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**Time of Request:** Monday, November 15, 2010 10:19:45 EST

**Client ID/Project Name:**

**Number of Lines:** 288

**Job Number:** 2822:253322645

Research Information

**Service:** Terms and Connectors Search

**Print Request:** Current Document: 1

**Source:** Doing Business in the United States

**Search Terms:** § 12.03 Non-Business Income: Fixed or Determinable, Annual or  
Periodical



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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 § 12.03*

**§ 12.03 Non-Business Income: Fixed or Determinable, Annual or Periodical**

Nonresident alien individuals, foreign entities taxable as nonresident alien individuals and foreign corporations (*see § 12.02 above*) are taxable by the United States on two classes of income: (1) "fixed or determinable, annual or periodical" n1 income ("FDAP") from United States sources; and (2) any income "effectively connected" n2 with the conduct of a United States trade or business, which income must generally but not always be from United States sources ("ECI").

What is a trade or business under the foreign tax rules and income effectively connected with a trade or business are discussed at *Sections 12.04* and *12.05* respectively. The discussion here will focus solely on FDAP.

The tax pattern for foreigners who are not engaged in United States trade or business with United States-source FDAP is as follows:

- (1) only United States-source FDAP is taxed;
- (2) the rate of tax is 30% of the gross amount of FDAP unless a treaty (*see § 12.09*) provides otherwise; and
- (3) the tax is imposed by withholding (*see § 12.08 below*) at the source of payment.

The chief problems that arise with FDAP are interpreting whether payments constitute FDAP, and withholding requirements. Also, bear in mind that the rules relating to FDAP do not exist in a vacuum, and that taxation of FDAP will depend upon other factors as well. These include: whether the recipient is engaged in a trade or business, n3 whether he or she is a United States resident, n4 and in some cases, how long he or she is present in the United States in a taxable year. n5 To the extent these factors change, items of income may or may not be considered FDAP with respect to a taxpayer. It is often useful to keep in mind the purpose of the definition of FDAP, which is basically designed to subject the income or yield of passive investments to tax, but to allow the appreciation on such investments to be realized tax-free.

Often the FDAP issues are intertwined with the withholding/payor requirements in such a manner that it is important for

taxpayers to be familiar with the withholding and reporting requirements in order to assert rights to a reduced rate of FDAP withholding, either pursuant to the Internal Revenue Code or a treaty provision.

### **[1] General Definition of FDAP**

The basic definition of FDAP is set out in identical language in Code Sections 871(a)(1)(A) and 881(a)(1), which state that FDAP is "interest (other than original issue discount as defined in Section 1232(b)), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income." n6 Additionally, certain classes of income that are generally entitled to capital gain treatment: gains on the sale of debt issued originally at a discount, and gains on the sale of specified intangibles are FDAP. Eighty-five percent of social security benefits are included, without the alternative limitation that is available to citizens. n7

The term "fixed or determinable, annual or periodical" is merely "descriptive of the character or class of income," and applies irrespective of whether it is paid in a lump sum. n8 Below is a general overview of the types of income treated as FDAP.

#### **Dividends**

With certain exceptions, all U.S. source dividend income that is not effectively connected with a U.S. trade or business is FDAP. This generally includes amounts received from domestic corporations, as well as foreign corporations if 25% or more of the foreign corporation's gross income was effectively connected with a U.S. trade or business over a three-year testing period. A portion of the dividend is taxable when received by a foreign person from a U.S. corporation that earns more than 80% of its income from active foreign business. If a domestic corporation derives 80 or more percent of its income, over a three-year period, from active foreign business activities, only the portion of dividends paid that equals the corporation's earnings from U.S. sources is subject to the 30-percent tax. n9

If a non-resident receives a dividend distribution from a regulated investment company ("RIC"), the RIC may designate the maximum amount permitted in respect of its distributions as qualified dividends, capital-gain dividends, short-term capital gain dividends, and interest-related dividends even if the designations cause inconsistent reporting of the RIC's income by its U.S. shareholders and non-resident alien shareholders. n10

Payments of dividends, interest (including factoring income equivalent to interest), rents, and royalties received by a controlled foreign corporation ("CFC") from a related CFC will not be treated as "foreign personal holding company income" of the recipient corporation to the extent such payments are attributable or properly allocable to non-Subpart F income of the payor. n11 A "related CFC" is defined as a CFC that controls or is controlled (i.e., ownership of more than 50% of stock by vote or value) by the other CFC, or that is controlled by the same persons or persons that control the other CFC.

#### **Interest**

U.S. source interest income, with certain exceptions, is considered FDAP and subject to 30% withholding if not effectively connected with a U.S. trade or business.

Interest income generally includes interest from the U.S., the District of Columbia and interest on bonds, notes and other inter-bearing obligations of non-corporate U.S. residents or domestic corporations.

However, if a Form W-8 is filed by the alien claiming status as a non-U.S. person, interest on so-called "portfolio interest" n12 is exempt from withholding. The portfolio interest exception applies to a wide variety of corporate and government debt instruments issued after July 18, 1984, which meet certain requirements. They include: most interest

from bonds issued by U.S. states and municipalities, and interest on short term OID obligations. A non-U.S. person qualifies for the exemption with respect to a debt obligation held through a partnership if the partnership is a 10-percent shareholder, even if the non-U.S. person's indirect interest does not reach the 10% threshold. The 10-percent shareholder test is determined at the partner level, rather than at the partnership level. If a partnership receives portfolio interest, the 10-percent shareholder test is applied to each of the partnership's non-U.S. partners. n13

Interest payments received by a nonresident alien on deposits with banks, savings institutions, or insurance companies are exempt from tax if they are not effectively connected with the recipient's U.S. trade or business. Interest paid by a savings institution qualifies for exemption only if it is paid on deposits or withdrawable accounts and deductible by the payer for U.S. income tax purposes. Interest paid by an insurance company qualifies for exemption only if it is paid on amounts held by that company under an agreement requiring the payment of interest. n14 In addition, treaty provisions may cause the rate to be lower with respect to this type of income.

### **Rents and Royalties**

U.S. source rents and royalties, subject to 30% withholding include: rents and royalties from property or interests in property located in the U.S. and rents and royalties received for the U.S. of intangible property within the U.S.

### **Wage Type Income**

The definition of FDAP is broad enough to cover not only yields from investments, but also income that is clearly not investment income, such as salaries, wages, and remunerations. The reason for including this type of income is to insure that all U.S. source personal service income of foreign persons is subject to tax. n15 Under a *de minimis* exception, compensation for personal services are not treated as a trade or business, they are performed for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or for an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or a domestic corporation, or by a nonresident alien individual temporarily present in the U.S. not longer than a total of 90 days during the taxable year and whose compensation for such services does not exceed \$3,000. n16

Accordingly, if an alien were paid in 2006, he or she would be taxable on this income much as if he or she were a United States citizen or resident. However, if the alien left the United States at the end of 2006, and was not paid for his or her services until 2008 and in that year he or she is not engaged in United States trade or business, he or she would not be taxed by the United States at all, n17 unless the payment constituted FDAP. For this reason, wages and the like, which in the normal case would be taxable as ECI, constitute FDAP if paid in a year when the recipient is not engaged in a United States trade or business.

Since the general definition of FDAP is intentionally broad, the Service has not been hesitant in interpreting it to cover just about any sort of income. The courts, when faced with the issue, have done the same. n18

In addition to all the items within the general definition, FDAP also includes certain specific items that are more in the nature of capital gains than income from services or investment yield. Those items will be discussed in detail below, but they must be understood to be exceptions to the general rule that FDAP does not include gains from the sale of property in the United States. Such gains can never be FDAP unless they constitute capital gains realized by a nonresident alien individual present in the United States more than 183 days in the year in which the gains are realized, or unless they are specifically included in the definition of FDAP under the rules discussed below.

The reason that gain from the sale of property in the United States generally is not FDAP is simply to provide an investment incentive to foreign persons. The purpose is that the income or yield should be taxed, but not the appreciation. That result is accomplished by the exclusion of gains from the sale of property from the definition of

FDAP. Where the foreign person is engaged in the United States trade or business, however, gains from the sale of property in the United States will constitute ECI and be taxable unless they are capital gains that the alien can prove are not related to his or her trade or business. n19

### **[2] Certain Annuities Received Under Qualified Plans**

If certain conditions are met, FDAP does not include amounts received as an annuity under a qualified employer-employee annuity plan, or from a qualified trust under a stock bonus, pension, or profit sharing plan. n20 The conditions that must be met in order for this exemption to be effective are:

(1) all of the personal services rendered with respect to which the annuity is payable were either services performed outside the United States by an individual who was a nonresident alien at that time, or services performed for a foreign employer by a nonresident alien in the United States; and

(2) at the time of the first annuity payment, 90% or more of the employees participating in the plan are citizens or residents of the United States. n21

### **[3] Lump Sum Distributions**

If nonresident alien individuals receive lump sum distributions from qualified employee benefit plans n22 or from qualified annuity plans, n23 the amount that would be treated as capital gains under the cited provisions is deemed to be FDAP. This special rule is necessary in order to distinguish these types of capital gains from investment-type capital gains, which are not taxable. These payments are included in FDAP because they would be FDAP if the nonresident alien received his or her distribution over a number of years. The mere election to receive such payments in a lump sum should not change their character. n24 The Code specifically includes such "deemed" capital gains as FDAP to insure that these amounts will be taxed, regardless of how received. n25 Note, however, that only the *capital gain*, not the whole distribution, is subject to tax under this rule (the remainder of the distribution, being ordinary income, would also be taxable, but as ECI rather than as FDAP). n26

### **[4] Timber, Coal and Iron Ore**

Under provisions of the tax law regarding natural resources, certain n27 dispositions of timber, coal, or iron ore result in capital gains. These dispositions are not "sales" in the ordinary sense, since the seller need not be the owner as that term is normally used, and the disposition generally is not a sale at all, but rather the act of cutting trees or mining coal or iron ore. In order for these provisions to apply, the seller must retain an economic interest in the property sold. In any case, gains of this type will constitute FDAP to a foreigner. The reason is that these provisions, like the provisions relating to lump sum distributions, were designed to grant a tax benefit, in the form of capital gains treatment, but not a tax exemption, which would result from capital gains treatment if these gains were not includible as FDAP. Again, as in the case of lump sum distributions, only the gain, and not the whole amount of the payment, is treated as FDAP.

### **[5] Gains from the Sale of Intangibles**

Since 1967, gains from the sale or exchange of intangibles, such as patents, copyrights, trademarks, franchises and the like, have been governed by a special rule for FDAP purposes. This rule provides that such gain will constitute FDAP to the extent that payments received by the transferor are contingent on the productivity use or disposition of the intangible. The test of whether the payments are so contingent is set out in the regulations, and looks primarily to whether the price is fixed and definite. n28 If the price is fixed, the payments will not be contingent, even if they are contingent as to the time of payment. If the price is not fixed, the payments will be contingent, and, thus, FDAP. However, since the statute only makes the payments FDAP "to the extent" they are contingent, n29 a further rule provides that if in any year more than 50% of the gain is from contingent payments *all* the gain in that year will be FDAP. n30

The special FDAP rules relating to the sale or exchange of intangible are exclusive as long as there is a sale or exchange. However, a special source rule applies to any gains within the special FDAP rule. The effect of the source rule is to treat only that portion of the gain that represents payments for the use of the underlying intangible in the United States as United States-source FDAP.

In the case of patents, a further special rule applies if the gain on the sale was capital gain under Code Section 1235 and the sale took place before 1967. In that case, the gain is wholly FDAP and is not treated under the special FDAP rules relating to intangibles.

### **[6] Capital Gains**

Unless capital gains are includible under the special FDAP rules discussed *above* or are capital gains resulting from the sale of real property discussed *below*, they do not, except in one instance, constitute FDAP. That single instance is when they are realized and recognized by a nonresident alien individual who is present in the United States for 183 days or more during the year in which the gains are realized and recognized. n31 Technically speaking, the 183 day rule does not transform the gains into FDAP--it merely taxes them as if they were. However, in recognition of the fact that capital gains are technically not FDAP, the 183 day rule taxes only the *net* capital gains for the taxable year. It thus allows the offset of capital losses. However, no carryover of prior capital losses from other years is permitted under this rule, and gains taxable under this rule are taxable only if received in the qualifying year. If gains or losses are taxable under the 183 day rule, they are taken into account at 100% whether they are short- or long-term. However, excess losses are not taken into account.

The 183 day rule applies only to individuals, and only to gains realized and recognized in years after 1966. As with all the special FDAP gain rules, the 183 day rule must be understood to be an exception to the normal FDAP rules, which are designed to exempt gains from dealings or sales of property in the United States from tax unless the foreigner is engaged in a trade or business.

### **[7] Taxation of FDAP**

Once it is determined whether amounts of United States-source income or gain constitute FDAP to a nonresident alien or foreign corporation not engaged in a United States trade or business, calculating the actual tax is relatively simple. The tax is imposed by Code Section 871 or 881 at a flat rate of 30% of the gross amount of the FDAP. This tax is to be imposed by withholding at the source of payment n32 of the FDAP, and in the case of gains treated as FDAP under the special FDAP rules, withholding will often be made against the gross amount (a zero basis), since the withholding agent may not know the foreigner's basis. n33 As to capital gains taxable under the 183 day rule, there is no withholding; however, in that event the nonresident alien may not be allowed to depart from the United States until he or she has paid the tax, or made other arrangements. Treaties, n34 where applicable, may alter rates of tax, items taxable, and withholding rules, since treaties in such cases override the general rules of the Code.

It should be noted that United States-source income that constitutes FDAP may, nonetheless, not be taxable by the United States at all in the final analysis. For example, income specifically excludible from the gross income of any taxpayer under various sections of the Code will also be excludible by foreigner, even if it constitutes FDAP. n35 By the same token, income that qualifies for nonrecognition to a foreigner, even if such nonrecognized income or gain, is FDAP. n36 Furthermore, a number of classes of United States-source income are specifically excluded from the gross income of foreigners under Code Sections 872(b) and 883. n37 In all of these cases, tax may be withheld, even though no tax is due; however, the foreigner who is so taxed may file a claim for a refund.

It should also be kept in mind that FDAP will be taxed as indicated above only if the foreigner is not engaged in a United States trade or business. Thus foreigners cannot rely upon the general exemption from FDAP of gains from the

sale of property to make such gains exempt from tax in every case, since it is quite possible that the sales themselves may constitute a trade or business. n38 The effect of such a finding is far-reaching, since it may cause other gains or income, such as capital gains of the foreigners, to be taxable as ECI. The point is that the FDAP rules do not exist in a vacuum and must be read in conjunction with the other rules discussed in Sections 12.04 and 12.05 *below* .

**FOOTNOTES:**

(n1)Footnote 1. *I.R.C. §§ 871(a)(1)(A), 881(a)(1).*

(n2)Footnote 2. *I.R.C. §§ 864(c), 871(b), 882.*

(n3)Footnote 3. *See § 12.04 below.*

(n4)Footnote 4. *See § 12.02 above.*

(n5)Footnote 5. *See § 12.03[5] below.*

(n6)Footnote 6. The Code bifurcates the discussion of FDAP into Section 871(a), which applies to taxes on nonresident alien individuals, and Section 881(a), which applies to taxes on income of foreign corporations not connected with a U.S. business. The concept of FDAP under both of these Code sections is the same.

(n7)Footnote 7. *I.R.C. § 871(a); Treas. Reg. § 1.871-7.* Certain kinds of (FDAP) income are required to be treated as ECI income under the Code. Alternatively, a taxpayer may elect to treat FDAP as ECI. Certain kinds of investment income are treated as ECI if they pass either the (i) "Asset-Use Test," i.e., the income is associated with U.S. assets used in, or held for use in, the conduct of a U.S. trade or business, or (ii) the "Business Activities Test," i.e., the activities of that trade or business conducted in the United States are a material factor in the realization of the income. In limited circumstances, some kinds of foreign source income may be treated as effectively connected with a trade or business in the United States.

(n8)Footnote 8. *Treas. Reg. § 1.1441-2(b)(ii).*

(n9)Footnote 9. *I.R.C. § 871(i)(2).* The classification of a dividend from a foreign corporation as FDAP under Code § 861(a)(2)(B) may have less meaning since the branch profits tax was imposed since there is no withholding tax imposed on payments made by foreign corporations subject to the branch profits tax. The branch profits tax, discussed *below*, is the functional equivalent of the 30% withholding tax.

(n10)Footnote 10. *Rev. Rul. 2005-31, 2005-21 I.R.B. 1084* . A domestic corporation that is registered under the Investment Company Act of 1940 as a management company and that satisfies certain rules relating to its asset mix and income may elect to be taxed as a RIC. In general terms, a RIC is a "conduit" entity, meaning that it is not taxed on income distributed to its shareholders, and certain types of income retain their character in the hands of the RIC shareholders (to the extent the RIC designates all or part of a distribution as comprising such income), including qualified dividend income subject to a reduced 15% tax rate when received by individuals, estates or trusts as well as net capital gains (the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year).

(n11)Footnote 11. The CFC rules are like the foreign personal holding company tax rules, under which U.S. shareholders are taxed upon earnings of the foreign corporation, whether or not they receive an actual distribution of those earnings. The provision is effective for taxable years of foreign corporations beginning after December 31, 2005 but before January 1, 2009 and for taxable years of U.S. shareholders with or within which the taxable years of the foreign corporations end.

(n12)Footnote 12. *I.R.C. § 871(h).* The "portfolio interest" exemption does not apply to certain interest received by a ten-percent shareholder, i.e., a person who owns 10% or more of the total combined voting power of all classes of

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stock of a corporation entitled to vote, or in the case of an obligation issued by a partnership, any person who owns ten-percent or more of the capital or profits interest in such partnership. *I.R.C. § 871(h)(3)*. See 1997-48 *I.R.B.* 8, Notice 97-66 .

(n13)Footnote 13. *T.D. 9323* ; *Treas. Reg. § 1.871-14(g)*, *Treas. Reg. § 1.871-14(i)*.

(n14)Footnote 14. *I.R.C. § 871(i)*.

(n15)Footnote 15. See *I.R.C. §§ 864(b)(1)*, *861(a)(3)*.

(n16)Footnote 16. *I.R.C. § 861(a)(3)*. Under *I.R.C. § 864(b)(1)* this activity also would not constitute a trade or business. See § 12.04 below.

(n17)Footnote 17. *I.R.C. § 864(b)(1)(B)* provides that if a foreign person is not engaged in a United States trade or business during the taxable year (in this case, the year in which payment is received) then none of his or her income may be treated as ECI. Accordingly, if his or her United States-source income did not qualify as FDAP, it would not be taxable.

(n18)Footnote 18. See *Treas. Reg. § 1.1441-2(a)(2)* (salesmen's commissions, distributions from trust or estates, expenses of landlords paid by tenants), *Rev. Rul. 65-283, 1965-2 C.B. 25* (alimony payments) and *Rev. Rul. 58-479, 1958-2 C.B. 60* (commissions of ship masters paid by suppliers).

See also *Timken v Commissioner, 6 TC 483 (1946)* (oil production income); *Trust of Welsh v Commissioner, 16 TC 1398 (1951)* , *aff'd sub nom. Girard Trust Corn Exchange Bank v Commissioner, 194 F2d 708 (3d Cir 1952)* , *cert. denied, 344 US 821 (1952)* (alimony payments); *Commissioner v Raphael, 133 F2d 442 (9th Cir 1943)* , *rev'g, Lang v. Commissioner, 45 B.T.A. 256 (1941)* , *cert. denied, 320 U.S. 735 (1943)* (interest employed in fixing damages as well as judgment interest); and *De Nobili Cigar Co. v Commissioner, 1 TC 673 (1943)* , *aff'd, 143 F2d 436 (2d Cir 1944)* (stock redemptions which have the effect of a dividend).

(n19)Footnote 19. See *I.R.C. § 864(c)(2)* and (3), and § 12.04 below .

(n20)Footnote 20. *I.R.C. § 871(f)*.

(n21)Footnote 21. *I.R.C. §§ 871(f)(1)* and (2). Pension payments received under a qualified United States pension trust by a nonresident alien individual, who was employed in the United States by a domestic corporation and returned to his or her country immediately upon retirement, do not fit in under the Section 871(f) FDAP exception, since the required conditions were not met. *Rev. Rul. 79-388, 1979-48 I.R.B. 8* .

(n22)Footnote 22. These plans are private retirement plans meeting special tax rules set out in *I.R.C. § 402(a)(2)*. Lump sum distributions are simply payments to employee-beneficiaries of such plans made in a lump sum, single payment.

(n23)Footnote 23. See *I.R.C. § 403(b)(2)*.

(n24)Footnote 24. See *Treas. Reg. § 1.1441-2(a)*.

(n25)Footnote 25. *I.R.C. § 871(a)(1)(B)*.

(n26)Footnote 26. These amounts would be treated as ECI under *I.R.C. § 871(b)(1)*.

(n27)Footnote 27. See *I.R.C. § 631(a)*.

(n28)Footnote 28. See *Treas. Reg. § 1.871-11(a)*.

(n29)Footnote 29. *See I.R.C. §§ 871(a)(1)(D), 881(a)(4).*

(n30)Footnote 30. *See I.R.C. § 871(e)(1).*

(n31)Footnote 31. *I.R.C. § 871(a)(2). See Rev. Rul. 78-253, 1978-1 C.B. 220*, where a copyright, which was purchased in a foreign country, was sold to a United States corporation by a nonresident alien who had been in the United States for more than 183 days in the year of sale. The gain on the sale constituted FDAP as capital gain of an alien present in the United States for 183 days or more during the year.

(n32)Footnote 32. *I.R.C. §§ 1441(a) and (b), 1442(a).*

(n33)Footnote 33. *See § 12.08 below.*

(n34)Footnote 34. *See § 12.09 below.*

(n35)Footnote 35. A typical example would be interest on governmental obligations excludible under *I.R.C. § 103*. Interest is clearly FDAP, but this particular interest would not be includible in the gross income of either a foreign or a domestic person. *See Treas. Reg. §§ 1.872-2(f), and 1.883-1(c)*, both of which provide that the "applicable sections of the Code" (such as *I.R.C. § 103*) are to be consulted to determine specific exclusions from the gross income of foreigners. *See generally § 11.02[2] above.*

(n36)Footnote 36. For example, stock dividends qualifying under *I.R.C. § 305(a)* would not be taxable as FDAP, even though they are dividends, because the receipt does not result in recognition of income or gain. The rule that gains which are not recognized under specific Code provisions will not be taxed to foreigners is subject to very complex limitations where the foreigner is a corporation seeking complex limitations, where the foreigner is a corporation seeking non-recognition under certain corporate nonrecognition rules. *See § 12.10 below*, relating to the discussion of *I.R.C. § 367*.

(n37)Footnote 37. For details of these exclusions, *see § 12.05[4] below.*

(n38)Footnote 38. *See § 12.04 below.*