Federal Taxation of Nonresident Aliens and Foreign Corporations

Ulysses S. Crockett Jr.

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This article, in attempting to provide the reader with an overview of current income tax treatment by the United States of nonresident aliens and foreign corporations, will also show several areas in which policy goals are not being met. The contribution of both recent and past legislation to these failures will be examined, and suggestions will be made concerning how present tax policy can be further modified to correct a system that has shown itself to easily lose its balance. The major recent legislation, the Foreign Investors Tax Act of 1966,[1] will be examined as to changes it brought to the taxing scheme, and the several areas where it has been detrimental.

Before attempting to explain the rather complicated sections of the Internal Revenue Code of 1954 dealing with taxation of nonresident aliens and foreign corporations, the concepts of residency and of income that is effectively connected with a trade or business within the United States must be explained. Together, these two concepts establish the method of taxation that will be applied to the income of an alien individual or a foreign corporation.

An alien individual is either classified as a United States resident or nonresident. Simple as these classifications may be, they are of prime importance in determining how an alien individual will be taxed. Generally, resident aliens are taxed at the same rates as American citizens,[2] while nonresident aliens are taxed only on their income derived from sources within the United States.[3]

The two classifications, resident and nonresident aliens, depend

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* Assistant Professor of Law, St. Louis University.
** J.D. St. Louis University.

1. Act of Nov. 13, 1966, Pub. L. No. 89-809, 80 Stat. 1539 [hereinafter referred to as FITA].
2. Treas. Reg. § 1.871-1 (1957). The regulation states that "in general, . . . a resident alien is taxable on income derived from all sources, including sources without the United States."
3. *Id.*

on whether an individual has established residency within the United States. Mere physical presence within the United States does not conclusively establish residency.[4] Rather, residency is based on a determination of transiency, since the regulations define a resident as one who is actually present in the United States and not a transient.[5] Transiency is in turn determined by the alien's intentions regarding the length and nature of his stay in the United States.[6] An alien who comes to the United States will not be considered a transient merely because he has no definite plans as to the length and nature of his stay.[7] Indeed, if an alien lives in the United States and has no definite intentions as to his future in the United States, he will be considered a resident,[8] whereas, if he comes into the country with definite plans to promptly accomplish some objective, he will be considered a nonresident.[9] There is a rebuttable presumption of nonresidence.[10] It has been held, however, that an alien living in the United States, for as little as one year, has rebutted the presumption of nonresidence in the absence of known facts indicating that he is a transient.[11]

4. Mary K. Sanford v. Commissioner, 27 CCH Tax Ct. Mem. 266 (1968).

5. Treas. Reg. § 1.871-2(b) (1957).

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.* Residency has been concisely defined as follows:

> [T]here must be an act or fact of being present, of dwelling, of making one's home in the United States for some time in order to become a resident . . . . Some permanence of living within borders is necessary to establish residence.

31 T.C. 1031, 1036 (1959). *See also* Green v. United States, 9 Am. Fed. Tax. R.2d 1096 (1962) where the court granted residency status to a woman who left England in order to join her husband, already a United States resident. The wife left England in 1957 but did not arrive in the United States until January 2, 1958. The question on appeal was whether she was a nonresident at any time during 1958. The court held that her act of leaving England and embarking on a voyage to the United States, with the intent to permanently reside was sufficient to establish residence in the United States.

10. Treas. Reg. § 1.871-4(b) (1957).

11. Rev. Rul. 69-611, 1969-2 CUM. BULL. 150. *See also* Treas. Reg. §§ 1.871-4(c)(1), (2) (1957) for proof that will rebut the presumption; Josette T. F. Verrier Friedman, 37 T.C. 539, 553 (1961) (issue of losing resident status).

One group of aliens is automatically granted nonresident status. Foreign government employees and representatives, along with their families are granted nonresident status if a domicile is established within the United States according to State Department Regulations. Rev. Rul. 71-565, 1971-2 CUM. BULL. 266. This may prove to be an advantage or a disadvantage depending on the income level of the individual. *See* note 28-68 *infra* and accompanying text. It should also be noted that the concept of residency is not only applicable to individuals and corporations but also to trusts established under the laws of a foreign jurisdiction where

In order to prevent United States citizens from giving up their citizenship and adopting a non-United States residence to avoid the normal graduated income tax on investment properties, such persons may be subjected to a greater rate of taxation.[12] Prior to the imposition of this tax it must be shown that the principle purpose behind the surrender of citizenship was the avoidance of taxes,[13] and that but for this section, the individual's taxes would be substantially reduced.[14] This section of the Code was added by the FITA because of the view stated in the House Ways and Means Committee report that doing away with the progressive taxation of nonresident aliens on their non-effectively connected trade or business income might encourage some Americans to surrender their citizenship.[15]

The second basic concept that must be considered is that of effectively connected income.[16] This concept is a primary determinant of the rate of taxation applicable to a nonresident alien. The general rule for determining whether income is effectively connected is stated negatively as follows:

> [I]n the case of a nonresident alien individual or a foreign corporation that is at no time during the taxable year engaged in a trade or business in the United States, no income, gain or loss shall be treated as effectively connected . . . with the conduct of a trade or business in the United States.[17]

It is evident that the major issue involved, in any determination of effectively connected income, is whether one is engaged in a trade or business within the United States. This, however, is not an easy determination.

The Treasury Regulations contain no concrete definition of engaging in a trade or business.[18] They do, however, state that certain

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the res of such a trust consists primarily of securities of United States corporations, traded on a domestic exchange, and controlled by United States citizens. Such a trust has been held to be a resident alien entity for tax purposes. Rev. Rul. 71-565, 1971-2 CUM. BULL. 266.

12. INT. REV. CODE OF 1954, §§ 877(a), (b).

13. *Id.* § 877(a).

14. *Id.* § 877(e).

15. H.R. REP. No. 1450, 89th Cong., 2d Sess. 9006 (1966).

16. Effectively connected income is the primary determinant of whether certain benefits will inure to the taxpayer. *See* text accompanying notes 28-37 *infra*.

17. Treas. Reg. § 1.864-3(a) (1972).

18. *Id.* § 1.864-2(a) (1968); *see* Berens, *United States Taxation of the American Income of Foreigners*, 45 TAXES 830, 838 (1967). *See also* Garelik, *What Constitutes Doing Business Within the United States by a Non-Resident Alien Individual or a Foreign Corporation*, 18 TAX. L. REV. 423 (1963).

factual situations do not constitute engaging in a trade or business.[19] This same section goes on to state that failure to fall within the stated exceptions does not necessarily mean that one is engaged in a trade or business.[20] Each case must be decided on the particular facts involved.

Sections 871(d)[21] and 882(d)[22] are exceptions to the general rule that one not engaged in a trade or business does not have effectively connected income. These sections allow a nonresident alien individual or a foreign corporation to elect to treat income derived from real property, "including rents or royalties from mines, wells, or other natural deposits . . .,"[23] as being effectively connected with the conduct of a trade or business within the United States, despite the fact that this income would not normally be so considered.[24]

Section 882(e)[25] is another exception to the general rule. This section, however, does not allow an election, but mandates that any corporation engaged in the banking business in a possession of the United States and organized under the laws of that possession must treat interest earned from obligations of the United States as being effectively connected with the conduct of a trade or business, regardless of whether that corporation is engaged in a trade or business within the United States.

The 871(d) and 882(d) exceptions have the effect of promoting foreign investment in real property and natural resources. The taxpayer, since he has an election, can treat the income as being, or not being, effectively connected, and thus choose the status which will give him the greatest tax benefit.

The question that arises in this writer's mind is whether we should promote foreign investment in this area. Might it not be wiser to encourage domestic, rather than foreign, control over real property and natural resources? While such a policy might be termed "neo-isolationism," when viewed in light of the current furor

19. Treas. Reg. § 1.864-2 (1968). Some of the areas specifically excepted are: performance of personal services for a foreign employer, trading in stocks and securities, and trading in commodities. The reader will have to read each classifiation in the regulations in order to completely understand what constitutes being engaged in a trade or business.

20. *Id.*

21. INT. REV. CODE OF 1954, § 871(d).

22. *Id.* § 882(d).

23. *Id.* §§ 871(d)(1)(A), 882(d)(1)(A).

24. *Id.* §§ 871(d)(1)(B), 882(d)(1)(B).

25. *Id.* § 882(e).

over growing foreign control over natural resources and energy reserves it could well merit consideration.

Section 875[26] of the Code, however, may have the opposite effect. This section states that if a nonresident alien or a foreign corporation is either a member of a partnership or a beneficiary of an estate or trust engaged in a trade or business within the United States, the individual or the corporation is held to be engaged in the same trade or business. Nonresident aliens and foreign corporations might, therefore, refrain from investing in partnerships and trusts doing business in the United States. Investment would be discouraged because under §§ 875 and 871 a nonresident alien or foreign corporation engaged in a United States business is taxed at progressive rates on income effectively connected with that business. In contrast, nonresident aliens not engaged in a United States business are only subject to taxation on their United States source investment income and certain capital gains at a flat rate of thirty percent.[27]

METHOD OF TAXATION OF NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS

Once it has been established that an alien individual is not a resident of the United States, he is taxed differently than an ordinary citizen.[28] Basically, income of a nonresident alien individual is taxed at the rates set forth in §§ 1 and 1201 of the Code,[29] if his income is effectively connected with a trade or business in the United States. Income that is not effectively connected is taxed at a rate of thirty percent,[30] if it has been derived from United States sources.[31]

Capital gains, income derived from the sale or exchange of capital assets, are taxed in essentially the same manner.[32] If a gain is derived from a source within the United States and is effectively connected, the gain is taxed at the rates set forth in §§ 1 and 1201 of

26. *Id.* § 875.

27. *Id.* § 871(a). The applicable rates of taxation are discussed in the following section on the Method of Taxation.

28. *See* text accompanying note 2 *supra*.

29. INT. REV. CODE OF 1954, § 1 (imposes the graduated income tax); *id.* § 1201 (gives the alternative tax used to determine tax liability when capital gains are involved).

30. INT. REV. CODE OF 1954, § 871(a)(1).

31. *Id.* §§ 871(a)(1), (b)(1).

32. *Id.* § 871(a)(2).

the Code. But, if the income is not effectively connected, but is derived from a United States source, it is taxed at the rate of thirty percent. There are, however, two important limitations affecting the taxation of capital gains that are not effectively connected. First, an individual must be within the country for 183 days or more before the gains are taxable.[33] Secondly, a nonresident alien is not permitted the use of § 1202 deductions for capital gains or § 1212 provisions dealing with capital loss carryover.[34]

Whether a taxpayer will be in a better position if his income is or is not effectively connected will be determined by the size of his income. Since non-effectively connected income is taxed at a rate of thirty percent, until a taxpayer has taxable income that on the graduated tax tables is taxed at a rate of thirty percent, he will prefer to have effectively connected income. As his income becomes larger it will be more advantageous to have non-effectively connected income.

In order to compute the income tax liability, it is necessary to determine what constitutes gross income for a nonresident alien. At first glance, the Code's definition of gross income appears to make little sense.[35] A close reading, however, shows that the language of the Code is intended to exclude income from sources outside the United States.[36] Therefore, such items as interest and dividends derived from non-United States personalty and realty, and income from personal services performed outside the United States[37] are not included in gross income.

The Proposed Treasury Regulations expand on the Code's rather sparse definition of gross income.[38] They include within the definition the gains and profits derived from dealings in stocks, securities and commodities, even though the individual may not be engaged in a trade or business.[39] In fact, by definition this activity does not constitute doing business in the United States.[40]

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33. *Id.*
34. *Id.*
35. *Id.* § 872.
36. *Id.* § 872(a)(1) (any income derived from sources within the United States, although not effectively connected, is included in gross income). Section 872(a)(2) includes in gross income, income which is effectively connected with the conduct of a trade or business in the United States. By a process of elimination the only income that is not taxed is income derived from sources outside the United States.
37. *Id.* § 862(a).
38. Proposed Treas. Reg. § 1.872-1, 36 Fed. Reg. 19,382 (1971).
39. *Id.* § 1.872-1(a)(2), 36 Fed. Reg. 19,382 (1971).
40. INT. REV. CODE OF 1954, § 864(b)(2).

The Code contains several exclusions from gross income. Income received by an individual for personal services performed in the United States is excluded, if performed for another nonresident alien, a foreign partnership or a foreign corporation; if the individual is present in the United States for less than ninety days; and if less than $3,000 is earned during the taxable year.[41] Income derived from the operation of ships and aircraft of foreign registry is also exempted from gross income if a reciprocal exemption is granted to citizens and corporations of the United States.[42] Compensation paid by foreign employers to certain individuals in the United States for the purpose of participating in certain exchange or training programs is also excluded from gross income.[43]

Once gross income has been determined, the availability of deductions and credits must be considered. Nonresident aliens are only permitted deductions to the extent that they are connected with effectively connected income.[44] Three deductions, however, are allowed regardless of whether such a connection exists:[45] deductions for loss to property within the United States arising from certain casualties or theft;[46] deductions for charitable contributions;[47] an allowance of one § 151 personal exemption.[48] The standard deduction is not allowed.[49] Finally, a foreign tax credit is given to a nonresident alien or foreign corporation that pays taxes to a foreign government on effectively connected income.[50]

In order to receive the benefit of deductions and credits allowed under the Code, a nonresident alien must file a "true and accurate" return.[51] This filing requirement, which has been characterized as an "in terrorem" clause, can lead to confusion on the part of both the taxpayer and the Internal Revenue Service. In the case of *Nino Sanzogno*,[52] the government, after having required a nonresident

41. *Id.* § 861(a)(3).
42. *Id.* § 872(b)(1)(2).
43. *Id.* § 872(b)(3).
44. *Id.* § 873(a).
45. *Id.* § 873(b).
46. *Id.* § 873(b)(1). The losses for theft and casualty are permitted regardless of whether the property is connected with a trade or business. *Id.* § 165(c)(3).
47. *Id.* § 170.
48. *Id.* § 873(b). This exception does not apply if the taxpayer is a resident of a contiguous country or is a national of the United States.
49. *Id.* § 142(b)(1).
50. *Id.* §§ 874(c), 906(a).
51. INT. REV. CODE OF 1954, § 874(a).
52. 60 T.C. No. 39 (June 4, 1973).

alien individual to file and have audited a form 1040C,[53] argued that he had not filed a form 1040B,[54] did thus not file a "true return," and consequently could not take the claimed deductions. The taxpayer argued that he had substantially complied with Code requirements[55] by giving all of the facts necessary for a computation of his tax liability. The Tax Court found that the form 1040C did constitute a return, and that the claimed deductions were, therefore, valid. The court reasoned that, since the form gave no notice that it was not a tax return, and that no notice was given as to other required forms, the taxpayer had done everything within his power to comply with the law. This bureaucratic pyramiding of forms is not only unnecessary, it is inexcusable. The number of forms required could easily be reduced to a more manageable level.[56]

Many of the same factors used in determining the income tax liability of nonresident aliens are also used to determine the tax liability of foreign corporations.[57] Corporations are classified in the same manner as alien individuals. "A nonresident foreign corporation is a foreign corporation which is not engaged in trade or business within the United States at any time during the taxable year."[58] A resident foreign corporation is a foreign corporation which is at some time during the taxable year engaged in a trade or business within the United States.[59] Foreign corporations, resident and nonresident, are taxed only on income derived from United States sources.[60] Resident corporations are liable for the normal tax imposed by § 11(b)[61] and are also liable for the surtax imposed by

53. A Form 1040C is a Departing Alien Income Tax Return.

54. A Form 1040B is a Nonresident Alien Income Tax Return.

55. INT. REV. CODE OF 1954, § 874.

56. Before rendering an opinion, the court made the following remark concerning the provisions relating to the tax treatment of nonresident alien individuals:

> [W]e shall now embark on a voyage through the various sections of the Income Tax Regulations which are enough to boggle the mind of an English speaking U.S. citizen.

60 T.C. No. 39 (June 4, 1973).

57. INT. REV. CODE OF 1954. §§ 7701(a)(3)-(5), (9), (10), defines a foreign corporation as a nondomestic corporation, association, or insurance company which is not created under a law of the United States or of any state.

58. Treas. Reg. § 1.881-1(a) (1973).

59. *Id.* In order to determine whether a foreign corporation is engaged in a trade or business within the United States see Treas. Reg. § 1.871-8, T.D. 6782, 1965-1 CUM. BULL. 63.

60. Treas. Reg. § 1.881-1(b) (1957).

61. *Id.* The normal tax is 22 percent of taxable income. INT. REV. CODE OF 1954, § 11(b)(2).

§ 11(c).[62] Nonresident corporations, on the other hand, are not subject to the tax imposed by § 11,[63] but are instead taxed at a flat rate of thirty percent.[64] These common considerations, as well as the likeness of deductions[65] and foreign tax credits[66] permitted, reflect the similarity of treatment of nonresident aliens and foreign corporations.

The exclusions granted to nonresident corporations are also similar to those granted an individual. For example, income earned from ships or aircraft of foreign registry is exempted, if the country of registry grants similar exemptions to United States citizens and corporations.[67] Additionally, income derived by a foreign corporation from the Communications Satellite System is similarly exempted from taxation if United States income from that system is granted a reciprocal exemption.[68]

Since we are dealing with the taxation of aliens, the effect of Code provisions dealing with international taxation, treaties and the protection of United States citizens and corporations, must be reviewed. The three most significant provisions are: the effect of treaties on the taxation of aliens in the United States; the exemption granted to foreign governments and international organizations; and the President's discretionary power to impose certain taxes.

Income exempted from taxation as a result of a treaty presents a unique situation.[69] Tax treaty or tax convention obligations govern

62. Treas. Reg. § 1.882-1(a). The surtax is 26 percent upon taxable income in excess of $25,000. INT. REV. CODE OF 1954, § 11(c)(3).

63. Treas. Reg. § 1.881-2(a), T.D. 6841, 1965-2 CUM. BULL. 200.

64. INT. REV. CODE OF 1954, § 881(a).

65. *Id.* § 882(c)(1).

66. *Id.* §§ 882(c)(3), 906.

67. *Id.* §§ 872(b), 883(a). The application of this exemption can be illustrated by a couple of examples. Rev. Rul. 73-69, 1973-1 CUM. BULL. 340, dealt with shipping corporations organized and domiciled in the Republic of China. It was held that since there was a reciprocal exemption agreement between the United States and China, the foreign shippers were entitled to the exemption. Rev. Rul. 70-263, 1970-1 CUM. BULL. 158, dealt with a controversy over the deposit of surplus working cash of a foreign shipping corporation in United States banks. It was held that the money was being used for immediate disbursement, in the conduct of a business, and that the incidental interest derived from the deposits was in the nature of earnings derived from the operation of ships. Again, since there was a reciprocal agreement with the foreign country, the shippers were entitled to the exemption.

68. INT. REV. CODE OF 1954, § 883(b).

69. *Id.* § 894(a), states: "Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle."

where they are contrary to the Code.[70] A self-executing treaty, however, is the only treaty that is the supreme law of the land,[71] and thus the only treaty that supersedes the Code. To the extent that Congressional action is required to implement a treaty, it is not self-executing.[72] Obviously, the issue is one of defining whether a treaty is self-executing.[73]

Foreign governments and international organizations are exempted from taxation on income derived from United States sources,[74] as are the wages of their alien employees.[75] Prior to 1950, this exemption applied only to governments and not to distinct entities such as government owned corporations.[76] This standard was subsequently relaxed when the Tax Court ruled that to the extent that the foreign owned *corporation* did not fall within the United States meaning and use of that term, the deduction would be allowed.[77] The Department's present position is that an organization separate in form and wholly owned by a foreign government, where no private shareholder or individual derives any benefit from net earnings, is exempt,[78] so long as it is not a corporation as that term is generally understood in the United States.[79] In order to determine whether an organization would be considered a corporation in the United States one must look at the purposes, functions and activities of the organization taken as a whole. If under this test, the organization would, in the United States, be considered a private enterprise for profit, it may not take advantage of §§ 892 or 893.

The Code also vests in the President certain discretionary powers in dealing with the taxation of nonresident aliens. The Code permits a retaliatory doubling of income taxes by the President, if he feels

70. *Id.* § 7852(d).

71. Valentine v. United States, 299 U.S. 5 (1936).

72. *Id.*

73. A self-executing treaty has been defined as one that:

> [M]anifests an intention that it become effective as the internal domestic law of the United States, it is self-executing so far as it is effective as the internal domestic law of the United States and it supersedes prior Congressional acts which are inconsistent.

Brecher, *Relationship of, and Conflicts Between Income Tax Treaties and the Internal Revenue Code*, 24 TAX EXEC. 175, 179 (1972).

74. INT. REV. CODE OF 1954, § 892.

75. *Id.* § 893(a).

76. Int. Rev. Code of 1939, ch. 1, § 116(c), 53 Stat. 48 (now INT. REV. CODE OF 1954, § 892).

77. 15 T.C. 403 (1950), *acquiesced in* 1952-1 CUM. BULL. 4.

78. INT. REV. CODE OF 1954, § 892.

79. *Id.* § 882(c)(1).

that United States citizens or corporations are being taxed in a discriminatory manner by a foreign government.[80] The President may also adjust the tax rate applicable to the income of aliens and corporations, if he concludes that a foreign government is imposing a "burdensome" or "discriminatory" tax on United States citizens or corporations.[81]

LEGISLATION

The Revenue Act of 1916[82] provided the first income taxation of nonresident alien individuals and foreign corporations by the United States. Although there have been substantial changes in the law dealing with these taxable entities, the basis of taxation—whether or not the income is derived from sources within the United States—has remained intact. The first major change concerning the taxation of aliens occurred with passage of the Revenue Act of 1936.[83] Prior to this Act, there was no dichotomy between the concepts of "engaged" and "not engaged" in business within the United States, and the entire net income derived from sources within this country was taxable.[84] Since it had experienced difficulty in both the collection and the enforcement of the tax,[85] the government attempted to alleviate these problems by classifying alien taxpayers according to the sources of their incomes. Thus, by introducing this dichotomy, the major effect of the Act was to tax only that income which was subject to withholding.[86]

The most important recent legislation in this area is the Foreign Investors Act of 1966 (FITA).[87] The act is traceable to President Kennedy's appointment of a task force to promote foreign investment and financing in the United States. The Treasury Department

80. INT. REV. CODE OF 1954, §§ 881(c), 891. Section 891 does provide a limitation on this tax, by stating: "In no case shall this section operate to increase the taxes imposed . . . to an amount in excess of 80 percent of the taxable income of the taxpayer . . . ."

81. *Id.* § 896. In either case, whether it be an imposition of a burdensome or discriminatory tax, the President may not act without a request by the United States, to the countries in question, that the burdensome or discriminatory treatment be terminated. *Id.* §§ 896(a)(2); (b)(2).

82. Act of Sept. 8, 1916, ch. 463 § 1(b), 39 Stat. 756.

83. Act of June 22, 1936, ch. 690, § 211-19, 49 Stat. 1648.

84. Act of May 10, 1934, ch. 277, §§ 11, 12(b), 13(a), 212(a), 213, 231(a), 48 Stat. 680.

85. Duke, *Foreign Authors, Inventors and the Income Tax*, 72 YALE L.J. 1093, 1096 (1963).

86. *Id.*

87. Act of Nov. 13, 1966, Pub. L. No. 89-809, 80 Stat. 1539.

studied the task force's report and submitted legislation in March of 1965. The House Ways and Means Committee viewed the bill as containing "a broad revision of the present method of taxing [and also as being]. . . . [D]esigned to increase the equity of the tax treatment accorded foreign investment in the United States."[88] The Senate Finance Committee had agreed that the taxation of nonresident alien individuals had been unnecessarily complicated and arbitrary.[89]

Passage of the act caused significant alterations in the method of taxing nonresident alien individuals and foreign corporations. One of the changes brought about concerned the rules for taxing capital gains. Capital gains are presently taxed on the basis of the taxpayer being within the United States for a period of 183 days.[90] Prior to being amended by the FITA,[91] the Code taxed a nonresident alien individual not engaged in a trade or business using a ninety day rule. If the alien was present within the United States for less than 90 days, a thirty percent tax was imposed on net capital gains derived from sources within the United States only to the extent that they were realized during his presence in this country. If, however, he was present for more than 90 days, the tax was imposed on his net capital gains derived from sources within the United States for the entire taxable year. Use of the present 183 day rule has brought the United States more in line with the tax policies of most of the other industrialized nations of the world.

The major change brought about by the FITA was the adoption of the concept of "effectively connected" income. Prior to the FITA, the prevalent method of taxation used by the United States was the "force of attraction principle." Under this principle,

> [I]f a foreign taxpayer was engaged in trade or business in the United States, all of the taxpayer's income from U.S. sources was "attracted" to the U.S. trade or business without regard to the actual relationship of the income to the U.S. business, thereby subjecting all such income to U.S. taxation at the regu-

88. H.R. Rep. No. 1450, 89th Cong., 2d Sess. 9006 (1966), 1966-2 Cum. Bull. 967, 970.

89. The Committee said that existing taxation of nonresident alien individuals was:

> [U]nnecessarily complicated and also makes arbitrary distinctions based upon the size of the individual's income and whether or not the individual has a trade or business in the United States which may be wholly unrelated to the specific income in question.

S. Rep. No. 1707, 89th Cong., 2d Sess. 26308 (1966), 1966-2 Cum. Bull. 1059, 1074.

90. Int. Rev. Code of 1954, § 871(a)(2).

91. Act of Nov. 13, 1966, Pub. L. No. 89-809, 80 Stat. 1539.

lar rates applied to taxable income.[92]

As was discussed earlier, under the effectively connected concept a nonresident alien's or foreign corporation's income is taxed at regular rates only when it is connected with the conduct of a trade or business within the United States. If the income is not effectively connected, it is taxed at a rate of thirty percent. Either rate of taxation, however, depends on the income being derived from sources within the United States.

The FITA has also had an effect on the treatment of income affected by treaty. Prior to the FITA many treaties provided that exemption or reduction in tax rates applied only to persons not having a permanent establishment in the United States. Today, however, this concept has been rendered meaningless since by definition within the FITA, if no effective connection is found, then there is no permanent establishment and the income is taxed at the lower treaty rate.[93]

While some writers praise the FITA in glowing generalities such as, "[T]he new law undoubtedly was an important step in the direction of ameliorating the international position of the dollar,"[94] other writers are not as pleased. Two apparent statutory anomalies, from which subsequent criticisms arose, are discussed below.

The taxation of the dividend income of nonresident alien individuals and corporations presents somewhat of a conflict. While a high-income bracket taxpayer will not want his dividend income to be considered as effectively connected because of the higher graduated rates imposed, foreign corporations will want their dividend income to be so classified because of the more advantageous deductions allowed by § 243(a)(1) of the Code.[95] Section 116(a)'s[96] exemption

92. Roberts, *Force of Attraction: Impact of the FITA of 1966 on the Code*, 28 J. TAXATION 232 (1968).

93. INT. REV. CODE OF 1954, § 894(b) states in part:

PERMANENT ESTABLISHMENT IN UNITED STATES — For purposes of applying any exemption from, or reduction of, any tax provided by any treaty to which the United States is a party with respect to income which is not effectively connected with the conduct of a trade or business within the United States, a nonresident alien individual or a foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year.

94. Sitrick, *U.S. Taxation of Stock and Securities Trading Income of Foreign Investors*, 30 J. TAXATION 98, 103 (1969).

95. INT. REV. CODE OF 1954, § 243(a)(1) provides:

GENERAL RULE — In the case of a corporation, there shall be allowed as a deduction from taxation for the first $100 in dividends received by a taxpayer does little to ameliorate the double taxation aspect of the Code. Consequently, the individual will most likely prefer to have the dividends taxed at a flat rate of thirty percent. A corporation, on the other hand, is permitted a deduction from its dividend income of at least eighty-five percent. Consequently, a corporation would prefer to have its dividend income treated as effectively connected so that it could take advantage of this deduction. In effect, dividend income of a corporation is taxed only once, while dividend income of an individual is taxed twice.

A second criticism that has been leveled at the FITA is that the complexities introduced by the Act may have the effect of discouraging foreign investment.[97] Foreigners attempting to comply with the Act's provisions must keep separate and detailed records for later determination of whether income is effectively connected,[98] whereas under the simpler European system of taxing, a foreign corporation is taxed on an agreed portion of its total income when the company maintains a branch office in the taxing country.[99]

CONCLUSION

The following is perhaps the best view of the problems encountered in the formulation and application of the present United States system of taxing nonresident alien individuals and foreign corporations:

> The bill [FITA], which became law on November 13, 1966, was a far different work product from its earlier ancestors. It was labeled the "Christmas Tree Act" and contained so many various riders that it barely passed the Senate on October 22, 1966. The original objective was still barely discernible — there was some encouragement for foreign investors to bring money

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an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:

(1) 85 percent, ...

96. *Id.* § 116(a) provides that:

EXCLUSIONS FROM GROSS INCOME — . . . Gross income does not include amounts received by an individual as dividends from domestic corporations, to the extent that the dividends do not exceed $100.

97. Brudno & Hawkins, *The Foreign Investors' Tax Act—The "Effectively Connected" Concept and Taxation of "Foreign Source Income"*, N.Y.U. 26th INST. ON FED. TAX 417 (1968).

98. *Id.* at 433.

99. *Id.* at 434.

> into the United States. But there were also new curbs on foreign trade and a complicated "effectively connected income" doctrine expanding the taxable income of foreign corporations engaged in a trade or business in the United States. The doctrine will surely spur administrative and judicial contests in tax cases.[100]

Apparently many of the tax policies described in this article are currently followed merely because of the historical sluggishness of Congress or the inability or the unwillingness of the Congress to drastically revise the current system of income taxation. Rather than claim inability on the part of tax experts, this writer would suggest that much of the slowness of change, and increasing complexity when there *is* change, is due to the growth of the concept of the taxation of income of a foreigner world-wide. The basic principles in this scheme have retained their grasp for years, with a resultant stream of modifications rather than any fresh departures.

The only time when a significant number of countries would want to depart from the established mode would be when all their economies are stable and when a change world-wide would have little economic *dis*advantage to any of them individually. It is, however, difficult to imagine a time since the turn of the century, when more than a few of the major industrial nations have been in such a position simultaneously. A degree of world cooperation far beyond that ever attained by the League of Nations and the United Nations, at a time of stable economies for most of the nations involved, would have to be attained before any striking change will be made. No one country would want to be "first," or the "guinea pig."

In these days of "uniform" acts, it would seem that a uniform treatment of taxation among all nations should be the goal. It is an unattainable goal only to the extent that any nation places its current economic position ahead of the benefits that a uniform treatment would hopefully provide. It would be fair to say that any method of taxation which treats all nations equitably would be preferable to the present-day defensive posture held by most nations simply because of the vagaries of history.

100. Slowinski, *Federal Taxation and Foreign Policy*, 20 U. FLA. L. REV. 489, 498 (1968).