TO: OUR FRIENDS AND PROSPECTIVE CLIENTS

FROM: THOMAS WILLIAMS, CPA

RE: U.S. INCOME TAX ISSUES OF FOREIGN NATIONALS

DATE: AS OF JANUARY 1, 2010

Dear Friends:

The following is an explanation of U.S. income tax issues of foreign nationals regarding a contemplated U.S. inbound investment transaction by a foreign individual or corporation duly organized and operating outside the U.S. This memo is limited to addressing whether the foreign person, (individual or corporation) will be treated as a foreign person for U.S. tax purposes. Accordingly, the issue of transfer taxes will not be dealt with at this time.

The first determination that should be made by an advisor to a foreign person is whether or not such a person will be treated as a foreign or U.S. person for U.S. income tax purposes. A U.S. person is subject to U.S. income tax on his or her world wide income, while a foreign person is, in general, subject to U.S. income tax on U.S. source income only. The test for determining whether or not a person is a U.S. person for U.S. income tax purposes is objective in nature.

Initially, the matter of taxation of foreign nationals will be dealt with as I consider it important that your client be aware how the U.S. deals with foreigner's business activities in the U.S. either generated individually or through their foreign based corporations. Accordingly, I will elaborate on three specific issues affecting foreign nationals; 1) the determination of resident status, 2) source of income and 3) the patterns of U.S. income taxation.

Regarding individuals residing in Mexico, reference should also be made to both the U.S./ Mexico Income Tax Treaty, ("U.S./ Mexico Treaty" or "Treaty") and the North American Free Trade Agreement which became effective January 1, 1994. I will briefly discuss some applications of each after dealing with the taxation of Foreign Nationals.

I. <u>DETERMINATION OF RESIDENT STATUS</u>

A. <u>Nonresident Aliens, ("NRA's")</u>

1. An alien individual is treated as a resident of the U.S. with respect to any calendar year if such individual either (i) is a lawful permanent resident of the U.S. at any time

during the calendar year, (the "Green Card Test"), or (ii) such individual meets the "Substantial Presence Test".

a. A lawful permanent resident is an individual who has been granted the privilege of residing permanently in the U.S. as an immigrant under the immigration laws. The test is called the "Green Card Test" because lawful permanent residence is evidenced by possession an Immigration and Naturalization Service Form I-151 or I-551 (Alien Registration Receipt Card, commonly called the "green card").

b. An individual meets the Substantial Presence Test if (i) such individual is physically present in the U.S. for 31 days during the current year, and (ii) the sum of the following equals or exceeds 183 days: the number of days the NRA is present in the U.S. during the current calendar year, plus 1/3 of the days in the first preceding calendar year plus 1/6 of the days in the second preceding calendar year.

c. <u>Exceptions to the Substantial Presence Test</u>.

(i) The Regulations provide an exception (the "Foreign Tax Home Exception" to the Substantial Presence Test: where an individual is present in the U.S. less than on- half of the current year, and such individual establishes a closer connection to a foreign country than to the U.S. This foreign tax home exception will apply if (i) such individual is present in the U.S. for fewer than 183 days during the current year and (ii) it is established that for the current year such individual has a tax home (as defined in the Regulations) in a foreign country and has a closer connection to such foreign country than the U.S. This examination is objective in nature requiring numerous factors to be considered in its determination.

(ii) <u>Exempt Presence and Individuals</u>

1. The Regulations provide that an individual shall not be treated as being present in the U.S. on any day if such individual was unable to leave the U.S. on such day because of a medical condition which arose while present in the U.S.

2. Foreign-government related individual.

3. Teacher, trainee or student.

B. <u>Foreign Corporations</u> - a foreign corporation is a corporation created or organized outside the United States.

II. <u>DETERMINATION OF SOURCES OF INCOME</u>

The following briefly describes the sourcing rules for some particular types of income. From a practical standpoint, the determination of the source of income derived from sales of inventory is often the most important to foreign nationals wishing to do business in the U.S.

A. <u>Interest</u>

1. U.S. source interest.

a. Generally, interest is from U.S. source if such interest is accrued on a U.S. obligation of a U.S. resident or corporation, except for interest accrued on an obligation of a resident alien or domestic corporation meeting the 80-percent foreign business requirement as provided under the Regulations.

b. 80-percent foreign business requirement. An individual or corporation meets the 80-percent foreign business requirement if, for the prior three tax years, at least 80 percent of the gross income of such individual or corporation (i) is foreign source; and (ii) attributable to the active conduct of a U.S. trade or business in a foreign country by the individual or corporation. If the oblige is a related person, a special look-through rule applies.

B. Dividends

1. U.S. source dividends

a. Generally, dividends are from a U.S. source if such dividends are generated by a domestic corporation or by a qualifying foreign corporation.

b. Qualifying foreign corporation. Dividends paid by a foreign corporation are U.S. source dividends if more than 25 percent of the foreign corporation's gross income for the preceding three years was effectively connected with the conduct of a U.S. trade or business.

C. Personal service income.

1. Income from personal services performed in the U.S. is from U.S. source unless the following three requirements are met:

a. The services were performed by a nonresident alien who was not present in the U.S. for more than 90 days during their taxable year;

b. the service income did not exceed $3,000; and,

c. the income is from services performed as an employee of either

(1) A nonresident alien, foreign partnership or corporation that is not engaged in a U.S. business in the U.S.; or

(2) A U.S. citizen, resident or domestic partnership or corporation if such services are for its foreign office.

2. An allocation made on a time basis is required for services performed partly within and partly without the U.S.

D. <u>Rents and Royalties</u>

1. Rents and royalties are U.S. source income if derived from one of the following:

a. the rental of real tangible personal property situated in the U.S.; or

b. the use of intangible property (e.g., copyright, patent, secret formula) in the U.S.

E. <u>Real Estate Sales</u>

1. Gain from the sale real property located in the U.S. is considered U.S. source gain.

F. <u>Sales if personal property</u>

1. Non-inventory property.

a. Sourcing rules.

(1) Except where the Regulations exempt income from the sale of personal property, (intangibles and depreciable personal property) provided certain exceptions are met, income realized by a U.S. resident from the sale of non-inventory personal property is treated as U.S. source income.

b. Definition of "U.S. resident and "nonresident"".

(1) For purposes of applying the Regulations with respect to the sales of personal property, the term "U.S. resident" generally means the following:

(a) a U.S. citizen who does not have a tax home (as defines in the Regulations) in a foreign country;

(b) a nonresident alien who has a tax home in the U.S.; and

(C) any corporation, trust or estate which is a U.S. person.

2. Inventory. The source of income derived from the sale of inventory property is generally determined by the place where all right, title and interest in the inventory passes to the purchaser. However, this general rule of sourcing income, often referred to as the "title passage" rule, does not apply in cases where (1) inventory is produced within and sold without the U.S.; (2) inventory is produced without and sold within the U.S.; and (3) inventory is purchased within a U.S. possession and sold within the U.S.

a. Under the title passage rule, the Regulations prescribe that a sale of property is "consummated at the time when and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale is deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss." The Regulations thus adopt a practical test of locating the point of sale where the seller's retention of bare legal title will not affect the determination that a sale has taken place, so long as the buyer has assumed the beneficial ownership and risk of loss.

(1) If title to an item of "purchased" inventory (as opposed to inventory "produced" by the taxpayer) passes inside the U.S., then the income from the sale of such item of inventory will generally be U.S. source income.

(2) If title of an item of "purchased" inventory passes outside the U.S., then income from the sale will generally be foreign source income.

(a) There is an exception for nonresidents. In the case of nonresidents, if title to an inventory item passes outside the U.S., then income from the sale will be U.S. source income if the gain is attributable to a U.S. office or U.S. fixed place of business of the seller. This exception does not apply; however, if the inventory is sold for use, disposition, or consumption outside the U.S. and a foreign office or other fixed place of business materially participated in the sale.

While the client will be better served if you were to further elaborate on the issues concerning passage of title and the principles of commercial law, it is appropriate to comment at this juncture some issues regarding the "title of passage" test. Under conflict-of-law rules, foreign law sometimes determines title passage in a cross-border sale. If U.S. law applies however, reference should be made to the Uniform Commercial Code, with respect to passage of title in the commercial context, as well as common law. It is worth mentioning that while State law determines the passage of rights and interests between the parties, Federal law determines the effect of these rights and interests on income taxation.

Additionally, the United States is party to the "United Nations Convention for the International Sale of Goods," (the "Sales Convention"), which entered into force for the United States on January 1, 1988. As of July 23, 1991, 26 countries, including Mexico, were signatories to the Sales Convention.

As you know, the Sales Convention generally applies to contracts for the sale of goods between parties whose places of business are in countries that are parties to the Sales Convention. The Sales Convention also provides that, the parties to a sales contract may exclude the application of the Sales Convention and does not provide rules for determining title passage. The Sales Convention amply deals with the issue as to the time when the risk of loss passes in a sale transaction.

The Internal Revenue Service has suggested that the Sales Convention is a fairly significant development in the area of U.S. commercial law. The Service has also indicated that, in cases where the Sales Convention applies, the Sales Convention rather than state UCC law "is likely to be important in future international title passage issues."

(b) With respect to the income derived from sales of inventory produced in one jurisdiction and sold in another jurisdiction, Regulations provide that the resulting income is allocated and apportioned between both jurisdictions. The processes or formulas of general apportionment to be used are prescribed in the related regulations.

III. PATTERNS OF U.S. INCOME TAXATION

In general, foreign investors are subject to U.S. income tax at progressive rates on net taxable business income. Alternatively, foreign investors are subject to a 30% flat tax on gross non-business income, without the benefit of any deductions. Since there is not an appreciable difference between the 30% flat tax on gross non-business income and the highest marginal rate on business income, it is usually advantageous to structure, where practicable, one's U.S. business activities as U.S. trade or business, and not as a passive non-business U.S. enterprise as the former is entitled to deduct expenses properly allocable to the generation of the income.

A. Foreign Corporation Doing Business in the U.S.

1. With regard to the issue of what constitutes a U.S. trade or business, unfortunately, the Internal Revenue Code and the Regulations there under do not provide a tremendous amount of insight into the definition of a U.S. trade or business. The Service will not issue a ruling on the question of whether a foreign person is engaged in a U.S. trade or business" depends on a number of factors, including the following:

(i) Continuity and regularity of the activity.

(ii) Presence of personnel with discretionary authority.

(iii) Significance of activity in producing income.

(iv) Nature and function of U.S. facilities and personnel.

(v) Number of transactions completed in the U.S.

A foreign corporation's position that it is not engaged in a U.S. trade or business is enhanced by limiting, as much as possible, its U.S. presence. A foreign corporation can limit its U.S. presence by, if possible, negotiation contracts outside the U.S., conducting solicitation and acceptance of orders outside the U.S., and conducting management and bookkeeping activities outside of the U.S.

a) It is unclear whether or not a person can be deemed to be engaged in a U.S. trade or business if such person is merely engaged in purchasing goods in the U.S. A person who regularly purchases goods in the U.S., and who conducts other activities may be engaged a trade or business in the U.S. The term “other activities” would include, but not be limited to, soliciting orders, inspecting merchandise and completing sales.

b) Revenue Rulings amply provide guidance concerning the determination of whether real estate activities amount to the conduct of a trade or business. Any activities in connection with domestic real estate that are beyond the mere receipt of income from rented property and the payment of expenses incidental to the collection thereof include the conduct of a U.S. trade or business, provided such activity is considerable, continuous and regular.

c) A foreign corporation is considered as engaged in a U.S. trade or business if the partnership of which such corporation is a partner is engaged in a U.S. trade or business. Similarly, a foreign corporation which is a beneficiary of an estate or trust which is engaged in a U.S. trade or business is treated as being engaged in such trade or business.

d) A foreign corporation can be deemed to be engaged in a U.S. trade or business through an individual or corporate agent. The activities of a foreign corporation’s agent will be attributed to the foreign corporation in determining whether the foreign corporation is engaged in a U.S. trade or business.

An existing Revenue Ruling held that a foreign corporation’s arrangement with a domestic corporation for the exclusive sales of its products within the U.S. was one of principal and agent, and that the foreign corporation was engaged in a U.S. trade or business as a result of the activities of its agent. The risk of an argument that a representative is an agent for tax purposes may be reduced if the representative acts in a complete independent manner, represents and holds itself out as representing or available to represent more than one client, takes title to products and independently markets products to third parties.

If practicable, a foreign corporation should prefer independent contractor relationships over agency relationships, and should not grant any U.S. representative the authority to negotiate and conclude contracts in the name of the foreign corporation. Additionally, a foreign corporation, directly or through a U.S. representative should avoid the maintenance of a stock of merchandise in the U.S. belonging to the foreign person from which the U.S. representative regularly fills orders on behalf of the foreign person. One U.S. case has held on its facts that a contract on consignment was an agency relationship.

Even if a contract is defined to be one of “independent contractor”, the risk that the independent contractor will be deemed to be an agent will remain where the representative acts if her is an “agent”. It is my understanding that under Texas law, it is possible that a person may be an independent contractor and agent at the same time for certain purposes. Again, Mr. Saks, you are better suited regarding further advice to your client on this specific matter.

3. <u>Business Taxable Income</u>

a) A foreign corporation engaged in a U.S. trade or business is subject to regular U.S. corporate tax (the “Regular Tax”) on its U.S. source income and occasionally on its foreign source income if it is established it is effectively connected with the conduct of a U.S. trade or business. A foreign corporation’s income would include U.S. source interest, dividends, rents, other fixed or determinable annual or periodic gains, profits and income, capital gains from sales or dispositions of capital assets that are effectively connected with the conduct of a U.S. trade or business.

With respect to the determination of foreign corporations’ effectively connected income, a foreign corporation is allowed to deduct from its effectively connected gross income expenses which are properly allocated as apportioned to that gross income. The amount of these deductions attributable to effectively connected income is determined under certain defined allocation and apportionment rules.

It is imperative that a foreign corporation file its income tax return on a timely basis as the Regulations provide that otherwise allowable deductions and credits will be disallowed if the return is not timely filed as set forth in the regulation.

4. In addition to being subject to the Regular Tax, a foreign corporation engaged in a U.S. trade or business is potentially subject to a 30% tax (the “Branch Tax”) on its “dividend equivalent amount.” The effect of the Branch Tax is to treat the U.S. trade or business conducted by a foreign corporation as though such branch was separately incorporated in a wholly-owned domestic subsidiary, ad then on an annual basis, to treat that portion of the effectively connected earnings and profits derived by its fictional domestic subsidiary which were not reinvested by the subsidiary in U.S. business assets as though such amounts had been repatriated to the “foreign” parent in the form of U.S. taxable dividends. Thus, the maximum effective rate of tax to which a foreign corporation is potentially subject, taking into account both the Regular Tax and the Branch Tax is approximately 53.8%.

The term “dividend equivalent amount” means the foreign corporation’s effectively connected earnings and profits for the taxable year adjusted as provided for in the Regulations. The term “effectively connected earnings and profits” means earnings and profits that are attributable to income that is effectively connected with the conduct of a U.S. trade or business. It is also essential to understand that the calculation of a corporation's earnings and profits is different from the calculation of the corporation's taxable income.

5. I must also point out that a foreign corporation's taxable income may be potentially subject to a 20% alternative minimum tax (the "Alternative Minimum Tax") on "alternative minimum taxable income." This Alternative Minimum Tax would only apply if the tax resulting from the Alternative Minimum Tax would exceed the corporation's Regular Tax liability.

6. A foreign corporation engaged in a U.S. trade or business at any time during a taxable year having a U.S. office or place of business is required to file an appropriate return on or before the fifteenth day of the third month following the close of the taxable year. The income tax return of a corporation that does not have a U.S. office or place of business is required to be filed on or before the fifteenth day of the sixth month following the close of its taxable year. A foreign corporation not engaged in a U.S. trade or business is not required to file a return if its tax liability is fully satisfied by the withholding of tax at source, except with regard to certain treaty-based return positions.

As was pointed out earlier that it is advantageous to structure, where practicable one's U.S. business activities as a U.S. trade or business in order to deduct expenses properly allocable to its income, a foreign investor has four (4) basic entities to chose from in structuring a business: the sole proprietorship, the partnership, the C Corporation and the Limited Liability Company. While tax considerations may be among the most important factors in determining the structure of the business entity, the foreign investor should be cautious to keep tax considerations in perspective and not be overly influenced by tax advisors who do not avoid "letting the tax tail wag the dog."

If your client decides to formalize his presence in the U.S. via the formation of a legal entity properly formed under a given State's law, numerous state and federal regulations will have to be observed with respect to the cross border movement of goods and services between Mexico and the U.S. Some of these rules address the rules of origin, custom procedures, and obligations regarding exports and imports and may be referred to in the North American Free Trade Agreement.

With respect to the U.S./Mexico Treaty regarding income taxes, one of its primary functions is to coordinate the tax laws of the U.S. with those of Mexico so as to avoid the double taxation of income and thereby enhance international trade and investment. It is not unusual therefore, that international transactions raise a myriad of U.S. and foreign tax issues and in certain instances, a single transaction may be subject to the taxing jurisdiction of two or more countries.

Similar to the exceptions to the substantial physical presence test under the closer connection test provided for in the rules determining the resident status of a foreign individual, the Treaty provides a series of tie breaker rules to determine the single State of residence for that individual. The first test involves a determination of the individual's permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, the individual will be considered to be a resident of the State where the individual's personal and economic relations are closer, i.e., the location of his or her "center of vital interests". If that test is also inconclusive, the individual will be treated as a resident of the State where he or she maintains a habitual abode. If the individual has a habitual abode in both States or in neither of them, he or she will be treated as a resident of his State of Nationality.

Other provisions of the tax treaty include the following:

1. The U.S. trade or business income of a nonresident alien or foreign corporation is not taxable unless such business is conducted through or effectively connected with a U.S. establishment.

2. Passive income is generally taxes at a reduced rate, or in the case interest certain patent or copyright royalties, such income may be totally exempt; and,

3. Personal service income is generally more favorably treated.

4. The branch tax rate may be reduced or eliminated altogether.

5. Double taxation is avoided through the allowance of foreign tax credits, foreign country exemptions or reduced rates of tax, and competent authority provisions, as provided by the Assistant Commissioner of International.

Taxpayers taking the position that a treaty provision overrides or otherwise modifies an internal revenue law and thereby effects a tax reduction are required to disclose the position on statement attached to their returns. Regulations implement both the disclosure requirement and the penalty imposed for failure to make such disclosure.

Finally, there are numerous disclosure requirements to various federal agencies and restrictions on foreign investment. When you deem it appropriate, I will be glad to furnish you with such information as well as elaborate on any of the specific issues you or your client may express further interest regarding the taxation of foreign nationals, the North American Free Trade Agreement and the U.S./and the respective country of citizenship Income Tax Treaty.

We kindly extend an invitation for you to schedule a visit to our office where we will gladly meet with you to discuss any tax matters pertinent to your situation.