International Investors and U.S. Income Taxes

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Gary S. Wolfe has over 34 years of experience, specializing in IRS Tax Audits and International Tax Matters including: International Tax Planning/Tax Compliance, and International Asset Protection.

As of July 2016, Gary Wolfe has internationally published 15 books and 28 articles. Gary has received 14 international tax awards from five different Global expert societies in LONDON/UK including being voted one of the 100 leading world's law firms with votes from over 150,000 voters in over 160 countries with the following award: Global 100 (2016) (KMH Media Group) - CA/US International Tax Planning Law Firm of the Year.

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International Investors and US Income Taxes

International Investors who immigrate to the United States will either be taxed as a resident alien (subject to US income tax on their world-wide income) or a non-resident Alien (subject to US income tax on US source income, only).

United States taxes "U.S. Persons" on their worldwide income according to IRC §61(A).

Under IRC §7701(a)(30) U.S. Persons include the following:

1. U.S. Citizens;

2. Resident Alien Individuals (Green Card Test; Substantial Presence Test, (IRC §7701(b)(1)(A));

3. Domestic Corporations
(Corporations created under the laws of one of the 50 states) - location of corporate headquarters is irrelevant, (IRC §7701(a)(4) and (a)(9));

4. Domestic Partnerships
(Partnerships created under the laws of one of the 50 states) (IRC §7701(a)(4) and (a)(9));

5. Any Estate other than a Foreign Estate
An estate is foreign if its foreign-source income is not subject to U.S. taxation (other than any income effectively connected with a U.S. trade or business (IRC §7701(a)(30)(D), (a)(31)(A));

6. Any Trust
If a U.S. court if able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust (IRC §7701(a)(30) (E)).

U.S. Income Tax - Foreign Nationals

A foreign national is taxed in the United States on world- wide income if they are classified as a U.S. income tax resident, under one of two tests:

1. Lawful Permanent Resident Test
A "Green-Card Holder" is automatically treated as a U.S. income tax resident and is taxed on world-wide income (IRC § 7701 (b)(1)(A) (i)).

2. Substantial Presence Test

A non-green card holder will be classified as a U.S. income tax resident if they meet the substantial presence test found in IRC§7701(b)(3)(IRC § 701 (b)(1) (A)(ii)):

(a) Resident in the U.S. for 183 days or more in any one tax year (IRC § 7701 (b)(3)(A)).

(b) Resident in the U.S. for at least 31 days during the current tax year and 122 days per year over 3 tax years (current year and prior 2 years). See Treas. Reg. § 301.7701(b)-1(b)-1(c)(1).

Non-resident aliens have special tax rules and have to file Form 1040 NR annually with the IRS (or face both civil and criminal penalties for tax non-compliance). US income tax treaties (61 to date) may ameliorate taxes due for the non-resident aliens subject to the treaty provisions.

U.S. Income Tax (Non-Resident Aliens)

Non-resident aliens are subject to U.S. Income Tax on U.S. source: (1) FDAP Income, (2) Effectively Connected Income.

1. "FDAP" Income
U.S. Source "FDAP Income" i.e., Fixed or Determinable Annual or Periodical Income (e.g., salaries, wages, interest, rents, dividends, royalties, annuity payments and alimony).

A non-resident alien is subject to U.S. federal income tax on FDAP income at a flat 30% tax rate (without the benefit of any related deductions) IRC §871(a), 873(a). The flat 30% income tax is withheld at the income source (IRC §1441).

"FDAP Income" includes:
Gains from sale of intangible property (i.e., patents, copyrights or

other intangibles) (IRC §871(a)(1)(D).

"FDAP Income" does not include:
1. Gain from the sale of stock of a domestic corporation (Treas Reg §1.871-7(a)(1)).
2. Interest on bank deposits and "portfolio interest" (IRC §871(h) and (i).

Capital gains from US sources are only subject to US income tax if the E-2 investor is either:

1. Present in the US for more than 183 days, or
2. The gains are effectively connected to a US trade or business (which includes gains from sale of US real property).

Income tax treaties may reduce or eliminate the 30% flat tax on the FDAP Income.

2. Effectively Connected Income
Income that is "effectively connected" to a U.S. trade or business.

A non-resident alien, who is engaged in a U.S. trade or business, is subject to U.S. federal income tax on his "effectively connected income", at same tax rates as U.S. citizens and resident aliens (IRC §871(b)).

For a non-resident alien, engaging in a U.S. trade or business is not the basis for U.S. income tax. U.S. income tax is imposed if a non-resident alien owns a business through a permanent establishment in the U.S., i.e., a fixed place of business, (e.g., place of management, a branch, an office, a factory).

If the non-resident alien is a resident of a country with which the U.S. has an income tax treaty, the treaty may reduce or eliminate U.S. federal income tax on effectively connected income.

A non-resident alien must file IRS Form 8833 to disclose reliance on a U.S. tax treaty for an exemption from U.S. tax on "effectively connected income."

Non-resident Aliens are subject to US income tax on their investment

income (known as “FDAP income” i.e. Fixed or Determinable Annual or Periodical Income) or their Income which is effectively connected to a US trade or business.

U.S. INCOME TAX TREATIES

Under U.S. Federal Income Tax Laws, an alien is either taxed as a resident alien (subject to U.S. Income Tax on world-wide income) or a non-resident alien (subject to U.S. Income Tax on U.S. source income).

Non-Resident Alien: U.S. Tax Resident

An alien is classified as a resident alien (U.S. tax resident) if:

1. He is a U.S. lawful permanent resident at any time during the calendar year (i.e., has a “green card”).

2. He meets the “substantial presence test” (present in the U.S. for 122 days per year over a 3 year period).

Substantial Presence Test

An alien satisfies the “substantial presence test” for any calendar year (the “current year”) if:

1. He is in the U.S. for at least 31 days during the current year.

2. The sum of the number of days in the U.S. in the current year and two preceding calendar years equals or exceeds 183 days (“183 day test”).

3. For the “183 day test”, each day in the U.S. in the current year is counted as a full day. Each day in the U.S. in the first preceding calendar year is counted as 1/3 of a day, each day of presence in the second preceding calendar year is counted as 1/6 of a day (IRC §7701(b)(3)(A)(ii)).

"Substantial Presence Test": Closer Connection Exception

An alien who meets the substantial presence test may avoid being classified as a U.S. tax resident if:

1. He is present in the U.S. for fewer than 183 days during the calendar year.

2. He maintains a tax home in a foreign country during the entire current year.

3. He has a closer connection to the foreign country (i.e., his tax home) during the current tax year.

4. He timely files IRS form 8840, and has not applied for a "green card" (IRC §7701(b)(3)(B) and (C)).

The United States has 61 income tax treaties (see below). To be eligible for the benefits of an income tax treaty, an individual must qualify as a resident of either the U.S. or the other country that is a party to the treaty ("the contracting state").

The U.S. Model Income Tax Treaty (Art 4(1)) defines "resident of a contracting state" as "any person who, under the laws of that state is liable for tax in the state, by reason of his domicile, residence, citizenship, place of management, place of incorporation".

If an alien is classified as both a U.S. tax resident and a resident of its treaty partner ("dual resident"), the tax treaties contain "tie-breaker" provisions which determine the dual resident's tax residence status as follows:

1. Tax resident in country with permanent home.

2. If permanent home in both countries, tax resident in country with "center of vital interests" (personal and economic interests).

3. If the center of vital interests cannot be determined, tax resident in country in which he has a habitual abode.

4. If the habitual abode is in both (or neither) countries, he is a tax resident of the country in which he is a national).

An alien who claims the benefit of a treaty, to be classified as a non-resident, will still be subject to U.S. federal income tax as a non-resident alien.

A non-resident alien who relies on a U.S. tax treaty for an exemption from U.S. tax that is effectively connected with a U.S. trade or business is required to file IRS Form 8833 to disclose the tax exemption reliance (IRC §6114; Treas Reg 301.6114-1).

The US currently has 61 treaties for income tax.
https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z

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