Chapter 9

FEDERAL TAXATION OF RESIDENT ALIENS

Jennifer A. Mace[1]

9.1 INTRODUCTION

Planning a foreign national's transfer to the United States requires consideration of a number of tax and non-tax related matters. This chapter summarizes some of the key tax considerations for a foreign national's move to the United States. Throughout the chapter, the focus will be on the taxation of a U.S. resident alien. To understand the taxation of a U.S. resident alien, however, it is important to have a general understanding of the taxation of a non-resident alien.

A resident alien, as determined by meeting one of the tests mentioned below, is taxed much the same as a U.S. citizen. As with a U.S. citizen, a resident alien is subject to worldwide taxation on items of gross income. Furthermore, a resident alien is allowed the same deductions available to a U.S. citizen.

In the case of a foreign national who does not meet one of the two tests described below, the individual would be considered a non-resident alien. Taxation of a non-resident alien is limited to income from U.S. sources, with some exceptions. Due to the limited scope of taxation, the deductions allowed for a non-resident alien are also limited.

It is important to note that in the year of arrival to, and departure from, the United States, it is possible to be considered both a resident alien and a non-resident alien. Foreign nationals who fall into this situation are considered dual-resident taxpayers.

9.2 RESIDENCY

In the United States, the term foreign national is used to describe individuals who are non-U.S. citizens – also referred to as aliens. A foreign national will either be considered a resident alien or a non-resident alien for U.S. tax purposes. The distinction between the two categories is crucial to understanding the taxation of a foreign national in the United States.

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[1] Jennifer A. Mace is a Certified Public Accountant at Clark Nuber, P.S.

U.S. residency for a foreign national is determined based on satisfying either one of two separate tests. In the event a foreign national meets either of the two tests discussed below, the individual would be considered a resident alien for at least part of the year. If the individual meets both of the tests below in the same year, then the U.S. residency start date is the earliest date in which one of the tests is met.

9.2.1 Green Card Test

The first of the two tests is the "lawful permanent resident" test, also known as the "green card" test. Under this test, a foreign national is considered a U.S. resident if the individual holds an alien registration card (also referred to as a green card) for immigration purposes. Physical presence in the United States is generally irrelevant under this test with the exception of the initial effective date of U.S. residency. Once the green card is received, U.S. residency will start on the first day of presence in the United States with a valid green card. If a green card holder does not travel to the United States in the year the green card is received, then U.S. residency begins on the first day of the next year, regardless of whether the green card holder ever comes to the United States.

U.S. residency continues for green card holders for as long as a valid immigration card is held. See Section 9.10 regarding expatriation, which is the step necessary to break U.S. residency for green card holders.

9.2.2. Substantial Presence Test

The substantial presence test is based solely on the number of days physically present in the United States. Under this test, residency is triggered once the number of days physically present in the United States, over the course of a three-year period, exceeds the threshold determined by the Internal Revenue Code. The three-year period includes the total days physically present in the current year as well as looking back to the previous two years. The criteria for resident status under this test are:

1. The foreign national must be physically present in the United States on at least 31 days during the current calendar year, and

2. The foreign national must be physically present in the United States on at least 183 days during the three-year period, using the look-back formula:

    a. 1/6 of Second Prior Year Days, plus
    b. 1/3 of First Prior Year Days, plus
    c. All Current Year Days

Example: A taxpayer arrives in the United States on February 1, 2009, for a 9 day vacation. The taxpayer then moves to the United States on June 15, 2009. The taxpayer spent 21 days in the United States during 2008 and 30 days during 2007. The three-year look-back rule would apply as follows:

1/6 of 2007 days: 5
1/3 of 2008 days: 7
All of 2009 days: 209

Total Days of Presence: 221

In this example, the taxpayer would be considered a resident for U.S. tax purposes as of June 15, 2009, under the substantial presence test.

When a foreign national meets the substantial presence test, the start date of residency will generally be the date of arrival in the United States. There is a nominal presence exception available, however. The nominal presence exception may be used to disregard up to 10 days of physical presence when determining a residency start date of a foreign national. As shown in the example, these days would still be included in the calculation to determine whether a foreign national is considered a resident under the substantial presence test.

If the February trip in the above example was for 11 days, then the residency start date would be February 1st because the nominal presence exception would not be met. If a foreign national is moving to the United States from a country without an income tax treaty with the U.S., then it is very important to monitor travel to the U.S. prior to an individual's move so as to not exceed 10 days. Failure to do so may result in more foreign income subject to U.S. taxation and potentially more tax due.

For non-Green Card holders, U.S. residency is broken when the foreign national leaves the U.S. with no intent to return and establishes residency in a new country. It is important to monitor travel back to the United States in the year of departure to avoid extending U.S. residency. The same 10 day nominal presence exception applies in the year of departure.

9.3 NON-RESIDENT ALIEN TAXATION

If a foreign national does not meet one of the two residency tests listed above, the individual would be considered a non-resident alien for tax purposes. Non-resident aliens are taxed only on income from U.S. sources. Income can be considered effectively connected to a U.S. trade or business or not effectively connected income. For a non-resident alien, whether income is considered effectively connected versus not effectively connected determines how the income is taxed.

9.3.1 Not Effectively Connected Income

Income not effectively connected to a U.S. trade or business is generally subject to a flat statutory tax of 30 percent on the gross amount, without a deduction allowed for associated expenses. Reduced tax rates are available, however, depending upon the type of income and whether U.S. tax treaties apply. Income considered not effectively connected to a U.S. trade or business includes, but is not limited to:

- Interest
- Dividends
- Rents & Royalties
- Other fixed or determinable annual or periodic (FDAP) income

In the case of certain types of interest income, the amount of income may be considered excluded from U.S. taxation under the Internal Revenue Code.

9.3.2 Effectively Connected Income

The tax calculated on income effectively connected to a U.S. trade or business is determined on a net basis. When calculating the tax on effectively connected income, certain deductions are allowed to arrive at a net taxable income. Effectively connected income is then taxed using the graduated rates of the U.S. tax system (see Section 9.8 for a further discussion of the U.S. tax rates). For a foreign national, effectively connected income can arise when a foreign national is working in the United States either on behalf of an employer or as a self-employed individual. Also, a foreign national who invests in a U.S. trade or business may have reportable effectively connected income from the business activities.

9.4 RESIDENT ALIEN INCOME TAXATION

If it is determined that a foreign national is considered a resident for U.S. tax purposes, he or she will be taxed on his or her worldwide income in the same manner as a U.S. citizen. Worldwide income includes any income received from anywhere in the world. Resident taxation begins on the start date of residency based on either one of the two tests mentioned above. Thus, it is possible to be taxed as a resident for only part of the year.

9.4.1 Worldwide Taxation

Determining gross income of a resident alien is fairly straightforward. All income, regardless of source, is considered taxable once a foreign national becomes a U.S. resident. In general, the types of income included are:

- Compensation income
- Interest, dividends, and other investment income
- Business income
- Capital gains
- Rental income
- Pension income

While the United States does have methods of mitigating double taxation through foreign tax credits, worldwide income must still be reported when filing a U.S. income tax return. For example, if a U.S. resident has capital gain income from shares of stock originally held in the foreign national’s home country, the income from the sale must be reported in the United States even though the income was generated outside of the United States.

9.4.2 Foreign Tax Credits

A credit for foreign taxes paid is allowed for either the amount of tax accrued or paid to the foreign country, or the amount of the U.S. tax liability associated with the foreign source income, whichever is less. If tax is paid to a foreign country on the capital gain income, as in the example above, then a credit would be allowed in the United States to the extent of the U.S. tax.

9.5 IMPACT OF TAX TREATIES

In addition to foreign tax credits, tax treaties may also help mitigate double taxation for individuals whose income is taxed by the United States and a foreign treaty country. Common treaty articles of note for U.S. residents include the residence or “tie-breaker” clause, reduced tax rates on certain types of income, and exclusion from income for certain personal service income.

9.5.1 Tie-Breaker Rules

In some cases the laws of the United States and of another country may consider a foreign national to be a simultaneous resident of both countries. Typically, a treaty will include a “tie-breaker” provision to classify a foreign national as a tax resident in only one country. The tie-breaker rule will override the domestic laws of each of the countries and determine residency based on the factors listed in the applicable treaty.

9.5.2 Reduced Withholding Tax Rates

Most treaties provide for a reduced withholding tax rate for certain types of income paid to a resident of another treaty country. The majority of treaties have provisions of this nature for interest, dividend and royalty payments. When payments are made from a resident alien’s home country, taxes withheld by the home country can be reduced via the benefits of the income tax treaty between the United States and the home country.

9.5.3 Personal Service Income

Personal service clauses generally allow for the exclusion of income from taxation when a resident of one country does not spend more than the specified number of days in another treaty country. For example, if a U.S. resident travels to a foreign treaty country for business, the income the individual earns while working abroad will not be taxable by the foreign country provided the individual is not present in the foreign country longer than the amount of time allowable under the treaty. While treaties may vary regarding the number of days a person may be present, the general limit is less than 183 days in the non-resident country during either a taxable year or a 12-month period. This treaty provision generally requires that the income be paid from/or borne by the resident country to be exempt from taxation in the non-resident country.

9.6 INCOME ADJUSTMENTS AND DEDUCTIONS

As with items of income, the availability of adjustments to income and deductions will depend on a determination of residency. A non-resident alien is only allowed to claim certain deductions against effectively connected income. No deductions are typically allowed against income that is not effectively connected. A resident alien, however, may claim the income adjustments and deductions available to a U.S. citizen.

9.6.1 Resident Alien

A resident alien may claim adjustments and deductions available to a U.S. citizen. These include trade or business deductions, adjustments to gross income, itemized deductions or a standard deduction, and exemptions.

Deductions are allowed for ordinary and necessary expenses that are incurred in the course of conducting a trade or business. These deductions directly reduce the income from the trade or business.

The following are examples of allowable adjustments to gross income:

- Educator expenses
- Health savings account contributions
- Moving expenses
- Certain contributions to retirement plans
- Student loan interest

In addition to the above, a resident may claim either the standard deduction or itemized deductions, whichever is greater. The standard deduction depends upon one's filing status (for example, single or married filing a joint return. See Section 9.7 for a discussion of filing status options in the United States). A single individual's standard deduction is $5,700 for 2009. A married individual filing a joint return with his or her spouse may claim a standard deduction of $11,400 for 2009. The types of itemized deductions available to a resident alien include:

- Medical and dental expenses
- State and local income taxes
- Mortgage interest
- Property taxes
- Charitable contributions to qualified U.S. charities
- Casualty and theft losses
- Limited miscellaneous deductions (i.e. tax preparation fees, etc.)

If total itemized deductions exceed the standard deduction, a resident alien may claim the higher itemized deductions to arrive at taxable income. In the event an individual is considered a dual-resident taxpayer during the tax year, only itemized deductions are available. The standard deduction is only available to an individual who is a full-year U.S. resident.

A resident alien may also claim a personal exemption of $3,650 for 2009 as well as additional exemptions for a spouse and children, as long as the spouse and children are also considered U.S. residents. Itemized deductions (or the standard deduction) and exemptions are deducted from adjusted gross income, to arrive at taxable income.

9.6.2 Non-Resident Alien

Because of the limited scope of taxation of a non-resident alien, only deductions against effectively connected income are allowed. Deductions against effectively connected income include certain adjustments to income, a personal exemption, and limited itemized deductions. In general, the standard deduction is not available to a non-resident alien.

9.7 FILING STATUS

After a foreign national determines his or her residence, the person determines the appropriate filing status. The amount of certain deductions, as well as the set of graduated tax rates applied to taxable income, will depend upon the filing status chosen. There are four main filing status options in the United States.

9.7.1 Married Filing Jointly (or Qualifying Widow)

The married filing joint status applies to married individuals who elect to file together with their spouse. When married individuals elect to file a joint return, their income, deductions and tax calculation are computed on a combined basis. In order for married individuals to file a joint return, the individuals must be married as of the close of their tax year, typically December 31st. Further, both individuals must be U.S. residents, or elect to be treated as U.S. residents, for the tax year.

Married foreign nationals who are full-year U.S. residents commonly file jointly with their spouses. A married foreign national who is a full-year U.S. non-resident must file separately from his or her spouse. In the year of dual-resident status, married foreign nationals must file separately, unless certain elections are made.

9.7.2 Married Filing Separately

Married individuals who do not elect to file a joint return or do not qualify to file a joint return instead file married filing separately. Married individuals filing separately compute income, deductions and tax on a separate basis.

9.7.3 Head of Household

For individuals to select the head of household filing status, they must meet certain requirements. To qualify, an individual cannot be married as of the end of the tax year or be a qualifying widow(er). The individual must meet the maintenance of household threshold as well as meet certain support requirements. The individual must also be a U.S. citizen or resident of the U.S. A married foreign national will be considered unmarried for this test if the spouse is a non-resident alien and an election is not made to file jointly**.**

9.7.4 Single

An individual filing a return under the single filing status is one who is not married as of the end of the tax year, is not head of household under the above requirements, and is not a qualifying widow(er).

A resident alien has the option to file as any of the above, depending upon applicability. However, non-resident aliens must file their tax returns on an individual basis (either married filing separately or single, whichever is applicable).

9.8 TAX RATES

The U.S. tax structure is based on graduated rates. As taxable income increases, the tax rate increases to a maximum percentage. For 2009, the United States has six tax brackets - 10 percent, 15 percent, 25 percent, 28 percent, 33 percent and 35 percent. An example of the progressive tax rate system in the United States for 2009 is as follows:

For Single Filers

- **10%** on income up to $8,350
- **15%** on the income between $8,350 and $33,950
- **25%** on the income between $33,950 and $82,250
- **28%** on the income between $82,250 and $171,550
- **33%** on the income between $171,550 and $372,950
- **35%** on the income over $372,950

9.9 U.S. DISCLOSURE OF FOREIGN ACTIVITIES

Once a foreign national becomes a resident for U.S. tax purposes, the individual must disclose certain non-U.S. activities. While there is no income tax associated with filing these disclosure forms, it is mandatory to file on time, or severe penalties may be assessed.

9.9.1 Foreign Bank Reporting

The U.S. Department of Treasury requires U.S. citizens or resident aliens of the United States to report any financial interest in, or signature authority over, non-U.S. financial accounts. A U.S. citizen or resident must report all foreign bank and financial accounts if the cumulative total of all accounts exceeded US $10,000 on any single day of the year. Foreign accounts include, but are not limited to, bank savings accounts, checking accounts, investment and securities accounts, as well as pension or retirement accounts held outside the United States.

Form 90.22.1 is used to report a financial interest in, or signature authority over, non-U.S. financial accounts. This form is due by June 30th for the prior calendar year. No extension of time to file is available for this requirement. A willful violation of the reporting requirement is punishable under both civil and criminal law. As of October 22, 2004, even a non-willful violation may trigger a penalty of $10,000. The U.S. Treasury may allow an abatement of the penalty for reasonable cause if the income from the account was properly accounted for on the individual’s tax return.

9.9.2 Foreign Entity Reporting

A U.S. citizen or U.S. resident’s ownership in a foreign corporation, partnership, or trust may trigger U.S. disclosure requirements. The IRS collects information about foreign corporations through Form 5471, foreign partnerships through Form 8865, and foreign trusts, gifts and inheritances through Forms 3520 and 3520-A. The minimum ownership percentage to trigger a U.S. reporting requirement is 10 percent for a foreign partnership or corporation. Penalties for failure to file depend upon the category of the filer, but typically the penalties start at a minimum of $10,000. A grantor or beneficiary of a foreign trust is required to file Form 3520 each time a reportable event occurs, and Form 3520-A annually. Penalties for failure to file required forms for a foreign trust can also be quite severe.

9.10 Expatriation Rules

As discussed above, a foreign national is considered a U.S. resident when the individual is considered a lawful permanent resident under the “green card” test. Lawful permanent residents are foreign nationals who have received a green card, or alien registration card, granting them the right to permanently reside in the United States for immigration purposes. A green card holder’s residency starts upon the first day of arrival in the United States while holding the green card or the first day of the following year if there is no U.S. travel in the year the green card is received. Once established, residency is considered permanent. Thus, the foreign national will remain a U.S. resident even if the individual is not physically residing in the United States. The individual will be considered a U.S. resident for tax purposes for as long as he or she holds the green card. In the event a green card holder returns to his or her home country outside of the United States, the individual is still responsible for filing a U.S. tax return to report worldwide income.

Termination of residency will occur only when the green card is revoked or administratively or judicially abandoned. When a green card is relinquished, there may be tax consequences, depending upon the length of time the green card was held.

Expatriation rules apply to foreign nationals considered long-term permanent residents. A long-term permanent U.S. resident is a foreign national holding a green card for any part of 8 out of the last 15 years. The United States has specific expatriation rules designed to prevent tax avoidance by long-term permanent residents. Income and wealth thresholds are used to determine whether a long-term permanent resident will be subject to the expatriation rules.

When expatriation rules apply, U.S. taxation depends on when expatriation occurs. Different rules apply if expatriation occurred before June 4, 2004, after June 3, 2004 and before June 17, 2008 or after June 16, 2008. The rules are complex and an immigration attorney or qualified tax expert should be consulted.

If the expatriation rules apply, a former long term permanent resident also has to file Form 8854 to terminate his or her U.S. residency for tax purposes. U.S. tax residency ends on the later of the date that the Green Card is revoked or abandoned, or the date that Form 8854 is filed.

9.11 Deadlines and Forms

In general, a U.S. individual income tax return is due by April 15th. When April 15th falls on a weekend, the tax form's due date is the Monday following the 15th. An extension of time to file is available to October 15th by filing Form 4868. While the due date for filing the return is extended, the tax liability is required to be paid by the April 15th due date to avoid or minimize interest or penalty assessments.

A non-resident alien's U.S. individual income tax return is filed using Form 1040NR. A resident alien's U.S. individual income tax return is filed using Form 1040. In the event an individual is a dual-resident taxpayer, both forms may be required.