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International Aspects of Tax Laws with Respect to Foreign Investment in the United States: An Outline-Summary

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United States taxation of foreign direct investment in the United States depends primarily on (1) status of the investor as a resident or nonresident for U.S. tax purposes and (2) type of income derived by the foreign investor. The U.S. tax rules can be modified by tax treaties.

I. Residence for U.S. Tax Purposes: Definition and Effect

A. *Definition*

1. Individuals: Test is physical presence coupled with intent to reside in the United States. As a rule of thumb, one year of continuous presence would constitute residence.
2. Corporations: Test is the place of incorporation. Also, a foreign corporation (i.e. incorporated in a foreign country) which is « engaged in a trade or business within the United States » is treated as a resident corporation but to a limited extent only.
3. Partnership, Trust and Estate.

B. *Effect*

An entity or individual treated as a resident of the United States is taxed on worldwide income while an entity or individual treated as a nonresident is taxed to a more limited extent and depending on the type of income received.

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†*Editorial Note:* Other tax aspects of foreign investment in the United States, such as the impact of state income taxes, federal estate taxes and Social Security, which were likewise considered, were not included in the outline-summary made available for publication.

II. U.S. Taxation of a Foreign Investment

A. *General Rules*

A nonresident individual or entity investing in the United States can derive three types of income which receive different tax treatment.

1. Passive investment income: Consists essentially of dividends, interest, rents and royalties.

—Such income is subject to a withholding tax in the United States provided it is from U.S. sources.

—Tax is imposed on the gross amount at a flat 30 percent rate.

—Rate can be reduced or eliminated by tax treaties. The following rates are typical of U.S. tax treaties:

- Interest: 0 to 15 percent
- Royalties: 0 to 15 percent
- Dividends: 15 percent (on portfolio investment) or 5 percent (on corporate direct investment).

2. Income which is effectively connected with a U.S. trade or business.

a. U.S. trade or business: Depending on the type and amount of business activities in the United States by the foreign investor, such activities can amount to the « conduct of a trade or business within the United States »
In case of treaty country residents, U.S. trade or business must be through a permanent establishment. Tougher rules apply to entertainment business. Treaties typically require factual connection.

b. Effectively connected income: Includes

- All U.S. source business income. Treaties typically require factual connection.
- All U.S. source passive income which is factually effectively connected with U.S. trade or business. Example of each.
- Certain foreign source income under U.S. technical tax rules that is earned by U.S. business. Could have changed source rules, but chose to do it this way. Limited to three types: (1) foreign rents or royalties actively derived by U.S. business and capital gains on such property; (2) interest or dividends actively derived by U.S. banking, financing or securities trading business and capital gains on such property; (3) certain sales income where U.S. office is active but title passes outside the United States so that source is foreign.

c. Taxation: Such income is subject to tax rules similar to those applicable to residents of the United States (Rates. Deductions and the problem of allocation. Carryback and carryover of losses. Capital gains and losses. Tax credits.)

3. Business income not amounting to U.S. trade or business: Free of U.S. tax. In the case of treaty country resident, business income is free of tax if there is no permanent establishment. Primarily sales income and service fees of corporations.

B. *Specific Tax Issues*

1. Organization and liquidation of investment: Investment structured as a U.S. subsidiary can be organized and liquidated free of U.S. income tax. Special aspects of liquidation of real estate investment.

2. Reallocation of income: Section 482 of the Internal Revenue Code. Scope and enforcement.

3. Compensation earned by nonresident alien individuals.

a. The 90-3,000 rule: Compensation received by a nonresident alien for personal service performed in the United States is exempt from tax in the United States if the individual (1) is present in the United States for a period during the taxable year not exceeding 90 days, (2) does not receive more than $3,000 as compensation and (3) performs the service under a contract with a foreign person. If the individual fails to meet any of these three requirements then:

—The individual is considered to be engaged in a U.S. trade or business.

—Compensation income is considered to be effectively connected with a U.S. trade or business.

—Presumably, his foreign employer is also deemed to be engaged in a U.S. trade or business.

b. Tax treaties modifications: Typically U.S. tax treaties extend the period of physical presence to 183 days and eliminate the limit on the amount of compensation as well as the requirement of a contract with a foreign person.