CHAPTER 3
TAXATION

There are different systems for taxing individuals, foreign corporations and branches of foreign corporations. Set out below is a brief introduction to the U.S. approach to taxation of all three.

1. U.S. Taxation of Nonresident Aliens

A. Residency Determination

Section 7701(b) provides two basic tests to determine whether an alien individual is a U.S. resident for any particular calendar year. If the individual fails both the green card test and the substantial presence test, he or she will be considered a nonresident alien.

An alien individual who is a lawful permanent resident under the immigration laws is automatically a resident alien under the green card test. An alien individual present under a non-immigration visa (such as a B-1, B-2, E-1, E-2 or L-1 visa) is subject to the substantial presence test; an objective test based upon time spent in the United States.

Under the substantial presence test, an individual adds the number of days on which he or she was present in the United States in the current year, one-third the number of days on which he or she was present in the first preceding year, and one-sixth of the number of days in which he or she was present in the second preceding year. If this sum is equal to or greater than 183 days, the individual meets the substantial presence test (absent the 30-day or tax home exceptions discussed below).

Under the 30-day exception, if an alien individual is physically present within the United States for 30 days or less during the current year, that individual will not be considered a U.S. resident, even if the 183-day formula would otherwise be met.

Under the tax home exception, an alien individual is treated as not being described by the substantial presence test with regard to any current year if (i) that individual is present within the United States on fewer than 183 days during the current year, and (ii) that individual establishes that for the current year, he or she has a tax home (as defined in § 911(d)(3)) in a foreign country and has a closer connection to such foreign country than to the United States. It should be noted that the tax home exception is not available for any year in which an individual takes steps to apply for a green card.

B. Determination of Tax of Nonresident Aliens

(1) Overview

Under current U.S. tax law, there are two classes of nonresident aliens: those with U.S. source fixed or determinable income not effectively connected with the trade or business in the United States and those who have income effectively connected with a U.S. trade or business. U.S. source income of a nonresident alien not effectively connected with a U.S. trade or business is taxed at a flat rate of 30 percent (or lower treaty rate) on gross income. Income effectively connected with a U.S. trade or business is taxed at regular tax rates. Income from dispositions of real property is treated as if the nonresident were engaged in a trade or business in the United States and subject to a minimum tax. Capital gains not effectively connected with a U.S. trade or business are taxed only to nonresident aliens who are physically present in the United States for 183 days or more during the year in which the gain is realized.

(2) Not Engaged in a Trade or Business in the United States

Section 871(a) provides that nonresident aliens are subject to a 30 percent U.S. tax on the gross amount of fixed or determinable income not effectively connected with a U.S. trade or business in the year the income is received. Fixed or determinable income includes U.S. source interest, dividends, rents, royalties, salaries, wages, premiums, annuities, compensation, remuneration, and emoluments.

Any person who pays fixed or determinable income from U.S. sources to a nonresident alien must withhold taxes from the payment. The withholding rate is 30 percent unless a lower treaty rate is in effect. No withholding is required on payments to foreign taxpayers on income that is effectively connected with a U.S. trade or business. Compensation for services performed in the United States is subject to graduated withholding rates in § 3402.

(3) Engaged in Trade or Business in the United States

A nonresident alien individual engaged in a trade or business in the United States but having no office or fixed place of business located here is potentially subject to tax on income from U.S. sources under two different criteria. First, United States source income not effectively connected with the conduct of a U.S. business, consisting only of the same class of income specified in § 871(a)(1) net capital gains that would be subject to a 30 percent rate of tax if he were engaged in a trade or business in the United States, is taxable at the 30 percent (or lower treaty) rate. Second, U.S. source income effectively connected with the U.S. business is taxed on a net basis and under the graduated rates. These statutory rules apply to the entire taxable year if the nonresident alien is engaged in a trade or business within the United States at any time during the year.

(4) Engaged in Trade or Business in the United States and Having an Office or Other Fixed Place of Business in the United States

A nonresident alien individual engaged in a trade or business in the United States with an office or other fixed place of business located here is taxed under two separate criteria but the income must be segregated into three different categories:

a. United States source income not effectively connected with the conduct of a U.S. business, taxable at 30 percent, applied to the gross amount;

b. United States source income effectively connected with the conduct of a U.S. business, taxable at graduated rates on a net basis;

c. Foreign source income attributable to the office or other fixed place of business located in the United States, taxable at graduated rates on a net basis.

The United States source income and the effectively connected foreign source income of a nonresident alien engaged in business in the United States through an office located here is taxable in exactly the same manner as a nonresident alien engaged in business in the United States without an office located here. However, U.S. tax on the foreign earnings of the nonresident alien may be offset by a foreign tax credit under Section 906.

2. U.S. Taxation of Foreign Corporations

A. Status Determination

A foreign corporation is any corporation which is not a domestic corporation. Under § 7701(a)(4) a domestic corporation is any corporation "created or organized in the United States or under the law of the United States or of any State." Therefore, a corporation formed in any jurisdiction other than the United States is a foreign corporation.

B. Income Taxation of Foreign Corporations

(1) Overview

Just as in the case of nonresident aliens, a foreign corporation is subject to separate tax regimes depending on whether its earnings are from U.S. or foreign sources and whether those earnings are effectively connected with a trade or business in the United States.

(2) Foreign Corporations Not Engaged in a U.S. Business

A foreign corporation not engaged in a U.S. trade or business is taxed only on its U.S. source income. Only those items specified in § 881(a), which constitute fixed or determinable income are subject to tax. A flat 30 percent rate (or lower treaty rate) of tax is imposed on the gross income from those items. Capital gains are not subject to tax.

(3) Foreign Corporations Engaged in a U.S. Business without a U.S. Office

A foreign corporation engaged in a U.S. trade or business but which has no U.S. office or fixed place of business is taxed only on its U.S. source income. The foreign corporation will be taxed on items of gross income described in § 881(a) which are not effectively connected with its U.S. trade or business. The rate of tax is 30 percent (or lower treaty rate). Capital gain which is not effectively connected is not subject to tax.

However, a foreign corporation which falls within this category is subject to tax at regular corporate rates on its effectively connected income. Effectively connected income includes effectively connected capital gain and items of FDAPI. U.S. source income other than capital gain and FDAPI items is treated as effectively connected income.

(4) Foreign Corporations Engaged in a U.S. Business with a U.S. Office

A foreign corporation engaged in a U.S. trade or business which has a U.S. office may be taxed on three types of income: U.S. source income not effectively connected with a U.S. trade or business; U.S. source effectively connected income; and certain foreign source effectively connected income. The first and second items are treated in the same manner as those items for a foreign corporation engaged in a U.S. trade or business with no U.S. office, as previously discussed.

Foreign source effectively connected income consists of three classes of income: rents and royalties from intangibles; certain dividends, interest, and gain on investment assets; and U.S. office sales income. These income items are considered effectively connected only insofar as they are attributable to the foreign corporation's U.S. office. They are taxed at domestic rates as is other effectively connected income. Deductions in a foreign tax credit are similarly available.

3. <u>U.S. Taxation of Branch of Foreign Corporation</u>

A. Purpose

A foreign corporation doing business in the United States may choose between operating with a domestic branch or utilizing a domestic subsidiary. Generally, each form of doing business is subject to the regular corporate income tax on its profits. However, repatriation of those profits, first to the foreign parent (or home office) and then to the ultimate shareholders, may result in significant tax differences between these two forms of doing business. If a domestic subsidiary of a foreign parent corporation repatriates its profits in the form of a dividend, a 30 percent withholding tax (or lower treaty rate) will be imposed on the distribution. However, when the foreign corporation distributes its profits to its ultimate shareholder, no additional U.S. taxes are imposed.

B. Branch Profits Tax

Section 884 imposes on any foreign corporation engaged in a U.S. trade or business a branch profits tax. The branch profits tax is in addition to the regular corporate tax imposed on those corporations under § 882. The branch profits tax is equal to 30 percent of the "dividend equivalent amount." The dividend equivalent amount is the foreign corporation's effectively connected taxable income with certain adjustments for any increase or decrease of investment of earnings in trade or business assets of the branch. In effect, the branch profits tax is a tax on profits of the branch other than those reinvested in the U.S. business operations.

The branch profits tax is not applicable if an existing income tax treaty prohibits a branch profit tax. In that case, the second-level withholding tax on dividends would apply to the extent permissible under the treaty.

Where treaty shopping exists, the branch profits tax will override any existing or subsequently enacted treaty provisions to the contrary. Treaty shopping would be deemed to exist if more than 50 percent (by value) of the stock of the foreign corporation is owned directly or indirectly or constructively by persons who are not residents of the country where the corporation is organized. Stock of corporations which is primarily and regularly traded on an established securities market in the country of which it is a resident would be exempted from this rule.