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Temporary Assignments in the U.S.—Tricks and Traps A Taxing Experience

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U.S. Tax Residency 101

The U.S., unlike all other countries worldwide (with the exception of the Philippines), does not use a separate, distinct and/or unique U.S. tax resident (U.S. resident alien) definition, preferring instead to piggy-back U.S. immigration law concepts with one exception. Therefore U.S. persons—U.S. citizens and legal permanent residents (green card holders)—are *always* defined as U.S. resident aliens. The above exception is any non-U.S. person meeting the Substantial Presences Test (SPT), who are also defined as U.S. resident aliens.

For these purposes however when dealing with foreign nationals coming to the U.S. to work and live, we will specifically concentrate on the latter type of U.S. resident aliens—those that may meet the SPT.

Consequences of Filing as a U.S. Nonresident Alien/ Becoming a U.S. Resident Alien

All U.S. resident aliens are subject to U.S. tax on their worldwide income, regardless of where the income is earned, the type of currency, or the location where the income is deposited.

All U.S. nonresident aliens are taxed in the U.S., only on their U.S. source income. The source of the income depends on the type or category of the income. A basic taxation premise is that the country of income source maintains the first right of taxation related to that income. However treaties usually seek to have such income taxed in the country of residence (and not the source country) to avoid a double filing compliance obligation.

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The SPT—To Be or Not To Be a U.S. Resident Alien

Under Internal Revenue Code Section¹ 7701(b)(3) individuals meet the SPT if they have at least 31 days of U.S. presence in the current year *and* when the following sums to 183 days or greater: 100 percent of the physical days of U.S. presence in the current year + 1/3 of the days of U.S. presence in the preceding year + 1/6 of the days of U.S. presence in the second preceding year. Therefore to summarize SPT determination, one looks at presence in the U.S. consisting of all days in the current year and fractions of days in the two-year look-back period.

For purposes of the SPT, partial days count as full days and, while fractional days add, any remaining fractional days are neither rounded up or down, but dropped. The SPT must continue to be met on an annual U.S. calendar tax period basis for an individual to continue to be considered a continuing U.S. resident alien year after year. As below—Starting Date, under Section 7701(b)(2)(C)(ii), up to 10 de minimus days may be excluded from U.S. presence for the determination of the SPT.

Ways Out of U.S. Tax Residency—Beating the System

Under Section 7701(b)(3)(B), the fractional two-year look-back period is effectively negated when an individual meets the SPT to become a U.S. resident alien having less than 183 days in the current year but is in excess of the requirements using the fractional two-year look-back rule in the preceding and second preceding tax years. In such cases, these individuals will be able to file IRS Form 8840, Closer Connection Exception Statement for Aliens, claiming a "tax home" and "closer connection" to a foreign country and remain U.S. nonresident aliens.

Such U.S. domestic relief, the Closer Exception Connection, is not available in cases where the SPT test is met based on days of U.S. presence in the current year alone. In such cases, the U.S. resident alien needs to seek relief under an income tax treaty between the U.S. and the alien's other country of residence (typically under OECD Model Article 4-Residence), generally referred to as the "treaty tiebreaker" article (see below).

Therefore, individuals may be classified as U.S. resident

aliens if they meet the SPT. If they fail the SPT, they are automatically classified as U.S. nonresident.

However in limited circumstances an individual's physical days of U.S. presence may be excluded for purposes of determining the SPT in cases where they were:

- *exempt individuals*: under Section 7701(b)(3)(D), a student in the U.S. on an F, J, M or Q visa, a trainee or a teacher in the U.S. on a J or Q visa, a professional athlete, or an individual with a medical condition;
- *others*: under Section 7701(b)(7), regular commuters who work in the U.S. from Canada or Mexico when in transit in the U.S. between other points for less than 24 hours, days in the U.S. as a crew member of a foreign vessel and all employees of international organizations or foreign governments.

Some exempt individuals need to complete IRS Form 8843, Statement for Exempt Individuals and Individuals with a Medical Condition, and attach it for filing with their annual U.S. tax return, either IRS Form 1040NR or 1040.

Of particular interest is the J visa type (exchange visitor visa) that is used very frequently in high profile scholar, doctor, attorney, professional and industrial trainee employment programs not to exceed 18 months, by leading attorney firms, hospitals and university or colleges alike.

However under Section 7701(b)(5)(E)(i) there are exceptions to the exempt individual rules above as related to J visa holders, where a teacher or trainee on a J visa was exempt as a teacher, trainee or student for any part of two of the last six prior calendar years. In that case in the current year one cannot exclude days of presence unless all four of the following apply as a teacher or trainee in the current year: (1) the visa holder was exempt as a teacher, trainee or student for any part of three or fewer of the prior six calendar years; and (2) a foreign employer paid all current year compensation; and (3) the visa holder was present in the U.S. as a teacher or trainee in any of the six prior years; and (4) a foreign employer paid all compensation during each of those prior six years the visa holder was present in the U.S. as a teacher or trainee.

Residency Starting Date

For persons who were not U.S. resident aliens at all during the prior tax year and who meet either the SPT or green card test their first day of presence (making them U.S. resident aliens) will be counted starting:

- (for the SPT) the first day that they enter the U.S. in the year in which they meet the SPT, excluding under Section 7701(b)(2)(C)(ii) up to 10 de minimus days of prior presence; and
- (for the green card test) the first time that they land on U.S. soil with a valid green card.

In cases where an individual's visa status changes from exempt to non-exempt, assuming that the individual meets the SPT, the individual's first day of U.S. residence is considered to be the actual date that the new non-exempt visa takes effect per U.S. Citizenship and Immigration Services (USCIS) notification of approval.

Residency Ending Date

For persons obtaining U.S. resident alien status as a result of compliance with the SPT, U.S. residency continues until the tax year that compliance with the SPT stops. In the year of actual physical departure, an individual continuing to meet the SPT is presumed to continue to be a U.S. resident alien up to December 31 of that tax year, unless he or she files a "closer connection" white paper statement claiming a "tax home" and "closer connection" to a foreign country at his or her actual physical date of departure. This filing is required to avoid continued U.S. residence and taxation on worldwide income. However there is controversy whether such white paper filing is required, or is a "closer connection" more a question of fact. Additionally where joint taxpayers departing earlier choose to remain U.S. residents up to December 31 for tax minimization reasons, the IRS has the right to step in and terminate residency on that earlier departing date citing closer connection status.

Non-Resident Aliens—Tax Forms, Forms, Forms ...

Nonresident aliens file U.S. income tax returns using Form 1040NR, U.S. Nonresident Alien Income Tax Return, which comprises five pages. Effectively connected income is reported² at U.S. regular graduated tax rates and non-effectively connected income is reported³ at the flat rate tax of 30 percent or a reduced treaty rate.⁴ Income effectively connected with a U.S. trade or business includes compensation income but excludes passive income.

U.S. nonresident alien filers cannot use the standard deduction nor the itemized deductions available to U.S. resident aliens, nor can they file jointly if married. Additionally, the claiming of exemptions for dependents is much more difficult. Furthermore, if foreign income is reported on a fiscal basis it must first be converted to a calendar year (January 1 to December 31) reporting period to be useful for U.S. reporting purposes (in the U.S. the calendar year is used as the tax reporting period).

Dual-Status

In cases where a foreign national in the U.S. has two statuses in a single tax year, for example, when going from a nonresident to resident status in the same U.S. tax calendar year, the foreign national is called a dual-status filer in recognition of these two statuses. The tax return that dual-status individuals file is based on their status on December 31 of the tax year. However dual-status filers must also file a statement with their tax return covering the other portion of the tax year for which they have the other status. Form(s) 1040 or 1040NR may be used for the statement reporting period indicating on the top of the form "Dual-Status Statement." A white paper statement will also suffice for these purposes. The statement is purely presentational with the amounts covering only the statement period.

If dual-status filers are married, they must file separately. They cannot use the Head of Household filing status or the Standard deduction.

Elections to be Treated as a U.S. Resident Alien

First-year election—Under Section 7701(b)(4) individual taxpayers who do not meet the SPT test in the year of entry may elect to be treated as U.S. resident aliens from the date of entry forward if they meet certain criteria. This election is not available to individuals, as above, whose days were either exempted or excludable under the SPT.⁵

Married election—Likewise under Section 6013(g) and (h) there exists an election for married persons to make both full year U.S. resident aliens. The election applies to either: (a) a full year U.S. resident alien married to a December 31 U.S. nonresident alien; or (b) to two dual-status December 31 U.S. resident aliens.⁶

State Tax Issues

In addition to a facts-and-circumstances “domicile” rule, many states have enacted a “statutory residence rule.” The main purpose of the statutory residence rule is to catch those individuals claiming a foreign state as their state of domicile, where the statutory residence rule sets down rules as to physical days of respective presence, and in some circumstances subjective terminology such as a “Permanent Place of Abode,” which has generally come to mean a temporary stay, for a fixed and limited period of time and for a particular business purpose.⁷

After Residency Ends ...

The “no lapse” rule—Under Section 7701(b)(2)(B)(iii) if, after departing and terminating U.S. tax residency in one calendar tax year, a nonresident alien returns to the U.S. and resumes U.S. tax residency at any time during the subsequent calendar tax year, the intervening period between nonresidency and residency is deemed to be a resident period. There are worldwide U.S. income taxation implications for this corresponding period.

Resumption of residency within three years (not to be confused with the no lapse rule)—Section 7701(b)(10)(A) provides a special rule for a U.S. resident alien who, after having been a U.S. resident during three consecutive calendar years and then having ceased to be a resident alien again becomes a U.S. resident alien before the close of the third calendar year beginning after the close of the first three calendar years. During this interim period, such individuals are still regarded as U.S. nonresident aliens, but they are subject to the regime for taxation of U.S. citizens and residents; that is, graduated rates of taxation on all income except that generally only U.S. source income is taxed.

IRS Form(s) 1040C, U.S. Departing Alien Tax Return, and/or Form 2063, U.S. Department Alien Income Tax Statement, are used to obtain a certificate or permit. The purpose of both forms is to obtain Certificates of Compliance or Departure Permits for SPT non-excepted U.S. resident aliens who depart the U.S. permanently, in order to ensure that all of their U.S. tax is paid in full prior to or on departure from the U.S.

Theoretically, either of these forms should be brought

to the IRS personally about 15 days, but no more than 30 days, prior to departure with copies of passports, visas, two years of past filed tax returns and the most current pay stub. These items are then presented to the IRS Field Assistant Area Director. Upon approval, the IRS Field Assistant Area Director will issue a Certificate of Compliance. This Certificate of Compliance is supposed to be furnished by the departing alien upon exiting the U.S., in addition to the payment all U.S. taxes owed.

The completion and presentation of Form 1040C or 2063, does not, however, relieve the taxpayer from filing a final tax return. Any taxes paid at departure would be treated as a withholding tax or extension payment on the final Form 1040NR tax return to be filed after departure (on the regular due date). Theoretically, any alien who tries to leave the U.S. without a departure permit may be subject to an income tax examination by an IRS employee at the point of departure. They then would be required to complete the income tax returns and statements and usually pay any taxes owed.

Certificate of Compliance or Departure Permits, however, are rarely if ever obtained. Most persons leaving the U.S. have been subject to tax withholding and have refunds owed to them. Furthermore, IRS agents are no longer posted at border crossings and there is only a slight chance that USCIS or U.S. Customs will know that an alien is departing the U.S. permanently. Based on years of practical experience regarding the preparation of Forms 1040C or 2063, it is not recommended that aliens obtain a Certificate of Compliance or Departure Permit.

Other Income Tax Matters

A general tax presumption is that the country of income source retains the first right of taxation. However treaties usually seek to have income taxed in the country of residence and not the country of source to avoid a double filing compliance obligation.

The U.S. has conveniently slipped into most income treaties, a provision to enable the U.S. to continue to tax U.S. resident aliens as if the income tax treaty did not exist. This is typically referred to as a “Savings Clause” or “Limitation on Benefits Clause.”

F, J or Q visa holders remaining as U.S. nonresident aliens, do not include in their gross income for U.S. tax purposes compensation paid to them by a foreign employer.

Under the Internal Revenue Code, the compensation of non U.S. citizen employees received from a foreign government or international organization for work performed in the U.S. will not be included in gross income and will be exempt from U.S. taxation.

Under the Internal Revenue Code, while a U.S. nonresident alien, interest income derived from U.S. bank deposits is exempt from U.S. taxation.

Foreign national individuals who are not eligible to obtain a U.S. social security number (since they are not U.S. citizens, nor U.S. green card holders, nor do not have valid U.S. work authorization) may obtain a U.S. Individual

Tax Identification Number (ITIN) valid for tax purposes only. The procedure is to complete and submit a Form W-7, Application for IRS Individual Taxpayer Identification Number, with the tax return remitted to the special ITIN unit in Austin, Texas, for processing. As either original or notarized copies of originals are required to accompany the Form W-7 application, it is recommended that applicants either: (1) apply at an IRS office; or (2) (if outside the U.S.) request that a U.S. embassy or consulate or "Acceptance Agent" certify the documents, as the transfer of original documents is an unwarranted risk. A U.S. notary public may notarize copies of such documents. However it must be a U.S. notary public, not a consulate or embassy notary. Generally a U.S. notary public is not authorized to transact outside their jurisdictional commission.

Sale of Principal Residence

In the five-year window prior to sale of the taxpayers' principal residence the taxpayer must have owned *and* used or lived in the home for at least two years (24 months = 730 days) for both spouses to qualify for the \$250,000 per spouse exclusion of gain. The two years for the owned and use test do not have to be the same two years within the five years prior to sale.

If taxpayers do not have the two years for both tests they will not qualify for the exclusion unless they have a change in location of employment, health reasons, or unforeseen circumstances.

Obviously the handicap for U.S. expatriate taxpayers is that although they usually meet the two-year test of ownership they do not meet the test on use. If the home is not the taxpayers' "main home" or principal residence or taxpayers do not meet the above tests and they have held the residence for more than one year, then the gain would be taxed at the long-term capital gain rate, which is currently 15 percent.

Social Security and Medicare Taxes or FICA (Federal Insurance Contributions Act)

Nonresident aliens filing Form 1040NR with a Schedule C, Profit or Loss from Business, are exempt from U.S. self-employment FICA tax on their net income from that business.

E, J or Q visa holders remaining as U.S. nonresident aliens, are exempt from the FICA payroll tax. All other foreign nationals present in the U.S. on any other work visa type are subject to U.S. FICA taxes.

If the taxpayer's country of nationality or former residence has negotiated a Totalization or Social Security treaty with the U.S. (where the taxpayer is currently either employed or self-employed), there may be an opportunity to obtain a retroactive Certificate of Coverage to ensure that they continue to pay into their home country's social security system for a specified maximum number of years to ensure that they receive full benefit for their social security contributions on earnings in the U.S.

¹Unless otherwise noted, all "Section" references are to the Internal Revenue Code of 1986, as amended.

²On Form 1040NR, pages 1 and 2.

³On Form 1040 NR, page 4.

⁴Form 1040NR also contains an information page (page 5).

⁵The election to be treated as a U.S. resident alien from the date of entry forward may benefit taxpayers with mortgage interest or other itemized deductions not allowed to U.S. nonresident aliens, or if they have foreign losses, e.g., foreign rental losses. Also in some cases it may facilitate breaking residence in their former country.

⁶This election to be treated as U.S. resident aliens for the full U.S. tax year may benefit taxpayers who can take advantage of the married filing joint tax rates, certain itemized deductions not allowed to married filing separate U.S. nonresident aliens, or if they have foreign losses, e.g., net rental losses. Additionally, in cases where this election would draw into U.S. taxation foreign income, there is the possibility of using either the: (1) foreign tax credit; or (2) a reverse Section 911 Foreign Earned Income Exclusion, to credit out dollar for dollar or exclude the foreign income taken into taxation under this election.

⁷Results vary from state to state.

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