

# UC Berkeley

## CUDARE Working Papers

### Title

Tax implications of foreign direct investment in U.S. farmland

### Permalink

<https://escholarship.org/uc/item/5rm8z4t0>

### Authors

Rausser, Gordon C.  
Schmitz, Andrew  
Warner, Rowely

### Publication Date

1980-07-01

Division of Agricultural Sciences  
UNIVERSITY OF CALIFORNIA

[ University of California, Berkeley.  
Dept. of agricultural and resource  
economics ]  
Working Paper No. 88

Working Paper No. 88

TAX IMPLICATIONS OF FOREIGN DIRECT INVESTMENT  
IN U. S. FARMLAND

by

Gordon C. Rausser, Andrew Schmitz, and Rowley Warner

GIANNINI FOUNDATION OF  
AGRICULTURAL ECONOMICS  
LIBRARY

AUG 7 1980

California Agricultural Experiment Station  
Giannini Foundation of Agricultural Economics  
July 1980

TAX IMPLICATIONS OF FOREIGN DIRECT INVESTMENT

IN U. S. FARMLAND

Gordon C. Rausser, Andrew Schmitz,

and Rowley Warner\*

Gordon C. Rausser is professor and chairman and  
Andrew Schmitz is a professor in the Department  
of Agricultural and Resource Economics,  
University of California, Berkeley; Rowley  
Warner is a Certified Public Accountant with  
Frederiksen and Company, San Francisco,  
California.

Foreign direct investment in U. S. farmland has become a controversial subject. Several states have passed legislation which limits or prohibits nonresident aliens from purchasing farmland. At the national level, Congress requested the General Accounting Office to determine how much of U. S. farmland is controlled by foreigners. The fact that there is opposition to ownership of farmland by non-U. S. residents is interesting, especially since the United States once encouraged such ownership. In 1791 Alexander Hamilton said: "Instead of being viewed as a rival (foreign investment) ought to be considered as a most valued auxiliary, conducing to put in motion a greater quality of production labor, a greater portion

of useful enterprise, than could exist without."<sup>1</sup>

The press has publicized many of the larger farmland transactions often giving the impression that the alien land-purchase phenomenon has reached crisis proportions. The following observations from Nuckton and Gardner,<sup>2</sup> information they obtained from press releases, illustrates why increased attention has been given to the foreign land investment issue:

1. Amrex, a San Francisco brokerage firm, reported that half of its agricultural land transactions (about \$50 million worth) were made with aliens in 1977. It also revealed that 32 French investors had been ready to purchase land in the California wine country but

3.

cancelled orders when elections in their country did not result in Communist-Socialist takeover.

2. Some 50 foreign branch banks are now operating in Chicago and handle investments from overseas.

3. Oppenheimer Industries, Inc., a Kansas City brokerage and management firm, reported that sales to foreigners have more than doubled in the past few years and now account for one-third of their annual volume.

4. The 1976 annual report of Northern Trust, another management firm, indicated that it manages 460,000 acres in 35 states for foreign interests.

5. The European Investment Research Center of Brussels estimated that Europeans spent \$800 million on American farmland in 1977.

In spite of the above examples of land purchases and the publicity the subject receives, foreign ownership of U. S. agricultural land, although growing, is not yet a significant portion of total holdings. Keeping in mind the difficulties of determining and documenting the extent of foreign landholdings in 1975, the U. S. Department of Commerce surveyed some 6,000 foreign individuals and companies with investments in the United States and found that their acreage totaled about 4.9 million. As Wunderlich<sup>3</sup> suggests, even if one doubles the 4.9 million figure to allow for uncounted parcels and measurement errors, the total investment from abroad amounts to less than 1 percent of U. S. private landholdings. However, because the

amount of foreign investment is growing<sup>4</sup> and the amount of land transacted in any particular year is indeed small relative to the total land utilized, it is important to understand the various aspects of outside investment and what the impacts of changes in policy toward foreign investment might be.

#### I. GOVERNMENT POLICY

The concern over foreign investment in U. S. farmland has led to the consideration of a number of public policies to monitor and control such investments. The major concerns relate to the indirect effects of foreign farmland investments on (1) the entry costs to potential domestic farmers, (2) the growing extent of absentee ownership and the disruption of the traditional



union between farm ownership and operation, and  
(3) the economic well-being of rural communities.

The effect of direct investment on land prices can be greater than, for example, the effect of foreign investment in apartment buildings because, as building prices increase, supply also increases. Land, however, is relatively fixed in supply. Unlike buildings, the supply of farmland is relatively price inelastic. Moreover, as noted earlier, only a small percentage of U. S. farmland is sold in any given year. The market for land is thus "thin"; hence, even a small additional demand component (e.g., foreign demand added to the demand by U. S. residents) can have a significant effect on land values and, thus, on the entry cost to potential domestic farmers.

In view of the tax advantages of foreign investment and because land is a store of value, there is an incentive for foreigners to purchase land, offer it to rental markets, or hire a farm-management company to operate the farm on a fixed or incentive fee basis. This simply adds to the already growing trend of increased separation between landownership and operation. The extent to which this separation occurs varies among states. For example, a much larger percentage of the land in California is farmed on a rental basis than in North Dakota. The largest percentage of the land leased to farmers is owned by U. S. urban residents.<sup>5</sup> This growing separation between landowners and farm operators has a negative impact on maintaining viable rural communities.

To be sure, the impact of foreign investment in U. S. farmland on the growth of the U. S. economy depends partly on whether or not technology and improved managerial expertise accompany the investment. For example, if a foreign entity could buy U. S. farmland and make it more productive through the introduction of a new variety of crop or improved managerial skills, the multiplier effects would be greater than if money from abroad were used merely to purchase U. S. farmland, leaving farming practices unchanged. Unfortunately, available evidence suggests that foreign investment merely bids up the price of farmland with little accompanying increase in output. The resulting increase in real wealth by existing owners of farmland thus need

not contribute to an increase in real gross national product.

A further important impact relates to rural credit markets. As noted in Rausser, Zilberman, and Just<sup>6</sup> and verified empirically in Shalit and Schmitz,<sup>7</sup> credit availability for farmland investment is strongly influenced by a farmer's net worth which, in turn, is determined principally by land values. The increase in land values emanating from foreign investment may give false signals to bankers who provide credit to domestic investors, both absentee and owner operators. These signals will be obviously false if the incentives for foreign investment are suddenly curtailed. The potential for such a change in incentives is certainly possible; and the

resulting disruption in rural credit markets could be catastrophic, particularly if such changes occur in conjunction with periods of low export demand and favorable domestic weather conditions.

To delineate the probable effectiveness of alternative policies designed to control or curtail foreign investments, we must understand the incentives for foreign investment. If the potential gains to foreign investment are sufficiently large, naive legislation which prohibits foreign ownership of agricultural land will prove ineffective. In addition to the tax advantages emphasized in this paper, the incentives for such investment include inter alia (a) technology and market nearness, (b) relative land prices and

political stability, (c) portfolio diversification, and (d) credit availability and U. S. agricultural policies.

As noted above, it is unlikely that much of the foreign investment that occurs in U. S. agriculture is motivated by superior technology or managerial expertise. A more important factor may well be that, in order to compete in the U. S. market, because of trade barriers and the like, production has to occur in the United States. To curtail this incentive on the part of foreign investors, a restructuring of tariffs would be required. Such a policy is most certainly not likely to be implemented for the sole purpose of mitigating or curtailing the incentives for foreign investment.

Another reason often cited for European investment in North American farmland relates to the availability of such land at a comparatively low price, especially in comparison to land prices in Europe. This is an important factor, especially in view of the appreciation of the German mark during the 1970s relative to the U. S. dollar and in view of the protectionist agricultural policies in Europe and in countries such as Japan. Again, tariff policies implemented by food-importing countries have the impact of increasing producer prices and, thus, the internal price of farmland. Investors from abroad stand to gain, especially if agricultural exports expand to Third World countries and even to European countries as imports are increased

because of tariff reductions which might occur at some time in the future. Again, such policy considerations are far broader than are policies focused on foreign investment in U. S. agricultural land.

Confidence in the stability of the U. S. political environment and the remote possibility that the United States will nationalize farming operations are additional reasons for foreign direct investment in U. S. farmland. Related to this stability is the inflow of oil money from countries belonging to the Organization for Petroleum Exporting Countries (OPEC). This capital has to be invested somewhere. Land is an excellent hedge against inflation during periods of rapid inflation when commodities such as gold and



land appreciate in value relative to other investment vehicles. This is due to the store of value such investments offer and the difference between ordinary and capital gains tax rates; thus, the effective after-tax interest rate in real terms is often negative.

Many foreign investors in U. S. farmland are motivated not by large expected returns but instead by risk reductions in their total investment portfolio. In other words, preservation of capital is enhanced by U. S. landownership due to its positive effects on the total risk across all investments. Such incentives are explained by general portfolio-diversification considerations and need not be elaborated here. What is generally not explained by this theory, however,

is the combined effect of exchange rates, inflation rates, and interest rates when foreign investments are evaluated. In particular, due to movements in exchange rates over the past decade, in terms of U. S. dollars, a potential foreign farmland investor who holds Swiss francs, deutsche marks, or Japanese yen has indeed been very fortunate. If he exchanges some of his existing currency portfolio for U. S. dollars, he will obviously be exposed to the risk of continued inflation in the United States. Even though this investor might expect the rate of inflation to be higher in the United States than, say, in West Germany, an excellent vehicle to hedge this risk is to exchange presently held currencies for dollars and, subsequently, dollars for U. S.

farmland. The attractiveness of this strategy is particularly obvious once it is realized that land investments in the United States are expected to increase at a more rapid rate than the rate of inflation. The favorable nature of this hedge is made even more attractive when credit financing can be arranged at a fixed interest rate below the rate of inflation. Under these circumstances, the foreign investor wins handsomely in both expected return and risk dimensions. Again, a public policy geared to manage these sorts of incentives would alter a number of important forces above and beyond foreign investment in U. S. agricultural land.

As indicated above, negative real interest rates provide an important incentive to invest in

agricultural land. In the late 1970s, the United States, in contrast to many other countries where foreign investment might take place, maintained fixed interest rates on long-term debt (i.e., an interest rate not indexed by the rate of inflation). Moreover, the U. S. government has often provided credit subsidies in one form or another to U. S. farmers.<sup>8</sup> These subsidies have spill-over effects in rural credit markets; specifically, to be competitive, rural commercial bankers offer credit terms that are frequently more attractive than those offered by their urban counterparts.

The above-mentioned incentives for leveraged investments in rural areas are enhanced by U. S. public policy affecting the agricultural sector. Specifically, for a number of years, the U. S.

government has actively intervened in agricultural production through support price schemes, acreage controls or set-asides, deficiency payments, target prices based upon the cost of production, subsidization of crop storage, and the like. The most recent U. S. Food and Agricultural Act (1977) modified previous forms of governmental intervention, but the heart of the governmental programs remains unchanged. One of the principal effects of these programs is an increase in land prices.<sup>9</sup> These programs for many crops limit an investor's downside risk and thus offer some clear incentives for foreign investment. In fact, the reduced price risk implied by the price-support provisions of these programs lowers the variance of returns for all

farmers, with large-scale operations benefiting more from such reductions than small-scale operations. Because of transaction costs, foreign investment usually assumes the form of a large-scale operation; thus, its marginal benefit from such programs is more attractive than is the corresponding benefit to a small, family farm operation. These incentives, along with the credit incentives, to foreign investment cannot be altered effectively without a complete restructuring of U. S. agricultural production policy. This is indeed unlikely since such policy is motivated by a number of considerations that are weighed more heavily than perceived problems emanating from foreign investment.

In addition to national policy, a number of individual states are currently evaluating or have implemented policies that attempt to control and/or reduce foreign investment in U. S. agricultural land.<sup>10</sup> However, there are a number of critical problems in enforcing state laws on foreign direct investment. One of these problems relates to owner identification; there certainly are numerous means by which foreigners can avoid being identified. True ownership can easily be disguised in trust partnerships, corporations, and proxy U. S. individual owners. Secondly, certain states now have rather strict investment laws which, even if they could be enforced, will not have the desired effect on the state's agricultural land prices. In particular, it is

important to recognize that foreign investment in a single region of the United States has an impact on the entire U. S. land market. If a state such as California has no restrictions, then proportionally more of the total foreign direct investment in U. S. farmland will occur in that location. However, the increase in land values in such a location due to this investment also causes (aside from the usual transport and transaction costs) land to increase in value in other parts of the United States. This can occur in several ways; namely, a California resident may sell his property and buy relatively more attractively priced land in Oklahoma; a city investor may sell California land and invest elsewhere. Those offering land



for sale in Oklahoma are aware of land prices in other parts of the United States, information which will influence their offer prices.

Factor-price equalization tends to occur among regions. As a result, the policy by an individual state in isolation to limit or prohibit foreign investment will eventually be ineffective in tempering increasing land values of that state so long as other states do not restrict foreign investment.

As the above discussion suggests, policies that have sufficient focus to alter and strongly influence the level of foreign investment in U. S. agricultural land relate to the U. S. tax structure. A frequently cited reason for foreign investment is the tax advantages offered to non-resident aliens in comparison to those offered to

U. S. residents. "The foreign investor in agricultural land can obtain substantial ordinary income and capital gains tax advantages. Investors from certain countries face a higher marginal tax rate compared with that in the United States. Tax treaty provisions with those countries provide further opportunities to lower or minimize taxes."<sup>11</sup> Unfortunately, such potential tax advantages have not been documented in the literature.

In the remainder of this paper, our purpose is to focus on the tax implications of foreign investment in U. S. farmland in order to determine the tax preference foreigners receive in the purchase of U. S. farmland. In addition, the impact of a change in the current tax laws toward

foreign investment will be investigated. During the first session of the 96th Congress, no less than eight bills have been introduced which would drastically change taxation in this area. The impact of this legislation will be examined in the final section of the paper.

## II. TAX LAWS AND REGULATION

U. S. citizens have become accustomed to the worldwide method of taxation employed in the United States. This concept requires U. S. citizens and business entities to include in their tax returns all of their income, regardless of its type or the country where earned. Moreover, because resident aliens receive the same benefits and protection under U. S. law as U. S. citizens, the worldwide taxation concept is also extended

to resident aliens. Therefore, foreigners and foreign business entities that are residents in the United States will pay full U. S. tax on their worldwide income. On a jurisdictional basis, that income earned in the United States should be taxed in the United States regardless of whether aliens have resident or nonresident status.

As a contrast, many other countries impose income taxes that are based on source, receipt, or citizenship (Table 1). Countries with a source concept generally tax only income earned within their borders. Receipt countries, on the other hand, tax all income received within their borders, regardless of where it is earned. And finally, citizenship countries tax only their

TABLE 1

## Basis of Income Taxation in Selected Countries

Country	Status of Individual		Status of Corporation	
	Resident	Nonresident	Resident	Nonresident
Bahamas	None	None	None	None
Barbados	Worldwide	Source	Worldwide	Source
Bermuda	None	None	None	None
Jamaica	Worldwide	Source	Worldwide	Source
Netherlands Antilles	Worldwide	a	a	a
Hong Kong	Source	Source	Source	Source
Indonesia	Worldwide	Source	Worldwide	Source
Korea	Worldwide	Source	Worldwide	Source
Malaysia	Worldwide	Source	Worldwide	Source
Singapore	Source & Receipt	Source	Source & Receipt	Source
Taiwan	Source	Source	Worldwide	Source
Argentina	Source	Source	Source	Source
Colombia	Worldwide	Source	Worldwide	Source
Costa Rica	Source	Source	Source	Source
Mexico	Worldwide	Source	Worldwide	Source
Panama	Source	Source	Source	Source
Venezuela	Source	Source	Source	Source

(Continued on next page.)

TABLE 1--continued.

Country	Status of Individual		Status of Corporation	
	Resident	Nonresident	Resident	Nonresident
Denmark	Worldwide	Source	Worldwide	Source
France	Worldwide	Source	Worldwide	Source
Italy	Worldwide	Source	Worldwide	Source
Netherlands	Worldwide	Source	Worldwide	Source
Sweden	Worldwide	Source	Worldwide	Source
Switzerland	Worldwide	Source	Worldwide	Source
United Kingdom	Worldwide	Source	Worldwide	Source
West Germany	Worldwide	Source	Worldwide	Source

<sup>a</sup>Tax based on specific type of income or activity and, therefore, not easily separated into one of the three categories.

citizens. By definition, countries which follow one of these three methods or any combination of them will tax a conceivably smaller amount of income than that to be taxed under a worldwide system.

Furthermore, due to their limited inclusionary powers, countries with receipt, source, or citizenship-based taxes are easily avoided.

By moving receipt of income to an offshore site, receipt-based taxes are easily avoided.

Citizenship-based taxes are easily avoided by incorporating business activities in a foreign country. Similarly, source-based taxes can be avoided by transacting business offshore.

Therefore, foreign investors must look at both their home country tax and the U. S. tax to determine whether an investment in U. S.

farmland is economically worthwhile from a tax standpoint.

In summary, it is possible for foreign investors to potentially operate tax free. For example, a citizen of a country that taxes receipts might operate through a corporation established in a source country and effectively operate that entity in the United States. As the income earned is not from the country of incorporation, there would be no source tax paid there. Since the income is earned by a foreign corporation, no tax would be paid in the individual's country under its citizenship rules. And, if the business conducted in the United States could by chance (or planning) escape trade or business status (a status to be discussed later), little or no U. S. tax might be paid.



Related to the issues of method of taxation is an additional one of the tax rates. The objective here is to incur the lowest rate of tax if the tax itself cannot be avoided. For example, let us say that a citizen of country Z, a country with a receipts tax, wants to operate in country Y, a citizenship tax country. He might choose to do business in country Y by using a corporation from country X. If country X is a source country, income earned by the country X corporation in country Y would avoid both Y's citizenship tax and X's source tax. In this example, a citizen of country Z can accumulate funds in country X from operations in country Y not incurring any tax. However, should these profits be distributed to X corporation's

shareholders (Z country citizens), the shareholders would most likely incur the receipt tax of country Z.

#### General U. S. Taxation

The Internal Revenue Code (I. R. C.) was written to provide for equivalent taxation of the worldwide income of U. S. citizens and business entities as well as aliens and foreign entities that do business within the U. S. borders. This is accomplished by the application of taxes on net income and gains, gifts, inheritances, and certain specified transactions. When considering foreign business entities and aliens, one must take into account the taxing jurisdiction of the United States as evidenced by the source of

income and the relationship to an ongoing business activity.

Generally speaking, foreign entities and individuals will pay a fixed-rate tax on income from U. S. sources. It is a commonly accepted principle of international taxation that each country has a right to tax transactions that occur within its borders. Income that is "fixed or determinable, annual or periodic," and paid from U. S. sources to a nonresident alien or foreign entity, will incur a flat 30 percent U. S. tax.<sup>12</sup> To prevent the evasion of tax through noncompliance with the tax law, i.e., not filing a return, the 30 percent tax is withheld at the source of the income by the payer.<sup>13</sup>

For example, U. S. corporations that pay

dividends (periodic and determinable) are required to retain 30 percent of the dividend and remit only 70 percent to a foreign taxpayer.

Other types of income that fall within this category include interest, rents, royalties, annuities, etc.<sup>14</sup> Not only is a 30 percent tax withheld, it is also the amount of tax due. As the tax withheld equals the tax due, it is generally not necessary to file a return to report this type of income.

On the other hand, an alien who is considered a resident of the United States or a foreign entity that is determined to have income that is "effectively connected with a U. S. trade or business"<sup>15</sup> will pay the graduated U. S. tax<sup>16</sup> on net income. In both situations,

entity or individual, net income implies taxable income, which is defined as gross income net of deductions allowed under the I. R. C. There is one major difference, however; the resident alien will pay tax on net worldwide income as he will be considered equivalent to a U. S. citizen.

Nonresident aliens who have an effectively connected business will generally pay tax only on net income related to that business.

It is, therefore, the object of tax planning for aliens and foreign entities to arrange their affairs so that they will not be construed as resident aliens or engaged in a U. S. trade or business. (There are some exceptions to the trade or business part of this argument.) The penalty for the individual who is considered a

resident will be taxation on his worldwide income. This includes income that would otherwise escape U. S. taxation. For the foreign entity, the determination of having a trade or business could cause other types of investments to be included as part of that trade or business and, therefore, to be subject to graduated U. S. tax rather than the 30 percent flat rate.<sup>17</sup>

These points are illustrated in the examples in Table 2. There are two farmers of equal income, in both their farming ventures and their outside investments. The first, Ole McDonald, is a U. S. citizen; the other, Otto McSchmidt, is a German citizen. Each farmer has income from dividends and interest from both foreign and U. S. corporations. Each also owns operating farms in

TABLE 2

Comparison of Tax Paid: U. S. Citizen vs. Nonresident Alien

	McDonald	McSchmidt	
	U. S. citizen	Nonresident alien	U. S. tax
	Income	Income	
	dollars		
<u>Dividends</u>			
Foreign corporation	6,000	6,000	exempt <sup>a</sup>
U. S. corporation	2,000	2,000	600 (30%) <sup>b</sup>
<u>Interest (nonbank)<sup>c</sup></u>			
Foreign corporation	7,500	7,500	exempt <sup>a</sup>
U. S. corporation	5,000	5,000	500 (30%) <sup>b</sup>
<u>U. S. farm</u>			
Income	15,000	15,000	d
Expense	<10,000>	<10,000>	
	<u>5,000</u>	<u>5,000</u>	700 (14%)
<u>Foreign farm</u>			
Income	25,000	25,000	
Expense	<10,000>	<10,000>	
	<u>15,000</u>	<u>15,000</u>	exempt
Total income	<u>40,500</u>	<u>40,500</u>	
Tax (using 1979 tax rates)	<u>9,581<sup>e</sup></u>	<u>2,800</u>	

(Continued on next page.)

## TABLE 1--continued.

<sup>a</sup>More than 50 percent of this company's income is foreign source; therefore, neither I. R. C. §861(a)(2)(B) nor §861(a)(1)(C) applies.

<sup>b</sup>Not an 80-20 corporation under I. R. C. §861(a)(2)(A) or §861(a)(1)(B).

<sup>c</sup>Generally, interest paid by U. S. banks, savings and loan associations, and insurance companies is foreign source income to a nonresident alien [ §861(c)].

<sup>d</sup>Blanks indicate not applicable.

<sup>e</sup>Assumes married and filing joint return, no itemized deductions, and no dependents.

Source: Computed.



the United States and overseas. Given the numbers as shown in Table 2, both farmers have equivalent incomes of \$14,500, but farmer McDonald pays more than twice the tax of farmer McSchmidt to the United States. Assuming that farmer McSchmidt does not personally oversee the operations of the U. S. farmland, he most likely will not be considered a resident alien. Therefore, he will be taxed only on income from U. S. sources and income that is effectively connected with a U. S. trade or business. (It is assumed here that the farm in the United States owned by McSchmidt is effectively connected with a U. S. business.) His interest and dividends paid from U. S. corporations are U. S. source income and will incur a 30 percent tax on the gross amount. The foreign dividends and interest are

not U. S. source and escape taxation when paid to nonresident aliens. Similarly, the income from the foreign farm is not connected with a U. S. trade or business and is also exempt from the U. S. tax. The income from the U. S. farm owned by McDonald is effectively connected and, therefore, will incur the graduated U. S. tax on net income (14 percent to 70 percent).

In addition, given our factual situation, farmer McSchmidt runs the risk that the interest and dividends earned from U. S. corporations could be construed as related to this farming business,<sup>18</sup> thereby qualifying for the graduated tax rates which could climb as high as 70 percent. Furthermore, should farmer McSchmidt come to the United States to operate his farm, thereby being reclassified as a

resident alien, his tax situation would change and become identical to that of farmer McDonald. Should this latter situation take place, both farmers will be able to avail themselves of the foreign tax credit and any tax treaty between their two countries. The foreign tax credit has not been explicitly considered in Table 2.

When a businessman deals with two or more countries, it is possible for the same income to be taxed in each country, i.e., double taxed. The current reaction to double taxation is much the same as was the early U. S. colonists' reaction to taxation without representation. Fortunately for U. S. taxpayers, relief is usually available from the confiscatory aspects of

double taxation through the mechanics of the tax treaties and the foreign tax credit.<sup>19</sup> For example, the treaty with Canada allows U. S. individuals and companies a credit for any taxes on income paid to the Canadian government. Under the treaty, the Canadian government is to reciprocate by allowing its citizens and companies a tax credit against the Canadian tax for taxes paid on income in the United States. The credit works in the following manner.<sup>20</sup> Let us say that our U. S. farmer, Ole McDonald, owns farmland in Canada. Under the tax laws of Canada, let us assume that farmer McDonald earns \$10,000 of net income on which he pays a \$5,000 Canadian tax. (The Canadian tax is generally higher than the U. S. tax on the same

amount of income.) It is further assumed that farmer McDonald has \$25,000 of U. S. income from his farm in California that will be treated as earned income and subject to a maximum 50 percent tax in the United States. Farmer McDonald owes the U. S. government \$17,500 in tax (\$35,000 x .5) by a foreign tax credit offset for the tax on the \$10,000 earned in Canada that is double taxed. The allowable foreign tax credit is computed from the following formula:<sup>21</sup>

$$\text{FTC} = \frac{\text{taxable foreign source income}}{\text{total taxable income}} \times \text{total U. S. tax.}$$

In our case, the fraction would be

$$\text{FTC} = \frac{\$10,000}{\$35,000} \times \$17,500 = \$5,000.$$

Therefore, in our example, farmer McDonald would pay no U. S. tax on his Canadian income as a credit of \$5,000 will be allowed against his total U. S. liability of \$17,500. Should our example change such that farmer McDonald paid \$7,000 in Canada, a 70 percent effective rate, the amount of credit allowed as an offset would not change. Although \$7,000 in foreign taxes was paid, a credit will not be allowed in excess of the U. S. tax rate on the income that is double taxed.

What is important to note is that a mechanism is available to offset double taxation. It is also important to remember that aliens treated as residents and taxed on their worldwide income are also able to avail themselves of

this credit procedure. Therefore, if farmer Otto McSchmidt, a German citizen, is held to be a resident of the United States, he would be taxed not only on his worldwide income but also he would be allowed a foreign tax credit of approximately \$6,742  $[(28,500/40,500) \times 9,581]$  based on his income as shown in Table 2.

To consider more closely the tax implications of a foreign investor buying U. S. farmland, let us say that a Spanish farmer, Ole Rancho, decides to invest in U. S. farmland. What Senor Rancho wants to know is, what will be his U. S. tax liability? The answer will relate to the manner and method in which he conducts his business in the United States. That is, will the farmland be individually owned or

owned through an entity? Will he personally be overseeing the investment on location or through U. S. agents or employees? And finally, will he lease the entire farm or will he operate it for his own gain? What Senor Rancho really needs to know is whether or not he will be considered a resident or nonresident alien. If Senor Rancho is rarely in the United States, he will most likely be considered a nonresident alien and, therefore, subject to tax only on U. S. source and trade or business income. Then he will want to know whether the income from his investment will be considered effectively connected with a U. S. trade or business. From the information above, business income will incur a full U. S. tax, whereas income that is not



effectively connected with a trade or business will be taxed at the flat 30 percent rate.

Income from his "farm" (investment in real estate) would be considered effectively connected if Senor Ranchero actively farms the land for his own profit. Whether he uses an agent, employees, or works the land himself, his direct supervision will generally cause the income to be considered trade or business income. Note also that his personal management of his farm from the United States would well cause him to be considered a resident alien and, therefore, his other foreign investments would be taxed in the United States. On the other hand, should Senor Ranchero decide to lease the entire farm on a net basis (i.e., all the costs incidental

to ownership are paid by the lessee), the lease payments would be considered not to be effectively connected trade or business income but rather income from U. S. sources to be taxed at the 30 percent rate.

Table 3 illustrates the difference between the foreign investor leasing his land or operating it as a trade or business. If the property is leased, the foreign investor has to pay \$18,000 taxes on \$60,000 lease income. He cannot deduct the interest, taxes, and depreciation. However, if he operates the investment as a trade or business, he pays much less tax since expenses can be claimed against income.

Although the above may not match the true costs of operating a farm, it does allow us to

TABLE 3

Comparison of U. S. Tax on "Net Lease Income" and "Net Income"

	Net lease income (rental)	Net income (operating)
	dollars	
(1) Lease payments	60,000	60,000 <sup>a</sup>
(2) Interest	40,000	40,000
(3) Taxes	6,000	6,000
(4) Depreciation	<u>10,000</u>	<u>10,000</u>
Net cash flow	<u>14,000<sup>b</sup></u>	<u>14,000<sup>b</sup></u>
Taxable income	<u>60,000</u>	<u>4,000<sup>c</sup></u>
Tax at maximum rates	<u>18,000</u>	<u>2,000</u>
After tax cash flow	<u>&lt;4,000&gt;</u>	<u>12,000</u>
Tax rate on taxable income (percent)	30	50

<sup>a</sup>To make this comparable to net lease income, the \$60,000 should be increased and management costs should be added. The table is used only to illustrate a point, and it is assumed that the \$60,000 is net of management and risk factors.

<sup>b</sup>Row (1) - (2) - (3).

<sup>c</sup>Row (1) - (2) - (3) - (4).

Source: Computed.

illustrate a point. The point is that, should Senor Ranchero rent his farm, he will incur a 30 percent tax on his \$60,000 income from rentals or \$18,000 of tax. This amount of tax would result in negative cash flow. On the operating side, however, his U. S. tax will never exceed 50 percent of his net income. Therefore, Senor Ranchero must make up his mind as to what tax he prefers to pay on his ordinary (noncapital gains) income: (1) 30 percent annual or periodic, fixed or determinable (U. S. source income) or (2) graduated tax rates on income effectively connected with a U. S. trade or business.

### III. TAXATION ON ASSET SALES

#### A. Capital Gain Taxation

To encourage the purchase and sale of investment property, the I. R. C. gives preferential treatment to taxable gains from the sale of capital assets.<sup>22</sup> This preferential treatment has been further extended to the gains from the sale of certain business assets.<sup>23</sup> For an individual, this preferential treatment results in a reduction by 60 percent of the total gain on the sale of capital assets held for more than one year. On the corporate level, net long-term capital gains are taxed at the lower of the graduated tax of the corporation or 28 percent.<sup>24</sup>

Relating this with the determination of effectively connected income can result in greatly different taxes from identical investments. Capital assets used in a trade or business that produces effectively connected income will be taxed at the capital gains rate when sold, regardless of the citizenship or residency of the seller. On the other hand, capital assets owned by a nonresident alien that are not used in a trade or business are generally exempt from capital gains taxation when sold. An exception to this exemption rule applies to aliens who are within the United States for more than 183 days in the year of sale.<sup>25</sup> In other words, as long as a nonbusiness capital asset is

sold in a year when the alien is not present in the United States for 183 days or more, the gain will escape U. S. taxation.

For example, let us assume that an Australian citizen and resident and a U. S. citizen and resident own identical parcels of undeveloped raw land. Each paid \$10,000 for his land and held it for five years before selling it for \$100,000. The U. S. citizen would pay tax on \$36,000 of gain at the graduated rates  $[(\$100,000 - \$10,000) \times 40 \text{ percent} = \$36,000]$ . The Australian citizen, if not within the United States for 183 days in the year of sale, is not taxable on any of the gain. If, however, instead of undeveloped land, the investment was in farmland and the Australian taxpayer was

effectively connected in farming, the sale of the farm would be taxable in both situations. To avoid the capital gains tax, nonresident aliens must own capital assets that are not connected with a trade or business, i.e., investment property, and not be in the United States for more than 183 days in the year of sale.

B. Trade or Business Election

From examining his alternatives, Senor Rancho would prefer to own and rent U. S. real property (a triple net lease) thereby not subjecting his foreign income to U. S. taxation (i.e., have nonresident status). However, he would also like to be taxed on net income from the rental property rather than pay the 30 percent tax. Senor Rancho knows that the



deductions allowed for interest, property taxes, and depreciation would reduce his net rental income to zero; therefore, he would pay no U. S. tax on the operations of the farm. Surprisingly, if Senor Ranchero makes a proper election in his U. S. tax return, his rental property will be treated as if it were a trade or business, and he will pay tax on net income.<sup>26</sup> There are, however, two drawbacks to this election. The first is that, once made, it is binding for all future years and on all pieces of real property subject to tax. Secondly, it subjects the gain on the sale of real property that is now trade or business property to the capital gains tax.

Ideally, Senor Ranchero would like to "have his taco and eat it, too!" If he were allowed

to make the trade or business election annually, he could elect to be taxed on net income in each year of operation and, because of the allowable deductions, pay no tax. And, if the election were annual, he could choose not to make the election in the year of sale, therefore returning the property to its original status as investment property not used in a trade or business; and thereby he would avoid the capital gains tax. Can he do it?

#### C. Treaty Shopping

Surprisingly, Senor Ranchero can achieve his desired result. It is possible, however, only through a proper combination of business form (corporation) and the proper tax treaty

(Netherlands Antilles).<sup>27</sup> As the income tax treaty between the United States and the Netherlands Antilles allows an annual election to treat rental property as a trade or business property, Senor Ranchero will want to make his investment in U. S. farmland through a corporation chartered in this "tax haven." Since the Netherlands Antilles levies little or no tax on income, dividends, or interest received, using a company incorporated there to invest in U. S. farmland will most likely allow tax-free operations until remittance of the profits to the home country (i.e., Spain).

Neither Senor Ranchero nor Farmer McSchmidt is able to avail himself of these annual elections in using a corporation chartered in his

own country. The United States has a tax treaty with Germany which does not allow the same benefits as in the Netherlands Antilles treaty.

There is no tax treaty between the United States and Spain.

Table 4 contains a brief summary of the general rules of U. S. taxation of both U. S. and foreign individuals and corporations.

(Partnerships have not been discussed since, if a business entity qualifies as a partnership under U. S. tax principles, the income of the partnership will be taxed to the partners only; partnerships do not pay tax.)

From reading the table, it appears that the prudent foreign investor in U. S. farmland would desire to arrange his affairs so that he would

TABLE 4  
A Brief Summary of U. S. Taxation

Type of taxpayer	Type of income		
	U. S. source income	Income effectively connected with a U. S. trade or business	All other foreign income
<u>U. S. citizen, U. S. corporation, resident aliens, and certain foreign corporations<sup>a</sup>:</u>			
Taxable	yes	yes	yes
Tax rate (percent):			
Individual	14-70	14-70	14-70
Corporation	17-46	17-46	17-46
Foreign tax credit	no	no	yes (if paid)
Capital gains taxable	yes	yes	yes
<u>Nonresident aliens and most foreign corporations:</u>			
Taxable	yes	yes	no
Tax rate (percent):			
Individual	30 <sup>b</sup>	14-70	none
Corporation	30 <sup>b</sup>	17-46	none
Capital gains taxable	no	no <sup>c</sup>	no

(Continued on next page.)

## TABLE 4--continued.

<sup>a</sup>Foreign corporations with a permanent establishment in the United States whose business is principally within the United States.

<sup>b</sup>Treaty rates are generally lower.

<sup>c</sup>Assumes companies incorporated in countries with tax treaties that allow the annual real property election such as that in § 871(d) of the Internal Revenue Code.

Source: Computed.

be taxed as a U. S. citizen or corporation (upper half) on operating income where the tax rates begin at 14 percent to 17 percent. Upon sale, the capital gains tax can be avoided if the investor can slide down to the lower half of the table and be taxed at the rates and rules that apply to nonresidents. This can be accomplished by incorporating in a country having a tax treaty with the United States that includes the annual real property election so that the investor can at the time of sale have his investment construed as not effectively connected with a U. S. trade or business.

In reading the table each taxpayer must determine his taxable entity and his types of income. U. S. citizens and corporations, as

well as resident aliens and foreign corporations residing in the United States, will read the top half of Table 4.<sup>25</sup> Nonresident aliens and foreign corporations not residing in the United States will read the bottom half. Once the taxable entity has been determined, tax rates, etc., can be found in the column for the appropriate type of income. Keep in mind that income that is effectively connected with a U. S. trade or business is a special class of U. S. source income and is shown in the middle column. All other types of income can be classified as either U. S. or foreign source, and their taxable consequences are listed in the outside columns.

There are four other principal means of avoiding the gain on sale of U. S. farmland by



foreign interests. These include the installment sale election, the one-year corporate liquidation, the sale of "shares" of a corporation, and the like-kind exchange. All these methods are available whether or not an annual or permanent trade or business election is available.

#### 1. Installment Sale

The nonresident alien or foreign corporation that is engaged in a trade or business and effectively paying no income tax on operations may reduce the capital gains tax on the sale of U. S. farmland by using the installment sale election. The installment sale provisions will allow the taxpayer to defer the gain on the sale until the year or years when cash is received.

As payments are made, a percent of each dollar received is taxed as gain in proportion to the percentage that the total gain is to the total sales price. Postponing receipt of cash to the year after the property sale and subsequent years will eliminate the capital gains tax even if the trade or business election cannot be revoked; receipts from installment sales in a year when the taxpayer has no other U. S. trade or business will not be taxable.

## 2. One-Year Liquidation Under I. R. C. § 337

If a foreign resident who owns U. S. real estate through a holding company sells the real estate and liquidates the corporation within one year, pursuant to the special requirements of I. R. C. § 337, the corporation will pay no

tax on the liquidation; and the shareholders of that corporation will be taxed as if they sold the stock and not the real estate. Generally, gains from the sale of corporate stocks are not taxable to nonresident aliens. Therefore, the one-year liquidation allowed under I. R. C. § 337 will eliminate any capital gains tax.

### 3. The Sale of Stock

If the shares of a corporation owning U. S. real estate are sold at a value based on the appreciation in the assets (U. S. farmland) of the corporation, nonresident alien shareholders would pay no tax. The stock purchasers could then liquidate the corporation either before or after the sale of the real estate to enable them

to receive either the cash or the property  
itself.

#### 4. Like-Kind Exchange

Under I. R. C. § 1031, the U. S. tax law allows for tax-free exchanges of "like kind" property. A nonresident alien investor in U. S. farmland could exchange his U. S. farm for any foreign real estate in a tax-free exchange. Foreign real property in the hands of a nonresident alien can be sold free of any U. S. tax. It is important to note here that, under the mechanics of the exchange rules, the foreign party may direct the choice of the specific properties he desires to own before the exchange.<sup>29</sup>

## IV. TAX IMPLICATIONS OF A DIFFERENT

## U. S. TAX LAW

A national policy that focuses specifically on foreign investment relates to the current U. S. tax structure. Since the current tax structure offers a number of important incentives for foreign investors, the effects of such policies are not confounded by other "public interest" targets. For this reason, during the session of the 96th Congress, no less than eight bills have been introduced that would drastically change taxation of foreign investment. Although similar in their taxation measures, some of these bills would tax only U. S. farmland, whereas others would tax any capital gain. It should also be noted that they

provide the means for terminating the four additional tax loopholes associated with capital gains (outlined in the previous section), viz., installment sale, one-year liquidation, sale of stock, and like-kind exchange.

Under the proposed bills, foreign holders of U. S. farmland would have to report to the buyer their foreign identity. U. S. companies and foreign corporations with the required foreign ownership of 50 percent or more would be required to make this declaration. The buyer would then be required to withhold 20 percent of either: (1) gain on the sale as reported by the foreign entity, (2) the appreciation on the property (in the case of an exchange or liquidation), or (3) the sales price if the gain cannot be determined.

The result of such legislation, if passed, would achieve an equality between taxation of domestic and foreign farmers or investors.

Table 5 illustrates the results of the proposed legislation. Using the same sources of income as in Table 2, this table presumes that both Mr. McDonald and Herr Schmidt sell their U. S. farms for \$275,000 (cost basis, \$50,000). Upon the sale, Herr Schmidt must disclose to the purchaser both his foreign citizenship and his taxable gain. The purchaser then would withhold \$63,000 of the U. S. tax  $[(\$275,000 - \$50,000) \times 28 \text{ percent tax rate}]$  and would remit \$212,000 to the seller. If Herr Schmidt is unable to determine his gain, the buyer must withhold a U. S. tax of \$77,000 from the sales price  $(\$275,000 \times 20 \text{ percent})$ .

TABLE 5

Comparison of Tax to be Paid Under Proposed Legislation:  
U. S. Citizen vs. Nonresident Alien

	McDonald <sup>a</sup>		McSchmidt <sup>a</sup>	
	U. S. citizen		Nonresident alien	
	Income	Income	U. S. tax	
	dollars			
<u>Dividends</u>				
Foreign corporation	16,000	16,000	exempt <sup>b</sup>	
U. S. corporation	12,000	12,000	3,600 (30%) <sup>c</sup>	
<u>Interest (nonbank)<sup>d</sup></u>				
Foreign corporation	17,500	17,500	exempt <sup>b</sup>	
U. S. corporation	15,000	15,000	4,500 (30%) <sup>c</sup>	
<u>U. S. farm</u>				
Income	25,000	25,000		
Expense	<10,000>	<10,000>		
	<u>15,000</u>	<u>15,000</u>	2,100 (14%)	
<u>Foreign farm</u>				
Income	20,000	20,000		
Expense	<10,000>	<10,000>		
	<u>10,000</u>	<u>10,000</u>	exempt	
<u>Gain on sale</u>				
Sales price	275,000	275,000		
Cost basis	<50,000>	<50,000>		
	225,000	225,000	63,000 (28%)	

(Continued on next page.)



TABLE 5--continued.

	McDonald <sup>a</sup>	McSchmidt <sup>a</sup>
	U. S. citizen	Nonresident alien
	Income	Income
		U. S. tax
	dollars	
Total income	<u>310,500</u>	<u>310,500</u>
Taxable income	175,000	
Tax (using 1979 tax rates)	<u>89,012</u>	<u>73,200</u>

<sup>a</sup>Assumes married, filing joint return, no itemized deductions, and no dependents.

<sup>b</sup>Not an 80-20 corporation under I. R. C. § 861(a)(2)(A) or § 861(a)(1)(B).

<sup>c</sup>More than 50 percent of this company's income is from foreign sources; therefore, neither I. R. C. § 861(a)(2)(B) nor § 861(a)(1)(C) applies.

<sup>d</sup>In general, interest paid by U. S. banks, savings and loan associations, and insurance companies is foreign-source income to nonresident aliens [I. R. C. 861(c)].

Without some legislation of this sort, it is a simple matter to demonstrate how foreign investors can be more successful than domestic investors in purchasing U. S. agricultural land. Since foreign investors can utilize current treaty commitments of the United States to effectively avoid a capital gains tax while still facing the same operating tax structure as a domestic investor, the bid price of foreign investors will exceed the corresponding bid price of domestic investors by the present value of the associated savings in capital gains tax. In other words, if a foreign investor is alike in all respects to a domestic investor (wealth positions, risk aversion, and the like), his bid price would exceed the latter's bid price by the

present value of the savings in capital gains tax. Assuming a discount rate of 10 percent and an asset-holding period of five years, Figure 1 reflects the difference between the bid price of a foreign investor and that of a domestic investor for alternative initial values of land (\$200, \$500, \$1,000, \$2,000, and \$25,000) and alternative rates of land appreciation (5 percent to 25 percent per year). As this figure reveals, for an initial value of \$2,000 per acre, if both a foreign investor and a domestic investor expect the rate of land value appreciation to be 25 percent per year for a five-year planning horizon, the foreign investor is prepared to offer above \$700 an acre more than a domestic investor would offer due to the

capital gains tax savings alone. This situation should most certainly be corrected, and it explains in large part the social concern with foreign direct investment in U. S. agricultural land.

The current bills before Congress allow a period of approximately five years for the United States to renegotiate its current treaty commitments. If such renegotiation does not take place, most of the proposed bills allow the new legislation to override existing treaties. Since there does not appear to be any grandfather clause or effective date on the beginning of foreign investment in U. S. agricultural land, the advantages to foreign investors resulting from avoidance of the capital gains tax will still be available until the new laws override the current treaties.

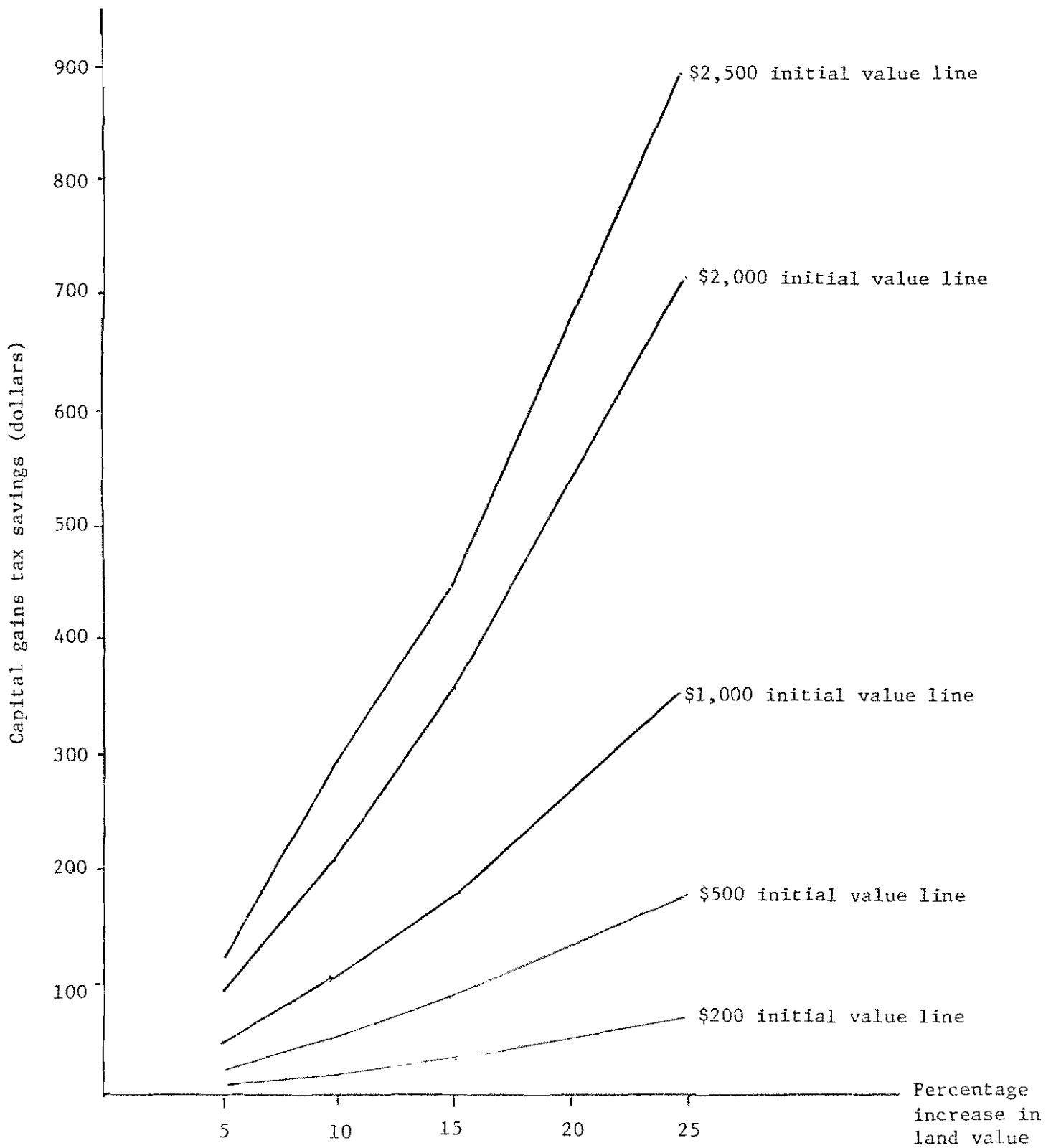


FIGURE 1. Percent of Five-Year Holding Period for Alternative Expected Rates of Land Price Appreciation

## FOOTNOTES

1. T. L. Anderson, A Summary of Alien Land Investment in the United States, Colonial Times to Present, In FOREIGN INVESTMENT IN U. S. REAL ESTATE (Gene Wunderlich, ed.), p. USDA-ERS (1976).
2. C. F. Nuckton and B. D. Gardner, Foreign Investment in U. S. Agricultural Land—Issues and Perspectives, J. AMER. SOC. FARM MANAGERS AND RURAL APPRAISERS 43, 41-49 (1979).
3. G. L. Wunderlich, SUMMARY OF THE REPORT: FOREIGN INVESTMENT IN U. S. RURAL ESTATE, USDA-ERS Report No. 400 (December 1976).

4. K. R. Krause, Foreign Investment in the U. S. Food and Agricultural System: An Overview, USDA-ESCS Report No. 456 (May 1980).
5. G. C. Rausser and A. Schmitz, Foreign Direct Investment in U. S. Farmland, STANFORD J. INT. STUDIES, forthcoming.
6. G. C. Rausser, D. Zilberman and R. E. Just, The Distributional Effects of U. S. Agricultural Policy: Deficiency Payments and Import Control, Dept. of Agricultural Economics, University of California, Berkeley, Working Paper No. 80 (1980).
7. H. Shalit and A. Schmitz, On Farmland Accumulation, Farmland Prices, and Credit Rationing, paper submitted to ECONOMETRICA.

8. K. M. Gordon, The Distributional Impact of Rural Financial Markets and Policies, Ph. D. Research Essay, Dept. of Agricultural and Resource Economics, University of California, Berkeley (June 1980).
9. Ibid.
10. For a detailed discussion of policies to control foreign investment, see Rausser and Schmitz, supra, note. 5.
11. Krause, supra, note 4, p. 38.
12. I. R. C. § 1441(a).
13. I. R. C. § 1441(a).
14. I. R. C. § 1441(b).
15. "Effectively connected" as defined in I. R. C. § 864(c); "trade or business" as defined in I. R. C. § 864(b).



16. Graduated U. S. tax is that tax rate imposed under the I. R. C. on individuals (14 percent to 70 percent) and on corporations (17 percent to 46 percent).
17. I. R. C. § 864(c.4).
18. For a definition of the terms, see footnote 12.
19. At this time, the United States has about 30 bilateral income tax treaties with other nations that (1) exempt certain types of income from tax, (2) allow for communications between the taxing authorities of both countries and (3) relieve the burden of double taxation through tax credits. These treaties are generally held to have authority over the authority of the I. R. C.

20. I. R. C. § 901-908.
21. Foreign tax credit limitations are shown in  
I. R. C. § 904.
22. I. R. C. § 1221.
23. I. R. C. § 1231.
24. For individuals, the total gain after  
reduction for the 60 percent capital gains  
deduction (I. R. C. § 12.02) is taxed at the  
graduated rate (the maximum effective rate  
is 28 percent). For corporations, the total  
gain is taxed either at the graduated rate  
(17 percent to 46 percent) or under the  
alternative capital gains rate of 28 percent  
(I. R. C. § 1201).
25. I. R. C. § 894 and 7852.d.
26. I. R. C. § 871.d.

27. A number of tax treaties with the United States allow for an annual trade or business election; the Netherlands Antilles is only one example.
28. Residing implies having a "permanent establishment" as defined in each tax treaty.
29. For further issues on taxation, see:  
M. J. Langer, When Does a Nonresident Alien Become a Resident for U. S. Tax Purposes?, J. TAXATION 44, 220-224 (1976);  
M. J. Langer, PRACTICAL INTERNAL TAX PLANNING (Practical Law Institute, N. Y.) (1979); R. Von T. Rhoades and E. G. Steinberg, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS (Matthew Bender,

N. Y.), (1979); and S. G. Strum, Taxation  
of the Foreign Investor in the United  
States, TAXES 55, 542-565 (1977).