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Marty Patrick*

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Abstract

The tax advantages once granted a foreigner using a foreign corporation to invest in United States real estate have disappeared.

KEYWORDS: ERTA, FIRPTA, impact

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Introduction

The tax advantages once granted a foreigner using a foreign corporation to invest in United States real estate have disappeared. This paper will comment on the provisions of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)[1] and the Economic Recovery Tax Act of 1981 (ERTA).[2]

Many foreign investors will be affected by the new laws. Recently, a study was conducted by the Secretary of the Treasury identifying foreign investment in United States real property. Although the information was taken from press clippings and the actual amount invested is probably much greater, the Office of Foreign Investment found that foreigners had invested $1,101,000,000 in United States real property in 1978.[3] Of this dollar volume, an estimated 25% was invested in Florida realty alone. As was reported in a recent edition of *Florida Trend* magazine,[4] $241,000,000 was invested in Miami in 1979, including an "alarming number [of investments] traced to . . . narcotics [money], tax evasion and currency smuggling." In view of this phenomenon, Congress promulgated FIRPTA and ERTA in an effort to curb the use of illicit funds in purchase of United States realty. Moreover, the legislation was passed to stem the growing tide of foreign investment with its perceived attendant influence on the American public.

1. Pub. L. No. 96-499, § 1121, 94 Stat. 2682.
2. Pub. L. No. 97-34, § 831, 95 Stat. 352.
3. Department of the Treasury, Taxation of Foreign Investment in U.S. Real Estate (May 1979).
4. Calonius, *Offshore Money Floods Miami*, Florida Trend, at 38.

Taxation of the United States Citizen and the United States Corporation by the United States

Unlike citizens of other countries, United States citizens, residents and corporations are taxed on their worldwide income. Deductions are allowed for most of the ordinary and necessary expenses involved in the earning of income.[5] Usually, gains from one activity may be offset against the losses of another.[6] The allowance of deductions and the ability to offset gains against losses are most important to the real estate investor. Income from real estate investments can be reduced by the amounts paid for operating the property,[7] mortgage interest,[8] insurance,[9] taxes[10] and depreciation.[11]

Real estate in Florida, appreciating rapidly over the last ten years, lures investors with the promise of large capital gain. Income earned from operating the property has not been the primary motivation for investment in Florida real estate, since it pales in comparison to the profits made through property resale.

When real estate which is held for more than one year is sold, the United States taxpayer must treat the gain, up to the amount of excess depreciation, as ordinary income and the remainder may be treated as capital gain.[12] Additionally, an individual is able to deduct sixty percent of the capital gain on the sale of the property and is only required to pay tax on the remaining forty percent.[13] Thus, with a maximum tax rate of fifty percent on ordinary income in 1982, the maximum effective rate of tax on an individual's capital gain will be twenty percent (forty percent of fifty percent).

An individual with substantial long term capital gain may be affected by the alternative minimum tax.[14] This tax, imposed on the sum of taxable income plus the long term capital gains deduction plus cer-

5. I.R.C. § 162.
6. *Id.* § 1231.
7. *Id.* § 162.
8. *Id.* § 163.
9. *Id.* § 162.
10. *Id.* § 164.
11. *Id.* § 167.
12. *Id.* § 1238.
13. *Id.* § 1202(a).
14. In determining the taxpayer's total tax liability, the alternative minimum tax

tain adjusted itemized deductions, is assessed at progressive rates up to twenty percent. The individual's tax liability is the higher of the tax computed by the ordinary rules, or the tax computed under the alternative minimum tax rules. In contrast, the long term capital gains of a United States corporation are taxed, without any special deduction, as ordinary income or at twenty-eight percent, whichever is lower.[15]

Taxation of Non-Resident Aliens and Foreign Corporations by the United States

The United States taxes a non-resident alien[16] or a foreign corporation[17] on three types of income. These include: income effectively connected with a United States trade or business as opposed to investment income;[18] certain other income including interest, dividends, rents and other gain from a United States source not effectively connected with a United States trade or business;[19] and income derived from real property located in the United States, if an election is made to treat that income as connected with a United States trade or business.[20]

Tax Treaties

Tax treaties avoid double taxation on the income of persons, residents or corporations organized in one country, deriving income in another.[21] These treaties regulate contracting states rights to tax par-

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is to be paid only to the extent that the tax exceeds the taxpayer's regular tax liability. *Id.* § 55.

15. *Id.* § 1201.

16. A non-resident alien is "an individual whose residence is not within the United States, and who is not a citizen of the United States." Treas. Reg. § 1.871-2(a), T.D. 6258, 1957-2 C.B. 368.

17. A foreign corporation is a corporation, association, joint-stock company or insurance company which is not created or organized under the laws of the United States or any state. I.R.C. §§ 7701(a)(3), (4) & (5).

18. This income can be offset by the usual allowable deductions and is generally taxed in the same manner as the income of a United States citizen or corporation.

19. No deductions are allowed to offset this type of income, and it is taxed at thirty percent (or less if a tax treaty applies).

20. I.R.C. § 871 (d); Treas. Reg. § 1.871-10, T.D. 7332, 1975-1 C.B. 204.

21. Tax treaties between the United States and foreign countries greatly change the results that would otherwise obtain under domestic tax law. *See generally* M.

ticular types of income through reciprocal concessions. Generally, United States treaties require the United States to recognize and allow a credit for taxes paid to the treaty partner and the United States agrees to reduce or eliminate its tax on United States source income of persons or corporations organized in the treaty partner's country.[22] Although recent treaties limit the aforementioned benefits, some of the older conventions do not, and they may still be used by third country residents for tax avoidance.[23]

In 1948, the United States signed an income tax treaty with the Netherlands,[24] the provisions of which were extended by protocol to the Netherlands Antilles in 1955.[25] A Naamloze Vennootschap (N.V.), a limited liability company similar to the familiar United States corporation, can deduct operating expenses, property taxes, mortgage interest and depreciation in calculating its corporate income tax.[26] Additionally, the Netherlands Antilles permits its corporations to issue bearer shares, which allows for anonymity.[27] Insofar as the United States assesses tax against the N.V., the United States-Netherlands Antilles treaty modifies the treaty partner's law in three ways which are of prime importance to the real estate investor.

Article V of the treaty states:
"Income of whatever nature derived from real property and interest from mortgages secured by real property shall be taxable only in the Contracting State in which real property is situated."[28]

This provision obviates the possibility of taxation by both treaty partners. Thus, foreign investors using an N.V. to hold title to United States real estate are assured that they will not be taxed in the Netherlands Antilles. The reservation clause of Article V permits the United States (i.e., the country in which the property is located) to tax the

LANGER, PRACTICAL INTERNATIONAL TAX PLANNING (2d ed. 1979).

22. *Id.*

23. *Id.*

24. M. LANGER, THE NETHERLANDS ANTILLES-UNITED STATES OF AMERICA INCOME TAX TREATY (1973).

25. *Id.*

26. *See generally* PRICE WATERHOUSE, DOING BUSINESS IN THE NETHERLANDS ANTILLES (1979).

27. *Id.*

28. *See* note 24 *supra*.

gains derived from the disposition of real property situated in the United States. However, in many instances, United States income producing property does not generate United States taxable income.[29] By taking all the allowable deductions, a real estate investor may be able to reduce his United States tax liability to a minimum. Thus, the typical N.V. investing in United States real estate pays little or no United States income tax, not because of the treaty, but because of normal United States tax rules which encourage investment in real estate by anyone as a tax sheltering device.

Article XII of the treaty states:
"Dividends and interest paid by a Netherlands Antilles corporation shall be exempt from United States tax except where the recipient is a citizen, resident or corporation of the United States."[30]

The treaty article takes priority over conflicting Internal Revenue Code provisions.[31] Consequently, this treaty provision allows interest to be paid tax free to the foreign shareholder of an N.V., effectively avoiding United States tax since I.R.C. Sections 1442 and 861 could subject that foreign shareholder to United States withholding tax in certain circumstances.[32]

Article X as amended by Article II of the 1963 Protocol states: "A resident or corporation of one of the Contracting States deriving from sources within the other Contracting State royalties in respect of the operation of mines, quarries, or natural resources, or rentals from real property, may elect for any taxable year to be subject to the tax of such other Contracting State on such income on a net income basis."[33]

This provision of the treaty allows the N.V. to elect to be taxed, on a net income basis, for all income derived from the rental of United States real estate and mineral royalties. The election allows the N.V. to

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29. J. BISCHEL, INCOME TAX TREATIES 405 (1978).

30. *See* note 24 *supra.*

31. I.R.C. § 7852(d). *See also* text accompanying notes 59 and 60 *infra.*

32. A shareholder of a foreign corporation will be subject to United States withholding tax on dividends received if fifty percent or more of the gross income of the foreign corporation was effectively connected with the conduct of a trade or business within the United States over a certain period of time. A similar withholding tax is applied to interest received by a shareholder of a foreign corporation. I.R.C. §§ 861(a)(2)(B), (a)(1)(C) & (D).

33. *See* note 24 *supra.*

take advantage of any deductions generated by the real property and subjects it to a progressive income tax on its net income rather than the flat thirty percent tax of Section 1442.

Obviously, Article X is important only when the N.V. is not actually engaged in a trade or business within the United States,[34] although the election subjects it to taxation as though it was. The guidelines are unclear as to when a foreign corporation is engaged in a United States trade or business as distinct from investment. It would seem that agricultural land held for investment, and net leased to a farmer, would not be considered connected with a United States trade or business. Similarly, improved property, leased to a single tenant under a net lease, should produce the same result.[35]

FIRPTA's New Rules

Extensive publicity about the large degree of foreign investment in United States real estate, including Florida farmland and income producing property,[36] resulted in Section 553 of the Revenue Act of 1978.[37] This provision directed the treasury department to conduct a study of the tax treatment of gain derived from the sale of United States real property owned by non-resident aliens and foreign corporations.[38]

From the recommendations of this study came Public Law No. 96-499, entitled the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) which added Section 897 to the Internal Revenue Code of 1954. Prior to the enactment of FIRPTA, a foreign investor could avoid United States income taxation on gain realized from the sale or exchange of United States real property[39] so long as the gain was "not effectively connected with the conduct of a trade or business within the

34. Garelik, *What Constitutes Doing Business Within the United States by a Non-resident Alien Individual or a Foreign Corporation,* 18 TAX L. REV. 423 (1963).

35. A net lease contains a provision which requires the lessee to pay taxes, insurance and maintenance in addition to rent.

36. *E.g., Calonius, Offshore Money Floods Miami,* FLORIDA TREND, Apr. 1980.

37. Pub. L. No. 95-600, § 553, 92 Stat. 2891.

38. *See* note 3 *supra.*

39. I.R.C. § 862(a)(5).

United States."[40] These avoidance devices included an installment sale,[41] a tax free exchange for foreign real property[42] and the sale of corporate stock to a corporate purchaser who would transfer the cost of the stock to the general assets of that corporation upon its liquidation.[43] The Act radically changed the way in which foreign investors are taxed on disposition of their real property investments and contains new filing and disclosure rules.

The new rule of Section 897 is: gain or loss from the disposition of a United States real property interest by a non-resident alien or foreign corporation must be reported under Section 871(B)(1) or 882(a)(1), "as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business."[44] This provision effectively eliminates the disparity in the tax treatment of foreign and domestic investors upon the disposition of United States real property.

Section 897 broadly defines a United States real property interest to include any interest in real property, including an interest in a mine, well or other natural deposit located in the United States.[45] The definition includes fee ownership, leaseholds, and options to acquire real property, as well as personalty associated with the real estate.[46] Additionally, it includes any interest in a domestic corporation holding real property.[47] Though an equity interest in a foreign corporation is not a United States real property interest,[48] the Act specifically requires the recognition of gain by a foreign corporation on a distribution to its shareholders of a United States real property interest including a distribution in liquidation or redemption.[49]

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40. *Id.* § § 872(a) & 882(b).
41. *Id.* § 453.
42. *Id.* § 1031.
43. *Id.* § § 331, 334(b)(2), & 336.
44. *Id.* § 897(a)(1).
45. *Id.* § 897(c)(1)(i).
46. *Id.* § 897(c)(6).
47. *Id.* § 897(c)(1)(ii).
48. *Id.* § § 897(c)(1)(i) & (ii) by negative implication.
49. The gain recognized is an amount equal to the excess of the fair market value of the United States real property interest over its adjusted basis. *Id.* § 897(d)(1).

Nonrecognition Provisions

Nonrecognition of gain or loss provisions are applicable to Section 897 only when there is an exchange of a United States real property interest for an interest which would itself be taxable when sold.[50] The secretary of the treasury, charged with the task of prescribing regulations necessary to prevent federal income tax avoidance, will determine the extent to which other nonrecognition provisions will apply.[51] Until regulations are issued, it would be imprudent to rely on any nonrecognition provisions other than Section 1031, involving like-kind exchanges of property.[52] However, a Section 1031 exchange of a United States real property interest for a foreign property interest will be subject to United States taxation under Section 897 because the property received would not be subject to future United States taxation.[53]

FIRPTA provides that gain will not be recognized "if the basis of the distributed property in the hands of the distributee is the same as the adjusted basis of such property before the distribution increased by the amount of any gain recognized by the distributing corporation."[54] However, the Economic Recovery Tax Act of 1981[55] amends this subsection to override the nonrecognition provision if the purchaser would not be subject to taxation on a later sale or exchange of the property. The new rule of Section 897(d)(1)(B) provides that in addition to the carryover basis requirement, the distributee must be subject to taxation on a subsequent disposition of the distributed property at the time the distributee received the property. The amendment makes it clear that a foreign corporation cannot avoid paying tax on gain from the disposition of a United States real property interest where a carryover basis transaction is entered for the purpose of avoiding taxation.

The following example illustrates the new provisions. Sociedad Anonima N.V., a Netherlands Antilles corporation, owns an apartment

50. *Id.* § 897(e)(1).
51. *Id.* § 897(e)(2).
52. This section provides nonrecognition treatment for the exchange of property held for productive use in a trade or business, or for investment, solely for like-kind property.
53. I.R.C. § 897(e)(1).
54. *Id.* § 897(d)(1)(B).
55. Pub. L. No. 97-34, § 831, 95 Stat. 352.

building in Miami. The corporation exchanges this United States real property for an apartment building in Rio de Janeiro in a Section 1031 like-kind exchange. The foreign property held by the N.V. after the like-kind exchange would never have been subject to United States taxation, as ultimately its disposition would not be that of a United States real property interest. Nonetheless, this transaction will now be subject to immediate United States taxation under Section 897. The result would be different if the N.V. exchanged the apartment building in Miami for one in Vail, Colorado. This exchange would not be subject to immediate United States taxation, since any gain realized on the later disposition of this property is subject to United States taxation.

Although permitted in the past, the Act specifically precludes a foreign corporation's utilization of Section 337 liquidation provisions in the disposition of a United States real property interest.[56]

As a result of these changes, the foreign investor is left with three unpleasant choices. The foreign corporation can sell the property and be taxed accordingly. Alternatively, the investor can sell the stock at a discount reflecting the tax liability the corporation would incur when it distributes the property. Finally, the foreign corporation can be liquidated and pay the tax imposed upon the liquidation.[57]

Effective Date

Section 894(a) provides that income of any kind will be exempt from taxation to the extent required by any treaty obligation of the United States, and Section 7852(d) precludes the application of any Internal Revenue Code provision which would be contrary to any treaty obligation of the United States. As previously noted, the United States entered into a bilateral treaty with the Netherlands Antilles in 1955.[58] Where no treaty exists, Section 897 is applicable to dispositions of United States real property interests after June 18, 1980. Where treaty obligations do exist, Section 897 will not apply until January 1, 1985. If, before January 1, 1985, an existing treaty is renegotiated, to resolve conflicts between the old treaty and Section 897 provisions, the new

56. I.R.C. § 897(d)(2).
57. Feder, *Planning Under the Foreign Investment in Real Property Tax Act of 1980,* 59 TAXES 81 (1981).
58. *See* text accompanying notes 21-35 *supra.*

treaty may delay the application of Section 897 for a period not to exceed two years after the signing of the new treaty.[59]

Disclosure Requirement

In 1980, Congress added Section 6039C and amended Section 6652[60] to provide new filing and disclosure requirements for foreign corporations having a substantial investor in a United States real property interest at any time during the calendar year.[61] A substantial investor is defined as any person whose holdings in a foreign corporation's United States real property interest exceed $50,000.[62]

The following information must be reported to the Internal Revenue Service:[63]

1) The name and address of each substantial investor.
2) Information regarding the entity's assets.
3) Any other information that the regulations might require.

A foreign corporation which is required to file must also provide the substantial investor with a statement containing the following:[64]

1) The name and address of the foreign corporation.
2) The substantial investor's pro-rata share of the United States real property interest held by it.
3) Any other information that the regulations may require.

Section 6039(b)(2) waives the filing requirement if the foreign corporation furnishes the "necessary security" to ensure payment of any taxes in connection with a United States real property interest. The committee report, accompanying the new legislation, partially clarifies the meaning of this term and states that the I.R.S. definition of necessary security will depend on individual facts and circumstances. The report provides illustration. A foreign corporation, whose only asset is a

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59. Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), Pub. L. No. 96-499, § 1125, 94 Stat. 2690.
60. *Id.* § 1123, 94 Stat. 2687.
61. I.R.C. § 6039C(b)(1).
62. *Id.* § § 6039C(b)(4)(B) (i) & (ii).
63. *Id.* § § 6039C(b)(1)(A), (B) & (C).
64. *Id.* § § 6039C(b)(3)(A), (B) & (C).

tract of undeveloped United States real property, might be required to provide the I.R.S. with a recorded mortgage giving it a security interest in the property or provide a guarantee of payment by a person who would pay the tax in the event that the foreign corporation did not. Where a corporation issues bearer shares, or the trustee refuses to disclose the identity of beneficial interest owners, the foreign corporation would be required to provide the necessary security. This provision may be used by foreign investors who are unwilling to disclose their participation in United States real property investments but who are willing to be taxed by the United States on the disposition of such property.

Failure to report the above information when required will result in penalties up to $25,000 per calendar year, until the information is provided.[65] Willful failure to file a return or supply information is a misdemeanor and the offender will be subject to a maximum fine of $10,000 and one year in prison.[66]

Conclusion

The provisions of FIRPTA and ERTA seem to diminish the attractiveness of investment in real estate by foreigners. Absent a novel approach, the utilization of an N.V. as a primary vehicle for foreign investment in Florida real estate is no longer advisable where income tax considerations are a prominent part of the investment decision.

Although most of the obvious tax advantages once associated with an N.V. are gone, there are several reasons foreign investment in Florida real estate will not diminish as rapidly as legislators believe. First, the United States is a stable democratic nation where real estate is unlikely to suffer great decreases in value. Second, it is unlikely that the United States government would take privately owned property without just compensation to the owner. These factors are attractive to foreign investors, who may fear political instability affecting property value, or uncompensated governmental takings, in their own countries. Finally, while the disparate tax treatment given local and foreign treaty investors has been minimized, United States real estate remains an ex-

65. *Id.* § 6652(g).
66. *Id.* § 7203.

cellent tax avoidance device for an investor, since United States tax law encourages investment in real estate.

Marty Patrick