GUIDEBOOK FOR U.S. TAXATION OF FOREIGN INDIVIDUALS

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The law firm of Tescher Gutter Chaves Josepher Rubin Ruffin & Forman, P.A. has provided this Guidebook to its friends and clients to assist them in their basic understanding of United States taxes in relation to foreign persons. The firm is composed of attorneys who have substantially limited their practice to United States and international tax matters. The firm is proud of its depth of experience, its creative abilities, its knowledge of international tax matters, and its desire to provide the highest level of service to its clients. For further information about the firm or any of its attorneys, please contact the firm at the address described on the cover of this Guidebook.

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1. INTRODUCTION

The United States taxes foreign persons on their income and assets related to the United States. Foreign persons who are *also* citizens, residents, or domiciliaries of the United States are generally subject to greater U.S. taxes than other foreign persons.

The rules of taxation in this area are complex and confusing. This Guidebook is intended to provide a basic understanding of those rules. It is not intended to substitute for the guidance of qualified tax counsel - however, it should go a long way in making such guidance more understandable and meaningful to the reader.

There are three general areas of U.S. tax that a foreign person should be concerned with. The first is income taxes - taxes on income earned by the foreign person. The second is estate taxes - taxes on the value of property transmitted by an individual at his death to his successors in interest. The third is gift taxes - taxes on the value of property given by an individual during his lifetime to other persons. Each general area has its own rules and tax rates.

These taxes are imposed by the Federal government of the United States. Additionally, states and local governments may impose similar taxes, but usually at lower rates. There are many other taxes imposed in the United States, including employment and social security taxes, real estate and other ad valorem taxes, excise taxes, and sales and use taxes - all of which may at times apply to foreign persons. Value added taxes are not generally imposed. These additional taxes are not discussed in this Guidebook.

The principal agency of the Federal government for tax collection and enforcement is the Internal Revenue Service. State and local governments have their own tax agencies - one example is the Florida Department of Revenue for the State of Florida.

The United States tax system is based largely on voluntary compliance. Taxpayers prepare tax and information returns by themselves. Then, they submit them to the tax authorities with the appropriate tax payments. Tax authorities review this voluntary system with audits of taxpayers. In an audit, the Internal Revenue Service examines the tax returns, books and records of a taxpayer to determine if the taxpayer complied the law. The Internal Revenue Service may increase or decrease the tax due and impose penalties.

Residents of countries with tax treaties with the United States may receive more favorable United States tax treatment than residents of non-treaty countries. These treaties can vary some of the general rules discussed in this Guidebook.

This Guidebook is limited to United States taxes on individuals. Separate taxation regimes apply in the income tax area to the taxation of corporations, partnerships, and other entities.

2. INCOME TAXES - CITIZENSHIP AND RESIDENCY

The United States taxes its *citizens* and *residents* on their world-wide income. Individuals who are *not* citizens or residents of the United States are taxed generally only on their income from United States sources. Therefore, for purposes of United States income taxes, foreign individuals usually desire to avoid United States citizenship and United States residency (that is, they usually desire to be "nonresident aliens").

It is important for a foreign person to know the basic rules that determine his income tax status. Generally, an individual is a United States *citizen* only if born or naturalized in the United States, or has United States citizen parents. Questions regarding citizenship for income tax purposes are generally resolved in accordance with United States immigration law. Individuals should consult with an immigration attorney to resolve questions concerning United States citizen status.

Even though an individual is not a United States citizen, he or she can still be a United States *resident*. Generally, such a person will be a resident only if (a) such individual has lawful permanent resident status for United States immigration purposes (*i.e.*, the individual possesses a "green card"), or (b) such individual spends so much time in the United States that he or she is deemed a resident under the "substantial presence" test.

Under the "substantial presence" test, an individual who spends 183 days or more in the United States during a calendar year will generally be considered a resident. In counting days present in a given year, the individual must add to the total number days present in the given year 1/3 of the days present in the preceding calendar year and 1/6 of the days present in the second preceding calendar year.

> ***EXAMPLE:*** Carlos Rivers was present in the United States 110 days in 1993, 120 days in 1992, and 240 days in 1991. His total days present in 1993 for this purpose are 190, computed as follows:
>
> | | |
> |---|---|
> | 1993 | 110 days |
> | 1992 (120/3) | 40 days |
> | 1991 (240/6) | 40 days |
> | | 190 days |
>
> Thus, Carlos will be considered a United States resident for income tax purposes in 1993.

Under the substantial presence test, special rules may exclude certain days present from being counted, and may also result in nonresident alien status even though the 183 day limit is exceeded. A useful guide in this area is an individual can usually avoid resident status by spending no more than 120 days in the United States in each and every year.

3. INCOME TAXES - NONBUSINESS INCOME

The United States imposes a thirty percent withholding tax on certain nonbusiness income paid to nonresident aliens from United States sources. Technically, this income is referred to as United States source income that is "fixed or determinable, annual or periodic." It includes United States source:

A. interest income;
B. dividend income;
C. rental income;
D. compensation income that is not effectively connected with a United States trade or business;
E. annuity income; and
F. certain other similar types of income.

Generally, the United States payor of such income must withhold the tax from the payment to the nonresident alien. However, if no such withholding occurs, the nonresident alien is required to pay the tax. Special rules determine when such income is from United States sources. Also, special exceptions from taxation apply. A principal exception is for interest paid on deposits with United States banks and savings and loan associations. Interest on certain portfolio debt obligations may also be exempt from this tax at times.

If such income is also characterized as income effectively connected with a United States trade or business, as explainedbelow in the Section "Income Taxes - Business Income," this thirty percent withholding tax will not apply. Instead, the income will be taxed as explained in that Section.

4. INCOME TAXES - BUSINESS INCOME

A nonresident alien that (a) is engaged in a United States trade or business, and (b) has income that is effectively connected with that United States trade or business, will be taxed on that income in the same manner as a United States person. That is, the United States will tax the nonresident alien of such income at graduated rates, after the income is reduced by deductions related to such income.

Generally, a nonresident alien will be considered to be in a United States trade or business if he or she conducts relatively continuous business activities from a fixed location in the United States. Most United States source income arising in that business will be considered "effectively connected" income, and some foreign source income will also be considered "effectively connected."

Determining the existence of a United States trade or business or effectively connected income, and the allocations of deductions to that income, can be a complex and difficult task.

5. INCOME TAXES - CAPITAL GAINS AND REAL PROPERTY GAINS

Generally, the United States does not tax nonresident aliens on their gains from the sale of a capital asset. Three principal exceptions to these rules are:

A. Such asset is used in a United States trade or business of the nonresident alien;

B. The nonresident alien is present in the United States in the year of disposition for 183 days or more; or

C. The capital asset is a United States real property interest.

Generally, a United States real property interest is vacant land, office buildings, houses, and condominiums, located in the United States. At times, stock in a United States corporation can also be a United States real property interest. If the sale is a sale of United States real property interest, under the "FIRPTA" rules the buyer of the property may be required to withhold ten percent of the purchase price and pay the ten percent to the Internal Revenue Service. This payment is a deposit towards any of the seller's taxes arising from the sale. Any withholding in excess of the tax actually due will be refunded by the Internal Revenue Service. There are a number of exceptions to this FIRPTA withholding requirement.

6. INCOME TAXES - LOCAL AND STATE TAXES

The preceding discussion describes Federal income taxes imposed on nonresident aliens. In addition to Federal income taxes, some states impose their own income taxes on individuals. Local governments, such as cities, may also impose their own income taxes. These taxes are generally at rates much lower than the Federal tax rates. Typically, but not always, they are payable under the same rules as the Federal income taxes, and thus are payable only when Federal income taxes are due.

7. ESTATE TAXES

The United States imposes estate taxes on the net value of property owned by a decedent at the moment of his death. If the decedent is a United States *citizen* or United States *domiciliary*, his "estate" will be taxed on the all of the worldwide assets of the decedent. If the decedent is *not* a United States citizen and *not* a United States domiciliary (i.e., he or she is a "nondomiciliary"), then the estate taxes will apply only to property *with a United States situs*. For decedents who are not United States citizens, a key determination therefore is whether the decedent is a nondomiciliary. Unlike the "residency" test for income tax purposes described above, there is no objective test for making this determination.

Generally, a person acquires a United States domicile only if, at the same time, (a) a person resides in the United States, and (b) has the intent to reside here indefinitely. This is determined on a facts and circumstances basis.

As discussed above, for a nondomiciliary only United States situs assets are subject to United States estate taxes. Generally, United States situs assets include stock in United States corporations, tangible personal property and United States real property located in the United States, and bonds and other debt instruments issued by United States persons. Exceptions from United States situs status exists for certain debt instruments issued by United States persons and funds held in a United States bank or savings and loan association account. Since stock in a non-United States corporation is not a United States situs asset, a non-United States corporation is often used by nondomiciliaries to hold their United States situs assets with the anticipation that this arrangement will shield them from United States estate taxes.

Usually, the first $60,000 in assets owned by a nondomiciliary will be exempt from United States estate taxes. Thereafter, United States estate taxes will apply at progressive rates up to a fifty percent maximum. However, if the decedent at his death passes his assets outright or in a qualified trust or other arrangement to a surviving spouse who is a United States citizen, the United States will not impose its estate tax on such assets at the death of the first spouse. If the surviving spouse is not a United States citizen, the decedent can achieve the same result by transferring his assets during his lifetime or at his death to as a "qualified domestic trust" for the benefit of the surviving spouse.

In addition to the Federal estate tax, state and local governments may also impose an estate tax.

8. GIFT TAXES

The United States taxes gifts of property from one individual to another. Generally, it imposes these taxes at the same rates as the Federal estate tax. The United States taxes United States citizens and domiciliaries on gifts of all property wherever situated. It taxes nondomiciliaries only on gifts of United States situs property.

The same definition of "domicile" used in the Estate Tax discussion above applies for gift tax purposes. However, a different definition of "United States situs" assets applies. For gift tax purposes, intangible assets such as stock in United States corporations and United States debt obligations are not United States situs assets. Thus, a nondomiciliary can gift these assets without gift taxes even though they may be subject to estate tax if owned by that same nondomiciliary at death.

Individuals can make certain gifts without incurring gift taxes. For example, any individual can gift up to $11,000 each year to as many individuals as he or she desires without the United States taxing such gifts, if the individual makes such gifts in the proper form. Further, a gift from one spouse to a United States citizen spouse is not subject to gift tax. If the recipient spouse is not a United States citizen, the spouse making gifts can give the recipient spouse gifts of up to $100,000 each year without gift taxes.

9. REPORTING REQUIREMENTS

Generally, a nonresident alien must file United States income tax returns only if he or she (a) engaged in a United States trade or business during the tax year, or (b) received United States source income subject to the thirty percent withholding tax but such withholding requirement was not followed by the payor of such income.

If a nonresident alien is required to file an income tax return but does not file, he or she will lose the ability to reduce his or her trade or business income by permitted deductions. In that situation, the United States will instead tax the nonresident alien on a gross basis.

Additional return requirements apply for estate tax and gift tax situations. Further, information returns are often required. For example, information disclosing related party transactions with entities engaged in a United States business often must be filed.

It is generally advisable that the assistance of a certified public accountant, with particular experience in international tax matters, be obtained for assistance in determining when returns are required and preparing the required returns. A tax attorney can help determine the scope of United States taxation and to plan for minimizing such taxation. Oftentimes, proper planning can mean the difference between substantial tax and no or *de minimis* tax.

10. PENALTIES AND ENFORCEMENT

In many countries of the world, taxation is typically a matter of negotiating with the local tax authorities. Corporations and bank accounts in tax havens, and double sets of books, are often established methods of dealing with the tax collector.

Individuals should avoid such tax practices in the United States. The United States will impose additional taxes and interest on those who fail to follow United States tax rules. Also, the United States may impose penalties for failure to comply with the law. In intentional evasion situations, the United States will impose criminal fines and jail sentences. Consequently, it is important for foreign persons to determine the scope of their United States tax obligations and to meet those obligations.

11. TAX PLANNING

This Guidebook has generally limited itself to a discussion of the principal taxes imposed on foreign persons. With proper planning, foreign persons can often minimize or avoid the United States taxes discussed in this Guidebook.

NOTE: The purpose of this guide is to summarize for informational purposes only certain tax information of interest to the clients and friends of Tescher Gutter Chaves Josepher Rubin Ruffin & Forman, PA. Applying the information herein to a specific situation may involve more complex analysis or other tax provisions that are not described herein for the purpose of simplification. The information contained herein is condensed from, and a general summary of, legislation, administrative rulings and other information, and should not be construed as legal advice or opinion, and is not a substitute for the advice of counsel or an accountant. For further information, please contact us at the above address.