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Doing Business in the United States

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CHAPTER 12 Taxation of Nonresident Alien Individuals and Foreign Entities

*2-12 Doing Business in the United States § 12.02*

### **§ 12.02 Residence**

The manner in which foreigners are subject to U.S. income tax depends on whether they are considered resident or nonresident aliens. Residents pay U.S. tax at graduated rates on worldwide income, the same as U.S. citizens. Nonresidents are subject to two tax regimes, depending on the type of income. Withholding tax at a 30% rate (subject to treaty reduction) is imposed on various categories of income of a nonresident alien, not engaged in a U.S. trade or business. If a nonresident alien is engaged in a U.S. trade or business, tax is paid at graduated rates on net income "effectively connected" with that trade or business (i.e., effectively connected income referred to as "ECI"). n1

#### **[1] Individuals**

A U.S. citizen is an individual born or naturalized in the U.S. and subject to U.S. jurisdiction as a citizen. Any individual who is not a citizen is an alien. The question of citizenship may be more complicated in the case of former United States citizens. It is clear that aliens who have applied for, but not yet received U.S. citizenship are considered aliens. Often tax laws alone will not resolve questions concerning citizenship, if the alien has connections with another jurisdiction. The regulations refer to immigration and other laws on these issues. n2

Individuals classified as alien, may be either resident or nonresident. Essentially an alien will be considered a resident if he or she satisfies either the "green card test" or the "substantial presence test." These tests are set forth in the Code, which was amended in 1984 to provide a bright line test, which had not existed before. n3 The requirements of these tests are as follows:

**Green Card Test:** An alien is a resident alien with respect to a calendar year if the individual is a lawful permanent resident, i.e., a green card holder, at any time during the year. Residence status continues unless it is rescinded administratively or judicially or determined to have been abandoned. n4 This provision resolves the problem of de facto abandonment through lack of use.

**Substantial Presence Test:** An alien individual is considered a resident alien if he or she has been present in the U.S. on at least 183 days during a three-year period, that includes the current year. For purposes of applying this test: (1) In determining whether the 183 days are satisfied: (a) each day of the presence in the current year is counted as a full day; (b) each day of presence in the first preceding year is counted as one-third of a day and (c) each day of presence in the second preceding year is counted as one-sixth of a day; (2) An individual is treated as present in the U.S. on any day

that he or she is physically present in the U.S., at any time during the day, subject to certain exceptions; n5 (3) An individual must be physically present for more than 30 days in the current year, despite the fact that presence in the prior years would put the total to 183 days or more. n6

Very specific regulations in this area should be examined in the case of a close call. n7 For example, the first day an individual is physically present may be disregarded, for purposes of the physical presence test, if it is less than 10 days. In other words, aliens may be present for up to 10 days without triggering a residency starting date.

Exceptions to Substantial Presence Test: Even if an individual otherwise meets the substantial presence test, he or she will be considered a nonresident alien for the current year if he or she falls within any of the exceptions:

(1) Closer Connection Exception: An alien is considered a nonresident of the U.S. because he or she has a closer connection to a foreign country and the following conditions are met: (a) He or she is present in the U.S. for fewer than 183 days in the current year; (b) He or she maintains a tax home in a foreign country during the current year; and (c) He or she has a closer connection during the current year to a single foreign country than to the U.S. n8

In determining whether this exception applies, special rules come into play. n9

(2) Exempt Individual: By virtue of their status, certain individuals are not considered residents, despite satisfaction of the substantial presence test. These include: (a) Foreign government-related individuals who are temporarily present in the U.S. as a full time employee of an international organization, by reason of diplomatic status of a special visa that represents diplomatic or consular status; n10 (b) Teachers or trainees, including immediate family, who are admitted to the U.S. temporarily as nonimmigrants under special provisions of immigration law;

(c) Students; and (d) Professional athletes. n11

In applying these tests, take note that special rules come into play with respect to satisfying both the green card test and the substantial presence test during the first and last year of residence. n12 Accordingly, aliens who are residents of the U.S. and who are also residents of a treaty partner, will be eligible for treaty benefits. However, these individuals will be treated as U.S. residents for matters not covered by a treaty. n13

## **[2] Corporations**

The definition of "domestic corporation" is key to determining whether a corporation is taxed on its worldwide income, or just its effectively connected U.S. source income. A domestic corporation is any corporation created or organized in the U.S., or under the laws of the U.S. or any state. n14 The Code provides that any entity that is not treated as a domestic corporation is a foreign corporation. n15 A foreign corporation may be resident or nonresident. It is considered a resident foreign corporation if it engages in a trade or business within the U.S. It is considered a nonresident foreign corporation if it does not.

In order for the special foreign tax rules to apply to a corporation, it is only necessary that the corporation be foreign. A foreign corporation is defined simply as any corporation that is not domestic, and a domestic corporation is any corporation "created or organized in the United States or under the law of the United States or of any State."

Another issue that can be important in this context is whether an entity is a corporation. For U.S. tax purposes, corporations are taxed in a different manner than individuals, trusts, estates or partnerships. Partnerships are not taxed as separate entities, unless an election to do so is made. Without such an election, partnerships are disregarded as separate taxable entities, and instead their tax attributes flow through to the tax returns of the owners. Classification issues are addressed in the regulations. n16 Other possible exceptions may arise if a corporation is disregarded as a sham, so that its place of incorporation becomes irrelevant; or, if a non-corporate association is treated, for tax purposes, as a

corporation, in which case it cannot be stated with certainty where the corporation might ultimately be located. Bilateral tax treaties often contain special rules that must be taken into consideration. n17

### **[3] Partnerships n18**

Like corporations, partnerships are generally considered foreign if they are formed under the laws of a foreign jurisdiction. However, their status as resident or nonresident is (other than for treaty purposes) not directly relevant. The key issue for foreign partnerships, and other entities such as limited liability companies or limited liability partnerships, is often whether the entity will be treated as a corporation or as a partnership for U.S. tax purposes.

As discussed above, partnerships are not taxed as separate entities, unless an election to do so is made. Instead, their tax attributes flow through to the tax returns of the owners. n19 However, the I.R.S. can reclassify a foreign entity as a corporation or partnership, depending on whether its characteristics make it look more like one than the other. n20

The distinction between partnership and corporate attributes is important in this context, because significant consequences can result from the classification. For example, shareholders/partners will be treated as engaged in a trade or business to the extent the entity is and the manner in which income is passed through to them will be affected by such status. Rights under treaties, types of filing requirements, and deferral opportunities are also affected.

It should be noted that this definition of residence is indirectly meaningful, since it looks to the significant question for tax purposes: whether the partnership is engaged in a United States trade or business. That issue, which will ultimately determine how the partners are taxed, will be discussed at *Section 12.04 below*. However, regardless of the residence of the partnership, the residence of the individual (or corporate) partners will be determined under the tests already discussed for individuals and corporations; the residence of the partnership will not be attributed to the partners.

### **[4] Trusts and Estates n21**

An estate or trust is foreign if: (1) the trust or estate receives non-U.S. sourced income (other than ECI), n22 and (2) that income is not taxable by the United States.

The effect of this definition is to make the application of the tax rules depend upon residence, since foreign entities that are United States residents clearly would be taxed upon their worldwide income as if they were domestic entities; nonresident foreign entities would not be so taxed. Thus nonresident foreign trusts and estates are taxable as individuals under the foreign tax rules, but account for their income under the trust rules.

Although the residence of the foreign trust or estate is the central issue in determining taxability, there is very little authority on the question. The authority that exists seems aimed mainly at reviewing the facts and circumstances of each case. If decisive factors can be extracted, they seem to be the residence of the fiduciary in the case of trusts, n23 and, with somewhat less certainty, the residence of the decedent in the case of estates. n24 Since neither of these factors alone is supported by much authority, neither can be relied upon with absolute certainty.

#### **FOOTNOTES:**

(n1)Footnote 1. *I.R.C. § 871(b)*.

(n2)Footnote 2. *Treas. Reg. § 1.1-1(c)*.

(n3)Footnote 3. *I.R.C. § 7701(b)* was enacted by the Tax Reform Act of 1984. It is effective for tax years beginning after December 31, 1984.

(n4)Footnote 4. Under *Treas. Reg. § 301.7701(b)-1(b)(3)*, if the alien initiates the determination as to abandonment, then abandonment occurs upon filing the application; if INS or a consular officer initiates rescission, then

it occurs upon issuance of a final administrative order of abandonment.

(n5)Footnote 5. For purposes of counting days of presence, certain days are excluded such as: days the person is an "exempt" individual, discussed *below*, days of transit between two points outside the U.S. and regular commuter trips between Canada or Mexico and the U.S.

(n6)Footnote 6. For example, if an alien individual is present in the U.S. for 25 days during the present year and 365 days in each of the preceding two years, the substantial presence test does not apply because the requisite 30 days has not been met for the current year.

(n7)Footnote 7. *See, e.g., Treas. Reg. § 301.7701(b)-4.*

(n8)Footnote 8. *Treas. Reg. § 301.7701(b)-2* spell out the specific requirements for satisfying this exception to the substantial presence test. For example, in order to establish an individual has a closer connection to a foreign country, facts and circumstances such as location of permanent home, family members, personal belongings, personal banking activities, etc., would be considered.

(n9)Footnote 9. For example, an individual can demonstrate that he or she has a closer connection to two foreign countries (but no more than two), if he or she maintains a tax home on the first day of the current year in one country and one in the second country for the remainder of the year; a closer connection to each foreign country than to the U.S. during the year and is proportionately taxed by both countries in accordance with the time spent in each. *Treas. Reg. § 301.7701(b)-2(a)(3).*

(n10)Footnote 10. *I.R.C. § 7701(b)(5)(A)(i), (B).*

(n11)Footnote 11. All of these exemptions are spelled out in *Treas. Reg. § 301.7701(b)-3.*

(n12)Footnote 12. *I.R.C. § 7701(b)(2)(B).* In addition, these residency rules must be coordinated with income tax treaties. *See Treas. Reg. § 301.7701(b)-7.*

(n13)Footnote 13. *I.R.C. § 7701 (b)* which defines aliens was not intended to override treaty obligations of the U.S.

(n14)Footnote 14. *I.R.C. § 7701(a)(4).*

(n15)Footnote 15. *I.R.C. § 7701(a)(5).*

(n16)Footnote 16. *See Treas. Reg. § 301.7701-2(b)(8)* for definition of foreign entities and *Treas. Reg. § 301.7701-3* regarding elective classifications with respect to foreign entities.

(n17)Footnote 17. *See § 12.09 below.*

(n18)Footnote 18. For discussion of taxation of partnerships *see Ch. 60 below.*

For discussion of partnerships *see Chs. 59, 61-66 below.*

For discussion of taxation of limited partnerships *see Ch. 67 below.*

(n19)Footnote 19. *See Treas. Reg. § 301.7701-2(b)(8)* for definition of foreign entities and *Treas. Reg. § 301.7701-3* regarding elective classifications with respect to foreign entities.

(n20)Footnote 20. *Treas. Reg. § 301.7701-3* sets forth the distinguishing characteristics of partnerships and corporations. The same rules apply to U.S. entities.

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(n21)Footnote 21. For discussion of taxation of business and investment trusts *see* Ch. 70 *below*.

(n22)Footnote 22. *See* § 12.05 *below*.

(n23)Footnote 23. *B. W. Jones Trust v Commissioner*, 132 F2d 914 (4th Cir 1943) .

(n24)Footnote 24. *See Rev. Rul. 64-307, 1964-2 C.B. 163 ; Rev. Rul. 62-154, 1962-2 C.B. 148 ; Rev. Rul. 60-181, 1960-1 C.B. 257 .*