

TAX RULES OF THE ROAD

by Paula Singer, Esq.

US tax rules are the most complex body of law and procedures in the world. The US federal tax rules consist of laws and income and estate tax treaties, plus regulations, rulings, notices, announcements, publications, forms and instructions issued by the Internal Revenue Service (IRS). The most complex and least well-defined tax rules are those that apply to transactions of foreign nationals. In all of its rulings and publications, the IRS fails to provide a framework so that taxpayers and their advisors can understand how to apply the tax rules to transactions of foreign nationals. The purpose of the "Tax Rules of the Road" is to provide you with that framework.

Rule One:

The general tax rule applies unless an exception is available, and the conditions for the exception, including procedural conditions, are met.

One general rule is that all compensation for employment services performed in the United States is subject to US social security and Medicare taxes (FICA). This is the case regardless of the location and currency of payment in most cases, because there is no blanket exception for employees paid outside the United States.

Rule Two:

The exception is not the general rule.

Tax laws typically include exceptions following the general rule. The exceptions may also have exceptions or conditions which can negate the exceptions.

One FICA exception is for nonresident aliens who are in F, J, M, or Q immigration status. Most individuals in such status assume that the general rule is that they are exempt from FICA, but that is not the general rule. The individual must meet all of the conditions of the exception in order to be exempt. For example, a J-2 dependent is not eligible for this exemption because the individual's employment is not "consistent with the purpose that the individual entered the United States," which was to accompany the primary visa holder.

Rule Three:

The Rules of the Road depend on the "Tax Highway" that you are on.

There are many Tax Highways, each with its own Rules of the Road such as:

- Federal income taxes
- State income taxes
- Federal estate and gift taxes
- State estate taxes
- Social security and Medicare taxes (FICA)

Taxpayers and advisors must know the Tax Highway that they are on in order to apply the Rules of the Road. For example, federal income tax law includes rules for determining when an individual is a resident alien and taxed like a US citizen; or a nonresident alien and taxed under special rules. These residency rules are the "green card" test and the "substantial presence test." However, the State Income Tax Rules of the Road define a resident for state income tax purposes. The residency rule for federal estate taxes is based on the concept of "domicile," but the residency rules for trust grantors, trustees, and beneficiaries are based on the federal income tax residency rules.

Rule Four:**The Tax Highway may intersect with another Tax Highway with another set of Rules of the Road.**

The FICA Rules of the Road include an exception for nonresident aliens in F, J, M, or Q status. However, the Federal Income Tax Rules of the Road define the term, "nonresident alien." An individual who meets either the "green card" or "substantial presence" test is a resident alien and, therefore, not eligible for the FICA exemption.

Rule Five:**A Treaty May Override the Rules of the Road**

An individual may be entitled to use Rules of the Road provided by an income tax treaty. An estate executor may be able to use an estate tax treaty to reduce U.S. estate taxes.

Under an income tax treaty, a resident of the treaty country for income tax purposes may be exempt from federal income taxes on items of income covered by the treaty provided the treaty conditions are met and the individual follows the procedural rules required by the IRS for the exemption.

Treaties also include general rules with exceptions, and exceptions to exceptions. A good example is the "saving clause." Because the United States taxes its citizens and residents on worldwide income, tax treaties include an exception preserving the right of the United States to tax its citizens and residents as if the treaty did not come into effect. The saving clause includes exceptions for certain benefits, such as for students, trainees, teachers, and researchers. However, these exceptions are negated if the individual becomes a U.S. citizen or U.S. lawful permanent resident ("green card" holder).

TAX RESIDENCY RULES

by Paula Singer, Esq.

Introduction

Where once only major multinational corporations employed foreign workers in the United States, now small and medium-sized businesses, and even individuals, may employ foreign workers. These workers may be in the United States in any number of immigration categories including – H-1B Specialty Worker, L-1 Intra-company Transferee, O-1 Person of Extraordinary Ability, TN Professionals from Canada or Mexico under NAFTA, F-1 Student under Optional Practical Training, J-1 Exchange Visitor, Q-2 Cultural Exchange Participant. U.S. income and employment tax rules vary with the employee's immigration status and substantial presence in the United States.

Federal Income Tax

Under the federal income tax rules, foreign workers who are *resident aliens* are subject to federal income tax in the same manner as U.S. citizens. U.S. citizens and *resident aliens* are subject to federal income tax on worldwide income regardless of where the individual resides or works, in the United States or abroad.

Foreign workers who are *nonresident aliens* are subject to federal income tax under a completely different set of rules. *Nonresident aliens* are subject to federal income tax on U.S. source income including "income effectively connected to a U.S. trade or business," Such income, called ECI, includes compensation for services performed in the United States. ECI is taxed after deductions at single or married filing separately rates. A *nonresident alien* cannot claim the standard deduction and, with few exceptions, can claim only one personal exemption.

A *resident alien* who meets specified income thresholds must submit a Form 1040 or 1040EZ tax return. Generally, a *nonresident alien* paid by a U.S. employer must submit a Form 1040NR or 1040NR-EZ regardless of the amount of ECI.

Employment Tax Considerations

The federal wage withholding rules mirror the federal income tax rules. For example, in completing Form W-4, *Employee's Allowance Certificate*, a *nonresident alien* worker must:

- Claim single status, whether single or married,
- Claim only one personal exemption with a few exceptions, and
- Include an additional withholding amount based on the payroll cycle to compensate for the standard deduction built into the withholding tables (except for students from India)

Additional personal exemptions may be available for:

- Neighbors from Canada and Mexico
- Nationals from Northern Mariana Islands and American Samoa
- Residents from South Korea and Japan (years prior to 2005)
- Students from India

In certain situations, a *nonresident alien* worker may be eligible for exemption from social security and Medicare taxes. IRS Publication 15, Circular E, Employer's Tax Guide describes these special withholding rules.

In order for an employer to apply the appropriate employment tax rules, an employer must know whether a foreign worker is a *resident alien* or a *nonresident alien*.

Resident Alien or Nonresident Alien

A foreign worker's residency status, *resident* or *nonresident*, depends upon the worker's immigration category and substantial presence in the United States. Generally, a foreign worker who is a U.S. lawful permanent resident (a "green card holder" or immigrant) is a *resident alien* for income tax purposes. A nonimmigrant, who is substantially present in the United States over a period of years, is also a *resident alien*.

A nonimmigrant is substantially present if his or her U.S. days (including partial days) over 3 calendar years equals or exceeds 183 days based on a formula. The 183-day formula considers all of the U.S. days in the current calendar year, plus 1/3 of the U.S. days in the prior year, plus 1/6 of the days in the year before the prior year. A nonimmigrant whose U.S. days average less than 122 per calendar year remains a *nonresident alien*.

A nonimmigrant, whose U.S. days under the formula equals or exceeds 183, is a *resident alien* unless an exception applies. A nonimmigrant who 1) has fewer than 31 U.S. days in the calendar year, 2) can support a claim of a closer connection to a foreign country than to the United States on IRS Form 8840, or 3) can support a claim of nonresidency status under a residency tie-breaker rule of an applicable income tax treaty is a *nonresident alien*.

Nonimmigrants in certain categories may remain *nonresident aliens* for policy reasons. These nonimmigrants, called "exempt individuals," are exempt from counting days for purposes of the 183-day residency formula. Exempt individuals are not exempt from tax unless a tax or income tax treaty exception applies.

“EXEMPT INDIVIDUALS” AND WHAT IT MEANS TO BE EXEMPT

by Paula Singer, Esq.

The application of U.S. federal income tax rules and the availability of income exemptions under the tax law or an income tax treaty may depend on whether a foreign national is a resident alien or a nonresident alien. A foreign national's residency status, resident or nonresident, depends upon the individual's immigration category and substantial presence in the United States. Generally, a foreign national who is an immigrant (a U.S. lawful permanent resident or “green card” holder) is a resident alien for income tax purposes. A nonimmigrant, who is not substantially present in the United States, is a nonresident alien.

Substantial Presence in the United States

A nonimmigrant is substantially present in the United States if the individual is present for at least 31 days in the current calendar year and the individual's U.S. days over 3 calendar years equals or exceeds 183 days based on a formula. The 183-day formula considers all of the U.S. days in the current calendar year, plus 1/3 of the U.S. days in the prior year, plus 1/6 of the days in the year before the prior year. A nonimmigrant whose presence in the United States satisfies the substantial presence formula is a resident alien.

A nonimmigrant may fail to satisfy the 183-day formula because some or all of the individual's U.S. days do not count for purposes of determining the individual's U.S. residency status. For example, the following days do not count:

- Days spent in the United States for a medical condition that arose while the foreign national was in the United States
- Days commuting from a residence in Canada or Mexico to work in the United States
- A day (less than 24 hours) passing through the United States from one foreign location to another foreign location
- Days of an athlete engaged in a charitable event in the United States

For policy reasons, Congress decided that foreign nationals in the United States in the certain immigration categories should not count U.S. days for specified periods. By not counting U.S. days, the foreign national remains a nonresident alien for a longer period of time regardless of the individual's actual days of physical presence in the United States. As a nonresident alien, the individual is subject to U.S. federal income tax only on U.S. source income and income effectively connected to a U.S. trade or business. Congress called such foreign nationals “exempt individuals.”

“Exempt Individuals”

There has probably been more confusion surrounding the term “exempt individual” than any other tax term. Exempt individuals are exempt from counting U.S. days for purposes of determining substantial presence in the United States, nothing more. They are not exempt from tax because they are exempt individuals, although such exempt individuals are frequently exempt from income and/or social security and Medicare taxes under a tax law or treaty provision.

Exempt individuals cannot claim “exempt” on line 7 of Form W-4. This is the case even if the individual is exempt from income tax under an applicable tax law or income tax treaty. A Form 8233 must be submitted for this purpose. Nor is income paid to an exempt individual exempt from information reporting, although the information form may be different. For example, employment

compensation exempt from tax under an income tax treaty must be reported on an information Form 1042-S and on a Form 1042 tax return, not on a Form W-2 and a Form 941 tax return.

There are three categories of exempt individuals:

1. "Foreign-government Related Individuals," which includes foreign nationals in "A" status (diplomats and their dependents, but not their employees) and "G" status (representatives of certain international organizations and their dependents, but not their employees).
2. "Students," which includes foreign nationals in "F" status (academic students and their dependents) and "M" status (vocational students and their dependents) as well as "J" status students (exchange visitors in the student category and their dependents). The tax law also includes "Q" status individuals in the student category, but there are none for immigration purposes.
3. "Teachers and Trainees," which includes non-student foreign nationals in "J" status (exchange visitors in any category except student and their dependents) and "Q" status (international cultural exchange participants and their dependents).

Each category has its own set of rules for determining when the individual's U.S. days do not count for substantial presence purposes.

U.S. TAXATION OF FOREIGN- GOVERNMENT RELATED INDIVIDUALS

by Paula Singer, Esq.

The application of U.S. federal income tax rules and the availability of income exemptions under the tax law may depend for policy reasons on an individual's immigration category. This is the case for foreign-government related individuals who may enter the United States in either "A" or "G" nonimmigrant status. A-1 and A-2 nonimmigrants are beneficiaries of employment based immigration petitions of foreign governments such as for ambassadors, ministers, diplomats, or consular officers. G-1, G-2, G-3, and G-4 nonimmigrants are beneficiaries of employment-based petitions of international organizations designated by Executive Order to be entitled to special privileges, exemptions and immunities. Dependents enter the United States in the same category as the beneficiaries (called "principals"). The personal employees of foreign-government related nonimmigrants, and their dependents, enter the United States as A-3 and G-5 nonimmigrants respectively. The special rules discussed below do not apply to these nonimmigrants.

A and G nonimmigrants may only be employed by the foreign government or international organization that sponsored them. A and G status dependents may be employed if they have obtained an Employment Authorization Document (EAD) from the immigration service. Dependents may engage in full or part-time education.

Nonresident Alien Tax Status

A nonimmigrant's U.S. tax residency status, *resident* or *nonresident*, depends upon the individual's immigration category and substantial presence in the United States. Nonimmigrants are substantially present in the United States if they are present for at least 31 days in the current calendar year, and their U.S. days over three calendar years equals or exceeds 183 days based on a formula.

For policy reasons, most foreign-government related individuals are *nonresidents* for U.S. income tax purposes. Therefore, they are subject to U.S. income tax only on their U.S. income (unless an exception applies), but not on their foreign income. This results from the fact that the U.S. days of A or G nonimmigrants do not count for purposes of determining substantial presence in the United States with two exceptions. Part-time employees of their organizations do not qualify for this special exception from counting U.S. days, and will become *residents* if they are substantially present. This special exception also does not apply to A or G status dependents who are 21 or over.

Special Tax Exemptions

Generally, *nonresidents* are subject to U.S. income taxes on U.S. source income, which includes compensation for employment services ("wages") in the United States. Wages for U.S. services are also subject to social security and Medicare (FICA) taxes. However, unique income tax exceptions apply to exempt A and G status principals from taxes on their wages for official services to the foreign government or international organization.

Wages paid by a foreign government for official services are exempt from U.S. income tax if the following two conditions are met:

1. The services are similar to services performed by U.S. government employees in foreign countries, and

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2. The U.S. State Department has certified that the foreign country grants an income tax exemption to U.S. government employees performing similar services in that country.

This tax exemption does not apply to services that are primarily in connection with commercial activity or that are performed for a controlled commercial entity.

Wages paid by an international organization designated by Executive Order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act for official services of its employees are exempt from U.S. income tax.

A blanket FICA exemption applies to wages paid by foreign governments and such international organizations without regard to any of the income tax conditions being met.

No other special tax exemptions relate to A or G immigration status. However, special tax exemptions such as for bank interest and portfolio interest are available to all *nonresidents*. U.S. income that is not exempt from tax under these special rules is subject to U.S. income tax under the normal rules that apply to payments to *nonresidents* unless an income tax treaty exemption applies.

Tax Treaty Exemptions

The United States has income tax treaties with over 60 countries. Most of these treaties include a Government Service Article stating that “salaries, wages, and remuneration...paid from the public funds of a Contracting State or a political subdivision or a local authority in the discharge of functions of a governmental nature” shall only be subject to tax in the treaty country.

Tax treaties also include articles reducing or eliminating tax on U.S. source income such as dividends, interest, royalties, etc. In order to qualify for these exemptions, the individual claiming the exemption must submit required documentation to the payor. These rules will be discussed more fully in future editions.

U.S. TAXATION OF FOREIGN STUDENTS

by Paula Singer, Esq.

The application of U.S. federal income tax rules and the availability of income exemptions under the tax law may depend on policy reasons on an individual's immigration category. This is the case for foreign students in F (academic), J (exchange visitor), and M (vocational) student categories. Depending upon the number of calendar years that foreign students have been in the United States in F, M, J, or Q status since 1985, students may be either a nonresident alien or resident alien for U.S. income tax purposes. The difference is important because different tax withholding rules apply to nonresident aliens.

Substantial U.S. Presence

Under the general rule for U.S. tax residency, foreign nationals are "substantially present," in the United States if they are present for at least 31 days in the current calendar year, and their U.S. days over 3 calendar years equal or exceed 183 days based on a formula. The 183-day formula considers all of the U.S. days in the current calendar year, plus 1/3 of the U.S. days in the prior year, plus 1/6 of the days in the year before the prior year. Foreign nationals whose presence in the United States satisfies the substantial presence formula are resident aliens and taxed like U.S. citizens.

The 5-Calendar Year Student Exception

For policy reasons, foreign students are nonresident aliens for U.S. income tax purposes for 5 calendar years. Therefore, they are subject to U.S. income tax only on their U.S. income (unless an exception applies), but not on their foreign income. This results from the fact that the U.S. days of foreign students do not count for purposes of determining substantial presence in the United States for 5 calendar years.

The 5 calendar years include all years of presence as an "exempt individual" in F, J, M, or Q status since 1985. Special transitional rules apply to students who were already in the United States in 1985. Calendar years include years in which foreign students spent in the United States in high school, or even as young children accompanying a student parent.

Closer Connection Extension

Foreign students who can support with facts that they are not intending to reside permanently in the United States can extend the 5-calendar year period by attaching a statement to Form 8843. This form is required to be submitted with a students' income tax return, or separately if no return is required. Although the tax law provides for procedures for requesting a letter from the IRS to support this claim, which would be needed for withholding purposes, effective procedures for requesting such a letter have yet to be implemented by the IRS.

Whether taxes are lower for foreign students who are resident aliens or nonresident aliens depends upon their type and source of income. Foreign students engaged in optional practical training in their 6th calendar year of U.S. presence frequently wish to remain nonresident aliens to avail themselves of the social security and Medicare tax exemption that applies to nonresident aliens in F-1 and J-1 status. However, foreign students who are intending to change status to H-1B Specialty Worker are not eligible for the closer connection extension of their nonresidency status.

TAX TREATY BENEFITS FOR FOREIGN STUDENTS

by Paula Singer, Esq.

The United States has income tax treaties with 63 countries. Treaties serve to:

- Avoid double taxation in situations in which a taxpayer could be taxed twice, once by the country in which the income arises (the "source" country) and once by the country where the taxpayer resides (the "residence" country)
- Reduce "excessive" withholding taxes on certain types of income such as investment income and royalties
- Establish agreed-to levels of activities in which taxpayers can engage in the treaty country before becoming subject to taxes
- Provide for the exchange of information
- Eliminate taxes in situations that treaty partners agree should have favorable tax treatment

Tax treaty benefits for foreign students vary considerably depending upon when the treaties became effective.

Pre-1987 Treaties

Prior to the *1986 Tax Reform Act*, scholarship and fellowship grants for students were exempt from tax. Grants for research scholars were given favorable U.S. tax treatment as well. U.S. students were able to offset work-study income with the standard deduction and personal exemption. Nonresidents cannot use a standard deduction to offset work-study income. U.S. tax treaties from this period generally provide complete exemption from tax for scholarships and fellowships for full-time students. (The former USSR treaty, which covers nine of the Newly Independent States, is the notable exception with a \$10,000 treaty maximum.) In addition, they provide for a limited exemption for earned income, typically \$2,000 to \$5,000, compensating for the lack of a standard deduction. Most treaties limit the student benefits to five taxable years.

To provide tax treatment similar to U.S. citizens for foreign students, a few tax treaties – Barbados, Jamaica, and Hungary – allow students to elect to be treated as residents.

Following the '86 *Act*, only qualified scholarship and fellowship grants - tuition and required fees, books, supplies, and equipment - are exempt from tax. All other grants are taxable but not subject to withholding or reporting for U.S. citizens and residents. Taxable grants of nonresidents are subject generally to 14 percent withholding and reporting on Form 1042-S. U.S. citizens and residents may use the standard deduction to offset taxable grants on their Form 1040; nonresident students cannot use the standard deduction on their Form 1040NR-EZ. U.S. treaty policy for student benefits does not reflect the difference (except for the treaty with India, which allows students a standard deduction and a personal exemption for a spouse).

U.S. Treaty Policy on Student Benefits

The U.S. Model Treaty states the U.S. policy regarding student benefits:

Payments received for the purpose of maintenance, education, or training by a student ... for the purpose of his full-time education or training shall not be taxed ..., **provided that such payments arise outside that State.**

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This limited benefit was included in treaties with Australia, Canada, Italy, New Zealand, Pakistan, and the U.K. (The treaty with Pakistan also includes a \$5,000 earned income exemption.) Nonresident students need no treaty benefit for such payments from abroad, which the Rev. Rul. 89-67 deems foreign source.

Post-1986 Treaties

The replacement treaties with Austria, Denmark, Ireland, Japan, Sweden, and Switzerland incorporate the U.S. treaty policy. The new treaties with Mexico, South Africa, Sri Lanka, and Turkey also incorporate this policy.

The Treasury Explanation for the treaty with the Netherlands notes that: "It is not standard U.S. treaty policy, particularly in treaties with developed countries, to include an earned income exemption for visiting students." The United States preserves the benefits from prior treaties when they are important to the treaty partner.

The replacement treaties with the Netherlands, France, and Germany preserve both the limited earned income exemption and the exemption for U.S. source grants. (The treaty with Germany includes a retroactive loss provision for earned income if the stay in the United States extends beyond four years.) The replacement treaties with Kazakhstan, Luxembourg, Russia, and the Ukraine preserve exemption for grants regardless of the source.

New treaties negotiated with China, the Czech Republic, Estonia, Indonesia, Israel, Latvia, Lithuania, Portugal, the Slovak Republic, Slovenia, Spain, Thailand, Tunisia and Venezuela - include benefits for scholarship and fellowship grants, regardless of the source and a limited exemption for earned income.