

# U.S. Taxation of J-1 Exchange Visitors

By Paula N. Singer, Esq.<sup>1</sup>

ONESOURCE® TAX INFORMATION REPORTING



THOMSON REUTERS™

The J-1 Exchange Visitor Program has long been used by institutions of higher education, teaching hospitals and research institutes to bring to the United States students, teachers, professors, research scholars, specialists, foreign physicians, and other short-term international visitors. With the expansion of the global business community, U.S. corporations increasingly employ J-1 Exchange Visitors as interns and trainees, and J-1 Exchange Visitors in the student category under academic training. However, many corporate employers are unfamiliar with the special tax rules that apply to individuals in J-1 status. This article provides an overview of these special tax rules and the tax opportunities and pitfalls that they present.

## U.S. TAX RULES FOR FOREIGN NATIONALS

The Internal Revenue Code (the Code) provides two separate tax structures – one for U.S. citizens and resident aliens and one for nonresident aliens. (For purposes of this article, resident alien and nonresident alien are tax terms and not immigration terms.)

Foreign nationals who are resident aliens are taxed in the same manner as U.S. citizens except for the year that they first become a resident alien. Resident aliens whose first day as a resident is not January 1 are dual-status taxpayers and taxed under special rules. Full-year resident aliens file a Form 1040, 1040A, or 1040EZ tax return. Resident aliens may claim exemptions for their dependents who 1) meet the definition of dependent 2) are either a U.S. citizen or national, resident alien, or a citizen of Canada or Mexico, and 3) have a U.S. taxpayer identification number.

Nonresident aliens are subject to U.S. income tax only on U.S.-source income and on income that is effectively connected to a U.S. trade or business. Effectively-connected income (ECI) includes compensation for services (employment and self-employment) performed in the United States and taxable scholarships paid to foreign nationals in J status. ECI is taxed after deductions (which are very limited) using single or married-filing-separately graduated tax rates. Other U.S.-source gross income, such as dividends, interest, royalties, and rents, is subject to a 30 percent tax rate. In certain situations an income tax treaty may apply to reduce or eliminate U.S. tax. Nonresident aliens file a Form 1040NR or 1040NR-EZ tax return. Only certain nonresidents may claim dependents. They include U.S. nationals, residents of Canada or Mexico, students and business apprentices from India, and residents of South Korea if the dependents have been with the taxpayer in the United States during the year. All other nonresident aliens may claim only one personal exemption even if they have a dependent who was born in the United States and is, therefore, a U.S. citizen.

Part-year resident aliens file Form 1040 with a statement for their nonresidency period income and deductions on Form 1040NR that are carried to their Form 1040 return. Dual-status taxpayers cannot use the standard deduction, and, if married, must use married-filing-separately rates. Nonresident aliens married to a U.S. citizen or resident alien may elect to file jointly with their spouse. They must report

worldwide income from January 1 in their U.S. tax return. Two married nonresident aliens may not make such an election, and, therefore, must file using married-filing-separately rates.

Nonresident aliens who are “exempt individuals” (described below) must submit a Form 8843, Statement for Exempt Individuals and Individuals with a Medical Condition, with their nonresident or dual-status tax return, or separately, if they have no tax return filing obligation.

The withholding and reporting tax rules, both for employment tax purposes and for withholding of tax at source, attempt to mirror the income tax rules. Therefore, in order to determine the appropriate withholding and reporting tax rules that apply to payments to a foreign national, a U.S. payer must first determine whether their foreign national employees and payees are resident aliens or nonresident aliens for U.S. tax purposes.

## DETERMINING U.S. TAX STATUS

A foreign national’s U.S. tax residency status is determined by the foreign national’s immigration status and countable days of U.S. presence over a three-calendar year period. In addition, any time spent in the U.S. in F, J, M or Q status from January 1, 1985 forward must also be taken into consideration. Foreign nationals who are U.S. lawful permanent residents (also called “green card” holders) are resident aliens for U.S. income tax purposes. Nonimmigrants are resident aliens if they are physically present in the United States at least 31 countable days in the calendar year in question, and their U.S. presence over a three-calendar-year period satisfies the 183-day residency formula (called the “substantial presence test”), unless an exception applies. The formula adds all of the countable U.S. days in the current year, plus 1/3 of the countable U.S. days in the prior year, plus 1/6 of the countable U.S. days in the second preceding year. For purposes of this formula, a U.S. day is any part of a day that an individual is physically present in the United States for any reason unless an exception applies. Therefore, a nonimmigrant whose U.S. presence averages 122 countable days or more per year will satisfy the 183-day residency formula and become a resident alien for U.S. income tax purposes. A nonimmigrant whose U.S. presence fails to meet the 183-day residency formula is a nonresident alien.

Nonimmigrants whose U.S. presence satisfies the 183-day residency formula, but who are physically present in the United States for fewer than 183 days in the current year, may be able to claim nonresident alien status under the closer connection exception. In order to meet the closer connection exception, they must submit a completed Form 8840, Closer Connection Statement for Aliens, with facts and circumstances supporting 1) a tax home in a foreign country or countries for the full calendar year and 2) a closer connection to a foreign country or countries than to the United States. Foreign nationals who have taken steps to become U.S. lawful permanent residents cannot use the closer connection test to avoid U.S. tax residency status.

## Exceptions for J-1 Exchange Visitors

The J-1 Exchange Visitor Program provides for various categories of exchange visitors and defines the rules that apply to each category. For tax policy reasons, foreign nationals in J Exchange Visitor status do not count their days of U.S. presence for purposes of the 183-day residency formula for a specified number of calendar years, thus remaining nonresident aliens for U.S. income tax purposes longer than other nonimmigrants. These foreign nationals are referred to as “exempt individuals” for the periods that they are exempt from counting days for purposes of the 183-day residency formula. (They may also be exempt from tax but under other rules and procedures discussed below.)

A J Exchange Visitor’s category determines which special exceptions apply for counting days. One rule applies to “students” and another rule applies to “teachers and trainees”. “Students” are J Exchange Visitors present in the United States in the student category. “Teachers and trainees” are J Exchange Visitors in all other J categories. (The category can be found on the Exchange Visitor’s Form DS-2019, Certificate of Eligibility for Exchange Visitor Status.) For purposes of this article “teachers and trainees” are referred to as J Non-students. The tax rules apply to spouses and other dependents in the United States in a J-2 derivative status as well.

## 5-Calendar-Year Rule for Students

A special 5-calendar year rule applies to maintain nonresidency status for J-1 Students. J-1 Students are exempt from counting U.S. days for purposes of the 183-day residency formula for 5 calendar years. J-1 Students in the United States for more than 5 calendar years must generally begin counting U.S. days for purposes of the 183-day residency formula. Just one U.S. day in the calendar year satisfies the one calendar year requirement. This is a once-in-a-lifetime test. J-1 Students who have been exempt from counting U.S. days for 5 calendar years (beginning in 1985, the first calendar year for which the 183-day residency formula was effective) must count their U.S. days for purposes of determining their U.S. tax residency status. In the typical situation, a J-1 Student must begin counting days in his 6th calendar year in the United States as a student. However, the individual must also count calendar years as an exempt individual in any F, M, J, or Q immigration status in the prior years as well. The Code allows a student to continue to be an exempt from counting days for purposes of the 183-day residency formula if they can prove to the IRS their intent not to reside permanently in the United States. This extension is claimed with Form 8843.

## 2-out-of-7-Year Rule for J-1 Nonstudents

A special 2-out-of-7calendar year rule exempts J-1 Nonstudents such as trainees and short-term visitors from counting days for purposes of the 183-day residency formula. Under this exception, a J-1 Nonstudent who has not been in the United States as an exempt individual at any time in the prior 6 calendar years is a nonresident alien for tax purposes. In the typical situation, a J-1 non-student is a nonresident

alien for two calendar years in the United States. J-1 Nonstudents in the United States for two years or longer become resident aliens in their 3rd calendar year when their U.S. days add up to 183 days. J-1 Nonstudents who have been in the United States as exempt individuals before, for example as F-1 or J-1 Students, will become resident aliens sooner if those years are in their prior six calendar years.

## 4-out-of-7CalendarYear Rule for Certain J-1 Nonstudents

A special 4-out-of-7calendar year rule applies to determine the residency status of J Nonstudents paid exclusively by a foreign employer. A “foreign employer” is defined by the Code as a nonresident alien individual, a foreign partnership or foreign corporation, or a branch or place of business maintained in a foreign country by a domestic corporation, domestic partnership or U.S. citizen or resident alien. A foreign government or foreign government agency is not included in this definition.

J-1 Nonstudents who receive all of their remuneration from a foreign employer are exempt from counting U.S. days for purposes of the 183-day residency formula for 4 out of 7 calendar years. If a J-1 Nonstudent receives any remuneration from U.S. sources, then the 2-out-of-7calendar year rule applies instead.

## WITHHOLDING AND REPORTING ON PAYMENTS TO NONRESIDENT ALIENS

U.S.-source income payments made to nonresident aliens are subject to 30 percent withholding unless an exception applies. There is an exception for wages paid to nonresident employees but special wage-withholding rules described below apply. The 30-percent tax applies to compensation payments made to independent contractors even though such income is taxed at graduated rates on the recipient’s U.S. tax return. The withholding tax is to ensure that taxes are paid by these U.S. income recipients who would be unlikely to voluntarily submit a U.S. tax return and pay their tax.

There is also an exception for noncompensatory scholarship and fellowship grants paid to or on behalf of nonresident alien recipients studying or engaged in training or research in the United States who are in F, J, M, or Q immigration status. Taxable grants to these recipients are subject to a lower 14 percent tax rate. A number of other possible tax exceptions for J-1 Exchange Visitors are discussed below.

U.S.-source income payments made to or on behalf of nonresident alien recipients must be reported to recipients and the IRS on a Form 1042-S information return. (Wages that are not exempt from tax under a tax treaty, however, are reported on Form W-2.) Employers and payers submitting Forms 1042-S must submit a Form 1042 tax return as well, even if no taxes were withheld.

## Nonresident Employees

The federal income tax withholding rules for compensation paid to nonresident employees include special provisions because of the limitations on

deductions and exemptions imposed upon nonresident aliens discussed above. Special Form W-4 rules apply to nonresident employees. They:

- Can only use single status
- Cannot claim “exempt” on Form W-4
- Can only claim one personal exemption unless an exception applies
- Must indicate “NRA” on line 6

In addition, payroll processes must apply a “phantom gross-up” to a nonresident employee’s salary before using the wage-withholding table to eliminate the standard deduction built into the wage table.

These special rules are described in IRS Publication 15, Employer’s Tax Guide. Foreign national employees submitting an invalid Form W-4 are subject to withholding at the default rate using single status and O exemptions.

Nonresident aliens making an election to be taxed as a resident alien with their U.S. citizen or resident alien spouse may make this election for wage withholding purposes as well. The election does not apply to FICA, however.

### Reimbursed Expenses

Compensation for services is subject to wage (for employees) or 30% (for NRA independent contractors) withholding unless an exception applies. One important exception for J-1 trainees and other temporary Exchange Visitors is the exception for temporarily-away-from-home business expenses. To qualify for this exception, a foreign national’s temporary visit must be anticipated to last a year or less. If the planned visit is for longer than a year the exception does not apply. If the planned visit is for a year or less but is extended to beyond a year, the exception does not apply from the time that the employer knew that the visit would extend beyond a year. If the recipient does not qualify for the temporarily-away-from-home exception because of the length of their stay in the United States or because the reimbursed expenses fail to satisfy the accountable plan rules, the reimbursed expenses are subject to wage withholding and Form W-2 income reporting.

Under these rules, an employee’s deductible travel, food, and lodging for a qualifying visit are excludable from income if the reimbursed expenses are made under an accountable plan. Per diem amounts paid in lieu of reimbursed expenses are excludable to the extent that they do not exceed U.S. government guidelines. Reimbursements for the employee’s family such as airfares, which are personal and not business expenses, are not excludable from income reporting or exempt from taxes under this exception. These rules also can apply to expenses and per diems paid to or for J-1 Exchange Visitors who are taxed as independent contractors with one exception. The per diem amounts for independent contractors are limited to the per diem for meals and incidentals. Lodging expense reimbursements must be based on receipts or paid directly to the hotel.

J-1 Exchange Visitors who are the recipient of a noncompensatory scholarship or fellowship grant may also use these rules to reduce the 14 percent tax on their taxable grant (described in IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities, page 21 under “Alternate Withholding Procedure”).

### SPECIAL TAX EXEMPTIONS FOR J-1 EXCHANGE VISITORS

Any one of several special Code provisions or treaty provisions may apply to exempt compensation paid to a J Exchange Visitor from U.S. taxes.

#### Payments by a Foreign Employer

A special U.S. tax rule applies to exempt from U.S. tax, remuneration that is paid to J-1 nonresident aliens by a foreign employer. Foreign employer, for purposes of this rule, has the same definition as for the 4-out-of-7-year rule discussed above. Once the J Exchange Visitor becomes a resident alien for income tax purposes this exemption no longer applies and the compensation paid from abroad is subject to U.S. tax unless another exception applies. If such a resident alien remains paid by the foreign employer, the foreign employer is subject to U.S. payroll tax obligations.

#### Social Security/Medicare Tax Exemption

Compensation for employment services performed in the United States is subject to Social Security and Medicare taxes unless an exception applies. Compensation paid to J-1 Exchange Visitors, regardless of the source of the payment, is exempt from Social Security and Medicare taxes if three conditions are met:

1. The J-1 Exchange Visitor is a nonresident alien,
2. The services performed are in connection with the purpose for which the Exchange Visitor entered the country, and
3. The employment is authorized under immigration rules.

A comparable exemption applies to federal unemployment taxes. The IRS does not allow this special tax exemption for a J-2 dependent because the J-2’s purpose for entering the United States is to accompany the primary visa holder.

This exemption is lost if the individual in J-1 status becomes a resident under the residency tax rules described above. In the calendar year that the individual must begin counting days for purposes of the 183-day residency formula, the IRS requires the employer to begin withholding Social Security and Medicare taxes from the individual’s compensation from the first countable U.S. day in the calendar year, typically calendar year 3 for Nonstudents and calendar year 6 for students. Employers can refund Social Security and Medicare taxes to foreign nationals who fail to become resident aliens in the calendar year through an adjustment of their Form 941, Employment Tax Return.

## Social Security (Totalization) Agreement

The United States has entered into social security agreements, called “totalization” agreements, with over 20 countries. The purpose of the agreements is two-fold:

1. To eliminate duplicate coverage and taxes on the same covered employment, and
2. To provide a formula for providing benefits to individuals who may not otherwise vest in either system.

To qualify for exemption from Social Security/Medicare taxes, the temporary employment assignment in the United States must be anticipated to last five years or less and the employee and the foreign employer must continue to make payments into the foreign social security system on the remuneration being paid for the assignment, regardless of where it is paid. To evidence the foreign coverage, the foreign national should obtain a certificate of coverage from the social security office of the country where social security coverage is being maintained.

## Income Tax Treaty Exemptions

The United States has income tax treaties in effect with over 60 countries. These treaties operate to exempt from U.S. income tax, compensation for services performed in the United States by a resident of the treaty country who meets the specific treaty criteria. (Income tax treaties generally do not apply to Social Security and Medicare taxes.) A foreign national’s immigration status and purpose for entering the United States determine which treaty benefits may be available. For example, the treaty with France includes the following articles exempting compensation income of a resident of France from U.S. income tax:

- Article 14 (Independent Personal Services) allows an exemption from U.S. tax on self-employment income if the individual does not have a fixed base (i.e. an office) in the United States.
- Article 15 (Dependent Personal Services) allows an exemption for employee compensation paid and borne by an employer that is not a resident of the United States provided that the employee’s U.S. days do not exceed 183 days in a 12-month period beginning or ending in the calendar year.
- Article 20 (Teachers and Researchers) allows a two-year exemption from tax on compensation for services earned by an individual engaged in teaching or research at an education or research institution. The research must be for the public benefit. The benefit can be claimed only once.
- Article 21 (Students and Trainees) allows an exemption from tax on an annual amount of up to \$5,000 for students, certain trainees, and individuals engaged in research who are also the recipients of a grant. Grants are also exempt from tax under this article. This article also provides an exemption from tax of up to \$8,000 for an employee of a resident of France who is in the United States to study at an educational institution or to acquire training.

Article 16 (Directors’ Fees) and Article 17 (Artistes and Sportsmen) can eliminate the benefits for individuals who would otherwise be covered by Articles 14 and 15. The benefits under Articles 14 and 15 are also lost if the foreign national either 1) fails to maintain tax residency in France, or 2) becomes a resident alien for U.S. tax purposes. The benefits of the other articles are not lost in either case as long as the foreign national claiming the benefits does not become a U.S. lawful permanent resident or U.S. citizen.

Although tax treaties by their terms apply to federal income taxes, a treaty exemption may be available from state income taxes as well. This typically occurs when a state defines income with reference to a federal definition of income.

Foreign nationals claiming tax treaty exemptions on compensation or scholarship or fellowship grants must submit their claim on their U.S. tax return. They may also claim an exemption from withholding tax by submitting a completed Form 8233 (for compensation) or W-8BEN (for non-compensation), to their employer or payer prior to payment. For the claim to be valid, both forms must include a U.S. taxpayer identification number (a Social Security Number or individual taxpayer identification number (ITIN)). Alternatively, a copy of Form 8233 must be submitted to the IRS ITIN Unit with a Form W-7, ITIN application following instructions. There is no exception to the requirement for an SSN or ITIN on a W8-BEN claiming treaty benefits for scholarship or grant income.

## SUMMARY

The Internal Revenue Code provides a number of tax saving opportunities for J-1 Exchange Visitors, particularly for those who remain employed and paid by a foreign employer. Special tax exemptions may also be available for J-1 visitors paid by U.S. employers or payers. However, these exemptions present a number of pitfalls for U.S. employers and payers. They must determine the J-1 Exchange Visitor’s U.S. tax residency status in order to allow the tax exemptions that only apply to nonresident aliens. Employers must also identify the tax residency status of their foreign national employees in order to apply the special wage-withholding and Form W-4 rules for nonresident employees. Lastly, income tax treaties and totalization agreements may provide special exemptions from U.S. tax. However, both employers and employees must follow special procedures in order to allow an exemption from withholding. Allowing exemptions from withholding and/or Social Security and Medicare taxes without following the proscribed rules and procedures exposes employers and payers to assessment by the IRS for underwithheld taxes, penalties, and interest.

---

<sup>1</sup>Copyright © 2007, Paula N. Singer. Ms. Singer is an attorney and partner in the tax law firm, Vacovec, Mayotte & Singer LLP, Newton, MA. She is also Chairman and co-founder of the tax and immigration software company, Windstar Technologies, Inc. Ms. Singer speaks and writes regularly on international tax topics. She is the author of nine tax guidebooks on the taxation of foreign nationals.

<sup>2</sup>Section 6013(g) and (h) of the Code

<sup>3</sup>See Section 7701(b) of the Code and the regulations under that section.

<sup>4</sup>Section 872(b)(3) of the Code

<sup>5</sup>Section 1441 of the Code and the regulations under that section

<sup>6</sup>IRS Notice 2005-76,

<sup>7</sup>Section 162(a)(2) of the Code

<sup>8</sup>Rev. Rul. 93-86, 1993-2 C.B. 71

<sup>9</sup>See Section 274 of the Code and the regulations under that section.

<sup>10</sup>Rev. Proc. 2006-41, 2006-43 I.R.B. 777

<sup>11</sup>Rev. Rul. 92-106, 1992-2 C.B. 258

<sup>12</sup>See Section 3121(b)(19) of the Code and the regulations under that section.

<sup>13</sup>For an overview of benefits of other treaties, see IRS Publication 901, U.S. Tax Treaties, Table II.