CHALLENGES FOR FOREIGN NATIONAL TAXPAYERS AND THEIR TAX RETURN PREPARERS

By Paula N. Singer, Esq.

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CONTENTS

There are two separate federal income tax systems, one for U.S. citizens and foreign nationals who are resident aliens under the Internal Revenue Code definition of that term and one for foreign nationals who fail to meet that definition and who are, therefore, nonresident aliens for federal income tax purposes. U.S. citizens and resident aliens are subject to U.S. income taxes on their worldwide income. Nonresident aliens are subject to U.S. income taxes only on their U.S.-source passive income such as dividends, interest, rents, and royalties and on income that is effectively connected with the conduct of a U.S. trade or business (called "effectively connected income"). Effectively connected income includes compensation for services (employment or self-employment) performed in the United States, pensions distributions related to U.S. services, and scholarships and fellowship grants but only for recipients in "F," "J," "M," or "Q" immigration status.

This article discusses the challenges facing foreign national taxpayers and their tax return preparers in preparing their U.S. federal and state tax returns. Many of the rules and related procedures discussed in this article are described in more detail in the instructions for the related forms and in IRS Publications 519, U.S. Tax Guide for Aliens; 901, U.S. Tax Treaties, and 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad.

1. RESIDENT ALIEN, NONRESIDENT ALIEN, OR DUAL-STATUS ALIEN

In order to know what information is relevant for a foreign national's federal tax return, the taxpayer's U.S. tax residency status - resident alien, nonresident alien, or dual-status alien – must first be determined because the tax return filing obligations are different for each category of taxpayer.

Resident aliens must file a Form 1040 tax return (or a simpler Form 1040A or 1040EZ) if they meet the income threshold for their filing status. Resident aliens who are not residents for the full calendar year are dual-status aliens and file a dual-status tax return unless they are eligible for and make a full-year election. Resident aliens with income from abroad must report such income on their Form 1040 in U.S. dollars using U.S. tax principles. Resident aliens with foreign assets may also be required to submit special disclosure forms reporting foreign financial accounts and assets.

Nonresident aliens with effectively connected income such as wages income must submit a Form 1040NR (or simpler Form 1040NR-EZ) if they have a U.S. tax return with one exception. If the taxpayer's only income is wages that do not exceed the personal exemption amount, no tax return is required unless a tax-treaty exemption from withholding was claimed on the income. Also, nonresident aliens whose only income is passive U.S.-source income on which the correct amount was withheld (including at a reduced tax treaty rate) have no U.S. tax return filing obligation provided the income and withheld taxes are reported on a Form 1042-S by the payer. Form 1040NR and 1040NR-EZ (collectively Form 1040NR(-EZ)) are due June 15 unless the taxpayer has wages subject to federal income tax withholding, in which case the return is due April 15.

Dual-status aliens are foreign nationals who are part-year nonresident aliens and part-year resident aliens (in either order). They file a dual-status tax return, a form 1040 with a Form 1040NR statement, or a Form 1040NR tax return with a Form 1040 statement. (These returns are illustrated in IRS Publication 519). Part-year resident alien status occurs in the year of arrival if the foreign national arrives after January 1, or is physically present on January 1 but the day doesn't count for purposes of determining federal tax residency based on substantial presence. Part-year residency status is also possible in the year of departure from the United States for taxpayers eligible to choose a residency end date earlier than December 31.

The terms "resident alien" and "nonresident alien" as defined for federal income tax purposes are different from the definitions of these terms when used for immigration purposes. "Nonresident alien" is the term used for nonimmigrants who are foreign nationals in the United States for a temporary purpose and period. Nonimmigrants might be either resident aliens or nonresident aliens for federal income tax purposes. The term "resident alien" is used for U.S. lawful permanent residents (also called "immigrants" or "green card holders") who generally are resident aliens for federal income tax purposes. The terms "resident" and "nonresident" for state income tax purposes are defined by the state's income tax rules and vary by state. Nonresidents for state income tax purposes include both U.S. citizens and foreign nationals who are not residents under a state's definition of resident.

2. U.S. TAX RESIDENCY DETERMINATION

Under the federal income tax rules, foreign nationals who are green card holders are resident aliens. Foreign nationals who meet the 183-day substantial presence test (SPT) during the tax year are also resident aliens. Under the SPT, foreign nationals who are in the United States at least 31 countable days in the tax year are resident aliens if their total countable U.S. days over a 3-calendar year period equal or exceed 183 days based on the following formula: all of the current calendar year's countable U.S. days, plus 1/3 of the prior calendar year's countable U.S. days, plus 1/6 of the calendar year before the prior year's countable U.S. days. Fractions must not be rounded in the computation. Partial days count as do days for any purpose including for vacation or business visits unless there is a specific exception.

The term countable days is significant because there are many U.S. days that do not count with the result that foreign nationals especially those in certain immigration categories may remain nonresident aliens much longer than foreign nationals with countable U.S. days. The following U.S. days do not count for purposes of this formula:

- Days spent commuting from a residence in Canada or Mexico to work in the United States provided the IRS definition of "commuting" is met
- A passing through day from one foreign point to another provided no business occurs in the United States during the stopover
- Days spent in the United States as a crewmember of a foreign flagged vessel
- Days spent in the United States because of a medical condition which arose while in the United States (Form 8843 required)
- Days spent by a professional athlete engaged in performing in a charitable event in the United States (Form 8843 required)
- Days spent in the United States as an exempt (from counting U.S. days) individual

3. INDIVIDUALS EXEMPT FROM COUNTING U.S. DAYS

In order to determine whether foreign nationals are exempt (from counting U.S. days) individuals, it is necessary to identify their immigration status while in the United States. IRS publications and form instructions use the term "visa" instead of status. A visa is a travel document required for entry into the United States at which point a Form I-94, Arrival/Departure Document or a passport stamp evidencing immigration status is issued. A foreign national's immigration status might change after entry into the United States, after which their status and visa will be different.)

Exempt (from counting U.S. days) individuals include:

- **Foreign government-related individuals** in "A" diplomatic status or "G" international organization employees. These foreign nationals do not count U.S. days and remain nonresidents.
- **Students in "F" academic student status**, "M" vocational student status or "J" exchange visitors in either student or student intern category. Students who substantially comply with the requirements of their status do not count U.S. days for 5 calendar years in which they were exempt (from counting U.S. days) individuals in "F," "J," "M," or "Q" immigration status since 1985.
- **Teachers and trainees**, a category that is much broader than its definition because it includes all J exchange visitors in any one of the many exchange visitor categories except students and student interns (collectively called "J nonstudents") and "Q" cultural visitors who substantially comply with the requirements of their status. As a result of this definition under the tax code, this category does not include teachers in any other immigration category such as H-1B or trainees in any other category such as H-3, which may cause confusion for both foreign national taxpayers and their return preparers. These foreign nationals do not count their U.S. days spent as exempt (from counting U.S. days) individuals for 2 out of the current 7 calendar years, (e.g. 2006 through 2012 for tax year 2012 tax returns).
- **J nonstudents employed by a foreign employer** continue to be exempt (from counting U.S. days) individuals for up to 4 out of the current 7 calendar years provided all of their remuneration for these years is pay for services provided by their foreign employer. A noncompensatory fellowship from a foreign grantor does not qualify the recipient for this extended period. A foreign employer for this purpose does not include a foreign government. Taxpayers who fail to meet the conditions of this extended period (because the source or type of their remuneration changed) revert to the 2-out of-7-calendar year rule. If they have already had 2 or more exempt calendar years while under the 4-out-of-7-calendar year rule, they must begin to count their U.S. days.

These categories include immediate family members in these categories as well. Immediate family members are unmarried children provided they are under 21, reside regularly in the exempt individual's residence, and are not members of another household.

Foreign nationals in "F," "J," "M" or "Q" status must take into account their U.S. presence as exempt (from counting U.S. days) individuals in prior tax years whether as students or teachers or trainees. Any day in a calendar year as an exempt (from counting U.S. days) individual causes the calendar year to be considered in the 5-calendar- year or 2-out-of-7-calendar year count. To make the residency determination for these foreign nationals, tax return preparers must collect information about the taxpayers' U.S. days from calendar years prior to the current 3 calendar years of the SPT formula. As a result, foreign nationals who have prior visits to the United States in one of these categories (not unusual for research scholars and students) might be nonresident aliens for the current tax year and resident aliens for the next tax year or vice versa. Their resulting residency status depends on their pattern of visits to the United States, their immigration status during the visits, and which calendar years during the prior visits were exempt (from counting U.S. days) years and which were not.

Exempt (from counting U.S. days) individuals in "F," "J," "M," or "Q" status must submit a Form 8843 whether they have a U.S. nonresident tax return filing obligation or not. Dependents have this information return filing obligation as well. No U.S. taxpayer identification number is required for this form which is an information return not a tax return. Form 8843 can be confusing to complete for foreign nationals who were exempt (from-counting-U.S.-days) individuals in some calendar years but not in other calendar years. Although the instructions are clear that it is only exempt calendar years that need to be indicated, the tax year's questions on the face of the form are not clear on that point.

4. RESIDENCY START AND END DATES

Foreign national taxpayers who become resident aliens under the substantial presence test (SPT) during in the tax year who were not resident aliens at any time during the prior tax year are resident aliens retroactive to their first countable U.S. day in the tax year, called the "residency start date." If that day is not January 1, the taxpayer is a dual-status taxpayer. Taxpayers who are exempt (from counting U.S. days) individuals do not apply this residency start date rule when they are exempt from counting days (or outside the United States) for the full calendar year. Taxpayers in "F," "J," "M," or "Q" immigration status who are exempt (from counting U.S. days) individuals who change to an immigration status other than "F," "J," "M," or "Q" status will be dual-status taxpayers for the tax year if they have 183 countable U.S. days or more in the tax year in that new status.

Taxpayers who arrived in the United States during the tax year may ignore up to 10 days of U.S. presence if they had a closer connection to and a tax home in a foreign country (or countries) during the period that includes those days, with the result that such taxpayers may have a later residency start date. Taxpayers resident in a country with which the United States has an income tax treaty may have facts that support U.S. nonresidency status under the applicable tax treaty's residency tie breaker rules delaying the residency start date to the date of relocation to the United States (Form 8833 required).

The tax rules for resident aliens who depart the United States vary depending on whether tax residency status is based on the taxpayer's green card status or the results of the substantial presence test (SPT).

Resident aliens under the green card test remain resident aliens and subject to U.S. income tax and return obligations following their departure from the United States until they lose such immigration status through abandonment or revocation by the immigration service. Green card status is not lost because the date on the green card holder's physical green card expires or because the green card holder has been absent from the United States for an extended period. Rather abandonment requires action by the green card holder and evidence of their abandonment such as their Form I-407, Application for Abandonment or evidence of the receipt of their letter to USCIS returning their physical green card and stating their intent to abandon their status. Certain long-term residents may have special reporting requirements and tax provisions under the U.S. expatriation tax provisions.

Resident aliens under the SPT who later depart the United States to live in another country are deemed to be resident aliens through December 31 of their tax year of departure. These taxpayers might be eligible to elect an earlier residency end date under the closer connection exception, the requirements and procedures for which are described in IRS Publication 519. Taxpayers who become tax resident in a country with an income tax treaty with the United States might have facts that support a claim of tax nonresidency status under the applicable tax treaty's residency tiebreaker rule (Form 8833 required).

Departing foreign nationals who have been working in the United States are advised by the IRS to get a departure permit from an IRS office in the area of their employment at least 2 weeks before departure but not earlier than 30 days before the planned departure date. The permit is applied for on a Form 1040C which requires an approximation of the departing foreign national's income and U.S. tax liability for the year of departure. Any taxes expected to be owed must be paid with the Form 1040C. Some departing foreign nationals might be eligible for the short Form 2063. IRS Publication 519 provides a list of the categories of departing foreign nationals who are exempt from the departure permit requirement such as foreign national students and scholars because their departure from the United States is presumed not to jeopardize tax collection.

5. TAX RESIDENCY EXCEPTIONS AND ELECTIONS

There are a number of exceptions and elections for which foreign national taxpayers might be eligible that can change their tax status from resident alien to nonresident alien or vice versa. These exceptions and elections require specified conditions to be met and procedures to be followed. (The exceptions and elections under the tax code and the procedures required for them are explained in more detail in IRS Publication 519 and the instructions to the related forms.) The exceptions and elections are typically made based on a tax projection that indicates a lower total tax will be paid if the taxpayer chooses to use the exception or make the election.

The closer connection exception may be claimed by taxpayers who are resident aliens based on the substantial presence test (SPT) formula but who have fewer than 183 countable days in the United States during the tax year provided they have a closer connection to and a tax home in a foreign country (or countries) for the full tax year (Form 8840 required). Taxpayers claiming this exception remain nonresident aliens for the tax year. Taxpayers who have no U.S. tax filing obligation as a result of their nonresident alien status must nevertheless file a Form 8840 with the IRS.

The closer connection extension for foreign students may be claimed by students who have become resident aliens for the tax year under the SPT because they have more than 5 calendar years in which they have been exempt (from counting U.S. days) individuals provided they have not taken steps to become U.S. green card holders. This exception may be claimed on a statement attached to Form 8843 about the closer connection to a foreign country and facts supporting no intention to change status to nonimmigrant to green card holder. (The IRS considers changing to a temporary immigration status such as H-1B to work in the United States to be the first step in that process toward obtaining green card status.)

The first year choice election may be made by nonresident aliens in their year of arrival provided they have at least 31 days in a row in the tax year and their U.S. days from the beginning of the 31-day period through December 31 equals or exceed 75 percent of the days in that period and the foreign national becomes a resident alien in the subsequent tax year. (Up to 5 foreign days during this period may be treated as U.S. days) This election may be made by the spouse and dependants thus allowing them to be claimed for exemptions on the part-year resident portion of the dual-status tax return. The electing taxpayer will need to extend the time to file the current year's tax return if the date that the SPT formula adds up to 183 days in the subsequent tax year (called the "residency change date") is after the due date of the current tax year's return. A statement making this election must be included with the return.

The marriage-based residency election may be made by nonresident aliens with a spouse who is a U.S. citizen or green card holder. The election allows the nonresident alien to be treated as a resident and file with the U.S. citizen or resident alien spouse using married-filing-jointly rates. Married-filing-jointly rates are the lowest tax rates. Deductions and exemptions are available to spouses filing jointly that are not available to spouses filing separately. This election may be made by a U.S. citizen's or green card holder's nonresident alien spouse residing abroad provided that spouse has or obtains a U.S. taxpayer identification number. A marriage-based election may also be made by spouses who are both part-year residents (either or both of which may be a part-year resident alien based on a first-year choice election). Spouses making this election must attach a signed statement to the first tax return for which this election is made. (Nonresident aliens married to a nonresident alien spouse may not make a marriage-based election.)

Nonresident aliens making a marriage-based election must include their worldwide income for the calendar year on the return. Foreign tax credits may be used to avoid double taxation on the foreign income reported on the return (Form 1116 required). Nonresident aliens making this election must continue to file as resident aliens (whether jointly or separately) until such status is revoked through application to the IRS or through divorce or death of a spouse. These resident aliens remain nonresident aliens for Social Security and Medicare (FICA) tax purposes because the tax code allowing this election does not apply to FICA. As a result, these resident aliens who are in F-1, J-1, M-1, or Q-1/Q-2 status may continue to be eligible for the NRA FICA Exception.

A tax treaty residency election may be made by students and business apprentices who came to the United States in that status when they were residents of Barbados, Hungary, or Jamaica. (Note that the new treaty with Hungary that is in the process of ratification does not include this provision. Elections made under the old treaty while in effect will not be revoked by the new treaty when it goes into effect.) A Form 8833 is required for a residency election. Such election does not prevent tax treaty benefit claims under student/trainee provisions of these treaties because of exceptions for these provisions allowing resident aliens to maintain the treaty benefits. This election also does not change the eligibility of taxpayers in F-1, J-1, M-1 or Q-1/Q-2 status who continue to be nonresident aliens under the SPT for claiming the NRA FICA Exception because income tax treaties do not apply to Social Security and Medicare taxes.

A tax treaty nonresidency election may be made by foreign nationals who are residents in a country with an income tax treaty with the United States provided the treaty has a residency tiebreaker rule. The taxpayer can support with facts a claim of tax nonresidency status for treaty purposes under the tiebreaker hierarchy: generally permanent home/center of vital economic interests/place of abode/nationality (Form 8833 required). Taxpayers making this election might continue to be obligated for some U.S. disclosure form obligations, however.

6. SPECIAL CONSIDERATIONS FOR NONRESIDENT ALIENS

Foreign nationals who are nonresident aliens for federal income tax purposes are not eligible for the same deductions, credits, and exemptions as resident aliens (and U.S. citizens). They must file using either single or married-filing-separately status (the highest rates) and may not claim the standard deduction with one exception. Only certain nonresident alien taxpayers may claim spousal or dependent exemptions.

Only U.S.-source income and income effectively connected with the conduct of a U.S. trade or business received by nonresident aliens is subject to U.S. tax. The most common sourcing rule is residence of the payer which is the rule for passive investment income. This simple sourcing rule does not, however, apply to many types of income payments received by nonresident aliens, however. For example:

- Compensation for services is U.S.-source income, regardless of the residence of the payer, if the payment relates to services that were performed in the United States. Such U.S.-source income is deemed by the tax code to be effectively connected with the conduct of a U.S. trade or business.
- Royalties are sourced where the intangible property is used regardless of the residence of the payer. Royalty income also includes payments contingent on the use of patents when the former patent holder who sold the patent is a nonresident alien when the contingent payments are received.
- Scholarship and fellowship grants made by U.S. grantors for study or research that will take place in the United States are U.S.-source. (Taxable grants include and noncash benefits such as room and board and reimbursed travel expenses.) Grants provided by foreign grantors or grants for study or research abroad provided by U.S. grantors are foreign-source.
- Prizes and awards are generally sourced based on the residence of the person providing the prize or award but there are exceptions for certain achievement awards for activities that occurred abroad.
- Pension distributions are U.S.-source income to the extent of employer contributions and tax-advantaged employee contributions related to services performed in the United States. These amounts are also effectively connected income. Any accretion in value is U.S. –source passive income.

Dependent exemptions may only be claimed by taxpayers who are U.S. nationals, residents of Canada, Mexico, or South Korea, or residents from India who are students or business apprentices. The requirements vary by category. Taxpayers who are not in one of these categories may not claim dependent exemptions even if the dependent child is a U.S. citizen because the child was born in the United States. In all cases, the taxpayer must record the U.S. taxpayer identification number for the spouse or child for whom an exemption is claimed or file the tax return with the necessary Form W-7 ITIN application(s) and required documentation with the ITIN Unit at the address given in the Form W-7 instructions.

The requirements for taxpayers who are U.S. nationals or residents of Canada or Mexico who may claim exemptions for a spouses and children are the same as such claims made by U.S. citizens except that the individual claimed is not required to be a U.S. citizen or a resident alien for U.S. tax purposes. U.S. nationals are individuals who are nationals of the Northern Marianas Islands or American Samoa. The rules for taxpayers who are residents of South Korea or residents from India who are students or business apprentices are more complicated because they are based on tax-treaty provisions. The rules for these taxpayers are described in detail in the Form 1040NR instructions.

Gains on the sale of personal property are not subject to U.S. income tax provided the nonresident alien seller is not physically present in the United States for 183 days in the tax year. This rule is a different 183-day test than the substantial presence test (SPT). The result of this rule is that foreign nationals who are exempt (from counting U.S. days) individuals might be subject to U.S. income tax on their gains if they are physically present for 183 days or more even though the days might not count for purposes of the SPT. To be subject to tax on their gains, however, the nonresident alien seller must be a "resident of the United States" as that term is defined for purposes of sourcing capital gains on personal property. The source of income rule for such gains is based on the location of the taxpayer's tax home. Generally, the taxpayer's tax home has changed to the United States if the taxpayer's stay is anticipated to be for more than one year. If the taxpayer's tax home has changed to the United States, gains on the taxpayer's worldwide assets are treated as

U.S.-source gains. There is an exception if the taxpayer was a student who came to the United States to study and has no effectively connected income (such as personal services income or taxable grants) during his or her U.S. stay. In that case, the taxpayer's tax home did not change to the United States and all of personal property gains are foreign-source. There is also an exception for contingent gains on intangible personal property such as patents which are subject to 30 percent (or lower treaty rate) withholding.

Deductions and credits available for resident aliens might not available for nonresident alien taxpayers. For example, nonresident aliens are not eligible for education credits even if they are issued a Form 1098-T by the institution where they are studying. Institutions are allowed by the reporting rules to issue the form to nonresident aliens because their administrative systems generally do not have information identifying nonresident aliens. Deductions are very limited for nonresident aliens. For example, nonresident aliens may claim only limited itemized deductions such as charitable contributions to U.S. charities and state income taxes. They may not claim the standard deduction with one exception. Residents from India who are students or business apprentices may claim the standard deduction because of a tax treaty provision allowing such a claim (but not the higher deduction allowed for married-filing-jointly status). Lastly, married nonresident aliens may only use married-filing-separately status (the highest rates). Many of these limitations also apply to dual-status returns. Deductions and credits may be disallowed if the nonresident alien taxpayer fails to file a Form 1040NR(-EZ) timely. For this purpose, timely is 18 months from the original due date of the tax return.

Nonresident aliens with self-employment income have effectively connected income. As a result they are required to submit a Form 1040NR even if the self-employment income is their only income, has been subject to 30 percent withholding, and does not exceed the personal exemption amount. Historically, nonresident aliens have not been subject to self-employment tax but this changed with the 2010 tax year when the IRS began to apply the long-standing (but long ignored) rules of Social Security agreements that cede coverage for social security to the country where the self-employment occurs. As a result, nonresident aliens who are residents of a country that has a Social Security agreement with the United States may be obligated for SE tax.

Taxpayers with self-employment income must also consider the impact that a tax return with Schedule C income might have on a future immigration benefit (e.g., a status allowing employment such as H-1B or an application for green card status) because this income raises the possibility of unauthorized employment because very few foreign nationals in the United States in a nonimmigrant status are authorized to engage in independent contractor activities. This is regardless of the fact that these workers are not required to complete a Form I-9, Work Authorization Verification as required under U.S. immigration law for employees.

Nonimmigrants authorized to engage in independent contractor activities include:

- Contact-specific nonimmigrants in O-1 or TN status who may work for under a contract for a specific U.S. entity;
- Itinerary-specific nonimmigrants in O-1 or P-status who are entertainers or athletes whose agents petitioned USCIS for permission to engage in performances according to the itinerary filed with the petition;
- Program-specific U.S. nonimmigrants in certain of the J-1 exchange visitor categories such as 1) those in the summer/work travel category, 2) professors and research scholars if prescribed regulations for authorization of the lectures and consulting within the terms and conditions of their exchange visitor program are followed and 3) certain short-term scholars depending on the terms of their exchange visitor program;
- B –status visitors who may accept an honorarium and associated incidental expenses for usual academic activities lasting not longer than nine days at any single institution if the payment is offered by a qualifying organization provided the visitor has not accepted such payment or expenses from more than 5 institutions or organizations in the previous 6-month period. Qualifying organizations include institutions of higher education including related or affiliated nonprofit entity or a nonprofit or Government research organization;
- On-campus employment activities of F-1 students that are typically paid as self-employment such as tutoring or giving music or sports lessons.

Other nonimmigrants authorized to engage in self-employment include foreign nationals with an employment authorization document (EAD) issued by USCIS but only so long as the document is unexpired.

Schedule C income might be from authorized self-employment or from misreported income such as a miscellaneous wage payment (e.g., nonqualified moving expenses) paid by Accounts Payable and misreported on a Form 1099-MISC as nonemployee compensation (box 7). Or the income might be from unauthorized independent contractor activities. Taxpayers with self-employment income from authorized activities or misreported income evidence with their tax records that explain the self-employment income should questions arise in a future immigration proceeding regarding whether the self-employment activities were authorized or not.

7. SPECIAL CONSIDERATIONS FOR RESIDENT ALIENS

Foreign nationals who become resident aliens for U.S. tax purposes are subject to U.S. income tax on their worldwide income. In addition, because of certain assets that they owned when they came to the United States or later acquired through inheritance, gift, or purchase, they may be required to submit one or more disclosure forms with their U.S. tax return or separately depending on the form's instructions. The IRS may impose significant penalties for failure to submit required disclosure forms. Lastly, unlike residents from countries with residence-based taxation (most of the industrialized world), resident aliens who are green card holders who relocate abroad have U.S. tax return filing obligations while living abroad. Green card holders who relocate abroad who fail to file required U.S. tax returns or who file as nonresident aliens rather than resident aliens might lose their green card status under immigration rules.

Foreign Income must be translated into U.S. dollars using the conversion method that best reflects income. For example, amounts paid periodically may be translated using the average exchange rate for the period but lump sum payments must be converted to U.S. dollars using the exchange rate on the date of payment. Because the U.S. tax law does not provide a step-up in basis for appreciated assets on the date that a foreign national becomes a resident alien in the United States, sales of appreciated assets while a resident alien will result in all of the appreciation from date of purchase to date of sale being taxed. Such transactions might have an imbedded unrealized exchange gain or loss depending on the change in the value of the foreign currency to the U.S. dollar between the date of purchase and date of sale. This is caused by the U.S. tax rule requiring the basis of foreign denominated assets to be converted to U.S. dollars at the exchange rate on the date of purchase and the sale proceeds converted using the exchange rate as of date of sale.

Tax treaty exemptions from tax are generally lost by resident aliens because of the saving clause in U.S. treaties that reserves the right of the United States to tax its citizens and residents as if the treaty had not come into effect. There are exceptions to the saving clause in all but 2 treaties (with Greece and Pakistan) which allow exceptions for claims under the student/trainee and teacher/researcher provisions of applicable treaties provided the taxpayer is a resident alien under the substantial presence test and not the green card test. The treaties with the People's Republic of China and the Former USSR which covers nine of the Newly Independent States (NIS), called the Commonwealth of Independent States (CIS) in the IRS publications, allows exceptions for green card holders as long as the article under which the treaty claim is made does not specify a "temporary" stay. (Green card holders are by definition intending to reside indefinitely in the United States.) The IRS provides instructions in Publication 519 for residents claiming treaty benefits.

Disclosure Forms may be required to be submitted with the taxpayer's Form 1040 tax return or separately depending on the form's instructions. The following are the potential disclosure forms:

- TD F 90.22-1, Report of Foreign Bank and Financial Accounts (called an "FBAR")
- Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation
- Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
- Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner
- Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations
- Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business
- Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund
- Form 8621-A, Return by a Shareholder Making Certain Late Elections to End Treatment as a Passive Foreign Investment Company
- Form 8938, Statement of Specified Foreign Financial Assets
- Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities
- Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships
- Form 8891, U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans
- Form 8898, Statement for Individuals Who Begin or End Bona Fide Residence in a U.S. Possession

Green card holders working or retiring abroad continue to be subject to U.S. taxes on their worldwide income and have tax return filing obligations while they are living abroad for work or retirement. These taxpayers (called "U.S. expatriates") may be subject to double worldwide income taxation if they live in a country that imposes residence-based taxation (most countries do). Double worldwide taxation may be avoided by claiming on their U.S. tax return foreign tax credits to offset U.S. taxes attributable to foreign income (Form 1116 required) or through the use of section 911 foreign earned

income exclusions (Form 2555 required). These mechanisms are described in IRS Publication 514, Foreign Tax Credits for Individuals, and Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad. Green card holders (and U.S. citizens) generally may not use a U.S. tax treaty to reduce their U.S. income taxes because of the saving clause included in all U.S. treaties giving the United States the right to tax its citizens and residents as if the treaty did not come into effect.

A U.S. departure tax might apply to foreign nationals who are long-term residents who lose their green card status. Long-term residents are foreign national who have been in green card status for any part of 8 out of 15 tax years ending with the year that green card status was lost. Not included in these years are years in which nonresidency status was claimed under a tax treaty tiebreaker rule (Form 8833 required). Long-term residents are subject to the departure tax (also called the "expatriation tax") if they meet the either the net worth test or average tax liability test, or they failed to meet their U.S. tax return filing obligations for the 5 tax years that end with their year of loss of status. A Form 8854 is required with the final U.S. tax return. A long-term resident who is an expatriate covered by these rules is a dual-status taxpayer in their final U.S. tax year. These rules are described in more detail in IRS Publication 519.

8. WHERE TO RECORD ITEMS OF INCOME ON THE RETURN

Most income paid by U.S. employers and payers is reported to the income recipient and the IRS on an information return. Wages subject to wage withholding are reported on a Form W-2 whether the employees are resident aliens and nonresident aliens. For non-wage income, the information return required varies with the type of income paid and whether the income recipient is a resident alien or nonresident alien. Non-wage income payments made to resident aliens (and U.S. citizens) are required to be reported on a Form 1099 if the payment is a 1099-reportable payment except for certain gambling winnings that are reported on a Form W-2G. U.S.-source income payments to nonresident aliens must be reported on a Form 1042-S. (Nonresident aliens are not subject to U.S. income tax on foreign-source income.) Unlike 1099-reportable payments, most income payments made to nonresident aliens are subject to withholding by the payer unless the recipient was eligible for an exemption from, or lower rate of, withholding under an applicable income tax treaty provision. Since many payers are unaware of the special reporting rules for payments to nonresident aliens, it is not unusual for nonresident aliens to receive a Form 1099 reporting their income instead of a Form 1042-S.

Where income is recorded on Form 1040 is described by IRS the helpful chart in the Form 1040 instructions, "Where to Report Certain Items from 2012 Forms W-2, 1097, 1098, and 1099." The chart has 3 columns: Form, Item and Box in Which It Should Appear, and Where to Report. The latter gives the Form 1040 line or additional schedule or tax form and line. Not all income is reported on an information return, however. For example, taxable scholarships and fellowship grants are missing from this chart because they are not subject to information reporting if the recipient is a resident alien (or U.S. citizen). These amounts must nevertheless be recorded on Form 1040 even though there is no specific line for scholarships and fellowship grants. Instead, the Form 1040 instructions instruct such amounts must be recorded with wages with "SCH" recorded on the line next to wages. Other unreported income amounts must also be recorded on the return including honorarium payments and other nonemployee compensation which were not 1099-reportable if the amount paid to the recipient by the payer was less than $600 for the tax year and the recipient provided a U.S. taxpayer identification number.

Resident aliens must also record their income from outside the United States in the corresponding line on Form 1040 depending on the type of income. Income must be translated into U.S. dollars using the method that most clearly reflects income and recorded using U.S. tax principles. For example, rents and expenses must be converted to U.S. dollars and reported on Schedule E. The residence must be depreciated using the rules for property predominately outside the United States, 40 years for residential real estate and 12 years for tangible personal property.

Where income is recorded on Form 1040NR or Form 1040NR-EZ is not described in an IRS chart in the instructions either for Form 1040NR or Form 1040NR-EZ. Form 1042-S includes an Income Code describing the type of income reported on the form and an Exemption Code describing why the income payment was exempt from withholding. A list of Form 1042-S code definitions is included with the form and in the Form 1042-S instructions (available on the IRS website). Historically this list was sent to the income recipients with their copy of the form. Since IRS began printing the lists on the opposite side of the form, however, many recipients no longer receive a copy of the code definitions with their Form 1042-S because the software printing the recipient copies fails to provide the lists with the form.

The Income Code is not always refined enough to ensure that the income is recorded on the proper line of a Form 1040NR(-EZ), however. For example, Income Code 14 applies to pensions, annuities, alimony, and/or insurance payments. Taxable pension distributions from a defined contribution plan are recorded differently with taxable amount attributable to employment income recorded as effectively connected income on page 1 of Form 1040NR and subject to graduated rates of tax and accretions in value recorded on page 4 with the gross amount subject to 30 percent tax. (The instructions for pensions in the instructions will not be helpful if the pension recipient has not kept sufficient records to determine how to allocate the pension amount.)

Even when the Income Code applies to only one type of income, such as Income Code 15 for scholarships and fellowship grants, the amount reported may be taxed differently depending on the immigration status of the recipient when the income was received. For example, only recipients of scholarships or fellowship grants who are in "F," "J," "M," or "Q" immigration status may record the taxable grant as effectively connected income subject to graduated rates. Recipients in other immigration categories must record these taxable amounts on page 4 of Form 1040NR under "Other" with the description of the income on the line. If withheld on correctly by the payer, recipients who were in "F," "J," "M," or "Q" status will have tax withheld at a 14 percent tax rate (or not withheld if treaty-exempt). The withholding rate for all other recipients is 30 percent rate (if correctly withheld upon).

A special long-standing withholding procedure (described in IRS Publication 515) allows a withholding allowance (deduction) in box 3 of Form 1042-S for recipients of taxable scholarships and fellowship grants in "F," "J," "M," or "Q" immigration status. These recipients are deemed by the tax code to be engaged in a U.S. trade or business. As a result, they are eligible for deductions such as travel reimbursements provided they are temporarily away from their tax home (i.e., away for a period not expected to exceed one year). Travel reimbursements for recipients whose travel is not related to services (employment or self-employment) may not be excluded from income even if paid or reimbursed under an accountable plan. The IRS provides this procedure instead. The withholding allowance needs to be analyzed to determine if travel reimbursements included in the amount are deductible. To deduct these amounts properly requires recording them on a Form 2106 or 2106-EZ as employee business expenses which requires a breakdown of the withholding allowance. The withholding allowance also might include deductions such a charitable deductions that are recorded on page 2 of Form 1040NR(-EZ).

Recording misreported income (e.g., on a Form 1099 instead of a Form W-2 or a Form 1042-S) can be problematic. For example, Form 1099-MISC Other Income (box 3) might be a prize or award recorded on page 4 of Form 1040NR as Other or a taxable fellowship recorded on page 1 of Form 1040NR(-EZ). It is also not unusual for nonresident aliens to receive a Form 1099 with income reported as taxable when it is not. The most common example is a Form 1099-INT reporting interest on a bank deposit even though such interest is not taxable if received by a nonresident alien. Form W-2 wages might also be problematic if the employer included wages for work days outside the United States which are foreign-source income and not subject to U.S. tax. This problem must be resolved with a Form W-2C or an allocation between U.S. and foreign income attached to the return to explain why the wages recorded on the Form 1040NR(-EZ) are different than as reported.

9. EXEMPTIONS FROM TAX UNDER AN INCOME TAX TREATY

The United States has income tax treaties with over 60 countries which provide exemptions and reductions in tax (called "treaty benefits") for eligible foreign nationals. IRS Publication 901, U.S. Tax Treaties provides overviews of treaty benefits in Table 1 for passive income and Table 2 for income related to U.S. activities. Table 2 should be used with caution since many of the limitations on benefits for teaching and engaging in research in provisions (called "articles") in various treaties are not included in the overviews or Table 2 footnotes. Also, the benefits available for engaging in research are not clear from the Table 2 because Income Code 18 is defined as "Compensation for teaching" even though all but 2 of the treaties with these provisions (the treaties with Greece and Pakistan) include for engaging in research. Taxpayers making a claim under a Table 2 article may not combine one treaty article with another to claim a higher benefit but if 2 specific articles apply by their terms to an item of income, the taxpayer may choose the article resulting in the highest benefit.

Taxpayers claiming benefits for the primary purpose of studying, training, teaching or engaging in research must be in an immigration status that supports such a claim as follows:

- Studying – F-1 or M-1 students or J-1 exchange visitors in the student category
- Training – J-1 exchange visitors in trainee, intern, or student intern category, H-3 trainees, or H-1B specialty workers who are medical residents
- Teaching – J-1 exchange visitors in the professor or teacher category or H-1B or E-3 specialty workers who are professors or teachers
- Engaging in research – J-1 research scholars or H-1B or E-3 specialty workers who are researchers

Taxpayers in other categories such as J-1 exchange visitors in the alien physician category (because they have patient contact no matter how little) who primary activity is one of the above are eligible for a treaty benefit will need to explain additional evidence supporting the claim with the tax return or the claim might be disallowed by the IRS reviewer. Taxpayers who came to the United States in one status (such as an F-2 spouse) and later changed to another status for

which a treaty benefit is allowed (such as F-1 student) are generally not eligible for the treaty benefit because they did not come to the United States for the purpose of that activity. Also, IRS policy (and many treaties) prevent a consecutive treaty benefit by a foreign national who was in one status (e.g., F-1 student) who changed to another status (e.g., J-1 researcher) without first returning home and reestablishing physical presence and residency in the treaty country and being absent from the United States for at least one year (365 days). The purpose of this policy is to ensure that the foreign national is a resident of the treaty country at the outset of the treaty claim and to prevent overly long periods during which treaty claims are made.

Not all types of income are covered by a specific treaty article. For example, there is no treaty article for prizes or for awards or gambling winnings. Income not dealt with by a specific treaty article may be covered by the Other Income Article of an applicable treaty if the Other Income Article covers U.S.-source income and other conditions regarding residency in the treaty country and nonresidency in the United States are met. A taxpayer who fails to meet the conditions for exemption under a specific article may not resort to the Other Income Article because the income was "dealt with."

Not explained in IRS Publication 901 are conditions regarding residency status in the treaty country which must be met to be eligible for a treaty benefit or residency status in the United States which can prevent an exemption from tax under an otherwise available tax treaty article.

Tax residence in the treaty country is required for eligibility for a treaty benefit. However, the timing of residency varies depending on the treaty article under which the treaty claim is made. For example, most treaty articles require the taxpayer to be a resident of the treaty country when income is paid, such as the articles for interest, dividends, and royalties. This income is reported on page 4 of Form 1040NR. Other articles require that the income recipient be a resident of the treaty country when the activities giving rise to the income paid occur, for example, independent contractor income. (Sometimes the activity occurs in one tax year and the payment is made in the subsequent tax year, necessitating a special explanation with the tax return.) Still other articles provide benefits if the income recipient was a resident of the treaty country when the taxpayer first visited the United States for the purpose of the article (e.g., studying, training, teaching, or engaging in research) or similar language. This income is effectively connected income recorded on page 1 of Form 1040NR(-EZ).

Foreign nationals who become resident aliens will lose most treaty benefits because of a "saving clause" included in treaties that preserves the right of the United States to tax its citizens and residents as if the treaty had not come into effect. Treaty benefits under articles for studying, training, teaching, or engaging in research are generally preserved for resident aliens under the substantial presence test but generally not for resident aliens who are green card holders. The IRS includes instructions in Publication 519, U.S. Tax Guide for Aliens, about how resident aliens may claim tax treaty benefits under a saving clause exception on a Form 1040.

Treaty-exempt income of nonresident aliens is reported on a Form 1042-S. Although treaty-exempt income of resident aliens is not required to be reported on Form 1042-S it may be which is helpful for both the taxpayer and the IRS return reviewer. If the treaty-exempt amount reported on Form 1042-S is fully exempt from tax, the Exemption Code is 04. If the amount reported is subject to a reduced rate of tax under a treaty (e.g., royalties under many treaties), the Exemption Code is 00. The Income Code on the Form 1042-S corresponds to the income codes in Table 1 or Table 2. Income Code 50 (Miscellaneous Income) is used for various types of income that do not have their own Income Code (e.g., prizes and awards).

Recording income exempt under a tax treaty provision is straight forward if the income is fully exempt and reported on a Form 1042-S under Exemption Code 04. Treaty-exempt income is recorded on line 22 of Form 1040NR or line 6 of Form 1040NR-EZ and described on Schedule OI (Other Information) item L or J respectively. Describing treaty-exempt income is not always easy, however, because the explanation and examples for fields such as "Number of months claimed in prior tax years" are not clear. This is especially the case if the taxpayer had a similar claim for a prior visit for the same purpose but IRS policy allowed a subsequent claim for the same type of benefit because of the time spent outside the United States back in the treaty country (a year or more). IRS wants information for this treaty claim in the current tax year that included claims that began in prior years to ensure that the maximum period for the benefit for this claim is not exceeded, typically 2 years for teacher/researcher article claims and 5 tax years for student/trainee article claims.

When treaty-exempt income is not reported on a Form 1042-S, nonresident aliens must include the same type of information with the return that would have been required for exemption from tax (i.e., the information that is required for a claim on Form 8233 for compensation for services or on a Form W-8BEN for all other types of income). The IRS reviewers have begun requesting information from the taxpayer's employer or paying organization when the treaty benefit being claimed was not reported on a Form 1042-S. This information is being requested because the organization may have facts relative to a treaty claim that are not recorded on the Form 1040NR(-EZ) such as immigration status changes or prior visits during which treaty benefits were claimed. The result is that some taxpayers who might be eligible for a treaty benefit may not be allowed the benefit because their organization refuses to provide the requested information.

Taxpayer and their return preparer might have to deal with a variety of information returns when preparing a tax return that include income eligible for a treaty-exemption.

- It is not unusual for a recipient with treaty-exempt income to receive both a Form 1042-S and a Form W-2. This can occur when an employee's wages exceed the treaty maximum amount for compensation while studying or training (Income Code 19) or are paid beyond the maximum benefit period in the case of a teacher/researcher article benefit (Income Code 18).
- Since some employers and payers do not allow treaty-exemptions from withholding, income eligible treaty exempt-income might be reported on a Form W-2 or a Form 1099, or on a Form 1042-S which includes taxes withheld. (This is in contravention of section 894(a) of the tax code which states that due regard must be given to treaties, which means that an employer or payer must provide a treaty exemption from withholding if a treaty-eligible income recipient provides a valid Form 8233 or Form W-8BEN with the treaty claim.)
- Some employers that allow a withholding exemption under a treaty based on a valid withholding certificate (or sometimes without a valid form) misreport the treaty-exempt income on Form W-2 instead of a Form 1042-S.
- Some taxpayers eligible for a treaty benefit might have part of the treaty-exempt income reported on a Form W-2 because it was subject to wage withholding. This typically happens when the employee fails to provide a valid Form 8233 (a calendar year form) before the first payroll of the year so the wages are withheld on. The treaty-exempt wages paid after the Form 8233 is received are reported on Form 1042-S under Exemption Code 04.

Unfortunately for the taxpayer, it is also not usual for an employer to double report treaty-exempt wages on both a Form W-2 and a Form 1042-S. This occurs when the employer's payroll provider does not have processes to facilitate the splitting payroll between treaty-exempt income reported on Form 1042-s and wages subject to wage withholding on Form W-2 and the payroll has not implemented procedures to reduce Form W-2 wages by treaty-exempt income either before it is issued or after issuance with a Form W-2C. The taxpayer will end up paying taxes on income misreported on Form W-2 if the employer does not issue a Form W-2C.

Misclassified income is also problematic for foreign nationals eligible for treaty benefits. For example, wages for research services misclassified and reported as a noncompensatory research fellowship either on a Form 1042-S or a Form-MISC can cause a tax return dilemma when the wages would be treaty-exempt but the treaty lacks a provision for exempting the fellowship from tax (typical of most treaties). If the fellowship is really wages depending on the facts – fixed work schedule, "salary" reviews based on performance, family health coverage, inclusion in a pension plan, etc. – the taxpayer will need corrected information returns in order to claim the treaty benefit because the IRS believes the information returns as issued.

10. TAXPAYER IDENTIFICATION NUMBER REQUIREMENTS

A U.S. taxpayer identification number (TIN) is required on a U.S. tax return whether the return is a Form 1040 or a Form 1040NR(-EZ). Foreign nationals who are authorized to work in the United States by their immigration status generally apply for a U.S. Social Security number at the outset of their employment and will have it by tax return filing time.

Because there is no federal requirement for a U.S. TIN in order to be paid, nor is a U.S. TIN required on a Form 1042-S if withholding was at the statutory rate, there are many foreign nationals with U.S. tax return filing obligations who do not have a U.S. TIN at tax return filing time. Such foreign nationals include:

- Entertainers and J-1 short-term scholars who are work authorized and, thereby, eligible to apply for an SSN but who are not in the United States long enough to apply for and receive an SSN based on Social Security Administration (SSA) guidelines. (SSA will not send an SSN to an individual outside the United States.)
- Recipients of a taxable scholarship or fellowship grant subject to withholding at the statutory rate, generally 14 percent.
- Border crossers and foreign nationals in B-1, B-2, visa waiver including Canadian walkovers who are not eligible to apply for an SSN even though they may be engaging in authorized self-employment activities under the B honorarium exception
- USAID per diem recipients in J-1 exchange visitor status because the per diem is ECI and not eligible for the tax-return ECI exception for wages not in excess of the personal exemption amount.

These individuals may apply to the IRS for a U.S. individual taxpayer identification number (ITIN) because they have a federal tax administrative requirement for a U.S. TIN. A U.S. TIN is also required for a spouse and children for whom exemptions may be claimed on a U.S. tax return. An ITIN is a nine-digit number beginning with the number "9", has a range of numbers from "70" to "88", "90" to "92" and "94" to "99" for the fourth and fifth digits and is formatted like a SSN (i.e. 9XX-7X-XXXX).

Application for an ITIN is made on a Form W-7, Application for IRS Individual Taxpayer Identification Number. A foreign national may apply for a pre-tax return ITIN if certain conditions described in the Form W-7 instructions are met. For example, foreign nationals eligible for a tax-treaty exemption from withholding are eligible to apply for a pre-tax return ITIN. However, most foreign nationals apply for an ITIN with the submission of a federal income tax return. Federal tax returns submitted with one or more ITIN applications must be submitted to the ITIN Unit at the address in the Form W-7 instructions.

Obtaining an ITIN may be problematic. It is not unusual for tax return preparers dealing with similarly situated foreign nationals to have some ITIN applications processed and others denied even though there was no difference in the types of documentation submitted. This occurs because ITIN application processors are most familiar with ITIN applications made with tax returns of unauthorized foreign workers and less familiar with ITIN applications for foreign nationals visiting the United States to study, train, or engage in independent research. Frequently, when their ITIN applications are rejected, the taxpayers have already returned to their home country. If a federal tax return is submitted and processed without a U.S. TIN, IRS procedures deny all deductions including the personal exemption amount for the taxpayer. This can result in a tax due on a return if the return would have had no tax if processed with a TIN because of the personal exemption amount.

The most common problems with applying for an ITIN are the rules for documentation supporting identity and eligibility requirements that have been changed periodically by IRS beginning in 2003, most recently in January 2013. A Form W-7 may be completed by the foreign national applicant without assistance or with the assistance of any of the following:

- A certified acceptance agent
- The Designated School Official (DSO) for foreign students and their dependents in their institution's Student and Exchange Visitor Program (SEVP)
- The Responsible Officer (RO)for J-1 exchange visitors and their dependents in their institution's SEVP
- An IRS Taxpayer Assistance Center (TAC) in the United States
- An IRS TAC abroad available in the U.S. Embassy in only 4 cities, London, Paris, Frankfurt, or Beijing

Whether documentation submitted with the application must be original, certified by the issuing agency (not a practical possibility in the case of a passport), or certified otherwise depends on how the Form W-7 application is submitted and the IRS instructions on documentation at the time of submission. Foreign nationals applying for ITINs or their return preparers need to double check both the Form W-7 instructions and the IRS website for the latest instructions before submitting an ITIN application to the IRS to ensure they are using the latest instructions and submitting the documentation required for their specific situation.

11. STATE INCOME TAX CONSIDERATIONS

The rules for determining residency status for state income tax purposes are different from the rules that determine whether a foreign national is a resident alien or nonresident alien for federal income tax purposes. A foreign national taxpayer will be a resident, a part-year resident, or a nonresident for state income tax purposes depending on the state's definition of these terms. Most, but not all, states define residents without reference to a taxpayer's federal tax residency status and most, but not all, states do not define residents with reference to a foreign national's U.S. immigration status. As a result, depending on the state, it is possible to be a resident for federal income tax purposes and either a resident or a nonresident for state income tax purposes or a nonresident alien for federal income tax purposes and either a resident or a nonresident for state income tax purposes. States also have their own rules about part-year residents and how to allocate income for state tax purposes. State documents defining residency status for state income tax purposes are generally available on the website of the applicable tax authority which may be accessed by state through www.taxadmin.org.

Each state has its own rules for determining what income is not taxable, for example, some states such as Massachusetts do not tax noncompensatory scholarships and fellowship grants of state nonresidents even though they are taxable for federal income tax purposes. If a state defines income with reference to the federal tax return, and the taxpayer files a Form 1040NR(-EZ), the taxpayer will only be subject to tax on U.S.-source income, not worldwide income. Some states have their own rules for filing jointly so that married nonresident aliens who may not file their federal tax return jointly might nevertheless be able to file their state income tax jointly. Also, a state might allow spousal or dependent exemptions without reference to federal exemptions. This can be problematic, however, if the state requires a U.S. taxpayer identification number (TIN) in such situations. If one spouse lacks a U.S. TIN and has no U.S. taxable income requiring a federal income tax return, that spouse has no federal tax administrative purpose for applying for a U.S. individual taxpayer identification number regardless of the fact that a U.S. TIN is required for state income tax purposes.

Whether income exempt under a tax treaty for federal income tax purposes is also exempt from state income taxes varies by state. Tax treaties by their terms apply to federal income taxes. Treaties apply to state income taxes indirectly when if state defines income for state income tax purposes with reference to federal gross income, taxable income, or adjusted gross income because treaty exempt income is not included in the federal income. A state's tax rules might require treaty-exempt income to be added back into income, however (Connecticut for example).

Finding automated solutions for state tax return filings may be difficult for foreign nationals who are nonresident aliens and file a Form 1040NR or Form 1040NR-EZ neither of which may be e-filed. Even though foreign national taxpayers might be eligible for a web e-file tax return preparation software, most software maps or describes input with reference to amounts on a Form 1040, not a Form 1040NR(-EZ).

12. SUMMARY

The tax return process for foreign nationals has been described by an experienced tax return preparer as spending several hours collecting and analyzing information and ending up with a few numbers on Form 1040, Form 1040NR or 1040NR-EZ tax return for a client who is wondering why the cost of such a simple return is so high. The tax return preparation process for foreign nationals is typically time intensive (and as a result potentially costly) because tax return software programs generally do not automate the data collection and residency and tax-treaty analyses required for preparing these tax returns. Preparing a correct tax return for foreign national clients might be further complicated by income that is misclassified and misreported, classified correctly but reported on the wrong information return, or not reported at all.

There are few tax-return solutions that provide for the type of data collection and analyses for residency status and tax-treaty benefits required for tax returns for foreign national taxpayers. One notable software exception is the Thomson Reuters Foreign National Tax Resource (FNTR) that provides both a content-laden website and an on-line tax return preparation process with both sophisticated tax residency and tax treaty analyses for Form 1040NR and 1040NR-EZ. FNTR also includes automated processes for collecting and correctly recording misreported and unreported income. FNTR is generally subscribed to by non-profit organizations such as colleges and universities for use by their foreign students and scholars.

GO TO COVER

GO TO CONTENTS