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Richard C. Jans

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ASSAULT ON FIRPTA – AN EXAMPLE OF THE PROBLEMS INHERENT IN THE CURRENT PROCESS OF WRITING TAX TREATIES

INTRODUCTION

One of the most dramatic changes in the taxation of foreign persons by the United States occurred late in 1980 when Congress passed the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), which has been codified as section 897 of the Internal Revenue Code.[1] One of the goals of FIRPTA was to treat all foreign investors in United States real property alike, and similar to their domestic counterparts.[2] But now, relatively soon after its enactment, FIRPTA may be undone if certain tax treaties are ratified. These treaties would either significantly modify FIRPTA provisions or overrule the Act completely. If these treaties are ratified, FIRPTA may be indirectly deleted from the Internal Revenue Code as quickly as it was added.

This article initially summarizes the provisions of FIRPTA and the impact that the proposed tax treaties will have on the Act. Additionally, the treaty writing process will be examined, as will a number of suggested changes to that process. Finally, the utilization of new tax treaties by tax practitioners and the problems inherent in treaty shopping will be discussed.

UNITED STATES TAXATION OF FOREIGN INVESTORS[3]

A foreign investor is either a nonresident alien individual, an individual who is neither a United States citizen or resident,[4] or a foreign corporation, a corporation not organized under United States law or the law of any state.[5] Prior to FIRPTA, foreign investors were subject to United States tax in one of two ways. Investment income, including capital gains, "effectively connected"[6] with a United States trade or business was taxed at the applicable

1. Foreign Investment in Real Property Tax Act of 1980, tit. XI, subtit. C of the Omnibus Reconciliation Act, Pub. L. No. 96-499, 94 Stat. 2682, § 1125(c)(1) [hereinafter cited as FIRPTA]. I.R.C. § 897 (West Supp. 1981).

2. H.R. REP. No. 1167, 96th Cong., 2d Sess. 511, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 5526, 5874 [hereinafter cited as H.R. REP.].

3. This discussion of the taxation of foreign investment in United States real property relies primarily on two articles dealing with FIRPTA. The first is a detailed analysis by W. Donald Knight, Jr., *Planning for Foreign Investment in U.S. Real Estate: An Update After the Foreign Investment in Real Property Tax Act of 1980,* 39 INST. ON FED. TAX'N § 30.01 (1981). The second is a brief overview by Professor David M. Hudson, *Capital Gain Taxation of Foreigner's Investments in U.S. Real Property,* 67 A.B.A. J. 1366 (1981).

4. *See* Treas. Reg. § 1.871-2(a) (1960).

5. I.R.C. § 7701(a)(4), (5) (1976).

6. *Id.* §§ 871(b)(1) & 882(a)(1) (Supp. III 1979). The Code first attempts to determine the income a foreign person has from sources within the United States. *Id.* § 861 (1976 & Supp. III 1979). In addition, "effectively connected" income is also subject to United States taxation. In determining what is effectively connected, the regulations set out two tests: (1)

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corporate or individual rate.[7] In computing taxable income under this method, the foreign investor would be taxed only on net income.[8] Alternatively, United States source income, income from the disposition of a United States real property interest, not "effectively connected" with a United States trade or business was taxed at a flat rate of thirty percent of gross receipts.[9] This latter category also included the capital gains of a nonresident alien individual present in the United States for more than 182 days.[10]

Because of problems inherent in the concepts of "trade or business within the United States" and "effectively connected," a foreign investor could elect under section 871(d) or section 882(d) to treat income from real property as effectively connected with the conduct of a trade or business within the United States.[11] This election, the net basis election, benefitted the foreign investor with large depreciation or interest deductions, but it also meant that capital gains from the disposition of real property would be taxed.[12] Moreover, the election could only be revoked with the consent of the Treasury Secretary,[13] an unlikely event if revocation were sought to avoid taxation of capital gains.[14] Thus, to avoid taxation of United States capital gains, one of five alternatives could be used:[15]

1. If election under 871(d) or 882(d) had never been made because the foreign investor was actually engaged in a United States trade or business, the sale of United States real property could be reported under the installment sales method, with the majority of the payments being received in years in which the foreign investor has no actual United States trade or business. The

whether the income derived from assets used in the conduct of a United States trade or business (the asset-use test) or (2) whether the activities of the trade or business were material factors in the realization of the income (the business activities test). Treas. Reg. § 1.864-4(c)(1)(i) (1972). *See also* Knight, *supra* note 3, § 30.02[5] (further explaining the operation of these tests).

7. *See* I.R.C. § 871(b)(1) (Supp. III 1979) (nonresident alien individuals); *id.* § 882(a)(1) (foreign corporations).

8. The foreign investor is entitled to reduce his effectively connected gross income with the deductions available to similarly situated United States investors, with some exceptions. *Id.* §§ 873 & 882(c)(1) (1976 & Supp. III 1979).

9. *Id.* §§ 871(a) & 881(a) (1976). Source income is further defined in H.R. REP., *supra* note 2, at 515.

10. I.R.C. § 871(a)(2) (1976).

11. *Id.* §§ 871(d)(1), 882(d)(1) (Supp. III 1979). Generally, a United States trade or business exists when the United States activity is "considerable, continuous, and regular." Rev. Rul. 73-522, 1973-2 C.B. 226. For a discussion of the meaning of "trade or business" as used in I.R.C. §§ 871, 881, 882, see Knight, *supra* note 3, § 30.02[4].

12. With the net basis election the foreign investor can make use of deductions as if he were dealing with effectively connected income. *See supra* note 8. The capital gain that escapes taxation because it is outside § 871(a)(2) will now be treated as if it were effectively connected with a United States trade or business and, therefore, § 871(b) would apply, subjecting the gain to taxation at the graduated rates.

13. I.R.C. §§ 871(d)(1), 882(d)(1) (1976).

14. *See* Hudson, *supra* note 3, at 1366; Knight, *supra* note 3, § 30.02[8].

15. U.S. DEP'T OF THE TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL PROPERTY (May 4, 1979) [hereinafter cited as TREASURY REPORT].

gain, therefore, could not be taxed as effectively connected with a trade or business.[16]

2. A foreign holding company with United States real property could adopt a plan of liquidation, selling the real property without recognizing gain, if the requirements for a section 337 corporate liquidation were otherwise met.[17] Upon liquidation, the shareholders would receive capital gains[18] which would be neither effectively connected with a United States trade or business, since the holding of the stock is not trade or business, nor within the section 871(d) or 882(d) election.[19]

3. The foreign investor could sell his shares in the foreign holding company which held the United States real property, instead of selling the real property itself. The capital gain on this sale would not be within the 871(d) or 882(d) election or effectively connected with a United States trade or business.[20] Again, the capital gain would not be taxed.

4. The foreign investor could exchange his United States real property for foreign property of a like-kind, thereby limiting his gain to the extent of any boot received, under section 1031.[21] Upon later sale of the foreign property, there would be no income from United States real property. Therefore, the section 871(d) or 882(d) election would be inapplicable, and any gain could not be effectively connected with a United States trade or business. The result would be no tax on the capital gain.

5. Finally, some tax treaties allow the foreign investor entitled to the treaty benefits to make the net basis election annually rather than permanently, unless revoked with the consent of the Secretary.[22] Under this method, the foreign investor makes the election while holding the real property, thereby taking advantage of the deductions available to him. When the United States real property is to be sold, the election is not made for that year and thus the capital gain upon the sale is exempted from United States tax.[23]

FIRPTA

With the above procedures in mind, Congress acted in 1980 to prevent disparate tax treatment of foreign and domestic investors in United States real property.[24] In most countries capital gains from the sale of real property are

16. I.R.C. §§ 871(a)(1), 882(a)(1) (1976 & Supp. III 1979). *See also* Treas. Reg. 1.871-8(c)(1) (1974).

17. Generally, no gain or loss is recognized by a corporation on the sale of its assets within 12 months of the adoption of a plan of complete liquidation. I.R.C. § 337 (1976 & Supp. III 1979).

18. *Id.* § 331(a)(1) (1976). All of this assumes that the unlikely situation of a nonresident alien individual present in the United States for more than 182 days does not exist. *See supra* note 10 and accompanying text.

19. *See supra* note 16.

20. *Id.*

21. I.R.C. § 1031 (1976).

22. *Id.* § 894. Any treaty provision allowing for an annual net basis election would override the revocable election provision.

23. *Id.*

24. *See* H.R. REP., *supra* note 2, at 511.

taxed alike regardless of whether the seller was a foreign or domestic investor.[25] The United States taxation of capital gains on real property not effectively connected with a United States trade or business was an exception. Congress eliminated that exception through FIRPTA, which added section 897 to the Internal Revenue Code.[26]

Section 897 requires that gains and losses from disposition of a "United States real property interest"[27] be treated as if they were United States source income effectively connected with a United States trade or business.[28] Section 897 thus eliminates use of the installment sales method to avoid tax on the capital gain, since such gain, whenever received, will be treated as effectively connected with a United States trade or business. Treatment under section 897(a)(1) also forecloses availability of the net basis election, whether under sections 871(d) and 882(d), or by treaty provision, as a means of exempting from taxation capital gain from the sale of United States real property, since such gain will be treated as effectively connected anyway. The avoidance techniques of corporate liquidation or exchange are likewise foreclosed under section 897(e), which limits application of nonrecognition provisions to transactions involving the exchange of the "United States Real Property Interest . . . for an interest the sale of which would be subject to taxation [by the United States]."[29]

FIRPTA creates an entity called a United States Real Property Holding Corporation (USRPHC)[30] to apply the rules of section 897. A USRPHC is a corporation, foreign or domestic, with fifty percent or more of the fair market value of its assets being United States Real Property Interests.[31] The sale of shares of a USRPHC would constitute the sale of a United States Real Property Interest and, therefore, would be effectively connected under section 897(a).[32]

Congress intended the provisions of section 897 to supersede conflicting provisions in treaties existing at the time of FIRPTA's effective date.[33] To allow renegotiation of treaties overridden by FIRPTA, a treaty honeymoon period was provided, allowing beneficiaries of existing treaties to utilize these terms

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25. TREASURY REPORT, *supra* note 15, at 13.

26. I.R.C. § 897(c)(1) (West Supp. 1981).

27. *Id. See also* Knight, *supra* note 3, § 30.02[12].

28. I.R.C. § 897(a)(1) (West Supp. 1981).

29. *Id.* § 897(e)(1).

30. *Id.* § 897(c)(2). *See also* Knight, *supra* note 3, § 30.02[13].

31. The definition of a United States Real Property Holding Corporation is more complex than just described, and a detailed analysis of § 897(c) is needed before one attempts to apply § 897. An extensive analysis of the definitions of a United States Real Property Holding Corporation and a United States Real Property Interest and the problems inherent in those definitions is beyond the scope of this article. For such an analysis, see Feder, *Planning Under the Foreign Investment in Real Property Tax Act of 1980*, 59 TAXES 81 (1981); Knight, *supra* note 3, §§ 30.02[12]-[20]; Wilkins, *The Foreign Investment in Real Property Tax Act of 1980*, 2 TAX MGMT. INT'L J. 26 (1981).

32. I.R.C. § 897(a) (West Supp. 1981).

33. H.R. REP., *supra* note 2, at 516.

until December 31, 1984.[34] After the honeymoon period, Congress anticipated section 897 would control.[35]

Finally, some foreign investors could make tax free sales of their United States real property to related parties before the effective date of FIRPTA, thereby securing a stepped-up basis to the property. FIRPTA, however, removes the tax motivation for such sales by providing a carry-over basis in sales to related parties as defined in section 453(f)(1), between December 31, 1979 and June 19, 1980.[36] This rule is also applied when the gain realized in such a sale is exempted because of a treaty obligation of the United States.[37]

RELATIONSHIP BETWEEN FIRPTA AND TAX TREATIES

Success in achieving the uniformity hoped for under FIRPTA depends on the operative language of treaties ratified after the effective date of FIRPTA. Under the United States Constitution, statutes and treaties are considered the supreme law of the land.[38] They are of equal weight, and thus Congress can override a tax treaty by subsequent legislative enactment,[39] as did FIRPTA. Likewise, Congress may supersede existing legislation by merely ratifying a treaty which has provisions inconsistent with that legislation.[40] The possibility that tax treaties modifying or completely overriding the provisions of FIRPTA, could be ratified so quickly after its enactment, has disturbed members of the congressional tax writing committees.[41] Moreover, this situation reflects problems inherent in the current tax treaty writing process.

Presently, proposed treaties with Canada, Argentina, and the Phillipines contain provisions inconsistent with FIRPTA, and thus threaten to modify or override FIRPTA to that extent. The proposed treaty between the United States and Canada[42] first would give Canadians a stepped-up basis in United

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34. FIRPTA, *supra* note 1, § 1125(c)(2) states that any treaty renegotiated between January 1, 1981 and January 1, 1985, will be overridden by § 897 when specified in the new treaty, but in no case later than two years after the treaty is signed.

35. H.R. REP. No. 1479, 96th Cong., 2d Sess. 193, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 5903, 5976. *Hearings on Tax Treaties & Protocols Before the Senate Foreign Relations Comm.*, 96th Cong., 2d Sess. 54 (1981) (statement of Chairman Dan Rostenkowski, House Ways & Means Comm.), *reprinted* in Tax Notes document No. 81-9059, at 3 [hereinafter cited as *Rostenkowski Statement*].

36. FIRPTA, *supra* note 1, § 1125(b)(1)-(2)(A).

37. *Id.* § 1125(d)(2)(B).

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

39. *See* Cook v. United States, 288 U.S. 102 (1933) (dictum). *See also* Rev. Rul. 80-201, 1980-2 C.B. 221.

40. *See* United States v. Lee Yen Tai, 185 U.S. 213, 220 (1902). *See also* R. RHOADES & M. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 9.02 (1981).

41. *Rostenkowski Statement, supra* note 35, at 1-4; Letter from Senator Robert Dole to Senator Charles Percy, *reprinted in* 13 Tax Notes, October 26, 1981, at 1005-06 [hereinafter cited as Dole Letter].

42. Convention on Income Taxes, September 26, 1980, United States-Canada, TAX TREATIES (CCH) ¶ 1301 [hereinafter cited as Canada Treaty].

States real property held on the date the treaty was signed[43] thereby avoiding FIRPTA tax on gain accruing to that date. Second, the treaty excludes property in which the business of the entity is carried on from the definition of real property,[44] which directly exempts certain property from FIRPTA. Third, the treaty has a different entity rule for partnerships, trusts, and estates than that of FIRPTA.[45] Fourth, the treaty would tax a Canadian resident on the sale of shares of a USRPHC only if he owned ten percent or more in the company, whereas section 897 has no limit on a privately held USRPHC, and only a five percent limit if stock in a corporation is regularly traded on an exchange.[46] Finally, the treaty provides that gains from the disposition of interests in entities owning real property may be taxed by one country only to the extent the other country taxes such gains.[47] Under current Canadian law, the sale or other disposition of an interest in a non-Canadian trust is not taxable, regardless of the assets involved.[48] Therefore, this provision would exempt the sale of an interest in a non-United States trust that has United States real property as its principal assets.[49] The Chairman of the House Ways and Means Committee, considering these possibilities indicated that ratification of the proposed United States-Canada treaty may be the beginning of the end of FIRPTA.[50]

The proposed treaty with Argentina also contains the provision found in the Canadian treaty that excepts property used in the business of an entity from the definition of real property.[51] The proposed United States-Phillipines treaty would have drastic effect, as it would completely overrule FIRPTA by allowing capital gains from the disposition of United States real property interest to be taxed only in the Phillipines.[52]

43. *Id.*, Art. XIII(9). The date of effect is September 26, 1980.

44. *Id.*, Art. XIII(3)(c). The treaty excepts from this definition: mines, oil and gas wells, rental property or property for agriculture or forestry. *Id.*

45. *Id.*, Art. XIII(3)(b), which holds that the gain on disposition from such entities is not taxed unless its assets consist principally of United States real property. Compare this to I.R.C. § 897(g) (West Supp. 1981) which provides for a pro-rata flow-through of United States Real Property Interest for such entities. *See also Hearings on Tax Treaties & Protocols Before the Senate Foreign Relations Comm.*, 96th Cong., 2d Sess. 12 (1981) (statement of David H. Brockway, Deputy Chief of Staff, Joint Comm. on Tax'n), *reprinted in* Tax Notes document No. 81-9060, at 14 [hereinafter cited as *Brockway Statement*].

46. *Compare* Canada Treaty, *supra* note 42, Art. XIII *with* I.R.C. § 897(c) (West Supp. 1981).

47. Canada Treaty, *supra* note 42, Art. XIII(3).

48. *Id.*

49. Canadian Income Tax Act § 115(1)(b). *See also* Boidman, *Canadian Investment in U.S. Real Estate — Impact of the New Canada-U.S. Tax Convention and the Foreign Investment in Real Property Tax Act of 1980* (Part II), 6 TAX MGMT. INT'L J. 12, 14-15 (1981).

50. *Rostenkowski Statement, supra* note 35, at 4. The Chairman stated: "If we are to extend such concessions to Canada, I cannot imagine that our other major treaty partners will not demand the same treatment." *Id.* It must be remembered that a treaty is the product of the give and take of negotiations and one party cannot always expect to receive all that it desires. *See infra* note 76 and accompanying text.

51. Convention on Income Taxes, May 7, 1981, United States-Argentina, TAX TREATIES (CCH) ¶ 303, Art. 13(5).

52. Convention on Income Taxes, October 1, 1976, United States-Phillippines, TAX TREATIES (CCH) ¶ 6617, Art. 14(2).

TAX TREATY WRITING PROCESS

Tax treaties and protocols are negotiated by the Office of International Tax Affairs of the Treasury Department. Negotiations generally proceed as follows.[53] The United States Model Tax Treaty[54] is used as a starting point for negotiations. Public comment is requested by the Treasury when it announces the intention to negotiate a tax treaty. When a text is agreed upon, the treaty is initialed by the negotiators. After official translations are prepared and the form of the tax treaty is approved by the State Department, the treaty is signed by the appropriate government officials which, in the United States, is usually the Secretary of State. The treaty is then sent to the White House where the President signs the letter of transmittal to the Senate, requesting that the Senate ratify the treaty. Hearings on the treaty are held by the Senate Foreign Relations Committee, which can report the treaty to the full Senate for rejection or approval, with or without alterations. The full Senate then acts on the treaty and any proposed changes. Approval requires a two-thirds majority vote. After approval, the President exchanges instruments of ratification. If the treaty was approved by the Senate with a reservation or an amendment, a protocol is negotiated with those changes which then requires approval of the Senate by a two-thirds majority vote.

As this process demonstrates, the House of Representatives and specifically the tax writing committees, has very little input in the tax treaty writing process. The Senate too is often restricted in its action because any change in the proposed treaty could affect a provision deemed important by the treaty partner and thus result in that partner's refusal to ratify.[55] In fact, the Chairman of House Ways and Means Committee has indicated that often the need to conform to the terms of a proposed tax treaty has required Congress to deviate from its own tax policies.[56] Although the staff of the Joint Committee on Taxation does assist the Senate Foreign Relations Committee and its staff, it is not involved in the formation of treaty policy or the negotiation of treaties.[57] The Senate Foreign Relations Committee and its staff do not have expertise in the tax area. Thus, tax treaties which must go to the Foreign Relations Committee under the present procedure, tend to receive low priority by that committee.[58]

Suggested Changes to the Current Process

Solutions to problems created by the current tax treaty drafting process, as

53. JOINT COMM. ON TAX'N, TAX TREATIES: STEPS IN THE NEGOTIATION & RATIFICATION OF TAX TREATIES (1979).

54. Convention on Income Taxes, Treasury Department's Model Income Tax Treaty, June 16, 1981, TAX TREATIES (CCH) ¶ 158.

55. *Income Tax Treaties: Hearings Before the Subcomm. on Oversight of the Comm. of Ways & Means*, 96th Cong., 2d Sess. 27 (1980) (statement from David Brockway to Chairman Sam Gibbons) [hereinafter cited as *Oversight Hearings*].

56. *Rostenkowski Statement, supra* note 35, at 1. As Chairman Rostenkowski stated: "Too often the treaty presented [to the Senate for ratification] conflicts with or negates the legislative tax policies that we in the tax writing Committees and in Congress have established." *Id.*

57. *Oversight Hearings, supra* note 55, at 15, 19 (statement of David Brockway).

58. *Id.* at 103 (statement of Carl Nordberg).

evidenced by FIRPTA and the proposed treaties with Canada, Argentina, and the Phillipines, should be sought. Recently four members of the Senate Foreign Relations Committee addressed a letter to the Treasury Secretary which contained several suggestions designed to overcome weaknesses in the tax treaty drafting process.[59] The senators requested that the Secretary's staff regularly brief the staff members of the Senate Foreign Relations and Finance Committees, the House Ways and Means Committee, and the Joint Committee on Taxation on all current and proposed negotiations.[60] They further requested specific notice of treaty provisions impacting substantially on current tax statutes.[61]

Another proposal, which gives Congress more control of the treaty writing process, goes to the nature of tax treaties. Tax treaties are self-executing. Consequently, they do not require implementing legislation by Congress to effect the treaty provisions. Treaties do not impose tax; only the laws of the treaty partners actually impose the tax.[62] Therefore, a proposal has been made that would require the tax writing committees of Congress to draft implementing legislation for tax treaties.[63] A similar proposal suggests adopting a drafting procedure for tax treaties similar to that used for trade agreements under the Trade Act of 1974, which requires extensive consultation with Congress before a treaty is submitted for approval.[64]

As early as 1946, there were suggestions to give the Joint Committee on Taxation a greater role in the tax treaty writing process because of its expertise.[65] A related suggestion is to create a special oversight group, consisting of majority and minority members from the House Ways and Means Committee, the Senate Finance Committee, and the Senate Foreign Relations Committee, to act as Congressional representatives in tax treaty negotiations.[66] Furthermore, this suggestion would require that Congress pass a joint resolution adopting the language of the United States Model Tax Treaty.[67] If a proposed treaty deviates from the model, the tax writing committee would have to approve the

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59. 14 Tax Notes 30 (Jan. 4, 1982).

60. *Id.*

61. *Id.*

62. For example, Article 2 of the United States Model Income and Capital Tax Treaty simply makes reference to the Internal Revenue Code. Basically, a treaty only modifies the source of income rules and some of the tax rates found in the Code. Where not modified the Code still applies. Treasury Department's Model Income Tax Treaty of May 17, 1977 Art. 2 (1977) (Treasury Dep't), *reprinted in* TAX TREATIES (CCH) ¶ 153 [hereinafter cited as Model Treaty]. Requiring congressional approval of the model treaties would also alleviate some of the problems in the current treaty process. This would enhance any suggestions designed to increase congressional input in the treaty writing process. *See infra* notes 65-69 and accompanying text.

63. *Oversight Hearings, supra* note 55, at 37 (letter from David Brockway to Chairman Sam Gibbons).

64. *Id.*

65. 92 CONG. REC. 56108-10 (June 1, 1946) (statements of Senators Taft and La Follette).

66. *Oversight Hearings, supra* note 55, at 161 (memorandum of Charles M. Bruce).

67. *Id.* This recommendation also states that the present position of International Tax Counsel on the Joint Comm. on Tax'n Staff should be made permanent. *Id.*

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change before the treaty could be sent to the Senate for action.[68] Again, these approval procedures would parallel those found in the trade agreement area.[69]

Another possible method of integrating national tax policy into the treaty drafting process would be inclusion of sunset provisions, allowing the treaty to automatically expire if not extended by Congress.[70] Sunset provisions would allow the Senate to exert greater control over the tax treaty policy by subjecting all existing treaties to its periodic review and approval.[71] Likewise, the Senate could exercise greater latitude in deciding whether to approve the revised treaties and to continue the treaty relationship if the consequence of rejecting the revised treaty would be to have no treaty at all.[72] The Chairman of the Ways and Means Committee has suggested that this procedure at least be adopted in treaties with developing countries.[73] Additionally, all treaties more than nine years old would be subject to hearings designed to recommend whether to keep or amend them.[74]

There are additional problems in the international setting because many of the United States' treaty partners would not agree to proposals that would open the tax treaty negotiation process to the public. Instead, they would prefer to maintain the secrecy provided in the current procedure.[75] Public hearings would tend to impede further the already cumbersome process of treaty writing and approval. The least objectionable proposal would be the addition of sunset provisions to tax treaties, thereby allowing the creation of exceptions to United States tax statutes when necessary, while ensuring that such exceptions do not exist beyond their utility. In all of these suggestions exceptions to tax statutes may be necessary in some instances, because of the bilateral nature of the treaty negotiating process, which requires compromise on both sides. Congress must be sensitive to the overall foreign relations conducted through the State Department because exceptions to tax statutes can serve as reciprocal concessions for more favorable results in other areas.[76]

Planning with Current and Proposed Treaties

Absent adoption of one of the above proposals, treaties inconsistent with tax statutes will continue to exist. It is necessary, therefore, for the tax practi-

68. *Id.*

69. *Id.* at 102 (statement of Robert Patrick, Jr.).

70. Sunsetting legislation is not new to Congress, *see, e.g.,* Comprehensive Environmental Response, Compensation and Liability Act of 1980, 42 U.S.C. § 9653 (Supp. IV 1980).

71. *Oversight Hearings, supra* note 55, at 38 (letter of David Brockway to Chairman Sam Gibbons).

72. *Id.*

73. *Rostenkowski Statement, supra* note 35, at 11.

74. Langer, *The Need for Reform in the Tax Treaty Area,* INCOME TAX TREATIES 755 (J. Bischel ed. 1978). At the Oversight Hearings, Mr. Langer stated that the United Kingdom does an annual review of all of its tax treaties. *Oversight Hearings, supra* note 55, at 156 (statement of M. Langer).

75. *Oversight Hearings, supra* note 55, at 60-61 (statement of David Rosenbloom, Int'l Tax Counsel, Dep't of the Treasury).

76. The proposed United States-Canada Treaty was negotiated over a six year period and the Treasury Department negotiators are said to believe it is the most favorable result they could have obtained. *Brockway Statement, supra* note 45, at 3.

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tioner to be aware of recently ratified treaties, as they may present planning opportunities apparently negated by the Internal Revenue Code. Dealing specifically with FIRPTA, the tax planner must remember the treaty honeymoon period provided in the Act, as it may allow tax avoidance if utilized within the proper time limits.[77] If the tax treaties with Canada, Argentina, and the Phillipines are ratified in their current form, the provisions in these treaties overriding FIRPTA may be applied as previously discussed. An additional consideration is that these treaties, in their present forms, would be applicable to entities created in Canada, Argentina, and the Phillipines, and, therefore, the use of a holding structure must be considered.[78]

The problem then faced by the tax practitioner is whether the United States taxing authorities recognize the third country holding structure as a person properly subject to tax on the United States real estate income in question.[79] The third country holding structure must serve some legitimate business purpose, or it will not be recognized for tax purposes. If the holding structure does not carry out a valid business function, and is created merely to take advantage of a treaty provision, it will be disregarded.[80] A second argument that could defeat the use of a third country holding structure is that, although the entity may not be disregarded as a sham, it is a mere conduit or agent used solely for the purpose of avoiding taxation.[81]

To counteract the problems inherent in treaty shopping the United States must insist that a provision is included in its tax treaties aimed at preventing or restricting treaty shopping abuse. Such a provision is found in the United

77. A treaty may allow the foreign investor to continue utilizing the avoidance techniques discussed until December 31, 1984 because of the delayed effective date of section 897 as it applies to tax treaties. FIRPTA, *supra* note 1, § 1125(c). For a detailed discussion on the use of tax treaties and the relationship with FIRPTA, see Knight, *supra* note 3, § 30.03.

78. The treaties apply to "residents" of the treaty partners and would include entities organized within Canada, Argentina and the Philippines within the treaty benefits.

79. Knight, *supra* note 3, § 30.03[7].

80. *See, e.g.,* Ingemar Johanson v. Commissioner, 336 F.2d 809, 64-2 U.S.T.C. ¶ 9743 (5th Cir. 1964) (no legitimate business purpose); Ross Glove Co. v. Commissioner, 60 T.C. 569 (1973) (valid business purpose); Perry R. Bass v. Commissioner, 50 T.C. 595 (1968) (valid business purpose and not to be disqualified if also organized to obtain the benefits of a tax treaty); Columbia Rope Co. v. Commissioner, 42 T.C. 800 (1964) (valid business purpose); William C. Hay v. Commissioner, 2 T.C. 460 (1943) (no valid business purpose), *aff'd,* 145 F.2d 1001 (4th Cir. 1944), *cert. denied,* 324 U.S. 863 (1945). Note that Rev. Rul. 75-23, 1975-1 C.B. 290, recognized for tax purposes a Netherlands Antilles corporation which was organized for the following reasons:

(1) Foreign investors were unfamiliar with the concept of a United States limited partnership.

(2) Stock was more readily transferrable.

(3) Without the corporation, individual investors as limited partners would have had to file tax returns. *Id.*

81. Aiken Indus., Inc. v. Commissioner, 56 T.C. 925 (1971). Although the entity was a "corporation" as defined in the United States-Honduras treaty, it acted only as a conduit and, therefore, interest payments were not "received by" the corporation in its own behalf and those payments were therefore not within the coverage of the treaty. *Id. See also* Frank Jerome v. Commissioner, 24 T.C.M. 1763 (1965).

States Model Tax Treaty.[82] The provision limits the benefits of the treaty to residents "other than individuals" in which more than seventy-five percent of the beneficial interest is owned, directly or indirectly, by individual residents of the treaty partner, provided that the income of such an entity is not substantially used to pay liabilities to persons not residents of that partner.[83] This limitation does not apply if the entity can establish that its principal purpose is not to obtain the tax treaty benefits.[84] The entity may show this by establishing that the income is incidental to or derived in connection with business operations in the partner state, or by demonstrating that the owners of the entity are residents of a country with treaty benefits substantially similar to those in the treaty so that no benefit is being obtained by use of the holding structure.[85]

It should be noted that merely because a treaty overrides FIRPTA or in some other way reduces or eliminates United States taxation, all investments should not be structured solely toward United States tax avoidance. Careful study of how the entity will be taxed in the treaty partner state must first be made because the use of the holding structure in a third country is rarely cost-free.[86] The investigation, however, may prove worthwhile. As one commentator noted, until Congress takes affirmative action to prevent treaty shopping, lawyers will not hesitate to advise their clients to do so.[87]

CONCLUSION

Congress enacted FIRPTA with the objective of obtaining equal treatment for foreign and domestic investors. Therefore, that Congress intended that

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82. *See* Model Treaty, *supra* note 62, art. 16. Article 16, entitled "Investment or Holding Companies," mandates:

> If 25 percent or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed by that State on that company with respect to dividends, interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on corporate business profits, then, not withstanding the provisions of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties), that other State may tax such dividends, interest or royalties. For the purposes of this Article, the source of dividends, interest or royalties shall be determined in accordance with paragraph 3(a), (b), or (c) of Article 23 (Relief from Double Taxation).

More recently, Congress passed the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. PL 97-248, 96 Stat. 324. Section 342 of the Act requires "the Secretary of the Treasury or his delegate" to "prescribe regulations establishing certification procedures, refund procedures, or other procedures." These procedures are to "ensure that any benefit of any treaty relating to withholding of tax under sections 1441 and 1442 of the Internal Revenue Code of 1954 is available only to persons entitled to such benefit." The Act further provides for prescription of these regulations within two years from its enactment date.

83. *Id.*

84. *Id.*

85. *Id.*

86. *Oversight Hearings, supra* note 55, at 75 (statement of David Rosenbloom).

87. Langer, *supra* note 74, at 743.

FIRPTA override existing treaties. Congress did not consider that FIRPTA could be modified or overridden because of the inadequacies in tax treaty drafting process and the resulting possibility of subsequent inconsistent treaty provisions.[88] More cooperation between the tax writing committees and the Treasury Department would help alleviate the present lack of consistency and reliability in federal tax policy caused by the failure to integrate national tax policy in the treaty drafting process. Furthermore, the present instability in tax legislation susceptible to subsequent treaty modification requires tax practitioners to know whether tax treaties could impact on their practice. As foreign investment in the United States continues to increase, more tax practitioners will have to stay abreast of the current status of United States tax treaties to obtain the best results for their clients.

RICHARD C. JANS

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88. Dole Letter, *supra* note 41, at 1006.