

Domestic Tax Issues for Non-resident Aliens

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Summary

They arrive with and without visas to live and work in the US. As these new arrivals settle in, they are confronted by unique tax issues. This course will provide the practitioner with the tools necessary to serve an expanding clientele. Topics will include the determination of residency for federal tax purposes, elections to be treated as resident aliens, dual-status issues, tax treatment of income and expenses for non-resident aliens, tax credits, administrative issues, and departure filing requirements.



Includes updates with regards to COVID-19 relief legislation

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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I. Summary of Tax Treatment

Unlike United States (US) citizens and permanent residents, non-resident aliens (NRAs) are taxed only on US-sourced income rather than worldwide income. As a result, NRAs frequently have less taxable income to report to US tax authorities; on the other hand, they may not be entitled to favorable deductions, credits, filing statuses and preferential tax rates.

NRA income that is US-sourced income only is categorized as either (1) income that is “effectively connected” or (2) “not effectively connected”. If connected, the income may be reduced by certain Itemized Deductions and is taxed using graduated tax rates. Income that is not effectively connected is taxed at a flat rate of 30%.¹

TAX TREATMENT OF NRAs

- Taxed only on US-sourced income
- Effectively connected income (reduced by certain deductions) is taxed at graduated rates
- Not effectively connected income is taxed at a flat rate of 30%

II. Determining Residency

Under US tax law, an individual is an NRA if the individual is neither a citizen nor a resident of the US. While citizenship – obtained at birth or through naturalization² – may be readily determinable, residency for tax purposes is often a bit murky.

To establish proper tax treatment, the taxpayer’s residency must be ascertained under one of two tests.

A. Green Card Test

Green Cards are issued to Lawful Permanent Residents by the US Citizenship and Immigration Services (USCIS).³ Officially titled **Form I-551, US Permanent Resident Card**, it looks much like any state-issued driver’s license and is considered permanent unless residency status is (1) administratively or judicially removed [deportation], (2) voluntarily abandoned by application⁴ and remittance of the Green Card to the USCIS or a US Consulate, or (3) forfeited by leaving the country for more than a temporary visit abroad.⁵ The mere expiration or casual abandonment of a Green Card does not terminate residency for tax purposes; once deemed to be a lawful permanent resident, such individuals continue to have US tax filing requirements.

GREEN CARD HOLDERS ARE...

- Permanent residents.
- Taxed like US citizens.
- Tax residency is not equivalent immigration residency and may extend beyond the expiration of the Green Card.

¹ IRC §871(a).

² In California, Governor Jerry Brown (D) signed a measure into law removing the word “alien” from the state’s Labor Code because the term is viewed as a derogatory description of individuals not born in the US [SB 432, effective January 1, 2016].

³ The USCIS was formerly known as the US Department of Immigration and Naturalization Service (INS) but became a part of the US Department of Homeland Security (DHS) in March 2003.

⁴ **Form I-407, Record of Abandonment of Lawful Permanent Resident Status.**

⁵ Generally, the DHS makes a rebuttable presumption that a lawful permanent resident intended to abandon his US residency status for immigration purposes if a single trip abroad extends beyond six months.

B. Substantial Presence Test (SPT)⁶

A person is considered to be a US resident for tax purposes if he has been physically present in the US (including all 50 states and the District of Columbia, but not US possessions or territories) *for at least 31 days during the tax year AND 183 days during the most recent 3-year period* which includes all of the days in the current year, 1/3 of the days in the previous year and 1/6 of the days in the year prior to that.⁷

Aviv was physically present in the US for 120 days in each of the years 2016, 2017 and 2018. To determine if he meets the SPT for 2018, the following number of days must be counted:

120 days in 2018 *plus*
40 days in 2017 (1/3 of 120) *plus*
20 days in 2016 (1/6 of 120)

Since the 3-year total is only 180 days, he is not considered a resident under the SPT for 2018.

The SPT measures the days of *presence* in the US. As such, both the days of arrival and departure are added to the count.⁸ However, days that are not counted include:

- Days on which the taxpayer regularly commutes to work in the US from either Canada or Mexico.
- Days during which he is in the US for less than 24 hours due to international transit.
- Days in US if he is a crew member of a foreign vessel.
- Days that he is unable to leave the US due to a medical condition.⁹
- Up to 60 consecutive days between February 1 and April 1, 2020 due to travel disruptions caused by the global pandemic¹⁰

Certain individuals are deemed to be exempt and need not count their days in the US.¹¹

- Foreign government employees or diplomats who only temporarily reside in the US.
- Teachers on “J” or “Q” visas [See **Appendix A** for commonly used immigration statuses] (UNLESS living in the US longer than 2 years).
- Students on “F”, “J”, “M” or “Q” visas (UNLESS living in the US more than 5 years).¹²
- Professional athletes in the US to compete in a charitable event.¹³

Exempt individuals must file **Form 8843 Statement for Exempt Individuals and Individuals with a Medical Condition** and attach it to the tax return. Exempt individuals are subject to the SPT for all periods before and after they held exempt status.

A foreign student F-1 visa-holder arrived in the US on January 1st, 2014 and is still considered an NRA for 2018. His wife (not a student) came with him on an F-2 visa and is also an NRA in 2018. However, both husband and wife will be considered residents in 2019, regardless of their academic status.

⁶ IRC §7701(b)(1).

⁷ IRC §7701(b)(3).

⁸ Travelers may view their US arrival and departure history for the past 5 years on the I-94 Website of the US Department of Homeland Security at <https://i94.cbp.dhs.gov/i94/#/home> (last accessed April 28, 2020).

⁹ IRC §7701(b)(7).

¹⁰ Rev. Proc. 2020-20.

¹¹ IRC §7701(b)(5).

¹² Additional information is available in IRS Publication 4011, Foreign Student & Scholar Resource Guide.

¹³ IRC §7701(b)(5)(A).

Because US citizens and residents are taxed on *worldwide* income rather than US-sourced income only, it is sometimes preferable to be treated as an NRA for tax purposes. Therefore, even if the SPT is met, the taxpayer may be treated as an NRA if he or she:

- is present in the US for less than 183 days during the year AND
- maintains a tax home¹⁴ in a foreign country AND
- has a closer connection to *one* foreign country.¹⁵

As per the Immigration and Nationality Act of 1952, every individual applying for a visitor visa is an intending immigrant eventually subject to US tax laws unless the purpose of the individual's trip is for business, pleasure or medical treatment, the trip is for a limited period, and the individual maintains a residence and binding ties outside of the US. Those claiming a closer connection to a foreign country must file **Form 8840 Closer Connection Exception Statement** and attach it to the return.¹⁶

Applicable tax treaties may override any of the rules stated above. If so, **Form 8833 Treaty-Based Return Position Disclosure** must be filed and attached to the tax return.

NOTE: An illegal immigrant may be illegal for immigration purposes but can still be considered a Resident Alien for tax purposes and must, therefore, file a US tax return.

SUBSTANTIAL PRESENCE TEST

- In the US ≥ 31 days in a year AND ≥ 183 days during most recent 3-year period (count ALL days in current year + 1/3 days in previous year + 1/6 days in year prior to previous).
- Certain days are not counted & some individuals are exempt from counting.
- If taxpayer maintains a foreign tax home & closer connection abroad, he may be treated as an NRA despite satisfying SPT.

C. Part-year and Dual-Status Aliens

Part-year residents are, by definition, deemed "dual-status" and must file as non-residents for part of the year and as resident aliens for the remaining portion. The residency date begins on the first day that the taxpayer is present in the US or is issued a Green Card (whichever is earlier); assuming no travel in or out of the country ensues. Thus, to accumulate the requisite 183 days for residency status, the immigrant must enter the US on or before July 1st.

Maria entered the US on April 10th and was issued a Green Card on July 15th. Her residency would seemingly have begun on July 15th (too late for the SPT), but since the Green Card was *issued in the same year* that her substantial presence began, her residency actually began on the earlier date.

While taxed only on US-sourced income during the portion of the year that they are deemed non-resident, dual-status aliens are denied more favorable filing statuses, community property rights, the Standard Deduction, and most tax credits. Such taxpayers often pay far more tax than citizen and resident taxpayers with similar incomes.

As a result, and under certain circumstances, dual-status aliens may choose to be treated as residents for tax purposes by making one or the other of two available elections:

¹⁴ "Tax Home" is defined as the place of business or employment and not necessarily the place of the family home [IRC §911(d)(3)]. Facts and circumstances used to determine the closer connection to a foreign country include, but are not limited to country of residence, location of permanent home, family, personal belongings, affiliations, voting rights and driver's license.

¹⁵ IRC §7701(b)(3)(B).

¹⁶ Teachers and students exempt from the day count for 2 and 5 years (respectively) are eligible to claim the closer connection exception, even if they have been in the US for longer than 183 days.

1. First-Year Election¹⁷

If an immigrant arrives on or after July 2nd, he would not qualify under the SPT for residency until the year after his arrival but may elect to backdate his residency status to the year of arrival if (1) he was present in the US for at least 31 consecutive days in the year of arrival AND (2) meets the SPT the year following arrival.

Juan came to the US on November 1st, 2017 and was here for 31 consecutive days before he returned to his home country for a 2-week visit on December 1st. He returned to the US on December 15th and then stayed in the US throughout 2018. He will, of course be considered a resident for 2018, but may use the special election to be considered a resident for 2017 as well.¹⁸

NOTE: Since the taxpayer must have been present in the US for at least 31 days in the year of arrival, an alien who enters the country after December 1st is ineligible for the election. Additionally, the alien must remain in the US for at least 75% of the time after the beginning of the 31-day period.

In the above example, Juan was in the US for 31 days prior to his departure and another 17 days after his return for a total of 48 days; equal to 78% of the time since the 31-day continuous interval began. Had Juan, instead, returned any time after December 19th, he would have failed the 75% test. But because rules allow for reclassification of up to 5 days of absence as days of presence, Juan would still qualify for the election if his travels abroad ended on or before December 20th.

2. Marriage Election¹⁹

A married individual²⁰ entering the US for the first time and considered to be dual status may opt to be treated as a resident for the entire year if:

- he was an NRA at the beginning of the year and is a resident alien or citizen at the end of the year AND
- he is married to a US citizen or resident alien at year-end.


Both spouses must agree to the election and must file a joint return.²¹ The election is made by attaching a statement signed by both spouses to the originally filed return or an amended return.²² The election may be revoked by either or both spouses. The election is automatically terminated by death or legal separation. However, neither spouse may ever again make the election, even upon remarriage.

¹⁷ IRC §7701(b)(4).

¹⁸ To make the election, the taxpayer must attach a signed statement to his original return declaring that he is making a “first-year election” for the current year, that he was not a resident in the prior year, and that he will satisfy the SPT in the following year.

¹⁹ IRC §6013(h).

²⁰ Foreign marriages are recognized for federal tax purposes if the relationship was sanctioned under the laws of a foreign jurisdiction, regardless of where the couple resides, if the marriage is recognized under the laws of at least one US state, possession or territory. Therefore, marriages legally performed and valid outside of the US are also legally valid in the US. **NOTE:** This rule also applies to same-sex couples and common-law marriages. [Treas. Reg. §301.7701-18(a)(2).]

²¹  As per the Coronavirus Aid, Relief, and Economic Security Act (CARES), NRA’s are ineligible to receive the COVID-19 stimulus payment of \$1,200. A US citizen taxpayer who has filed jointly with an NRA spouse must submit his request for the Recovery Rebate Credit with his timely filed tax return for TY’20.

²² Reg. §1.6013-6(a)(4).

Danielle and Maxime are married, and both are non-resident aliens at the beginning of the year. In June, Maxime became a resident alien and remained a resident for the rest of the year. Danielle and Maxime may both choose to be treated as resident aliens and must file a joint return for the election year but can file either joint or separate returns in later years.

NOTE: Once elected, both spouses are treated as US residents, who – if all other qualifying criteria are met – may claim the Foreign Earned Income Exclusion.²³

A similar election²⁴ is available to citizen or resident taxpayer who is married to a non-resident spouse, even if that spouse lives abroad. Of course, the non-resident spouse will be required to obtain a taxpayer identification number.

Bob is a US resident with \$120,000 in worldwide income. His wife lives abroad and has no income. Bob can file separately or elect to file jointly, thereby lowering his tax liability.

Mathilda and her son live permanently in the US. Her husband Friedrich joins them during the year. They may elect to file jointly or Mathilda may file separately using the Head of Household status, even though she is married because her husband (not she) is an NRA. Friedrich would then be required to file his own non-resident or dual-status return.

BEWARE: An NRA who has elected to be treated as a US resident alien – either under the First Year or the Marriage Election – is a “US person” subject to foreign bank account reporting (FBAR) and Foreign Account Tax Compliance Act (FATCA) filing obligations.

DUAL STATUS (PART-YEAR) RESIDENTS MAY ELECT:

- To back-date residency to the year of arrival, even before satisfying the SPT.
- Residency treatment if NRA files joint return with US citizen or resident alien spouse.

D. Special Note for Residents of US Territories²⁵

Full-year bona fide residents of American Samoa, Guam, Puerto Rico, the Commonwealth of Northern Mariana Islands, and the US Virgin Islands are treated as residents for US tax purposes and taxed as though they were US Citizens; but may be eligible for the Possession Exclusion²⁶ on all locally-sourced income except wages earned as US government employees.²⁷ In contrast, residents of other US insular areas²⁸ (including Baker Island, the Howland Islands, Jarvis Island, Johnston Island, Kingman Reef, the Midway Islands, Palmyra Atoll, and Wake Island) may not avail themselves of the Possession Exclusion.²⁹

²³ In fact, each spouse is treated as a US resident for the entire year for purposes of the IRC Code Chapters 1, 5, and 24, as well as §§ 6012, 6013, 6072 and 6091.

²⁴ IRC §6013(g).

²⁵ If a taxpayer moves to or from a territory and has worldwide income of more than \$75,000 that year, it is necessary to file **Form 8898 Statement for Individuals Who Begin or End Bona Fide Residence in a US Possession**. The penalty for failure to file is \$1,000.

²⁶ IRC §931.

²⁷ IRC §7701(b)(1)(B).

²⁸ The US Department of Interior defines an insular area as a jurisdiction that is neither a State nor a Federal district.

²⁹ Immigration law, on the other hand, distinguishes between US citizens and US nationals.²⁹ All US citizens are US nationals but not all nationals are citizens. A national is a person who was born in or has ties with an outlying US possession – currently only American Samoa and Swains Island – owes permanent allegiance to the US. While nationals may hold a US passport and may live and work without restrictions in the US, they cannot vote or hold elected office.



NOTE: Taxpayers with income from US possessions may have to file a tax return with the tax department of that possession only, or may have to file with both the possession and the IRS [Refer to *IRS Pub 570 Tax Guide for Individuals With Income From US Possessions*].

III. Tax Treatment of Income and Expenses

A. Income

The locale where income is earned is a moot point for US citizens and resident aliens who must report *worldwide* income.³⁰ Although some income may be exempt from taxation under various treaties or be eligible for the Foreign Earned Income Exclusion, all income (regardless of its source) must be reported on **Form 1040**. NRAs, however, need only report US-sourced income on Form 1040NR.

Dual-status aliens, on the other hand, may exclude all foreign-sourced income on **Form 1040NR** for the part of the year during which they are considered non-residents, but must then include worldwide income on **Form 1040** for the remainder of the year during which they are considered residents.

Non-US Source Income (not taxable to the NRA)

- Interest paid by a US corporation if at least 80% of the company's gross income is *derived from sources outside the US* due to active conduct of business in a foreign country in the preceding three years.³¹
- Interest if funds are *deposited into a foreign branch* of a domestic commercial bank.³²
- Corporate dividends *received from a foreign corporation* if more than 25% of the company's gross income is effectively connected with US business.³³
- Personal service compensation received for *work performed outside the US*. However, personal service income received for work performed in the US must be pro-rated based on the percentage of time worked in the US and included in US-sourced income.³⁴

Jean, an NRA, is a professional hockey player with a US hockey club. Under Jean's contract, he received \$98,500 for 242 days of play during the year which included pre-season training, regular season play and, and post-season play-offs. Jean spent 194 days performing services in the US and 48 days playing in Canada. Jean's US-sourced income is computed as follows: $(194 \div 242 \text{ days}) \times \$98,500 = \$78,963$.³⁵

³⁰ Michael Phelps, for example, was taxed on the value of the medals won at the 2016 Olympics in Rio de Janeiro; roughly \$564 each for his golds in the 200-meter butterfly and the 4 X 200 freestyle relay. (*Forbes* contributor Anthony DeMarco estimates that a silver medal would have been worth \$305 if earned in Rio but that a bronze medal would have had "little intrinsic value".) Phelps was also taxed on \$25K cash bonuses received for each gold (\$15K for silver and \$10K for bronze), although the income was likely offset by allowable business expenses (e.g., the cost of training and travel) if he treated his sports activity as a business. [Erb, *Olympic Medals and Prize Money Remain Taxable – For Now* (available at <https://www.forbes.com/sites/kellyphillips/2016/08/10/olympic-medals-and-prize-money-remain-taxable-for-now/#73658d7a2672>, last accessed April 29, 2020)].

³¹ IRC §871(i)(2)(B).

³² IRC §861(a)(1).

³³ IRC §861(a)(2).

³⁴ IRC §861(a)(3).

³⁵ Most states similarly tax out-of-state players based on an allocation of income earned while playing in state. [Dundon, *How Professional Athletes Attribute "Rest Days" for State Income Tax Purposes: A Major Controversy Brews* (available at <https://www.johnrdundon.com/how-professional-athletes-attribute-rest-days-for-state-income-tax-purposes-a-major-controversy-brews/>, last accessed April 29, 2020)].



- Gain on sale of personal property, including furniture and equipment, if the *taxpayer's tax home is not in the US*.³⁶
- Revenues from the sale of inventory is sourced where the property is sold regardless of where the items were originally *purchased* but can be pro-rated if the items were *produced* in the US and sold abroad.³⁷
- Gain on sale in excess of allowable depreciation can be pro-rated based on the amount of the depreciation taken in the US versus abroad.³⁸
- Portfolio interest unless NRA owns more than 10% of the outstanding stock.³⁹
- Gain on sale of a personal residence may be excluded up to \$250,000 (single) or \$500,000 (married) if all other applicable provisions are satisfied.⁴⁰
- US-sourced employee compensation is tax-exempt if the NRA worked for a foreign company, the NRA was only temporarily present in the US for periods less than 90 days at a time AND the wages received were less than \$3,000 in total.⁴¹

Alfred, an NRA from Kenya, worked abroad for a US company but was sent to work in the US for 2 months. He was paid \$2,500 in December 2018 and again in January 2019. Although US-sourced, Alfred's wages would have been tax exempt had he earned less than \$3,000 in total but because he received \$5,000, he will have to include his earnings in each of the taxable years.

1. Community Property Issues

State and foreign community property laws relative to community income (e.g., France, Spain, Mexico and Philippines) must be disregarded if both spouses are NRAs or one spouse is an NRA while the other is not and the marriage election under IRC §6013 is not claimed. Instead, business and partnership income are attributed to the spouse who earned it.

California, for example, has not conformed to this treatment of separate income. Since there are no Green Card or Substantial Presence Tests, immigrants to California are considered residents for tax purposes on the day that they arrive in state. It follows, then, that they must report worldwide income on the state tax return; of course, they may then also claim all deductions and credits to which any resident would be entitled. The tax liability is computed based on the ratio of California-sourced taxable to worldwide taxable income.

With few exceptions, taxpayers must use the same filing status for the California return as they did on the federal return.⁴² Therefore, NRAs and part-year residents are generally required to file as Single if unmarried and as Married-Filing-Separately if married.

³⁶ IRC §865(a)(2).

³⁷ IRC §865(b).

³⁸ IRC §865(c).

³⁹ IRC §871(h)(3).

⁴⁰ IRC §121.

⁴¹ IRC §861(a)(3).

⁴² Exceptions to the uniform filing status rule may occur when an improper filing status was used on the federal return or when one spouse is a non-resident without state-sourced income [CA Rev & Tax §18521.].

A married couple arrived in California on December 1st, 2018 from Japan and now resides permanently in the US. Since they did not meet the SPT for 2018, they must each file a non-resident federal return for 2018 and a part-year resident return for California using the MFS status. Alternatively, both spouses may agree to claim the First-Year Election, allowing them to file jointly for federal and state purposes. **NOTE:** Regardless of the federal election, a California resident spouse may choose to file separately if the non-resident spouse has no California-sourced income.

2. Connected or Not?

For the NRA, income may be either effectively or not effectively connected to the US. Effectively connected income is revenue which is derived from a US trade or business, is reported on Page 1 of **Form 1040NR**, and can be reduced by itemized deductions. The net taxable income is then subject to the graduated tax rates currently in effect. On the other hand, income which is not effectively connected is reported on Page 4 of **Form 1040NR** and cannot be reduced by deductions. Instead, it is subject to a flat tax of 30%, unless a lower treaty rate applies.⁴³

Effectively Connected Income can be identified by one of two tests:

- **Asset-use Test:** Whether income is derived from assets used in the conduct of a US business, or
- **Business-activities Test:** Whether the activities of the US business were a material factor in the realization of income.⁴⁴

Not Effectively Connected Income:

- Includes fixed, determinable or periodic income—such as interest, dividends, rents, royalties and annuities.⁴⁵
- Any income that does not meet the Asset-use or Business-activities Tests.

Effectively Connected (taxed at graduated rates)	Not Effectively Connected (taxed at 30% rate)
Wages earned in US	Interest income [subject to certain limitations discussed later]
Nonqualified scholarships	Dividends
Business income, incl. foreign-sourced income if fixed place of business in US and produced in ordinary course of business	Rental income
Partnership income	Royalty income
Gains on sale of US real estate and business assets	Capital gains (exempt if taxpayer in US less < 183 days) ⁴⁶
Pension income	Social Security benefits (85% includable unless exempt under treaty) ⁴⁷
Transportation income if fixed place of business in US and ≥ 90% attributable to regularly scheduled transportation ⁴⁸	Transportation income earned for travel that begins or ends in US but does not meet fixed place and 90% tests (taxed at 4% flat rate) ⁴⁹

⁴³ IRC §871(a).

⁴⁴ Reg. §1.864-4(c)(1)(i).

⁴⁵ Capital gains are *not* effectively connected and are taxed at a flat rate of 30% unless a lower treaty rate applies [IRC §871(a)(2)]. **HOWEVER:** Capital Gains are tax-exempt if NRA is in the US for less than 183 days.

⁴⁶ IRC §871(a)(2).

⁴⁷ IRC §871(a)(3).

⁴⁸ IRC §863(c)(2)(A).

⁴⁹ IRC §887(c).

Scholarships

Scholarships and fellowship grants are generally taxable if received from a US payer. However, “qualified” scholarships by degree candidates for tuition, books and supplies at an eligible institution are tax-exempt.⁵⁰ Scholarship payments are reported to the student on **Form 1042-S**. This amount must be transferred to **Form 1040NR**, Line 12. Any amount excluded is reported on Line 31. If the scholarship is excluded from taxation by an applicable international treaty, the amount is reported on **Form 1040NR**, Line 22 and Schedule OI, Item L.

Partnership Income

Individual foreign partners in a domestic partnership must file **Form 1040NR** on the allocated share of partnership income that is effectively connected, as well as US-sourced income that is not effectively connected if US taxes were not properly withheld at source.

Foreign partnerships with effectively connected income or income from US sources must file **Form 1065** even if the principal place of business is outside the US or all members are foreign persons.⁵¹ A foreign partnership with US-sourced income is not required to file **Form 1065** if it qualifies for either of the following two exceptions:

- a. Exception for foreign partnerships with US partners, if the partnership
 - had no effectively connected income,
 - had US-sourced income of \$20,000 or less,
 - had less than 1% of any partnership item allocable to US partners AND
 - is not a withholding foreign partnership.
- b. Exception for foreign partnerships without US partners, if the partnership
 - had no effectively connected income,
 - had no US partners at any time during its tax year,
 - filed all requisite **Forms 1042** and **1042-S**,
 - has satisfied each partner’s tax liability by withholding tax at source AND
 - is not a withholding foreign partnership.

Gambling Winnings

Generally considered to be not effectively connected, an NRA’s gambling winnings cannot be reduced by gambling losses and are taxed at a flat rate of 30%. However, certain types of gambling winnings are exempt from taxation and include blackjack, baccarat, craps, roulette, big 6-Wheel, and certain horse- and dog-racing winnings.⁵² Additionally, some international tax treaties exempt gambling winnings for residents of the signatory countries.⁵³ Canadian residents, on the other hand, may avail themselves of a special treaty provision that allows them to File **Form 1040NR** and use gambling losses to reduce or offset winnings.⁵⁴

⁵⁰ IRC §117(b).

⁵¹ Foreign corporations must file **Form 1120F**.

⁵² IRC §871(j).

⁵³ Austria, Czech Republic, Denmark, Finland, France, Germany, Hungary, Ireland, Italy, Japan, Latvia, Lithuania, Luxembourg, Netherlands, Russian Federation, Slovak Republic, South Africa, Spain, Sweden, Tunisia, Turkey, Ukraine and the United Kingdom.

⁵⁴ Article 22 (Protocol 3) of the Canada-India Income Tax Treaty.



Rental and Royalty Income

Such income is considered to be not effectively connected and cannot be reduced by deductions typically applicable to the maintenance and management of rental property. Thus, the NRA is taxed on the gross rental revenue. However, the NRA may elect to treat the rental income as effectively connected under § 871(d) and would then be allowed to deduct rental expenses, so that he would ultimately be taxed on only the net rental income.⁵⁵

Manel is a non-resident alien and is not engaged in a US trade or business. She owns a single-family house in the US which she rents out for \$10,000/year. It is her only US-sourced income. Since the rental income is considered to be not effectively connected, it is subject to tax at a 30% rate. Manel receives a **Form 1042S Foreign Person's US Source Income Subject to Withholding** showing that her tenants properly withheld this tax from rents paid to her. She does not have to file a US tax return because her US tax liability is satisfied by the withholdings. However, if she chooses to consider the rental income effectively connected, she can offset the \$10,000 income by allowable rental expenses. The resulting net income is then taxed at the usual graduated rates.

NRA's TAXABLE INCOME:

- Must be US-sourced.
- Is effectively connected if used in a US business.
- Can only be reduced by associated deductions, if effectively connected.
- Foreign community property laws are disregarded; income is attributed to the spouse who earned it.
- Excludable income includes bank interest, most investment income, gain on sale of personal residence, & de minimis wage income if only on temporary assignment in US

B. Cost Basis

Although the general rule holds that assets of aliens obtaining US residency do not receive a stepped-up basis,⁵⁶ NRAs may take advantage of a pre-immigration tax planning opportunity. By engaging in certain transactions prior to becoming subject to US taxation, the NRA could potentially re-set the cost basis of his assets.⁵⁷

TAX TIP: The NRA may sell US-sited assets to an offshore entity, thereby engaging in a transaction that recognizes a step-up in basis for US tax purposes without actually being subject to US taxation. He may then sell the asset with its stepped-up basis in the year that he becomes a US resident, avoiding most if not all taxable gains.

NOTE: The exclusion of the gain on sale of certain small business stock⁵⁸ is not applicable to foreign stock since the rules specifically mandate that the shares must be issued by a domestic (US-based) corporation.

⁵⁵ The election may be made on a property-by-property (but not year-by-year) basis by attaching a statement to the tax return for the initial year of choice and will remain in effect for all subsequent taxable years unless revoked with the permission of the Secretary of Treasury. Once revoked, the election may not be made again for five years.

⁵⁶ **EXCEPTION:** Covered expatriates – defined as lawful permanent residents during at least 8 of the last 15 years [IRC §877(e)(2)] – are subject to the Expatriation Tax when renouncing their US residency. The regime applies an exit tax on all of the departing taxpayer's assets valued on the date of departure; thereby marking these assets to market and establishing a stepped-up basis should the expatriate at some later time choose to repatriate to the US.

⁵⁷ Interestingly, Canada has a deemed acquisition rule that treats a non-resident's property outside of Canada as sold and immediately reacquired fair market value on the date that the individual becomes a Canadian resident, thereby re-setting the new resident's cost basis.

⁵⁸ IRC §1202.

C. Deductions and Adjustments

Unlike US citizens and resident aliens, NRAs may not claim the Standard Deduction and must instead itemize. **QUIRKY EXCEPTION:** Students and business apprentices from India are eligible to use the Standard Deduction under special treaty provisions.⁵⁹

Since an NRA's allowable deductions must be related to effectively connected income,⁶⁰ only state, local and real estate taxes paid as well as contributions to qualified US (not foreign) charities may be deducted; but medical, personal property taxes, and mortgage interest may not.

NOTE: Dual-status aliens may also not use the Standard Deduction but may claim *all* of the same Itemized Deductions allowed to US residents and citizens.

Additionally, the NRA may make contributions to Individual Retirement Accounts and other qualified retirement plans under the same rules which apply to US residents. The NRA may deduct student loan interest and even penalties on early withdrawals of savings if the interest income is effectively connected.⁶¹

IV. Tax Credits

NRAs with effectively connected income may only claim some of the credits available to US residents:

Credits which may be claimed by the NRA under the same rules which apply to US residents:

- Credit for Prior Year Minimum Tax
- Energy Credits
- Retirement Savings Contribution Credit

Credits available to married NRAs if they elect to file jointly with their US citizen spouse:⁶²

- Adoption Credit
- Child and Dependent Care Credit
- Earned Income Credit – available only if the NRA has a qualifying child who is a US citizen or resident and is claimed as a dependent on the tax return.
- Education Credits

Other Credits subject to special rules:

- Child Tax Credit – if the NRA has a qualifying child who is a US citizen or resident and is claimed as a dependent on the tax return.
- Credit for Other Dependents – available only to US nationals, residents of Canada, Mexico or South Korea, as well as qualified students and business apprentices from India.
- Foreign Tax Credit – may be claimed for income taxes paid to a foreign country on foreign-sourced income which is effectively connected to the US.

⁵⁹ Article 21(2) of the US-India Income Tax Treaty.

⁶⁰ IRC §873(a).

⁶¹ Reg. §1.882-5.

⁶² As per IRC §6013(h).

TAX DEDUCTIONS & CREDITS:

- NRAs may only claim Itemized (not Standard) Deductions which must be related to effectively connected income.
- Many tax credits are only available to NRA who is married to and files jointly with a US citizen spouse; only a few credits are available to the NRA under the same rules applicable to US citizens and residents.

V. Tax Return Specifics

While US citizens and resident aliens (residents) may use **Form 1040**, an NRA must use **Form 1040NR**⁶³ or **Form 1040NR-EZ**.⁶⁴

A part-year resident, also known as a dual-status alien, must use:

- **Form 1040** if he entered the US during the year and is a resident *on December 31st*; or
- **Form 1040NR** if he was a US resident who left during the year and no longer resides in the US *on December 31st*.

In either case, the returns should bear a notation at the top indicating that they include the income of a dual-status alien and a statement should be attached to allocate income earned during periods of pre- and post-residency. If filing **Form 1040**, the resident taxpayer may use **Form 1040NR** in lieu of such statement; if filing **Form 1040NR**, the non-resident taxpayer may attach **Form 1040** in lieu of the requisite statement.

A. Filing Status

Only Single (S), Married Filing Separately (MFS) or Qualifying Widower (QW) filing statuses are available to the NRA unless the NRA is married to a US citizen or resident and claims the Marriage Election. The Head of Household (HOH) status is not available to the NRA,⁶⁵ although a resident spouse may file HOH if married to an NRA who is not treated as a spouse for tax purposes.

Married NRAs may elect to file as single, *only* if:

- they reside in Canada, Mexico, or South Korea or are married to a US national (a resident of American Samoa or Northern Mariana Islands who has sworn allegiance to the US) AND
- have lived apart from their spouse for the last six months of the tax year.

In addition to US citizens, residents of Canada, Mexico, South Korea, American Samoa, and Northern Mariana Islands may file as QW if all other criteria are satisfied.

B. Dependents

While the Tax Cuts and Jobs Act (TCJA)⁶⁶ suspended the personal exemption for the taxpayer and each qualified dependent for tax years 2018 - 2025, it nevertheless remains critical to determine which members of the taxpayer's household may be claimed as dependents for the purpose of claiming tax credits and other tax benefits. As determined under the rules applicable to US citizen and resident taxpayers, a dependent is a qualifying child or relative who is a US citizen or resident, or a resident of Canada or Mexico.

⁶³ Reg. §1.6012-1(b).

⁶⁴ A taxpayer may be able to use **Form 1040NR-EZ** if his only income from US sources is wages, salaries, tips, refunds of state and local income taxes, scholarship or fellowship grants, and nontaxable interest or dividends. If the taxpayer had taxable interest or dividend income, he must use **Form 1040NR** [Department of the Treasury, *Instructions for Form 1040NR*].

⁶⁵ IRC §2(b)(3)(A).

⁶⁶ Public Law 115-97 (enacted December 22, 2017).

Nevertheless, most NRAs may not claim even otherwise qualified dependents except those NRAs eligible for the following treaty-based exceptions:

- A student or business apprentice from India may claim exemptions for a spouse with no gross income and children who are US citizens or residents.
- A South Korean resident whose spouse and children lived with him in the US at some time during the tax year may claim pro-rated exemptions based on the ratio of his US-sourced effectively connected income relative to his aggregate income from all sources.
- A resident of Canada, Mexico, American Samoa or Northern Mariana Islands whose spouse has no US-sourced income and is not the dependent of another taxpayer may claim qualified dependents under the same rules which apply to US residents.⁶⁷

Since 1996, Individual Taxpayer Identification Numbers (ITIN) have been issued by the IRS to taxpayers who are ineligible to apply for Social Security Numbers (SSN) and may be used for tax filing purposes only.⁶⁸ They do not affect the taxpayer's immigration status or work eligibility. NRA dependents and spouses must have an ITIN, as do NRAs seeking to avail themselves of tax treaty benefits or reduced withholding rates (if they do not already have an SSN).⁶⁹

To obtain an ITIN, **Form W-7 Application for IRS Individual Taxpayer Identification Number** and all documentation required to certify identity and foreign status must be attached to the front of a paper copy of the taxpayer's return and mailed⁷⁰ to:

Internal Revenue Service
ITIN Operation
P.O. Box 149342
Austin, TX 78714-9342

Once **Form W-7** has been received and an ITIN has been assigned, the IRS will process the tax return which may take up to ten weeks. **NOTE:** Taxpayers cannot electronically file a tax return using an ITIN in the calendar year that the ITIN is issued but may e-file returns in ensuing years. However, taxpayers should never request ITINs in advance for a spouse and dependents and should instead wait to make the request with a timely filed tax return.⁷¹

Under certain circumstances, **Form W-7** may be filed independently if a tax return is otherwise not required to be filed (e.g., to claim reduced withholdings).

FILING STATUS & EXEMPTIONS:

- Single NRA may generally only file S; he may not file HOH.
- Married NRA may only file MFS (or MFJ if § 6013(g) election is made).
- Only certain NRAs may claim a qualified dependent under special treaty provisions.
- The NRA's spouse and dependent – if claimed on the return – must have an SSN or ITIN.

⁶⁷ IRC §873(b)(3).

⁶⁸ An ITIN is a nine-digit number that always begins with the number 9 and has a range of 70-88 in the fourth and fifth digit. Effective **April 12, 2011**, the range was extended to include 900-70-0000 through 999-88-9999, 900-90-0000 through 999-92-9999 and 900-94-0000 through 999-99-9999.

⁶⁹ Reg. §1.1441-1(e)(4)(vii)(A).

⁷⁰ Do not mail the tax return to the address listed in the instructions for **Forms 1040**.

⁷¹ ITINs, if not used on a federal income tax return for any year during a period of five consecutive years, will expire [IR-News Release 2014-76, June 30, 2014; codified by the Consolidated Appropriations Act, 2016, Division Q Protecting Americans from Tax Hikes (PATH) Act of 2015 (P.L. 114-113) on December 18, 2015].



VI. Administrative Issues

A. Due Dates & Mailing Addresses



Like US residents, the NRA must file annually by April 15th. If, however, he did not receive any wages subject to withholdings, he may file as late as June 15th.⁷² Upon proper application, an NRA's return may be extended to October 15th. Due to the global pandemic, all taxpayers who have a filing or payment deadline that falls between April 1st and July 15th, 2020 are entitled to an automatic extension until July 15th, 2020.⁷³ The extended deadline applies to **Form 1040NR** and any FATCA forms required to be attached the individual income tax return. The COVID-extension, however, does not apply to FBAR filings which are *automatically* extended to October 15th if not filed timely on April 15th.

The completed **Form 1040NR** should be sent to:

No balance due:
Department of the Treasury
Internal Revenue Service
Austin, TX 73301-0215

With payment:
Internal Revenue Service
P.O. Box 1303
Charlotte, NC 28201-1303

Estates and trusts should mail forms to:

No balance due:
Department of the Treasury
Internal Revenue Service
Cincinnati, OH 45999-0048

With payment:
Internal Revenue Service
P.O. Box 1303
Charlotte, NC 28201-1303

B. Tax Treaties⁷⁴

The US has income tax treaties with several foreign countries which provide for reduced tax rates or exemptions from taxation of certain types of income received in the US and abroad by NRAs.⁷⁵ If a treaty does not address a particular type of income or if there is no treaty between the foreign country and the US, the income is taxed as per the instructions for **Form 1040NR**.⁷⁶ It is important to note that not all states conform to the federal treatment of income; as a result, international tax treaty provisions may not apply at the state level.

Tax treaties reduce the US tax of NRAs. With certain exceptions, treaties do not reduce the tax of US citizens or residents. Treaty provisions generally are reciprocal and apply to both treaty countries. Treaty-based positions must be disclosed on **Form 8833 Treaty-based Return Position Disclosure** which should be attached to a timely filed return.⁷⁷ A return must be filed even if a treaty-based position eliminates all taxable income. Failure to file **Form 8833** may result in a \$1,000 penalty.

⁷² Reg. §1.6072-1(c).

⁷³ IRS Notice 2020-23.

⁷⁴ Refer to *IRS Publication 901—US Tax Treaties* for additional information. **BEWARE:** Unless licensed to give legal advice, a practitioner should urge that his client to consult with an attorney about the interpretation and application of treaty provisions.

⁷⁵ IRC §894(a).

⁷⁶ The IRS has announced that it will not issue letter rulings or determination letters whether a person is entitled to benefits of a foreign tax treaty or whether, in fact, the taxpayer has met the SPT or is an NRA [IRB 2015-1, §3.01].

⁷⁷ IRC §301.6114.



Yoshi is an NRA who is single and a resident of a foreign country that has a tax treaty with the US. He received gross income of \$25,500 in 2018 from US sources, consisting of the following items: \$1,400 dividends on which the tax is limited to a 15% rate by treaty and \$24,100 compensation for personal services. Yoshi has no deductions. His tax liability is determined as follows:

Personal service compensation	\$24,100
Less: Pers. Exmptn. (\$0 as per TCJA for TY'18 – '25)	<u>0</u>
Taxable income	\$24,100
Tax as per TY'18 tax table for Single	\$2,699
Plus: Tax on gross dividends (= \$1,400 X 15%)	<u>210</u>
Total Tax Due	\$2,909

A foreign government employee's wage (not pension) income will be exempt from US taxation by treaty or by US law if the NRA performs services for the foreign government similar to those services that would be required by his US government employee counterparts.⁷⁸ **BEWARE:** The foreign taxpayer must obtain a certification of eligibility under IRC § 893(b) from the US Secretary of State that a similar exemption is available to US government employees performing services in the foreign country from which the taxpayer hails.⁷⁹

1. Foreign Account Reporting (FBAR)

A Green Card holder who under a tax treaty elects to be treated as a non-resident for US tax purposes,⁸⁰ must nevertheless comply with all foreign account reporting applicable to US citizens and residents. **FinCEN 114** must be electronically filed on or before April 15th each year⁸¹ if the individual has a financial interest in or signature authority over a foreign financial account valued in excess of \$10,000 at any time during the prior calendar year. Penalties for non-compliance are steep!

2. State Conformity

Tax treaties are agreements between foreign governments and the US – as such, they are federally binding. States, on the other hand, are not bound and often do not conform to federal tax treatment. California's *FTB Publication 1031*, for example, states that "[w]hen you are present in California for temporary or transitory purposes, you are a non-resident of California. For instance, if you come to California for a vacation, or to complete a transaction, or are simply passing through, your purpose is temporary or transitory." Therefore, the specific facts and circumstances of each taxpayer's situation (not federal tax treaties with foreign governments) will govern whether income is taxable by the state.

⁷⁸ Reg. §1.1441-4(b)(1).

⁷⁹ *Harrison* (2012), 138 TC No. 17.

⁸⁰ The lawful permanent resident must attach **Form 8833 Treaty-based Return Position Disclosure** to **Form 1040NR** to state that he should be treated solely as a resident of a foreign country under applicable tie-breaker rules of a relevant treaty [Treas. Reg. §301.7701(b)-7(b)].

⁸¹ An automatic six-month extension until October 15th is available. The FBAR filing deadline for US citizens and residents residing abroad is automatically extended until June 15th, with an additional four-month extension available until October 15th [Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (Pub. Law 114-41)].



C. Special Reporting Rules

Calendar Year

If income was earned abroad in countries which use a different tax year, the taxpayer must allocate income and expenses to accurately reflect and report what was earned on a calendar-year basis on his US return.

Foreign Currency

All amounts reported on US tax returns must be reported in US dollars. If income was earned abroad and received in foreign currency, it must be converted into US dollars at the prevailing exchange rate on the date the income was received. If income was earned evenly throughout the year, the taxpayer may use an average exchange rate for the period if the foreign currency was in fact reasonably stable.⁸²

Depreciation

Real property outside of the US used in a trade or business must be depreciated on a straight-line basis over a 40-year period; personal property held abroad must be depreciated over a 12-year period.⁸³

The depreciable basis equals the cost of acquisition converted to US dollars using the currency exchange rate on the date of acquisition. For resident aliens, basis must be reduced by the amount of depreciation that would have been allowable (under US rules) during the period that the individual was an NRA, prior to changing residency status. **NOTE:** There is *no* automatic step-up in basis on the date of residency change, although certain transactions such as the sale of an asset to an offshore business entity may yield a basis step-up.

Sales Proceeds

Capital gains resulting from the sale of real property held abroad must be computed based on the difference between the sales proceeds (converted to US dollars using the exchange rate in effect on the date of sale) and the acquisition cost (converted to US dollars using the exchange rate in effect on the date of purchase). NRAs may claim the IRC §121 exclusion of the gain on sale of a personal residence (if otherwise eligible) but will be subject to the exclusion's limitations when filing MFS. **NOTE:** Due to varying currency exchange rates, the taxpayer may be taxed on an unrealized gain if the exchange rate declined between the date of purchase and the date of sale.⁸⁴

Additional Reporting

- Gifts and inheritances received from abroad must be disclosed on **Form 3520 Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts** if they exceed \$100,000.
- Owners of foreign entities may be required to file **Form 5471 Information Return of US Persons with Respect to Certain Foreign Corporations**, **Form 8858 Information Return of US Persons with Respect to Foreign Disregarded Entities**, **Form 8865 Return of US Persons with Respect to Certain Foreign Partnerships**, amongst others.
- Certain transfers of property to foreign corporations must be disclosed on **Form 926 Return by a US Transferor of Property to a Foreign Corporation**.

⁸² Many online currency converters are available; for example, www.oanda.com/currency/converter/ (last accessed April 29, 2029).

⁸³ IRC §168(g).

⁸⁴ If the property was encumbered by a mortgage on the date of sale, the taxpayer must *also* calculate the gain or loss resulting from the foreign exchange rate conversion when the loan is paid off. If the exchange rate increased in the period between loan inception and loan pay-off, it will cost the taxpayer more to repay the debt and, therefore, the taxpayer will realize a loss. If the mortgage was used to purchase a personal residence, this loss is non-deductible [IRC §165]. On the other hand, any gain attributable to a decrease in exchange rates will be reportable as ordinary income.

D. Net Investment Income Tax (NIIT)

As of January 1, 2013, certain high-income US taxpayers (as well as some estates and trusts) are required to pay a 3.8% surtax on the lesser of (1) net investment income or (2) the amount of modified adjusted gross income (MAGI) which exceeds the applicable threshold (\$200,000 for Single; \$250,000 for Married-Filing-Joint). Although the surtax does not apply to NRAs,⁸⁵ it of course applies to NRA spouses who are US citizens and resident aliens. These individuals must file as unmarried – unless claiming the Marriage Election – and are, therefore, subject to a MAGI threshold amount of only \$125,000.

Healthcare Insurance

The NIIT was instituted under the Affordable Care Act of 2010 to help fund the expansion of healthcare coverage. The act requires that citizens and resident aliens must have minimum essential health insurance or be subject to a shared responsibility payment [read: penalty]. Residents of US territories, foreign nationals who have not satisfied the SPT, and US citizens living abroad for at least 330 days within a 12-month period are not required to have insurance coverage and are, therefore, not subject to the penalty.⁸⁶

F. Estimated Tax Payments

NRAs must make estimated tax payments (ES) under the same rules as US residents. However, if an NRA does not have any wages subject to withholding, the first ES payment normally due April 15th may be postponed until June 15th; at which time, one-half (rather than one-quarter) of the total annual ES liability must be paid. The remaining balance may then be paid in quarterly installments on September 15th and January 15th.



Due to the COVID-19 pandemic, the IRS has extended the payment deadlines for both first and second quarter payments (normally due 4/15 and 6/15) until July 15th, 2020.⁸⁷ Therefore, NRAs – already exempt from the April 15th deadline – may defer payment of the combined ES liability until July but must then submit an amount equal to one-half of the total annual ES liability.

G. Withholdings

The NRA is subject to tax withholdings on wages earned and must provide his employer with **Form W-4** indicating “Single and 1” or preferably “Single and 0”, since the NRA in all likelihood will not be able to claim any dependents.⁸⁸

The NRA is also subject to Social Security and Medicare withholdings unless he is in the US on a student visa performing only on-campus work⁸⁹ or can claim an exemption from withholdings based on an applicable treaty.⁹⁰ **NOTE:** An NRA who is self-employed is not subject to the Self-

⁸⁵ Bona fide residents of US territories may be subject to the surtax depending upon whether they are residents of Guam, Northern Mariana Islands or the US Virgin Islands (not subject to the surtax); or Puerto Rico or American Samoa (subject to surtax). Treas. Reg. 1.1411-2(a)(2)(iv).

⁸⁶ The federal penalty was repealed for tax years 2019 and beyond.

⁸⁷ IRS Notice 2020-23.

⁸⁸ The IRS recommends that NRAs complete **Form W-4** using the modified instructions in Notice 1392 since NRAs cannot claim the standard deduction. **EXCEPTION:** No withholdings are required for an NRA employee of a foreign employer if employee’s pay is less than \$3,000/year and employee is temporarily present in US for less than 90 days.

⁸⁹ IRC §3121(b)(19).

⁹⁰ The NRA must file **Form 8233 Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual** with his employer to claim a treaty-based exemption and should not complete **Form W-4**.



employment Tax (SE Tax) unless he is a resident of Puerto Rico, Virgin Islands, Guam or Northern Mariana Islands.

Raul authored and published a book in Argentina while he was a resident there. He later moved to the US, received his Green Card and continued to receive royalties from the foreign publisher. Once a resident alien, Raul must report his royalties as self-employment income and must pay SE Tax on these earnings.

If a Social Security or Totalization Agreement is in effect between the US and a foreign country, the employee will only pay Social Security tax to the country in which he is working.⁹¹ However, if he normally works abroad but is sent to the US to work temporarily, he will pay Social Security taxes only to his home country.⁹²

Although an NRA may be subject to Social Security tax in the US, he will not necessarily be entitled to collect future benefits. Much will depend on the taxpayer's place of residence, current citizenship and applicable bilateral agreements (or lack thereof) in effect at the time the taxpayer seeks to collect. He should contact the Social Security Administration for evaluation of his status and potential processing of his claim.

Pension income is subject to an automatic withholdings rate of 30% unless the NRA uses **Form W-8ECI** to elect that his pension be treated as effectively connected and taxed at graduated rates. And upon disposition of real property, 15% of the amount realized will be automatically withheld.⁹³ **Form W-8BEN** may be filed to request an exemption or reduction from automatic withholdings due to treaty provisions.⁹⁴

PAYROLL TAX WITHHOLDINGS

- NRA's wage income is subject to income tax & FICA withholdings.
- NRA students working on-campus are exempt from FICA taxes.
- Most self-employed NRAs are not subject to SE Tax.
- Totalization agreements ensure that Social Security taxes are paid only to the country in which the employee works (not lives).

G. State Rules

Individual states may have differing rules applicable to non-residents which should be verified on a case-by-case basis. California, for example, considers everyone present in the state—regardless of the length of time spent—to be a “resident”.⁹⁵ Therefore, everyone must file either

⁹¹ Reg. §301.6114-1(c)(vi).

⁹² The US currently has Social Security agreements in effect with 30 countries - Australia (2002), Austria (1991), Belgium (1984), Brazil (2018), Canada (1984), Chile (2001), Czech Republic (2009), Denmark (2008), Finland (1992), France (1988), Germany (1979), Greece (1994), Hungary (2016), Iceland (2019), Ireland (1993), Italy (1978), Japan (2005), Luxembourg (1993), the Netherlands (1990), Norway (1984), Poland (2009), Portugal (1989), Slovak Republic (2014), Slovenia (2019), South Korea (2001), Spain (1988), Sweden (1987), Switzerland (1980), the United Kingdom (1985), Uruguay (2018). [as per Social Security Administration, https://www.ssa.gov/international/agreements_overview.html, last accessed April 29, 2020].

⁹³ IRC §1445(a).

⁹⁴ Reg. §1.1441-1(d).

⁹⁵ In fact, California's tax regime is domicile-based, whereby the state defines “domicile” as the place where a taxpayer voluntarily establishes himself, not merely for a special or limited purpose but with the intention of making it his true, fixed and permanent home. It is the place where, whenever absent, the taxpayer intends to return. It is, therefore, very difficult to escape state taxation unless most (if not all) ties to the state are cut. However, California offers a Safe Harbor Rule which provides that an individual domiciled in California who is outside California under an employment-related contract for an uninterrupted period of at least 546 consecutive days will be considered a non-resident unless the individual has intangible income exceeding \$200,000 in any taxable year during which the employment-related contract is in effect or the principal purpose of the individual's absence is to avoid personal income tax [California Revenue and Taxation Code §17014].



Form 540 if present in-state for the entire year or **Form 540NR** if present only part of the year.⁹⁶ A non-resident's income from certain sources (such as income from business activities outside of the state) may be apportioned, while other income (such as out-of-state wages, interest and dividends) is not subject to in-state tax.

Additionally, California requires the filing of **Form 592 Resident and Nonresident Withholding Statement** along with **Form 592-V Payment Voucher for Resident and Nonresident Withholding** by any individual or entity making payments of California-sourced income to non-resident (out-of-state) individuals, partnerships, corporations, estates or trusts that do not have a permanent place of business in-state. Tax is required to be withheld at a rate of 7% on compensation for services performed, rents and royalties for properties in California, estate and trust distributions, prizes and lottery winnings, as well as partnership income. **Form 592** must be filed, and withholdings must be submitted quarterly on April 15th, June 15th, September 15th and January 15th.

VII. Estate and Gift Taxes

US citizens and residents are subject to the US estate and gift tax laws. For estate and gift tax purposes, residency is not determined in the same manner as it is for income tax purposes. Rather than by application of the Green Card or Substantial Presence Tests, a decedent quite simply is considered to have been a "resident" *if he was domiciled in the US at the time of his death*. If he lived in the US, even for a brief period of time, and did not have any definite intention of returning to a foreign country, he is deemed domiciled in the US.⁹⁷ The estate's executor must file an **Affidavit of Domicile** to certify the decedent's place of residence at the time of death.

The gross estate of US-domiciled NRAs subject to US estate taxation includes *all tangible and intangible property located in the US*.⁹⁸ The deduction for allowable administrative expenses is limited by the ratio of the NRA decedent's US gross estate to his worldwide gross estate. NRAs are entitled to a limited marital deduction⁹⁹ and only allowed the unlimited marital deduction *if the surviving spouse either already is a US citizen or becomes a US citizen by the due date (plus extensions) of the tax return*, or if the assets are left to a qualified domestic trust, or if treaty provisions stipulate accordingly.¹⁰⁰ NRAs are allowed a mere \$60,000 estate exclusion¹⁰¹ (and no portability of a deceased spouse's unused estate tax exemption) rather than the inflation-adjusted amount exclusion currently allowed to US citizens.¹⁰² To ensure proper application of these provisions, NRAs must use **Form 706NA, United States Estate Tax Return - Estate of Nonresident Not a Citizen of the United States**.

Foreign estates—defined as those of US citizens who are permanent residents of foreign countries, whose assets are located entirely abroad, and whose fiduciaries are foreign corporations located abroad—are subject to US taxation only on income derived from US sources or income that is effectively connected.

⁹⁶ As per the federal Veteran's Benefits and Transaction Act of 2018, a military spouse may now elect a non-tax or low-tax state as his or her state of residence even if the couple is stationed in California, as long as the service member is an out-of-state resident. This supersedes the Military Spouses Residency Relief Act of 2009 which only allowed the election if the non-military spouse shared the same domicile as the service member prior to his or her move to be with the military spouse.

⁹⁷ *Estate Planning Tools for Nonresident Aliens* available at Lexis Hub for New Attorneys.

⁹⁸ IRC § 2103.

⁹⁹ \$157,000 in 2020.

¹⁰⁰ IRC §2056(d).

¹⁰¹ Applicable Unified Credit in 2020 is \$4,577,800 which equates to an estate exclusion of \$11.58 million.

¹⁰² IRC §2102(b).

NRAs are subject to tax on gifts of US-situated property (i.e. real estate and tangible personal property located within the US). However, NRAs generally are exempt from gift tax on transfers of intangibles, such as stock and securities, regardless of where the property is situated.¹⁰³ Cash gifts are subject to US gift tax. NRAs enjoy the same annual gift tax exclusion as US citizens¹⁰⁴ but may not elect gift-splitting between spouses.¹⁰⁵ NRAs must report taxable gifts and compute the attendant gift tax liability on **Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return** but must diligently apply the nuanced rules since **Form 709** is shared with US citizen and resident taxpayers and only the form's instructions – but not line entries – serve to highlight applicable rule differences.

ESTATE & GIFT TAX RULES

- US citizens, residents and those domiciled in the US are subject to US estate tax.
- Domicile is determined by the taxpayer's intent to remain in the US.
- Gross Estate of US-domiciled NRAs consists only of US-based property.
- Deductions & exclusions for US-domiciled NRAs are limited.
- NRAs must pay gift tax on transfers of real estate & tangible (but not intangible) property.

VIII. Leaving the US

Aliens leaving the US must apply for an exit permit in person at a local IRS office no sooner than 30 days prior to their scheduled departure by filing **Form 1040C US Departing Alien Income Tax Return** and paying any tax due. The taxpayer may instead file the shorter **Form 2063 US Departing Alien Income Tax Statement** if he has previously filed all requisite income tax returns, paid all taxes due, and does not have any taxable income in the year of departure or the preceding year.¹⁰⁶ Filing **Forms 1040C** or **Form 2063** does not, however, satisfy the taxpayer's final tax return filing requirement; he must, therefore, file his normal US return on **Form 1040** or **Form 1040NR**, whichever is applicable. Any amounts paid with **Form 1040C** may be deducted against his final tax liability.

Certain aliens are exempt from exit permit filing, including

- Foreign government diplomats.
- Employees of international organizations whose wages are tax-exempt and who receive no other income from US sources.
- Students, industrial trainees, and exchange visitors (as well as family members) who receive no US-sourced income except reimbursement of incidental expenses.
- Students on "M1" or "M2" visas who receive only interest income that is not effectively connected.
- NRAs only temporarily in the US who receive no taxable income during their stay in the US.
- Residents of Canada or Mexico who commute in and out of the US and whose US wages are subject to payroll withholding.¹⁰⁷

¹⁰³ IRC §2501(a)(2).

¹⁰⁴ IRC §2503(b).

¹⁰⁵ IRC §2513(a)(1).

¹⁰⁶ Reg. 1.6851-2(b).

¹⁰⁷ IRC §6851(d)(1).



IX. Tabular Summary of Filing Requirements

	US Citizen & Resident	Non-resident Alien (NRA)	Dual-Status Alien	Exempt (Teachers/Students)	Illegal Alien
Lives in US?	Yes	No	Part-Year	Yes	Yes
Which form?	1040	1040NR	<ul style="list-style-type: none"> 1040 if resident on 12/31 1040NR if non-resident on 12/31 	1040NR	1040
Taxable Income?	Worldwide	US-sourced	<ul style="list-style-type: none"> US-sourced while NRA Worldwide while resident 	US-sourced	Worldwide
Tax Rules	All familiar rules apply	<ul style="list-style-type: none"> Cannot file MFJ unless Marriage Election made Generally, no dependency exemptions Cannot claim standard deduction Only limited itemized deductions allowed 	<ul style="list-style-type: none"> Cannot file MFJ unless full year residence or Marriage Election made Cannot file HOH Cannot claim standard deduction Can claim all allowable itemized deductions 	<ul style="list-style-type: none"> Cannot file MFJ unless Marriage Election made Generally, no dependency exemptions Cannot claim standard deduction Only limited itemized deductions allowed 	All familiar rules apply

X. Tabular Summary of Available Elections

Title	Source	Description	Tax Benefit
First-Year	IRC §7701	Back-date residency	File as US resident
Marriage	IRC §6013	File jointly with citizen spouse	Eligible for certain credits & increased MAGI threshold for NIIT
Rental Income	IRC §871	Treat as effectively connected	Deduct rental expenses
Sale of Real Estate	IRC §1441	Claim treaty position (if applicable)	Avoid automatic 15% w/h
Pension Income	IRC §1445	Treat as effectively connected	Avoid automatic 30% withholding
Filing Status	Treaty	Married NRA from Canada, Mexico or South Korea may file as "Single"	Does not need to use Married-Filing-Separate (MFS) filing status
Military Spouse	Veteran's Act 2018	Claim residency in service member's resident state	File in low-tax state even if resident in high-tax state while service member on duty

APPENDIX A

Visa Types: Employment Restrictions & NRA Taxation

Type of Visa	Work Restrictions	NRA Withholding Requirements
Foreign Government Officials A-1 & A-2 Officials and their dependents A-3 Attendant or personal employee of official	Some dependents may work if USCIS-approved May only work for A-1 or A-2 visa holder	Exempt for SPT day count; subject to FICA N/A since employed by foreign govt.
Visitors B-1 Temporary visitors for business B-2 Temporary visitors for pleasure	No work authorization No work authorization	N/A N/A
Aliens in Transit C-1 Transit visa C-2 In transit to United Nations C-3 Attendant of govt. official in transit	No work authorization No work authorization No work authorization	N/A N/A N/A
Crewmen D Foreign crewmen	May only work for vessel or aircraft	N/A
Treaty Trades and Investors E-1 Treaty trader, spouse or child E-2 Treaty investor	Work authorized for the sponsoring employer only Work authorized for the sponsoring employer only	SPT day count required; subject to FICA SPT day count required; subject to FICA
Academic F-1 Academic Students F-2 Dependents of F-1	On-campus work authorized for ≤ 20 hours/week No work authorization	SPT exempt for 1 st 5 years; FICA exempt N/A
International Organizations G-1, G-2, G-3 and G-4 Employees G-5 Attendant or employee of G-1, 2, 3, or 4	Work authorized for the sponsoring employer only May only work for G-1, 2, 3, or 4	SPT day count required; subject to FICA N/A since employed by foreign organization
Temporary Workers H-1B Worker in Specialty Occupation H-1C Registered Nurse H-2A Agricultural Workers H-2B (Un)skilled Workers for Labor Shortage H-3 Trainee H-4 Dependents of H-visa holders	Work authorized for the sponsoring employer only Work authorized for the sponsoring employer only Work authorized for the sponsoring employer only Work authorized for the sponsoring employer only Work authorized for the sponsoring employer only No work authorized	SPT day count required; subject to FICA SPT day count required; subject to FICA SPT day count required; subject to FICA SPT day count required; subject to FICA SPT day count required; subject to FICA N/A
Foreign Media I-1 Journalists	Work authorized for the sponsoring employer only	N/A since employed by foreign news org.
Exchange Visitors J-1 Visitors incl. exchange students & scholars J-2 Dependents of J-1	May work only for program sponsor only Work authorized under certain circumstances	SPT exempt for 1 st 5 years; FICA exempt SPT exempt for 1 st 5 years; FICA exempt
Fiancés K-1 Fiancé of US citizen K-2 Fiancé's child	Work authorized & must marry w/i 90days No work authorized	SPT day count required; subject to FICA N/A
Intra-company Transferees L-1 Transf'd fr. overseas subsidiary or affiliate L-2 Dependents of L-1	Work authorized for the sponsoring employer only May work if authorized	SPT day count required; subject to FICA SPT day count required; subject to FICA
Vocational and Language Students M-1 Vocational Student M-2 Dependents of M-1	Work authorized under certain circumstances No work authorization	SPT exempt for 1 st 5 years; FICA exempt N/A
Workers with Extraordinary Abilities O-1 Science, education, bus., athletics or arts O-2 Accompanying Workers O-3 Dependents of O-1 or O-2	Work authorized for the sponsoring employer only Work authorized for the sponsoring employer only No work authorization	SPT day count required; FICA exempt SPT day count required; FICA exempt N/A
Athletes and Entertainers P-1 Internat'lly known athletes & entertainers P-2 Performers under exchange program P-3 Culturally unique entertainers P-4 Dependents of P-1, 2, 3	Work authorized for the sponsoring employer only Work authorized for the sponsoring employer only Work authorized for the sponsoring employer only No work authorization	SPT day count required; subject to FICA SPT day count required; subject to FICA SPT day count required; subject to FICA N/A
Cultural Exchange Visitors Q-1, Q-2 International Cultural Exchange Q-3 Dependents of Q-1 & Q-2	Work authorized for the sponsoring employer only No work authorization	SPT exempt for 1 st 5 years; FICA exempt N/A
Religious Workers R-1 Religious Workers R-2 Dependents of R-1	Work authorized for the sponsoring employer only No work authorization	SPT day count required; subject to FICA N/A
North Amer Free Trade Agrmt (NAFTA) TN Canadian (TN-1) or Mexican (TN-2) TD Dependents of TN-1 or TN-2	Work authorized for the sponsoring employer only No work authorization	SPT day count required; subject to FICA N/A
Lawful Permanent Residents (LPR) V-1 Spouse of LPR V-2 Unmarried child of LPR	Work authorized Work authorized	SPT day count required; subject to FICA SPT day count required; subject to FICA



APPENDIX B Glossary of Terms

Abode	Taxpayer's domestic home where he maintains his family, social and political ties.
Accidental American	A citizen of a country other than the US who may also be considered a citizen of the US or eligible for US citizenship, but is not aware of having such status which may lead to inadvertent residency for tax purposes
Alien	A person from another and very different family, people, or place; a creature from outer space; a plant or animal that occurs in a region to which it is not native; a person who owes political allegiance to another government; a non-US citizen.
Asset-use Test	Effectively connected income is derived from assets used (in)directly by a US business.
Business-activities Test	Effectively connected income results from business activities that are material to its production.
Domicile	Permanent home to which the taxpayer intends to eventually return.
Dual-status Aliens	Also known as Part-year Residents.
Dual Citizen	An individual regarded as a national by more than one country, with the option to be treated as a citizen by one or both based on treaty provisions.
Effectively Connected Income	Is taxed at graduated rates.
Green Card	Also known as Alien Registration Card.
Illegal Alien	An undocumented immigrant who entered the US without authorization or an alien who once entered legally and then overstayed his welcome.
Immigrant	An alien who has been granted the right by the USCIS to reside permanently in the US and work without restrictions.
Insular Area	A jurisdiction that is neither part of a state nor federal district but is overseen by the US Congress, including 3 in the Caribbean and 11 in the Pacific. All have a civilian government, a constitution, and enjoy some degree of local political autonomy. Congress has extended citizenship rights by birth to all inhabited territories except American Samoa [see US National below].
ITIN	Individual Taxpayer Identification Number issued by IRS in lieu of Social Security Number (SSN) or Employer Identification Number (EIN).
Long-term US Resident (LPR)	A lawful permanent resident who has resided in the US for at least 8 of 15 years
Naturalization	The legal act or process by which a non-citizen in a country may acquire citizenship or nationality.
No-match Letters	Issued if SSN on W-2 does not match Social Security Administration's records.
Non-immigrant	An alien who has been granted the right to reside temporarily in the US.
Not Effectively Connected Inc.	Is taxed at 30%.
NRA	Non-resident Alien.
Physical Presence Test (PPT)	Taxpayer must be physically present in a foreign country for at least 330 full days during a period of 12 consecutive months to be eligible for the Foreign Earned Income or Foreign Housing exclusions.
Sailing or Departure Permit	Certification verifying that aliens leaving the US do not have any outstanding tax liabilities.
§ 871(d)	Election to treat rental income as effectively connected.
§ 7701	First-Year Election to be treated as a resident.
§ 6013	Election by a married couple to treat NRA spouse as a resident.
Substantial Presence Test (SPT)	Used to determine US residency status.
Tax Home	The taxpayer's place of business or employment.
Totalization Agreements	Eliminate dual coverage and dual contributions of social security taxes.
USCIS	US Citizenship and Immigration Services (formerly INS).
US National	A resident of American Samoa who has sworn allegiance to the US.

