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Taxation of Foreign Shareholders of U.S. Corporations

BY ANTHONY MALIK, EA

Introduction

Foreign persons pursue a variety of economic interests by investing in the stock of U.S. corporations. Common scenarios include portfolio investment and expansion of business operations in the U.S. through domestically incorporated entities. While the varying reasons for U.S. corporate ownership are usually premised on myriad non-tax considerations, it is imperative for the tax practitioner to know that the different economic arrangements trigger various tax laws. This article focuses on the tax implications of sales of foreign-owned U.S. stock.

Determining the correct tax treatment of a foreign shareholder's sale of U.S. stock requires an understanding of the shareholder's relation to the corporation's function. Unlike a U.S. shareholder, the tax treatment of a foreign shareholder's U.S. stock sales depends on a broader set of facts and circumstances extending beyond the transaction itself. Narrowly focusing on, and simply reporting, the transaction is improper and in most cases will subject the foreign shareholder to global double taxation. Gathering the relevant facts underpinning the stock sale is imperative because two identical transactions with different underlying economics will have completely different tax implications to the foreign shareholder. Thus, tax practitioners must consider the economic backdrop of the transaction to ascertain the applicable tax laws.

In the ensuing sections, we will examine the rules governing the treatment of such capital gains and losses. The examination will reveal that the taxation of such unfolds

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in a legal maze demanding an exploration beyond the peripheral assumptions surrounding common stock sales. To keep the topic manageable, this article will explore these rules as they pertain to non-U.S. individuals. Furthermore, to achieve the same end, this article will also not delve into possible modifications to federal law by the invocation of international tax treaties.

Capital Gains: The General Rule

By default, stocks are classified as personal property under two broad property types. Stock is typically a capital asset in the hands of the shareholder, the disposition of which generates capital gains or losses. Generally, gain from the sale of personal property is sourced to the seller's country of residence (IRC Sec. 865(a)(2)). Therefore, unless an exception applies, capital gains resulting from U.S. stock sales by foreign persons are taxable in their respective countries of residence, not in the United States. Counterintuitive as it may seem, international tax literature and practitioners alike routinely and correctly refer to such gains as "foreign source income."

Based on this, one can see that for the most part, capital gains from the sale of foreign-owned U.S. stock will neither be reportable to, nor subject to tax by, U.S. tax authorities. This general rule applies indiscriminately of whether a foreign person holds a minimal amount of U.S. stock in portfolio investments or is the sole shareholder of a U.S. corporation conducting business operations in the United States. Understanding the rationale concerning the somewhat mystifying second scenario necessitates grappling with a term of art—"U.S. trade or business."

Basically, in order for a foreign person's non-investment income to be subject to U.S. taxation, the person must be considered engaged in a U.S. trade or business. The international tax provisions of the Code do not explicitly define a U.S. trade or business (IRC Sec. 864(b)). However, case law has defined the concept as profit-oriented activities conducted in the United States that are regular, substantial, and continuous in nature (*Higgins v. Commissioner*, 312 U.S. 212 (1941) and *Continental Trading, Inc. v. Commissioner*, 16 T.C.M. (CCH) 724 (1957)).

Certainly, ownership of a U.S. corporation itself does not rise to the level of a U.S. trade or business within the meaning of this jurisprudentially crafted definition. Furthermore, under IRC Sec. 871(a)(2), a foreign person's capital gains not attributable to a U.S. trade or business are exempt from U.S. taxation as long as the foreign person is present in the United States for fewer than 183 days during the tax year. As such, the foreign person in the scenario under consideration would not be taxed on capital gains, provided the statutorily imposed U.S. presence limitation is not exceeded.

U.S. Real Property Interests: The Game Changer

As in the domestic realm, U.S. real estate invites its own special taxing rules in the international realm. And these rules trickle down to foreign shareholders of U.S. corporations, the primary business of which is U.S. real estate. Capital gains taxation connected to the disposition of stock of such a corporation sits in contrast to the general rule in the sense that the gains are subject to U.S. taxation by deeming attribution to a U.S. trade or business.

As mentioned previously, under the general rule, a foreign investor not engaged in a U.S. trade or business would not have U.S. source gain on the sale of a capital asset because U.S. capital gains derived by foreign persons are sourced to their respective countries of residence. However, if a foreign shareholder sells an equity interest in a U.S. real property holding corporation (USRPHC), the foreign shareholder is automatically deemed to be engaged in a U.S. trade or business, whether or not he or she is actually engaged in a U.S. trade or business, thereby sourcing the capital gains to the United States.

While a detailed discussion regarding USRPHC status determination is outside

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the scope of this article, it is necessary to consider the basic notion for purposes of the topic at hand.

Essentially, a corporation is a USRPHC if the fair market value of the corporation's U.S. real property interests is at least 50 percent of the fair market value of the corporation's total worldwide assets (IRC Sec. 897(c)(2)). Based on this limited definition alone, barring additional conditions and exceptions (such as 5 percent or less ownership of a publicly traded corporation), tax practitioners can immediately infer that they must necessarily conduct a USRPHC study before ascertaining the tax treatment of the appurtenant capital gains.

Further stupefying is the fact that USRPHC status is not static. Depending on the company's ongoing asset exhaustions, acquisitions, and dispositions, it may fail the USRPHC test in a given year, but may very well meet it in a subsequent year. Tax advisors serving foreign clients with U.S. real estate investments held in corporate formations need to be especially aware of USRPHCs and the related international tax laws.

Office or Other Fixed Place of Business in the United States: Beyond the Pale

While highly unlikely, it is theoretically possible for a foreign shareholder's U.S. stock (non-USRPHC) sales gains to be sourced to the United States. This theoretical possibility may be a function of bad tax planning, unavoidable realities, or perfectly legitimate business reasons. The rarity of these scenarios accounts for the fact that neither the Internal Revenue Code nor the regulations directly address this issue. Nonetheless, the letter and application of various statutes provide a semblance of an answer via a process of induction.

A significant exception to the taxing rules of IRC Sec. 865(a) discussed earlier articulates that gain from any sale of personal property attributable to an office or other fixed place of business maintained in the United States by a non-resident is U.S. source income (IRC Sec. 865(e)(2)(A)). Moreover, many streams of income otherwise classified as foreign-source are treated as U.S. source once attributable to an office or other fixed place of business in the United States.

Generally, a foreign person engaged in a U.S. trade or business through an office, store, or plant in the United States is considered as having an office or other fixed place of business in the United States. (Treas. Reg. Sec. 1.864-7). Notice here that engaging in a U.S. trade or business is a *sine qua non* for meeting the legal definition of an office or other fixed place of business in the United States. Thus, barring bad tax planning and unavoidable realities, foreign shareholders with legitimate business reasons to specifically meet this test would most likely be high-earning employee-owners of personal service corporations present in the United States for short periods of time.

It bears mentioning that the jurisdictional shift under IRC Sec. 865(e)(2)(A) is in line with customary international law. Under the "first-bite-at-the-apple rule" adopted by the League of Nations in 1923, the source jurisdiction has the primary right to tax income arising within it, and the residence jurisdiction is obligated to prevent double taxation by granting an exemption or credit. So it follows that the application of the aforementioned guidance to capital gains derived by foreign persons with an office or other fixed place of business in the United States from the disposition of U.S. stock, authorizes U.S. federal (IRS), and as appropriate, state and local revenue agencies to flex their taxing muscles.

Capital Losses: The Other Side of the Coin

Losses from sales of foreign-owned U.S. stocks are sourced in the same manner as gains. However, depending on the taxpayer's global financial position, tax practitioners need to be aware that the details regarding the utilization of losses are governed by a complex network of tax rules. Treas. Reg. Sec. 1.865-2 provides details regarding the allocation and apportionment of losses.

Conclusion

It is crucial for tax practitioners to gain an understanding of a cross-border stock sale's context. This understanding is a necessary element to rendering any sort of evaluative professional judgment. Slight circumstantial changes surrounding an international stock sale implicate entirely disparate sets of tax rules. Considering the underlying economics of a foreign-owned U.S. stock sale draws into the practitioner's purview the legal oscillation necessary to ascertain the applicable laws and the resulting tax treatment of the appurtenant gains or losses. EA

About the Author:

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