UNC SCHOOL OF LAW

NORTH CAROLINA JOURNAL OF INTERNATIONAL LAW AND COMMERCIAL REGULATION

Volume 7 | Number 2

Article 5

Spring 1982

Taxation of Foreign Personnel in the United States

John L. Gornall Jr.

Philip J. Marzetti

Taxation of Foreign Personnel in the United States

by John L. Gornall, Jr.*
Philip J. Marzetti**

I. Introduction

An alien who comes to the United States to work is often subject to U.S. taxation. Therefore, it is important for both the foreign employee and the domestic or foreign employer to be aware of the U.S. tax liability to which foreign personnel will be subject as a result of their employment in the United States. This article will focus upon certain key tax concepts that affect foreign personnel working in the United States, including an alien's liability for U.S. income, estate, gift, and social security taxes. The intent of this article, however, is not to provide an in-depth treatment of the taxation of foreign personnel, but rather to provide an overview of some of the tax problems faced by foreign personnel working in the United States.

II. Income Taxation of Resident and Nonresident Aliens

The Internal Revenue Code of 1954, as amended (the "Code"), contains two very different statutory schemes for taxing resident and nonresident aliens. Accordingly, the threshold determination that must be made with respect to the income taxation of any alien is whether or not the alien is a U.S. resident. Despite the important consequences that stem from this determination, statutory guidelines are virtually non-existent. Indeed, the Code itself does not define either the term "resident" or the term "nonresident." While the Treasury regulations do distinguish a resident from a nonresident alien, they do so in extremely vague terms. The regulations provide as follows:

> An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intention with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly

---

* Partner, Powell, Goldstein, Frazer & Murphy, Atlanta; B.S.F.S., 1969, School of Foreign Service, Georgetown University; J.D., 1972, Emory University.
** Associate, Powell, Goldstein, Frazer & Murphy, Atlanta; B.A., 1972, Boston College; J.D., 1975, Harvard University.

> accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.[1]

As one may well imagine, this definition leaves many questions unanswered.

The determination of resident status proceeds from the presumption that "an alien, by virtue of his alienage" is a nonresident alien.[2] This presumption, however, may be negated by a showing that the alien has filed a declaration of intention to become a U.S. citizen, or that the alien has filed a Form 1078. The presumption may also be negated by proof of acts or statements of the alien indicating a definite intention to acquire residence in the United States.[3] Thus, the determination of resident status is "based upon the facts and circumstances of each particular case."[4]

There are several factors that the Internal Revenue Service (IRS) and the courts have deemed to be significant in determining an alien's status for tax purposes. One of the most important of these factors is the alien's visa classification. The Treasury Regulations (the "Regulations") specifically provide that an alien with a temporary visa is not a U.S. resident in the absence of exceptional circumstances.[5] Although an alien holding a permanent or resident visa (the so-called "Green Card," which is now made of blue laminated plastic) is not automatically a resident for income tax purposes, both the IRS and the Immigration and Naturalization Service (INS) regard claiming the tax benefits of nonresident alien status as inconsistent with permanent resident status in the United States. Therefore, an alien who obtains a Green Card probably will be considered a resident for income tax purposes if there is any additional evidence to support such a finding.

As one might expect, another significant factor is the length of the alien's stay in the United States. Presence in the United States for a period of less than one year will give rise to a presumption of nonresidency, absent exceptional circumstances.[6] Conversely, a more or less continuous presence of one year or longer creates a presumption of residency that places the burden of going forward with evidence of nonresidence on the alien.[7] However, this presumption of residency based upon

---

[1] Treas. Reg. § 1.871-2(b) (1960).

[2] Id. § 1.871-4(b).

[3] Id. § 1.871-4(c).

[4] Jellinek v. Commissioner, 36 T.C. 826, 834 (1961); see also Lemery v. Commissioner, 54 T.C. 480 (1970).

[5] Treas. Reg. § 1.871-2(b) (1960).

[6] Rev. Rul. 64-285, 1964-2 C.B. 184, 185.

[7] Rev. Rul. 69-611, 1969-2 C.B. 150.

an alien's presence in the United States for one year may be rebutted by "any proper evidence showing that the alien is, in fact, a transient, that is a nonresident."[8]

The Regulations also focus on the alien's "intentions" with regard to the length and the nature of his stay in the United States. Generally, these intentions cannot be proven directly except by testimony of the alien himself, which is often self-serving. Representations of residency to government officials and similar statements on legal documents such as wills, deeds, and divorce petitions, however, have sometimes come back to haunt aliens.[9]

There are numerous other factors relied on by the courts to determine an alien's status. Often these factors relate to the alien's "center of gravity," i.e., whether his connections with his native country are stronger than his connections with the United States.[10] These miscellaneous factors include:

(1) Whether the alien's U.S. living accommodations are of a permanent or temporary nature;
(2) Whether the alien maintains a residence in his home country, and if so, the type of residence;
(3) Where the alien's family lives;
(4) Where the alien's personal belongings are kept;
(5) Where the alien's children attend school;
(6) Whether the alien becomes active in community affairs or joins local clubs;
(7) Whether the alien has an international or U.S. driver's license;
(8) Whether the alien obtains and uses local credit cards;
(9) Whether the alien maintains a business office abroad or in the United States, or both; and
(10) Whether the alien returns to his home country on a regular basis.

A. *Taxation of Resident Alien*

Once an alien becomes a resident of the United States, he will be subject to U.S. taxation for as long as he remains a resident.[11] As a U.S. resident, he will be taxed not only on his U.S.-derived income, but on his entire worldwide income in the same manner and to the same extent as a U.S. citizen.[12] Further, income that is earned overseas while the alien was a nonresident but received after the alien became a resident, generally will be subject to U.S. taxation. Similarly, the entire amount of gain realized by a resident upon the sale of property overseas will be taxable

---

[8] Id.

[9] See, e.g., Bowring v. Bowers, 24 F.2d 918 (2d Cir.) (deed), cert. denied, 277 U.S. 608 (1928); Farmers' Loan & Trust Co. v. United States, 60 F.2d 618 (S.D.N.Y. 1932) (will); Patino v. Commissioner, 13 T.C. 816 (1949) (divorce petition), aff'd, 186 F.2d 962 (4th Cir. 1950); Goldring v. Commissioner, 36 B.T.A. 779 (1937) (trust), acq. 1938-1 C.B. 12. Cf. Adams v. Commissioner, 46 T.C. 352 (1966), acq. 1967-2 C.B. 1.

[10] See Lemery v. Commissioner, 54 T.C. 480, 487 (1970); Jellinek v. Commissioner, 36 T.C. 826, 834-35 (1961).

[11] Treas. Reg. § 1.871-1(a) (1960); Friedman v. Commissioner, 37 T.C. 539, 551 (1961).

[12] Id.

even though most or all of the appreciation in value occurred prior to his becoming a resident. The resident alien will, however, be entitled to a foreign tax credit for income taxes paid to other countries.[13]

B. Taxation of Nonresident Alien

In contrast to resident aliens who are taxed on their worldwide income, nonresident aliens generally are taxed only on income that originates in the United States.[14] The manner in which a nonresident alien ("NRA") is taxed in the United States depends primarily upon (i) whether the NRA is engaged in a trade or business within the United States, (ii) the source and type of income received by the NRA, and (iii) whether the NRA is the beneficiary of an income tax treaty between the United States and his country of residence.

1. Alien Not Engaged in U.S. Trade or Business. An NRA who is not engaged in a trade or business within the United States during a taxable year is taxed only to the extent that he has income from U.S. sources of one of the types described in section 871(a) of the Code.[15] Section 871(a) describes four basic types of income for which an NRA not engaged in U.S. trade or business will be taxed.

First, fixed or determinable, annual or periodic gains, profits, and income (FDAP), such as interest, dividends, rents, royalties and annuities described in section 871(a)(1)(A), will be taxed to the NRA and will be subject to the withholding tax under section 1441. The language of this subsection has been given a broad sweep by the Regulations and has been found to include lump sum payments,[16] alimony,[17] gambling winnings,[18] and the surrender of a life insurance policy.[19] Second, the NRA will be taxed on gains described in (i) section 402(a)(2), relating to the treatment of total distributions from certain employees' trusts, (ii) section 403(a)(2), relating to treatment of certain payments under certain employee annuity plans, and (iii) section 631(b) or (c), relating to treatment of gain on disposal of timber, coal, or iron ore with a retained economic interest.[20] Third, original issue discount on certain obligations payable more than six months from the date of original issue is taxable to the NRA.[21] Finally, the NRA will be taxed on gains from the sale or exchange of patents, copyrights, and similar property to the extent the payments are contingent on the productivity, use, or disposition of the

---

13 See I.R.C. § 901(b)(3) (1976).

14 Treas. Reg. § 1.871-1(a) (1960).

15 I.R.C. § 871(a) (1976).

16 Treas. Reg. § 1.1441-2(a)(1), 26 C.F.R. § 1.1441-2(a)(1) (1981).

17 See Howkins v. Commissioner, 49 T.C. 689 (1968) (alimony paid by resident alien to NRA from London account held to be income from "sources within the United States").

18 See generally Rev. Rul. 58-479, 1958-2 C.B. 60.

19 Rev. Rul. 64-51, 1964-1 C.B. 322.

20 I.R.C. § 871(a)(1)(B) (1976).

21 Id. § 871(a)(1)(C).

property sold or exchanged.[22]

In the absence of a treaty provision exempting an item from taxation or lowering the applicable tax rate, income described in section 871(a) is subject to a flat thirty percent withholding tax on the gross amount of the income.[23] No deductions are allowed for related expenses, such as the cost of collecting these items.[24] The withholding tax is collected by imposing upon all persons having the "control, receipt, custody, disposal or payment" of the income, the duty to withhold and pay over to the United States an amount equal to the tax.[25]

U.S. source capital gains, other than gains effectively connected with a U.S. trade or business or treated as such (e.g., gains from the sale of U.S. real estate), are not taxable unless the NRA is present in the United States for at least 183 days or more during the taxable year.[26] If he is, the gain is taxed at the rate of thirty percent.[27]

Foreign source income, and U.S. source income not described above, are not subject to U.S. taxation.

2. *Alien Engaged in U.S. Trade or Business*. If, however, an NRA is engaged in a trade or business within the United States, he is generally taxed on his income (whether from foreign or domestic sources) that is "effectively connected" with such trade or business.[28] If the NRA also realizes U.S. source income that is not effectively connected with a U.S. trade or business, such income is taxed as if the alien were not engaged in a U.S. trade or business. Thus, the NRA's effectively connected income must be segregated from his non-effectively connected income. Each category of income will then be taxed separately.[29]

An NRA will be deemed to be engaged in a U.S. trade or business if his activities and/or the activities of his agents (dependent or independent) are "considerable, continuous and regular."[30] An NRA will not be deemed to be engaged in a U.S. trade or business if his activities are limited to the receipt of income and the payment of expenses.[31] As one might expect, it is often difficult to determine at what point an NRA's activities constitute a U.S. trade or business. The following general rules, however, do provide some guidance.

---

22 Id. § 871(a)(1)(D).

23 Id. § 871(a).

24 Id. § 873.

25 Id. § 1441(a).

26 Id. § 871(a)(2).

27 Id.

28 Id. § 871(b) (Supp. III 1979).

29 Treas. Reg. § 1.871-8 (1974).

30 Lewenhaupt v. Commissioner, 20 T.C. 151, 163 (1953); see also Commissioner v. Spermacet Whaling & Fishing Co., 281 F.2d 646 (6th Cir. 1960); Pinchot v. Commissioner, 113 F.2d 718, 719 (2d Cir. 1940).

31 Herbert v. Commissioner, 30 T.C. 26 (1958), acq. 1958-2 C.B. 6; Neill v. Commissioner, 46 B.T.A. 197 (1942); Rev. Rul. 73-522, 1973-2 C.B. 226.

First, the performance of personal services within the United States at any time during the taxable year is generally deemed to constitute a U.S. trade or business.[32] In contrast, trading in stocks, securities, or commodities through a resident broker, commission agent, custodian, or other independent agent is *not* a U.S. trade or business unless the NRA has an office or fixed place of business in the United States through which, or by direction of which, the transactions are effected.[33] Similarly, trading stocks, securities, or commodities for one's own account, personally, by employees, or through a resident agent with discretionary authority, is not a U.S. trade or business if the NRA is not a dealer in stocks, securities, or commodities.[34] The foregoing rules apply to commodities only if the commodities are of a kind customarily dealt in on an organized commodities exchange, and if the transactions in commodities are of the kind customarily consummated at such place.[35] In addition, if an NRA is a member of a partnership or is a beneficiary of an estate or trust which is engaged in a U.S. trade or business, then the NRA will be deemed to be engaged in such U.S. trade or business.[36] The foregoing rule applies to limited partnerships as well as to general partnerships.[37]

The determination of whether an NRA is engaged in a U.S. trade or business is made on an annual basis.[38] If at any time during a taxable year an NRA is engaged in a U.S. trade or business, he will be considered to be engaged in a U.S. trade or business for the entire taxable year.[39] Income attributable to a U.S. trade or business received in a year in which the NRA is not engaged in a U.S. trade or business, however, will not be taxed as if it were effectively connected with a U.S. trade or business.[40]

Section 864(c) of the Code and the regulations thereunder prescribe rules for determining whether income, gain, or loss from sources within the United States should be treated as effectively connected with a U.S. trade or business. These rules differentiate between (i) FDAP, capital gains, and other types of income described in section 871(a),[41] and (ii) all other income from U.S. sources.[42] The regulations also provide special rules for determining when foreign source income is treated as effectively connected income.[43] There are two tests for determining whether FDAP, capital gains, and other types of income described in section 871(a) con-

---

32 I.R.C. § 864(b) (1976).

33 Id. § 864(b)(2)(A)(i), (B)(i), (C).

34 Id. § 864(b)(2)(A)(ii), (B)(ii).

35 Id. § 864(b)(2)(B)(iii).

36 Id. § 875.

37 See Rev. Rul. 75-23, 1975-1 C.B. 290, 292.

38 Treas. Reg. § 1.871-8(c)(1) (1974).

39 Id.

40 Id.

41 Treas. Reg. § 1.864-4, 26 C.F.R. § 1.864-4 (1981).

42 Id.

43 Id. § 1.864-5 (1972).

stitute effectively connected income. These are the "asset use" test and the "business activities" test. The asset use test generally applies to "income, gain, or loss of a passive type where the trade or business activities do not give rise directly to the realization of the income, gain or loss."[44]

Under the asset use test, income, gain, or loss is effectively connected if it is derived from assets used in or held for use in the conduct of a U.S. trade or business. An asset is treated as falling within the purview of the asset use test if (1) it is held for the principal purpose of promoting the U.S. trade or business, or (2) it is acquired and held in the ordinary course of the trade or business, or (3) it is held in a "direct relationship" to the U.S. trade or business.[45] The Regulations provide that "[i]n determining whether an asset is held in a direct relationship to the trade or business conducted in the United States, principal consideration shall be given to whether the asset is needed in that trade or business."[46] A "direct relationship" is presumed, however, if the asset is acquired with funds generated by the trade or business, the income from the asset is retained or reinvested in the trade or business, and U.S. personnel exercise significant control over the investment of the asset.[47]

The "business activities" test applies to persons who are normally engaged in business activities that generate what would otherwise be passive income, such as a lending company or a securities dealer.[48] If the activities of a U.S. trade or business are a material factor in the realization of the income, gain, or loss, then the income, gain, or loss will be treated as effectively connected with the U.S. trade or business.[49] All other U.S. source income (viz., income that is not FDAP, capital gains, or of the type described in section 871(a)) is automatically treated as effectively connected income.[50]

As a general rule, income, gain, or loss from sources outside the United States is not treated as effectively connected income and the NRA is not taxed thereon.[51] Such foreign source income will be taxed as effectively connected income, however, if the NRA has an office or fixed place of business in the United States to which the income is attributable, and the income consists of: (1) rents or royalties for the use or for the privilege of using patents, copyrights, secret processes, goodwill, etc.,[52] or (2) dividends or interest, or gain or loss from the sale or exchange of stocks, bonds, or evidences of indebtedness derived by an NRA if derived from the active conduct of a banking, financing, or similar business in

---

[44] Id. § 1.864-4(c)(2)(i) (1972).
[45] Id. § 1.864-4(c)(2)(ii).
[46] Id. § 1.864-4(c)(2)(iii)(a).
[47] Id. § 1.864-4(c)(2)(iii)(b).
[48] Id. § 1.864-4(c)(3).
[49] Id. Example (1).
[50] Id. § 864(c)(3) (1976).
[51] Treas. Reg. § 1.864-5 (1972).
[52] I.R.C. § 864(c)(4)(B)(i) (1976) (referring to intangible property); id. § 862(a)(4) (referring to specific intangibles).

the United States,[53] or (3) income, gain, or loss from the sale outside the United States of inventory items or of property held primarily for sale to customers in the ordinary course of business unless a foreign office participates materially in the sale.[54] Rents or royalties derived from real property or tangible personal property located outside of the United States are not included unless such rents and royalties are derived in the active conduct of a U.S. trade or business.[55]

3. U.S. Source Income. As indicated above, an NRA generally is subject to taxation only upon his U.S. source income. Therefore, determination of the source of an NRA's income is extremely important. Sections 861 and 862 of the Code set forth the scheme for determining how various types of income will be treated.

Under section 861(a) of the Code, *interest* is deemed to be "sourced" at the place of residence of the borrower. One important exception to this rule, however, is that income earned on deposits with persons or firms carrying on a banking or an insurance business in the United States is deemed to be from sources outside the United States unless the income is effectively connected with a U.S. trade or business.[56] Therefore, interest earned on *deposits* with foreign branch banks of domestic corporations engaged in the commercial banking business is not effectively connected with a U.S. trade or business.[57] This source rule enables many nonresident persons and foreign corporations to receive substantial payments of interest on demand deposits or certificates of deposit from U.S. banks and savings and loan associations without liability for U.S. income tax.

In contrast, *dividends* are usually sourced in the country of incorporation of the payor corporation. There are, however, two major exceptions. The first exception applies to dividends paid to an NRA by a U.S. corporation. If a corporation organized in the United States derives less than twenty percent of its gross income from U.S. sources for the three year period ending with the taxable year before it declared the dividend (the so-called 80/20 corporation), the dividend from such corporation would be considered to be foreign source income.[58] For example, J, an individual citizen of Spain, receives in 1980 a cash dividend of $10,000 from M, a U.S. corporation. For the three year period ending with 1980, M had been engaged in a trade or business in the United States and had received gross income effectively connected with a trade or business in the United States equal to fifteen percent of its gross income from all sources. Since less than twenty percent of M's gross income had been derived

---

53 Id. § 864(c)(4)(B)(ii).

54 Id. § 864(c)(4)(B)(iii) (referring to personal property as defined by I.R.C. § 1221(1) (1976)).

55 Treas. Reg. § 1.864-5(b)(1) (1972).

56 I.R.C. § 861(a)(1)(A) (1976).

57 Id. § 861(a)(1)(F) (Supp. III 1979); Rev. Rul. 73-505, 1973-2 C.B. 224.

58 Id. § 861(a)(2)(A) (1976).

from U.S. sources, the dividends will be treated as income from sources without the United States. Similarly, dividends received from a Domestic International Sales Corporation (DISC) or former DISC[59] are treated as foreign source income "to the extent such dividends are attributable to qualified export receipts of the DISC or former DISC."[60] This same test is used to determine whether the dividends paid by a U.S. corporation to an NRA will be treated as income from sources within or without the United States under the twenty percent test of the Code.[61]

The second exception involves dividends paid by foreign corporations. If fifty percent or more of the foreign corporation's gross income for a three year period is effectively connected with a trade or business in the United States, then a portion of the dividends paid by the foreign corporation will be treated as U.S. source income. The portion attributable to U.S. sources is equal to the proportion of the corporation's foreign source business gross income to United States source business gross income for the period.[62] Conversely, if less than fifty percent of the gross income of a foreign corporation from all sources for the three year period was effectively connected with a U.S. trade or business, then no portion of the dividends paid by such foreign corporation will be treated as income from sources within the United States.[63]

U.S. source income also includes rents and royalties from property located in the United States.[64] Rentals of real or personal property are sourced where the property is located.[65] Royalties for the use of or for the privilege of using patents, copyrights, formulas, trademarks, and other intangibles are sourced where the property may be exploited.[66] For example, a patent may be exploited only in the country of issue. If royalties are received from both U.S. and non-U.S. sources, the parties may allocate between U.S. and foreign sources if a proper basis for such allocation exists.[67]

Taxpayers often categorize rents or royalties as proceeds from the sale of a capital asset. The IRS has consistently attacked this categorization, arguing that it is merely a scheme to recharacterize U.S. source income into foreign source income and thus avoid taxation.[68] In addi-

---

59 Id. § 992(a) defines "DISC" and "former DISC."

60 Rev. Rul. 73-68, 1973-1 C.B. 336.

61 Id. See supra note 58 and accompanying text for a description of the 20 percent test for dividends. See also Treas. Reg. § 1.861-3(a)(2) (1979).

62 Treas. Reg. § 1.861-3(a)(3) (1979).

63 Id.

64 I.R.C. § 861(a)(4) (1976); Treas. Reg. § 1.861-5 (1975).

65 Neither I.R.C. § 861(a)(4) nor Treas. Reg. § 1.861-5 differentiates between real and personal property.

66 I.R.C. § 861(a)(4) (1976); Treas. Reg. § 1.861-5 (1975).

67 See I.R.C. § 861(a)(4) (1976) (specifying income treatment of rents and royalties based on source). See also Rohmer v. Commissioner, 5 T.C. 183 (1945), aff'd, 153 F.2d 61 (2d Cir. 1946) (full amount of royalty income deemed to be from sources within the U.S. because no basis shown for proper allocation).

68 See, e.g., Sabatini v. Commissioner, 32 B.T.A. 705 (1935), aff'd in part, 98 F.2d 753 (2d

tion, the IRS has taken the position that royalties paid by one foreign person to another foreign person for the use of a U.S. patent constitute U.S. source income which is subject to withholding even though neither foreign person is engaged in business in the United States.[69]

Gain from the sale or exchange of realty is sourced where the real property is located.[70] Income from natural resources is also sourced at the place where the natural resources are located.[71] In contrast, gain from the purchase and sale of personal property is generally sourced where title to the property is transferred.[72] Generally, title to personal property transfers where and when the rights, title, and interest of the seller in the property are transferred to the buyer. Where no clear intention is stated, courts look to terms of the contract such as F.O.B., C.I.F., or C&F.[73] For example, if goods are sold F.O.B., Miami, title is transferred in Miami. If goods are sold C.I.F., Caracas, title is passed in Venezuela.

Annuities are sourced at the residence of the person or company obligated to pay the annuity.[74] Similarly, alimony payments are sourced at the residence of the person who is obligated to pay.[75] Finally, absent a specific Code provision, the dispositive factors in determining the source of other types of income are the location of the property or the situs of the activities which give rise to such income.[76]

C. *Taxation of an NRA Employee*

As a general rule, only compensation for personal services rendered within the United States will be subject to U.S. taxation as effectively connected income. In many cases, however, an NRA will render services both within and without the United States. Therefore, because an NRA is taxed only on compensation derived from services rendered in the United States, it will be necessary to apportion his total compensation between U.S. and foreign sources. The Regulations provide that an apportionment based upon the number of days on which services are rendered in the United States, divided by the total number of days for which the NRA is compensated, will generally be acceptable.[77]

Section 861(a)(3) of the Code contains a *de minimis* exception to the

---

Cir. 1938) (lump sum payment for exclusive right to produce motion pictures held to be royalty paid in advance rather than a sale); Ehrlich v. Higgins, 52 F. Supp. 805 (S.D.N.Y. 1943) (periodic payments for exclusive use of memorabilia held to be royalties and not a sale).

69 Rev. Rul. 80-362, 1980-2 C.B. 208.

70 See I.R.C. §§ 861(a)(5), 862(a)(5) (West & West Supp. 1982).

71 See I.R.C. §§ 861(a)(4), 862(a)(4) (West & West Supp. 1982).

72 See I.R.C. §§ 861(a)(6), 862(a)(2) (1976).

73 Miami Purchasing Service Corp., Inc. v. Commissioner, 76 T.C. 818 (1981).

74 See, e.g., Rev. Rul. 72-12, 1972-1 C.B. 440.

75 See, e.g., Rev. Rul. 69-108, 1969-1 C.B. 192.

76 See, e.g., Rev. Rul. 70-304, 1970-1 C.B. 163.

77 Treas. Reg. 1.861-4(b)(1)(i), 26 C.F.R. § 1.861-4(b)(1)(i) (1981); Rev. Rul. 77-167, 1977-1 C.B. 239; Rev. Rul. 76-66, 1976-1 C.B. 189, 190.

rule that compensation for services rendered in the United States constitutes U.S. source income. Compensation earned by an NRA for U.S. services will be considered foreign source income if the following three requirements are met:

(1) The NRA is not present in the U.S. for more than ninety days during the taxable year;
(2) The compensation received for his U.S. services does not exceed $3,000; and
(3) The services are rendered for a foreign individual, partnership or corporation not engaged in a business in the U.S. or for a foreign office or place of business of a U.S. citizen, resident, corporation or partnership.

If an NRA earns more than $3000 in a particular year, his entire compensation is treated as U.S. source income, not just the excess above the $3000 figure.[78]

The time and place of payment is irrelevant for purposes of determining the source of the income. Therefore, compensation paid for services rendered in the United States will constitute U.S. source income even if paid to the NRA by his foreign employer after he returns to his home country.[79]

In order for U.S. source compensation to be taxable to the NRA, however, it must also be "effectively connected with the conduct of a trade or business within the United States."[80] Section 864(b) of the Code provides that the term "trade or business" includes the performance of personal services within the United States at any time during the taxable year. Section 864(b)(1) contains a $3000 ninety-day exception which is substantively identical to the exception described above.

Generally, compensation received in a taxable year in which services are rendered in the United States will be deemed to be effectively connected income. If, however, an NRA is not engaged in a trade or business within the United States during the year in which U.S. source compensation is received, then the compensation will not be effectively connected income.[81] Such income nevertheless will be deemed to be FDAP and will thus be *subject to the thirty percent withholding tax imposed by Section 871(a).*

Current compensation paid an NRA employee is generally subject to regular income tax withholding on a graduated basis under Code section 3402.[82] Under present regulations, deferred compensation is also apparently subject to regular wage withholding. Since the thirty percent

78 Rev. Rul. 69-479, 1969-2 C.B. 149.

79 Such compensation will not, however, be deemed to be effectively connected income unless the compensation is received in the taxable year in which the services are rendered. See Treas. Reg. § 1.864-3(b), Example (3) (1972).

80 I.R.C. § 871(b) (Supp. III 1979).

81 See Treas. Reg. § 1.864-3(b), Example (3) (1972).

82 See I.R.C. § 1441(c)(4) (1976); id. § 3401(a)(6) (West Supp. 1982); id. § 3402 (West & West Supp. 1982); Treas. Reg. § 1.441-4(b)(1)(i), 26 C.F.R. § 1.441-4(b)(1)(i) (1981); id. § 31.3401(a)(6)-1(a), 26 C.F.R. § 31.3401(a)(6)-1(a) (1981).

tax imposed by section 872(a) applies to deferred compensation which is not effectively connected income, however, the amount of tax withheld will rarely approximate the NRA's tax liability. Therefore, a regulation has been proposed which provides that remuneration paid to an NRA for services performed within the United States during a previous taxable year shall be excepted from wages and shall not be subject to wage withholding under section 3402 if the NRA is not engaged in a U.S. trade or business in the year of payment and uses the cash method of accounting. Instead, such remuneration will be subject to withholding under section 1441.[83]

An individual who is a resident alien for an *entire* taxable year must file a Form 1040, U.S. Individual Income Tax Return, for such year in the same manner and at the same time as a U.S. citizen. If his spouse was also a resident alien for the entire year, they may file a joint return. An individual who is an NRA on the last day of his taxable year must file a Form 1040NR,[84] U.S. Nonresident Alien Income Tax Return, if (i) he was engaged in a trade or business in the United States during such year, or (ii) he was not engaged in a U.S. trade or business, but he received income subject to withholding on which all the tax owed to the United States was not withheld. An NRA need not file a return if he was not engaged in a U.S. trade or business and his entire U.S. tax liability was satisfied by withholding.

An individual who received wages subject to withholding during a taxable year must file by the fifteenth day of the fourth month of the succeeding year (April fifteenth for a calendar year taxpayer). An individual who did not receive wages subject to withholding in a taxable year need not file until the fifteenth day of the sixth month of the succeeding year (June fifteenth for a calendar year taxpayer).

An NRA is entitled to only one personal exemption unless he is a resident of Canada, Mexico, Japan, or Puerto Rico.[85] In addition, an individual required to file a Form 1040NR cannot file a joint return. If an NRA's spouse is a U.S. resident on the last day of the taxable year, the NRA and spouse can file a joint return if the NRA elects to be taxed as a resident alien for the entire taxable year.[86] If such election is made, the worldwide income of the NRA and spouse for the entire taxable year will be subject to U.S. taxation, notwithstanding tax treaty provisions to the contrary.

An individual who is an NRA at the beginning of a taxable year, but is a resident alien at the end of the taxable year, is known as a "dual status taxpayer" and his U.S. taxable income is computed under two

---

[83] 41 Fed. Reg. 28,517 (1976) (to be codified at 26 C.F.R. pts. 1, 31) (Proposed July 12, 1976).

[84] Forms 1040NR are filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

[85] I.R.C. § 873(b)(3) (1976).

[86] Id. § 6013(g) (1976 & Supp. III. 1979).

different sets of rules. For the period during which he was an NRA, he is taxable only on his income effectively connected with a U.S. trade or business and on his other U.S. source income subject to withholding. For the period after he becomes a resident alien, he is taxable on his worldwide income. In determining the tax rate applicable to a dual status taxpayer, his effectively connected income for the period of nonresidence must be aggregated with his income from the period of residence. A dual status taxpayer must file a Form 1040 for the year in which he becomes a U.S. resident, and must attach a schedule to such return showing his U.S. taxable income for the period during which he was an NRA. Form 1040NR should be used as this schedule. A dual status taxpayer cannot file a joint return unless he elects to be taxed as a resident alien for the entire taxable year.[87] Again, such election means that his worldwide income for his entire taxable year will be subject to U.S. taxation.

III. Role and Function of International Social Security Totalization Agreements

A. U.S. Employment Taxes

An alien that comes to the United States to work temporarily is often surprised to learn that he is subject to U.S. employment taxes even though he is unlikely to derive any benefits therefrom.[88] If the alien is an employee, he and/or his employer will generally be subject to the taxes imposed by both the Federal Insurance Contributions Act (FICA)[89] and the Federal Unemployment Tax Act (FUTA).[90] This is true whether he is a resident alien or a nonresident alien.[91] If he is self-employed, he will be subject to the taxes imposed by the Self-Employment Contributions Act (SECA) only if he is a resident alien.[92]

1. FICA. Unless a specific exception applies, "wages" received by an NRA for *services rendered in the United States* are subject to FICA taxes regardless of the nationality or residence of the employee and employer.[93] For 1982, the first $32,400 in "wages" received by a NRA for "employment" within the United States is subject to a 6.7 percent FICA tax payable by both the employer and the employee, resulting in a total FICA tax of 13.4 percent.[94] The employee's portion of the tax is supposed to be withheld by the employer and paid over to the IRS along

87 Id. § 6013(h).

88 Until recently, the applicability of employment taxes to aliens was virtually ignored by the IRS because of the relatively low tax rates and small tax bases of U.S. employment taxes. With both the tax rates and bases rising rapidly, however, the IRS has stepped up its enforcement in the area.

89 I.R.C. §§ 3121-3126 (West & West Supp. 1982).

90 Id. §§ 3301-3311.

91 See id. §§ 3121(b), 3306(c).

92 Id. § 1402(b) (1976).

93 Id. § 3121(b) (1976 & Supp. III 1979).

94 Id. § 3101 (Supp. III 1979).

with the employer's portion.[95]

Although there is some support for a contrary position, the IRS has held that the standard provision in most U.S. tax treaties exempting compensation paid to an NRA employee present in the United States for 183 days or less from U.S. tax does *not* apply to FICA taxes.[96] Because the tax on the employer is an excise tax and not an income tax,[97] this tax is not covered generally by income tax treaties.[98] Therefore, even if an income tax treaty might exempt compensation paid to an NRA employee from the employee's portion of FICA, it will not exempt the employer from its liability for matching FICA taxes.

2. *FUTA*. Like FICA, the FUTA tax is generally imposed on employers for "wages"[99] paid to employees for "employment" within the United States regardless of the residence or nationality of either the employee or employer.[100] An employer is not liable for FUTA tax on wages, however, unless (i) it paid wages totalling at least $1500 in a calendar quarter of the present or preceding year, or (ii) it employed at least one employee in the United States for all or part of a day during twenty separate weeks in the present or preceding year.[101] A tax at a set rate of 3.2 percent[102] is imposed on the first $6000 of wages paid to each employee.[103] A credit of up to 2.7 percent of such wages is allowed for state unemployment taxes.[104]

Because the FUTA tax, like the FICA tax, is an excise tax, no U.S. income tax treaties currently in force provide any relief. A 1942 Executive Agreement between the United States and Canada,[105] however, basically provides that wages received by a Canadian resident who performs services within both the United States and Canada will be subject only to Canadian unemployment taxes if the employee's base of operations or, if he has no base of operations, the place where his services

---

95 Id. § 3102(a).

96 Rev. Rul. 56-609, 1956-2 C.B. 1066 (holding that the U.S.-Canada Income Tax Convention does not affect FICA taxes).

97 See Steward Machine Co. v. Davis, 301 U.S. 548, 578-83 (1937).

98 Article XXIX(4) of the proposed Convention Between the United States of America and Canada with respect to Taxes on Income and on Capital, dated September 26, 1980, which was submitted to the U.S. Senate for ratification contains a provision retroactively exempting from FICA taxes (both employee's and employer's portion) any compensation paid to a Canadian resident that was exempt from U.S. income taxation under the old treaty. Convention with respect to Taxes on Income and Capital, art. XXIX, para. 4, Sept. 26, 1980, United States-Canada, Tax Treaties (CCH) ¶¶ 1301, 1304.

99 I.R.C. § 3301 (1976); see id. § 3306(b) (West & West Supp. 1982) (defining "wages").

100 Id. § 3306(c) (West & West Supp. 1982) (defining "employment").

101 Id. § 3306(a) (1976).

102 Id. § 3301.

103 Id. § 3306(b).

104 Id. § 3302(a)-(c) (1976 & Supp. III 1979).

105 Agreement on Unemployment Insurance Benefits, March 6-12, 1942, United States-Canada, 56 Stat. 1451, E.A.S. No. 244. The purpose of this agreement is to prevent duplication of unemployment tax contributions and payment benefits.

are directed or controlled, is in Canada.[106] Otherwise, such wages are subject to FUTA.[107]

3. SECA. Unlike FICA and FUTA, SECA does *not* apply to NRAs.[108] Resident aliens are, however, subject to the SECA tax. For 1982, a resident alien must pay the SECA tax on the first $32,400 of his "self-employment income."[109] The tax rate for 1982 is 9.35 percent.[110]

B. Totalization Agreements

Because of the hardships which may result to individuals who work for a set period of time in more than one country and thus become subject to multiple social security systems, the United States has embarked upon a program designed to alleviate these problems. This program involves the execution of "totalization" agreements with those countries desirous of coordinating their social security systems with the United States social security system. The term "totalization" is derived from the practice of combining or "totalizing" social security credits acquired in several countries in order to establish a worker's entitlement to benefits under one or more countries' social security systems. In 1977, legislation was enacted which authorized the President to enter into executive bilateral agreements with other countries concerning social security.[111] This Act (which is also included as Section 233 of the Social Security Act) has led to totalization agreements with Italy, West Germany, and Switzerland.[112] This enabling legislation, however, provides that totalization agreements may be entered into only with respect to old age, survivors, and disability insurance.[113] This legislation, therefore, does not authorize agreements regarding hospital insurance or Medicare benefits.

Totalization agreements are designed to solve two basic problems. First, such agreements are intended to avoid the imposition of double social security taxes on the wages of citizens or nationals of one country working in another country. They apply to self-employment taxes imposed on self-employment income as well as employment taxes imposed on wages. Secondly, totalization agreements are also designed to prevent the loss of social security benefits resulting from the splitting of periods of

---

106 The same rule applies to U.S. citizens. See Rev. Rul. 79-391, 1979-2 C.B. 352 (wages paid to U.S. employee by Canadian company not engaged in business in U.S., where employee performs all services in U.S., held subject to FUTA and FICA taxation).

107 Id.

108 I.R.C. § 1402(b) (1976); Treas. Reg. § 1.1402(d), 26 C.F.R. § 1.1402(d) (1981).

109 I.R.C. § 1402(b)(1) (1976).

110 Id. § 1402(a), (b) (West & West Supp. 1982).

111 Social Security Amendments of 1977, Pub. L. No. 95-216, § 233, 91 Stat. 1538 (codified at 42 U.S.C. § 433 (Supp. III 1979)).

112 Agreement on Social Security, May 23, 1973, United States-Italy, 29 U.S.T. 4263, T.I.A.S. No. 9058; Agreement on Social Security, Jan. 7, 1976, United States-West Germany, 30 U.S.T. 6099, T.I.A.S. No. 9542; Agreement on Social Security, July 18, 1979, United States-Switzerland, — U.S.T. —, T.I.A.S. No. 9830.

113 42 U.S.C. § 433(b)(1) (Supp. III 1979).

coverage between two countries, with neither total of covered years being sufficient to entitle the individual to receive benefits from either of the respective countries.

1. Italian Agreement. Under the Italian social security system, an Italian national employed outside Italy and his employer are not normally covered by the Italian social security system. The Italian Agreement provides, however, that services performed by an Italian national in the United States for an Italian employer or an enterprise controlled by an Italian firm will be covered by the Italian social security system.[114] This provision thus parallels the U.S. system.[115]

The Italian Agreement also provides that an Italian national who would be covered under both the U.S. and Italian systems for the same period of work (i.e., an Italian national working in the United States for an Italian firm) may elect under which system he is to be covered.[116] Thus, an Italian who chooses to be covered only by the Italian system would be exempt from U.S. social security taxes. Conversely, an Italian working in the United States may choose to be covered by only the U.S. system during his stay here, in which event he and his employer would pay only U.S. social security taxes.

Under article 8 of the Italian Agreement, periods of coverage under the system of one country are credited as periods of coverage under the system of the second country, where such credit is necessary to qualify a nonresident alien worker for benefits in the second country.[117] Thus, if an Italian national has twenty quarters of coverage in Italy and ten quarters of coverage in the United States, he is treated as having thirty quarters of coverage under both systems. Once the "totalized" period of coverage of the Italian national is determined, the benefit that would be payable to him by each country under its system based on such total coverage is multiplied by a fraction, the numerator of which is the quarters of coverage in that country and the denominator of which is the total number of covered quarters.[118] Thus, in Italy he would be entitled to two thirds (20/30) of the benefit that would be payable with thirty quarters of coverage solely in Italy, and in the United States he would be entitled to one third (10/30) of the benefit that would be payable with thirty quarters of coverage solely in the United States. An Italian that would otherwise be entitled to normal benefits in Italy higher than the pro rata benefits produced by totalization can elect such higher normal benefits.[119] An Italian, however, cannot qualify for a totalized pro rata benefit in the United States unless he has at least six quarters of coverage

114 U.S.-Italian Social Security Agreement, supra note 112, art. 7, para. 3.
115 Id. para. 2.
116 Id. para. 4(b).
117 Id. art. 8, para. 2.
118 See id. art. 9, para. 2.
119 See id. para. 3.

in the United States.[120] As an example of how the system works, consider the following example:

> *A*, an Italian national, comes to the U.S. to work for an Italian employer. Under the Italian Agreement, *A* is subject to the social security systems of both countries. *A* can avoid the possible loss of coverage and benefits under the Italian system, however, by electing to be covered by the Italian system and by paying Italian social security taxes during that period. If he makes such election, then neither he nor his employer will be required to pay FICA taxes. If, instead, he elects to be covered by the U.S. system, he and his employer will pay FICA taxes for his period of employment in the U.S., but will not pay Italian social security taxes during that period. In addition, *A*'s quarters of employment covered by the U.S. system can be treated as covered periods under the Italian system to establish the minimum period of coverage for qualification for Italian benefits. Further, if he works at least six calendar quarters in the U.S., he will be entitled to a totalized pro rata benefit from the U.S..

2. German Agreement. The German Agreement[121] adopts an approach opposite to that of the Italian Agreement. The German Agreement provides that an individual working overseas is generally not subject to tax in his home country but rather is taxed only in the country in which he is working.[122] This general rule, however, is subject to what is known as the "sending state" exception. Under this exception, an individual who is "sent" by his home country employer to work "temporarily" in the other country will be subject to tax *only* in the sending country without regard to either his taxable status in the receiving country or the country of his nationality.[123] No specified time limit is placed on the "temporary" employment. An individual who is subject to the social security taxes of the country in which he is working may apply to the social security authorities of that country for an exemption from such tax if his employer consents and if the exemption will result in taxation of the individual in the other country.[124]

The German Agreement also provides for totalized pro rata benefits calculated in much the same manner as under the Italian Agreement. As in the Italian Agreement, minimum coverage of six quarters is required for U.S. benefits.[125]

3. Swiss Agreement. Entered into force on November 1, 1980, the Swiss totalization agreement follows the approach used in the German Agreement, including the "sending state" exception.[126] Thus, an individual is generally subject to tax in the country in which he is working unless he qualifies for the "sending state" exception. In order for a Swiss

---

[120] Id. art. 8, para. 4.
[121] U.S.-West Germany Social Security Agreement, supra note 112.
[122] Id. art. 6, para. 1.
[123] Id. para. 2.
[124] Id. para. 5.
[125] Id. art. 7.
[126] U.S.-Switzerland Social Security Agreement, supra note 112, art. 6, para. 2.

individual working in the United States on a temporary basis to qualify for the "sending state" exception, his employer must obtain a certificate of coverage from Swiss social security authorities indicating that his U.S. employment is being covered under the Swiss system.[127] If a Swiss individual does not qualify for the sending state exception and is therefore subject to U.S. social security taxes, his employer must get a certificate of coverage from the U.S. Social Security Administration in order to be exempt from Swiss taxes.[128]

IV. Estate and Gift Taxation of Aliens

U.S. citizens and residents are generally treated alike under the U.S. estate and gift tax laws. Thus, the gross estate of a resident alien includes "all property, real or personal, tangible or intangible, wherever situated."[129] NRAs are, however, subject to special estate taxation rules.

Gift taxes are imposed upon the transfer of property by gift "by any individual, resident or nonresident."[130] The following types of gifts made by a nonresident alien are, however, exempted from U.S. taxation:

(a) Gifts of intangible property situated within the United States.[131]
(b) Gifts of property situated outside the United States.[132]

The test for estate and gift tax purposes is "domicile." Domicile requires both residence and intent to remain.[133] A person acquires a domicile in a place by living there, for even a brief period of time, with no definite, present intention of later removing therefrom. Thus, residence without the requisite intention to remain indefinitely will not constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.[134] Residence and domicile for estate and gift tax purposes must be "unified." Therefore, an NRA's domicile and residence must be the same if he is to be subject to estate and gift taxation. In contrast, residency for income tax purposes contemplates the possibility of a resident retaining a residence abroad.[135] Therefore, an alien may be treated as a resident alien for income tax purposes but a nonresident alien for estate tax purposes.[136]

---

[127] Administrative Agreement on Social Security, art. 3, July 18, 1979, United States-Switzerland, — U.S.T. —, T.I.A.S. No. 9830.

[128] Id.

[129] I.R.C. § 2031 (1976).

[130] Id. § 2501(a)(1) (West. Supp. 1982).

[131] Id. § 2501(a)(2) (West Supp. 1982); id. § 2511(b) (1976).

[132] Id. 2511(a) (1976).

[133] Mitchell v. United States, 88 U.S. (1 Wall.) 350, 353 (1874).

[134] Fifth Ave. Bank of New York, 36 B.T.A. 534 (1937).

[135] Treas. Reg. § 1.871-2(b) (1974).

[136] Rev. Rul. 74-364, 1974-2 C.B. 321 (holding that person in U.S. on G-4 visa, conferring nonimmigrant status, is an NRA for estate tax purposes, because of no legal capability to freely choose domicile).

A. Tax Rates

Estates of nonresident aliens are subject to special tax rates on property deemed situated in the United States. Under the Tax Reform Act of 1976 (the TRA), the estate tax rate for nonresident decedents dying after December 31, 1976, is based upon a "unified" concept of combining all taxable gifts and the taxable estate to determine a tentative tax with a credit for gift tax previously paid on taxable gifts.[137] Rate schedules for estate taxation of NRAs are as follows:[138]

Up to $100,000	6% of such amount
Over $100,000 but not over $500,000	$6,000 + 12% of excess over $100,000
Over $500,000 but not over $1,000,000	$54,000 + 18% of excess over $500,000
Over $1,000,000 but not over $2,000,000	$144,000 + 24% of excess over $1,000,000
Over $2,000,000	$384,000 + 30% of excess over $2,000,000

Under the TRA, the gift tax rates for NRAs are the same as the gift tax rates for U.S. citizens.[139] The gift tax is based on the cumulative amount of gifts. Pre-TRA gifts are taken into account in determining the tax bracket for post-TRA gifts.[140]

B. Determining the Taxable Estate of an NRA

The gross estate of an NRA is that part of his gross estate which at the time of his death is situated in the United States.[141] Situs rules for determining whether property is situated in the United States for U.S. estate tax purposes are found in the Code and applicable estate tax treaties.[142] When not found in those sources, certain general principles of situs are set forth in the Regulations.[143]

1. Situs of certain assets. The situs of real estate is determined by its physical location.[144] In determining whether certain property is real property, i.e., mineral rights, fixtures, crops, etc., the courts look to common usage and the law of the state where the property is situated.[145]

Similarly, the situs of tangible property is generally determined by

---

137 I.R.C. § 2101(b) (1976).

138 Id. § 2101(d).

139 Id. § 2502, 2501 (West Supp. 1982).

140 Id.

141 Id. § 2103 (1976).

142 See, e.g., id. § 2104 (describing situs rules for stock, properly transferred within three years of death, and debt obligations).

143 Treas. Reg. § 20.2104-1(a), 26 C.F.R. § 20.2104-1(a) (1981).

144 Id.

145 Estate of Margaret Thaw Carnegie De Perigny v. Commissioner, 9 T.C. 782, 786 (1947) (999 year lease subject to Kenyan estate tax on "immovables" held to be "real property" excludable from U.S. tax).

its permanent location.[146] A long line of cases has decided that the situs of a chattel is not determined by its mere physical presence at a given place on a given day. On the contrary, the concept of situs for estate tax purposes "involves some degree of permanence in an established abiding place or home base for the chattel, analogous to the notion of domicile as applied to the person."[147]

Shares of stock owned and held by estates of NRAs are deemed to be property within the United States only if the shares were issued by a domestic corporation; therefore, shares of stock issued by a foreign corporation and owned by an estate of an NRA have a non-U.S. situs. Location of the stock certificates is immaterial.[148]

All debt obligations of the United States or one of its political subdivisions are deemed to be situated in the United States.[149] Similarly, debt obligations of "persons" are deemed to be situated in the United States unless less than twenty percent of the debtors' gross income during the preceding three years was derived from U.S. sources.[150] Deposits in U.S. banks and savings and loan associations, and deposits with U.S. insurance companies and with domestic branches of foreign corporations, are deemed to be property situated outside the United States unless interest on such deposits is effectively connected with the trade or business in the United States.[151] Cash in a safety deposit box, however, is deemed property within the United States.[152] Under no circumstances, however, are deposits with a foreign branch of a domestic corporation or partnership engaged in the commercial banking business to be deemed property within the United States. In addition, amounts received as insurance on the life of an NRA are not deemed property within the United States.[153]

Foreign law controls the determination of the decedent's interest; however, the taxable consequences of an interest created by foreign law are determined solely by U.S. federal tax law.[154] Therefore, assets located in the United States do not normally have a U.S. situs for estate tax purposes if owned by a corporation in which the decedent has an interest, since the corporation, not the shareholder, is the owner. If a foreign partnership is treated as a juridical person under foreign law and the partnership does not terminate at the death of the NRA partner, the decedent's estate is not subject to estate tax on the decedent's pro rata

---

146 Treas. Reg. § 20.2104-1(a), 26 C.F.R. § 20.2104-1(a) (1981).

147 Delaney v. Murchie, 177 F.2d 444, 448 (1st Cir. 1949) (holding that property in the possession of an NRA during a transient stay in Florida was not property "situated in the United States").

148 I.R.C. § 2104 (1976); Treas. Reg. § 20.2104-1(a)(5), 26 C.F.R. § 20.2104-1(a)(5) (1981); id. § 20.2105-1(f), 26 C.F.R. § 20.2105-1(f) (1981).

149 I.R.C. § 2104(c) (1976).

150 Id. § 861(a)(1)(B).

151 Id. § 2105(b).

152 Rev. Rul. 55-143, 1955-1 C.B. 465.

153 I.R.C. § 2105(a) (1976).

154 Treas. Reg. § 301.7701-1(c), 26 C.F.R. § 301.7701(c) (1981).

share of the foreign partnership's U.S. assets.[155] A non-resident decedent beneficiary of a trust (U.S. or foreign) is treated as owning a pro rata share of the trust's U.S. property if the NRA decedent beneficiary would otherwise be required to include the interest in his estate.[156]

2. *Deductions Granted the Taxable Estate of an NRA*. The taxable estate of an NRA is allowed deductions for funeral and administrative expenses, claims against the estate, unpaid mortgages, taxes, and losses similar to those allowed to citizens and residents.[157] Such expenses and claims are not limited to specific charges against U.S. property, but also include expenses and claims against the estate worldwide.[158] The deduction allowed is an amount equal to the total amount of such items multiplied by a fraction, the numerator of which is the value of the gross estate situated in the United States, and the denominator of which is the value of the worldwide gross estate. The formula for such determination is thus:

$$\frac{\text{Gross Estate in U.S.}}{\text{Total Gross Estate}} \times \text{Expenses} = \text{Allowable Deduction}$$

No deduction is permitted, however, unless the estate files a return showing the value and character of the *entire* gross estate of the NRA, wherever situated.[159]

If an NRA decedent owned mortgaged real estate and was liable on such mortgage, the full encumbered value of the mortgaged property is included in the gross estate and only a pro rata portion of the mortgage debt, as calculated by the limiting fraction described above, may be deducted. If, however, the decedent is *not* liable on the mortgage, and the debt can only be satisfied out of the property, only the equity is included in the gross estate.[160] Further, any contractual claims against the estate, whose consideration was not an adequate and full consideration in money and moneys worth, are deductible only to the extent that such claims would qualify as charitable bequests.[161]

An NRA's estate generally is entitled to the same charitable deductions as an estate of a U.S. resident or citizen. The recipient of a transfer must be a domestic corporation and the donation must be used for eleemosynary purposes solely within the United States.[162] No marital deduction, however, is allowed to an estate of a nonresident alien unless an

155 Rev. Rul. 55-701, 1955-2 C.B. 836; Sanchez v. Bowers, 70 F.2d 715 (2d Cir. 1934); G.C.M. 18718, 1937-2 C.B. 476, declared obsolete, Rev. Rul. 70-59, 1970-1 C.B. 280.

156 See I.R.C. § 2104(b) (1976); Estate of Swan v. Commissioner, 247 F.2d 144 (2d Cir. 1957); Rev. Rul. 55-163, 1955-1 C.B. 674.

157 I.R.C. § 2106 (1976).

158 Treas. Reg. § 20.2106-2(a)(2), 26 C.F.R. § 20.2106-2(a)(2) (1981).

159 I.R.C. § 2106(b) (1976).

160 Treas. Reg. § 20.2053-7 (1963).

161 I.R.C. § 2106(a)(1) (1976).

162 Id. § 2106(a)(2).

applicable treaty provides otherwise.[163]

In addition to these deductions, the TRA permits a $3600 credit against the unified estate and gift tax.[164] The maximum credit for state death taxes allowable against the federal estate tax imposed on the estates of NRAs is to be an amount which bears the same ratio to the credit as the value of the property upon which the state death taxes are paid (and which is includable in the gross estate) bears to the value of the total gross estate.[165]

The following table demonstrates the manner in which an NRA's estate will be taxed under current U.S. estate tax laws:

		U.S. ESTATE	
		Included	Excluded
(a)	Four acres of undeveloped real estate in Atlanta, Georgia, value $700,000—$450,000 mortgage with personal liability.	$ 700,000	
(b)	1000 shares of IBM Corp.	$ 70,000	
(c)	Home in Atlanta, Georgia.	$ 170,000	
(d)	$1,000,000 office building on Peachtree Road with $450,000 in non-recourse mortgages.	$ 550,000	
(e)	Certificates of deposit with Georgia bank.		$ 40,000
(f)	U.S. currency in a safe deposit box in a Georgia bank.	$ 25,000	
(g)	A car located in Atlanta, Georgia.	$ 15,000	
(h)	Life insurance policy on NRA's own life.		$ 100,000
(i)	Other assets not connected with the United States.		$1,500,000
		$1,530,000	$1,640,000

COMPUTATION OF U.S. ESTATE TAX

U.S. Gross Estate		$1,530,000
Less: Deductions:		
Mortgage—U.S. Real Estate	$450,000	
Expenses —Worldwide	75,000	
	$525,000	

$$\frac{1{,}530{,}000}{3{,}170{,}000} \times 525{,}000 = \$\ 253{,}390$$

U.S. Taxable Estate	$1,276,610
U.S. Estate Tax	$ 210,384

[163] Id. § 2106 sets forth the allowable deductions and exemptions for determining the taxable estate of an NRA.

[164] Id. § 2102(c).

[165] Id. § 2102(b).

C. Determining the Taxable Gifts of an NRA

Intangible property transferred by an NRA is not subject to the gift tax even though the situs of the property might be in the United States.[166] Real property and tangible personal property physically present in the United States is subject to gift tax.[167] The situs rules for such property generally follow estate tax situs rules.[168]

V. Taxation of Foreign Investors in Money Market and Related Instruments

A. Interest-Bearing Obligations

There are many different types of interest-bearing obligations in which a foreign investor can invest. Some of these obligations generate interest subject to the thirty percent withholding tax imposed by section 871(a) of the Code (unless a treaty provides otherwise), while others produce interest exempt from U.S. tax. An NRA is only taxed on interest derived from U.S. sources.

Generally, the source of interest is determined by the residence of the obligor. Under the Code, interest is considered U.S. source interest if paid by:

(1) The United States, any of its territories or States, or the District of Columbia;[169]
(2) An individual that is a U.S. resident, unless such individual is a resident alien and it can be shown that less than twenty percent of his gross income has been derived from U.S. sources for the previous three years;[170]
(3) A domestic corporation unless it can be shown that less than twenty percent of its gross income for the prior three years was derived from U.S. sources;[171]
(4) A partnership which is engaged in a U.S. trade or business during the taxable year;[172] and
(5) A foreign corporation if fifty percent or more of its gross income for the prior three years was effectively connected with a U.S. trade or business.[173]

Sections 861(a)(1)(A) and 861(c) provide an important exception: interest paid on deposits with U.S. banks, savings and loan associations, and insurance companies will be treated as *foreign source* interest exempt from U.S. tax so long as the interest is not effectively connected with a U.S. trade or business. In addition, original issue discount on obligations of six months or less is specifically excluded from the application of the thirty percent tax imposed by section 871(a) of the Code. Finally, inter-

[166] Id. §§ 2501(a)(2), 2511.
[167] Treas. Reg. § 25.2511-3(b)(1) (1973).
[168] Id. § 20.2104-1, 26 C.F.R. § 20.2104-1 (1981).
[169] I.R.C. § 861(a)(1) (1976 & Supp. III 1979).
[170] Id. § 861(a)(1)(B) (1976).
[171] Id.
[172] Id. § 875.
[173] Id. § 861(a)(1)(C).

est earned on state and local government obligations is exempt from U.S. tax if it would have been exempt in the hands of a U.S. resident.

In summary, the following types of interest are exempt from U.S. taxation:

(1) Interest paid on deposits with a U.S. bank (bank deposits include interest bearing certificates of deposit and multiple maturity time deposits);

(2) Interest paid on deposits or withdrawable accounts with U.S. or state chartered savings and loan associations;

(3) Interest paid on deposits with a foreign branch of a U.S. bank;

(4) Interest paid on amounts held by an insurance company;

(5) Interest paid in the form of an original issue discount (an "original issue discount" being the difference between the issue price of an obligation and its stated redemption price at maturity) arising from obligations payable within six months after they were first issued. The category generally includes Treasury Bills and discount notes guaranteed by the Farm Credit Bank, Federal Home Loan Bank or Federal National Mortgage Association. The date on which the six month period commences for purposes of determining whether the obligation is payable within six months after it was first issued is the date of the obligation's original issuance, not a subsequent date on which the obligation is sold by its original purchaser to a new purchaser.[174]

> For example: Y purchases a Treasury Note on January 1, 1982, which will mature on January 1, 1983. Because the Treasury Note matures in more than six months from the date it was first issued, the original issue discount is considered U.S. source interest income subject to a thirty percent withholding tax. If Y sells the Treasury Note to Z on September 1, 1982, even though the Treasury Note will mature less than six months from the date of Z's purchase, the interest arising from the Treasury Note will still be subject to withholding. This result occurs because the obligation must be payable within six months after it was first issued. The six month period commences with the date on which the Treasury Note was originally issued, not from the date of a subsequent purchase.

(6) Interest paid pursuant to obligations issued by certain international organizations (e.g., the World Bank, Inter-American Development Bank, Japan Development Bank and Asian Development Bank);

(7) Interest paid on repurchase agreements (generally bank issued repurchase agreements commonly known as "repos") of less than six months duration; and

(8) Interest earned on state and local government obligations if such amounts would be tax-exempt if received by a U.S. person (generally municipal bonds).[175]

---

[174] Id. § 861(a)(1)(F) (Supp. III 1979).

[175] The following chart separates various forms of interest yielding investments into two categories—those subject to withholding and those not subject to withholding:

B. Money Market Funds

It is important to note that amounts paid by the now popular "money market funds" are considered dividend distributions, not interest, and thus are not exempt from withholding under any of the interest exemptions described above. Therefore, distributions from a U.S. money market fund to an NRA will be subject to the thirty percent withholding tax imposed by section 871(a) of the Code unless a contrary treaty provision is applicable.

VI. Conclusion

As the above discussion illustrates, a wide range of complex tax issues faces the alien who comes to work in the United States. It is hoped that this article will alert the foreign worker as well as his employer to some of the tax problems the foreign employee faces in the United States.

Investments Yielding Interest Not Subject to Withholding	Investments Yielding Interest Subject to Withholding
Deposits with U.S. banks	U.S. Treasury Notes
Deposits with U.S. or state chartered savings and loan associations	U.S. Treasury Bonds
Deposits with a foreign branch of a U.S. bank	Money market funds
Amounts held by an insurance company	Commercial paper
Repurchase agreements (bank "repos")	Commercial bonds issued by U.S. corporations
Certificates of deposit issued by U.S. banks	Loans to U.S. residents
Obligations issued by certain international organizations	
Municipal bonds	