



INTERNATIONAL TAXATION

**Summary of Selected Provisions of United States Taxation of
Foreign Investment in the United States**

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I. INTRODUCTION

The purpose of this paper is to present a brief report which covers the main topics of an introductory course in international taxation. Although this paper is introductory in scope, it is this author's intention to scrutinize provisions of the United States Internal Revenue Code ("the Code") which would be of concern to a foreign investor investing in the United States. Clearly, this paper makes no attempt to analyze provisions which would be of concern to a United States person or domestic corporation investing abroad since the taxation consequences to these investors is dependent upon the rules and regulations of each foreign sovereign.

The legal analysis of the paper is divided into three separate categories. The first category concerns income taxation of foreign individuals and foreign corporations investing in the United States. Some of the subcategories in the area of income taxation include: residency determination; source income and its taxation treatment; branch profits tax which places branches of foreign corporations on a par with subsidiaries of foreign corporations and domestic corporations; and, the Foreign Investment in Real Property Tax Act.

The second category of legal analysis concerns estate and gift tax considerations. Estate and gift tax considerations do not take the importance of income taxation in this day and age of a growing global economy. Nevertheless, they do merit discussion since foreign investors may either die while holding United States property, or foreign investors may decide to make a gratuitous transfer of United States property.

Lastly, the third category of the legal analysis concerns section 1446 of the Code which is a special provision of withholding tax on foreign partners who are partners either in a domestic partnership or a foreign partnership that has effectively connected income with the United States. This category, while undoubtedly important in the area of partnership taxation law, is a relatively minor one in the broad area of international taxation, and therefore, will be given weight accordingly.

II. LEGAL ANALYSIS

A. INCOME TAXATION

Residency Determination. In the initial analysis of any potential Federal income taxation problem concerning foreign investment in the United States one must ask the threshold question: Is the alien individual a resident for Federal income taxation purposes? It is imperative that this question is answered in the initial analysis because, as a general rule of Federal income taxation law, resident aliens are taxed the same as United States citizens, whereas, non-resident aliens are taxed only United States “source” income.¹

Residency of an alien individual can be established if the individual has (1) been lawfully admitted as a permanent resident of the United States,² (2) meets the “substantial presence” test, or (3) makes a valid first year election to be treated as a resident.³ Of these three alternatives, the first is the least troublesome since whether an alien individual has been admitted as a permanent resident is simply a question of fact. The latter two, however, are more complicated in that they require application off a mathematical formula determining the number of days an alien individual is present in the United States, and thereby meeting residency requirements.

In the substantial presence test, an alien individual will be considered a resident if the individual was present in the United States at least 31 days during the present calendar year and at least 183 days for the three-year period ending in the current year, using a weighted average.⁴ The weighted average is as follows: days present in the current calendar year are multiplied by 1; days present in the

¹ All references are to the Internal Revenue Code of 1986, as amended. I.R.C. § 7701(a)(30)(A) provides that all “United States persons” are defined as either United States citizens or resident alien individuals. All United States persons are subject to Federal income taxation at the graduated rates provided in § 1 of the Code.

Equally important, all United States persons are subject to taxation on worldwide income. *See, Cook v. Tait*, 265 U.S. 47 (1924), which provides the basis for taxation (United States citizen who was a resident of Mexico taxed on worldwide income; *held*: for the United States because United States citizens enjoy benefits of citizenship regardless of where they may reside).

Discussion of taxation treatment of nonresident alien individuals and foreign corporations *infra*, pp. 4-5.

² This has sometime been referred to as the “green card” test. *See, Doernberg, Richard L., International Taxation in a Nutshell*, (St. Paul, Minnesota: West Publishing, 1989), p. 17.

³ I.R.C. § 7701(b)(1)(A).

⁴ *Id.*

first preceding year are multiplied by 1/3; and, days present in the second preceding year are multiplied by 1/6.⁵ Thus, the substantial presence test is a two-prong test which requires both presence in the United States during the current year, as well as presence during the last three year period.⁶

There are several exceptions to the substantial presence test. The first exception is where an alien individual spends fewer than 183 days in the United States during the current year, has a tax home in a foreign country and has a closer connection to that foreign country than to the United States.⁷ Secondly, the code provides that certain alien individuals are exempt from the substantial presence test by virtue of their status as professionals.⁸ And, third, days present in the United States are not counted if an alien individual is unable to leave because of medical reasons,⁹ or if an alien individual is a regular commuter from Canada or Mexico.¹⁰

⁵ I.R.C. § 7701(b)(3)(A).

⁶ For example, suppose an alien individual spent 140 days in the United States in the present calendar; 120 days in the United States during the first preceding calendar year; and 90 days present in the United States in the second calendar year. The weighted average of the substantial presence test would be applied as follows:

$$(140 \times 1) + (120 \times 1/3) + (90 \times 1/6) = 195$$

Since this alien individual has been present in the United States at least 31 days during the present calendar year, and since this alien individual has also been present in the United States for at least 183 days, using the weighted average method, during the three-year period ending the current calendar year, this alien individual has met the required number of days for the substantial presence test and will be considered a resident alien for Federal income taxation purposes.

⁷ I.R.C. § 7701(b)(3)(B). For example, assume an alien individual spent 120 days in the United States during the current year; 120 days in the United States in the first preceding year; and 180 days during the second preceding year. Were it not for the exception to the substantial presence test, this alien individual would be considered a resident for Federal income taxation purposes because this alien individual has spent at least 31 days in the United States in the current year and at least 183 days, using the weighted average method, during the three-year period ending the current calendar year:

$$(120 \times 1) + (120 \times 1/3) + (180 \times 1/6) = 190 \text{ days}$$

However, if this alien individual has a tax home in a foreign country and can prove a closer connection to that country than the United States, the exception to the rule will apply since this alien individual has spent less than 183 in the United States in the calendar year.

⁸ I.R.C. § 7701(b)(5). The section provides:

- IN GENERAL. - An individual is an exempt individual for any day if, for such day, such individual is -
- (i) a foreign government related individual
 - (ii) a teacher or a trainee
 - (iii) a student or
 - (iv) a professional athlete who is temporarily in the United States to compete in a charitable sports event.

⁹ I.R.C. § 7701(b)(4).

¹⁰ I.R.C § 7701(b)(7).

An alien individual may elect to make a first election, and thereby receive United States residency status.¹¹ To make a valid first year election an alien individual must be present in the United States 31 consecutive days in the election year and be present in the United States at least 75% of the days in part of that election year, beginning with the first of the 31 consecutive days.¹² Again, this is a two-prong test, requiring presence in the United States during two specific time periods.¹³

A final remark concerning residency: up to this point the discussion has been centered on alien individuals. In the same vein, corporations are considered domestic corporations if they are incorporated in the United States; foreign corporations are those that are incorporated abroad. Domestic corporations are generally taxed on worldwide income, the same as United States citizens and resident alien individuals. Foreign corporation tax treatment generally parallels the treatment of nonresident alien individuals.¹⁴

Taxation Treatment of Nonresident Alien Individuals and Foreign Corporations. If United States residency cannot be established for Federal income tax purposes, the foreign investor with United States source income will be taxed as a nonresident. Nonresident alien individuals and foreign corporations are taxed a flat 30 percent (or lower tax treaty) rate on certain types of gross income received from all United States source income.¹⁵ United States sources, as enumerated in the Code, include: interest; dividends; rentals and royalties; disposition of United States property; sale or exchange of personal property; and, social security benefits.¹⁶

On the other hand, the Code distinguishes United States source income derived from a United States trade or business from United States source income

¹¹ I.R.C. § 7701(b)(4).

¹² *Id.*

¹³ For example, suppose an alien individual wishes residency status for Federal income taxation purposes. Suppose further that this alien individual arrives in the United States March 1 of the election year. In order to make a valid first year election this alien individual must be present a total of 274 days during the election year (365 X 75%) with the first 31 days of the 274 days consecutive. Thus, if the alien individual is present in the United States the entire month of March, which has 31 days, the remaining 243 days (274 - 31) must be spent in the United States between April 1 and December 31 of that election year.

¹⁴ I.R.C. § 882.

¹⁵ I.R.C. §§ 871(a) and 881.

¹⁶ I.R.C. § 861(a).

derived from passive investments. Nonresident alien individuals and foreign corporations who are engaged in a United States trade or business earning United States source income “effectively connected” with a trade or business are taxed at the same graduated rates as United States citizens, or resident alien individuals, and domestic corporations.¹⁷ Thus, if a nonresident alien individual or foreign corporation is engaged in a United States trade or business and has income which is effectively connected to the United States, that nonresident alien individual or foreign corporation is not subject to the flat 30 percent (or lower tax treaty) rate, but rather will be able to take advantage of the Code’s graduated rates for Federal income taxation liability.¹⁸

Nature and Source of Income. Interest is generally sourced by reference to the residence of the payor.¹⁹ Hence, interest from the United States, a state or political subdivision of a state, or the District of Columbia, and interest from a resident individual of the United States, a domestic corporation or partnership is United States source interest.²⁰ Interest, for application of the source rules, consists of interest on a bond, note, or other interest obligation,²¹ as well as interest received on any United States Federal or state income tax refund.²²

As an exception to the residence-of-the-payor rule, interest paid by a resident individual of the United States or a domestic corporation will not be treated as United States source income if that resident individual or domestic corporation’s gross income, computed during the three preceding taxable years, is at least 80 percent derived from a foreign source trade or business.²³ Also, interest paid by a foreign branch of a United States bank will not be treated as United States source

¹⁷ I.R.C. §§ 871(b) and 882(a).

¹⁸ This also allows nonresident alien individuals and foreign corporations to take business deductions prior to computing gross income. Accordingly, this is a distinct advantage over the United States sourcing rules which do not allow deductions other than losses from the sale or exchange of a capital asset. Treas. Regs. § 1.871-7(3).

¹⁹ I.R.C § 861(a)(1).

²⁰ *Id.*

²¹ *Id.*

²² Treas. Regs. § 1.861-2(a)(1).

²³ I.R.C. §§ 861(a)(1)(A) and 861(c)(1). For example, suppose a United States corporation builds high-rise office buildings in France as its sole activity and earns all of its income from the sale of these high-rise office buildings. Suppose further that 90 percent of the buyers are French resident individuals and corporations, whereas 10 percent of the buyers are United States residents or domestic corporations. All interest paid to foreign lenders would be foreign source, and not subject to the flat 30 percent rate because this United States corporation derives at least 80 percent of its gross income from a foreign source trade or business. But see, branch profits tax *infra*, pp. 12-14.

income.²⁴

Additionally, certain types of United States source income are excepted from the United States source income either temporarily or permanently. First, in the case of an original issue discount obligation, the nonresident lender is not subject to the 30 percent tax on investment income until the debt instrument is sold, exchanged or retired.²⁵ Second, a nonresident is not subject to the 30 percent tax if the United States source interest paid is portfolio interest; portfolio interest meaning, for purposes of this rule, interest which is paid on any obligation which is reasonably designed to ensure that it will be sold to a non-United States person who purchases such debt obligation.²⁶ And, third, interest earned by a nonresident alien individual or foreign corporation on United States bank deposits are not subject to the 30 percent tax.²⁷

Dividends, as with interest, are generally sourced by reference to the payor.²⁸ Accordingly, dividends which are paid by a domestic corporation to a nonresident alien individual or foreign corporation are usually subject to the flat 30 percent tax rate for United States source income. There is, nevertheless, an exception to the general rule, where at least 80 percent of a domestic corporation's gross income is derived from foreign source business income for the preceding three years. In such case, the dividend will still be considered United States source income, but the portion of that dividend which is attributable to the foreign source income is not subject to the 30 percent tax.²⁹

Dividends which are paid by a foreign corporation to foreign shareholders are not United States source income.³⁰ However, if 25 percent or more of a foreign corporation's gross income for the three preceding years is effectively connected with a United States trade or business, then that portion of the dividend from the

²⁴ I.R.C. § 861(a)(1)(B).

²⁵ I.R.C. §§ 871(a)(1)(C) and 881(a)(3). Note: an original issue discount is one in which the face value exceeds the issue price. Thus, the difference between the issue price and the face price is treated as interest, which would normally be taxable upon receipt. However, because of these particular Code sections the tax is deferred until there is a sale, exchange or retirement of the debt instrument.

²⁶ I.R.C. §§ 871(h) and 881(c).

²⁷ I.R.C. § 881(d).

²⁸ I.R.C. § 861(a)(2)(A).

²⁹ I.R.C. §§ 861(c) and 871(i).

³⁰ I.R.C. § 861(a)(2)(B).

United States trade or business is considered United States source income and is subject to the 30 percent tax.³¹

Rents and royalties from property located in the United States, including any rentals or royalties from the use of, or privilege of using of, United States patents, copyrights, goodwill, trademarks and franchises, are United States source income, and therefore, subject to the 30 percent tax.³² Conversely, rents and royalties from property located outside the United States is not United States source income, and as such, is not subject to any United States income taxation by nonresident alien individuals or foreign corporations.³³

In the area of real property a special rule applies.³⁴ If there is gain or loss from the disposition of United States real property or stock of a United States real estate holding company, such gain is United States source income effectively connected with a United States trade or business under section 897 of the Code and is taxed at United States graduated tax rates. Such income is subject to a special 10 percent withholding tax on the amount realized.³⁵ Again, conversely, gain or loss from the disposition of real property located outside the United States is not United States source income subject to any United States income taxation by nonresident alien individuals or foreign corporations.³⁶

The sale or exchange of personal property, which has a major impact upon the world economy, is perhaps the most important area in the application of the source rules. As a general rule, gain from the sale or exchange of inventory property is sourced where the sale takes place, usually the location where title passes.³⁷ Thus, it is possible for nonresident alien individual and foreign corporations selling inventory for use in the United States to structure their sales so

³¹ *Id.* To illustrate, suppose a foreign corporation with United States business income of \$500,000 and gross income of \$10 million during the preceding three-year period makes a \$50,000 distribution to a nonresident alien shareholder. The portion of the dividend that will be subject to the 30 percent tax will be \$2,500 (\$50,000 X \$500,000/\$10 million).

³² I.R.C. § 861(a)(4).

³³ I.R.C. § 862(a)(4).

³⁴ See discussion, *infra*, of *Foreign Investment of Real Property Act (FIRPTA)* on pp. 14-15.

³⁵ I.R.C. § 1445.

³⁶ I.R.C. § 862(a)(5).

³⁷ I.R.C. §§ 861(a)(6), 862(a)(6) and 865(b). For example, suppose that a United States shoe store purchases shoes in Brazil and title passes to the United States shoe store in Brazil. The Brazilian shoe seller will not be subject to a flat 30 percent tax rate under the sourcing rules because the shoes are sourced where the title passes, i.e., Brazil.

that title passes abroad, thereby avoiding United States taxation.³⁸

The title-passage rule does not apply, however, to inventory that is manufactured abroad, rather than purchased abroad, by a United States seller. Income from the sale of this inventory is allocated for source purposes between the country of manufacturing and the country of sale.³⁹

And lastly, depreciable personal income consists of business equipment, automobiles and machinery. The gain may be broken down into two components: depreciation adjustments and appreciation.⁴⁰ Gain realized from depreciation adjustments will be allocated between sources in the United States and outside the United States.⁴¹ Thus, to the extent that depreciation deductions were taken against United States source income, that depreciation adjustment will be treated as United States source income, whereas depreciation taken against foreign source income will be treated as foreign source depreciation adjustments. In contrast, gain realized from appreciation of depreciable personal property will be treated as if it were inventory property.⁴²

Business Income. As discussed, *supra*, nonresident alien individuals and foreign corporations who are engaged in a United States trade or business are taxed at the same graduated rates as United States persons and domestic corporations on income effectively connected to a United States trade or business. Thus, in order for the graduated taxation rates to apply, a two-prong test must be satisfied.

In the first prong, the phrase “trade or business” consists of words of art which the Code provides no definition even though the phrase can be found in over

³⁸ I.R.C. § 864(c)(4). But note, there are limitations to title passage manipulation:

If the primary purpose of the manipulation is tax avoidance, the title passage rule may not apply. The Service will look to all factors of the transaction, including negotiations, execution of the agreement, location of the property and place of payment. Treas. Regs. § 1.861-7(c).

Also, if a nonresident alien maintains an office or other fixed place of business in the United States, income from the sale of inventory attributable to such place is sourced in the United States. I.R.C. § 865(a)(2)(A).

³⁹ I.R.C. §§ 865(b) and 863(b)(2). Doernberg, *supra*, pp. 42-43. To illustrate, suppose a Japanese manufacturer of automobiles makes all of its automobiles in Japan and sells all of its automobiles in the United States. Fifty percent of the gain is attributable to Japan, and 50 percent of the gain is attributable to the United States.

⁴⁰ I.R.C. § 865(c).

⁴¹ I.R.C. § 865(c)(1).

⁴² I.R.C. § 865(c)(2).

50 sections and 800 subsections of the Code.⁴³ Section 864(b) does attempt to define a “trade or business within the United States”, generally, as performance of personal services within the United States during the taxable year.⁴⁴ This definition is overly broad and explains very little. Consequently, it is necessary to look at the case law for guidance.

The case law endeavors to sort the facts and circumstances of each fact pattern in order to determine if the taxpayer’s activities rise to a sufficient level of economic penetration in the United States to be considered a trade or business within the United States. Indeed, upon examination of the cases, the reader will discover that the courts tend to subjectively weigh the quantity of the taxpayer’s business activities with United States contacts, rather than scrutinize the nature of the business transaction(s).

The first case presented demonstrates the courts’ willingness to find that the taxpayer, who participated in a single United States business transaction, was not engaged in a trade or business within the United States. In *Pasquel v. Commissioner*,⁴⁵ Petitioner, a citizen and resident of Mexico, filed no United States income tax for the tax year in question, nor did he enter into the United States. Petitioner was contacted by a United States businessman for the sole purpose of supplying the United States businessman with \$100,000 so that the United States businessman could conclude a ship purchasing deal. Petitioner and the United States businessman agreed that once the United States businessman resold the ships to an unknown third party, Petitioner would receive his \$100,000 back and one-half of the profits from the resale. The United States businessman guaranteed Petitioner that Petitioner would net at least \$25,000. The United States businessman regarded the arrangement, which was made entirely in Mexico City, as a loan and felt that he had a moral obligation to return the money. The United States businessman resold the ships. Petitioner received his original \$100,000 plus \$75,000 from the resale of the ships. *Held*: the Tax Court found that Petitioner was

⁴³ *Commissioner v. Goetziner*, 480 U.S. 23, 27, 107 S.Ct. 980, 983 (1987).

⁴⁴ I.R.C. § 864(b). The Code section is more notable for its two exceptions rather than any definitive explanation as to what constitutes a trade or business:

The first exception is where personal services are performed by a non-United States person for a nonresident employer or business for a period or periods of less than a total 90 days and whose compensation does not exceed \$3,000 in the aggregate for the taxable year.

The second exception includes trading in stocks, securities and commodities through independent parties or for one’s own account.

⁴⁵ 12 T.C.M. (CCH) 1431, 1954 T.C. Memo (P-H) ¶54,002 (1953).

not engaged in a United States trade or business because the transaction resembled a loan. Apparently, the Tax Court was persuaded that the transaction was a loan since Petitioner did not purchase the ships for resale and that this was only a single transaction.⁴⁶

Another case which examines whether the taxpayer's activities rise to the level of a trade or business within the United States is *United States v. Balanovski*.⁴⁷ In *Balanovski*, Taxpayer came to the United States to purchase trucks and equipment which were then to be resold to the Argentine government. Upon locating the trucks and equipment for resale, Taxpayer contacted his father-in-law in Argentina who procured the sale to the Argentine government. Taxpayer was in the United States ten months where he conducted business from a hotel room with the help of a secretary. Taxpayer's business activities included soliciting orders, inspecting merchandise, and making purchases and sales. *Held*: the taxpayer's business activities were so numerous that they rose to the level of a trade or business within the United States.

Difficultly in determining whether a non-United States person is engaged in a United States trade or business also occurs where the taxpayer is not actually conducting the trade or business but relies on a partner or agent. In the case of partners, the Code clearly provides that partners in a partnership is engaged in a trade or business in the United States.⁴⁸ In the case of agents, activities of an agent are imputed to the principal.

One such case which imputes that activities of an agent to the principal is *Lewenhaupt v. Commissioner*.⁴⁹ Here, Petitioner was a nonresident alien and citizen of Sweden. During World War II, Petitioner was in the Swedish army and engaged in an importing and exporting business in Sweden. Petitioner received personal and real property assets, located in California, from two family trusts. In June 1941, Petitioner appointed an agent, who was a resident of California, to manage his California assets. The California agent had broad powers of attorney and used the power to buy and sell real estate, execute leases, collect rents, arrange for repairs, pay taxes and mortgage interest, and arrange for insurance. *Held*: the Tax Court found that since the agent's activities were carried in the Petitioner's

⁴⁶ *Note*: since the income received was deemed interest, Petitioner was subject to the 30 percent flat rate under the United States source rules.

⁴⁷ 236 F.2d 298 (2nd Cir. 1956).

⁴⁸ I.R.C § 875(1).

⁴⁹ 20 T.C. 151 (1953).

behalf, and since the agent's activities were "considerable, continuous and regular",⁵⁰ the Petitioner was engaged in a trade or business within the United States.

The second prong of the test is the "effectively connected" concept. Section 864(c)(3) provides that if a non-United States person or foreign corporation is engaged in a trade or business within the United States, then, as a general rule, all sales, services and manufacturing income from United States sources is effectively connected income.⁵¹ Active conduct of a United States trade or business, for purposes of this section, is the conduct which takes place in an office or other fixed place of business, *i.e.*, a store, plant or office where an agent has the authority to contract or maintains regular stock.⁵²

Finally, there are two noteworthy provisions in the area of effectively connected income that merit comment. These provisions concern future earnings of nonresident alien individuals and foreign corporations who are no longer conducting business within the United States. The first pertains to foreign taxpayers who sell inventory or perform services on the installment method with payment due over the course of the next ten years. Even though the foreign taxpayer is no longer engaged in a United States trade or business, the payments, as received, will be treated as effectively connected income with the United States trade or business if the payments would have been treated as effectively earned income during the year of sale.⁵³ The second provision pertains to foreign taxpayers who cease to conduct a trade or business in the United States and then dispose of business property. Similarly, the business property retains the character for ten years after business ceases to be conducted with the United States, and any gain received from the sale of the business property will be effectively connected

⁵⁰ *Id.*

⁵¹ I.R.C. § 864(c)(3). For example, suppose a Hong Kong shirt vendor is engaged in a trade or business of selling shirts through its branch in Buffalo, New York. Any sales income generated by this United States branch is effectively connected income. Suppose further that the Hong Kong shirt vendor sells directly from its Hong Kong home office shirts to a New York City department store chain which are currently warehoused in Buffalo. The income from that sale will also be effectively connected income. Treas. Regs. § 1.864-7.

⁵² I.R.C. § 864 (c)(5)(B) and Treas. Regs. § 1.864-7.

⁵³ I.R.C. § 864(c)(6). To illustrate, suppose the Hong Kong vendor in Footnote 51 decides to close down its operations in the United States. Suppose further that the Hong Kong shirt vendor sells all of its stock in the Buffalo warehouse to a buyer on an installment sale payment arrangement. Under the statute, as payments are received, the payments are characterized as effectively connected income even though the Hong Kong shirt vendor no longer conducts any business within the United States.

income.⁵⁴

Branch Profits Tax. In the case of domestic corporations, investment income is taxed at what is sometimes referred to as a second-level or second-tier withholding tax, *i.e.*, a double tax on corporate earnings.⁵⁵ This means that earnings of domestic corporations are first taxed at the corporate level,⁵⁶ and then again at the shareholder level when they are distributed or deemed distributed.⁵⁷ If foreign investors (shareholders) own a domestic corporation, or a subsidiary of a foreign corporation which is incorporated within the United States, the outcome would be the same.⁵⁸

On the other hand, prior to the Tax Reform Act of 1986, it was likely that foreign investors who owned foreign corporations which conducted business within the United States through an agent or branch would not be subject to the second level tax since a distribution was treated as foreign source income.⁵⁹ It was because of this lack of symmetry between tax treatment of foreign investors who owned domestic corporate shares and foreign investors who owned foreign corporate shares in corporations that conducted business within the United States

⁵⁴ I.R.C. § 864(c)(7).

⁵⁵ Kaplan, Richard L., Federal Taxation of International Transactions, (St. Paul, Minnesota: West Publishing, 1988), p. 596.

⁵⁶ I.R.C. § 11(b). This rate is approximately 34 percent. The subsection provides:

(b) AMOUNT OF TAX. —

(1) IN GENERAL. — The amount of the tax imposed by subsection (a) shall be the sum of —

- (A) 15 percent of so much of the taxable income as does not exceed \$50,000
- (B) 25 percent of so much of the taxable income as exceeds \$50,000 but does not exceed \$75,000, and
- (C) 34 percent of so much of the taxable income as exceeds \$75,000.

In the case of a corporation which has taxable income in excess of \$100,000 for any taxable year, the amount of the tax determined under the preceding statement for such taxable year shall be increased by the lesser of (i) 5 percent for such excess, (ii) \$11,750.

⁵⁷ Kaplan, *supra*, p. 596.

⁵⁸ The domestic corporation would be taxed the marginal 34 percent rate on earnings and the foreign investor would be taxed the flat 30 percent (or lower tax treaty) rate of United States sourced income under section 871(a)(1)(A) of the Code. This flat 30 percent rate roughly corresponds to the rates specified under section 1 of the Code for United States persons.

⁵⁹ Doernberg, *supra*, pp. 55-56. An unincorporated branch of a foreign corporation is part of the corporation itself. As such, the foreign corporation would be taxed on the portion of profits that were earned as part of a United States business. When the remainder of the after-tax profits was repatriated to the foreign corporation's home, the distribution actually took place at the foreign corporation's home, and therefore, was distributed outside the United States.

that drove Congress to enact a branch profits tax in 1986.⁶⁰

The branch profits tax imposes an additional 30 percent tax, which is paid by the foreign branch, on “dividend equivalent amount”.⁶¹ The dividend equivalent amount, as defined in the Code, is that amount of the foreign corporation’s effectively connected earnings and profits for the taxable year, subject to certain specified adjustments.⁶² Adjustments are made to decrease the dividend equivalent amount if profits from a foreign corporation’s branch profits are reinvested in qualifying United States assets.⁶³ Conversely, adjustments are made to increase the dividend equivalent amount if a foreign corporation’s branch profits are either repatriated to the home office or the corporation converts qualifying United States assets into non-qualifying assets.⁶⁴ For purposes of this subsection, qualifying United States assets consist of money and property used by the foreign corporation in connection with the conduct of a business within the United States.⁶⁵

Equally important to the 30 percent tax which is levied against dividend equivalent amounts, Congress imposed a 30 percent tax on interest paid by a branch of a foreign corporation engaged in a United States business.⁶⁶ The tax is

⁶⁰ *Id.*

⁶¹ I.R.C. § 884(a).

⁶² I.R.C. § 884(b).

⁶³ I.R.C. § 884(b)(1).

⁶⁴ I.R.C. § 884(b)(2).

⁶⁵I.R.C. § 884(c)(2)(A). For example, suppose the following: Xanadu is a foreign corporation which was incorporated in 1987. Xanadu earned \$1 million of net income from its United States branch for the taxable year of 1987. Xanadu paid its corporate tax liability and repatriated the remaining profits to its home office. Xanadu’s tax liability will be, at the marginal 34 percent corporate rate, \$340,000 (or, \$1 million X 34%) plus an additional 30 percent on the remaining profit which is \$198,000 (or, \$1 million - \$340,000 X 30%) for a total tax liability of \$538,000 (or, \$340,000 + \$198,000).

However, if Xanadu does not wish to repatriate its after-tax profits to its home office, but instead reinvests the after-tax profits in a qualifying United States asset, there will be no additional tax liability of 30 percent. Xanadu will only be taxed the marginal 34 percent corporate rate on its United States business profits.

Alternatively, suppose Xanadu does reinvest the after-tax profits from its United States branch in a qualifying United States asset, but decides in 1988 to transfer \$500,000 to its home office because its United States branch has earned no profits in 1988. That \$500,000 will be subject to the 30 percent branch profits tax by Xanadu’s divestment of a qualifying United States asset.

Note: even if Xanadu earns no net net income and repatriates no money to its home office in 1988, it may be liable the 30 percent on depreciation taken since depreciation of United States property will effectively decrease the basis of Xanadu’s United States assets under section 1016 of the Code.

⁶⁶ I.R.C. § 884(f).

paid by the branch. The rationale for taxing foreign corporations on interest paid is that interest payments decrease taxable income, thereby changing effectively connected earnings and profits, and eventually, the dividend equivalent amount on which the branch profits tax is base.⁶⁷

Accordingly, there are two important rules for taxing interest paid by a foreign corporation engaged in a United States business. The first rule provides that interest paid by a foreign corporation will be taxed as though it were paid by a domestic corporation.⁶⁸ The second rule provides that any interest actually paid that exceeds the interest allowable as a deduction under section 882 will be treated as paid by a fictional subsidiary to the parent, and therefore, it will be subject to the 30 percent rate.⁶⁹

Foreign Investment in Real Property Tax Act (FIRPTA). In the same way that Congress wished similar treatment between foreign corporations and domestic corporations by enacting the branch profits tax, Congress enacted section 897, the Foreign Investment in Real Property Tax Act, or FIRPTA, in 1980.⁷⁰ Prior to FIRPTA, foreign investors who were engaged in a business of buying and selling real property within the United States were taxed upon the gain from the sale of real property, whereas foreign investors who were not engaged in a business of buying and selling real property within the United States were not.⁷¹ Today, under FIRPTA, any foreign investor who receives gain from the sale of a United States real property interest has a tax liability on that gain as if the taxpayer were engaged in a trade or business within the United States which is effectively connected to that United States trade or business.⁷² If a foreign investor holds a United States real property interest through a partnership or trust, and that United States real property interest is subsequently sold for a gain, the Code will look through the entity and attribute that gain to the foreign investor.⁷³ Such income is subject to a special 10 percent withholding tax on the amount realized on the disposition of the

⁶⁷ Doernberg, *supra*, p. 59.

⁶⁸ I.R.C. § 884(f)(1)(A). As a result, the investor who receives the interest payment will be subject to the flat 30 percent rate.

⁶⁹ I.R.C. § 884(f)(1)(B).

⁷⁰ Doernberg, *supra*, p. 62.

⁷¹ *Id.*

⁷² I.R.C. § 897(a). For purposes of the section, section 897(c) provides that a United States real property interest shall include fee simple ownership, leaseholds, options, and natural resources interests.

⁷³ I.R.C. §§ 875 and 897(g).

real property interest.⁷⁴

One final note concerning FIRPTA: a stock interest in a domestic corporation is a United States real property interest, and as such, it will be subject to FIRPTA if the corporation is a United States real property holding corporation.⁷⁵ A United States corporation will be considered a United States real property holding corporation if the fair market value of its total real property interest equals or exceeds 50 percent of the fair market value of its total real property interest and business assets.⁷⁶ Thus,, if a foreign investor owns shares in a foreign corporation that owns both foreign and United States real property interests, it is possible that the foreign corporation will be considered a United States real property holding corporation which will subject the foreign investor to the same tax treatment as though the foreign investor owned shares in a domestic corporation.⁷⁷

B. ESTATE AND GIFT TAX CONSIDERATIONS

Estate Taxation. In the area of estate taxation, property which is deemed situated in the United States is includible in the nonresident alien decedent's United States gross estate.⁷⁸ Property situated in the United States is determined by

⁷⁴ I.R.C. § 1445. *Note:* a foreign corporate shareholder is not generally taxed on the sale of a United States real property interest under FIRPTA because it is the foreign corporation itself which is taxed on any gain.

⁷⁵ I.R.C. § 897(c)(2).

⁷⁶ *Id.*

⁷⁷ To illustrate, suppose a foreign corporation owns United States real property with a fair market value of \$500,000, foreign real property with a fair market value of \$250,000, and business assets with a fair market value of \$50,000. That foreign corporation would be considered a United States real property holding corporation under the statute because the fair market value of the United States real property exceeds 50 percent of the corporation's total real estate assets and business assets. — ($\$500,000/\$800,000 = \$60,000$) — Thus, the stock would be considered a United States real property interest.

However, if the asset ratio changes it will effect the foreign corporation's status as a United States real property holding corporation.

But, *caveat:* there is a five-year testing period which sets the determination date. Those dates are usually either the last day of the corporation's taxable year and the date of each transaction which will change the corporation's status. Treas. Regs. § 1.897-2(c).

⁷⁸ I.R.C. § 2103. For estate taxation purposes, as opposed to income taxation, the Code does not define nonresident alien individuals. The Regulations do, however, define a resident decedent as a decedent who was domiciled within the United States with the intention of permanently staying. Treas. Regs. § 20.01(b)(1). Thus, one can infer from the Treasury's definition of a resident decedent that a nonresident alien decedent would be an alien decedent who was not domiciled in the United States and did not have any intention of doing so. Accordingly, an individual may be a resident for income taxation purposes, but not a resident for estate taxation purposes.

separate rules according to the type of property. Some of the more unique types of property which are of concern to foreign investors include stock in a United States corporation and debt obligations.

The Code provides that stock held in a United States corporation by a nonresident alien decedent has a United States situs for estate tax purposes, and therefore, is includible in the gross estate.⁷⁹ Conversely, stock held in a foreign corporation does not have a United States situs.⁸⁰ Thus, the situs of stock is determined by whether it is stock of a United States corporation or stock of a foreign corporation.

As a general rule, debt obligation of a United States person or the United States government, a state or political subdivision is a United States situs property.⁸¹ There are exceptions to the rule, the most noteworthy is the instance where a United States corporation has 80 percent or more of its gross income from foreign business for a three-year period, the debt obligation of the corporation is not a United States situs property.⁸² Other exceptions include: deposits with a foreign branch of a United States bank have a foreign situs;⁸³ United States bank deposits do not have a United States situs;⁸⁴ and, portfolio interest which is exempt under section 871(h)(1) of the Code does not have United States situs.⁸⁵

Estate tax rates applicable to United States citizens also apply to nonresident alien decedents.⁸⁶ The rates range from 18 percent on the first \$10,000 of the taxable estate to a maximum of 55 percent on taxable estates in excess of \$3 million.⁸⁷ Computation of estate tax liability for nonresident alien decedents is as follows: a tentative tax is first computed on the amount of the United States taxable estate and the amount of adjusted taxable gifts not included in the United States

⁷⁹ I.R.C. § 2104(a).

⁸⁰ Treas. Regs. § 20.2105-1(f).

⁸¹ I.R.C. § 2104(c).

⁸² *Id.*

⁸³ I.R.C. § 2105(b)(3).

⁸⁴ I.R.C. § 2105(b)(1).

⁸⁵ I.R.C. § 2105(b)(3).

⁸⁶ I.R.C. § 2101(b).

⁸⁷ I.R.C. § 2001(c).

taxable gross estate.⁸⁸ Then an amount is subtracted equal to a second tentative tax using the estate tax rates on adjusted taxable gifts.⁸⁹ An adjusted taxable gift is defined as the total amount of gifts made by the decedent after December 31, 1976.⁹⁰

Gift Taxation. In the area of gift taxation, nonresident alien individuals are subject to United States gift tax on any gratuitous transfers of tangible property situated within the United States.⁹¹ Intangible property transferred by a nonresident alien individual is not subject to gift tax,⁹² as is the case with the estate tax. Property situated within the United States is, however, determined under the same principals as estate taxation.⁹³ Thus, in order for property to be subject to gift taxation by nonresident alien individuals, it must be situated in the United States and it must be tangible property.

C. SPECIAL PROVISION OF WITHHOLDING TAX ON FOREIGN PARTNERS

Section 1446 of the Code requires foreign and domestic partnerships to pay a withholding tax on any effectively connected income from a United States trade or business allocable to foreign partners.⁹⁴ Foreign partners are defined as any partner who is not a United States person.⁹⁵

The rates of withholding vary according to the classification of the foreign partner. Foreign partners who are individuals are subject to a withholding of 31

⁸⁸ I.R.C. § 2101(c).

⁸⁹ *Id.*

⁹⁰ I.R.C. § 2101(c).

⁹¹ I.R.C. §§ 2501(a) and 2511(a).

⁹² *Id.* Note: there has been much discussion as to what constitutes tangible and intangible property for Federal gift taxation purposes. Of special interest in the area of transfers of bank accounts located within the United States by a nonresident alien. If a gift of a bank account is made by an assignment, most commentators agree that it is not subject to Federal gift taxation since an assignment of a bank account is considered a transfer of intangible property. However, if a gift is made by check of the proceeds in that account, it is subject to Federal gift taxation since the Service views checks as the equivalent of cash, cash being tangible property.

⁹³ I.R.C. § 2511.

⁹⁴ I.R.C. § 1446(a).

⁹⁵ I.R.C. § 1446(e).

percent.⁹⁶ Foreign partners which are corporations are subject to a withholding rate of 34 percent.⁹⁷ Each foreign partner of a partnership is allowed a credit under section 33 of the Code for such partner's share of the withholding tax paid by the partnership,⁹⁸ and once the withholding tax has been paid by the partnership, a partner's share of the withholding tax is treated as a distribution to the partner.⁹⁹ Hence, a partnership may have several classes of partners, each with different applicable rates of withholding requirements.¹⁰⁰

III. CONCLUSION

As we have seen, in the area of income taxation, the first step in the analysis is determination of the foreign investor's residency status. If the foreign investor is a United States resident for Federal income taxation purposes that foreign investor will be taxed on all worldwide income as that foreign investor were a United States citizen. On the other hand, if the foreign investor is not a United States resident for Federal income taxation purposes, that foreign investor will be taxed a flat 30 percent (or lower treaty) rate on certain types of passive investment gross income received from all United States sources. If a foreign investor is engaged in a trade or business and that United States source income is effectively connected with the United States, then that foreign investor will be taxed on that income at the same graduated rates which apply to United States citizens. Thus, a foreign investor may be taxed (1) on all worldwide income if United States residency applies for Federal income taxation purposes, (2) a flat 30 percent (or lower treaty) rate on United States source income from passive sources, or (3) at the graduated income taxation rates if the income is effectively connected to a United States trade or business.

Corporations which have branch offices in the United States are taxed the

⁹⁷ I.R.C. § 1446(b)(2).

⁹⁸ I.R.C. § 1446(d)(1).

⁹⁹ I.R.C. § 1446(d)(2).

¹⁰⁰ To illustrate, suppose ABCD partnership has four partners: a domestic corporation (A), a United States resident individual (B), a foreign corporations (C), and a foreign individual (D). suppose further that each partner's share of the partnership's income and lost is 25 percent and that the partnership earns \$100,000 of effectively connected income for the taxable year. The partnership must withhold \$8,500 ($\$25,000 \times 34\%$) with respect to C's distributive share of effectively connected income and \$7,000 ($\$25,000 \times 28\%$) with respect to D's distributive share of effectively connected income. Thus, the partnership must withhold a total of \$15,500 ($\$8,500 + \$7,000$) on the effectively connected income allocable to the foreign partners. C will receive a tax credit in the amount of \$8,500 which it must treat as an amount distributed by the partnership, thereby reducing C's basis in the partnership, and D will receive a tax credit in the amount of \$7,000 which must be treated as an amount distributed by the partnership, which will also reduce D's basis in the partnership.

same as domestic corporations or subsidiaries of foreign corporations if income earned in a United States trade or business which is effectively connected to the United States is repatriated to the foreign corporation's home office. The branch profits tax provisions, however, do give relief to a foreign corporation if its branch profits are reinvested in a qualifying United States asset.

Moreover, foreign investors who invest in real property within the United States have parity with United States persons and domestic corporations with the enactment of the Foreign Investment in Real Property Act. Thus, foreign investors in United States property will have their gain taxed as though they are engaged in a trade or business of buying and selling real property within the United States.

With respect to estate and gift taxation, we have seen that all property which is located in the United States will be part of a foreign investor decedent's United States gross estate, and therefore, subject to the same estate tax provisions as United States persons. The gift tax provisions generally mirror the estate tax provisions of the Code. There is one important distinction between the two. That is, intangible property transferred by a nonresident alien individual is not subject to the gift tax.

And finally, domestic partnerships and foreign partnerships with effectively connected income must withhold a portion of the proceeds from a foreign partner's distribution. The amount of proceeds to be withheld depends upon whether the foreign partner is an individual, in which case it would be 31 percent of the distribution, or whether the foreign partner is a corporation, in which case it would be 34 percent.