AN ANALYSIS OF THE 1984 WITHHOLDING REQUIREMENTS UNDER THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT: ARE NEW METHODS OF HANDLING U.S. REAL ESTATE TRANSACTIONS ON THE HORIZON?

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In 1984, Congress enacted a withholding system to serve as the enforcement mechanism for the collection of taxes under the Foreign Investment in Real Property Tax Act. Although promulgated as a response to widespread dissatisfaction with the initial reporting system, the withholding scheme soon proved equally unsatisfactory.

This Comment argues that on a disposition of U.S. real property by a foreign investor, the withholding obligation should be based on gain recognized rather than on amount realized. If this proposal is accepted, the two principal inequities created under the present withholding system — insufficient cash to meet the withholding obligation and excess withholding — will be eliminated, and the congressional goal of capital gains taxation of foreigners will be preserved.

1. Introduction

Traditionally, the United States has welcomed foreign investment in U.S. real estate [1] because of the economic advantages which flow from the influx of foreign capital [2]. Foreigners, too, have recognized the benefits of owning property in the U.S., where the investment climate is characterized by political and economic stability, strength of foreign currencies relative to the dollar, and depressed land values [3]. In the 1970s, however, the common perceptions of Arabian chieftains buying up huge tracts of land [4] and the increased foreign ownership of U.S. property [5] led to a multitude of congressional enactments [6]. This activity culminated in the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) [7], which imposes a tax on the disposition of foreign-owned U.S. real estate.

Congress initially designed a reporting system to enforce collection of the tax imposed under FIRPTA [8], but compliance was difficult due to the confusion and uncertainty surrounding the reporting rules [9]. In apparent recognition of the complexity and ineffectiveness of the reporting requirements, Congress replaced them in 1984 with withholding requirements to


This Comment is dedicated to my parents for their inspirational guidance and constant support.
ensure payment of the tax liability [10]. Under the new system, a purchaser of a U.S. real property interest (USRPI) [11] from a foreigner [12] will be required to withhold and transmit to the Internal Revenue Service (IRS) ten percent of the amount realized by the foreigner on the transaction [13]. This broad rule potentially subjects parties to a U.S. real estate transaction to unreasonable liabilities [14]. For example, purchasers are required to withhold ten percent of the purchase price even when the initial cash consideration is less than ten percent, as in the case of some installment sales [15]. In addition, there is a substantial risk of excess withholding, i.e., withholding more than the tax liability imposed by FIRPTA [16]. Although it is possible to obtain a withholding certificate which permits reduced withholding [17], the IRS normally requires ninety days to process the request, depriving the foreign investor of the use of the withheld funds [18].

By placing the liability for withholding on the purchaser and depriving the seller of the use of excess amounts withheld, the 1984 withholding requirements deter foreign investment in the U.S. To remedy this result, Congress should modify the withholding system to base the amount withheld on gain recognized rather than on amount realized. Under this proposal, the amount withheld would more accurately reflect the actual tax liability and reduce the "forced loan" to the IRS. By curing the inequities and uncertainties inherent under the present withholding system, the proposed modification would stimulate the currently depressed level of foreign investment in U.S. real estate [19] which, in turn, would provide the U.S. with the benefits of foreign ownership of U.S. real estate [20].

This Comment reviews the pre-FIRPTA public and legislative responses to foreign investment, analyzes FIRPTA and the withholding provisions, and concludes that the modification described above is necessary to mitigate FIRPTA's negative effect on the U.S. real estate industry. Section 2 begins by examining the state and federal regulations concerning foreign investment in U.S. real estate. The problems created by FIRPTA in imposing a tax on foreign investors are then explored in Section 3. In Section 4, the 1984 amendments to FIRPTA implementing a withholding system to ensure collection of the tax are analyzed and found to contain serious flaws. As a solution to the withholding problems, Section 5 proposes a withholding rule based on gain recognized rather than on amount realized. The Comment concludes by arguing for enactment of the suggested amendments to the present withholding laws.

2. 1970s: Mounting Concern over Increasing Foreign Investment

The 1970s were marked by an unprecedented growth in foreign investments in the U.S. [21]. Various reasons suggested for this tremendous surge include:
the political and economic stability of the U.S. [22]; favorable fluctuations in international exchange markets [23]; and increased funds in the hands of certain foreign investors [24]. Moreover, foreigners perceived investment in U.S. real estate as the best method to preserve capital and offer growth potential [25]. This foreign investment, primarily in U.S. agricultural land and other types of real property, precipitated widespread discussions among many U.S. citizens concerning the desirability of foreign investment in their land [26].

Proponents of foreign investment in U.S. real estate assert that the flow of foreign capital into this country has been an essential part of U.S. economic growth and development [27]. Specifically, foreign capital has tended to stimulate the U.S. real estate industry [28], thus benefiting the national economy through increased tax revenues and reduced unemployment rates [29]. Further, it has been observed that foreign investment has stimulated new methods of providing services for participants in real estate markets [30].

Opponents of foreign ownership of U.S. land argue that foreign participation in the real estate market drives prices to levels which exclude U.S. investors from the competition [31]. Foreign investors are willing to pay higher prices because U.S. land prices are considerably lower than those in competitive foreign markets [32]. This exclusionary effect is limited because U.S. citizens own approximately ninety-nine percent of all U.S. farmland [33]. Assuming that this percentage also reflects the number of potential investors, it would follow that foreigners only account for one percent of interested purchasers. The effect on the prices of U.S. real estate, therefore, would be rather insignificant [34].

Opponents also argue that foreign control of U.S. agricultural land affects the production, marketing, and pricing of certain agricultural products [35]. This fear is unwarranted because of the relatively small percentage of U.S. farmland under foreign control [36]. In addition, local managers, who are usually U.S. citizens, often handle the production, marketing, and pricing for the foreign owners [37]. Therefore, although in theory a slight potential for foreign influence does exist, in practice there is no such effect [38]. Furthermore, most foreigners plan to hold the property for long-term capital appreciation and have no desire to upset the equilibrium of the U.S. agricultural market [39].

One final contention of opponents is that national security is threatened by foreign ownership of the U.S. food supply [40]. They aver that foreign owners would send their produce abroad thus forcing the U.S. to purchase domestically grown food at potentially restrictive prices. This perceived danger has little factual support because, as previously discussed, foreigners only own about one percent of all U.S. agricultural land [41]. Moreover, foreign ownership of U.S. real estate is the safest form of foreign investment because land and office buildings are fixed assets [42] and hence cannot be physically
removed from the U.S. Compared to bank deposits, stocks, and bonds which have a high degree of liquidity, real estate interests are immobile and illiquid [43]. Finally, the U.S. government always has the option of expropriating the property under the doctrine of eminent domain [44].

Based on the foregoing analysis of the respective arguments, foreign investment in U.S. real estate should be encouraged. The benefits of foreign investment exceed the costs, and domestic concerns are, in general, overstated and unfounded [45]. Still, xenophobic and nationalistic concerns, such as the fear of foreign control and the belief that America should be owned by Americans [46], prompted the U.S. Congress and many state legislatures to take investigative and protective measures with regard to foreign investment [47].

2.1. State Legislatures Enact Protective Statutes

State legislation is the most prevalent source of regulation of foreign investment in U.S. land [48]. Although the public concern over foreign investment in U.S. real estate was nationwide, not every state reacted in the same manner [49]. By 1980, some states had enacted statutory restrictions limiting the amount of land that foreigners could own [50], while others limited the length of time that the land could be held [51]. Some state legislatures simply imposed reporting and disclosure requirements with forfeiture of the land as the penalty for noncompliance [52]. Perhaps the most arbitrary legislative responses were restrictions solely on agricultural land where no such restrictions on urban land existed [53]. These varying state enactments [54] evince a collective determination by states to actively protect their land [55], an attitude shared by the federal government [56].

2.2. Federal Legislation Monitors Foreign Investment

The dramatic increase in the level of foreign investment in the U.S., along with the Arab oil embargo of 1973 [57], resulted in a flurry of congressional committee hearings and legislative proposals [58]. These hearings highlighted the lack of adequate information regarding the extent, nature, and effects of foreign investment [59]. In 1974, Congress passed the Foreign Investment Study Act (FISA) [60], directing the Secretaries of Commerce and the Treasury to conduct a two-year study of foreign investment in the U.S. FISA was intended to focus, in part, on the effects of foreign investment in U.S. real property, including agricultural land [61]. Although considered ineffective by many people [62], FISA did highlight the need for collection of data on a continuing basis [63]. Congress responded by enacting the International Investment Survey Act of 1976 (IISA) [64], which required the President to obtain current information and analyze U.S. investment abroad and foreign
investment in the U.S. at least once every five years [65]. Notably, IISA expressly stated that there was no intent "to restrain or deter foreign investment in the United States or United States investment abroad" [66].

There was an inherent flaw in IISA with regard to foreign real estate holdings. Regulations promulgated by the Department of Commerce required the reporting of such holdings only if they comprised at least 200 acres or cost at least one million dollars [67]. Also, an exception was granted if land was held exclusively for personal use [68]. As a result, information in the most sensitive area of foreign investment - U.S. agricultural land - was noticeably lacking [69].

Congress reacted to this lack of information concerning foreign investment in agricultural land by enacting a new federal law - the Agricultural Foreign Investment Disclosure Act of 1978 (AFIDA) [70]. According to AFIDA, a foreign person who acquires or transfers any interest, other than a security interest, in agricultural land must file a report with the Secretary of Agriculture within ninety days after the completion of such a transaction [71]. Detailed information including name and address, citizenship, type of interest, and purchase price [72] must be supplied or substantial fines will be assessed [73]. These reports disclosed that foreign ownership was less than one-half of one percent of the 1.29 billion acres of agricultural land held privately in the U.S. [74].

In summary, FISA, IISA, and AFIDA were enacted to gather and analyze information. Although there was no stated plan to do more than monitor foreign investment, it was evident that increasing congressional awareness of the situation would lead to stronger federal regulation [75].

3. The Foreign Investment in Real Property Tax Act of 1980

3.1. Purpose and Provisions of FIRPTA

While claiming that its intent was neither to discourage nor to restrict foreign investment [76], Congress enacted FIRPTA to close a longstanding loophole [77]. This loophole allowed foreign investors to avoid paying tax on the disposition of their U.S. real property [78]. Prior to the enactment of FIRPTA, a foreign person was generally subject to tax on the gain realized from the disposition of capital assets only if the gain was "effectively connected with the conduct of a trade or business within the United States" [79]. Although the Internal Revenue Code (Code) sets forth specific guidelines to determine whether income is "effectively connected" [80], it fails to define the meaning of the phrase "conduct of a trade or business within the United States" [81]. In general, the "conduct of a trade or business within the United States" test is met if a foreign person conducts sufficiently regular, substantial, and continuous profit-oriented activities within the U.S. [82] Astute foreign
investors, aware that capital gains “effectively connected” with a U.S. trade or business were taxed while gains not so related were not taxed, could take advantage of this distinction through careful planning. Various techniques utilized to maximize these financial benefits by avoiding U.S. taxation included [83]: liquidations [84], installment sales [85], and tax-free exchanges [86].

In real terms, the benefit to foreign investors of avoiding U.S. capital gains tax was de minimus given the inability of foreign investors to take advantage of tax shelters and deductions [87]. A 1979 Treasury Department study of the tax treatment of foreign real estate investment in the U.S. concluded that

...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 off than domestic taxpayers when all the differences are considered together depends on the circumstances of a particular investment and investor [88].

Thus, Congress' real motivation in passing FIRPTA does not appear to have been tax equity between U.S. and foreign investors because the loophole available to the latter group was relatively insignificant. Similarly, Congress did not intend to raise significant revenues through FIRPTA [89]. The real motivation behind FIRPTA was a desire to curb or at least monitor foreign investment [90].

Regardless of the underlying motivation supporting its enactment, FIRPTA has significantly altered the taxation of foreign investors in the U.S. [91]. To satisfy the requirement that the disposition of real property has to be “effectively connected with a U.S. trade or business” to be taxable [92], FIRPTA provides that gain or loss resulting from the disposition of a U.S. real property interest (USRPI) by a nonresident alien or foreign corporation will be treated as if it were “effectively connected” income [93].

A USRPI is an interest in real property located in the U.S. [94]. Further, a USRPI includes any interest (other than solely as a creditor) in a domestic corporation which is a U.S. real property holding company (USRPHC) or was a USRPHC during the shorter of (1) the period after June 18, 1980, during which the taxpayer held the interest, or (2) the five-year period ending on the date of the disposition of the interest [95]. A USRPHC is any foreign or domestic corporation in which the fair market value of its USRPIs equals or exceeds fifty percent of the fair market value of its real property interests and any assets used in a trade or business [96]. The broad inclusion of corporate stock as a USRPI is subject to two exceptions. First, it does not apply to stock that is “regularly traded on an established securities market,” unless the investor holds more than five percent of that company's stock [97]. Secondly, it does not cover stock of a corporation that was not a USRPHC during the period in which the investor held its stock [98].
Inevitably, the complexity of FIRPTA will trap unwary foreign investors [99]. Despite a plethora of temporary and proposed regulations [100], the IRS has never issued final regulations which could have provided some degree of certainty for foreign investors and U.S. tax advisers [101].

3.2. Problems Created by FIRPTA

3.2.1. Conflicts with Existing Tax Treaties

According to the U.S. Constitution, laws enacted under the Constitution itself and all treaties entered into "shall be the supreme Law of the Land" [102]. Congress has entered into over 100 treaties conferring commercial, industrial, and financial privileges to other signatory nations [103]. Great attention has been accorded specifically to tax treaties [104]. Notwithstanding other favorable provisions, such as an annual net basis election [105] and reduced or eliminated withholding taxes on dividends, interest, or rentals [106], the most important provision in many treaties relating to FIRPTA is the exemption of capital gains from U.S. taxation [107]. While this exemption typically excludes gains resulting from disposition of real property [108], it does apply to gains realized on the sale of corporate stock in a real estate holding company [109]. Thus, there is a direct conflict between the capital gain exemptions found in tax treaties and FIRPTA's taxation of USRPHC stock.

Congress could have provided that all of the existing treaties would take precedence over FIRPTA. Foreign investors could have circumvented the statute by establishing a holding company in a nation that has a bilateral tax treaty with the U.S., which treats capital gains favorably [110]. Alternatively, Congress could have nullified the effect of these treaties simply by enacting inconsistent legislation, such as FIRPTA [111]. Yet, because the fundamental idea of any treaty is that "countries [come] together and [negotiate] a package of incentives and concessions that [is] mutually acceptable" [112], this nullification would be a unilateral renunciation of only unfavorable provisions and would undermine the entire treaty process [113].

Congress' solution was to honor the treaty exemptions until January 1, 1985; at that time, all conflicting treaty provisions would be superseded by FIRPTA [114]. In addition, if a treaty were renegotiated before 1985, the old treaty's exemption would remain in effect for up to two years after the new treaty was signed [115]. Thus, as of January 1, 1987, FIRPTA will take precedence over all inconsistent provisions of U.S. tax treaties with other countries.

This superseding of U.S. tax treaties by FIRPTA was supported by the Treasury Department, the agency charged with negotiating U.S. tax treaties [116]. At a congressional hearing, Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, stated that "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 become effective" [117]. Congress has not diminished the impact of its affront to international comity by endorsing the extension of tax treaty exemptions, because FIRPTA, in essence, creates a fait accompli. The exemption from capital gains tax provided for in those treaties will be lost; the negotiable issue is only when. The solution chosen to resolve the FIRPTA–treaty conflict may establish an ominous precedent for future treaty negotiations [118]. It is highly debatable whether the benefits of FIRPTA outweigh this heavy cost.

3.2.2. Burdensome and Ineffective Reporting Requirements

Once FIRPTA was enacted, Congress faced the issue of enforceability. The collection of taxes is usually a difficult process, but collecting taxes from foreigners — often nonresidents of the U.S. — is further complicated by the federal government's inability to impose customary enforcement sanctions for noncompliance [119]. The enforcement mechanism chosen by Congress was to require comprehensive reporting of foreign ownership of U.S. real property by means of annual information returns [120].

Under FIRPTA, as originally enacted, three distinct reporting groups were recognized [121]: domestic corporations having foreign shareholders [122]; entities with substantial investors in U.S. real property, including foreign corporations and all foreign or domestic partnerships, trusts, and estates [123]; and foreign direct investors [124]. Domestic corporations that were USRPHCs [125] during the year or during any of the past four years were required to report the name and address of each of their foreign shareholders and any transactions which involved those shareholders [126]. Similar obligations were imposed upon foreign corporations and any partnerships, trusts, or estates in which the fair market value of a foreign person's pro rata share of the USRPI [127] held by that entity exceeded $50,000 [128]. In addition, foreign direct investors who held USRPIs with a fair market value of at least $50,000 were required to report their names and addresses, as well as a description of the USRPIs they held at any time during the year [129]. These reporting provisions, combined with other information requirements which were to be prescribed by regulations [130], created a substantial injustice. Not only were they burdensome, but they were so far-reaching that investors whose dispositions would not even be taxable were required to file reports [131].

Beyond the burden of compliance, foreign investors were generally even more distressed by the potential disclosure of their identity to U.S. tax officials [132]. One reason that foreign investors desired to keep their identities undisclosed is that countries such as France, Italy, and Mexico either forbid or heavily tax overseas investments [133]. The information is available to foreign countries because the U.S. furnishes information to its tax treaty partners under broad exchange of information provisions [134]. Even in cases where a treaty does not exist, governments often accommodate requests for such
information, regardless of legal authorization to do so [135]. An article in the Florida Bar Journal described the situation quite accurately:

Section 6039C has created significant concern among foreign investors, much more so than the prospect of paying federal income tax pursuant to Section 897. Their fears result primarily from the belief that the information concerning themselves and their U.S. investments will ultimately find its way back to unfriendly governments, terrorist groups, or business or political opponents [136].

Although it was true that foreign investors could avoid the reporting requirement by posting a security deposit with the Secretary of the Treasury [137], this put the IRS in the position of selling investor anonymity [138]. Further, investors who would not owe tax upon disposition were not exempt from the inconvenience and expense of furnishing the security deposit. A Zurich tax specialist characterized the reporting requirements and the security agreement alternative as “a nightmare ... of very great concern to lawyers, bankers and others faced with compliance” [139].

4. Broad Withholding Rules Added in the 1984 Deficit Reduction Act

The Deficit Reduction Act of 1984 [140] introduced a withholding system and dramatically reduced the reporting requirements, making them virtually obsolete [141]. Effective January 1, 1985, a purchaser of a USRPI from a foreign person is “required to deduct and withhold a tax equal to 10% of the amount realized on the disposition” [142]. Two types of real property interests are exempt from the withholding requirements: residences purchased for $300,000 or less [143] and stock that is regularly traded on an established domestic or foreign securities market [144]. In addition, there is no withholding obligation if the seller furnishes an affidavit stating, under penalty of perjury, that he or she is not a foreign person [145] or, with regard to a disposition of stock, if the purchaser receives an affidavit from the corporation stating that it is not and has not been a USRPHC [146]. A purchaser cannot rely on these certificates if he or she has actual knowledge or notice that the affidavit is false [147]. If the purchaser fails to withhold the proper amount, then he or she is liable for the entire tax due [148].

Although Congress intended the withholding system to establish order in the collection of taxes from real estate sales by foreigners [149], many skeptics question the wisdom and efficacy of such a system [150]. The criticisms focus on two major issues: insufficient cash and excess withholding [151].

4.1. Insufficient Cash Generated to Cover the Withholding Requirement

One problem with the withholding system is that, in the case of a highly-leveraged acquisition such as an installment sale, the initial cash consideration
may be less than ten percent of the purchase price or the "amount realized" by the seller [152]. The temporary regulations define "amount realized" to encompass the cash exchanged, the fair market value of any other property transferred, and the amount of any liabilities to be assumed by the transferee or to which the property disposed of is subject [153]. As a result, the purchaser may be obligated to withhold more than is due to the seller upon closing of the sale and must fund the difference [154] unless a special agreement is obtained [155] from the IRS authorizing reduced withholding [156]. Absent this withholding certificate, the transferee is liable for the entire tax and must make full payment within ten days of the "date of transfer" [157]. Furthermore, it appears that the IRS is not willing to be, in essence, a lender to parties who cannot meet their current tax obligations [158]. Hence, the withholding system eliminates the principal benefit of installment sales – deferral of the payment of tax [159].

This result also conflicts with the congressional objective of tax parity between foreign and U.S. taxpayers, one of the stated purposes for enacting FIRPTA [160]. There is no tax equity when U.S. sellers can defer taxes on a sale in 1986 until April 1987 or later, while foreign sellers must meet their tax liability at the time of the sale. If the amount required to be withheld exceeds the net cash that purchasers are willing to pay, then the number of transactions involving foreign sellers could decline, causing a potential chilling effect on the U.S. real estate market [161]. These results indicate a need to change the method of withholding so that sufficient funds will be available to cover the withholding obligation.

4.2. Substantial Risk of Excess Withholding

Another difficulty with the withholding requirements is the substantial risk of excess withholding beyond the tax liability imposed by FIRPTA [162]. The amount to be withheld may be reduced or eliminated if the transferee receives a withholding certificate from the IRS [163]. Nevertheless, the full ten percent must be withheld if, on the date of the transfer, the application for the withholding certificate is still pending [164]. Generally, this amount must be paid over within ten days [165]. If, however, the application was submitted at least thirty days in advance of the date of the transfer, the amount withheld need not be reported and paid over until the tenth day following the IRS's final ruling on the application [166]. This provision does not apply if the application is submitted for the "principal purpose" of delaying payment of the amount withheld. In such instances, the IRS will assess interest and penalties and charge the amount to the transferee [167]. This principal purpose of delaying payment is presumed, although the presumption is rebuttable, if the transferor's maximum tax liability is determined to be at least ninety percent of the amount otherwise required to be withheld [168].
however, that the transferee can avoid this presumption by having the transferor file the application [169].

The withholding certificate evaluates the transferor's maximum tax liability as the basis for reduced withholding [170]. The IRS is authorized to take up to ninety days to respond to the request [171] and even longer if necessary [172]. If the date of the transfer is within thirty days of the date the application for a withholding certificate was filed, then the seller must wait at least ninety days to receive the certificate. The seller may then use this certificate as the basis for an early refund [173]. Assuming the refund takes another three months, the IRS will have had an interest-free loan of the seller's money for half of a year [174].

One solution to this problem is to obtain a withholding certificate from the Secretary of the Treasury or at least submit the application more than thirty days in advance of the date of the transfer, although this may not always be feasible [175]. This thirty day window will decrease the liquidity of foreign-owned U.S. real estate and also may have a deterrent effect on foreign investors, sending them to look for better opportunities elsewhere [176]. Excess withholding puts the burden on the foreigner to obtain a refund for the amount withheld which exceeds the maximum tax liability. Moreover, the paperwork required to obtain a refund increases the possibility that the foreign investor's own government, or other interested parties, will obtain information about the foreigner's real estate holdings and transactions [177].

5. Proposal: Withholding Should Be Based on "Gain Recognized" Rather than on "Amount Realized"

Congressional concern with regard to tax compliance methods has traditionally focused on two policy issues: inconvenience to foreign investors and the burden on domestic withholding agents [178]. The Code has long relied on withholding provisions to ensure the collection of taxes owed by nonresidents [179]. Unfortunately, withholding requirements, such as the present withholding system under FIRPTA [180], are often irreconcilable with these policy considerations [181].

A compliance system is possible under FIRPTA which would not be inconvenient to the foreign investors or place undue burdens on the domestic withholding agents. The two major problems, insufficient funds transferred at closing to cover the amount required to be withheld and the danger of excess withholding, can be virtually eliminated. To meet these objectives, withholding must be calculated as a flat percentage of the gain recognized – twenty percent for individuals and twenty-eight percent for corporations [182]. By calculating the withholding on the basis of gain recognized instead of on the basis of amount realized, the funds withheld will more closely approximate the actual
tax liability. The IRS need not worry about collection of the full tax obligation because the maximum amount potentially due will have been withheld. Although it has been suggested that the computation of gain is a difficult and delicate task [183], the present withholding system already requires that the amount of gain recognized be determined in the case of certain distributions by a foreign corporation [184].

Under this proposal, the transferor would assess the gain recognized on the transaction and deliver to the transferee a form signed under penalty of perjury [185]. The transferee would then withhold the appropriate amount and send it with the form to the IRS Director of the Foreign Operations District within ten days after the date of transfer [186]. Although there is always the possibility of fraud [187], the IRS already trusts the foreign seller with regard to the nonforeign affidavit [188]; this proposed gain recognition form is neither more nor less subject to abuse.

In addition, the effect of this modification on all of the parties concerned would be minimal, yet it would greatly reduce the burdens and inequities in the present system. The IRS would receive gain recognition forms in lieu of withholding certificates. The purchaser would not be held liable for the seller's taxes once the form was obtained and the indicated taxes were withheld. The foreign seller would give the form to the purchaser rather than send in a withholding certificate to the IRS thirty days before the sale. Adoption of this proposal would mitigate the present inconvenience to the IRS, the purchaser, and the foreign seller.

While it might appear that abandoning the thirty day advance filing requirement would be an equally effective solution, such action would address the problem of liquidity but not of anonymity [189]. As long as the tax is based on amount realized and not on gain recognized, the foreign seller will still need to fill out a withholding certificate, even on the day of the sale. This will discourage foreigners who desire anonymity from investing in the U.S., and beneficial capital will instead be diverted to foreign markets [190].

This proposed modification of the withholding system will now be applied to the two primary concerns noted above regarding the present withholding system – insufficient cash and excess withholding.

5.1. Effect on Insufficient Cash under the Proposal

In transactions where the cash exchanged at closing may be less than the amount required to be withheld, the proposed withholding obligation would be determined by applying the appropriate percentage to the gain recognized. The gain recognized each year would be "that proportion of the payments received in that year which the gross profit ... bears to the total contract price" [191]. For example, in installment sales, the tax liability would be spread equally over the number of installments, ensuring that there would also
be sufficient funds to withhold as each installment was paid. There would be no danger of uncollected taxes because the transferee in possession of the real property would forward the tax on the gain recognized each subsequent period to the IRS. If the transferee failed to withhold, the IRS could attach a lien on the property since the value of the real property would almost always exceed the tax owed. From the viewpoint of the purchaser, the gain recognition form would effectively relieve any fears of personal liability for the tax because the potential for underwithholding is removed. Perhaps the single most significant result under this proposed system is that tax benefits would be restored to the foreign investor [192].

5.2. Effect on Excess Withholding under the Proposal

Similarly, the problem of excess withholding would also be resolved under this proposed modification to the withholding system. The percentage of the gain recognized which is subject to withholding is also the maximum tax liability; therefore, there would be no danger of an insufficient amount being available to cover the tax obligation. The IRS could then allow reduced withholding based on the gain recognition form. Of course, the nonrecognition notice, which presently exempts withholding based on certain sections of the Code or various provisions in U.S. tax treaties, would still be available to reduce or eliminate withholding altogether [193]. If foreigners qualified for reduced withholding, then they could submit a nonrecognition notice. If they did not qualify, then the amount already withheld, i.e., twenty percent of the gain recognized, would be the exact amount of their tax liability and nothing more would be required.

This proposal eliminates the need for qualifying statements and withholding certificates. By eliminating the necessity of filing these forms, Congress will have aided the foreign investor in maintaining anonymity.

6. Conclusion

The present withholding system, adopted to enforce FIRPTA, is simply too burdensome. Withholding currently imposes the burden and liability upon the purchaser for paying the taxes of the seller. The risks of insufficient funds to cover the withholding obligation, excess withholding, and other transactional burdens create a disincentive to foreign investment in U.S. real estate which otherwise would draw needed capital into the U.S. Foreign capital expands the tax base, provides jobs, and offsets trade deficits [194]. As one legal commentator recently asked: “Query whether congressional forays into the real estate marketplace to attempt to set U.S. foreign policy through taxation are not more harmful than helpful in all respects?” [195].
By amending the withholding rules to require that the amount withheld be determined as a percentage of gain recognized on the transaction and not as a percentage of amount realized, problems such as insufficient cash and excess withholding can be eliminated. This less complex withholding mechanism would guarantee that the IRS would receive the tax obligations due, while ensuring that the congressional goal of equity between foreign and domestic investors would be achieved. Further, this proposal would remove the burdensome uncertainties, duties, and liabilities that presently exist on transferees. Taxation of foreign investors is a valid congressional objective; however, when that goal can be realized through two methods differing in complexity and inconvenience, the congressional "conscience" should dictate that the less intrusive path be travelled.

Notes

[1] On Oct. 2, 1963, President Kennedy appointed a task force, later known as the "Fowler Task Force," to examine ways and means of promoting increased foreign investment in the U.S. In a report submitted to President Johnson, the Task Force recommended revision of the U.S. approach to taxation of foreign investors as one of the most productive ways to increase the flow of foreign capital into the U.S. Report to the President of the United States from the Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad 21–30 (Apr. 27, 1964).


[4] Note, supra note 2, at 149. The most active nations in the U.S. real estate industry are the United Kingdom, Canada, the Netherlands, France, and Latin American countries. Id. See generally U.S. Dep't of Commerce, Foreign Direct Investment in the United States 15 (1985) [hereinafter cited as Commerce Report] (listing, in Table II, the foreign direct investment transactions in the U.S. by country from 1980 to 1984).


[12] Although the withholding requirements do provide special rules for foreign corporations, partnerships, trusts, and estates, the majority of Code § 1445 discusses foreign investment in the context of individual investors. Unless otherwise specified, this Comment will use the term “foreigner” to signify an individual foreign investor.


[19] See generally Commerce Report, supra note 4, at 55 (showing, in Figure 17, that the number of foreign investments in the U.S. real property sector peaked in 1981 and steadily plunged in each of the following three years).

[20] See supra note 2 and accompanying text.


Foreign investment in the U.S. dates back to the 1770s when European countries, scouting for new investment opportunities, focused their attention on the young nation. C. Lewis, America’s Stake in International Investment 78 (1938). But the U.S. was by no means opposed to this sudden interest. Alexander Hamilton, generally considered the first U.S. proponent of foreign investment (K. Crowe, America for Sale 248 (1978)), viewed it as critically important to the
country's economic growth and development. Jarchow, Foreign Investment in U.S. Real Estate, 12 St. Mary's L.J. 1069, 1070 (1981). Investment levels consistently rose, reaching a peak in 1914 and then consistently rose, reaching a peak in 1914 and then declining steady through World War II. Id. at 1071.

For an excellent historical analysis, see B. Zagaris, Foreign Investment in the United States 1–7 (1980). See generally Katz, Foreign Direct Investment in the United States — Advantages and Barriers, 11 Case W. Res. J. Int'l L. 473, 474 (1979) (at the start of World War I, the assets of many foreign firms investing in the U.S. were liquidated and the money used to purchase war materials; thereafter, due to the Depression and World War II, the level of foreign investment remained at unusually low levels).


[27] See Note, Monitoring Foreign Investment in United States Real Estate, 2 B.U. Int'l L.J. 29, 34 (1983). There is some concern that regulation of U.S. real estate may be perceived as a shift in the U.S. open door policy and thus deter foreign investment. Id. at 34.

[28] See Note, supra note 2, at 147.

[29] Id.


[31] Note, supra note 2, at 148.


[34] Contra Note, supra note 27, at 32 (arguing that foreign investors focus their investments in specific geographical areas). Thus, foreign ownership in certain locations is much greater than one percent. The most popular urban centers include New York City, Houston, Dallas, Chicago, San Francisco, Denver, Los Angeles, Miami, Washington, D.C., and Atlanta. International Investment, supra note 25, at 5–6.


[37] Kaplan, supra note 3, at 1126.

[38] 1984 Report, supra note 5, at 50–51.

(40) Note, supra note 2, at 152–53.
(41) See supra notes 33–34 and accompanying text.
(42) Id. at 1127–28.
(43) Id.
(44) U.S. Const. amend. V.
(45) See supra notes 31–44 and accompanying text.
(46) Xenophobia is defined as "fear and hatred of strangers or foreigners or of anything that is strange or foreign". Webster's Third New International Dictionary 2644 (1966). For a discussion of xenophobia in the context of foreign ownership of U.S. real property and a list of the most commonly cited reasons to fear foreign land investment, see Note, supra note 2, at 151–53. Typifying the attitude of many Americans, Mr. Jan Eric Cartwright, Attorney General of Oklahoma, warned the public that "Idi Amin could be your next-door neighbor." Frazier, National Sentiment Against Land Holdings of Foreigners Strikes Chord in Oklahoma, Wall St. J., July 7, 1980, pt. 2, at 1, col. 4.
(47) See Report of Committee on Foreign Investment in U.S. Real Estate, Foreign Investment in U.S. Real Estate: Federal and State Laws Affecting the Foreign Investor, 14 Real Prop. Prob. & Tr. J. 1 (1979) [hereinafter cited as Committee Report]. See generally B. Zagaris, supra note 21, at 307 (suggesting that the federal, state, and local legislatures are using foreigners as scapegoats to quell the rising concern over foreign investment).

The Tenth Amendment to the U.S. Constitution provides that "powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X. Since control over the possession and disposition of land is not an enumerated power of the federal government under the U.S. Constitution, it is within the dominion of the state governments. See Hauenstein v. Lynham, 100 U.S. 483 (1879) (suit to recover inheritance brought by foreign next-of-kin to American intestate).

"The law of nations recognizes the liberty of every government to give to foreigners only such rights, touching immovable property within its territory, as it may see fit to concede.... In our country, this authority is primarily in the States where the property is situated." Id. at 484. But see Note, Regulation of Foreign Investment in United States Real Estate: State or Federal Prerogative?, S. Ill. U. L.J. 21 (1981) (asserting that regulation of foreign investment is within the federal domain based upon the federal government's plenary foreign relations and foreign commerce powers) [hereinafter cited as Note, Regulation of Foreign Investment].

(49) For an analysis of current state laws pertaining to foreign investment in U.S. real estate, see Note, supra note 2, at 157–63.
(50) Mo. Rev. Stat. § 442.560–.581 (1978) (illegal for nonresident aliens or foreign businesses in which a controlling interest is owned by aliens to acquire or lease more than five acres of agricultural land for longer than ten years); S.D. Codified Laws Ann. § 43-2A-1 to -2 (1983) (nonresident aliens or foreign governments may not acquire any interest in agricultural land in excess of 160 acres).

(51) Iowa Code § 567.5 (1985) (nonresident aliens, foreign businesses and foreign governments that acquire agricultural land by devise or descent after January 1, 1980, must dispose of that land within two years); N.D. Cent. Code §§ 47-01-11, 47-10.1-02 (Supp. 1985) (nonresident aliens or foreign governments may acquire any interest in agricultural land in excess of 160 acres).

(52) Ark. Stat. Ann. §§ 77–2201, -2203 (1981) (acquisition of any interest in agricultural land by a foreign party must be registered with the circuit court of the county where the land is located); Ill. Rev. Stat. ch. 5, §§ 601–603 (1985) (any acquisition or transfer of any interest in
agricultural land by a foreign person must be filed with the Illinois Director of Agriculture); Ohio Rev. Code Ann. § 5301.254 (Page 1981) (nonresident aliens acquiring an interest in Ohio property in excess of three acres or that has a market value in excess of $100,000 or has any mineral or mining rights must file a report with the Secretary of State); Va. Code §§ 3.1–22.22 to –22.24 (1983) (any foreign person owning, acquiring, or transferring any interest in agricultural land must submit a report to the Commissioner of Agriculture and Consumer Service.


[54] See generally Note, Regulation of Foreign Investment, supra note 48, at 27 (the author suggests a classification of state laws based on the types of restrictions).


[56] See Kollucu, supra note 3, at 108–09.

[57] See generally Lillich. Economic Coercion and the International Legal Order, 51 Int’l Aff. 358 (1975) (advocating the imposition of sanctions on countries, such as the OPEC nations, that use their natural resources as economic weapons).


[59] See supra note 58 and accompanying text.


[63] The results of the studies were submitted to Congress in 1976. See Hearings on S.2839 Before the Subcomm. on Foreign Commerce and Tourism of the Senate Comm. on Commerce, 94th Cong., 2d Sess. (1976). Senator Inouye, Chairman of the Subcommittee, noted the lack of information on foreign investment in the U.S. and stated that, “[w]ithout adequate and reliable data it becomes difficult, if not impossible, to formulate a rational and constructive policy on investment.” Id. at 1.


[65] 22 U.S.C. § 3103(b); see also Exec. Order No. 11,961, 3 C.F.R. 86 (1977) (President Gerald R. Ford designated the Department of Commerce as the federal agency responsible for collection of the data).


[68] Id. § 806.8.


[72] Id. § 3501(a)(1), (2), (4), (6).

[73] Id. § 3502(a), (b) (penalties are determined by the Secretary of the Treasury up to a maximum of 25% of the fair market value of the foreign investor’s real estate interest).

Ownership of U.S. Agricultural Land iii, 4 (1980). Total foreign ownership of U.S. agricultural land, as of Oct. 31, 1979, was 5.2 million acres. Id. at iii. A majority of foreign investors are from Canada, the United Kingdom, France, and West Germany. Id. at 10. Foreign real estate investments are mainly located in southern states. Of the total 2,899,998 acres reported under AFIDA by the end of 1979, some 285,775 were in Tennessee, 223,412 were in Georgia, and 220,125 were in South Carolina. Id. at 4.


[79] I.R.C. §§ 871(b), 882 (1982). However, a nonresident alien individual is still subject to tax on the gain from disposition of capital assets if physically present in the U.S. for at least 183 days during the year in which the gain is realized. I.R.C. § 871(a)(2) (1982).

[80] Section 864 of the Code provides that effectively connected income is income which is "derived from assets used in or held for use in the conduct of [the taxpayer's] trade or business." I.R.C. § 864(c)(2)(A) (1982).


[82] See 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). Although a foreign person's activities may not qualify as conduct of a U.S. trade or business, a nonresident alien individual may elect to treat certain gains and losses as if the investor were engaged in a U.S. trade or business during the taxable year and as if such gain or loss were effectively connected with such trade or business. I.R.C. § 871(d) (1982); see also Ross, supra note 81, at 316-17. A similar election is available to foreign corporations under I.R.C. § 897(t) (1982). For an in-depth analysis of the § 897 election, see Horten & Harrison, FIRPTA "Domestication" Election: Tax Planning Considerations, 83 Tax Mgmt. Int'l J. 3 (June 1983).


[84] Section 337 of the Code provides that if a corporation adopts a plan to liquidate completely within one year, gain or loss is not recognized to the corporation from sales of property during that period. I.R.C. § 337(a) (1982). In the case of a foreign person, the investor could own the stock of a corporation created solely to hold the U.S. real property. Because stock ownership fails to constitute a trade or business and capital gain from the sale or exchange of stock is generally tax-exempt, the purchaser of the stock could subsequently liquidate and pay no U.S. income tax. I.R.C. §§ 864(b)(2), 1012 (1982); see also Silbergliet, The 897(t) Election: Impact of Prop. Regs on Affected Foreign Corporations, Shareholders, 60 J. Tax'n 103 (1984).

[85] Section 453 of the Code states that gain from an installment sale shall be recognized in "that proportion of the payments received [during a taxable year] which the gross profit ... bears to the total contract price." I.R.C. § 453(c) (1982). Through an installment sale, a foreign investor
could defer recognition of most of the capital gain because payments received in subsequent years, when the foreign seller no longer conducted a U.S. trade or business, did not constitute "effectively connected" income and thus were not subject to U.S. taxation. Treas. Reg. § 1.864-3(a) (1982); see also Zimmerman, supra note 83, at 324-25.

[86] Section 1031 of the Code provides that no gain or loss is recognized on like-kind exchanges. A foreign investor could exchange U.S. real property for foreign real property and then upon subsequent sale, incur no tax liability because the sale did not produce "effectively connected" gain. I.R.C. §§ 862(a)(5), 864(c)(4), 1031(a) (1982); see also Zimmerman, supra note 83, at 324.

[87] See generally Comm. on Finance Hearing, supra note 14, at 37, 50-54 (statement of W. Donald Knight, Jr.) (arguing that interest deductions, depreciation, and write-offs are just as important in a real estate transaction as is capital gains treatment).

[88] United States Dep't of the Treasury, Taxation of Foreign Investment in U.S. Real Estate 51-52 (1979) [hereinafter cited as Treasury Report].


[90] Kaplan, supra note 3, at 1128.


[93] Id. § 897(a)(1).

[94] Id. § 897(c)(1)(A)(i).

[95] Id. § 897(c)(1)(A)(ii).

[96] Id. § 897(c)(2).

[97] Id. § 897(c)(3).

[98] Id. § 897(c)(1)(B).


[102] U.S. Const. art. VI, para. 2.


[105] Treaties often permit a foreign investor to annually elect whether income not "effectively
connected" to a U.S. trade or business will be subject to taxation. The election can be made in years when the investor would benefit from taxation due to deductions and graduated tax rates. Likewise, the election can be refused when taxation would not prove advantageous, such as in the year of sale. See Hollingsworth & Banks, supra note 104, at 39; Jarchow, supra note 21, at 1093.


[108] See Norwegian Treaty, supra note 107, art. 12(1); German Treaty, supra note 107, arts. IX(1), IXA(1); Netherlands Treaty, supra note 107, art. XI; Newton, Foreign Investment in United States Real Property, 34 Tax Executive 12, 21 (1981). But see Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, United States—Canada, Tax Treaties (CCH) ¶¶ 1301, 1313, art. XIII(9), as amended by Protocol, June 14, 1983, Tax Treaties (CCH) ¶ 1317P, art. VI(3) (allowing a fresh start basis, as of Dec. 31 of the year of the treaty ratification, for U.S. real estate held by Canadian taxpayers on Sept. 26, 1980).

[109] See Kaplan, supra note 3, at 1110.

[110] This method of tax avoidance was quite common prior to FIRPTA. Foreign investors from countries which do not have favorable tax treaties, or possibly any treaties at all, would establish a Netherlands Antilles corporation. The Antilles supplements treaty benefits with internal tax structures—such as no taxation by the Antilles on U.S. real estate income—which favor investors from nontreaty nations. See Vogel, Bernstein, & Nitsche, Inward Investments in Securities and Direct Operations Through the British Virgin Islands: How Serious a Rival to the Netherlands Antilles Island Paradise?, 34 Tax L. Rev. 321 (1979); Zimmerman, supra note 83, at 333.


[113] Id. at 1111-12.


[117] Id.

[118] See generally Kaplan, supra note 3, at 1113 (arguing that the conflict between FIRPTA and existing tax treaties may be endemic to the treaty process).

[119] See generally 4 B. Bittker, Federal Taxation of Income, Estates and Gifts ¶ 111.5.4 (1981) (discussing the use of federal tax liens on property). A foreign investor probably would not have extensive holdings that the IRS could attach in order to satisfy the liability.
[120] I.R.C. § 6039C (1982). (This section was substantially amended by DRA § 129(b).) The discussion in this Comment will focus on the reporting requirements as originally enacted under FIRPTA and amended by ERTA § 831(a), (e). See generally Richards, Telling the Taxman: Reporting and Avoidance Under FIRPTA, 17 Real Prop. Prob. & Tr. J. 7–17 (1982) (analyzing FIRPTA’s reporting requirements and expressing concern over their impact on the real estate industry).

[121] I.R.C. § 6039C(a), (b), (c) (1982); see also Neill, Tax Planning for Foreign Investors, 38 J. Mo. B. 451, 452 (1982); Zimmerman, supra note 83, at 330.


[123] Id. § 6039C(b).

[124] Id. § 6039C(c).

[125] Id. §§ 897(e)(1)(A), 6039C(a)(1)(B)(ii).

[126] Id. § 6039C(a)(1)(A)(i), (A)(ii), (B). These requirements do not apply to corporations whose stock "is regularly traded on an established securities market at all times during the calendar year." Id. § 6039C(a)(2).

[127] Id. §§ 897(e)(1)(A), 6039C(d)(1).

[128] Id. § 6039C(b)(1), (3), (4)(A), (4)(B)(i). No return is required "if such entity furnishes to the Secretary [of the Treasury] such security as the Secretary determines to be necessary to ensure that any tax imposed by IRC § 897 with respect to USRPIs held by such entity will be paid." Id. § 6039C(b)(2). For a discussion of the security agreement, see Knight & Kraft, supra note 8, at 16–18.

[129] I.R.C. § 6039C(c)(1)(A), (1)(B), (2)(B) (1982). This requirement applies only if the foreign person “did not engage in a trade or business in the United States at any time during the calendar year.” Id. § 6039C(c)(2)(A).


[134] See, e.g., German Treaty, supra note 107, art. XVI; see also 3 R. Rhoades & M. Langer, Income Taxation of Foreign Related Transactions § 14.06 (1985) (discussing the methods used by government to procure information).


[136] Id. at 822.


[139] Knight & Kraft, supra note 8, at 26 n.186. Congress had considered these disclosure


[141] Under the reporting requirements, as amended, the IRS is authorized to require foreign owners to report direct investment in U.S. real estate with a value of $50,000 or more. I.R.C. § 6039C(a), (b)(2) (West Supp. 1985).


[143] Id. § 1445(b)(5) (the property must be used by the purchaser as a residence); Treas. Reg. § 1.1445-2T(d). See generally Saunders, The Xenophobia Form, Forbes, Mar. 25, 1985, at 147 (suggesting that real estate brokers are advising their clients to lower the asking price to below $300,000 in order to facilitate the sale).


[152] Feingold & Glicklich, supra note 10, at 302. With regard to installment sales, the purchaser is required to satisfy his entire withholding obligation out of the initial installment payment. Compare Treas. Reg. § 1.1445-1T(g)(5) (future installments are included in amount realized) with Treas. Reg. § 453 (1982) (tax payable based on installments realized during that tax year); Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 502-06 (1948) (future installments are not considered realized until received).


[154] See supra note 152. But see Feingold & Glicklich, supra note 10, at 302 & n.30 (questionable whether buyer would be held liable for more than was due to the seller).

[155] Such a request may be made by either the transferrer or the transferee. I.R.C. § 1445(c)(1)(B) (West Supp. 1985); see also Hirschfeld, supra note 16, at 671-72, 675.

“The date of transfer ... is the first date on which consideration is paid or a liability assumed by the transferee.” Id. § 1.1445-1T(g)(8).

Hudson, supra note 18, at 168.

Hirschfeld, supra note 16, at 672.

See supra notes 76–101 and accompanying text.

Heath, supra note 150, at 21–22.

See supra notes 18 and accompanying text.

Hudson, supra note 18, at 167–68 (parties to transaction must arrange for necessary cash to pay the withholding); Quinn, supra note 153, at 101.

See supra notes 154–56 and accompanying text.

See supra notes 15–56 and accompanying text.

See supra notes 16 and accompanying text.

See supra notes 17 and accompanying text.

See supra notes 18 and accompanying text.

Generally, there is no withholding requirement if the transferor provides the transferee with a “notice of nonrecognition treatment,” and the transferee files a copy of the notice with the IRS Foreign Operations District within 10 days after the date of the transfer. The transferor may not need to recognize any gain or loss either by virtue of a nonrecognition provision in the Code or by virtue of a provision in a U.S. treaty. However, the transferee may not rely on the notice if the transferor and the transferee are related parties, or if only a part of the gain is entitled to nonrecognition, or if the transferee knows or has reason to know that the transferor is not entitled to the nonrecognition treatment claimed. Treas. Reg. § 1.1445–2T(d)(2); see also Hudson, supra note 18, at 167–68 (parties to transaction must arrange for necessary cash to pay the withholding); Quinn, supra note 153, at 101.

See supra notes 154–56 and accompanying text.

See supra notes 15–56 and accompanying text.

See supra notes 16 and accompanying text.

See supra notes 17 and accompanying text.

See supra notes 18 and accompanying text.

See supra notes 17 and accompanying text.

The IRS will notify the applicant usually by the 45th day that additional time will be necessary. Treas. Reg. §§ 1.1445–3T(a), –6T(a).

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It has been suggested that the withheld funds could be deposited in a special escrow account until the IRS rules on the application. Hudson, supra note 18, at 165.

Assume a foreign investor who purchases an office complex for $49 million and then the following year sells it for $50 million. The gain on the sale would be $1 million and, assuming the tax rate for foreign investors is 20% (see below), the tax liability would be $200,000. The profit realized would be $80,000. Under the present withholding system, the purchaser would withhold and send 10% of the purchase price, or $5 million, to the IRS. Assuming that the IRS holds the money for the six months and assuming further that the market interest rate is 12%, the foreign seller is losing six percent on the withheld funds. But the seller is not entitled to the full $5 million because of the $200,000 tax liability; therefore, the loss is, in effect, six percent on $4.8 million, or $288,000. The result is that the foreign seller, originally with a profit of $800,000, now has an additional cost of almost $300,000. The net effect is that the profit falls from $800,000 to just over $500,000—a 36% reduction.

FIRPTA provides that the minimum tax for foreign individuals is 20% of net U.S. real property gain. I.R.C. § 897(a)(2) (1982). In 1981, Congress reduced the maximum tax on income, which resulted in the maximum U.S. tax rate on individual capital gains equalling the FIRPTA minimum tax rate, I.R.C. §§ 1, 1202(a) (1982). The result is that foreigners are taxed at a flat tax
rate of 20%. Foreign corporations, whether or not "effectively connected" with a U.S. trade or business, are taxed on capital gains at a maximum rate of 28%. I.R.C. §§ 897(a)(1)(B), 882(a)(1), 1201(a) (1982).

[175] Hudson, supra note 18, at 165.

[177] See supra notes 132–39 and accompanying text.


[181] See supra notes 140–77 and accompanying text.
[182] See supra note 174 and accompanying text.
[183] Kaplan, supra note 3, at 1119; Note, supra note 178, at 467.

[184] I.R.C. § 1445(e)(2) (West Supp. 1985). It has even been suggested that withholding based upon gain realized would be feasible in the case of partnerships, trusts, and estates. Such entities would have all the necessary information to determine the gain realized. Quinn, supra note 153, at 104.

[185] The exact wording of the gain recognition form could be adopted from the nonforeign affidavit and could include:

1. name and address of the transferor,
2. description of the property,
3. amount of gain recognized, and
4. a statement, under penalty of perjury, that the foregoing is accurate.

[186] Treas. Reg. § 1.1445-2T(d)(2)(i)(B) (the proposed procedure is adopted from this existing regulation).

[187] Most foreign investors are not concerned with the short-term. Instead, they invest in the U.S. based on long-term prospects such as capital appreciation and political stability. Kaplan, supra note 3, at 1123. Thus, it is unlikely that a foreign investor would close himself to future investment in the U.S. by committing fraud.

[188] The transferor need only furnish an affidavit stating the transferor's taxpayer identification number and that the transferor is not a foreigner. I.R.C. § 1445(b)(2) (West Supp. 1985).

[189] See supra notes 132–39 and accompanying text.
[190] See supra notes 176–77 and accompanying text.


[194] Note, supra note 2, at 147.