

## **FOREIGNERS DOING BUSINESS IN THE UNITED STATES**

### **U.S. Taxation Overview**

The U.S. economic activities of foreign individuals and entities are classified as “inbound” transactions while the foreign economic activities of U.S. individuals (based on citizenship or residence) and U.S. corporations are classified as “outbound” transactions.

In general, foreign persons engaged in a trade or business in the United States, are taxed on two categories of income:

1. Income effectively connected with the conduct of a trade or business in the United States (ECI), and
2. Certain fixed and determinable annual or periodic (FDAP) income that is not effectively connected with the conduct of a trade or business in the United States. These items of income include but are not limited to interest, dividends, services, rents, royalties, wages, etc.

The main difference in taxation between these two categories is that ECI is taxed at graduated rates on a net basis and FDAP is taxed at a fixed rate on a gross basis. The graduated individual and corporate tax rates can be found in Appendix A.

For this reason, once it has been established that a foreign person has sufficient presence in the United States to be considered engaged in a trade or business, it is necessary to determine if the income received by such person is effectively connected with such trade or business or not and thus, determine which tax regime is applicable.

Generally if the income is treated as ECI, the tax rate will range from 10% to 35% depending on the amount of taxable income and the entity that generated the taxable income. If the income is treated as FDAP, the withholding rate will be 30%. Treaty provisions could apply to both tax regimes which would reduce the rate of tax.

### **ENGAGED IN A TRADE OR BUSINESS**

Whether foreign persons are engaged in a trade or business is a question of fact that depends upon their economic activities conducted within the United States.

The courts have applied a facts and circumstances analysis to determine whether a foreign person is engaged in a trade or business. As a general rule, a foreign person’s activities must be regular, continuous and substantial in order for the person to have sufficient presence in the United States to be considered engaged in a trade or business.

### ***Sale of U.S Real Property Interest***

Foreign persons that sell or otherwise dispose of certain interests in real property located in the United States are taxed on a net basis at graduated rates on the gain from the sale or disposition, as though it were effectively connected income.

### ***Rental of Real Property***

Foreign persons that own real property in the United States and rent it out may be considered to be engaged in a trade or business if the activities related to their investment are regular, continuous and substantial.

If the activities are limited to the receipt of rent and payment of related expenses, the foreign person will generally not be regarded as engaged in a trade or business.

## **GENERAL U.S. TAXATION OF CERTAIN ENTITIES**

### ***U.S. Partnership w/Foreign Partners – U.S. Taxation***

If a partnership is engaged in a U.S. trade or business, then each of its foreign partners is deemed to be so engaged. A partnership that generates ECI must withhold tax on each foreign partner's "applicable percentage" of their ECI.

Income effectively connected with a U.S. trade or business will be separately stated on a reporting statement and the partnership will be required to withhold taxes based on the applicable percentage of ECI associated with each foreign partner. Generally, the withholding rate will be at 30%.

The ECI will be taxed to the partner at the graduated tax rates that apply to U.S. citizens and residents. The rates range from 10% to 35%.

Any withholding from the partnership will apply against the tax due, along with any foreign tax credits allowed.

### ***U.S. Corporation w/Foreign Shareholders – U.S. Taxation***

A U.S. corporation with foreign ownership is taxed the same as a U.S. domestic corporation at graduated tax rates between 15% and 35%.

Distributions from U.S. corporations to foreign shareholders will generally have withholding at 30%, unless a reduced treaty rate applies.

### ***Foreign Partnership – U.S. Taxation***

A foreign partnership that has ECI is required under U.S. taxation to file income tax returns the same as a U.S. domestic partnership. In addition, the foreign partners with allocable ECI are required to file a U.S. income tax return and pay any applicable U.S. income tax.

### ***Foreign Corporation – U.S. Taxation***

The tax treatment of foreign corporations is significantly similar to that of nonresident alien individuals. A foreign corporation is taxed on its ECI at graduated tax rates between 15% and 35%.

In addition to the above taxing provisions, foreign corporations are also subject to the branch profits tax. A flat tax of 30% (lower if treaties exist between the countries) is imposed on the dividend equivalent amount of each U.S. branch of any foreign corporation. In effect, the 30% tax is imposed on the amount of corporate earnings deemed repatriated. Thus foreign corporations may bear effective U.S. tax on ECI at a 54.5% rate (35% + (1 - 35%) x 30%), computed without regard to state and local taxes.

## **WITHHOLDING ISSUES**

Foreign persons who receive U.S. income are subject to withholding. A foreign person includes a nonresident alien individual, foreign corporation, foreign partnership, foreign trust, a foreign estate, and any other person that is not a U.S. person.

Generally, a withholding agent is required to withhold 30% from the gross amount paid to a foreign payee unless the payment can reliably be associated with documentation that establishes either of the following:

1. The payee is a U.S. person, or
2. The payee is a foreign person that is the beneficial owner of the income and is entitled to a reduced rate of withholding.

A withholding agent is a U.S. or foreign person that has control, receipt, custody, disposal, or payment of any item of income of a foreign person that is subject to withholding. A withholding agent may be an individual, corporation, partnership, trust, association, nominee, or any other entity. Withholding agents are required to withhold on Form 1042-S *Foreign Person's U.S. Source Income Subject to Withholding* and file an annual Form 1042 *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*.

A Form W-9 *Request for Taxpayer Identification Number* is used to certify a payee is a U.S. person.

The Form W-8 series is used by foreign persons to certify they are the beneficial owner of the U.S. payment. Following is a list and description of the Forms W-8:

1. W-8BEN: Certifies the recipient's non U.S. status and status as beneficial owner of the income being paid. It may also be used to claim withholding related treaty benefits.
2. W-8IMY: Provided to a withholding agent by a foreign recipient that is an intermediary or flow-through entity.
3. W-8ECI: Provided to a withholding agent by a foreign recipient who is the beneficial owner of a reportable amount, when the income is ECI that the recipient is to report on a U.S. tax return.
4. W-8EXP: Provided to a withholding agent by a foreign person who is the beneficial owner of the reportable income claiming certain withholding exemptions applicable to tax-exempt entities.

## **TREATIES**

The objectives of U.S. tax treaties have been the avoidance of international double taxation. The objectives of eliminating double taxation are generally accomplished in treaties by the agreement of each treaty partner to limit, in certain specific situations, its right to tax income earned from its territory by residents of the other country and by the requirement that the country of residence allow a credit for taxes that are paid to the source country under the provisions of the treaty.

The important functions of treaties are:

1. To define the term "resident" so that an individual or corporation will not be subject to tax as a resident of both treaty countries;

2. To define the taxes to which a treaty applies;
3. To provide that the taxes will be creditable income taxes for purposes of the convention; and
4. To state source rules for dividend, interest, royalty, and real property income, as well as business profits and personal service income, for purposes of allowing a reduced rate of tax or complete exemptions from taxation in one or the other treaty country

## **INTERNATIONAL COMPLEXITIES**

The complexities that exist with international transactions are too numerous to detail here. There is a vast array of filing requirements applicable to each situation. In addition, the IRS imposes severe penalties for failure to file and failure to pay (among just a few).

It is imperative that if you are doing business internationally, that you engage a knowledgeable tax advisor who specializes in international taxation. Even simple transactions such as owning U.S. real estate can involve onerous filing requirements.

As a rule, U.S. businesses are the withholding agent. As a withholding agent, if you fail to withhold, the IRS will assess the withholding agent for the amount that was supposed to be withheld, plus penalties and interest.

Oftentimes the withholding amount is far greater than the actual tax owed. Many foreign taxpayers mistakenly do not file a US tax return, and therefore significantly overpay their tax.

Bosma Group's Lisa Carlon is the ONLY international tax expert in Northern Nevada. She can help you with your international tax planning and compliance needs.

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## **STATEMENT PURSUANT TO TREASURY REGULATIONS (CIRCULAR 230)**

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This Memorandum addresses certain U.S. federal income tax issues only and does not address state, local or foreign tax issues. Our analysis is based on the Internal Revenue Code of 1986, as amended, the Treasury Regulations promulgated thereunder, and other relevant authorities. These authorities are all subject to change, and such change could have retroactive effect. Any such changes could thus have an effect on the validity of our conclusions. Unless you specifically request otherwise, we will not update this Memorandum for subsequent changes or modifications to these authorities. Further, this Memorandum is based on our interpretation of these authorities; another knowledgeable party (such as the IRS or a court hearing the same facts) might reach different conclusions.

The above are general rules (exceptions abound) and not intended to provide specific advice. Contact your tax advisor to get an answer for your specific situation.

**APPENDIX A**  
**TAX RATE SCHEDULES**

**U.S. Individual Tax Rate Schedules-2008**

Married Filing Jointly

Taxable Income

\$0-16,050	x 10%	minus	\$ 0.00	=	Tax
\$16,051-65,100	x 15%	minus	802.50	=	Tax
\$65,101-131,450	x 25%	minus	7,312.50	=	Tax
\$131,451 – 200,300	x 28%	minus	11,256.00	=	Tax
\$200,301-357,700	x 33%	minus	21,271.00	=	Tax
\$357,701 and over	x 35%	minus	28,425.00	=	Tax

Single

Taxable Income

\$0-8,025	x 10%	minus	0.00	=	Tax
\$8,026-32,550	x 15%	minus	401.25	=	Tax
\$32,551-78,850	x 25%	minus	3,656.25	=	Tax
\$78,851-164,550	x 28%	minus	6,021.75	=	Tax
\$164,551-357,700	x 33%	minus	14,249.25	=	Tax
\$357,701 and over	x 35%	minus	21,403.25	=	Tax

**Corporation Tax Rate Schedule-2008**

Taxable Income

\$0-50,000	x 15%	minus	0.00	=	Tax
50,001-75,000	x 25%	minus	5,000.00	=	Tax
75,001-100,000	x 34%	minus	11,750.00	=	Tax
100,001-335,000	x 39%	minus	16,750.00	=	Tax
335,001-10,000,000	x 34%	minus	0.00	=	Tax
10,000,001-15,000,000	x 35%	minus	100,000.00	=	Tax
15,000,001-18,333,333	x 38%	minus	550,000.00	=	Tax
18,333,334 and over	x 35%	minus	0.00	=	Tax