Guide to U.S. Income Taxation of Foreign Nationals

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Despite the economic and financial turmoil of the past 21 months, the U.S. economy still lies at the center of the economic universe. The fact that the U.S. maintains such a high economic profile is based on several factors. First, it is one of the most stable governments in the world and has a very well-established legal system in place to protect investors' rights. Second, it has the most liquid debt and equity markets in the world, in part because of the diversity of the U.S. economy and the strength of the U.S. dollar. For these reasons, especially during the tumultuous times after September 11th, almost everyone looks to the U.S. for leadership and economic stability.

Because of the U.S.'s high economic profile, most wealthy foreign nationals find themselves subject to U.S. taxation at some point, which can take many forms.

Tax planning for foreign nationals includes an entrance, a U.S. tax presence and an exit strategy.

Foreign Nationals with a U.S. Taxable Presence

The two main types of foreign nationals that fall within the regime of U.S. income taxation are:

- *The foreign investor who spends little or no time in the U.S.:* His U.S. investments generally consist of U.S. stocks and bonds, and perhaps U.S. real estate or real estate investment trusts.
- *The foreign businessperson who spends a good deal of time in the U.S.:* His investment portfolio may be weighted toward U.S. assets. Generally, for substantial stays, he also possesses a U.S. nonimmigrant visa.

Before any tax planning can begin, an adviser must determine whether a foreign citizen is a resident alien (RA) or a nonresident alien (NRA) for U.S. tax purposes. The difference is important; an RA is taxed by the U.S. on worldwide income, an NRA only on U.S.-source investment income and income "effectively connected" with a U.S. trade or business.

U.S. Tax Residency for Income Tax Purposes

The term "resident" for U.S. income tax purposes is not the same as for estate tax purposes. The rules on U.S. residency for income tax purposes are largely contained in Sec. 7701(b) and the regulations.

For U.S. income tax purposes, generally, a foreign national is treated as a U.S. resident for any calendar year if he (1) is a lawful permanent U.S. resident at any time during the calendar year or (2) meets the substantial-presence test. Under certain circumstances, an alien can elect to be treated as a resident.

Lawful permanent resident. To become a lawful permanent U.S. resident, a person must be "lawfully accorded the privilege of residing permanently in the U.S. as an immigrant in accordance with the immigration laws." Therefore, a green-card holder qualifies. A lawful permanent resident continues to be a resident for U.S. tax purposes until this status has been rescinded or administratively or judicially determined to have been abandoned.

Substantial-presence test. Generally, under Sec. 7701(b)(3), a foreign national meets the substantial-presence test and qualifies as a U.S. resident if he is present in the U.S. for at least 31 days during the tax year and meets the 183-day test. The foreign national satisfies the 183-day test if the sum of days present in the U.S. during the current year, plus one third of the days present in the first preceding year, plus one sixth of the days present in the second preceding year, equals at least 183.

However, even if he qualifies under the substantial-presence test, Sec. 7701(b)(3)(B) could prevent an alien from being treated as a U.S. resident if he (1) is actually present in the U.S. for fewer than 183 days during the current year; (2) has a tax home in a foreign country during the year; and (3) has a closer connection to that country than the U.S. for the entire year. Note: an individual does not satisfy the closer-connection test if he has an application pending for a change of immigration status or has taken other steps to apply for a green card.

When counting days in the U.S., an individual would be present for a particular day if he is physically present in the U.S. (not including Puerto Rico and other U.S. territories) at any time during such day. Many exceptions exist in determining whether a day in the U.S. actually counts as a day for the 183-day test. This determination can be quite complex; when the alien wants to establish residency under the substantial-presence test, he should keep very detailed records.

If a foreign national meets certain criteria, he could elect to be treated as a U.S. resident for a portion of the year that immediately precedes the year in which he first meets the substantial-presence test. This allows an individual to elect to have U.S. residence begin when he moves to the U.S., even though he does not meet the substantial-presence test until the next year. This situation may not occur frequently, but it requires extra due diligence when offering the appropriate tax planning advice.

Tax treaty considerations for dual residents. Under most income tax treaties, when an individual is a resident under the laws of both the U.S. and a treaty country, the treaty determines the individual's residence through a series of tie-breaker rules. The tie-breaker rules for residence (provided by Article 4 of the U.S. Model Treaty of 1996 (U.S. Model Treaty), which mirror the tie-breaker rules of most U.S. income tax treaties) are generally applied as follows:

1. The individual is first considered a resident of the country in which he has a permanent home available to him;

2. If the individual has a permanent home in both or neither of the countries, residence will be in the country with which his personal and economic relations are closer (center of vital interests);

3. If the individual's center of vital interests cannot be determined, residence will be in the country of the individual's habitual abode;

4. If the individual has a habitual abode in both or neither of the countries, he will be a resident of the country in which he is a national; and

5. If all of the previous rules do not provide a clear answer, the individual's residence will be determined by a mutual agreement between the competent authorities of the contracting states.

To claim treaty benefits as a resident of a foreign country, a U.S. RA must file a U.S. NRA return and include a form that details the basis for the treaty-based filing position. Claiming foreign residence under a tax treaty is purely elective; it can be quite complex, requiring a thorough review of the foreign national's financial affairs (e.g., the existence of a controlled foreign corporation) and a comparison of the expected global tax liabilities as both a U.S. RA and NRA. A U.S. green-card holder must take particular care; the decision to claim treaty benefits as a foreign resident could potentially be considered as expatriating, and can have significant U.S. income tax consequences.

U.S. NRAs and Tax Issues

No U.S. trade or business. A foreign multinational investor generally invests in U.S. stocks, bonds and real estate. If he does not spend much time in the U.S., he should qualify as a nonresident for U.S. tax purposes, subject to U.S. tax at a 30% rate on U.S.-source investment income not effectively connected with a U.S. trade or business.

A withholding tax system collects the tax due from NRAs on U.S.-source investment income because of the relative ease of enforcement. The tax is generally withheld at the source by the applicable withholding agent (e.g., the person paying the income (generally a financial institution)). Secs. 871 and 1441 and the regulations generally impose a 30% tax on income earned by NRAs and require collection of U.S. withholding tax from NRAs at a flat 30% rate (except for compensation income, which is subject to tax at a graduated rate). The 30% rate can be reduced only by an income-tax treaty. The withholding tax is generally assessed on interest, dividends, rents, royalties and other types of fixed and determinable annual or periodic (FDAP) income.

Interest. Interest (other than qualifying original issue discount (OID)) generally is subject to a 30% tax, unless it qualifies for exemption from U.S. tax. Generally, OID interest is not taxable at the 30% rate until the underlying debenture is either sold or matures. However, the OID exception is not applicable to obligations payable in 183 days or less from the issuance date, or to tax-exempt obligations. The withholding tax system basically converts the accrual rules for U.S. residents to a cash-basis system for NRAs.

The first exception is the portfolio-interest exception, which makes both the U.S. income tax and the 30% withholding tax inapplicable to the interest income from the most common type of debt obligations. This exception was carved out to prevent U.S. debt securities from trading at a disadvantage relative to their foreign counterparts.

Two categories of debt instruments generally qualify for the portfolio-interest exception. The first category is registered obligations. If the debt instrument is in registered form, the portfolio-interest exception applies only if a statement (e.g., Form W-8BEN) declaring that the beneficial owner is not a U.S. person is filed. If such filing is not made, the withholding agent is obligated to withhold at the 30% rate.

The second category is unregistered obligations. If a debt instrument is not in registered form, no statement to the withholding agent is required, as long as the debt instrument was issued under guidelines to prevent it from coming into the hands of a U.S. person. The purpose of the guidelines is to prevent a U.S. person from evading U.S. income tax by capitalizing on the portfolio-interest exemption on an unregistered obligation.

Additional exemptions from withholding tax are interest income from bank deposits, deposits with domestic savings and loan associations and amounts held by an insurance company under an agreement to pay interest.

Dividends. U.S.-source dividends are generally subject to the 30% withholding tax. However, an exception exists for dividends paid from domestic corporations that derive at least 80% of their income from business carried on overseas. The term "dividends" also includes any constructive dividends. For NRAs, constructive dividends should apply only to closely held companies.

Capital gains. U.S.-source capital gains are generally exempt from withholding tax. However, there are a couple of exceptions. First, for proceeds from intellectual property sales, if the price of the property is contingent on its productivity, use or disposition, it would be subject to withholding tax.

Another exception exists for an NRA physically present in the U.S. for 183 days or more during the year. Accordingly, the NRA is subject to a 30% tax to the extent U.S.-source gains on sales or exchanges of capital assets exceed U.S.-source losses. This tax is not enforced by withholding. Note: The 183-day test for Sec. 871 purposes is different from the 183-day test for the Sec. 7701(b) substantial-presence test. The Sec. 871 183-day test does not include Sec. 7701 exclusions. Therefore, in very limited circumstances, the foreign national could be an NRA for U.S. income tax purposes and an RA for the Sec. 871 capital-gain tax. If an income-tax treaty applies, this issue should be eliminated.

Compensation. Compensation is generally accorded treatment different from the typical FDAP-income item. Compensation for a foreign national's services should be treated as if the income were earned from foreign sources, and therefore not subject to U.S. taxation, if:

1. The foreign national is temporarily present in the U.S. for a period(s) not exceeding a total of 90 days during the tax year;

2. The compensation for such services does not exceed $3,000 in the aggregate; and

3. The foreign national's employer is either a foreign person not engaged in a U.S. trade or business or a foreign office of a U.S. person.

Generally, if the compensation does not meet the above criteria, the compensation income would be treated as effectively connected income (ECI) and taxed accordingly. In addition, compensation income (other than certain pension income) would be subject to wage withholding (rather than the 30% FDAP withholding).

Real property. Rents might be subject to 30% withholding. More often than not, rental property qualifies as a U.S. trade or business, subjecting rental income to tax as ECI, not as income subject to the Sec. 871 withholding tax rules. A special election under Sec. 871(d) allows taxpayers to treat a passive rental real estate investment as a U.S. trade or business. This treatment is generally recommended, because deductions (e.g., mortgage interest, real estate taxes, and repair and maintenance costs) are not allowed under the withholding tax regime. For treatment as a U.S. trade or business, refer to "U.S. RA and Tax Issues."

U.S. real property (USRP) sales. Strategies for investing in U.S. real estate were radically changed when Congress passed the Foreign Investment in Real Property Tax Act of 1980.

Generally, under Sec. 897, NRAs must treat the disposition of a USRP interest as ECI with a U.S. trade or business. For individual investors, this would generally result in gains from the sale of USRP interests being taxed at capital-gain rates. A USRP interest is an interest in real property located in the U.S. (or the U.S. Virgin Islands) or any interest (other than an interest solely as a creditor) in any domestic corporation, unless the taxpayer can prove that the corporation does not qualify as a U.S. real property holding corporation (defined simply as a corporation whose USRP interests equal or exceed 50% of its trade or business assets) for the five years prior to its disposition.

U.S. trade or business with ECI. The ECI rules can be quite complex, having a significant impact on an NRA's tax liability. Generally, if an NRA has a U.S. trade or business, the trade or business could affect the tax treatment of FDAP-income items (i.e., withholding tax regime), because of the Sec. 864(c) "force-of-attraction" principles. However, this rule's effect is limited, because the NRA's FDAP-income items must meet either an asset-use test or a business-activities test to be taxed at marginal tax rates, if he also has a U.S. trade or business.

These tests are driven by facts and circumstances. Non-FDAP-income items earned by an NRA through a U.S. business will generally be treated as ECI if they are from U.S. sources. Only in certain limited circumstances would foreign-source income be considered ECI with a U.S. trade or business.

Asset-use test: An NRA meets this test if he derives income from assets used in (or held for use in) the conduct of a U.S. trade or business. The regulations provide three situations that meet the asset-use test:

- The asset is held for the principal purpose of promoting the present conduct of a U.S. trade or business (e.g., plant and equipment);
- The asset is acquired and held in the ordinary course of the U.S. trade or business and is effectively connected with the business (e.g., accounts and notes receivable); or
- The asset is held to meet the present needs of the U.S. trade or business (e.g., bank accounts and securities).

The third example is generally the most applicable to FDAP items. If bank accounts, securities (there is an exception for stock for tax years beginning after June 5, 1996) or other investments are held to meet the business's present (as opposed to future) needs, the assets may be considered used in a U.S. trade or business. The third test would presumably be met if the asset were acquired from funds generated by the U.S. trade or business, income from the asset were retained by the U.S. trade or business and the U.S. trade or business exercised "significant" control over the asset.

Business-activities test. An NRA would satisfy this test if the activities of the U.S. business were a material factor in the realization of the income, gain or loss. Because of the complex nature of this area, many planning opportunities

exist. For example, if the taxpayer were highly leveraged, he would benefit if his assets were in a U.S. trade or business. Proper structuring can play a very important role in a foreign national's U.S. tax planning.

Treaty considerations. Income-tax treaties generally offer residents of the treaty country many U.S. tax benefits. Generally, the withholding tax on interest and dividends is reduced, usually to 0% and 15%, respectively. Also, exemption from U.S. income tax for U.S.-source compensation income (generally limited to $3,000 for foreign nationals temporarily present in the U.S. for no more than 90 days) is expanded to an unlimited amount under most income-tax treaties, provided an individual spends less than half of the year in the U.S. and the compensation is not paid (or borne by) a U.S. employer or a U.S. permanent establishment of a non-U.S. employer.

U.S. RA and U.S. Tax Issues

A foreign national who is a U.S. resident either under the permanent-resident test or the substantial-presence test is generally accorded all of the same rights and privileges under the U.S. tax law as a U.S. citizen. However, there are a few exceptions and special considerations for U.S.-resident foreign nationals.

One of the main differences is the ability to file a joint return. If an RA's spouse does not reside in the U.S., the RA would not generally be allowed to file a joint return. However, Sec. 6013(g) allows an RA to elect to treat an NRA spouse as a U.S. resident, thus allowing them to file a joint return. Once this election is made, it is effective for all future tax years until the election is terminated. The election can be terminated by revocation by the RA and his NRA spouse, death of either spouse, legal separation or at the IRS's discretion. Because the U.S. taxes worldwide income, the nonresident spouse's income would be subject to U.S. tax if the election were made. Therefore, the benefits and costs must be weighed carefully before making an election.

Another issue is the allowance of deductions for dependents. Generally, an NRA should not be able to qualify as a dependent. A limited exception is provided under Sec. 152(b) if the NRA was a resident of a country contiguous to the U.S. (i.e., Mexico or Canada). If both the spouse and a child live in another country, the resident spouse would not be able to take a deduction for the child, unless the child possessed dual citizenship.

One area of confusion can be charitable contributions. Although this is not the proper venue for a thorough discussion of charitable contribution planning for foreign nationals, a couple of points should be noted. For the contribution to be deductible under U.S. law, a charitable contribution must be made to a qualifying domestic charity; accordingly, charitable contributions to foreign charities are not deductible. However, the benefit the funds provide does not have to be to persons or organizations within the U.S. Depending on the foreign national's intentions, charitable contributions could provide planning opportunities.

Once a foreign national is a resident, leaving the U.S. taxation regime is not as easy as it was to enter it. Therefore, exit strategies are important for foreign nationals who do not intend to live out their days in the U.S. Sometimes, the only available option to avoid U.S. taxation of RAs is to expatriate. However, expatriating creates certain consequences and can be an administrative burden.

Expatriation

Any person who relinquishes U.S. citizenship with the principal purpose of avoiding U.S. income, gift or estate tax is subject to an alternative taxation for the 10 years following expatriation. Prior to the passage of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), this regime only applied to RAs in a limited fashion. The HIPAA, in part, amended the expatriation rules to also apply to any long-term U.S. resident who (1) ceases to be a lawful permanent U.S. resident or (2) commences to be treated as a resident of a foreign country and does not waive the benefits of such treaty application to such residents. Under Sec. 877(e)(2), a long-term resident is an individual who is a lawful permanent U.S. resident for at least eight tax years during the 15 tax years ending with the tax year during which the expatriating event occurred (i.e., the eight-year test).

Regardless of actual purposes, the loss of long-term residency is deemed tax-motivated if the expatriating individual has an annual U.S. tax liability of more than $100,000 over the preceding five years, or had net worth of at least $500,000. These threshold amounts for both tests have been indexed for inflation since 1996, and are $120,000 and $599,000, respectively, for expatriations occurring in 2002. Individuals who file a ruling request to determine whether the expatriation was not tax-motivated may be excepted.

Individuals who expatriate and who may submit a ruling request include (1) those born a dual citizen of the U.S. and another country and who continue to be a citizen of the other country following expatriation; (2) those who return to the country in which they were born, their spouse was born or either of their parents was born and (3) those not present for more than 30 days in any year of the 10-year period preceding expatriation.

To avoid the "expatriation tax," foreign nationals must submit a ruling request to the IRS in good faith. Notice 97-19 provided that the individual had to submit the ruling request and the IRS had to make a determination before the individual was considered to have expatriated without a tax-avoidance purpose. Because of the administrative burden, Notice 98-34 changed the expatriation process. A ruling request need only be submitted before the expatriating individual will not be subject to the expatriation tax rules. (However, if the IRS were to determine that an individual's expatriation was tax-motivated, he would have to amend any returns filed while the ruling request was pending.)

The documentation that must be submitted with an expatriation ruling request is extensive and requires a series of complicated tax calculations (both U.S. and foreign), filing a balance sheet listing all assets (including interests in trusts), a list of all gifts made five years prior to expatriation (or expected to be made over the next 10 years), the returns filed for each of the tax years preceding expatriation, the status of any ongoing IRS audits and much more. In addition, any individual who expatriates and whose net worth exceeds $500,000 must file Form 8854, Expatriation Information Statement. The U.S. tax consequences of expatriation can be very serious, and pre-expatriation tax planning should be sought.

Summary

A complete tax planning strategy for foreign nationals includes an entrance strategy, tax planning for a U.S. tax presence and an exit strategy. The entrance strategy is to evaluate whether the foreign national should remain offshore and be taxed as an NRA or should come onshore and be taxed as a U.S. resident. After the creation of a U.S. taxable presence, the entrance strategy chosen limits the foreign national to either the withholding tax regime (and possibly the ECI regime) or taxation similar to that of a U.S. citizen.

The exit strategy can be quite simple for an NRA or quite burdensome for an RA (especially one who qualifies as a long-term resident). Therefore, structuring assets prior to establishing a U.S. tax presence is very important. However, even the best-laid plans can be thwarted by business, familial or personal needs. Therefore, a flexible strategy is the best strategy.