

Nonresident Taxability and Where or How?

Nonresident? Is it Taxed and “If” So, “Where and How” on the Tax Return?

November 1, 2011

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The goal of this article is to provide a comprehensive checklist of information for the foreign national to consider prior to accepting an assignment in the US.. This article is not designed to teach you the technical competence required to perform self compliance; however it will certainly arm you with the knowledge to determine if your US tax preparer knows all that they should know to provide you with technically competent professional services.

If:

All US nonresident aliens are taxable in the US, only on US source income. Internal Revenue Code (IRC) Sec. 861 governs US sourced income, Sec. 862 governs Non US sourced income and Sec. 865 governs sourcing rules for personal property sales.

However US negotiated income tax treaties may override the source of specific items taxed, and therefore the applicable income tax treaties always need to be consulted in tandem with domestic US law treatment. Additionally in the case of US persons- citizens and green card holders- the US has conveniently slipped in to most income treaties a provision usually, under Miscellaneous Rules, to enable them to continue to tax their people as if the income tax treaty did not exist. This is typically referred to as a “Savings Clause” or “Limitation on Benefits” clause.

Where and How:

Where on the tax return that income is taxed and how it is taxed depends upon whether the income is effectively connected with a US trade or business, which includes compensation income but excludes passive income, or is non effectively connected income. IRC Sec. 871 governs which US sourced income is effectively connected with a US trade or business and which income is non US effectively connected income.

Effectively connected income is reported on Form 1040NR page 1 and is taxed at US regular graduated tax rates and non effectively connected income is reported on Form 1040NR page 4 and is taxed at a flat rate tax of 30%, or reduced treaty rates.

However there is one exception below, in the case of Capital Assets (includes everything you own except business related assets, includes shares held for investment, basically all personal property, but not real property) not effectively connected with a US trade or business. Under this one instance if a taxpayer is present in the US physically for 183 days or less in the tax year, the gain from the Capital Asset is not taxable. More than 183 days and the gain is considered not effectively connected with a US trade or business. This is the only clause in IRC Sec. 871 that deals specifically with the “If”.

If and Where and How:

We have constructed a table to facilitate these determinations:

<u>Income type:</u>	<u>US source rule: "IF"</u>	<u>If US sourced, effectively connected rule: WHERE and HOW:</u>
Interest income	Received from a US resident payer	Not effectively connected, unless from asset or produced by US trade/ business. Under 871 interest from US bank deposits not taxable.
Dividend income	Received from a US domestic corporation	Not effectively connected, unless from asset or produced by US trade/ business.
Personal service income- wages, salaries, commissions, fees. Per diem allowances & bonuses	If performed in the US	Performance in the US is considered effectively connected.
Rent/ Royalties	Property located in the US	Not effectively connected, unless from asset or produced by US trade/ business. However election on rental income to make effectively connected is available.
Royalties	For use in the US- patents, copyrights, good will TM, etc..	Not effectively connected, unless from asset or produced by US trade/ business.
Real property sale	Property located in the US	Always effectively connected
Inventory- purchased	Sold in US	Always effectively connected
Sale of personal property:	Seller's "tax home", special exceptions include: depreciable, intangibles, sales through office / fixed place of business	Not effectively connected, unless from asset or produced by US trade/ business (see below). If not effectively connected Capital Asset (includes everything you own except business related assets, includes shares held for investment, basically all personal property) then- 183 day rule- or more, not effectively connected, less than 183 days and tax exempt. Only instance of overriding US source rules. If you only trade stock through a US resident broker you are not engaged in a US trade or business. Even if you are in the US. From asset or produced by US trade/ business- Always effectively connected income, whether or not connection. Two tests determine if investment income (fixed or determinable- interest, rent royalty, Gains (rare types) or Capital Gains) are effectively connected to business- 1) Asset Use and 2) Business Activities Tests.
Scholarships, grants, prizes and awards	Residence of payer for activities performed in US	Either excluded or see Personal service income above.
Pension income	Portion related to US performed services	See Personal service income above.
Alimony	Paid by a spouse to ex-spouse	Residence of spouse obligated to make payments

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