents and the sale takes place in another country. If there is favorable tax treatment of gains on the liquidation of a corporation, this may offer another route for disposing of real property with little or no tax.

In short, the United States, along with the United Kingdom, is exceptional in not taxing nonresidents on gain from the disposition of real property other than business property; but there are enough loopholes in most foreign laws that, despite their frequently broader scope in attempting to tax non-residents, effective taxation of gain on the disposition of real property by nonresidents is probably rarely realized.

Examples of Capital Gains Taxes Applicable to Nonresidents on Sales of Real Property

The following examples are very simplified and do not attempt to describe the complex variations in different countries' taxation of capital gains. Moreover, they look only to income taxes and do not consider, for example, taxes on capital. The rates indicated are individual income tax rates. References to sales are meant to include other dispositions which give rise to tax liability, e.g. exchanges or deemed sales.

A. <u>No taxation of gain on real property</u>

The United Kingdom taxes nonresidents on capital gains only if derived from the sale of assets of a U.K. business. The Netherlands does not tax gains on real property under the income tax but applies a transfer tax on the sale.

B. <u>Taxation of gain on real property but not shares</u>

Denmark, Italy, Japan, Luxembourg, New Zealand, Norway and Sweden are among the countries which tax nonresidents on gains from real property but not gains from the sale of corporate shares. Thus, the tax does not apply if, instead of holding the real property directly, the nonresident sets up a corporation to own the property and sells the shares of the corporation. However, Italy taxes corporations on the appreciation in value of land and buildings not directly used in commercial operations; the tax applies on the disposition of such property or every 10 years if no transfer takes place.

C. Taxation of gains on real property and "substantial holdings" of corporate shares

Several other countries, including Austria, Belgium, Canada, France, and the Netherlands, do not single out real estate holding companies but tax gains on the sale of shares in domestic corporations if the shares sold amount to 25 percent or more (33 percent in the Netherlands) of the outstanding shares of the corporation. In Canada, the tax applies to any sale if the corporation is privately held, as opposed to a publicly owned corporation. Canada also has complex rules to prevent avoidance of the tax through the use of trusts, etc.

Again, however, gain on the sale of real property directly may be exempt from tax if the property was held for a specified number of years. Gain on the sale of a substantial holding is rarely exempt after a holding period, but long-term gains in general may be taxed at lower rates than apply to ordinary income.

In Austria, gain on the sale of real property is exempt if the seller owned the real property for more than 5 years. Otherwise, ordinary income tax rates apply (about 20-60 percent).

Belgium taxes gain on the sale of undeveloped land at 33.5 percent on residential land held less than 10 years and on other undeveloped land held less than 5 years, at 16 percent on residential land held from 10-16 years and other land held for 5-8 years, and exempts the gain on residential land held longer than 16 years and on other land longer than 8 years. (The ordinary rates applicable to individuals' income range from about 40-60 percent.)

In Canada the holding period is not relevant, but capital gains are taxed at one-half the ordinary rates (6-43 percent Federal).

In France, the taxable portion of gain on the sale of real property varies with the period of ownership; after 10 years, one half of the gain is excused and after 20 years the gain is exempt. Taxable gains are adjusted for inflation and taxed at a flat rate of 33 1/3 percent, or 15 percent on securities held more than 10 years. (For residents tax is calculated as 5 times the tax due at ordinary income tax rates (5-60 percent) on one-fifth of the gain; i.e., the tax in effect averages the gain over a 5-year period.)

The Netherlands does not have a special regime for capital gains. Gains on the sale of business assets or on substantial holdings of corporate shares are taxed under the income tax, but in the case of gain on the sale of a substantial shareholding, a flat 20 percent tax applies if it results in a lower tax than the ordinary rates (of about 20-70 percent for individuals). Sales of real property are subject to a transfer tax of 5 percent of the market value of the property.

D. <u>Taxation of gains on real property and of shares representing real property</u>

Finland, Germany, Ireland, Israel and Mexico are examples of countries which, in addition to taxing gains from the direct sale of real property, also tax gains on the sale of shares in a corporation whose assets consist primarily of real property.

Finland taxes nonresidents on gains from the sale of shares in a Finnish corporation if 50 percent of the corporate assets consist of real property. However, gains on the direct disposition of real property held more than 10 years are exempt. Gains which are not exempt are taxed at full income tax rates (individual rates range from about 10-51%).

Germany also taxes non-residents on gains on real property or rights relating to real property in Germany. However, gains on assets held longer than two years are considered long-term gains and are not taxed. Short-term gains are taxed at full income tax rates (22-56% for individuals).

Under Ireland's capital gains tax, introduced in 1975, nonresidents are taxable on gains from real property in Ireland and from shares deriving their value from Irish real property, without regard to the period of ownership. A flat rate of 30 percent applies (cf. income tax rates of about 26-77%).

Israel taxes nonresidents on real property in Israel, on assets representing a direct or indirect right to such property, and on the sale of more than 25 percent of the shares of an Israeli corporation. On property held longer than two years, the gain is adjusted for price increases or devaluation of the Israeli currency. The inflationary gain is taxed at 10 percent, the real gain at ordinary tax rates (about 25-60%) but not more than 50 percent.

Mexico taxes gains on the sale of real property or of shares of real estate holding companies. The taxable portion of the gain declines with the period of ownership to 50 percent on property held 10 years or more. Gains on the sale of real property are taxed 80 percent at lower rates and 20 percent at ordinary rates. Gains on shares are taxed at ordinary rates (13-50 percent) and the buyer must withhold 20 percent of the purchase price. In the case of direct sales of real property, there is no withholding, but the buyer is jointly liable for the tax.

E. Taxation of gains on real property and all corporate shares

Some countries, including Argentina and Brazil, tax nonresidents on gains realized on the sale of shares of domestic corporations as well as on the dispostion of real property itself. Ordinary income tax rates apply. There is generally an inflation adjustment. In Argentina, the gain on real property is adjusted for inflation only if the property is held more than two years.

Exchange controls can be used to help enforce such a tax. For example, in both Argentina and Brazil, a penalty tax is levied on "excess remittances" when dividends paid by local corporations to nonresident shareholders exceed a specified percentage of the registered capital of the corporation. When a sale of shares takes place between nonresidents on a foreign exchange, it is in the interest of the nonresident purchaser to report the purchase price so that the registered capital will be increased for purposes of the excess remittance tax.

Spain taxes gains on the sale of real property and moveable property, including corporate stocks and bonds. Real property held less than 3 years and movable property held less than 1 year are taxed as ordinary income. Property held longer than those periods is taxed at a flat rate of 15 percent, except that gains on stocks and bonds held more than 5 years are exempt. Certain real estate holding companies are exempt from income tax altogether. These provisions seem to apply to nonresidents as well as residents.

APPENDIX C

Technical Analysis

This Appendix analyzes in greater detail the hypothetical investment in U.S. agricultural land set forth in Chapter 5. The land is purchased for $1 million and financed by a $200,000 down payment and an $800,000 recourse mortgage. Table A-1 shows the value of various items over the ten years the land is owned. Rental income shown in Column (1) is $50,800 per year in each of the ten years. The mortgage has a forty year repayment period and a 10 percent interest rate, so $81,808 must be repaid each year. Columns (2) through (5) show the total annual mortgage payment, the mortgage interest, the repayment of principal, and the principal amount outstanding at the end of each year, respectively. Column (6) indicates property taxes, administration costs and other deductible expenses paid by the investor. Column (7) shows the taxable income, (in this case, a loss), which equals rental income less mortgage interest and other deductible expenses; because land cannot be depreciated for tax purposes, the taxable income is not reduced by a depreciation deduction, as it would have been for commercial real estate. If a domestic investor has other income, he can reduce his total U.S. tax liability by offsetting his real estate loss against that income. The domestic tax saving shown in Column (8) equals 60 percent of the tax loss shown in Column (7). This 60 percent rate would be appropriate for a married couple filing a joint return with taxable income of $109,400, or an unmarried individual with taxable income $55,300. Because investments generating tax losses are more valuable to high-income than to low-income taxpayers, a 60 percent tax bracket may be typical for real estate investors.

Column (9) shows the net cash flow to the foreign investor; it equals the $200,000 outflow when the land is purchased and the difference between rental income and the sum of the mortgage payment and operating expenses in each subsequent year. Column (10) shows the present value of the cash flow in Column (9); that value is calculated by dividing the actual cash flow by $\underline{(1+i)}^n$, where _i_ is the discount rate and assumed to be 10 percent here,* and _n_ is

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* The appropriate discount rate to use in these calculations is the taxpayer's after-tax rate of return on alternative investments.

Table A-1

Numerical Values of Hypothetical Investment
in Agricultural Land

Year	Rent (1)	Mortgage Payment (2)	Mortgage Interest (3)	Repayment of Mortgage Principal (4)	Mortgage Principal Outstanding (5)	Other Expenses (6)	Taxable Income (7)	Domestic Tax (8)	Cash Flow to Foreign Investor (9)	Discounted: Present Value of Previous Column (10)	Accumulated Value of Previous Column (11)	Cash Flow to Domestic Investor (12)	Discounted: Present Value of Previous Column (13)	Accumulated Value of Previous Column (14)
Purchase									-200,000	-200,000	-200,000	-200,000	-200,000	-200,000
1	50,000	81,808	80,000	1,808	798,192	10,000	-40,000	-24,000	-41,808	-38,007	-238,007	-17,808	-16,189	-216,189
2	50,000	81,808	79,819	1,989	796,203	10,000	-39,819	-23,891	-41,808	-34,552	-272,559	-17,917	-14,807	-230,996
3	50,000	81,808	79,620	2,188	794,015	10,000	-39,620	-23,772	-41,808	-31,411	-303,970	-18,063	-13,571	-244,567
4	50,000	81,808	79,402	2,406	791,609	10,000	-39,402	-23,641	-41,808	-28,555	-332,525	-18,167	-12,408	-256,975
5	50,000	81,808	79,161	2,647	788,962	10,000	-39,161	-23,497	-41,808	-25,959	-358,484	-18,311	-11,370	-268,345
6	50,000	81,808	78,896	2,912	786,050	10,000	-38,896	-23,337	-41,808	-23,600	-382,084	-18,471	-10,426	-278,771
7	50,000	81,808	78,605	3,203	782,847	10,000	-38,605	-23,163	-41,808	-21,454	-402,538	-18,645	-9,568	-288,339
8	50,000	81,808	78,284	3,523	779,324	10,000	-38,284	-22,970	-41,808	-19,504	-423,042	-18,838	-8,788	-297,127
9	50,000	81,808	77,932	3,876	775,448	10,000	-37,932	-22,759	-41,808	-17,331	-440,373	-19,049	-8,079	-305,206
10	50,000	81,808	77,544	4,263	771,185	10,000	-37,544	-22,526	-41,808	-16,119	-456,492	-19,282	-7,434	-312,640
Final Sale							751,402	450,841	2,107,320 [1,818,373]	812,463 [701,062]	355,971 [244,570]	1,656,478	638,644	326,004

Office of the Secretary of the Treasury
Office of Tax Analysis

the number of years elapsed between the initial purchase and the cash flow to be discounted. Column (11) gives the accumulated value of all prior amounts shown in Column (10). Columns (12), (13), and (14) show the current cash flow, discounted present value and accumulated discounted present value, respectively, for a domestic investor; the cash flow to the domestic investor equals the cash flow to the foreign investor shown in Column (9) plus the tax saving shown in Column (8).

The bottom row in Table A-1 indicates what happens when the property is sold for $2,878,505.at the end of the tenth year. The foreign investor pays off the outstanding mortgage principal, $771,185 and keeps the remainder, $2,107,320. The domestic investor must pay not only the mortgage balance, but also a capital gains tax. With an original basis of $1,000,000, his net gain is $1,878,505. Assuming he can deduct 60 percent of this amount and pay tax at the rate of 60 percent on the remaining 40 percent (i.e., the effective rate is 24 percent of the net gain), his tax on the capital gain would be $450,841. Thus, the domestic investor's net proceeds are $1,656,478, which equals $2,878,320 minus $771,185 and minus $450,841.

If the foreign investor had to treat his capital gain as if it were effectively connected with a U.S. trade or business, he would have the same net gain as the domestic investor, $1,878,505, 40 percent of which, $751,402, would be taxable. This income could, however, be reduced by the accumulated value of the last seven years' losses, $269,824, leaving $481,578 subject to tax. If the tax rate is 60 percent, the amount of the tax is $288,946. The net proceeds from the sale of the property by a foreign investor subject to capital gains taxation is, thus, $1,818,373. The present value of those net proceeds is $701,062, which would bring the accumulated present value down to $244,570. These last three items are shown in brackets under the bottom row of Table A-1.

This example can also be used to illustrate how a partnership between a domestic and a foreign investor can be structured to yield a higher return to the two taken together than is obtained by either one separately. Suppose that the partnership is structured as follows. The domestic and the foreign investor each put up half of the initial down payment, $100,000. The domestic partner assumes full responsibility for making up any cash deficits from operations. Upon the sale of the land, the proceeds are distributed as follows:

1. The outstanding mortgage principal is paid off. If the proceeds are insufficient for these purposes, the domestic investor makes up the shortfall.

2. The domestic investor recovers the after tax amount of accumulated advances (apart from the initial down payment) plus interest calculated at a rate of 10 percent per annum. If the proceeds net of the repayment of mortgage principal are less than the full amount of the accumulated advances plus interest, the domestic investor is entitled to recover no additional amounts from the foreign investor.

3. Any proceeds remaining after repayment of mortgage principal and the domestic investor's recovery of accumulated advances plus interest are shared equally by the domestic and foreign partners.

In the hypothetical example given, the domestic investor would advance each year the $41,808 shortfall in the cash flow. After ten years, the accumulated value of those payments plus interest at the rate of 10 percent is $666,312. When the property was sold for $2,878,505, the proceeds net of the repayment of mortgage principal are $2,107,320. When the partnership is liquidated, the domestic investor receives $666,312 plus half of the remaining $1,441,008 ($720,504), which totals $1,386,816 and the foreign investor receives $720,504.

What might be the tax consequences of this arrangement? If the partnership's tax allocations have substantial economic effect (section 704),* the partnership could allocate the full operating loss to the domestic partner; If the foreign partner's capital gain is tax exempt, and 40 percent of the domestic partner's capital gain, $1,258,001, is taxable at a rate of 60 percent, the latter's capital gain tax would be $301,920.**

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* The Internal Revenue Service and the Treasury Department are developing regulations to describe when an allocation has substantial economic effect.

** If the interest payment to the domestic partner is a guaranteed payment under section 707, that portion of the amount received by the domestic partner would be ordinary income rather than capital gain. One half of the partnership's interest deduction would also be allocated to the domestic partner, so the results under this alternative are not substantially different from those in the table.

-69-

The present value of the investment to the foreign-domestic partnership can now be determined. Prior to the final sale, the accumulated present value is minus $312,460, the same as it was when the investment was undertaken by the domestic investor alone. To this amount would be added $812,463, the present value of the net proceeds of the sale (see the next to last row of Column (10) of Table A-1), less $116,403, the present value of the domestic partner's capital gains tax. The final present value would, thus, be $383,600. This, in turn, is greater than the final present value of the same investment undertaken by either the domestic partner or the foreign partner separately.

Figure 5-1 in the text depicts the accumulated present value of the cash flow to a foreign and a domestic investor as shown in Columns (11) and (14), respectively.

Senator BRYD. The next witnesses will be Mr. Reuben L. Johnson, director, legislative services, National Farmers Union; and Mr. Vernie R. Glasson, director, National Farm Bureau Federation. Welcome.

Ms. RICE. Senator Byrd, members of the subcommittee, my name is Grayson Rice, assistant director of the American Farm Bureau Federation. I will be speaking to you this morning in Mr. Glasson's place, if I may.

Senator BYRD. Fine. You may proceed.

Ms. RICE. Thank you.

STATEMENT OF GRACE ELLEN RICE, ASSISTANT DIRECTOR, NATIONAL AFFAIRS, AMERICAN FARM BUREAU FEDERATION, WASHINGTON, D.C.

Ms. RICE. The American Farm Bureau Federation which represents over 3 million member families throughout 49 States and Puerto Rico, is the Nation's largest general farm organization.

Tax policy has a significant effect upon the Nation's farmers and ranchers, and Farm Bureau appreciates the opportunity to offer comments on S. 208, a bill that would tax foreign investors on gains from the sale of U.S. farmland and other rural land.

Several negative effects have been attributed to foreign investment in our agricultural lands, particularly during the past year. For instance, the escalation in land values which has occurred in recent years probably has been accelerated by the added competition of foreigners for a limited supply of productive U.S. farmland. Increases in land values which exceed the general rate of inflation create a serious problem for young people who are trying to get started in farming.

Questions have been raised with regard to the tax treatment of capital gains received by a foreigner upon the sale of U.S. real estate.

At the 60th annual meeting of the American Farm Bureau Federation, the official voting delegates representing the member State Farm Bureaus adopted the following, which reads in part:

Foreign investment in U.S. assets is a growing concern. We will:

One, oppose preferential tax treatment of foreign investments in agricultural land under federal tax law or treaty provisions;

Two, support legislation that will subject foreigners to capital gains taxes on the sale of U.S. farmland.

We believe that S. 208 adequately addresses the inequity of the present preferential treatment of capital gains realized by foreigners. While we do not advocate a ban on foreign investment in U.S. assets, we do support legislation to prevent foreign investors from receiving a more favorable tax treatment than domestic landowners when capital gains are realized.

Senator Byrd, this was the text of a letter we have submitted to the subcommittee. I would just like to add that the Farm Bureau is very much in support of Senator Wallop's bill, because we do feel that there are a number of questions concerning the ultimate control of our food and fiber system in this country. We believe that there really is no justification for an added tax incentive for foreigners to invest in U.S. farmland at this time.

We appreciate very much your time given to us in hearing our statement this morning.

Senator BYRD. Thank you.

[The prepared statement of Mr. Johnson follows:]

National Farmers Union

STATEMENT OF

REUBEN L. JOHNSON
DIRECTOR OF LEGISLATIVE SERVICES
NATIONAL FARMERS UNION

TO THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
UNITED STATES SENATE COMMITTEE ON FINANCE

Relative to S. 208 and S. 192
Pertaining to the Taxation of Foreign Investment
in U. S. Farm Land, Other Property

June 25, 1979

Mr. Chairman, as you well know, the members of the National Farmers Union have been acutely interested in the question of foreign investment and the extent to which tax policy may encourage U. S. capital to go abroad or foreign capital to be invested here.

You will recall that Farmers Union strongly urged members of the U. S. Senate not to create a new incentive for foreign investment in U. S. agricultural land by approving Article 9 (4) of the United Kingdom Tax Treaty. Members of the Senate are to be commended strongly for rejecting that provision of the treaty.

Likewise, last year, Farmers Union actively supported and promoted the adoption of Public Law 95-460, the Agricultural Foreign Investment Disclosure Act.

At that time, some questioned the need for such a statute, alleging that former ownership and control of U. S. farms was negligible in extent.

Now, however, this "Right to Know" measure is beginning to provide the truth about foreign investment. It appears now that the extent of foreign ownership and control will be much larger than even we anticipated.

The USDA-ASCS office which is processing these disclosure reports is literally swamped by the reports, even though the deadline for reporting (August 6th) is still six weeks off.

Suite 600, 1012 14th Street, N.W., Washington, D.C. 20005 – Phone (202) 628-9774

Our office has examined the first 600 disclosure reports, available for public examination as of June 18, and the tally shows investments in 47 states on the part of investors in 32 countries.

When the first results are available, after August 6, we believe there will be a compelling amount of evidence to substantiate that the amount of foreign ownership is alarming indeed.

Several studies, by governmental agencies and by independent tax and legal specialists, concur that foreign investment in U. S. real estate is on a tax-free basis to an important degree.

The Treasury Department study of May 4, 1979, observes that "foreign persons rarely incur capital gains tax on the disposition of their U. S. property holdings."

We believe that U. S. policy regarding foreign investment, ours or theirs, should be based on the economic self-interest of our country.

We are not saying that our investment elsewhere or foreign investment in our country should be stopped, but there should be a balanced policy and it should not be tilted in favor of foreign investment.

At the worst, U. S. government should be neutral on foreign investment. But, if it is to lean one way or another, it ought to lean in favor of domestic investment.

Over the past two decades, U. S. policies have encouraged investments in foreign rather than domestic activities. We have an energy crisis because too much U. S. capital was invested in the Middle East and not enough in oil and gas development in the U. S.

Corporate decisions have often diverted investment capital to multinational activities abroad at the expense of modernizing U. S. plants. So we have aging plants and uncompetitive operations in several industries.

Farmers Union believes that legislation regarding land ownership and control is best handled by the state legislatures, but because federal tax policy does provide an incentive for foreign investment, federal legislation along the lines of the Wallop and Bumpers bills should be adopted by the Congress.

At our 1979 National Farmers Union convention, delegates approved the attached statement on foreign farm land investment.

Attachment

NATIONAL FARMERS UNION

1979 POLICY STATEMENT
Adopted March 11-14, 1979
Kansas City, Missouri

B. Corporation, Real Estate Trusts, and Foreign Ownership of Agricultural Lands

The Farmers Union urges passage of state and federal laws to prohibit entry into the business of farming and ranching or the ownership of agricultural lands to be used in farming or ranching, except:

1. Natural persons and estates of such persons;

2. Trustees of trusts for the benefit of natural persons;

3. Owner-operator, family farm corporations;

4. Family-owned-and-operated cooperative farm corporations; and

5. Partnerships, provided that each partner shall be a person or entity enumerated in items 1, 2, 3, or 4 outlined above.

Foreign interests (except families or individuals seeking United States citizenship) shall be prohibited from acquiring agricultutal lands.

We respect the right of other nations to put similar limitations on American and other foreign interests owning agricultural land in their nations.

Senator BYRD. At this point, I will insert into the record a letter to the committee from the Florida Farm Bureau Federation supporting Senator Wallop's proposal and one from the Montana Farm Bureau Federation and one from the Wyoming Farm Bureau Federation also supporting S. 208.

[The material referred to follows:]

FLORIDA FARM BUREAU FEDERATION
POST OFFICE BOX 730 · TELEPHONE 378-1321 · GAINESVILLE, FLORIDA 32602

June 14, 1979

The Honorable Harry F. Byrd
United States Senate
4024 Russell Senate Office Building
Washington, D. C. 20510

Dear Senator Byrd:

We understand your subcommittee on Taxation and Debt Management will hold a hearing on June 25 on the taxation of foreign investors in U. S. property. We also understand Senator Wallop (R.,Wyo) has introduced a bill, S. 208, which would tax foreign investors on gains from the sale of U.S. farmland and other rural land. Our purpose in writing is to encourage your support of S. 208.

Land cost is the number one expense for farmers today, followed by energy. The cost of land has skyrocketed the past few years. A major contributing factor being purchases made for speculation by foreign investors. It is driving the cost of farmland out of reach of our own farmers who wish to expand acreage and, particularly difficult for young men wanting to go into farming.

The tax loopholes in effect mean the federal government is actually subsidizing foreign investors at the expense of our own farmers.

Farmers are having a difficult time already with a cost-price squeeze without tax loopholes that encourages American soil to be sold from under their feet.

We encourage your support to dampen the foreign investors' speculation by closing the tax loopholes regarding capital gains tax.

Sincerely,

Walter J. Kautz

Walter J. Kautz
President

WJK:bk
cc: Senator Richard Stone
Senator Lawton Chiles
Representative Richard Kelly

Montana Farm Bureau Federation
125 West Mendenhall, Box 1237
Bozeman, MT. 59715
Phone: 406/587-3153

June 14, 1979

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A Farm Bureau SPEEDLINE message for:

SENATOR HARRY F. BYRD
CHAIRMAN SENATE FINANCE SUB. COMMITTEE
UNITED STATES SENATE
WASHINGTON, D.C. 20510

DEAR SENATOR BYRD:

IT IS OUR UNDERSTANDING THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, SENATE FINANCE COMMITTEE, WILL HOLD A HEARING ON JUNE 25 ON THE TAXATION OF FOREIGN INVESTORS IN U.S. PROPERTY.

UNDER PRESENT LAW, INVESTORS ARE GENERALLY NOT TAXABLE ON CAPITAL GAINS WHEN THEY SELL U.S. PROPERTY. INTERNAL REVENUE CODE AND EXISTING TREATY PROVISIONS BEAR UPON THIS RESULT. IN THE REVENUE ACT OF 1978, CONGRESS REQUESTED A TREASURY DEPARTMENT STUDY AND RECOMMENDATIONS ON THIS SUBJECT. THE REPORT, "TAXATION ON FOREIGN INVESTMENT IN U.S. REAL ESTATE," WAS RECENTLY SUBMITTED TO CONGRESS. WE BELIEVE ITS FINDINGS ARE IMPORTANT TO ALL OF AGRICULTURE.

DURING THE RECENT MONTANA LEGISLATIVE SESSION, WE WHOLLY SUPPORTED LEGISLATION WHICH WOULD HAVE REPEALED TAX ADVANTAGES NOW ENJOYED BY FOREIGN INVESTORS IN U.S. PROPERTY. WE CONTINUE TO DO SO AT ALL LEVELS OF GOVERNMENT.

WE ARE IN SUPPORT OF S. 208 AND HOPE YOU WILL DO THE SAME.

ZACK STEVENS FOR:
MONTANA FARM BUREAU
MONTANA FARMER'S UNION
MONTANA N.F.O.
MONTANA W.I.F.E.
MONTANA GRANGE
MONTANA CATTLEMEN'S ASSOCIATION

Wyoming Farm Bureau Federation
Box 1348
Laramie, WY 82070
Phone: 307/745-4835

June 19, 1979

A Farm Bureau SPEEDLINE message for:

THE HONORABLE HARRY F. BYRD, JR.
UNITED STATES SENATE
WASHINGTON, D.C. 20510

DEAR SENATOR BYRD:

WE WERE PLEASED TO LEARN THAT YOUR SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE HAS SCHEDULED A HEARING JUNE 25 ON THE TAXATION OF FOREIGN INVESTORS IN U. S. PROPERTY.

THIS IS A SUBJECT OF SUBSTANTIAL CONCERN TO RANCHERS AND FARMERS IN WYOMING. OUR MEMBERS HAVE EXPRESSED INCREASING CONCERN ABOUT GROWING FOREIGN INVESTMENT IN UNITED STATES ASSETS.

WE OPPOSE PREFERENTIAL TAX TREATMENT OF FOREIGN INVESTMENTS IN AGRICULTURAL LAND UNDER FEDERAL TAX LAW OR TREATY PROVISIONS. WE SUPPORT LEGISLATION, LIKE S. 208 INTRODUCED BY SENATOR MALCOLM WALLOP, WHICH WOULD TAX FOREIGN INVESTORS ON GAINS FROM THE SALE OF U.S. FARMLAND AND OTHER RURAL LAND.

WE RESPECTFULLY REQUEST THAT YOU AND THE MEMBERS OF YOUR SUBCOMMITTEE FAVORABLY REPORT S. 208 TO CORRECT A DISCRIMINATORY PRACTICE WHICH CURRENTLY GIVES FOREIGN INVESTORS AN UNFAIR ADVANTAGE OVER UNITED STATES CITIZENS, PARTICULARLY FARMERS AND RANCHERS.

THANK YOU FOR CONSIDERATION OF OUR OPINION ON THIS IMPORTANT SUBJECT.

SINCERELY,

DAVE FLITNER, PRESIDENT
WYOMING FARM BUREAU

CC: SEN. WALLOP
SEN. SIMPSON
REP. CHENEY
GOV. HERSCHLER
VERNIE GLASSON

Senator BYRD. Let me ask you this.

Of course, the price of farmland varies a great deal and it is difficult to generalize. Does the American Farm Bureau have any figures showing what the current average price of farmland is now?

Ms. RICE. Senator Byrd, I do not have those figures with me, but I know that the price of farmland has doubled within the last 5 years, with an appreciation of 12 to 14 percent per year.

I frankly would imagine that the average value now is about $450 to $500 an acre, although I cannot verify that right now.

Senator BYRD. Thank you.

Senator Wallop?

Senator Wallop: Thank you, Mr. Chairman.

Are the concerns you have expressed derived from specific instances, or are they just general concerns?

In other words, have members of the Farm Bureau identified areas that are particularly prone to foreign investment?

Ms. RICE. Our statement was one of a general attitude toward tax incentives for foreign investors, but I would have to say that there are particular States in the country which have experienced this problem more than others.

I think the No. 1 State right now in foreign investors is Oregon. In Arkansas—I am a native of Arkansas and I know that that has been a real problem down there. We have been working through various State Farm Bureaus, such as the Arkansas Farm Bureau, on this problem. Of course, many of our State farm bureaus have been active in State legislation that would restrict or otherwise forbid foreign investment as a whole.

Our membership is very concerned that there is preference for foreigners over younger farmers who would choose to get into agriculture at this point.

Senator WALLOP. I assume you have identified, as I have, that this advantage in taxes gives initial purchasing leverage that is not available to the young farmer.

Do you have any statistics on that? Have you made any estimates?

Ms. RICE. I can submit those to you later, if I may.

Senator WALLOP. If you would do that, I think the committee will welcome the Farm Bureau's idea of how that leverage works.

[The material to be furnished follows:]

We had hoped to present the Subcommittee with specific examples and statistics that illustrate the leverage that exists for foreign investors because of the tax advantages available to them. Unfortunately, our information is incomplete at this time. The Farm Bureau recognizes that foreign investors are able to spend more money per acre than many domestic purchasers, particularly younger farmers. This is because the future sale of farm land is exempt from the capital gains tax. American farm land has become a haven for foreign purchasers who seek a safe investment for their money. This factor, plus the tax advantages, allows many foreigners to pay a premium price for land. This situation has the unfortunate result of rendering young farmers unable to compete with foreigners whose investments are enhanced by tax treaties and the Internal Revenue Code.

Senator WALLOP. Thank you, Mr. Chairman.

Senator BYRD. Senator Dole?

Senator DOLE. I would like to place in the record some information about the State of Kansas. As of September 22, 1978, it appears at least 8 or 9 or 10 counties have had substantial sales of farmland to different West Germany buyers and Swiss corporations.

Somebody bought some wasteland, a German purchase, a Canadian purchaser, so it is an indication that there is some activity, quite a bit of activity, in our State. One owner, reported to be a Syrian, 5,000 acres; 577 acres of cropland, 4,000 acres of pastureland.

I would like to put this in the record to underscore the reason for the concern of the American Farm Bureau, the Kansas Farm Bureau and other farm groups. It is just not an isolated instance in one or two States.

I think that there is concern, and the concern is that they should not be given any preference.

[The material referred to follows:]

STATE OF KANSAS SURVEY OF PURCHASE OF AGRICULTURAL LAND BY FOREIGN INVESTORS

a. Confirmed sales to foreign buyers

Cheyenne County—960 acres sold to a West German buyer.

Grant County—A sale of 160 acres with 130 acres cropland, 30 acres of pasture.

Jefferson County—One sale of 80 acres of pastureland to a foreign buyer.

Miami County—One sale of 245 acres, with 80 acres of cropland and 161 acres of pasture to a Swiss corporation.

Seward County—One sale of 320 acres of cropland to a Swiss corporation.

Stevens County—Two sales to foreign buyers totaling 734 acres with 117 acres cropland and 617 acres of pasture and wasteland.

Total—2,499 acres.

b. Sales believed to be to foreign buyers

Doniphan County—Three sales totaling 2,733 acres with 1,278 acres cropland and 995 acres pasture.

Gove County—One sale of 236 acres with 230 acres of cropland and 6 acres wasteland.

Chautauqua County—One sale of 4,985 acres with 215 acres cropland and 4,770 acres of pasture to a German purchaser.

Total—7,954 acres.

c. Sales reported in progress

Chautauqua County—Abstract work underway to a owner reported to be a Syrian. The sale involves 4,589 acres with 577 acres of cropland and 4,012 acres of pastureland.

Wallace County—Reported an offer to purchase 4,304 acres by a firm from Montreal, Canada, believed to be for a German buyer.

Total—8,893 acres.

Senator DOLE. I have no other questions. I appreciate your statement and will state, for the record, that you certainly improve the image of the American Farm Bureau Federation.

Thank you.

Senator BYRD. Thank you.

Next will be a panel of three witnesses: Mr. Marshall J. Langer; Mr. John I. Forry; and Mr. Michael Abrutyn, all attorneys.

Gentlemen, the committee is glad to have you and you may proceed.

STATEMENT OF JOHN I. FORRY, ESQ., FORRY GOLBERT SINGER AND GELLES

Mr. FORRY. Mr. Chairman, members of this distinguished subcommittee, my name is John I. Forry. I am an attorney in private practice in Los Angeles and San Francisco, Calif. I have been involved extensively in the representation of foreign investors in the United States for about 10 years. However, I wish to point out no client of my firm has requested or paid for my participation in these hearings.

My testimony will provide a somewhat detailed description of the present U.S. statutory and treaty pattern for taxing foreign investments in U.S. real estate. Mr. Abrutyn will provide examples and some discussion of policy questions involved in such taxation, and Mr. Langer will make some technical observations and suggestions regarding possible legislation.

Within my longer written statement, which I have submitted to the subcommittee this morning, I wish to concentrate primarily on the portions dealing with capital gains on the disposition of properties. I will turn first to investments in unimproved property, and second to investments in income producing property and property acquired for development.

First, as to unimproved property, the simplest structure for proposed investors in unimproved property is the direct ownership of such property by the foreign investors. If, after a holding period, the investors sell the property and realize long-term or short-term capital gain on the sale, the Federal income tax consequences to them will be as follows: capital gain realized by an individual investor will be tax free if (1) the gain is not effectively connected with the conduct of a trade or business within the United States by the individual—so-called effectively connected income—and if (2) the individual is not present in the United States for at least 183 days during his taxable year in which the sale occurs.

Capital gain realized by a foreign corporation on sale of the property will likewise be tax free if the gain is not effectively connected income. In the case of a foreign corporation, there is no supplementary test based on less than 183 days' presence in the United States. It should be noted that, under most U.S. income tax treaties, the income from direct real estate investments in the United States continues to be taxed by the United States in accordance with many of the basic statutory provisions applicable to nontreaty investors.

A corollary of the tax-free treatment accorded this capital gain is that no deductions for real estate taxes, interest or other carrying charges are permitted to the investors since such deductions generally are permitted to them only to the extent allocable to effectively connected income.

If the foreign investors wish to form a U.S. or foreign partnership to own the unimproved property, the determination whether gain on sale of the property is effectively connected income generally depends on whether the partnership is engaged in a U.S. trade or business, since each of the partners will then be considered to be so engaged.

In addition, the taxable character of a foreign entity as a partnership for U.S. tax purposes will depend on U.S. standards; this may often be an issue where a foreign entity has attributes similar to those of a U.S. corporation.

A major additional factor in planning investments in U.S. real estate by foreign individuals is the impact of Federal gift and estate taxes on the individual investors. A gift by a nonresident alien individual of his interest in U.S. real estate, whether owned directly or through a partnership, generally will be taxable by the United States at the substantial gift tax rates applicable to U.S. citizens and residents. Similarly, on the death of such an individual foreign investor, Federal estate tax of up to 30 percent generally will apply to his interest in U.S. real estate owned directly or through a partnership; a credit of $3,600 is allowed against this estate tax.

However, if the foreign individuals form a foreign corporation to hold their interests in unimproved U.S. real estate, no Federal gift tax will apply to transfers of the foreign corporation's stock by the individuals, nor will Federal estate tax apply to the foreign corporation's stock on the death of any of the individuals.

Such U.S. real estate investments also are subject to State income, gift, estate and inheritance taxes which vary with the State in which the real estate is located or other activities of the investors are carried on. In many States, foreign investors are treated approximately the same as out-of-State U.S. investors. Such State taxes often do not exempt capital gain from sale of unimproved property, contrary to Federal taxation.

Second, foreign investors may choose to invest in income-producing property, or to acquire and develop property. Rental income from an office building, apartment building, shopping center or similar income producing property, which is received by the foreign investors either directly or through a partnership, will usually be effectively connected income.

The same is true of sales proceeds from U.S. property developed and held for sale by the investors, such as from sales of condominiums or other subdivided property. Such effectively connected income will be taxable by the United States to foreign individuals on a net basis at the ordinary rates paid by a U.S. citizen or resident. Such income will be similarly taxed to a foreign corporation on a net basis at the ordinary rates paid by a U.S. corporation—from 17 percent of the first $25,000 of taxable income up to 46 percent of the balance over $100,000.

If the foreign investors eventually realize long-term or short-term capital gain on sale of the income-producing property or property developed by them, the capital gain will also be effectively connected income because it is derived from assets which have been used in a U.S. trade or business.

Such gain will be taxed to a foreign corporation by the United States approximately as capital gain derived by a U.S. corporation and will be taxed to foreign individuals approximately as capital gain derived by U.S. citizens or residents. Any long-term capital gain will be further subject to the minimum tax on tax preferences.

The taxable character of such gain is in contrast to the generally tax-free capital gain—as described above—on the sale of unimproved property which has not been used in a U.S. trade or business by the foreign investors.

In some cases, where little or no business activity is carried on in the United States by foreign investors or their resident agents, the income from the property may not constitute effectively connected income. This is particularly likely where net lease arrangements—such as for agricultural property, or an industrial warehouse—provide that all maintenance and other activities and costs are to be undertaken by the tenant rather than the foreign owners. In the case of rental income, such treatment is usually extremely undesirable because the income will be subject to a withholding tax of up to 30 percent of the gross amount without any deductions—which tax may not be reduced even under a treaty—so that the tax will often equal or exceed the net income from the property.

However, where such taxation appears likely, a foreign investor may make a special statutory election to have his share of the income taxed on a net basis as effectively connected income. Such an election must apply to all U.S. real property interests of an electing foreign corporation, and to all such interests held for the production of income by an electing individual.

In addition, once made and not modified within the 3-year period for amending the original year's tax return, the election remains in force for all subsequent years unless revoked by the taxpayer with the tax authorities' permission. In case of such revocation, a reelection generally may not be made for another 5 years without further permission.

This may cause capital gains on the sale of the same or other unimproved property owned by the investor to be taxable, whereas no tax would apply if the election were not made.

However, the election may be made from year to year under a number of U.S. income tax treaties. Accordingly, the treaty may permit the investor simply to avoid the election in a year in which tax-free capital gain from selling the same or other property is expected.

Senator WALLOP. If I may ask a question at this point, the election and the change back, as you stated, is with the permission of the taxing authority. Is that ever denied?

Mr. FORRY. Probably it would be denied in the case of a statutory election, if the revocation of the statutory election is sought in the year of sale of the property. The reason is that the Treasury would not want to see that election revoked simply for capital gains tax avoidance purposes.

Senator WALLOP. In your experience, has it been?

Mr. FORRY. Yes.

Senator WALLOP. Thank you.

Mr. FORRY. It should be noted that this treaty election does not permit the foreign investor to elect to have his property treated as nonbusiness property if, in fact, it is business property; so when he comes to the year of sale, he may, in fact, continue to have business property and the capital gain will be effectively connected income.

As an alternative, the foreign investor can exchange the property tax free for other property of like kind.

However, again in the case of income producing property, if the property is owned directly or through a partnership, it will generally be subject to Federal gift and estate taxes. To avoid these taxes, individual foreign investors often organize a foreign corporation, perhaps in a tax haven, to hold their interest in the property.

The income of this corporation is usually effectively connected income because it is operating income from the property. In addition, dividends and interest that are paid by the corporation may be subject to a U.S. withholding tax of 30 percent except that, in the case of some tax treaties, we do allow that income to be paid free of the withholding tax for foreign shareholders.

If such a corporation is used to own a property, on the sale of the property, the following alternatives are available:

One, the corporation can sell the property free of tax if it is property that has not been used in a trade or business in the United States.

Two, as an alternative, the corporation can exchange the property tax free for other property of like kind.

Three, as an alternative, beyond that, the foreign shareholders may sell their shares of the corporation for tax-free capital gain. The purchaser also can acquire a stepped-up tax basis by liquidating the corporation after he purchases it.

Four, the property may be sold and the corporation liquidated pursuant to a 12-month plan of liquidation. Then there is no income tax on the corporation itself except as to recapture of certain depreciation and, in addition, the liquidation proceeds may be distributed to the foreign shareholders free of any U.S. capital gains or withholding tax.

Five, the property may be sold on an installment basis and installments after the year of sale—when the corporation is no longer engaged in U.S. trade or business—generally will be taxfree capital gain because not effectively connected income.

I think I will stop at this point, and refer you to my prepared statement for further details.

Senator BYRD. Thank you, Mr. Forry.

The next witness?

STATEMENT OF MICHAEL ABRUTYN, ESQ., COLE, CORETTE AND BRADFIELD, WASHINGTON, D.C.

Mr. ABRUTYN. Mr. Chairman, my name is Michael Abrutyn. I am an attorney in Washington, D.C. in private practice. I have represented foreign investors in U.S. real estate over the course of time, and I am not appearing before this committee on behalf of any client.

Mr. Forry has outlined the basic rules for foreign investment in U.S. real estate and, in my prepared testimony, I have two relatively simple examples which will illustrate the application of these rules and then what I would like to do is address myself to some policy questions.

The first case, and the pivotal question, as we have heard this morning, is whether you are engaged in trade or business or whether you are not engaged in trade or business. A first example where you are not engaged in a trade or business would be where a foreign investor would acquire farmland and enter into a net lease with a tenant where, under the terms of the net lease, the tenant would operate the farm, take care of all the repairs, maintenance, real estate taxes and the like.

In that instance, when the foreigner is not engaged in business in the United States, he is very similar to a passive investor. He is collecting his monthly rent check.

There, as we have heard this morning, since he is not engaged, the gross rental income, his monthly check, would be taxed on a gross basis of 30 percent absent the treaty provision reducing the rate to something less than that. When he goes to sell the property, the capital gain would be exempt from U.S. tax. Obviously, the detriment in that situation to the foreign investor is that the gross rental income, the monthly rental check, would be taxed on a 30-percent basis. Whereas, if you took into account all of the deductions associated with the property, interest, taxes, insurance, depreciation, if you will, the tax on the net taxable income taxed at the normal rates would be much lower.

Therefore, there are two options. There is a Code election which would allow you to be taxed upon a net basis, but the difficulty with that is that the gain is then subject to tax. It is here where the tax treaty would come into play. If you formed a corporation in the Antilles, you could take advantage of a net election on an annual basis so that the rent checks coming in would be taxed on a net basis. After the allowance of deductions, the ultimate tax would be very small. Then, in a year, when you sell the property, you do not make the net election. If you could time the sale on the first day of the new taxable year, there would be no price to be paid.

Thus, it is in that case that the treaty solves your dilemma.

The second case is where you are engaged in business, for example, a nonresident alien acquires a farm and operates it. There you have no problem on the current income because it is taxed on a net basis under our Code rules.

But you are planning, at that point, to exempt the capital gain and it is here that there are many technical provisions in the Code which allow you to have the capital gain also exempt from tax even though you have made an active investment instead of a passive investment.

The 337 liquidation was mentioned. The installment sale is another opportunity. A like kind exchange is another opportunity and the last is a change of structure of your business—you operate the farm in one year, the next year you do not operate. You have a lease. The third year you sell the farm and you will accomplish the goal.

Mr. Langer will address himself to making some suggested changes to change these rules, if Congress feels it is appropriate.

However, if Congress desires to make some changes, I think there are some policy considerations which I would like to bring to your attention for careful consideration.

The first policy consideration is coordination with State income tax and State laws for regulation of foreign ownership and recording of foreign ownership. I think that coordination in that area could go a long way to solving some of the enforcement problems and some of the other problems that were mentioned earlier this morning.

The second policy decision that I would like to bring to your attention is dealing with making the change in such a way that you will override a tax treaty. I think, from a policy standpoint, that would be the wrong policy to engage in and very careful consideration ought to be given in that regard.

If you were to unilaterally override a treaty, that would be an example that would go beyond the tax area. This country has other treaties that it has negotiated in the commercial area, in the defense and other areas. A unilateral override of the tax treaty could be considered by our treaty partners to be a bad precedent in those other areas.

In this regard, it was mentioned this morning that the treaties provide mechanisms for amendment, renegotiation, and determination. In this area it is my judgment that we ought to make use of those provisions in the treaties, particularly when you are dealing with countries like Canada and the United Kingdom. In the case of Canada, you do have substantial investment in U.S. real estate by Canadian entities.

The next area for policy consideration is the effective date. It seems to me that there are three ways to deal with the effective date. One is to pick the effective date to the date you acquire the property; the second is to pick the effective date to the date of sale; the third to have a fresh start or a valuation of the property as of today and deal with capital appreciation after a given period.

I will note, in this regard, when Canada and the United Kingdom imposed a capital gains tax for the first time, they allowed a fresh start or a current valuation date.

With respect to real estate, perhaps some relief from retroactivity would be appropriate. As you know, investments were made under the current system where incentives were allowed and encouraged for years and real estate is relatively ill-liquid. I am sure foreign investors did make the investment decision as if the current tax rules applied.

The last area for policy consideration alluded to this morning was that the manner in which you make the change could be very important as it affects the foreign investor's view of the United States as a comfortable and secure market for his investment.

If you, for example, limit the distinction to change in farmland, that is, perhaps, viewed in one way. If you extend it to commercial property, it may be viewed in another way. If you go on to portfolio investments, it could be viewed in a third way.

Beyond that, if you do it retroactively, if you override treaties and extend it to an existing investment, then you would have to carefully consider whether a foreign investor would view those types of changes as tarnishing the reputation for the United States as being a secure place for foreign investment without exposing that type of investment to political risk.

The last point I would like to make, from the standpoint of a tax practitioner, is that it is possible to make the distinction between farmland, commercial property, and portfolio investments, in drafting any change, if the committee decides that those distinctions are viable.

With that, I think that I will complete my testimony and leave it to Mr. Langer to deal with some of the suggested changes.

Of course, I would be delighted to answer any questions that anyone might have.

Senator BYRD. Thank you, sir.

Mr. Langer?

STATEMENT OF MARSHALL J. LANGER, ESQ., BITTEL, LANGER & BLASS, MIAMI, FLA.

Mr. LANGER. Mr. Chairman, my name is Marshall Langer. I am an attorney in private practice in Miami, Fla., and, like my colleagues here, I represent many foreign clients who invest in the United States in real property, generally in farmland, and in other types of investment in this country. Like them, I am not appearing here today on behalf of any individual client.

I have been asked to describe what might be done to legislate in this area.

First of all, I think that the Treasury recommendation would probably produce greater equity and fairness but that it would not achieve the results that have been intended by the sponsors of the Wallop and Grassley bills. I believe that foreign persons are investing in United States mostly because they feel that this is a great country and that our real estate is a safe and secure investment.

They do not buy U.S. real estate because of the tax breaks or benefits that they get, and they will continue to buy U.S. real estate whether or not the Congress succeeds in taxing their capital gains.

If you simply close all of the loopholes that have been pointed out in the Treasury report, you will achieve the collection of a small amount of revenue, but I do not think that you will achieve the goal of stopping people from buying farmland and other rural land in the United States.

Senator WALLOP. To make the record clear, it is not my goal, and it is not Congressman Grassley's goal, to prevent foreign investments in U.S. agricultural land, but to deny the advantage that the tax situation now provides foreign investors.

I really want that clearly understood.

I agree with Senator Bumpers. It is not my plan to, nor do I think we can prevent foreign investments. We simply want to treat foreign investors in the same manner that we treat American investors and to provide an equally competitive status to all purchasers.

Mr. LANGER. Thank you, Senator Wallop.

I believe that if you were to close these loopholes with respect to farmland, but to leave them open with respect to other types of real estate, that in any event, you would probably succeed in redirecting some of these foreign investors away from farmland and into commercial and residential property, and that may or may not be considered a desirable goal by the Congress.

Looking now at some of the more technical problems in the area, if we look at Senator Wallop's bill, that bill talks about taxing land used in farming, land suitable for use in farming, and land in a rural area.

Those definitions are taken by cross-reference in the first two cases to other sections of the Internal Revenue Code and in the third case to another area of the United States Code having nothing to do with taxes.

I believe that it would be better if we were to have these various definitions that we have them straightforward in the law rather than in cross-references.

We particularly believe that that would be true in the case of "land in a rural area." That "land in a rural area" is a bad cross-reference. It is a negative cross-reference to a section that says, "Land in a rural area shall not include land in a city or town of more than 10,000 persons." It does not say what is land in a rural area, and I believe that any definition in a taxing statute ought to be more specific.

In addition, it does not talk about unimproved land in a rural area, but simply talks about land in a rural area. I had occasion recently to give a talk on this subject at a hotel in Miami Beach, Fla., and I told the persons attending that session that it would not include that particular hotel in Miami Beach, Fla., but that this definition would probably include the land underlying another hotel of a similar size in Key Biscayne, Fla., since Key Biscayne, Fla., is technically not in a city or town and is therefore an unincorporated area.

I believe that the land to be covered by any bill of this type should be of a particular minimum size. I would suggest something like 40 acres because I do not believe foreign people are buying quantities less than that typically. And I believe it should be unimproved land in a rural area, rather than improved land.

Mr. Forry has focused on the various methods used as pointed out in the Treasury report by foreign persons to flip-flop from being engaged in a trade or business during the period in which they own the property to subsequently being able to get a tax-free capital gain by no longer being engaged in trade or business in the United States.

I think the so-called loopholes described in there probably can be closed without a great deal of effort. I will take them one at a time.

One method described is the installment sale under which persons who are engaged in trade or business at the time they make the sale are no longer engaged in the trade or business at the time they receive an installment payment. A simple provision could be drafted under which if a foreign taxpayer is engaged in trade or business in the United States at the time that he makes the sale, any subsequent installment payments received would continue to be taxed as if effectively connected with that business, even though received in later years in which he is not engaged in trade or business.

There is another so-called loophole involving the possible exchange of domestic property for foreign property and I think that could be prohibited in a straightforward way.

A third method uses a sale of property by a corporation and a subsequent liquidation in a period of 12 months under section 337 of the Code, and I believe that could be closed in a straightforward way.

The fourth method involves the sale of shares of a holding company, then the liquidation thereafter by the purchaser who can get a step-up in basis, I think the best way of attacking that would be to eliminate the step-up in basis to the purchaser under those circumstances.

The fifth method is the treaty situation with the annual election already described and perhaps the best method of handling that would be to make all real estate considered to be effectively connected income, or at least all agricultural real estate effectively connected income.

Earlier this morning I had occasion to look briefly at the new Treasury proposal and my first reaction is that it is incredibly complex. It has the possibility, at least, of scaring off all foreign investors in the United States.

I would appreciate an opportunity to submit a written statement subsequently commenting on the Treasury proposal.

Thank you, Mr. Chairman.

Senator BYRD. The committee will be glad to have such a statement, and it will be made a part of the record.

[The material referred to follows:]

SUPPLEMENTARY STATEMENT OF MARSHALL J. LANGER, MIAMI, FLA.

I have analyzed the Treasury's proposal for taxing capital gain on foreign interests in United States real property. As already indicated in my oral testimony, I don't think the Treasury's proposal to try to tax foreign investors on gains from all United States real property makes good sense. It would be more effective if it was confined to farmland and unimproved rural land. That would redirect many foreign investors away from farmland and into other types of property.

There may be a sound reason for trying to "equalize" the tax treatment of foreign persons and domestic persons investing in farmland. There is little reason for doing the same with other real property unless the same is also done with other investments. To do this the Congress would have to tax nonresident aliens and foreign corporations on:

Interest paid by banks, savings institutions and insurance companies;

Capital gains from the sale of portfolio securities;

Interest (or original issue discount) on short-term Treasury bills.

None of these are presently taxable to foreign persons investing in the United States.

The recent Treasury Department report on "Taxation of Foreign Investment in U.S. Real Estate" appeared to recommend simple legislation to prevent unintended tax avoidance. Legislation of the type suggested in my oral testimony would do an adequate job of closing the existing loopholes.

During the 7 weeks that elapsed between issuance of the Treasury's report and Assistant Secretary Lubick's testimony before this Subcommittee the Treasury apparently changed its mind. It now seeks complex legislation that is supposed to be "foolproof" in its loophole-closing efforts.

The new Treasury proposal won't work. It isn't foolproof. It is loaded with defects, exceptions, exceptions to exceptions, and new loopholes. Its incredible complexity will scare away many foreign investors, not just from real estate but from other investments as well. Many foreign persons may see the proposal as a forerunner of similar legislation to tax gains from other types of investments.

The "central concern" of the Treasury's proposal is to pevent foreign persons from escaping United States capital gains tax by placing real estate in a "real estate holding company" and selling the shares tax-free. The Treasury fears that many foreign investors will sell the shares of real estate holding companies instead of the property and thereby avoid the intended 28 percent capital gains tax. This fear is unrealistic and unfounded.

The foreign investor may try to sell the shares of his real estate holding company but the vast majority of buyers won't buy them. In my experience, and that of many of my colleagues, a buyer wants real estate not the shares of a real estate holding company. That is generally true today even when the buyer can liquidate the acquired real estate holding company and get a step-up in basis to the price he paid for the shares.

If the entitlement to a step-up in basis is eliminated (as I have suggested in my oral testimony), virtually nobody will be willing to buy real estate holding company shares. The discount on the shares will be about as much as the capital gains tax sought to be avoided.

Assume that Juan Sanchez of Panazuela buys a farm for $1 million through a real estate holding company. Some years later a buyer is willing to pay $2 million for the farm. The maximum capital gains tax would be $280,000.

A buyer will not pay anything close to $2 million for the holding company shares if he cannot get a step-up in-basis by liquidating the holding company. He doesn't want to keep the company with its overhanging tax liability and unknown corporate liabilities.

Thus, the "central concern" of the Treasury's proposal is a myth, not a reality. With that background, let us take a detailed look at the Treasury proposal.

THE TREASURY PROPOSAL

The proposal contains two key definitions. One is a "foreign-controlled United States real property corporation (or partnership or trust)" which I call a "PROPCO" for short. The other is a "United States real property interest" which I call a "USIRP".

The PROPCO is a domestic or foreign entity that meets either an income test or an assets test and an ownership test [¶2].

USIRP includes both direct interests in United States real property and the shares of a PROPCO [¶1].

The Treasury proposal would tax capital gains derived by foreign persons from the disposition of USIRP [¶3]. Thus, it would tax gains from the direct sale of real estate or from the sale of shares of a PROPCO. It would not tax gains from the sale of shares of a holding company that was not a PROPCO.

Incredibly, under the Treasury's "foolproof" proposal, a publicly-held Saudi Arabian investment company owning 100,000 acres of Wyoming farmland through a wholly-owned Bahamian subsidiary could sell the shares of the Bahamian corporation at a profit without paying any capital gains tax. The Bahamian corporation would not be a PROPCO because it would "flunk" the ownership test. The proposal would tax the gain from the sale of shares only if during the year of sale more than 50 percent of the value of the outstanding stock of the Bahamian corporation was owned, directly or indirectly, by or for not more than 10 nonresident alien individuals. A publicly-held foreign corporation would generally escape tax under this rule.

A closely-held real estate holding company could also avoid classification as a PROPCO with careful planning. Consider this example:

Juan Sanchez sets up a foreign real estate holding company in 1979. It buys a tract of undeveloped rural land for investment purposes, paying $1 million. It does not rent out the land and it derives no income from it during 1980, 1981 and 1982. In 1983, Sanchez sells the shares of the real estate holding company for $2 million. At that time the holding company also owns $250,000 of non-U.S. real property. The gain would be taxfree. The foreign holding company would not be a PROPCO because it would fail both the income and assets test.

It would fail the income test because it has no gross income or gains of the type covered by the definition during the three-year period ending with the taxable year preceding the year of sale.

It would fail the assets test because more than 90 percent of the corporation's assets are not USIRP, since 10 percent or more is foreign real property.

Juan Sanchez would require careful tax planning to avoid the proposed capital gains tax. The large publicly-held foreign corporation would not. If it fails the ownership test it can sell holding companies owning farmland or gasoline stations without becoming subject to tax. I do not understand the rationale of the Treasury's proposal to tax gain on the sale of a real estate holding company that is closely held by a small group of nonresident aliens while not taxing the same gain if the holding company is owned by a giant foreign multinational corporation.

The Treasury proposal suffers from a number of other defects. Consider these:

The assets test for a PROPCO redefines USIRP to exclude real property used in a trade or business. An exception to the exception reincludes it if it is farmland or land in a rural area.

The exclusion for property used in a trade or business would exempt from tax the gain derived by a foreign oil company on the sale of shares of a holding company owning gasoline stations but would tax the foreigner selling a condominium apartment either directly or through a holding company. This is not what I consider equal treatment of all taxpayers. If the proposal is going to cover all real estate then it should cover all real estate and all real estate holding companies without exception.

The term "land in a rural area" should be changed to "unimproved rural land" and should be redefined without cross reference. The present definition would include land under a hotel or manufacturing plant if it is located outside a city or town of 10,000 persons. There should also be an acreage de minimis, perhaps 40 acres.

Under the ownership test, if Sanchez and I each own 50 percent of a real estate holding company it is not a PROPCO and his gain on the sale of its shares is taxfree. Mine, of course, is taxable.

Every buyer of every single parcel of real estate in the United States would be required to obtain proof that the property is not beneficially owned by foreign persons [¶4]. If he doesn't obtain a satisfactory statement the buyer must withhold 28 percent of the purchase price. This amount could exceed the entire cash at closing.

The withholding approach should be eliminated entirely in favor of a requirement that the seller either prove that there is no foreign beneficial ownership or produce at the closing a tax-clearance certificate from the IRS showing that the tax has been adequately provided for or paid.

The annual information return requirement [¶5] would be obnoxious to many foreign investors because it requires annual disclosure of the "ultimate beneficial owners." The provision is unlikely to raise any revenue and it is susceptible to large-scale cheating. There is no way the IRS can satisfactorily verify the true beneficial owners of a foreign corporation with bearer shares or a discretionary foreign trust.

The provision may also be susceptible of misuse. By failing to supply proof of stock ownership a dealer in real estate could apparently convert ordinary income into capital gain, with a step-up in basis.

The provision concerning like-kind exchanges [¶6] should deal directly with exchanges of domestic for foreign real estate. Such exchanges could remain tax-free, but only with an IRS ruling that there is not tax-avoidance motive.

Finally, existing income tax treaties should be amended by protocol and not by executive agreements [¶7].

EFFECTIVE DATE

I agree with my colleagues that whatever legislation is eventually adopted in this area should not be made retroactive.

CONCLUSION

In my opinion, the Treasury proposal is based upon a false premise—that in order to prevent foreign persons from escaping capital gains tax on the sale of farmland (and other United States real estate), you must go to incredible lengths to try to prevent these foreign persons from selling shares of real estate holding companies. This simply is not true.

Most foreign investors will not be able to sell shares of real estate holding companies because nobody will buy them—at least not without substantial guarantees and a discount that may equal or exceed the applicable capital gains tax.

There is a much simpler way to prevent most foreign persons from avoiding United States capital gains tax on the sale of shares of real estate holding companies. Simply disallow a step-up in basis on the liquidation of a real estate holding company unless tax has been paid on the sale of the shares.

The loopholes pointed out in the recent Treasury report can be closed by legislation far simpler than that contained in the Treasury's tax proposal.

Senator BYRD. Let me ask you this. From your experience, where do foreign investors show the greatest interest? Is it in farmland? Is it in residential property, or commercial property?

Mr. FORRY. My own experience is that it is commercial property.

Mr. ABRUTYN. That is consistent with mine.

Mr. LANGER. I find them investing in all of them.

Senator BYRD. Thank you.

Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman.

Mr. Langer, I appreciate your pointing out difficulties with the definitions, but would not most of those problems be resolved by including all real estate, all real property?

Mr. LANGER. Yes; but I think they could be resolved in other ways, and the Treasury report uses your definitions in some form of an exception which I really do not understand from a first and second reading.

Senator WALLOP. I welcome your further testimony on that, and I think it is useful, but I would like to inquire a little further into your statement that we may risk scaring off all foreign investors.

Did you mean portfolio investors as well?

Mr. LANGER. In reading a draft of the Treasury proposal, it sets forth definitions of foreign controlled U.S. real property companies partnerships and trusts and definition of U.S. real property interests which are so incredibly complex that I think they may go well beyond what we normally think of as real estate holding companies and perhaps cover many instances of what we would normally cover as portfolio investment.

Senator WALLOP. From the beginning that has not been my intention. We are trying to zero in on certain competitive disadvantages American farmers have in the purchase of farmland. That was my initial concern, and the reason the bill was drafted as it is.

The Treasury's suggestion to include all real properties has certain attractions. I do not think it need be so complicated that the result is what you suggest. Hopefully we can find the middle ground and achieve desirable results.

I would like to ask you to comment on your statement in your paper on the need for tax reform in the tax treaty area. Your statement, regarding the treaty override concerns that you have expressed, is:

> Our treaty partners may be very upset if the U.S. unilaterally enacted legislation overriding the treaties. However, I doubt that most of our treaty partners would object to antiabuse legislation, since the OECD has recently called upon all of its members to take steps to prevent the avoidance and evasion of taxes.

Can you tell me if you reach the same conclusion.

Mr. LANGER. I am not sure that this is an antiabuse area, Senator. Perhaps that is the problem. I think there are some antiabuse areas that could be involved. This is more of a policy area where it may be desirable to have legislation taxing people, but I do not know that it is necessarily abuse to have the policy that we have had for many, many years.

Mr. ABRUTYN. The two treaty provisions override that you are talking about is the so-called net election and, more important the exemption for taxation of capital gains on the transfer of sales.

That exemption, if you are now going to override that provision, that would raise the question of portfolio investment as well.

Senator WALLOP. I think that the attempt to provide that 5-year negotiation period and the apparent confidence of Treasury in their ability to achieve that amicably, is noteworthy.

I am concerned with the perception that my idea, at least, is to prevent foreign investment in agriculture. I do not think we can or should. Most of the concern expressed today was over the capital gains taxation, but are there other important issues on the taxation of foreign investors in the United States that have been overlooked, for instance in the estate tax area?

Mr. FORRY. Certainly much of the motivation for structuring investments as they have been is estate and gift tax oriented. However, to the extent that we try to extend our estate and gift taxes to, let's say, the stock of a foreign corporation owned by foreigners because the assets are U.S. assets, I believe that would require substantial treaty negotiations with other countries and, possibly is beyond accepted practice in international taxation.

In addition, much of the structuring of investments where an investor intends to hold property for 2 years and sell it is not so much gift and estate tax oriented as income tax oriented. I do not think the estate and gift tax issues are as crucial there.

Mr. ABRUTYN. Senator, here is where some of the statistics would be very helpful to everyone, because you have a delineation in the type of investor. If it is a wealthy individual investor, certainly my experience has been the estate gift tax considerations are involved because if he bought the property directly, he would be subject to an estate and gift tax. If he uses a foreign corporation, the foreign individual is not. That consideration does not apply where the large multinational is coming in to acquire either commercial property or farmland.

Senator WALLOP. Let me ask you this. You each expressed concern about what it would do to foreign investors. Are you really persuaded that if we equalize the rules, as is the intent, on taxation of foreign and domestic investors, that foreign investors would suddenly be deterred from investing in American real estate, agricultural or otherwise?

Mr. FORRY. The kind of loophole closing that Mr. Langer referred to would be substantially less of a deterrent than what I consider a very complex and difficult Treasury Department proposal, that has, I believe, the same basic tax effect. The degree to which foreign investors would be substantially deterred from investing in this country would depend a lot upon the complexity of the system which was used—for example, by coming up with an entirely new structure of taxation with a rather onerous set of duties on real estate holding companies and the like.

It would also depend upon whether the tax changes were limited to agricultural property or other types of property.

Senator WALLOP. I have not had a chance to study the Treasury's report any more than you have, And am not certain I can discuss it with you any better than you can discuss it with to me.

I am concerned with your suggestion, as I understand it, that it tends toward portfolio investors more than it would just to real estate investors.

Mr. LANGER. The Treasury proposal may have an effect on titles of real estate on every parcel of property in the United States. It seems to deal with a burden placed upon a purchaser of real property to act as a withholding agent and make him get a certificate from the seller of every piece of real estate in the United States.

I just find it incredibly complex and I think it perhaps is an overkill.

In direct answer to your question, Senator, I do not think that the mere imposition of a 28-percent tax, or a tax of up to 28 percent on capital gains on foreign people, is going to prevent them from coming into the United States to make investments.

Senator WALLOP. Thank you.

Senator BYRD. Thank you, gentlemen.

[The prepared statements of the preceding panel follow:]

PREPARED STATEMENT OF JOHN I. FORRY, ATTORNEY AT LAW

Mr. Chairman and members of this distinguished subcommittee:

I appreciate this opportunity to discuss the taxation of foreign investment in real estate in the United States. My testimony will provide a brief description of the present U.S. statutory and treaty pattern for taxing such investments. In addition, I may wish to submit a more extensive written statement at a later date within the period permitted by this subcommittee. Here I will turn, first, to investments in unimproved property and, second, to investments in income producing property and property acquired for development.

First, foreign investors--whether nonresident alien individuals, foreign corporations or other foreign persons--may choose to invest in unimproved property primarily to be held for appreciation in value. (For purposes of my testimony here, the taxation of individuals who have previously been U.S. citizens or residents is excluded.) Perhaps the simplest structure for a proposed investment in unimproved property is the direct ownership of such property by the foreign investors. If, after a holding period, the investors sell the property and realize long-term or short-term capital gain on the sale, the Federal income tax consequences to them will be as follows:[1/] Capital gain realized by an individual investor will be taxfree if (1) the gain is not effectively connected with the conduct of a trade or business within the United States by the individual ("effectively connected income") and if (2) the individual is not present in the United States for at least 183 days during his taxable year in which the sale occurs. Capital gain realized by a foreign corporation on sale of the property will likewise be taxfree, if the gain is not effectively connected income. In the case of a foreign corporation, there is no supplementary test based on less than 183 days' presence in the United States. It should be noted that, under most U.S. income tax treaties, the income from direct real estate investments in the United States continues to be taxed by the United States in accordance with many of the basic statutory provisions applicable to nontreaty investors.

A corollary of the taxfree treatment accorded this capital gain is that no deductions for real estate taxes, interest or other carrying charges are permitted to the investors, since such deductions generally are permitted to them only to the extent allocable to effectively connected income.

If the foreign investors wish to form a U.S. or foreign partnership to own the unimproved property, the determination whether gain on sale of the property is effectively connected income generally depends on whether the partnership is engaged in a U.S. trade or business, since each of the partners will then be considered to be so engaged.2/ In addition, the taxable character of a foreign entity as a partnership for U.S. tax purposes will depend on U.S. standards; this may often be an issue where a foreign entity has attributes similar to those of a U.S. corporation.3/

A major additional factor in planning investments in U.S. real estate by foreign individuals is the impact of Federal gift and estate taxes on the individual investors. A gift by a nonresident alien individual of his interest in U.S. real estate, whether owned directly or through a partnership, generally will be taxable by the United States at the substantial gift tax rates applicable to U.S. citizens and residents. Similarly, on the death of such an individual foreign investor, Federal estate tax of up to 30% generally will apply to his interest in U.S. real estate owned directly or through a partnership; a credit of $3,600 is allowed against this estate tax. However, if the foreign individuals form a foreign corporation to hold their interests in unimproved U.S. real estate, no Federal gift tax will apply to transfers of the foreign corporation's stock by the individuals, nor will Federal estate tax apply to the foreign corporation's stock on the death of any of the individuals.[4/]

Such U.S. real estate investments also are subject to state income, gift, estate and inheritance taxes which vary with the state in which the real estate is located or other activities of the investors are carried on. In many states, foreign investors are treated approximately the same as out-of-state U.S. investors. Such state taxes often do not exempt capital gain from sale of unimproved property, contrary to Federal taxation.

Second, foreign investors may choose to invest in income producing property, or to acquire and develop property. Rental income from an office building, apartment building, shopping center or similar income producing property, which is received by the foreign investors either directly or through a partnership, will usually be effectively connected income. The same is true of sales proceeds from U.S. property developed and held for sale by the investors, such as from sales of condominiums or other subdivided property.[5/] Such effectively connected income will be taxable by the United States to foreign individuals on a net basis at the ordinary rates paid by a U.S. citizen or resident. Such income will be similarly taxed to a foreign corporation on a net basis at the ordinary rates paid by a U.S. corporation--from 17% of the first $25,000 of taxable income up to 46% of the balance over $100,000.

If the foreign investors eventually realize long-term or short-term capital gain on sale of the income producing property or property developed by them, the capital gain will also be effectively connected income because it is derived from assets which have been used in a U.S. trade or business. Such gain will be taxed to a foreign corporation by the United States approximately as capital gain derived by a U.S. corporation, and will be taxed to foreign individuals approximately as capital gain derived by U.S. citizens or residents. Any long-term capital gain will be further subject to the minimum tax on tax preferences.6/ The taxable character of such gain is in contrast to the generally taxfree capital gain--as described above--on the sale of unimproved property which has not been used in a U.S. trade or business by the foreign investors.

In some cases, where little or no business activity is carried on in the United States by foreign investors or their resident agents, the income from the property may not constitute effectively connected income. This is particularly likely where net lease arrangements--such as for agricultural property or an industrial warehouse--provide that all maintenance, activities and costs are to be undertaken by the tenant rather than the foreign owners. In the case of rental income, such treatment is usually extremely undesirable because the income will be subject to a withholding tax of up to 30% of the gross amount without any deductions--which tax may not be reduced even under a treaty--so that the tax will often equal or exceed the net income from the property.[7/] However, where such taxation appears likely, a foreign investor may make a special statutory election to have his share of the income taxed on a net basis as effectively connected income.[8/] Such an election must apply to all U.S. real property interests of an electing foreign corporation, and to all such interests held for the production of income by an electing individual. In addition, once made and not modified within the three-year period for amending the original year's tax return, the election remains in force for all subsequent years unless revoked by the taxpayer with the tax authorities' permission. In case of such revocation, a re-election generally may not be made for another five years without further permission. This may cause capital gain on the sale of the same or other unimproved property owned by the investor to be taxable, whereas no tax would apply if the election were not made.

However, the election may be made from year to year under a number of U.S. income tax treaties.[9/] Accordingly, the treaty may permit the investor simply to avoid the election in a year in which taxfree capital gain from selling the same or other property is expected.

As an alternative, the foreign investors may be able to exchange the property wholly or partly for other property of like kind. In that case, the currently taxable gain will be limited to the sum of the money and the fair market value of other property not of like kind--if any--which is received by the investors in the exchange.10/

As in the case of unimproved real property, the interest of a foreign individual in U.S. income producing property or property acquired for development, if owned either directly or through a partnership, generally will be subject to Federal gift tax on a gift by the individual. His interest generally will also be subject to Federal estate tax on his death. In order to avoid such taxes, the individual investors may wish to organize a foreign corporation in a tax haven to own their interests in such property, since no Federal gift or estate taxes will apply to their transfer of stock in the corporation itself.

However, the use of such a foreign corporation by foreign investors is somewhat more difficult in the case of income producing or development property than in the case of unimproved property. The income of the foreign corporation from the property will usually be effectively connected income, subject to U.S. taxation on a net basis at the ordinary 17%-46% rates paid by a U.S. corporation; this may be higher than the rates which would be payable by the investors if they received the income individually. In addition, if the foreign shareholders of the corporation receive the proceeds from operation or sale of the property by way of dividends from the foreign corporation, the profits will often be subject twice to Federal income tax--once at the corporate level, and once by a withholding tax at the payment of dividends. If the U.S. profits are instead accumulated in excess of the reasonable business needs of the foreign corporation, a substantial accumulated earnings tax may be imposed on the corporation.[11/] The shareholders also may receive income by way of interest charges on loans they make to provide part of the corporation's operating funds, if the corporation maintains an adequate debt-to-equity ratio and the interest charges are at arm's length rates.[12/] Such interest will be deductible by the corporation, if attributable to its U.S. income. However, the interest payments to the shareholders often will still be subject in turn to a U.S. withholding tax. These U.S. withholding taxes on dividends and interest paid by the foreign corporation are likely because, if at least one-half of the foreign corporation's gross income for the most recent three full taxable years is effectively connected income, a like proportion of the dividends or interest paid by the corporation will be subject to a U.S. withholding tax of 30% of the gross amount paid.[13/]

However, under various U.S. income tax treaties, this U.S. withholding tax is in most circumstances not imposed on dividend or interest payments by a foreign corporation organized in the treaty country.

Where such a foreign corporation is used to own just one property, on sale of the property the following principal alternatives are available to the investors: If the foreign corporation itself sells the property, capital gain on the sale will be free of Federal tax if the property has not been used in a U.S. trade or business by the corporation. Such gain is particularly likely where unimproved real estate has been acquired and held for appreciation by the corporation. In the case of a corporation organized in any one of a number of treaty countries, the election to treat real property gain as effectively connected income may be made or revoked on a yearly basis. As an alternative, the corporation may engage in a like kind exchange of property, in which event its currently taxable gain will be limited to any money and the value of any other unlike property received in the exchange.

Alternatively, the foreign shareholders may sell their shares of the corporation generally for taxfree capital gain. The purchaser usually may acquire a stepped-up tax basis in the property equal to the purchase price of the shares by liquidating the corporation.[14/]

As a further alternative, the property may be sold and the corporation liquidated pursuant to a 12-month plan of liquidation, with no Federal income tax on the corporation itself except principally for recapture of personal property depreciation and accelerated depreciation on the property.[15/] In addition, no Federal income tax generally will be imposed at the shareholder level on distributions to the foreign shareholders, since they are considered to receive the proceeds of sale of the property in exchange for their stock and therefore receive taxfree capital gain. However, this advantageous treatment is not available if the foreign corporation is a collapsible corporation, which is particularly likely where unimproved property has been developed by the corporation.[16/] Nor is it available where the foreign corporation is owned at least 80% by another corporation.

Foreign investors also may organize a U.S. corporation to own their income producing property or property acquired for development, or even unimproved property, often for nontax reasons. The individual investors then may make gifts of their stock in the U.S. corporation without the imposition of Federal gift tax. However, such stock will still be subject to Federal estate tax in the event of an individual investor's death.

In addition, rental or other income generated by the property will be taxed on a net basis at the rates ordinarily applicable to any U.S. corporation. The U.S. corporation may take deductions for arm's length interest charges payable to its foreign shareholders. However, such interest payments will be subject to U.S. withholding tax of 30% of the gross amount paid. In addition, any dividends paid by the U.S. corporation out of its accumulated profits will be subject to a further withholding tax of 30% of the gross amount paid. Excessive accumulation of profits may also result in imposition of the penalty tax alluded to above in the case of a foreign corporation. This contrasts with direct ownership of the property, where the foreign investors pay only one tax at ordinary rates on the effectively connected income realized directly by them from the property.

However, under a number of U.S. income tax treaties, the U.S. withholding tax on such interest and dividend payments may be eliminated or reduced to 15% or less of the gross amount.

In the event of sale of the property, capital gain to the U.S. corporation will be fully taxable at the usual U.S. corporate capital gain rate of 28%. By contrast, in the event unimproved property is involved, foreign investors owning such property directly will often receive such capital gain taxfree. In addition, regardless of what type of property is involved, distribution of the sale proceeds to the foreign shareholders generally will constitute a dividend to the extent of the corporation's accumulated profits and thus be subject to an additional U.S. withholding tax of 30% (or a lesser treaty rate).

As one alternative, the U.S. corporation--as in the case of a foreign owner described earlier--may engage in a like kind exchange of the property. In that case, the currently taxable gain will be limited to any money and the value of any other property not of like kind received by the corporation in the exchange.

Alternatively, the foreign shareholders may be able to sell the shares of their U.S. corporation for capital gain. This generally will be taxfree because, in itself, it is not effectively connected income to them.

A further possibility is sale of the property and liquidation of the U.S. corporation pursuant to a 12-month plan of liquidation, which will avoid most income tax at the corporate level, except for recapture of certain depreciation taken by the U.S. corporation. Again, this alternative is not available where the U.S. corporation is a collapsible corporation. Nor is it generally possible if a corporation owns at least 80% of the U.S. corporation's stock.

Foreign investors also may wish to joint venture a U.S. real estate project with a U.S. developer or other investors. In the case of a partnership between the U.S. party and, for example, a foreign corporation owned by the foreign investors, because the domestic and foreign investors may have different income goals or are subject to different tax treatment, special allocations may be made among them of partnership income and deductions, or of capital gain and ordinary income, or of land and improvements ownership, or of equity and loan participation. For example, for foreign investors, excess tax writeoffs may often be unnecessary since they may have little or other U.S. income against which to use them. Such investors are more often concerned to spread available deductions over several years in order to reduce future taxable income from the same property or group of properties.

Finally, in the case of income producing property or property acquired for development, as in the case of unimproved real property, state income, gift, estate and inheritance taxes also apply.

* * *

I hope that this discussion gives the subcommittee a basis for appraising the present U.S. statutory and treaty pattern for taxing foreign investments in U.S. real estate. I also hope that the subcommittee will agree with my view that the technical details involved in this area are complex, and that the related policy questions are of corresponding difficulty.

Footnotes

1. *See generally* Internal Revenue Code of 1954, as amended ("IRC") §§871-874, 881-884.

2. IRC §875(a).

3. Treas. Reg. §301.7701-2.

4. *See generally* IRC §§2101-2108, 2501-2524.

5. IRC §864(c).

6. IRC §§55-58.

7. *Cf*. *Evelyn M.L. Neill*, 46 B.T.A. 197 (1942); Rev. Rul. 73-522, 1973-2 Cum. Bull. 226.

8. IRC §§871(d), 882(d).

9. *Cf*. United States-France Income Tax treaty of 1967, as amended, Article 5(3).

10. IRC §1031.

11. IRC §531.

12. IRC §482.

13. IRC §§861(a)(1)(D), 861(a)(2)(B), 871(a)(1), 881(a).

14. IRC §§331, 334(b)(2).

15. IRC §§337, 1245, 1250.

16. IRC §341.

END

Statement by

Michael Abrutyn, Esq.
Cole Corette & Bradfield
Washington, D. C.

Mr. Forry, the first member of this panel to testify, has outlined the general U.S. rules for taxation of nonresident alien individuals and foreign corporations. Mr. Langer will subsequently provide some suggestions for modifying these rules if Congress decides that the present system needs to be amended. My purpose is to briefly describe the application of these rules to foreign investment in U.S. real estate.*

The manner, type and structure for foreign investments in U.S. real property has run the gamut of all the infinite variables available. Since there are several different provisions which can be utilized, favorable tax results can be achieved -- often irrespective of whether the investment is active or passive. These results are: (1) no substantial Federal or state income taxes payable on income derived from real property; (2) no substantial Federal or state income taxes payable on gain from sale of real property; (3) no estate or inheritance tax payable in the event of death of an individual owner of property; and (4) no substantial taxes payable in the country where any corporation or other entity is organized for the purpose of acquiring the property.

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* For a more detailed discussion see Abrutyn, "Investment in United States Real Estate by Nonresident Alien Individuals and Foreign Corporations," 77-2 TMIJ (1977); Langer and Bittel, "How Foreigners Invest in U.S. Real Estate, U.S. Taxation of International Operations," (Prentice-Hall 1975); Forry, "How to Structure Foreign Investments in U.S. Real Estate, Prentice-Hall Tax Ideas (Prentice-Hall 1975).

The most advantageous form of investment would naturally depend on all the factors involved in the transaction, including the type of property involved (income producing or unimproved real estate), any state law prohibitions against foreign ownership, the resident country of the potential investor, the expected period for which the property will be held, and the myriad of other factors normally associated with this type of real estate investment. Several alternative forms for investing in U.S. real estate are available which may have different tax consequences. The forms for such investments include purchase of the real estate directly, investments in stock of a wholly-owned United States corporation which would purchase and hold the real estate, investment in stock of a foreign corporation which would, in turn, invest in the real estate either directly or indirectly through a U.S. subsidiary, or use of a foreign trust or holding company. Where U.S. investors are involved, a general or limited partnership is typically used to own and operate the property so that the foreign investor actually invests in the partnership.

The pivotal issue in structuring any investment in U.S. real estate is whether the investment will result in the owner being engaged in a trade or business within the United States. The answer to this question will determine how the income from the property and any gain upon its disposition will be taxed, if at all, by the United States. Although when a nonresident alien individual or foreign corporation will be considered to be engaged in a trade or business in the United States is not always clear, with respect to real estate there is sufficient authority so that it should be able to be determined whether real property ownership will or will not be so considered. The first of two examples will involve an investment where the foreign investor is not engaged in a United States trade or business and the second where the investor so engaged. These examples are designed to illustrate the basic rules.

Foreign Investor Not Engaged in A Trade or Business Within The U.S.

A nonresident alien individual or foreign corporation acquires either commercial rental property in a major city or farmland. The property costs $1 million and is purchased for $200,000 down plus an $800,000 debt secured by a first mortgage on the property. The property is leased to one unrelated tenant pursuant to the terms of a net lease. The tenant pays the real estate taxes, operating expenses, repairs and property insurance. Four years later on the first day of the next taxable year, the property is sold for $2 million.

The above transaction would not result in the foreigner being engaged in a U.S. trade or business. Therefore, the minimum monthly rental income plus the amount paid by the tenant for real estate taxes, operating expenses, repairs and property insurance (all of which are for tax purposes expenses of the landlord) would be subject to tax on a gross basis without the allowance of deductions, and the tenant would be required to withhold from the rental payments at the rate of 30 percent of the gross rental income -- assuming that the withholding rate has not been reduced by treaty. The economic gain upon disposition of $2 million plus any gain attributable to depreciation would not be subject to tax if owned by a foreign corporation; and, if owned by an individual, provided the individual is not present in the U.S. for 183 days or more during the taxable year.

Taxation of the rental income on a gross basis might be disadvantageous because the tax paid under this alternative would probably be higher than the tax which would be due on net taxable income after deductions. To deal with this circumstance, the Code provides for a special election which may be made by a nonresident alien individual or foreign corporation.

This election provides that the income can be taxed upon a net basis, but it also provides that once the election is made any gain realized from its sale, even if incurred in subsequent years, will be treated as effectively connected income and, therefore, subject to U.S. tax. However, there are planning techniques which can be utilized to result in the gain being exempt even after a Code net election is made. In many instances, this apparent dilemma is avoided in the first instance because the investment is made by a foreign corporation organized in a jurisdiction which contains a tax treaty with the United States allowing the net election to be made on a yearly basis -- for example, the treaty applicable to the Netherlands Antilles. In the example described above, the yearly net election would be made in the years when the property is owned so as to avoid the 30% withholding tax on a gross basis. Then, in the year of sale this special election would not be made -- it would be avoided -- so that the gain, as well as any recapture items, would be exempt under the general rule that extempts capital gains of foreign individuals and corporations. The tax treaty might also provide the benefit of exempting any dividends declared by a corporation formed in the treaty country from the so-called second level U.S. withholding tax. Also, use of a foreign corporation shields the nonresident alien individual from the Federal estate and gift taxes.

Foreign Investor Engaged in A Trade
<u>or Business Within The U.S.</u>

The second example illustrates the case where the foreign investor is engaged in a U.S. trade or business. This case might arise where a foreign investor becomes a partner in a U.S. partnership which owns and operates income producing property such as, an office building, an apartment house, or a farm. Assume the foreign investor is a partner in a U.S. limited partnership, in which the general partner is a U.S. corporation or individual that carries full responsibility for the management and maintenance of the property.

In this situation, the partnership would be engaged in a U.S. trade or business, and accordingly all partners would be treated as so engaged. The taxable income is calculated, but not taxed, at the partnership level and each partner must report on his own return his distributive share of the taxable income. For example, each foreign partner would report his share of the income from the rental operation. This income would be effectively connected income taxable on a net basis, at the normal graduated rates applicable to individual or corporations and not the flat 30% withholding rate. If the partnership has other income which is not effectively connected to the rental income (such as, bank deposit interest or dividends on portfolio stock), the foreign partners will be taxable on their share of such other income as if received directly; that is, the bank deposit interest would not be subject to U.S. tax if not effectively connected and the dividends would be subject to U.S. withholding tax of 30 percent (or a lower rate provided by tax treaty). The partnership would be responsible for withholding as to non-effectively connected income distributable to foreign partners.

Since the current income would be taxed upon a net basis under the applicable Code rules, the next objective is to structure the transactions so that any capital gain will be exempt. Generally, when prcperty of a partnership engaged in trade or business is sold by the partnership, each partner is taxed on his pro-rata share of the gain since it is effectively connected income. The character of the gain is determined at the partnership level. Normally, a sale of income-producing real estate will give rise to capital gain (short or long-term gain, depending upon the holding period) except to the extent of recapture of accelerated depreciation, which is treated as ordinary income under sections 1245 and 1250 of the Code. There may also be investment credit recapture. Real property used in a trade or business and held for more than one year is a section 1231 asset. Thus, any gain upon the sale (after recapture) will be treated as capital gain and any loss will be treated as ordinary loss.

A nonresident individual or foreign corporation selling such property is eligible for the preferential capital gain rates.

The techniques which may be utilized to exempt all or a major portion of gain upon disposition from Federal income tax are installment sales, a liquidation pursuant to section 337 of the Code, a like kind exchange under section 1031 of the Code, a restructuring so that the owner is not engaged in a trade or business within the U.S., or, possibly, a sale of the partnership interest outside of the United States. In most cases at least one of the techniques can be used. The ease with which this can be accomplished is illustrated by examining a typical section 337 liquidation. Assume the foreign individual investor causes a domestic corporation to be organized, and it purchases and operates a farm, or it owns an interest in a partnership operating the farm. The U.S. corporation would pay normal Federal income tax upon its net income after allowance of all deductions. The corporation could enter into a contract of sale of the farm, (or its partnership interest) to a third party and liquidate, qualifying under section 337. The corporation would incur no tax liability upon the sale of its asset or liquidation, and the nonresident alien who realized a capital gain upon liquidation would be exempt provided there was no presence in the United States for 183 days or more. **

** State income tax must also be considered, but since the States either use Federal taxable income as the starting point for computation or have similar statutes, often the same favorable results can be achieved.

Some Policy Considerations

The next member of this panel, Mr. Langer, will testify as to suggested methods of amending the Code to change the current system in the event Congress decides to amend the Code. The May 1979 report of the Department of the Treasury entitled, "Taxation of Foreign Investment in U.S. Real Estate" also contains suggestions for amendments.

The Code amendments require changing the installment sale and like kind exchange provisions as well as changing certain basic rules for the taxation of nonresident alien individuals and foreign corporations so that all sales of U.S. real estate and shares of stock in corporations owning U.S. real estate will be treated as effectively connected income subject to tax. Another area which should be considered is coordination of Federal tax law with State income tax provisions and State laws regulating foreign investment.

As a tax practitioner, I am of the view that these changes can be accomplished, but care must be taken to avoid unintended results. For example, the taxation of the transfer of shares of corporations owning U.S. real estate presents difficult questions of enforcement and, if drawn carelessly, could encumber legitimate stock sales. Additionally, a rule whereby the property itself is deemed to be subject to a tax lien, if a stock transfer is made without a tax payment, might diminish the enforcement problem because the buyer would have to shoulder the risk. But, this approach could result in clouds upon title which would not be apparent to subsequent bona fide purchasers, and, thereby unduly restrict the transferability of real property. Finally, under any of the changes being suggested, it appears to me to be viable to limit these amendments to farmland, while leaving the present rules for commercial property.

From a tax policy standpoint, I would like to bring several issues to your attention. As pointed out in the Treasury Department report, it might be necessary to override some existing provisions in bilateral tax treaties and the decision to do this does have negative implications from an overall standpoint. These implications include making future treaty negotiations more difficult and establishing a precedent enabling our treaty partners to change their domestic tax law on this or other issues where it is felt that a treaty provision is too favorable to the U.S. This may be unwise because of the greater amount of U.S. investment abroad. Moreover, and, perhaps, more importantly, this would serve as an exemple which could be applied to our treaties in the commercial, defense and other areas beyond taxation. The treaties contain mechanisms for amendment and terminations through negotiations with our treaty partners and should be utilized.

The second policy issue for consideration is the effective date for any change. An effective date rule could govern sales made after a certain date (S-208 has an effective date of February 28, 1978), could govern property acquired after a certain date, or present owners could be given a stepped-up basis to the present fair market value. A fresh start to recognize capital appreciation occurring over time would require determinations as to the present value, but does have recent precedent in our tax law (such as the fresh start for the carryover basis rules in the estate tax area) as well as in the law in other countries. It is noted that a real estate investment can be quite substantial, is often illiquid, and is made with expectations of certain economic returns which would be substantially reduced by imposition of tax either in whole or in part on a retroactive basis.

A non tax policy aspect for your consideration is whether there would be any adverse incidental effects upon the overall U.S. investment climate as perceived by foreign investors caused by a change in the tax law. In this regard, the scope and manner of the change can be important and should be geared to the underlying reasons for change. If the purpose is to eliminate the incentives, the changes would be different than if the purpose is to preclude foreign ownership of farmland. On the one hand, eliminating the current incentives for foreign real estate investment does not involve taxing foreigners any differently then taxing domestic investors, yet would not impose any special disincentive to investment in farmland. On the other hand, elimination of the incentives could be perceived as a shift in the United States receptiveness to foreign investment. If a large foreign syndicate of 200 foreign investors acquires a commercial office building through shares in a foreign corporation, their investment can be passive in the economic sense and it is very similar to making a portfolio investment in a public company. Taxation of the transfer of such shares may be perceived by the international investment community as the first step in taxation of all portfolio investments. Limitation of the change to the special case of farmland may be viewed differently than extending the change to commercial properties. Further, if the change is accomplished retroactively and by overriding existing treaties, the favorable image of the U.S. as a source of secure investment not subject to substantial political risk may be tarnished. Of course, whether the changes will result in a withdrawal of investment and what effect if any, such withdrawal could have on the exchange rates and future rates of inflation are matters for your careful consideration.

Senator BYRD. The next witness will be Mr. Hoag Levins, chief investigative reporter for Expo magazine.

Good morning, Mr. Levins.

Mr. LEVINS. Good morning, Senator.

STATEMENT OF HOAG LEVINS, CHIEF INVESTIGATIVE REPORTER, EXPO MAGAZINE

Mr. LEVINS. I have submitted to the committee, as requested, 100 copies of my article. It is the cover story in the summer issue of Expo magazine. It is 17 magazine pages long, and I have also submitted a synopsis of some of the principal points.

I do not really have an opening statement, because the article is my statement. I will just open myself to questions. I assume I have been asked here to answer questions about what that article reports.

[The material referred to follows:]

Expo
THE CONTEMPORARY JEWISH MAGAZINE

226 SOUTH 16th STREET
PHILADELPHIA,
PENNSYLVANIA 19102
PHONE 215-893-5757

June 22, 1979

TO: Mr. Michael Stern
Staff Director
Senate Finance Director
2227 DSOB
Washington, D.C. 20510

RE: Principal points of statement delivered to Senate Finance Committee hearings on Taxation of Foreign Investment, Monday, June 25, 1979.

The statement consists of the 17-page magazine article which appears in the Summer issue of EXPO Magazine titled "Who Owns America?"

The principal points are:

- That immediately after the 1973 October War Arab leaders meeting in Kuwait charged that they had been cheated of victory over Israel by the United States and the other Western nations whose massive support efforts allowed the Israelis to survive simultaneous attacks at either end of their borders.
- That at that 1973 meeting and again at the 1974 Arab Summit in Rabat, Arab leaders vowed to "Unsheath the Sword of Oil" against America and other Western nations. They announced to Western reporters that they would begin using the massive oil price hikes to generate billions which they intended to use to buy into or take over American companies. When queried about their reaction to suggestions by American Congressmen that the U.S. might enact laws to stop such takeovers, the Arab leaders said "If Congress passes legislation to block Arab takeover bids, we can transfer billions from U.S. banks into European institutions."
- That during the last six years, those Arab oil-producing countries have engaged in an organized, seven-prong financial campaign to purchase influence throughout the highest circles of American government, industry and education.
- That one of those seven tactics has been used at least once to successfully blackmail the United States Congress.
- That Arab operatives have now taken a direct hand in attempting to influence the outcome of elections involving American officials such as Sen. Frank Church, chairman of the Senate Foreign Relations Committee.
- That those Arab operatives have targeted Atlanta, Georgia for investment because its industrial, financial and agricultural communities provide a direct route to influence and access to top White House aides and associates.
- That the Arabs have a free hand in such activities because the laws governing foreign investment are fragmented and inconsistent.
- That there is no systematic attempt made by the federal government to monitor, record or otherwise accurately document the nature and extent of such foreign investment in America.
- That because of this, the U.S. Congress, the White House, the Commerce Department, the U.S. Treasury and other top U.S. officials have no accurate information on exactly how much influence on or surreptitious control Arabs have established over the primary political, economic and financial instutions of the United States.

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Takeover!

The Secret Arab Strategy to Buy America

BY HOAG LEVINS

Arab Takeover

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This is a story about a loud peace and a quiet war.

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That ultimate Arab weapon has now been perfected. And even as the world has been celebrating the Israeli-Egyptian peace engineered by Jimmy Carter, its full force has been positioned and detonated.

That weapon is money: unlimited petrobillions now being used in a secret, organized campaign that has already overturned the world's monetary system, revolutionized traditional concepts of international battle and accomplished the most drastic realignment of world power since World War II.

That campaign—employing a potent, seven-pronged operational strategy inside the United States—has directly involved every American as an unwitting pawn on a global Arab battle board where every move has one initial goal: the breakdown of the American support that has enabled Israel to withstand three decades of Arab ground and air attacks.

A good place to start the story is amid the gaudily-colored collection of circus tents which were stretched across the lawns of the White House on March 26. There, thousands of revelers and celebrants pranced before the tv cameras to declare peace and sit down to a feast of steak and champagne.

But those tv cameras did not show the entire story of the day to their audiences around the world. They did not show how two of the private firms—Chase Manhattan and the Bank of America—which donated funds for that peace banquet have been serving as willing and creative partners in the revolutionary form of secret warfare first unleashed back in 1973.

They did not show how the brother, best friend and various other political and business colleagues of President Carter have taken a direct and aggressive part in that secret war.

They did not show how, on the same day the peace treaty was signed, Arab leaders of this new, unorthodox secret effort met in Geneva to map out a new battle strategy. Their initial move was masked as yet another oil price hike—an increase that brought the cost per barrel to an unprecedented $14.55. In effect, that increase opened a harsh offensive in the quiet war whose prime targets are now Egypt, Israel—and the United States.

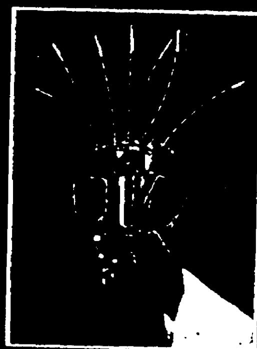
What follows is the story of the complete evolution of that six-year war: a global conflict that now involves dozens of combatant countries, wildly innovative war-making techniques, Arab operatives, prominent American collaborators. And a new battle tool whose awesome potential for international havoc exceeds that of any weapon ever used by one nation against another. Except possibly the atomic bomb.

Strangely, what follows has never been told before in its entirety, although much of this information has been readily available to anyone curious enough—and sufficiently concerned—about the future of Israel. And America.

Hoag Levins, a nationally-known investigative reporter, is the only journalist to have won the Philadelphia Grand Award for Best Reporting for three consecutive years. Pulitzer nominee Levins also received the 1978 Keystone State Award for Best Investigative Reporting and the Philadelphia Bar Association's first annual Media Award for Outstanding Journalism.

BEST COPY AVAILABLE

Arab officials, operators and entrepreneurs have bought their way into America's highest social, financial, military and political circles, in a nationwide campaign financed by petrodollars collected from U.S. consumers.



The Petrobillions Conquest

A 7-Pronged Arab Invasion of America

Despite the denials of government officials and the silence of the media, *Expo* has discovered that tens of billions of petrodollars collected from U.S. consumers have been recycled since 1973 to finance a nationwide campaign through which Arab officials, operators and entrepreneurs have bought their way into America's highest social, financial, military and political circles.

Records at the Departments of State, Commerce and Defense; at the Securities and Exchange Commission; in federal and local courts, Congressional testimony and published financial reports and records indicate that Arab nationals have been involved in hundreds of billions of dollars worth of financial activity in America during the past six years.

Cross-referencing the patterns of these transactions, *Expo* has been able to reconstruct a seven-pronged petrodollar penetration strategy through which Arab countries have gained entry into and rapidly expanding influence on the mainstream institutions of American life.

Those seven areas of activity are:

• Direct physical acquisition, through takeover, buy in or merger, of hundreds of properties including billion-dollar banks; office buildings; hotels and other real estate; brokerage houses; manufacturing plants; construction companies; cattle ranches, farms and grain future. (See "How We're Helping Arabs to Buy Us . . . with Our Own Money," page 60.)

• *Financial "paper" acquisitions* involving various stocks, bonds and similar commercial paper investments. Treasury Department records indicate that Arab investment in U.S. Treasury bonds, bills and notes rocketed from $2.2 billion in 1973 to $10.7 billion in 1975. *Treasury Bulletin and International Capital Movement Reports* indicate that between 1973 and 1977, Arab investment in non-Treasury stocks went from $365 million to $1.4 billion; holdings in other bonds zoomed from $685 million to $1 7 billion. However, this includes only directly traceable investments made openly in the international market. Much of the recent Arab investment in all fields has been made through third-party countries or international corporations set up to hide the investors' true identities. At the same time, a 1978 survey by *Business Week* magazine found that Saudi Arabia is now the largest holder of the paper of the Federal National Mortgage Association. The Association, which has $40 billion in assets and is the sixth largest corporation in America, is the major supplier of home mortgage loan money in this country. (See "How Much Do The Arabs Really Control?" page 56.)

• Short-term bank deposits for use as immediate political leverage. Late in 1975, the Senate Foreign Relations Subcommittee on Multinational Corporations tried to determine exactly how much control foreign investors had in American banks, and sought to subpoena American bank records as part of that investigation. Kuwait and Saudi Arabia openly challenged the Subcommittee and said they held about $11 billion in American banks—including $7 3 billion in short-term deposits; and that they would transfer the money to European institutions if the Subcommittee did not stop trying to subpoena the American bank records that showed the extent of Arab holdings.

The Subcommittee backed down and stopped that portion of its investigations; Subcommittee members explained that they had "no other choice." It was the second time since the 1974 Rabat Summit that the Arab bloc threatened to collapse the Federal Reserve System if they did not get their way They apparently succeeded

Among those known to be directly involved in representing, counseling or directly employed by Arab financial operatives are a major candidate for the U.S. Presidency in 1980, the former U.S. Budget Director, President Carter's brother, two former Senators and an ex-U.S. Attorney General.

both times; Congress never did pass legislation to control or even require registration of Arab investments in America.

• Petrodollar courtships aimed at buying contacts and "advisors" in the highest circles of government. Among those currently known to be directly involved in representing, counseling or in the direct employ of Arab financial operatives are a major candidate for the United States Presidency in 1980; the former U.S. Director of the Budget and close friend of President Carter; the brother of President Carter; a former poll-taker and personal friend of President Carter; a former U.S. Vice President; a former CIA director; two former CIA station chiefs; two former Senators, including the former head of the Senate Foreign Relations Committee; a former U.S. Attorney General; four former Assistant Secretaries of State; a former Assistant Secretary of the U.S. Treasury; a former Secretary of Defense and former Secretary of the Air Force. (See "Carter Connection," page 55 and "All-Star Puppet Show," page 64.)

• "Linkage" programs designed to draw segments of top U.S. industry close to Arab governments. This is reflected in the reports of Arab-American Ventures Inc. of San Francisco, which indicate that U.S. exports to Arab countries just prior to the 1973 Mideast war were less than $1 billion annually. By late last year, that figure had increased to more than $15 billion. The extent of this new wave of "linkage" is also seen in the recruitment efforts of the Arab-American Association for Commerce and Industry, headquartered in New York and open to "any private corporation, partnership or membership which is interested in the aims and purposes of the Association."

The Association, which represents the member nations of the Arab League, is financed by dues paid by the 167 member companies. Those dues, according to the Association's records, support Arab research, forum meetings, business briefings, informal luncheons, conferences, industry workshops and trade missions across the United States. Records show that the dues-paying member companies include 18 of America's top 100 defense contractors, among them Western Electric, Westinghouse and General Electric; 21 of *Fortune* magazine's top 100 U.S. corporations with combined yearly sales totaling $400 billion—such companies as the Ford Motor Company, IBM, ITT, Union Carbide and U.S. Steel; and ten of America's top twenty banks with combined assets of about $280 billion, including the Bank of America, Chase Manhattan and Bankers Trust Company.

One of the most recent new recruitments is Hill and Knowlton, Inc. Headquartered in New York, the company is the world's largest public relations firm. Hill and Knowlton signed on with the Arab Association last November.

• Direct political action through a greatly expanded and highly sophisticated lobbying effort in Washington and through direct financial involvements in the home districts of legislators whose actions have displeased the Arabs. The Arab lobby, now acknowledged as "formidable" in the capital, is credited with being the pivotal force in last year's controversial Congressional vote on the F-15 jet deal.

A chilling example of local political action can be seen in the situation of Idaho's Senator Frank Church. Church has investigated Arab financial dealings, helped block military equipment shipments to Arab countries and opposed such proposals as the F-15 agreement. In an effort to neutralize Church, the Arabs have now landed in Idaho and begun buying support for a pro-Arab candidate who is gearing up to run against Church in 1980 (See "The Arabs vs. Senator Church," page 66.)

• Educational grants and endowments through which Arab nations, according to the State Department, have increased their "linkage" with American colleges more than ten times over since 1973. At least 75 universities and colleges have accepted gifts from various Arab states for the establishment of Arab Studies programs. Typical is a $1 million gift from Saudi Arabia received by the University of Southern California to fund a professorship in Arab Studies. To get the money, the University agreed to allow the Saudi government to approve the instructors chosen to direct the program.

Even when university officials stand fast against Arab attempts to dictate hiring policy and violate federal anti-discrimination regulations, alternate routes are found to accomplish the same goal. One device involved an Arab-endowed $1.5 million working grant to MIT for engineering studies of various problems in desert societies. When the grant stipulated that no Jews be allowed to participate in the program, the school balked at signing such an agreement. So the Arabs hired away all the non-Jewish MIT experts they needed to set up the identical program—as a "private business" with no official ties to MIT's resources.

There are no indications that the Arabs have softened on their stated intention of using all business dealings and "linkages" in America as a direct political tool:

Middle East magazine is the official business organ of the Arab world and the journal used by American firms seeking trade there. The opening pages of *Middle East's* October 1978 issue pull no punches. In an editorial directed toward readers, advertisers and prospective clients, the magazine states bluntly, "The day when you can expect to do business with the Arab world and not take note of what they believe in and fight for has long gone. The Arab world is sufficiently strong today not only to fight for what it believes in, but to expect that its friends and allies will stand up and be counted.

"Today, politics and economics not only mix, but are totally interdependent. There is a consensus among the Arabs that to do business with the Arab world means taking a political stand not incompatible with Arab interests and legitimate rights."

Battle Plan

How The Plot Began

The real beginning of this story lies half a dozen years in the past—at a time when America paid scant attention to the Middle East. The price of oil hovered at a constant and comfortable $2.42 per barrel. Then on a sunny, shocking October day, headlines suddenly began to chronicle the flaming progress of another, familiar, kind of war.

• • •

It is late October 1973, and the air along the Golan Heights is thick with the smell of spent explosives and scorched steel.

Overhead, the sky is webbed with the exhaust trails of F-4 Phantom jets shrieking north and east into Syria. Bomb thunder rumbles through the afternoon. Thick oily plumes of smoke broil up from a dozen points along the horizon.

Below, the sands are littered with ragged clusters of still-smoldering tanks whose sides are fire-blackened and gutted outward, like burst metal melons. Strewn haphazardly among these machines are the grotesquely stiff shapes of former crewmen, their bodies already beginning to bloat and crack pink in the desert heat.

This was the turning point, the place at which the Syrian invasion to the south was broken. Syrian armies are now scattering north, in disorganized retreat. The American-made M-60 tanks which roar past are marked with Stars of David and hastily-scrawled slogans. "On to Damascus."

To the west, in the Sinai, the banks of the Suez Canal are rimmed with fire and carpeted with twisted remnants of the Russian ZIL trucks, rocket launchers and artillery pieces which the Egyptian Third Army used to front its assault across the waterway on Yom Kippur. Now, two weeks into that war, the Egyptian Third has been badly mauled and outmaneuvered. Surrounded by Israeli forces, its 20,000 surviving members and 400-odd tanks sit immobile in the relentless sun...facing the choice of total surrender or certain annihilation.

Out across the Atlantic Ocean, the skies are hung with a hovering archipelago of U.S. military tanker planes, positioned for continuous mid-air refueling of the fleet of El Al 747's ferrying supplies from Peace Air Force Base in New Hampshire to Israel.

Meanwhile, in Delaware, caravans of U.S. C-5A cargo planes lumber off the runways of Dover Air Force Base, round the clock, headed for Tel Aviv. The largest airlift in history is underway.

In the Arab capitals of the Middle East, eyes which have spent months gazing downward in confident perusal of desert war maps abruptly lift skyward, bringing that airlift into hostile focus. That American airlift. That military jugular that has enabled Israel to score its fourth triumph over Arab invaders since 1948.

One pair of those eyes broods in the Riyadh throne room of Saudi Arabia's King Faisal. An angry Faisal dispatches a message to U.S. President Richard Nixon. The king's messenger is Adnan Khashoggi—a man whose name will become increasingly familiar in the quiet war that is just beginning. A member of the Saudi royal court, Khashoggi is frequently used by Faisal as an emissary and operative. In this case, Khashoggi is particularly useful. Six years before, the Saudi courtier had taken it upon himself to back Nixon's campaign; during the intervening years, Khashoggi has made a conscious effort to retain Nixon's friendship and easy access to the President.

Khashoggi meets with Nixon in Washington—reportedly at the Watergate Apartment House suite of Presidential secretary Rosemary Woods. He delivers the message in which Faisal suggests that if the White House really wants to end the war, it can do so by merely halting the resupply efforts that now permit Israel to continue the conflict.

Faisal's suggestion is ignored. The resupply continues. The Israelis move to within 50 miles of both Damascus and Cairo. And even as the troops are still engaged and flaming planes still fall from the skies. Arab leaders meet again—in Kuwait. They charge that they have once again been cheated of victory. They announce the formation of a united Arab front and the opening of yet another campaign against Israel. This time, they

King Faisal swung his rifle in the direction of America as the cameras snapped away.

vow publicly, they will "unsheath the sword of oil." They also vow to punish the Western nations whose support and supplies have enabled the Israelis to repulse Arab attacks.

Thus began the oil embargo and the first round of massive price hikes.

THE OPENING SALVOS

It is one year later. The gas stations of America have roiled in shoutfests, fistfights and even shoot-outs as drivers have been forced to queue up for hours to receive small rations of gasoline. The stock market caroms off kilter, still unable to right itself after a series of shocks which have struck at its foundations. Industry after industry has been forced to cut back and shut down operations. Waves of workers have been laid off. European countries which previously balked at selling arms to the Arabs have abruptly reversed that policy. The PLO has been hurriedly recognized at the United Nations. Israelis, recalling the horror of the previous year's Holy Days, have been forced to attend the 1974 Yom Kippur services with rifles in their hands. Everywhere, the price of oil continues to explode upward. Yet the media of the Western world do little to connect these symptoms of the quiet war.

In the air above the Middle Eastern deserts, leaders of 19 Arab nations are flying to Morocco. There they announce plans to create a new world monetary system whose primary currency will be petrodollars. Henceforth, they say, all oil-and-monetary negotiations with the outside world will be inseparably linked with "other issues."

The primary "other issues" they list are lower prices for Western goods and services they want to buy—and "full Israeli withdrawal from our territory."

The tone of that Arab Summit in Rabat is one of threat and bluster. Meeting with the Western press, Arab leaders explain that they have already accumulated billions in profits from the oil price hikes they have imposed over the last year. They say this is only the beginning. Now they intend to begin long-term investments of that money in America and Europe. They will be taking over a number of major companies and industries in a campaign for greatly expanded Arab influence and recognition as the new world superpowers.

The Arab leaders react strongly to the apprehension of U.S. Senators and Congressmen about massive foreign takeovers of American business. In effect, they threaten to cripple or collapse the American banking system if they are trifled with. They phrase their warnings baldly: "If Congress passes legislation to block Arab takeover bids, we can transfer billions from U.S. banks into European institutions."

At one of the final Rabat sessions in October 1974, King Faisal, leading spokesman for the Arab bloc, makes an inspection tour of Moroccan troops and their just-delivered arms. Faisal finishes the tour and hefts one of the weapons for the benefits of foreign press photographers. Holding the deadly sniper's rifle to his shoulder and peering through its telescopic sight, the now-deceased King swung the barrel in a westerly direction—toward distant America—as the photographers snapped away.

Nearby, Faisal's spokesman pointed out that "We don't want to ruin America any more than you want to take military action against us. There is no reason why a compromise can't be worked out."

OF SECRECY AND SAFEGUARDS

It is Spring 1979. The world has long forgotten the Rabat Summit at which Arab leaders vowed to use their new oil money to buy influence and change the foreign policy of America and other Western nations. There is no time for such ancient history. Now, all attention is focused on the colorful and crowded White House lawn, on the celebration in which Menahem Begin and Anwar Sadat claim to pass through the portal from war to peace.

Little notice is being paid to statements coming regularly from Arab capitals. Threats of "financial retaliation" against the peace treaty—threats against Egypt as well as the U.S. and Israel.

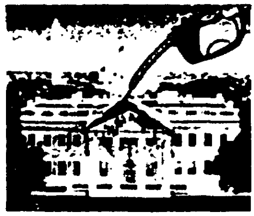
But in some quiet corners—beyond the glare of the klieg lights and the commotion of the banquet hall—a few people have not forgotten Rabat. They are somberly trying to assess the extent of America's vulnerability to a concerted effort of Arab "financial retaliation."

What they find is that the Arabs' six-year-old invasion of America's power base has eroded more deeply than anyone had previously thought. The Arabs have fought their quiet war in board rooms and campuses and government suites. Exactly how much control they have gained is impossible to measure.

No one can document precisely the total

CONTINUED ON PAGE 56

The Carter Connection



As a key tactical part of their seven-pronged petrodollar penetration of American industry and government, the Arab countries have been moving to establish a friendly "Carter Connection" at the White House.

Court documents, published financial reports and on-the-record admissions by the individuals involved indicate that the same Arab bloc which has pledged to use its petrodollars to annihilate Israel, has been using petrodollars to weave a thick web of influential connections encircling the Oval Office of President Jimmy Carter.

For at least three years, those Arab financial operatives have carefully courted— and won—the support of a number of close relatives, friends, former business associates and political compatriots of President Carter.

Consider the following items:

• President Carter's brother, Billy Carter, has become increasingly involved with the Libyan government of Colonel Muammar al-Qadaffi—the same Qadaffi who is involved in an operation in Idaho where he is deploying oil money and "trade delegations" in an attempt to oust Senator Frank Church, the "unfriendly" head of the Senate Foreign Relations Committee.

Last year, Billy Carter hosted a similar "trade delegation" of Libyan officials in Georgia. Carter, who denies the obligation to comply with State Department regulations and register as a foreign agent for such activities, also allowed the Libyan government to pay for his recent trip to that country. There, he and other Georgia businessmen reportedly negotiated a detailed plan to establish a new American corporation as a joint venture owned by Carter and Qadaffi's representatives. The venture would be involved in a variety of business enterprises in and around Georgia.

• David Gambrell, partner in the Atlanta law firm of Gambrell and Mobly and treasurer of President Carter's 1970 Georgia gubernatorial campaign, reportedly was "consulting" with Billy Carter on the legal aspects of that Libyan venture.

• Patrick Caddell, friend of Jimmy Carter and Presidential pollster, has been hired as a poll-taker by Saudi Arabia. Caddell's Presidential polling company, formed during Carter's campaign for the White House, was financed by loans from Barnett Banks of Florida—a $3 billion bank-holding company and investment firm headed by Frederick H. Schultz. Schultz has just been appointed by Carter to a seat on the Federal Reserve Board which regulates banking practices.

• Bert Lance, close friend and longtime business associate of Jimmy Carter, left his position as U.S. Budget Director in a swirl of controversy and investigations involving financial improprieties and other questionable practices at his Georgia bank. One of the controversies involved a deal in which Lance sold a large block of stock in the troubled institution to Saudi Arabian Ghaith R. Pharaon. That purchase was channeled through the Houston law firm of Vinson & Elkins. That is the law firm in which Presidential candidate John Connally is a partner; it often represents Arab interests seeking to make large investments in America.

Lance also surfaced in another highly controversial move in which he acted as a "front" to hide the identities of four Arab officials seeking to secretly buy up controlling interest in a Washington D.C. bank holding company.

• In another recent incident, it was revealed that Lance is still interceding for Arab interests at the White House. Early in April, it was disclosed that the office of President Carter's assistant Hamilton Jordan had arranged a meeting, at Lance's request, for R. Eugene Holly with the State Department's officer for the Arab emirate of Qatar. Holly, who was being prosecuted for his part in obtaining a Qatar oil concession with a $1.5 million bribe, was seeking to work out the difficulties that prosecution had caused his Qatar operations.

A consortium of Arab countries has been making a concerted move during the last two years to invest heavily in Atlanta, where Jimmy Carter served as governor, and where he put together the political and financial infrastructures for his presidential campaign. Carter's roots, like those of most of his top aides and advisors, reach directly back into that business and political milieu of Atlanta— the hub of industry and banking for much of the southeastern United States. The same Atlanta which *Middle East* magazine has hailed as the "New Target for Arab Investment."

Arabs now own a number of major properties in Atlanta, including the $100 million Hilton Hotel complex, a 1,700 acre housing development site just outside the city and a variety of banking interests. A number of local Atlanta companies and government agencies are actively seeking additional Arab investments.

In a recent interview with *Middle East* Richard T. Lewis of the Miller, Lewis and Company investment and real estate firm assured interested Arabs that they need not worry about public disclosure of their activities in Atlanta because their money and identities would be handled "on a strictly confidential basis."

Another Atlanta firm, Corporate Finance Associates, recently announced that unnamed "members of a royal family in one of the Arab countries" had retained the firm to direct its investment of half a billion dollars in America.

And in a recent issue of *Middle East* which focused on Atlanta's investment possibilities and benefits, Arabs were informed that "Atlanta is making a big investment play for global money managers and private investors . . . so billions in foreign cash are now being readied for quick entry into the United States."

The publication also assured investors that Georgia's economy promised good returns in the near future. Because those investors could "assume that President Carter, himself a Georgian, will pump up the economy by 1980 to boost his re-election."

CONTINUED FROM PAGE 54

extent of this petrodollar penetration of America. One reason is the tight cloak of secrecy which has been drawn around most of the Arab transactions here. Another is the repeated failure of Congress to enact proposed legislation which would require systematic recording, monitoring and disclosure of organized financial activities by foreign nationals.

Because of this lack of records, or even minimal Federal foreign investor registration requirements, not even the Treasury, the Commerce Department nor the White House knows for sure how much of the United States is being purchased each day by other nations

For years top government officials have continued to assure the public that the stories of widespread Arab purchases were just rumors. One man, Gerald L. Parsky, Assistant Secretary of the U.S. Treasury during the Nixon and Ford administrations, reacted to news stories which cited mounting pressure for enactment of some sort of legislation to document or monitor foreign buy-ins. But Parsky told *Newsweek* magazine that the Treasury Department had found that "no massive flow [of Arab money] has taken place."

And Arabs here have heatedly denied even the suggestion that any substantial amounts of Arab money are being plowed into American industries or institutions. For example, in a tour through Florida, Georgia and California last January, Ahmed Al-Shahati, second-in-command to Libya's leader Muammar al-Qadaffi, charged that such allegations were "ill-intentioned distortions" made by the American media's "Zionist conspiracy."

Expo's investigation has found that many of the officials who were publicly debunking suggestions of large-scale Arab financial operations throughout America were privately moving to take a leading and lucrative role in directing those very operations. Like Gerald Parsky himself.

Parsky left the Treasury Department to become manager of the Washington law offices of the Los Angeles-headquartered law firm of Gibson, Dunn & Crutcher, which frequently handles Arab investments throughout the country. According to New York court records and reports, Parsky recently acted as go-between for a group of Saudi and Kuwait investors who made an unsuccessful $50 million offer for three of Manhattan's major midtown hotels

Financial Paper Acquisitions

How Much Do The Arabs Really Control?

Attempts to document the exact extent of Arab financial involvements in America are thwarted immediately by two obstacles: the lack of federal laws requiring systematic recording and disclosure of such foreign activity and the shroud of secrecy drawn around such transactions by Arab financial operatives in this country.

Many large corporations prefer to operate discreetly beyond the harsh glare of publicity for numerous practical reasons; but the Arab businessmen who have swarmed into the country since 1973 display a particular obsession for ultra-secrecy. Nor is this limited to their American operations. The 1975 Oxford Seminar on Oil Wealth which sought to study the impact of the new flow of petrodollars into Western economies found that Arab transactions in Europe and the United States were characterized by "meticulous insistence on the secrecy of the investments."

Throughout America, *Expo* has found, Arab financiers routinely hide their identities. They frequently work through Americans hired as "front men." And they regularly seek the camouflage of complex webs of international corporations which make it virtually impossible to trace the true source of investment funds

A good example of how this is being done can be found in the case involving the Arab attempt to take over Financial General Bankshares, Inc., a $2.2 billion Washington D.C. holding company that owns strings of banks in Maryland, Virginia and New York.

The Bankshares case first surfaced early in 1978 when the Securities and Exchange Commission charged that a group of Arab investors was trying to take over the bank company illegally. The SEC charged that the group was working through former U.S. Budget Director Bert Lance and that each group member was buying up just under five percent of the bank's stock. According to Federal law, an unidentified purchaser may buy no more than five percent of such stocks. But by operating as individuals, the group managed to buy up more than 20 percent of the bank before it was stopped by an SEC investigation and legal actions brought against it by the company itself.

The issue quickly hit the front pages as the latest in a number of controversial transactions in which President Carter's close friend was playing front man to Arab investors. In the wake of the disclosure and public criticism of his involvement, Lance charged that "the great Jewish ownership of the press" was behind such unfair criticism. Although he later apologized for the remark, it continued

The Arabs threatened to withdraw their funds from American banks . . . crippling or possibly even collapsing the Federal Reserve System.

to send shock waves across the country and the capital.

Lance soon announced that he was backing out of the Bankshares deal. At the same time, it was disclosed that the Arabs had hired another former top government official to be their front—Stuart Symington, former Senator and Secretary of the Air Force.

In complex legal proceedings involving the SEC and Bankshares, which continued to fight the takeover bid, the Arab group admitted it was seeking control of the banking firm and agreed to allow other companies to bid publicly for control, as the law requires.

It was then announced that a "Dutch firm" was going to buy control

That firm's name was Credit and Commerce American Holdings, N.V. (CCAH) of the Netherlands Antilles.

CCAH has a wholly-owned subsidiary in the Netherlands called Credit and Commerce American Investments, B.V. (CCAI).

CCAI, in turn, is owned by Sheikh Kamal Adham, former head of the Saudi Arabian Intelligence Agency; Faisal Saud al Fulaij, former chairman of Kuwait Airways; Abdullah Darwaish, financial advisor of the royal family of Abu Dhabi, and the company known as Intercontinental Credit and Commerce Ltd., located in the Grand Caymans.

That Grand Cayman Islands firm, in turn, is the major owner of the Bank of Credit and Commerce International, a bank headquartered in London but originally incorporated in Luxembourg by Arab investors.

For one thing, such a set-up will be recorded as investments by the "Netherlands," under the current record-keeping system of the U.S. Commerce Department.

For another, the Byzantine structure which totally obscures the investors' identities will allow the Arabs to shuttle money back and forth between corporations and escape about three-quarters of the taxes that would normally be due on such an American investment by foreigners.

Stuart Symington's direct involvement in such operations began as a surreptitious move aimed at the takeover of a number of American banks by Arab interests. His activities raise a number of curious questions, in light of his former actions as a Senator and a member of the Senate Foreign Relations Subcommittee on Multinational Corporations.

Late in 1978, Symington was part of the five-member Subcommittee attempting to document the extent of foreign depositors' control over the U.S. banking system. The Subcommittee prepared to subpoena records of American banks to pursue their investigation, but they were warned by Kuwait and Saudi Arabia not to continue their probe. The two countries threatened immediate withdrawal from American banks of more than $7 billion in short-term deposits, if the Subcommittee subpoenaed the bank records that would detail the true extent of Arab holdings in the American institutions. Such a move would immediately cripple or possibly even collapse the Federal Reserve System.

Senators Frank Church of Idaho and Clifford Case of New Jersey were in favor of forcing the issue. They argued that Congress had a right to know how much of the country's banking system was controlled by foreign interests.

Senators Charles Percy of Illinois and Stuart Symington of Missouri were in favor of backing down and stopping that part of the investigations because—as Percy explained—"It is simply not worth the risk."

Senator Richard Clark of Iowa remained neutral because he was new to the Subcommittee.

In the end, the Subcommittee caved in to the Arab threats and halted its investigation into that area. No one really knows how much control the Arabs hold over American banks.

Recycling Oil Profits and Arms Commissions

How We're Helping The Arabs To Buy Us... With Our Own Money

A good place to begin a microcosmic look at the interior mechanics of direct Arab acquisitions is San Jose, California—a city whose name is familiar to most people only because it recalls a popular Burt Bacharach tune. Aside from that, San Jose—which bills itself as the "Dried Prune Capital of the World"—has remained obscure to the rest of the country.

It is not a chic, trendy spot like its northern neighbor, San Francisco. Nor is it a glittery media hotspot like Los Angeles to the south. Physically, it is not even a "city" in the traditional sense in which Easterners think of that word. Viewed from one of the mountains which surround it, San Jose is a loose cluster of farmlands and suburbs which meander southward across a broad valley from the lower tip of San Francisco Bay. Carpeted with some of the most fertile soil on Earth, this valley has prospered on its agriculture for more than two centuries. Today, San Jose is the largest frozen vegetable processing and packaging center in the country.

During the last decade, large portions of farmland have been converted into unusually attractive industrial parks. Laid out like college campuses, many simulate the gardens and Spanish architecture of the 18th century missions that still dot the area. But inside the graceful buildings, modern technology holds sway; the parks are fast becoming a national center for the electronics and computer software industries.

Here, in San Jose, the politics, general economy and social milieu can be summed up in six words: very solid, very conservative, very rich. With well run farms, heavily attended churches and 100-year-old banks, San Jose is unmistakably bedrock America. The America they talk about in the insurance ads and Army recruitment posters. The America that stockbrokers and pollsters try never to lose sight of. The America that rarely raises its voice, but whose quiet strength decides national elections. The America that Adnan Khashoggi of the Saudi Arabian royal court set out to buy in 1973.

THE KHASHOGGI SAGA

The Khashoggi saga is a complex and colorful story which stretches from the throne rooms of Saudi Arabia to the board rooms of America's weapons manufacturers to the back rooms of Richard Nixon's White House. And that is just for starters.

Boiled down, Adnan Khashoggi's is the story of an Arab entrepreneur who operated under the aegis of the Saudi throne to "twincycle" petrobillions—creatively.

First, by using oil profits to buy weapons and equipment for Arab armies from American defense contractors. Then, by charging those same American weapons firms hundreds of millions of dollars in "commissions" for arranging such deals with Saudi officials. Then, by taking those "commissions" made from equipping Arab armies and recycling them again—into the purchase of American banks, cattle ranches, restaurants, mutual funds, trucking firms and similar properties. Which, in turn, feed *their* profits back into the original swirl of money supporting further and even more extensive weapons deals.

One of the banks subjected to such a purchase attempt was the century-old First National Bank of San Jose—which Khashoggi was eventually blocked from buying. That failure—one of very few the Saudi entrepreneur has suffered during his billion dollar dealings throughout America—is why the bank is so interesting. By failing to gain control, Khashoggi left behind a trail of records—and a number of people willing to talk. All of these provide interesting insights into the methods used by this key operative of the Saudi throne to amass enormous wealth as a U.S. businessman.

FROM SAUDI COURT TO SOUTHERN CALIFORNIA

Adnan Khashoggi's father was Dr. Mohammed Khashoggi, the first Western-trained physician in Saudi Arabia and hence, physician to the king. Such intimate proximity to the throne made Dr. Khashoggi a person of great importance in that royal court of the 1930s. At the time, the Saudi royal family was still coming to grips with the novel fact that its impoverished desert kingdom sat atop the richest oil deposit on Earth.

Adnan was the first of three sons born to the doctor and his wife; he grew up in an atmosphere of opulence and royal privilege that is beyond the imagination of most Americans. Like most youngsters of the royal household, the Khashoggi sons were sent abroad for their higher education. Adnan went first to Egypt and then to America, where he attended a small California college.

After school, Adnan Khashoggi returned to Saudi Arabia. Virtually overnight, he established himself as a multi-millionaire who set up billion-dollar truck, equipment and arms deals between American and European manufacturers and Saudi Arabian military officials.

By the late 1960s, Khashoggi had become the primary conduit for HAWK missiles made and sold by the Raytheon Corporation of America to the Arab military.

Congressional investigation reports and Pentagon files indicate that Khashoggi was receiving as much as $45 million at a time in commissions from numerous American companies which supplied weapons to the Arabs.

In 1973, Khashoggi rapidly began to expand his business scope. The billion-dollar Arab armaments dealer became a full-fledged, large scale American entrepreneur. He set up the world's first Arab multinational corporation—Triad Holding Company—and immediately began to purchase banks, ranches, businesses and real estate throughout the Western world.

One of his first purchases was a bank in Walnut Creek—an ultra-affluent community on the outskirts of San Francisco. There, newly-elected Democratic Congressman Fortney Stark sold Khashoggi majority control of the $100 million Security National Bank, which has five offices throughout Alameda and Conta Costa counties.

By 1974, Khashoggi had established homes and offices in Walnut Creek, Phoenix, New York, Geneva, London, Beirut, Riyadh, Jeddah, Brazil and Indonesia, from which he operated a labyrinthine organization, buying up businesses and land. Then Khashoggi began his move against the First National Bank of San Jose, 40 miles south of his office in Walnut Creek.

At first, Khashoggi's approach was low key. In secret meetings with the bank's directors, he proposed that they issue 650,000 shares of new capital stock which he would buy and which would give him effective control of the $300 million bank.

Shortly after those meetings, the first stories of Khashoggi's plan were leaked to local press—by bank directors with strong reservations about the takeover.

Then, several things happened:

-Bank directors who had previously supported the idea in private sessions began softening their views in the wake of a public outcry from the institution's depositors.

-Khashoggi threatened to begin offering greatly inflated prices for existing bank stocks and to buy up a controlling interest of the bank on his own—if the directors did not go along with his original proposal for a new stock issue.

-Both bank directors and community

The new Arab breed of entrepreneur twincycles petrobillions ... creatively.

leaders charged that Khashoggi was now trying to bludgeon his way into control of the bank.

-As part of a strong public relations campaign Khashoggi granted an interview to *San Jose Mercury* reporter Frank Hawkins Jr., who accompanied Khashoggi across the Middle East in his sumptuous private jet, where the interview took place. Hawkins' report in the *Mercury*, a Knight-Ridder paper, described Khashoggi as "a stocky Arab with twinkling eyes," and mistakenly been identified with Arab oil money."

-More bank directors broke with the proposal.

-Khashoggi filed suit, asking the courts to force the bank directors to go through with the original proposal— which had not been voted on.

-Then Congressman Fortney Stark—who gave Khashoggi his original entree into American banking circles by selling him the National Security Bank of Walnut Creek—faced reporters and admitted that he had made a mistake in that encounter. Stark acknowledged that he had not understood who he had been dealing with at Walnut Creek. Stark's congressional office had investigated Khashoggi in the interim and found that the entrepreneur was using the "commissions" from oil-financed Arab arms deals to buy the banks in California. The Congressman charged that the bid on the San Jose bank was being made with Khashoggi's commission from the sale of Lockheed fighter jets to the Arabs; as a consequence of the information his office had put together, Stark decided to recommend legislation to prohibit such takeovers by foreign nationals.

-Khashoggi, calling himself a spokesman for the Arab world, threatened that if the "fanatics" who were blocking his attempt to gain control of the bank did not desist, the flow of Arab oil money into the American business community would stop.

-The bank directors asked stockholders to vote on the pending stock sales proposal. Bank officials reported that the response showed a "strong shareholder feeling against the transaction" and announced that the deal was off.

-Khashoggi charged that he had been the victim of "a Zionist-inspired wave of anti-Arab hatred."

A San Jose financial official close to the controversy who asked not to be identified explained, "The intensity of the struggle behind the scenes on that [Khashoggi] proposal was extraordinary. A lot of friendships and old comfortable business relationships were ruffled there. The lure of the money and the connections that Mr. Khashoggi represented were very tempting and evoked some very strong emotions.

"On one hand," he continued, "here was an opportunity to make a direct connection into the worldwide flush of Arab money. Financially, there were an awful lot of sound reasons to go through with it. But on the other hand, to achieve such a goal, the bank had to be virtually turned over to foreign interests. The bottom line was, 'Do we really want to sell this central financial institution of our community to a foreign power?' Many people were sorely tempted. But the stockholders had very firm thoughts against such an idea, regardless of any financial advantage such a move would have provided."

The San Jose incident did not end Khashoggi's interest in the San Francisco area. Along with a number of other holdings, he bought a 7,000 acre ranch in the Santa Clara Valley, acquired another bank and formed the Palo Alto Investment Company as a front for further investments in 15 Bay Area companies. He also surfaced in court records: these detail a highly complex legal action involving his company's secret partnerships with local realty firms charged with investment fraud schemes and other irregularities surrounding a $40 million townhouse and industrial park development project near Palo Alto.

Khashoggi has also endowed the "Triad Foundation," which he described as a "philanthropic agency" located on the grounds of St. Mary's College near Moraga, California. The announced purpose of the college project is to "train banking and finance experts for developing nations."

Meanwhile, the petrodollar-financed Arab armament sales which are the lifeblood of his sprawling interests continued; late in 1975, they began to draw the interest of a Congress just beginning its years-long investigation into multi-national corporations.

That was just one of a number of problems closing in on the high-rolling entrepreneur at the time. Another was the increasingly bitter behind-the-scenes power struggle within the Saudi royal court. In the course of the battle, Khashoggi lost power and began a decline from favor with the royal family. Currently, he is officially on the outs with the throne he once represented—although his business and monetary connections are reportedly still well plugged in at the highest Saudi government and military levels.

In 1975, the Senate Foreign Relations Committee's Subcommittee on Multinational Corporations, headed by Senator Frank Church of Idaho, began to study Khashoggi's activities and decided they wanted to talk to the Arab weapons merchant.

Khashoggi announced to the press that he was greatly "annoyed" that he had been subpoenaed to testify before the Subcommittee about his "commissions."

Senator Church, meanwhile, made it very clear that he was not investigating "commissions." His Subcommittee was investigating bribes.

Petrodollar Courtships

All-Star Puppet Show

The roster of public figures and former top government officials reported to represent the Arab countries in a variety of ways reads like a who's who of headliners who are using years of front-rank political alliances on behalf of their lucrative new clients.

John Connally, former Secretary of the Treasury, Special Advisor to the President and current Republican Presidential candidate who announced last month that he is considering financing his own campaign rather than submit to the spending limitations federal election money would impose. Connally was legal and political counsel to Saudi Arabian bank-buying interests—including one connected to former U.S. Budget Director Bert Lance.

Spiro T. Agnew, former U.S. Vice President. Providing political advice and guidance to the Organization of Petroleum Exporting Countries.

Stuart Symington, former Senator and Secretary of the Air Force. Representing financial interests—including those of the former director of the Saudi Arabian Intelligence Agency—of Saudi Arabia, Kuwait and Abu Dhabi as they purchase interests in American banks.

J. William Fulbright, former Senator and Chairman of the Senate Foreign Relations Committee. Consultant collecting $25,000 a year from the United Arab Emirates and $50,000 a year from Saudi Arabia.

Clark Clifford, former Secretary of Defense. Consultant collecting $150,000 a year from Algeria and legal counsel to Saudi Arabian interests.

Richard G. Kleindienst, former U.S. Attorney General. Consultant collecting $120,000 a year from Algeria.

Richard P. Helms, former Director of the U.S. Central Intelligence Agency and U.S. Ambassador. Consultant to Iran and partner in a joint American-Iranian import-export business.

Raymond Close, former CIA Station Chief, Middle East. Financial advisor to the Saudi Arabian royal families.

John O'Connell, former CIA Station Chief, Middle East. Consultant to Jordan.

Frederick G. Dutton, former Assistant Secretary of State. Legal and financial consultant collecting $200,000 a year for representing Saudi Arabia and its state-owned gas and oil monopoly, Petromin.

A. Linwood Holton, former Assistant Secretary of State. Consultant to OPEC countries on "Congressional Relations."

Willis C. Armstrong, former Assistant Secretary of State. Retained as a "Washington watcher" for Saudi Arabia.

Gerald L. Parsky, former Assistant Secretary of the Treasury. Currently managing Washington law office—Gibson, Dunn and Crutcher—which frequently provides legal and financial counsel to Saudi Arabian and other Arab interests seeking to do business across America.

Patrick Caddell, close friend and pollster for President Carter. Hired to do polls of public opinion for Saudi Arabia.

Crawford Cook, close friend of John West, American Ambassador to Saudi Arabia. Hired for long-range "public information programs" by Saudi Arabia.

Illustrated (l. to r.): Clark Clifford, Richard Helms, Stuart Symington, William Fulbright, John Connally.

Direct Political Action

The Arabs vs. Senator Church

Senator Frank Church has not had an easy time of it with the member nations of the Arab League.

The first major public confrontation came with the Khashoggi investigation. Digging in, the Subcommittee exposed extensive details of a worldwide web of connections in which people like Khashoggi shuttled petrobillions and war materiel which generated a copious "commission" flow. The Church hearings opened the window on a lot of the new connections and inroads the Arabs have made in Washington and other seats of power. When the Subcommittee investigated his dealings with American defense contractors, Khashoggi was represented by Clark Clifford, former Secretary of Defense, known as the dean of the capital's lawyers.

Democrat Church, Chairman of the Senate Foreign Relations Committee, is one of the most powerful men in Washington. He has consistently opposed moves to sell highly sophisticated military hardware to the Arabs. Last year, Church's fight against the controversial F-15 proposal was bitterly criticized by the White House.

In another arena, Church has become locked in a low-profile but high-intensity battle behind the scenes with Libya, which has been lobbying for the Senate Foreign Relations Committee to drop the prohibitions that have held up the export of military equipment to that country

The controversy began some years ago, when Libya purchased five C-130 Hercules planes, two Boeing 727s, large numbers of Oshkosh trucks and spare parts from American manufacturers. The equipment was to add to the formidable arsenal Libya has already assembled with $2 billion in Russian military equipment, including 100 MIG jets manned by crack North Korean fighter pilots

The C-130s were the central part of the American purchase. Although usually characterized in press reports as only "cargo" planes, the Hercules is the most versatile warplane ever built. It has been the workhorse of the American military for 20 years.

The four-engine turbo-prop aircraft—known to U.S. troops as "Herks" or "Herky birds"—are designed for rough-field landings and lightning military strikes; Israeli troops flew C-130s to make their famous 1976 rescue raid at Entebbe Airport in Uganda. The planes are also designed for rapid paratroop drops, have a 5,000-mile range and can carry 110,000 pounds of jeeps, trucks, heavy artillery and similar cargos.

Herks are also easy to convert into lethal gunships, like the ones which ravaged the Ho Chi Minh Trail during the Vietnam War.

These seemingly innocuous "cargo" planes can be quickly fitted with an astounding array of weapons, including 105 milimeter howitzers, 40 milimeter cannons, bomb racks, missile pods, grenade dispensers and the infamous six-barrel "Vulcan" 20 milimeter machine gun which can shred a truck convoy or a barracks in seconds with its 3,000-rounds-per-minute firing capacity.

Three Presidents, the State Department and the Senate Foreign Relations Committee decided that it was not a good idea to put such equipment in the hands of Libyan strongman Muammar al-Qadaffi. Qadaffi has openly allowed his country to be used as a haven and staging base for PLO commandos, hijackers and other international terrorists. Libya was the only country in the world to aid Ugandan dictator Idi Amin in the revolution that led to his overthrow this spring.

Qadaffi has been unable to get the U.S. export licenses he needs to move the C-130s and other equipment from American warehouses to military bases in Libya. He has vowed to change American opinion about Libya, and has mounted an all-stops-out campaign to persuade the Senate Foreign Relations Committee to approve those export licenses.

But Committee chairman Frank Church has refused to relent or even soften his view on the Libyan planes.

So, late in 1977, the Arabs began an economic invasion of Idaho aimed at "neutralizing" the Senator.

First, Kuwait bought up the sprawling Idaho Harding Livestock and Land Company, one of the largest land and cattle companies in the state.

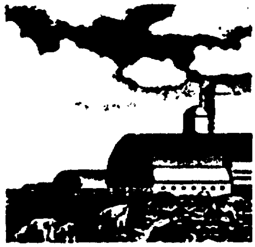
Then Libya began making arrangements to buy almost everything else.

BUCOLIC BATTLEGROUND

Idaho can best be described by the short list of things it is nationally famous for: baking potatoes, exploding grain silos, Sun Valley's ski slopes. And Frank Church. It is the least populated state in the Union, with fewer than 800,000 residents on its 84,000 square miles. Seventy percent of those people live on the rural farmlands that are Idaho's economic backbone; 22,000 of them belong to the Idaho Farm Bureau—the state's most powerful political group.

Two years ago, the Arabs started arriving in this unlikely spot in America's

In Idaho, a state known for exploding grain silos, rural farmland and baking potatoes, the Arabs are establishing a political beachhead.



isolated northwestern corner. They began to buy things—in units measurable in tens of millions of dollars.

Officially, Washington has made no mention of what is happening in Idaho. Unofficially, senior State Department officials have expressed increasing concern with Arab activities they describe as "an interesting end run around the federal government to establish a beachhead in the mountains of Idaho."

So far, this is what has happened in Frank Church's backyard:

—After Kuwait purchased Idaho Harding, Libya sent a seven-member "trade delegation" which prowled the state, meeting with state officials, farmers, sheep ranchers, newspaper editors and university officials. They mentioned two things very frequently: their desire to make massive purchases of local products and their displeasure that Senator Church was helping to hold up delivery of their cargo planes.

—Three separate junkets of Idaho congressmen, state officials, farmers and university leaders have toured Libya, where they were wined, dined, entertained—and introduced to Arab officials who invited them to discuss "the possibility of new trade programs."

—Then Arabs began meeting frequently in both Idaho and Washington D.C. with Idaho Congressman Steven Symms, a Republican who has announced that he will run against Frank Church next year. An arch-conservative with seven years in Congress, Symms is not popularly known in Idaho for any major legislative accomplishments. He is perhaps best known for his right-wing rhetoric, his backing of the "Liberty Amendment" which calls for the abolition of all income taxes, and his catchy campaign slogan, "Take a bite of government."

—Symms' office has told the local press that the Libyans aren't so bad, that Qadaffi has promised that Libya will mend its ways and "no longer give aid or support to terrorists," and "We believe him."

—Arabs have negotiated the purchase of about $40 million in wheat. They have stated an interest in making future buys into Idaho's corn, soybeans and lamb products.

—Arabs have announced they intend to give a half million dollar Agricultural Studies grant to the University of Idaho.

—Libya has coyly suggested that it might want to establish its U.S. trade mission office in Boise, Idaho—if it would be "welcome."

—The 22,000-member Idaho Farm Bureau is now aggressively trying to "convince" the Libyans to put their trade mission in Boise. It has begun caustic criticism of Senator Church for not actively backing the project.

—Senator Church, who is preparing to open his campaign for re-election in Idaho next year, is keeping a very low profile on the subject.

POLITICAL SAVVY

"In effect, Senator Church is running for election against the Arabs. I don't think there has ever been a race like this in which a foreign country has taken such a direct part. And let me tell you, we're watching it," explained one Washington Congressional aide who has been on the Hill since 1970.

"But Church is not the only one feeling pressure from the Arabs," the aide continued. "They are now a major force in Washington. The progress they have made is incredible. Four years ago, the Arab lobby was a joke. You had maybe two people here who knew what they were doing. The rest of them were tiptoeing around like nuns in a whorehouse. They didn't know what they were doing or even how to find out. They didn't even understand the *theory* of the system, let alone how it works here on the Hill.

"No more. They are well organized, highly polished and—it goes without saying—extremely well financed. They have good staff people and they know how to keep their fingers on the pulse and deliver well-documented position papers or backgrounders to 'balance' the issues. They also have some dynamic law firms and former Hill people—ex-senators, representatives and aides—pounding the drum for them.

"The Jewish lobby is still far more formidable because it can bring down the public wrath of the local communities. But the Arabs are closing. They have tightened their act to the point where they have real clout. You only have to look at the F-15 deal to understand that. I mean, that was all-out war. We have every Jewish organization you can imagine, and bigwigs from Israel, coming in. There was arm-twisting like you can't believe—on both sides. Everything but the kitchen sink came floating down the halls on that one.

"And the Arabs won. Israel has never lost a vote like that one before. It was 55-54 to sell the planes to the Arabs. Israel had gone all out to defeat it. But they lost. I don't think most folks out there in the real world understand just how significant that was.

"From where we sit, it was a major watershed. The Arabs demonstrated they now have the know-how and connections to affect the passage of legislation.

"Not a lot of people will admit it publicly, because the topic is such a touchy one. It's explosive now with the oil situation. But Israel lost ground behind the scenes on that vote. They've lost ground in general, you could see that in the concessions they made for the Egyptian negotiations. There is a growing undercurrent here—if we want to keep the oil flowing, we've got to take a new look at our relationships with the Arabs.

"Egypt and Israel may be friends now, but that doesn't lessen the tensions. Egypt is a bankrupt country armed with equipment left over from the Russians—equipment they can't get parts for. They are not an oil power and we expect them to stay under fire from the Arab oil states for striking a deal. Right now, you can't move on an issue involving the Mideast until you take Arab oil money into account. When it comes to the Midwest, man, 'balance' is the new catchword here."

THE F-15 PRECEDENT

The F-15 deal was at the center of a storm of controversy in the winter and spring of 1978. It involved something more than the sale of jets to Arab countries. The legislation set a major precedent by linking sales of top-of-the-line military equipment to Israel with mandatory sales of the same equipment to Arab states.

The F-15 is no mere jet, but a superplane: the sleek, twin-tailed fighter is the most advanced aircraft in the world. It is a flying, computerized, total overhead destruction machine, armed with 20 milimeter machine guns, Sparrow air-to-air missiles, Sidewinder rockets—and an arsenal of other ordinance for destroying buildings and bunkers, men and machines, like no other plane can.

With the fall of the shah in Iran, the "balance" achieved by selling the jets to both Israel and Saudi Arabia in 1978 now appears to have gone out of kilter. One of the first public acts of Khomeini's Islamic regime was to pledge full support to the PLO's campaign to destroy Israel. That pledge carried with it the weight of the arsenal of American weapons that the new Iranian government inherited from the old. Overnight, a new fleet of F-15s was added to those now being purchased by Saudi Arabia, shifting the "balance" in drastic lopsided favor of the Arab League.

The Ultimate Fate Of America

The coffee arrives in delicate bone china cups rimmed with gold flake, set on an antique mahogany serving tray. Vanishing as quickly as she materialized, the secretary closes the thick wooden door, leaving the two men alone again. Across the desk, the man in the blue suit remains standing. For the second time in as many minutes, he seeks verbal assurance that the interview is off the record. Strictly off the record. Speaking in vaguely apologetic tones, he gestures toward the window and the Washington streets below as he explains. "The Arab-Israeli situation is a very, sensitive subject at this time."

Mr. Bluesuit has been in and around Washington's central power core for more than two dozen years. A former high official in two government agencies, he is now a private consultant to government and industry on legal and financial matters involving international trade.

Bluesuit unfurls a large map of the world across his desk. Its corners are held down by crystal paperweights and empty gold-rimmed coffee cups. Its surface is etched with colored lines that criss-cross heavily in some places, obscuring large sections of geographical detail.

Red lines. Green lines. Blue lines. Yellow lines. Each starts at some major point in the Americas or Europe or Asia and stretches seaward, to join with others. The lines form colored cables that arc across the oceans, round the capes, cross the channels and traverse canals that bring them to one final massive coagulation in the vicinity of the Persian Gulf.

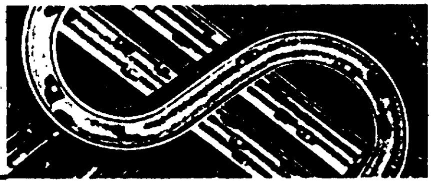
Tanker routes. Traced across the globe like some enormously complex electrical schematic, wiring the continents together. Outlining the delicate and colorfully intricate structure through which the black viscous blood of industrialized civilization flows. From the desert kingdoms of the Middle East to the refineries and factories and gas pumps of the rest of the world.

Bluesuit leans across the map, ignoring the cigarette ash that begins collecting in the area of Australia. "This," he says, tapping to indicate the entire surface of the world, "is the new strategy map for the Mideast War.

"Journalists and the general electorate of America have failed to comprehend that there has been a genuine revolution in the world since 1973," he continued. "We have experienced a drastic change in the definition of the basic units of monetary value and a radical alteration in the previously-recognized concepts of international 'power.'"

"In effect, the Western industrialized societies which ruled the world in 1972

"Israel's fate may well be determined on the Los Angeles Freeway or the New Jersey Turnpike."



have been transformed into revenue-producing colonies of the Arab world in 1979. This reality has not yet been throughly absorbed by the general citizenry or political machinery of our country. It is not a concept that the traditional American psyche can readily tolerate.

"We have also seen the evolution of a new kind of warfare that you might term 'econo-conflict,' in which one national group battles another without ever firing a shot. Sure, economic measures of one form or another have always been a part of modern war. But not quite like this. The billions of dollars worth of various Arab transactions in America you asked me about earlier are only one portion of a larger picture. The Arab nations have spread out to use the entire planet as a strategy board on which they plan to settle their border dispute with Israel. In short, what they failed to do in the desert with their tank charges, they are now attempting to do in board rooms and brokerage houses— with their petrodollars.

"You're too young to remember, but just prior to World War II, there was a controversy over the question of using airplanes and aircraft carriers as primary weapons of war. It had never been done and Americans did not want to think about the crazy idea that ships with airplanes on top of them could be a major weapon of war. It was too unusual a thought. So for years, while the controversy continued, we did nothing. We sat there, confident in our own battleships and watched the horizon for the enemy battleships to come—because that is how war had always come in the past. Then, at Pearl Harbor, in the space of a few hours, a handful of planes bombed the hell out of us. We were forced to take notice of the fact that the art of war had changed, and battleships did not matter so much any longer. You see, it took a catastrophe to bring home that simple realization.

"This is similar to what's happening in Washington right now. The old heads of the Jewish movement down here insist in thinking in old terms. In effect, they are still watching the horizon for the next wave of Arab tanks to come. That is how war has always happened in the Mideast. But that is not how the Arabs are operating any longer. Now they are attacking with money.

"The influential American Jews with whom I deal on a regular basis seem to dwell on the old vision: Israel has little to worry about because it has proved its invincibility in tank battles, muzzle-to-muzzle, time and time again. Their primary concern here is to make sure that Israel receives enough new tanks and other hardware. Quite frankly, I've been amazed by their inability as a group to see that they are now engaged in a war of nozzles, rather than muzzles: the nozzles on every gasoline pump in America. I'm not being at all facetious when I suggest that the ultimate fate of Israel may well be determined on the freeways of Los Angeles or the New Jersey Turnpike.

"If I were Jewish and felt a deep personal attachment to Israel as it now exists, I'd be pretty damned worried about this country's devil-may-care attitude about energy. The Arabs have used our own money—each one of us gave it to them when we filled our cars with gasoline—to acquire the new position of power and influence from which they are subtly changing American attitudes about Israel."

Rolling up the map, Bluesuit reached inside a desk drawer and handed his visitor a manila folder whose contents he characterized as "a little more food for thought."

Inside the folder were the results of a national Gallup poll conducted within the last year. The poll surveyed American attitudes about Arabs and Israel. The report showed that 42 percent of the Americans surveyed were more sympathetic to the Arabs than they had been a year before.

During the same year, 34 percent of the Americans surveyed had become less sympathetic toward Israel.

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As *Expo* goes to press, events and changes continue with lightning speed across the Middle East. Three disturbing newspaper stories appeared within a single week:

TEHRAN—*Iran announced today that it was raising oil prices by 13 percent over the basic level set by the Organization of Petroleum Exporting Countries last month. The new prices will be $16.57 a barrel for Iranian light crude and $16.05 for a barrel of heavy crude.*

WASHINGTON D.C.—*A Senate report drawing on subpoenaed oil company documents concludes that Saudi Arabia will limit its oil production in the 1980s to not more than 12 million barrels a day—a level so low it could possibly touch off 'a fierce political and economic struggle' among the consuming countries. [The present daily production level stands at an alarming eight and one-half million barrels.]*

RIYADH—*Crown Prince Fahd, long identified by American ambassadors and policymakers as the key to stability and stronger U.S. ties to Saudi Arabia, is yielding much of his power to other members of the Saudi royal family, according to U.S. intelligence reports.*

The causes of Fahd's declining influence still are not clear to U.S. analysts. But the decline has suddenly become a major preoccupation for the Carter administration, which fears that the Fahd problem may be part of a potential crisis in Saudi leadership that could vitally threaten the most fundamental and basic premises of the U.S. foreign and energy policy. ▲

Senator BYRD. I wonder if you could briefly summarize the key points of your article?

Mr. LEVINS. What I do with my article, the article specifically attempts to do a survey, as best as possible from the available public information on the amount of investment and control of property in America specifically by Arab OPEC nations and investors from those nations.

What I tried to do was survey all the available public information as best I could, go to the Government agencies charged with monitoring and documenting it and reporting this information on foreign investment.

I asked them a simple question. Can you tell me who owns what and where they own it, and I believe you have an example of the sort of answer I received from virtually every Government agency.

Earlier this morning, when Mr. Lubick, who is Assistant Secetary of the Treasury and in charge of assembling this sort of information explained that he had only very shaky figures on any of this and he had no accurate reflection of who owned what or where.

My assignment on this article was to try to find out how much the Arabs owned. The Arabs were specifically isolated because their investments, as best I can discern, seem to be very, very different from the sorts of investments being made by other foreign countries such as West Germany, such as Japan.

For this reason, no other foreign country that I know of has attached such a malevolent intent to its investment, and what I tried to do is document that. By that intent, what I mean, the Arab nations, on a number of occasions during the last 6 years, have threatened to use their investments and their holdings in banks and securities and properties as a direct lever against the U.S. Congress and against 200 million Americans.

To give you an example of the kind of thing I am talking about, during the now famous 1973 and 1974 oil embargo that began shortly after the Israeli war in 1973, which the Arabs lost, Arab leaders met at Rabat in 1974 and vowed that they would "unsheath the sword of oil" and use it against America and the other Western industrialized nations whose support had allowed Israel to continue and win that particular war.

In 1975, the Senate Foreign Relations Subcommittee on Multinational Corporations, a five-member subcommittee, was intending to investigate the holdings. One part of their investigation was an attempt to find the holdings of foreign countries, particularly in the superbanks in New York which, as I understand it, are what the Federal Reserve System pivots around.

I am no banker or financial expert, but at that time, the subcommittee attempted to subpena some of the documents of the banks to allow them to see, at least to some extent, how much control the Arabs had. And Kuwait and Saudi Arabia they had $7.2 billion in short-term investments and I understand that is similar to when I go every week to the bank and put in my paycheck, I can pull it out at anytime. My paycheck makes no difference, but my understanding is that $7.2 billion does.

As a result of that threat against the Congress, the Congress specifically stopped that investigation, decided not to press the point, decided not to find out how much the Arabs did hold; in effect, caved in to the threats of a foreign nation on its investigation.

In another incident, and a more recent one, on June 6, 1979, just the other day, the Washington Post had a very extensive report about a very complex suit that involved the International Association of Machinists and the suit they have against the OPEC nation for price fixing, involving petroleum products.

Again, I am no lawyer. I do not understand all the complexities of that suit. I do understand that the Carter administration announced that it was considering backing the OPEC countries against the American International Association of Machinists because it said—this is a quote—"Because Treasury Secretary Blumenthal is concerned that OPEC might withdraw billions of dollars in U.S. securities and cash and U.S. bonds if the American union won its case."

In another incident, which is just in yesterday's Washington Post, there is a report in the financial section—this does not concern America but concerns the same concept—that the Canadian dollar last week had dropped. That story went on to explain that the latest drop was caused by threats from the Arab monetary fund to boycott Canadian banks and securities.

The threat followed an announcement by Prime Minister Joe Clark that Canada plans to move its Embassy from Israel to Jerusalem from Tel Aviv.

The point of my article was an attempt to document as best I could not only the holdings of theirs but what would appear to me to be a very unusual intent and use of those holdings by Arabs, to push around both the country and the Congress and to subvert many of the political institutions, at least as I understand them from my client's point of view of a citizen in America.

The article itself is sort of too large to encapsulate. It involves seven specific areas which I found that the Arabs appear to be moving in which range everywhere from the physical properties that we were talking about earlier this morning to even educational grants in 75 different universities around America, many of which carry stipulations such as there was one in MIT, one of a number, I understand, where the stipulation was that no Jews be allowed to take part in that particular project. In that instance, MIT refused and what the Arab country did was simply hire every non-Jewish engineer and person it needed from MIT instead of a private corporation not officially affiliated with the university, but very obviously was doing the same business.

I was trying to assess the threat of that and how much leverage they have. That is pretty much the article.

Senator BYRD. Let me ask you this. Senator Wallop's proposal deals primarily with the problem of farmland or real estate. In your investigations, do you find that the Arab investor is more interested in real estate, or is he more interested in, as you mentioned, banks or shares of other large corporations.

Mr. LEVINS. Senator, one of the biggest problems I have found, in direct answer to your question—I do not know the answer to that, nor does the Assistant Secretary of the Treasury, nor is it my understanding, according to any of the reports I have, does any

Member of Congress because the laws do not allow for the Congress or the Treasury or the Commerce Department or even the White House to collect in a systematic way just the basic information about which foreign countries, be they Arab or otherwise, own anything anywhere.

I do not know. I do not know if anyone else in the city really knows.

That is one of the scarier things that I found.

Senator BYRD. Thank you.

Senator Wallop?

Senator Wallop. Thank you, Mr. Chairman.

Mr. Levins, in your article you make a number of controversial points relating to investments by individuals in Arab countries. Have you any specific examples of Arab investments in agricultural lands or other U.S. real estate?

Mr. LEVINS. Specific investments in real estate, I know the Khashoggi has various investments in California. I cannot list them off the top of my head.

I do have a list of those investments. I know Kuwait bought real estate and cattle farms in Idaho. I know that Libya has been doing a lot. I am not sure you are including agricultural projects, wheat and et cetera, but the Libyans, for the last 2 years, have been buying up substantial items throughout Idaho in what appears to be an attempt to overthrow Senator Frank Church, and I deal with that because it is so unusual. It seems to be the first time that a major U.S. Senator or Congressman will be running for office, not against another candidate so much as against a foreign power whom he has displeased.

I understand the Idaho Farm Bureau has been dealing with the Libyans. They may be able to supply more specifics on locations and properties and direct quantities to date as to who bought what.

Senator WALLOP. I have a hard time understanding that the purchase of agricultural products that would be an attempt to overthrow a U.S. Senator. We will leave that for another time.

Mr. LEVINS. I can give you a short explanation on that. As best as I understand it.

Senator WALLOP. The important thing is whether or not their activities are taking advantage of the so-called loopholes that have been identified in this bill.

Mr. LEVINS. I am not specifically—what I was simply asked to comment on here was the basis of my article, not because I know—I was not even familiar with your bill, nor am I familiar with taxation. The request was that I come and answer questions about the broad range of things that I found.

I cannot speak directly to your bill, Senator.

I can speak to the other point you raised; that is, particularly in an isolated State like Idaho, where there are only 800,000 people and the most powerful political group appears to be the 22,000-member Idaho Farm Bureau, I think that it is clearly evident when a foreign power comes in and promises that Farm Bureau, that most powerful body, that it will buy virtually everything it makes at higher prices than it has been getting, that that foreign country immediately acquires an enormous amount of clout in that isolated State that it can use in a number of political ways.

I am suggesting that that is going on in Idaho right now.

Senator WALLOP. In your research, have you found that Arab investors, in whatever kinds of properties, channel their funds through tax treaty countries such as the Netherlands Antilles or the British Virgin Islands, or do they invest directly?

Mr. LEVINS. A good deal of what I found involved that very thing, not just one country but, in fact, this occurred in 1974 and 1975.

The subcommittee investigation I alluded to in which there seemed to be a national feeling that maybe we had better know more about this and Congress began to look at it. After that point, the investments seemed to change. Instead of directly, as Khashoggi and some of the others would come in and directly buy a number of companies set up in Luxembourg and a number of Arab banks which connected with those companies, they set up subsidiary in the Netherlands Antilles. They set up American subsidiaries or bought in through portfolio investments to companies in America.

Exactly how much of that has been done, no one knows, because no one has access to portfolio investment identity. There is even another congressional subcommittee, under Senator Metcalf, I believe, who attempted a few years ago to find that very thing, just to find out from banks how much foreign influence was involved in stock purchases and holdings. They were unable to do so.

I do not know. I do not know that anybody else knows either.

Senator WALLOP. Thank you.

Senator BYRD. What Senator Wallop's proposal seeks to do and what the committee is exploring is what is regarded as a need to correct the preferential tax treatment which is now being given foreign investments, particularly in agricultural land.

I assume that, as a matter of policy or as a matter of principle, you would favor that principle?

Mr. LEVINS. Yes, I would, Senator, although I would see it as rather generating money or providing equity in terms of agriculture. I would see it as a first step in what I see as a real problem, and that is a total lack of information.

I am assuming that taxation of that sort would require a sort of collection of information about who owns or has invested in once so that they may be taxed for that.

That information and the compilation of that is more important to me than the actual money or the equity in agriculture, foreign investments versus the domestic American investments.

The information seems to be the biggest problem in this whole thing.

Senator BYRD. I would agree with you that I would like to see a great more information available than is available. Thank you.

Mr. LEVINS. Thank you.

Senator BYRD. The next witness is Mr. George L. Ball, chairman, Committee on Capital Formation and Tax Policy; and Nicholas A. Rey, chairman, International Committee on Behalf of the Securities Industry Association.

We are glad to have you, gentlemen.

STATEMENT OF GEORGE BALL, CHAIRMAN, COMMITTEE ON CAPITAL FORMATION AND TAX POLICY, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY NICHOLAS A. REY, CHAIRMAN, INTERNATIONAL COMMITTEE, SECURITIES INDUSTRY ASSOCIATION

Mr. BALL. Thank you. I am George Ball, president of E. F. Hutton Co. and chairman of the Securities Industry Association's Committee on Capital Formation and Tax Policy. Maybe you know E. F. Hutton's motto: "When E. F. Hutton talks, people listen." You notice Hutton does not actually say anything in that commercial. Today will be an exception to that rule of ours.

With me today is Mr. Nicholas Rey. Nick is part of that admirable, bullish on America, thundering herd, Merrill Lynch. His formal title is managing director of the Merrill Lynch White Weld Capital Markets Group, which is quite a mouthful. He is also chairman of the SIA International Committee.

Senator BYRD. E. F. Hutton and Merrill Lynch together.

Mr. BALL. One of the few times that we are really together. We do appreciate this opportunity to comment on legislation affecting the taxation of foreign investment. I would like to say at the outset that foreign ownership of U.S. farmland is a subject outside our sphere of expertise. SIA does not have a position on this issue. But we do understand the effects of investment and investors on the economy.

In this regard, it is quite clear that foreign investment in shares of U.S. companies clearly promotes capital formation, productivity and job creation, and helps to reduce inflation, lower interest rates and the U.S. balance-of-payment deficits. I would like to ask Nick Rey to outline the importance of foreign portfolio investment to our economy and capital markets.

Thank you.

Mr. REY. Mr. Chairman, foreign investors, primarily Europeans, have become a major source of funds in the U.S. equity markets over the past 10 years. Foreigners have been net purchasers of U.S. shares in every year and their average annual net purchases have been $2.1 billion. Last year, their net purchases amounted to $2.4 billion.

Foreign transactions are essential to the depth and liquidity of the U.S. securities markets. From 1970 to 1978, foreign activity accounted for 8 percent to 11 percent of all public activity on registered securities exchanges annually. In 1978 alone, foreign purchases and sales amounted to just under $38 billion, an alltime record, and were almost $13 billion higher than the previous year.

Today, domestic institutions favor long-term commitments to bonds and other fixed-income securities instead of equity investments. For example, only slightly more than one-half of the total assets of private noninsured pension funds are now invested in equities compared to almost 75 percent at year-end 1972. For mutual funds, life insurance companies, and property-liability companies, the pattern is much the same.

This explains to a great extent the increased relative importance of foreign investors to the U.S. equities markets. Whereas foreign portfolio investment was about 4 percent of total net inflows into the U.S. equity markets in 1971, this percentage shot up to over 40 percent in 1975 and was 37 percent during the first 9 months of 1978.

Needless to say, any reduction in the interest by foreign investors in U.S. equities would serve as a major depressant on the stock market. A withdrawal by foreign investors would represent a crippling blow to the stock market, especially in light of the relatively uninterrupted net selling by individuals and the continued disenchantment of institutional investors with stocks.

Based on Treasury benchmark data for year-end 1974, and after adjusting for price changes and flows during the 1974-78 time period, we estimate that private foreign investors held $44.7 billion in equities by year-end 1978.

Enactment of S. 192 would seriously and adversely affect the U.S. economy.

With decreasing capital inflows caused by reduced foreign investment, the economy would be unable to expand without increasing inflationary pressures.

U.S. capital spending on new plant and equipment as well as research and development has been depressed in real terms. Nonresidential fixed investment as a percentage of GNP is now at the lower end of its historical range and productivity has been cut in half during the past decade. Repeal of the capital gains exemption for foreign investors would decrease the capital available to U.S. business which, in turn, would increase the cost of capital and decrease investing in plant and equipment.

The Conference Board estimates that almost $32,000 of new capital is required to create one job. While precise estimates cannot be made, reduced foreign investment will adversely affect job creation.

More importantly, the attractiveness of U.S. securities markets to foreign investors is essential in recycling for a productive domestic use some of the hundreds of billions of dollars in the Euromarkets.

Mr. BALL. S. 192 would impose a U.S. tax on capital gains realized from the sale of securities, domestic or foreign, on a U.S. stock exchange by a foreign investor. Such a drastic modification of exiting law would cause great disruption in and a withering of the U.S. securities markets. S. 192 would shift securities transactions from United States securities markets to those in London, Montreal, Tokyo, Toronto, Zurich, and other foreign cities.

The recent Department of Treasury report, "Taxation of Foreign Investment in U.S. Real Estate," notes that since 1936 the United States has generally not taxed the capital gains realized by foreign investors on their passive investments in our country. Indeed, a declared policy of the Foreign Investors Tax Act of 1966 was to encourage foreign investment in our country.

Moreover, most existing tax treaties to which the United States is a party contain provisions generally reserving to the country of residence the right to tax capital gains. Most countries do not assert tax jurisdiction over capital gains realized by foreign investors from passive portfolio investments.

Thus, if S. 192 were to be enacted, the United States would put itself at an increased disadvantage relative to competing nondomestic investment opportunities in other nations which do not tax the capital gains of foreign investors. In short, SIA opposes S. 192

because its application to securities is contrary to international tax law, detrimental to the Nation's economy, and would irreparably damage the U.S. capital market.

For many of the same reasons for which SIA opposes S. 192, we have long advocated repeal of the withholding tax on interest and dividends received by foreigners from U.S. portfolio investments. Elimination of these taxes would bring about an estimated $7 billion a year in additional purchases by non-U.S. individuals and entities of American companies' fixed-income securities and yield-oriented shares.

S. 208 is clearly and primarily focused on foreign investment in U.S. farmland. However, as drafted, it would tax that portion of a capital gain realized by a foreign party which is attributable to appreciated farmland. The notion of taxing even a portion of the capital gains realized by foreign investors from the sale of securities has much broader implications than farmland per se.

Rather than adopt a tax policy contrary to general international practice and disadvantageous to investment in all securities, we urge the committee to explore alternate means of dealing with foreign investment in U.S. farmland, including those outlined by the Treasury.

In summary, in summarizing his letter transmitting the Department's report, Secretary Blumenthal stated, "The Treasury does not believe that taxing capital gains on the sale of corporate shares is desirable or practical." We summarily second his sound sentiments.

We would be very happy to answer any questions.

Senator BYRD. Thank you, gentlemen.

As I understand it, you strongly oppose S. 192?

Mr. BALL. Yes, sir.

Senator BYRD. In regard to the taxing of farmland, applying a capital gains tax to the gain on the sale of farmland, you do not oppose that?

Mr. BALL. We would oppose it if it is done through taxation of a capital gain from the sale of shares generally. In other words, the bill as initially drafted.

We think that the proposals outlined by the Treasury, or other means, such as those suggested by the panel of attorneys testifying this morning would diminish or reduce our problems.

Senator BYRD. So Senator Wallop's bill, if it could be modified in some degree would not prevent the problem, from your point of view, that you forsee if it is kept in its present form? Is that it?

Mr. BALL. As you know the SIA often testifies against things. I think, with proper modifications, we could find ourselves in the happy paradoxical position of supporting a bill.

I would say that we would like to see some grandfather language so that people who previously have invested do not have the ground rules changed. The actual drafting, the Treasury's recommendations, we saw for the first time today. They seemed to have a good thrust to them.

Obviously we want to study them more, but away from that hedge language, yes, it is something we could support.

Senator BYRD. Treasury's proposal, generally speaking, improves, from your point of view, the Wallop bill?

Mr. BALL. At first blush, yes, they would appear to improve the bill. We really would like to look at them. The thrust that they are taking, the direction they are taking, certainly seems to be sensible.

Senator BYRD. Thank you.

Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman.

Do not blush too often. I think that it would solve the problem and I want to assure you that it is not my intent, at any level, to attack or to jeopardize foreign portfolio investment or any foreign investment in this country. I approve of it.

But your main concern with S. 208 is the provision in the bill which calls for the taxation of capital gains on the scale of corporate stock. As I understand it, you fear that that action, the limited scope, would be interpreted by foreigners as a signal from the United States that Congress would soon begin taxing portfolio investments. Could you comment on negotiating reciprocal agreements on the shares, as Treasury suggests, and if that action would not indicate that Congress does not want to tax portfolio investment?

Mr. REY. Senator, I think that such negotiations should be very limited in scope and conducted under rules clearly defined by the Congress as applying only to sales of farmland. That is something that we could not object to. That would be sensible.

Senator WALLOP. I think that you might agree with the panel of tax experts or tax attorneys that the effective date of the act ought to grandfather most investments if not all—perhaps a date like June of this year, about the time the thing begins rolling, so that poeple have a signal that this may be coming.

Mr. REY. That is right, Senator. I think that one of the things many foreigners look to the United States for is its fundamental stability of its regulations and policies. It would be important to treat them fairly in that sense, yes, sir.

Senator WALLOP. I do not have any argument with that. The purpose is not to penalize somebody but to eliminate an advantage in land and real estate generally that is not available.

Mr. BALL. As to the grandfather date, I am not sure that there is general awareness as to the applicability of this bill to possible assets other than farmland rural real estate. So I think you may want a later date as an effective data than today.

Senator WALLOP. I imagine that after today there will be greater awareness sweeping through the country.

Mr. BALL. Yes, sir.

Senator WALLOP. I appreciate your testimony. I wonder if you would take a look at the Treasury proposal.

Mr. BALL. We certainly will do that.

Senator WALLOP. And please submit to the committee whatever ideas or concerns you have about it. Your concerns will be taken into consideration and answered.

Mr. BALL. We certainly will do that, and will appreciate the opportunity to do so.

Senator WALLOP. Thank you.

Senator BYRD. Thank you, Mr. Ball and Mr. Rey. We are pleased to have you.

[The prepared statements of Messrs. Ball and Rey follow:]

Statement of George L. Ball, President, E. F. Hutton & Co.

I am George L. Ball, President of E. F. Hutton & Company, Inc. and Chairman of the Securities Industry Association's Committee on Capital Formation and Tax Policy. Accompanying me today is Nicholas A. Rey, Managing Director, Merrill Lynch White Weld Capital Markets Group, and Chairman of SIA's International Committee.

The Securities Industry Association represents almost 500 securities firms headquartered throughout the United States and Canada and is the industry's spokesman. Its members include securities organizations of virtually all types--investment bankers, brokers, dealers, and mutual fund companies as well as specialists and other firms functioning on the floors of exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America.

We appreciate this opportunity to comment on legislation affecting the taxation of foreign investment. At the outset, it should be acknowledged that the securities industry's expertise on foreign investment in general is greater than its familiarity with the foreign purchase and control of U. S. farm land. We are not here to comment on, nor does the SIA have a position on, the issue of foreign ownership of farm and rural land. This is a matter outside our sphere of expertise. On the other hand, we do know investments, investors and the economy.

In this regard, foreign investment in shares of U. S. companies clearly promotes capital formation, productivity and job creation, and helps to reduce inflation, interest rates and U. S. balance of payments deficits. If Congress concludes that sound public policy requires a change in the tax treatment of gains realized by foreign investors on the sale of U. S. farm lands, the legislative remedies addressing this concern should be drafted to avoid undermining the positive effects of foreign portfolio investment. Indeed, international tax practice serves as an important guide in recognizing the distinction between investment in real estate and in securities.

The Importance of Foreign Portfolio Investment

Foreign investors, primarily Europeans, became a major source of funds in the U.S. equity markets starting with 1968. Heavy net purchases continued through 1969 as European investors were joined by offshore mutual funds. After sharply reducing their activity in U. S. equities during 1970 and 1971, foreign net purchases of stocks, principally from Europe, amounted to $2.2 billion and $2.8 billion in 1972 and 1973, respectively. As the stock market plunged in 1974, these purchases fell to $540 million.

Foreign investors played a significant role in the U. S. equities markets during 1975 and 1976. The reasons for their decisions to place massive amounts of funds into the U.S. equity markets were straightforward: The strength of the U. S. dollar in 1975 and 1976; a recession in Europe and Japan; and low interest rates in U. S. government securities.

In 1977 and 1978, the appetite of foreign investors for U. S. securities waned. Foreign net purchases amounted to $2.7 billion in 1977, and fell to $2.4 billion in 1978 (see Table I), largely reflecting the slumping U. S. dollar and the woes which caused its weakness.

TABLE I

FOREIGN TRANSACTIONS IN U.S. EQUITIES
($ Millions)

Year	Gross Purchases	Gross Sales	Net Purchases
1968	$13,118	$10,848	$2,270
1969	12,429	10,942	1,487
1970	8,927	8,301	626
1971	11,626	10,894	731
1972	14,361	12,173	2,188
1973	12,767	9,978	2,790
1974	7,636	7,096	540
1975	13,355	10,678	4,678
1976	18,227	15,475	2,753
1977	14,154	11,479	2,675
1978	20,069	17,699	2,370

Source: U.S. Treasury

Foreign Transactions in Equities

Whereas net foreign purchases of U. S. equities continued downward in 1978, gross foreign activity (purchases and sales) spurted dramatically. Foreign purchases and sales amounted to just under $38 billion, an all-time record, and were almost $13 billion higher than the previous year. Activity from Europe continued at a vigorous rate and, as usual, accounted for the bulk of gross foreign activity. Total activity in U. S. equities rose dramatically in several major European countries. The change was particularly noticeable in France, Germany, Switzerland and the United Kingdom, where gross purchases and sales rose sharply in 1978 relative to 1977.

From 1970 to 1978, foreign activity as a percentage of all activity on registered securities exchanges ranged from a low of about 6% to a high of over 8.5%. However, foreign activity as a percentage of total public activity is considerably greater. If professional trading were excluded from the volume figures, the foreign proportion as a percentage of total public participation would be approximately 8% to 11%. This demonstrates the importance of foreign transactions to the depth and liquidity of the U. S. securities markets.

Importance of Foreign Investors to Stock Prices

In the late 1960's and early 1970's, purchases of fixed income securities by domestic institutions were short-term, acting as a transitory harbor for funds subsequently committed to the equities market. Today, institutional investment programs are once again favoring long-term commitments to bonds and other fixed-income securities as compared to equities.

For example, only slightly more than one-half of the total assets of private non-insured pension funds are now invested in equities compared to almost 75% at year-end 1972. For mutual funds, life insurance companies, property-liability companies and individual investors, the pattern is much the same. This explains to a great extent the increased relative importance of foreign investors to the U.S. equities markets. Whereas foreign portfolio investment ranged from a low of about 4% of total net inflows into the U. S. equity markets in 1971 to a high of almost 21% in 1973, this percentage shot up to over 40% in 1975 and has not fallen lower than 23% since then.

Needless to say, any reduction in the interest by foreign investors in U. S. equities would serve as a major depressant on the stock market. The exemption from capital gains taxes has attracted foreign investors into those securities with low yield, but a favorable probability of capital appreciation. Without substantial foreign investment, stock prices will fall, making equity capital even more expensive and difficult to raise than it has been in recent years. A withdrawal by foreign investors would represent a crippling blow to the stock market, especially in light of the relatively uninterrupted net selling by individuals and the continued disenchantment of institutional investors with stocks.

Table 2

FOREIGN PARTICIPATION COMPARED TO INSTITUTIONAL PARTICIPATION IN U.S. EQUITIES ($ Millions)

Net Purchases By:	1965	1970	1975	1976	1977	First Nine Months of 1978
Private Pension Funds	$3,030	$4,585	$5,714	$7,046	$4,522	$2,645
Mutual Funds	1,365	1,225	(1,195)	(2,550)	(3,506)	(1,059)
Life Insurance Companies	390	1,795	1,152	2,024	500	(514)
Property & Casualty Insurance Companies	(185)	890	(1,003)	610	650	850
State and Local Retirement Systems*	n.a.	2,137	2,048	2,282	2,478	1,417
Foreign Investors	(413)	626	4,672	2,731	2,664	1,936
Total Net Inflows	4,187	11,258	11,394	12,165	7,308	5,275
Percentages Accounted for by Foreigners		5.6%	41.1%	22.6%	36.5%	36.7%

* Book value

Sources: SEC, U.S. Department of Commerce and U.S. Treasury

Aggregate Amounts Held by the Private Foreign Sector

Based on Treasury benchmark data for year-end 1974, and after adjusting for price changes and flows during the 1974-78 time period, we estimate that private foreign investors held $12.9 billion in corporate bonds and $44.7 billion in equities at year-end 1978. Excluded from these figures is the large amount of U. S. Treasury securities held mainly by foreign government agencies, although some of these instruments are held by the private sector as well. The equity figure equals 5.6% of the dollar value of all common stocks listed on the New York Stock Exchange.

Repercussions from S.192

We believe that S.192, by imposing significant new tax burdens on foreign investors in the United States, would have the effect of seriously diminishing the flow of investment funds into the United States at a time when they are needed most. S.192 would by its terms tax all capital gains derived by foreign investors from sources within the United States. This would encompass far more than gains from farm or real estate investment. For example, under the source rules presently contained in the Internal Revenue Code, a capital gain realized from the sale of securities on a stock exchange located within the United States is considered U. S. source. Thus S.192 would impose U. S. tax on capital gains realized from the sale of securities (domestic or foreign) on a U. S. stock exchange by a foreign investor. Such a drastic modification of existing law would cause great disruption of the U. S. securities markets.

The Foreign Investors' Tax Act of 1966 (Pub. Law 89-809) spelled out very detailed and careful rules for the application of the United States income laws to non-resident aliens and foreign corporations. A declared policy of that Act was to encourage foreign investment in the United States by providing income tax rules for foreigners that would be fair and would promote foreign investment in the United States. The present rule of Internal Revenue Code Section 871 (a) (2) for applying the United States tax to capital gains of foreigners derives from the 1966 law. As stated by the Senate Finance Committee:

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

S. 192 would shift securities transactions from United States securities markets to those in Toronto, Montreal, London, and other foreign cities. Thus, this legislation cannot conceivably produce revenue for the United States Treasury except when an unwary foreign investor continues to sell securities in the United States. What useful purpose then, is served by shifting this business and employment from New York and other American cities to exchanges in major foreign cities?

Enactment of S. 192 would have the following adverse effects on the economy:

1. <u>Inflation</u>

   Last year, inflation rose by about 9% and is now galloping along at a double-digit rate. With decreasing capital inflows caused by reduced foreign investment, the economy would be unable to expand without increasing inflationary pressures. Employment would decrease and so would national income and profits. Such an economic slowdown would lead to higher spending on federal assistance programs as well as lower tax revenues. The federal deficit would be

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* Senate Finance Committee Report No. 1707, 89th Cong., 2d Sess.; I.R.B. 1966-2. P. 1064 (policy and p. 1075 addressed to present IRC Section 871 (a).

increased, thereby exacerbating what may observers believe to have been a major cause of inflation in this nation in recent years.

2. Capital Formation

Even a nation as richly endowed as the U. S. has been unable to stretch its economic resources to meet all desirable goals. For one thing, capital spending on new plant and equipment as well as research and development has been depressed in real terms. After reaching a relative high of 10.7% in 1973, non-residential fixed investment as a percentage of GNP (all expressed in constant dollars) is now at the lower end of its historical range. This has led to a slowdown in productivity gains which have been cut in half during the past decade. Repeal of the capital gains exemption for foreign investors would decrease the capital available to U. S. business which, in turn, would increase the cost of capital and decrease investing in plant and equipment .

3. Jobs

The Conference Board estimates that almost $32,000 of new capital is required to create one job. While precise estimates cannot be made, reduced foreign investment will adversely affect job creation.

4. Health of the Dollar

Less investment from abroad would weaken the dollar and hurt our balance of payments. In 1977, the U. S. current account balance plunged to a negative $15.3 billion and increased to a $16 billion deficit during 1978. Such deficits have led to a weaker dollar, a loss of confidence in dollar denominated assets and higher inflation. A tax on capital gains realized by foreigners would decrease capital inflows, causing the U. S. balance of payments to deteriorate further, and thereby weaken the dollar even more.

Foreign portfolio investment has been an important offset to our ever increasing outlays for foreign oil. More importantly, the attractiveness of the U. S. securities markets to foreign investors is essential in recycling for productive domestic use some of the hundreds of billions of dollars on deposit in the Euromarkets.

S. 192 Is Contrary to International Practice

The recent Department of Treasury report, "Taxation of Foreign Investment in U. S. Real Estate," contains a very useful analysis of the issue under discussion. As noted in the Treasury report, since 1936 the United States has not taxed the capital gains realized by foreign investors on their passive investments in the United States (i.e., investments not involving the active conduct of a trade or business within the United States), with a few very limited exceptions.

Moreover, many existing tax treaties to which the United States is a party, as well as the U. S. and OECD model tax treaties, contain provisions generally reserving to the country of residence the right to tax capital gains, again subject to certain exceptions, including gains on the sale of real property. Appendix B of the Treasury report explains that most countries do not assert tax jurisdiction over capital gains realized by foreign investors from passive investments other than real estate. Thus, the United States would put itself at an increased disadvantage relative to competing opportunities for investment by imposing a tax on capital gains of foreign investors. In short, SIA opposes S.192 because its application to securities is contrary to international tax law, detrimental to the nation's economy and would irreparably damage U. S. capital markets.

Foreign Withholding Taxes

For many of the same reasons for which SIA opposes S. 192, we have long advocated repeal of the withholding tax on interest and dividends received by foreigners from United States portfolio investments. Elimination of these taxes would stimulate a conservatively estimated $7 billion in dollar flows back to the United States by making fixed income securities and yield-oriented shares attractive investments for foreigners. These withholding taxes, which now are as high as 30%, act as an effective impediment to potential investment from abroad.

The withholding tax already has been removed from foreigners' interest-bearing bank deposits (including Certificates of Deposit) or such other short-term investments as commercial paper and U. S. Treasury bills. Not only does this discriminate in favor of one savings and investment vehicle at the expense of others, it also favors short-term investments by foreigners at the expense of more stable long-term debt and equity investments.

The revenue loss to the Treasury from repeal of the tax on interest would be insignificant -- the tax produced only $21 million in 1976. Bonds purchased by foreigners in the U. S. represent only a fraction of their potential investment in these instruments as illustrated by the steady decline of such purchases relative to purchases abroad of U. S. dollar denominated Eurobonds. The revenue loss from repeal of the tax on dividends ($271 million* in 1976) should be more than offset by increased domestic income tax revenue stemming from the stimulative effect on our economy resulting from greater foreign investment.

Two large investment bankers--Merrill Lynch and Morgan Stanley--have prepared estimates of the potential capital inflow if foreign withholding taxes were repealed. Merrill Lynch surveyed the managers of its worldwide office network and concluded that $7 billion in the U. S. portfolio investments could be expected within a year or two of repeal. Merrill Lynch estimates the shift into U. S. bonds at $4.7 billion and into equities at $2.3 billion. Morgan Stanley surveyed key institutional investors abroad and concluded that $7 billion of Eurodollar bond portfolios could shift into U. S. bonds; investment in U. S. equities could increase by 10% to 15%. Since neither study takes into account possible shifts out of other

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*The $271 million includes $34 million in inter-corporate dividends. Elimination of the withholding tax on foreign portfolio investment would not affect this $34 million in tax revenue.

currency or short-term dollar investments, the estimates may well be too low.

Drawbacks to S. 208

S. 208, while more narrowly focused on the tax treatment of foreign investment in U. S. farmland, also contains features which gravely concern the members of this Association. Of primary concern is that capital gains realized on a sale of corporate stock (or other form of equity interest) by a foreign investor would be subject to U. S. tax. While this provision would apply only to that portion of the gain which is attributable to appreciated farmland, the concept of taxing capital gains realized by foreign investors on the sale of securities has much broader implications. Foreign investors may view enactment of S. 208 as a signal that the fundamental rules of the game are changing, that the United States no longer welcomes foreign portfolio investment. This could lead to anticipatory capital outflows as foreigners come to fear that the next step will be to tax capital gains on all securities.

The Treasury report states that "taxing capital gains on the sale of corporate shares would not be justified by general international practice and would, in fact, run contrary to U. S. tax treaties." Furthermore, enforcement of the withholding requirement would seem to be a difficult--if not impossible--task, especially in the case of a taxable sale of shares occurring outside the United States between two foreign investors. Rather than adopt tax policy contrary to general international practice and disadvantageous to investment in all securities, we urge the committee to explore alternate means of dealing with the problem of indirect purchase of farmland through holding companies or other entities formed to make land purchases.

Conclusion

We acknowledge that Congress may want to equalize the U. S. tax treatment of domestic and foreign investors in U.S. farmland. We strongly feel, however, that measures that would accomplish this objective by imposing a U. S. tax on capital gains arising out of transactions in securities, or requiring withholding of tax where it is not now required, would be counterproductive.

In his letter transmitting the Department's report, Secretary Blumenthal stated, "The Treasury does not believe that taxing capital gain on the sale of corporate shares is desirable or practical." We concur.

Senator BYRD. The final witness is Mr. Bryon L. Dorgan, State tax commissioner for the State of North Dakota.

Welcome, Mr. Dorgan.

STATEMENT OF BYRON L. DORGAN, STATE TAX COMMISSIONER OF NORTH DAKOTA

Mr. DORGAN. Thank you, Mr. Chairman. I have some copies of the testimony that I have prepared.

I appreciate your hearing me. I intend, rather than to read the testimony just to make a couple of brief remarks.

Senator BYRD. Yes, and your testimony will be published in full, and you can summarize it.

Mr. DORGAN. Let me indicate first that I am a statewide elected official in North Dakota, but my principal area of interest is not in the agricultural area. I am the State tax commissioner.

However, in the process of involving myself in a number of tax issues in recent years, we have come across some interesting insights into the process by which this country has negotiated tax treaties with foreign countries.

I was one of several tax administrators from around the country who was nearly a permanent pen pal of Mr. Lubick and Mr. Blumenthal through the last 18 months on the subject of the United States-United Kingdom tax treaty that you turned down in the U.S. Senate until it was modified.

In fighting that United Kingdom tax treaty, I filed a freedom of information request with the Treasury Department to find out who they had discussed the tax treaty with during its negotiation and we found that, probably without much surprise that the Treasury Department had had fairly close contact with multinational corporations in developing this tax treaty with the United Kingdom, despite the fact that they had no contact with State governments, part of whose tax base they were spending while negotiating that tax treaty.

We discovered that that tax treaty, like many other tax treaties with other countries, would, in effect, give preferences to persons who wished to invest in this country in certain ways, and could have created preferences for those who would invest in farmland. And I think that the pressures on the family farm in America are substantial enough without having to develop tax policy that would give incentives to foreign interests to purchase farmland at a price higher than the price the American family farmers could pay for that land.

Senator Wallop indicated a couple of minutes ago that one of the previous witnesses suggested that this legislation might be to prevent or to discourage foreign investment in farmland. He indicated he did not think that was the intent.

I am here to say that I think that that ought to be the intent. I am here to certainly support your bill, Senator Wallop. I think it is a step in the right direction, but I think, in fact, that we should discourage foreign investment in American farmland.

Our State just passed a bill in the last legislative session earlier this year that prevents foreign ownership of North Dakota farmland. We have legislation in North Dakota that has been on the books for many years that prohibits a corporation from owning farmland in this country.

It seems to me if we back up again toward the general policy area, while still recognizing the balance-of-payments problem and various investment problems, we must consider what is good public policy in the agricultural sector. All of us ought to understand, I think, that Thomas Jefferson's statement, "the small landowners are the most precious part of the state," is still true. And yet the Federal Government, through its tax code discourages farming and encourages the concentration of farmland ownership and corporate farming and foreign investment in farming.

Five percent of the people produce food for the other 95 percent of the people in this country. Fifty-three percent of all the agricultural receipts are received by 6 percent of the farmers. Thirty percent of all the agricultural program benefits in this country accrue to 5 percent of the largest farmers.

You probably are well aware of all those statistics. I guess my message is that they certainly support what Senator Wallop and others are trying to do in this legislation, but I would like to say I think it is too timid. I think we need a bolder approach to dealing with the basic issue of how we encourage and enhance family farming in this country. We cannot encourage and strengthen family farming by continuing to say if you have two persons engaged in the use of farmland, one driving a tractor and planting corn making $20,000 in income, and the other buying and selling farmland for speculative investment purchases, that the one driving the tractor will pay twice as much in Federal income tax as the one who is buying and selling for investment purposes.

That is the counter to the policy and goal of supporting the family farmer.

I have additional written testimony that I have submitted to the committee. I would like to enter it into the record.

Senator BYRD. Thank you, sir.

You support Senator Wallop's proposal, but you feel that it does not go far enough, but it is a good first step, in your judgment?

Mr. DORGAN. Yes, indeed.

Senator BYRD. Let me ask you this. Speaking generally, what is the prevailing price of farmland in North Dakota today?

Mr. DORGAN. Well, it ranges to extremes, because we have some of the most productive land in the world in the Red River Valley which is useful for sugar beet farming, and so on—$1,400 and $1,500 an acre, to the ranchlands in western North Dakota which, in some cases, are at a low of $100 to $125 an acre.

American farmland has become a very attractive investment and Petrodollars will come back in megabuck proportions to invest in American farmland unless something is done about it, because the increase in value in farmland has made it one of the best investments that one can make in America.

The pressure will increase on the family farmer because of other persons who want to enter the market, not only farmers, but those off-farm investments who would like to buy a quarter-section or a half-section of land in this country.

Senator BYRD. I had lunch Saturday with several key economists, several financial experts, and the consensus seemed to be that the price of real estate and farmland now has topped out and probably from here on there will certainly be no increase and probably a reduction in value.

Have you gotten any indication of that in North Dakota?

Mr. DORGAN. Well, I know a fellow who has been in the realty business for 40 years and he has been saying that for 40 years, and he has been wrong for most of those years. He keeps saying "the price ain't going to go any higher."

I would like to mention I used to teach economics and I think you used a contradiction in terms. I do not think there are any "key" economists. I think there are only economists.

I beg the indulgence of the economists listening.

It seems to me that, once again, the pressures on farmland prices are going to continue in this country unless we in the States and you at the Federal level develop programs that discourage concentrations of corporate ownership of farmland as well as discouraging foreign investments.

I proposed in North Dakota a 30-page booklet describing a graduated land tax.

A recent poll in North Dakota showed that 57 percent of the people in North Dakota supported a graduated land tax, saying when you want to buy the 101st quarter of a section of land, you had better be prepared to pay a fairly high marginal tax in order to own it.

You can own it, if you like, but we want tax policies designed to discourage large concentrations. We have to begin doing some of those bolder things in the area of public policy if we really are going to preserve the family farm.

Senator BYRD. Thank you.

Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman.

Let me begin by saying that I do not disagree with the statements you make on the need to preserve the family farm. The jurisdiction within this committee is limited, particularly on this type of thing.

We feel we are making a step in the right direction, but there are a variety of attitudes within the States in this country as to the nature of the extent of the reporting requirements for, and other elements of foreign investment.

It seems to me that the Federal position with regard to taxation, which is what we are dealing with here, ought to be a matter of equity. The States, North Dakota, Wyoming, Iowa, ought to determine for themselves the laws they want.

This is sort of basically a States rights issue. Have you any quarrel with that?

Mr. DORGAN. I do not have any particular quarrel with it. From the Federal standpoint, however, I do want to reiterate, that two people engaged in the use of farmland, one to plant corn and one to use for speculative investment purposes and the one planting corn is paying twice the Federal income tax on the dollar, I think that says something about how various persons are encouraged to buy or not buy farmland for speculative purposes.

Senator WALLOP. One of the purposes of this bill is to remove, at least, the speculative advantage which is significant as demonstrated by the chart before us and is even more apparent just because of the purchasing patterns permitted in this country for equity in the initial purchase price.

Certainly it is not within the scope of this committee, and maybe not within the scope of Congress to dictate to the States who may or may not own property. I agree that there is a speculative advantage. What we are trying to do is to equalize that, and I think the Treasury recommendations will deal effectively with the speculative advantage that you perceive regarding income versus holding and gains.

In North Dakota, do you have reporting requirements as to who has total ownership of a given corporate? You cannot have a corporate entity?

Mr. DORGAN. We have an anticorporate farming law which prevents corporations from farming.

Senator WALLOP. Do you have a law preventing foreign investments?

Mr. DORGAN. We do now. Yes.

Senator WALLOP. Has that been tested?

Mr. DORGAN. No, it has not.

Senator WALLOP. Has it been challenged?

Mr. DORGAN. Some people have suggested, of course, that it should be challenged. It has not been challenged.

Senator WALLOP. It has not been yet.

Mr. DORGAN. I expect that it will be challenged at some point. I think most of the constitutional scholars that discussed it with the legislators decided that it was constitutional.

Senator WALLOP. With consideration to treaties, among other things—I do not think it is appropriate to engage in some kind of a prohibition against foreign ownership, but the equalization of the tax circumstances between American owners, investors or otherwise, and foreign owners is probably the most appropriate place we could head.

Mr. DORGAN. That is right. I understand the public policy consequences on the other side of foreign investment in the United States and the need for the balance-of-payments considerations. All I am saying, I guess, and the reason I wanted a chance to speak to the committee is, that there needs to be a less timid approach in moving toward a solution of some of these problems than the committee exhibits from time to time.

I appeared before the committee several times over the last years and I understand, for example in the oil industry situation, the committee has been very generous in using the tax code to either encourage or discourage certain kinds of things.

I am saying I want to encourage you to do the same kinds of things with respect to the goal of family farming because I think that the family farm is not an inefficient economic unit any longer. It is not inefficient at all. The efficiencies of the large farms are largely paper efficiencies. They externalize much of the cost.

But most of what we do in Government in our tax code and our basic agricultural policies are not geared to sustain the family sized farms. The preponderance of the benefits go to the largest of the farmers.

Senator WALLOP. I do not disagree with that, but I would not advocate using the tax code as a means of prohibiting ownership of farmland.

Mr. DORGAN. I agree with you. I do not like the tax code to be used as a clothes hanger to do everything we think is good, except that it has been for a long time in many areas and it has been very lucrative to a number of industries. I am suggesting if we do continue that, we ought to make it lucrative for the family-sized farms.

There is an area of encouragement that would be very productive for us in the area of public policy.

Senator WALLOP. I appreciate the testimony and I do not disagree.

I thank you, Mr. Chairman.

Senator BYRD. Thank you.

[The prepared statement of Mr. Dorgan follows:]

STATEMENT OF BYRON L. DORGAN, TAX COMMISSIONER, NORTH DAKOTA

Mr. Chairman, members of the Finance Committee: I have asked for the opportunity to testify before this Committee today because I feel that the legislation introducted by Senator Wallop, though important and worthwhile in and of itself, is only a partial step toward what should be the most important goal of our nation's agricultural policy. That goal is the preservation of the family sized farm unit in America.

Over the last 30 years, many actions taken by the Federal government have worked against the interest of the family sized farm and, in fact, have encouraged the concentration of farmland ownership in America. Various price support programs have helped subsidize big farming operations at a substantial cost to the government and to the rural areas in which they are located. Several of the tax treaties that we have negotiated with foreign countries have been a boon to foreign investors, giving them preferential tax treatment on their American farmland investments and thereby allowing them to pay from 10 to 15 percent more than American farmers can afford for the purchase of such land.

Senator Wallop's bill would move toward closing the tax loophole that gives foreign investors in American farmland a distinct advantage over American farmers. However, I believe the Congress should consider a far more dramatic and comprehensive approach to the problems of the family farmer, and I think it is appropriate to talk about that at this hearing inasmuch as this specific tax provision is only one part of a larger solution.

We need to adopt a policy on the Federal level that discourages both corporate ownership of American farmland and speculative foreign investment in rural areas. Some states, including the state of North Dakota, currently have legislation that discourages farming by large corporations and absentee landlords, and are currently considering methods such as graduated land taxes to discourage excessive concentration of land ownership. The Federal government should encourage other states to develop similar legislation.

We should revise current tax policies, state and Federal, to discourage speculative investment in land and counter the increasing development of prime agricultural land for purposes other than farming. A tax structure which imposes heavy taxes on speculative profits and land diverted to non-agricultural uses would relieve some of the current pressures which are driving land prices upward and squeezing the family farmer out of the market.

We should develop new loan programs which address the credit needs of the family sized farm and the beginning farmer. If the prospective small farm owner is to have any chance of competing successfully with his larger, corporate-owned neighbors, he must have access to capital at interest rates he can afford. If the family farm is an institution worth preserving in this country, as I believe it is, then it is worth the cost of a federally-sponsored low-interest credit system that really focuses on the small, family sized farm.

If price support programs are to continue as a major thrust of Federal farm policy, then the monetary benefits of such programs should be distributed in inverse proportion to the size of the farming unit, with the small farm getting the benefit of the majority of price supports. In this way we could use price support programs as a means of strengthening small farm units vis-a-vis large concentrations of farmland ownership.

I would also urge that every tax treaty between the United States and a foreign country be analyzed to determine how that treaty affects foreign investment in American farmland. Foreign investment, which is increasing dramatically as petro dollars flood into this country from the oil-rich Arab states, helps escalate the price of American farmland and futher threatens the existence of the family farmer.

These are just some of the areas in which action could be taken in support of the American family farm. More important than any of these specific proposals is a commitment by Congress and the Administration to reverse the current trend in agricultural policy away from small farm interests, and to insure the continuation of this basic and necessary part of American society. If Senator Wallop's bill is accepted in this spirit, it will give new hope to thousands of American farmers.

Thank you.

Senator BYRD. The committee will stand in adjournment.

[Thereupon, at 12:15 p.m. the subcommittee recessed, to reconvene at the call of the Chair.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

LAW OFFICES
LEVENFELD AND KANTER
8TH FLOOR
10 SOUTH LA SALLE STREET
CHICAGO, ILLINOIS 60603
(312) 346-8380
TELEX 25-3842
CABLE "TAXLAW, CHICAGO"

MILTON A. LEVENFELD
BURTON W. KANTER
CHARLES A. LIPPITZ
RICHARD K. JANGER
CALVIN EISENBERG
ELLIOT G. STEINBERG (CALIF)
DONALD A. GLASSBERG
DONALD A. STATLAND
LUCINDA LEE (CALIF)
MICHAEL R. FRIEDBERG
MARSHALL E. EISENBERG
ALAN F. SEGAL
STEVEN A. LAMPERT
MICHAEL S. PINSKY
JERRY H. BIEDERMAN
STEVEN A. FELSENTHAL
JOSEPH A. SPERSKE (CALIF)
RANDALL G. DICK (CALIF)
HOWARD B. SAMUELS
STEVEN B. NAGLER
LINDA KREER WITT
ROBERT D. ZIMELIS
RICHARD J. FIRFER
JOHN C. LYON (CALIF)

220 JACKSON STREET
SAN FRANCISCO, CALIFORNIA 94111
(415) 434-4774

37TH FLOOR, 110 E. 59TH STREET
NEW YORK, NEW YORK 10022
(212) 486-0830

OF COUNSEL
RICHARD C. SCHWARTZ (CALIF)

June 11, 1979

Mr. Michael Stern
Staff Director Commissioner on Finance
Room 2227 - Dirksen Senate Office Building
Washington, D.C. 20510

Dear Sir:

Reference is made to the hearings to be held by the Senate Finance Committee on June 25 with respect to S208 relating to the taxation of non-resident aliens on gains from the sale of farm land and other rural land in the United States.

I believe that it is unnecessary for me to attend the hearing to express my views to the Senate Finance Committee as this does not require extended time. Consequently, I would appreciate the reading of the content of this letter into the record.

The bill as introduced is applicable under its terms "with respect to sales and exchanges occuring after February 28, 1978". However, the Congressional Record on October 7, 1978 at page S17577 provides that the bill will "in general apply to sales and exchanges in taxable years beginning after December 31, 1978". The companion bill introduced in the House on March 20, 1979 as HR 3106 provides that it will "apply to sales and exchanges of farmland or other rural land on or after the date of the enactment..."

The varied effective dates quoted above lead to much confusion and lack of certainty among taxpayers. I believe that the Senate Finance Committee should, as soon as possible, go on record as to an effective date which coincides with an effective date in the House bill, so as to put an end to this confusion. I believe that the effective date provided in the House bill is fair and equitable, because until the legislation is passed, there is uncertainty as to the content of the legislation.

There may be changes required in the bill. The uncertainty engendered in a retroactive effective date would thus be compounded, and the unfairness to taxpayers made even more manifest. The Treasury Department's recent report on the taxation of non-resident aliens leaves no doubt that no great amount of revenue is involved in the proposed legislation, and therefore nothing stands in the way of the Senate treating taxpayers fairly with a prospective effective date.

The Senate Finance Committee will also be considering S-192, which is a bill taxing all of the capital gains realized by non-resident alien individuals and corporations. This is a grossly novel assertion of taxing authority by a sovereign state, as is pointed out in the Treasury study on the "Taxation of Foreign Investment in the United States Real Estate" released by the Treasury Department on May 8, 1979, at IV A of the report dealing with tax policy considerations. None or very few other sovereign states tax non-resident aliens on their capital gains with respect to items unrelated to their presence in their country either through a permanent establishment or by doing business. By doing so, the U.S. would inhibit foreign investment in our country, much to the country's economic detriment. An outflow of dollars from the United States at the present time caused by novel and inappropriate tax legislation could have disastrous effects on our balance of payments.

S-192 also does not have an effective date; but, rather than clarify this aspect of the bill, it is our opinion that the bill should be dropped entirely for the reasons stated above.

Your kind consideration of the above will be greatly appreciated.

Sincerely yours,

LEVENFELD AND KANTER

Milton A. Levenfeld

By Milton A. Levenfeld

mal:t

WASHINGTON
WOMEN FOR THE
SURVIVAL OF
AGRICULTURE

June 18, 1979

Committee On Finance
Michael Stern, Staff Director
Room 2227, Dirksen Senate Office Bldg.
Washington, D. C. 20510

Dear Sir:

Washington Women for the Survival of Agriculture has passed a resolution in support of legislation taxing foreign landowners, operators and lessees at the same basis United States citizens are taxed. Currently foreign investors are given an unfair advantage over United States citizens in that they are not taxed as we are. It would seem only fair that all people be taxed equally.

Sincerely,

Mrs Ronald Gamache

Mrs. Ronald Gamache
Federal Legislation Chairman
Rt. 1, Box 1748
Toppenish, Wa. 98948

LAW OFFICES
GROOM AND NORDBERG
SUITE 450
1775 PENNSYLVANIA AVENUE, N. W.
WASHINGTON, D. C. 20006
(202) 857-0620

THEODORE R. GROOM
CARL A. NORDBERG JR.
ROBERT B. HARDING
LAWRENCE J. HASS
LOUIS T. MAZAWEY
MICHAEL F. KELLEHER
SHARON GALM

July 16, 1979

Harry F. Byrd, Jr., Chairman
Subcommittee on Taxation and
Debt Management
Committee on Finance
United States Senate
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Attn: Michael Stern, Staff Director

Dear Mr. Chairman:

The following statement is submitted for inclusion in the record of the Subcommittee's recent hearings on taxation of foreign investment in the United States. The purpose of this submission is to recommend that the Internal Revenue Code be amended to permit U.S. financial intermediaries to manage and invest funds of foreign retirement plans on a nontaxable basis. We believe that such an amendment would be consistent with, and would add balance to, the specific proposals upon which hearings were held. The proposed amendment would attract foreign investment to the United States under circumstances where U.S. financial institutions would control each specific direct investment. Moreover, the tax treatment suggested as appropriate for investment of foreign retirement funds is the same as that already accorded U.S. retirement funds, and hence tax equity between foreign and domestic investors would be preserved.

Current Law

U.S. law does not generally tax investment income and capital gains set aside for retirement income purposes pursuant to a variety of arrangements specified in the Internal Revenue Code. This tax-favored treatment is provided for direct investment by trustees and for investment arrangements involving U.S. financial intermediaries such as insurance companies, banks and mutual funds. Thus, a U.S. financial intermediary may receive funds from a trust fund, invest such funds, and repay the resulting accumulation of principal and income either directly to the trust or in the form of benefits to employers or to other participants without U.S. income tax being imposed. The participant, of course, must include distributions and other benefit payments in income as received by him.

U.S. law and practice has developed in a way in which investment by foreign retirement plans in the United States does not qualify for the favorable U.S. tax treatment. Generally, favorable U.S. tax treatment requires satisfaction of specific U.S. qualification requirements. Even if a foreign retirement plan satisfied U.S. requirements, this would be difficult to establish since the foreign plan would not obtain a determination from the U.S. Internal Revenue Service that the plan is qualified. Therefore, amounts paid by a U.S. financial intermediary to a foreign pension fund (other than distributions that retain the character of capital gains distributions) would be subject to a 30% withholding tax, or if applicable, to a tax at a lower treaty rate. Additionally, while the Internal Revenue Code structure applicable to U.S. life insurance companies is intended, generally, to permit U.S. life insurance companies to invest amounts for U.S. pension funds on a non-taxable basis, these provisions are not applicable to investment on behalf of foreign plans. For example, many U.S. retirement plans invest their funds through life insurance company separate account arrangements under which capital gains, as well as investment income, credited to the plan would not be subject to tax. On the other hand, a life insurance company would be subject to tax on separate account capital gains attributable to reserves for a foreign retirement plan.

Reasons in Support of Proposal

There seems to be widespread agreement that foreign investment in the United States is desirable in situations where the rules applicable to the foreign investor are the same as, or no more favorable than, those applicable to U.S. investors. Currently, there appears to be relatively little use of U.S. life insurance company funding facilities by foreign retirement plans. One reason for this is that such plans may invest in the country in which they are formed on a tax-free basis, but investment in the United States through life insurance companies would have to be on a taxable basis. If foreign retirement plans were permitted to invest on a non-taxable basis in the United States, we do not know how much additional foreign investment might be attracted. However, those managing foreign retirement systems from a number of countries have indicated a desire to participate in arrangements currently offered by U.S. life insurance companies to U.S. pension plans.

It is believed that U.S. investments by foreign retirement plans will not have the negative effects sometimes associated with other forms of foreign investment. Under the proposal, the U.S. financial intermediary, rather than the foreign interest, will have control over each direct investment decision. Moreover, since pension funds investments are ordinarily long-term in nature, foreign pension fund investments are likely to be a relatively stable form of foreign investment.

Most importantly, as previously indicated, the proposal would not give foreign investors an advantage not enjoyed by U.S. residents. Since U.S. pension funds are already tax-exempt, U.S. laws, if amended as proposed, would treat similarly situated U.S. and foreign investors equally.

The concern has been expressed that one difficulty with the principal legislation which was the subject of hearings (S.208 and S.192) is that its adoption might indicate a U.S. attitude of hostility to foreign investment generally. In this context, one advantage of the proposals set forth in this letter is that their adoption would provide a signal to foreign investors that foreign investment is welcome in the United States as long as the foreign investor does not gain an advantage over U.S. investors. Our proposal would lend balance by providing an opportunity to give concrete evidence that this principle will be applied in an even-handed manner -- a tax would be imposed on capital gains where U.S. investors are currently subject to a tax; on the other hand, tax would be eliminated for a category of foreign investor where no tax now is imposed on a comparable category of U.S. investor.

We intend to furnish additional information concerning the details of the proposed amendments to Congressional Staffs and Treasury representatives in the near future.

Very truly yours,

Theodore R. Groom

Theodore R. Groom
Attorney for
Aetna Life & Casualty
Connecticut General Life Insurance Company
The Equitable Life Assurance Society of the United States
John Hancock Mutual Life Insurance Company
Metropolitan
Phoenix Mutual Life Insurance Company
The Prudential Insurance Company of America
The Travelers

north dakota farm bureau
P O Box 2064, 1101-1st Ave No., Fargo, North Dakota 58102/(701) 237-9717

July 5, 1979

RECEIVED
JUL 7 1979

The Honorable Milton R. Young
United States Senator
5205 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Young:

Thank you for your letter regarding S. 208, which you co-sponsored with Senator Malcolm Wallop of Wyoming.

North Dakota Farm Bureau has been concerned about the capital gain tax advantage on the sale of agricultural land that foreign taxpayers have over domestic taxpayers. Therefore, we support both S. 208 and H.R. 3106.

Not only do we believe in tax equity, but also think that exemption from capital gain taxation has encouraged foreign investors to bid up the price of U.S. farmland.

We believe that the provision in H.R. 3106, which would override tax treaties five years after its date of enactment, is worthy of favorable consideration. I understand that this is not included in S. 208.

If you wish to have these remarks included in the part of the record, you have our permission.

Thank you again for your continued efforts to improve United States agriculture.

Best personal regards.

Sincerely,

Jim

James H. Marsden
Director, Public Affairs

JHM/mac

APPENDIX A

DESCRIPTION OF S. 192 AND S. 208
RELATING TO
TAX TREATMENT OF FOREIGN INVESTMENT IN THE UNITED STATES

INTRODUCTION

The bills described in this pamphlet (S. 192 and S. 208) have been scheduled for a hearing on June 25, 1979, by the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee.

These bills relate to the tax treatment of foreign investment in the United States. S. 192 (introduced by Senator Bumpers) would tax nonresident alien individuals and foreign corporations on all U.S. source capital gains, and S. 208 (introduced by Senator Wallop and others) would tax foreign investors on gains from the sale of U.S. farmland and other rural land.

The pamphlet first briefly summarizes the bills. This is followed by a discussion of present law and the issues involved, an explanation of the bill provisions, the effective dates, and the estimated revenue effects of the bills.

I. SUMMARY

S. 208 (Senator Wallop and Others)[1]

The bill would generally subject to U.S. tax the capital gains of foreign investors from the sale of farmland, land suitable for farming, or rural land. Under present law, such gains are generally not taxed unless they are effectively connected with a U.S. trade or business. The tax would be imposed at the rates generally applicable to U.S. taxpayers. The bill would not override U.S. tax treaty obligations.

S. 192 (Senator Bumpers)

The bill would generally tax the U.S. source capital gains of foreign investors from the sale of any capital assets. Under present law, such gains are generally not taxed unless they are effectively connected with a U.S. trade or business. The bill would not override U.S. tax treaty obligations.

[1] The cosponsors are Senators Baker, Baucus, Bayh, Bellmon, Boren, Burdick, Cannon, Chiles, Church, Cochran, Cranston, Culver, Danforth, DeConcini, Domenici, Exon, Goldwater, Hart, Hatch, Hayakawa, Heinz, Hollings, Jepsen, Kassebaum, Leahy, Lugar, McClure, McGovern, Melcher, Morgan, Nelson, Sasser, Schmitt, Simpson, Stevens, Stone, Tower, Young, Zorinski, and Thurmond.

II. TREASURY REPORT

Section 553 of the Revenue Act of 1978 required the Treasury Department to conduct a study and analysis of the appropriate tax treatment of income from, or gain from the sale of, interests in U.S. property held by nonresident aliens and foreign corporations. The study was submitted to Congress on May 4, 1979. The Treasury report found that foreign persons rarely incur U.S. tax on their disposition of U.S. property holdings. The Treasury report recommends that modifications be made to certain specific statutory provisions which are utilized by foreign investors to avoid U.S. tax on capital gains derived from the disposition of U.S. real estate.

III. DESCRIPTION OF BILLS

A. Present Law and Issues

Present law

General

Under the Code, nonresident aliens and foreign corporations engaged in a U.S. trade or business are generally taxed on the U.S. source income of that business in the same manner, and at the same rates, as U.S. persons. (However, their foreign source income not connected with that business is not taken into account in determining the applicable rates of U.S. tax.)

In contrast, the U.S. source income of a nonresident alien or foreign corporation which is not effectively connected with a U.S. business is generally subject to a different tax regime. The Code provides that a foreign individual or corporation is ordinarily subject to a 30-percent withholding tax on the *gross* amount of certain passive income, such as rents, dividends, and interest, which are received from U.S. sources and are not effectively connected with a U.S. business. This withholding tax satisfies the taxpayer's U.S. income tax liability on the income. Capital gains not effectively connected with a U.S. business are not subject to any U.S. income tax, except in the limited situation of nonresident individuals who were present in the United States 183 days or more during the year, who are taxed at the flat rate of 30 percent on the gains.

Foreign investment in U.S. property

Whether a foreign investor in U.S. real estate is engaged in a U.S. trade or business depends on all the facts and circumstances. For example, a foreign investor who enters into a single long-term net lease (under which the lessee is responsible for operation of the property and pays the expenses) probably would not be engaged in a U.S. trade or business, whereas a taxpayer who owns and manages a number of commercial buildings would be so engaged.

If a foreign taxpayer is not actually engaged in a U.S. trade or business, he is permitted under the Code to elect to be treated as if he were so engaged with respect to all his real property held for the production of income. This election is provided because rental income, unlike other types of passive income, ordinarily has associated with it significant expenses. Therefore, a tax equal to 30 percent of the gross rentals could frequently exceed the entire economic income from the property. If the election is made, the taxpayer may reduce his gross income from the real property by the deductible expenses, such as depreciation, mortgage interest, and real property taxes and is taxed at the graduated rates which generally apply to U.S. taxpayers rather than paying 30 percent on his gross rental income. Often, the investor will pay no tax on the current income because depreciation, mortgage interest, real property taxes and other expenses exceed gross income. (This result would be the same if a U.S. person owned the property.) However, by making the election, the taxpayer will also subject himself to U.S. tax on any capital gains from the sale or exchange of the property. The election, once made, is binding on the taxpayer in all subsequent years unless consent to revoke it is obtained from the Internal Revenue Service.

Apart from the Code election, a number of planning techniques exist whereby a foreign investor may obtain the advantages of being taxed on current income from real property on a net basis. However, unlike the Code election, these techniques also offer the opportunity to avoid tax on the capital gain which would result on the sale of the property. Also, unlike the Code election, they may be employed on a property-by-property basis. For example, a foreign investor who is actually engaged in a U.S. real estate business will be taxed on current income from the property on a net basis (which might result in no current tax because of the allowable deductions). He may sell the property on an installment basis and receive most or all of the payments in years following the year of the sale. If he is not actually engaged in a U.S. trade or business in later years when the installment payments are received (and has not made the election to be treated as if he were), the gain would not be treated as effectively connected with a trade or business in the later years and would therefore go untaxed.

Secondly, a foreign investor could generally exchange his U.S. real property held for productive use or investment for other property of a like kind, whether within or without the U.S., without recognition of gain. If the property he acquired in the exchange were outside the U.S., the gain he would recognize on the ultimate sale of the property received in the exchange would not be subject to U.S. tax. This would be the case whether the investor was actually engaged in a U.S. trade or business or had made the election to be so treated.

Other planning techniques may also be employed by investing in U.S. real property indirectly through a foreign holding company which either is actually engaged in U.S. business or makes the election. The holding company would be subject to tax on the income it receives from the property, but, as noted earlier, often there would be no taxable income on a current basis. Moreover, the corporation often could reduce or eliminate its taxable income by paying deductible interest to its investors. Ordinarily, dividends and interest paid by a foreign corporation deriving most of its income from U.S. sources are subject to U.S. withholding taxes. However, these taxes are often waived, on a reciprocal basis, under tax treaties between the United States and other countries. If the recipient of the income is entitled to such a treaty benefit, then income paid to him currently by the corporation would escape that U.S. tax. (Foreign investors frequently utilize U.S. treaties applicable to the Netherlands Antilles and British Virgin Islands, because the treaties contain the necessary waivers and because these jurisdictions impose low or no taxes on the income.)

The investors in the holding company could avoid U.S. tax on the gain from the sale of the property by either of two methods. First, if the corporation sells the property and follows a plan of liquidation meeting certain requirements, the corporation will not be taxable on the gain under a general rule of the Code which exempts liquidating corporations from tax on gains from the sale of property (sec. 337). Moreover, the shareholders and security holders will generally not recognize a gain when they exchange their stock and securities in liquidation for the proceeds of the sale of the real property because, as foreign investors, they generally are not subject to U.S. capital gains tax. Even though the corporation is engaged in a U.S. trade or business, that business is not imputed to its investors. Since mere ownership or sale of stock is generally not a trade or business, the gains ordinarily would not be effectively connected with a U.S. business and thus would escape U.S. tax.

Second, if the investors instead sell their stock or securities, they would generally not be subject to tax on the gain for the same reasons that they would generally not recognize gain in a liquidation. Assuming that the sales price reflected the appreciated value of the real property, the purchaser of the corporation, even if a U.S. person, could then liquidate it without realizing a gain subject to U.S. tax because his basis in the stock for purposes of determining his gain on the liquidation would be his purchase price for the stock. He would also get a stepped-up basis for the real property equal to his purchase price for the stock.

Even if U.S. law were amended to subject these gains to tax, the treaty provisions waiving withholding on dividends and interest could be used to reduce the amount of gain. The corporation could borrow against appreciation in the value of the corporation's real property and pay out the proceeds as dividends (assuming adequate earnings and profits) or interest (in a reasonable amount). These current payments, if they escaped U.S. tax under the treaties, would reduce the net worth of the corporation and hence the capital gain realized on sale of the stock and securities or on liquidation.

Finally, some U.S. tax treaties (such as the treaties with the Netherlands Antilles and the British Virgin Islands) provide for a real property election similar to that in the Code, but the election may be made on a year-by-year basis. A foreign investor entitled to the benefits of such a treaty and not actually engaged in a U.S. business could use the treaty election to be taxed on a net basis in years prior to the year of sale. In that year, the taxpayer would not make the treaty election and would not be taxed on the gain on sale of the property because of the absence of a U.S. trade or business.

A number of U.S. tax treaties contain reciprocal provisions which prevent the United States from taxing certain types of U.S. source capital gains of foreign investors who are entitled to the treaty benefits. The Code provides that these treaty exemptions are to prevail if they require the exclusion from gross income of gains which the United States would otherwise tax.

Issues

The issue is whether, and to what extent, nonresident aliens and foreign corporations should be taxed on gains from the sale or exchange of U.S. property which now are not subject to U.S. tax. In particular, an issue is whether farmland, all real property, or all capital assets should be subject to tax. If Congress decides to tax foreign investors only on capital gains from U.S. real property or only from farmland, another question is whether taxes should be imposed on gains from stock or securities of corporations owning that property. Finally, if the provisions adopted would conflict with U.S. tax treaties, there is an issue as to whether the treaties should prevail over the legislation, be overridden by the legislation, or whether some period of time (e.g., 5 years) should be allowed for renegotiation of the treaties.

B. Description of S. 208

(Senator Wallop and Others)

Explanation of provisions

The bill would treat as effectively connected with a U.S. trade or business, and hence subject to U.S. tax, gain from the sale or exchange of real property located in the United States which is land used in farming, land suitable for use in farming, or land in a rural area.

Also taxable would be gain in excess of $3,000 for the taxable year from the sale or exchange of stock in a corporation, or interest in a partnership, trust, or estate, determined by the Treasury to be properly attributable to (i) the net unrealized appreciation in such land which is held by the corporation, partnership, trust, or estate and (ii) if the the foreign investor used a holding company and utilized the Code provision (sec. 337) allowing the corporation to sell the land and liquidate without recognizing the gain on the sale of the land, an amount equal to the gain realized (but not recognized) by the corporation on the sale of that property.

The gain would be taxed at the graduated rates applicable to U.S. taxpayers. Purchasers of the farmland or rural land (or stock or other interest if the real estate was held indirectly) would be required to withhold and pay over to the government an amount equal to 30 percent of the gain. The seller could obtain a refund of the difference between this and the amount due under the applicable U.S. tax rates by filing a refund claim.

However, no gain would be taxable under any of these provisions to the extent that any U.S. tax treaty requires that the gain not be included in gross income.

The bill also requires any corporation to file a report with the Treasury if 20 percent or more of the value of its assets at any time during the year is attributable to farm land, land suitable for farming, or rural land.

Effective date

The bill would apply with respect to sales and exchanges occurring after February 28, 1978.

Revenue effect

It is estimated that this bill could increase tax liabilities by up to $22 million at the 1979 level of gains. To the extent that U.S. tax treaties require certain gains to be excluded from gross income, there would be a corresponding reduction in the revenue gain.

C. Description of S. 192

(Senator Bumpers)

Explanation of provisions

The bill would provide that all U.S. source capital gains of foreign investors, whether from real property or personal property (such as stocks and securities), would be subject to U.S. tax. The bill leaves unchanged the rule that gains effectively connected with the conduct of a U.S. trade or business are generally taxed in the same manner of such gains of U.S. persons. However, the bill also would subject to tax all U.S. source capital gains (to the extent they exceed U.S. source capital losses) which are not effectively connected with a U.S. business. The bill would not, however, override U.S. tax treaties which would require the exclusion of such gains from gross income.

Effective date

The bill would be effective upon enactment.

Revenue effect

According to a very rough estimate in the Treasury report on taxation of all capital gains of foreign investors could increase tax liabilities by $276 million at the 1979 level of gains. This figure would be substantially reduced under S. 192 because a portion of the gains would be excluded from gross income as the result of U.S. tax treaties.

APPENDIX B

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Congressional Research Service

WASHINGTON, D.C. 20540

March 28, 1979

TO: Senator Malcolm Wallop
Attention: Bob Reynolds, Legislative Assistant

FROM: Harry G. Gourevitch HGG
Senior Specialist in Taxation and Fiscal Policy

SUBJECT: Issues under a Federal Estate Tax on foreign investment in U.S. real estate through a foreign holding company

Summary

This memorandum discusses certain issues that would arise under a legislative proposal to impose a Federal estate or gift tax on nonresident aliens or their estates holding U.S. farmland through a foreign corporation.

As a technical matter, appropriate statutory language can be drafted which would attribute to a nonresident alien shareholder his proportionate interest in U.S. farmland held through a foreign corporation and which would include such proportionate interest in the nonresident alien shareholder's gross estate for federal estate tax purposes.[1/] Such an approach would not be completely without precedent, as a similar tracing provision already exists in the Internal Revenue Code (section 2107) to prevent avoidance

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1/ The memorandum focuses on possible imposition of the estate tax on transfers at death, devoting little attention to possible imposition of the gift tax on intervivos transfers. In the Foreign Investors Tax Act of 1966, Congress repealed the gift tax on gifts of intangible property by nonresident aliens. The Senate Finance Committee at the time stated,

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

of Federal estate taxes by expatriate Americans. Also, the Commentary to the 1966 OECD Model Estate Tax Treaty discusses an elective tracing provision for real property held through partnerships or other unincorporated, though separate, legal entities.

Anti-tax avoidance legislation of this kind does not raise serious issues under established principles of international law or under the United States Constitution.

The real problems raised by the proposal are in the areas of tax treaties and enforcement. The proposal would be inconsistent with nearly all U.S. estate tax treaties in force, as well as with the U.S. and OECD model estate tax treaties. Potential conflict between the proposed statute and existing treaties can be avoided by giving the treaties precedence over inconsistent statutory provisions, or possibly through the use of deferred effective dates for the statutory provisions. Such a solution would still leave the statutory change with a certain scope of operation, as it would still apply to the estates of individuals domiciled in a country

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FOOTNOTE 1/ cont'd

> In practice this rule has proved to be impossible to enforce, since there is no practical way for the Internal Revenue Service to find out when these gifts are made. Moreover, it does not occur to many nonresident aliens that these transfers are subject to U.S. gift tax. Thus the revenue significance of this provision is minimal.
>
> For the above reasons the bill amends present law to provide that gifts of intangible property by nonresident aliens are not to be subject to the U.S. gift tax."

(H.R. 13103, The proposed Foreign Investors Tax Act of 1966, Report No. 1707, p. 57, Committee on Finance, United States Senate, 89th Cong., 2nd. Sess.)

with which the United States does not have an estate tax treaty who have invested in U.S. farmland through a foreign corporation.

The enforcement problems would be difficult to solve. It is not clear how the Internal Revenue Service would be in position to learn on a systematic basis the identity of nonresident aliens who invest in U.S. real estate through a foreign holding company if shares of stock in the foreign holding company are held in the name of a foreign bank or other nominee rather than in the name of the individual investor. Even if the Service learns the identity of the foreign investors involved, it is uncertain to what extent liability for estate or gift tax can be effectively enforced. On the other hand, there may be a certain amount of voluntary compliance with the new law on the part of foreign investors or their estates.

The proposed legislation is not likely to raise significant amounts of tax revenues. However, if the objective is to discourage foreign investment in U.S. farmland, it is entirely possible that despite the enforcement problems the legislation would serve such an objective.

Current Law

Under current law a nonresident alien can avoid liability for Federal estate and gift tax on a transfer by gift or at death of real estate situated in the United States if he owns the real estate through a foreign holding company rather than directly. A nonresident decedent's estate is subject to Federal estate tax only with respect to property which is situated in the United States at death (Code section 2103). While U.S. real estate is situated in the United States for estate tax purposes, shares of stock in a corporation organized outside the United States do not have a U.S. situs even if the corporation's assets consist solely of U.S. real estate. (Code section 2104(a)).[2/] As already noted, gift tax is also avoided as, except for gifts by certain expatriate Americans, the gift tax does not apply to gifts of shares of stock or other intangible property by a nonresident alien.[3/]

Availability of the holding company device means that foreigners investing in U.S. real estate or other assets, such as shares of stock of a domestic corporation, having a U.S. situs are subject to Federal gift or estate tax only in limited situations. As has been noted by one commentator, "the estate tax will probably be paid by very few aliens,

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2/ U.S. real property transferred by a nonresident alien to a wholly-owned or controlled foreign corporation may possibly be includible in the individual's U.S. gross estate under sections 2104(b) and 2038; a transfer to a foreign corporation made within three years of the transferor's death may also be includible in his U.S. gross estate under sections 2104(b) and 2035.

Attempts by the Internal Revenue Service to disregard a foreign holding company as a sham have generally not been successful. However, in Fillman v. U.S., 355 F.2d. 632 (Ct. Cl., 1966) it was held that two Argentine corporations acted merely as custodians and not as real owners of a portfolio of securities maintained with a U.S. bank and the value of the securities was includible in the U.S. gross estate of the nonresident alien decedent who was their real owner.

3/ Code section 2501(a)(2).

in most cases by those who blunder into its provisions."[4/] A 1976 Treasury Department study on foreign investment in the United States similarly stated, "the attitude of many foreign investors is that the U.S. estate tax is a foolish tax and can be easily avoided."[5/]

Proposals to amend the Law

As one possible legislative approach, the Internal Revenue Code can be amended so as to treat U.S. farmland owned by a foreign corporation as owned proportionately by its nonresident alien shareholders. The amount of the nonresident alien shareholder's proportionate interest to be included in his U.S. gross estate would be determined at his death by including in the gross estate that proportion of the market value of his holdings of stock in the foreign corporation which is equal to the proportion of the fair market value of the corporation's total assets which consists of U.S. farmland. This is the formula used in section 2107(b) (discussed later) to determine the includible portion of the stock of a foreign corporation holding U.S. property in an expatriate American's gross estate. The formula is rather complicated as it requires fair market value determinations not only for the corporation's U.S. farmland, but also for the decedent's holdings of stock in the foreign corporation and for the foreign corporation's holdings of assets other than U.S. farmland, if any.

4/ Ross, S., United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments, 27 Tax Law Review 277, 359 (1967).

5/ U.S. Treasury Department, Report to the Congress on Foreign Portfolio Investment in the U.S., 43 (1976).

As an alternative, it would be possible to compute the amount includible in the gross estate by multiplying the market value of the foreign corporation's U.S. farmland by a fraction representing the decedent shareholder's proportionate stock interest in the corporation. This formula would be easier if a corporation has only one class of stock outstanding, but it would be more complex than the section 2107(b) formula if the corporation has more than one class of stock outstanding.

Under the proposed tracing provision the foreign corporation would be treated as a sort of permeable entity for estate tax purposes, the statute looking through the foreign corporation in order to include the underlying U.S. real estate in a decedent shareholder's gross estate. As an alternative, it would also be possible to change the situs rule of Code section 2104 which now provides that shares of stock owned by a nonresident alien have a U.S. situs only if issued by a domestic corporation. An amendment can be drafted which would provide that shares of stock of a foreign corporation owned by a nonresident alien shall have a U.S. situs if the corporation's underlying assets consists of U.S. farmland. However, this alternative leads to complications if only part of the foreign corporation's assets consist of U.S. farmland.

Under the proposed tracing provision a decedent shareholder's representative would need to know at the valuation date the market value of the corporation's U.S. farmland and of its other assets, if any. The foreign corporation could be required to file this kind of information on a periodic basis with the Internal Revenue Service and to submit copies to its shareholders.

It is questionable whether estate tax liability should attach to nonresident alien shareholders of any foreign corporation owning U.S. farmland regardless of how small a percentage of the corporation's total assets consists of farmland. For example, a foreign industrial corporation may have important investments in U.S. industrial facilities, including relatively minor holdings of U.S. farmland. Imposing potential estate tax liability on the nonresident alien shareholders of such a corporation may simply result in discouraging foreign direct investment in the United States. Such a result would go considerably beyond a policy objective to limit foreign investment in U.S. farmland. Thus, as provided with respect to information return requirements in proposed section 6039C in S208, it would be appropriate to limit estate tax liability to the estates of nonresident alien shareholders of foreign corporations at least 20% of the assets of which consist of U.S. farmland.

In addition to such a corporate assets test, consideration should also be given to a stock ownership test. For example, estate tax liability might be limited to the estates of nonresident alien shareholders owning at least 1% (or some other percentage) of the foreign corporation's outstanding stock. The case for such a stock ownership test may, however, be less compelling if the proposed legislation already includes a corporate assets test.

International or Constitutional Law Issues

Under international law, the U.S. clearly has jurisdiction to tax a nonresident alien or his estate on the transfer of property situated in the United States.[6/] In taxing a nonresident alien decedent's gross estate on U.S. realty held through a holding company, jurisdiction to tax is still based on the U.S. situs of the underlying real estate. The gross estate would include only the decedent's proportionate interest in U.S. real estate, not his proportionate interest in other corporate assets. Thus, we do not believe the proposal raises a genuine international law issue.

We do not see a genuine constitutional issue either. Congress' power to enact the proposed legislation rests on two separate constitutional bases: its taxing power, and its power to regulate the economic activity of aliens. As an exercise of the taxing power, the proposed legislation would take its place alongside the accumulated earnings tax, the foreign personal holding company tax, and Subpart F of the Internal Revenue Code, all of which are statutory provisions disregarding under specified circumstances the separate legal entity of corporations in order to prevent tax

6/ In Burnet v. Brooks, 288 U.S. 378, (1933) the Supreme Court held that no principle of international law was violated when the United States imposed an estate tax on shares of stock and bonds of foreign and domestic corporations owned by a nonresident alien decedent if the bonds and stock certificates are physically located in the United States at death. The case arose under the Revenue Act of 1924 which included in a nonresident alien decedent's gross estate all property situated in the United States at the time of death.

avoidance by the corporations or their individual or corporate shareholders. Upholding the constitutionality of the accumulated earnings tax, Judge Learned Hand some years ago stated, "Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose."7/ While these statutory provisions involve attempts to prevent avoidance of the Federal income tax and the proposed legislation would be designed to prevent avoidance of the Federal estate tax, with respect to either tax Congress is or would be exercising its incidental power, referred to by Judge Hand, to defeat obstructions to its powers to lay and collect taxes, duties, imposts and excises.

Although generally courts do not inquire into Congressional motives in enacting tax legislation, even if the proposed legislation were to be viewed as essentially regulatory rather than revenue raising, it would be sustained as an exercise of Congress' extensive powers over the economic entry of aliens into the United States. Constitutional challenges to legislation regulating or restricting the economic activity of aliens have

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7/ United Business Corporation v. Commissioner, 62 F.2d. 754, 756 (2nd Cir., 1933). The constitutionality of the foreign personal holding company was upheld in Eder v. Commissioner, 138 F.2d. 27 (2nd Cir., 1943); the constitutionality of taxing shareholders on undistributed corporate income under Subpart F was upheld in Garlock v. Commissioner, 489 F.2d. 197 (2nd Cir., 1973).

been few and, as far as we have been able to determine, unsuccessful.[8/] As stated by Vagts, "... there is little indication that legislation, observing reasonable standards in restricting alien business corporations' activities, would run afoul of constitutional objections."[9/]

Precedents

We have not examined the gift and estate tax legislation of other countries in order to learn how other countries deal with the tax avoidance use of a foreign holding company by nonresident alien investors. However, there are two existing precedents which are worth noting.

The first is the anti-expatriation provision in the Federal estate and gift tax which applies these taxes to certain transfers of U.S. property by Americans who expatriated themselves for tax avoidance purposes. Under Section 2107(b) of the Internal Revenue Code an expatriate American's gross estate includes his proportionate share of the U.S. assets of a foreign corporation of which he is a shareholder, provided his ownership of stock in the foreign corporation meets certain control requirements. This provision, which was enactd as part of the Foreign Investors Tax Act of 1966, provides that the expatriate's gross estate includes that proportion of the market value of the corporation's shares of stock owned by

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8/ In Central Vermont Co. v. Durning, 294 U.S. 33 (1935), the Supreme Court upheld a Federal statute excluding foreign-owned corporations from coastal shipping against the argument that a foreign owned corporation which had been so engaged at the time of enactment and which was not grandfathered by the legislation was deprived of property without due process of law under the 5th Amendment.

9/ Vagts, Detlev F., The Corporate Alien: Definitional Questions in Federal Restraints on Foreign Enterprise, 74 Harvard Law Review 1489, 1496 (1961).

the decedent which the market value of the corporation's U.S. situs assets bears to the market value of all its assets. The purpose of this tracing provision was to prevent an expatriate American from avoiding Federal estate tax on the transfer of U.S. situs assets by shifting their ownership to a foreign corporation. 10/ A related gift tax provision was enacted under Section 2501(a)(3). It should be noted that we have not found any court decisions interpreting this tracing provision, and it is possible that it has found little application.

The other noteworthy precedent is contained in the Commentary to the OECD's 1966 model estate tax treaty. As discussed later, the model treaty itself does not contain a tracing provision. However, the Commentary to the model treaty suggests that parties to a treaty may wish to include an elective tracing provision. Under this elective provision set forth in the Commentary, if a nondomiciliary investor owns real estate situated in a treaty country through a partnership, the country where the real estate is situated may treat the foreign partnership interest as an interest in the real estate itself even if the partnership is treated under applicable law

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10/ H.R. 13103, Foreign Investors Tax Act of 1966, Rept. No. 1450, pp. 46-48, House Ways & Means Committee, 89th Cong., 2nd Sess.; Rept. No. 1707, pp. 28-29, Senate Committee on Finance, 89th Cong., 2nd. Sess.

as a separate legal entity.[11/] This approach disregards the intervening legal entity of a partnership in order to enable the country where the real estate is situated to assert its situs jurisdiction.

The OECD Commentary's elective provision applies only to real estate held through a partnership or other unincorporated associations, whereas the proposal under discussion would not be so limited and would apply the Federal estate tax, as under the anti-expatriation provisions, to foreign corporations. This appears not to be a major difference, however, as the elective provision in the OECD Commentary explicitly applies to unincorporated associations which, like incorporated ones, are separate legal entities. Moreover, under existing U.S. law certain unincorporated associations are treated for tax purposes as corporations.[12/]

11/ The model elective provision states: "In the application of this Convention, interests in associations of individuals, whether legal persons or not (civil associations, general partnerships, limited partnerships) shall, to the extent that their value is related to any property referred to in Article 5, 6, or 7, be treated as though they were property of such kind forming part of the estate; they may to the said extent be taxed in the Contracting State in which the property referred to in Article 5 or 6 or the place of effective management of the enterprise referred to in Article 7, as the case may be, is situated. If, however, such interests are not regarded as taxable by the domestic law of one Contracting State, then the other State shall retain its right to tax in full."

12/ Treasury Reg. Sec., 301.7701-2.

Enforcement

There are serious questions as to whether the legislation under discussion could be properly enforced. The first problem involves determining the identity of a nonresident alien who invests in U.S. farmland through a foreign corporation. The second problem is how to enforce the tax liability once the identity of the individual is known.

In order to apply an estate and gift tax on transfers of U.S. real estate held by nonresident aliens through a foreign holding company, the first thing the Internal Revenue Service would need to know is the name and address of each nonresident alien investor in the foreign holding company whose estate may be subject to estate tax. An attempt to obtain such a list can be made by enacting a provision similar to proposed Section 6039C in S208, requiring each foreign corporation investing in U.S. real estate to file an information return listing the name and address of its shareholders.

To conform the reporting requirements to the substantive provisions, information returns should be required only of foreign corporations at least 20% of the assets of which consist of U.S. farmland. Also, a foreign corporation meeting the assets test should perhaps be required to list on its information return only shareholders satisfying a stock ownership test, for example, having to list only shareholders owning at least 1% (or some other percentage) of the corporation's outstanding stock. A stock ownership test means that a big corporation which meets the corporate assets test and which has thousands of shareholders would not have to list on its information return the name and address of each and every shareholder.

Unless a solution is found to the use of foreign banks or other nominees and/or the use of bearer shares in order to mask the identity of foreign investors, a significant potential for avoidance of the estate and gift would still remain.14/

The other problem involves enforcement of the tax once the identity of the foreign investor is known. Unless the foreign investor or his estate pays the tax voluntarily, estate or gift tax can be enforced only against the investor's assets within the United States.

There are two applicable lien provisions in the Internal Revenue Code. Under section 6321 the United States acquires a lien on property, real or personal, belonging to a taxpayer who neglects or refuses to pay a tax after demand. Under section 6324 the estate tax is a 10-year lien on the decedent's gross estate unless the tax is sooner paid or becomes unenforceable by reason of lapse of time. Section 6324 does not require a prior demand for payment of the tax in order for the lien to attach. Thus, under section 6324 the Service automatically acquires a 10-year lien on a nonresident alien's assets includible in his gross estate.

14/ One possibility, which we are not recommending but which may deserve further study, would be to enact a requirement that foreign corporations investing in U.S. farmland may have only individuals as shareholders. Such a requirement would be somewhat similar to that for individual shareholders in a Subchapter S corporation under Code section 1371(a)(2). To prevent the issuance of bearer shares, the statute would also have to require that the corporation may issue only registered shares. The enactment of such requirements would be rather drastic, but there can be little doubt that under the Constitution Congress has the power to enact such legislation.

Under the proposed legislation a nonresident alien shareholder's proportionate interest in U.S. farmland held by a foreign corporation would be includible in his gross estate. Sections 6321 and 6324 could be amended in order to make it clear that the United States could or would acquire a lien on these proportionate interests in U.S. farmland. Under state law the owner of the farmland would be the foreign corporation, whereas for Federal estate tax purposes the owner(s) would be the nonresident alien shareholder or shareholders. However, we do not believe that giving the United States a lien on the underlying real estate would create an unconstitutional Federal interference with state rights. As discussed earlier, Congress has extensive powers to impose and collect taxes and excises and to regulate the economic entry of aliens into the United States.

While we do not believe that giving the United States a lien would create a genuine Constitutional issue, it may lead to complications of a practical nature, especially if the foreign corporation has more than one shareholder. If the foreign corporation has several shareholders, in an action to enforce the government's lien on the property it is unclear whether a court would order 1) a sale of the entire property with an accounting to the other owners, 2) a partition of the property, or 3) some other remedy.

It is of course not essential that the legislation give the United States a lien on the underlying real estate. However, not to do so would be likely to make it more difficult to enforce the proposed statutory changes as a nonresident alien shareholder or his estate may not have other U.S. assets which the government could reach. Actually, there may be a certain amount of voluntary compliance with the new law, especially if alien investors or their estates wish to keep clean hands for the day when they or family members decide to emigrate to the United States.

Tax Treaties

Legislation taxing a nonresident alien decedent's estate on the transfer of shares in a foreign corporation holding U.S. real estate would probably be contrary to every U.S. estate tax treaty now in force, except possibly the Australian and Swiss ones. Such legislation would also be contrary to the U.S. and OECD model estate tax treaty.

As of January 1979, the United States was a party to thirteen estate tax treaties.[15/] The situs rules in each of these treaties provide that immovable property is deemed to be situated at the place where the property is located.[16/] This situs rule retains for the United States the right to tax a nonresident alien or his estate on his holdings of U.S. real estate. However, most of the treaties also provide that the situs of shares of stock of a corporation shall be the place of incorporation.[17/] Under such

15/ Australia (also gift tax treaty), Canada, Finland, France, Greece, Ireland, Italy, Japan (also gift tax treaty), Netherlands, Norway, Switzerland, South Africa, the United Kingdom. One of these treaties, the treaty with Japan, also applies to gift taxes. There is also a separate gift tax treaty with Australia. Revised or new estate tax treaties have been or are being negotiated with France, the United Kingdom, Denmark, and Germany. These latter treaties have not yet entered into force.

16/ See for example, Australia, Art. III (1)(a); Ireland, Art. III (2)(a); Italy, Art. III (1)(a); South Africa, Art. III (2)(a).

17/ See, Finland, Art. III (2)(d); France, Art. III (2)(g); Greece, Art. III (2)(g); Ireland, Art. III (2)(d); Italy, Art. III (1)(d); Japan, Art. III (1)(d); Norway, Art. III (2)(e); South Africa, Art. III (2)(d); United Kingdom, Art. III (2)(d).

a treaty rule shares of stock of, say, a Finnish corporation or a Netherlands Antilles corporation may not be included in the U.S. gross estate of a nonresident alien who at the time of his death was a domiciliary of the other treaty country (e.g. Finland), as the situs of the shares is outside the United States.

With respect to U.S. real estate held by a foreign holding company there is a problem of treaty interpretation. If all the assets of the Finnish or Netherlands Antilles corporation consist of U.S. real estate, which situs rule governs, the one for real estate or the one for shares of stock? While the estate of a nonresident alien decedent holds directly the shares of stock, indirectly it holds the U.S. real estate.

This problem was considered by the Senate Foreign Relations Committee when it examined the estate tax treaty with Canada. Canada has repealed its estate tax, but the estate tax treaty with Canada has not yet been terminated. In any event the Committee's interpretation of that treaty is still valid with respect to other estate tax treaties having similar situs rules. In its report on the Canadian treaty the Committee stated as its understanding that where real estate is held through a foreign corporation the situs of the deceased's property shall be governed by the situs rule for shares of stock and not for real estate.[18/] In attributing to a nonresident alien shareholder ownership of a proportionate interest

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18/ The Committee report states:

"In order to clarify the meaning of the convention, the committee wishes to state that it has acted upon the convention with the following understanding and intention:

in U.S. real estate held by the foreign corporation, the proposed legislation would reach a result which is inconsistent with the treaty situs rules as interpreted by the Foreign Relations Committee.

Two estate tax treaties, the ones with Australia and Switzerland, appear not to be in conflict with the proposed statutory rule. The treaty with Australia does not have a situs rule as to shares of stock and the one with Switzerland contains no general situs rules.

In 1966 the OECD issued a model estate tax treaty under which jurisdiction to tax is based primarily on a person's domicile at the time of death rather than situs of particular classes of property. The OECD model treaty gives the state of the situs the right to tax immovable property (Article 5) and movable business property used in a permanent establishment

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FOOTNOTE 18/ cont'd

> If a deceased has any rights or interests in property described in paragraph (h) (relating to shares in a partnership) or paragraph (f) (relating to stock, etc., of a company) of article II, and if the partnership or company in which he has such rights or interests has rights or interests in property described in any paragraph of paragraphs (a) through (o) of article II other than the paragraph describing the rights or interests of the deceased in the partnership or company (as the case may be), the situs of the deceased's rights or interests in the property described in paragraph (h) or paragraph (f) shall be determined exclusively under the provisions of such paragraph (h) or paragraph (f), and not under the provisions of any other paragraph of article II."

Report on the Convention with Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on the Estate of Deceased Persons, Committee on Foreign Relations, United States Senate (1CCH Tax Treaties, p. 1253-18).

of a business enterprise (Article 6). In respect of all other property, including shares of stock of a corporation, the right to tax is reserved to the state of the decedent's domicile (Article 8). These rules were followed in the estate tax treaty the United States signed with the Netherlands in 1969. In 1977 the United States issued a model estate tax convention which is patterned after the OECD model and which incorporates the same shift in emphasis from situs rules to domicile rules.

As noted earlier, the Commentary to the OECD model treaty contains an elective tracing provision for real estate held through a partnership or other unincorporated association. While the U.S. model estate tax treaty is patterned after the OECD model, the U.S. did not adopt the elective provision in the OECD Commentary.

Inconsistency between proposed legislation and existing tax treaties can be avoided by giving existing estate tax treaties precedence over subsequently enacted inconsistent statutory provisions. In the absence of any specific declaration of legislative intent, the instrument which was adopted last in time takes precedence. However, Congress can express a contrary intent, as it did in Code Section 7852(d) with respect to treaty provisions in effect at the time of enactment of the Internal Revenue Code of 1954.[19/] Similarly, in the Foreign Investors Tax Act of 1966 Congress

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19/ Section 7852(d) states: "No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title."

provided (in Section 110) that, "... no amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States."

When a proposed statutory change will be inconsistent with a number of existing treaties, it may be appropriate to provide that the inconsistent treaty provisions shall take precedence, or it may be desirable to give the legislation a deferred effective date in order to give the Treasury Department time to renegotiate the treaties in force. Even if treaties are given precedence over the proposed legislation, the legislation could still have some effect. The legislation would still apply to the estates of individuals domiciled in a country with which the United States does not have an estate tax treaty (e.g. Venezuela) investing in the United States through a foreign real estate holding company (e.g. a Netherlands Antilles corporation).

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