

**A PRIMER  
ON  
TAX ASPECTS OF U.S. BUSINESS  
AND INVESTMENT ACTIVITIES BY FOREIGN PERSONS**

BRIAN W. FITZSIMONS  
TUCKER ELLIS & WEST LLP

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## **Preface**

This booklet is meant to present a general overview of the tax rules and some tax planning considerations applicable to business or investment activities in the United States by foreign businesses or persons who are neither U.S. citizens nor U.S. residents (that is, "foreign" businesses or "foreign" persons from a U.S. perspective). The purpose is not to present an exhaustive and detailed analysis but rather a "big picture" approach. The advantage sought here is brevity. Once the reader understands the big picture in relatively simple terms, it is easier to pick up the details as necessary. Please review the Table of Contents and the Introduction for an indication of what subjects are covered . . . and what subjects are not.

My hope is that you will find this to be a good "primer" or introductory exposure to the relevant tax issues or a source for a quick review of the basic concepts. After reviewing this material I hope you agree.

Brian W. FitzSimons  
Tucker Ellis & West LLP  
1150 Huntington Building  
925 Euclid Avenue  
Cleveland, Ohio 44115-1475  
(216) 696-2487  
b.fitzsimons@TuckerEllis.com

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**Brian W. FitzSimons  
Tucker Ellis & West LLP**

**I. Introduction.**

**A. Some General Observations.** For any contemplated business or investment activity in the United States by a nonresident business entity or non-citizen, taxes are an important consideration. (For the remainder of this discussion we will call such persons either "foreign corporations" or "nonresident aliens". Where the discussion is dealing with non-corporate forms of business entities, I will make a specific distinction. At times I will refer to all such foreign persons whether individuals or business entities collectively as "foreign taxpayers").

1. United States business transactions are subject to a wide range of complex tax provisions at the federal, state and local level.
2. This pattern becomes even more complex when nonresident taxpayers are involved.
3. The nonresident taxpayer must also take into account the domestic tax rules of his or her country of residence (and possibly his or her country of citizenship if different). These subjects are beyond the scope of this discussion.

**B. Basic Issues to Consider.** When contemplating a business activity in the United States or the acquisition of a U.S. investment, a nonresident taxpayer (whether a nonresident alien or a foreign corporation or other foreign business entity) must consider the following basic U.S. tax issues.

1. You must consider the general tax rules applicable to various U.S. business entities. An examination of these rules is important in order to select the appropriate entity (e.g., corporation, partnership, trust, etc.) to acquire the investment or operate the business. See Section VIII. below for a further discussion of this issue.

2. You must also consider the U.S. taxation of nonresident taxpayers with respect to the type of income generated by the acquired U.S. business or investment. See Section IV for a summary of these rules and Section II for a more detailed discussion.
3. Finally you should consider the U.S. taxation of various structures through which the acquisition of a U.S. business or investment can be accomplished. See Section IX concerning this issue.

**C. A Caution on Subjects Not Covered.** By necessity a primer of this size cannot address every subject which might be relevant for business or investment planning in the United States. Specifically, the following potentially relevant topics are not covered in this presentation:

1. State and local tax considerations.
2. Tax considerations of the county of residence and/or citizenship.
3. Estate and gift tax considerations (except as briefly described in this primer).
4. The particular overriding provisions of various tax treaties between the U.S. and various foreign countries.
5. Non-tax legal and business considerations and restrictions.

## **II. Overview of Federal Taxation of Foreign Persons.**

**A. Taxation of Resident Aliens.** (A resident alien is an individual who is not a U.S. citizen but who nevertheless establishes residency in the U.S.)

1. With minor exceptions, aliens residing in the United States are taxed the same as U.S. citizens (e.g., taxed at regular U.S. income tax rates on income derived from all sources world-wide). Treas. Reg. § 1.871-1.



2. If an alien individual was a resident for a portion of the taxable year and a nonresident for the other portion, he is taxable as if his taxable year consisted of two separate periods. Treas. Reg. § 1.871-13(a)(1).
  - a. The alien's tax year is not terminated by the fact that his status changes from resident to nonresident. Simenon, 44 TC 820 (1965).
  - b. For purposes of applying the graduated tax rates to an alien individual whose residency status changed during a tax year, all income during the residency period and all "effectively connected" income during the nonresidency period are aggregated. Treas. Reg. § 1.871-13(a)(1).
3. Income of a cash method taxpayer from sources outside the United States which are not "effectively connected" to a U.S. trade or business is not taxable if received by an alien while he is not a U.S. resident even if he becomes a resident after its receipt and before the end of his taxable year or even if earned while he was a resident. Treas. Reg. § 1.871-13(b), (c). Example: An alien receives income from a foreign source in January 2001 and becomes a U.S. resident on July 1, 2001. The income is not subject to U.S. taxation. Second Example: A resident alien earns income from a foreign source but does not receive the income until after his U.S. residency terminates. The income is not subject to U.S. taxation.
4. But income of a cash method taxpayer from sources outside the U.S. which is not "effectively connected" and which is received while a resident is taxable even if earned earlier while he was a nonresident or even if he becomes a nonresident after receipt but before the end of his taxable year. Treas. Reg. § 1.871-13(b), (c). Example: An alien earns income from a foreign source on January 2001 before he becomes a U.S. resident and receives the income in July 2001 after he becomes a U.S. resident. The income is subject to U.S. taxation.

**B. Taxation of Nonresident Aliens and Foreign Corporations.**

1. Nonresident aliens and foreign corporations are generally subject to U.S. taxation only on U.S. sourced income. The type of tax imposed on such U.S. source income depends on whether the nonresident alien or foreign corporation is “engaged in a trade or business” (generally limited to maintaining a “permanent establishment” for treaty countries) and whether the income is “effectively connected” to such trade or business. See Section III.C. for details.
  - a. Income effectively connected to a U.S. trade or business is generally taxed at graduated rates applicable to U.S. residents or U.S. corporations. The tax is on the net income (i.e. gross income less applicable expenses). IRC §§ 871(b); 882(a).
  - b. U.S. source income not effectively connected to U.S. trade or business is generally taxed at 30% (or lower applicable treaty rate). The tax is on the gross income. IRC §§ 871(a); 881(a).
2. Therefore, the major concern for income not effectively connected with a U.S. trade or business is whether it is U.S. sourced. If not, it is generally not subject to U.S. tax. Consequently, once it is determined that the taxpayer is a nonresident alien or a foreign corporation, the sequence of analysis should be as follows:
  - a. Is the income U.S. sourced under the “sourcing rules”? (See Section III.B. below).
  - b. If the income is U.S. sourced, is the taxpayer engaged in a U.S. trade or business? (See Section III.C. below).
  - c. If the taxpayer is engaged in a U.S. trade or business, is the income “effectively connected” to such business? (See Section III.D. below).

- d. If the income is effectively connected to a U.S. trade or business or is nevertheless still U.S. sourced, is it subject to a special exemption from taxation? (See IRC § 872(b), 883, 871(f), 894 and Section III.E. below).

One word of caution: From the series of questions listed above it would seem the first line of inquiry would be to review the "sourcing rules" with respect to any particular item of income. However, those sourcing rules, as described at III.B. below, don't expressly state that business profits from a U.S. trade or business are deemed U.S. sourced - although that is a fairly obvious proposition. Instead, IRS § 864(i)(2) states that profits and income from U.S. sources will be deemed effectively connected with a U.S. trade or business (and will therefore be subject to U.S. taxation under IRC §§ 871(b)(1) and 882(a)(1) respectively - depending on whether the foreign taxpayer is an individual or corporation) if such income is derived from assets used in a U.S. trade or business or the activities of such trade or business were material factors in realizing such income. Obviously, operating profits of a U.S. business are generated by that business' assets and activities and will therefore be deemed effectively connected and consequently taxable. Therefore, without expressly stating it in the sourcing rules of IRC §§ 861-863, the implication is that such U.S. based operating profits are deemed U.S. sourced.

**C. Impact of Applicable Tax Treaties.**

1. Tax treaties between the U.S. and various countries around the world generally limit the concept "engaged in a trade or business" to the concept "permanent establishment." See Section III.B. below for details.
2. Such tax treaties also generally reduce the tax rate on U.S. source income which is not effectively connected to a permanent establishment.

3. In addition, sometimes the relevant tax treaty will alter the tests for residency or U.S. income sourcing rules. See Section III.A.6. below regarding treaty impact on residency rules.
4. Any foreign person from a country which maintains a tax treaty with the U.S. must carefully review the provisions of such treaty for special rules which may be applicable to business or investment activities in the U.S.

### III. Overview of Major Concepts.

**A. Residency v. Nonresidency:** IRC § 7701(b) defines “resident alien” with detailed criteria and then defines “nonresident alien” by exclusion (i.e., an alien who is not a resident).

1. An alien (meaning a person who is not a U.S. citizen) is a U.S. resident with respect to any calendar year if and only if he meets one of three tests:
  - a. “Green Card Test” (lawfully admitted permanent resident at any time during such year).
  - b. Substantial Presence Test.
  - c. First Year Election Test.
2. Application of substantial presence test: Pursuant to IRC § 7701(b)(3), an individual meets this test for any calendar year if (i) he was present in the United States on at least 31 days during the year and (ii) the sum of the number of days he was present in the U.S. during the current year plus the two preceding years (when multiplied by an applicable multiplier) equals or exceeds 183 days.
  - a. Applicable multipliers:
 

current year:	1
1st preceding year:	1/3
2nd preceding year:	1/6

- b. Example: assume an alien was first present in U.S. in 1999. He was present for 133 days in 2001, 60 days in 2000 and 180 days in 1999:

<u>year</u>	<u>days</u>	<u>multiplier</u>	<u>total</u>
2001	133	1	133
2000	60	1/3	20
1999	180	1/6	<u>30</u>
			183

Therefore, the individual would be considered a U.S. resident starting on the first day he was present in 2001.

- c. Subject to a few narrow exceptions, a day of presence is any time spent in the U.S. on a given day. Therefore a partial day of presence generally counts as a full day of presence. IRC § 7701(b)(7)(A).

3. Exceptions to substantial presence test.

- a. “Closer connection exception”: An alien will not be treated as meeting the substantial presence test for any year if (i) he was present less than 183 days during such year and (ii) he had a “tax home” in a foreign country for such year and (iii) he had a closer connection to such foreign country than to U.S. for such year. However, this exception will not apply to an alien if (i) he had an application for adjustment of status pending for such year or (ii) he took other steps during such year to apply for status as a lawful permanent resident. IRC 7701(b)(3)(B), (C).
- b. Medical condition exception: An alien will not be treated as being present in the U.S. on any day if he was unable to leave the U.S. on such day because of a medical condition which arose while he was present in the U.S. IRC § 7701(3)(D).

- c. Mexican/Canadian commuter exception: An alien who regularly commutes to U.S. employment from a residence in Canada or Mexico will not be deemed present in the U.S. because of such commuting. IRC § 7701(b)(7)(B).
  
- d. Exempt individual exception: An alien will not be treated as being present in the U.S. on any day if he was an “exempt individual” for such day. IRC § 7701(b)(5)(A). Exempt individuals are defined as:
  - (i) A foreign government related individual (e.g., diplomats and their families).
  - (ii) A teacher or trainee (subject to special limitations in IRC § 7701(b)(5)(E)).
  - (iii) A student (subject to special limitations in IRC § 7701(b)(5)(E)).
  - (iv) A professional athlete who is temporarily in the U.S. to compete in a charitable sports event as described in IRC § 274(l)(1)(B).
  
- e. Special Residency Trap for Capital Gains: At IRC § 865(g)(1)(A)(i)(II) there is a special rule for defining a U.S. resident for purposes of determining the source of capital gain income from the sale of personal property. Under this rule a nonresident alien who spends at least 183 days in the U.S. (but who would otherwise not be considered a U.S. resident because of an exception to the substantial presence test such as the exceptions described above) could nevertheless be considered a U.S. resident for this sourcing rule if he or she maintains a tax home in the U.S. As a consequence, all world-wide capital gain income of such person from the sale of personal property will be sourced in the U.S. pursuant to IRC § 865 and will be subject to U.S. taxation pursuant to IRC § 871(a)(2). For example, if a foreign student, who would not otherwise be considered a U.S. resident, is present in the U.S. for

183 days and has a U.S. tax home, his world-wide capital gain income could be subject to U.S. taxation. For this purpose a "tax home" has the meaning set forth at IRC § 911(d)(3) and does not necessarily mean the principal place of residence.

4. Application of first year election test: IRC § 7701(b)(4) allows an alien who becomes a resident under the substantial presence test to make an election (under certain circumstances) to be treated as a resident during the immediately preceding calendar year if he had a certain minimal amount of presence in the U.S. during such immediately preceding year.
5. Caution: Consult Treas. Reg. § 301.7701(b)-1 *et seq.* Concerning these residency tests and exceptions.
6. Congressional Committee Reports to The Tax Reform Act of 1984 state that this new statutory definition of resident alien is not intended to affect the definition of resident for federal estate and gift tax purposes nor to override any contrary residency provisions of an applicable treaty. In this regard it should be noted that the tax treaties that the U.S. has established with various foreign countries usually contain detailed provisions regarding residency rules (typically in Article 4 of the treaty) including "tie-breaker" rules for when an individual would otherwise be considered a resident of both countries.
7. Finally it should be noted that U.S. residency can arise in ways other than under the 3 residency tests described above. The residency trap for capital gains discussed at Section III.A.3.e. above is one example. Another is the election permitted under IRC § 6013(g) to treat a nonresident alien married to a U.S. citizen as a U.S. resident. Nothing is simple concerning these tax rules!

**B. U.S. Sourcing Rules.**

1. These sourcing rules are important because unless an item of income is deemed from a U.S. source, it is generally not subject

to U.S. taxation. If an item of income is deemed from a U.S. source, it will generally be subject to U.S. taxation unless it is exempted under special rules or treaty provisions such as those described at Section III.E. below. How the U.S. sourced income will be taxed will depend on whether or not the item of income is deemed effectively connected with a U.S. trade or business. See III.C. and D. below in this regard.

2. If the U.S. sourced income is deemed effectively connected with a U.S. trade or business then the net amount of such income (i.e. the gross amount less applicable expenses) is subject to U.S. taxation at the regular U.S. graduated tax rates under IRC § 871(b)(1) for nonresident aliens or under IRC § 882(a)(1) for foreign corporations. If such U.S. sourced income is not deemed effectively connected with a U.S. trade or business, the gross amount of such income is generally subject to U.S. taxation at a flat 30% rate (or lower applicable treaty rate). See III.C. and D. below concerning the standards for determining when an item of U.S. sourced income is deemed effectively connected with a U.S. trade or business.
3. Therefore, the tax inquiry should begin by asking whether the item at issue is considered to be from a U.S. source.
4. However, the Internal Revenue Code does not specify how to determine the source of each item of income. For example, the operating profits of a U.S. trade or business are obviously U.S. sourced but the sourcing rules under IRC §§ 861-863 do not specifically say so. (Rather, as described at II.B.2. above, such profits are taxed directly under IRC §§ 871(b)(1) or 882(a)(1) as "effectively connected" income pursuant to IRC § 864(C)(2) and as implicitly U.S. sourced. With respect to those items of income which are expressly addressed in the sourcing rules, IRC § 861 specifies certain types of income which will be deemed from U.S. sources and IRC § 862 specifies when certain types of income will be treated as from sources outside the U.S. IRC § 863 covers items not treated under IRC §§ 861 and 862 (such as income which must be prorated between U.S. and foreign



sources). In addition, special rules are found at IRC § 865 for sourcing gain from sales of personal property. See III.A.3.e. above.

5. The following outline summarizes the major statutory sourcing rules. Be aware, however, that some treaties have their own sourcing rules or provide for special exceptions to these rules.
6. Interest Income: IRC § 861(a)(1); Treas. Reg. § 1.861-2.
  - a. Generally interest on debt obligations of U.S. resident debtors is U.S. sourced interest. There is an exception, however, for interest from an "80-20 corporation" (which is described at IRC § 861(c)) or resident alien debtor meeting similar standards. IRC § 861(a)(1)(A).
  - b. Under prior law, interest received by nonresident aliens or foreign corporations on deposits with U.S. banking institutions were deemed foreign sourced if not effectively connected to U.S. trade or business and therefore exempt from U.S. taxation. Prior IRC § 861(a)(1)(A), (C). Now such deposits are directly exempt from U.S. taxation. IRC § 871(i); 881(d).
  - c. Portfolio interest (which generally means interest on publicly-traded corporate debt instruments payable to foreign persons - other than to a 10% owner of the debtor) is directly exempt from U.S. taxation. IRC § 871(h); 881(c).
7. Dividend Income: IRC § 861(a)(2); Treas. Reg. § 1.861-3.
  - a. Dividends from U.S. corporations are generally treated as U.S. sourced.
  - b. However, dividends from an 80-20 corporation (described at IRC § 861(c)) are exempt from the 30% tax in the same proportion as the 80-20 corporation's foreign sourced income. IRC § 871(i)(2)(B), 881(d).

- c. Dividends from a foreign corporation are treated as foreign sourced if less than 25% of the corporation's gross income over the preceding 3 years was effectively connected with a U.S. trade or business. IRC § 861(a)(2)(B). However, see also the "Branch Tax" rules of IRC § 884 described at VII. below.
- 8. Compensation for Personal Services: IRC § 861(a)(3); Treas. Reg. § 1.861-4.
  - a. Compensation for labor or personal services performed in the U.S. is generally deemed U.S. sourced.
  - b. However, there is an exception for compensation of a nonresident alien temporarily present in U.S. for a period not exceeding 90 days during the year provided such compensation does not exceed \$3,000 and the services were performed for a foreign employer not engaged in a U.S. trade or business or for a foreign office of a U.S. employer.
- 9. Rents and Royalties. IRC § 861(a)(4); Treas. Reg. § 1.861-5.
  - a. Rents and royalties from property located in U.S. is U.S. sourced.
  - b. Rents and royalties from use of intellectual property in U.S. is also U.S. sourced.
- 10. Disposition of U.S. Real Property Interest. IRC § 861(a)(5).
  - a. Gains from sales of U.S. real property interest are U.S. sourced.
  - b. See FIRPTA at Section VI. below.
- 11. Sale or Exchange of Personal Property. IRC §§ 861(a)(6), 865; Treas. Reg. § 1.861-7.

- a. The general rule is that the source depends on the residence of the seller. IRC § 865(a). However, it should be noted that for this purpose there is a special definition of U.S. resident at IRC § 865(g) that is not tied to the residency rules described at III.A. above. Under this special definition, a nonresident alien who has a tax home in the United States could be considered a U.S. resident. See IRC § 865(g)(1)(A)(i)(II). For this purpose a "tax home", which is defined at IRC § 911(d)(3), does not necessarily mean a principal place of residence. See a further discussion of this issue at III.A.3.e. above.
- b. Exception for inventory: source of income from the sale of inventory generally depends on the location of the sale. IRC §§ 861(a)(6), 862(a)(6), 865(b). But see special allocation rules of IRC § 863(b)(2), (3).
- c. Special rule for depreciable personal property: IRC § 865(c).
- d. Special rule for sale of intangibles. IRC § 865(d).
- e. Special rule for sales through offices or fixed places of business. IRC § 865(e).
- f. Special rule for sale by U.S. resident of stock in a foreign affiliate. IRC § 865(f).

**C. Meaning of Trade or Business/Permanent Establishment.**

1. Assuming the taxpayer is a nonresident alien individual or foreign corporation, a primary inquiry must be whether the taxpayer is engaged in a U.S. trade or business.
2. Meaning of Trade or Business. IRC § 864(b), Treas. Reg. § 1.864.2.
  - a. The Internal Revenue Code does not shed much light on what constitutes a "trade or business." Rather than provide a comprehensive definition, it just provides at IRC

§ 864(b) for an express inclusion within the concept “trade or business” for the performance of personal services within the U.S. at any time within the taxable year, subject to two express exclusions:

- (i) Performances of personal services by a nonresident alien for a foreign employer not engaged in a U.S. trade in business or for a U.S. employer at a foreign location if the alien was only temporarily in the U.S. for 90 days or less during the year and his compensation for such services did not exceed \$3,000. IRC § 864(b)(1).
  - (ii) Trading of securities or commodities through a resident broker or independent agent or for one's own account. IRC § 864(b)(2).
- b. Otherwise it doesn't take a great deal of activity to constitute a U.S. trade or business. Rev. Rul. 56-165, 1956-1 C.B. 849. The business does not have to be U.S. based and it does not need to have a U.S. office or fixed business location. A foreign principal can be deemed to have a U.S. trade or business because of the activities of his agent. Rev. Rul. 70-424, 1970-2 C.B. 150. See Higgins v. C.I.R., 312 U.S. 212 (1941) regarding the meaning of “carrying on a trade or business”.
- c. For planning purposes, unless treaty relief is available, if a nonresident alien or foreign corporation has any substantial business contacts in the U.S., it should be assumed that a U.S. trade or business has been established.
- (i) Mere passive ownership of real property might not be considered a trade or business (particularly if net leased to a single tenant) but active management of rental property would be a trade or business. Rev. Rul. 73-522, Treas. Reg. §1.864-4(c)(3)(ii), 1.864-6(b)(2)(ii).

- (ii) Sale of goods (or even solicitation of orders) if done on a continuing and active basis could constitute a trade or business.
- d. If a partnership, limited liability company, estate or trust is engaged in a U.S. trade or business, any nonresident alien or foreign corporation which is a partner in such partnership, a member of such limited liability company (unless the LLC elects to be taxed as a corporation) or a beneficiary of such estate or trust will be considered engaged in such U.S. trade or business. IRC § 875.
- e. However, the mere ownership of stock in a U.S. corporation does not cause the foreign shareholder to be deemed engaged in a U.S. trade or business.
- f. Finally, a word should be spent mentioning "disregarded entities" under the "check-the-box" Treas. Reg. at § 301.7701-1 et al. Certain non-corporate entities (called "eligible entities") with only one member, most notably single-member limited liability companies, can be treated as disregarded entities for tax purposes which means such an entity will not be treated as an entity separate from its owner. See Treas. Reg. § 301.7701-3(g). Therefore, for example, if a foreign corporation is the sole member of a U.S. limited liability company, unless an election is made to treat the LLC as a corporation for tax purposes, the LLC will be disregarded for tax purposes and its business activities in the U.S. will be treated as a direct branch operation of the foreign corporation.

3. Treaty Relief - Permanent Establishment Concept.

- a. Tax treaties generally provide relief from this vague concept of "U.S. trade or business" by limiting U.S. taxation of residents of the treaty country to U.S. sourced "business profits" (e.g., trade or business income) which are "attributable" (e.g., effectively connected with) a "permanent establishment." See for example:

Luxembourg-U.S. Income Tax Treaty, Article 5 for an illustration of the recent U.S. approach to defining permanent establishment.

- b. "Permanent establishment," unlike U.S. trade or business is specifically defined (although the definitions vary by treaty) and is a more narrow concept than U.S. trade or business.
- c. A permanent establishment generally requires a fixed place of business including a branch office, factory, mine, etc. but the existence of an agent (other than an independent agent) in the U.S. with authority to bind the foreign principal, can be deemed a permanent establishment.
- d. The permanent establishment definition usually excludes specified activities such as:
  - (i) Mere storage, display or delivery of goods.
  - (ii) Maintenance of a stock of goods for the purpose of storage, display or delivery.
  - (iii) Maintenance of a stock of goods for the purpose of processing by a third party.
  - (iv) Maintenance of a fixed place of business for the purpose of purchasing goods.
  - (v) Short term construction or installation projects. See for example: U.S.-U.K. Income Tax Treaty, Article 5.
- e. The regulations under the "reverse sourcing rule" may provide analogy and guidance for interpreting the meaning of permanent establishment. See Treas. Reg. § 1.864-7.

**D. Meaning of "Effectively Connected".** Generally, income must be U.S. sourced under the sourcing rules described at Section III.B. above before it will be

deemed effectively connected to a U.S. trade or business. There is a “reverse sourcing” exception to this general rule described at Section III.D.3. below. Whether U.S. sourced income is to be deemed “effectively connected” is determined under the rules of IRC § 864(c) and depends upon the category of income involved.

1. FDAP and Passive-Type Income. Investment and compensation type income and other “fixed or determinable annual or periodical gains, profits and income,” (sometimes called “FDAP”), “portfolio interest” in certain debt obligations (i.e., income described at IRC § 871(a) and (h) with respect to nonresident aliens and at § 881(a) and (c) with respect to foreign corporations) and capital gains or losses: This type of income, if U.S. sourced, is deemed effectively connected if it qualified under either the asset use test or the business activities test. IRC § 864(c)(2). Treas. Reg. § 1.864-4(c).
  - a. Asset use test: Was the income, gain or loss derived from assets used in or held for use in the conduct of the U.S. trade or business (e.g., capital gain on sale of U.S. trade or business assets or income earned on temporarily invested U.S. trade or business working capital)? IRC § 864(c)(2)(A).
  - b. Business activities test: Were the activities of such trade or business a material factor in the realization of the income, gain or loss (e.g., compensation for business services rendered, interest income from lending business). IRC § 864(c)(2)(B).
  - c. If such classes of income are U.S. sourced but fail to meet these tests, they will not be considered “effectively connected” to the U.S. business and, consequently, they will only be taxed under the 30% rate (or lower applicable treaty rate).
  - d. If any of these classes of income are not U.S. sourced or are subject to a special exception (e.g., the capital gain exception), they will not be subject to U.S. taxation at all. See Section III.E. below concerning such exceptions.

It should be noted, however, that the sourcing rules described at III.B. above, do not explicitly state that operating profits from a U.S. trade or business are U.S. sourced - see discussion at II.B.2 and III.B.4. above. Nevertheless, it is fairly obvious that such profits are to be considered U.S. sourced for the application of these tests under § 864(e)(2) and will therefore be considered effectively connected with such U.S. trade or business and be subject to U.S. taxation under either IRC § 871(b)(1) or nonresident aliens in IRC § 882(a)(1) for foreign corporations.

2. All other U.S. sourced income (see sourcing rules at III.B. above) is deemed effectively connected. IRC § 864(c)(3). Treas. Reg. § 1.864-4(b).
  - a. This means that if a nonresident alien or foreign corporation has a U.S. trade or business (or maintains a permanent establishment under an applicable treaty), all of its U.S. sourced income not specifically exempted will be deemed “effectively connected” to that U.S. business and will be taxed at the resident taxpayer graduated rates.
  - b. This rule applies even if the items of income were unrelated to the U.S. trade or business (unless there is applicable treaty relief). Treas. Reg. § 1.864-4(b).
3. Income from Sources outside U.S. IRC § 864(c)(4); Treas. Reg. § 1.864-5 to 1.864-7.
  - a. Under limited circumstances these “reverse sourcing rules” will tax foreign sourced income as effectively connected with a U.S. trade or business.
  - b. The foreign taxpayer must have an office or other fixed place of business in the U.S. for these rules to apply.
  - c. These rules will only apply to certain specified categories of income and only if that income is “attributable” to the U.S. office or fixed place of business.



4. Certain deferred payments. Income or gain of a nonresident alien or foreign corporation for any taxable year which is attributable to the sale of property or the performance of services in any other taxable year will be treated as effectively connected with a U.S. trade or business if it would have been so treated if the income or gain were taken into account in the other taxable year. IRC § 864(c)(6).
5. Income and Gain from Certain Property Transactions: If property ceases to be used in a U.S. trade or business, the determination of whether any income or gain attributable to its sale within 10 years after such cessation is effectively connected with a U.S. trade or business will be determined as if the sale occurred immediately before such cessation. IRC § 864(c)(7).
6. For purposes of computing taxable income effectively connected with a U.S. trade or business, the foreign taxpayer may only claim deductions related to such effectively connected income. IRC § 873.

**E. Special Rules and Exceptions.** After having determined whether or not an item of income is U.S. sourced and whether or not it is effectively connected to a U.S. trade or business, one still must review various special rules and exceptions before determining how such income will be taxed under the general rules of IRC §§ 871, 881 and 882.

1. Special election for real estate investment. IRC §§ 871(d), 882(d).
  - a. If a nonresident alien or foreign corporation invests in U.S. real property and it is not deemed effectively connected to a U.S. trade or business, the rental income will nevertheless be considered U.S. sourced and taxed at the 30% rate of IRC § 871(a) or § 882(a) (or lower applicable treaty rate).
    - (i) This tax is imposed on the gross rental income.

- (ii) There is no opportunity to deduct related expenses before the application of the tax.
- b. However, such foreign taxpayers are allowed to elect to have such rental activity treated as effectively connected with a U.S. trade or business. IRC § 871(d), 882(d).
  - (i) This permits such activity to be taxed pursuant to IRC § 871(b) or 882(a) under the resident taxpayer rules. These rules impose a tax on “taxable income” (i.e. net income not gross income) so related expenses can be deducted pursuant to IRC § 861(b).
  - (ii) FIRPTA eliminated the major historic disadvantage to making such an election (e.g., by subjecting capital gain on sale of U.S. real property by foreign persons to U.S. taxation). See Section VI. below for discussion of FIRPTA.
  - (iii) However, such an election must be with respect to all such income and is irrevocable (unless IRS consents to a revocation). But some treaties provide for a similar election on an annual basis.

2. Special exclusion for certain capital gains. IRC §§ 871(a)(2).

- a. Generally foreign corporations are not subject to U.S. taxation on U.S. sourced capital gains not effectively connected to a U.S. trade or business because such gains do not fall under the categories of income taxed under IRC § 881(a).
  - (i) If such gains are effectively connected with a U.S. trade or business they are subject to tax under the regular resident rules pursuant to IRC § 882.
  - (ii) Gain from the sale of a U.S. real property interest will be deemed effectively connected and therefore

taxed under IRC §882. See FIRPTA at Section VI. below and IRC § 897.

- b. A nonresident alien is subject to the 30% tax under IRC § 871(a) (or lower applicable treaty rate) on his U.S. sourced capital gains which are not effectively connected to a U.S. trade or business if he is present in the U.S. for more than 183 days during the year. Otherwise such non-effectively connected capital gains are not subject to U.S. taxation. IRC §871(a)(2). In this regard it should be noted that, as discussed at III.A.3.e. above, there is a special definition of U.S. resident for purposes of the capital gains sourcing rule at IRC § 865(g) which definition includes as a U.S. resident a nonresident alien who is present in the U.S. for 183 days and maintains a U.S. "tax home". Consequently the world-wide capital gains of such an individual would be considered U.S. sourced for purposes of this taxing provision even though such person may not be considered a U.S. resident for other purposes.
  - (i) If such capital gains are effectively connected with a U.S. trade or business they are subject to tax under the regular resident rules pursuant to IRC § 871(b).
  - (ii) Gain from the sale of a U.S. real property interest will be deemed effectively connected and therefore taxed under IRC § 871(b). See FIRPTA at Section VI. below and IRC § 897.
- 3. Special exclusions for other categories of income not effectively connected to a U.S. trade or business but otherwise U.S. sourced under the general sourcing rules.
  - a. Interest from 80-20 corporations (as defined in IRC § 861(c)) and similarly situated resident alien debtors. IRC § 861(a)(1)(A).

- b. Partial exclusion for dividends from 80-20 corporation. IRC § 871(i)(2)(B), 881(d).
  - c. Interest on U.S. deposits. IRC § 871(i)(2)(A), 881(d).
  - d. Portfolio interest. IRC § 871(h), 881(c).
  - e. Compensation income from temporary U.S. presence. IRC § 861(a)(3).
  - f. Income affected by an applicable treaty. IRC § 894.
  - g. Certain annuities received under qualified plans. IRC § 871(f).
- 4. Special exclusions from the gross income of nonresident aliens. IRC § 872(b).
  - 5. Special exclusions from the gross income of foreign corporations. IRC § 883.
  - 6. Special exclusion from general rule of IRC § 1041 regarding tax-free transfers of property to a spouse or former spouse incident to a divorce. This rule is not available if the transferor spouse or former spouse is a nonresident alien.

**F. Withholding Rules.**

- 1. Non-effectively connected income. IRC §§ 1441, 1442.
  - a. To insure collection of the taxes on the generally passive investment and compensation income not effectively connected with a U.S. trade or business which is taxed to nonresident aliens under IRC § 871(a) and to foreign corporations under IRC § 881, the IRC imposes a withholding tax on the payor at the 30% (or lower treaty) rate. See the discussion of tax treaties at II.C. above.
  - b. If the withholding tax equals the foreign taxpayer's full tax liability, and such taxpayer is not engaged in a U.S.

trade or business no U.S. tax returns need to be filed. Otherwise the nonresident alien must file a form 1040 NR and a foreign corporation must file a 1120 F.

2. Partnership Payments to Foreign Partner or LLC Payments to a Foreign Member of a Limited Liability Company. IRC § 1446.
  - a. If a partnership has income effectively connected to a U.S. trade in business, a withholding tax based on the highest rate of tax imposed for individuals (35%) or corporations (35%) is imposed on any partnership income allocable to a foreign partner. Since limited liability companies are generally subject to the partnership tax rules unless they elect to be taxed as corporations, foreign members of a U.S. limited liability company would also be subject to these withholding rules.
3. FIRPTA Gain. IRC § 1445.
  - a. The transferee of a U.S. real property interest from a foreign person must withhold 10% of the amount realized by the transfer on the disposition.
  - b. See general FIRPTA discussion at Section VI . below.

#### **IV. Summary of Taxation by Type of Income.**

##### **A. Items Generally Taxed at Resident Taxpayer Rates:**

1. Business profits and income effectively connected with U.S. trade or business.
2. Investment income (rents, interest, dividends, etc.) compensation and other "fixed and determinable annual or periodic income" effectively connected with a U.S. trade or business.
3. Gain from sale of U.S. real property interest.
4. Capital gains effectively connected to U.S. trade or business.

5. Any other income effectively connected to U.S. trade or business.

**B. Items Generally Taxed at 30% (or lower treaty rate).**

1. U.S. sourced passive income (rents, royalties, interest, dividends, etc.), compensation and other "fixed and determinable annual or periodic income" not effectively connected with a U.S. trade or business.
2. U.S. sourced non-FIRPTA capital gains not effectively connected if nonresident alien present in U.S. more than 183 days.
3. All other U.S. sourced income not effectively connected to U.S. trade or business.

**C. Items Generally Not Subject to U.S. Taxation.**

1. U.S. sourced non-FIRPTA capital gains of a foreign corporation if not effectively connected to a U.S. trade or business.
2. U.S. sourced non-FIRPTA capital gains of a nonresident alien if not effectively connected to a U.S. trade or business and if nonresident alien not present in U.S. more than 183 days.
3. Interest on U.S. deposits not effectively connected to a U.S. trade or business.
4. Interest on publicly-traded corporate debt obligations ("portfolio interest").
5. Compensation income not effectively connected and from a temporary U.S. presence.
6. Additional specific items excluded by statute.
7. Additional specific items excluded by treaty.
8. All non-U.S. sourced income not effectively connected with a U.S. trade or business.

**V. Summary of Taxation By Foreign Person Status.**

**A. Employee Status.**

1. Performing services in U.S. for either a U.S. or foreign employer will cause an employee to be considered engaged in a U.S. trade or business unless the temporary worker exception is applicable. See III.B.8. above.
  - a. Such taxable compensation is subject to the regular resident graduated rates. IRC § 871(b).
  - b. But remember to determine if there is a treaty exception to this general rule.
2. Performing services in U.S. could cause an employee to be deemed a resident which would subject his world-wide income to U.S. taxation. IRC § 7701(b), See Section III.A. above.
3. Performing services outside the U.S. will generally not give rise to U.S. sourced income for a nonresident alien.

**B. Independent Contractor Status.** Same basic analysis as at A. above concerning employees.

**C. Shareholder Status.**

1. Owning shares in a U.S. corporation does not cause the foreign shareholder to be deemed engaged in a U.S. trade or business.
  - a. Corporate income will be subject to regular resident tax rules. IRC § 11. Sale of U.S. real property interest could trigger FIRPTA rules. See FIRPTA at Section VI. below.
  - b. Corporate dividends will generally be treated as U.S. sourced and subject to 30% tax (or lower treaty rate). Dividend payments will be subject to withholding. See Section III.F. above.

- c. Sale of shares could be subject to FIRPTA rules if the corporation deemed a "U.S. real property holding company." See FIRPTA at Section VI. below. Otherwise, a sale of corporate shares should avoid U.S. taxation if it occurs outside the U.S.
- 2. Owning shares in foreign corporation doing business in U.S. will not cause foreign shareholder to be deemed engaged in U.S. trade or business but the foreign corporation will be so engaged unless, pursuant to an applicable treaty, the corporation is not deemed to have a permanent establishment. See Section III.C. above.
  - a. Corporate income effectively connected to a U.S. business will be subject to regular resident tax rules. IRC § 882. A sale of a U.S. real property interest could trigger FIRPTA rules. See Section VI. below.
  - b. A foreign corporation doing business in the U.S. could also be subject to the Branch Tax. IRC § 884. See Section VIII. below
  - c. Dividend distributions to foreign shareholders will generally not be considered U.S. sourced and therefore not subject to U.S. taxation unless more than 25% of gross earnings come from U.S. business. See IRC § 861(a)(2)(B) and Section III.B.7. above. If the Branch Tax not applicable but such distributions are considered U.S. sourced they would be subject to the "second tier withholding tax."
- 3. Owning shares in foreign corporation not engaged in a U.S. trade or business.
  - a. The tax on corporate income from U.S. sources will depend on type of income.
    - (i) Generally compensation and investment income will be subject to the 30% tax (or lower treaty rate).



- (ii) Non-FIRPTA capital gains and interest on deposits generally will not be subject to U.S. taxation.
  - (iii) FIRPTA capital gains will be subject to regular resident tax rules. IRC §§ 897, 882. See Section VI. below.
- b. Dividend distributions to foreign shareholders will generally not be considered U.S. sourced and therefore not subject to U.S. taxation.

**D. Partner or LLC Member Status.**

1. A foreign partner in a partnership or limited liability company which is engaged in a U.S. business will be deemed engaged in a U.S. business.
  - a. Partners' share of partnership income which is effectively connected will be subject to regular resident tax rules. IRC § 871(b). A withholding tax based on the highest rate of tax imposed for individuals or corporations is imposed on any distributions to foreign partners. IRC §1446. See Section III.F.2. above.
  - b. Any U.S. sourced partnership income not effectively connected is generally taxed at the 30% rate (or lower treaty rate). But such items of income may be deemed effectively connected and taxed at the regular rates. See Section III.D.2. above.
  - c. Any non-U.S. sourced income generally is not subject to U.S. taxation.
  - d. Since limited liability companies are generally subject to the partnership tax rules unless they elect to be taxed as corporations, a foreign member of a limited liability company will also be subject to these partnership rules. However, see III.C.2.f. above regarding the possible treatment of single member limited liability companies as disregarded entities.

2. A foreign partner in a partnership or limited liability company which is not engaged in a U.S. trade or business (e.g., no permanent establishment under an applicability treaty) will not be deemed engaged in a U.S. trade or business. The tax on such partner's or LLC member's U.S. sourced income will depend on type of income:
  - a. Generally compensation and investment income will be subject to 30% tax (or lower treaty rate).
  - b. Non-FIRPTA capital gain will be subject to 30% tax or lower treaty rate if the partner or LLC member is present in U.S. for more than 182 days. IRC §871(a)(2). See Section III.E.2.b. Otherwise such capital gains not subject to U.S. taxation. See Sections III.E.2.b. and IV.B. above.
  - c. FIRPTA capital gains will be subject to regular resident tax rates. IRC § 897, 871(b). See VI. below.
  - d. Business profits and interest on deposits generally will not be subject to U.S. taxation.

**E. Proprietor Status.** Same basic analysis as described for Partnerships at Section V.D. above.

**F. Creditor Status.**

1. U.S. sourced interest on deposits not subject to U.S. taxation unless effectively connected to U.S. trade or business. IRC § 871(i). If effectively connected they are taxed under regular resident tax rules. IRC §§ 871(b), 882. See Section III.B.6. above.
2. Portfolio interest not subject to U.S. taxation. IRC §871(h). See Section III.B.6.c. above.
3. Other U.S. sourced interest generally taxed at 30% (or lower treaty rate) unless effectively connected with U.S. trade or

business. IRC §§ 871(a), 881. If effectively connected, interest is taxed under regular resident tax rules. IRC §§ 871(b), 882.

## **VI. FIRPTA. IRC § 897.**

**A. Introduction.** Prior to FIRPTA, foreign taxpayers not engaged in a U.S. trade or business were generally not subject to U.S. taxation on capital gains. See III.E.2. above. Because of this rule and the absence of a withholding requirement in circumstances when a tax was imposed, the tax was not being collected on the sale of appreciated U.S. real estate. The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") was passed to impose and collect such a tax.

### **B. Basic Philosophy of FIRPTA:**

1. Gains on the sale of U.S. real property by foreign taxpayers is considered to be "effectively connected" income and therefore subject to regular resident tax rules.
2. Interests in certain U.S. corporations holding real property are treated as if they were themselves real property interests.
3. Conflicting treaty provisions are specifically overridden.
4. A withholding requirement is imposed on the payor.

**C. General Rule:** Gain or loss of a nonresident alien or a foreign corporation from the disposition of a United States real property interest ("USRPI") shall be taken into account as effectively connected income under IRC §§ 871(b) and 882(a) respectively.

1. As a result, the taxpayer's gain is subject to the regular resident tax rules.
2. Alternatively, in the case of a nonresident alien individual, his net USRPI gain will be potentially subject to an alternative minimum tax on the individual's net real property gain. IRC § 897(a)(2).
3. A net loss on such nonresident alien individual's USRPI transactions for the year will only be allowed if the loss really

was connected with a trade or business (and not merely deemed so under the general FIRPTA rule). IRC § 897(b).

**D. Meaning of USRPI.** IRC § 897(c).

1. In general, USRPI means any interest in real property (including mines, wells and mineral deposits and including leaseholds, improvements and options to acquire such interests) located in the U.S. or the Virgin Islands and any interest (other than solely as a creditor) in any U.S. corporation unless the taxpayer can establish that the corporation was not a "U.S. real property holding corporation" (USRPHC) during the previous 5 years.
  - a. Once a U.S. corporation meets the USRPHC test, it keeps such taint for 5 years even if it no longer otherwise meets the test.
  - b. But USRPHC can lose such taint if at the time its stock is sold it has no USRPI and any USRPI it held during the taint period was disposed of in a fully taxable transaction. IRC § 897(c)(1)(B).
2. Meaning of USRPHC. IRC § 897(c)(2).
  - a. Any corporation is a USRPHC if the fair market value of its USRPI equals or exceeds 50% of the fair market value of the sum of (i) its USRPI, (ii) its interests in real property located outside of the U.S., plus (iii) any other of its assets which are used or held for use in a trade or business.
  - b. Note that only an interest in a U.S. corporation which is a USRPHC is treated as a USRPI but in determining if a U.S. corporation meets this definition (and only for this purpose a foreign corporation holding USRPI can be treated as a USRPHC so its interests could be treated as USRPI in the hands of a domestic corporation). For example, assume Corp A is a U.S. corporation and its assets consist of the following:

	<u>FMV</u>
(i) U.S. real property	45
(ii) Other business assets	45
(iii) Interest in Corp B	<u>10</u>
	100

Corp B is a foreign corporation whose assets consist of the following:

	<u>FMV</u>
(i) U.S. real property	60
(ii) Other business assets	<u>40</u>
	100

For purposes of determining if Corp A is a USRPHC, Corp B is considered a USRPHC so Corp A's interest in Corp B is considered a USRPI. Therefore Corp A is considered a USRPHC and any interest in Corp A is considered a USRPI. (Note however that the calculation would be different if Corp A held a "controlling interest" in Corp B - See Section VI.D.2.d. below). Therefore the disposition of an interest in Corp A could trigger the FIRPTA rules. However the disposition of an interest in Corp B (absent a special election under IRC § 897(i) as discussed at Section V.L. below) will not trigger the FIRPTA rules.

- c. For purposes of this asset test, any assets held by a partnership, trust or estate shall be treated as held proportionately by its partner or beneficiaries. IRC § 897(c)(4)(B). For example, if Corp B described above had been a partnership and Corp A had been a 50% partner, the asset test for Corp A would be as follows:

	<u>FMV</u>
(i) U.S. real property (direct)	45
(ii) U.S. real property (via B)	30
(iii) Other business assets (direct)	45
(iv) Other business assets (via B)	<u>20</u>
	140

Therefore Corp A would be a USRPHC.

- d. If one corporation holds a controlling interest in another corporation (i.e., more than 50% of the fair market value of all classes of stock), for purposes of these tests, the first corporation shall be treated as holding its proportionate share of each of the second corporations' assets in a fashion similar to that described in c. above. IRC § 897(c)(5).
- e. Exclusion for certain publicly traded stock. If any stock is publicly traded, it will be treated as a USRPI only with respect to a person who held more than 5% of such stock during the 5-year taint period. IRC § 897(c)(3).
  - (i) Constructive ownership rules of IRC § 318(a) apply for purposes of this test. IRC § 897(c)(6)(C).
  - (ii) The regulations contain a similar provision with respect to interests in publicly-traded partnerships and trusts. Treas. Reg. 1.897-1(c)(2)(iv).

**E. Sale of Stock in USRPHC.** Since an interest in a USRPHC is considered a USRPI, a sale of stock by a foreign taxpayer in a USRPHC will trigger the FIRPTA rule and the gain will be taxed under the regular resident tax rates.

**F. Sale of Stock in a Foreign Corporation.**

1. Since stock in a foreign corporation is not considered a USRPI, the sale of such stock - even if the corporation holds USRPI's - will not trigger the FIRPTA rules.

2. However, the FIRPTA rules will generally prevent such a foreign corporation from either selling the USRPI or distributing or otherwise disposing of the USRPI without triggering the FIRPTA rules; so the policy behind the rules is preserved.

**G. Sale of Interest in Partnership, Trust or Estate. IRC § 897(g).**

1. Under regulations to be prescribed by the IRS, any gain recognized by a foreign taxpayer on the sale of an interest in a partnership, trust or estate, to the extent attributable to a USRPI, will be considered gain from the sale of a USRPI, thereby triggering the FIRPTA rules. See Treas. Reg. § 1.897-1(c)(2)(iv), § 1.897-2(e)(2). Presumably these rules would also apply to a limited liability company taxable as a partnership.
2. Special Rules for REITS. IRC § 897(h).

**H. Distributions by Foreign Corporations. IRC § 897(d).**

1. General Rule: Gain shall be recognized by a foreign corporation on the distribution of a USRPI measured by the excess of the USRPI's fair market value over its adjusted basis.
2. Exception: However, gain is not recognized on a distribution if the distributee would be subject to U.S. taxation on subsequent disposition of the USRPI and distributee has a carryover basis.

**I. Special Rules for Distributions by REITS. IRC § 897(h).**

**J. Suspension of Other IRC Nonrecognition Rules. IRC § 897(e).**

1. General Rule: Except as provided in regulations, any other IRC nonrecognition provisions will not apply to an exchange of a USRPI unless the interest received in the exchange will continue to be subject to taxation.
2. For Example: The nonrecognition rule of IRC §351 will not apply to a transfer of a USRPI to a corporation if the shares received by the foreign shareholder/taxpayer will not be subject

to U.S. taxation (e.g., if such stock would not itself be considered a USRPI).

3. Another Example: The nonrecognition rules of IRC §§ 354 and 368 will not apply with respect to a foreign shareholder who is a party to a merger of a USRPHC into another corporation which is not a USRPHC.

**K. Nondiscrimination Rule and Election Under IRC § 897(i).**

1. Many U.S. treaties contain nondiscrimination clauses which generally provide that residents of treaty countries doing business in the U.S. will not be treated less favorably than U.S. residents carrying on the same business activities.
2. To insure that the imposition of the FIRPTA rules on a foreign corporation would not treat such corporation more harshly than a U.S. corporation under similar circumstances, IRC § 897(i) allows a foreign corporation to elect to be treated as a U.S. corporation for purposes of the FIRPTA rules.
3. To make the election, the corporation must waive any treaty benefits which would otherwise prevent the FIRPTA tax on the gain resulting from a disposition of a USRPI.

**L. Withholding Requirements. IRC § 1445.**

1. General Rule. A transferee of a USRPI from a foreign person must withhold 10% of the amount realized by the foreign person on the disposition. Transferee includes any person foreign or domestic. IRC § 1.1445-1(g)(4).
2. Exceptions.
  - a. Where the USRPI is a residence and the amount realized does not exceed \$300,000.
  - b. Where transferor furnishes certification of nonforeign status.



- c. Where the property transferred is stock in a publicly traded U.S. company (or a non-public U.S. corporation issues a certification on non-USRPI status).
  - d. Where the transferee receives a statement from the IRS to the effect that the transferor is excused from the tax or has reached an accommodation with the IRS concerning its payment.
3. See the extensive regulations covering the withholding rules. Treas. Reg. § 1.1445-1 *et seq.*

**M. Summary Comments.**

1. Ownership of USRPI through foreign corporation still makes sense for estate tax and non-tax reasons.
2. However, the Branch Tax could cause problems. See Section VII. below.
3. Therefore consider the use of a foreign corporation in tandem with a U.S. holding company.

**VII. U.S. Branch Tax.**

**A. Introduction.** First introduced in 1986, the Branch Tax was designed to tax U.S. branches of foreign corporations in the same manner as a U.S. subsidiary of a foreign corporation would be taxed. This tax, generally, is in addition to regular U.S. corporate income taxes. While directed towards foreign companies, this tax scheme ultimately can affect foreign creditors of the U.S. branch who may have no U.S. business operations.

**B. Basic Philosophy of Branch Tax.**

1. To decrease discrepancy between taxation on U.S. subsidiaries and foreign corporations doing business in branch form by imposing a tax on profits of the U.S. branch that is similar to the 30% withholding tax on dividends repatriated by a U.S. subsidiary.

2. To treat repatriated interest of the branch in a similar way as interest paid by a U.S. subsidiary of the foreign corporation.
3. To treat a U.S. branch similar to U.S. subsidiary by taxing any interest deduction claimed which actually exceeds the interest financed by the subsidiary.
4. To coordinate I.R.C. provisions with tax treaties between the U.S. and foreign countries; to prevent foreign corporations from “shopping” for the most favorable treaty provisions.

**C. Three Bases for Tax.**

1. Branch Profits Tax: The Branch Profits Tax applies to the profits from the U.S. operations of a foreign corporation that are repatriated to the foreign country (i.e. profits not reinvested in the U.S. branch operations).
  - a. Application: The Branch Profits Tax applies to those engaged in a U.S. trade or business or those who receive income treated as effectively connected with the conduct of a U.S. trade or business. Treas. Reg. § 1.884-1(f)(1). In addition, the tax also applies to:
    - (i) any foreign corporation that is a partner in a partnership (or presumably a member in a limited liability company taxable as a partnership) which is engaged in a trade or business in the U.S. I.R.C. § 875, Treas. Reg. §§ 1.884-0(a), 1.884-1(f)(1); and
    - (ii) any beneficiary of a trust or estate that is engaged in a U.S. trade or business. I.R.C. § 875, Treas. Reg. §§ 1.884-0(a), 1.884-1(f)(1).
  - b. Tax Rates: After application of regular federal U.S. corporate income tax, the taxpayer’s effectively connected earnings and profits (ECEP) attributable to effectively connected income (ECI) are taxed at an additional 30%.

- c. Example: If a corporation has \$1,000 of ECI and \$350 of regular federal income tax, the result is \$650 of ECEP. If all \$650 is repatriated, then there will be \$195 of additional branch tax.
- d. The tax does not apply to:
- (i) Profits arising from any activity not constituting engaging in a trade or business.
  - (ii) Amounts taxed only under I.R.C. § 881.
- e. Computing Branch Profits Tax:
- (i) The 30% tax applies to the corporation's dividend equivalent amount (DEA). The DEA equals (ECEP) minus (the growth in U.S. net equity for the year). Treas. Reg. §1.884-1(b)(1). The change in equity helps measure whether branch earnings are retained and reinvested in the branch or whether they are disinvested and repatriated to the foreign country.
  - (ii) ECEP consists of earnings and profits defined under IRC § 312 that are attributable to ECI. Treas. Reg. §§ 1.312-6(b), 1.884-1(f). However, ECEP is not reduced by amount of distributions to shareholders of foreign corporation nor reduced by the amount of branch profits tax or tax on excess interest paid by the foreign corporation. Treas. Reg. § 1.884-1(f)(1) (Treas. Reg. § 1.884-1(f)(2) lists those items that are excluded from ECEP).
  - (iii) Net equity: This means U.S. assets minus U.S. liabilities (Treas. Reg. § 1.884-1(c)).
    - A. U.S. asset consists of property other than an interest in a partnership, trust or estate, if all the income from its use and all gain from its disposition is ECI as of the "determination date" (the determination date

under Treas. Reg. § 1.884-1(c)(3) is defined as the close of the day on which the amount of U.S. net equity is required to be determined). If the asset is only partially a U.S. asset, then only that proportionate part of adjusted basis can be included for branch tax purposes. Treas. Reg. § 1.884-1(d).

B. Excluded from U.S. assets:

1. Those items specifically excluded by I.R.C. § 884(d)(2).
2. U.S. assets acquired by a foreign corporation if one of the principal purposes is to increase artificially the foreign corporation's U.S. assets. Treas. Reg. § 1.884-1(d)(5)(ii).

C. U.S. liability (Treas. Reg. § 1.884-1(e)): This measurement represents the value of U.S. Connected Liabilities of the foreign corporation. Such liabilities are determined by either of two methods:

1.  $\text{U.S. assets} \times (\text{worldwide liabilities} \div \text{worldwide assets})$  under Treas. Reg. § 1.882-5(c)(2); or
2. U.S. assets x fixed ratio:
  - a. For a foreign corporation conducting banking or financing business the fixed ratio is 93%.
  - b. For a foreign corporation which is neither a bank or an insurance

company, the fixed ratio is 50%.  
Treas. Reg. § 1.882-5(c)(4).

- (iv) Example: F has \$1,000 of U.S. net equity at the end of 2000. During 2001, F generates \$100 of ECEP. F reinvests only \$40 of its ECEP in U.S. assets, resulting in a U.S. net equity at the end of 2001 equal to 1040. F's DEA would be \$60: \$100 of ECEP adjusted downward by F's \$40 increase in U.S. net equity.

2. Branch Interest Withholding Tax:

- a. This tax distinguishes between interest that is treated as paid by the branch of the foreign corporation from the interest generally paid by the foreign corporation. Interest paid by the U.S. trade or business of a foreign corporation will be treated as if it were paid by a U.S. domestic corporation. Therefore, such interest is characterized as U.S. source income resulting in a tax on foreign recipients at a 30% withholding rate, absent treaty relief. I.R.C. §§ 881, 884(f)(1)(A).
  - (i) Exceptions: The withholding rate does not apply to interest paid to a foreign person if, for example, the interest is effectively connected with a U.S. trade or business of the recipient, the portfolio interest exemption applies, or the bank deposit interest exemption applies. I.R.C. § 881(a), (c)-(d).
- b. Definition of Branch Interest:
  - (i) a liability that is a booked liability defined under Treas. Reg. § 1.882-5(d)(2),
  - (ii) insurance liability on U.S. business and liabilities giving rise to interest expense that is directly allocated to income from a U.S. asset

- (iii) in the case of a foreign corporation other than one with a U.S. banking branch or agency, a liability “specifically identified” as a liability of the corporation’s U.S. trade or business provided that:
  - A. an amount of such interest does not exceed 85% of the amount of interest of the corporation that would be excess interest
  - B. notification requirements are met under Treas. Reg. § 1.884-4(b)(3)(ii)
  - C. It is not a liability incurred in ordinary course of a foreign business or secured by a foreign assets and is not a booked liability. Treas. Reg. § 1.884-4(b)(1)(i)-(ii)

3. Excess Interest: Taxing excess interest of a U.S. branch of a foreign corporation serves as a way to recapture excess interest deductions which are taken by the corporation. Unlike the branch interest withholding tax, this tax amount is actually imposed on the foreign corporation paying the interest rather than imposed on the recipient of the interest. The tax is imposed on amounts that are *apportionable* to the foreign corporation’s ECI under Treas. Reg. § 1.882-5, but that are not *actually* paid by the branch. The resulting tax applies as if the excess interest were paid to the foreign corporation by a wholly owned domestic subsidiary. Treas. Reg. § 1.884-4(a)(2)(ii).

a. Basis of tax: A foreign corporation will be liable for tax under I.R.C. § 881(a) with respect to the excess of:

- (i) the amount of interest allocated or apportioned to ECI under Treas. Reg. § 1.882-5 for the taxable year

over

- (ii) the amount of interest deemed paid by the foreign corporation's U.S. branch under I.R.C. § 884(f)(1)(A). Treas. Reg. § 1-884-4(a)(2)(i).
- b. Determining interest allocated to ECI in order to determine tax on excess interest.
  - (i) Calculate the value of U.S. assets described in Treas. Reg. § 1.884-1(d)(1)(i).
  - (ii) Determine amount of liabilities deemed to be U.S. connected liabilities pursuant to Treas. Reg. § 1.882-5(c)(1):
    - 1. U.S. assets x (worldwide liabilities ÷ worldwide assets) under Treas. Reg. § 1.882-5(c)(2); or
    - 2. U.S. assets x fixed ratio under Treas. Reg. § 1.882-5(c)(4).
  - (iii) Apply the appropriate interest rate to the liabilities determined in subsection (ii):
    - 1. If liabilities defined as booked liabilities equal or exceed U.S. connected liabilities then the applicable rate is determined under Treas. Reg. § 1.882-5(d)(4)(i).
    - 2. If U.S. connected liabilities exceed booked liabilities, then the applicable rate is determined under Treas. Reg. § 1.882-5(d)(5).

**D. Application of U.S. Tax Treaties.**

- 1. Generally: The branch tax may not be imposed on a foreign corporation if the corporation is able to qualify for treaty relief pursuant to a tax treaty the United States has entered into with

another country. In order to qualify for Treaty Relief, the corporation must:

- a. Meet the treaty requirements under the respective treaty.
- b. Satisfy the I.R.C. § 884 "treaty shopping requirement."
- c. Not trigger the denial of treaty benefit with respect to "hybrid entities" under IRC § 894(c).

2. In order to satisfy the "treaty shopping requirements," the foreign corporation:

- a. must be resident of the foreign country and meet the treaty's limitation on benefits (LOB) requirements; AND
- b. (i) be a qualified resident of the treaty country; or  
(ii) be claiming relief under a treaty whose LOB provisions entered into force or were amended after Dec 31, 1986. Treas. Reg. § 1.884-1(g)(1) and (2).

3. Qualified Resident Test: The corporation must be a resident of the country and one of the following:

- a. meet stock ownership and base erosion standards. Treas. Reg. § 1.884-5(a)(1), (b)-(c);
  - (i) 36-Month Rule: Treaty benefits may only be applied to portion of corporation's DEA attributable to accumulated ECEP if the foreign corporation is a qualified resident for each of the taxable years, in whole or in part, includible in a 36 month period that includes the taxable year of the DEA.
- b. the stock of the corporation is primarily and regularly traded on a public market. Treas. Reg. § 1.884-5(a)(2), (d);



- c. satisfies requirements relating to conduct of active trade or business in country of residence. Treas. Reg. § 1.884-5(a)(3), (e); or
  - d. obtains a ruling from IRS that the corporation is a qualified resident of its country of residence. Treas. Reg. § 1.884-5(a)(4), (f).
- 4. Options for Treaty Relief Specific to Branch Withholding Tax: A foreign corporation paying interest can qualify for relief either under the treaty of its country of residence or pursuant to a treaty of the country of residence of the recipient. Treas. Reg. § 1.884-4(b)(8)(i)-(ii).
- 5. Options for Treaty Relief Specific to Excess Interest: A paying corporation can only qualify for relief based on fulfilling provisions of the treaty of its country of residence, and not the treaty of the country of residence of the recipient. Treas. Reg. § 1.884-4(c)(3)(ii).

## **VIII. Structural Alternatives for Holding a U.S. Business or Investment.**

**A. Introduction.** There are a number of different ways a foreign taxpayer can hold an investment in a U.S. business. This Section lists the major alternatives and highlights the main tax considerations with respect to each such alternative.

### **B. Direct Equity or Debt Investment in a U.S. Corporation.**

- 1. Avoids U.S. trade or business status for foreign investor.
- 2. Avoids exposure of foreign investor to U.S. jurisdiction.
- 3. The business income from the investment is subject to a potential double level taxation.
  - a. First, the business income is taxed at the U.S. corporate tax. IRC § 11.

- b. Second, a 30% (or lower treaty rate) tax is imposed on dividends paid to the foreign investor. IRC §871(a) or 881; or
  - c. If the investment is a debt investment rather than an equity investment, then a 30% (or lower treaty rate) tax is imposed on interest payments to the foreign investor. IRC § 871(a) or 881) unless the interest qualifies as portfolio interest. IRC § 871(h).
  - d. As a consequence the aggregate tax rate on repatriated profits is very high.
- 4. A sale of the investment by the foreign investor is not subject to U.S. taxation unless FIRPTA applies or the sale occurs in the U.S.
  - 5. This is a preferred alternative where there would be retained earnings not repatriated and where multiple investments are to be held under holding company format.

**C. Branch Operation of Foreign Corporation.**

- 1. Foreign corporation probably will be deemed engaged in U.S. trade, business (e.g., will probably have a permanent establishment if a treaty country corporation).
- 2. This structure exposes the foreign corporation to U.S. tax and non-tax jurisdiction.
- 3. The business income from the branch is subject to a potential double level of taxation.
  - a. First, the foreign corporation will be subject to the regular resident tax rules on its effectively connected income of the branch. (In addition, any business profits from unrelated activities will be deemed effectively connected. See III.D.2. above).

- b. Second, the branch operation exposes the foreign corporation to the Branch Tax. IRC § 884. See Section VII. above.

**D. Direct Operation of Business by Foreign Nonresident Individual.**

1. This structure subjects the nonresident alien to the regular resident tax rules on effectively connected income. Any business profits on unrelated activities could be deemed effectively connected. See III.D.2. above.
2. This structure also exposes the individual to U.S. tax and non-tax jurisdiction and tax-filing requirements.
3. This structure does avoid potential double taxation thereby allowing repatriation of profits at a relatively lower level of taxation than through corporate ownership.
4. This is not a preferred structure for an equity investment but may be a preferred structure for a debt investment by a foreign individual.
5. This structure also causes estate tax problems.

**E. Investment in U.S. Partnership or Limited Liability Company.**

1. This structure avoids the double taxation on repatriated earnings that would apply to an investment in a U.S. corporation as long as the foreign partner is an individual. But if the foreign partner is itself a corporation, this structure is similar to a branch operation. A foreign corporation which is a partner in a U.S. partnership is subject to the same double tax exposure described at VIII. C. above.
  - a. First, the foreign corporate partner will be deemed engaged in the partnership's trade or business in the U.S. (See III.C.2.d. above) and, consequently, will be subject to the regular resident tax rules in its allocable share of partnership income. It will also be subject to a

withholding tax on that allocable share of income as described at 4. below.

- b. Second, as described at VII.C.1.a.(i) above, the foreign corporate partner will be subject to the Branch tax with respect to any portion of that allocable share of the partnership income which is repatriated.
2. This structure also directly subjects the foreign partner (whether an individual or a corporation) to U.S. taxation on business income (so the partner needs to file a U.S. return).
3. This structure also could cause potential “phantom income” problems (e.g. the foreign partner (whether an individual or a corporation) may be allocated more taxable income than cash distributions).
4. The foreign partner would be subject to the withholding tax rules for its allocable share of partnership income. See Section III.F.2. above.
5. This structure is not preferred for an investment with phantom income potential. It could be a preferred alternative for loss investments (i.e. an investment which will generate tax losses) if the investor has U.S. income sources and can avoid the passive loss limitation problems of IRC § 469. It could also be a preferred alternative for passive investments by foreign partners who are individuals where earnings must be repatriated.
6. This structure also could cause estate tax problems for foreign partners who are individuals. There is little authority on this point and arguments can be made that holding a partnership interest in a partnership that holds U.S. assets should not subject the foreign partner to U.S. estate taxation – particularly if it is a foreign rather than a U.S. partnership. If estate tax exposure could be avoided this form of ownership could be preferred.
7. The sale of interests in the U.S. partnership or limited liability company would be subject to U.S. taxation whether the foreign

partner (or foreign LLC member) is a corporation or individual because either is deemed engaged in the U.S. business of the partnership or the LLC. See Revenue Ruling 91-32.

**F. Use of a Combination of Structures.**

1. To gain some additional advantages a combination of structures could be used.
2. For example, a foreign corporation could own the shares of a U.S. corporation which owns the U.S. business assets. This structure could avoid estate tax problems and also avoid U.S. capital gain taxation on the sale of the foreign corporation shares. This would work best where operating income is not being repatriated during the life of the investment and the foreign investor can "cash out" by selling stock in the foreign corporation rather than selling either the shares in the U.S. corporation or the underlying U.S. business assets.
3. A foreign investor could own a foreign corporation which in turn would own an interest in a U.S. partnership which owns the U.S. business assets. This structure could avoid the application of U.S. estate taxation on the death of the foreign investor and would permit a U.S. tax-free exit if the investor can exit by selling the shares of the foreign corporation (as long as FIRPTA does not apply).

**IX. Structural Alternatives for Acquiring a U.S. Business.**

**A. Introduction.** Once it is determined what investment or business will be acquired and in what form it will be held, it must be determined how it will be acquired. Obviously the answer to this question is intertwined with the answers to the first two questions. There are three general acquisition structures to be considered:

1. A taxable acquisition of the assets or equity of the target enterprise.

2. A tax-free acquisition of the assets or equity of the target enterprise.
3. A partnership or joint venture arrangement with the target enterprise.

**B. Taxable Acquisitions.**

1. Gain realized by the seller is immediately taxable.
2. The transaction could be either an asset or equity acquisition.
  - a. An asset acquisition allows the buyer to avoid unwanted assets and unknown liabilities. Buyer could also obtain a “stepped up” depreciable basis for the acquired assets.
  - b. An asset acquisition could be more difficult mechanically to accomplish because of third party consents, filing requirements, etc.
  - c. A taxable asset acquisition from a C corporation could trigger two levels of taxation of shareholders of selling company.
  - d. A stock acquisition, on the other hand, requires the buyer to assume all of the liabilities of the target enterprise - whether known or unknown.

**C. Tax-Free Acquisitions. IRC §§ 354, 368.**

1. Avoids immediate gain recognition to seller.
2. Could consist of either an asset or stock acquisition but it generally must be an acquisition of “substantially all” of the target’s assets or stock unless accomplished via a merger transaction.
3. Consideration used to acquire the target must consist generally of voting stock of an acquiring corporation.
  - a. Such consideration may not be acceptable to either party.

- b. Seller will have a continuing equity interest in the buyer.
- 4. Tax-free acquisitions will rarely be a viable option unless the foreign investor establishes a U.S. corporation to participate in a merger transaction.

**D. Joint Ventures.**

- 1. This approach could be used when there will be less than a total acquisition.
- 2. Buyer and Seller will have continuing business relationship.
- 3. Could be accomplished through the use of a partnership, limited liability company or a holding company format.
- 4. Typically the foreign investor will establish a U.S. corporation to be the member of the joint venture.

**X. General Comments on Specific U.S. Investments.**

**A. Introduction.** What follows is a general summary of tentative conclusions on how different types of U.S. investments might be held by foreign taxpayers to avoid major problems and maximize tax advantages.

**B. U.S. Profitable Operating Business.**

- 1. Typically such a business should be held in corporate form for estate tax and non-tax reasons and, if earnings are required to be retained in the U.S. business, to avoid phantom income problems. As an exit strategy, the foreign investor (whether a corporation or individual) could avoid all capital gain taxation by selling the shares of the corporation as long as the FIRPTA rules described at VI. don't apply. But if the corporation is the seller of the business assets (as opposed to the foreign investor selling the corporate shares) then the gain on the sale will not be eligible for the lower capital gain rates (because these rates do not apply to corporate sellers). The use of a partnership or limited liability company structure for a foreign individual investor would

eliminate the double taxation of repatriated earnings and would permit the application of the lower capital gain rates on a sale of the business assets, but such a structure might lead to exposure to U.S. estate tax liability and could cause a direct U.S. tax and non-tax nexus for such individual.

2. A U.S. corporate form for the investment insulates the foreign investor (whether a nonresident individual or a foreign corporation) from trade or business/permanent establishment status.
3. Consider using a U.S. holding company if the foreign investor has other U.S. corporate holdings - particularly loss corporations.
4. A U.S. corporate form also avoids the Branch Tax but dividends or interest payments from the U.S. corporation will generally be subject to second level tax when repatriated. Actually, whether the business is held in corporate or partnership (or limited liability company) form, there will be a double level tax cost to repatriate operating profits back up through the structure to a foreign corporate investor. See VIII. C. and VIII. E. above.

**C. U.S. Loss Operating Business.**

1. This type of investment which generates tax losses should typically be held in U.S. corporate form for estate tax and non-tax reasons and to insulate the foreign investor from trade or business/permanent establishment status. However, if the potential exposure to U.S. estate taxation and possible direct U.S. tax and non-tax nexus is not considered a problem (e.g. the investor is a foreign corporation), a partnership or limited liability structure might permit a more efficient use of tax losses by the foreign investor. But see 3. and 4. below.
2. Consider U.S. holding company if foreign investor has other U.S. corporate holdings - particularly profit corporations.
3. Could use a branch approach to "repatriate" losses but this would subject foreign corporation to U.S. jurisdiction and would



subject any unrelated U.S. sourced business income to resident tax rates. See III.D.2. above. (This would not be a consideration if the foreign corporation is already operating in the U.S.) A branch structure would also cause Branch Tax problems when the business turns profitable. These same considerations would apply to a foreign corporation investing in a U.S. partnership or limited liability company (See VIII.E.1. above).

4. Should generally avoid direct ownership or a partnership or limited liability company structure for same reasons as set forth at 3. above unless the nonresident taxpayer is already subject to U.S. taxation and could use the losses as an offset against other profitable businesses.

**D. Real Estate Investments.**

1. Could use a partnership or limited liability company structure to pass through losses and avoid double taxation but this structure is subject to the phantom income problem. Also estate tax considerations may dictate use of a corporate ownership structure.
  - a. Would use a foreign corporation to avoid estate tax problems unless an applicable estate tax treaty is available to exempt stock in a U.S. company.
  - b. However, direct ownership of real property by a foreign corporation may cause Branch Tax problems. Could consider the imposition of a U.S. holding company subsidiary.
  - c. Coordinate title holding arrangement with estate planning - possibly use an irrevocable trust.
2. Gains will be subject to resident tax rates whether held directly, in partnership or in corporate form (FIRPTA).
3. If the investment is not considered a trade or business, the foreign taxpayer could make an election under IRC § 871(d),

882(d) to gain use of business deduction and have tax apply to net income rather than gross income. However, in such case, regular resident tax rates rather than a lower treaty rate will apply. See III.E.1. above.

**E. Passive Stock Investments.**

1. Generally direct ownership is acceptable unless countervailing non-tax reasons or country of resident tax considerations.

**F. Passive Debt Investments.**

1. Generally direct ownership is acceptable (particularly if the investment qualifies for the special rules for deposits or portfolio interest; See Sections III.B.6. and V.F. above) unless countervailing non-tax reasons or country of resident tax considerations would cause a problem.
2. Weigh the potential rate of investment return against taxable v. non-taxable categories of investments.

**G. Summary Recommendations.** All else being equal, you should structure the deal to attempt the following:

1. Avoid trade or business/permanent establishment status.
2. If you have trade or business/permanent establishment status, minimize effectively connected income.
3. Avoid exposure to U.S. court jurisdiction.
4. Avoid U.S. tax filing and reporting requirements.
5. Avoid phantom income potential.
6. Avoid U.S. residency status.
7. Minimize U.S. sourced income taxed at non-treaty rates.
8. Maximize non-taxable or favorable treaty rate income.
9. Avoid double taxation on repatriated income.

10. Avoid trapping losses in an unusable category (e.g., maximize offsets and avoid passive loss and other loss limitation and loss deferral rules).

**BUT, OF COURSE, EVERYTHING ELSE NEVER IS EQUAL**

**XI . A Concluding Comment.**

This primer should not be considered definitive legal or tax advice. As I hope the foregoing presentation indicates, "in-bound" tax planning for foreign individuals and businesses is a complicated affair and numerous details and whole subject areas could not be addressed in a work of this scope. In addition, the tax laws of the United States are constantly changing (at what appears to be an accelerated pace) while this primer is not. Nevertheless, I hope you find this to be a handy overview and a resource for quick reference. If you have any constructive comments or suggestions, feel free to pass them along.

Brian W. FitzSimons  
Tucker Ellis & West LLP  
1150 Huntington Building  
925 Euclid Avenue  
Cleveland, Ohio 44115-1475  
(216) 696-2487  
b.fitzsimons@TuckerEllis.com

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