Taxation of Canadian Investment in United States Real Estate

Edward J. Hawkins
Robert J. Eidnier

Follow this and additional works at: https://scholarlycommons.law.case.edu/cuslj
Part of the Transnational Law Commons

Recommended Citation
Available at: https://scholarlycommons.law.case.edu/cuslj/vol8/iss/4

This Article is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Canada-United States Law Journal by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.
Taxation of Canadian Investment in United States Real Estate

by Edward J. Hawkins

and

Robert J. Eidnier*

I. INTRODUCTION

Two basic sources of law exist that determine U.S. taxation procedures and amounts, the U.S. Internal Revenue Code of 1954 (Code), and the tax treaty between the United States and Canada. However, both might be called moving targets because of the many changes both have experienced and may still experience.

The major change to the Code is covered in the Foreign Investment in Real Property Tax Act (FIRPTA). FIRPTA was enacted in 1980, amended first in 1981 and then in 1982 and, if the Boat Safety Act is passed by Congress, will be further amended. FIRPTA subjects the sale of U.S. real estate by non-U.S. persons to taxation by the United States. 1 It contains substantive taxing provisions, 2 provides for complex reporting requirements, 3 and provides penalties for failure to comply with these reporting requirements. 4 Also, regulations under FIRPTA have been published. 5 The effective date of FIRPTA is June 18, 1980, for any property disposition which is not otherwise covered under a tax treaty. 6

---

The current tax treaty (Current Treaty) between the United States and Canada became effective on January 1, 1941. A new treaty (Renegotiated Treaty) was signed on September 26, 1980, but has not yet been ratified by the U.S. Senate. The Renegotiated Treaty now includes a protocol signed on June 14, 1983, that conforms the new treaty to FIRPTA. The Renegotiated Treaty has several effective dates. For tax withheld at the source on dividends, interest, royalties, and pensions and annuities, the Renegotiated Treaty shall generally apply to amounts paid or credited on or after the first day of the second month following the date of ratification. For taxes on other types of income, the Renegotiated Treaty shall generally apply to taxable years beginning on or after the first day of January following the date of ratification, or a year later in cases where the old rule was more liberal.

II. INVESTMENT BY CANADIANS IN U.S. RENTAL PROPERTY

Three concepts affect the taxation of rental income earned by both individuals and corporations. The determination of tax on rents depends on whether the property may be considered a “trade or business,” whether that business is a permanent establishment, and whether the rental income is “effectively connected” with that business.

The answer to whether the rental property is a “trade or business” is not found in the Code. Rather, guidance is found in cases and rulings, which turn on the extent of activities of the owner or his agent with respect to the property. If the owner or the agent collects rents, supervises repairs, pays expenses, and otherwise exercises constant supervision over the property, it will be considered a trade or business. On the other hand, if the owner does not maintain control and is under a strict net lease, the owner will be deemed to not be engaged in a trade or business.

If the rent is not effectively connected with a U.S. trade or business,
the Code provisions impose a 30% withholding tax, absent treaty provisions to the contrary.\(^{(13)}\) Under the current treaty, the U.S. can impose a maximum tax of 15% of gross rents received, provided the Canadian has no "permanent establishment" in the United States.\(^{(14)}\) A Canadian who is not engaged in a U.S. trade or business will not be deemed to have a permanent establishment in the United States.\(^{(15)}\)

Under the Renegotiated Treaty, the United States will have the unfettered right to tax rents derived by Canadians from U.S. property.\(^{(16)}\) Thus, absent an election to have rents that are not effectively connected with a U.S. trade or business taxed as though they were so connected, the United States will subject such gross rents to a 30% withholding tax.\(^{(17)}\)

If the rent is effectively connected with a U.S. trade or business, the Code subjects the "taxable income" to tax at the rates applicable to U.S. persons.\(^{(18)}\) Effectively connected "taxable income" means effectively connected gross income\(^{(19)}\) less deductible items allocable to such income, such as cost recovery deductions on U.S. real property and a portion of deductible expenses not directly allocable to any income.\(^{(20)}\) The tax rates on individuals currently range from 11% to 50%.\(^{(21)}\) An alternative minimum tax (AMT) also exists, however, which an individual must pay if the AMT exceeds the regular tax,\(^{(22)}\) thereby limiting the amount of benefits that an individual can receive from "tax preference items" such as accelerated cost recovery deductions and capital gain deductions. The tax on corporations ranges from 15% to 46%.\(^{(23)}\)

Under the Current Treaty, if the Canadian recipient of the effectively connected rents does not have a "permanent establishment" in the United States, such recipient is treated the same as a recipient of non-effectively connected rents; that is, the tax is limited to a maximum of 15% of such rents.\(^{(24)}\) Protocol 3(F) defines permanent establishment in standard terms primarily directed at selling operations:

1. If the foreign principal has a U.S. employee or agent with general authority to enter into contracts, the principal has a permanent establishment in the U.S.;

2. Business dealings in the U.S. through a commission agent, broker


\(^{(14)}\) Current Treaty, supra note 7 at art. XI(1).

\(^{(15)}\) I.R.C. § 894(b) (1982).

\(^{(16)}\) Renegotiated Treaty, supra note 9, at arts. VI, VII(6).

\(^{(17)}\) See infra notes 28-31 and accompanying text for election to have rents taxed as though they were effectively connected with a U.S. trade or business.


\(^{(24)}\) Current Treaty, supra note 7, at art. XI.
or other independent agent does not, by itself, constitute a permanent establishment.

The holding in deAmodio v. Commissioner suggests that U.S. real property held for rental does not necessarily constitute a permanent establishment. Traditional factors described above were held to be controlling. If the Canadian recipient of the effectively connected rents does have a permanent establishment in the United States, the Current Treaty does not limit the rate of tax that the U.S. can impose on such rents.

The Renegotiated Treaty provides no protection for recipients of rents that are effectively connected with a U.S. trade or business, whether or not the owner has a permanent establishment.

As stated earlier, persons may elect to have rents taxed as though they were effectively connected with a U.S. trade or business. Under the Code, a foreign recipient, whether an individual or a corporation, of rents from U.S. real property that are not effectively connected with a U.S. trade or business, may elect under the Code to have such rents taxed as though they were effectively connected with a U.S. trade or business. This election can be particularly beneficial in the early years of real estate investments when high interest and depreciation (capital recovery) deductions will frequently equal or exceed income. Note, however, first, that the election applies to all U.S. real properties of the electing taxpayer and second, that the election can be revoked only with the consent of the Secretary.

The Current Treaty also provides an election to have real property rents taxed as though they were effectively connected with a U.S. trade or business. The Current Treaty election, however, provides the additional advantage of being available on an annual basis, thus permitting the taxpayer to choose which produces the lower tax liability.

Like many modern treaties, the new Treaty does not provide the election described above. Thus, once this Treaty becomes effective, a Canadian real property owner will be forced to rely on the Code election. At that time, due to the increase in withholding from 15% to 30% the election will be of even greater value.

III. TAXATION OF GAINS ON SALE OF REAL ESTATE BY CANADIANS

This section addresses the taxation of U.S. real property held primarily for sale, not rental purposes, the classic example being the land depl...
The gain on the sale of U.S. real property, whether by a Canadian or U.S. person, is ordinary income to the seller if the property was held as inventory or “primarily for sale to customers in the ordinary course of [the seller’s] trade or business.” Factors such as the following determine whether real property is held for sale:

1. The extent to which the seller or his agent engages in the development of the property or in sales activity;
2. The reason for the seller’s acquisition of the property; and
3. The number, continuity, and frequency of sales.

Generally, when an owner subdivides a tract of land before selling it, his gain is ordinary income. An individual (but not a corporation) may qualify for capital gain treatment in such circumstances if he held the real property for five years, made no substantial improvements to the property, and meets certain other requirements. Ordinary income from the sale of real property is taxed, as are rents that are effectively connected with a U.S. trade or business.

Before FIRPTA, under the Code, non-U.S. sellers of U.S. real property held as a capital asset could avoid U.S. income tax on the sale of such property provided:

1. Gain on the sale was not effectively connected with a U.S. trade or business; and
2. If the seller was an individual, that he was not present in the U.S. for 183 days or more during the tax year in which the sale occurred.

Under the Current Treaty, a Canadian seller, whether an individual or a corporation, of U.S. real property could avoid U.S. income taxation of the resulting capital gain even if the property was effectively connected with a U.S. trade or business, and regardless of the number of days the seller spent in the United States, so long as the seller did not have a permanent establishment in the United States.

FIRPTA imposes a tax on non-U.S. sellers of U.S. real property where such real property was not held by the seller as inventory or primarily for sale to customers. FIRPTA imposes this tax through a set of provisions contained in I.R.C. § 897 and provides for enforcement of these provisions through complex reporting requirements set forth in I.R.C. § 6039C, discussed in Part VI.

Under FIRPTA, any gain or loss realized by a non-U.S. individual or corporation on the disposition of a “United States real property interest”;

---

See I.R.C. § 1221 (1982). This result is unaffected by FIRPTA, the impact of which is discussed infra notes 37-51 and accompanying text.


See supra notes 18-26 and accompanying text.

I.R.C. §§ 871(a), 881(a) (1982).


Current Treaty, supra note 7, at art. VIII.
(USRPI) is taxed as though the gain were effectively connected with a U.S. trade or business. Provided a USRPI was held more than one year before sale and was not held primarily for sale, gain from its sale is taxed at long-term capital rates, which in the case of an individual is 40% of the normal rate, and in the case of a corporation is the normal tax rate, but not in excess of 28%. If the property is held for one year or less before it is sold, the resulting gain is subject to tax at the rates applicable to ordinary income.

However, one must always keep in mind that the U.S. tax on individuals is the higher of regular tax or the “alternative minimum tax.” In the case of a non-U.S. person, the “alternative minimum tax” is never less than 20% of his net gain from sales of USRPI’s during the year.

A USRPI is defined as follows:
1. An interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the Virgin Islands; and
2. Any interest (other than an interest solely as a creditor) in a domestic corporation, unless the seller establishes that such corporation was not a United States real property holding corporation (USRPHC) during a specified period.

“Real property,” as defined for purposes of FIRPTA, includes three categories of property:
1. Land and unsevered natural products of the land;
2. Improvements, i.e., buildings or any other inherently permanent structures; and
3. Personal property associated with the use of the real property, such as movable walls and furnishings.

As indicated above, I.R.C. § 897 generally applies to dispositions of USRPI’s occurring after June 18, 1980. If, however, a treaty provides for a lesser tax than would result from application of I.R.C. § 897, that treaty applies to sales occurring before January 1, 1985. If a treaty is renegotiated to resolve conflicts between such treaty and I.R.C. § 897, and the renegotiated treaty is signed on or after January 1, 1981 and before January 1, 1985, then the original treaty will override I.R.C. § 897 up to the date specified in the renegotiated treaty, but in no event later than two years after the renegotiated treaty was signed. This additional delay in

---

**Footnotes:**

89 I.R.C. § 1202(a) (1982).
94 FIRPTA § 1125(c)(1).
94 FIRPTA § 1125(c)(2).
the effective date of § 897 was intended to permit the Senate adequate
time to consider ratification of the renegotiated treaty.\(^47\)

If a Canadian sells a USRPI before January 1, 1985 and the Current
Treaty is in effect at the time of the sale, gain from the sale will generally
not be subject to U.S. tax.\(^48\)

Ratification of the Renegotiated Treaty will cause the following:
1. Article VIII of the Current Treaty will remain in effect until the
end of the first taxable year beginning on or after January 1 following the
date on which the Renegotiated Treaty enters into force.\(^49\)
2. Thereafter, sales will be subject to FIRPTA tax.\(^50\) Where, how-
ever, the seller of the property owned such property on September 26,
1980 (the date the Renegotiated Treaty was signed) or acquired the prop-
erty in a nontaxable transaction, and the property did not form part of
the business property of a permanent establishment, the Renegotiated
Treaty provides, in effect, a step-up in basis to fair market value at the
end of the year in which such Treaty enters into force.\(^51\)

IV. INDIRECT INVESTMENT THROUGH ENTITIES

Indirect investment may be made through four entities. The first is
investment through a partnership. A partnership itself is not subject to
U.S. income tax; the income, gains and losses of a U.S. or non-U.S.
partnership flow through to the individual partners, generally in accord-
dance with the partnership agreement.\(^52\) Based on this conduit theory, if
the partnership is engaged in a U.S. business, all the partners will be con-
sidered to be so engaged.

Ordinary income of the partnership, whether rents or gains from the
sale of property held primarily for sale, will be taxed only at the partner
level as though the partners had received the income directly. Also, taxa-
tion of capital gains will only occur at the partner level. The amount and
character of the gain from the sale of a USRPI by a partnership will be
deemed to have been realized by the partners, and they will be taxed
pursuant to FIRPTA and the treaty in effect at the time. The sale by a
non-U.S. person of an interest in a partnership owning USRPIs will be
treated as though the seller had sold his proportionate interest in the
USRPIs.\(^53\)

Not every partnership is treated as such for U.S. tax purposes. A
partnership will be taxed as a corporation if it has more than two of the
following four corporate characteristics: a) centralized management; b)

\(^{48}\) Current Treaty, supra note 7 at art. VIII. See supra note 37 and accompanying text.
\(^{49}\) Renegotiated Treaty, supra note 8 at art. XXX (2), (5).
\(^{50}\) Id. at art. XIII, as amended, June 14, 1983, and XXX (2), (5).
\(^{51}\) Id. at art. XIII (9).
\(^{52}\) I.R.C. §§ 701-703 (1982).
\(^{53}\) I.R.C. § 897(g) (1982).
free transferability of interests; c) unlimited life; and d) limited liability.\(^\text{64}\)

In summary, a partnership generally provides tax consequences very similar to those of direct investment. The partnership vehicle, however, permits the pooling of any number of investors' funds while passing losses directly through to the investors, a benefit not available with a corporation. Also, partners of such a partnership may benefit from special allocations of items of income, gain and loss, and the potential liabilities of selected partners can be limited where the limited partnership form is selected.

The second entity for indirect investment is a Canadian corporation.\(^\text{55}\) The first consideration in this area is the taxation of dividends paid by a Canadian corporation to a Canadian shareholder. The Code provides that if at least half of a non-U.S. corporation's gross income for the three-year period, ending with the close of the taxable year preceding the declaration of a dividend, was effectively connected with a U.S. trade or business, then a like proportion of the dividend paid by the corporation to a non-U.S. person will be subject to a 30% withholding tax.\(^\text{66}\) Dividends paid by a corporation that is not engaged in a U.S. trade or business are not subject to the U.S. withholding tax. Also, the Current Treaty precludes U.S. taxation of dividends paid by a Canadian corporation to a non-U.S. person.\(^\text{57}\)

The Renegotiated Treaty permits the U.S. to tax dividends paid by a Canadian corporation to a Canadian shareholder only where 50% of the corporation's "gross income from all sources was included in the computation of the business profits attributable to a permanent establishment" in the U.S.\(^\text{58}\) Thus, the question of whether the income is attributable to a permanent establishment is crucial.\(^\text{59}\)

The second tax consideration involves the disposition of stock. Stock in a non-U.S. corporation can never qualify as a USRPI. Thus, the gain from the sale of such stock by a non-U.S. investor is not subject to U.S. income tax.\(^\text{60}\) Similarly, gain realized by a non-U.S. investor on the liquidation of a non-U.S. corporation is not subject to U.S. tax.

If a Canadian corporation is liquidated, notwithstanding the provisions of the Code generally permitting the tax-free liquidation of a corporation, a non-U.S. corporation is required to recognize gain on the distri-
bution, or sale in contemplation of liquidation, of USRPI's. An exception to this rule applies if the distributee of the property takes the property with a basis equal to that of the distributing corporation, and the distributee would be subject, under the Code, to U.S. income tax on the sale of that property. However, a liquidating Canadian corporation with no permanent establishment in the U.S. should be able to avoid this tax under the Current Treaty because the tax is, in effect, a tax on capital gain derived by the corporation from the disposition of U.S. real property. After the Renegotiated Treaty becomes effective, such gains realized by Canadian corporations will not be protected from U.S. taxation.

A non-U.S. corporation can elect, under I.R.C. § 897(i), to be treated as a domestic corporation and thus be eligible for the tax-free liquidation rules applicable to U.S. corporations, provided the corporation is domiciled in a country having a treaty with the U.S. containing a non-discrimination clause. The Current Treaty does not have such a clause, but the Renegotiated Treaty does. Thus, such an election can only be made after the Renegotiated Treaty takes effect. A corporation can make this election only if its shareholders consent to being taxed as if the corporation were a domestic corporation. Thus, if an electing corporation qualifies as a United States real property holding corporation, discussed below, gain on the sale of its shares will be subject to U.S. tax.

A corporation meeting several requirements can elect to be treated for tax purposes as a conduit through which all income, gains, and losses flow directly to its shareholders regardless of whether or not the corporation makes a distribution. An electing corporation, known as an "S corporation," is treated similarly to a partnership. This election is not available here, however, because an S corporation cannot have any non-U.S. shareholders.

An additional consideration is the personal holding company (PHC) tax or in the alternative, the accumulated earnings (AE) tax. A corporation is a PHC if it is owned by five or fewer individuals and its gross income, after certain adjustments, is at least 60% "PHC income," i.e., passive income and amounts received for personal services performed by a shareholder. In general, rents constitute PHC income unless: 1) rents comprise more than 50% of the corporation's income; and 2) dividends paid during the year equal or exceed the amount by which the corpora-

---

61 I.R.C. § 897(d) (1982).
63 Current Treaty, supra note 7, at art. VIII.
64 Renegotiated Treaty, supra note 9, at art. XXV.
69 I.R.C. § 542(a) (1967).
tion's non-rent PHC income exceeds 10% of its gross income. A PHC is subject to a penalty tax of 70% of its undistributed income, after certain adjustments.

Generally, a corporation that is not a PHC is subject to an AE tax if it has accumulated earnings for the purpose of avoiding U.S. income tax at the shareholder level. The tax is levied on the undistributed earnings of the corporations, after certain adjustments, at the rate of 27.5% on the first U.S. $100,000 and 38.5% on the excess over $100,000.

The PHC and AE taxes are, in essence, penalty taxes on the undue accumulation of earnings by a corporation. The Current and Renegotiated Treaties preclude application of the PHC and AE taxes to a Canadian corporation if more than 50% of its outstanding stock is owned by Canadian individuals.

Investment in U.S. real estate can also be made through a U.S. corporation. The Code generally provides for a withholding tax at the rate of 30% on dividends paid by U.S. corporations to non-U.S. shareholders, whether individual or corporate, provided at least 20% of the corporation's gross income is derived from sources within the U.S. The Current Treaty limits the rate of withholding tax on U.S. corporate dividends paid to Canadian shareholders to 15%. This rate is further reduced to 5% where the shareholder is a corporation that controls, either alone or with up to three other corporations, the U.S. corporation, and the U.S. corporation derives not more than one-fourth of its gross income from interest and dividends. The Renegotiated Treaty will, in general, continue to limit withholding taxes on dividends paid by U.S. corporations to Canadian shareholders to 15%. Where the recipient is a Canadian corporation that owns at least 10% of the voting stock of the U.S. corporation, the withholding tax is limited to 10%.

Stock in a U.S. corporation, unlike stock in a non-U.S. corporation, can qualify as a USRPI, thus subjecting gain on the sale thereof to U.S. income tax under FIRPTA. An important exception to this rule precludes taxation where the class of stock sold is regularly traded on an established securities market, provided that before the sale the seller held

---

71 I.R.C. § 541 (1967).
73 I.R.C. § 531 (1967).
74 Current Treaty, supra note 7, at art. XIII(1); Current Treaty Reg. § 519.114. Renegotiated Treaty, supra note 9, at art. X(5), (8).
76 Current Treaty, supra note 7, at art. X(2); Protocol, para. 6, as amended, supra note 31.
77 Renegotiated Treaty, supra note 9, at art. X(2).
78 Id.
79 I.R.C. § 897(a), (c) (1982).
less than 5% of such class of stock. The Current Treaty precludes taxation of gain realized by a Canadian from the sale of stock in a U.S. corporation held for investment. The Renegotiated Treaty would permit taxation of such gains if taxable under FIRPTA. The Treaty, however, would modify the measurement of such gains by effectively permitting the seller to increase his basis in the stock to its fair market value on December 31 of the year in which the Renegotiated Treaty enters into force, provided the seller had held the stock since September 26, 1980.

One type of investment treated as a USRPI is an equity interest in a United States real property holding corporation (USRPHC), which is defined as any corporation if, during the test period:

i) the fair market value of its USRPI's equals or exceeds 50% of—
ii) the fair market value of:
   aa) its USRPI's,
   bb) its interests in real property located outside the U.S., plus
   cc) any other of its assets that are used or held for use in a trade or business.

The Code provides an exception from USRPHC status for a corporation that would otherwise qualify as a USRPHC, but which has disposed of all of its USRPI's in taxable transactions. The test period for USRPHC status is the shorter of:

i) the period after June 18, 1980 during which the taxpayer held such interest; or
ii) the five-year period ending on the date of the disposition of such interest.

The scope of assets deemed to be used or held for use in a trade or business that can be taken into account in determining USRPHC status was significantly expanded by the proposed regulations issued November 3, 1983, and now includes:

i) property held primarily for sale;
ii) depreciable property;
iii) livestock held for use in a trade or business;
iv) purchased goodwill and going concern value, patents, franchises, customer lists, and similar intangible property, but only to the extent such property is held for use in the corporation's trade or business; and
v) cash, securities, receivables and options or contracts to acquire any of the foregoing, provided such assets are used in the corporation's
Under the Code, a U.S. corporation can generally avoid tax on the distribution of its assets in liquidation, and on the sale of its assets in contemplation of liquidation. If the U.S. corporation is a USRPHC, the Canadian distributee will recognize gain on the receipt of the property as though he had sold his stock for the property received.

The Current Treaty generally precludes the taxation of capital gain recognized by a Canadian distributee on the liquidation of a U.S. corporation. The Renegotiated Treaty would permit the U.S. to tax such distributions to Canadian shareholders.

The S corporation election, discussed above, is not available here because an S corporation cannot have a nonresident alien of the U.S. as a shareholder. However, the PHC or AE tax is applicable if the requirements for application are met.

The fourth entity is a real estate investment trust (REIT). The definition of REIT is very complex, but includes the following criteria:

- a) the entity would be subject to taxation as a U.S. corporation but for the REIT law;
- b) it has 100 or more owners, and ownership is not too concentrated;
- and
- c) it invests in U.S. real property and/or obligations secured by mortgages on U.S. real property.

A REIT that distributes its income on a current basis is not subject to tax on the distributed income. If a REIT fails to distribute most of its income, the REIT taxation rules will not be applicable to it. Distributions by a REIT to a non-U.S. shareholder are generally taxed as are dividends from a U.S. corporation, except that to the extent a distribution is attributable to gain from the sale of USRPI's by the REIT, it is treated as a sale of a USRPI by the shareholder. Stock of a "domestically-controlled REIT," i.e., a REIT in which less than 50% of the stock is held by foreign persons, does not constitute a USRPI. The USRPI status of stock in a non-domestically controlled REIT apparently depends upon whether the REIT qualifies as a USRPHC, which it normally would.

---

89 I.R.C. §§ 331(a) (1978).
90 Current Treaty, supra note 7, at art. VIII.
93 I.R.C. § 857(b) (1982).
96 I.R.C. § 897(h) (1982).
V. GIFT AND ESTATE TAX CONSIDERATIONS

A. Gift Tax

A nonresident alien of the United States is generally subject to U.S. gift tax only on gifts of tangible property (including real estate) situated in the United States. A Canadian's gift of stock in a corporation, whether Canadian or U.S., is not subject to the gift tax even if the corporation's only asset is U.S. real property, since the stock itself is intangible property. Taxable gifts of a nonresident alien of the United States are taxed cumulatively over the lifetime of the donor at graduated rates ranging from 18% to a 55% marginal rate for gifts over $3,000,000 in value. The maximum marginal rate is reduced to 50% for gifts after 1984; such rate will apply to gifts greater than $2,500,000 in value. An exclusion from the gift tax is available for the first $10,000 of gifts, other than gifts of future interests in property, to any one donee in a particular year. No marital deduction is allowed. Canada and the United States do not have a gift tax treaty, and neither the Current Treaty nor the Renegotiated Treaty has gift tax implications.

B. Estate Tax

All the assets, tangible and intangible, of a nonresident alien of the U.S. that are situated in the U.S. at the time of his death are included in his gross estate and are thus subject to the U.S. estate tax. Shares of a U.S. corporation, but not of a non-U.S. corporation, are deemed to be situated in the United States and are thus subject to the estate tax.

In determining his taxable estate, i.e., gross estate less deductions, a nonresident alien of the United States is permitted a number of deductions. The amount of a mortgage on property subject to the estate tax is deductible, but only to the extent of the ratio of U.S.-situated property to worldwide property. Deductions are also permitted for U.S. charitable contributions, and for an allocable portion of the worldwide administrative expenses, losses and taxes incurred by the estate.

The estate tax rates applicable to estates of nonresident aliens of the U.S. range from 6% on taxable estates of less than $100,000 to a 30%
marginal rate on taxable estates of more than $2,000,000. For purposes of computing the estate tax, post-1976 gifts that were subject to the U.S. gift tax are included in the taxable estate and a credit is then given for the amount of the estate tax applicable to the gifts; the net result is an increase in the effective rate of the estate tax.\textsuperscript{106}

The estate tax treaty currently in effect between Canada and the U.S. has little, if any, effect on the rules described above. The treaty will terminate at the end of the calendar year during which the Renegotiated Treaty enters into force, and no treaty will take its place.\textsuperscript{107}

VI. REPORTING REQUIREMENTS

A. FIRPTA Reporting Requirements

Every U.S. corporation that has been a USRPHC at any time during the current or preceding four calendar years must file Form 6659 if, during the year, the corporation had at least one non-U.S. shareholder.\textsuperscript{108} If, however, stock of the corporation is regularly traded on an established securities market at all times during the year, this reporting requirement is inapplicable.\textsuperscript{109} Form 6659 requires, among other information, the name and address of each foreign shareholder and certain information regarding stock transfers to and from non-U.S. shareholders during the year.\textsuperscript{110} If a nominee holds stock for a foreign person and such person fails to provide the corporation with the information required by Form 6659, the nominee must file the Form.\textsuperscript{111}

All entities (i.e., corporations, partnerships, trusts, and estates), except U.S. corporations, which have a “substantial investor in U.S. real property” at any time during the calendar year must file Form 6660.\textsuperscript{112} A substantial investor in U.S. real property is defined, with respect to an entity, as a non-U.S. interest-holder in the entity whose pro rata share of the entity’s USRPI’s has a value in excess of $50,000.\textsuperscript{113} Where the entity is a foreign corporation, a shareholder need not be a non-U.S. person to qualify as a substantial investor.\textsuperscript{114} Form 6660 requires, among other information, the name and address of each substantial investor and a

\textsuperscript{105} I.R.C. § 2101(d) (1979).
\textsuperscript{106} I.R.C. § 2101(b), (c) (1979).
\textsuperscript{107} Renegotiated Treaty, supra note 9, at art. XXX(8).
\textsuperscript{109} I.R.C. § 6039C(a)(2) (1980).
\textsuperscript{111} I.R.C. § 6039C(a)(3) (1980).
description of all USRPI's owned by the entity. An entity required to file Form 6660 must also provide a statement to each substantial investor indicating, among other information, his pro rata share of the entity's USRPI's.

Every person satisfying the following three criteria must file Form 6661:

i) the person did not engage in a U.S. trade or business during the year;
ii) the person held USRPI's at some time during the year with a value of $50,000; and
iii) the person is not required to file Form 6660.

Form 6661 requires, among other information, the name and address of the person filing and a description of all the USRPI's that he owned at the end of the year or that he disposed of during the year.

The forms described above must be filed on a calendar year basis and are due on May 15 following the close of the year to which they apply. None of the forms described above, however, has yet been due even though the reporting requirements took effect on June 18, 1980. The due date for the 1980, 1981, 1982 and 1983 forms has been delayed and will be established by the forthcoming final regulations under I.R.C. § 6039(c).

The statements to substantial investors required in conjunction with Form 6660 must be furnished by January 31 of the year following the year to which the statement applies. Like the forms described above, however, substantial investor statements for the years 1980, 1981, 1982, and 1983 have not yet been due. Their due date will also be established by the forthcoming final regulations under I.R.C. § 6039(c). An entity or individual may avoid the reporting and substantial investor statement requirements by entering into a security agreement with the Internal Revenue Service (IRS). While the application for such an agreement might require the disclosure of certain information that the applicant would prefer to keep confidential, the extent of disclosure required for the application should generally be much less than that re-
quired by the forms. The temporary regulations grant the IRS "absolute discretion" to determine the type and amount of security required.\textsuperscript{184} These regulations, however, also state that the amount of security generally required will be the excess of the appraised fair market value of the applicant's USRPI's over the applicant's basis in the USRPI's, multiplied by the applicable long-term capital gain rate.\textsuperscript{185} The appraisal must be made by a competent appraiser within 60 days after the end of the calendar year and must establish the value of the USRPI's as of the end of the calendar year.\textsuperscript{186} The regulations list mortgages on U.S. real property, escrowed funds, letters of credit and surety bonds among the possible types of security.\textsuperscript{187}

An application for a security agreement must be submitted to the IRS by January 30 following the calendar year to which the security agreement will apply.\textsuperscript{188} For years 1980, 1981, 1982, and 1983, however, the application must be filed by the date to be established by the forthcoming final regulations under I.R.C. § 6039C.\textsuperscript{189} Generally, a security agreement will apply to only one year.

The penalty for failing to file a required form or furnish a required substantial investor statement, absent reasonable cause, is $25 for each day the failure continues.\textsuperscript{190} A separate $25 penalty applies to each such failure; thus, if an entity fails to furnish two substantial investor statements, the penalty is $50 per day. The maximum penalty that can be imposed on an entity required to file Form 6659 or 6660 and/or to furnish substantial investor statements is $25,000 for any one calendar year.\textsuperscript{191} The maximum penalty that can be imposed on a person required to file Form 6661 is the lesser of $25,000 or 5% of the aggregate value of the USRPI's owned by such person.\textsuperscript{192}

A bill is currently pending before the U.S. Senate that would substitute a withholding system for the current reporting requirements.\textsuperscript{193} The sponsors of the bill believe a withholding system would be a more effective enforcement mechanism than the reporting system because currently a non-U.S. person can sell U.S. real property and remove the proceeds from the jurisdiction of the United States before the tax becomes due.\textsuperscript{194} Critics of the current reporting system also claim it is unduly burdensome.

\textsuperscript{185} Id. § 6a.6039C-5(c).
\textsuperscript{186} Id. § 6a.6039C-5(e).
\textsuperscript{187} Id. § 6a.6039C-5(b).
\textsuperscript{188} Id. § 6a.6039C-5(h).
\textsuperscript{189} Id.
\textsuperscript{190} I.R.C. § 6652(g) (1983).
\textsuperscript{191} I.R.C. § 6652(g)(3)(A) (1983).
\textsuperscript{192} I.R.C. § 6652(g)(3)(B) (1983).
The proposal would require that a portion of the purchase price be withheld by a transferee of U.S. real property, an agent of a transferee or transferor, or a settlement officer, where the transferor is a foreign person. The amount required to be withheld would be the smallest of the following:

1. The purchase price multiplied by the approximate tax rate applicable to the seller;
2. The maximum tax liability that the U.S. Treasury determined that the seller could owe; or
3. The fair market value of that portion of the purchase price that was within the withholding agent's control.

The Senate has made three previous unsuccessful attempts to substitute a withholding system for the FIRPTA reporting requirements. The current proposal might be successful, however, as some of the perceived shortcomings of the previous proposals have been eliminated.

B. "Non-U.S. Controlled Corporation" Reporting Requirements

Effective for tax years beginning after December 31, 1982, a U.S. corporation or non-U.S. corporation engaged in a U.S. trade or business is subject to a set of reporting requirements under I.R.C. § 6038A if at least 50% of the value or voting power of such corporation's stock is owned by a foreign person. The information to be reported includes a description of any corporation that is a member of a controlled group of corporations of which the reporting corporation is also a member, but only if the reporting corporation had a transaction with the related corporation during the year. A controlled group includes brother-sister corporations and parent-subsidiary corporations. Also required is a description of the relationship between the reporting corporation and the related corporation, and a description of the transactions between the corporations.

Absent reasonable cause, a penalty of $1000 will be imposed for each tax year for which there is a failure to provide the required information. Furthermore, if the failure continues beyond 90 days after notice of the failure by the IRS, the penalty will increase by $1000 for each 30-day period during which such failure continues, with a maximum increase in penalty of $24,000.

Proposed regulations issued on December 19, 1983 indicated that the required information is to be provided on Form 5472 and established the filing date as the later of the due date for the corporate tax return or March 15, 1984. The IRS recently announced that because it has not...
yet prepared Form 5472, the due date has been postponed and will be announced in final regulations under I.R.C. § 6038(a)."