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RECENT DEVELOPMENT

Capital Gains Treatment under the U.S.-Canadian Income Tax Convention of 1980: Conflicts with Congressional Policy

I. INTRODUCTION

On September 26, 1980, the United States and Canada signed the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital1 (1980 Convention), concluding seven years of negotiations.2 The complicated economic relationship between the two countries3 is reflected in the provisions of the 1980 Convention, one of the most detailed and complex tax treaties4 ever submitted to the U.S. Senate for its consent to ratification.5 Major changes in the tax laws and policies of both countries have necessitated the replacement of the current tax treaty which the United States and Canada signed in 1942 (1942 Convention) and last amended in 1966.6


5. Under the U.S. Constitution, the Senate gives its advice and consent to ratification by the President. U.S. CONST. art. II, § 2. Ratification occurs when the President exchanges instruments of ratification with the foreign government. 14 M. WHITEMAN, DIGEST OF INTERNATIONAL LAW 57 (1970) [hereinafter cited as Whiteman].

Growing U.S. concern with foreign investment in U.S. real estate, business, and securities has paralleled Canadian concern with U.S. investment in Canada. Both Canada and the United States have recently enacted legislation designed to strengthen domestic regulation of foreign investment. Canada has been particularly preoccupied with U.S. corporate involvement in the exploitation of its energy resources. On October 28, 1980, the Canadian Government published proposals to require greater Canadian ownership of companies in the gas and oil industries, and greater taxation of foreign companies. In the United States, Congress enacted the Foreign Investment in United States Real Property Tax Act of 1980 (FIRPTA) to subject foreign corporations and nonresident aliens to U.S. taxation on gains realized from the disposition of U.S. real property interests.

Rather than to discourage foreign investment in the United States, Congress intended FIRPTA to place foreign investors in U.S. real estate on an equal footing with U.S. taxpayers. Prior to FIRPTA, the United States generally did not tax foreign investors on gains realized from the disposition of U.S. real property, subject to certain exceptions. Congress, by enacting FIRPTA, has eliminated most methods of avoiding U.S. taxation upon the disposition of U.S.

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8. See Income Tax Act, CAN. REV. STAT., 1952, ch. 148, Can. Stat. ch. 63 (1970-71-72). See generally Bale, The Individual and Tax Reform in Canada, 49 CAN. B. Rev. 24 (1971). For example, prior to 1972 Canada did not tax capital gains. Generally, only capital gains accruing subsequent to December 22, 1971, to publicly traded shares, and December 31, 1971, to other property, are subject to taxation. See Income Tax Act § 115. Canada taxes nonresidents at a rate of 25% on capital gains realized from the disposition of taxable Canadian property. Taxable Canadian property is defined as: real estate in Canada; capital property used in carrying on a business in Canada; shares in a Canadian private (close) corporation; shares in a Canadian public corporation if at any time in the preceding five years, the nonresident together with related persons owned 25% or more of the corporation; interest in a partnership if, at any time during the 12 months prior to disposition, 50% or more of the fair market value of all the partnership property consisted of Canadian assets; and interests in resident trusts. Income Tax Acts § 115(1)(b). Cf. U.S. legislation enacted in 1980, note 140 and accompanying text infra. On April 9, 1974, the U.S. government enacted the Foreign Investment Review Act (FIRA) in order to regulate foreign investment in Canada. See note 69 and accompanying text infra.


real property interests. However, several older U.S. tax treaties, such as the 1942 Convention between the United States and Canada, exempt gains realized by foreign investors on the disposition of U.S. real property interests from U.S. taxation. Thus, in such situations the United States may not exercise its taxing jurisdiction to the extent authorized by FIRPTA.

The 1980 Convention adopts the evolving U.S. policy toward greater taxation of capital gains realized by nonresident investors. Capital gains are currently not taxable under the 1942 Convention unless the investor maintains a "permanent establishment" in the taxing country. In contrast, under the 1980 Convention, gains realized from the disposition of directly held real property would be taxable generally by the country in which the property is situated (the source country). In addition, gains from the disposition of shares or interests in real property holding organizations would be taxable generally.

Nonetheless, the 1980 Convention has drawn sharp criticism from both Houses of Congress. Members of Congress are concerned that provisions in the 1980 Convention defining real property holding companies and the maximum percentage a nonresident investor may own in such companies before incurring tax liability represent an impermissible deviation from FIRPTA.

14. See Jarchow, supra note 7, at 1095-1102.
16. See 1980 U.S. CODE CONG. & ADMIN. NEWS 5875; 1980 Convention, supra note 1, art. XIII. See also note 146 and accompanying text infra.
17. 1942 Convention, supra note 6, art. VIII. "Permanent establishment" is a basic term of art in tax treaty law, appearing in over twenty-five U.S. tax treaties, and is defined somewhat differently in every U.S. tax treaty. Permanent establishment is a treaty concept which, if applicable, allows the United States to tax a foreigner only if the foreigner maintains a fixed place of business of indefinite duration. See generally Williams, Permanent Establishments in the United States, in PRACTISING LAW INSTITUTE, INCOME TAX TREATIES 189-312 (1978) [hereinafter cited as Williams]. The 1942 Convention defines permanent establishment to include branches, mines and oil wells, farms, timber lands, plantations, factories, workshops, warehouses, offices, agencies and other fixed places of business of an enterprise. 1942 Convention, supra note 6, Protocol, para. 3(f).
18. 1980 Convention, supra note 1, art. XIII(1). See note 89 and accompanying text infra.
19. 1980 Convention, supra note 1, art. XIII(3). See note 89 and accompanying text infra.
1980 Convention would not permit the United States to tax capital gains to the extent mandated by Congress in FIRPTA. Senator Robert Dole (R-Kan.), Chairman of the Senate Finance Committee, expressing his concern in a letter to the Senate Foreign Relations Committee and the Treasury Department, noted that the new capital gains provisions would constitute significant concessions of the taxing jurisdiction of the United States. While aware that treaties by their very nature alter somewhat domestic legislation, members of Congress have adamantly voiced their refusal to yield any of the taxing powers established by FIRPTA. Congress has indicated its intent to not permit the Treasury Department to "bargain away" the taxes imposed by FIRPTA through the operation of the 1980 Convention. Consequently, the Senate Foreign Relations Committee, which has jurisdiction over tax treaties, has suspended review of the 1980 Convention, requesting that the Treasury Department reopen negotiations with Canada.

The conflicting provisions of the 1980 Convention and FIRPTA have exposed a significant political question. The executive branch is responsible, through the Treasury Department, for the negotiation and ratification of tax treaties. Ratification, however, is predicated upon Senate approval. The Senate may refuse to consent to treaties it considers inimical to the policies and laws it has established through domestic legislation. However, the Senate in the past has tolerated restrictions on the Congressional taxing jurisdiction which occur through the operation of treaty provisions such as the "permanent establishment" clause in the 1942 Convention. The effect of the "permanent establishment" clause, contained in innumerable U.S. tax treaties, is to allow a foreign investor to avoid source country taxation in situations in which he would otherwise be liable. On the other hand, Congress, by its stance on the 1980

23. Id. at 1006.
24. See id.
25. Id.
28. Conversation with Prof. Hugh J. Ault, Professor of Law, Boston College Law School, Mar. 2, 1982. Professor Ault, who testified before the House Subcommittee on Oversight, supra note 26, is a distinguished scholar and expert in the field of domestic and international taxation.
32. 1942 Convention, supra note 6, art. VIII.
33. See Williams, supra note 17, at 241-44 for a list of treaties.
34. See id. at 190, 208, 242-312. The existence of a permanent establishment indicates that a foreign
Convention, has indicated the extent to which it is unwilling to allow treaty provisions to unilaterally amend domestic tax legislation.\textsuperscript{35} That the signing of the 1980 Convention and the enactment of FIRPTA occurred within three months of each other renders the problem particularly acute. Congress expected that new treaties would expressly stipulate that FIRPTA was to override any contrary treaty provisions.\textsuperscript{36} The 1980 Convention does not so provide. Congressional concern that the capital gains provisions would undermine the intent of FIRPTA has resulted in an emphatic exercise of the Senate's political prerogative to not only refuse consideration of the 1980 Convention, but also to suggest to the executive branch that Congress will not tolerate significant unilateral abrogation of domestic tax legislation.\textsuperscript{37}

An examination of the capital gains provisions of the 1980 Convention as originally negotiated may reveal to what extent Congress will tolerate deviation from domestic legislation in this and future tax treaties, particularly in the area of foreign investment. An understanding of the problem requires a comparison among FIRPTA, the 1942 Convention and the 1980 Convention. This Comment provides a brief discussion of the tax treaty negotiation process in comparison with the tax legislative process, followed by an overview of the singular economic relationship between Canada and the United States. This Comment analyzes the differences between capital gains taxation under the 1980 Convention and FIRPTA, demonstrating the extent to which the 1980 Convention falls short of the policies established by Congress.

II. Preliminary Considerations

A. The Interaction of Tax Treaty Law with Domestic Tax Law

A basic premise behind every U.S. tax treaty is that such treaty will amend the Internal Revenue Code (the Code) in the Code's application to residents of the other country in return for reciprocal treatment of U.S. residents by the other country.\textsuperscript{38} Tax treaties not only modify the tax laws established by Congress but...
also determine to a certain extent tax policies which are not reflected in the Code. 39 Under the U.S. Constitution, treaties and legislation are on an equal footing. 40 The general rule 41 is that in the case of conflict between treaty law and domestic law, the later in time prevails. 42 Even though tax treaties may override Code provisions, the tax-writing committees of Congress are not involved in formulating the underlying policies for such agreements. 43 The participation of Congress and the public is much more restricted than in the case of tax legislation. 44 Tax legislation originates in the House of Representatives, is often initiated by Congress, and can be readily modified by Congress both during the process of enactment and thereafter. 45 In contrast, tax treaties are initiated by the executive branch with little input from Congress. 46

The Office of International Tax Affairs of the Treasury Department negotiates tax treaties on an administrative level. 47 Although the Treasury Department makes public announcements of the status of negotiations and holds public meetings to discuss selected treaty issues, treaty negotiations generally proceed in secret. 48 The Treasury does not release treaty texts until the representatives of both governments formally sign them. 49 The President submits the treaty as a fully negotiated document to the Senate for its consent and advice to ratification. 50 The Senate is thus presented with a fait accompli and has little choice other than to accept or reject the treaty. 51 Any change by the Senate in the treaty provisions could result in the refusal of the treaty partner to ratify the

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39. Id. at 37 (statement of David H. Brockway, International Tax Counsel of the Joint Committee on Taxation).
41. P. McDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 152 (1978).
43. Hearing, supra note 26, at 160 (statement of Charles M. Bruce, Attorney-at-Law).
44. Hearing, supra note 26, at 37 (statement of David H. Brockway, International Tax Counsel of the Joint Committee on Taxation).
46. Hearing, supra note 26, at 79-80 (statement of David Rosenbloom, former International Tax Counsel of the Treasury Department).
47. Id.
49. Hearing, supra note 26, at 80 (statement of David Rosenbloom, former International Tax Counsel of the Treasury Department).
50. Id.
51. Williams, supra note 17, at 752.
treaty. Alternatively, the Senate could consent to ratification only to later subordinate the treaty to domestic law. However, unilaterally overriding a tax treaty obligation with domestic legislation is inimical to healthy foreign relations. Finally, the Senate may attach reservations to the treaty, which may prove to be unacceptable to the other country and result in no treaty at all.

Congress has prescribed a mechanism to harmonize the Code with tax treaty provisions which may conflict with domestic tax statutes. I.R.C. section 894(a) exempts income from U.S. taxation to the extent allowed by treaty obligations of the United States. The result of section 894(a) is to give treaty provisions precedence over Code provisions. FIRPTA, however, provides that after December 31, 1984, section 894(a) shall not apply to treaty provisions which conflict with FIRPTA. After that date, FIRPTA automatically overrides any conflicting tax treaty provisions. Until that date, however, FIRPTA does not apply to such provisions. The purpose of delayed effective dates is to put U.S. treaty partners on notice and allow ample time for renegotiation. Congress intended the delayed effective date to apply to existing tax treaties such as the 1942 treaty between the United States and Canada, and not to newly renegotiated treaties such as the 1980 Convention, concluded by Canada and the United States only shortly before the enactment of FIRPTA. The purpose of the delayed effective date was thus to give the negotiators the opportunity to avoid the very problem the 1980 Convention has engendered, which is conflict between its provisions and FIRPTA. The 1980 Convention contains no provision stipulating that FIRPTA will override conflicting provisions in the 1980 Convention after December 31, 1984. The absence of such provision in addition to the override provision of FIRPTA would result in the unilateral abrogation of a U.S. treaty obligation, a result Congress feels the Treasury Department could have avoided.

52. Id.
54. Id. at 16.
55. Williams, *supra* note 17, at 752.
57. *Hearing,* supra note 26, at 34 (statement of David H. Brockway, International Tax Counsel of the Joint Committee on Taxation); Bischel, Basic Income Tax Treaty Structures, in PRACTISING LAW INSTITUTE, INCOME TAX TREATIES 1, 5 (1979) [hereinafter cited as Bischel].
58. FIRPTA § 1125(c).
59. Id.
60. Id.
62. Id. The United States and Canada signed the 1980 Convention on September 26, 1980. FIRPTA was enacted into law on December 5, 1980, but applies retroactively to June 18, 1980. FIRPTA § 1125.
63. See *Hearing,* supra note 26, at 34 (statement of David H. Brockway, International Tax Counsel of the Joint Committee on Taxation).
64. See *Dole Comments on Pending Tax Treaties,* 13 TAX NOTES, Oct. 26, 1981 at 1005-06.
B. The Political and Economic Prelude to the 1980 Convention

The problems confronting the Treasury negotiators and the tax-writing committees of Congress are particularly acute with respect to Canada. Canada has long been sensitive to the dominating influence of the United States in the Canadian economy, particularly in the oil and gas industries. The greatest direct invest in Canada occurred after World War II, when the United States poured massive amounts of capital into Canada and imported vast quantities of Canadian resources into the United States. Between 1945 and 1967 foreign investment in Canada increased six-fold. In response to broadening domestic opposition to unbridled foreign investment, Canada in 1973 enacted the Foreign Investment Review Act (FIRA). FIRA provides for administrative review of foreign direct investment in Canada involving takeovers of domestic corporations, establishment of new businesses, and foreign participation in Canadian resource development. If, upon completion of the review process, the Foreign Investment Review Agency concludes that a transaction is not of significant benefit to Canada, the Minister of Industry, Trade and Commerce may reject an application and refuse to allow the foreign investor to proceed with the transaction. In addition to FIRA, both federal and provincial Canadian statutes create further requirements restricting foreign transactions in the Canadian energy resource industries. On February 17, 1980, Pierre Elliott

67. Id. During this period foreign investment in Canada increased from $7 billion to $45 billion (Canadian) (one Canadian dollar equals approx. $.82 U.S.).
68. Id.
70. Id. The legislation provides for the establishment of a Foreign Investment Review Agency to review proposed investments in Canada by “non-eligible” persons to determine if they are of “significant benefit” to Canada. FIRA authorizes review of only non-eligible investors. A non-eligible person may be an individual, a foreign government or agent, a corporation, or a group of investors. Id. § 3., p. 621. An individual who is a non-citizen is a non-eligible person if he is not a permanent resident of Canada or is a permanent resident present in Canada for at least one year after he is eligible for citizenship. Id. FIRA requires the non-eligible investor to send a notice of the proposed investment to the Agency. The Agency has 60 days to approve or deny the transaction. Id. § 8(1), p. 636.
71. Id. § 2(2), p. 620. Following review of the investor’s application, the Agency must submit to the Minister of Industry, Trade and Commerce the Agency’s recommendation whether the transaction should be allowed. The Agency bases its recommendation on an analysis of the transaction’s benefits to Canada. In assessing whether the activity or transaction is of significant benefit to Canada, the Agency considers numerous factors, including employment of Canadian citizens, Canadian participation in ownership and control, and impact on Canadian resources. Id.
72. Id. § 12, P. 641. The Minister of Industry, Trade and Commerce makes an independent determination of the benefits of the transaction, and recommends that the Cabinet issue an Order-in-Council either approving or rejecting the transaction. Id. See generally Olson, supra note 66.
73. See Territorial Lands Act, CAN. REV. STAT. ch. T-6 (1970), which regulates, in part, foreign
Trudeau’s Liberal Party regained control of the Canadian Parliament on a platform pledging increased Canadian control of its economy, especially with respect to the exploitation and development of Canadian energy resources. The Trudeau government has proposed to reduce foreign ownership of the oil and gas industry from the current seventy-two percent to fifty percent by 1990. Trudeau has also advocated tighter controls on all investments by subsidiaries of foreign companies operating in Canada, eighty percent of which are controlled by U.S. interests.

The Reagan Administration has warned the Trudeau government of unspecified potential U.S. retaliatory action in the event that Canada implements nationalization plans aimed at limiting U.S. investment in Canada. In addition, sentiment exists in Congress that such plans could trigger U.S. retaliation in the form of a moratorium on Canadian investment in the United States. Canadian investors form the largest block of foreign landholders in the United States. They own 1.3 million acres of U.S. realty and their commercial and residential property holdings total $10 billion. In light of the extensive economic relations between the United States and Canada and the sensitive nature of those relations, the need for intergovernmental resolution of problems concerning foreign investment is acute.

Income tax treaties have generally been effective in harmonizing domestic and foreign tax laws in situations such as that now facing the United States and Canada. However, tax treaties with the United States are effective only to the extent the treaty provisions do not engender damaging controversy and Congressional opposition, delaying or possibly preventing Senate consent to ratification. As a pragmatic matter, treaties should not include new provisions which are inconsistent with the Congressional policies reflected in the Code. Tax policies should be established through the regular legislative process, where they investment in exploration, mining, and oil and gas development on territorial lands. British Columbia and Quebec have enacted provincial legislation restricting foreign investment in energy resources development. See The Mineral Act, B.C. Rev. Stat. ch. 259, § 2(1) (1977); The Mining Act, Que. Rev. Stat. ch. M-13 (1965).

76. Id.
77. Id.
78. Id.
81. Id.
can be debated fully and adopted on their merits, rather than as a quid pro quo for a perhaps unrelated concession. Information from the Treasury concerning the status and substance of ongoing treaty negotiations with Canada, for example, could have been useful to the tax-writing committees of Congress in drafting the legislation for FIRPTA. Consequently, coordination at an early stage between the treaty negotiators and the members of Congress involved in the tax legislative process would lessen or eliminate the occurrence of conflicting treaty provisions and provide for the presentation of a more coherent national policy, thereby enhancing U.S. foreign relations.

III. FOREIGN INVESTMENT IN THE UNITED STATES AND THE 1980 CONVENTION

A. Closing the Loop-hole under the 1942 Convention

The 1980 Convention changes the tax treatment of capital gains which exist under the 1942 Convention between Canada and the United States. Under Article VIII of the 1942 Convention, the source country may not tax gains realized from the sale or exchange of capital assets, located in the source country, by a resident, corporation or other entity of the other country unless such investor has a "permanent establishment" in the source country. For example, a Canadian investor who directly holds U.S. real estate, interests in a trust whose res is comprised of U.S. real estate, or shares in a corporation holding U.S. real estate, avoids U.S. taxation on the sale or exchange of his holdings, provided he does not have a permanent establishment in the United States.

Foreign investors frequently use U.S. or foreign corporations to invest in U.S. real property. Prior to FIRPTA, foreign investors could employ several techniques to dispose of their U.S. real property interests without being subject to U.S. taxation. FIRPTA eliminates such tax-free dispositions of U.S. real prop-

85. Hearing, supra note 26, at 27 (statement of David H. Brockway, International Tax Counsel of the Joint Committee on Taxation).
88. 1980 Convention, supra note 1, art. XIII.
89. 1942 Convention, supra note 6, art. VIII.
90. See note 17 supra.
91. 1942 Convention, supra note 6, art. VIII. In determining their tax liability under the Internal Revenue Code and tax treaties, nonresident aliens and foreign corporations must ascertain whether they realize income from U.S. sources. Williams, supra note 17, at 197. I.R.C. §§ 861-864 provide a set of income source and allocation rules. Under the Code, a foreign taxpayer must pay U.S. tax on income from U.S. sources if he engages in a trade or business within the United States. I.R.C. § 882. Generally, gains derived from the sale of real property situated in the United States constitute U.S. source income. See I.R.C. § 861(a)(5). The situs of real property depends on its physical location. See id. See also I.R.C. § 862(a)(5). U.S. treaties define real property as "immovable property." Bischel, supra note 57, at 39.
92. See 1942 Convention, supra note 6, art. VIII.
93. Jarchow, supra note 7, at 1093.
94. Id. at 1095. See note 104 and accompanying text infra.
roperty by foreign investors. However, the 1942 Convention between the United States and Canada serves to create a "loop-hole" in current U.S. tax law. Despite the enactment of FIRPTA, Canadian investors can still avoid U.S. taxation on the disposition of direct property holdings and shares or interests in entities which hold U.S. real property, by invoking the 1942 Convention. The Treasury Department, in the period over which it negotiated the 1980 Convention, was aware of Congressional desire to eliminate tax advantages enjoyed by foreign investors. Accordingly, the 1980 Convention appears to follow Congressional policy by closing the loop-hole created by the effect of the current treaty on FIRPTA. Nonetheless, the capital gains provision of the 1980 Convention do not go as far as FIRPTA in subjecting Canadian investors to U.S. taxation on capital gains.

B. The Situation of Foreign Investors Prior to FIRPTA

Prior to the enactment of the Foreign Investment in U.S. Real Property Tax Act of 1980, the United States could not tax capital gains realized by a foreign investor unless such gains were "effectively connected" with a U.S. trade or business. Under the Internal Revenue Code, capital gains are "effectively connected" if they are derived from assets used in the course of a trade or business. Foreign investors could also come under U.S. taxing jurisdiction by virtue of the "183-day rule," even if an investor's gains were not effectively connected income. Under the 183-day rule, the United States may tax gains realized by a nonresident alien, as opposed to a foreign corporation, if the alien was present in the United States for more than 183 days in the year sale of the property occurs.

95. Jarchow, supra note 7, at 1095.
96. See 1942 Convention, supra note 6, art. VIII. See note 128 and accompanying text infra.
97. Dole Comments on Pending Tax Treaties, 13 TAX NOTES, Oct. 26, 1981, at 1005-06. See Hearing, supra note 11, at 72 (statement of David Rosenbloom, former International Tax Counsel of the Treasury Department). The then International Tax Counsel, explaining the policy of the Treasury, stated:

In the 96th Congress more far-reaching legislation has been introduced which would tax foreign investors on their gains from the disposition of shares in real property holding organizations — entities formed to hold any U.S. real property. The legislation has broad congressional support, and the Treasury has supported the general idea behind it.

In the face of these developments, we have modified our treaty policy and now seek a provision granting reciprocal rights to source state taxation of capital gains on the sale of shares in corporations formed for the sake of holding real property situated in that state.

Id.
100. See I.R.C. §§ 864(c), 871, 882. See Kroll, supra note 13, at 177.
102. I.R.C. § 871(a)(2); Treas. Reg. § 1.871-7(d).
103. I.R.C. § 871.
However, even if a foreign investor was engaged in a U.S. trade or business, he could employ several techniques to dispose of his interests in U.S. real property without incurring any substantial U.S. tax liability. Such techniques included selling his interests under the installment method of reporting, employing the “net basis election” of the Code or applicable treaty, and exchanging U.S. property for like-kind property outside the United States. Under the first technique, a nonresident alien or foreign corporation, subject to U.S. taxation because of the 183-day rule or because of gain which was “effectively connected,” could avoid or minimize tax liability by electing to report any gain realized on the installment method. Gains from the sale of U.S. real property reported on the installment method were generally not taxable by the United States if the foreign investor was not engaged in a U.S. trade or business in the installment years. A foreign investor could thus sell his direct real property holdings under the installment method, reporting most of the gain in later years when he was not engaged in a U.S. trade or business.

A second technique which foreign investors used to avoid or minimize tax liability was the “net basis election.” A nonresident alien or foreign corporation may elect to be treated by the Internal Revenue Service as though engaged in a U.S. trade or business with respect to U.S. real property income. This provision allows the taxpayer to offset all his deductions attributable to U.S. real property holdings to which the election applies against all his effectively connected income for that taxable year. The taxpayer treats property to which the

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104. Jarchow, supra note 7, at 1095.
105. I.R.C. § 453. The function of the installment method of reporting is to permit the taxpayer to spread his income recognition over the period in which payment is received. See generally Surrey, Warren, McDaniel & Ault, supra note 45, at 762.
106. See Kroll, supra note 13, at 165. Such gain would not be subject to U.S. taxation if the nonresident alien was not present in the United States for 183 days both in the year of sale and in the year in which he recognized the deferred gain, Treas. Reg. § 1.871-7(d)-(2)(i), or if the nonresident alien had income which was not effectively connected with a U.S. trade or business in the year in which the deferred gain was recognized and the gain was not effectively income. I.R.C. § 864(c)(1)(B).
107. See I.R.C. § 453. Congress amended § 453 in 1980. Previously, the taxpayer could not elect to report income from the sale of real property on the installment method if the total purchase price was payable in a lump sum in a taxable year subsequent to the year of sale. The 1980 revision eliminates the requirement that two or more payments exist in order to qualify for installment method reporting. I.R.C. § 453. See S. Rep. No. 1000, 96th Cong., 2d Sess. 7-12, 18-19, 25-26 (1980). The Treasury Department plans to issue regulations prescribing election rules relating to the treatment of gains from deferred payment sales of nonresident aliens. Id.
110. Treas. Reg. § 1.871-10(c)(1)-(2).
election applies as a capital asset which, if depreciable, is subject to depreciation allowance.\textsuperscript{111} The Internal Revenue Service treats net gain upon disposition of the property as effectively connected income unless the Service consents to revocation.\textsuperscript{112} The disadvantage for the foreign taxpayer arises from the fact that he must recognize the gain corresponding to the deductions previously taken.\textsuperscript{113}

In contrast to the Code election, many treaties allow the foreign taxpayer to make an election on an annual basis.\textsuperscript{114} Under those treaties permitting such an annual net election, the foreign taxpayer may elect to subject his real property investments to taxation on a net basis in the years he receives income from that property. Through proper planning, the foreign investor could avoid U.S. capital gains taxation by not making the election in the year of sale.\textsuperscript{115} The foreign taxpayer would then avoid U.S. tax on the gain unless such gain was effectively connected with a U.S. trade or business or, if the foreign taxpayer was a nonresident alien, unless he was present in the United States 183 days or more in that year.

A third technique\textsuperscript{116} enabled a foreign investor to avoid recognition of gain by exchanging his U.S. real property held for use in a U.S. trade or business, or for investment, for "like-kind" property.\textsuperscript{117} Section 1031 provides for nonrecognition of gain if the taxpayer exchanges property held for use in a trade or business, or for investment, for property possessing a similar character.\textsuperscript{118} The taxpayer retains his original basis in the traded property as his basis in the newly acquired property, i.e. the substituted basis,\textsuperscript{119} and normally recognizes gain only upon subsequent disposition of the new property.\textsuperscript{120} If the property ac-

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\item Treas. Reg. § 1.871-10(c)(1)-(2). Such election does not apply to the personal residence of a nonresident alien not held for the production of income. Treas. Reg. § 1.871-10(b)(2)(ii).
\item Treas. Reg. § 1.871-10(d)(2).
\item See I.R.C. §§ 167(g), 1011.
\item KROLL, supra note 13, at 190. The Treasury is seeking to eliminate the annual election from its treaties. Id. The annual election contained in Article XIII of the 1942 Convention is not present in the 1980 Convention.
\item See 1980 U.S. CODE CONG. & ADMIN. NEWS 5873.
\item I.R.C. § 1031. However, the taxpayer recognizes gain to the extent he receives non-like-kind property (e.g. cash "boot") in exchange. I.R.C. § 1031(b).
\item I.R.C. § 1031. Such result obtains even if the investor were actually engaged in a U.S. trade or business. 1980 U.S. CODE CONG. & ADMIN. NEWS 5873.
\item I.R.C. § 1031(d). Basis is increased only by the amount of gain recognized upon the receipt of non-like-kind property. See I.R.C. § 1031(b), (d).
\item See generally SURREY, WARREN, McDaniel & AULT, supra note 45, at 762.
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quired in the exchange were located outside the United States, any gain realized on the ultimate sale of the property would not be subject to U.S. taxation.\textsuperscript{121}

In addition to direct investment, foreign investors may invest indirectly in U.S. realty through foreign or U.S. corporations, trusts, partnerships, or real estate investment trusts (REITs).\textsuperscript{122} Prior to the enactment of FIRPTA, foreign investors commonly used corporations to invest in U.S. real property in order to avoid U.S. taxation.\textsuperscript{123} However, using a U.S. corporation to acquire U.S. real property exposed gains realized by the corporation to U.S. taxation.\textsuperscript{124} Further, the foreign investor, by involving himself in the affairs of the corporation, could run the risk of coming within the U.S. taxing jurisdiction.\textsuperscript{125} The most advantageous method for foreign investors to acquire U.S. real property was through a foreign corporation which benefitted from a U.S. tax treaty, such as the 1942 Convention between Canada and the United States.\textsuperscript{126} As a shareholder in a foreign corporation holding U.S. real estate, the foreign investor had several options available to avoid U.S. taxation on the appreciation in value of the underlying property upon the sale or exchange of that property.\textsuperscript{127}

First, the foreign investor could simply sell his stock in the corporation. Such sale would not be a taxable event in the United States, provided the foreign investor did not otherwise subject himself to U.S. taxation, or could invoke the protection of a U.S. tax treaty.\textsuperscript{128} Second, an investor could arrange for the corporation to effectuate a like-kind exchange, exchanging appreciated interests in U.S. real property for non-U.S. interests.\textsuperscript{129} Third, the corporation could avoid tax on the gain realized from the sale or exchange of U.S. property by adopting a plan of liquidation under Code section 337.\textsuperscript{130} Prior to FIRPTA, foreign corporations could avoid any tax at the corporate level under section 337

\begin{enumerate}
\item[121.] See Rev. Rul. 68-363, 1968-2 C.B. 336. Section 1031 allows a taxpayer to exchange U.S. real property either for other U.S. real property or for foreign situs real property. Id. Before FIRPTA, the result would be either a deferral of U.S. taxes (where the exchange was for U.S. property), or avoidance of U.S. taxes (where the exchange was for foreign property, which could then be disposed of without incurring U.S. tax liability). FIRPTA retains the deferral option but eliminates the avoidance possibility. See I.R.C. § 897(e)(1)(2). FIRPTA allows a taxpayer to effectuate a like-kind exchange only if the acquired property is a U.S. real property interest and hence subject to U.S. taxation. See note 173 infra.
\item[122.] Jarchow, supra note 7, at 1094.
\item[123.] Id. Generally, direct ownership of U.S. property by a nonresident has always been ill-advised, because the alien will incur U.S. taxation with respect to income generated by that property. Direct ownership could also be a factor in determining residency. Kroll, supra note 13, at 163. See Treas. Reg. § 1.871-2(a).
\item[124.] I.R.C. § 11.
\item[125.] Kroll, supra note 13, at 166.
\item[126.] Id.
\item[127.] Jarchow, supra note 7, at 1095.
\item[128.] Id. See note 179 and accompanying text infra.
\item[129.] I.R.C. § 1031. See note 117 and accompanying text supra.
\item[130.] I.R.C. § 337.
\end{enumerate}
if, within twelve months of adopting a plan of complete liquidation, the corporation disposed of its property and distributed its assets to its shareholders.\textsuperscript{131} Further, under section 331(a), the shareholder treats proceeds distributed in complete liquidation of a corporation as full payment in exchange for the stock.\textsuperscript{132} Thus, the foreign shareholder, by invoking a treaty or by staying beyond the taxing jurisdiction of the United States, could treat the transaction as a tax-free sale of stock.\textsuperscript{133}

In the case of a parent-subsidiary relationship, where the foreign parent corporation owned at least eighty percent of the stock of a U.S. company holding U.S. real property, the U.S. subsidiary could distribute its property under a plan of liquidation without paying U.S. tax.\textsuperscript{134} The foreign parent corporation would recognize no gain or loss,\textsuperscript{135} but would receive a carryover of basis from the subsidiary.\textsuperscript{136} However, upon subsequent sale or liquidation\textsuperscript{137} into its foreign shareholders, the parent could avoid U.S. taxation by invoking the protection of a tax treaty such as the 1942 Convention. The 1942 Convention generally exempts gain from dispositions from U.S. taxation.\textsuperscript{138} With the enactment of FIRPTA, Congress established rules which eliminate the foregoing tax-free methods of disposing of U.S. real property, although a foreign investor may still sell stock in a foreign corporation which holds U.S. real property without paying U.S. tax. However, in spite of FIRPTA, foreign investors whose country benefits from an exemption provision, such as Article VIII of the 1942 Convention, can still avoid U.S. taxation, at least until the delayed effective date of FIRPTA.\textsuperscript{139}

C. The Situation Under FIRPTA

The pace of foreign investment in the United States has increased considerably following World War II.\textsuperscript{140} U.S. balance of payments deficits in the late
1960's and the decline of the dollar in the early 1970's combined to create a climate favorable to foreign investors.\textsuperscript{141} Consequently, foreign investment in U.S. business, agriculture and securities continued to expand throughout the 1970's.\textsuperscript{142} Foreign investors, however, were generally not taxed on gains derived from their U.S. real property investments, unless they otherwise exposed themselves to U.S. taxing jurisdiction.\textsuperscript{143} In response to popular insistence that foreign investors in U.S. real property bear the same tax burdens as U.S. investors,\textsuperscript{144} Congress enacted the Foreign Investment in United States Real Property Tax Act of 1980, which created Code sections 897 and 6039C.\textsuperscript{145} The intent behind \textit{FIRPTA} was to place the foreign investor on an equal tax footing with his U.S. counterpart.\textsuperscript{146} \textit{FIRPTA} treats gain or loss of a nonresident alien or foreign corporation from the disposition of a U.S. real property interest as though the taxpayer were engaged in a U.S. trade or business during the taxable year, and as though such gain or loss were effectively connected with such trade or business.\textsuperscript{147} A U.S. real property interest includes interests in real property located in the United States and interests, other than as a creditor, in a foreign or domestic corporation which is a U.S. real property holding corporation (RPHC).\textsuperscript{148} A corporation is an RPHC if the fair market value of its U.S. RPIs equals or exceeds fifty percent of the fair market value of its U.S. RPIs, plus its interests in real property located beyond the United States plus any of its other assets used or held for use in a trade or business (qualifying assets).\textsuperscript{149} \textit{FIRPTA} thus allows the United States to tax gains derived by a foreign investor from the disposition of directly-held interests in U.S. real estate and stock in foreign or domestic U.S. real property holding corporations, since such dispositions are dispositions of U.S. RPIs.\textsuperscript{150} Also, \textit{FIRPTA} treats U.S. RPIs held by a partnership, trust or estate as owned proportionately by its partners or beneficiaries.\textsuperscript{151} Subject to further regulations
by the Treasury Department, the United States may treat the amount of any money — and the fair market value of any property, received by a nonresident alien or foreign corporation in exchange for all or part of its interest in a partnership, trust, or estate — as an amount received from the sale or exchange in the United States of such property, to the extent the interest is attributed to U.S. RPIs.152

If a U.S. corporation distributes U.S. RPIs to a foreign person as a dividend or similar distribution,153 the foreign shareholder’s basis in the distributed property equals the basis of the property in the hands of the distributing corporation, plus the sum of any gain recognized by the distributing corporation, plus any tax paid by the foreign shareholder upon distribution.154 Thus, if the foreign shareholder receives a distribution which exceeds his basis in his stock in a domestic RPHC, the foreign shareholder recognizes gain to the extent the fair market value of the property received exceeds his basis for the stock.155 FIRPTA treats such gain as effectively connected with a U.S. trade or business, and such gain triggers U.S. taxation.156

Foreign investors often use foreign corporations to own RPHCs in order to insulate themselves from U.S. taxation.157 Earlier versions of FIRPTA extended the taxing jurisdiction of the United States to encompass gain realized by foreigners from sales of interests in foreign corporations which held U.S. RPIs.158 The final version abandons this approach. FIRPTA does not allow the United States to tax dispositions of shares in foreign corporations. However, FIRPTA restricts the ability of foreign corporations to transfer property without recognizing gain.159 A foreign corporation which distributes a U.S. RPI must recognize gain in an amount equal to the excess of the fair market value of the interest at the time of distribution over its adjusted basis.160 Thus, even though a foreign shareholder may sell stock in a foreign corporation without paying U.S. tax, the purchaser of the stock may not liquidate the corporation without incurring U.S. tax at the corporate level on gain in the corporation’s U.S. RPIs.161 Because the purchaser will not be entitled, as in the past,162 to liquidate the corporation without incurring tax, and to step-up his basis in the corporation’s underlying U.S. RPIs to reflect the price paid for the stock,163 the purchaser will presumably

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152. I.R.C. § 897(g).
153. See, e.g., I.R.C. § 301.
155. I.R.C. § 301(c)(3).
156. I.R.C. § 897(a)(1).
157. Jarchow, supra note 7, at 1094.
159. See I.R.C. § 897(d).
161. I.R.C. § 897(d), (e).
162. See I.R.C. §§ 331, 352, 334(a), 334(b)(2).
insist on discounting the price paid to the seller.\textsuperscript{164} This consideration will tend to reduce the advantage the seller derives from his tax-free status.\textsuperscript{165}

Further, FIRPTA provides that section 337 shall not apply to any sale or exchange of a U.S. RPI by a foreign corporation.\textsuperscript{166} Thus, a foreign corporation can no longer avoid U.S. taxation by selling its U.S. real property and distributing the proceeds to its shareholders under a section 337 plan of liquidation. However, a foreign corporation may elect treatment as a domestic corporation, provided the foreign corporation has a permanent establishment in the United States and can invoke an income tax treaty which requires the United States to treat the corporation no less favorably than a domestic corporation.\textsuperscript{167} Such election allows the foreign corporation to employ section 337. It also subjects the corporation’s foreign shareholders to U.S. income tax upon gain realized from the disposition of shares in the corporation, which includes gain realized upon liquidation.\textsuperscript{168} A foreign corporation can still undergo liquidation under sections 331-336,\textsuperscript{169} but FIRPTA requires the foreign corporation to recognize any gain.\textsuperscript{170} FIRPTA allows an exemption to this rule if the distributee takes a carryover basis in the distributed assets,\textsuperscript{171} as in the case of a liquidation of a subsidiary into the parent corporation.\textsuperscript{172} Thus, foreign corporations which own U.S. RPIs can no longer liquidate without triggering tax unless the distributee-shareholder takes a carryover of basis.\textsuperscript{173}

However, the distributee may then be able to invoke the protection of an income tax treaty which exempts the distributee’s gains from source country taxation. For example, the 1942 Convention between the United States and Canada exempts gains realized from the sale or exchange of capital assets situated in the source country from source country taxation.\textsuperscript{174} If, for instance, the parent corporation were Canadian and the liquidating company were a U.S. company, the latter would be exempt from U.S. tax under section 336,\textsuperscript{175} and

\textsuperscript{164} Jarchow, supra note 7, at 1102.
\textsuperscript{165} Id.
\textsuperscript{166} I.R.C. § 897(d)(2).
\textsuperscript{167} I.R.C. § 897(i)(1).
\textsuperscript{168} See I.R.C. §§ 301, 305(b).
\textsuperscript{169} I.R.C. §§ 331-336. See note 134 and accompanying text supra.
\textsuperscript{170} I.R.C. § 897(d), (e).
\textsuperscript{171} I.R.C. § 897(d)(1)(B).
\textsuperscript{172} I.R.C. §§ 332, 334(b).
\textsuperscript{173} I.R.C. § 897(d). Section 897(e) provides that nonrecognition provisions of the Code are to apply to an exchange of U.S. real property interests only where such interests are exchanged for another interest the sale of which would be subject to U.S. taxation. Because the installment method of reporting is not a nonrecognition provision, it appears that § 897(e) would not apply to such transactions. However, section 897(a), by treating all gain (or loss) from the disposition of U.S. real property interests as though the taxpayer were engaged in a U.S. trade or business in the taxable year, appears to pre-empt the installment method as a device to avoid U.S. taxation.
\textsuperscript{174} 1942 Convention, supra note 6, art. VIII.
\textsuperscript{175} I.R.C. § 336.
the parent-shareholder could invoke the protection of the 1942 Convention. The 1942 Convention thus creates a loop-hole through which Canadian investors may escape U.S. tax liability.

IV. CHANGE IN CAPITAL GAINS TREATMENT UNDER THE 1980 CONVENTION: CONFLICTS WITH CONGRESSIONAL POLICY

A. The 1942 Convention

Article VIII of the 1942 Convention provides that even if a Canadian investor is engaged in a U.S. trade or business, he is exempt from U.S. taxation on gains derived from the sale or exchange of capital assets located in the United States. Prior to FIRPTA, this exemption was useful in instances where the investor’s gain would have been subject to U.S. taxation because the gain was effectively connected income, or, in the case of nonresident individuals, because of the 183-day rule. Because of the new FIRPTA rules, the consequences of the 1942 treaty exemption are even greater. Canadian investors may continue to avoid U.S. taxation on the disposition of direct property holdings and shares or interests in entities which hold U.S. real property interests.

B. The 1980 Convention

The 1942 Convention is one of the oldest U.S. tax treaties in existence. Since 1942, however, tax laws and policies of both countries have undergone major changes. By enacting FIRPTA, Congress intended to bring a measure of equality to the tax treatment the United States accords U.S. and foreign investors. However, investors who are residents of countries such as Canada can, by invoking the beneficial provisions of the applicable tax treaty, such as the 1942 Convention, insulate themselves from the effect of U.S. domestic tax legislation. The Treasury, aware of the change in Congressional attitude toward foreign investment, has undertaken to revise or renegotiate existing tax

176. 1942 Convention, supra note 6, art. VIII.
177. Id.
178. See note 100 and accompanying text supra.
179. See note 102 and accompanying text supra.
180. See 1942 Convention, supra note 6, art. VIII.
181. See Williams, supra note 17, at 242-45.
184. Hearing, supra note 26, at 72 (statement of David Rosenbloom, former International Tax Counsel of the Treasury Department).
treaties in accordance with Congressional policy. The 1980 Convention between the United States and Canada is a recent product of that effort.

Article XIII of the 1980 Convention contains three primary provisions which would allow the United States to tax gains realized by Canadian investors on dispositions of U.S. real property and on dispositions of shares or interests in qualifying real property holding organizations. Article XIII(1) accords each country the broad, basic right to tax gains derived by a resident of the other country from the alienation of real property situated in the first country, the source country. This provision is based on a similar provision in the U.S. Model Income Tax Treaty, which the Treasury has used as the starting point for all tax treaty negotiations since 1977. Article XIII(2) provides that the source country may tax gains from the alienation of personal property forming part of the business property of a permanent establishment or of a fixed base used to perform personal services. Subarticles (1) and (2) represent a major change in U.S. attitudes toward foreign ownership of U.S. property. These provisions expand the taxing jurisdiction of the United States by provid-

186. 1980 Convention, supra note 1.
187. Id. art. XXX(1). Article XIII(1) provides that "[g]ains derived by a resident of a Contracting State from the alienation of real property situated in the other Contracting State may be taxed in that other State." Id. The 1980 Convention speaks in terms of the "alienation" of property rather than its sale or exchange as under the 1942 Convention. Alienation includes property passing by gift or inheritance upon death, and other deemed dispositions which are taxable events under the taxation laws of the state applying the provision. Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, at 26, signed at Washington, D.C. on Sept. 26, 1980 (available from the U.S. Dept. of the Treasury) [hereinafter cited as Technical Explanation]. Under Canadian law, alienation of property takes place upon the death of an owner. Income Tax Act § 70. Canada deems the taxpayer to have disposed of all his capital property at fair market value, and all his depreciable property at the midway point between its fair market value and its undepreciated capital cost, immediately prior to death. Id. § 70(5). See A. FEDER, TAX AND OTHER PROBLEMS ACROSS THE U.S.-CANADA BORDER 277, 403 (1974). The United States does not impose tax at death and permits the tax basis of the property to be stepped up. I.R.C. § 1014.
189. Hearing, supra note 26, at 70 (statement of David Rosenbloom, former International Tax Counsel of the Treasury Department).
191. The 1980 Convention does not define the term "fixed base." Accordingly, the term is to be defined under the law of the state invoking the Convention. See 1980 Convention, supra note 1, art. III(2).
192. Article XIII(2) of the 1980 Convention, provides:

Gains from the alienation of personal property forming part of the business property of a permanent establishment which a resident of a Contracting State has or had (within the twelve-month period preceding the date of alienation) in the other Contracting State or of personal property pertaining to a fixed base which is or was available (within the twelve-month period preceding the date of alienation) to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment or of such a fixed base, may be taxed in that other State.

Id. art. XIII(2).
ing for taxation of hitherto exempted capital gains derived from the disposition of real property and personal property connected with a trade or business. 193

Article XIII(3) governs the taxation on dispositions of shares or interests in qualifying real property holding organizations. 194 Under Article XIII(3), the source country may tax gains derived from the alienation of shares which form part of a substantial interest in the capital stock of a company which is not a resident of the taxpayer's country if the value of such shares is derived principally from real property situated in the source country. 195 A substantial interest exists if the shareholder owns ten percent or more of any class of capital stock in the corporation. 196 Similarly, the source country may tax gains derived from the alienation of interests in a partnership, trust or estate if the value of such interest is derived principally from real property situated in the source country. 197 Significantly, the source country may tax such gains only if the other country has laws in force at the time of alienation which would impose tax on foreign investors in comparable circumstances. 198 Thus, if at the time of alienation the country of residence does not, under its domestic law, impose tax on gains derived from the alienation by foreign investors of a class of shares or interests, the source country may not impose tax in similar situations.

If ratified as originally negotiated, 199 the provisions of Article XIII would circumscribe the scope of FIRPTA in five significant ways. First, the reciprocity requirement of Article XIII(3) does not allow the United States, as source country, to tax a resident of Canada on gains from the sale of interests or shares

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193. See 1942 Convention, supra note 6, art. VIII.
194. Article XIII(3) of the 1980 Convention, provides:

Gains derived by a resident of a Contracting State from the alienation of:

(a) Shares forming part of a substantial interest in the capital stock of a company which is not a resident of that State the value of which shares is derived principally from real property situated in the other Contracting State; or

(b) An interest in a partnership, trust or estate the value of which is derived principally from real property situated in the other Contracting State

may be taxed in that other State, provided that the laws in force in the first-mentioned State at the time of such alienation would, in comparable circumstances, subject to taxation gains derived by a resident of that other State. For the purposes of this paragraph,

(c) The term "real property" includes the shares of a company the value of which shares is derived principally from real property or an interest in a partnership, trust or estate referred to in subparagraph (b), but does not include property (other than mines, oil or gas wells, rental property or property used for agriculture or forestry) in which the business of the company, partnership, trust or estate is carried on; and

(d) A substantial interest exists when the resident and persons related thereto own 10 percent or more of the shares of any class of the capital stock of a company.

1980 Convention, supra note 1, art. XIII(3).
196. 1980 Convention, supra note 1, art. XIII(3)(d).
197. [d. art. XIII(3)(c).
198. [d. art. XIII(3).
199. The Senate has requested the Treasury to re-open negotiations concerning the 1980 Convention. See Tax Notes, Feb. 1, 1982, at 272.
in a real property holding organization unless Canada has similar legislation. \textsuperscript{200} Canada currently does not tax U.S. residents on the sale of shares in non-Canadian companies, nor does it tax gains from the disposition of interests in non-Canadian trusts, even where the assets of the trust are comprised entirely of Canadian real estate. \textsuperscript{201} On the other hand, FIRPTA authorizes the United States to tax the sale of an interest in a non-U.S. trust to the extent the interest is attributable to U.S. real property interests owned or held by the trust. \textsuperscript{202} Thus, the reciprocity provision of Article XIII(3) would prevent the United States from exercising its power to tax such sales.

Second, Article XIII(3) provides that the source state may tax gains derived from the alienation of an interest in a partnership the value of which is derived principally from real property situated in the source state. \textsuperscript{203} Although the 1980 Convention does not define the term “principally,” the U.S. Treasury Department’s technical explanation to the 1980 Convention defines “principally” as more than fifty percent. \textsuperscript{204} FIRPTA provides that the amount of any money and the fair market value of any property received by a nonresident alien or foreign corporation in exchange for all or part of its interest in a partnership may be subject to U.S. taxation to the extent that any such gain is attributable to U.S. real property interests. \textsuperscript{205} FIRPTA does not impose any limitations as does the 1980 Convention. Thus, the limitation imposed by the “principally” rule of Article XIII(3) conflicts with the wide-open rule of FIRPTA.

Third, Article XIII(3) excludes from the treaty definition of real property property in which the business of the partnership, corporation, trust or estate is conducted. \textsuperscript{206} Consequently, the source country may not take into account the business premises in determining whether an entity is a real property holding organization. In contrast, FIRPTA includes such business property in its definitions of U.S. real property interests and real property holding corporations. \textsuperscript{207} For example, FIRPTA authorizes the United States to tax real property used in the business of the partnership. \textsuperscript{208} Article XIII(3) exempts such gains from source country taxation. \textsuperscript{209} Also, under FIRPTA, the United States may tax the disposition of shares in U.S. RPHCs. \textsuperscript{210} If the assets of a corporation consist of thirty percent business real property, twenty percent other U.S. real estate, and

\begin{itemize}
\item \textsuperscript{200} 1980 Convention, \textit{supra} note 1, art. XIII(3).
\item \textsuperscript{201} See Income Tax Act § 115(l)(b).
\item \textsuperscript{202} I.R.C. § 897(g).
\item \textsuperscript{203} 1980 Convention, \textit{supra} note 1, art. XIII(3)(c).
\item \textsuperscript{204} Technical Explanation, \textit{supra} note 187, at 26.
\item \textsuperscript{205} I.R.C. § 897(g).
\item \textsuperscript{206} 1980 Convention, \textit{supra} note 1, art. XIII(3).
\item \textsuperscript{207} See I.R.C. § 897(c)(4), (c)(6)(A).
\item \textsuperscript{208} I.R.C. § 897(c)(6).
\item \textsuperscript{209} 1980 Convention, \textit{supra} note 1, art. XIII(3)(c).
\item \textsuperscript{210} I.R.C. § 897(a), (c).
\end{itemize}
fifty percent personal property holdings, the corporation meets the FIRPTA definition of a U.S. RPHC, since the corporation's underlying U.S. RPIs equal fifty percent of the sum of all its RPIs and trade and business assets.\textsuperscript{211} Since, under FIRPTA, interests in a corporation are U.S. RPIs,\textsuperscript{212} shares in the corporation represent U.S. RPIs, which the United States may tax upon disposition.\textsuperscript{213} Article XIII(3) provides an exemption in such situations by excluding business property from the definition of real property.\textsuperscript{214}

Fourth, under Article XIII(3)(d), a source country may tax a shareholder on gains from the alienation of shares in a real property holding company only if the shareholder owns ten percent or more of the capital stock of any class of the company.\textsuperscript{215} This provision creates an exclusion for shareholders owning less than ten percent. FIRPTA, however, provides for an exclusion only in the case of public corporations.\textsuperscript{216} If any class of stock of a U.S. RPHC is regularly traded on an established securities market, the United States can treat the stock of such class as a U.S. RPI only if the shareholder holds more than five percent of such class of stock.\textsuperscript{217} Thus, whereas Article XIII(3) provides an exclusion for shareholders owning less than ten percent in any corporation, FIRPTA provides an exclusion only for shareholders who own less than five percent of a public corporation, and provides no exclusion at all for owners of stock of private (close) corporations.

Fifth, Article XIII(9) provides a transition rule which reduces the amount of gain the taxpayer would otherwise recognize upon disposition of real property.\textsuperscript{218} If, on September 26, 1980, a Canadian owned U.S. real property which did not form part of the business property of a permanent establishment, the Canadian taxpayer may reduce the amount of gain otherwise taxable by the United States by the proportion of the gain attributable to the period ending on December 31 of the year in which the Convention enters into force.\textsuperscript{219} This provision will avoid sudden sales and repurchases of property prior to the effective date of the 1980 Convention by people seeking to mitigate the harsher tax consequences which would follow.\textsuperscript{220} As a further transition provision, Article XXX(5) extends any exemption available under Article VIII of the 1942 Convention into the first tax year following the year in which the treaty enters

\textsuperscript{211} I.R.C. § 897(c)(2).
\textsuperscript{212} I.R.C. § 897(c)(1)(A).
\textsuperscript{213} I.R.C. § 897(a)(1).
\textsuperscript{214} 1980 Convention, supra note 1, art. XIII(3).
\textsuperscript{215} Id. art. XIII(3)(d).
\textsuperscript{216} I.R.C. § 897(c)(3).
\textsuperscript{217} I.R.C. § 897(c)(3).
\textsuperscript{218} 1980 Convention, supra note 1, art. XIII(9).
\textsuperscript{219} Id. arts. XIII(9), XXX. The 1980 Convention will enter into force when Canada and the United States exchange instruments of ratification. Id. art. XXX(2).
\textsuperscript{220} Dole Comments on Pending Tax Treaties, 13 Tax Notes, Oct. 26, 1981, at 1005-06.
into force. These transition rules further erode the taxing jurisdiction of the United States which FIRPTA has provided, because they reduce the amount of capital gain which the taxpayer must recognize and extend the exemptions available under the 1942 Convention possibly beyond even the delayed effective date of FIRPTA.

Overall, the capital gains provisions of the 1980 Convention represent significant concessions of U.S. taxing jurisdiction. Each of these items runs contrary to the Congressional intent in enacting FIRPTA by not permitting the United States to tax capital gains realized by Canadian investors to the extent which FIRPTA otherwise mandates. Furthermore, Congress expected that new treaties would state specifically that FIRPTA was to supercede conflicting treaty provisions. The 1980 Convention contains no such provision. Instead, the 1980 Convention, like most modern U.S. tax treaties, contains a non-discrimination provision. In addition to the standard non-discrimination clause, Article XXV contains several variations covering diverse situations. Members of Congress have expressed the concern that Article XXV would not permit the United States to disallow the section 337 plan of liquidation for foreign corporations. Article XXV(6) protects a resident of one country from discriminatory taxation of any permanent establishment he owns in the other country. The United States, for example, would not be able to tax Canadian corporations which maintain a permanent establishment in the United States at a higher rate than that at which the United States taxes comparable domestic corporations. However, FIRPTA eliminates the applicability of section 337 to foreign corporations. Because of FIRPTA, foreign corporations cannot avoid U.S. taxes at the corporate level by undergoing a section 337 plan of liquidation, unlike their domestic counterparts.

This FIRPTA provision appears at first glance to contradict the non-discrimination requirement of Article XXV(6). However, concern over this issue appears ill-founded. FIRPTA, through section 897(i), allows a foreign corpora-

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221. See 1980 Convention, supra note 1, art. XXX(5). Such exemptions include those provided by art. XIII(3).
223. See supra note 1, art. XXV.
224. Id.
225. Id.
226. Gifford, Permanent Establishments and the Nondiscrimination Clause, in PRACTISING LAW INSTITUTE INCOME TAX TREATIES 419 (1978). The non-discrimination clause is a standard provision in U.S. income tax treaties. Generally, under this provision a country must treat residents of the other country no less favorably than its own residents, or residents of a third country. Id.
227. 1980 Convention, supra note 1, art. XXV.
228. See supra note 1, art. XXV.
229. 1980 Convention, supra note 1, art. XXV(6).
230. Id.
tion to elect treatment as a domestic corporation for taxation purposes. To make the election, section 897(i) requires the foreign corporation to have a permanent establishment in the United States and benefit from a treaty under which the corporation's permanent establishment may not be treated less favorably than domestic corporations carrying on the same kind of activity. The corporation must receive permission from the Treasury Department to revoke the election. An electing foreign corporation then receives tax treatment equal to domestic corporations. Equal treatment in this context means that the foreign corporation can undergo liquidation tax-free at the corporate level under section 337, as though it were a domestic corporation. Section 897(i) is a mechanism which assures U.S. taxation of foreign corporations in the spirit of FIRPTA in spite of non-discrimination provisions such as Article XXV of the 1980 Convention, since the apparent effect of section 897(i) is to provide the means for a foreign corporation to choose equality of treatment. However, the only foreign corporations which may take the election under section 897(i) are those which are already subject to the full taxing jurisdiction of the United States, by virtue of having a permanent establishment. The second requirement, that the corporation benefit from a treaty with a non-discrimination clause, raises the suspicion that Congress intended section 897(i) to circumvent treaty non-discrimination provisions without giving away any of the taxing jurisdiction which FIRPTA provides.


The 1980 Convention, as originally negotiated, significantly revises the tax treatment of capital gains under the 1942 Convention. However, the new capital gains provisions do not go as far as FIRPTA in subjecting Canadian investors to U.S. taxation. Congress provided that FIRPTA will override conflicting treaty provisions after December 31, 1984. Commentators have been concerned that the effect of such override provisions may be detrimental to U.S. relations with countries whose U.S. tax treaties themselves make no reference to such a contingency. Testifying before the Subcommittee on Oversight of the Committee on Ways and Means of the House of Representatives, David H. Brockway, International Tax Counsel of the Joint Committee on Taxation, commented that:

232. I.R.C. § 897(i).
233. I.R.C. § 897(i).
234. I.R.C. § 897(i)(2).
235. I.R.C. § 897(i).
236. I.R.C. § 897(i)(1).
237. FIRPTA § 1125(c). See note 58 and accompanying text supra.
238. Hearing, supra note 26, at 34 (statement of David H. Brockway, International Tax Counsel of the Joint Committee on Taxation).
even with delayed effective dates, many observers feel that it is a very bad idea for the United States to abrogate its treaty obligations unilaterally. They argue that if the United States wants to change its tax policies in a way which would conflict with an existing treaty obligation, the conflict should only be resolved through renegotiation of the treaty. . . . [however] a policy of against [sic] unilaterally overriding treaties even with a delayed effective date would leave Congress with little room in which to maneuver. One way in which both sets of concerns might possibly be accommodated would be to recognize in the treaties the possibility that either country might subsequently wish to adopt tax legislation which conflicted with the treaty provisions and to provide in the treaty some mechanism designed to resolve the conflict. For example, the treaty could provide that either country could amend its tax laws to include provisions inconsistent with the treaty provided the conflicting provisions did not go into effect for a period of, say, 5 years after notice of the amendment was given to the other country. This would permit such changes without a breach of international obligations.239

The 1980 Convention contains no such mechanism. Thus, after 1984, FIRPTA will unilaterally override the conflicting provisions of Article XIII.240 Congress has indicated its insistence that the Treasury Department write into tax treaties provisions indicating that conflicting treaty provisions will not supercede FIRPTA.241

Commentators both within and without Congress have suggested ways to anticipate and avoid potential points of variance between treaty provisions, such as the capital gains provisions under the 1980 Convention, and U.S. domestic tax law.242 Because of the significant impact which treaties exert on domestic tax policies, and the absence of any opportunity for the House of Representatives or

239. Id.

240. See I.R.C. § 897(i). The delayed effective date may be extended up to two years beyond the signing of a new treaty before January 1, 1985. See I.R.C. § 897(i)(2).


242. See Tax Treaties and the Foreign Relations Committee, 14 TAX NOTES, Jan. 4, 1982, at 30 (letter from Senators Charles H. Percy, Charles McC. Mathias, Jr., Clairborne Pell, and Christopher J. Dodd to Treasury Secretary Donald Regan); Dole Comments on Pending Tax Treaties, 13 TAX NOTES, Oct. 26, 1981, at 1005-06 (letter from Sen. Dole to Sen. Percy); Hearing, supra note 26, at 160 (statement of Charles M. Bruce, Attorney-at-Law); Langer, supra note 31, at 753-54. These suggestions encompass three objectives: first, to allow the House Ways and Means Committee, the Senate Finance Committee and the Joint Committee on Taxation to offer their considerable expertise on domestic taxation to the Treasury negotiators with respect to issues under negotiation liable to affect current or proposed domestic legislation; second, to keep the Senate Foreign Relations Committee, which has jurisdiction over treaties, informed, especially as to the revenue impact of treaty provisions; and third, to ensure Congressional notice of the consequences of a proposed treaty. The ultimate goal is to achieve a closer integration of the tax treaty process and the tax legislative process without impeding the legitimate objectives of the treaty network. See Tax Treaties and the Foreign Relations Committee, 14 TAX NOTES, Jan. 4, 1982, at 30.
V. Conclusion

By returning the 1980 Convention to the Treasury Department for further negotiations, Congress has demonstrated that it will not tolerate tax treaty concessions to foreign countries in the area of capital gains derived by foreign investors from the disposition of U.S. real property interests. Although the 1980 Convention reflects the general policy of the United States toward greater taxation of capital gains realized by foreign investors, the new treaty would not permit the United States to tax capital gains derived by Canadians to the extent provided by Congress in the Foreign Investment in United States Real Property Tax Act of 1980.

The capital gains provisions of the 1980 Convention conflict with FIRPTA in five significant ways. First, the reciprocity provision of Article XIII(3) would not allow the United States to tax a Canadian investor on gains from the disposition of interests in real property holding organizations unless Canada has similar legislation. Second, the United States would not be able to tax capital gains realized by Canadians investing in U.S. real property through a partnership to the extent authorized by FIRPTA. Third, the 1980 Convention alters the FIRPTA method for determining whether an entity is a U.S. real property holding organization by excluding trade or business property from the defini-
tion of real property. Fourth, the 1980 Convention uses a different standard than that provided by FIRPTA for determining when a Canadian shareholder of a company which holds U.S. real property interests incurs taxation upon the sale of his interest. Fifth, the 1980 Convention provides in effect a step-up in basis, for sale purposes, for Canadian-owned U.S. real property to the effective date of the 1980 Convention.

As a consequence of these conflicts, the Senate has postponed further action on the treaty. With the Treasury Department planning to expand the U.S. tax treaty network, the need for greater coordination between the tax treaty negotiation process and the tax legislative process is evident. Failure to present a more cohesive international tax policy can only result in dissatisfaction at home and disaffection abroad.

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