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Taxation of Foreign Nationals by the US

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Contents

Executive summary

A foreign national may be subject to one of two drastically different systems of taxation by the United States depending on whether he/she is classified as a resident or a nonresident alien of the United States. The determination of residency status is critical. Classification as a nonresident alien may result in differences in taxation. In individual cases, the advantages or disadvantages of resident versus nonresident status may vary from year to year. Therefore, it is important for foreign nationals coming to the United States to annually review their tax liability in the United States as well as in their home countries. T*axation of Foreign Nationals by the United States* provides a basic overview of U.S. taxes and how they affect foreign nationals.

Tax cuts and Jobs Act of 2017 (tax reform)

On December 22, 2017, President Trump signed into law U.S. tax reform legislation (P.L. 115-97, commonly referred to as the 2017 Tax Reform Act). This bill represented the largest change to the U.S. tax system in over 30 years. Though initially enacted in 2017, updates to this legislation are ongoing. Some key changes effective for tax years 2018-2025 consist of revisions to tax rates and brackets, repeal of personal exemptions, increase of standard deduction, revisions to itemized deductions including mortgage interest, state tax and foreign real property tax deduction, taxability of moving expenses and tax treatment for alimony payment.

Resident aliens

The rules defining residency for U.S. income tax purposes are very specific, with only limited exceptions once the objective criteria or mechanical tests are met. Individuals classified as resident aliens are taxed on their worldwide income derived from any source. Tax rates are graduated, and income is determined in the same manner as for U.S. citizens. Various elections may be available in the first year of residency to reduce the U.S. tax liability.

Nonresident aliens

Nonresident aliens are normally taxed only on income derived from U.S. sources. U.S.-source income that is considered "effectively connected" with a U.S. trade or business, such as salary and other forms of compensation, is taxed at graduated rates. Taxable income from U.S. trade or business entities can include some kinds of foreign-source income, as well as U.S.-source income. U.S. investment income is generally taxed at a flat 30% tax rate, which may be reduced by a tax treaty. Certain types of investment income may be exempt from U.S. tax.

Tax treaties

For many nonresident aliens, the burden of U.S. tax is reduced by tax treaties between the United States and their home countries. Further, treaties may modify U.S. income taxation (for example, in determining residency status) and should be reviewed in tax-planning situations involving a foreign national.

Foreign investment in real property

U.S. real property can be a secure, diversified investment for foreign nationals. Many real estate investments in personal residences are converted into rental properties, and special rules apply to their treatment. Depreciation rules (relating to property placed in service after 1998) increase the period over which deductions are spread. Passive loss rules may further reduce current tax benefits. Gains on sales of U.S. real property are taxable regardless of the residency status of the investor. Nonresident aliens, however, may have fewer opportunities to defer capital gains (for example, through tax planning such as like-kind exchanges or corporate reorganization) than residents or citizens. Special reporting and withholding rules may apply when nonresident aliens own U.S. real property or "U.S. real property interests" (for example, stock in a U.S. corporation whose principal assets include U.S. real property).

Other taxes

In addition to federal income tax, foreign nationals may be subject to social security and estate, gift, and state taxes. These should all be considered in evaluating the tax effects of a U.S. assignment.

Tax planning

Timing of income recognition and the length of an assignment can significantly affect a foreign national's U.S. tax liability. Also, the tax basis (tax cost) of assets may not be computed for U.S. tax purposes in the same way as in the foreign national's home country. Unrealized appreciation or loss inherent in a personal residence and other foreign investments should, therefore, be reviewed before beginning or ending an assignment in the United States. Additionally, the United States has a large and sophisticated body of rules dealing with the taxation of certain U.S. resident shareholders on income earned by foreign corporations that they control (whether or not the income is distributed) and noncontrolled foreign corporations that are primarily investment vehicles, as well as with taxation of the income of certain trusts to their creators. Tax planning considerations should be reviewed prior to a move to the U.S. to mitigate these rules.

Chapter 1 | Resident aliens

Resident alien defined

A *resident alien* of the United States is a foreign national who meets either of two objective tests: the lawful permanent residence test or the substantial presence test. An alien who meets neither test is a nonresident alien for federal income tax purposes for that year. (The test of residence is different for federal estate and gift tax purposes, and certain states may impose their own residency rules.)

Under the *lawful permanent residence test* (also known as the *green card test*), an individual is considered a resident alien from the day that he/she is admitted to the United States as a lawful permanent resident (that is, given a "green card") until the day that this status is officially revoked or judicially found to be abandoned. While the alien officially has lawful permanent resident status, he/she is considered a U.S. tax resident even while living outside the United States.

Under the *substantial presence test*, an individual must meet the following conditions to be considered a resident alien:

- He/she must be physically present in the United States for thirty-one days in the current year, and
- He/she must be physically present in the United States for a weighted average of 183 days over a three-year testing period that comprises the current and the two preceding years. Days of U.S. presence are computed under a weighting formula that counts the following days of presence:
  - All days in the current year
  - One-third of the days in the preceding year
  - One-sixth of the days in the second preceding year

Exempt individuals may exclude some days from this calculation (see below).

Several substantial presence test calculations are provided in Example 1.1.

The weighting formula permits an alien to spend up to 121 days each year in the United States without becoming an income tax resident. Also, the alien will not be considered a U.S. resident for any year in which he/she has been present in the United States fewer than thirty-one days.

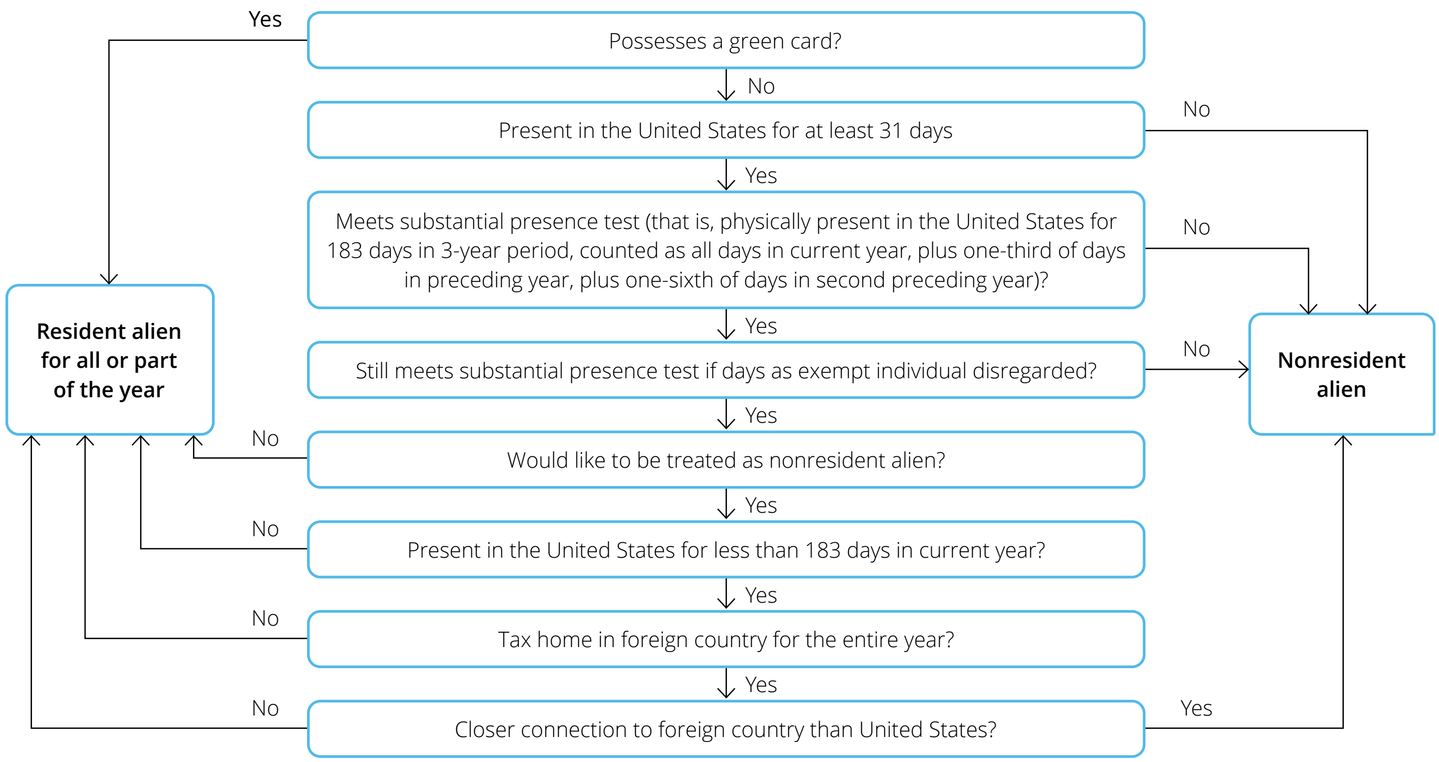
Example 1.1

In each of the cases below, the individual will be considered a resident alien in the current year for federal income tax purposes under the substantial presence test.

Case	Days present in the United States	Percentage (%)	Days counted in test
Case 1:			
Current year	183	100	183
First preceding year	0	33.33	0
Second preceding year	0	16.67	0
			183
Case 2:			
Current year	122	100	122
First preceding year	122	33.33	40.66
Second preceding year	122	16.67	20.34
			183
Case 3:			
Current year	60	100	60
First preceding year	360	33.33	120
Second preceding year	18	16.67	3
			183

Figure 1.1

Determining resident and nonresident alien status



A day of U.S. presence is acquired if an individual is physically present in the United States at any time during the day. There is no minimum time needed for the day to count. Days are excluded from the calculation for the following individuals:

- Exempt individuals (see below)
- Individuals who regularly commute to work in the United States from Canada or Mexico
- Individuals who, while in transit between two points outside the United States, are physically present in the United States for less than twenty-four hours during that trip
- Individuals who are not able to leave the United States because of a medical condition that arose while they were present in the United States

Figure 1.1 shows a decision tree that can be used in determining residency status

Exempt individuals

Exempt individuals are not legally "present" in the United States, even though they may be physically located there. These individuals are:

- Employees of foreign governments
- Teachers or trainees with J visas
- Students with F and J visas
- Professional athletes competing in charitable (as opposed to commercial) sports events, but only during actual competition

Except for professional athletes, the exempt status of an individual also applies to members of his/her immediate family. Form 8843 (Statement for Exempt Individuals and Individuals with a Medical Condition) must be filed to explain the basis of a claim to exclude days of presence in the U.S. for an exempt individual (other than an employee of a foreign government) or an individual with a medical condition.

The teacher–trainee and student statuses are conditional on the terms of the visa that accords that status, even though the visa may remain in effect. For example, a student on an F visa who accepts unauthorized employment ceases to be exempt and becomes present for purposes of the substantial presence test even though the visa may remain in effect.

Closer-connection exception

A foreign national satisfying the substantial presence test may be taxed as a nonresident if he/she is present in the United States for fewer than 183 days during the current year (cases 2 and 3 in Example 1.1) and the foreign national can show that during the entire year, he/she has a tax home in a foreign country and a closer connection to that country than to the United States.

Form 8840 (Closer Connection Exception Statement) must be used to satisfy this requirement. Failure to file Form 8840 may result in the disallowance of the closer connection exception.

Establishing a foreign tax home and showing a closer connection to a foreign country than to the United States requires an examination of various facts and circumstances, such as the location of the individual's permanent home, family, business, and social and political relationships. This exception is unavailable when certain actions have been taken during the current year to change the foreign national's status to that of a permanent resident of the United States.

Residency period

In the year that a foreign national becomes a U.S. resident (and sometimes in the year that he/she ceases to be a U.S. resident), his/her tax status is that of a *dual-status alien*. For years in which a foreign national is both a resident alien and a nonresident alien, two returns are generally prepared, attached to each other, and filed simultaneously. One return reports income and deductions for the residency period, and the other reports income and deductions for the non-residency period. The includible income and deductions are different for each portion of a dual-status year.

Therefore, it is important to determine the starting and ending dates of the period of residence. The starting date depends on whether the individual qualifies under the green card test or under the substantial presence test. An alien who meets only the green card test becomes a resident on the first day that he/she is physically present in the United States as a lawful permanent resident. Under the substantial presence test, the starting date is generally the first day that the alien is physically present in the United States in the calendar year. However, a nominal presence of up to ten days is disregarded to allow the alien to conduct pre-move business or make house-hunting trips. This nominal presence period may be excluded only for determining the period of residency; these days must be counted in the calculations determining substantial presence. See Example 1.2.

Example 1.2:
Mr. A, a foreign national who has never been a U.S. resident, comes to the United States for the first time on 6 February 20X1 and attends a business meeting until 10 February 20X1, when he returns to his country. On 5 July 20X1, he moves to the United States for the remainder of the year. Mr. A will be considered a U.S. resident alien for 20X1 under the substantial presence test (the five days in February plus the 180 days after his move causes the total days of presence to exceed 183). The period of residency begins on 5 July 20X1. The trip in February is disregarded in determining the start of the residency period.

A resident alien who meets the green card test is considered resident until the day that his/her status as a lawful permanent resident officially ends—that is, when he/she formally revokes the lawful permanent resident status or when an administrative decision is made that this status has been abandoned, provided that for the remainder of the calendar year his or her tax home was in a foreign country and he or she maintained a closer connection to that foreign country than to the United States. Until that time, the green card holder is a U.S. tax resident even when out of the country.

On the other hand, the treatment of a departing resident alien who does not hold a green card is subject to some variation, depending on the particular circumstances.

- If the individual does not meet the substantial presence test for the year of departure, the individual is simply a nonresident alien for the entire year.
- If the individual meets the substantial presence test, the individual is considered a resident alien for the entire year, unless the individual establishes that, following the departure date, the individual has a closer connection with a foreign country. The individual establishes the closer connection by attaching a residency termination statement to his/her tax return. If a closer connection is thus established, the last day of residence will be the day of departure, and the individual will be a dual-status resident for the year of departure.

Note that regulations governing departing non-green card holders stipulate that unless the residency termination statement is filed, an individual who meets the substantial presence test for the year of departure will be considered resident for the entire year. It therefore appears that a departing individual who meets the substantial presence test for the year might simply choose not to file the residency termination statement, in order to be considered a full-year resident of the United States. The choice should presumably be made in light of the same considerations that influence the first-year election to be treated as a full-year resident (see *Special First-Year Election*, below)—what other income will thereby become subject to U.S. tax, whether the choice will allow access to married-filing-joint-return rates, and so on.

The residency termination date for an alien meeting both the substantial presence test and the green card test is the later of the date on which the alien no longer has lawful permanent residence or the date on which the alien is last present for the substantial presence test. Up to ten days of U.S. presence following the termination of the U.S. assignment will be disregarded in determining the cutoff date for being taxed as a resident.

Figure 1.2

First-year election to be treated as a resident alien

Individual does *not* meet either green card or substantial presence test in year of arrival.

↓

Individual does *not* meet either green card or substantial presence test in year before arrival.

↓

Individual *does* meet substantial presence test in year following arrival.

↓

Individual is present in the United States for
(1) at least 31 consecutive days in year of arrival *and*
(2) at least 75% of days beginning with the first day of the 31-day period and ending with 31 December of year of arrival.

↓

Individual may elect to be treated as a resident alien for the year of arrival.

Example 1.3:

Ms. B, a foreign national who had not previously been a U.S. resident, comes to the United States on 1 November 20X1 on a visa and is present for thirty-one consecutive days (through 1 December 20X1). On 1 December, she returns to her home country and remains there until 17 December 20X1, when she returns to the United States. She remains in the United States and meets the substantial presence test in 20X2. She may elect to be treated as a resident alien in 20X1 because (1) she was not previously a resident, (2) she did not meet the green card or substantial presence test in 20X1 but (3) did meet the substantial presence test in 20X2, and (4) she was present in the United States in 20X1 for thirty-one consecutive days and for 75% of the days following 1 November 20X1.

Special first-year election to be treated as a resident alien

A special election is available to a foreign national who is unable to meet the substantial presence test in the year he/she arrives in the United States but wants to be taxed as a resident in that initial year. To make this election, he/she must satisfy all the following criteria:

- The foreign national was a nonresident for all of the preceding year.
- The foreign national meets the substantial presence test in the year following arrival.
- The foreign national is present in the United States for at least thirty-one consecutive days in the year of arrival.
- During the year of arrival, the foreign national meets the continuous presence test—that is, he/she is present in the United States for at least 75% of the days between the first day of the thirty-one-day period and the last day of the year of arrival. For purposes of applying the 75% test, up to five days of presence outside the United States can count as days of presence in the United States.

The US tax return containing the first-year residency election may not be filed until the foreign national has satisfied the residency requirement under the substantial presence test for the following year. The foreign national may request an extension of time to file until the necessary period passes for satisfying the test in the following year, but tax must be paid with the extension application on the basis that the substantial presence test will be satisfied in the following year.

Figure 1.2 is a flowchart for determining whether a foreign national qualifies to make the first-year election. See also Example 1.3.

Taxation of resident aliens

Income subject to taxation

All income received by a U.S. resident alien or U.S. citizen, derived from any source, is subject to federal income tax unless specifically exempt or excluded. A resident alien is taxed at graduated rates after allowance for deductions.

Income comprises salary and allowances, moving expense reimbursements, dividends, interest, gains from selling property, and other income from any source. For example, income received by the resident alien employee for services performed on temporary business trips overseas (outside the United States) is subject to U.S. taxation. (A foreign tax credit may be allowed as an offset against the U.S. tax liability if the individual also pays non-U.S. taxes on this income.) For individual income tax purposes, *income* generally refers to cash or the fair market value of property or services received by or made available to the individual. The appreciation in the value of investments or of other property is not income until the property is sold or exchanged for other property. See Example 1.4.

Deemed income

U.S. tax law contains a number of provisions less commonly found in the tax laws of other countries, deeming U.S. investors to have received income earned by foreign corporations that they control, by passive foreign investment companies, and by trusts that they have established for the benefit of U.S. persons. These provisions apply fully to resident aliens, and, while these provisions tend to affect few resident aliens, their tax consequences can be surprising. These rules must therefore be considered carefully in evaluating U.S. income tax status. See Example 1.5.

Deductions from income

Various items are deductible from income if specifically authorized by statute. The following are the most common.

Losses from capital transactions

Losses from capital transactions (such as sales of stocks and bonds) are deductible to the extent that an individual has capital gain income and are also deductible from ordinary income up to $3,000. Losses above the $3,000 limit may be carried forward and deducted in future years.

Itemized deductions or the standard deduction

Itemized deductions include state and local income taxes, real estate taxes, donations to U.S. charitable organizations, residential mortgage interest and investment interest expenses. The combined deduction for state and local income tax and real estate taxes is capped at $10,000 ($5,000 for married filing separate). Foreign real property taxes are not deductible.

The sum of a taxpayer's net itemized deductions after the reduction is compared to a statutory *standard deduction*. The larger of the two amounts may be deducted from income. A taxpayer's standard deduction is determined by his/her tax return filing status (see below). Standard deductions for recent tax years are shown in Appendix A.

Other common deductions

Contributions to individual retirement accounts and qualified retirement plans

Example 1.4:
Mr. A is a resident alien of the United States for all of 20X1 and receives an annual salary of $45,000. Because of Mr. A's outstanding performance, his employer awards him an automobile with a fair market value of $16,000. In addition, he receives dividends and interest income of $1,000 from U.S. sources and $600 from sources within his home country. In March 20X1, Mr. A purchases ten shares of ABC Corporation stock for $1,000 and five shares of XYZ Corporation stock for $1,500. He sells the ten shares of ABC stock in August for $4,000, and the value of the XYZ stock at year-end is $2,000.

Mr. A's total income to be reported for 20X1 is computed as follows:

Compensation from US sources (salary plus car)	$61,000
Interest and dividends from US sources	1,000
Interest and dividends from foreign sources	600
Gain from the sale of ABC stock	3,000
Increase in fair market value of unsold XYZ stock	—
Total income	**$65,600**

Example 1.5:
The following situations may cause a resident alien to have deemed income:

- *Grantor trust.* Before moving to the United States, Ms. B established a trust into which she placed certain investments (stocks, bonds, a rental property, and so forth). The trustee may accumulate income or may distribute it to any of the following: Ms. B, her husband, or their minor children. The trust will terminate after ten years, and the property will revert to Ms. B. Ms. B later becomes a U.S. resident alien for income tax purposes. Her trust is considered a *grantor trust*, and she is subject to tax on all of its income at the time it is earned, regardless of whether it is distributed to her.
- *Controlled foreign corporation.* Ms. C (who is a resident alien) and two friends (both U.S. citizens) set up a trading company, ABC Company, in a foreign tax haven. ABC Company buys products from their U.S. manufacturing company and sells them around the world. ABC is a controlled foreign corporation, and Ms. C and her friends must include certain amounts of the income ABC Company earns from these sales in their U.S. taxable incomes even if the tax-haven company pays no dividends to them.
- *Passive Foreign Investment Company.* Mr. D (who is a resident alien) buys shares of stock in a foreign mutual fund whose assets are primarily stocks and bonds. If Mr. D does not make an election to be taxed currently on his share of the corporation's income (or, in the case of some publicly traded funds, on the annual increase in the stock's value), he will be taxed on certain distributions from the fund (or on gain from the sale of the stock) with an added interest charge extending back over his entire holding period.

may in some cases be deducted. Alimony payments are deductible by residents. For divorces finalized after December 31, 2018, alimony payments will no longer be deductible.

Filing status

A resident alien taxpayer must choose one of the following four filing statuses on his/her tax return:

1. Single (for unmarried taxpayers only)
2. Married filing jointly (for spouses filing together)
3. Married filing separately (for spouses filing separately)
4. Head of household (for unmarried taxpayers and certain taxpayers married to a nonresident alien, who have dependents living with them)

Each filing status has its own tax rate schedule (see Appendix B). Resident aliens may use any one of the four schedules that applies to them and is to their best advantage. Generally, it is more advantageous for married couples to file jointly rather than separately, and the head-of-household tax-rate schedule produces a lower tax than the single tax-rate schedule.

Joint returns in dual-status years

Filing a joint tax return is not possible if one or both spouses are not residents for the full year. However, two elections are available to married foreign nationals that enable them to file a joint tax return and qualify for the lower "married filing jointly" tax rates. The first election may be made by an individual who, at the close of the year, was a nonresident alien married to a U.S. citizen or resident. The second election is available to an individual who, at the start of the year, was a nonresident alien and who, at the close of the year, was a resident alien married to a U.S. citizen or resident. Each of these elections requires both spouses to consent. Consequently, for either election, both spouses must report and pay U.S. tax on their worldwide income for the entire tax year. Although this additional income must be included, the individual may effectively reduce his/her tax liability because a lower tax rate may be used (because the married filing joint rates may be applied rather than married filing separate) and additional deductions claimed. Also, any income taxes paid to a foreign country may be claimed as an itemized deduction or used as a credit against U.S. tax.

Example 1.6 illustrates the joint filing election.

Foreign tax credit

Income taxes paid by a resident alien to a foreign country may be deducted as an itemized deduction or may be credited against the resident alien's U.S. tax liability. Since claiming foreign taxes as credits reduces the U.S. tax liability on a dollar-for-dollar basis, it will generally produce a lower net tax liability than would claiming an itemized deduction. An intricate series of limitations applies to the foreign tax credit. Foreign taxes paid on one type of income cannot be used as credits against U.S. tax on other types of income. Any unused credits may be carried back for one year and forward for ten years to reduce U.S. tax incurred on non-U.S. income.

Departing aliens

As described above, a resident alien who meets the green card test is considered resident until the day that his/her status as a lawful permanent resident officially ends. Special rules may apply for long-term permanent residents who relinquish their green card. A long-term permanent resident is defined as an individual who is a lawful permanent resident (green card holder) of the U.S. for at least part of 8 of the 15 years preceding termination of residency.

A person who qualifies as a long-term permanent resident is subject to a special "expatriation" tax upon relinquishing the green card if he/she meets any one of the following three tests:

- Net Income Tax Test – For the five-year period before expatriation, the individual had an average annual U.S. income tax liability in excess of certain amounts (see Appendix A).
- Net Worth Test – The individual's net worth is at least $2 million.
- Certification Test – The individual fails to certify that he or she satisfied all applicable U.S. tax obligations for the five years before expatriation.

An individual who meets any one of these tests is considered a "covered expatriate". A "covered expatriate" will be subject to two key tax components; first, a deemed sale of all assets as of the day before expatriation, and second, a tax on the receipt of gifts or bequests by a U.S. person from an individual who expatriated after June 17, 2008.

Complex rules apply to this special "expatriation" tax. A long-term permanent resident who may be subject to these rules should consult with a qualified tax adviser prior to relinquishing the green card.

Example 1.6:
Mr. A, a citizen of the United Kingdom, enters the United States with his wife for a five-year work assignment on 15 May 20X1. If they so elect, the couple may file a joint return for 20X1. If no election is made, the husband and wife must file separate returns using the higher married-filing-separately rates, and they will each be taxed on their separate worldwide incomes for the period from 15 May through 31 December 20X1.

Tax treaties

The United States has negotiated tax treaties with other countries to reduce the burden of double taxation. A treaty may override the income tax laws of the United States for items covered by the treaty. Any item not specifically addressed by the treaty will be taxed in accordance with U.S. income tax laws.

Generally, treaties do not change the U.S. taxation of a U.S. citizen or resident. However, treaties may specifically define or modify residency status for purposes of the tax rules in the treaty. In general, an individual is considered resident in the country in which he/she is subject to taxation. In some situations, that individual may be considered a resident by both treaty countries under their domestic laws. Many treaties include tiebreaker rules to determine the country of residence for treaty purposes. The tiebreaker rules override the domestic laws of each country and are based on such factors as the location of the individual's permanent home and his/her economic and personal relationships.

Individuals who are considered U.S. resident aliens under either the green card or substantial presence test may be able to use treaties to reduce U.S. taxation. For example, a green card holder living abroad and qualifying as a resident of the treaty country under the tiebreaker rule of the treaty may qualify for a U.S. tax exemption or reduction to the extent provided in the treaty. However, the treaties can be used to reduce U.S. taxation only in specific situations.

Green card holders are cautioned that filing Form 1040NR (the nonresident return) with a disclosure statement claiming residence in a foreign treaty country could adversely affect their continuing qualification for the green card.

Dual-resident foreign nationals claiming treaty benefits must file Form 1040NR as nonresident aliens with respect to that portion of the tax year for which they were considered nonresident. The return must contain Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).* Penalties could apply for failure to file this form or a similar statement.

An individual who is a U.S. resident under a treaty may also use the treaty's rules to reduce taxation in the other country when appropriate. For example, a U.S. resident alien may be able to claim a reduced withholding tax rate on interest and dividend income generated in his/her home country, provided that he/she is deemed to be a U.S. resident under the treaty between the United States and the home country.

Income tax treaty countries

See Appendix C for a list of countries with which the United States has income tax treaties in effect.

Chapter 2 | Nonresident aliens

Taxation of nonresident aliens

As illustrated in Table 2.1, nonresident aliens are taxed separately on income from U.S. sources that is not effectively connected with a U.S. trade or business (for example, investment income) and on income that is effectively connected with a U.S. trade or business (for example, business and compensation income). Generally, the source of income is the geographic location where the related services are performed and where the income-producing asset is located. The nonresident alien tax base is compared to the resident alien tax base in Figure 2.1.

Table 2.1

Taxation of Nonresident Aliens

Type of tax	Type of income
Tax at graduated rates	Income effectively connected with a U.S. trade or business
Tax at 30%-or-lower treaty rate	U.S.-source income that is not effectively connected with a U.S. trade or business and is fixed or determinable annual or periodic income
No tax	Foreign-source income of a nonresident alien not engaged in a U.S. trade or business

Figure 2.1

Comparison of Resident and Nonresident Alien Tax Bases

Resident alien tax base	Nonresident alien tax base
All US employment income	Some US employment income
All foreign employment income	
All US passive income	Some US passive income
All foreign passive income	
All US capital gains	US real estate gains
All foreign capital gains	
Some income earned by controlled foreign corporations	

Income not effectively connected with a U.S. trade or business

A nonresident alien's U.S.-source income that is not effectively connected with a U.S. trade or business is subject to tax at the flat rate of 30% of gross income (see Table 2.1); no deductions are allowed. Treaties may reduce this flat rate.

Income subject to this 30% tax includes interest, dividends, royalties, rents, and other fixed or determinable annual or periodic income. An exception is provided for portfolio income on certain U.S. registered bonds and bank accounts. This interest is not taxed unless it is effectively connected with a U.S. trade or business.

Except in the case of real property investments (see Chapter 3), a nonresident alien's U.S.-source net capital gains—gains in excess of losses from the sale of investment property—are not subject to taxation unless the alien is in the United States for at least 183 days during the year. (Because an individual who is present in the United States for this period of time is normally a resident under the substantial presence test and under the tiebreaker rules of treaties, this tax principally affects exempt individuals such as diplomats, teachers, and students. See Chapter 1.) The general exemption for capital gains applies regardless of the number of transactions or amount of gain realized during the year. See Example 2.1.

The United States has extensive withholding provisions to ensure the collection of income taxes imposed on nonresident aliens. Ordinarily, the 30% (or lower treaty rate) will be deducted from payments made to the nonresident alien. (If withholding is not deducted, the nonresident alien must file a tax return and pay the tax due; otherwise, the withholding agent (the person paying the income) is liable for the tax.) A tax return may be filed after year-end to request a refund of excess withholding.

Example 2.1:
Ms. B, a citizen of the Netherlands who is a nonresident alien, periodically visits the New York offices of her company's subsidiary. During 20X1, she makes five trips to New York and spends a total of 128 days in the United States. During her trips to New York, Ms. B sells stock, and her net profit on twenty separate transactions totals $10,000. (None of the stocks constituted U.S. real property interests. See Chapter 7). She will not be liable for any U.S. tax on this profit. (Note that she could be taxed on compensation earned during her visits to the United States, as discussed under the heading "Effectively Connected Income," if the provisions of an income tax treaty do not apply.)

Effectively connected income

Nonresident aliens are taxed separately on income arising from the activities of—or assets used in—a U.S. trade or business. This income, less allowable deductions, is taxed at the graduated rates that apply to U.S. citizens and resident aliens.

The term *trade or business* is not specifically defined. Whether the income arises from a trade or business depends on the nature of the activities and the economic interests in the United States. Business income generally includes the following:

- An individual's compensation for personal services performed in the United States. An exception applies if the amount earned is less than $3,000 and is paid by a foreign employer to a nonresident alien who is in the United States for fewer than 90 days during the year. Tax treaties may extend the period for up to 183 days and may increase or eliminate the $3,000 ceiling.
- Income and profits from the operation of a business in the United States.
- Income from the sale of the capital assets of a U.S. business or from the sale or disposition of U.S. real property.
- Income from real property operated as a business or held for investment (see Chapter 3).
- Income from a partnership engaged in a U.S. trade or business or from the disposition of an interest in a partnership that is, directly or indirectly, engaged in a U.S. trade or business.

If an individual is no longer engaged in a U.S. trade or business but continues to receive income effectively connected to that business, the income that the individual receives may still be considered effectively connected (see Example 2.2). Similarly, assets used in a trade or business will generate effectively connected income if sold any time within ten years after the business ceases.

Deductions from income

Unlike the flat tax on gross income not effectively connected with a U.S. trade or business, the tax on effectively connected income is applied to net income. The deductions that can be taken by the nonresident alien against effectively connected income are limited to contributions to U.S. charities, casualty and theft losses, and other expenses that are related to the earning of effectively connected income. Examples of such related expenses are contributions to individual retirement accounts and state and local income taxes imposed on effectively connected income.

The standard deduction is not allowed to nonresident aliens. *Available deductions may be disallowed if tax returns are not filed on a timely basis.*

Filing status

Individuals who are nonresident aliens at any time during the tax year normally are not eligible to claim head-of-household status and generally may not file a joint tax return. They must use the single filing status or, if married, must file separate tax returns. However, a nonresident alien who is married to a citizen or resident of the United States may elect to file a joint tax return (see Chapter 1).

Foreign tax credit

Under very unusual circumstances, a nonresident alien may be subject to U.S. income tax on income earned outside the United States. Should this occur, any resulting U.S. tax liability may, in most circumstances, be offset by any foreign income tax that is also incurred on this income.

Tax treaties

Most tax treaties will either eliminate or reduce withholding requirements on U.S. income, such as dividends, interest, and royalties, received by nonresident aliens. Therefore, the applicable treaty, if any, should be reviewed to determine whether the flat 30% tax rate is reduced for the specific type of income. It is also necessary to establish that the recipient is a qualified resident of the treaty partner country.

Example 2.2:
Mr. A, a foreign national, is in the United States on a three-month assignment and receives compensation of $12,000 in 20X1. He returns to his home country on 15 December 20X1. In 20X2, he receives a bonus of $4,000 related to his services in the United States. The compensation of $12,000 is considered effectively connected income and is taxed at the graduated rates in 20X1. The bonus of $4,000 is also considered effectively connected income and is taxed at the graduated rates in 20X2.

Tax treaties may also exempt nonresident aliens from U.S. taxation on the following types of income:

- Compensation received from a foreign employer that is not engaged in a U.S. trade or business if the employee is in the United States for fewer than 183 days. Some treaties also contain a dollar threshold for tax exemption.
- Pensions from former foreign employers.
- Compensation and pensions received by teachers who are temporarily in the United States.
- Foreign income received by students and trainees who are in the United States for maintenance, training, and education.

A list of countries with which the United States has negotiated tax treaties can be found in Appendix C.

Chapter 3 | Filing requirements

When to file

Tax returns for individuals are due on the fifteenth day of the fourth month following the close of the tax year (15 April for calendar-year taxpayers). An additional automatic extension of six months, to 15 October, is available by filing Form 4868, *Application for Automatic Ex¬tension of Time To File U.S. Individual Income Tax Return*. This extension provides additional time to file the income tax return; however, it does not extend the date to pay any tax owed. Interest will accrue on any amount owed until the tax liability has been paid.

If the due date for filing a return (including the automatic extension) falls on a Saturday, Sunday, or national holiday, the due date is deferred to the next earliest business day. A return is considered filed on time if there is an official postmark (U.S. or foreign postmark is accepted) dated on or before the last day for filing, including extensions. Similarly, returns filed through an IRS designated, private delivery service are also considered filed on the date mailed. Tax returns filed by a private delivery service which is not an IRS designated private delivery service must reach the IRS office by the required due date. See Appendix A for a list of currently designated private delivery services.

If a return is mailed after its original or extended due date, it is not considered filed until actually received by the IRS.

Interest and penalties on balance due

A properly filed extension relieves the taxpayer from a late filing penalty on the net tax due (4.5% per month for late filing plus .5% per month for late payment until the payment is made; the combined penalties may not exceed 25%). It does not, however, eliminate the liability for interest that is charged on any unpaid tax from the original due date (without extension).

Estimated tax

Estimated tax payments are required if the amount of total tax due with the return after withholding is expected to exceed $1,000. See Appendix A for a schedule of current year payment due dates. In general, each installment must be 25% of the lesser of: 90% of current year tax or 100% of the prior year tax (or 110% of prior year tax if adjusted gross income for the current year is in excess of $150,000 for joint filing or $75,000 for married filing separate). If there is an underpayment of the estimated tax and no exceptions apply, a penalty is imposed at the interest rate applicable to assessments of tax. This penalty is not generally deductible for income tax purposes. Interest is not charged for the late payment of estimated tax. The penalty for failure to pay estimated tax generally does not apply when tax liability for the year is less than $1,000, or if there was no tax liability in the preceding tax-year, provided it was a full 12-month period (i.e., calendar year tax-year).

Example 3.1:
Taxpayer B is living in the U.S. as of 15 April 20X2. On 10 April 20X2, he files a valid Form 4868 extension for his 20X1 U.S. income tax return. He then files the return on 15 September 20X2 and there is a $1,000 balance due.

Because B filed his return prior to the 15 October extended due date, there is no late filing penalty assessed. He will be subject to the late payment penalty and interest charges, calculated as follows (assume a 8% annual interest rate):

Late payment penalty: 0.5% x 5 months x $1,000 = $25
5 months counted from 15 April to 15 September
Interest: 8% x 154 days/365 days x $1,000 = $34
154 days counted from 15 April to 15 September

Taxpayer identification numbers

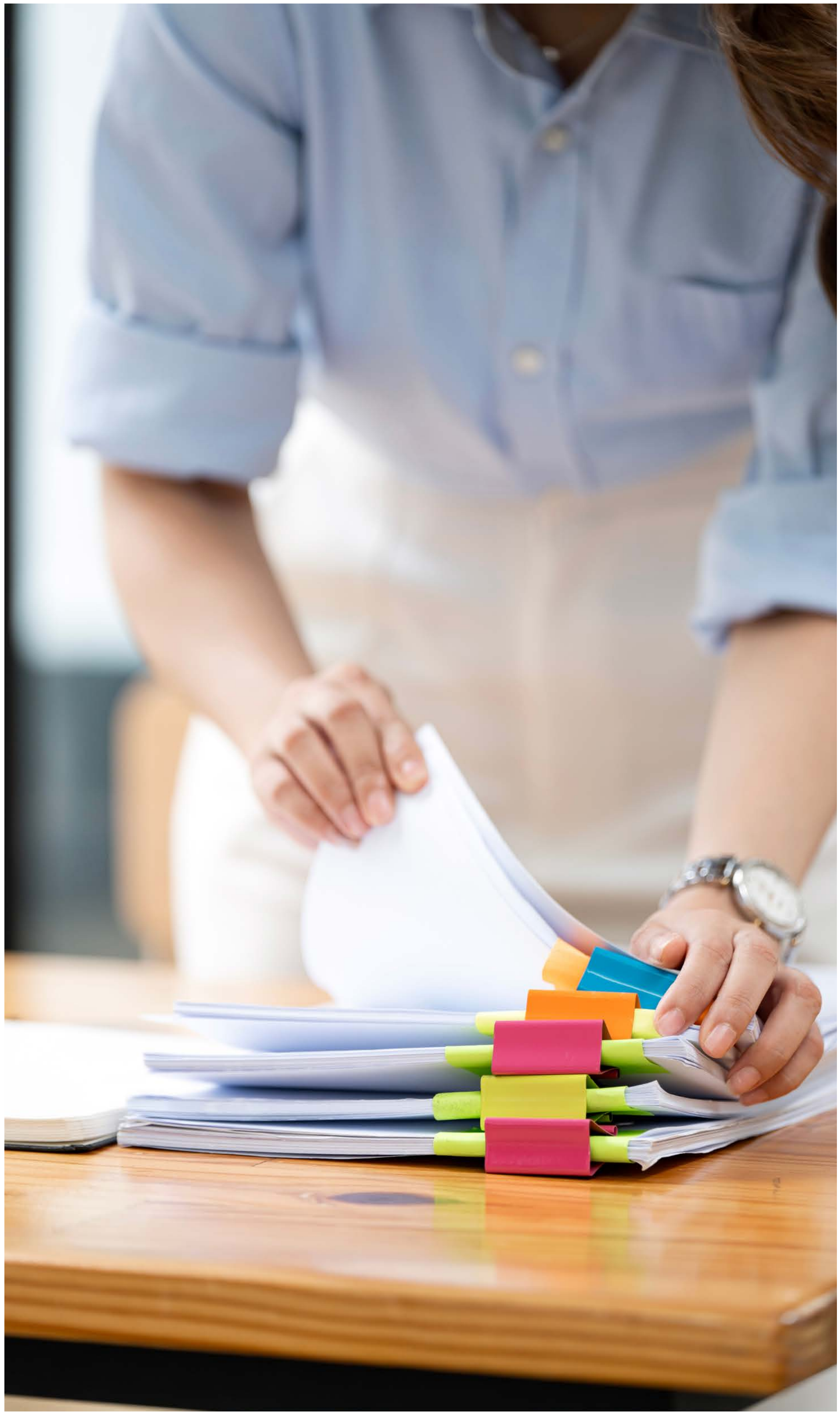
Regardless of U.S. income tax residency status, an individual must have a valid *U.S. Social Security Number* (SSN), or valid *Individual Taxpayer Identification Number* (ITIN) to file a U.S. income tax return. Family members accompanying a taxpayer in the U.S. also require either an SSN or ITIN to claim an individual as a dependent or receive dependency credit or potentially file a joint return.

Aside from U.S. citizens and lawful permanent residents, only U.S. aliens lawfully admitted to the U.S. and holding a valid Visa which permits the individual to “work” in the U.S. may receive a SSN. To apply for an SSN, the resident alien must submit Form SS-5 with valid documentation to the Social Security Administration (SSA). Generally speaking, category B-1 visa holders and visa waiver business visitors are excluded from the group of aliens eligible for SSNs (see Chapter 7). In most cases, spouses and dependents of aliens temporarily working in the U.S. are denied SSNs because their visas only allow them to reside but not work in the U.S. In that case, ITINs will be required.

Nonresident aliens, resident aliens and spouses or dependents of aliens not eligible for a SSN can apply for an ITIN following IRS prescribed procedure using Form W-7, *Application for IRS Individual Taxpayer Identification Number.* Each ITIN applicant must submit the original income tax return for the year which the application is made along with appropriate documentation as proof of identification as an attachment to the completed

Form W-7. The preferred appropriate documentation to Form W-7 is the original passport of the applicant, or a certified copy of the passport from the issuing agency. Notarized copies of a passport are not accepted. Other types of appropriate documentation may be submitted as proof of identification should a passport of the ITIN applicant be unavailable. Alternatively, the taxpayer can use an IRS-approved Certified Acceptance Agent (CAA) to help submit the identification documentation with Form W-7, or apply in-person at an IRS Taxpayer Assistance Center (TAC). Deloitte Tax LLP has been approved by the IRS to act as a CAA and is able to certify identification documents in certain situations. In this circumstance, the taxpayer will need to have a face-to-face or virtual meeting with a Deloitte person, who can attest to the authenticity of the passport. Individuals requesting Deloitte CAA services may be required to obtain separate authorization from the employer. Other documentation is required, including the attestation that the documents are true and complete copies. However, this option is only available for the taxpayer and spouse. Any dependents will still need to secure "certified" copies of their documentation to apply for an ITIN or apply through the IRS TAC.

For more information regarding the process of applying for an ITIN, please consult a tax adviser.



Chapter 4 | Foreign investment in real property

There are no federal restrictions imposed on the ownership of U.S. real estate by aliens. However, states may place restrictions on the ownership of real property by foreign nationals. For instance, some restrict—or even prohibit—ownership of land, others deny the right of an alien to inherit real property, and still others permit land ownership by aliens only if the alien's country of origin grants similar privileges to U.S. citizens. These state restrictions may be modified or even nullified by various U.S. treaties.

Individuals who want to purchase property should seek legal counsel to determine whether any restrictions apply in their circumstances. Individuals should also determine whether a particular state imposes reporting requirements on foreign owners of real estate.

A foreign investor may purchase real property within the United States in a variety of ways: in his/her own name; through a U.S. corporation, partnership, or trust; or through a foreign legal entity. The income and estate tax consequences of owning or selling property will vary depending on the vehicle through which the actual investment is made. Among corporate owners, foreign corporations may be subject to additional withholding tax and the U.S. branch profits tax, while a U.S. corporation will not. A foreign investor who owns the real property directly or through a U.S. corporation or partnership will also likely be subject to U.S. estate and gift taxes, although the insertion of a foreign corporation into the ownership structure may eliminate this exposure. These and other tax differences resulting from the form of entity chosen to own the property can be important and emphasize the need for advance consultation with your tax adviser.

In the following discussion, it is assumed that the individual purchased real property in his or her own name.

Example 4.1:
Ms. B, a nonresident alien, holds U.S. residential real estate for rent. In this case, her rental activities do not constitute a trade or business. During 20X1, she receives rental income totaling $15,000 and incurs real estate taxes, mortgage interest, and other expenses that total $12,000. Because her income is not effectively connected with a U.S. trade or business, her U.S. tax for 20X1 would be calculated on a gross basis as follows:

Gross income of $15,000 x 30% = $4,500

Example 4.2:
Assume the same facts as in Example 4.1, except that the rental activities do constitute a U.S. trade or business. In this case, the expenses of carrying the property may be offset against the rental income. The net rental income will be effectively connected income and taxed at graduated rates, as follows:

Gross income	$15,000
Expenses	(12,000)
Taxable income	3,000
Tax (at 10% rate)	**$300**

If the individual in this example has other effectively connected income or losses, such as salary or losses from other real estate activities, they may generally be aggregated with the income in this example (although some limitations may apply).

Taxation of income from US real estate

Property owned by nonresident aliens

As previously discussed, U.S.-source rent received by a nonresident alien that is not effectively connected with a U.S. trade or business is subject to tax at the statutory rate of 30% of gross income or, if applicable, a lower tax treaty rate. (U.S. tax treaties do not normally provide for a lower tax rate for rental income from real property.) Such rent can result in an extremely disadvantageous tax position if the property has expenses associated with it, as shown in Example 4.1. Contrast this example with Example 4.2.

Whether a nonresident alien's rental income is subject to the 30% gross tax or to the graduated rates on a net basis depends on whether the owner's rental activity is a U.S. trade or business. To be considered a trade or business, rental activities and maintenance of the property must be regular and continuous, and the owner or the owner's agents must be involved in advertising for renters, repairing, and so forth. In other words, the business of renting property results from activities beyond the mere holding of the property and collection of rents. The rental of one small property may not be a trade or business. Furthermore, "net" lease arrangements, under which the tenant pays all expenses and merely pays net rent to the owner, are often considered not to be U.S. trades or businesses.

Election to treat real property income as income connected with a trade or business

The inability to claim deductions against rental income, as shown in Example 4.1, can be a severe disadvantage to nonresident alien property owners. U.S. income tax law provides an election to treat property income as effectively connected even though it would not be in the absence of the election. (A foreign corporation is eligible to make a similar election.) By making this election, the owner is able to calculate his or her tax liability on a net basis.

The individual makes this election by filing a statement with his/her tax return. The election cannot be made until gross income from real property is reportable, and it applies to all real property located in the United States and held for the production of income. Furthermore, the election, once made, remains in effect for subsequent years and cannot be revoked without the consent of the Internal Revenue Service (IRS). For example, if an individual made the election in 20X1, sold the real property concerned in 20X4, and purchased a second property in 20X8, the election would continue to be in effect for the second purchase. Because of its extensive effect, individuals should consult their tax advisers before making this election.

While the statutory net tax election for real property is a continuing election (and is not easily revoked), a few tax treaties provide for a similar election on an annual basis. This annual election is a much more liberal treatment; therefore, it is important to review relevant tax treaties carefully to determine whether an individual can plan for that election.

Property owned by resident aliens

As previously discussed, no distinction is made in the tax treatment of resident aliens between income that is effectively connected with a U.S. trade or business and income that is not effectively connected with a U.S. trade or business. Thus, the net of rental income (gross rental income minus rental expenses) will be added to other taxable income received from worldwide sources and taxed at graduated tax rates.

Depreciation

The cost of purchasing rental property is not itself a rental expense. However, the portion of the purchase price attributable to buildings, improvements, and other depreciable parts of the property may be recovered through depreciation deductions taken over the life of the property. Depreciation is not an optional deduction; it must be claimed each year. The property owner cannot postpone taking the deduction until some later time.

The depreciation deduction is a function of the depreciable basis of the property. This basis consists of the original purchase price, other capital costs incurred in purchasing the property (for example, attorney fees, state taxes, broker commissions, and travel and transportation costs), and the cost of improvements. Special rules may apply when property is acquired by gift or inheritance. Land itself is not a depreciable asset. Therefore, when both land and buildings are purchased, the total purchase price must be allocated between the cost of the building and that of the land.

Depreciation on residential rental real property located in the United States and purchased after 31 December 1986 is recovered ratably (that is, on a straight-line basis) over twenty-seven and one-half years. The recovery period is thirty-nine years for nonresidential rental property purchased after 12 May 1993. Removable furniture and fixtures are depreciated over a shorter recovery period.

Passive loss rules

Income or loss from any source has been categorized as a*ctive, passive, publicly traded partnership, or portfolio*. Each of these classifications attracts specific tax consequences for individuals and certain closely held corporations.

Generally, the income tax law provides that losses from passive activities, such as rental real estate, may be used to reduce income only from other passive activities, not active (salary) or portfolio (interest and dividend) income. Thus, it is not possible to reduce salary income by losses from passive activities. Passive losses not usable in a current year can be carried forward until sufficient passive income is received to use the losses or until the activity is disposed of, at which time all accumulated losses from that activity can be fully used against other types of income.

Passive income comes from a trade or business in which the individual does not actively participate in any material way. A common source of passive income is an investment by the individual as a limited partner in a limited partnership that conducts active business. In addition, rental real estate activity is defined as a passive activity per se, regardless of the level of activity by the owner.

Although rental real estate is statutorily categorized as passive, a very important exception allows a maximum of $25,000 in real estate losses incurred by *resident aliens* to be used against any type of income, whether passive, active, or portfolio. The $25,000 exception is subject to a phaseout of one dollar for every two dollars of gross U.S. income in excess of $100,000 and is not available when gross U.S. income reaches $150,000.

To qualify for this exception, an individual must meet an active participation test. This means the investor must personally participate in the management of the property, which includes approving tenants, determining rental terms, or scheduling capital and repair expenditures. Participation need not always be regular, continuous, or substantial. For example, provided that the investor participates in the management decisions, he or she could hire a rental agent to handle the operations without forfeiting the $25,000 deduction.

Generally, individuals filing separate or "dual-status" returns are precluded from using the active participation exception.

Personal use of rental property

If a rental property is also used by the owner or the owner's family for personal purposes, expenses of that property must first be allocated between the rental period and the personal use period. Expenses allocable to personal use are not deductible unless specifically allowed. Real estate taxes and mortgage interest are examples of non-business expenses that can be deducted by a resident alien or citizen. A nonresident alien, however, cannot deduct any non-business expenses. Foreign real estate taxes allocable to personal use are no longer deductible. Foreign real estate taxes allocable to the rental use of the property continue to be deductible as a business expense.

This allocation need not be made if the property was rented for fewer than fifteen days during the year; in such a case, no rental income need be reported, and no rental expenses can be claimed.

Unless expenses are specifically attributable to a particular period, they are allocated to the rental period according to the following ratio:

$$\frac{\text{Number of days per year unit is rented at fair rental}}{\text{Total number of days per year unit is used}}$$

An overall limitation on deductions associated with rental property comes into play if the owner (or the owner's family) personally uses the residence for more than the greater of (1) 14 days or (2) 10% of the number of days during the year in which the property is rented at a fair rental value. If the owner's personal use exceeds this limitation, he or she can deduct expenses only to the extent of the rental income from the property (that is, net losses are not allowed). Property owners should therefore carefully

Example 4.3:
Mr. A, a nonresident alien, owns residential real property, which he rents out for ten months of the year. He personally uses the property for the remaining two months.

His rental income for this ten-month period totaled $15,000, and his expenses for the year are as follows:

Expenses	Amount ($)
Interest	5,000
Property taxes	3,000
Utilities	1,000
Insurance	750
Depreciation	3,750
Commissions	1,500

These expenses must be apportioned between the periods of personal use (two months) and rental (ten months). Because Mr. A uses the property for more than 14 days, he cannot claim a deduction for expenses apportioned to the rental period in excess of $15,000 in any event. Assuming that his rental activity constitutes a U.S. trade or business—or that he has made the election to treat income from real property as trade or business income—his taxable income from renting out the property would therefore be calculated as follows:

Rental income		$15,000
Less expenses:		
Interest expense ($5,000 × 10/12)	($4,167)	
Property taxes ($3,000 × 10/12)	(2,500)	
Utilities ($1,000 × 10/12)	(833)	
Insurance ($750 × 10/12)	(625)	
Depreciation ($3,750 × 10/12)	(3,125)	
Commissions*	(1,500)	
Total expenses (deductible amount limited to $15,000)		(12,750)
Net rental income		**$2,250**

* Commissions are not prorated as they apply specifically to the time period during which this property was a rental property.

monitor the number of days that they personally use rental property. See Example 4.3. carefully monitor the number of days that they personally use rental property. See Example 4.3.

Sale of property by resident aliens

The gain or loss on the sale of residential rental property is the difference between the net selling price (sales price less expenses of sale) and the adjusted basis of the property. A property's adjusted basis is its original cost less the total amount of depreciation expenses claimed during its life. (The calculation of a gain or loss is illustrated in Example 4.4.)

A gain will normally be treated as a long-term capital gain and will be taxed at graduated rates (see appendix B), limited to the maximum individual capital gain tax rate of either 15% or 20% on long-term gains. Short-term capital gains are subject to tax at graduated rates. The portion of the gain related to depreciation is taxed at a special rate of 25%. (Special rules apply, however, to the sale of a principal residence). Losses on the sale of property used in a trade or business are capital losses and, with restrictions, may be deductible, but losses on the sale of a personal residence or property not held for the production of income are not deductible.

Sale of property by nonresident aliens

In general, a gain or loss from a sale or other disposition of a USRPI by a nonresident alien is treated as if it were effectively connected with a trade or business within the United States, regardless of the property's actual use. All nonresident alien individuals—regardless of whether they engaged in a trade or business or elected to treat real property income as effectively connected with a trade or business—will be treated alike when taxed on gains from sales of real property.

Example 4.4:
Ms. B, a resident alien, purchased real property for $200,000. She later sells the property for $300,000 (net of expenses of sale). Total improvements made to the property amounted to $10,000, and depreciation claimed during the years it was operated as a business totaled $95,000. The gain on the sale would be determined as follows:

Net selling price (net of sale expenses)		$300,000
Adjusted basis:		
Original purchase price	$200,000	
Improvements	10,000	
Accumulated depreciation	$(95,000)	(115,000)
Gain realized		**$185,000**

Real property for this purpose can consist of—but is not exclusively limited to—undeveloped land, buildings, residential dwellings, options on land, and real estate partnerships. Taxable USRPI, however, also include stock and other equity interests in certain U.S. corporations.

Any gain from the disposition of a USRPI will be taxed at the graduated rates, limited to a maximum tax of 15% or 20% if the USRPI is a capital asset and the gain is long-term. As with resident aliens, losses can be offset against gains only if the property was actually used in a business or income-producing property; personal-use property does not generate a deductible loss.

Upon purchasing a USRPI from a nonresident alien, the purchaser may be required to withhold 15% of the proceeds, to be applied against the seller's tax on the gain. Upon application, the IRS may agree to lower the rate of withholding if the expected tax would be less than the otherwise required 15% withholding. Withholding does not apply if the sale or exchange falls within a few narrowly defined tax-free exchanges (although reporting may be required) or if the purchaser acquires the property for use as his or her residence and the amount realized does not exceed $300,000.

A nonresident alien disposing of his or her U.S. real estate investment should consider a number of other special rules. For example, if the property is sold on an installment basis, the IRS will not generally refund any portion of the 15% tax withheld until the gain is reported in full. Also, if the nonresident alien holds the U.S. real estate in a U.S. partnership, the purchaser will not be required to withhold the 15% tax on the disposition by the partnership. However, the managing partner of the partnership will be required to withhold 20% of the gain allocable to the nonresident alien partner, regardless of whether any cash is distributed from the partnership. Additional withholding requirements may apply to the partnership's distribution of cash to a nonresident alien partner.

Tax treaties

As previously indicated, tax treaties may provide a more attractive result than domestic laws for some kinds of real property income. Although no treaties completely eliminate taxation of gains on a USRPI, they may:

- Provide elections to treat real property rent as effectively connected income
- Provide rules for allocation of expenses

Chapter 5 | Other taxes

Net investment income tax

Certain U.S. taxpayers may be subject to an additional net investment income tax (NII). The tax is in addition to regular federal income tax and intended to reach certain higher income taxpayers' unearned income. Nonresident aliens, including those who assert nonresident U.S. tax status under an income tax treaty, are not subject to NII. Dual status resident taxpayers are subject to NII only with respect to the portion of their residency period of the dual status tax-year.

For individuals subject to tax on NII, tax is imposed at 3.8% on the lesser of:

- the individual's net investment income for the tax year, or
- the excess of the individual's Modified Adjusted Gross Income over the threshold amount (the MAGI threshold amount is $250,000 for individuals filing a joint return, $125,000 for married taxpayers filing a separate return and $200,000 for all other individuals).

As discussed in Chapter 1, special elections are available for a U.S. citizen or resident who is married to a nonresident alien to allow them to file a joint tax return. Special rules apply for couples who have made this election with respect to the NII and the thresholds that apply. Consideration of the potential impact of the NII should be included when deciding on these elections.

An individual's *Net Investment Income* includes three general categories of income: (1) gross income from interest, dividends, annuities, rents and royalties; (2) income derived from a passive activity or a trade or business of trading financial instruments or commodities; and (3) net gain recognized on dispositions of property.

The rules regarding the NII are detailed and complex. A taxpayer should consult with a qualified tax adviser if his/her income is higher than the above thresholds and the taxpayer would like to discuss planning considerations regarding this tax

Affordable Care Act

As part of the Patient Protection and Affordable Care Act (ACA), individuals and their dependents are required to maintain minimum essential healthcare coverage throughout the year. Failure to maintain coverage previously resulted in a penalty known as a shared responsibility payment, which was calculated on the individual income tax return. Medical insurance provided through a U.S. employer will generally qualify as minimum essential coverage. In addition, there are specific exceptions from this requirement for individuals residing outside of the U.S. or for gaps in the period of coverage of less than three months. A taxpayer should consult with a qualified tax adviser for further details regarding the ACA healthcare requirements and exceptions. After December 31, 2018 there will be no penalty imposed for failing to maintain minimum essential coverage.

State and local income taxes

Almost all of the fifty states, the District of Columbia, and even some cities levy some form of personal income tax that is separate and distinct from the income tax imposed by the federal government. The tax base may be broader or narrower than that used by the federal government. California's "unitary" tax is a well-known example of a broad tax base. On the other hand, the states of New Hampshire and Tennessee have personal income taxes but apply them only to passive investment income (that is, interest, dividends, and capital gains).

State income taxes are independent of each other as well as of the federal tax. This can lead to double or even multiple state taxation of the same income. Double taxation is usually prevented by a credit, which is allowed on the tax return of the state of residence for taxes paid to the state that is the source of income.

State income taxes are generally levied on the worldwide taxable income of residents of the state. For nonresidents, they are levied on income from sources within the state. (See Example 5.1.) The states use various rules for apportioning income to the state, including a proration of worldwide income. This apportionment can affect the tax rate applied as well as the amount of income subject to tax. An individual who moves into a state and becomes a resident will usually be taxable as a nonresident for the period before the move (on income from sources within the state) and as a resident for the period after the move (on income from all sources).

Example 5.1:
Many individuals who work in New York City commute from their homes in New Jersey. Since they maintain their residences in New Jersey, they are liable for New Jersey tax on their worldwide income, including compensation earned in New York. However, since their compensation was earned in New York, it is subject to taxation by New York State as New York–source income. New Jersey will grant a credit against its tax for tax paid to New York, but only to the extent of the tax that otherwise would be due on that income.

As discussed at the beginning of this chapter, specific rules exist regarding when to file a tax return. For each state, separate filing deadlines and rules regarding timely filing of the tax return may apply, depending on the state. Taxpayers should consult with a tax adviser regarding specific state filing requirements.

State residency rules

Residency for state tax purposes may not be defined in the same manner as residency for federal income tax purposes. In dealing with a particular state, it will therefore be important to review the residency rules. For example, California defines the term resident as a person domiciled in the state or physically present in the state other than for a temporary or transitory purpose. An individual who is present in California for more than nine months in the tax year is presumed to be a resident. New York, on the other hand, defines *resident* as a person who is domiciled in the state or who (1) maintains a permanent place of abode in the state and (2) spends more than 183 days of the tax year in the state.

Most states use a combination of three tests to determine residency:

1. Domicile
2. Whether a permanent place of abode is maintained within the state
3. The number of days physically present within the state

These apply equally to both U.S. citizens and foreign nationals. For example, a Japanese executive who is transferred from Tokyo to Los Angeles on a temporary business assignment is subject to the same California residence tests as the American executive who is transferred from New York to Los Angeles on a temporary business assignment.

Treaties that the United States have with foreign countries generally have no direct control over state taxation

The method of taxation and the rates imposed by each of the states varies widely. States that impose a tax based on personal income generally follow federal law in computing taxable income. The extent of state conformity to federal law is wide-ranging and includes many deviations from the federal computation of taxable income. Some states directly piggyback on the federal income tax. For example, some states impose its income tax as a percentage of the federal income tax of residents and nonresidents, including estates and trusts. Other states adopt federal taxable income as the starting point for computing state taxable income.

While adopting the federal definition of taxable income, most states provide for various adjustments in determining state taxable income. Some common variances from federal taxable income include the taxation of state pension income, Social Security income, and interest on state and local bond interest. In addition to providing variances from federal taxable income in the computation of state taxable income, states also provide different itemized and standard deductions than what is allowed for federal purposes.

Convenience of employer rule

The "convenience of the employer rule" (i.e., convenience rule) is a rule some states apply for sourcing income earned by nonresidents who work for in-state employers at a location outside the state (e.g., from a home office). Under the convenience rule, the sourcing of this income depends on whether the nonresident taxpayer was working remotely for the convenience of the employer or due to the employer's necessity. Four states (Delaware, Nebraska, New York, and Pennsylvania) apply the convenience rule. Connecticut and New Jersey applies the convenience rule only if the taxpayer's resident state applies a similar rule for work performed for a Connecticut or New Jersey employer, respectively. If the individual is an employee of a company or assigned to an office of a company based in a state with the Convenience of Employer (CoE) rule, the state would consider any day worked from a home office, as a day spent working in the assigned office during the year. The convenience rule also has implications for the income tax credit, where states allow resident taxpayers to claim a credit for taxes paid to other jurisdictions (i.e., resident credit). Although the resident credit is generally intended to avoid double taxation, differences in the income sourcing rules between states can result in the same income being taxed by two states. Hence it is important to review the residency rules to see if the Convenience of Employer rule applies for an individual and prepare their state tax returns accordingly.

Social security tax

Compensation for services performed within the United States as an employee is subject to U.S. social security tax, regardless of the citizenship or residency of either the employer or employee (see Appendix A for a summary of the rates and current year income limitations). The employer pays a tax of equal amount. Self-employed individuals are subject to a social security tax as well. Nonresident aliens are exempt from social security on self-employment income.

An additional Medicare tax of 0.9% is imposed on employment wages for certain higher-income taxpayers (income of more than $250,000 for married couples filing jointly or surviving spouse, $125,000 for married couples filing separately, and $200,000 for all other taxpayers). Employers have an obligation to withhold this additional tax for any employee whose wages exceed $200,000, regardless of the filing status of that individual. This additional tax is reconciled on the actual tax return if the individual is subject to additional Medicare withholding in excess of the correct threshold confirmed by the actual tax return filing status. For example, if too much additional Medicare tax was withheld from the employee during the year, the excess is credited back to the individual on their tax return. Conversely, if a deficiency exists, an additional payment is charged on the tax return to account for any shortfall.

Additional Medicare applies only to the employee, not to the employer. However, as noted, the employer has an obligation to withhold amounts of excess Medicare tax from the employee's wages. This tax applies for any employee who is otherwise subject to U.S. social security tax, including nonresident aliens covered by the U.S. social security program. Employees on assignment in the United States who are exempt from U.S. social security tax due to a totalization agreement between the United States and their home country are also exempt from this additional Medicare tax if a valid certificate of coverage is in place with the employer (see next section for further details).

Totalization agreements

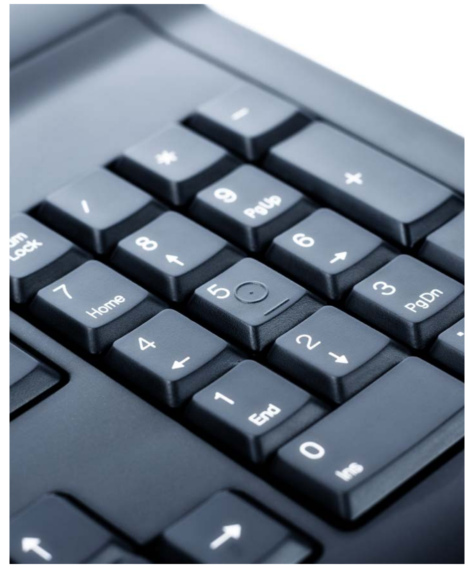
Income tax treaties do not cover social security taxes, so even if a nonresident alien is exempt from U.S. income tax under an applicable treaty, any U.S.-source earnings will still be subject to social security tax. As a practical matter, however, the IRS does not normally enforce the social security tax provisions in cases in which the foreign national is exempt from income tax.

The United States has entered into social security totalization agreements with several countries that may eliminate duplicate coverage (taxes) and provide for "totalized" benefits for individuals who cannot qualify for full social security benefits in one country or the other. See Appendix C for a list of totalization agreements which are currently in effect.

To qualify for the coverage provisions of such an agreement, an employee must be transferred by his or her employer from one country to the other. Direct hires in the host location do not qualify. The employer must apply for a certificate of coverage from the home country to avoid the tax in the host country. Self-employed individuals must move an existing business from one country to the other to qualify. Totalization agreements will provide for an exemption from the host country's social security taxes for employees for at least five years, although certain agreements may provide for a longer period; the exemption for self-employed individuals may apply for only two years.

Employer payroll tax obligations

The U.S. tax system also imposes payroll tax obligations with respect to U.S. employment. These apply to all U.S.-source employment income, regardless of whether the employer is U.S. or foreign (subject to applicable income tax treaties). These obligations take two basic forms. First, employers are required to withhold and deposit certain taxes owed by the employee. These include federal, state, and local income taxes and the employee portion of the social security tax. Second, employers must pay their separate payroll tax obligations,



including the employer portion of the social security tax as well as federal and state unemployment taxes. In addition to making the tax deposits, employers must meet separate quarterly and annual reporting requirements. These deposit and reporting rules apply to many allowances and noncash fringe benefits, including unsubstantiated business expenses. Failure to comply can result in the imposition of severe penalties. In addition, it is the employer's responsibility to withhold taxes appropriately for individuals who fall under the convenience of employer rule and are working remotely.

Estate and gift taxes

Residence for estate and gift tax ("transfer tax") purposes does *not* have the same meaning as it does for income tax purposes. Residence for purposes of the U.S. transfer tax means domicile. To be domiciled in the United States, a foreign national must reside here and intend to continue doing so indefinitely. The IRS will consider several factors in determining one's domicile, including duration of stay in the United States, location of family and friends, location of business interests and social affiliations, and any declarations of intent in such documents as visa applications, wills, deeds of gift, or trust instruments. Many foreign nationals temporarily assigned to the United States will be considered non-U.S. domiciled for U.S. transfer tax purposes.

The United States imposes a transfer tax on all gifts and all property included in the estates of U.S. citizens and U.S. domiciliaries. In the case of non-U.S. domiciled individuals, the estate tax generally applies only to U.S.-situs property, including tangible and intangible property located in the United States and stock or debt issued by U.S. persons. Gift tax generally applies to non-domiciled individuals only on tangible property located in the U.S. Not all of the situs rules are self-evident, and careful planning may be required to avoid unanticipated results. The fair market value of the assets at the time of the transfer or date of death (or the alternate valuation date) is the basis for the tax for citizens, residents, and nonresidents alike.

The taxable estate is derived by reducing the gross estate by allowable deductions. These deductions include expenses incurred in administering the estate, certain taxes, certain indebtedness, and charitable contributions. Most deductions for the estate of a non-domiciled individual must be prorated between the U.S.-situs assets and the foreign-situs assets. One of the most significant exceptions to this rule applies to non-recourse debt. Generally, the deduction for indebtedness must be allocated as described above. However, if the non-domiciled individual decedent was not personally liable for a particular mortgage, only the value of the property subject to the mortgage, reduced by the amount of the mortgage, is included in the taxable estate. Thus, in effect, a deduction for the entire amount of the mortgage is permitted.

Estate and gift tax rates currently range from 18-40%. The rates are the same for U.S. citizens, U.S. domiciliaries and non-U.S. domiciliaries. The estate and gift tax bases - are illustrated in Figure 5.1.

Figure 5.1

Comparison of U.S Domiciliary and non-U.S. Domiciliary Estate and Gift Tax Bases

U.S. Citizen/ U.S Domiciliary Transfer Tax Base	Non-U.S. Domiciliary Transfer Tax Base
US real estate	US real estate
Foreign real estate	
Stocks of US corporations	Stocks of US corporations*
Stocks of foreign corporations	
Deposits with all investment companies	Deposits with US investment companies
All deposits in US commercial banks or savings and loans	Deposits in US commercial banks or savings and loans connected with a US trade or business
All debt obligations	US-based debt obligations
Proceeds of insurance policies	

* For U.S. estate tax only. For gift tax purposes, stock of a U.S. corporation is an intangible asset and is therefore not subject to U.S. gift tax

Non-domiciled individuals with U.S. assets over $60,000 in value may be subject to substantial U.S. tax on their estates because the exclusions and deductions permitted are not as favorable as those permitted to citizens and residents. Credits or treaty provisions may reduce this liability, depending on the status and terms of any existing treaty with the country of domicile. See Appendix C for a list of estate tax treaties or estate and gift tax treaties which are currently in effect.

Gifts made to a spouse who is a U.S. citizen are generally exempt from gift tax due to an unlimited marital deduction. Gifts made to a non-U.S. citizen spouse, however, do not qualify for this marital deduction. An increased annual exclusion for gifts of a “present interest” is available for transfers to a non-U.S. citizen spouse. Gifts in excess of certain amounts are subject to U.S. transfer tax (see Appendix A for the inflation-adjusted amounts).

With respect to estates, property passing to a U.S. citizen spouse is generally eligible for an unlimited marital deduction and thus exempt from estate tax. Property passing to a surviving non-U.S. citizen spouse does not qualify for the marital deduction, unless the bequest is to a qualified domestic trust. These trusts must meet a number of requirements, the effect of which is to enforce the transfer tax at the time property is distributed from the trust or at the death of the nonresident surviving spouse, whichever occurs first.

A foreign national whose estate will be exposed to U.S. tax should consult with tax advisers to quantify the exposure and discuss planning considerations.

Chapter 6 | Tax planning

The need for tax planning

Various actions that resident and nonresident aliens take can affect the amount of tax they will pay in the United States. Tax planning, therefore, is essential for foreign nationals who are or will become subject to taxation by the United States.

This chapter presents several planning considerations, which may depend on variables previously discussed, such as taxation status, assignment timing, income level, and country of citizenship and residency. Note that the planning considerations covered in this chapter are focused on the impact to US tax payable. In some circumstances, the planning may result in increases of foreign tax, possibly even in excess of US tax savings. It is therefore essential that, before an individual moves to the United States or establishes a US business or investment presence, the individual seek personal tax advice to consider both the US and the foreign country tax regimes.

Example 6.1:
Mr. A, a citizen and resident of Germany, purchased 100 shares of ABC Company stock for Euro 10,000 in September 20X1. He enters the United States on a two-year assignment in January 20X8 and sells the ABC Company stock in July 20X8 for Euro 9,600. Fair market value of the ABC Company stock was Euro 9,000 in December 20X7.

Mr. A's basis in the stock for US tax purposes is Euro 10,000, translated at the September 20X1 exchange rate of approximately 1.125 to equal $11,125. His sales price is translated at the July 20X8 rate of approximately 1.355 to equal $13,008, resulting in a gain for US tax purposes of $1,883. Had he sold the original ABC Company stock in December 20X7 and repurchased it prior to entry in the United States, Mr. A would have had a Euro 1,000 loss in Germany and would have entered the United States with a $12,330 basis (Euro 9,000 translated at the December 20X7 rate of approximately 1.37). This strategy would have reduced his US gain on the stock sale from a gain of $1,883 to a gain of only $678.

Example 6.2:
Ms. B, an India resident, enters the United States for a two-year assignment on 20 June 20X1. Her salary is borne by an India company throughout the assignment. Since she is present in the United States for more than 183 days in 20X1, she will be taxed as a US resident starting on 20 June. If she had waited until 3 July to enter the country, she would have been present in the United States for 182 days and could have been treaty-exempt from US federal income tax for 20X1.

Residency

As explained, resident aliens and nonresident aliens are taxed according to different rules, and each status has its advantages and disadvantages. Resident aliens can file tax returns under the married-filing-jointly status and can use foreign tax credits. Nonresident aliens pay tax principally on income from a US source and only on limited non-US income. Which status would be more beneficial for a particular foreign national depends on that individual's circumstances. Planning for the impact of one's US presence in the United States may therefore be beneficial.

Timing of income recognition

Foreign nationals are subject to normal US accounting rules. They recognize income in the amounts and at the times prescribed in US tax law, even though this income may pertain to activity that had no US connection. For example, income earned by a cash-basis taxpayer before becoming a resident but received by him/her after becoming a resident will be subject to US income tax in the year received. See Example 6.1.

Some possible considerations when planning for the timing of income recognition include:

- Exercising stock options before US residency begins
- Accelerating receipt of bonuses or other deferred compensation to a point before—or deferring it until after—the period of US residency
- Deferring recognition of losses until the period when US residency begins, and paying deductible expenses when a US resident
- Accelerating recognition of income so as to receive it as a nonresident, before US residency begins
- Obtaining a step-up in basis before US residency begins by selling and reacquiring appreciated assets
- Selling a foreign residence before US residency begins, to avoid US tax on any gain

Timing and length of assignment

The length of an employment assignment, as well as the timing of its beginning and ending, can significantly affect the US tax liability. Some planning considerations are as follows:

- Residents of a treaty country who remain on a foreign payroll and whose presence in the United States in any year is fewer than 183 days may not have a US income tax liability (see Example 6.2).

  This planning must consider the specific treaty provisions in effect between the two countries, as some treaties are based on 183 days in a calendar year (e.g., the US-India treaty, per the above example), whereas some treaties consider 183 days in any consecutive 12 month period (e.g., the US-UK treaty), in which case this planning would not have worked in the above example, as Ms. B would have been in the US for more than 183 days in the 12 month period from 3 July 20X1 through 2 July 20X2.

- Foreign nationals for whom it is advantageous to be taxed as a resident but who do not meet the 183-day substantial presence test may make the first-year election (see chapter 1), which would allow them to be taxed as a US resident.
- Certain married dual-status aliens may elect to be treated as resident aliens for the entire year if electing that status results in a lower tax liability (see chapter 1).
- Foreign nationals who maintain non-US domiciles may be able to deduct away-from-home living expenses, such as housing, food, laundry, and transportation costs, for assignments not expected to last more than one year.
- When a foreign national has been present in the United States as a resident for part or all of three consecutive years, with each year including at least 183 days in the US, and subsequently becomes a nonresident, he/she should consider delaying returning to the United States as a resident until three intervening calendar years have elapsed. If the reentry is not delayed, the foreign national will be subject to complicated rules which generally tax the individual's US-source income as if they were a US resident during the intervening nonresident years. The total tax owed, when applicable, is limited to tax on income effectively connected with the conduct of a US trade or business within the US for such period (see Example 6.3).

Tax treaties

Some of the more commonly used treaty benefits are:

- Tax exemption for compensation earned under certain dollar limits or during limited periods of time
- Lower rates of withholding for interest and dividend income
- Exemption from social security withholding (under social security totalization agreements)
- Preferential treatment for capital gains and pension income

Under many treaties, the foreign national must receive his or her compensation from a foreign employer in order to receive treaty exemptions. Therefore, tax planning must involve consideration of the employee's payroll arrangement.

Disposition of principal residence

The rules enacted appear to place nonresident aliens on the same footing as resident aliens and citizens with respect to the disposition of a principal residence. In general, up to $250,000 ($500,000 for taxpayers who are married and file joint returns) of gain from the sale of a principal residence can be entirely excluded from income, provided that the home in question has been owned and used as a principal residence for at least two of the five years preceding the sale. A pro-rata portion of the exclusion is available for taxpayers who fail to meet the two-year use test by reason of a change in employment, health, or other unforeseen circumstances. If, for example, a taxpayer is transferred by an employer and must sell a house that has been occupied for only one year, the taxpayer will be entitled to one-half the maximum exclusion (i.e., to $125,000, or to $250,000 if the taxpayer is married and files jointly). For purposes of the exemption, it is not important whether the taxpayer is a resident alien or a nonresident alien at the time of sale. However, a recoverable withholding tax may be applied if the seller is nonresident, so that a nonresident seller might wish to seek a withholding tax waiver.

Complications can arise in several different circumstances (e.g., where the residence has been rented for a period or where gain from the sale of a previous residence has been deferred). Readers should seek professional tax advice about proposed home sales.

At least two other considerations deserve specific mention in connection with the sale of a personal residence. The first is the effect of the potential exchange gain or loss. As seen in Example 5.1, which illustrates the sale of securities, the taxpayer's basis in the residence is determined at the time of purchase, while the sales proceeds are determined by using the exchange rate at the date of sale. The second consideration is the effect of the exchange rate in paying off the mortgage. There may be an exchange gain on the mortgage that cannot be offset by a loss on the sale of the residence.

Example 6.3:
Mr. A, a citizen of Mexico, entered the United States on 1 May 20X1 as a lawful permanent resident. On 31 December 20X3, he surrenders his green card and terminates his US residency. He has met the initial residency period requirement because he was a resident of the United States for part of three consecutive years (20X1, 20X2, and 20X3). He returns to the United States on 5 October 20X6, as a lawful permanent resident.

Because Mr. A established his residency in the United States before the close of the third calendar year (20X6) following his initial period of US residency (20X1 to 20X3), he would be subject to US federal taxation as a resident for US-source income for the years 20X4, 20X5, and 20X6, even though he did not live or work in the United States. The US federal taxation only applies to his US-sourced income.

Additionally, gain attributable to a period of nonqualified use by a taxpayer is not excludable from gross income. The amount of gain allocated to a period of nonqualified use is the total amount of the gain multiplied by a fraction, the numerator of which is the total period of nonqualified use during the entire period the property was owned, and the denominator of which is the total period the property was owned.

A period of nonqualified use is defined as any period during which the property is not used by the taxpayer, the taxpayer's spouse or former spouse as a principal residence. Three exceptions apply to this definition:

- Any period of the five-year period after the last day the property is used as a principal residence of the taxpayer or spouse
- Any period, up to 10 years, during which the taxpayer or spouse is on extended duty with the military, Foreign Service, or the intelligence community, and
- Any period, up to two years, during which the taxpayer is temporarily absent by reason of change of employment, health conditions or other unforeseen circumstances

See Examples 6.4 and 6.5 for application of these rules.

Example 6.4:
Mr. Brown buys a principal residence on 1 May 20X1 and moves out of his principal residence on 1 August 20X3 to work abroad. While living abroad, Mr. Brown rents out his home. Mr. Brown does not reoccupy this home and he sells the property on 1 June 20X4 for a gain of $100,000. Mr. Brown owned and used the property as his principal residence for at least two of the last five years (1 June 20X1 through 31 July 20X3), so he meets the two-of-five year test, and even though he rented the property, he still meets the first exception above, in that the rental period is considered a period after the last day the property was used as his principal residence. Therefore, this period is not considered a period of nonqualified use. Mr. Brown is therefore entitled to the full exclusion of $250,000, subject to the depreciation from the rental period being taxable.

Example 6.5:
Ms. Smith buys a principal residence on 1 May 20X1 and is sent abroad by her employer on 1 May 20X3, leaving the property vacant. She returns to live in the residence on 1 May 20X6, and sells the property on 1 May 20X8, for a gain of $200,000. Smith meets the two-of-five year test so she is eligible to exclude a full $250,000 of the gain. However, a portion of this gain is related to a period of nonqualified use so the exclusion is limited, as follows:

- 1 May 20X1–30 April 20X3—2 years in which the property was used by Smith
- 1 May 20X3–30 April 20X6—3 years property was not used. However, per the third exception above, she is entitled to a 2-year absence by reason of change of employment. Therefore, only one year is considered nonqualified use.
- 1 May 20X6–30 April 20X8—2 years in which the property was used by Smith

Accordingly, one out of her seven years of ownership is considered a period of nonqualified use. Therefore, one seventh of the gain is not eligible for the exclusion, or $28,571 ($200,000 gain * 1/7), and is included in gross income in the year of sale. The remaining gain of $171,429 is less than the $250,000 exclusion so it is fully excluded from gross income.

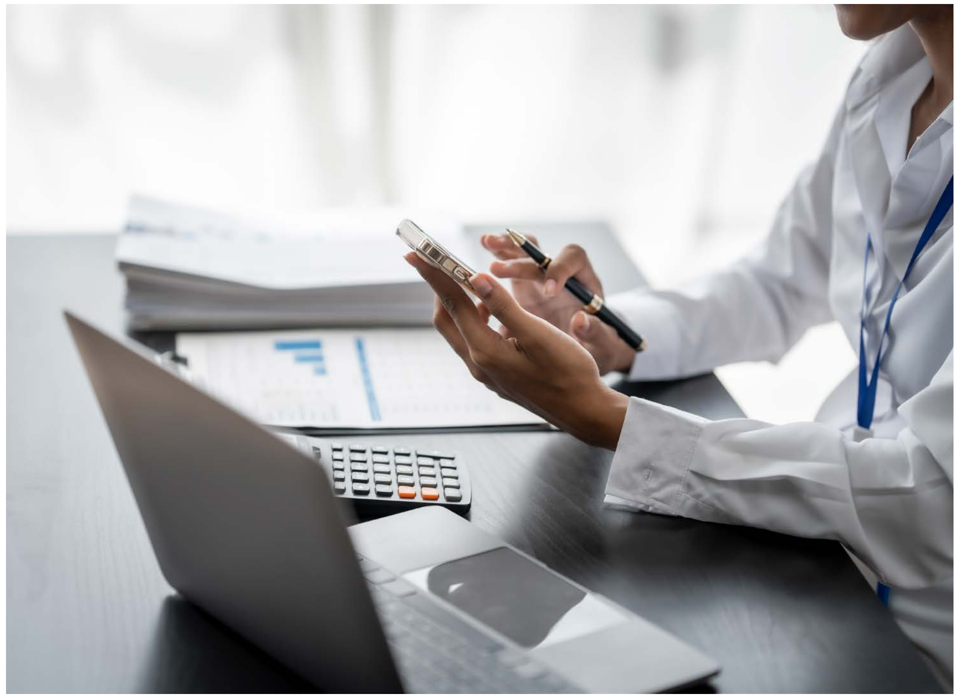
Foreign investments

Foreign investors should have their investments carefully reviewed as part of the tax-planning process before the start of a US assignment. Some ideas to consider are as follows:

- Foreign trusts, of which the nonresident alien is a beneficiary, may choose to distribute current and (especially) accumulated income before the beneficiary becomes a resident alien. (The United States imposes a disadvantageous tax regime on distributions of accumulated income from foreign trusts.)
- Foreign corporations controlled by a nonresident alien may choose to pay out dividends before the nonresident establishes US residency. Dividends paid out while the individual is considered a nonresident are not subject to US taxation. In addition, the corporation will have reduced its accumulated earnings and profits, which could favorably affect later income tax treatment.

Miscellaneous considerations

- A foreign national who owns stock in a company classified as a *passive foreign investment company* (PFIC) may be subject to an interest charge on "excess" distributions from the company. In general, a foreign company is a PFIC if 75% or more of its income consists of passive income or 50% or more of its assets produce passive income. An excess distribution is, in general, the amount of deemed distributions occurring during the US reporting period (generally the calendar-year) that exceeds 125% of the average amount of deemed distributions on that stock in the preceding three calendar years. It may be advantageous to make a special election to report the shareholder's current share of earnings to avoid the interest charge and complexity associated with excess distributions. Further, distributions occurring within the fund need not be paid or received to be taxable. Foreign mutual funds paying dividends automatically reinvested are considered a distribution and subject to tax under the PFIC regime, regardless of the right to receive cash in lieu of the automatic reinvest. A sale of a PFIC fund during US residency, in most instances, is deemed an excess distribution and also subject to tax and interest under the PFIC excess distribution regime. Additional considerations outside the US tax cost associated with holding PFICs also merit attention. Of note is the administrative burden of gathering the necessary information for US compliance reporting. Note, the non-US financial institution or entity where the PFIC is maintained may not provide readily available access to the specific fund information on a calendar-year basis. This burden is amplified when multiple funds are maintained in a single account because each require separate disclosure on the US return irrespective of whether tax may be assessed.



Some additional tax-saving considerations include:

- *Establishing individual retirement accounts*. Foreign nationals may make contributions to individual retirement accounts. Their contributions and withdrawals are subject to the same rules as are those of US citizens, except in those instances in which a treaty has overriding beneficial provisions.
- *Possibly electing the foreign-earned income exclusion.* Foreign nationals who are lawful permanent residents of the United States (green card holders) but who are considered foreign residents under an income tax treaty may, in certain circumstances, be able to elect the foreign-earned income exclusion.
- *Selecting a fiscal year.* In some cases, use of a fiscal-year accounting period may result in tax savings. The primary advantage of selecting a fiscal-year period is that it enables the resident alien to shorten the period during which he or she is considered a nonresident or dual-status taxpayer. It also enables the nonresident alien to take better advantage of certain treaty and Internal Revenue Code provisions.
- *Basing estimated tax payments on the prior-year liability.* Foreign nationals in the United States for their first full year are allowed to base their estimated tax prepayments on 100% of their prior-year tax liability (110% for high-income taxpayers), regardless of whether the prior year was a nonresident or dual-status tax year, provided that they filed US tax returns in the prior year. The Internal Revenue Code requires only that there be a tax liability on a return covering twelve months in the prior year.
- *Considering visa status*. Foreign nationals present in the United States as teachers, trainees, or students (that is, on F or J visas) will generally be taxed as nonresidents.
- *Withholding on interest payments*. Resident aliens who make interest payments to a foreign lender (such as mortgage interest on the resident alien's home in the foreign country) must withhold and deposit with the IRS 30% of the interest paid. The 30% may be reduced by an applicable income tax treaty.
- *Electing out of installment sales*. Foreign nationals who sell property on an installment basis are subject to US tax on the gain relating to payments received after becoming a US resident, even if the sale was made before US residency was established. The foreign national can make an election on his or her first US income tax return out of the installment sale method and thereby avoid US tax on the gain.
- *Making treaty disclosures*. Resident aliens taking advantage of provisions of US income tax treaties must disclose certain positions in their US income tax returns, including the application of any nondiscrimination provisions. Provisions that do not generally need to be disclosed include reduced withholding tax rates, determination of residency, and modification of the tax on items such as pensions and annuities. Disclosure is usually made by completing Form 8833,

Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).

Foreign bank accounts and specified foreign financial assets

Foreign Bank Account Reporting (FBAR)

The Department of the Treasury requires that every US citizen or resident alien with an interest in or signature authority over foreign bank accounts, securities, or other financial accounts that exceed $10,000 in aggregate value at any time during the calendar year must report that relationship. The original deadline aligns with that of the individual income tax return (that is, 15 April) and an automatic six-month extension is provided for anyone who fails to meet the original deadline. Nonresident aliens are not required to report these accounts. A tax adviser should be consulted to determine whether a foreign national has to file this separate report.

The report is made electronically on Form 114, *Report of Foreign Bank and Financial Accounts (FBAR)*, filed online and separately from the income tax return through the BSA E-Filing System website (http://bsaefiling.fincen.treas.gov/main.html). Failure to file Form 114 may result in the imposition of civil and criminal penalties.

Specified foreign financial asset reporting

Additional reporting of specified foreign financial assets may also be required as part of the individual's tax return. Where required, disclosure is made by attaching Form 8938, Statement of Specified Foreign Financial Assets to the tax return. The due date to file Form 8938 is the same as the tax return and may be extended by a timely and valid extension request of time to file the individual's income tax return.

Table 6.1

	Not living abroad		Living abroad	
	Not filing jointly	Filing jointly	Not filing jointly	Filing jointly
Last day of tax year	$50,000	$100,000	$200,000	$400,000
Any time during tax year	$75,000	$150,000	$300,000	$600,000

Form 8938 applies to *specified individuals* holding an interest in *specified foreign financial asset(s)* over the applicable Form 8938 reporting threshold for the underlying tax-year.

"Specified individuals" generally include US citizens and green card holders, as well as US alien individuals filing a resident US income tax return. These individuals must attach Form 8938 to their US tax return when they hold an interest in specified foreign financial assets in excess of the applicable reporting threshold.

"Specified foreign financial assets" may include:

- any depository, custodial, or other financial account maintained by a foreign (non-US) financial institution,
- any stock, security, financial instrument or contract issued by a person other than a US person held outside of a financial institution, and,
- any separate interest in a foreign entity not held in a US institutional account.

In determining the value for Form 8938 reporting threshold and disclosures, the total value of specified foreign financial assets also include non-US estates, pension plans and deferred compensation plans.

Table 6.1 summarizes the Form 8938 reporting threshold for each type of individual classified as a specified person and is based on the aggregate total value (in US dollars) of all specified foreign financial assets held on either the last day of the tax year, or at any time during the tax year.

When required, all accounts and financial assets located outside the US require disclosure on Form 8938. If an individual is a "specified person" for less than the entire year, e.g., a dual-status alien, the individual is only required to report on the period of the year that the individual is a "specified person", e.g., a tax resident. Otherwise the reporting period for individuals is the complete tax year.

The recent move towards global tax compliance merits sufficient due diligence be exercised when Form 8938 or FBAR disclosure filing is required. Items and amounts should be fully disclosed in an accurate and reliable manner to safeguard against substantial penalties. The US and many foreign countries have formal Tax Information Exchange Agreements (TIEAs) which provide mechanics for sharing of global financial tax information. Additionally, following the enactment of the Foreign Account Tax Compliance Act (FATCA), on January 12th, 2015 the IRS announced the launch of its information exchange Web program. Collectively and with regard to individual US taxpayers, TIEAs and FATCA agreements are aimed to mitigate cross-border tax evasion through global information sharing amongst taxing jurisdictions.

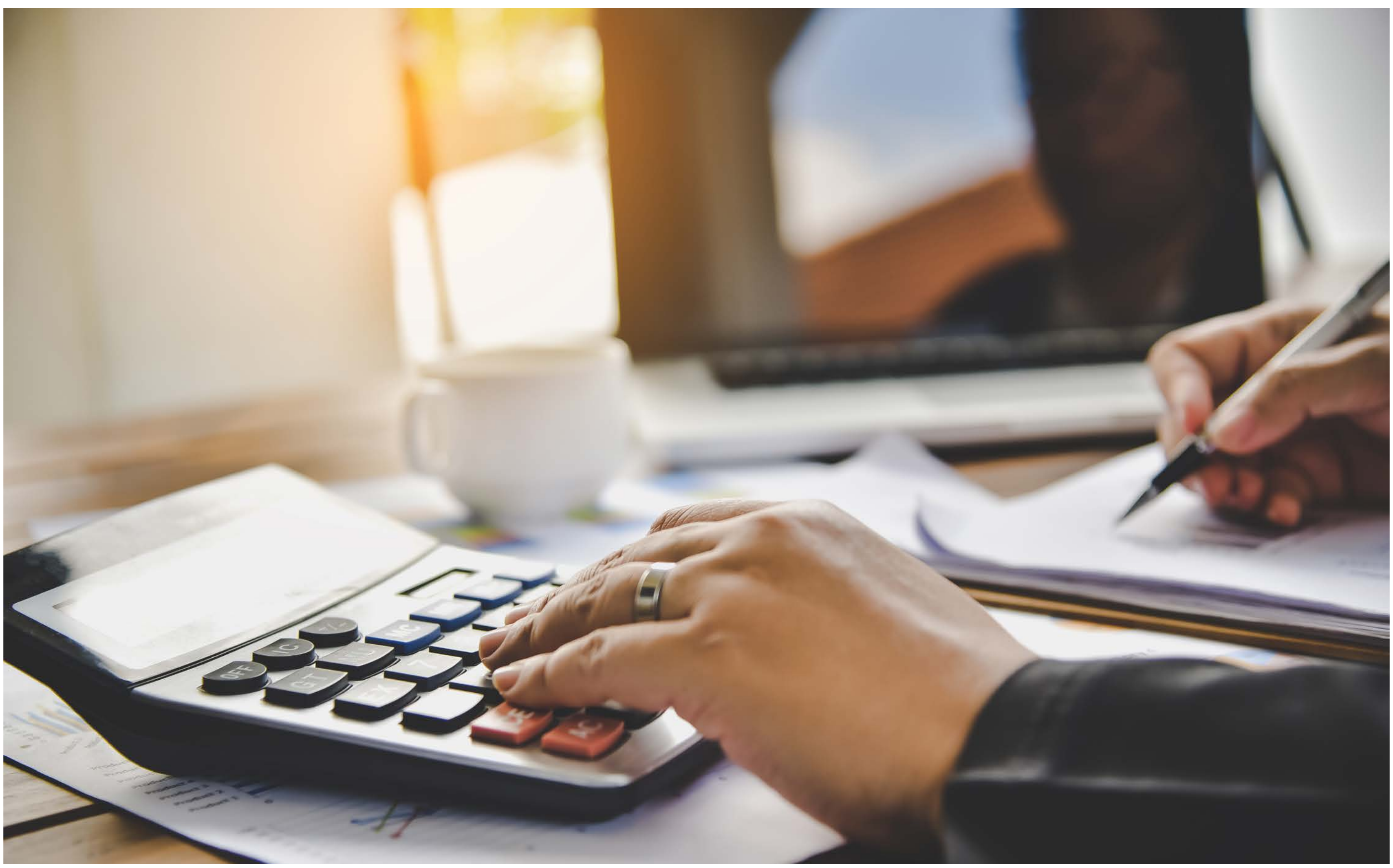
Non-US trusts and additional reporting requirements

Under US tax law, certain types of foreign accounts or entities are classified as non-US trusts. If a US citizen or resident (as defined under Chapter 1) including treaty nonresident is considered the beneficiary, trustee, or owner of one of these trusts, they may be required to file certain information reporting forms with respect to the trust. These information reporting forms are filed separately from an individual's personal tax return and may have separate filing deadlines. Applicable penalties and interest of at least $10,000 may be due for failure to file timely any required forms. In recent years the IRS has increased scrutiny around timely and accurate filing of these forms, so care should be taken to proactively identify any applicable filing requirements for foreign accounts considered non-US trusts.

A few common types of foreign accounts or entities that are classified as non-US trusts are some Canadian Tax-Free Savings Account (TFSA), Canadian Registered Education Savings Plan (RESP), some family trusts and certain Superannuation funds, though many other accounts could also be considered a non-US trust. Determination of what is classified as a non-US trust should be made based on the full facts and circumstances of each account or entity. It is possible for an entity to be classified as a trust for US tax purposes when it is classified differently in the foreign jurisdiction. Classification under US tax law will drive the US filing requirements, even if it is inconsistent with the requirements in the non-US jurisdiction.

Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, is filed annually by an owner of a non-US trust to report ownership of the trust. In addition, the form must be generally filed by an individual for the year they make a contribution or loan to a foreign trust, receive a distribution or loan from a foreign trust, or receive gifts over a certain value from non-US persons or entities. The form must be filed by the due date, including any extensions, of the individual's tax return.

Form 3520-A, Annual Information Return of Foreign Trust with a US Owner, is filed annually by the trustee of a foreign trust with a US owner. In contrast to the Form 3520, the original due date of the Form 3520-A is generally March 15th for a calendar year trust. A six-month extension may be requested by March 15th to extend the due date of the form.



Appendix A | Key figures

1. Standard deduction

Filing status	2025
Single	15,000
Married filing jointly	30,000
Married filing separately	15,000
Head of household	22,500

2. Expatriation

Net income tax test—For the five-year period before expatriation, the individual had an average annual US income tax liability in excess of at least $206,000 in 2025.

3. Private delivery services

The following private delivery services are currently designated by the IRS, as of this publication:

- DHL Express: DHL Express 9:00, DHL Express 10:30, DHL Express 12:00, DHL Express Worldwide, DHL Express Envelope, DHL Import Express 10:30, DHL Import Express 12:00, DHL Import Express Worldwide
- Federal Express (FedEx): FedEx First Overnight, FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2 Day, FedEx International First Next Flight Out, FedEx International Priority, and FedEx International First, FedEx International Economy; and
- United Parcel Service (UPS): UPS Next Day Air Early AM, UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

4. Estimated tax payments

Payment dates for 2025 are:

- April 15, 2025
- June 16, 2025
- September 15, 2025
- January 15, 2026.

5. Income bases for OASDI and HI

	2025			
	Income subject to OASDI		Income subject to HI[c]	
Tax	**Rate**	**Maximum**[a]	**Rate**	**Maximum**
FICA (employee)	6.2%	$10,918.20	1.45%	Unlimited
SECA (self-employed)	12.4%	$21,836.40	2.9%	Unlimited

a. OASDI wage base = $176,100; $176,100 x 6.2% = $10,918.20; $176,100 x 12.4% = $21,836.40.

b. Self-employed taxpayers are allowed a deduction equal to one-half of their SECA tax liability when computing adjusted gross income.

c. Subject to additional 0.9% Medicare tax on income in excess of predefined amounts.

An individual is liable for Additional Medicare Tax of 0.9% if the individual's wages, compensation or self-employment income (together with that of his or her spouse if filing a joint return) exceed the threshold amount for the individual's filing status for 2025:

Filing status	Threshold amount
Married filing Joint	$250,000
Married filing separate	$125,000
Single	$200,000
Head of Household	$200,000

6. Annual gift tax exclusion for transfers to a non-citizen spouse

Gifts in excess of $190,000 in 2025 are subject to US transfer tax

Appendix B | 2025 US Federal Rates

Single

From	To	Amount	Excess
$0	$11,925	$0	10.00%
11,925	48,475	1,192.50	12.00%
48,475	103,350	5,578.50	22.00%
103,350	197,300	17,651	24.00%
197,300	250,525	40,199	32.00%
250,525	626,350	57,231	35.00%
626,350		188,769.75	37.00%

Head of household

From	To	Amount	Excess
$0	17,000	$0	10.00%
17,000	64,850	1,700	12.00%
64,850	103,350	7,442	22.00%
103,350	197,300	15,912	24.00%
197,300	250,500	38,460	32.00%
250,500	626,350	55,484	35.00%
626,350		187,03	37.00%

Married filing joint

From	To	Amount	Excess
$0	23,850	$0	10.00%
23,850	96,950	2,385	12.00%
96,950	206,700	11,157	22.00%
206,700	394,600	35,302	24.00%
394,600	501,050	80,398	32.00%
501,050	751,600	114,462	35.00%
751,600		202,154.50	37.00%

Married filing separate

From	To	Amount	Excess
$0	11,925	$0	10.00%
11,925	48,475	1,192.50	12.00%
48,475	103,350	5,578.50	22.00%
103,350	197,300	17,651	24.00%
197,300	250,525	40,199	32.00%
250,252	375,800	57,231	35.00%
375,800		101,077.25	37.00%

Estates and trusts

From	To	Amount	Excess
$0	$3,150	$0	10.00%
$3,150	11,450	$315	24.00%
11,450	15,650	$2,307	35.00%
15,650		$3,777	37.00%

2025 long term capital gain and qualified dividends rates for taxpayers with taxable income in the specified ranges

Married filing joint

$0	$96,700	0.00%
96,700	600,050	15.00%
600,050		20.00%

Single

$0	$48,350	0.00%
48,350	533,400	15.00%
533,400		20.00%

Married filing separate

$0	$48,350	0.00%
48,350	$300,000	15.00%
300,000		20.00%

Estate and trusts

$0	$3,250	0.00%
3,250	15,900	15.00%
15,900		20.00%

Head of household

$0	$64,750	0.00%
64,750	566,700	15.00%
566,700		20.00%

Additional 3.8% tax imposed on the lesser of the individual's net investment income or the excess of the individuals modified gross income over certain thresholds ($250,000 for married couples filing jointly or surviving spouse, $125,000 for married couples filing separately, and $200,000 for all other taxpayers).

Appendix C | United States income tax treaties

As of December 2024, the United States had tax treaties in effect with the countries listed in Figure 1.4.

Figure 1.4
Tax treaty countries

Armenia[1]	Iceland	Philippines
Australia	India	Poland
Austria	Indonesia	Portugal
Azerbaijan[1]	Ireland	Romania
Bangladesh	Israel	Russia
Barbados	Italy	Slovak Republic
Belarus[1]	Jamaica	Slovenia
Belgium	Japan	South Africa
Bulgaria	Kazakhstan	Spain
Canada	Korea (Republic of)	Sri Lanka
China (People's Republic of)	Kyrgyzstan[1]	Sweden
Chile[2]	Latvia	Switzerland
Cyprus	Lithuania	Tajikistan[1]
Czech Republic	Luxembourg	Thailand
Denmark	Malta	Trinidad and Tobago
Egypt	Mexico	Tunisia
Estonia	Moldova[1]	Turkey
Finland	Morocco	Turkmenistan[1]
France	Netherlands	Ukraine
Georgia[1]	New Zealand	United Kingdom
Germany	Norway	Uzbekistan[1]
Greece	Pakistan	Venezuela

1 The Department of the Treasury announced that the income tax treaty with the Soviet Union will continue in effect for these countries until separate agreements are concluded and come into effect; this position was confirmed in the 2016 IRS Publication 901. However in practice the convention is not consistently applied between all countries.

2 The U.S. Department of the Treasury announced that the United States has provided formal notice to the Russian Federation to confirm the suspension of the operation of Paragraph 4 of Article 1 and Articles 5-21 and 23 of the Convention between the United States of America and the Russian Federation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, as well as the operation of its accompanying Protocol, by mutual agreement. The suspension took effect both for taxes withheld at source and in respect of other taxes on August 16, 2024, and will continue until otherwise decided by the two governments.

3 The U.S.– China income tax treaty does not apply to Hong Kong.

As of December 2024, the United States had totalization agreements in effect with the countries listed in Table 5.1

Table 5.1
US totalization agreements

Country	Latest effective date
Australia	October 1, 2002
Austria	January 1, 1997
Belgium	July 1, 1984
Brazil	October 1, 2018
Canada	October 1, 1997
Chile	December 1, 2001
Czech Republic	May 1, 2016
Denmark	October 1, 2008
Finland	November 1, 1992
France	July 1, 1988
Germany	May 1, 1996
Greece	September 1, 1994
Hungary	September 1 2016
Iceland	March 1, 2019
Ireland	September 1, 1993
Italy	January 1, 1986
Japan	October 1, 2005
Korea (Republic of)	April 1, 2001
Luxembourg	November 1, 1993
Netherlands	May 1, 2003
Norway	September 1, 2003
Poland	March 1, 2009
Portugal	August 1, 1989
Slovakia	May 1, 2014
Slovenia	February 1, 2019
South Korea	April 1, 2001
Spain	April 1, 1988
Sweden	November 1, 2007
Switzerland	August 1, 2014
United Kingdom	September 1, 1997
Uruguay	November 1, 2018

Table 5.2
Estate and gift tax treaties

Country	Type of treaty
Australia	Separate estate and gift
Austria	Combined estate and gift
Canada[a]	Estate only
Denmark	Combined estate and gift
Finland	Estate only
France	Combined estate and gift
Germany	Combined estate and gift
Greece	Estate only
Ireland	Estate only
Italy	Estate only
Japan	Combined estate and gift
Netherlands	Estate only
South Africa	Estate only
Switzerland	Estate only
United Kingdom	Combined estate and gift

a Although the United States and Canada do not have a separate estate tax treaty, taxes upon death are covered within the provisions of the US–Canada income tax treaty.

Appendix D | IRS forms and statements location information

The current versions of all forms can be obtained from the IRS web site:
http://www.irs.gov