Organizations with Foreign Employees Face Compliance Challenges

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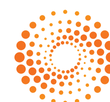
ONESOURCE® NONRESIDENT ALIEN TAXATION



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In this global economy, U.S. employers both large and small routinely employ non-U.S. citizens as well as U.S. citizens. The payroll withholding and reporting rules that apply to non-U.S. citizen employees are generally the same as for U.S. citizen employees if they are resident aliens (RAs) as that term is defined by section 7701(b) of the Internal Revenue Code (IRC). However, withholding rules differ for non-U.S. citizen employees who are nonresident aliens (NRAs) because they do not satisfy one of the two tests for being a resident alien (discussed below).

Nonresident employees are subject to special federal income tax rules. As a result, different wage withholding rules designed to approximate the tax liability of nonresident aliens apply to their wages. Also, for policy reasons, some nonresident employees are exempt from Social Security and Medicare (FICA) taxes. Wage reporting for nonresident employees is generally the same as for U.S. citizen employees with one exception. Wages exempt from withholding under an income tax treaty (discussed below) must be reported on a Form 1042-S, not a Form W-2. State withholding and reporting rules are based on state definitions of resident and nonresident, which vary by state. Some states' residency definitions treat nonimmigrants such as students as state nonresidents (e.g., Wisconsin). State withholding and reporting rules are typically the same for U.S. citizens and non-U.S. citizens alike.

A. SPECIAL PAYROLL RULES FOR NONRESIDENT EMPLOYEES

Special payroll rules, described in IRS Publication 15, Circular E, Employer's Tax Guide, apply to nonresident employees. Exceptions from the rules for withholding on income of nonresident aliens, such as exemptions from tax under income tax treaties, are explained in IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities.

Withholding rules for nonresidents result in higher withholding because nonresident taxpayers generally pay higher taxes. The higher taxes result from nonresident taxpayers not being able to claim on their tax return (a Form 1040NR or 1040NR-EZ) many of the personal exemptions, deductions, and credits that U.S. citizens and resident aliens may claim on their Form 1040 tax return.

1. Special Form W-4 Rules

Because of the special tax rules that apply to nonresident aliens, nonresident employees may not use the standard rules for completing Form W-4, Employee's Allowance Withholding Certificate. Instead, when completing Form W-4, nonresident employees must:

- not claim "exempt";
- use single status even if married;
- claim only one allowance (with a few exceptions);
- write "nonresident alien" or "NRA" above the dotted line on line 6.

Additional personal allowances may be claimed only by the following nonresident employees and only under certain circumstances:

- residents of Canada or Mexico
- residents of South Korea
- U.S. nationals from the Northern Mariana Islands and American Samoa
- residents of India who entered (and remain) as students or business apprentices

Other nonresident employees may not claim additional personal exemptions even if their dependents are U.S. citizens. To comply with these rules, self-service payroll processes must prevent nonresident employees from using the W-4 rules that apply only to U.S. citizens and resident aliens. Additional information on Form W-4 completion by nonresident aliens can be found in IRS Notice 1392, "Supplemental Form W-4 Instructions for Nonresident Aliens."

2. Phantom Gross-up

Under the payroll rules for nonresident employees, employers are required to calculate federal income tax withholding on wages under a special procedure. Before applying the wage withholding tables, they must add to the wages of nonresident employees an amount that varies by pay period to offset the assumed standard deduction that is incorporated into the wage tables using a table provided in IRS Publication 15, Circular E, Employer's Tax Guide.

These amounts do not affect income for Form W-2 purposes, Social Security or Medicare (FICA) wages or taxes, or wages for federal unemployment tax (FUTA) liabilities.

Residents of India who entered (and remain in) the United States as students or business apprentices are not subject to this procedure because of a special provision in the U.S./India Tax Treaty (see Rev. Proc. 93-20, 1993-1 C.B. 528).

3. The NRA FICA Exception

IRC section 3121(b)(19) provides an exception from FICA for compensation services performed in the United States:

- by nonresident aliens;
- temporarily in the United States in principal F, J, M or Q status;
- for authorized employment; and
- for work consistent with the purpose of the employee's immigration status

This exception is not available for dependents (e.g., J-2 status employees) whose purpose is to accompany the primary visa holder to the United States.

This exception is also not available for resident aliens. Therefore, employers must project the residency status of foreign employees based on the end date of their immigration status to avoid exempting ineligible employees. FICA refunds may be claimed if an eligible employee who has paid FICA leaves the United States before becoming a resident alien. If, however, the individual returns to the United States in the year of

departure, such presence might be enough to cause the individual to be a resident alien for the calendar year. As a result, such FICA refunds are best processed after the end of the calendar year when all the facts are known.

IRC section 3306(b)(19) provides a FUTA exception for these FICA-exempt employees.

B. SPECIAL EXEMPTIONS UNDER BILATERAL AGREEMENTS

Special exemptions from payroll taxes may be available to foreign national employees who are (or were) a resident of a country with a bilateral agreement with the United States. Social Security agreements allow eligible employees to remain covered by their home country social security system and provide exemptions from FICA (but not FUTA) taxes. Income tax treaties provide exemptions from income taxes and related withholding for eligible residents from tax treaty countries.

1. Income Tax Treaties

The United States has income tax treaties with over 60 countries. Tax treaties frequently provide exemptions from income taxes (but generally not from employment taxes) for foreign nationals in the United States to study, acquire training, teach, or engage in research who are (or were) tax residents in a treaty country when they came here for that purpose. Although all treaties include provisions (called "articles") for exempting employment income (called "dependent personal services"), these articles generally require that the employer be either a resident of the treaty country or not be a resident of the United States. IRS Publication 901, U.S. Tax Treaties, explains these articles. Table 2 in IRS Publications 515 and 901 include an overview of tax treaty benefits and limitations for compensation for services performed in the United States.

Nonresident employees may request an exemption from wage withholding by presenting a completed Form 8233 (required annually), which the employer must verify, sign, and submit to the IRS within five days of acceptance of the form. Resident alien employees may request treaty benefits on a specially annotated Form W-9 explaining their treaty claim (not required annually) which is not sent to the IRS but, rather, is maintained in the employer's files to support the tax exemption.

Income exempted from withholding under an income tax treaty must be reported on a Form 1042-S information return. Organizations issuing one or more Form 1042-S must also submit a Form 1042 tax return (even if all of the income reported had no taxes withheld).

2. Totalization Agreements

The United States has Social Security agreements (commonly called "totalization agreements") with more than 20 countries. These agreements eliminate dual coverage and dual contributions (i.e., taxes) for the same compensation. Home country social security coverage and exemption from FICA under a totalization agreement applies to resident aliens, nonresident aliens, and even to U.S. citizens who relocate to the United States and meet the condition of being a resident of a country with an agreement. Totalization agreements do not apply for FUTA purposes.

Foreign employees may remain covered under another country's social security system when they are sent to work temporarily for an organization by an affiliated foreign employer under the detached worker rule of an applicable agreement. Generally, a detached worker is an employee who comes to the United States to work temporarily for a period not expected to exceed five years.

A few countries allow employees working outside the country temporarily to make voluntary social security payments on U.S. wages into the home country's social security system. In both situations, coverage by another country under a totalization agreement must be supported by a certificate of coverage issued by the social security agency of the other country (or alternatively by the U.S. Social Security Administration) as evidence that the employee is covered by and paying taxes on the U.S. wages into that country's social security system.

The agreements and helpful descriptions are available at http://www.ssa.gov/international.

3. The Immigration/Tax Nexus

The tax rules for determining whether a foreign national is a resident alien or a nonresident alien are tied to the foreign national's U.S. immigration status and U.S. presence. The challenges for employers with foreign national employees are 1) to determine which employees are nonresident aliens and 2) to apply the special withholding rules, and exemptions from tax, for wages paid to these employees.

Foreign national employees may be authorized to work in the United States under a variety of immigration categories each with its own terms and conditions. These categories of foreign national employees include (but are not limited to) the following:

- Immigrants, also called U.S. lawful permanent residents, more popularly called "green card holders";
- Workers sponsored for work by the organization such as H-1B specialty workers, L-1 intra-company transferees, and O-1 persons of extraordinary ability;
- J-1 exchange visitors under an organization's exchange visitor program in the category or categories allowed by the organization's designation letter;
- J-1 exchange visitors sponsored by an umbrella organization for designated employers;
- F-1 students engaged in curricular or optional practical training (CPT or OPT) with an employer in their field of study pursuant an annotated I-20 or employment authorization document (EAD), respectively;
- J-1 students engaged in academic training in their field of study with a designated employer; and

- Foreign employees in other categories (collectively called "nonimmigrants") as well as pending adjustment applicants working under an EAD issued by the immigration service (the EAD category code corresponds to the explanation for its issuance under U.S. immigration law).

A nonimmigrant's immigration status may change while the individual is in the United States, in many cases even while the employee is working for the same employer. For example, one common situation is a change in status by an F-1 student working under OPT who changes to H-1B status sponsored by the same employer. Many nonimmigrant employees may also adjust their immigration status to immigrant while in the United States. This status may be through petition by their employer or by a family member.

While the immigration rules and procedures are generally handled by in-house specialists or outside advisors such as immigration attorneys, the payroll rules and procedures are generally administered by payroll professionals not specifically trained in the special rules and procedures that can apply to some (but not necessarily all) foreign national employees. Even payroll professionals for large employers with programs for employees relocating internationally administered by specialists and outside advisors face the challenge of administering payroll for foreign employees such as J-1 trainees, J-1 exchange visitors in Summer/Work Programs, and F-1 and J-1 students engaged in practical or academic training because these employees are not typically included in such relocation programs.

4. Identifying Nonresident Alien Employees

The first challenge for payroll administrators is to identify the organization's nonresident employees so that they can apply the special payroll rules. Section 7701(b) of the Internal Revenue Code (IRC) and regulations thereunder provide two methods for determining whether a foreign national is a resident alien or not, one for green card holders and one for nonimmigrants that is based on their substantial physical presence in the United States.

1. Green Card Holders

Foreign employees who are green card holders (U.S. Lawful Permanent Residents, or LPRs) are resident aliens for tax purposes under the green card test. Green card holders are resident aliens from their first day of physical presence in the United States in that status (it might be earlier if they were also substantially present as described below). They retain their green card status until it has been lost by abandonment or revocation. Green card holders working in the United States are subject to the same payroll tax rules as are U.S. citizen employees.

While it is not necessary for payroll to track these employees once their green card status is known, the employer should keep track of these employees systematically for two reasons: 1) during a payroll audit, IRS might ask for a list of all alien employees, a term which includes green card holders and 2) green card holders working abroad for the employer are not generally eligible for all of the special tax rules and procedures that apply to U.S. citizens working abroad. For example, the special payroll rules for reducing or eliminating wage withholding for expatriates apply specifically to U.S. citizens. They may also apply to a foreign national employee if the employee is a national of a country with which the United States has an income tax treaty because of the nondiscrimination clause of the treaty.

2. Foreign Employees Substantially Present

Resident aliens include nonimmigrants substantially present in the United States as defined by the tax code. Nonimmigrants are substantially present in the United States if they meet the conditions of the 183-day residency formula called "the substantial presence test." (This test applies to workers whether work-authorized or not.)

Any nonimmigrant employee meets the substantial presence test if 1) they are physically present in the United States for at least 31 countable days in the current calendar year and 2) their countable U.S. days over three calendar years equal or exceed 183 days based on a 183-day substantial presence formula. Nonimmigrants whose presence in the United States fails to satisfy the 183-day substantial presence test are nonresident aliens.

The 183-day substantial presence formula considers:

- all of the countable U.S. days in the current calendar year; plus
- plus 1/3 of the countable U.S. days in the prior year; plus
- plus 1/6 of the countable U.S. days in the year before the prior year.

Partial U.S. days of arrival and departure do count. Fractions under the formula must be considered in the math. The U.S. days of presence that must be counted generally include days in the United States prior to their current employment regardless of the purpose for the visit and whether or not they were subject to U.S. tax during the prior visit.

Some U.S. days of presence do not count. For example, days spent commuting from a residence in Canada or Mexico to work in the United States (provided they satisfy the regulatory definition of commuting days). In addition, some days may be disregarded under a de minimis rule if certain conditions are met (see "de minimis presence" in IRS Publication 519.) Also, days spent as an exempt individual (discussed below) do not count for purposes of this formula. Under this formula, a foreign national who averages 122 or more countable U.S. days of presence per calendar year will become a resident alien for tax purposes unless an exception applies. Exempt individuals are identified by their current immigration status category (described below) with one exception. Professional athletes in the United States for a charitable event are exempt individuals for the day(s) of the event, but not for days engaged in training.

3. Exempt Individuals

Exempt individuals do not count U.S. days for specified periods that vary with their immigration status. IRS refers to these individuals as "exempt (from counting days) individuals" to make it clear that this exemption is not for tax or withholding purposes.

Individuals in the following immigration categories are exempt from counting days for specified periods:

- Foreign-government related employees (A-status diplomats and G-status international organization employees) and their spouses in derivative status do not count their U.S. days, without limitation.
- F, J, M and Q status students do not count their U.S. days for five calendar years, which includes any exempt-from-counting calendar years since 1985 regardless of the number of years in between. Although students not intending to reside permanently in the United States may extend the calendar years beyond five, IRS has not provided procedures for obtaining the IRS letter needed for using this rule for withholding purposes.
- Teachers and trainees (see below) do not count U.S. days for two out of the current seven calendar years. They do not count U.S. days for four out of seven calendar years if they receive compensation for services and all of their remuneration (i.e., pay for services including in-kind payments) is paid by a foreign employer, a term which does not include foreign governments.

The term "teachers and trainees" includes J exchange visitors in any category other than student or student intern but not teachers and trainees in any other immigration category (e.g., H-1B professors or H-3 trainees.) The term also includes Q cultural visitors. These nonimmigrants are collectively referred to by the more descriptive term "nonstudents." Care must be taken in evaluating the exempt days of J and Q individuals, as their status as student or nonstudent determines which set of rules applies to them.
These exempt-from-counting-days rules apply to accompanying spouses and unmarried children who are in derivative status (e.g., J-2) with one exception. Unmarried children are only exempt if they are under age 21, reside regularly in the household of the parent they accompanied, and are not a member of another household.

Because there is no de minimis rule for purposes of determining exempt days, even one day in the calendar year as an exempt (from counting days) individual causes that calendar year to be counted as exempt. For example, a J-1 research scholar who arrived on December 28, 2010, and who has not been in the United States in F, J, M, or Q status in the 6 prior years, has used up one (2010) of his two calendar years in which he is exempt from counting days. Because 2010 is an exempt (from counting days) calendar year, he will effectively have only one calendar year (2011) to use the NRA FICA Exception (discussed above). It does not matter that he neither worked nor received pay in 2010.

4. Residency Start and End Dates

An individual who becomes a resident alien during the calendar year is a resident retroactive to the first countable day of presence in the calendar year that the employee becomes a resident alien. IRS advises employers to treat such potential resident aliens as resident aliens from January 1 or their first countable day in the calendar year when they might become resident aliens. This procedure will ensure collection of payroll taxes, particularly FICA taxes in the case of those individuals who would qualify for the NRA FICA Exception but for the fact they are resident aliens.

An individual's residency end date is deemed by IRS regulations to be December 31 of their last calendar year of residency. Departing individuals may choose an earlier end date (typically the last day of physical presence) under the closer connection exception described in Publication 519 for tax return (but not withholding) purposes. To claim an earlier residency end date the individual must 1) have a closer connection to a foreign country and 2) have a tax home in the foreign country. As a result, this election is not available for individuals who simply change from an immigration status during which U.S. days count (e.g., H-1B) to an exempt-from-counting-days status (e.g., F-1). While such an individual might have a closer connection to a foreign country, the individual's tax home did not change to a foreign country following their change in status. Even though the individual is an RA through December 31 of the year of change, that calendar year in F-1 status still counts as one of the five exempt-from-counting calendar years.

An individual might return to the United States during the calendar year of departure, thus extending his or her residency end date to the new date of departure (ignoring up to 10 noncontiguous U.S. days). Therefore, applying the December 31st end date rule is the most conservative approach for reporting and withholding purposes. Individuals who are eligible to claim an earlier date on their U.S. tax return (and who would, as a result, be dual-status taxpayers) may claim overwithheld income taxes as refunds on their dual-status tax return. Dual-status taxpayers who return to the United States the following calendar year and become resident aliens once again are treated under an anti-lapse rule as full year residents for both calendar years.

5. Substantial Presence Examples

Determining residency status for foreign employees who have not been in the United States in F, J, M, or Q status in the current and prior two calendar years is straightforward.

> Example 1: Jane, an H-1B researcher visits the United States from August 15, 2009 to June 30, 2011. She had one prior visit for a week-long vacation in 2008.

- NRA for 2009 (<183 countable US days based on the formula.)
- RA for 2010 (>183 countable US days)
- RA for 2011 (>183 countable US days based on the formula)

Earlier visits might impact some years but not all years. Assume Jane had also been in the United States as a J-1 research scholar from August 15, 2004 to June 30, 2006. U.S. days for 2006 count and must be considered in the formula. This earlier visit has no impact on 2010 or 2011 because 2006 is not one of the 3 calendar years being analyzed for each of those years.

Determining residency status for nonstudents is straightforward for foreign employees who are on their first visit to the United States in F, J, M, or Q status.

> Example 2: Peter, a J-1 trainee, visits the United States from August 15, 2009 to Sept 30, 2011. He had no prior visits.

- NRA for 2009 (exempt from counting days)
- NRA for 2010 (exempt from counting days)
- RA for 2011 (>183 countable U.S. days)

Determining residency status for students is straightforward for foreign employees who have not visited the United States before in F, J, M, or Q status but requires collecting information about calendar years prior to the current three calendar years.

> Example 3: Jessica, a J-1 student, visits the United States from August 15, 2006 to Sept 30, 2011. She had no prior visits (2006-2008 are 3 calendar years exempt from counting).

- NRA for 2009 (4th exempt calendar year)
- NRA for 2010 (5th exempt calendar year)
- RA for 2011 (>183 countable U.S. days)

Determining residency status for students who have been to the United States before in F, J, M, or Q status (either as students or as nonstudents) requires collecting information about the prior visits in F, J, M, or Q status as well as information about the current visit.

> Example 4: Chris, a J-1 student, visits the United States from August 15, 2009 to Sept 30, 2011. He visited as an F-1 Student (2003-2007, 5 exempt from counting calendar years)

- NRA for 2009 (counts days for 2009, but < 183 countable U.S. days)
- RA for 2010 (counts days for 2010; >183 countable U.S. days)
- RA for 2011 (counts days for 2011; >183 countable U.S. days)

The tax law does not limit time spent in F, J, M, or Q status to visits that are in the same category. As a result, prior visits in another category, such as an F-1 student with an earlier visit as a J-1 nonstudent and vice versa must be taken into account in determining which calendar years have countable days.

> Example 5: Conrad, a J-1 nonstudent, is in the United States August 15, 2009 to Sept 30, 2011. He visited as an F-1 Student 2003-2007 (5 years exempt from counting)

- NRA for 2009 (counts days for 2009, as he already had 2 exempt years in the 6-year lookback period of 2003-2008, but < 183 countable U.S. days)
- RA for 2010 (counts days for 2010, as he already had 2 exempt years in the 6-year lookback period of 2004-2009,; >183 countable U.S. days)
- RA for 2011 (counts days for 2011 as he already had 2 exempt years in the 6-year lookback period of 2005-2010,; >183 countable U.S. days)

These residency determinations are particularly complicated for individuals in J-1 nonstudent status who have had one or more prior visits to the in J-1 nonstudent status, a frequent occurrence for J-1 research scholars. Some years in that status count and some do not. As a result tax residency status can change from nonresident to resident or from resident to nonresident, which might be difficult for the individual as well as payroll to understand. This can occur when calendar years that might be exempt from counting (or not) drop out of the 7 calendar years that are being used to determine residency status. The history of exempt and nonexempt calendar years during prior visits cannot be changed because the tax law specifically refers to exempt calendar years when describing the limitations, not just calendar years in that status. As a result, the residency status each year can vary greatly with the patterns of travel.

6. Resident and Nonresidency Elections

There are several possible elections that nonimmigrants may make either to be treated as resident aliens or to remain nonresident aliens. As described below, many of these elections are not available for withholding purposes.

(a) Residency Elections

Nonimmigrant employees who are nonresident aliens who are married to a U.S. citizen or resident alien spouse as of December 31 may elect with their spouse to be treated as a resident alien in order to file jointly with their spouse. Nonresident employees who have made such an election may also make this election for wage withholding purposes using a statement similar to that described in IRS Publication 519, U.S. Tax Guide for Aliens for tax return purposes. This election does not change an employee's nonresidency status for FICA purposes. (This election is also not effective for purposes of IRC section 1441 withholding, popularly called "NRA withholding, on income other than wages.) A nonresident alien married to a nonresident alien may not make a marriage-based election to be treated as a resident alien.

The Student articles of the current tax treaties with Barbados, Hungary and Jamaica allow individuals who meet the criteria of the article to elect to be treated as residents for income tax purposes. Unlike the marriage-based election described above, these treaty-based elections apply to all income types for withholding and reporting purposes, not only to wages. They do not render an individual ineligible for the section 3121(b)(19) NRA FICA exemption if they

would be eligible for it notwithstanding the treaty election because income tax treaties do not apply to employment taxes.

The first-year choice election allows certain foreign nationals with countable U.S. days in their year of arrival to claim part-year residency status. The procedures for making this election are explained in IRS Publication 519. Because the facts supporting this election cannot be known until after the end of the year, this election is not available for withholding purposes.

The fact that a nonresident alien incorrectly submitted a Form 1040 tax return which was not rejected by the IRS does not cause the individual's residency status to change to resident alien.

(b) Nonresidency Elections

There are three exceptions that allow a foreign national to remain a nonresident alien longer than the period determined under the SPT analysis: 1) the closer connection exception (Form 8840 required), 2) the closer connection exception for students (special statement required), and 3) nonresidency under an income tax treaty residency tiebreaker rules (Form 8833 required).

IRS provides instructions for claiming the closer connection exceptions in IRS Publication 519. Because the facts supporting the closer connection exception (e.g., fewer than 183 days in the calendar year) cannot be known before the end of the year, this exception is not available for withholding purposes. IRS has not issued procedures for students to request a letter supporting a closer connection exception claim for withholding purposes. The procedure for a nonresidency claim under a treaty for withholding purposes is not provided in any IRS publication. Presumably such a claim may be made as is required on Form 8833 for tax return purposes.

5. Processing Issues for Payroll

Payroll professionals must determine which of their organization's employees are nonresident aliens subject to special withholding tax rules and exemptions from tax, and then correctly apply the special rules to wages paid to these nonresident employees.

(a) Social Security Numbers

Regardless of the residency status of nonimmigrant employees, one problem that payroll must face for such employees on their first U.S. work-authorized visit is the delay in obtaining a U.S. Social Security number (SSN) from the employee. Under Social Security Administration (SSA) rules, a work-authorized employee must wait at least 10 days after arrival in the U.S. before making application to SSA for an SSN. The delay is to provide time for admission information to be entered into the immigration service's Systematic Alien Verification for Entitlements (SAVE) system. SSA accesses SAVE for proof of current work authorization before issuing an SSN. If there are documentation problems, the issuance of an SSN to an employee will be delayed, sometimes for months, until the problem is resolved. Delays are exacerbated when the employee has changed status within the U.S.

Sometimes the delay is caused by the employees' not understanding the process or importance of applying for an SSN at the outset of their employment. (If they return abroad before obtaining one, they must resort to applying for an individual taxpayer identification number (ITIN) for U.S. tax return purposes. Occasionally, a work-authorized employee (e.g., a J-1 short-term scholar) will be unable to apply for an SSN because following the 10-day delay for application, the employee will not be in the United States long enough to receive the SSN from SSA. (SSA will not deliver an SSN outside the United States to an individual who applied in the United States and will not process applications for individuals whose immigration documentation indicates that there is less than one month remaining on their authorized stay at the time of application.)

There is no tax law requiring a taxpayer identification number to be paid and IRS has (informally) stated that a Form W-4 without an SSN is valid as long the form is otherwise correct. Since under U.S. labor law, payroll must pay an employee for work done, payroll might have to resort to a workaround for payroll system processing such as use of a dummy number (being careful to not issue one that could be confused with an ITIN). To avoid a penalty for failure to include an SSN on Form W-2, payroll must follow due diligence requirements for requesting an SSN as described in IRS Publication 1586, Reasonable Cause Regulations and Requirements for Missing and Incorrect Name/TINs.

(b) Substantial Presence Issues

Although the substantial presence formula is straightforward, applying the formula to specific situations for payroll purposes is not always easy because these rules were originally designed for tax return purposes (only estate and gift taxes are specifically excluded), not withholding purposes.

Projecting U.S. Presence. The substantial presence formula assumes that all U.S. days during the calendar year are known when the formula is applied, which is the case for tax return purposes, but not for withholding purposes. This information must be projected for withholding purposes based on the foreign employee's immigration status expiration date and reasonable expectations about their departure or continued presence (i.e., through a program extension). This information might be available from the Form I-9, Work Authorization Verification submitted at the hiring stage, or if not, may be collected separately for payroll purposes. (Requesting additional immigration documentation after the individual for payroll purposes does not implicate the nondiscrimination rules which apply only for hiring purposes.)

It is important to keep in mind that the fact that an individual has to count days toward substantial presence does not automatically make them a resident for tax purposes. For example, a J-1 nonstudent in their third calendar year in the United States in that status

(assume no prior visit) must start counting days as of their first day of presence in the third year. However, if they do not meet the 183-day threshold, they will still be an NRA for tax purposes. Assuming they leave the U.S. prior to meeting the threshold and do not return for the remainder of the year, they will still be an NRA even though their days all count. Such an individual would therefore still qualify for the 3121(b)(19) NRA FICA exception discussed earlier. (This section of the code specifies that the individual must be an NRA, not that they must be exempt from counting days of presence.)

The challenge for the employer is in deciding at the beginning of the year whether or not the individual is likely to meet the substantial presence test that year. This is why it is crucial to have a good understanding of the individual's (and the organization's) intentions with respect to the individual's continued presence in the United States. As mentioned earlier, IRS generally wants payers to treat an individual in this situation as an RA as of the first day of the year, as it is easier, for example, to refund overwithheld FICA once all the facts are known after the end of the year than it is to recover underwithheld FICA from someone who barely meets the 183-day test but has left the country and is no longer receiving wage payments. However, there are some situations where an organization will have sufficient knowledge of a particular case to justify NRA treatment at the beginning of the year.

Collecting Data about Prior Visits. In-house immigration systems and documentation are unlikely to include information about prior visits to the United States that may impact the employee's residency status. Even government systems such as the Student and Exchange Visitor Information System (SEVIS) currently lack the capability to consolidate information about prior U.S. visits tied to one individual with visits to multiple organizations. Information collected from the employee rather than from internal systems and documentation needs to be verified against documents available within the organization. This process is necessary since many foreign employees understand how to limit their immigration information in order to appear eligible for tax breaks such as the NRA FICA Exception.

Determining Countable Days. All of a foreign national employee's U.S. days of physical presence might not count for purposes of this formula. In most cases, whether U.S. days are countable or not is determined by the foreign national employee's U.S. immigration status because days spent in F, J, M, or Q immigration status do not count for some calendar years while in that status (but might count for other calendar years while in that status).

Identifying Sources of Data Impacting Residency Status. The SPT analysis must be done 1) when a foreign employee is hired,2) when immigration status is extended, changed or adjusted; and 3) annually for those individuals in F, J, M, or Q status (and for employees traveling internationally frequently). In order for these rules to be applied properly, payroll must be notified of extensions of stay and immigration status changes that occur during the calendar year because of their potential impact on the individual's residency status. Also, some immigration status changes impact whether withholding exemptions continue to apply or not. For example, a change in status from F-1 student to H-1B specialty worker can cause loss of the NRA FICA Exception (discussed above).

Implementing Interdepartmental Data Flow Procedures. Obviously, in order to apply these rules payroll needs systems and procedures to collect immigration status and U.S. presence history from the organization's foreign employees at the outset of the employment. Payroll also needs internal communications from departments such as Human Resources and the International Students and International Scholars Offices in institutions of higher education. Payroll must also collect information from foreign employees regarding their prior visits to the United States, which should be verified against existing information known to the organization such as resumes and admissions applications. (On an audit, the IRS will request this information which payroll is deemed to know whether it was communicated to them or not.)

Implementing Systems for SPT Data Collection and Processing. The type of immigration information collected and method used to collect it will vary by the types of nonimmigrants typically employed by the organization. How such information is collected and analyzed - manually, with simple spreadsheet processes, with standalone automated processes that produce SPT results to enter into the paying system manually, or sophisticated automated systems interfaced with existing paying systems - will depend on the complexity and volume of the organization's foreign employees.

For example, organizations with the following foreign employees might make do with manual or simple spreadsheet systems to stay in compliance:

- Sponsored employee in H-1B, O-1, or L-1 status (since many L-1 employees remain paid abroad for benefit purposes, payroll will need special procedures to comply with U.S. withholding and reporting on amounts paid abroad);
- Occasional foreign students engaged in practical or academic training in their field of study;
- J-1 exchange visitors for periods that average less than 123 days each calendar year such as those in camp counselor and summer work/travel categories.

But organizations with the following foreign employees will need more sophisticated processes in order to stay in compliance:

- Large numbers of J-1 nonstudent exchange visitors, many of whom have prior visits in J-1 nonstudent or F-1 status;
- Large numbers of F-1 students engaged in OPT for extensive periods such as employers eligible for STEM optional practical training;

- Many nonimmigrant employees who either extend their stay, change their immigration status, or apply to adjust status to green card holder while working for the employer.

Relying on (potentially) self-serving residency statements by foreign employees, or worse, doing nothing, in this compliance environment are no longer good options.

(c) Applying Special Withholding Rules

Payroll is responsible for applying and monitoring processing compliance with a variety of rules.

Collecting Correct Forms W-4. Once nonresident employees are identified, payroll should ensure that they provide (and do not change) a Form W-4 completed using the special rules for nonresident aliens, and then apply the wage withholding to wages adjusted by the phantom gross-up (either by the payroll system or manually). If the initial Form W-4 submitted lacks an SSN, payroll should apply due diligence in obtaining the SSN from the employee.

Documenting and Monitoring Exemptions from Wage Withholding. Payroll should allow exemptions from withholding only under income tax treaties based on a valid Form 8233 or annotated W-9 signed by the employee. Form 8233 should be collected timely, at the outset of employment and annually before the first payroll of the calendar year for multi-year benefits. Each Form 8233 should be reviewed, signed, and sent timely to the IRS as specified in the form's instructions. A treaty-based Form W-9 technically is not required to be renewed each year; however, as an individual's treaty eligibility can change from year to year, it is a good idea to do so. Payroll should monitor the benefit end period and apply withholding based on a Form W-4 to wages that exceed the treaty amount during the calendar year or for periods after the treaty benefit period ends. Exemptions from tax under certain treaties for teachers and researchers should be monitored to ensure that withholding begins timely if benefits will be lost retroactively because of the treaty terms.

Documenting and Monitoring Exemptions from FICA. Exemptions from FICA taxes under the NRA FICA Exception should be supported by documentation of the employee's immigration status and nonresident alien status. FICA should be withheld if the employee will potentially become a resident alien in the calendar year in order to ensure collection of FICA during the retroactive residency period. FICA exemptions under a totalization agreement should be supported by a certificate of coverage from the home country social security agency. The end period for the exemption should be monitored with extensions requested by the employee if employment is extended beyond the initial period of the certificate. Payroll should timely begin withholding FICA when an exemption is no longer available because of a change to resident alien, a change in immigration status such that the exemption no longer applies (e.g., F-1 to H-1B), or at the end of a certificate of coverage.

Issuing Correct Reporting Forms. Organizations allowing exemptions from withholding under income tax treaties should ensure that treaty-exempt compensation is reported on a Form 1042-S information return. Gross wages on Form W-2 must be reduced by tax-exempt wages (otherwise, the employee will be taxed on the double-reported income when they submit their tax return).

SUMMARY

Understanding and correctly applying all the rules and procedures for making wage payments to foreign employees is more important now than ever before. Because of the international tax gap, IRS is now focusing on compliance with international tax rules for paying foreign nationals in all sectors, for-profit and government entities as well as the tax-exempt sector which was IRS's initial focus for enforcing compliance with these rules. IRS is now aided by technical tools such as automated notification about sponsored employees provided by the immigration service. As a result, employers should anticipate that payroll compliance audits will include audits of the organization's application of the special payroll rules for wages paid to nonresident employees and implement policies and procedures to ensure compliance with these rules.

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