Bloomberg Tax

Tax Management
International Journal™

Foreign Incorporations of U.S. Real Estate: No You Can't; Yes You Can

By Robert E. Ward, J.D., LL.M.[*]
WardChisholm, LLP
Vancouver, British Columbia and Bethesda, Maryland

Tax questions are often simple. Answers, rarely so. In this case, the simple question is ''Can I transfer my real estate in the United States to a foreign corporation without U.S. taxation of the unrealized gain?'' This question may arise as a result of foreign restructuring. It may also arise in the case of a non-resident alien owning U.S. real estate because of concerns regarding U.S. estate taxation.[1] In the latter context, ownership of the U.S. real estate through a U.S. corporation does not solve the estate tax problem,[2] but ownership of the U.S. real estate or the domestic corporation owning the property through a foreign corporation will.[3] However, appetite for this solution will likely depend on the tax cost of implementation.

Transfers of investments in U.S. real estate by foreign corporations and non-resident alien individuals (NRAs) are dispositions on which gain and (in some cases) loss is taken into account by the transferor as effectively connected income (ECI).[4] Amounts paid by transferees are subject to 15% withholding.[5] The property's unrealized gain or loss enters into the computation of the foreign corporation's tax under §882 or the NRA's tax under §871(b). A casual reading of §897 (if such a thing may be said to occur with respect to any provision of the Internal Revenue Code) may lead one to despair. Section 897(j) provides that foreign corporations and NRAs are subject to gain recognition on transfer of a United States real property interest (USRPI) to a foreign corporation ''if the transfer is made as paid in surplus or as a contribution to capital'' in an amount equal to the difference between the fair market value of the property transferred over the transferor's adjusted basis (increased by the amount of gain recognized by the transferor as a result of application of other Code provisions). Hope, however, lingers as a result of the preface to §897(j): ''Except to the extent otherwise provided in regulations. . . .'' Indeed, the regulations do offer hope, pinned to the notion of what it is to be a USRPI: in this case an equity interest in a domestic corporation which satisfies the definition of a United States Real Property Holding Corporation (USRPHC).[6] In essence, the regulations provide that an exchange of one USRPI for another USRPI is sufficient in certain cases to avoid §897 gain recognition. While a foreign corporation cannot be a USRPI, it can pretend to be one by making an election under §897(i).

Eligibility for the §897(i) election is subject to two requirements:

---

[*] Robert E. Ward, J.D., LL.M. is a fellow of the American College of Tax Counsel who advises businesses and individuals on U.S. international and domestic tax matters from his firm's offices in Vancouver, British Columbia and Bethesda, Maryland. The assistance provided by Sean Tevel, Holland & Knight, Miami, is acknowledged and greatly appreciated.

[1] *See generally* §2103. All section references are to the Internal Revenue Code, as amended (the ''Code''), or the Treasury regulations thereunder, unless otherwise indicated.

[2] §2104(a)

[3] Ownership of U.S. real estate by a foreign corporation is not the only nor necessarily the best means by which a non-U.S. person may avoid U.S. estate tax. *See generally* Ward, *Impulse Buying in the Wake of Tax Reform: Reconsidering Structures for Foreign Ownership of U.S. Real Estate,* 47 Tax Mgmt. Int'l J. 475 (July 13, 2018).

[4] §897(a)(1). Further complicating matters, NRAs may also be subject to alternative minimum tax. *See* §897(a)(2).

[5] §1445(a)

[6] §897(c)(1)(A). Section 897(c)(2) defines a USRPHC as any corporation if the fair market value of USRPIs owned by that corporation exceeds 50% of the fair market value of (a) those USRPIs plus (b) interests in real property located outside the United States and (c) other assets used by the corporation in a trade or business.

ISSN 0090-4600

- the foreign corporation seeking to elect must hold a USRPI and
- the foreign corporation must be organized in a country with which the United States has a tax treaty providing for non-discriminatory treatment with respect to the USRPI.

The first requirement creates a classic chicken-and-egg problem. The election requires the corporation to hold a USRPI. However, transfer to a foreign corporation is a gain recognition event which can only be avoided by making a §897(i) election. How then does one elect without triggering the gains sought to be avoided? The regulations again come to the rescue by providing that acquisition of the USRPI simultaneously with the effective date of the election is sufficient to satisfy the pre-existing ownership requirement.[7] In fact, the election may be made at any time before the first disposition of the stock of the electing foreign corporation.[8] Finally, merely owning a USRPI is not sufficient. The regulations require that the USRPI be significant enough to cause the electing foreign corporation to be a USRPHC.[9]

In addition to holding a USRPI of sufficient magnitude to enable the foreign corporation to qualify as a USRPHC,[10] the foreign corporation must be organized in a treaty jurisdiction. Most if not all U.S. treaties provide for non-discriminatory treatment with respect to USRPIs.[11]

In addition to the statutory requirements, the regulations specify the form and manner by which the §897(i) election is made. The election is made by filing a statement with the information and detail required by the regulations with the IRS service center in Ogden, Utah.[12] In addition, the foreign corporation must submit a binding waiver of treaty benefits that would otherwise mitigate the gain or loss recognized by the foreign corporation on the disposition of the USRPI with which it is capitalized. This is a recognition that the provisions of §897 override contrary provisions of U.S. tax treaties, making the §897 election the ''exclusive remedy'' for avoiding inclusion of gain or loss recognized by a USRPI in the computation of the NRA's or foreign corporation's ECI.[13] The §897(i) election requires the stockholders of the foreign corporation to sign a consent to the election and waive treaty benefits. As an alternative to disclosing the identity of its stockholders, the foreign corporation may place a legend on its stock certificates disclosing the existence of the election and the potential obligation of any purchaser of the stock of the foreign corporation to withhold tax at the time of purchase. The electing foreign corporation must confirm in its election statement that it has received the signed consents and waivers of treaty benefits from its stockholders and that it will retain the consents and waivers for at least three years from the date of the election and provide those documents to the IRS within 30 days of request.[14]

Transfer of a USRPI to a foreign corporation made as ''paid in surplus or as a contribution to capital'' is regarded by the regulations as an exchange of the USRPI for the stock of the foreign corporation.[15] In other contexts, such a transaction might qualify for non-recognition under §351. Section 897 does not foreclose the availability of non-recognition treatment offered by §351 or other non-recognition provisions of the Code. However, §897(e) limits application of the non-recognition provisions of the Code to those circumstances in which a USRPI is exchanged for ''an interest the sale of which would be subject to taxation under this chapter.''[16] Temporary regulations issued in 1988 clarify the interest received in the exchange must be subject to U.S. income taxation on its disposition if transferred immediately after such exchange.[17] Additional reporting requirements set forth in the regulations must also be satisfied.[18]

The 1988 temporary regulations address dispositions of USRPIs in the context of non-recognition transactions and provide several examples by which an exchange of one USRPI for another USRPI in the context of a non-recognition transaction (such as §351) will and will not qualify for non-recognition under §897.[19] One of the examples which qualifies for non-recognition under §897 is a transfer of U.S. real

---

[7] Reg. §1.897-3(b)(1).

[8] Reg. §1.897-3(d)(1). In the case of elections made after the first disposition of stock, a special payment of tax is required. *See* Reg. §1.897-3(d)(2)(i).

[9] Reg. §1.897-8T(b).

[10] §897(i)(1)(B); Reg. §1.897-3(b)(2).

[11] *See* Notice 88-1, 1988-1 C.B. 471, modified by Notice 88-53, 1988-1 C.B. 538.

[12] Reg. §1.897-3(c).

[13] *See* Reg. §1.897-3(a).

[14] Reg. §1.897-3(c)(4)(ii). Consent and waivers are not required from stockholders of foreign corporations whose stock is regularly traded on established securities markets unless the stockholders' ownership of the class of stock which must consent to the election exceeds 5%. §897(i)(3); Reg. §1.897-3(c)(4)(i). Constructive ownership rules apply. *Id.*

[15] Reg. §1.897-6T(b)(5).

[16] §897(e)(1).

[17] Reg. §1.897-6T(a)(1)

[18] *Id*. The transferor of the USRPI must submit a U.S. income tax return for the year in which the transfer of the real estate to the foreign corporation occurs accompanied by a statement that includes the information and declarations set forth in Reg. §1.897-5T(d)(1)(iii).

[19] *See* Reg. §1.897-6T.

ISSN 0090-4600

estate by an NRA to a domestic corporation.[20] It would be reasonable to expect the example would also apply to a foreign corporation which has made a §897(i) election. However, the same temporary regulation contains the following statement.

> *No exceptions*.—No exception to the recognition of gain under paragraph (a)(1) of this section is provided for the transfer of a U.S. real property interest by a foreign person to a foreign corporation in exchange for stock in a foreign corporation other than is provided in this paragraph (b). Thus, no exception is provided where — (i) such exchange is made pursuant to Section 351 and the U.S. real property interest transferred is not stock in a U.S. real property holding corporation;. . . .[21]

This language might easily be understood to require that the real estate first be encased in a domestic corporation whose stock is then transferred to a foreign corporation by the NRA or foreign corporation. Indeed, the text of paragraph (b) of the temporary regulations and examples contained therein reinforce the no-exception statement quoted above.[22] Such a reading of the no-exception provision is misplaced, inasmuch as a foreign corporation which has made a §897(i) election is no longer regarded as a foreign corporation for purposes of §897.[23] A foreign corporation which has made the §897(i) election will come within the scope and intent of the example described above despite not otherwise satisfying the requirements set forth in paragraph (b) of the temporary regulation. This conclusion is important inasmuch as transfer of the stock of a domestic corporation to a foreign corporation is an inversion subject to the consequences of §7874.[24]

Although the Code and regulations contain statements which appear contradictory and confusing, the NRA or foreign corporation owning U.S. real estate can transfer that property to a foreign corporation without triggering a disposition subject to §897(a). Yes you can.

---

[20] *See* example one at Reg. §1.897-6T(a)(7).

[21] Reg. §1.897-6T(b)(3).

[22] *Accord* PLR 201032016 (Aug. 13, 2010).

[23] The author has confirmed the conclusion in the text by informal conversation with personnel in the office of IRS Chief Counsel.

[24] The §897(i) election is effective to treat the foreign corporation as a domestic corporation for purposes of §897, §1445, and §6039C, but not other provisions of the Code. §897(i)(4); Reg. §1.897-3(a). Rev. Rul. 89-130, 1989-2 C.B. 117.

ISSN 0090-4600