

USING A §897(I) NON-DISCRIMINATION ELECTION TO AVOID F.I.R.P.T.A.

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Mistakes happen. Often nonresident alien individuals buy U.S. real property, often personal use property, in their individual names. This can be a costly mistake.¹ With certain exceptions, if such an individual were to die while owning the property, a U.S. estate tax of approximately 40% of the value of the property could be imposed.

There is one method to restructure this investment in the case of a foreign individual, or an entity owned by a foreign individual, if such a person is eligible to claim the benefit of an income tax treaty with the United States and the treaty contains a so-called “Nondiscrimination Clause.” These clauses provide that a resident of a treaty state will not be treated any less favorably than a U.S. resident carrying on the same activities. This article will look at how a Nondiscrimination Clause can be used to avoid onerous F.I.R.P.T.A. provisions when a foreign person invests in U.S. real property.

The technique described in this article essentially permits a nonresident alien individual to transfer U.S. real property on a tax-free basis to a foreign entity, which will be treated as a domestic entity for income tax purposes and as a foreign (non-taxable) entity for U.S. estate tax purposes.

A nondiscrimination claim has to be argued and proven by the foreign person. To preempt such claims under F.I.R.P.T.A., Congress included a Code §897(i) provision (the “§897(i) Election”) that allows foreign corporations in treaty countries to elect to be treated as domestic corporations for the purposes of F.I.R.P.T.A., provided they meet certain criteria.

THE §897(I) ELECTION

The §897(i) Election allows a foreign corporation to be treated as a domestic corporation for purposes of Code §897 (disposition of investment in U.S. real property), Code §1445 (withholding), and Code §6039C (foreign person returns). The §897(i) Election is the exclusive remedy for any person claiming discriminatory treatment with respect to the rules that apply to foreign investment in U.S. real property.²

There are four criteria that a corporation must meet before it is permitted to make a §897(i) Election:³

¹ See *Insights* Vol. 2 No. 2, “Tax 101: Understanding U.S. Taxation Of Foreign Investment In Real Property – Part III” and additional publications regarding F.I.R.P.T.A.

² Code §897(i)(4).

³ Treas. Reg. §1.897-3(b).

“The requirement for holding a U.S.R.P.I. is satisfied when a U.S.R.P.I. is acquired simultaneously with the §897(i) Election.”

1. **The foreign corporation must hold a U.S. real property interest (“U.S.R.P.I.”).**

The requirement for holding a U.S.R.P.I. is satisfied when a U.S.R.P.I. is acquired simultaneously with the §897(i) Election. As previously discussed in the prior Tax 101 series on F.I.R.P.T.A., a U.S.R.P.I. is any interest in real property located in the U.S. or the U.S. Virgin Islands and the personal property associated with its use, or, in any domestic corporation unless the domestic corporation was at no time a U.S. real property holding corporation during when the interest was held or the five years preceding the date of disposition.⁴

This provision allows a foreign person transferring a U.S.R.P.I. to a newly formed foreign corporation qualifying for nonrecognition under Code §351⁵ to avoid recognition on the gain of the transfer by making this §897(i) Election.⁶

2. **The foreign corporation must be entitled to nondiscriminatory treatment with respect to that U.S. real property interest under an applicable U.S. treaty.**

The corporation indirectly holding the U.S.R.P.I. has to be entitled to the non-discriminatory treatment. This entails going through the applicable treaty affecting the parties and looking for an antidiscrimination clause that covers the discrepancy in taxation between a U.S. and foreign person. Although the most common place to find these clauses are the income tax treaties, the Economic Tax Act of 1981 expanded “U.S. treaty” to mean any treaty obligation of the U.S. including Nondiscrimination Clauses under treaties of friendship, commerce, and navigation as well.⁷

3. **The foreign corporation must qualify as a U.S. real property holding corporation (“U.S.R.P.H.C.”) upon making the election.**

A corporation must qualify as a U.S.R.P.H.C. upon making the election. Generally a corporation is a U.S.R.P.H.C.⁸ if the fair market value of the U.S. real property interests held by the corporation on any determination date equals or exceeds 50% of the sum of its:

- U.S.R.P.I.’s,
- Foreign real property interests, and
- Certain business assets.

If a foreign corporation is not a U.S.R.P.H.C., the election will not be permissible since allowing it to make an §897(i) Election would enable it to avoid being taxed under Code §897(d).

⁴ See “Definitions of Terms and Procedures Unique to FIRPTA: U.S. Real Property Interest.”

⁵ Code §351(a) provides that no gain or loss shall be recognized if property is exchanged solely for stock of a corporation, immediately after which the transferor is in control of that corporation.

⁶ P.L.R. 201032016.

⁷ P.L. 97-34, Code §831(d).

⁸ Treas. Reg. §1.897-2.

4. The foreign corporation must submit the election in proper form and in a timely manner.

To successfully make the election, the foreign corporation must show that it has met the requirements of the §897(i) Election. At this time the necessary documents, listed below, must be mailed to the I.R.S. Service Center in Ogden:

- A general statement signed by a responsible corporate officer under penalties of perjury indicating that an §897(i) Election is being made and providing:
 - The electing corporation's name, address, identifying number, and place and date of the incorporation;
 - The treaty and article number under which the electing corporation is seeking nondiscriminatory treatment;
 - Descriptions, acquisition dates, adjusted bases, and fair market values of the U.S.R.P.I.'s held directly or indirectly by the corporation; and
 - Information regarding any dispositions of interests in the foreign corporation between related persons between January 1 and June 18, 1980.
- A binding waiver of treaty benefits that may apply to any gain or loss from the disposition of any U.S.R.P.I. during the period in which the §897(i) Election is in effect. No other treaty benefits will be affected by this waiver.
- A binding agreement to pay income tax like a domestic corporation on any gain that is recognized upon the disposition of the U.S.R.P.I. or any property acquired in exchange for a U.S.R.P.I. in a transaction to which nonrecognition treatment applies under Code §897(e) during the time of the §897(i) Election.
- Unless the shareholder is a shareholder of a publicly traded corporation whose stock ownership satisfied the exception to U.S.R.P.I., on the date of the election each shareholder has to file a signed consent to the making of the election and a waiver of U.S. treaty benefits with respect to gain or loss from the disposition of any interest in the foreign corporation. Along with the shareholders' consent to the election, a list identifying and describing the interests held by each shareholder in the foreign corporation has to be submitted, as well.
- There is an alternative to filing the shareholders' consents and waivers. The electing corporation can avoid the requirement by placing a legend stating that an §897(i) Election has been made on all outstanding certificates of stock. In addition, it has to include with its election (a) a statement that it has received the signed consents and waivers from all required shareholders, (b) a list that describes the interest of the corporation held by the shareholders, and (c) an agreement that the corporation will retain in its possession all signed consents and waivers for a period of three years from the date of the election.

- The election corporation must make a statement that no interest was disposed of during the longer of the last ten years before the date of the §897(i) Election or the last ten years prior to the date on which one or more domestic shareholders or related persons are in control of the foreign corporation.⁹

The election becomes effective on the date on which it is made or on such earlier date as specified in the election. The I.R.S. will acknowledge receipt of an §897(i) Election filing within 60 days. The election applies for as long as the corporation exists.

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TAX CONSEQUENCES OF AN §897(I) ELECTION

There are several factors to consider when making an §897(i) Election.

The primary advantage of the election is that it enables a foreign corporation to benefit from certain nonrecognition provisions of the code that it would not be able to take advantage of otherwise. In addition, a §897(i) Election only causes the foreign corporation to be treated as a domestic corporation for F.I.R.P.T.A. purposes, not for estate tax purposes. This means that the corporation may still take advantage of treaty benefits in other areas. Furthermore, the election allows the foreign corporation to avoid F.I.R.P.T.A. withholding tax on the disposition of the U.S.R.P.I.

Once a foreign corporation has elected to be treated as a domestic corporation, a transfer of the real estate to the corporation will be eligible for nonrecognition under Code §351 and Code §897(e). Under Treas. Reg. 1.897-6T, the corporation must comply with certain filing requirements including the filing of a notice of nonrecognition under Treas. Reg. §1.1445-2(d)(2) within 20 days of the transfer.

Nonetheless, the disadvantages need to be weighed as well. The consent and waiver requirements mean that the direct shareholders have to shed their anonymity so that the accuracy of the documents may be verified. The major tax disadvantage is that the corporation exposes any gain in the non-U.S.R.P.I. assets to U.S. income tax because it becomes a U.S.R.P.H.C. This means that the sale of stock of a foreign corporation becomes taxable, and at its full value at the shareholder level.

CONCLUSION

An §897(i) Election enables a foreign corporation to be treated as a domestic corporation for F.I.R.P.T.A. purposes and eligible to participate in a nonrecognition transaction. This can be very useful when a foreign person wants to transfer U.S. real property to a foreign corporation and avoid U.S. estate tax. The §897(i) election is a useful “second chance” for the taxpayer eligible to claim treaty benefits.

⁹ Treas. Reg. §1.897-3(c)(5), as announced to be modified by Notice 89-85, 1989-2 C.B. 403, and Notice 2006-46, 2006-1 C.B. 1044.