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Problem of Residence and Federal Income Taxation of Nonresident Alien Individuals

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THE PROBLEM OF RESIDENCE AND FEDERAL INCOME TAXATION
OF NONRESIDENT ALIEN INDIVIDUALS

I. Introduction

The number of aliens admitted to study, conduct business, make investments, and fill positions in United States industries as regular workers and industrial trainees has risen significantly in recent years. Since these individuals carry with them a potential liability for the federal income tax, the increase in their number portends a corresponding increase in problems for tax counselors and employers alike. This Note, attempting to present in usable form a portion of the law on the income taxation of such persons, focuses first, on the problem of determining an alien individual’s residence or nonresidence for income tax purposes, and second, generally outlines the method of taxing those determined to be nonresident aliens. The latter is considered in the light of the changes brought about by the Foreign Investors Tax Act of 1966.

Alien individuals are accorded different income tax treatment depending upon their classification as resident or nonresident. In general, resident aliens are taxed in the same manner as United States citizens, i.e., on all income from whatever source derived. Nonresident aliens, however, are taxed only on income from sources within the United States and, under circumstances to be discussed, on income from sources outside the United States only if that income is “effectively connected with the conduct of a trade or business within the United States.”

Though the Internal Revenue Code provisions and accompanying Regulations thus provide special treatment and methods of tax determination for nonresident aliens, nowhere do they offer an affirmative definition of that term. Rather, one seeking to determine if his client or employee falls under this classification must search through a fairly complicated series of negative definitions and rebuttable presumptions—some of which add to the complexity by overlapping each other—to find an answer.

Beginning this quest, Treasury Regulation section 1.871-2 defines a nonresident alien individual as “an individual whose residence is not within the
United States, and who is not a citizen of the United States."\(^{10}\) Whether a person is or is not a citizen for income tax purposes is fairly obvious.\(^{11}\) The first part of the definition, however, whether or not an alien is a *resident*, causes the legal complications. Treasury Regulation section 1.871-2(b) defines a "resident alien" as "[a]n alien actually present in the United States who is not a mere transient or sojourner. . . ."\(^{12}\) Conversely, a nonresident alien can thus be further described as an alien individual who is a transient or sojourner in this country.

Whether a particular alien is a transient, and thus a nonresident, depends upon his intention concerning the length and nature of his stay.\(^{13}\) This is primarily a fact question that must be resolved according to the circumstances of the particular case.\(^{14}\) Certain general rules have been provided, however, for construing an alien's intention.\(^{15}\) If the alien's intention of returning to his home country is a "mere floating intention, indefinite as to time,"\(^{16}\) or if he has no intention as to the length of his stay, then the alien will be considered a nontransient and thus a resident.\(^{17}\) Conversely, if his purpose in coming to the United States will require an extended stay, and for that purpose the alien makes his home here, then he will be considered a resident regardless of his continuing intention to return to his home country.\(^{18}\) Finally, if the alien's stay is limited to a definite period by the type visa or permit under which he entered the United States, then such an alien is a nonresident "in the absence of exceptional circumstances."\(^{19}\)

In addition to these guidelines, the Regulations also set out evidentiary

\(^{10}\) Id. The term also includes a nonresident alien fiduciary, *id.*, whether corporate or individual, *Int. Rev. Code* of 1954, § 7701(a)(6).

The tax status of a trust or estate—a separate taxable entity for income tax purposes, *Int. Rev. Code* of 1954, § 641—as resident (domestic) or nonresident (foreign) will depend upon the residence or nonresidence of the fiduciary trustee rather than the residence of the legatee or beneficiary. *8 Mertens, Law of Federal Taxation*, § 45.15 (rev. ed. 1964); *See* Lambert Tree Trust Estate, 38 T.C. 392 (1962).

\(^{11}\) The term "citizen" is defined in the Regulations:

Every person born or naturalized in the United States and subject to its jurisdiction is a citizen. For rules governing loss of citizenship, see sections 349 to 357, inclusive, of the Immigration and Nationality Act (8 U. S. C. 1481-1489). A foreigner who has filed his declaration of intention of becoming a citizen but who has not yet been admitted to citizenship by a final order of a naturalization court is an alien.

*Treas. Reg. § 1.1-1(c) (1956).*

\(^{12}\) *Treas. Reg. § 1.871-2(b) (1957).*

\(^{13}\) *Id.* But see an opinion by the United States Attorney General that states that the distinction between a transient and a resident alien is "not so much a matter of intention as of length and nature of stay." 32 Op. Att'y Gen. 497, 504 (1921). This view can be reconciled with that stated in the Regulation when it is considered that the alien's intention, for the most part, can only be made known by his objective manifestations of intent, which include the length and nature of stay.

\(^{14}\) *See* L. B. Peeples, 27 B.T.A. 879 (1933); *Note, The Residence Concept and Taxation of Foreign Income*, 51 Colum. L. Rev. 378 (1951).

\(^{15}\) *Treas. Reg. § 1.871-2(b) (1957).*

\(^{16}\) *Id.*

\(^{17}\) *Id.*

\(^{18}\) *Id.*

\(^{19}\) *Id.*

\(^{20}\) *Id.*
rules that govern in determining whether an alien in the United States has acquired residence here. Under this procedure an alien in the United States is presumed to be a nonresident "by reason of his alienage." This presumption is rebuttable by a showing that the alien has filed a declaration of his intention to become a naturalized citizen, or that he has filed a Form 1078 (declaration of residency) with his employer. In either case, the alien has manifested a clear subjective intent to reside in the United States. The presumption of nonresidency can also be rebutted under a third rule which focuses on the alien's objective intent, i.e., if the alien, by his acts or statements or the extended nature of his stay, has shown a definite intention to acquire residence in the United States, he will be treated as a resident.

The effectiveness of these rules and guidelines is rather limited. Since the distinctions that they draw are cast in general terms such as "floating," "definite," or "extended"—each of which requires its own interpretation—the guidelines offer a solution only in the extreme case. The nonresidency presumption, however, does furnish a workable starting point for finding an answer. In the typical case, however, the courts, the Internal Revenue Service, and consequently the taxpayer himself are left to their own determinations as to what conduct and circumstances will demonstrate an intention sufficient to overcome the presumption.

II. Residency or Nonresidency of Aliens

A. Factors Considered in Determining Residency

As already indicated, residency for income tax purposes is an elusive concept. An intention to permanently reside in the United States is not necessary to bring an alien within the definition of a resident, and the term itself has been judicially construed to mean something less than domicile. By the

22 Id. § 1.871-4(b) (1957).
23 Id. § 1.871-4(c)(i) and (ii). If an employer pays wages to a nonresident alien employee without withholding the tax on nonresident aliens, unless he has been exempted from doing so (see Treas. Reg. § 1.1441-4 (1967)), he will have the burden of proving that the employee was a resident, and therefore that no such withholding was required. Treas. Reg. § 1.871-6(a) (1957). He can satisfy this burden using any competent evidence. See Treas. Reg. §§ 1.871-1 to 1.871-5 (1957) for the framework to follow in so doing. However, when the employee files a Form 1078 indicating that he is a resident, the employer can rely on that statement as proof of the alien's status. Treas. Reg. § 1.871-6(b) (1957).
25 See Note, supra note 14, at 380.
26 At least one court resorted to a dictionary definition in an attempt to find the "usual meaning" of the word "resident." Joyce de la Begassiere, 31 T.C. 1031, 1035 (1959). This resort is of little help. Webster defines "resident" as "[o]ne who resides in a place; one who dwells in a place for a period of more or less duration. Resident usually implies more or less permanence of abode, but is often distinguished from inhabitant as not implying as great fixity or permanency of abode." WEBSTER'S NEW INTERNATIONAL DICTIONARY (2d ed. 1960). It then gives, as an illustration of this concept, the Regulations' negative definition of "one who is not a mere transient or sojourner . . . ." Id.
27 Ceska Cooper, 15 T.C. 757, 763 (1950).
28 Bowring v. Bowers, 24 F.2d 918 (2d Cir.) cert. denied, 277 U.S. 608 (1928); Josette J. F. Verrier Friedman, 37 T.C. 539, 552 (1961). Though the terms may often appear to be used interchangeably by courts and statutes, the concepts of residence and domicile are distinct
same token, it has been clearly held that an alien cannot establish a residence in the United States by intent alone.\(^9\)

[T]here must be an act or fact of being present, of dwelling, of making one's home in the United States for some time in order to become a resident of the United States. Some permanence of living within borders is necessary to establish residency.\(^0\)

Rudolf Jellinek\(^3\) is an example of an alien exhibiting the requisite intent, but without any conduct or presence physically corroborating it. In that case a foreign actor came to the United States at the invitation of an employer and filed a declaration of intention to become a citizen, apparently rebutting the presumption of nonresidence.\(^2\) However, the facts showed that the alien had never made himself a part of any particular community in the United States and that his expressed intention was actually conditioned on his finding suitable employment. When such work failed to materialize after less than two months, he left the country.\(^3\) The Tax Court held that his presence had never amounted to residence for there had been no “permanence of living within borders.”\(^3\)

Facts and circumstances connoting stability of residence will, of course, indicate that an alien should be regarded as a resident. Thus, the fact that an alien has brought the members of his family\(^2\) or all his possessions\(^2\) with him to this country lends strong support to a finding that he is a resident. Use of a resident address in the United States for legal purposes, such as a declaration of residency in a state of the United States for a divorce petition,\(^3\) has contributed to a finding of residence. Statements made by an alien in his will describing himself as a resident of a particular state\(^8\) and statements attesting to permanent residency made in order to obtain a re-entry permit upon departure from the United States\(^9\) have been given similar effect.

It should be noted that none of the above factors standing alone was considered determinative of the question of residency. Each fact, taken together with the other circumstances of the case, contributed to the final finding. That

in the income tax provisions of the Code. Schneider, *Aliens and the United States Income Tax—1956*, 34 TAXES 583, 585 (1956). Accordingly, an alien on a temporary visa, whose domicile was definitely not in the United States, has been held a resident, Marsman v. Commissioner, 205 F.2d 335 (4th Cir. 1953), *cert. denied*, 348 U.S. 943 (1955); whereas, a wife was considered a nonresident even though her domicile was legally that of her husband, who had residence and domicile in the United States, *I.T. 3859, 1947-2 Cum. Bull. 98*.

30 *Id.*
32 *Id.* at 828-29. Recall that Treasury Regulation \$ 1.871-4(c)(1) (1957) makes this one of the factors rebutting the presumption of nonresidence.
34 *Id.* at 833; *see* Green v. United States, 62-1 U.S. Tax Cas. ¶ 9343 (E.D. Mich. 1954) (requiring intent plus an “overt act” to establish residency).
35 J. P. Schumacher, 32 B.T.A. 1242, 1247 (1935). Of course, such a fact is only indicative and not conclusive, *see* Commissioner v. Nubar, 185 F.2d 584 (4th Cir. 1950), *rev'd* 13 T.C. 566 (1949), *cert. denied*, 341 U.S. 925 (1950).
36 *Cf.* John Ernest Goldring, 36 B.T.A. 779, 783 (1937) (removal of possessions contributed to a finding of abandonment of residence).
37 Cristina de Bourbon Patino, 13 T.C. 816, 822 (1949), *aff'd*, 186 F.2d 962 (4th Cir. 1950).
38 Farmers' Loan & Trust Co. v. United States, 60 F.2d 618, 619 (S.D.N.Y. 1932).
these facts, when viewed outside their context, can be misleading is illustrated by the recent case of William E. Adams. In that case a Canadian citizen, who was in the United States about seventy days out of the year for the purpose of visiting his wife and children in Florida, applied for an immigration visa, declared Florida his domicile, and took out a driver's license after having registered his car in that state. Stated out of context such facts would appear conclusive as to residency. However, set in the peculiar circumstances of the case — that each of Adams' acts was required under Florida law in order for his children to attend public schools — even these facts were not sufficient to rebut the presumption of nonresidence.

B. Presumptions Based on the Length of Stay

The basic presumption of nonresidency provided by the Regulations is limited in its application by another long-standing presumption of residency. Although an alien is presumed to be a nonresident when he arrives here, the presumption shifts if he has resided in the United States for as much as one year. This presumption of residency arising from length of stay can be rebutted by evidence showing that the alien is in fact a transient. Its net effect, like that of the presumption of nonresidency, is merely a shift in the burden of persuasion after a fairly extended passage of time.

A more particularized presumption of residency relates to foreign students studying in the United States. If such an alien is pursuing a course of study towards a degree in this country and is thereby required to take up temporary residence here for a minimum of two years, he will be classified a resident. However, if the facts of the case show that the student lives in a dormitory and returns to his home country for holidays and summers, he may still be considered a nonresident.

In a recent ruling implementing the Regulations and the presumption of residency after two years of study in the United States, an apprentice engineer from India who trained in this country for more than two years was ruled a

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41 Id. at 355, 360.
42 Id. at 360.
43 Id. at 360-61. In order to comply with Florida laws requiring such actions if his children were to be allowed to attend that state's public schools, the alien acted in a manner which would otherwise demonstrate a clear intent to establish residency in the United States.
44 Treas. Reg. § 1.871-3 (1957).
45 O.D. 197, 1919-1 Cum. BULL. 164.
46 Id.
47 Id.
resident for federal income and employment tax purposes. The alien performed the same work as a domestic engineer under a combination work-training program. The intention of both the trainee and his employer was for the alien to eventually take the skills thus derived back to the employer's Indian operation. Another trainee, performing essentially the same duties, but whose stay was to be only eight months, was ruled a nonresident for income tax purposes apparently because of the short length of his stay.

C. Visa Status as a Determinative Factor

Resort to an alien's visa status furnishes a useful, but not conclusive, test of his intention as to residency. Section 1.871-2(b) of the Treasury Regulations provides that "an alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident . . . ." Thus, a European refugee in the United States on a temporary visa and an alien here after several extensions of a deportation order were both considered nonresidents on this basis.

This presumption of nonresidence in Treasury Regulation section 1.871-2(b) is limited by the proviso that it does not apply in "exceptional circumstances." The Commissioner has made it quite clear that the fact that an alien's visa limits his stay is only one of the elements determining his residency and that the "exceptional circumstances" spoken of in this Regulation will be frequently found. In Commissioner v. Nubar an alien, who had been admitted on a visitor's visa and was permitted to remain in this country during World War II through visa extensions granted because of wartime travel conditions, was considered a resident. During his stay, the alien had derived large profits from speculation on the stock and commodity futures markets. On these facts the Fourth Circuit said,

[W]e think that the conclusion of the Tax Court that taxpayer was an alien non-resident . . . was clearly erroneous . . . We find nothing in the

51 Whether an alien is subject to the withholding of federal employment tax depends upon whether he has the status of an employee under common law rules. Id.; see Employment Tax Regulations, §§ 31.3121(d)-1(c), 31.3306(i)-1, and 31.3401(c)-1. In this instance, facts showing that the two Indian engineers were under the direction and control of their United States employer were sufficient to establish the common law relationship of employer-employee. Rev. Rul. 66-76, 1966-1 Cum. Bull. 238.
53 Id. The engineer determined to be a resident was paid a monthly salary, while the nonresident took an hourly wage. Though this distinction between pay periods is some evidence of residency, it is not clear what weight, if any, was given it. Id. If the two engineers had entered the United States under F or J visas, which cover participants in certain exchange, education, or training programs, they would both have been entitled to special tax treatment. Int. Rev. Code of 1954, § 871(c).
54 Treas. Reg. § 1.871-2(b) (1957).
55 Marie-Anne De Goldschmidt-Rothschild, 9 T.C. 325, 335 (1947), aff'd, 168 F.2d 975 (2d Cir. 1948).
56 Florica Constantinescu, 11 T.C. 37, 43 (1948).
58 Id.
59 185 F.2d 584 (4th Cir. 1950), rev'g 13 T.C. 566 (1949), cert. denied, 341 U.S. 925 (1950).
law or in the facts to justify the exemption of this alien, who had lived in
our country during the war years because of the difficulties and dangers
of departure, and who had availed himself of his presence here to make a
fortune by trading on our exchanges, from taxes required of others by the
country whose protection he had enjoyed and whose economic organization
he had utilized for his profit . . . .
It was never intended that persons who were present within the country
for long periods of time and had taken advantage of its facilities for the
purpose of carrying on business, should be exempted from taxation on
income derived from sources within the country merely because they were
aliens.60

Although possession of a temporary or visitor’s visa is not determinative,
it has been urged that an alien’s possession of an immigrant visa should be
“well-nigh conclusive” as to residency.61 However, possession of such a visa,
while it may be strongly indicative of the fact that an alien is not a transient,
is likewise only one of the elements to be considered in viewing the alien’s entire
background.62 This position seems particularly appropriate when it is considered
that a domestic employer might bring an alien employee to this country on an
immigrant visa solely because no other type visa will allow the employee to
perform the desired services in this country. In such cases, the possession of an
immigrant visa should certainly not be determinative of the question of
residency.

D. Change or Loss of Residence

Once an alien’s residence has been established, it is presumed to continue
until it can be shown to have changed.63 Thus, the resident alien cannot become
a nonresident until he actually departs from the United States with the inten-
tion of abandoning his residence here.64 Determining whether abandonment
has occurred requires a re-examination of the facts on which residency was
first determined, i.e., consulting the alien’s declarations, conduct, character,
temperament and any other facts that might shed light on his real intention.65
The act of departure from the United States, standing alone, does not require
a change of status.66 If a resident alien merely has the intention of returning
to his native country for a limited period,67 or is merely absent from the United

60 Id. at 586.
61 Schneider, supra note 28, at 586.
63 8 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 45.09 (rev. ed. 1964).
64 I.T. 4057, 1951-2 CUM. BULL. 93. See Treas. Reg. § 1.871-5 (1957); Schneider,
supra note 28, at 586.
65 See, e.g., Josette J. F. Verrier Friedman, 37 T.C. 539 (1961); Walter J. Baer, 6 T.C.
1195 (1946). For a clear case of abandonment of residence, see John Ernest Goldring, 36
B.T.A. 779, 783 (1937), where a taxpayer, after his remarriage, took his second wife and
all their belongings to Canada to set up a permanent residence there and returned to this
country only for temporary visits.
66 For special rules on retaining United States residency in the case of alien employees
of United States corporations who are temporarily assigned abroad, see 8 U.S.C. § 1427(b)
(1) and (2) (1964).
States without an intention of changing residence, he will still be considered a resident.

A departing alien can manifest a prima facie intent to retain his resident status if, on departure, he obtains a re-entry permit. He will be treated as having retained his residence at least until the end of the period covered by the permit, or its extension, or until he takes some other definite action indicating nonresidence.

III. Taxation of Nonresident Alien Individuals

Once the hurdle of determining an alien's status as a nonresident has been cleared, the second problem of determining his tax liability, if any, remains. The Code provisions governing this determination, before their amendment by the Foreign Investors Tax Act of 1966, had been criticized as archaic and illogical, unnecessarily complicated and arbitrary. A brief outline of the way in which those provisions operated will be given here as an introduction to the recent revisions, which hopefully “represent a long step toward simplification of the old crazyquilt pattern of taxing foreigners.”

A. Taxation Before 1967

Prior to 1967, nonresident alien individuals were divided into three classes on the basis of their occupation in a trade or business within the United States, or if they were not so engaged, upon the level of their respective incomes. The first classification consisted of those aliens who were not engaged in a trade or business within the country and whose aggregate gross income for the tax year did not exceed $21,200. These persons were subject to the tax at a

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70 Id. The expiration of a re-entry permit, or extension thereof, does not automatically change the tax status of a resident alien abroad to that of a nonresident. The circumstances surrounding the absence must indicate an abandonment of United States residence. Rev. Rul. 60-129, 1960-1 Cum. Bull. 272.
72 This Note does not purport to exhaust the methods of, and problems involved in, taxation of nonresident alien individuals. Rather, the intent is to present, in brief form, the methods of such taxation prior to the Foreign Investors Tax Act of 1966, and to point up the general method of taxation under present law.
75 Joseph & Koppel, Foreign Investors Tax Act, 45 Taxes 113 (1967).
77 Joseph & Koppel, supra note 75, at 114.
flat thirty percent rate\textsuperscript{80} on all "fixed or determinable annual or periodical income" from sources within the United States.\textsuperscript{81} This included:

interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (including amounts described in section 402(a) (2), section 403(a) (3), section 631(b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets) . . . .\textsuperscript{82}

The amount of capital gains of persons in this class taxable\textsuperscript{83} at the same thirty percent rate depends upon the number of days that the persons are present in the United States.\textsuperscript{84} If the aggregate number of days of an alien's presence in this country during the tax year was less than ninety, then only those gains from sales effected during the alien's presence were taxable.\textsuperscript{85} However, if the number of days in the United States amounted to more than ninety, then all the net capital gains realized at any time during the taxable year were brought under the thirty percent tax.\textsuperscript{86} Except for the fact that capital losses could be set off against gains, the tax on aliens in this class was computed on their income without the benefit of any deductions.\textsuperscript{87} The tax, therefore, on income of aliens in this class was a flat thirty percent of gross income, including capital gains.

Nonresident alien individuals not engaged in a trade or business within the United States, but whose total fixed or periodic income, plus capital gains, exceeded \$21,200 made up the second class of taxpayers.\textsuperscript{88} Because domestic taxpayers in this income level would be taxed at rates higher than thirty percent, Congress decided that such nonresidents should not be given preferential treatment.\textsuperscript{89} Consequently, they were taxed, like citizens and resident aliens, according to regular income and capital gains tax rates.\textsuperscript{90} However, since tax-
payers in this class could claim deductions from their gross income, their effective tax rate might be reduced below the thirty percent tax imposed on nonresident aliens in the first tax class. Foreclosing this possibility, the provision made such individuals taxable at regular rates or thirty percent, whichever was greater.

The third class of nonresident alien taxpayers under the Code prior to its amendment consisted of nonresident alien individuals "engaged in trade or business within the United States." These persons were taxed at regular rates on their capital gains and business income from sources within the United States. Moreover, the fact of this participation in United States business acted as a "force of attraction," attracting all business and investment income to the trade or business to be likewise subject to taxation at regular rates. Thus, if at any time during the taxable year a nonresident alien individual was engaged in a business within the United States, he was taxed at regular rates on all his taxable income from sources within the United States, whether or not such income was at all related to his trade or business carried on in this country. In computing his tax, the taxpayer could claim deductions to the extent allocable to income from United States sources and certain special deductions regardless of their connection with the United States business.

would approximately equal the tax under the flat rate. Thus, when tax rates were increased in 1942, Revenue Act of 1942, ch. 619, §§ 103, 106, 56 Stat. 802, 807, the cut-off point was reduced to $15,400. Duke, supra note 83, at 1096-98. The Revenue Act of 1964, § 113(b) (1), Pub. L. No. 88-272, 78 Stat. 19, generally reduced tax rates and correspondingly increased the dividing line to $21,200, where it remained until abolished by the Foreign Investors Tax Act of 1966.

91 Treas. Reg. § 1.871-7(c)(3) (1957).
92 26 U.S.C. § 871(b)(1) and (2) (1964); Duke, supra note 83, at 1098.
93 Nonresident aliens who are bona fide residents of Puerto Rico during the taxable year make up a fourth class. Treas. Reg. § 1.871-7(a)(4) (1957). Their income is taxed in the same manner as U.S. citizens and residents. Int. Rev. Code of 1954, § 876.
94 26 U.S.C. § 871(c) (1964). The quoted phrase included the performance of personal services within the United States at any time during the taxable year except services performed for:

(1) a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or
(2) for an office or place of business maintained by a domestic corporation in a foreign country or in a possession of the United States, by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. Such term does not include the effecting, through a resident broker, commission agent, or custodian, of transactions in the United States in stock or securities, or in commodities . . . . Id.

See 8 MERTENS, LAW OF FEDERAL INCOME TAXATION § 45.20 (rev. ed. 1964) for cases and rulings defining the phrase.
97 Id. "Business and investment income," in this sense, includes all income from United States sources other than that derived from the United States trade or business engaged in by the nonresident.
99 These deductions included: (1) losses incurred in transactions entered into for profit, provided the transaction would have been subject to United States income tax had it resulted in a profit; (2) casualty losses, if the loss was of property within the United States; (3) charitable contributions, but only to United States charities; and (4) a single personal exemption, except for residents of Canada and Mexico. 26 U.S.C. § 873(b)(c) and (d) (1964); Treas. Reg. § 1.873-1(c)(2) (1957).
B. Taxation of Nonresident Individuals under Present Law

The Report of the Senate Finance Committee on the Foreign Investors Tax Act\(^\text{100}\) aptly described the defects of the system of taxation that has been outlined above:

[The present tax treatment of nonresident aliens is unnecessarily complicated and also makes arbitrary distinctions based upon the size of the individual's income and whether or not the individual has a trade or business in the United States which may be wholly unrelated to the specific income in question.\(^\text{101}\)]

To remedy these deficiencies, and at the same time to ease the United States balance-of-payments problem by making our tax provisions more attractive to foreigners,\(^\text{102}\) Congress made extensive revisions in the provisions for taxation of nonresident alien individuals and foreign corporations.\(^\text{103}\)

The resulting scheme of taxation of nonresident alien individuals still makes use of both a flat thirty percent rate and a regular tax.\(^\text{104}\) However, the distinctions requiring different tax treatment are no longer drawn according to the level of the individual's income or the fact that he may be engaged in a trade or business within this country. Instead, the nature of the income received by such an individual is determinative. Now, only if that income can be considered "income which is effectively connected with the conduct of a trade or business within the United States,"\(^\text{105}\) is it taxable at regular income tax rates.\(^\text{106}\) Income from sources within the United States that is not "effectively connected" with a United States business is subject only to the thirty percent tax.\(^\text{107}\)

Regulations have yet to be issued defining or giving examples of what type income is so "effectively connected."\(^\text{108}\) In the interim, the amended Code, however, does provide certain general rules for determining whether fixed or determinable, annual or periodical income fits within that concept.\(^\text{109}\) The two factors to be taken into account in making that determination include first, whether the income or gain is derived from assets used in, or held for use in, the conduct of a domestic trade or business,\(^\text{110}\) and second, whether the activities of a domestic trade or business were a material factor in the realization of the

\(^{100}\) S. REP. No. 1707, supra note 76.

\(^{101}\) Id. at 23.

\(^{102}\) Id.

\(^{103}\) Act of Nov. 13, 1966, Pub. L. No. 89-809, 80 Stat. 1541 '(codified in scattered sections of Title 26 of the Internal Revenue Code of 1954). This Note is limited to the aspects of the Foreign Investors Tax Act which concern the taxation of nonresident alien individuals. For an analysis of the other provisions of the Act, as it affects foreign corporation income taxes and estate and gift taxes, see Joseph & Koppel, supra note 75.

\(^{104}\) INT. REV. CODE of 1954, § 871.

\(^{105}\) Id. § 871(b). For the Code's definition of that term, see id. § 864(c).

\(^{106}\) Id. § 871(b).

\(^{107}\) Id. § 871(a).


\(^{109}\) INT. REV. CODE of 1954, § 864(c)(2).

\(^{110}\) Id. § 864(c)(2)(A).
income or gain.\textsuperscript{111} Furthermore, while it is not, by itself, determinative, consideration is also given to whether or not the income or assets producing the gain were derived from the United States business.\textsuperscript{112}

A new Code provision makes the rather broad statement that all other types of income from United States sources\textsuperscript{113} are to be treated as effectively connected with the conduct of a trade or business within the United States.\textsuperscript{114} As has been noted, such an all-inclusive approach is understandable as to profits from sales of merchandise and other business income. There is, however, no reason to believe that Congress intended to include income which has no connection with the conduct of a trade or business, such as income from racetrack betting.\textsuperscript{115}

So it is likely that the broad rule will be qualified.

Under the Code prior to its amendment in 1966, only income from sources within the United States was subject to tax.\textsuperscript{116} This feature of our tax law interacted with the tax laws of certain foreign countries to permit use of this country as a tax haven for certain aliens.\textsuperscript{117} In an attempt to close this loophole, the Act amended the Code so as to provide that certain types of income\textsuperscript{118} may be treated as income effectively connected with a domestic trade or business, and therefore taxable at regular rates, even though its source is outside the United States.\textsuperscript{119} Such foreign source income will be given this treatment if it is received by a nonresident alien individual (1) who is engaged in a trade or

\begin{itemize}
\item \textsuperscript{111} Id. § 864(c)(2)(B).
\item \textsuperscript{112} Id. § 864(c)(2).
\item \textsuperscript{113} This broad category includes all income other than "fixed or determinable annual or periodical" income and capital gains from sources within the United States. See Int. Rev. Code of 1954, § 864(c)(2).
\item \textsuperscript{114} Id. § 864(c)(3).
\item \textsuperscript{115} Joseph & Koppel, supra note 75, at 119.
\item \textsuperscript{116} 26 U.S.C. § 871 (1964).
\item \textsuperscript{117} The tax avoidance in such a case can be illustrated by a foreign corporation which is organized in a country which does not tax its domestic corporations on income derived from the conduct of a business outside the country. If such a corporation desires to sell products into countries, other than the United States or the country of its incorporation, it can, in many instances, avoid all or most taxation on the income from these sales by establishing a sales office in the United States. The income from the sales is not taxed by the United States because (under the title passage rule [i.e. that the sale must be effected, the title have passed, in the United States for the sale to be taxed. See Treas. Reg. § 1.861-7(c) (1957)]) it is not derived from sources within the United States. The income may not be taxed by countries where the products are sold because the corporation does not have a permanent establishment there, and the income is not taxed by the country of incorporation because the business is not conducted there.
\item \textsuperscript{118} Foreign source income attributable in this manner is limited to income of three types: (1) rents and royalties for use of intangible property such as patents, copyrights, franchises, etc., or gains or losses from the sale of such rights, derived from the active conduct of the trade or business, Int. Rev. Code of 1954, § 864(c)(4)(B)(i); (2) dividends or interest on, or gain from the sale or exchange of, securities, if derived from the active conduct of a banking, financing, or other similar business in the United States, or if received by a corporation whose principal business is trading in securities for its own account, id. § 864(c)(4)(B)(ii); and (3) profits derived from the sale of merchandise abroad through an office or fixed place of business in the United States, unless the merchandise sold is for use abroad and the taxpayer's office outside the country participates materially in the sale, id. § 864(c)(4)(B)(iii).
\item \textsuperscript{119} Int. Rev. Code of 1954, § 864(c)(4)(B).
\end{itemize}
business within the United States,\textsuperscript{120} (2) who has an office or other fixed place of business within the country,\textsuperscript{121} and (3) the foreign source income is "attributable" to that fixed place of business.\textsuperscript{122}

\textbf{C. Aliens Not Engaged in a U.S. Business}

Although the rate of taxation no longer depends upon the fact whether or not a nonresident alien individual is engaged in a trade or business within the United States, it still provides a convenient means of classifying nonresident aliens for the purpose of illustrating the recent revisions in their taxation.

The income of nonresident alien individuals not engaged in a trade or business within the United States is, by statute, not effectively connected with the conduct of a trade or business within the United States,\textsuperscript{123} and is therefore not subject to tax at regular rates.\textsuperscript{124} A flat thirty percent tax is levied on the alien's gross\textsuperscript{125} fixed or periodic income from United States sources.\textsuperscript{126} This class of income has been expanded by the addition of original issue discount received on bonds or other evidences of indebtedness.\textsuperscript{127}

Though they would ordinarily also fall within the designation of fixed or periodic income and thus be subject to a flat tax without deductions, certain gains and income derived from real property within the United States may now be treated as effectively connected income.\textsuperscript{128} Section 871(d) of the Internal Revenue Code allows the nonresident alien individual to elect to be taxed at regular rates on his real property income such as rents from buildings, rents or royalties from mines or wells or other natural deposits, and gains from the sale or exchange of any interest in real property.\textsuperscript{129} In this way he can

\textsuperscript{120} "Trade or business" is defined under the present Code provision, \textit{Int. Rev. Code of 1954}, § 864(b), basically in the same manner as old section, 26 \textit{U.S.C.} § 871(c) (1964), see note 94 \textit{supra}, but with two exceptions. (1) Personal services performed for compensation less than $3,000 by a nonresident alien who is present in this country less than ninety days is now excepted from inclusion in "trade or business" if performed for the foreign office of a United States citizen, resident, or domestic partnership, as well as for the foreign office of domestic corporations, \textit{Int. Rev. Code of 1954}, § 864(b)(1)(B). (2) The exception, excluding trading in stock, securities, or commodities through a resident broker from the definition of "trade or business" under old section, 26 \textit{U.S.C.} § 871(c) (1964), now explicitly provides that this activity does not constitute engaging in a United States trade or business even though the resident broker may have discretionary authority in effecting the transaction, see \textit{Int. Rev. Code of 1954}, § 864(b)(2); Joseph & Koppel, \textit{supra} note 75, at 114-15.

\textsuperscript{121} \textit{Int. Rev. Code} § 864(c)(4)(B). This term includes an office the nonresident alien individual himself might have, and, under certain conditions, the office or fixed place of business of that individual's agent. \textit{Id.} § 864(c)(5)(A). See Roberts, \textit{supra} note 96, at 1426-27.

\textsuperscript{122} For the rules to be used in determining whether foreign source income can be so attributed, see \textit{Int. Rev. Code of 1954}, § 864(c)(5)(B) and (C).

\textsuperscript{123} \textit{Id.} § 864(c)(1)(B).

\textsuperscript{124} \textit{Id.} § 871(b)(1).

\textsuperscript{125} No deductions are allowed to individuals in this class, except in the case of deductions attributable to real property income which such aliens may elect to treat as income effectively connected with the conduct of a trade or business within the United States under § 871(d) of the Internal Revenue Code of 1954.


\textsuperscript{127} \textit{Id.} § 871(a)(1)(C). Interest on deposits with United States banks, heretofore excluded from fixed or periodic income, 26 \textit{U.S.C.} § 871(a) (1964), is now included. \textit{Int. Rev. Code of 1954}, § 871(a). Moreover, income from patents and other similar intangibles which was fully taxable under old section 871(a), is now taxed in a more limited manner by the present section 871(a)(1)(D) of the 1954 Code.

\textsuperscript{128} \textit{Int. Rev. Code of 1954}, § 871(d).

\textsuperscript{129} \textit{Id.}
claim deductions such as depreciation, depletion, and interest allocable to the production of that income and possibly enjoy an effective tax rate lower than the thirty percent on gross income he would otherwise pay.\textsuperscript{130}

Net capital gains from domestic sources is subject to the thirty percent tax, but only if the nonresident alien was present in this country more than 183 days out of the tax year.\textsuperscript{131} The old rule taxing capital gains of aliens who happened to be present in the United States when the gain was realized had been criticized as an arbitrary rule constituting only "a trap for the unwary,"\textsuperscript{132} and was abolished. The old period of ninety days was extended to 183 in order to more closely parallel the rule applied by most of the world's industrial nations.\textsuperscript{133}

**D. Aliens Engaged in a U.S. Business**

Under the present Code, the nonbusiness income of nonresident aliens engaged in a United States trade or business is no longer "attracted" to an unrelated business.\textsuperscript{134} Rather, it receives the same thirty percent treatment as taxpayers not so engaged.\textsuperscript{135} When computing his tax, therefore, the alien engaged in business must segregate his income into two categories depending upon whether it is effectively connected with the conduct of a trade or business within the United States.\textsuperscript{136} Certain special deductions, as under prior law,\textsuperscript{137} can be claimed regardless of their connection with a domestic business.\textsuperscript{138} As a general rule, however, an individual in this class can now deduct from gross income only insofar as his deductions are allocable to income which is effectively connected to a domestic business.\textsuperscript{139}

Capital gains that are not "effectively connected" are taxed if the alien is within the country for 183 days,\textsuperscript{140} and then only at the thirty percent rate. If such gains are "effectively connected," however, they are subject to regular tax rates even though the alien is present in this country for less than the requisite number of days during the year.\textsuperscript{141}

**E. Expatriation To Avoid Tax**

When the Act eliminated progressive taxation with respect to income of nonresident aliens not effectively connected with the conduct of a domestic trade or business, it could have produced an obvious incentive for citizens to

\textsuperscript{130} Joseph \& Koppel, \textit{supra} note 75, at 117.
\textsuperscript{131} \textit{Int. Rev. Code} of 1954, § 871(a)(2).
\textsuperscript{132} \textit{S. Rep. No. 1707, supra} note 76, at 23.
\textsuperscript{133} \textit{Id.} at 24.
\textsuperscript{134} Roberts, \textit{supra} note 96, at 1422.
\textsuperscript{135} \textit{Int. Rev. Code} of 1954, § 871(a). Such nonbusiness income is taxed at the flat rate even though the taxpayer may be engaged in a United States business.
\textsuperscript{136} Roberts, \textit{supra} note 96, at 1415-17.
\textsuperscript{138} \textit{Int. Rev. Code} of 1954, § 873(b). However, the Act deleted the deduction of losses incurred in transactions entered into for profit.
\textsuperscript{139} \textit{Id.} § 873(a).
\textsuperscript{140} \textit{Id.} § 871(a)(2).
\textsuperscript{141} \textit{Id.} § 871(b).
move abroad and give up their citizenship. By so doing, a well-heeled taxpayer in a high tax bracket could avoid steep progressive rates on his investment income and be taxed instead at a flat rate of thirty percent. As a result of such considerations, Congress added a new section to the Code to discourage United States citizens from expatriating to avoid taxes. The new section provides that both effectively connected income and any other United States source income of an expatriated nonresident alien be taxed at regular rates if (1) he lost his citizenship within the last ten years (but only after March 8, 1965), and (2) one of the principal purposes of the expatriation was the avoidance of United States taxes.

IV. Conclusion

The initial question of residence for aliens under the Internal Revenue Code and Regulations, though unnecessarily complicated by presumptions and counterpresumptions, can be reduced to a single basic issue—a determination of an alien’s objectively manifested intention. Like the tort concept of “reasonable care,” this determination cannot be resolved by general rules, but requires close examination of facts in particular contexts.

The taxation of those thus found to be nonresidents has been rendered more equitable and more logical by the changes incorporated in the Code by the Foreign Investors Tax Act of 1966. Whether the Act has correspondingly facilitated the actual application of the tax, however, depends upon the definition given the Act’s key concept of “effectively connected” income. This answer will, or at least should, be found when the new Regulations are promulgated.

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144 Id. § 877(a). The burden of proving such a purpose or motive on the part of the expatriate is initially on the Commissioner, Int. Rev. Code of 1954, § 877(e). However, if he can establish that it is reasonable to believe that the expatriate’s loss of citizenship would result in a substantial reduction of taxes on his probable income for the taxable year, then the burden of proving freedom from a tax avoidance motive shifts to the expatriate. Id.