

Rental Income of Nonresident Aliens

To the extent it is not effectively connected with a U.S. trade or business, rental income received by a foreign investor from sources within the U.S. is classified as FDAP and is generally subject to a 30 percent withholding tax on the *gross rent* received.¹⁹ Furthermore, there are no allowances for deductions based on such income since the activity usually is not deemed a U.S. trade or business.²⁰ However, two tests exist under which the rental income may be deemed effectively connected with a foreign investor's U.S. trade or business (thereby subjecting the income to the 35 percent withholding on the *net rent received*).²¹ First is the "asset use test," which provides that rental income is effectively connected if it is derived from assets used in the conduct of a U.S. trade or business.²² This is designed to include income that is derived from assets used in the foreign investor's trade or business, but that typically is regarded as investment income. Second is the "business activities test," which provides that the rental income is effectively connected if the foreign investor's U.S. trade or business activities are a material factor in realizing the rental income.²³ This is designed to capture income that, due to the direct relationship between the foreign investor's business activities and the realization of the income, is more properly regarded as business income, even though it would typically be regarded as investment income.

Notwithstanding the foregoing, a foreign investor can achieve certainty as to the trade or business status of rental income from a U.S. real property interest by making an election on behalf of the U.S. entity (that holds title to the real estate) to treat the U.S. rental activity as effectively connected to a U.S. trade or business.²⁴ This would in turn subject the rental income to a 35 percent²⁵ net withholding tax on taxable income and will then enable the U.S. entity to take business deductions before paying the tax.

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