U.S. INCOME TAXATION OF FOREIGN PARTIES: A PRIMER

By Professor Ernest R. Larkins*

Over the last five years for which data are available, the number of foreign corporations showing net income on Form 1120F, U.S. Income Tax Return of a Foreign Corporation, has increased 36.5 percent.[1] In addition, the number of individuals granted temporary stays in the United States as non-immigrants has steadily increased from 9.5 million in 1985 to 24.8 million in 1996, an average annual increase of 9.1 percent.[2] These increases evidence growing opportunities to serve international clients and suggest that tax professionals must have a fundamental working knowledge of the way the U.S. tax system treats foreign parties.[3] This article analyzes the basic provisions for tax professionals who wish to obtain such knowledge and highlights tax planning opportunities.

FOREIGN PARTIES DEFINED

U.S. citizens and resident aliens are subject to U.S. taxation on their worldwide taxable incomes. In contrast, the Internal Revenue Code taxes nonresident aliens only on income that is effectively connected with a U.S. trade or business and U.S. source income.[4] Thus, the correct determination of an individual's tax classification is an imperative first step in the calculation of U.S. tax liability.

In a similar manner, corporations are taxable in the United States based on their characterization. Domestic corporations are subject to U.S. tax on a worldwide basis. Foreign corporations, like nonresident aliens, are taxable only on income that is effectively connected with a U.S. trade or business and U.S. source income.

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1. IRS STATISTICS OF INCOME—1994 and 1989. CORPORATION INCOME TAX RETURNS–1997 and 1992.

2. U.S. DEPARTMENT OF JUSTICE, IMMIGRATION AND NATURALIZATION SERVICE, 1996 STATISTICAL YEARBOOK OF THE IMMIGRATION AND NATURALIZATION SERVICE, Chart L, 110 (1996).

3. This article uses the term "foreign parties" to refer to both nonresident aliens and foreign corporations.

4. For a detailed discussion of the source rules, *see* Ernest R. Larkins, *Source of Income Rules: The Debits and Credits of International Taxation*, U.S. TAXATION OF INTERNATIONAL OPERATIONS 6111 (1997).

Nonresident Aliens

A nonresident alien is an individual who neither resides in the United States nor has U.S. citizenship. While the citizenship of a person is often easy to determine, resolving the question of residency for an individual without U.S. citizenship can be rather involved. Generally, U.S. residency occurs when one meets either a lawful permanent residence test or a substantial presence test under I.R.C. § 7701(b)(1).

Treas. Reg. § 301.7701(b)-1(b)(1) treats persons as lawful permanent residents when the U.S. government grants them the legal right to reside permanently in the United States as immigrants. The U.S. Immigration and Naturalization Service issues a card that evidences this right. Though cards issued today are white, they were green at one time. Hence, the lawful permanent residence test is sometimes called the "green card" test.[5] Once individuals secure the right to reside permanently in the United States, they are considered U.S. residents or resident aliens (rather than nonresident aliens). They continue to qualify as U.S. residents until they abandon such status or their rights as U.S. residents are rescinded.

Even when alien individuals are not residents under U.S. immigration law, they still may be residents under U.S. tax law. The substantial presence test is generally satisfied when an alien individual is physically present in the United States during at least 31 days during the current year and 183 "weighted days" over a three-year period.[6] In testing whether the 183-day threshold is reached, I.R.C. § 7701(b)(3) counts each day of U.S. presence during the current year as a whole day. Every day of U.S. presence in the preceding year is counted as one-third of a day, and days of U.S. presence in the second preceding year are weighted by one-sixth. Consider a foreign national who is present in the United States during 140 days in 1999, 90 days in 1998, and 120 days in 1997. This individual meets the substantial presence test during 1999 since her weighted days total 190 (i.e., 140 + 30 + 20). Thus, she is a U.S. resident (or resident alien) in 1999 rather than a nonresident alien.

Individuals close to the 183-day threshold may be able to extend or shorten their U.S. stays depending on whether they desire U.S. residency status. Documentation of U.S. visits and their durations is important.

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5. In 1996, nearly 916,000 alien individuals became U.S. immigrants, an increase of 195,000 over 1995 totals. U.S. DEPARTMENT OF JUSTICE, IMMIGRATION AND NATURALIZATION SERVICE, 1996 STATISTICAL YEARBOOK OF THE IMMIGRATION AND NATURALIZATION SERVICE (1996), at 11.

6. *See, e.g.*, I.R.C. § 7701(a)(9). *See generally*, P.L.R. 9012023 in which the United States generally includes the 50 states, the District of Columbia, and U.S. territorial waters. Thus, an alien individual physically present in a U.S. possession (e.g., Guam or Puerto Rico) is not present in the United States.

Alien individuals can use airline receipts, passport stamps, and personal logs to support assertions of their status under U.S. law.

When either the lawful permanent residence or substantial presence test is met, an individual generally becomes a U.S. resident on the first day of U.S. presence.[7] Three special elections allow persons who are becoming U.S. residents to accelerate their starting residency dates in some situations: (1) the first-year election permits one who arrives in the United States too late during the year to meet the substantial presence test to become a U.S. resident for at least part of the arrival year, (2) the nonresident election allows a nonresident alien married to a U.S. person to become a U.S. resident for the entire year, and (3) the new resident election permits an individual who becomes a U.S. resident for part of the current year to elect U.S. residency status for the entire year.[8]

Using one of these elections to shift the residency starting date assists one in timing income and deduction items so that worldwide income tax is minimized. For example, a deferred bonus from the home country generally should be received before the residency starting date to avoid potential double taxation. However, if the home country exempts bonuses received after the starting date and the U.S. effective tax rate is below that of the home country, the alien individual might shift his or her residency starting date so that the bonus is received as a U.S. resident.

Special rules often preclude certain individuals from becoming U.S. residents even though they meet the substantial presence test. Full-time diplomats and other foreign government-related personnel generally are considered nonresident aliens even though their U.S. stay may be protracted. Teachers, students, and trainees who are temporarily in the United States are usually nonresidents also. The U.S. presence of students is generally temporary if the stay does not extend beyond five calendar years. Teachers and trainees are considered temporarily in the United States for at least two calendar years. Since the special treatment extended to teachers, students, and trainees is partially based on the type of visa held, the strategic application for the right type of U.S. visa can have favorable income tax implications. Of course, some visas may be more difficult to obtain from U.S. immigration authorities than others, depending on an individual's circumstances. Finally, other foreign persons with closer connections to their home country, individuals that regularly commute to work from Mexico or Canada, aliens who must prolong their U.S. stays because of medical conditions that developed

7. I.R.C. § 7701(b)(2)(A)(iii); Treas. Reg. § 301.7701(b)-4(a).
8. I.R.C. §§ 7701(b)(4), 6013(g), (h).

while present in the United States, and certain professional athletes temporarily in the United States to compete in a charitable sporting event can avoid U.S. residency status.[9]

Notwithstanding the rules discussed above, U.S. income tax treaties can affect an individual's residency status in some circumstances. In particular, an alien individual is a "dual resident" if he is a U.S. resident under the above rules and, under local law, also a resident of his or her home country with which the United States has a treaty. Dual residents must apply a series of tie-breaker rules to determine their country of residence under the treaty. For example, the U.S. Model Treaty indicates that one should determine residency, if possible, on the basis of his permanent home.[10] When he has a permanent home available in both countries, his residency depends on his center of vital interests (i.e. the country to which his personal and economic relations are closer). If no permanent home exists or the center of vital interests is not clear, an individual resides in the country of his habitual abode. When he has such an abode in both or neither countries, the U.S. Model Treaty uses citizenship as the determining factor. The competent authorities in the treaty countries (e.g., the IRS) determine the residency status of individuals who are citizens of both or neither countries.

Foreign Corporations

Under I.R.C. § 7701(a)(5), a domestic corporation is created under the laws of the United States or one of its states. In contrast, a foreign corporation is organized abroad. Thus, the sole determinant of corporate character under U.S. law is the location where articles of incorporation or similar papers are filed.

Incorporated entities created under the laws of a foreign country or U.S. possession (e.g., Guam) are foreign corporations. A corporation organized abroad is a foreign corporation even if most or all of its employees, assets, or business activities are located in the United States. Unlike the tax laws in many countries, the place from which a corporation is controlled and its "seat of effective management" are irrelevant in determining whether the entity is a domestic or foreign corporation.

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9. I.R.C. § 7701(b)(5), (7). To qualify under these special rules, alien individuals generally must timely file Form 8843, Statement for Exempt Individuals and Individuals with Medical Conditions, or Form 8840, Closer Connection Exception Statement for Aliens. For a more detailed discussion of U.S. residency, *see* Ernest R. Larkins, *Individual Tax Planning: Resident vs. Nonresident May Be Critical*, 7 J. INT'L TAX'N 410 (1996); Ernest R. Larkins, *Resident vs. Nonresident: Tax Planning Includes Elections, Timing*, 8 J. INT'L TAX'N 172 (1997).

10. Convention for the Avoidance of Double Taxation, Sept. 20, 1996, U.S.- ,1 TAX TREATIES (CCH) ¶214 (1998), at art. 4(2) [hereinafter U.S. Model Treaty].

Like the choice some alien individuals have between U.S. residency or non-residency, an entity's initial decision of whether to organize as a domestic or foreign corporation is an important one. As discussed in more detail later, the United States exempts some income of foreign corporations from taxation and taxes other income items at varying rates.

TRADE OR BUSINESS REQUIREMENT

Unless a treaty provides otherwise, income of a foreign party that is effectively connected with a U.S. trade or business (ECI) is subject to U.S. taxation at regular rates. ECI cannot generally exist under I.R.C. § 864(c)(1)(B) unless the foreign party is engaged in a U.S. trade or business. In other words, the existence of a trade or business is a prerequisite to a finding of ECI. The first line of defense for foreign parties that do not wish to be taxed on ECI is to establish the lack of a U.S. trade or business.

Though the Internal Revenue Code and Treasury Regulations use the phrase "trade or business" ubiquitously, neither defines it. Moreover, Rev. Proc. 98-7, 1998-1 I.R.B. 222, §4.01(3), indicates that the IRS ordinarily will not rule on whether a party is engaged in a U.S. trade or business nor whether income is effectively connected with a U.S. trade or business. Prior judicial and administrative rulings provide the most relevant guidance on trade-or-business-type questions.

Generally, a trade or business is any considerable, continuous, and regular activity engaged in for profit.[11] Rev. Rul. 73-522, 1973-2 C.B. 226, normally characterizes minimal, sporadic, or irregular transactions as investment, rather than business, activities. I.R.C. § 875 treats a foreign party as engaged in a U.S. trade or business if the partnership of which the foreign party is a member is so engaged. *United States v. Balanovski,* treats partnerships as carrying on business when one or more of their partners are conducting business on the partnership's behalf.[12] For example, the ABC partnership is organized in Brazil, and each of its three partners are Brazilian citizens and residents. Partner A conducts business in the United States on behalf of the partnership. As a result, the partnership is considered to be engaged in a U.S. trade or

11. *See, e.g.,* Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987); European Naval Stores, Co., S.A. v. Commissioner 11 T.C. 127, 133 (1948); Lewenhaupt v. Commissioner, 20 T.C. 151, 163 (1953), *aff'd per curiam*, 221 F.2d 227, 227 (9th Cir. 1955).

12. United States v. Balanovski, 236 F.2d 298 (2nd Cir. 1956).

business, as are partners B and C. A similar rule applies to the beneficiaries of estates and trusts.[13]

Beyond this general definition, certain specific activities have been held to constitute trades or businesses. For example, a foreign party that regularly sells goods into the United States through a dependent or exclusive, independent agent is conducting a U.S. trade or business.[14] Similarly, an agent that regularly exercises broad powers to manage a foreign party's U.S. real estate investments (beyond mere ownership or collection of rent) causes the principal to be engaged in a U.S. trade or business.[15]

Rev. Rul. 56-165, 1956-1 C.B. 849 treats a foreign enterprise as engaged in a U.S. trade or business when it sends an employee or other dependent agent to the United States to sell goods and conclude contracts. Employees that do not have the power to conclude contracts but who must send solicited orders to the home office for approval is one arrangement that can avoid trade or business status. However, if marketing representatives or employees are technically precluded from concluding contracts but the home office approves virtually all orders through no more than a "rubber stamp" procedure, the IRS will likely view the activity as a trade or business; the fact that the representative cannot conclude contracts must be more than a formality.

In contrast to the situations above, direct sales into (or purchases from) the United States are not considered a trade or business if the foreign seller (or purchaser) has no office, employee, or agent in the United States or if sales are made through a nonexclusive, independent agent with multiple principals.[16] Also, technical services performed in the United States incident to the sale of goods are not, by themselves, a trade or business. Absent other activities, the mere creation of a corporation, collection of passive income (e.g., in relation to a net lease), ownership of realty or corporate stock, investigation of business opportunities, or distribution of earnings do not constitute a trade or business.[17]

Higgins v. Commissioner confirms that mere investment activities on one's own account, even if actively and continuously engaged in, are

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13. I.R.C. § 875; *see, e.g.,* Di Portanova v. United States, 690 F.2d 169 (Ct. Cl. 1982).

14. Handfield v. Commissioner, 23 T.C. 633 (1955); Rev. Rul. 70-424, 1970-2 C.B. 150.

15. Lewenhaupt v. Commissioner, 20 T.C. at 163, *aff'd per curiam,* 221 F.2d 227 (9th Cir. 1955); Rev. Rul. 73-522, 1973-2 C.B. 226.

16. Amalgamated Dental, Co., Ltd. v. Commissioner, 6 T.C. 1009, 1018 (1946); Tech.Adv.Mem. 81-47-001 (Jan. 3, 1979).

17. G.C.M. 18835 (1937), 1937-2 C.B. 141; Neill v. Commissioner, 46 B.T.A. 197 (1942); McCoach v. Minehill & Schuylkill Haven R.R. Co., 228 U.S. 295 (1913); U.S. v. Balanovski, 131 F.Supp. 898 (S.D.N.Y. 1955); Abegg v. Commissioner, 50 T.C. 145 (1968), *aff'd on other grounds,* 429 F.2d 1209 (2nd Cir., 1970).

not considered a trade or business.[18] Thus, a foreign investor that trades commodities (of the type normally listed on organized exchanges), stocks, and securities in the United States on its own behalf or through an independent agent is generally not carrying on a U.S. trade or business. However, I.R.C. § 864(b)(2) indicates that a trade or business does exist if the investor is a dealer in such stocks and securities or, in the case of trading through an independent agent, the investor has a U.S. office or other fixed place of business at any time during the taxable year through which trading is directed.

Occasional or single, isolated transactions generally do not lead to a finding of trade or business activities.[19] However, the IRS and the courts have held that a single event (often involving substantial personal service income) can be a trade or business. For example, a prize fighter's engagement in one or more boxing matches has been held to be the conduct of trade or business activities.[20] Rev. Rul. 67-321, 1967-2 C.B. 470 held that a French company that contracts to perform a floor show or night club revue in a U.S. hotel over a ten-week period is engaged in a U.S. trade or business. Similarly, the purse winnings of a horse entered in only one race within the United States may be taxable since the IRS has ruled that a single race is a U.S. business activity.[21] On the other hand, *Continental Trading, Inc. v. Commissioner* held that numerous but "isolated and noncontinuous" sales transactions do not constitute a trade or business when motivated for tax avoidance, rather than profit-making, reasons.[22]

The rendition of personal services is generally considered carrying on a trade or business. However, a nonresident alien performing de minimis services in the United States, whether as an employee or independent contractor, is not engaged in a U.S. trade or business when the three conditions of I.R.C. § 864(b)(1) are met. First, the compensation cannot be more than $3,000 for the U.S. services. Second, the U.S. presence during the taxable year cannot exceed 90 days. Third, the services must be rendered for either a foreign party not engaged in a U.S. trade or business or a foreign office or place of business of a U.S. party.

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18. Higgins v. Commissioner, 312 U.S. 212 (1941).

19. Pasquel, 12 T.C.M. 1431 (1954); European Naval Stores, Co., S.A. v. Commissioner, 11 T.C. 127 (1948).

20. Rev. Rul. 70-543, 1970-2 C.B. 172; Johansson v. United States, 336 F.2d 809 (5th Cir., 1964).

21. Rev. Rul. 58-63, 1958-1 C.B. 624; Rev. Rul. 70-543, 1970-2 C.B. 172.

22. Continental Trading, Inc. v. Commissioner, 265 F.2d 40 (9th Cir. 1959).

EFFECTIVELY CONNECTED INCOME

Once the existence of a U.S. trade or business is established, the next question is whether any income is effectively connected with it.[23] Under I.R.C. § 864(c)(1)(B), foreign parties do not have ECI unless they are engaged in a U.S. trade or business during the taxable year. Six exceptions to this general rule exist in which the tax law treats income as ECI despite the absence of a trade or business or despite the lack of relationship between the income and a trade or business.

- I.R.C. §§ 871(d) and 882(d) allow foreign parties to treat any income from investment realty, including gains from sale or exchange, as ECI. Any such election continues in effect for all subsequent years unless revoked with IRS consent.
- Under I.R.C. § 882(e), interest on U.S. obligations that a possession corporation receives is ECI if the corporation is carrying on a banking business. The effect of this provision is twofold: (1) it allows possession banks to offset interest income from U.S. sources with business expenses, such as interest expense they pay to depositors, and (2) it removes a major disincentive for possession banks to invest their capital into the U.S. economy, namely a 30 percent tax on gross interest income.
- I.R.C. § 897 treats gain from the sale, exchange, or other disposition of a U.S. real property interest as ECI. A U.S. real property interest includes direct holdings in U.S. realty and certain indirect holdings through domestic corporations (as discussed later).
- When a foreign party receives deferred compensation during a year when no U.S. trade or business is conducted, I.R.C. § 864(c)(6) taxes it as ECI if attributable to a prior year when the foreign party did engage in a U.S. trade or business. For example, assume a foreign corporation carries on a U.S. retail business in 19x1 and makes an installment sale. Before the end of 19x1, the corporation closes the retail establishment and ceases to conduct any U.S. trade or business. When the installment obligation is collected in 19x2 or a later year, the deferred profit from the 19x1 sale is taxed as ECI.
- Under I.R.C. § 864(c)(7), a foreign party that ceases to use an asset in its U.S. trade or business and disposes of the asset within ten years of such cessation is taxable on any resulting gain as ECI, even if the foreign party is no longer engaged in a U.S. trade or business.

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23. *See, e.g.*, Alan B. Stevenson, *Is the Connection Effective? Through the Maze of Section 864*, 5 NW. J. INT'L L. & BUS. 213 (1983); Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689 (1987); and Christine Bouvier, *Foreign Corps. in U.S. Must Be Wary of Effectively Connected Income*, 2 J. INT'L TAX'N 287 (1992).

• When a foreign party does engage in a U.S. trade or business, I.R.C. § 864(c)(3) treats all U.S. source income that the tax law does not explicitly tax or exempt as ECI. This limited "force of attraction" rule assures that income the United States intends to tax is not inadvertently overlooked. In effect, U.S. source income (other than investment income and capital gains) is attracted to the foreign party's U.S. trade or business and taxed the same as business profits or ECI. To illustrate, Treas. Reg. § 1.864-4(b) assumes a foreign manufacturer with a U.S. selling branch. If the home office occasionally sells its manufactured products directly to U.S. customers without involving the U.S. branch and title to the sales pass in the United States, such profit is treated as ECI even though the U.S. branch played no role in generating the income. Note that the simple way to avoid ECI in this case is to pass title on the sale outside the United States; foreign source income is not subject to this force of attraction rule.

When nonresident aliens performing services in the United States meet the three de minimis conditions discussed earlier, they are not engaged in a U.S. trade or business; thus, their compensation is not ECI. In addition, the satisfaction of these three conditions assures that the compensation is treated as foreign source income under I.R.C. § 861(a)(3).[24] Since the compensation is foreign source income that is not ECI, it is exempt from U.S. taxation. The rules found in U.S. income tax treaties generally are more lenient than these statutory provisions. Thus, personal service income not exempt under the de minimis test may, nonetheless, be exempt under treaty.[25]

U.S. Source ECI

Once the existence of a U.S. trade or business is established, whether a given income item is taxable as ECI is often clear. For example, the net profit from sales a foreign corporation earns from a sales branch or retail outlet in the United States is ECI. However, types of

24. For a specific application, *see* Rev. Rul. 64-184, 1964-1 C.B. 323. Rev. Rul. 69-479, 1969-2 C.B. 149, indicates that any personal service income above the $3,000 threshold causes all of the income to be from U.S. sources, not just the excess portion. A similar interpretation presumably would hold for exceeding the 90-day threshold.

25. For example, Article 15(2) of the U.S. Model Treaty, *supra*, note 10, exempts the income from employee services that a nonresident alien renders in the United States if: (1) the recipient's U.S. presence does not exceed 183 days in any 12-month consecutive period that begins or ends in the taxable year, (2) the employer paying the compensation to the nonresident alien (or the employer on whose behalf the compensation is paid) is not a U.S. resident, and (3) a permanent establishment or fixed base that the employer maintains in the United States does not ultimately bear the expense of the compensation.

income that traditionally have been classified as investment or passive in nature are ECI in some cases; it depends on the income's source.

The manner in which ECI is determined differs for U.S. and foreign source income. U.S. source income that satisfies either the asset use test or business activities test of I.R.C. § 864(c)(2) is ECI. Under both tests, one must give due regard to how the U.S. trade or business accounts for the item in question.

The asset use test treats U.S. source income as ECI if the income is derived from assets currently used or held for current use in the U.S. trade or business. This test applies primarily to passive income such as interest and dividends. Treas. Reg. § 1.864-4(c)(2)(i) indicates that interest from a temporary investment of idle working capital in U.S. Treasury bills is ECI since it is held to meet the *present* needs of the business. In contrast, the income from a long-term investment of excess funds in U.S. Treasury bills with the expectation of using the accumulations for the *future* expansion of product lines or to meet *future* business contingencies is not ECI.

The business activities test concludes that income from U.S. sources is ECI whenever the activities of a U.S. trade or business are a material factor in realizing the income. This test applies to income that, though generally passive, arises directly from business activities. Treas. Reg. § 1.864-4(c)(3)(i) indicates that interest income of a financing business, premiums of an insurance company, royalties of a business that primarily licenses intangibles, dividends and interest of a dealer in stocks and securities, and fees of a service business are ECI under the business activities test.

Foreign Source ECI

Prior to 1966, foreign parties often used the United States as a tax haven for sales activities. The United States, at that time, did not tax foreign source income. Thus, a foreign party might establish a U.S. sales office through which it could sell to third countries. The home country did not tax the profit on such sales because, for example, it was derived from foreign sources. The United States did not tax the profit as long as title passed abroad. The third country did not tax the profit because the seller had no permanent establishment there. Thus, the profit on these sales often escaped income tax altogether.

Under current U.S. law, foreign parties are not taxed on most foreign source income. However, to prevent abuses such as those described above, foreign source income is considered ECI when the three conditions in I.R.C. § 864(c)(4) and (5) are met. First, the foreign party (or the

party's dependent agent) must have a U.S. office or fixed place of business. Second, the office must be a material factor in the production of the foreign source income and must be regularly used in business activities that produce the type of income in question. Third, the foreign source income must be one of the following: (1) royalties from the use of intangible property abroad or (2) dividends or interest derived in the active conduct of either a U.S. banking or finance business or a corporation whose principal business is trading stocks and securities for its own account.

I.R.C. § 864(c)(4)(B)(iii) indicates that foreign source income a foreign party earns through the material effort of a U.S. office is ECI. However, the interaction of this provision with the source of income rules assures that foreign source ECI will never result. In particular, sales of personalty (including inventory) through a U.S. office generally result in U.S. source income, which is ECI through the business activities test.[26] On the other hand, if a foreign office materially participates in the sale and the property is sold for consumption abroad, the income is from foreign sources and is not ECI.[27] In effect, when a foreign party sells inventory through a U.S. office, the profit must be either U.S. source ECI or foreign source income that is not ECI; it cannot be foreign source ECI.

Ordinary Income Taxation

I.R.C. §§ 872(a) and 882(b) grant the United States jurisdiction to tax foreign parties on two broad categories of income: (1) ECI and (2) U.S. source income that is not ECI, which is primarily investment-type income. Other income of foreign parties is exempt from U.S. taxation. For example, the foreign source income of a nonresident alien is not taxable in the United States unless it is ECI.

When no treaty is in force, I.R.C. §§ 871(b) and 882(a) tax the ECI of foreign parties at the regular rates applicable to U.S. parties. Whether the ECI is from U.S. or foreign sources does not matter. I.R.C. § 1231 gain on the sale or exchange of business assets is considered ECI the same as income from business operations.

If an income tax treaty exists, taxation of ECI depends on whether the foreign party has a U.S. permanent establishment. Article 7(1) of the U.S. Model Treaty exempts a foreign party's ECI from U.S. taxation unless the ECI is attributable to a permanent establishment that the foreign party has in the United States. Similarly, the "commercial traveler"

26. I.R.C. §§ 864(c)(2), 865(e)(2).
27. I.R.C. §§ 864(c)(4)(B)(iii), 865(e)(2)(B).

article in U.S. income tax treaties can exempt nonresident aliens' income from dependent personal services that otherwise might be taxable as ECI.[28] Among other things, treaty exemption usually depends on the length of stay in the host country. Article 15 of the U.S. Model Treaty and many other treaties allow stays of no more than 183 days.

I.R.C. §§ 871(a)(1) and 881(a) generally tax U.S. source income that is not effectively connected at 30 percent. The 30 percent rate is withheld at the time of the transaction and is applied to gross income; no deductions are allowed. I.R.C. §§ 1441 and 1442 usually designate the last U.S. party to control the income payment as the withholding agent.[29] For example, a U.S. corporation declares a $1,000 dividend. A foreign party residing in a country that has no income tax treaty with the United States owns all of the U.S. corporation's stock. The U.S. corporation should pay $700 to the foreign party and remit $300 in withheld taxes to the U.S. Treasury. Failure to withhold and remit the correct amount of tax can cause the withholding agent to be liable for the tax.[30]

Most U.S. source income taxable at 30 percent is investment income. I.R.C. §§ 871(a)(1)(A) and 881(a)(1) include dividends, interest, rent, royalties, and annuities in this list. Dividends include only gross income received out of a corporation's earnings and profits.[31] Any original issue discount that is accrued on an obligation's sale date is treated the same as interest per I.R.C. §§ 871(a)(1)(C)(ii) and 881(a)(3). Rental income is subject to the 30 percent withholding tax only if the rental activity is not treated as a trade or business. *Commissioner v. Wodehouse* clarifies that royalties from non-business activities are subject to withholding whether received periodically or as a lump-sum amount.[32] Only the income portion of annuities are taxable; any annuity amount received that is, in essence, a return of capital is not taxed. Similarly, Rev. Rul. 64-51, 1964-1 C.B. 322 provides that the income due when a

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28. *See, e.g.*, Lym H. Lowell, et al., *Tax Issues in the Provision of Inbound Services*, 9 J. INT'L TAX'N 36 (1998).

29. I.R.C. §§ 1441, 1442. Under some circumstances, a foreign party is the payor and, thus, the withholding agent. *See, e.g.,* Rev. Rul. 80-362, 1980-2 C.B. 208, in which a nonresident alien licensed the rights to use a patent within the United States to a Netherlands corporation. The royalty the corporation paid was subject to withholding as U.S. source income.

30. I.R.C. §§ 1461, 1463, 6672.

31. Rev. Rul. 72-87, 1972-1 C.B. 274, clarifies that corporate distributions in excess of earnings and profits are nontaxable returns of capital to the extent of the distributee's tax basis in the stock and capital gain to the extent of any additional amounts received. Since the U.S. corporate distributor may not know what portion of a distribution is from earnings and profits when the distribution is made, it must withhold at 30 percent or a lower treaty rate on the entire distribution. If it is determined later that part of the distribution was not made out of earnings and profits, the foreign distributee will be entitled to a refund.

32. Commissioner v. Wodehouse, 337 U.S. 369 (1949)

life insurance policy matures or from surrendering a life insurance policy is subject to the withholding tax.

U.S. income tax treaties often reduce the tax rate on U.S. source investment income below 30 percent. Interest and royalties are exempt in many treaties and are taxable at 5 to 15 percent in most others. Similarly, treaties normally tax dividends at 5 to 15 percent. The lower 5 percent withholding rate is generally reserved for corporate recipients that own a specified minimum stock percentage of the distributor. For example, Articles 10 through 12 of the U.S. Model Treaty exempt most interest and royalty income from host country taxation and require 15 percent withholding on dividends. However, dividends paid to corporations that own at least 10 percent of the distributor's voting stock are subject to a withholding tax of only 5 percent.

Some types of U.S. source income other than investment returns are subject to a 30 percent withholding tax. For example, amounts received as prizes, awards, gambling winnings (unreduced by gambling losses), and alimony are taxable.[33] I.R.C. §§ 871(a)(1)(B) and 881(a)(2) tax gain on the disposal of timber, coal, and domestic iron ore if the seller retains an economic interest. Similarly, I.R.C. §§ 871(a)(1)(D) and 881(a)(4) tax gain from the sale or exchange of intangibles to the extent the payments are contingent on future productivity, use, or disposition. Treaties may exempt these gains and income items from host country taxation.

Under I.R.C. § 871(a)(3), 85 percent of U.S. Social Security benefits are taxable at 30 percent. However, some treaties exempt such benefits from host country taxation. Assume that under the U.S.-France totalization agreement, a French national and resident is entitled to a $1,000 monthly benefit from the United States. The U.S. Social Security Administration should withhold a tax of $255 each month (i.e., $1,000 x 85% x 30%). Article 18(1)(b) of the U.S.-France income tax treaty does not exempt the income.[34] Now assume that the individual is a national and resident of Germany instead and that the $1,000 benefit is received pursuant to the U.S.-Germany totalization agreement. Under Article 19(2) of the U.S.-Germany income tax treaty, the Social Security benefit received is exempt from U.S. taxation.[35]

Under Treas. Reg. § 1.1441-4(b)(1), compensation from rendering independent personal services (i.e., as a non-employee) may be subject

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33. Barba v. United States, 2 Cl.Ct. 674 (Cl. Ct. 1983); Howkins v. Commissioner, 49 T.C. 689 (1968); Rev. Rul. 58-479, 1958-2 C.B. 60.

34. Convention for the Avoidance of Double Taxation, Aug. 31, 1994, U.S.-Fr., S. TREATY DOC. NO. 103-32 (1994).

35. Convention for the Avoidance of Double Taxation, Aug. 29, 1989, U.S.-F.R.G, 1 TAX TREATIES (CCH) ¶3249 (1998).

to 30 percent withholding.[36] For example, assume a self-employed, non-resident alien attorney receives $50,000 for his advice regarding an international reorganization. If the services are rendered in the United States and unless a smaller percentage is negotiated with the IRS, the income is subject to 30 percent withholding.[37] Unlike the withholding on investment income, Rev. Rul. 70-543, 1970-2 C.B. 172, clarifies that the 30 percent withheld is an estimated prepayment of the tax liability; the actual tax due might be more or less than the amount withheld. U.S. treaties might provide for a different treatment. Article 14 of the U.S. Model Treaty exempts independent services income from host country taxation unless the recipient has a fixed place of business in the host country that is regularly available to him (e.g., an office) and the income is attributable to such place. Thus, if the attorney in the above example had no fixed place of business in the United States available to him, any treaty between his home country and the United States likely would exempt the $50,000 from U.S. taxation.

The two-by-two matrix in Figure 1 summarizes the ordinary income provisions discussed above.

FIGURE 1: U.S. INCOME TAXATION OF FOREIGN PARTIES' ORDINARY INCOME[38]

		Effectively Connected Income	
		Yes	**No**
Source of the Income	**U.S.**	Regular U.S. Tax Rates	30% Withholding Tax on Gross
	Foreign	Regular U.S. Tax Rates	Exempt from U.S. Taxation

36. *See, e.g.,* Rev. Rul. 70-543, 1970-2 C.B. 173.

37. *See also* Rev. Rul. 58-479, 1958-2 C.B. 60, in which commissions that a marine supplier paid to a tramp steamer's foreign shipmaster was subject to U.S. withholding tax.

38. U.S. income tax treaties often exempt effectively connected income. Examples include the treaty articles dealing with business profits not attributable to a permanent establishment and dependent personal service income from short stays in the host country. For non-effectively connected income, U.S. income tax treaties often exempt U.S. source investment income or tax it at rates below 30%

CAPITAL GAIN TAXATION

Capital gain of foreign parties that is ECI is subject to U.S. regular rates, the same as I.R.C. § 1231 gain.[39] The tax treatment of capital gain that is not ECI depends on the source of the gain and the type of taxpayer. For the remainder of this section, capital gain is assumed not to be ECI.

Foreign source capital gain of foreign parties is exempt from U.S. taxation. In addition, foreign corporations are not taxable on U.S. source capital gain.[40] As a practical matter, most capital gain of foreign corporations is foreign sourced. However, U.S. source capital gain can result in some situations, such as when a foreign corporation sells an intangible asset for a contingent price based on future productivity or use within the United States.[41] If such capital gain is not ECI, it is exempt from U.S. tax.

Under I.R.C. § 871(a)(2), a nonresident alien is taxable on U.S. source capital gain only if her presence in the United States is at least 183 days during the taxable year. Recall that an alien individual whose U.S. presence during the taxable year totals 183 days or more is generally a resident under the substantial presence test rather than a nonresident. At first glance, it might appear as though this provision has no application. Nonetheless, foreign government-related persons, teachers, students, trainees, commuters from contiguous countries, and other alien individuals can continue their status as nonresident aliens despite their substantial U.S. presence (as mentioned earlier). When nonresident aliens in one of these special categories have 183 days of U.S. presence, the Internal Revenue Code imposes a 30 percent withholding tax to the difference between capital gains and capital losses for the taxable year. The 50 percent exclusion on capital gains from the sale of certain small business stock under I.R.C. § 1202 is not allowed. Also, no I.R.C. § 1212 capital loss carryovers are allowed to reduce current capital gains.

Several U.S. income tax treaties exempt nonresident aliens from the withholding tax that the Code otherwise imposes on U.S. source capital gains. For example, Article 13(5) of the U.S.-Ireland treaty exempts from host country taxation the capital gains on the disposition of many

39. Arkansas Best Corp. v. Commisioner, 485 U.S. 212 (1988) clarified that a capital asset can be held in connection with a trade or business and that the motivation in acquiring the asset is irrelevant in its classification.

40. I.R.C. § 871(a)(2) imposes a withholding tax on the U.S. source capital gains of nonresident aliens. However, no parallel provision exists to impose a similar tax on foreign corporations; the statute's silence is equivalent to exemption.

41. I.R.C. §§ 861(a)(4), 865(d)(1)(B).

types of "movable" properties.[42] Article 13(6) of the U.S.-Sweden treaty allows only the home country to tax capital gain from disposing of most investment assets other than real estate.[43]

The three-by-two matrix in Figure 2 summarizes the provisions applicable to U.S. source capital gains.

FIGURE 2: TAXATION OF FOREIGN PARTIES' U.S. SOURCE CAPITAL GAINS[44]

	Effectively Connected Income: Yes	Effectively Connected Income: No
Nonresident Alien Present in U.S. < 183 days	Regular U.S. Tax Rates	Exempt from U.S. Taxation
Nonresident Alien Present in U.S. ≥ 183 days	Regular U.S. Tax Rates	30% Withholding on Tax Gains
Foreign Corporation	Regular U.S. Tax Rates	Exempt from U.S. Taxation

REAL ESTATE TAXATION

The management of U.S. real estate is generally considered to be the conduct of a U.S. trade or business. *Fackler v. Commissioner* held that, even when substantial time is not required, paying expenses (e.g., utilities and insurance), making arrangements for necessary repairs, and approving new tenants often is sufficient to qualify the activity as a trade or business.[45] Rev. Rul. 73-552, 1973-2 C.B. 226, clarifies that activities beyond merely collecting rent and paying expenses incidental to the col-

42. Convention for the Avoidance of Double Taxation, July 28, 1997, U.S.-Ir., S. TREATY DOC. NO. 105-31 (1997).

43. Convention for the Avoidance of Double Taxation, Sept. 1, 1994, U.S.-Swed., S. TREATY DOC. NO. 103-29 (1994).

44. The 30% withholding tax applies to the difference between U.S. source capital gains and capital losses allocable to such gains. The Section 1202 exclusion of half the gain from the sale or exchange of small business stock is not allowed. Neither are carryover losses permitted under Section 1212. U.S. income tax treaties often exempt U.S. source capital gains.

45. Fackler v. Commissioner, 133 F.2d 509 (6th Cir. 1943).

lection effort generally result in trade or business status as long as the general conditions of continuity, regularity, and considerableness are met. As discussed earlier, the rental income from business activity, whether directly conducted or carried out through an agent, is taxable at regular U.S. rates since it is ECI. Rental expenses are deductible against rental income only to the extent permitted under U.S. law. Thus, the I.R.C. § 469 passive activity rules can preclude deductions otherwise allowed in computing ECI.

Gross income from investment real estate (other than gain from disposition, which is discussed later) is generally taxable at 30 percent or a lower treaty rate with no deductions for expenses related to the investment. The disallowance of depreciation, interest, and other real estate-related expenses can cause a foreign party to pay a very high effective tax rate. Further, the U.S. tenant in a "net lease" arrangement may pay certain expenses directly to the obligee in lieu of additional rental income (e.g., property taxes paid to the state taxing agency). If the foreign landlord is not engaged in a U.S. trade or business, Rev. Rul. 73-552, 1973-2 C.B. 226, clarifies that the substitute rental payment is subject to withholding the same as rental income actually received.

To alleviate the potential inequity or hardship of taxing investment real estate on a gross basis, foreign parties are allowed to elect net basis taxation under I.R.C. §§ 871(d) and 882(d). Once elected, net basis taxation applies to all U.S. investment realty that the taxpayer holds and generally remains in effect for all subsequent years. However, the election is available only if the foreign party derives some income from the property during the taxable year. Failure to generate income at any time during the year causes the deduction for real estate expenses to be lost. Neither can the expenses be capitalized and added to the real estate's basis according to Rev. Rul. 91-7, 1991-1 C.B. 110. As a practical matter, the taxpayer should arrange to earn at least a nominal amount of income from the property to preserve its deductions.

Rev. Rul. 92-74, 1992-2 C.B. 156, holds that any net loss resulting from the election can be used to offset ECI from other business activities and, if some portion of the loss remains, to generate a net operating loss to carryover to other taxable years. If elected, all income from all U.S. real properties must be treated as ECI. Unless revoked with IRS consent, any election remains in effect for all subsequent years. U.S. income tax treaties often allow a similar election.[46]

Prior to 1980, foreign parties could easily dispose of investment real estate held in the United States with no U.S. tax consequences. For

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46. *See, e.g., supra,* note 10, at art. 6(5).

example, nonresident aliens avoided tax if their presence within the United States totaled less than 183 days during the taxable year. Foreign corporations escaped U.S. taxation simply because the Internal Revenue Code did not impose a tax on capital gain unless it was ECI (as discussed previously). Amid growing reports that foreigners were amassing vast holdings of U.S. farmland because of the favorable investment climate, Congress enacted the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[47]

Under I.R.C. § 897(a)(1), FIRPTA treats a foreign party's gain from the disposition of a U.S. real property interest (USRPI) as ECI, which is taxable at regular U.S. rates, even if the party engages in no U.S. trade or business. The U.S. buyer must withhold income tax on the foreign party's gain. Since the buyer in most cases does not know the seller's adjusted basis in the USRPI, I.R.C. § 1445(a) adopts an alternative withholding method to estimate the required withholding. Unless the seller establishes that a smaller amount should be withheld, the buyer must withholding a tax equal to ten percent of the seller's amount realized (rather than the seller's gain). In contrast to most other withholding procedures, the withheld amount is a mere estimate of the tax liability; any additional tax owed or refund due must be settled on the U.S. tax return for the year. For example, Juan (a nonresident alien) owns U.S. real estate that he bought for $820,000 two years ago. Juan sells the real estate to David (a U.S. citizen) for $1 million, which results in $180,000 gain. Generally, David must withhold $100,000 income tax on the sale so that Juan receives only $900,000. When Juan files his U.S. tax return, he should be entitled to a refund of the excess withholding (assuming no other taxable income). If Juan's effective U.S. tax rate is 21 percent, his actual tax liability from the sale is $37,800 (i.e., 21 percent of $180,000), and he is entitled to a refund of $62,200 (i.e., $100,000 withheld less $37,800).

When a loss results from the disposition of a USRPI, it is deductible only to the extent the taxpayer has ECI; that is, it is not deductible against the foreign party's U.S. source investment income. If the loss is from the sale or exchange of a capital asset, Rev. Rul. 92-74, 1992-2 C.B. 156, indicates that the deductibility of the loss is further limited to a foreign corporation's capital gains and a nonresident alien's capital

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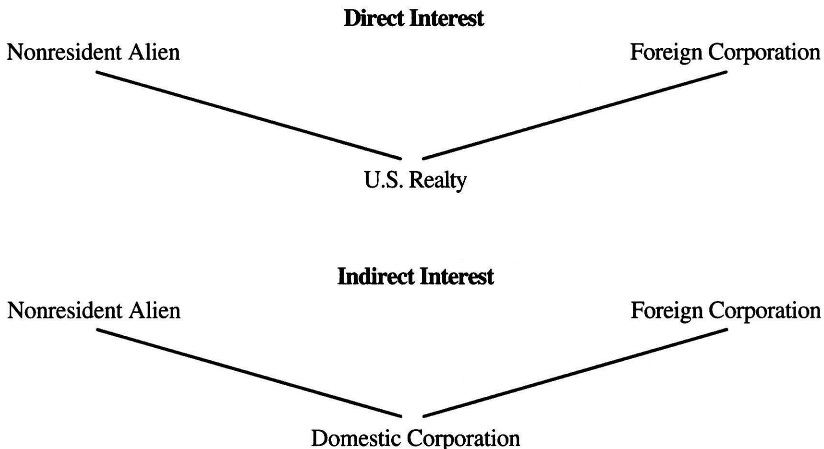
47. For a more detailed discussion of the pre-1980 environment, see U.S. DEPARTMENT OF THE TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE (1979); William H. Newton III, *Structuring Foreign Investment in United States Real Estate*, 50 U. MIAMI. L. REV. 517 (1996); Yoseph M. Edrey, *Taxation of International Activity: FDAP, ECI and the Dual Capacity of an Employee as a Taxpayer*, 15 VA. TAX. REV. 653 (1996); and Irwin O. Segal, et.al., *Foreign Investment in U.S. Real Estate: No Perfect Structure*, 9 J. INT'L TAX'N 22 (1998).

gains plus $3,000. In addition, a FIRPTA loss that constitutes a passive activity loss is deductible only to the extent of the taxpayer's passive activity gain. When a nonresident alien incurs a FIRPTA loss, I.R.C. § 897(b) permits a deduction only if the disposed real estate is (1) used in a for-profit activity or (2) damaged or lost through a casualty or theft. Thus, FIRPTA losses must clear several hurdles before their deductibility is allowed.

As depicted in Figure 3, USRPIs take one of two forms—direct ownership of U.S. real estate and indirect ownership. Under I.R.C. § 897(c)(1)(A)(ii), the indirect ownership involves an interest in a domestic corporation that is a U.S. real property holding company. I.R.C. § 897(c)(2) states that a U.S. real property holding company exists if at least 50 percent of the domestic corporation's assets (measured by fair market value) are direct and indirect interests in U.S. realty. For example, a domestic corporation that owns U.S. investment realty valued at $11, foreign realty valued at $6, and other business assets worth $3 is a U.S. real property holding company (i.e., $11 is at least 50 percent of $20). Thus, any foreign party that sells stock in this domestic corporation is taxable on any resulting gain at regular U.S. rates.

FIGURE 3: U.S. REAL PROPERTY INTERESTS: ECI ON DISPOSITION[48]



Treas. Reg. § 1.897-2(b)(2) specifies an alternative test for U.S. real property holding company status based on book value (rather than fair market value). The alternative test is administratively easier to monitor, but the threshold is only 25 percent (rather than 50 percent). In the prior example, assume that the book values of the U.S. realty, foreign

48. At least 50 percent of the assets' fair market value or 25 percent of the assets' book value is attributable to direct or indirect interests in U.S. realty.

realty, and business assets are $2, $6, and $2, respectively. Under the book value test, the domestic corporation is not a U.S. real property holding company (i.e., $2 is less than 25 percent of $10). Assuming this alternative test is used, any gain that results when the foreign party in this example sells the domestic corporation's stock is not subject to FIRPTA.

Branch Profit Taxation

The U.S. branch of a foreign corporation is taxed at regular rates on its ECI. The U.S. subsidiary of a foreign corporation is similarly taxed on its ECI. In addition, the dividends that the U.S. subsidiary pays to its foreign parent company are subject to U.S. taxation at 30 percent or a lower treaty rate (as discussed earlier). Absent an equivalent tax on profits that a branch remits to its foreign office, the branch form of operation is treated more favorably than a subsidiary doing business in the United States.

To assure parity between subsidiaries and branch operations, I.R.C. § 884 imposes a branch profits tax on foreign corporations with U.S. business operations. Since branch remittances may be difficult to measure or monitor, the tax is based on a "dividend equivalent amount." To determine this base, the foreign corporation's annual earnings and profits from ECI are increased (decreased) for reductions (increases) in U.S. net equity. In other words, reinvestments (withdrawals) of net equity into (from) U.S. operations reduces (increases) the dividend equivalent amount. Like dividends, the tax rate is 30 percent unless an income tax treaty specifies a lower rate.

For example, assume a foreign corporation has ECI of $100 during the current taxable year and pays a U.S. tax of $34. The earnings and profits from ECI are $66 (i.e., $100 - $34). Also assume that the foreign corporation's U.S. net equity is $700 at the beginning of the year and $650 at year end. Thus, the reduction in net equity suggests that the U.S. operations remitted not only the $66 in earnings and profits but $50 that previously was part of the U.S. operation's equity or capital. Thus, the dividend equivalent amount is $116 (i.e., $66 + $50). Unless a U.S. income tax treaty reduces the branch profit tax, it will be approximately $35 (i.e., $116 x 30 percent).

Interest that the U.S. branch pays is generally considered to be from U.S. sources. Thus, "branch interest" paid to the home office or any other foreign party is subject to U.S. taxation if not exempted, for example, as portfolio interest (which is discussed later). If the foreign corporation apportions interest expense to the ECI of its U.S. business

activities, I.R.C. § 884(f) imposes the branch interest tax to the excess of such apportioned deductions over interest the branch pays to a foreign party.[49]

TAX LIABILITY CALCULATION

The manner in which foreign parties determine their U.S. tax liabilities differs most notably from the procedures of U.S. parties in the types of income subject to taxation. U.S. parties are taxed on their worldwide incomes. In contrast, foreign parties are only taxed on: (1) ECI and (2) U.S. source income that is not ECI. Additionally, foreign parties can exclude specially-designated income items, are restricted in their deductions and credits, and may face more progressive effective tax rates than comparably-situated U.S. taxpayers.

Gross Income Exclusions

Foreign parties generally are entitled to exclude the same items of income as U.S. parties. To increase the flow of foreign capital to the United States, the Internal Revenue Code also excludes portfolio interest and interest from certain deposits. Other exclusions are allowed to facilitate international commerce, to enhance cultural ties with other countries, and for administrative reasons. In addition to exclusions that the Code grants, U.S. income tax treaties often exclude certain items from host country taxation.

Under I.R.C. §§ 871(h) and 881(c), portfolio interest includes U.S. source interest income (or original issue discount) paid pursuant to the terms in qualified debt obligations issued to foreign parties, as long as it is not ECI. Portfolio interest does not include interest income that a U.S. person beneficially receives. That is, the ultimate beneficiary must be a foreign party; otherwise, the policy objective to attract foreign capital is not achieved. Portfolio interest also does not include interest income of a ten-percent owner. For example, interest income that a foreign party receives from a corporation in which the foreign party owns 10 percent or more of the voting power cannot be excluded as portfolio interest. Similarly, when the debtor is a partnership in which the foreign recipient owns at least 10 percent of either capital or profits, the interest income is not portfolio interest.

The exclusion for portfolio interest is allowed on certain obligations that foreign parties hold. In addition, I.R.C. §§ 871(i)(2)(A) and

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49. For background discussion, see Fred Feingold and Mark E. Berg, *Whither the Branches?* 44 TAX. L. REV. 205 (1989).

881(d) attract foreign capital through excluding interest income derived from deposits with banks, savings institutions, and insurance companies. Like portfolio interest, this exclusion is allowed only if the interest income is not ECI. U.S. income tax treaties often exempt these types of interest income also.

Dividends that a foreign party receives from a domestic corporation are generally taxable at 30 percent or a lower treaty rate. However, I.R.C. §§ 871(i)(2)(B) and 881(d) exclude some or all of the dividends when 80 percent or more of the corporation's gross income for the preceding three taxable years is derived from the conduct of an active foreign business. The percentage of dividends excluded is equal to the ratio of the corporation's foreign source gross income to total gross income over the same three-year testing period. For example, assume that a foreign party receives $100 of dividends from a domestic corporation in 19x4. During 19x1 through 19x3, the domestic corporation conducted a foreign business from which it derived 87 percent of its gross income. Three percent of the domestic corporation's gross income was from foreign investment activities and ten percent was from U.S. sources. In this case, the foreign party can exclude $90 of the dividends; only $10 is taxable.

The United States allows the income of foreign parties from the international operation of ships or aircraft to transport people or cargo to be excluded. Income from the full or bareboat rental of ships or aircraft is excluded also. However, the exclusion is available only to residents of countries that provide an equivalent exemption to U.S. parties engaged in international transportation activities.[50] The reciprocal exemption often is formalized in an international transportation agreement between the two countries or in a U.S. income tax treaty.

I.R.C. § 872(b)(3) permits nonresident aliens participating in certain exchange or training programs in the United States to exclude the compensation their foreign employers pay them. For this purpose, a foreign employer is either a foreign party or the foreign office of a U.S. party. The exclusion applies only for nonresident aliens who are temporarily in the United States as nonimmigrants. Generally, the individuals who qualify are students, teachers, or trainees.

Income that nonresident aliens derive from certain gambling activities is excluded from U.S. taxation under I.R.C. § 871(j). Winnings from

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50. I.R.C. §§ 872(b)(1), (2), (5), 883(a)(1), (2), (4). U.S. source gross transportation income that cannot be excluded and that is not ECI may be subject to a four percent excise tax under I.R.C. § 887. For more information, *see* Ernest R. Larkins, *Locating a Transportation Company Offshore May Still Be the Best Route*, 3 J. INT'L TAX'N 218 (1992).

blackjack, baccarat, craps, roulette, and big-six wheel are exempt. Presumably, this exclusion exists because collection of the tax on these types of gambling income is administratively infeasible.

Deductions and Credits

If a foreign party fails to file a "true and accurate" return in the United States, I.R.C. § 874(a) or 882(c)(2) disallows all deductions and credits. Absent a showing of good cause, a return that is not timely filed fails the true-and-accurate standard. U.S. returns of nonresident aliens filed 16 months late are deemed not to be timely filed. Similarly, foreign corporations that file their U.S. returns 18 months late may lose deductions and credits. Some foreign parties that believe they have no ECI may nonetheless choose to file a "protective return" to preserve future deductions and credits in the event the IRS determines that they do, in fact, have ECI.[51]

Assuming a true and accurate return is filed, foreign parties are entitled to deductions and credits only against ECI.[52] No deductions are permitted against U.S. source investment income and other amounts of gross income taxable at 30 percent or a lower treaty rate. Business and un-reimbursed employee expenses are generally deductible to the extent related to ECI. If otherwise allowed, the expenses of moving to the United States are deductible, but the expenses incurred when returning to the home country are not.

Most deductions are determined through allocation and apportionment procedures. Expenses are allocated to classes of gross income according to their degree of relatedness to the classes. Then, the allocated expenses are apportioned between ECI and non-ECI income according to some factual relationship. Special allocation and apportionment rules apply to interest expense, research and development costs, stewardship expenses, legal and accounting fees, income taxes, and certain losses. As noted above, only those expenses apportioned to ECI are deductible.

I.R.C. § 63(c)(6)(B) precludes nonresident aliens from claiming the standard deduction; thus, they must itemize. Several personal-type expenses that U.S. individuals can deduct are disallowed since the expenses are not allocable to ECI. Among these items are interest on residential mortgages, personal property taxes, and medical expenses. Nonetheless, if they otherwise quality, I.R.C. § 873(b) allows nonresi-

51. Treas. Reg. §§ 1.874-1(b), 1.882-4(a).

52. I.R.C. §§ 873(a), 882(c)(1), 906(a). Also, the instructions to Form 1040NR, U.S. Nonresident Alien Income Tax Return, allow nonresident aliens to deduct expenses incurred to (1) produce non-business income and (2) determine tax liability.

dent aliens to deduct some items in full without apportionment: charitable contributions to qualified U.S. organizations, casualty losses on U.S. property, and one personal exemption. Nonresident aliens residing in some locations can claim additional personal or dependency exemptions. For example, I.R.C. § 151(b)(3) grants residents of Canada, Mexico, and American Samoa exemptions for their dependents and, if they have no U.S. source income, their spouses. Residents of Japan and South Korea can claim some pro rata portion of dependency exemptions for their spouses and children who live with them at some time during the taxable year.[53]

Tax Rate Schedules

The same tax rate schedules that U.S. parties use apply to the ECI of foreign parties. However, nonresident aliens are ineligible to file in certain ways. I.R.C. § 6013(a)(1) generally requires married nonresident aliens to file separate U.S. returns from their spouses, the worst possible filing status (i.e., the most progressive tax rates). Married nonresident aliens can file a joint return only if they make either the nonresident or new resident election.

The nonresident election in I.R.C. § 6013(g) allows an individual who is otherwise a nonresident alien during the taxable year to be treated as a U.S. resident for the entire year and, thus, to file jointly. To be eligible, the person must be married to a U.S. citizen or resident at year end, and both spouses must join in the election. Once made, the election remains in effect until either spouse revokes it, one of the spouses dies, the spouses legally separate, or the IRS unilaterally terminates the election for failure to maintain or supply tax-related information. Each married couple can make this election only once during their lifetimes.

The new resident election in I.R.C. § 6013(h) allows an individual with dual status during the taxable year (i.e., nonresident alien on the first day and resident alien on the last day) to be treated as a U.S. resident for the entire year. This provision allows an individual who becomes a U.S. resident during the year to file a joint return. As with the nonresident election, the nonresident alien must be married to a U.S. person to be eligible, both spouses must join in making the election, and the spouses can never join in making this election again.

53. Convention for the Avoidance of Double Taxation, Mar. 8, 1971, U.S.-Japan, 23 U.S.T. 967, T.I.A.S. No. 7365, art. 4(5), *reprinted in* 1 TAX TREATIES (CCH) ¶5203 (1998); Convention for the Avoidance of Double Taxation, June 4, 1976, U.S.-Korea, 30 U.S.T. 5253, T.I.A.S. No. 9506, art 4(7), *reprinted in* 1 TAX TREATIES (CCH) ¶5403 (1998).

Both the nonresident and new resident elections grant joint filing benefits to nonresident aliens who qualify. In addition to the preferential tax rate structure, joint filers have higher adjusted gross income thresholds for phasing out itemized deductions and personal and dependency exemptions under I.R.C. §§ 68(b)(1) and 151(d)(3), respectively. Further, joint filers are entitled to larger exemptions for alternative minimum tax purposes per I.R.C. § 55(d)(1), larger exclusions for gain from sale of small business investment company stock under I.R.C. § 1202(b)(3), and several other tax benefits.

When neither election discussed above is made, unmarried nonresident aliens must file as single individuals. I.R.C. § 2(b)(3)(A) does not permit nonresident aliens to file as head of households. Also, filing as a surviving spouse is allowed only if the deceased spouse was a U.S. citizen or resident and the surviving spouse resides in Canada, Mexico, Japan, Korea, American Samoa, or the Northern Mariana Islands.[54]

Conclusion

Increasingly, tax professionals must have some awareness of the special issues that arise for foreign clients. The U.S. tax liability of foreign parties depends on special residency elections, whether a U.S. trade or business is conducted, whether income is effectively connected with a U.S. trade or business, and net basis elections for real estate income. In addition, foreign parties exclude some income items, such as portfolio interest and capital gains from selling investment assets, on which U.S. parties are taxed. Income tax treaties often grant benefits beyond those the Internal Revenue Code provides. For example, treaties generally exclude ECI when no permanent establishment exists and tax U.S. source investment income at rates below the 30 percent statutory rate. Finally, to preserve tax deductions and credits and avoid statutory penalties, foreign parties should be careful to file true and accurate returns on a timely basis.

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54. I.R.C. § 2(a)(2)(B); Treas. Reg. § 1.2-2(a)(4). *See also* TREASURY DEPARTMENT, U.S. TAX GUIDE FOR ALIENS, Pub. 519 (1997) 20.