Nonresident Taxability and Where or How?

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

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

If:

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

However, U.S. negotiated income tax treaties, if elected may override the source of specific items taxed, and therefore the applicable income tax treaties always need to be consulted in tandem with domestic U.S. law treatment.

Additionally, in the case of U.S. persons- citizens and green card holders- the U.S. has conveniently slipped into most income treaties a provision usually, under Miscellaneous Rules, to enable the U.S. to continue to tax U.S. persons as if the income tax treaty does not exist. This is typically referred to as a “Savings Clause” or “Limitation on Benefits” clause.

Where and How:

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

Effectively connected income is reported on Form 1040-NR page 1 and is taxed at U.S. regular graduated tax rates and non-effectively connected income is reported on Schedule NEC (Form 1040-NR)- and is flat taxed at a rate of 30%, or reduced treaty rates.

However, there is one exception below, in the case of Capital Assets (includes everything you own except business related assets, includes shares held for investment, basically all personal property, but not real property) not effectively connected with a U.S. trade or business. Under this one instance if a nonresident alien taxpayer is present in the U.S. physically for 183 days or less in the tax year, the gain from the Capital Asset is tax exempt, unless effectively connect with US trade or business.

If a nonresident alien taxpayer is present in the U.S. physically for more than 183 days, the gain is U.S. source for entire calendar year and taxed at 30% or lower treaty

Regardless of the taxpayers “Tax Home”, which generally governs the source of the sale of personal property.

Basically, this is the only instance of the Effectively Connected rules overriding U.S. source rules. IRC Sec 865 overrides IRC Sec. 871

If and Where and How:

We have constructed a table to facilitate these determinations:

Income type:	**U.S. source rule: "IF"**	**If U.S. sourced, effectively connected rule: WHERE and HOW:**
Interest income	Received from a U.S. resident payer	Not effectively connected, unless from asset or produced by U.S. trade/ business. Under 871 interest from U.S. bank deposits not taxable.
Dividend income	Received from a U.S. domestic corporation	Not effectively connected, unless from asset or produced by U.S. trade/ business.
Personal service income- wages, salaries, commissions, fees. Per diem allowances & bonuses	If performed in the U.S.	Performance in the U.S. is considered effectively connected.
Rent/ Royalties	Property located in the U.S.	Not effectively connected, unless from asset or produced by U.S. trade/ business. However election on rental income to make effectively connected is available.
Royalties	For use in the U.S.- patents, copyrights, good will TM, etc..	Not effectively connected, unless from asset or produced by U.S. trade/ business.
Real property sale	Property located in the U.S.	Always effectively connected
Inventory- purchased	Sold in U.S.	Always effectively connected
Sale of personal property:	Seller's "tax home", special exceptions include: depreciable, intangibles, sales through office / fixed place of business Rate of tax/ Period covered: - if in US 183 days or more during tax year= US source for **entire calendar year** at **30% or lower treaty**. -if in US less than 183 days during tax year capital gains **tax exempt** unless effectively connect with US trade or business	Not effectively connected, unless from asset or produced by U.S. trade/ business (see below). If not effectively connected Capital Asset (includes everything you own except business related assets, includes shares held for investment, basically all personal property) then- 183 day rule- or more, not effectively connected, less then 183 days and tax exempt. **Reporting- Where:** Report gains/ losses from sale/ exchanges of capital assets: -NEC w/ US trade/business- **Sch NEC** -ECI w/ US trade/business- **Sch D**. -If you only trade stock through a U.S. resident broker you are not engaged in a U.S. trade or business. Even if you are in the U.S. -From asset or produced by U.S. trade/ business- Always effectively connected income, whether or not connection. Two tests determine if investment income (fixed or determinable- interest, rent royalty, Gains (rare types) or Capital Gains) are effectively connected to business- 1) Asset Use and 2) Business Activities Tests.
Scholarships, grants, prizes and awards	Residence of payer for activities performed in U.S.	Either excluded or see Personal service income above.
Pension income	Portion related to U.S. performed services	See Personal service income above.
Alimony	Paid by a spouse to ex-spouse	Residence of spouse obligated to make payments

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