Residency for U.S. Income Tax Purposes

by Jo Anne C. Adlerstein

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The central mission of many immigration lawyers is getting their clients "green cards." Foreign nationals can wait over 20 years to become lawful permanent residents (LPR). The immigration law definition of "resident" is found in Immigration and Nationality Act (INA)[1] §101(a)(20): a person who has "been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws ...." It does not say "in accordance with federal law." There is another definition of "resident" in the U.S. Code, and immigration lawyers have a critical responsibility to understand it and explain it to their clients. It is the definition used for U.S. income tax purposes, which is the subject of this article.

RESIDENCY FOR TAX PURPOSES

For purposes of U.S. tax law, a foreign national is a resident if he or she meets one of two tests:

- **The Green Card test.** If your client has a green card, he or she is a resident. If your client gets a green card on December 31, 2014, he or she is a resident for all of 2014.

- **The Substantial Presence Test.**[2] Get your calculator out. If your client is present during the calendar year for **183 days or more**, he or she is a resident! This is true even if your client is present on a non-immigrant visa (with few exceptions) or visa waiver.

  or

  If a foreign national is present during the current calendar year **at least 31 days and** the number of days present in the current calendar year _____

[1] Immigration and Nationality Act of 1952 (INA), Pub. L. No. 82-414, 66 Stat. 163 (codified as amended at 8 USC §§1101 *et seq*.).

[2] 26 U.S. Code §7701(b)(1)(a). FAQs about the substantial presence test are on the IRS website: www.irs.gov/Individuals/International-Taxpayers/Substantial-Presence-Test.

plus 1/3 sum of days present in preceding calendar year +_____
plus 1/6 sum of days present in second preceding calendar year +_____
EQUALS OR EXCEEDS 183 DAYS =_____

Under the Internal Revenue Code, non-residents must only report their U.S. source-income to the Internal Revenue Service (IRS). This is done on Form 1040NR.

RESIDENTS MUST REPORT WORLDWIDE INCOME TO IRS

Under the Internal Revenue Code definition, residents must report their worldwide income on U.S. tax returns. This is done on IRS Form 1040.

This reporting requirement does not necessarily mean that your clients will pay tax to both their home country and the IRS. The United States has entered into treaties to avoid double taxation with most countries. Under these treaties, the tax is generally paid to the country where the income is received. Thus, your client will pay tax to his or her home country on the interest from his or her bank accounts there. Your client will report the same interest income on Form 1040, and get a credit on Form 1040 for the taxes paid overseas. Sometimes, the client will have to pay U.S. tax on income that is not taxable in their home country. For example, when an Israeli owns a rental apartment, he or she may not be required to pay tax on the rental income if it is under a set monthly threshold. If he or she is a U.S. resident for tax purposes, that income will need to be reported on Form 1040 and will be taxable.

EXCEPTIONS TO SUBSTANTIAL PRESENCE TEST

There is a "closer connection exception" to the Substantial Presence Test for foreign nationals who are in the United States for more than 183 days in the current year and have a tax home in a foreign country. It requires the foreign national to prove to IRS that he or she maintained a tax home outside the United States during the year and maintained more significant ties and contacts with the foreign country than with the United States.[3] The location of the following will be probative:

- Your client's permanent home (available at all times, not just short stays);
- Your client's family;
- Your client's personal belongings, such as cars, furniture, clothing, and jewelry;
- Your client's current social, political, cultural, or religious affiliations;
- Your client's business activities;
- The jurisdiction in which your client holds a driver's license; and
- Charitable organizations to which your client contributes.

[3] 26 USC §152(b)(3)(A).

Your client will not be able claim to have a closer connection to a foreign country if either of the following applies:

1. He or she personally applied, or took other steps during the year, to change status to that of a lawful permanent resident (LPR); or
2. She had an application pending for adjustment of status to LPR during the current year.

There are other exceptions to the substantial presence test:

- Sometimes the tax treaty between the United States and your client's home country will provide a way out. Most U.S. tax treaties contain an article which defines residency for the purposes of the treaty. That definition may be different than the Internal Revenue Code definition.

- Some clients who meet the substantial presence test during the current year, may opt to be treated as dual status residents. They will file Form 1040 marking it as "Dual-Status return" and attach Form 1040 NR or a statement explaining the split of tax treatment.

- Other clients, married to U.S. citizens or LPRs, may elect to be treated as residents for tax purposes.

Details on these exceptions are on the IRS website in Publication 519: *U.S. Tax Guide for Aliens.*

RESIDENTS MAY NEED TO FILE FBARs

The Report of Foreign Bank and Financial Accounts (FBAR) (now FinCen Form 114) is not new. The Bank Secrecy Act of 1970 is where the authority for requiring such a report began. Oversight for the reporting was assigned to the Financial Crimes Enforcement Network, a bureau of the Treasury Department until 2003, when IRS took over. IRS scrutiny and enforcement has increased since 2009, when IRS ran its first well-publicized Offshore Voluntary Disclosure Program.

The FBAR must be filed annually by a United States "person" who has an interest in or signature power or other authority over financial accounts in a foreign country that have an aggregate value of more than $10,000 in a calendar year.

Foreign financial accounts include bank accounts, savings, checking, time deposits, mutual funds, brokerage accounts (including options and commodities future accounts), pension accounts, and life insurance and annuity policies with cash values.

FBARs must be filed electronically through the BSA E-filing system of FinCen—**Bsaefiling.fincen.treas.gov**. FBARs are not part of the income tax return. They cannot be filed by mail.

FBARS are due by June 30th following a calendar year in which aggregate account value exceeds $10,000. The June 30th filing date cannot be extended. FBARs can be filed late, but they may result in the assessment of penalties.

Civil and criminal penalties for non-compliance with the FBAR filing requirements are severe. Civil penalties for a non-willful violation can range up to $10,000 per violation. Civil penalties for a willful violation can range up to the greater of $100,000 or 50 percent of the amount in the account at the time of the violation. Criminal penalties for violating the FBAR requirements while also violating certain other laws can range up to a $500,000 fine, 10 years imprisonment, or both. Civil and criminal penalties may be imposed together.

RESIDENTS MAY NEED TO FILE STATEMENTS OF SPECIFIED FOREIGN FINANCIAL ASSETS (IRS FORM 8938)

The Foreign Account Tax Compliance Act (FATCA) was signed into law in March 2010 as part of the Hire Act. FATCA is the law which is presently being implemented to require participating foreign financial institutions (PFFIs) to report the details of the accounts of U.S. citizens and residents at their institutions to the IRS. Form 8938 was first required to be filed as part of the 2011 Form 1040. A U.S. citizen or resident (IRS definition) who resides in the United States must file the form if he has foreign financial assets valued at $50,000 on the last day of the calendar year or $75,000 at any time during the calendar year. There are other thresholds for married taxpayers and taxpayers living overseas.

Form 8938 does not replace or affect the FBAR filing requirement. Many U.S. persons will have to file both. IRS has a chart comparing the FBAR and Form 8938 that is worth reviewing: www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements.

THE ROLE OF THE IMMIGRATION ATTORNEY

As you now should understand, your client who is not an LPR may nonetheless be a resident for income tax purposes. It is critical that you explain this definitional concept to virtually all non-immigrant visa, visa waiver and Temporary National (TN) clients. Why? As a U.S. immigration attorney, you may be the only lawyer who talks to a foreign national before he or she enters the United States. Your client is concerned about getting into the United States to rejoin his or her family or start a new job. Very few clients will consider the need to do any tax planning. Some clients will later get Forms W-2 and go to a neighborhood tax preparation service, which may not advise them that they should be filing a U.S. non-resident tax return. Other clients may be properly advised to file a U.S.

resident tax return, but not be told that they must report income from other countries or file an FBAR (Report of Foreign Bank or Financial Accounts) or Form 8938.

It is not enough to explain the definitions. You must consider the practical implications for each client. Clients with overseas assets may enter as LPRs and discover that when they sell their homes abroad they have to pay U.S. tax on the gain, even if their home country does not tax the sale. Clients expecting overseas compensation may want to accelerate it to the year before they become residents. Clients on L or E visas may want to limit their physical presence in the United Statews to 120 days per year to avoid ever becoming residents. It may be appropriate to refer such clients to U.S. tax attorneys or certified public accountants who specialize in taxation of non-citizens.

In contrast, a family member coming to the United States who is not leaving assets or high income behind, may benefit from becoming a resident as soon as possible for tax purposes. He or she may qualify for the Earned Income Tax Credit (EITC). To qualify for EITC your client must have earned income from employment, self-employment or another source and meet certain rules. She must either meet the rules for workers without a qualifying child or have a child that meets all the qualifying child rules. Your client may also be eligible for a state tax credit. Most importantly, Form 1040 must be filed to claim the EITC, even if low income does not require filing a return.

Whether your clients are rich or poor, you will want to alert them to the substantial presence test. That way, you can avoid the dreaded words "Why didn't you tell me?"

SUGGESTED CLIENT ALERT

1. IRS and USCIS define "U.S. resident" differently. You may be a U.S. resident for tax purposes before you have your green card.

2. The U.S. taxes "U.S. residents" on their worldwide income. That includes bank account interest, sale of a home, and every other type of foreign compensation.

3. If you have property, a business, assets, bank accounts or income overseas, you may want to meet with a U.S. tax attorney or certified public accountant for situation-specific advice.

4. If you are earning money in the United States, you need to file federal, state, and sometimes city tax returns annually. You need to go to a U.S. certified public accountant who understands the issues that affect foreign nationals. Some foreign nationals will file non-resident returns; others will have to file resident returns.

5. If you are a U.S. resident, you will have to report foreign bank and financial reports when you own or have signatory authority on accounts overseas with an aggregate value over $10,000. This report is not a tax return. It is a Report of

Foreign Bank and Financial Accounts, Form 114, and must be filed before June 30th each year. It is not filed with the tax returns. It is filed electronically.

6. If you are a U.S. resident with over $50,000 in foreign bank and financial accounts, your tax return will need to include Form 8938, "Statement of Foreign Financial Assets," in your federal tax return.