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U.S. Taxation and the Nonresident Alien

Foreign individuals conducting business within the U.S. are subject to taxation on income. Some of the considerations that need to be made include determination of residency status as well as what income is effectively connected (or not) with U.S. trade or business.

Foreign direct investment (FDI)—investment in new or established businesses and real estate in the United States—is currently on the rebound from a 2009 slump. According to the U.S. Department of Commerce's Economics and Statistics Administration Issue Brief #02-11, issued in June 2011, FDI grew 49% in 2010 and is pushing toward its historical highs. With increased new FDI comes a potential influx of foreign individuals entering the country to evaluate investment opportunities and possibly reside in the U.S. on a "temporary" basis in order to oversee the resulting transactions. Therefore, it will be helpful to review how the investment and business activities of foreign individuals are taxed by the U.S.

Taxation of Foreign Individuals

The initial step in establishing how foreign individuals are taxed is the determination of their residency status as defined by IRC §7701(b): resident alien or nonresident alien. A nonresident alien is a person who is not a U.S. citizen nor a lawful permanent resident (i.e., a "green card holder") nor an individual who has established residency by way of "substantial presence" within the U.S. as defined under IRC §7701(b)(3). It's important to note that it isn't necessary for a foreign individual to establish a permanent home in the U.S. in order to be classified as a resident alien by federal tax law. An alien's mere physical presence in the U.S. can trigger residency status unless one of the limited exceptions applies. Exceptions include medical concerns, commuters from Canada and Mexico, students, and diplomats (IRC §7701(b)).

U.S. citizens and resident aliens are subject to taxation on their worldwide income from whatever source it's derived. Nonresident aliens, however, are subject to taxation under two separate platforms: (1) for income from U.S. sources that is "not effectively connected" (NEC) with a U.S. trade or business and (2) for income that is "effectively connected" (EC) with a U.S. trade or business (IRC §871(b)).

NEC Income

Generally, a flat tax rate of 30% of gross income applies to U.S.-sourced income and gains deemed NEC with a U.S. trade or business. This tax is generally collected by the entity making the payment to the foreign individual (IRC §1441 and §1442). Income subject to this flat rate includes, but isn't limited to: interest on bonds, notes, or other interest-bearing obligations of U.S. residents or domestic corporations; dividends and dividend equivalent payments determined to be from U.S. sources; rents on U.S. properties; and royalties, alimony, annuities, and other fixed or determinable annual or periodic amounts (IRC §861and §871). The manner or place of payment is immaterial in the determination of taxability. Nonresident aliens present in the U.S. less than 183 days during the tax year are generally exempt from taxation on NEC capital gains, for example, on sales of shares in domestic companies (IRC §871(a)(2)). With limited exceptions, presence is defined under IRC §7701(b)(7) as being in the U.S. at any time during a day.

When nonresident aliens sell U.S. real estate or natural deposits, special regulations and tax withholding rules apply under the For-

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eign Investment in Real Property Act (see IRC §897 and §1445). Generally, the buyer is required to withhold and remit to the IRS 10% of the amount realized (rather than amount recognized) on the sale—unless a statement is obtained to the effect that the seller is a U.S. citizen or resident or an IRS withholding certification is acquired. U.S. real property interest is any interest in real property or deposits located in the U.S. or the U.S. Virgin Islands.

EC Income

Generally, to have EC income, nonresident aliens must be self-employed individuals, employees, or principals engaged in a trade or business at some time during the tax year. Income from personal services performed in the U.S. is considered EC income regardless of where payment is paid (IRC §864(b)). Fringe benefits related to the income from the U.S. are also subject to taxation. Under this general rule, nonresident aliens who work temporarily in the U.S. are considered as earning compensation from sources related to U.S. trade or business. IRC §861(a)(3) allows for an exception (with limitations related to presence in the U.S. and dollar amounts) for services performed for foreign employers. All business profits and loss from the operation of a business within the U.S. are EC and, therefore, subject to taxation. A nonresident alien's partnership share of a partnership's U.S.-source profit and losses income is also EC trade or business income under the purview of IRC §875.

EC income is subject to current graduated tax rates. These tax rates are applied to taxable income, which is gross income less apportioned expenses. The expenses that can be deducted by nonresident aliens, however, aren't as extensive as those allowed to resident aliens. Nonresident aliens also face limitations on filing status options, allowable exemptions, itemized deductions, and certain tax credits.

Nonresident Alien Filing Requirements

All nonresident aliens engaged in a trade or business within the U.S. at any time during the tax year are generally required to file an individual income tax return. They must file even if the income is exempt from income tax. (There are a limited number of exceptions depending on such issues as visa type.) A tax return must also be filed if a nonresident alien received NEC income and the incorrect amount of tax was withheld. In addition, nonresident aliens must adhere to the filing deadlines for U.S. tax returns and are subject to penalties and interest for late submission of returns and underpayments of tax. If the individual taxpayer received wages subject to withholding, Form 1040NR is due by April 15 following the end of the tax year. Otherwise, the form is due June 15 following the end of the tax year.

The U.S. government enforces substantial federal taxation jurisdiction over nonresident aliens who receive income with a sufficient U.S. nexus. Once it has been established that the individual is classified by U.S. tax law as a nonresident alien, the tax advisor should consider any applicable tax treaty. Currently there are more than 55 treaties in force—all of which typically provide the nonresident alien extensive U.S. tax relief. In addition, tax advisors must consider U.S. Estate and Gift Tax Treaties, state and local tax regulations, and the impact of home-country tax obligations on their foreign clients. **SF**

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