The U.S. Tax Effects Of Choice Of Entities For Foreign Investment In U.S. Real Estate And Businesses And The Taxation Of Dispositions Of U.S. Partnership Interests

I. Introduction.

A. Overview of the Key U.S. Tax Consequences of the Foreign Investor Utilizing Alternative Investment Entity Structures.

1. Basic Income Tax Objectives. Foreign investors generally have the same goals of minimizing their income tax liabilities from their U.S. real estate and business investments, as do their U.S. counterparts, although their objective is complicated by the very fact that they are not U.S. persons. That is, non-U.S. investors must be concerned not only with income taxes in the United States, but also income taxes in their home country. Further, the United States has a special income tax regime that is applicable to foreign persons. Specifically, if the non-U.S. person derives certain types of passive income, it is typically taxed at a flat 30% rate (without allowance for deductions), unless an applicable U.S. tax treaty reduces this statutory rate. In contrast, if the U.S. activities of the foreign person rise to the level of constituting a "U.S. trade or business" (as opposed to being merely a "passive investment"), then the foreign person is taxed largely in the same manner as a U.S. person (i.e., on the net income from the business, at graduated rates). Since the typical income-producing real estate property will constitute a U.S. trade or business, a foreign person's investment in such a property normally will be taxed at the same graduated rates that would apply to a U.S. person [i.e., at a current maximum of 35%\(^1\) if the foreign person invests individually (or via a taxable trust) or at a basic maximum of about 38% to 44%, including Federal and state income taxes, if the foreign person invests through a corporate vehicle]. However, individuals (and trusts) have the benefit of a preferential long-term capital gains rate that currently is normally a maximum of 15%, whereas there is no preferential capital gains rate for corporations, so that the typical federal plus state maximum corporate rates ranging from roughly 38% to 44% will apply, which is approximately double the individual

\(^1\) The Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27 (“JGTRRA”), reduces the maximum income tax rate to 35% for 2003 through 20010. For 2011 and thereafter, the maximum income tax rate will return to 39.6% unless new legislation is enacted to extend the rate reductions from. The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (“EGTRRA”) had earlier reduced the top individual income tax rate to 38.6% to 35% in 2006, so that this rate reduction was accelerated, but it still subject to a “sunset” at the end of 2010, so that the maximum rate will return to 39.6%, absent further legislation on same.
(and trust) capital gains tax rate. On the other hand, ordinarily it will be possible to achieve the commercial law benefits of limited liability, while still obtaining the potentially lower individual income tax rates, if an appropriate “flow-through entity” (such as a limited partnership or limited liability company) is utilized as the investment vehicle.

2. **Tax Effects of Entity Choice.** The first tax goal in utilizing a partnership, limited liability company or trust will be to insure that it is taxed as a "partnership" or "trust," rather than as an "association taxable as a corporation." The reasons for this objective include (a) wishing to avoid the two-tiers of tax that normally will be applicable to a corporation and its shareholders (since the income of the partnership or trust, in contrast, generally will be taxable only to the entity’s beneficial owners), and (b) the ability to have the lower individual capital gains rates of tax (at a maximum of 15%) apply when the beneficial owners are individuals (although ordinary income rates may now rise to 35%), rather than the potentially higher corporate capital gains tax rates (at a maximum of about 38% to 44% when state corporate income taxes are also taken into account). Moreover, the U.S. corporate income tax rates can rise to approximately 61% if the corporate and shareholder level taxes are both applicable.\(^2\) Thus, a properly structured partnership, limited liability company or trust has the advantage of being a "pass-through entity" which normally can serve to cap the foreign investors U.S. income tax rate at the maximum 15% capital gains rate applicable to individuals - a potential savings of at least 23% to 46% vis-à-vis the applicable corporate rates. Thus, if U.S. income taxes were the only consideration, the use of a pass through entity (such as partnerships or trusts) or direct individual ownership clearly would be the preferable investment approach (vis-à-vis the corporate structures).

3. **U.S. Estate and Gift Tax Considerations.** On the other hand, the individual foreign investor also must be concerned with the U.S. gift and estate taxes that can apply to the U.S. situs assets of a nonresident alien at the time of a gift or his/her death. In case of corporations, for example, U.S. corporate stock is a U.S. situs asset that is subject to U.S. estate tax when held directly by a nonresident alien at the time of his/her death.\(^4\) In contrast, stock in a foreign corporation is considered a non-U.S. situs asset that is exempt from the U.S. estate tax on nonresident aliens.\(^5\) The U.S. estate tax rules for nonresident aliens with respect to trusts and partnerships are somewhat more complex and less certain, respectively. Thus, the determination of which type of "pass-through entity" would be preferable from a U.S. estate perspective may be critical to the determination of which type of pass-through entity would be preferable for the foreign investor. As a result, it would be useful to first review the basic U.S. estate and gift tax rules applicable to nonresident aliens.

\(^2\) See note 1, supra, regarding the JGTRRA and EGTRRA provisions that reduce the maximum income tax rate to 35% for the period from 2003 through 2010 and related sunset provisions for 2011 and thereafter. Depending upon the state in which the U.S. real estate is located, the foreign investor may also be subject to state individual income taxes which may raise the combined, effective individual income tax to a range of approximately 38% to 42%, as contrasted to the combined corporate income tax rates of 38% to 44%.

\(^3\) In addition, if the foreign person utilizes a foreign corporation to invest directly in a U.S. real estate project (or other U.S. business), the foreign corporation also may be subject to the "branch profits tax" which is imposed at the rate of 30% on the after-tax U.S. profits of the foreign corporation from a U.S. trade or business. Thus, the overall effective U.S. tax rate on a foreign corporation doing business in a state (such as New York and California) with relatively high corporate income tax can rise to approximately 61% \([i.e., 42\% + (30\% \times 58\%)]\) during its operating phase. This branch profits tax may be eliminated or reduced, though, when the foreign corporation is organized in a "favorable U.S. treaty country" \(i.e., a foreign country with which the U.S. has an income tax treaty that serves to override or limit the branch profits tax, as many U.S. income tax treaties do), and the treaty-based corporation is more than 50% owned by residents of that treaty country (or U.S. persons).

\(^4\) Treas. Regs. § 20.2104-1(a)(5).

\(^5\) Treas. Regs. § 20.2105-1(f).
Applicable Rates and Taxable Assets. The United States imposes significant estate and gift taxes on certain U.S. asset transfers of nonresident aliens. The estate tax rates for nonresident alien decedents will be gradually reduced from the recent maximum of 55% to 35% by 2007, and the estate tax will be eliminated by EGTRRA in 2010, but returning to the previous levels in 2011. Among the U.S. assets that typically will be subject to U.S. estate and gift tax are directly held interests in U.S. real estate, tangible personal property located in the United States, U.S. corporate stock (estate tax only, and the foregoing assets when held by so-called "grantor trusts") and certain other types of trusts over which the foreign investor retains significant elements of control or ownership rights.

Applicability of U.S. Estate Tax to Partnerships. As discussed in greater detail below, the extent to which the U.S. estate tax rules apply to partnerships and other pass-through entities held by foreign persons are not totally free from doubt. While the author’s research and analysis of the subject over the past 25 years has made him quite comfortable with the non-U.S. situs of partnership interests (particularly when formed in non-U.S. jurisdictions), the author acknowledges that there is somewhat less certainty when contrasted to the relatively clear U.S. estate tax exemption for U.S. investments through a foreign corporation (at least when proper corporate formalities and business purpose concepts are observed). Because of this perceived uncertainty, many foreign investors and their advisors have heretofore avoided testing the parameters of this U.S. estate tax exposure for pass-through entities, even though pass-through entities definitely offer significantly better income tax advantages. However, as the foreign investor population has enjoyed significant gains in recent years and paid the unrelentingly higher corporate income taxes, foreign investors and their advisors are recognizing that the overall tax efficiencies of partnership structures should be revisited, with the relative benefits and risks being reevaluated as to whether the much better income tax results are not worth assuming what the author believes to be a relatively diminimus risk on the estate tax side (and no gift tax risk).

II. Non-Corporate Ownership Approaches And Their Taxation.

Overview of Structuring Alternatives. As noted above, the combined corporate/shareholder tax rates may rise to the 57% to 61% range, versus individual rates of 15% for capital gains and up to 35% federal rates for ordinary income (without taking into account state individual income taxes). In addition, the potential inability of the foreign investor to claim a credit against his home-country income tax for the underlying U.S. corporate tax will also serve to increase the overall domestic and foreign tax burden on a U.S. investment via a corporate structure. In light of these very significant corporate income taxes, individual foreign investors may appropriately question whether it is preferable to hold U.S. real estate or U.S. businesses via a non-corporate investment vehicle in order to obtain the lower individual income tax rates. As discussed further below, such direct ownership approaches may, in fact, be far more tax efficient overall if the foreign individual is prepared to recognize and accept that arguably less certainty emanates from the U.S. situs rules applicable to partnership interests.

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6 EGTRRA contains automatic sunset provisions which provide that the estate tax will come back into effect for 2011 and after (with maximum rates of 55%) unless new legislation is enacted to overcome such sunset provisions and extend the estate tax repeal or rate reductions to tax years after 2010.

7 Under Code § 2501(a)(2), a nonresident alien (other than a so-called “U.S. tax expatriate”) is not subject to U.S. gift tax on the transfer of intangible property (such as corporate stock or a partnership interest), even if it is a U.S. situs asset.

8 See note 1, supra, regarding the JGTRRA and EGTRRA provisions that reduce the maximum income tax rate to 35% for the period 2003 through 2010, but with the pre-EGTRRA maximum rate of 39.6% for 2011 and thereafter, absent further legislation on same.
versus the seemingly more certain results generally assumed to be applicable with a foreign holding company.

The traditional forms of non-corporate ownership are: (1) direct individual ownership, (2) use of a trust, and (3) use of the partnership form (which includes limited liability companies). Individual ownership generally is undesirable due to the unquestionable exposure to U.S. estate and gift taxes, the prospect of unlimited personal liability and the lack of confidentiality regarding the ownership. Many investors also will be reluctant to use the trust form—both because of the tax risk of a trust with business activities being characterized as an "association taxable as a corporation" and the degree to which the investor typically must give up beneficial ownership and control in favor of heirs to achieve the desired protection against U.S. estate tax. Thus, a partnership (and specifically a limited partnership or limited liability company taxed as a partnership) normally will be the most desirable form of non-corporate ownership. As indicated above, the only arguable U.S. tax negative to the partnership form of ownership is the question of whether it creates any exposure to U.S. estate taxation. However, as detailed below, with proper planning and structuring, the U.S. estate tax exposure can be minimized and often eliminated as a serious impediment.

B. **Traditional Partnerships.** The use of a traditional partnership (regardless of whether it is domestic or foreign, general or limited) has the very significant advantage of enabling the individual foreign investors to obtain the benefits of the lower individual income tax rates on all of the U.S. trade or business income being generated. If the U.S. business is generating a substantial amount of income that the foreign investor wishes to repatriate or use for other non-U.S. business purposes, this benefit can serve to cut the U.S. income tax rate by approximately one-half \( i.e. \), individual rates of up to 15% for capital gains and at least 35% for ordinary income versus combined corporate/shareholder rates of 57% to 62%). In addition to these U.S. income tax benefits, the partnership also provides a vehicle for making U.S. tax-exempt gifts of the partnership's underlying U.S. real estate through transfers of the partnership interest itself. In contrast, if a nonresident alien were to own U.S. real estate and business assets directly in his or her own name, then a gift of all or any portion of those assets would be subject to the U.S. gift tax. The U.S. gift tax rates on nonresident aliens range from 18% on the first $10,000 of taxable gifts to a maximum rate of 50% effective January 1, 2002 on cumulative lifetime U.S. taxable gifts in excess of $2.5 million. However, this U.S. gift tax on nonresident aliens is not applicable to gifts of intangible interests, such as a partnership interest.

On the other hand, it appears that there may be at least some risk that the IRS might assert that a partnership engaged in a U.S. trade or business will be classified as a U.S. situs asset for purposes of the U.S. estate tax on nonresident alien decedents, regardless of whether it is a domestic or foreign partnership. However, in the author’s opinion, the validity of such an assertion would be invalid and inappropriate for the reasons explained hereafter. That is, there are at least two significant theories that should serve to invalidate such an IRS position and hold that the partnership interest, as an intangible property interest not otherwise covered by the basic statutory situs rule, is non-U.S. situs property whenever it is held by a foreign person or, alternatively, when formed in a jurisdiction outside of the United States (regardless of whether it is engaged in a U.S. trade or business). Moreover, even if we assume arguendo that the courts

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10 See Code § 2501(a)(2).
11 See Code §§ 2512(a), (b).
12 Code §§ 2502(a); 2001(c). Pursuant to the EGTRRA, the maximum gift tax rate in 2010 will be 35% for taxable gifts above $1,000,000. Unless the sunset provisions of the EGTRRA are overcome through new legislation, the maximum gift tax rate will revert in 2011 to 55% for taxable gifts above $3 million.
13 Code § 2501(a)(2).
might sustain such an IRS position, there are a number of different techniques that might be utilized to avoid (or deal with) this potential estate tax exposure in any event.

1. Why the IRS Seemingly Might Argue that the Trade or Business of a Partnership controls the Situs of its Interests. As noted above, there may be some risk that the IRS will assert that a traditional partnership interest should be classified as "U.S. situs property" (and, thus, subject to the U.S. estate tax on nonresident aliens) when the partnership is engaged in a U.S. trade or business. This is the conclusion one may seemingly extract from an analysis (with some interpolation of ill-defined terms) of Treas. Regs. § 20.2104-1(a), which provides what appears to be, in broad conceptual terms, a comprehensive list of the assets that may constitute "property within the United States." Under that regulation, both real property and tangible property located in the United States are U.S. situs assets, as are shares in U.S. corporations and debts issued by U.S. persons and U.S. governmental bodies (with certain enumerated exceptions). Quite importantly, in the case of decedents dying before November 14, 1966 (when the Foreign Investors Tax Act of 1966 went into effect), there also was a rule that "the written evidence of intangible personal property which is treated as being the property itself, such as a bond for the payment of money, [will be U.S. situs property] if it is physically located in the United States." This was the so-called "physical presence test," and it applied to an even broader spectrum of intangible assets when it was first adopted by the Treasury Regulations in 1924. At that time, the physical presence test applied not only to all bonds, but also shares of non-U.S. corporations.

Further, the 1934 Treasury Regulations expanded the physical presence test to cover "intangible personal property which is treated as being the property itself." Thus, starting in 1934, the physical presence test applied to all forms of intangible property interests that had intrinsic value in and of itself, other than shares in U.S. corporations, which from inception had been classified as a U.S. situs asset, regardless of where such U.S. corporate shares were held. These 1934 Treasury Regulations were issued some 18 months after the IRS had achieved its significant victory before the U.S. Supreme Court in *Burnet v. Brooks* which held that the non-U.S. stocks and bonds and other U.S. securities that had been physically maintained in the United States at the time of the decedent’s death were properly subject to the physical presence test of the 1924 Treasury Regulations and, therefore, were U.S. situs assets and subject to the U.S. estate tax on nonresident aliens. Consistent with this broad application of the physical presence test, the 1934 Treasury Regulations also adopted a general “catch all rule” providing that “intangible personal property has a situs within the United States if consisting of a property right issuing from or enforceable against a corporation (public or private) organized in the United States or a person who is a resident of the United States.” Importantly, this “catch all rule” from 1934 when the physical presence test reigned supreme is substantially the same “catch-all intangible situs rule” that appears in Treas. Regs. § 20.2104-1(a)(4) today.

Specifically, the current version of this catch-all intangible situs rule provides that U.S. situs property includes “intangible personal property the written evidence of which is not treated as being the property itself, if it is issued by or enforceable against a resident of the United States"

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15 The list of U.S. situs assets at Treas. Regs. § 20.2104-1(a) lacks any explicit mention of partnership interests, but such interests arguably would be covered under the post-November 14, 1966 intangible personal property rule of Regs. § 20.2104-1(a)(4).
17 Treas. Regs. §§ 20.2104-1(a)(6), (7).
20 288 U.S. 378 (1933).
21 Perhaps significantly, the assets addressed by the U.S. Supreme Court in *Burnet v. Brooks* did not include any partnership interests, so that decision did not deal directly with the situs issue with which this present analysis is principally concerned.
under a domestic corporation or a governmental unit.”

Under Treas. Regs. § 301.7701-5, a partnership is deemed to be a resident of the United States whenever it is engaged in a U.S. trade or business, regardless of where it is formed. Thus, Treas. Regs. § 20.2104-1(a)(4) could be read as saying that interests in partnerships (assuming such interests are “intangible personal property the written evidence of which is not treated as being the property itself”) are U.S. situs if issued by a partnership that is engaged in a U.S. trade or business (and, therefore, is a U.S. “resident” partnership).

2. Why Treas. Regs. § 20.2104-1(a)(4) is Invalid if it Purports to Create a U.S. Trade or Business “Residence” Test for Determining Situs of Intangibles Not Covered by the Basic Statutory and Regulatory Rules. As noted above, when the original “catch-all rule” for otherwise uncovered intangibles was adopted by the 1934 Treasury Regulations, the “physical presence test” was the predominant situs rule for all intangibles other than shares issued by U.S. corporations. During this same period, there were dicta in some otherwise authoritative cases that suggested that the physical presence test for the situs of intangibles might also be met if the foreign entity (whose equity interests were being tested) was itself engaged in a U.S. trade or business. For example, in Farmers’ Loan & Trust Co. v. Minnesota,24 the U.S. Supreme Court observed that “[cites omitted] recognize the principle that choses in action may acquire a situs for taxation other than at the domicile of their owner if they have become integral parts of some local business [but the] present record gives no occasion to inquire whether such securities [should be so treated].”25 Similarly, in Sanchez v. Bowers,26 after already finding that the “sociedad de gananciales” (a juridical entity under the then applicable Cuban law) was deemed liquidated upon the death of Sanchez (such that the underlying securities which the sociedad de gananciales had maintained in New York were U.S. situs under the physical presence test), Justice Learned Hand went on in dicta (indicating that he was applying the ratio decidendi of Farmers’ Loan & Trust Co. v. Minnesota) to speculate as follows:

“It may be that a foreign corporation by its activities can also so subject itself to the power of Congress as to be ‘present’ as obligor, for the purpose of taxing the devolutions of its shares or debts, just as it may make itself ‘present’ for personal judgment. In that event the question here would be how continuously and substantially Sanchez carried on the ‘business’ of the ‘sociedad de gananciales’ in New York. If his [the sociedad de gananciales] activities were enough, his individual estate could be made liable for the devolution of some part of his dividend in liquidation, which is all we are holding it for anyway.”27

Based on the research of the author and his colleagues, Sanchez v. Bowers appears to come closest to articulating (albeit in a pure dicta context) the concept that a business presence of a foreign entity might be sufficient to cause the equity interests in the foreign entity to be deemed physically present in the United States under the then applicable physical presence test for determining situs of intangibles. However, several points are critical. First, neither Farmers’ Loan & Trust Co. v. Minnesota nor Sanchez v. Bowers, in fact, come to the conclusion that a business presence of a foreign entity is sufficient to cause its equity interests to be deemed “present” in the jurisdiction (outside of its country of incorporation) where it is engaged in a trade or business for U.S. estate tax purposes, and certainly there is nothing in either decision to suggest that such a rule, if adopted (which it was not), should apply when the foreign entity is

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23 Treas. Regs. § 20.2104-1(a)(4). Emphasis added. Quite importantly, this subparagraph starts off by stating “Except as specifically provided otherwise in this section or in § 20.2105-1 (which specific exceptions, in the case of decedents dying on or after November 14, 1966, cause this subparagraph to have relatively limited applicability).” Emphasis added.
24 280 U.S. 204 (1930).
25 Id at 213.
26 70 F2d 715 (2d Cir. 1934).
27 Id at 718. Emphasis added.
only deemed to be engaged in a U.S. trade or business (as would be the case when a second-tier partnership holds an interest in a lower-tier partnership that is engaged in a U.S. trade or business only because of the artificial attribution rule of Code § 875(1)).

Second, the case law illustrates that there is no stand-alone “U.S. trade or business of a foreign entity causes its equity interests to be U.S. situs” rule. To the contrary, it is evident from a careful review of the discussions in the pertinent case law, that the idea of a U.S. trade or business having any impact on the situs of an intangible only came into speculative possible application in the context of deciding whether the intangible had sufficient nexus with the United States to be deemed “present” under the then applicable “physical presence test.” In other words, the consideration of whether a U.S. trade or business should be taken into account was only a potential sub-analysis under the “physical presence test”—it was never a stand alone test adopted and applied by any U.S. federal court in the U.S. estate tax context. Thus, to the extent that the catch-all situs rule for intangibles first included in the 1934 Treasury Regulations purported to adopt a “U.S. trade or business test” when referring to whether an intangible interest was issued by or enforceable against a “person who is a resident of the United States,” then it obviously was already making an extension of the case law that the courts had not adopted or applied (nor did the courts ever do so subsequently).

On the other hand, given the seemingly significant sweep of the U.S. Supreme Court’s decision in favor of the physical presence test in Burnett v. Brooks and the seemingly supportive dicta of Justice Learned Hand in Sanchez v. Bowers (quoted above), the introduction of such a “U.S. trade or business” test for determining physical presence in a catch-all rule might have seemed like a reasonable extension of the then evolving precedents in the early 1930s. However, as we shall see, what arguably might have been a reasonable extension of the statutory and judicial precedents in 1934 when the “physical presence test” was at its peak and what is a reasonable statutory interpretation today when the physical presence test effectively has been repealed are two entirely different stories. Starting in at least 1958 and ending in November 1966 with the enactment of the Foreign Investors Tax Act of 1966, the “physical presence test” was abandoned and replaced by situs rules that turn on where the underlying entity is organized, regardless of whether engaged in a U.S. trade or business and where the physical certificates may be held. By 1958, the Treasury Regulations had already been amended to provide that shares in a non-U.S. corporation would be classified as a non-U.S. situs asset, mirroring the long-standing rule that U.S. corporate shares were always U.S. situs. This, of course, was a retreat from the physical presence test and the holding in Burnett v. Brooks that the non-U.S. shares involved therein were U.S. situs because they were physically maintained in the United States at the time of the decedent’s death. The last remnants of the physical presence test were eliminated by the Foreign Investors Tax Act of 1966, and the Treasury Regulations were amended to provide the new test for “the written evidence of intangible personal property which is treated as being the property itself, such as a bond for the payment of money” no longer would depend on the physical presence of such intangibles.28

As a result, since 1966, we have ended up with the principal situs rules providing (i) that real and tangible personal property are sitused based on where physically located and (ii) that stocks and bonds are sitused based on the place of incorporation of their issuer or obligor, with no consideration of where such entities are engaged in trades or businesses or where the physical certificates of such corporate entities are held. Thus, if the catch-all intangible situs rule today is intended to be simply analogous to the principal entity situs rule that turns on the place of incorporation of the issuer or obligor, then it would be a logical extension of the principal corporate intangible situs rule and one might accept that such a rule’s application to a partnership interest should be that (a) if the partnership is formed in the United States, then its interest will have a U.S. situs, whereas (b) if the partnership is organized outside the United States, its interests are non-U.S. situs. On the other hand, if the continuing reference to

“resident” of the United States is intended to import a “U.S. trade or business test” in the case of partnerships, then it would appear to be a wholly unreasonable interpretation and an arbitrary and capricious adoption of a rule that lacks both statutory and judicial precedents, especially following the effective repeal of any remaining use of the “physical presence test” by the Foreign Investors Tax Act of 1966. Thus, it would be the author’s opinion that Treas.Regs. § 20.2104-1(a)(4) is patently invalid to the extent it purports to create a “U.S. trade or business test” in the case of partnership equity or debt interests.

3. Use of Foreign Partnership Provides Non-U.S. Situs Exclusion Position. As indicated above, if the current catchall rule of Treas. Regs. § 20.2104-1(a)(4) is intended to be simply analogous to the principal rule that the situs of corporate stock and bond interests turns on the place of incorporation of the issuer or obligor, then the analogous rule would provide that if the partnership is formed in the United States, its equity and debt interests will have a U.S. situs, whereas if the partnership is organized outside the United States, its equity and debt interests are non-U.S. situs. As a result, it would be most prudent for the partnership to be formed outside the United States if you wish to achieve non-U.S. situs treatment for its equity and debt interests. Furthermore, it is generally thought to be prudent to ensure that the foreign partnership is regarded (under local, foreign law) as an entity separate from its partners and that the death of the partner in question does not terminate the partnership.

The principal authorities most frequently cited for these "foreign entity" issues are Sanchez v. Bowers and GCM 18718. As noted above, in Sanchez v. Bowers, after analyzing the Cuban law applicable to the “sociedad de gananciales,” Justice Hand concluded that it terminated on the decedent's death and his estate was subject to U.S. estate tax on the liquidating distribution from the sociedad to the extent it was attributable to intangible assets physically located in the United States. As a result, this decision is generally interpreted as standing for the proposition that if a partnership is deemed to terminate upon the death of a partner, a nonresident alien partner will be considered as owning his fractional share of the partnership's assets, with the result that the normal situs rules will be applied to such underlying assets. The corollary to this finding would be that if the sociedad de gananciales had not terminated, its equity interests would have been a non-U.S. situs asset (but for the possible application of the “U.S. trade or business” analysis that Justice Hand goes on to speculate might be required to be applied under the then applicable “physical presence test”).

In GCM 18718 (1937), which was declared obsolete by Rev. Rul. 70-59, a French citizen and resident had been a partner in a French civil law partnership (i.e., a "societe en commandite simple") that was, in turn, a partner in a U.S. partnership engaged in the real estate business in the United States. The IRS determined that the "legal personality of the societe en commandite is as complete in contemplation of the law of France as that of a corporation organized under French law." GCM 18718 goes on to hold that the French partnership interest constituted independent personal property and that the decedent was not deemed to own the assets of the U.S. or French partnerships. Thus, GCM 18718 rejects the "look-through" approach that had been adopted by a year-earlier GCM that GCM 18718 overruled. Moreover, GCM 18718 did not raise the issue of whether the French partnership might be deemed to be engaged in a U.S.

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30 70 F.2d 715 (2d Cir. 1934).
31 1937-2 C.B. 476.
32 In this regard, it is significant to note that Regs. § 1.708-1(b)(1)(i)(a) provides that "upon the death of one partner in a two-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business." [Emphasis added.]
33 1970-1 C.B. 280.
34 1937-2 C.B. 480.
35 See GCM 16164 XV-1 C.B. 363 (1936).
trade or business (via its being a partner in the U.S. partnership that was engaged in a U.S. trade or business) as being relevant to the determination of the French partnership interest situs. Instead, GCM 18718 held that because the partnership interest was in a French entity, it necessarily constituted a non-U.S. situs property interest, without the necessity of analyzing whether it was engaged in a U.S. trade or business. Although GCM 18718 was declared obsolete, it is noteworthy that the GCM was not "revoked" per se. Instead, GCM 18718’s being declared obsolete in 1970 would appear consistent with the abolishment of the remaining remnants of the physical presence test by the Foreign Investors Tax Act of 1966, and consistent with the fact that the Treasury Regulations also had been amended by that date to drop any such physical presence analysis in favor of the place of incorporation tests of the principal types of intangibles, which is the same principle for which this GCM effectively stood. 36

4. "Mobilia Sequuntur Personam" is the Controlling Legal Maxim for Determining the Situs of a Partnership Interest. The second principal argument for the non-U.S. situs of partnership interests owned by nonresident alien domiciliaries is that intangible property has its situs at the domicile of its owner under the maxim "mobilia sequuntur personam," as was held by the U.S. Supreme Court in the landmark case of Blodgett v. Silberman. 37 In that 1928 case, the U.S. Supreme Court addressed the basic question of whether the State of Connecticut had the right to impose its state inheritance tax on a Connecticut decedent who had owned an interest in a New York partnership whose assets were principally within, and its business was conducted principally in, the State of New York. In reaching the conclusion that Connecticut did have authority to tax the Connecticut decedent on his New York partnership interest, the U.S. Supreme Court essentially decided two subsidiary issues. First, it concluded that the common law maxim of "mobilia sequuntur personam" applied, so that "intangible personalty has such a situs at the domicile of its owner that its transfer on his death may be taxed there." 38 Having concluded that Connecticut would have the authority to tax the New York partnership interest if it constituted intangible personalty, the Court goes on to analyze whether the partnership interest was "a chose in action and intangible personalty." 39 After analyzing the applicable New York partnership law and finding that a partner does not have a direct ownership right in the underlying assets of the partnership, but rather the partner has "simply a right to share in what would remain of the partnership assets after its liabilities were satisfied," the Court concluded "it was merely an interest in the surplus, a chose in action." 40 The New York partnership interest was, therefore, an intangible personalty subject to the mobilia sequuntur personam rule. Thus, Blodgett v. Silberman, can be read as standing for the proposition that a partnership interest is a separate intangible asset, and the location of its assets or the place where the partnership carries on its business is immaterial in determining the situs of the intangible interest. 41

36 Further, GCM 18718 being declared obsolete in 1970 would reinforce the view that Treas. Regs. § 20.2104-1(a)(4) was not intended to perpetuate any U.S. trade or business test that might have been introduced in the predecessor subparagraph of the 1934 Treasury Regulations. See also note 23, supra.
37 277 U.S. 1 (1928).
38 277 U.S. 1, 10. In reaching this conclusion, the Court noted that this holding would not be undermined by the possibility that the transfer of such intangibles might also be subject to estate taxation in another jurisdiction.
39 Id.
40 277 U.S. 1, 11; emphasis added.
41 In Rev. Rul. 55-701, 1955-2 C.B. 836 (in which the IRS holds that a New York partnership interest held by a British decedent was U.S. situs property, subject to U.S. estate tax, because the partnership was engaged in a U.S. trade or business) the IRS cites Blodgett v. Silberman for the proposition that a partnership interest constitutes intangible personal property and that "the situs of the partnership interest is not to be determined by the location of the underlying assets of the partnership." [1955-2 C.B. 836, 837.] However, notwithstanding the IRS foregoing citation, the IRS goes on to hold that the situs of a partnership interest is under applicable U.S. estate tax law, that the partnership interest situs is based on where the partnership is engaged in business, citing no U.S. authorities but rather a U.K. case!
One may also draw comfort for this second situs theory from the decision in Estate of Paul M. Vandenhoeck, in which the Tax Court stated, in dicta, that "the rule [of mobilia sequuntur personam] merely means that the situs of personal property, for purposes of taxation, is the domicile of the owner unless there is a statute to the contrary." Because there is no explicit Code provision dealing with the situs of partnership interests (domestic or foreign), the principle of mobilia sequuntur personam, thus, can be said to control the situs of a partnership interest. As a consequence, a nonresident alien domiciliary would be exempt from U.S. estate tax on partnership interests (formed domestically or abroad) that constitute intangible personal property simply by virtue of their own nondomiciliary status, because there is no Internal Revenue Code provision that would override the maxim of mobilia sequuntur personam. Moreover, while authorities such as Burnet v. Brooks, supra, severely eroded the scope of the doctrine of mobilia sequuntur personam when the physical presence test was deemed to be the controlling statutory rule for determining the situs of certain intangibles (notably non-U.S. stocks and bonds), those cases were rendered moot and inapplicable once the last vestiges of the physical presence test were put to rest by the Foreign Investors Tax Act of 1966. Thus, in the absence of what at one time was seen as an overriding statutory authority (the physical presence test), consistent with the unequivocal holding of Blodgett v. Silberman and the more recent dicta of Paul M. Vandenhoeck, the doctrine of mobilia sequuntur personam should be seen as having sprung back into being the controlling legal determinant for the situs of intangibles whose situs is not otherwise explicitly determined by the statute (or regulations consistent with the enunciated statutory principles). Nonetheless, notwithstanding the evident logic and strong legal precedents for this nondomiciliary finding for partnership interests under the doctrine of mobilia sequuntur personam, it would appear that foreign investors still would be well advised to utilize a foreign partnership in order to have access also to the preceding "foreign entity exemption theory," as well as the maxim or mobilia sequuntur personam.

5. Gifts of Partnership Interest. As indicated above, nonresident aliens may make gifts of intangible interests (such as a partnership interest) without being subject to U.S. gift tax. In addition, even if a decedent makes a gift of a U.S. partnership interest within three years of his death, that partnership interest will no longer be included in his taxable estate for federal estate tax purposes (on the premise that the transfer was made in anticipation of his death), unless the transfer involves (a) gifts of life insurance or (b) interests in property otherwise included in the value of the gross estate pursuant to Code §§ 2036, 2037, 2038 or 2042. Thus, even if one is concerned with the possibility that a U.S. or foreign partnership interest will constitute a U.S. situs property (when the partnership is engaged in a U.S. trade or business or otherwise), the nonresident alien should be able to avoid U.S. estate tax so long as he/she makes a gift of the subject partnership interest prior to his/her death. Of course, the principal cases in which this technique will not be effective are those cases where the nonresident alien dies unexpectedly (i.e., the so-called "sudden death" cases, such as fatal accidents or heart attacks). In order to provide the nonresident alien protection against these sudden death cases, it may be necessary to carry appropriate life insurance. Accordingly, even if the reader does not subscribe to the author’s opinion that the partnership interest should be deemed a non-U.S. situs asset under either or both of the forgoing analyses, this "gift before death" approach should enable the nonresident alien to avoid U.S. estate tax in all but a statistically minor number of cases, with those latter sudden-death cases being covered, when desired, by appropriate life insurance.

42 4 T.C. 125 (1944).
43 4 T.C. 125, 135. Emphasis added
44 Code § 2501(a)(2).
45 Code §§ 2104(b), 2035(d).
46 Presumably, a term life policy that only covers such sudden death causes would be less expensive than a life insurance policy which covers all types of casualty risks, although it is not clear that such narrower, term life policies are, in fact, available.

1. **Issue.** What are the potential U.S. tax consequences when a nonresident alien sells an interest in a U.S. limited partnership (a “USLP”) that is engaged in a U.S. trade or business and only a portion of its assets are attributable to U.S. real property interests?

2. **Executive Summary.** Internal Revenue Code (“Code”) § 741 provides in general that the sale of a partnership interest will be treated as the sale or exchange of a capital asset. Any gain to the foreign partner on the sale, therefore, should be characterized as capital gain except to the extent the ordinary income recharacterization rules of Code §751 or the U.S. real property interest “look through” rule of Code §897(g) apply.

However, the important characterization issue for the foreign partner is whether the gain is (1) U.S. source gain that is effectively connected to the partner’s U.S. trade or business and hence taxable; or (2) non-effectively connected capital gain that escapes tax altogether, except to the extent attributable to U.S. real property interests held by the partnership.47

Because the foreign partner's interest in a partnership is treated as an investment asset under Code §741 -- separate and distinct from the underlying assets of the partnership -- it would appear that any gain on sale of the partner's interest is attributable to the partner's investment activities and not the business of the partnership conducted at its office or fixed place of business in the United States. Moreover, such gain would not appear to be effectively connected to a U.S. trade or business. Under this view, the gain on the sale of the partnership interest should be treated as foreign source income and not subject to U.S. income tax, except to the extent the gain is attributable to U.S. real property interests which may be subject to 10% FIRPTA withholding tax, creditable against the capital gains tax due on such portion of the gain.

The invocation of an otherwise applicable U.S. Income Tax Treaty (“Treaty”) will not serve to exempt the taxable portion of the partnership interest sale attributable to the USLP’s U.S. real property interests, nor should it subject to U.S. income taxes the portion of the sale which otherwise should be exempt under the foregoing U.S. statutory rules.

3. **Legal Analysis.**

   a. **United States Real Property Interests (“USRPI”).**

Interests in partnerships generally are not considered USRPIs. Therefore, dispositions of partnership interests by foreign persons are not automatically subject to the 10% FIRPTA withholding tax that normally applies to dispositions of USRPIs by non-U.S. persons. However, an interest in a partnership is treated as a USRPI in its entirety for purposes of the Code § 1445 FIRPTA withholding tax if 50% or more of the value of gross partnership assets consists of USRPIs and 90% or more of the value of the gross partnership assets consists of USRPIs plus cash and cash equivalents.49 Presumably, the USLP does not have gross assets consisting of USRPIs in excess of 50% of the total value of the gross partnership assets. Therefore, withholding tax should not apply to the entire sales price of the USLP units, but rather only to the proportionate part of the sales price attributable to the partnership’s U.S. real property interests.

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47 To the extent the gain is attributable to U.S. real property interests of the partnership, the gain is deemed to be effectively connected with a U.S. trade or business under Code §897(g).


49 Treas. Regs. 1.897-7T(a).
Pursuant to Code § 897(g), however, an interest in a partnership is treated as a USRPI to the extent that the gain on its disposition would be attributable to USRPIs (and not cash and cash equivalents). A foreign investor in a partnership with USRPI would be taxable on the disposition of his interest in the partnership to the extent that the gain represented his pro rata share of the relative net book value of the USRPIs owned by the partnership.

In other words, if a foreign person sells or exchanges an interest in a partnership, the transaction is treated for purposes of Code § 897 as a disposition of the partner's proportionate interest in the underlying assets of the partnership. If the entity owns USRPIs, a proportionate share of the amount realized in the sale or exchange is considered received for the USRPIs, and gain or loss is computed separately for this indirect disposition. The separately computed gain or loss is subject to Code § 897. In the instant case, assuming the USLP has held its USRPIs for more than a year, the gain will qualify for long-term capital gain treatment at 15% subject to any applicable depreciation recapture.

For example, assume a nonresident alien sells his interest as partner of a partnership that owns a hockey arena in Florida that represents 25% of the relative net book value of the partnership assets. A 25% portion of the amount realized and a 25% portion of the partner's basis for the partnership interest will be deemed allocated to the partner's indirect interest in the hockey arena. The difference between these two figures will be the gain or loss on disposition of the underlying USRPI (hockey arena).

b. **Internal Revenue Service position: sale of U.S. partnership interest viewed as aggregate sale of all of partnership’s assets (aggregation theory).**

In Rev. Rul. 91-32, the IRS addressed the issue of the US tax consequences on disposition of a foreign partner's interest in a domestic partnership that conducts a trade or business through a fixed place of business or permanent establishment in the United States. The IRS, apparently proceeding from the premise that gain on the sale of a U.S. partnership interest by a foreign partner is governed by the entity rule of §741, nevertheless reached a result which can only be achieved by embracing an aggregate approach.

The IRS determined that when a partnership is engaged in a trade or business through a fixed place of business in the United States, gain on the sale of the partnership interest is U.S. source.
gain under §865(e)(2) because the partnership interest is attributable to the foreign partner's U.S. trade or business. The IRS also concluded that, in those circumstances, a foreign partner's interest in the partnership is an asset of the partner effectively connected with that trade or business ("ECI property") under §864(c)(2). The IRS recognized, however, that strict application of an entity approach, in conjunction with the IRS's interpretation of §§864 and 865, might improperly subject a foreign partner to tax with respect to appreciated foreign source property. As a result, the IRS concluded that in applying the source rules of §865(e), and the effectively connected rules of §864(c), the sale of a foreign partner's interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States should be treated on an aggregate basis. In other words, the foreign partner should be treated as having disposed of an aggregate interest in the partnership's underlying property for purposes of determining the source and effectively connected character of the gain or loss realized by the foreign partner.

The IRS demonstrated application of this aggregate approach by use of three examples. In the first situation, a nonresident alien individual (FP1) is a partner in a partnership (PS1) that is engaged in a trade or business through a fixed place of business in the United States. PS1 owns appreciated personal property located in the United States that is used or held for use in PS1's U.S. trade or business. FP1 disposes of his partnership interest. On these facts, the IRS concludes that FP1's gain (or loss) is effectively connected U.S. source gain (or loss) to the extent such gain (or loss) is attributable to ECI property of the partnership.

In situation 2, the IRS illustrates the manner in which gain or loss on sale is deemed attributable to U.S. source or foreign source appreciated property. The facts in situation 2 are the same as in situation 1, except that, in addition, FP1 has a distributive share of 25% of the income, gain, loss, deduction and credit of the partnership, and the assets of the partnership consist of the following:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$300,000</td>
</tr>
<tr>
<td>Real property outside the United States</td>
<td>500,000</td>
</tr>
<tr>
<td>Machinery outside the United States</td>
<td>500,000</td>
</tr>
<tr>
<td>Personal property used in U.S. business</td>
<td>200,000</td>
</tr>
<tr>
<td>Total</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>

FP1's adjusted basis in his partnership interest is $375,000. FP1 sells its partnership interest for $475,000.

The gain or loss attributable to the partnership's ECI property is defined as the amount that bears the same ratio to the gain or loss realized by the foreign partner from the disposition of his partnership interest as the foreign partner's distributive share of the partnership net ECI gain or loss would have borne to the foreign partner's distributive share of partnership net gain or loss if the partnership had disposed of all its assets at fair market value at the time the foreign partner disposes of its partnership interest. This deemed disposition rule places primary importance on the manner in which the partners have agreed to share the net proceeds on sale of the partnership's assets under the partnership agreement. The special allocation of non-ECI gain to a foreign partner may survive the substantial economic effect test of §704(b), provided the foreign partner bears a substantial risk with respect to the bottom line economic effect of such allocation. If a special allocation of non-ECI gain to a foreign partner under the partnership agreement were found to possess substantial economic effect under the §704(b) regulations, the allocation would presumably be taken into account for purposes of the deemed disposition rule of Rev. Rul. 91-32.

In the above example, since FP1's distributive share of net ECI gain on a deemed disposition of
the partnership's assets equals 75% of its total share of the partnership's gain (i.e., 75,000/100,000), the portion of FP I's gain from the disposition of its partnership interest that is attributable to ECI property of the partnership equals $75,000 (75% of the $100,000 gain on sale). This gain is treated as ECI gain (U.S. source) subject to U.S. tax. In applying the above rules, a foreign partner's gain on the disposition of an interest in a partnership that is engaged in a U.S. trade or business is presumed to be U.S. source ECI gain in its entirety.55

In situation 3, the IRS applied the above aggregate approach in a situation where the tax consequences of the foreign partner are subject to a treaty whose provisions are identical to those of the Draft United States Model Income Tax Treaty (June 16, 1981) (the Treaty). FP2, an alien individual resident in Country Y, is a partner in partnership PS2. PS2 has a permanent establishment in the United States within the meaning of the Treaty. The assets of PS2 consist of immovable and movable property located in Country Y, and movable property located in the United States that are assets of the permanent establishment. Under the Treaty, gain from the disposition of movable property by the U.S. treaty partner is generally exempt, except that such gain is generally taxable if from the alienation of movable property that are assets of a permanent establishment in the United States; FP2 disposes of the partnership interest.

The IRS, noting that: (1) the partnership's permanent establishment is imputed to its partners;56 and (2) the determination of whether gain from the alienation of movable property is attributable to a permanent establishment in the United States is generally made by applying analogous principles to those applied to determine whether an item is effectively connected with the conduct of a trade or business within the United States, ruled that to the extent the partner's potential distributive share of unrealized gain of the partnership is attributable to the partnership's United States permanent establishment, such gain is taxable under the Treaty.

c. Criticism of IRS aggregation theory

When a partnership is engaged in operations both within and without the United States, taxation of a foreign partner on the full amount of the gain realized on the sale of its partnership interest improperly subjects the foreign taxpayer to U.S. tax on foreign source income earned outside the United States. By the same reasoning, treatment of the full amount of the gain in the above situation as foreign source, non-ECI gain improperly permits the foreign partner to escape U.S. tax on gain that is related to business operations of the partnership carried on in the United States. The aggregate approach adopted by the IRS solves this dilemma by taxing the foreign partner on gain on sale of its partnership interest, but only to the extent such gain is attributable to the partnership's business activities in the United States.

Although the IRS's position in Rev. Rul. 91-32 may be defensible from a tax policy standpoint, the IRS's interpretation of the Code and Regulations advanced in support of this result is without merit. As noted above, the IRS reaches two independent conclusions in Rev. Rul. 91-32: (1) that in applying the general entity rule of Code § 741, a foreign partner's gain on the sale of its interest in a partnership that is engaged in a U.S. trade or business through a fixed place of business in the United States is effectively connected (U.S. source) gain, and (2) that in view of the possibility of improperly taxing a foreign partner on gain on sale of its interest due to appreciated foreign source property, an aggregate mechanism should be applied for purposes of

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55 Rev. Rul. 91-32 indicates that for purposes of applying the above test, the ECI (U.S. source) property of the partnership does not include U.S. real property interests held by the partnership. §897(g) governs the treatment of amounts on sale that are attributable to U.S. real property interests held by the partnership, and applies before the ruling test is applied.

56 See: Unger v. Comr., T.C. Memo 1990-15, aff'd, 936 F.2d 1316 (D.C. Cir. 1991), citing Donroy, Ltd. v. U.S., 301 F.2d 200 (9th Cir. 1962). In Unger, the Court held that a Canadian national with an interest in a U.S. limited partnership was attributed the U.S. permanent establishment of the USLP for purposes of the U.S. -Canada Income Tax Convention. Accordingly, the Court held that the taxpayer was subject to U.S. taxes under the Treaty on his share of the USLP’s capital gains.
determining the source and character of gain on sale of the partnership interest. As discussed below, neither of these conclusions is supported by the Code.

i. **The Foreign Partner's Interest as ECI Property.**

As noted in Rev. Rul. 91-32, whether a foreign partner's gain on sale of an interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States is U.S. source gain depends on the application of Code §865(e)(2). Code §865 can be best understood in the context of the taxation of a foreign partner on his distributive share of the partnership's operating income and its gain on the sale of its assets. Code § 865(e)(2) provides an exception to the general residence rule of §865(a) and states that gain from the sale of personal property is treated as U.S. source gain when the sale of such property is attributable to an office or fixed place of business of the taxpayer in the United States. Because of the imputation rule of Code §§875, a foreign partner is deemed to be engaged in a U.S. trade or business when the partnership is found to be so engaged, and thus the foreign partner is properly taxed on the U.S. source operating profits of the partnership. Code §865(e)(3) provides that for purposes of determining whether a sale is attributable to the taxpayer's office or fixed place of business in the United States within the meaning of §865, the principles of §864(c)(5) apply. Under §864(c)(5)(B), the taxpayer's gain is not considered attributable to an office or fixed place of business of the taxpayer unless (1) such office or fixed place of business is a "material factor" in the production of such gain and (2) such office or fixed place of business "regularly carries on activities of the type from which such ... gain ... is derived." There appears to be little question that when a partnership has an office or fixed place of business in the United States, the business activities of the partnership carried on at such place constitute a "material factor" in generating the U.S. source operating profits of the partnership. Thus, a foreign partner is taxed on his share of any partnership gain resulting from the partnership's sale of its assets used in its U.S. trade or business.

Subchapter K of the Code is quite clear, however, in its decision not to treat the gain on the sale of a partnership interest on an aggregate basis except where the statutes specifically provide otherwise. 57 While the partnership's activities are a material factor in the production of the operating profits of the partnership in many situations, and while the profitability of the partnership no doubt affects the value of the partner's interest in the partnership, the Code does not apply an aggregate approach to determine the partner's gain on sale. Consistent with the entity approach adopted by Congress in enacting Code §741, the partnership's activities should be viewed as a material factor in the partnership's profits generated from its office or fixed place of business, but not with respect to the gain inherent in the partner's partnership interest. This conclusion is buttressed by the second prong of the "attribution" test in Code §865(c)(5)(B), which requires that the office or fixed place of business regularly carry on activities of the type from which the gain on sale is derived. The partnership is not in the business of selling partnership interests or other investment assets, the activity from which the gain on sale of the partnership interest is derived. The IRS ignores this second prong of the source test entirely in concluding that a sale of a partnership interest is attributable to the U.S. trade or business under Code §865(e)(2).

The same issue that arises in the source context also arises with respect to whether the gain on sale of the foreign partner's interest is properly viewed as effectively connected to the partner's U.S. trade or business. Code §864 defines when income, gain, or loss is treated as effectively connected with the conduct of a trade or business within the United States. With respect to U.S. source income, Code §864 provides two sets of rules: one applies to fixed or determinable annual or periodic gains, profits, and income ("FDAP") income and gain or loss from the sale or exchange of capital assets and the other applies to all other U.S. source income. U.S. source FDAP and capital gains are treated as effectively connected to the taxpayer's U.S. trade or

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57 See: e.g., Code §§751 or 897(g)
business if: (1) the income, gain or loss is derived from assets used or held for use in the taxpayer's trade or business ("asset-use test"); or (2) the activities of the taxpayer's trade or business were a material factor in the realization of the income, gain or loss ("business activities test"). All other U.S. source income is treated as effectively connected with the taxpayer's U.S. trade or business.

Under the asset-use test, the typical class of income swept in as effectively connected is income derived from the temporary investment of funds needed in the trade or business (working capital). The class of assets defined under the regulations as "held for use" in a trade or business -- (1) assets held for the "principal purpose of promoting the present conduct of a trade or business," (2) assets acquired and held in "the ordinary course" of a trade or business, and (3) assets "otherwise held in a direct relationship" to a trade or business, indicates that the regulations are concerned with investment income derived from assets that are directly used or held for use in the taxpayer's trade or business and not assets that instead represent an ownership interest in such trade or business. If the partnership were to sell its underlying assets, the partnership's gain on sale would clearly represent gain from assets used in the partnership's trade or business. When a foreign partner sells his interest in the partnership, however, the partner and not the partnership realize the gain. Moreover, Code §741 requires that this gain be viewed as gain from the sale of a separate investment asset -- not the sale of a divided share of such underlying assets. Since the foreign partner's interest is not an asset itself used in a U.S. trade or business, gain from the sale of such asset would appear not to constitute effectively connected gain under the asset-use test.

The business activities test provides no greater support for the IRS's position. Income satisfying the business activities test generally includes portfolio type income that has the appearance of FDAP, but is earned in the active conduct of a trade or business of the taxpayer and thus is more properly viewed as ECI income. Thus, for example, royalties from active licensing operations are treated as effectively connected. While it is certainly true in some sense that a partnership's activities in the United States may represent a material factor in the realization of the gain inherent in a foreign partner's interest in such partnership, at least to the extent that the value of the partnership's U.S. operations affects the value of the foreign partner's interest, since the foreign partner is not engaged in the active conduct of the sale of partnership interests, it would appear that the business activities test would not be met. The IRS conceded this result in Rev. Rul. 91-32, stating that "since a foreign partner's gain or loss from the disposition of its interest in a partnership is not gain or loss realized directly from the active conduct of a trade or business within the United States the character of the foreign partner's gain or loss must be determined pursuant to [the asset use test]."

ii. Adoption of Aggregate Approach.

The IRS suggested in Rev. Rul. 91-32 that, without a special aggregate mechanism, the application of the general rules of Code §§741, 864 and 865 result in a situation in which a foreign partner is taxed on the full gain on sale of its interest, even though a portion of the gain may be attributable to gain which would be foreign source income of the partnership if the partnership sold its assets and liquidated. As discussed above, a less tortured reading of §§741, 864, and 865, suggests that, without an aggregate mechanism, the foreign partner may in fact escape tax altogether on the sale of its partnership interest.

Whether a foreign partner's gain on the sale of a partnership interest is taxable in the United States depends on the source and character of the gain. Although there is no directive in Subchapter K for treating the sale of an interest on an aggregate basis for purposes of

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58 §864(c)(2).
59 §864(c)(3).
60 Treas. Regs. §1.864-4(c)(2)(iv).
determining the source and character of the foreign partner's gain, the IRS in Rev. Rul. 91-32 concluded that such determination makes sense in view of the overall taxing scheme applied to foreign taxpayers. Assuming arguendo that this is so, Code §741 states a definite, contrary rule (i.e., that the sale of a partnership interest must be treated as the sale or exchange of a capital asset and not the underlying assets of the partnership).

When Congress has decided that an aggregate view of the partnership is appropriate for purposes of determining the tax consequences on the sale of a partnership interest, Congress has legislated such view. For example, when Congress believed it inappropriate to permit a taxpayer to convert ordinary income into capital gain by contributing appreciated ordinary income property to a partnership and then selling one's interest in the partnership, it enacted the collapsible partnership rules of Code §751. Similarly, in the international context, when Congress determined that it was inappropriate for a foreign taxpayer to avoid tax on U.S. real property gains on the sale of a partnership interest, it enacted Code §897(g) treating the sale of a partnership interest on an aggregate basis for purposes of determining the character of the foreign partner's gain on disposition of an interest in a partnership that holds U.S. real property interests. The suggestion by the IRS in Rev. Rul. 91-32 that treating the sale of a partnership interest on an aggregate basis evidences the view of Congress that "a foreign partner's gain or loss from the disposition of an interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States need not always be treated as ECI gain or ECI loss from United States sources in its entirety" misses the importance of the above rules. While Code §§751 and 897(g) indicate that an entity view does not apply to the sale of a partnership interest in all circumstances, these rules indicate that where Congress believes an exception to the general entity rule of Code §741 is appropriate, it knows how to enact such an exception. Since Congress has failed to provide a specific aggregate rule for determining source and character of gain on sale of a partnership interest by a foreign partner, except in circumstances in which Code §897(g) applies, this would appear instead to evidence the view of Congress that the general entity rule of Code §741 should apply. Accordingly, the gain on the taxpayer’s sale of his partnership interest should not be subject to US tax, except to the extent that Code §897(g) applies with respect to the USRPI.

iii. Policy may favor IRS but statutory authority still lacking

The conclusion that a proper reading of Code §§741, 864 and 865 suggests that gain on the sale of a partnership interest by a foreign taxpayer will escape all U.S. tax even when the partnership is engaged in a trade or business in the United States raises the issue of whether this result is sensible from a tax policy viewpoint. The failure to tax a foreign partner on disposition of its partnership interest appears to treat foreign partners in a manner similar to foreign shareholders, who are generally not subject to tax on the sale of their stock in corporations engaged in U.S. trades or businesses. Although a nonresident shareholder in a U.S. corporation may similarly escape U.S. tax on the sale of his interest, the corporation remains subject to tax on any appreciation in its assets. The government's revenue loss is thus limited to the second level corporate tax imposed at the shareholder level. It has been pointed out, however, that in the case of a sale of a partnership interest by a nonresident alien, if the gain on sale of the interest goes untaxed, the U.S. government may forever lose the opportunity to tax the appreciation in the partnership's U.S. business assets. This may occur in a situation in which a Code §754 election is in place, since the party acquiring the partnership interest receives a step-up in his share of the inside basis of the partnership's assets equal to the appreciation in the partnership's assets. In the domestic context, the use of the Code §754 election generally does not cause

62 Code §754 generally permits a taxpayer purchasing a partnership interest to receive a step-up in his share of the "inside basis" in the partnership assets where the cost of the partnership interest exceeds his share of the existing inside basis.
hardship to the government since the selling partner pays tax on any appreciation in the partnership's assets upon the sale of the interest.

Notwithstanding the legitimate revenue concerns of the Treasury, if the entity view under Code §741 is applied and the partnership interest of the foreign partner is viewed instead as attributable to his U.S. trade or business (and effectively connected with that business), the foreign partner may be overtaxed where the partnership has operations and assets outside the United States. That is, if the gain on sale is treated as attributable to, and effectively connected with, a U.S. trade or business, such gain is fully subject to U.S. tax. This result is inconsistent with the fundamental U.S. (and international) tax principle that a country's tax laws do not reach foreign source income earned by foreign taxpayers through foreign activities.

Assuming that, in the case of a foreign partner, gain from the sale of a partnership interest which is attributable to U.S. operations should be subject to U.S. tax, but that gain attributable to foreign operations should not be, the theoretically correct approach to taxing the gain on disposition of a partnership interest by a foreign partner would be to apply an aggregate rule, looking through to the underlying assets of the partnership. The problem with this approach is that Code §741 suggests that an entity approach to the sale of the partnership interest must be applied unless the Code provides otherwise (e.g., as it does in the case of Code §751 or §897(g)). Nevertheless, the IRS has sought to impose this policy (aggregate treatment) in Rev. Rul. 91-32. While the general aggregate approach adopted in Rev. Rul. 91-32 arguably reaches the correct tax policy result, it is questionable whether the Code supports such a result.


In Brown Group, Inc. v. Commissioner,63 the Brown Group, Inc., and its domestic and foreign affiliates (together, the “Brown Group”) manufactured and sold shoes in the United States and abroad. In 1986, the year at issue in the litigation, Brown Group International, Inc., a domestic member of the Brown Group, owned all the stock of a Cayman Islands subsidiary that owned an 88 percent interest in a Cayman Islands partnership. The Cayman Islands partnership purchased shoes in Brazil as agent for various domestic members of the Brown Group, which resold them into the U.S. domestic market. The Cayman Islands partnership earned substantial commissions for its purchasing activities.

If the Cayman Islands partnership had been a corporation, it would have been a “controlled foreign corporation” and its income would have been “foreign base company sales income.” The partnership's only business was purchasing goods manufactured in Brazil for sale in the United States by its U.S. affiliates.

The government took the position that the character of the income generated by the partnership's activities should be determined at the partner level under the aggregate theory of partnerships and that, viewed from the perspective of the Brown Group's Cayman Islands subsidiary, the income was without doubt Subpart F income.

The taxpayer argued that the character of the income should be determined at the partnership level and rested its case primarily upon the proposition that, under Code § 954(d)(3) as in effect before the enactment of TRA '86, a partnership controlled by a CFC was not considered a “related person” to the controlling CFC—with the result that the Cayman Islands partnership was not purchasing shoes on behalf of a “related” person and therefore was not earning “foreign base company sales income” as defined in Code § 954(d)(1).

The Court rejected the government's aggregate theory of partnerships argument and squarely held, based on a long line of authority, that the character of the partnership's

63 Brown Group, Inc. v. Commissioner, 77 F.3d 217 (8th Cir. 1996); vacating Brown Group, Inc. v. Commissioner, 104 TC 105 (1995)
income must be determined at the partnership level. The Court could have decided the case on a very narrow technical ground that would have had little or no continuing effect, but it chose instead to base its decision on the general proposition that partnerships are treated as entities under the Code, rather than as aggregations of their partners.

Although the specific issue raised by Brown Group may now be moot, the broader policy issue is very much alive: when and to what extent should the entity approach to partnership taxation give way to an aggregate approach in order to preserve the policies of the international tax provisions of the Code? The Service disagreed with the decision in Brown Group and vowed to apply the partnership anti-abuse regulations and other applicable authorities “to treat a partnership as an aggregate of its partners as appropriate to carry out the purposes of any provision of the Code or regulations.” Despite this assertion, the fact remains that Rev. Rul. 91-32 is clearly inconsistent with Code §741 and there is no other statutory basis for the Service’s position. The opinion of the court in Brown Group casts further doubt upon the validity of the Service’s position in Rev. Rul. 91-32. Interestingly, the Service has not published a notice reexamining Rev. Rul. 91-32 in light of recent developments.

d. Implications of U.S.-Canada Income Tax Treaty

(“Treaty”).

As an example of whether this U.S. income taxation of partnership interest would be impacted by the typical U.S. Income Tax Treaty, we shall address whether this issue is effected by the U.S.-Canada Income Tax Treaty (the “U.S.-Canada Treaty”). Article XIII of the U.S.-Canada Treaty authorizes the United States to tax gains from the alienation of personal property associated with a permanent establishment in the United States and real property situated in the United States. Real property situated in the United States includes a USRPI and real property as that term is defined under the domestic laws of the country in which such real estate is located. Article XIII of the U.S.-Canada Treaty was amended in 1983 to conform to the U.S. Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) that was enacted a few months after the original U.S.-Canada Treaty was signed. Consequently, a USRPI under the U.S.-Canada Treaty has the same definition and is subject to the same rules of taxation described in FIRPTA. The U.S.-Canada Treaty, predictably, does not change the foregoing analysis with respect to the taxability of the USRPI held by the USLP.

The U.S.-Canada Treaty authorization to tax gains derived from sales of personal property ultimately does not change the foregoing analysis and conclusions with respect to the U.S. taxation of the sale of the taxpayer’s units in the USLP. The path to this conclusion, however, is a bit more circuitous.

In Unger v. Commissioner, the Court held that a Canadian national with an interest in a U.S. limited partnership was attributed the U.S. permanent establishment of the USLP for purposes of the U.S.-Canada Income Tax Convention. Accordingly, the Unger Court held that the taxpayer was subject to U.S. taxes under the U.S.-Canada Treaty on his share of the

66 In FSA 200128037, the Service reiterated its general look-through position in Rev. Rul. 91-32 but did not cite any authority for the position.
67 Article XIII.2.
68 Article XIII.1.
69 Article XIII.3 (a)
70 Note that the IRS in Rev. Rul. 91-31 acknowledged that Code 897(g) applies first with respect to any USRPI of the partnership and the USRPI is not included in the test advocated by the IRS in Rev. Rul. 91-32; See also Note 53 supra.
71 T.C. Memo 1990-15, aff'd, 936 F.2d 1316 (D.C. Cir. 1991)
USLP’s capital gains. The Unger case, arguably, may be authority for the proposition that a U.S. permanent establishment of the USLP can be attributed to the taxpayer and that the income, gains and losses of the partnership may therefore be taxable to the Taxpayer in proportion to his distributive share. In the instant case, however, the gain in question is not a partnership gain that naturally must flow-through to the partners, but rather a gain from the sale of an individual partner’s investment interest in the partnership.

Code §894(b) generally provides that a taxpayer will not be deemed to have a permanent establishment in the United States with respect to income that is not effectively connected with the conduct of a trade or business in the United States. Based on the foregoing analysis, the gain from the sale of the partnership interest is not considered effectively connected with the conduct of a trade or business in the United States. Consequently, the taxpayer should not be deemed to have a permanent establishment in the United States.

Assuming, arguendo, that the U.S. permanent establishment of the USLP is indeed attributable to the taxpayer as a partner, he would be deemed to have a permanent establishment in the United States. Notwithstanding a deemed permanent establishment in the United States, the gain from the sale of the USLP units is still considered foreign source income based on the foregoing analysis of the U.S. domestic tax law and, therefore, not subject to U.S taxation, except to the extent the gain is attributable to the partnership’s USRPIs.

III. Use Of Corporate Ownership Structures.

A. Background. Historically, both foreign corporations and foreign individuals have made their direct investments in the United States principally through corporate ownership structures. Frequently, a foreign corporation was used as either the direct U.S. investment owner or as a holding company for a U.S. subsidiary (which, in turn, owned the direct U.S. investment). In the case of foreign corporate investors, the necessity of utilizing a corporate ownership structure obviously emanates from their inherent nature. Moreover, individual foreign investors have also preferred use of corporate structures heretofore for at least three reasons, to wit, (a) anonymity/disclosure benefits, (b) avoidance of U.S. estate and gift taxes on nonresident aliens, and (c) individual federal income tax rates on ordinary income were higher than corporate income tax rates. However, the JGTRRA reduces the individual ordinary income tax rates to a maximum of 35% effective 2003 through 2008, which is equal to the maximum corporate rate, thereby eliminating one of the three historical reasons for using corporations.\(^\text{72}\) In addition, foreign investors seeking anonymity continue to gravitate towards the use of foreign corporations, which normally provide a greater measure of anonymity than alternative U.S. corporate and direct ownership structures. Nonetheless, the overriding reason for using foreign corporate structures probably continues to be the nonresident alien's objective of avoiding the U.S. estate and gift taxes.

On the other hand, the direct ownership of U.S. businesses by foreign corporations is generally no longer advisable because of the branch profits tax introduced by the 1986 TRA,\(^\text{73}\) which ordinarily will serve to increase the normal maximum federal corporate income tax rate of 34% up to a maximum of 54.5%, an increase of over 20%. On the other hand, the branch profits tax typically will be reduced or inapplicable if the foreign investor is from a favorable U.S. treaty country and the foreign investor utilizes a home-country/treaty company.\(^\text{74}\) The existence of a home-country treaty with the United States that overrides or limits the branch profits tax, therefore, may make a critical difference in the U.S. tax planning approaches. As a result, the

\(^{72}\) See note 1, supra, regarding the JGTRRA and EGTRRA sunset provisions that may restore the 39.6% maximum income tax rate for 2011 and after.

\(^{73}\) Code § 884, as amended by TAMRA § 1012(q).

\(^{74}\) Code § 884(e)(2)(B); Treas. Regs. § 1.884-5T. See Notice 87-56, note 50, infra, regarding the favorable U.S. treaty jurisdictions.
corporate structural options for investment in U.S. real estate and other U.S. businesses are analyzed below in terms of whether or not such a favorable U.S. treaty is available.


1. Direct Ownership by Home-Country/Treaty Company. Based upon the clarification first provided by Notice 87-56, it is clear that many older U.S. income tax treaties will serve to override the branch profits tax, with certain notable exceptions (e.g., Australia, Canada, France and the new treaty with Switzerland). Thus, if the foreign investor is from a favorable U.S. treaty jurisdiction and the foreign investor is prepared to utilize a home-country/treaty company, then the foreign investor will find that the use of such a company to directly own the U.S. real estate or business will usually produce the best overall U.S. tax results. The obvious drawback, however, of direct ownership of U.S. real estate or business by a home-country/treaty company is the lack of home-country anonymity to which some treaty investors had become accustomed (by formerly relying on Netherlands Antilles or other tax-haven companies). If such home-country anonymity remains of paramount importance to the treaty investor, then he may be forced to consider the non-treaty investor alternatives discussed below. In addition, any interest paid by the home-country/treaty company to the treaty investor may be taxed at home-country rates that are higher than those at the U.S. branch level. If this is the case, then leveraging of the U.S. investment through shareholder loans may be inadvisable.

2. Hybrid Structures Benefiting from Entity Characterization Differences. A variation on the direct ownership of U.S. assets by a home-country/treaty company would be the use of a home-country entity that qualifies as a "corporation" for U.S. income tax purposes and a "partnership" for home-country tax purposes. The possibility of having such a conflicting characterization, coupled with certain other predicate treaty provisions, may combine to provide the best overall tax results in both the United States and the home-country. These tax benefits may include a single level of U.S. income tax on the U.S. business profits, exemption from home-country taxation on these U.S. business profits and, in rare cases, exemption from both U.S. and home-country income tax of amounts paid as interest by the home-country/treaty "corporation" to its treaty "shareholders/ lenders." In order for this combination of results to obtain, a number of predicate factors must be present. First, a favorable U.S. income tax treaty that overrides the branch profits tax is still essential because the foreign entity must constitute a "corporation" from a U.S. tax perspective in order to obtain the benefits of the assured U.S. estate tax insulation and the financing options discussed below. In addition, treaty articles providing for the taxation of the U.S. real estate income or other U.S. business income only in the United States is also important (although a basic home-country rule exempting foreign source income from home-country taxation would also suffice for this purpose). The real key to this combination of results, however, lies in the conflicting characterization of the foreign entity as between the U.S. and home-country tax laws, something that has been facilitated by the U.S. "check-the-box" rules. As a result, it would be possible to structure a foreign entity treated as a corporation for U.S. purposes, even though the entity would be viewed as constituting a "partnership" (or other form of "transparent entity") under the home-country tax laws.

real estate directly by the home-country/treaty company will expose that treaty company to home-country income taxation at rates that are higher than those applicable in the United States, then it generally will be preferable to have a treaty company own a U.S. subsidiary company that, in turn, owns the U.S. real estate or U.S. business. This tandem "treaty parent/U.S. subsidiary" approach normally will insulate the U.S. real estate income from current home-country income taxation. Also, the tandem "treaty parent/U.S. subsidiary" approach may be advisable if the applicable U.S. treaty does not exempt foreign corporations formed in that treaty jurisdiction (e.g., Canada, France, Australia or Switzerland) from the U.S. branch profits tax.

Because the parent company is assumed to be a beneficiary of a favorable U.S. income tax treaty in this section, any interest paid by the U.S. subsidiary to the treaty parent company typically will be subject to reduced or no U.S. withholding tax on those interest payments. This interest payment would, thus, reduce the overall U.S. income tax liability from the U.S. real estate or other business operations (although the deductibility of this interest by the U.S. subsidiary would be subject to the anti-income stripping provision of Code § 163(j)). Nonetheless, a factor to consider in adopting this subsidiary debt approach is the home-country income taxation of those interest payments. Reducing the U.S. tax liability through debt/leverage normally will be inadvisable if the interest received by the treaty parent company is taxed at higher rates in the home-country than those applicable in the United States.

C. Non-Treaty Country Investors.

1. Direct Ownership by Non-Treaty Foreign Company Generally Not Advisable. If the foreign investor is from a country with which the United States either does not have a treaty or, if it does, the treaty does not override the U.S. branch profits tax (hereinafter collectively referred to as "non-treaty investors"), then one option is generally eliminated for the holding of income-producing U.S. real estate and other U.S. business assets. That is, because the non-treaty investor would be exposed to the U.S. branch profits tax if he relied on a non-treaty/home-country company as an operations entity, direct investment via such a home-country company would be inadvisable, in most circumstances, if the investment consists of a U.S. business or income-producing U.S. real estate. In this case, the home-country company would be exposed to U.S. income tax rates of up to nearly 55%.

Nor can the non-treaty investor utilize a company formed in a third-country U.S. treaty jurisdiction to avoid the branch profits tax. This special tax has its own "anti-treaty shopping rule" which precludes access to the normal U.S. treaty benefits for the non-treaty investors attempting to rely on another country's treaty.\(^78\) In other words, if a treaty company (that ordinarily would be exempt from the branch profits tax) is at least 50% owned, directly or indirectly, by persons who are not residents of that particular treaty country (or the United States), then the normal exemption from the branch profits tax under that favorable treaty will not be applicable.\(^79\) Thus, the possibilities of using either a home-country/non-treaty company or a company formed in a third-country treaty jurisdiction where the investor is not a resident are no longer viable ownership options, in most cases, because both possibilities expose the foreign investor to the U.S. branch profits tax.

2. Tandem "Foreign Parent/U.S. Subsidiary" Approach Normally Best. As former foreign corporate ownership options have been foreclosed, the non-treaty investor may consider establishing a foreign corporation that wholly owns a U.S. subsidiary that, in turn, owns the income-producing U.S. real estate or U.S. business. By taking this tandem "foreign parent/U.S. subsidiary" approach, the non-treaty investor may both insulate himself from U.S. estate tax and avoid the branch profits tax that otherwise would apply if the U.S. real estate or business were held directly by a non-treaty (or nonqualified) foreign corporation.

\(^78\) Code § 884(e)(1)(B), as amended by TAMRA § 1012(q)(2)(A).

\(^79\) Code § 884(e)(4)(A)(i).
Absent use of appropriate financing options, this tandem foreign parent/U.S. subsidiary company structure will result in normal U.S. corporate income tax on the operating profits and imposition of the capital gains tax on the ultimate disposition of the U.S. real estate or U.S. business. Both the U.S. corporate income tax rate and capital gain tax rate are now typically a maximum of 34%, with state income tax rates generally raising the combined, effective rates to about 38% to 44%. However, under this tandem foreign parent/U.S. subsidiary company approach, there should be no branch profits tax (which otherwise could result in nearly 20% of additional effective tax) and no further shareholder-level income tax on the ultimate disposition of the U.S. and foreign companies if the capital gains are fully recognized and taxed at the U.S. subsidiary level. This shareholder-level income tax exemption on the ultimate liquidation should result because the U.S. subsidiary corporation would no longer be a "U.S. real property holding corporation" ("USRPHC") following the taxable disposition of its U.S. real estate interests. In addition, foreign persons are not generally subject to U.S. income tax on the sale of non-USRPHC stock that is not effectively connected to a U.S. trade or business.

IV. Summary Of Entity Ownership Options.

A. Overview. As the foregoing discussion illustrates, the U.S. tax rules for foreign investment in U.S. real estate and U.S. businesses will require careful consideration of the alternative structures, because of the widely differing income and (possibly) estate tax results that may obtain. In particular, foreign individuals will have to weigh carefully the theoretical estate tax risks of partnership approaches versus the potentially very significant income tax savings those partnership approaches may provide. Likewise, the anti-income stripping provision of Code § 163(j) makes related party financing far less beneficial and is likely to result in more portfolio debentures and creative, unrelated party financing.

B. Partnership Versus Corporate Vehicles. For those foreign investors wishing to obtain the lower individual income tax rates, U.S. investment via foreign limited partnerships should be given serious consideration. Although historically some tax advisors have assumed that partnerships involve some risk of a U.S. estate tax exposure (at least when the partnership is engaged in a U.S. trade or business), it is the author’s view that this risk is relatively diminimus in comparison to the far more certain income tax benefits to be achieved, such that the overall tax efficiencies weigh in favor of the pass-through entity structures in most cases. Specifically, there are two significant theories that a foreign partnership interest owned by a nonresident alien domiciliary is not a U.S. situs asset, even when the partnership is engaged in a U.S. trade or business. However, if the nonresident alien investor is seeking absolute certainty of exemption from the U.S. estate tax, then the more traditional corporate approaches will become necessary (e.g., foreign parent/U.S. subsidiary), with a significant increase in the normal U.S. income tax liabilities. Thus, individual foreign investors typically will have to reconcile themselves either to paying the higher corporate income taxes (in order to guarantee insulation from U.S. estate tax) or accepting a certain degree of estate tax risks for the sake of potentially saving significant amounts of U.S. income tax. The profile of the particular investor and the specific target acquisition obviously will be critical in evaluating these alternatives.

Even in the case of foreign corporate investors, a number of different corporate structures might be considered for the U.S. investment. For example, some treaty-country companies may be able to utilize intermediary hybrid structures that provide flow-through tax treatment in their home countries and corporate status in the United States. Likewise, the benefits of home-country companies versus tax-haven companies must be evaluated, particularly in light of

80 The maximum federal corporate income tax rate increases to 35% for taxable income in excess of $10 million.
81 See Code § 897(c)(1)(B).
82 See Code §§ 871(a)(2), 881(a),(b), 864(c)(2).
any related-party financing plans.

C. **Specific Investor Planning Still Crucial.** The foregoing discussion is intended to provide the reader with a basic understanding of the principal planning alternatives and the basic U.S. tax considerations of foreign investment in U.S. real estate and other U.S. businesses. It should be evident from this summary, however, that this is a relatively complex subject, especially if the foreign investor must consider reorganizing an existing U.S. real estate or business structure. In addition, it is important to note that this area is constantly subject to new developments and changes, as Congress continually entertains new tax laws, the Internal Revenue Service promulgates new regulations, rulings, announcements and interpretations, and the U.S. courts issue new opinions impacting these subject areas. As a result, it is crucial that the foreign investor and his advisors review his particular circumstance with a qualified U.S. tax advisor when planning a proposed U.S. real estate or business investment, both to ensure that the proposed planning alternative is appropriate for the foreign investor's specific factual circumstances, and to ensure that there has not been new developments or changes which would render that planning approach inadvisable. With such careful, individualized planning, the foreign investor may reduce substantially his U.S. tax liabilities emanating from the U.S. business and real estate investments.

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