Part 2: U.S. Taxation of Foreigners

Taxation of income of foreign persons derived from economic activities having some nexus with the United States

When are foreigners taxed by U.S.?
- U.S. source investment income not related to a U.S. business (30% withholding tax on gross income, no deductions, possible treaty relief on rates, even to zero)
- Not engaged in business in U.S. — not taxed except as above.
- Engaged in Trade or Business in U.S. (ETB)
  - Investment income related to U.S. trade or business
  - U.S. source business income (ECI)
  - Limited foreign source ECI
  - All other U.S. source income (force of attraction)
- By treaty, business income taxable only if PE and income related to the PE

Taxation of Periodical, Etc., Income

Code Section 871(a)
(a) Income not connected with United States business—30 percent tax.
(1) Income other than capital gains. Except as provided in subsection (h), there is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as—
   (A) interest . . . dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other
   Fixed or Determinable Annual or Periodical gains, profits, and income (FDAP).
   * * *
   (2) Capital gains of aliens present in the United States 183 days or more.

Code Section 871(b)
(b) Income connected with United States business—graduated rate of tax.
(1) Imposition of tax. — A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 or 55 on his taxable income which is effectively connected with the conduct of a trade or business within the United States.
(2) Determination of taxable income. — In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States

Swallows Holding Ltd. (2006)
Application of Chevron Deference
- Facts: Tp is a Barbados corporation with two principal shareholders, Raimundo Arnaiz-Rosas and Aurora Elsa Arnaiz. It held real property in San Diego, California, that generated rental income and had some associated expenses. In 1999, Tp filed returns for tax years 1993-96, well past the filing deadlines set forth in Treas. Reg. 1.882-4(a)(3)(i). Under that regulation, a Tp filing after the 18 month grace period deadline is not allowed to claim most deductions, including deductions incurred to earn income.
- Issue: Is the regulation invalid on the ground that IRC § 882(c)(2) gives the IRS the power to set the “manner” of filing, with no mention of a time limit?
- Holding: “Manner” does not necessarily exclude time, so the statute is unclear; the regulation is a reasonable interpretation of an unclear statute and thus valid under Chevron.

Frank Handfield v. Comm’r (1955)
Canadian individual selling Folkards in U.S.
- Facts: Frank Handfield is a nonresident alien individual residing in Canada. He manufactured picture postal cards in Canada and managed the business from Canada. He spend 24 days in the U.S. on business. Sales in the U.S. were made under a contract between Handfield and the American News Company. Handfield employed a U.S. resident to check the card vendors to see that the cards were properly displayed.
- Issue: Is Handfield engaged in business in the U.S. because of the activities in the U.S. of American News?
- Holding: Yes, American News was an agent, not a distributor, to its activities are attributable to Handfield.
**Cokes v. Comm’r (1988)**

**Doing Business status attributed to Partners**

- **Facts:** TP owned a working interest in an oil lease that gave tp the right to extract oil from the land subject to the lease. The extraction was done by an operating company that the Tp did not control but that constituted a partnership of the owners of the working interests.
- **Issue:** Is Tp subject to self-employment tax because she was carrying on a trade or business as a partner in a partnership.
- **Holding:** Yes, if a partnership is engaged in business in the U.S., then so are all the partners.

**Eugene Higgins v. Comm’r (1941)**

**Investment activities as engaging in business**

- **Facts:** Tp, living in Paris, had extensive U.S. investments in real estate, bonds and stocks and devoted a considerable portion of his time to the oversight of his interests and hired others to assist him in U.S. offices rented for that purpose. The real estate activities concededly constituted a business.
- **Issue:** Does the stock and securities activities constitute a business, thereby allowing the Tp to deduct his related expenses?
- **Holding:** No, it is not a business merely to keep records and collected interest and dividends from ones securities.

**Inverworld, Inc. v. Comm’r (1996)**

**Engaged in business through financial activities**

- **Facts:** Inverworld Ltd (LTD) is an investment management and financial services company organized in the Cayman Islands, a tax haven. Its business was to provide U.S. and foreign investment opportunities to the Mexican clients of its sister Mexican company while avoiding (evading) tax in Mexico. LTD received clients’ funds and placed such funds with third parties. A substantial part of the activities that produced LTD’s income took place in San Antonio.
- **Issue:** Was LTD engaged in a trade or business in the U.S., and was its income ECI?
- **Holding:** Yes to both questions.