

Chapter 9: International Taxation

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Corrections were made to this material through January of 2012. No subsequent modifications were made.

The area of international taxation embraces many familiar tax concepts. The notion of making strategic use of the tax laws in different jurisdictions to reduce tax liabilities is nothing new. However, facing double taxation due to tax liabilities that cross international borders is a major concern for individuals and businesses alike. Tax treaties between nations attempt to address this concern. In addition, tax compliance and filing requirements in jurisdictions outside the United States are relevant. Developing a working knowledge of specific foreign tax laws, the calculation of foreign tax credits, and how to work with foreign currencies is essential in this area.

Moreover, various tax statutes, regulations, and other tax laws within nations, including those of the United States, are often superseded by specific provisions in a tax treaty that may exist between nations. Reference must always be made to any existing tax treaty to determine whether nations have agreed to terms that differ from the norm under their respective home tax laws.

International taxation is also inextricably linked with immigration law. Immigration laws in the United States and other nations have an impact on the nexus of a jurisdiction to tax an individual or business. Nations vary on how immigration laws apply to establishing tax nexus.

This chapter discusses the more important aspects of international taxation that apply to the individual taxpayer. Not only is the impact of U.S. immigration law discussed, but key tax rules are addressed that apply to individuals whose activities span from the United States into one or more other countries.

Finally, a brief discussion of transfer pricing issues for international businesses is included. This particular area has recently been a major IRS focal point and is certain to gain increasing attention as multinational businesses continue to use strategies to reduce their effective tax rates.

TAX STATUS IN THE UNITED STATES

The Code uses **three types of tax status** to determine how an individual is taxed.

1. U.S. citizen
2. Resident alien (RA)
3. Nonresident alien (NRA)

U.S. citizens are generally required to pay U.S. income tax on worldwide income. Worldwide income constitutes all income earned or received from all sources inside or outside the United States. The constitutionality of this extraterritorial aspect of U.S. taxation was upheld by the Supreme Court in *Cook v. Tait*.¹ The court reasoned that because the U.S. government benefits U.S. citizens wherever those citizens may be or wherever their property is found, the government may use citizenship as a basis for taxation. This differs from limiting tax nexus solely to persons or property within the United States. Naturalized citizens are subject to the same tax rules as native-born citizens.² Therefore, either U.S. citizenship or a noncitizen's residence in the United States constitutes sufficient nexus for U.S. taxation. Resident aliens are also subject to the worldwide income reporting rule.³

Note. The notion of using citizenship as the nexus to tax is a rather unique aspect of U.S. international tax law. Sufficient nexus in other nations is generally limited to residency and domestic source income, which U.S. tax law also embraces with specific rules.

U.S. CITIZENSHIP

The Code does not define "U.S. citizen." However, Treas. Reg. §1.1-1(c) indicates that every person born or naturalized in the United States and subject to its jurisdiction is a citizen. U.S. citizens retaining citizenship of another country are taxed as U.S. citizens on worldwide income regardless of other citizenships maintained.⁴

Example 1. Alberto is a U.S. citizen living in Germany. His only source of income is rental income earned from property Alberto owns in Germany and Italy. He owns no property in the United States and has no U.S. source income. Alberto is subject to U.S. tax on all his rental income because of his U.S. citizenship.

Example 2. Sven is a naturalized U.S. citizen who was born in Sweden. Sven lives in Sweden where he is employed by a Swedish automobile parts manufacturer. He also heads a small business that translates English and Swedish books and documents. The translated materials are sold in Sweden to libraries and museums. Sven is subject to U.S. taxation on all of his employment income and self-employment (SE) income.

Note. The taxpayers in the above examples may be taxed by authorities in the jurisdictions in which they live in addition to being subject to U.S. taxation. This leads to double taxation. However, a U.S. tax credit may be available. This issue is discussed later in the chapter.

Relinquishing Citizenship or Residency

The extraterritorial aspect of U.S. federal income taxation gives it broader reach than taxation imposed by other countries, which often limit nexus to only residents or domestic sources of income. This broad reach in U.S. federal taxation, based on citizenship, frequently provides a motive for relinquishing U.S. citizenship to reduce or eliminate U.S. taxation.

A U.S. citizen generally loses U.S. citizenship only if there is:

- Voluntary renouncement of U.S. citizenship, **and**
- Performance of at least one act of expatriation under section 349 of the Immigration and Nationality Act with the intention of relinquishing U.S. citizenship.

¹ *Cook v. Tait*, 265 U.S. 47 (1924).

² *U.S. v. Rexach*, 185 F.Supp. 465 (D. Puerto Rico 1960).

³ IRC §§871 through 898 limit the scope of U.S. taxation to foreign persons. These sections apply only to nonresident aliens and foreign corporations. Therefore, resident aliens, by implication, are subject to the same tax rules as U.S. citizens.

⁴ *Atef. A. Gamal-Eldin v. Comm'r*, TC Memo 1988-150 n.2 (Apr. 12, 1988).

Some of the expatriation acts under section 349 of the Immigration and Nationality Act are:

- Obtaining naturalization or citizenship of a foreign country while age 18 or older;
- Taking an oath or other formal declaration of allegiance to another foreign country while age 18 or older;
- Entering or serving in any capacity in a foreign country's armed forces that are hostile to the United States;
- Serving as a commissioned or noncommissioned officer in a foreign country's armed forces;
- Accepting, serving in, or performing the duties of any employment of a foreign country while age 18 or older if the nationality of the foreign country is also acquired;
- Formally renouncing U.S. citizenship before a U.S. diplomatic or consular officer; and
- Conviction by court or court martial of treason, bearing arms against the United States, or attempting to forcefully overthrow the United States.

A **resident alien** is an individual who is not a U.S. citizen but has obtained the lawful ability to reside in the United States. An alien acquiring residence in the United States retains this status until the status is abandoned and actual departure from the United States occurs.⁵ Mere intention to change residency is not sufficient.

Expatriation and Tax Avoidance Provisions

Using U.S. citizenship as nexus to tax causes some individuals to relinquish their U.S. citizenship as a tax avoidance measure.

Expatriation on or before June 3, 2004. The date that U.S. citizenship or residency status is lost is referred to as the "expatriation date."

Prior to the changes in 2004 and 2008 outlined in the next section, the applicable expatriate tax rules operated on a presumption and rebuttal system. Under these older rules, an individual relinquishing citizenship, or a resident alien terminating lawful residency, was **presumed to** have tax avoidance as a principal purpose for doing so if:

- Average annual net income for the five years prior to relinquishing citizenship or residency was more than \$124,000, and
- Net worth as of the loss of citizenship or residency was \$622,000 or more.

To rebut this presumption, the expatriate was required to request a ruling from the IRS within one year of the expatriation date.

If the expatriate was unsuccessful in rebutting the presumption, regular tax rules applied for the 10-year period following the expatriation date. These rules applied in a similar manner to the rules that were effective June 3, 2004, to June 16, 2008.

⁵ Treas. Reg. §1.871-5.

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Expatriation from June 3, 2004, to June 16, 2008. Expatriate taxation is addressed primarily by IRC §877 for expatriation dates from June 3, 2004, to June 16, 2008. The American Jobs Creation Act of 2004 made substantial changes to §877 for expatriates and long-term residents who relinquish U.S. citizenship or residency status. Expatriates continue to be treated as U.S. citizens or residents for tax purposes even after their expatriation date. Expatriates meeting any one of the following three criteria may be subject to continued U.S. taxation.

1. The expatriate has average annual tax liability (2011) of \$147,000⁶ for the five taxable years preceding the expatriation date (the “**tax liability test**”).
2. The expatriate has a net worth of \$2 million or more on the expatriation date (the “**net worth test**”).
3. The expatriate fails to certify to the IRS that all tax compliance requirements were met for the five taxable years preceding expatriation (the “**failure to certify test**”).

Note. Prior to June 3, 2004, a **tax avoidance motive** was necessary for continued exposure to U.S. taxation. This is no longer the case.

For the **10-year period following** expatriation, IRC §877 applies a special alternative tax to the expatriate.⁷ The alternative tax subjects the expatriate to taxation only on U.S. source income and gains for the 10-year period.⁸ Normal, graduated tax rates are used and the AMT applies.⁹

However, within this 10-year period, physical presence in the United States for more than 30 days during a taxable year terminates application of the special alternative tax for that taxable year.¹⁰ Instead, the expatriate becomes subject to U.S. taxation as a U.S. resident. This means the expatriate is taxed on worldwide income for that year instead of only U.S. source income. Certain types of employment for up to 30 days annually within the United States are permitted without being counted towards the 30-day physical presence test for this rule.¹¹

Individuals relinquishing U.S. citizenship or long-term residency continue to be treated as U.S. citizens, subject to the worldwide income requirement, until the individual:

- Provides notice of expatriation to the Department of State or Homeland Security, and
- Files Form 8854, *Initial and Annual Expatriation Information Sheet*, in compliance with IRC §6039G.

IRC §6039G requires the expatriate to file Form 8854 for each year the expatriate is subject to IRC §877.

The tax liability test and net worth test do not apply to a **dual citizen**.¹² A dual citizen is an individual who, at birth, became a citizen of the United States and another country simultaneously and who has an absence of substantial contacts with the United States.¹³ The absence of substantial contacts with the United States is defined as:

- Never residing in the United States,
- Never owning a U.S. passport, and
- Not being physically present in the United States for more than 30 days during any one of the 10 calendar years immediately preceding the loss of U.S. citizenship.¹⁴

⁶ This amount is indexed each year for inflation. \$145,000 is the applicable figure for 2009 and 2010. The 2011 figure is \$147,000.

⁷ IRC §877(b).

⁸ IRC §§877(b)(1) and 872(a).

⁹ IRC §877(b).

¹⁰ IRC §877(g).

¹¹ IRC §877(g)(2).

¹² IRC §877(c)(2).

¹³ IRC §§877(c)(2)(A)(i) and (ii).

¹⁴ IRC §877(c)(2)(B).

Expatriation after June 16, 2008. The Heroes Earnings and Assistance Relief Act of 2008 created IRC §877A. IRC §877A retains the same three tests of §877. However, the tax liability and net worth tests do not apply to certain dual citizens under these new rules. The **dual citizen requirement exemption** requires qualification under more stringent rules. The expatriate is not treated as meeting the tax liability or net worth test if:

- At birth, the expatriate became both a U.S. citizen and a citizen of another country simultaneously,
- The expatriate continues to be a citizen of the other country and is taxed as a resident of that other country, or
- The expatriate has not lived in the United States for more than 10 of the 15 taxable years ending with the taxable year of expatriation.

Under §877A, a U.S. citizen becomes an expatriate and is treated as relinquishing U.S. citizenship on the **earliest** of four possible dates.¹⁵

1. The date the citizen renounces citizenship before a U.S. diplomatic or consular officer under §349(a) of the Immigration and Nationality Act and receives approval of renunciation by the Department of State
2. The date the citizen furnishes a signed statement of voluntary relinquishment of citizenship to the Department of State confirming an act of expatriation under §349(a)(1), (2), (3), or (4) and receives Department of State approval of renunciation
3. The date the Department of State issues a certificate of loss of citizenship to the taxpayer
4. The date a U.S. court cancels the citizen's certificate of naturalization

A long-term **resident alien** becomes an **expatriate** when they:¹⁶

- Lawfully and permanently resided in the United States, and
- Resided in the United States for at least eight of the 15 taxable years ending with the year in which the individual ceased being a lawful permanent resident.

Note. Resident aliens who have held a green card for less than eight years are not affected by this legislation.

An expatriate that meets either the tax liability test, the net worth test, or the failure to certify test as outlined in §877(a)(2) is a **covered expatriate** to whom IRC §877A applies.¹⁷

IRC §877A dramatically changes the tax treatment of expatriates compared to §877. IRC §877A imposes mark to market tax treatment. In this regard, there is a deemed sale of all worldwide property at FMV belonging to the expatriate. The deemed sale occurs the day **before** the taxpayer's expatriation date.¹⁸ Both gains and losses are recognized in the deemed sale.¹⁹ There is an exclusion amount of \$636,000 (for 2011),²⁰ adjusted annually for inflation from 2008 onward. This exclusion amount can be applied against the amount included in the expatriate's net income in the year of the deemed sale.²¹

¹⁵ IRC §877A(g)(4).

¹⁶ IRC 877(e)(2).

¹⁷ IRS Notice 2009-45 provides substantial additional guidance on the application of IRC §877A.

¹⁸ IRC §877A(a).

¹⁹ IRC §877A(a)(2).

²⁰ IRC §877A(a)(3)(A). This amount is indexed for inflation.

²¹ IRS Notice 2009-85 provides substantial guidance on the application of the expatriation mark to market rules.

Some assets are not subject to the deemed sale provision. For example, deferred compensation plans are not subject to the deemed sale. If such a plan is “eligible,” as defined in the statute,²² the payor must withhold and remit 30% of any payments to the IRS.²³ An ineligible plan is taxed as if the entire plan benefit was received by the expatriate on the day before expatriation.²⁴ Different tax treatment is also provided for interests in certain tax deferred accounts and in nongrantor trusts.²⁵

Involuntary Relinquishment of Citizenship. A taxpayer that relinquishes U.S. citizenship may later claim that the action was involuntary. When an administrative agency or court finds the renunciation invalid, the taxpayer is treated as if citizenship was never relinquished and is subject to U.S. taxation.

RESIDENT ALIENS

Resident aliens (RAs) are subject to U.S. taxation on worldwide income at normal tax rates in the same manner as U.S. citizens. Nonresident aliens (NRAs) are subject to special rules. When an alien (non-U.S. citizen) has taxable income, it is imperative to determine the location of that person’s residence. A non-U.S. citizen is considered an RA, generally subject to the same tax rules as a U.S. citizen, if either the **green card test** or **substantial presence test** is met.²⁶

Green Card Test

In order for an RA to begin to lawfully live and work in the U.S., a green card must be obtained.²⁷ Upon receipt of the green card, the recipient becomes a lawful permanent resident (LPR).

If the alien does not meet the substantial presence test for the year but is present within the United States when the green card is received, the alien is treated as a U.S. resident for the entire taxation year. Therefore, the starting date of residency is January 1 of the year in which the green card is received. If the alien does not meet the substantial presence test and receives the green card outside the United States, the starting date is the date of entry into the United States.

Note. The RA’s starting date of residency is the first date covered by the RA’s first U.S. tax return.

Substantial Presence Test

An alien individual having substantial presence in the United States becomes an RA for tax purposes.²⁸ Substantial presence in the United States exists if the alien individual is physically present in the United States for at least 183 days during the 3-year period that includes the current year. The current year is the year for which residency status is being determined.

²² IRC 877A(d)(3).

²³ IRC §877A(d)(1)(A).

²⁴ IRC §877A(d)(2)(A)(1).

²⁵ IRC §§877A(e)(1) and 877(f).

²⁶ Treas. Reg. §301.7701(b)-1.

²⁷ Treas. Reg. §301.7701(b)-1(b).

²⁸ Treas. Reg. §301.7701(b)-1(c).

Special Counting Rules. An individual is considered present for a day in the United States when physical presence in the United States exists for any time during the day.

To calculate the number of days present in the United States, the following rules²⁹ apply for each day the individual is present in the United States.

- Each actual day present in the United States during the current year is counted as a **full** day.
- Each actual day present in the United States during the year immediately preceding the current year is counted as **one-third** of a day.
- Each actual day present in the United States during the second preceding year is counted as **one-sixth** of a day.

U.S. residency starts on the first day of presence in the United States within the taxable year in which the substantial presence test is met.

Example 3. Vladimir is a Russian citizen. He spends 60 actual days in the United States in 2009 and spends 120 actual days in the United States in 2010. In 2011, he remains in Russia for the first two months of the year and arrives in the United States on March 1. He remains in the United States until July 31, when he returns to Russia. Therefore, he has been in the United States for 153 days in 2011. Vladimir has no green card. Vladimir must determine if he is a resident for U.S. tax purposes in 2011.

Under the substantial presence test, Vladimir's time in the United States in the 3-year period (2009, 2010, and 2011) is relevant. The calculation for determining residency is as follows.

Calendar Year	Counted Days	Multiplier	Substantial Presence Days
2009	60	$\frac{1}{6}$	10
2010	120	$\frac{1}{3}$	40
2011	153	1	153
Total			203

Vladimir's has a total of 203 substantial presence days during the 3-year period that includes the 2011 taxation year. In order to become a resident for U.S. tax purposes, he needs to have at least 183 substantial presence days. He meets this requirement. Therefore, Vladimir's presence in the United States for 2009, 2010, and 2011 has been substantial enough to trigger residency in the United States for 2011 tax purposes. He is not considered a U.S. resident for 2009 or 2010. Even though Vladimir reached his 183rd counted day on July 11, 2011, his starting day for U.S. residency in 2011 is March 1, 2011, the first day of presence in the United States within the year.

If the RA meets **both** the green card test and substantial presence test, the starting date of residency is the **earlier of**:

- The first day physically present in the United States as an LPR, **or**
- The first day present under the substantial presence test.

Declining Physical Presence Exemption. An exception to the substantial presence test exists for individuals who meet the test but have minimal presence in the United States in the current year.

When the substantial presence test is met but there are less than 31 days physically present in the United States within the current year, the alien is deemed to **not** meet the substantial presence test. The alien is therefore regarded as a nonresident alien for U.S. tax purposes.

²⁹ Ibid.

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Exempt Individuals. The days present in the United States as an exempt individual are not counted for purposes of the substantial presence test. Exempt individuals include the following individuals.³⁰

- A person who is a full-time employee of an international organization, or who has full-time diplomatic or consular status³¹
- A person who intends to leave the United States but is unable to leave due to medical illness when the illness arose in the United States and is not a pre-existing condition³²
- A teacher or trainee temporarily admitted into the United States under sections 101(a)(15)(J) or 101(a)(15)(Q) of the Immigration and Nationality Act who substantially complies with the terms of their visa³³
- A student temporarily admitted into the United States under sections 101(a)(15)(F), (J), (M) or (Q) of the Immigration and Nationality Act who substantially complies with the terms of their visa³⁴
- Commuters from Canada or Mexico regularly attending their workplace in the United States for more than 75% of their workdays³⁵
- Professional athletes participating in a **charitable** sports event held in the United States³⁶

Closer Connection Exemption. An alien that meets the substantial presence test is nevertheless considered a nonresident alien if **both** of the following conditions are met for the entire **current year**.

1. There are **less than 183 days of physical presence** in the United States
2. The individual maintains a tax home in a foreign country with which the individual has a **closer connection** than the connection with the United States

Tax home is defined as the individual's regular or principal place of business. If the individual is not engaged in a business, their tax home is their regular place of abode in a real and substantial sense.³⁷

A **closer connection** with a foreign country exists when the individual maintains more significant contacts with the foreign country than with the United States. This can be established by either the individual or the IRS and is determined by reference to the facts and circumstances of each individual's situation. Some factors considered when **determining a closer connection** include the following.

- Location of the individual's permanent home

Note. A **permanent home** can be a house, apartment, or furnished room and can be either owned or rented. However, it must be available for use at all times continuously, not merely available for short stays.

- Location of the individual's family
- Location of personal belongings, such as automobiles, furniture, clothing, and jewelry owned by the individual and their family

³⁰ Treas. Reg. §301.7701(b)-3.

³¹ Treas. Reg. §301.7701(b)-3(b)(2).

³² Treas. Reg. §301.7701(b)-3(a). See Treas. Reg. §301.7701(b)-3(c) for additional rules and limitations on this exemption.

³³ Treas. Reg. §301.7701(b)-3(b)(3). See Treas. Reg. §301.7701(b)-3(b)(6) and (7) for additional rules and limitations on this exemption.

³⁴ Treas. Reg. §301.7701(b)-3(b)(4). See Treas. Reg. §301.7701(b)-3(b)(6) and (7) for additional rules and limitations on this exemption.

³⁵ Treas. Reg. §301.7701(b)-3(e) provides additional limitations and details.

³⁶ Treas. Reg. §301.7701(b)-3(b)(5) provides additional limitations and details.

³⁷ Treas. Reg. §301.7701(b)-2(c).

- The location of any social, political, cultural, or religious organizations with which the individual has a current relationship
- The location at which the individual conducts banking and any business activities
- The jurisdiction that issued the individual's driver's license
- The jurisdiction in which the individual votes
- The country of residence that the individual has indicated on forms and documents
- The official forms and documents filed by the individual

Observation. The closer connection exemption cannot be used by an alien in the year in which the alien applies to become a permanent U.S. resident by filing the necessary Immigration and Naturalization Service forms or taking other affirmative steps toward obtaining U.S. residency.

In order to claim the closer connection exemption, the taxpayer must attach a statement with the tax return for the year the claim is made.³⁸

NONRESIDENT ALIENS

The term “nonresident alien” (NRA) refers to an individual who is not a U.S. citizen and who does not have the ability to lawfully reside in the United States.³⁹ In contrast to U.S. citizens and RAs who are subject to U.S. taxation on worldwide income, NRAs are taxed only on certain types of income. It is useful to develop knowledge of income characterization and terminology specific to this area of tax law.

Note. Federal and state tax laws apply to U.S. citizens and resident aliens. This section discusses federal tax issues for NRAs. State tax laws may also apply to NRAs.

Type of Income

NRAs must distinguish between two types of income on which they are taxed.⁴⁰

1. U.S. source income that is **fixed or determinable annual or periodical** (FDAP)⁴¹
2. **Income effectively connected** with a U.S. trade or business (ECI)

Examples of FDAP income include the following.

- Compensation for personal services
- Pension and annuity payments
- Alimony
- Royalties
- Dividends
- Interest
- Rental income
- Sales commissions

³⁸ Treas. Reg. §301.7701(b)-8.

³⁹ See Treas. Reg. §1.871-2, which defines “nonresident alien” and “residence.”

⁴⁰ Treas. Reg. §1.871-8(a).

⁴¹ FDAP income is defined in Treas. Reg. §1.1441-2(b).

FDAP income does not include capital gains or other income realized from the sale of property. FDAP income is taxed at a flat rate of 30%⁴² unless the income qualifies for a reduced flat rate of 14%.⁴³ NRA teachers, trainees, or students holding an F, J, M, or Q visa may qualify for the reduced 14% tax rate. This reduced tax rate is available to them on scholarships for study, training, or research if they are not a degree candidate at a typical educational organization⁴⁴ and the scholarship is granted by:

- A §501(c)(3) tax-exempt organization,
- A foreign government,
- An international organization or a foundation or commission in connection with the Mutual Educational and Cultural Exchange Act of 1961, **or**
- A political subdivision of the United States or any government agency.

Note. These flat tax rates may be changed by an existing tax treaty between the United States and the NRA's country. In addition, NRAs frequently obtain a refund of the tax paid by filing the appropriate tax return.

Business deductions can be claimed to reduce ECI. In addition, ECI is taxed at the normal, progressive tax rates that apply to U.S. citizens and resident aliens. **ECI is generally regarded as more favorable than FDAP because FDAP income is subject to a flat 30% tax rate on a gross basis without deductions.**

Characterizing the Income

FDAP income and U.S. source capital gains and losses may be considered ECI if effectively connected with a U.S. trade or business.

U.S. source capital gains and FDAP income constitute ECI instead of FDAP income if **one** of the following two tests is met.⁴⁵

1. **Asset-use test.** The income, gain, or loss derived from capital assets was used or held for business purposes.
2. **Business activities test.** The activity of a trade or business conducted in the United States was a material factor in the realization of the income.⁴⁶

The **asset-use test** is normally applied to types of income that do not have a direct relationship to a business in the United States. The **business activities test** is normally applied when a direct relationship exists between the income and a U.S. business.

The taxation of an NRA depends upon whether the NRA is engaged in a U.S. trade or business.

NRA Not Engaged in U.S. Trade or Business

Specific rules apply to the taxation of U.S. source income for NRAs not engaged in a U.S. trade or business. Different rules apply to the taxation of capital gains.

⁴² IRC §§1441(a) and (b).

⁴³ Ibid.

⁴⁴ As defined in IRC §170(b)(1)(A)(ii).

⁴⁵ Treas. Reg. §1.864-4.

⁴⁶ Treas. Reg. §1.864-4 provides further guidance on the application of these two tests and some additional income classification rules.

Taxation of Income

The general rule is that U.S. source income is characterized as FDAP and taxed at a flat rate of 30%.⁴⁷ An applicable tax treaty between the United States and the NRA's home country may specify a reduced rate of tax. In addition, an NRA not engaged in any U.S. trade or business within a taxable year has no ECI for that taxable year⁴⁸ except if the NRA:

- Is a foreign teacher, trainee, or student falling under a special exception⁴⁹ for ECI income (discussed later in this chapter), **or**
- Used a special tax election⁵⁰ to treat rental income from U.S. real property as ECI instead of FDAP (discussed later in this chapter).

For an NRA not engaged in a trade or business, the IRS does not tax income from a source outside the United States.

Capital Gains Taxation — General Rules

For NRAs not engaged in a U.S. trade or business, the tax treatment of U.S. source capital gains and losses depends upon the time spent in the United States during the taxable year in which the gains and losses are realized.

183-Day Rule. NRAs are subject to tax on capital gains from the sale or exchange of property within the taxable year if they are present in the United States for 183 days or more within that taxable year.⁵¹ Only gains derived from U.S. sources are taxed. Losses that are allocable to U.S. sources can be used against gains. It is not necessary for the NRA to be physically present in the United States at the particular day or time the asset is sold. In addition, the physical presence period of 183 days or more need not be arrived at through a single, continuous period of presence in the United States. It is sufficient for the NRA to be present in the United States for one or more periods of time which, in the aggregate, constitute a presence of 183 days or more within the taxable year.⁵² Gains taxed under this 183-day rule are subject to a flat 30% tax.⁵³ A tax treaty may reduce this flat rate.

U.S. source capital gains realized by the NRA in taxable years in which they have no presence in the United States are not taxed by the United States. In addition, gains realized in years in which the NRA has less than 183 days of U.S. presence are not taxed by the United States.⁵⁴ This is true even if the NRA is present in the United States at the time of the transactions giving rise to the gain.

Capital Gains Not Subject to 183-Day Rule. While the 183-day test is used to determine taxability for most capital gains, some special types of gains are not subject to this test.⁵⁵ A flat 30% tax applies to U.S. source capital gains on the disposal of timber, coal, or iron ore⁵⁶ with physical presence being irrelevant.⁵⁷

Other Gains Not Subject to 183-Day Rule. Gains relating to the treatment of distributions from an employee trust⁵⁸ or employee annuity plan⁵⁹ from within the United States are subject to a flat 30% tax.⁶⁰ This is true regardless of the time spent in the United States by the nonresident alien.

⁴⁷ Treas. Reg. §1.871-7(b).

⁴⁸ IRC §864(c)(1)(B).

⁴⁹ Treas. Reg. §1.871-9.

⁵⁰ IRC §871(d); Treas. Reg. §1.871-10.

⁵¹ Treas. Reg. §1.871-7(d)(2).

⁵² Treas. Reg. §1.871-7(d)(3).

⁵³ Treas. Reg. §1.871-7(d)(1).

⁵⁴ Treas. Reg. §1.871-7(d)(2)(ii).

⁵⁵ Treas. Reg. §1.871-7(c)(2).

⁵⁶ These gains are addressed by IRC §§631(b) and (c).

⁵⁷ This type of income is one of several types covered by a special election available to the NRA.

⁵⁸ As outlined in IRC §402(a)(2).

⁵⁹ As outlined in IRC §403(a)(2).

⁶⁰ Treas. Reg. §1.871-7(c)(1).

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Election for Rental and Other Types of Income. Rental income is regarded as FDAP income⁶¹ and taxed at the corresponding 30% flat rate, **without any deductions permitted.** This is also true for **rents and royalties from mines, oil or gas wells, and other natural resources** and **capital gains** from the disposal of **timber, coal, or iron ore.**

However, an NRA can instead elect to have these types of income treated as ECI.⁶² If the election is made, it must cover **all** of the preceding types of income received by the nonresident alien.⁶³ There is no provision, for example, to elect to have timber income treated as ECI and rental income remain as FDAP. Moreover, once the election is made, it is effective for each tax year until revoked. A request for a revocation must be made in writing.⁶⁴ This election is available to an NRA whether or not engaged in a U.S. trade or business.

Example 4. Morgan lives in Toronto, Canada. She is a Canadian citizen and is married to a Canadian citizen. Her husband has no income for U.S. tax purposes. In addition, she has one dependent child who is also a Canadian citizen. Morgan's husband and child have applied for and received U.S. tax identification numbers.

Morgan owns a Florida condominium which she purchased on January 1, 2011. She rents it out to a year-round tenant. The rent is \$2,200 per month. The condominium was rented out for eleven months of the 2011 tax year. Morgan spent five days during the month of January in Florida repainting and repairing the condominium for the new tenant. Her rental income and expenses are as follows.

Rental income		\$24,200
Expenses		
Advertising	\$ 500	
Cleaning and maintenance	300	
Insurance	450	
Legal	325	
Repairs	725	
Supplies	560	
Taxes	1,740	
Utilities	220	
Waste removal	680	
Total expenses	\$5,500	(5,500)
Net rental income		\$18,700

Depreciation on the condominium from Form 4562 for the year is \$5,400.

Upon the advice of her financial advisor, Morgan has kept some money in the United States during the past few years. She has invested those funds in a U.S. brokerage account. She therefore has interest and dividends each year. Morgan received the following amounts of investment income.

Personal investment interest	\$723
Ordinary dividends	567

Morgan also made a charitable contribution of \$1,200 to a church in Florida. The church sent Morgan a written receipt for the donation.

The personal exemption amount for 2011 is \$3,700.

⁶¹ Treas. Reg. §1.871-7(b)(1).

⁶² IRC §871(d). A similar election is available for foreign corporations under IRC §882(d).

⁶³ Treas. Reg. §1.871-10(b).

⁶⁴ See Treas. Reg. §1.871-10(a) for more information about revocations.

Observations.

1. The \$723 of interest received by Morgan is exempt from tax under IRC §871(i). It does not appear on the Form 1040NR.
2. Morgan is entitled to claim an exemption for her husband and her child. Because she is a resident of Canada, the child is treated the same way as a child of a U.S. citizen or resident alien and is eligible for the child tax credit.
3. Morgan made an election under IRC §871(d) and Treas. Reg. §1.871-10 to treat her rental income as ECI in the United States. This allows her to claim all expenses against that income and have the net income taxed at normal, progressive tax rates that apply to U.S. citizens and resident aliens. She completed the required statement, with all necessary details, to make this election.
4. The dividends are FDAP income. While IRC §871(a)(1)(A) states that the applicable tax rate is 30% on this income, the convention between Canada and the United States, (Canada-U.S. Tax Treaty) provides for a lower treaty tax rate of 15%. The child tax credit cannot be used against the tax liability on this FDAP income.

2011 Workbook

For Example 4

Form 1040NR Department of the Treasury Internal Revenue Service	U.S. Nonresident Alien Income Tax Return For the year January 1–December 31, 2011, or other tax year beginning , 2011, and ending , 20	OMB No. 1545-0099 2011																					
Please print or type	Your first name and initial Morgan S.	Last name Davis	Identifying number (see instructions) 123-45-6789																				
	Present home address (number, street, and apt. no., or rural route). If you have a P.O. box, see instructions. 25787 Curtis Street, Apartment # 499		Check if: <input checked="" type="checkbox"/> Individual <input type="checkbox"/> Estate or Trust																				
	City, town or post office, state, and ZIP code. If you have a foreign address, see instructions. Toronto, Ontario, Canada																						
	Foreign country name Canada	Foreign province/county Ontario	Foreign postal code M8W 3G4																				
Filing Status Check only one box.	1 <input type="checkbox"/> Single resident of Canada or Mexico or single U.S. national 2 <input type="checkbox"/> Other single nonresident alien 3 <input checked="" type="checkbox"/> Married resident of Canada or Mexico or married U.S. national If you checked box 3 or 4 above, enter the information below. (i) Spouse's first name and initial Brian R. (ii) Spouse's last name Davis (iii) Spouse's identifying number 987-65-4321																						
Exemptions If more than four dependents, see instructions.	7a <input checked="" type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 7a b <input checked="" type="checkbox"/> Spouse. Check box 7b only if you checked box 3 or 4 above and your spouse did not have any U.S. gross income		Boxes checked on 7a and 7b 2																				
	c Dependents: (see instructions) (1) First name Last name (2) Dependent's identifying number (3) Dependent's relationship to you (4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 9)	No. of children on 7c who: • lived with you 1 • did not live with you due to divorce or separation Dependents on 7c not entered above																					
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">(1) First name</td> <td style="width: 30%;">Last name</td> <td style="width: 20%;">(2) Dependent's identifying number</td> <td style="width: 20%;">(3) Dependent's relationship to you</td> <td style="width: 10%;">(4) <input type="checkbox"/> if qualifying child for child tax credit (see page 9)</td> </tr> <tr> <td>Benjamin</td> <td>Davis</td> <td>456-12-8923</td> <td>Son</td> <td><input checked="" type="checkbox"/></td> </tr> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td><input type="checkbox"/></td> </tr> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td><input type="checkbox"/></td> </tr> </table>	(1) First name	Last name	(2) Dependent's identifying number	(3) Dependent's relationship to you	(4) <input type="checkbox"/> if qualifying child for child tax credit (see page 9)	Benjamin	Davis	456-12-8923	Son	<input checked="" type="checkbox"/>					<input type="checkbox"/>					<input type="checkbox"/>	Add numbers on lines above 3	
(1) First name	Last name	(2) Dependent's identifying number	(3) Dependent's relationship to you	(4) <input type="checkbox"/> if qualifying child for child tax credit (see page 9)																			
Benjamin	Davis	456-12-8923	Son	<input checked="" type="checkbox"/>																			
				<input type="checkbox"/>																			
				<input type="checkbox"/>																			
Income Effectively Connected With U.S. Trade/Business. Attach Form(s) W-2, 1042-S, SSA-1042S, RRB-1042S, and 8288-A here. Also attach Form(s) 1099-R if tax was withheld.	8 Wages, salaries, tips, etc. Attach Form(s) W-2 9a Taxable interest b Tax-exempt interest. Do not include on line 9a 9b 10a Ordinary dividends b Qualified dividends (see instructions) 10b 11 Taxable refunds, credits, or offsets of state and local income taxes (see instructions) 12 Scholarship and fellowship grants. Attach Form(s) 1042-S or required statement (see instructions) 13 Business income or (loss). Attach Schedule C or C-EZ (Form 1040) 14 Capital gain or (loss). Attach Schedule D (Form 1040) if required. If not required, check here <input type="checkbox"/> 15 Other gains or (losses). Attach Form 4797 16a IRA distributions 16a 16b Taxable amount (see instructions) 17a Pensions and annuities 17a 17b Taxable amount (see instructions) 18 Rental real estate, royalties, partnerships, trusts, etc. Attach Schedule E (Form 1040) 19 Farm income or (loss). Attach Schedule F (Form 1040) 20 Unemployment compensation 21 Other income. List type and amount (see instructions) 22 Total income exempt by a treaty on page 5, Schedule OI, Item L (1)(e) 22 23 Combine the amounts in the far right column for lines 8 through 21. This is your total effectively connected income		8 9a 10a 11 12 13 14 15 16b 17b 18 13,300 19 20 21 22 23 13,300																				
Enclose, but do not attach, any payment.	24 Educator expenses (see instructions) 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 Deductible part of self-employment tax. Attach Schedule SE (Form 1040) 27 28 Self-employed SEP, SIMPLE, and qualified plans 28 29 Self-employed health insurance deduction (see instructions) 29 30 Penalty on early withdrawal of savings 30 31 Scholarship and fellowship grants excluded 31 32 IRA deduction (see instructions) 32 33 Student loan interest deduction (see instructions) 33 34 Domestic production activities deduction. Attach Form 8903 34 35 Add lines 24 through 34 35 36 Subtract line 35 from line 23. This is your adjusted gross income 36		35 36 13,300																				

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see instructions. Cat. No. 11364D Form **1040NR** (2011)

For Example 4

Form 1040NR (2011) Part

Schedule NEC – Tax on Income Not Effectively Connected With a U.S. Trade or Business (see instructions)

Enter amount of income under the appropriate rate of tax (see instructions)

Nature of income	(a) 10%	(b) 15%	(c) 30%	(d) Other (specify)	(g) GAIN
				%	If (d) is more than (e), subtract (d) from (e)
1 Dividends paid by:					
a U.S. corporations					
b Foreign corporations		567			
2 Interest:					
a Mortgage					
b Paid by foreign corporations					
c Other					
3 Industrial royalties (patents, trademarks, etc.)					
4 Motion picture or T.V. copyright royalties					
5 Other royalties (copyrights, recording, publishing, etc.)					
6 Real property income and natural resources royalties					
7 Pensions and annuities					
8 Social security benefits					
9 Capital gain from line 18 below					
10 Gambling—Residents of Canada only. Enter net income in column (c). If zero or less, enter -0-.					
a Winnings					
b Losses					
11 Gambling winnings—Residents of countries other than Canada. Note. Losses not allowed					
12 Other (specify) ▶					
13 Add lines 1a through 12 in columns (a) through (d)		567			
14 Multiply line 13 by rate of tax at top of each column		85			
15 Tax on income not effectively connected with a U.S. trade or business. Add columns (a) through (d) of line 14. Enter the total here and on Form 1040NR, line 53				15	85

Capital Gains and Losses From Sales or Exchanges of Property

16 Enter only the capital gains and losses from property sales or exchanges that are from sources within the United States and not effectively connected with a U.S. business. Do not include a gain or loss on disposing of a U.S. real property interest; report these gains and losses on Schedule D (Form 1040).	(a) Kind of property and description (if necessary, attach statement of descriptive details not shown below)	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Sales price	(e) Cost or other basis	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
17 Add columns (f) and (g) of line 16							
18 Capital gain. Combine columns (f) and (g) of line 17. Enter the net gain here and on line 9 above (if a loss, enter -0-) ▶							18

Form 1040NR (2)

2011 Workbook

For Example 4

Schedule OI—Other Information (See instructions)

Answer all questions

- A** Of what country or countries were you a citizen or national during the tax year? Canada
- B** In what country did you claim residence for tax purposes during the tax year? Canada
- C** Have you ever applied to be a green card holder (lawful permanent resident) of the United States? Yes No
- D** Were you ever:
1. A U.S. citizen? Yes No
2. A green card holder (lawful permanent resident) of the United States? Yes No
- If you answer "Yes" to (1) or (2), see Pub. 519, chapter 4, for expatriation rules that apply to you.
- E** If you had a visa on the last day of the tax year, enter your visa type. If you did not have a visa, enter your U.S. immigration status on the last day of the tax year. Non-resident alien
- F** Have you ever changed your visa type (nonimmigrant status) or U.S. immigration status? Yes No
- If you answered "Yes," indicate the date and nature of the change. ▶ _____
- G** List all dates you entered and left the United States during 2011 (see instructions).
- Note.** If you are a resident of Canada or Mexico AND commute to work in the United States at frequent intervals, check the box for **Canada or Mexico** and skip to item H Canada Mexico

Date entered United States mm/dd/yy	Date departed United States mm/dd/yy
01/05/11	01/10/11

Date entered United States mm/dd/yy	Date departed United States mm/dd/yy

- H** Give number of days (including vacation, nonworkdays, and partial days) you were present in the United States during:
2009 0, 2010 0, and 2011 5.
- I** Did you file a U.S. income tax return for any prior year? Yes No
- If "Yes," give the latest year and form number you filed . . . ▶ _____
- J** Are you filing a return for a trust? Yes No
- If "Yes," did the trust have a U.S. or foreign owner under the grantor trust rules, make a distribution or loan to a U.S. person, or receive a contribution from a U.S. person? Yes No
- K** Did you receive total compensation of \$250,000 or more during the tax year? Yes No
- If "Yes," did you use an alternative method to determine the source of this compensation? Yes No
- L** Income Exempt from Tax—If you are claiming exemption from income tax under a U.S. income tax treaty with a foreign country, complete (1) and (2) below. See Pub. 901 for more information on tax treaties.
1. Enter the name of the country, the applicable tax treaty article, the number of months in prior years you claimed the treaty benefit, and the amount of exempt income in the columns below. Attach Form 8833 if required (see instructions).

(a) Country	(b) Tax treaty article	(c) Number of months claimed in prior tax years	(d) Amount of exempt income in current tax year

- (e) Total.** Enter this amount on Form 1040NR, line 22. Do not enter it on line 8 or line 12
2. Were you subject to tax in a foreign country on any of the income shown in 1(d) above? Yes No

2011 Workbook

For Example 4

**SCHEDULE E
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships,
S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040, 1040NR, or Form 1041. ▶ See separate instructions.

OMB No. 1545-0074

2011

Attachment
Sequence No. **13**

Name(s) shown on return

Morgan S. Davis

Your social security number

123-45-6789

A Did you make any payments in 2011 that would require you to file Form(s) 1099? (see instructions) Yes No

B If "Yes," did you or will you file all required Forms 1099? Yes No

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C** (see instructions). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

Caution. For each rental property listed on line 1, check the box in the last column only if you owned that property as a member of a qualified joint venture (QJV) reporting income not subject to self-employment tax.

1	Physical address of each property—street, city, state, zip	Type—from list below	2	Fair Rental Days	Personal Use Days	QJV
A	234 Sunnyvale Blvd, Unit #787 Winter Park, FL	1	For each rental real estate property listed, report the number of days rented at fair rental value and days with personal use. See instructions.	A	334	5
B		B				
C		C				

Type of Property:

- | | | | |
|---------------------------|------------------------------|-------------|--------------------|
| 1 Single Family Residence | 3 Vacation/Short-Term Rental | 5 Land | 7 Self-Rental |
| 2 Multi-Family Residence | 4 Commercial | 6 Royalties | 8 Other (describe) |

Income:

		Properties		
		A	B	C
3a Merchant card and third party payments (see instructions)	3a			
3b Payments not reported to you on line 3a	3b	24,200		
4 Total not including amounts on line 3a that are not income (see instructions)	4	24,200		

Expenses:

5 Advertising	5	500		
6 Auto and travel (see instructions)	6			
7 Cleaning and maintenance	7	300		
8 Commissions	8			
9 Insurance	9	450		
10 Legal and other professional fees	10	325		
11 Management fees	11			
12 Mortgage interest paid to banks, etc. (see instructions)	12			
13 Other interest	13			
14 Repairs	14	725		
15 Supplies	15	560		
16 Taxes	16	1,740		
17 Utilities	17	220		
18 Depreciation expense or depletion	18	5,400		
19 Other (list) ▶ Waste removal	19	680		
20 Total expenses. Add lines 5 through 19	20	10,900		
21 Subtract line 20 from line 4. If result is a (loss), see instructions to find out if you must file Form 6198	21	13,300		
22 Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22	()	()	()

23a Total of all amounts reported on line 3a for all rental properties	23a			
23b Total of all amounts reported on line 3a for all royalty properties	23b			
23c Total of all amounts reported on line 4 for all rental properties	23c	24,200		
23d Total of all amounts reported on line 4 for all royalty properties	23d			
23e Total of all amounts reported on line 12 for all properties	23e			
23f Total of all amounts reported on line 18 for all properties	23f	5,400		
23g Total of all amounts reported on line 20 for all properties	23g	10,900		
24 Income. Add positive amounts shown on line 21. Do not include any losses	24		13,300	
25 Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	()		
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2	26		13,300	

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11344L

Schedule E (Form 1040) 2011

For Example 4

Department of the Treasury
Internal Revenue Service

Re: Election under IRC §871(d)

Morgan S. Davis

123-45-6789

April 15, 2012

This statement is being filed as an attachment with my 2011 tax return. Please be advised of the following.

1. I hereby make an election under IRC §871(d), as per Treas. Reg. §1.871-10 to treat my income from rental property that I own in the United States as income effectively connected with a trade or business in the United States.
2. The following is a schedule of the real property owned by me in the United States, the income from which this election shall apply:

234 Sunnyvale Blvd., Condominium Unit #787
Winter Park, FL 32792
3. I am sole owner of the property.
4. The property is located in the municipality of Winter Park, Orange County, Florida.
5. There have been no substantial improvements to the property since my purchase of the property on January 1, 2011.
6. I have never made an election previously under IRC §871(d) or Treas. Reg. 1.871-10.

This election shall be effective until revoked by me as per Treas. Reg. §1.871-10.

NRA Engaged in U.S. Trade or Business

Taxation of Income. An NRA engaged in a U.S. trade or business is taxed in the same manner as an NRA that is not engaged in a U.S. trade or business in respect of the following.

- Income not effectively connected with a U.S. trade or business (flat 30% or lower treaty rate)
- Capital gains and losses (the 183-day rule applies)
- Gains not subject to the 183-day rule (flat 30% or lower treaty rate)

The tax treatment in connection with the above items is exactly as outlined in the previous section for an NRA who is not engaged in a U.S. trade or business.

The special election to treat real estate rental income as ECI is still available to an NRA engaged in a U.S. trade or business.

ECI income is taxed under normal tax rules using the same progressive tax brackets under IRC §1.⁶⁵ Deductions for expenses incurred to produce ECI are also allowed. The amount taxed is the net amount of ECI after appropriate expenses are deducted.

⁶⁵ Treas. Reg. §1.871-8(b)(2)(i).

An NRA engaged in a U.S. trade or business must segregate ECI from non-ECI.⁶⁶ The non-ECI is not taken into account in applying the normal tax rates and brackets and tax calculations that apply to the ECI.⁶⁷

Income from Foreign Sources. Income from foreign sources is typically not taxed in the United States. However, income from foreign sources received by the NRA may be considered ECI. It is taxable in the United States if the income is attributable to an office or fixed place of business maintained in the United States by the NRA.

Note. Typically, a bank or other financial institution or intermediary has a procedure for establishing an account for an NRA. This includes automatically withholding and remitting the required 30% flat tax to the IRS on any interest or other income paid by the financial institution. The tax remitted is credited to the NRA's tax account for the taxable year. This tax account is identified by a tax identification number obtained by the NRA as a prerequisite to opening the account.

Students, Trainees, Teachers, and Other Specialists. Students, trainees, teachers, and other specialists temporarily present in the United States under §§101(a)(15)(F), (J), (M), or (Q) of the Immigration and Nationality Act are treated as NRAs engaged in a trade or business in the United States.⁶⁸ Accordingly, their scholarships or fellowship grants received from U.S. sources are considered ECI. A special withholding rate of 14% applies.⁶⁹ Compensation paid to the individual by a foreign employer is tax-exempt.⁷⁰ A tax treaty may change these tax rates.

EMPLOYMENT OUTSIDE THE UNITED STATES

A U.S. citizen or RA is required to report worldwide income. This includes income earned from certain types of employment outside the United States. However, special tax rules apply to taxpayers with income earned outside the United States.

FOREIGN EARNED INCOME EXCLUSION

The foreign earned income exclusion (FEIE) allows a U.S. citizen or RA to elect to exclude from income a limited amount of remuneration received from employment outside the United States.⁷¹

To qualify for the FEIE, a U.S. citizen or RA **must**:

- Have received employment income from work in a foreign country,⁷²
- Meet either the **bona fide residency test** or the **physical presence test**, and
- Have a **tax home** in the foreign country.

⁶⁶ Treas. Reg. §1.871-8(a).

⁶⁷ Ibid.

⁶⁸ IRC §871(c).

⁶⁹ IRC §1441(b).

⁷⁰ IRC §872(b)(3).

⁷¹ IRC §911(a)(1).

⁷² "Foreign earned income" and "earned income" are defined by IRC §§911(b)(1)(A) and 911(d)(2), respectively. Both terms are also defined in Treas. Regs. §§1.911-3(a) and (b).

Bona Fide Residency Test

The **bona fide residency test** is met if the taxpayer is either:

1. A U.S. citizen who is a bona fide resident of a foreign country for an uninterrupted period that includes the entire taxable year, **or**
2. An RA who is:
 - a. A citizen or national of a country with which the United States has a tax treaty, **and**
 - b. A bona fide resident of a foreign country for an uninterrupted period that includes the entire taxable year.⁷³

Bona fide residence also depends upon the intention regarding length and nature of the stay in the foreign country. If the foreign stay is for a definite, temporary purpose followed by an immediate return to the United States, bona fide foreign residency does not exist. However, when an indefinite, extended stay is required and the taxpayer makes the foreign country home, bona fide foreign residence may exist. Evidence of intention may be in the form of the taxpayer's words or actions. The taxpayer's **actions prevail** when words and actions conflict. When a foreign tax authority deems the taxpayer exempt from foreign taxation because the taxpayer has claimed nonresident status in the foreign country, the taxpayer is not considered a bona fide resident of the foreign country and does not meet the bona fide residency test.⁷⁴

Caution. The bona fide residency test is **not** automatically met by living in a foreign country for an entire tax year or longer. Whether a taxpayer has established a bona fide residence in a foreign country depends on a facts and circumstances analysis. The length of the stay and nature of the job are only some of the factors considered.

Example 5. Carl works for a major U.S. construction company. He receives a temporary assignment to work on a building project in Dubai, United Arab Emirates, from December 2009 until January 15, 2011. His employer indicates that Carl will be returning to U.S. headquarters on January 15, 2011. His family remains in the United States and Carl stays in living quarters located on his employer's construction worksite while in Dubai. It is not likely that Carl will meet the bona fide residency test.

Example 6. Use the same facts as **Example 5**, except Carl's employer assigns Carl to work on the Dubai construction project until the construction project is completed, with no definite return date. Carl lives in a rented apartment in Dubai. Carl is in Dubai from December 2009 until January 2011. Carl may meet the bona fide residency test for 2010. However, the IRS might successfully argue that he does not meet the bona fide residency test depending upon other specific facts and circumstances that exist pertaining to Carl's overseas stay.

Example 7. Use the same facts as in **Example 6**, except Carl's family moves with him to Dubai. Carl and his family live in the rented apartment. They continue to own their U.S. home, but rent out the home until Carl and his family return to the United States when the construction project is completed. They are unsure exactly when they might be returning to the United States. Carl now appears to have established bona fide residency in Dubai and will likely meet the test.

⁷³ IRS Pub. 901, *U.S. Tax Treaties*.

⁷⁴ IRC §911(d)(5).

Physical Presence Test

The **physical presence test** is met if the taxpayer is a U.S. citizen or RA physically present in a foreign country or countries for an aggregate of at least 330 full days during any **consecutive** 12-month period. The 12-month consecutive period need not be the calendar year. The 330-day period need not be continuous.⁷⁵ Unlike the bona fide residence test, the physical presence test is based solely on the time spent in a foreign country without regard to intentions about returning to the United States or the nature and purpose of the trip abroad. Work or vacation days while physically present in one or more foreign countries count toward the 330-day requirement.

In **Example 5**, Carl may not have satisfied the bona fide residency test, but he may satisfy the physical presence test if he was in Dubai for 330 days in 2010.

The physical presence test may be met when a stay outside the United States is interrupted due to circumstances such as terrorist acts or civil unrest.⁷⁶

Tax Home Test

Once the taxpayer meets either the bona fide residency test or the physical presence test, they must satisfy the tax home test for the duration of their time in a foreign country.⁷⁷

The **tax home** is the regular or principal place of business or employment. If there is no regular or principal place of business because of the nature of the business, the taxpayer's tax home is the place regularly lived. The taxpayer cannot have a foreign tax home during the time when the regular place lived is in the United States. However, being temporarily present in the United States or maintaining a dwelling in the United States does not preclude establishment of a foreign tax home. This is true even when the U.S. dwelling continues to be used by the taxpayer's spouse or children while the taxpayer is away.⁷⁸

How to Claim the FEIE

The FEIE can only be claimed in connection with income earned from services performed in the course of employment.⁷⁹ A distribution of earnings and profits does not qualify.⁸⁰ SE income qualifies, with some limitations.⁸¹

Note. The FEIE does not apply to wages of U.S. military personnel and civilian employees of the U.S. government.

The bona fide residency test requires a full year of foreign residency. This means that a taxpayer relying on the bona fide residency test claims the FEIE amount for the full year, without any prorating for a part-year claim. However, the physical presence test's 330-day requirement, which might be less than a full 365-day taxable year, may result in a prorated partial-year claim. Moreover, the 330-day requirement may span over two taxation years, resulting in a prorated claim in each of those two years. The FEIE claim is based on the number of physical presence days that fall within each taxable year.

Note. A filing extension may be necessary to allow the taxpayer to accumulate enough time to satisfy the requirements of either test. Form 2350, *Extension of Time to File U.S. Income Tax Return*, is used to file an extension.

⁷⁵ Treas. Reg. §1.911-2(d)(2) provides additional rules on the counting of days when the taxpayer is traveling.

⁷⁶ Rev. Proc. 2011-20, 2011-11 IRB 551.

⁷⁷ Treas. Reg. §1.911-2(a).

⁷⁸ Treas. Reg. §1.911-2(b).

⁷⁹ IRC §911(b)(1)(A).

⁸⁰ IRC §911(d)(2)(A).

⁸¹ IRC §911(d)(2)(B).

2011 Workbook

To claim the FEIE, the taxpayer makes an **election** to exclude the appropriate amount of foreign earned income.⁸²

There are three steps in reporting foreign earned income and claiming the FEIE.

Step 1. The amount of employment income is reported in U.S. dollars on line 7 of Form 1040 along with any other wages earned in the United States during the year.

Step 2. The amount of the FEIE claim is determined by showing the necessary calculations on Form 2555, *Foreign Earned Income*.⁸³

Step 3. The amount of the exclusion is entered as a negative income amount on line 21 of Form 1040.

The taxpayer can elect to exclude up to a maximum of \$92,900⁸⁴ of employment income earned outside the United States. In addition, Form 2555EZ, *Foreign Earned Income Exclusion*, can be used instead of Form 2555 if the taxpayer:

- Does not have foreign earned income in excess of the maximum exclusion amount,
- Has no SE income,
- Is not claiming any business or moving expenses, and
- Is not claiming any foreign housing deduction (discussed in the next section).

Note. A tax advisor may need to determine whether it is more advantageous to take the foreign tax credit discussed later in the chapter.

Once the election is made, it remains in effect for the year in which it is made and for all subsequent years unless it is revoked.⁸⁵ A revocation is made by filing a statement with the tax return.⁸⁶ If revoked, the election cannot be made again for the five taxable years following the taxable year of revocation.⁸⁷ There are special FEIE rules for married couples when both spouses qualify for the election.⁸⁸

Note. The FEIE can also be used to exclude foreign earned SE income. Income and expense amounts, expressed in U.S. dollars, are reported on Schedule C. The net income amount is reported on line 12 of Form 1040, *U.S. Individual Income Tax Return*. Steps 2 and 3, listed previously, are then followed.

⁸² Treas. Reg. §1.911-7(a)(1).

⁸³ Ibid.

⁸⁴ This \$92,900 amount represents the maximum exemption amount for 2011. It is indexed for inflation and may increase annually.

⁸⁵ IRC §911(e).

⁸⁶ See Treas. Reg. §1.911-7 for details about the revocation.

⁸⁷ IRC §911(e)(2).

⁸⁸ Treas. Reg. §1.911-5.

Example 8. Louise, a U.S. citizen, received \$12,000 in employment income as an interior designer while working in New York City for the month of January 2011. At the end of January, she received an opportunity to work on a project for an employer in France. She was unsure how long the project would take, but accepted the offer. She left for France on January 31, 2011, arriving in France later that same day. For the remainder of 2011, she worked in France as a design consultant and was paid 60,000 Euros (€60,000). Louise was on vacation for the month of December 2011 and spent that month in Italy. She returned to France to work in early January 2012. Finally, after finishing work on the project, Louise leaves France on May 1, 2012, and arrives in New York City later that same day. After returning to her apartment in New York City, she receives her Form W-2 for her \$12,000 wages earned in New York City in January 2011. She must now prepare her 2011 U.S. tax return.

Because she earned income outside the United States during 2011, Louise believes she may qualify for the FEIE. In order to qualify, she needs to meet either the bona fide residency test or the physical presence test. Once she meets either of these tests, she also needs to demonstrate that her tax home existed in a foreign country for the time period applicable under either the bona fide residency or physical presence test.

Bona fide residency test. Louise will only meet the bona fide residency test if she made France her home for an indefinite, extended stay for an uninterrupted period that included the entire 2011 taxable year. Because she was in the United States for the month of January 2011, **she does not meet this test.**

Physical presence test. Louise can qualify for the FEIE if she meets the physical presence test. To meet this test, she is required to be physically present in a foreign country for a total of at least 330 days during any consecutive 12-month period. Louise traveled to France on January 31, 2011. This travel day does not count toward the 330-day requirement because she traveled over international waters and was not physically present in any foreign country for that day. Louise was physically present in both France and Italy for the full 365 days of the continuous 12-month period from February 1, 2011, through January 31, 2012. These 365 days meet the minimum 330-day requirement. The number of days physically present in one or more foreign countries counts towards the 330-day requirement. In addition, both work and vacation days qualify. Therefore, the number of days Louise spends in both France and Italy count toward the 330-day requirement. Louise **meets the physical presence test.**

Louise was physically present in a foreign country for all of the 2011 tax year with the exception of the 31 days of January 2011. She was therefore physically present in a foreign country for 334 days (365 – 31) of the 2011 tax year.

Tax home test. Louise is eligible to claim the FEIE if her tax home was in a foreign country during the 334 days within 2011 that she was physically present in one or more foreign countries. Louise's tax home is the principal place of business, employment, or post of duty during the 334 days of physical presence in a foreign country, regardless of where her apartment is maintained. Louise's principal place of employment for the 334-day period was in France. **She meets the tax home test.**

Louise qualifies for the FEIE because she meets both the physical presence test and the tax home test.

All amounts shown on Louise's income tax return must be expressed in U.S. dollars. Louise earned €60,000 when she worked in France during 2011. Louise obtains the yearly average annual exchange rate between the U.S. dollar and the Euro. The rate is 0.755. The €60,000 Louise earned equates to \$79,470 (€60,000/0.755). This is the U.S. dollar amount for her foreign earnings that Louise reports on her 2011 tax return.

Note. For details on how to complete exchange rate calculations, see the Appendix at the end of this chapter.

Louise is eligible to claim her FEIE on Form 2555-EZ. Form 2555-EZ has two pages. The first page indicates whether she relies on the bona fide residency or the physical presence test. It also requires Louise to affirm that she meets the tax home test throughout the applicable period.

2011 Workbook

For Example 8

Form **2555-EZ**

Department of the Treasury
Internal Revenue Service (99)

Foreign Earned Income Exclusion

▶ See separate instructions. ▶ Attach to Form 1040.

OMB No. 1545-0074

2011
Attachment
Sequence No. **34A**

Name shown on Form 1040
Louise Devereaux

Your social security number
123-45-6789

You May Use This Form If You:

- Are a U.S. citizen or a resident alien.
- Earned wages/salaries in a foreign country.
- Had total foreign earned income of \$92,900 or less.
- Are filing a calendar year return that covers a 12-month period.

And You:

- Do not have self-employment income.
- Do not have business/moving expenses.
- Do not claim the foreign housing exclusion or deduction.

Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

1 Bona Fide Residence Test

- a Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)? Yes No
- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
 - If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.
- b Enter the date your bona fide residence began ▶ _____, and ended (see instructions) ▶ _____.

2 Physical Presence Test

- a Were you physically present in a foreign country or countries for at least 330 full days during—
{ 2011 or
any other period of 12 months in a row starting or ending in 2011? } Yes No
- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
 - If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.
- b The physical presence test is based on the 12-month period from ▶ Feb. 1, 2011 through ▶ Jan. 31, 2012

3 Tax Home Test.

- Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies? Yes No
- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
 - If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

The second page of the Form 2555-EZ shows the calculations for the amount of FEIE that Louise can claim based on the number of days she was physically present in a foreign country.

2011 Workbook

For Example 8

Part IV Figure Your Foreign Earned Income Exclusion

13 Maximum foreign earned income exclusion	13	\$92,900	00
14 Enter the number of days in your qualifying period that fall within 2011	14	334	days
15 Did you enter 365 on line 14? <input type="checkbox"/> Yes. Enter "1.000." <input checked="" type="checkbox"/> No. Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places). }	15	× 0 . 91507	
16 Multiply line 13 by line 15	16	85,010	
17 Enter, in U.S. dollars, the total foreign earned income you earned and received in 2011 (see instructions). Be sure to include this amount on Form 1040, line 7	17	79,470	
18 Foreign earned income exclusion. Enter the smaller of line 16 or line 17 here and in parentheses on Form 1040, line 21 . Next to the amount enter "2555-EZ." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	18	79,470	

Form **2555-EZ** (2011)

Louise can exclude all her foreign income earned in France for U.S. tax purposes. Her total earned income for 2011 in U.S. dollars is as follows.

Earned Income Item	Amount (U.S. Dollars)
Income earned in U.S. (shown on W-2)	\$12,000
Foreign earned income	79,470
Total	\$91,470

Louise's total earned income for the year and her FEIE are shown on the first page of her Form 1040 as follows.

FOREIGN HOUSING EXCLUSION

A qualified individual with foreign earned income who has foreign home expenses may qualify for the foreign housing exclusion (FHE). The FHE provides an election to exclude or deduct a foreign housing cost amount.⁸⁹ This can be claimed in addition to the FEIE previously discussed.

A **qualified individual** is a taxpayer who meets **all** the following requirements.

- Is a U.S. citizen or RA
- Has foreign earned income from work in a foreign country
- Has a tax home in the foreign country
- Meets either the bona fide residency test or the physical presence test for the FEIE
- Has paid or incurred foreign housing expenses

The amount deductible for foreign housing is subject to both floor and ceiling amounts that are based on the maximum excludible FEIE amount.⁹⁰ The maximum excludible FEIE amount for 2011 is \$92,900 and is indexed each year for inflation. The floor amount for a possible deduction is calculated by multiplying the FEIE amount by 16%. Only expenses in excess of this amount can be deducted. There is a ceiling amount which places an upper limit on the deduction. This is calculated by multiplying the FEIE amount by 30%. These floor and ceiling amounts that affect the FHE deduction are calculated as shown in the following example.

Example 9. Ben, a U.S. citizen, lives and works in Germany. He has lived in Germany for the entire 2011 tax year and pays rent for his apartment. He also pays utilities and other housing costs. Ben's housing costs may be deductible on his 2011 U.S. tax return. The floor and ceiling limits for 2011 are calculated as follows.

	2011 Maximum FEIE Exclusion		Multiplier		Resulting Limit
Floor	\$92,900	×	16%	=	\$14,864
Ceiling	92,900	×	30%	=	27,870

Only the amount of Ben's expenses for 2011 in excess of \$14,864 qualify for the FHE. In addition, the 2011 maximum amount that Ben can deduct is \$27,870 if he has qualifying housing costs sufficient to reach the ceiling.

Note. While the above ceiling applies in most instances, there are some foreign areas with particularly high housing costs. The U.S. taxpayer may receive an increased ceiling amount for foreign residency in these areas. These areas, and the applicable increased ceiling amounts, are listed in the instructions for Form 2555 each year.

⁸⁹ IRC §911(a)(2).

⁹⁰ IRC §§911(c)(1) and (2).

2011 Workbook

A taxpayer can only deduct foreign housing costs attributable to the number of days within the taxable year that the taxpayer qualifies for the FEIE. The floor and ceiling limits as calculated in **Example 9** are used for a taxpayer who qualifies for the FEIE for a full 365-day taxable year. For taxpayers with an FEIE qualifying period that is less than the full 365 days, the above limits are calculated on a per-day basis. The per-day amount is then applied to the number of FEIE qualifying days for the taxpayer. Qualifying foreign housing costs greater than the floor amount and less than the ceiling amount are deductible by the taxpayer, subject to other limitations.⁹¹ In addition, the taxpayer cannot deduct housing costs that are greater than the amount of foreign earned income for the year.⁹² The taxpayer must deduct the full amount of the housing deduction allowed. A partial deduction is not permitted.⁹³

Employment Income and SE Income

Qualified housing costs that are incurred to earn employment income are taken into account in the housing exclusion calculations for the taxpayer. However, there are limitations on qualified housing costs attributable to earning SE income.⁹⁴

Qualified Housing Expenses

Qualified expenses are reasonable expenses paid or incurred in the year for foreign housing for the taxpayer and a spouse or dependents that live with the taxpayer.⁹⁵ Reasonable expenses are expenses that are not extravagant or lavish.⁹⁶ Reasonable expenses for a second foreign home for a spouse and/or dependents also qualify if the primary foreign tax home of the taxpayer is located in an area of warfare or civil unrest or where conditions are otherwise dangerous or unhealthful.⁹⁷ Special rules apply for married couples when both spouses have qualified housing costs.⁹⁸

While the following is not an exhaustive list, some basic housing costs that qualify and do not qualify are as follows.⁹⁹

Qualifying Expenses	Nonqualifying Expenses
Rent or fair rental value of employer-provided housing	Deductible interest and taxes
Utilities, excluding telephone charges	Costs of purchasing property including principal mortgage payments
Real and personal property insurance	Costs of domestic labor
Furniture and accessory rentals	Costs of property improvements and other expenses that increase the value or prolong the property's life
Cost of repairs	Costs of purchased furniture or accessories
Residential parking fees	Any depreciation or amortization of property or improvements

⁹¹ IRC §911(c).

⁹² Treas. Reg. §1.911(d)(1).

⁹³ Ibid.

⁹⁴ Treas. Regs. §§1.911-4(d)(3) and 1.911-4(e).

⁹⁵ Treas. Reg. §1.911-4(a).

⁹⁶ Treas. Reg. §1.911-4(b)(4).

⁹⁷ Treas. Reg. §1.911-4(b)(5).

⁹⁸ Treas. Reg. §1.911-5(a)(3).

⁹⁹ Treas. Reg. §1.911-4(b)(2); IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

How to Make the Housing Exclusion Claim

As with the FEIE, the housing exclusion is claimed on Form 2555. Because foreign income is excluded from the taxpayer's taxable income for the year, any expenses attributable to that foreign income are not deductible. Form 2555 outlines all the essential calculations to arrive at the final amount for both exclusions. The total of both exclusions is then shown as a negative amount on line 21 of the Form 1040.

Coordination with the FEIE Amount

U.S. citizen or RA taxpayers living abroad often claim both the FEIE and housing exclusion. Special rules serve to **integrate** these two exclusionary amounts so that they do not result in excluding the same amounts from income twice.¹⁰⁰ The amount of both exclusions cannot exceed the overall amount of foreign earned income received in the year.

MOVING EXPENSES

A taxpayer may deduct moving expenses in connection with the commencement of work as an employee or as a self-employed individual in a new principal place of work.¹⁰¹ **Commencement** of work includes the following.

- The beginning of employment or self-employment for the first time
- The beginning of full-time employment or self-employment after a substantial period of part-time employment or unemployment
- Beginning employment with a different employer
- Beginning work for the same employer in a new location
- Engaging in a new self-employment trade or business
- Engaging in self-employment in a new location¹⁰²

Moving expenses include only reasonable expenses of the following.

- Moving household goods and personal items from the old to the new residence¹⁰³
- Traveling between the old and new residences (including any lodging)

¹⁰⁰. Treas. Reg. §1.911-4.

¹⁰¹. IRC §217.

¹⁰². Ibid.

¹⁰³. IRC §217(b)(1).

In order to be deductible, **all** of the following must apply.

- The moving expenses must be incurred within one year of the actual move, unless there is good cause for expenses beyond one year.¹⁰⁴
- The taxpayer's commute from their former home to the new work location is at least 35 miles longer than the commute to the former workplace.¹⁰⁵
- The taxpayer is employed full-time for at least 39 weeks in the year immediately following the move.
- The taxpayer is self-employed full-time for at least 78 weeks in the 2-year period following the move with at least 39 of those weeks within the first of those two years.¹⁰⁶

Note. Rules associated with the deduction of moving expenses are found in Treas. Reg. §1.217-2.

Special Rules for Foreign Moves

A foreign move is a move from the United States to a foreign country or from one foreign country to another that meets the **commencement of work requirement**.¹⁰⁷ In addition to the deductible expenses available under the rules that apply for a domestic move, a foreign move also allows a deduction for:

- Costs of moving household goods and personal effects to and from storage, and
- Costs of storing household goods and personal effects for part or all of the time the taxpayer is employed abroad.¹⁰⁸

Note. A move from a foreign country back to the United States is not considered a foreign move.

FOREIGN TAX CREDIT ON EMPLOYMENT OR SE INCOME

A U.S. citizen or RA who earns income in a foreign country often is subject to the foreign country's income tax laws. This results in the payment of foreign income taxes on the employment or SE income earned. When that taxpayer subsequently reports the same income in the United States, double taxation occurs.

To alleviate the double taxation issue, U.S. federal tax rules provide the U.S. taxpayer with a foreign tax credit (FTC) for the taxes paid to a foreign tax authority. The amount of FTC is claimed against any U.S. tax liability on the income reported. In order for the paid foreign tax to qualify for the FTC, **all** of the following rules apply.

- The tax must be an income tax, or a tax in lieu of an income tax, imposed on the taxpayer.
- The income tax must have been paid or accrued.
- The tax must be a legal and actual foreign tax liability.
- The tax must be compulsory without the ability to be avoided.

Note. There also may be an applicable tax treaty between the United States and the foreign country in which the taxpayer resides. The tax treaty may have terms that further alleviate the double taxation issue.

¹⁰⁴ IRC §217(c).

¹⁰⁵ Ibid.

¹⁰⁶ Treas. Reg. §1.217-2(c)(4).

¹⁰⁷ Treas. Reg. §1.217-2(h)(3).

¹⁰⁸ IRC §217(h)(1) and Treas. Reg. §1.217-2(h)(2).

The amount of the FTC that can be claimed is based on the amount of foreign tax actually paid. To make an FTC claim, the taxpayer must first express the qualifying amount of foreign taxes paid in U.S. dollars. Subsequently, the taxpayer can choose to claim the amount on the U.S Form 1040 as either:

- A tax **deduction**, which is itemized on Schedule A, **or**
- A tax **credit**, using Form 1116, *Foreign Tax Credit*, which is filed with the Form 1040.

Neither a deduction nor credit can be taken on foreign tax paid on the amount of income excluded using the FEIE or the FHE.

Note. The FTC is limited to the amount of tax liability allocable to the foreign taxable income reported. If there is no U.S. tax liability on foreign income or if all foreign income is excluded, the FTC cannot be claimed.

FOREIGN WORK AND FICA

General Rules

Employment Earnings. Social security and Medicare payments on earnings are mandated by the Federal Insurance Contributions Act (FICA). Employment income earned outside the United States that is paid by a foreign employer is generally not subject to FICA. However, if the taxpayer works outside the United States and is paid by a U.S. employer, the wages are subject to FICA.

SE Income. A U.S citizen or RA earning SE income outside the United States is subject to the SE tax in the same manner as if self-employed within the United States.

Totalization Agreements. The United States has entered into agreements with several other countries which are designed to prevent double taxation of income in connection with FICA. Provisions of these agreements supercede the preceding general rules. A totalization agreement with a country specifies the payroll tax obligations of the U.S. citizen working in that country. These agreements may cover very specific employment or SE situations. Procedures for claiming an exemption from FICA taxes under a totalization agreement are found in Rev. Procs. 80-56 and 84-54 and in Rev. Rul. 92-9.

INVESTING OUTSIDE THE UNITED STATES

U.S. citizens and RAs are generally subject to the same tax rules, including the worldwide income reporting requirement. Accordingly, income from foreign accounts, investments, or other assets must be included in income and reported for the taxable year in which they are received.

Compliance with the foreign income reporting requirement has been an IRS concern. As a result, the IRS has aggressively stepped up its efforts to increase compliance with the requirement to disclose the foreign accounts or assets. This is a requirement for many taxpayers even when there is no foreign income from offshore accounts or assets to report.

Note. For a detailed discussion of the disclosure requirements for foreign accounts and assets, refer to the section entitled “Foreign Asset Disclosure Requirements” found in Chapter 7, Individual Taxpayer Topics.

RETIREMENT OUTSIDE THE UNITED STATES

U.S. citizens and RAs retiring outside the United States continue to be subject to U.S. tax law and the worldwide income reporting requirement. Income from U.S. and foreign pension plans and retirement accounts, along with all other types and amounts of income, must be reported to the IRS and are taxed at normal tax rates.

FOREIGN TAX CREDIT FOR FOREIGN TAXES PAID

Living in a foreign country likely exposes the taxpayer to foreign tax liability. Absent any special rule to the contrary, the U.S. citizen or RA can generally claim a FTC for any taxes paid to the foreign country of residency. This is accomplished either by taking a deduction for the foreign taxes paid on Schedule A or claiming a credit for foreign taxes paid by completing Form 1116, as previously discussed.

Note. The main purpose of the FTC rules is to prevent double taxation on income. An FTC claim may not accomplish this goal. Differences between the applicable U.S. and foreign tax rates and rules are a factor. Exchange rates can also be a major factor with the application of progressive tax rates.

The decision to retire outside the United States should be made with due regard to the following tax areas, which have a large impact upon the taxation of the retired individual or couple.

- The nature and impact of the tax laws in the foreign country of residence
- Whether any foreign taxes paid qualify for the FTC
- The existence and terms of any applicable tax treaty between the United States and the foreign country of residence

Retirement in a foreign country that has favorable tax treaty terms with the United States may be desirable. Frequently, tax treaties have specific provisions affecting the taxation of various types of retirement income or benefits for U.S. citizens living in that foreign country.

Example 10. The United States-Canada income tax treaty has a provision stating that Canada taxes the recipient of social security benefits. However, only 85% of the benefits are reported and taxed. The remaining 15% is tax exempt in Canada.

Retirees cannot claim the FEIE in connection with pension or other forms of retirement income because these types of income do not constitute **earned income** under the FEIE rules.¹⁰⁹

RESIDENT ALIENS LIVING OUTSIDE THE UNITED STATES

RAs who wish to retire outside the United States may face significant problems. Immigration issues can arise for RAs absent from the United States for an extended period of time. A green card provides the RA with lawful permanent resident (LPR) status. This includes the legal ability to work in and establish permanent residence in the United States indefinitely. The green card also serves as the necessary documentation for the RA to obtain reentry into the United States after a period of absence.

¹⁰⁹ IRC §911(d)(2).

In some circumstances, immigration authorities may believe that an RA no longer lives in the United States because of an extended stay outside the United States. Generally, absences greater than one year may cause immigration authorities to deny reentry into the United States. Frequent shorter trips evidencing a greater amount of time spent outside of the United States than within can also cause a similar problem. The intentions of the RA on maintaining or relinquishing LPR status is a key factor. Obtaining an appropriate reentry visa can manifest the RA's intention of maintaining LPR status, especially if an extended stay outside the United States is intended.

Caution. As a result of losing LPR status through extended absence from the United States or any other reason, the RA may become a **covered expatriate** under the IRC §877A expatriate tax provisions discussed earlier.

U.S. citizenship can only be relinquished through the commission of some affirmative act manifesting an intention to do so, as discussed earlier. Therefore, U.S. citizens do not have the same concerns pertaining to extended absences outside the United States that RAs have.

FOREIGN PERSONS IN THE UNITED STATES FOR EDUCATION

Visiting professors, teachers, researchers, and students from foreign countries are subject to special tax rules. These tax rules are based, in part, on the rules regarding the various types of **visas** provided to these individuals by U.S. Citizenship and Immigration Services (USCIS).

Under U.S. immigration law, a foreign individual holding a visa to teach, train, or attend school in the United States is categorized as a “nonimmigrant.” A nonimmigrant is an individual who has represented to immigration authorities that they are a permanent resident or citizen of a foreign country. They further represent that they intend to return to their country after a temporary stay in the United States.

The general rule is that an NRA who is present in the United States for the requisite amount of time necessary to meet the substantial presence test becomes an RA for tax purposes. However, there are special exemptions for education visa holders in the United States.

9

EXEMPTIONS AND RELATED RULES

Teachers or trainees holding J or Q visas under §101(15) of the Immigration and Nationality Act have exempt status.¹¹⁰ Having exempt status means that their days present in the United States are not counted toward meeting the substantial presence test. A visa holder may lose exempt status if it is determined that they are not complying with the terms of their visa.

Note. While USCIS reviews visa compliance issues, the IRS has been granted independent authority to assess visa compliance.

Teachers and trainees lose their exempt status once they have been exempt for any two calendar years during the preceding six calendar years. However, if the teacher or trainee received compensation by a foreign employer, the exemption will be lost after being exempt for four of the preceding six calendar years.¹¹¹

¹¹⁰ IRC §§7701(b)(5)(A)(ii) and (5)(C).

¹¹¹ IRC §7701(b)(5)(E)(i).

Similarly, **students** holding F, M, J, or Q visas under §101(15) of the Immigration and Nationality Act also have exempt status.¹¹² While exempt, the days present in the United States are not counted toward meeting the substantial presence test. Continual compliance with visa requirements ensures the exempt status is not lost. Once the student has been exempt for five calendar years, the student is no longer eligible for exempt status.¹¹³

Moreover, while exempt, F, M, J, and Q visa holders are taxed as NRAs. For most types of **scholarships or fellowships**,¹¹⁴ the holder of an F, M, J, or Q visa is treated as engaged in a trade or business within the United States¹¹⁵ and an initial flat withholding rate of 14% applies.¹¹⁶ Appropriate deductions can be claimed against this ECI income. The net amount after applicable deductions is taxed at normal tax rates.

While taxed as an NRA, **wages** earned by the teacher, trainee, or student are considered FDAP income and taxed at a flat 30% rate. These wages — if earned within the scope of the F, M, J, or Q visa held — are exempt from social security and Medicare taxes.

After loss of the exemption, continued presence in the United States may cause the teacher, trainee, or student to meet the substantial presence test. If this test is met, the teacher, trainee, or student is taxed as an RA. This results in the same tax treatment as a U.S. citizen. The usual tax code rules applicable to scholarships, wages, and payroll taxes begin to apply.¹¹⁷

ATTENDING SCHOOL OUTSIDE THE UNITED STATES

Education costs are typically associated with applicable annual tax credits or deductions. Moreover, distributions from special tax savings accounts can be used to pay for these costs each year. Making proper inquiries before attending a foreign school ensures that the tax advantages associated with these items are preserved.

ANNUAL TAX DEDUCTION OR CREDIT FOR EDUCATION COSTS

There are three different tax relief options to choose from in connection with qualified tuition and related expenses.

1. The lifetime learning credit
2. The American opportunity credit
3. An above-the-line deduction for tuition of up to \$4,000, subject to AGI limitations¹¹⁸

The rules differ among these three options. However, all three options are premised on the payment of tuition and related expenses paid to an **eligible educational institution**. An eligible educational institution is a college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education.¹¹⁹ Many foreign schools participate in Department of Education student aid programs. For students planning to attend school abroad, the deduction and credits available only apply if the particular school participates in the Department of Education student aid program.

The educational institution should be contacted in order to determine whether it qualifies under U.S. law as an eligible educational institution.

¹¹² IRC §§7701(b)(5)(A)(iii) and (D).

¹¹³ IRC §7701(b)(5)(E)(ii).

¹¹⁴ IRC §§1141(b)(1) and (2).

¹¹⁵ IRC §871(c).

¹¹⁶ IRC §1441(a).

¹¹⁷ IRC §117.

¹¹⁸ IRC §222. Under current law, this tax deduction option expires at the end of 2011.

¹¹⁹ “Eligible educational institution” is defined at IRC §529(e)(5) by reference to §481 of the Higher Education Act.

COVERDELL AND QUALIFIED TUITION PLAN DISTRIBUTIONS

Distributions from a Coverdell account and a qualified tuition plan may be used for qualified higher education expenses.¹²⁰ Use of these plans for postsecondary education requires student enrollment in an **eligible educational institution**.¹²¹ Eligible educational institution, for this purpose, is defined in the same manner as discussed in the previous section.

A distribution from these plans paid in connection with an educational institution that is not eligible constitutes a taxable distribution. The normal rules for a taxable distribution apply, including the 10% penalty.

PRINCIPAL RESIDENCE RULES

MAINTAINING THE U.S. HOME WHILE ABROAD

When maintaining their U.S. home while abroad, U.S. citizen and RA taxpayers continue to pay property taxes and/or mortgage interest on their principal residences. In doing so, they can deduct these itemized expenses each year. These expenses are reported on Schedule A along with any other itemized expenses.

Renting out a principal residence involves the conversion to a rental property for tax purposes. The basis of the property must be determined for depreciation purposes. Basis is the **lesser** of FMV or the adjusted basis of the property, excluding the FMV or cost of the land, on the date of conversion.

Rental expenses can only be claimed for the portion of the year that the property was a rental property. Expenses cannot be claimed for the portion of the year that the property was used as a residence.

SELLING THE HOME

Note. For a detailed discussion on the sale of a principal residence, see the 2010 *University of Illinois Federal Tax Workbook*, pages 125–130. This can be found on the accompanying CD.

A taxpayer may exclude up to \$250,000 of gain realized on the sale of a principal residence.¹²² To qualify for this exclusion, the ownership and use of the home within the 5-year period ending on the sale date are relevant. For at least two of those five years, the taxpayer must:

1. Own the home (ownership test),
2. Use the home as a principal residence (use test),¹²³ and
3. Not have used the exclusion for at least two years from the date the last home was sold (2-year test).¹²⁴

MFJ taxpayers can exclude up to \$500,000¹²⁵ if one spouse meets the ownership test **and** if both spouses meet the use test **and** neither spouse violates the 2-year test.¹²⁶

¹²⁰ IRC §§ 530(b)(1) and 529(b).

¹²¹ IRC § 529(e)(3).

¹²² IRC §§ 121(a) and (b)(1).

¹²³ IRC § 121(a).

¹²⁴ IRC § 121(b)(3).

¹²⁵ IRC § 121(b)(2)(A).

¹²⁶ Ibid.

To meet the use test for the requisite 2-year period, the use need not be continuous.¹²⁷ Short, temporary absences may be counted as periods of use, even if the property is rented out during such periods.¹²⁸ Moreover, the ownership and use tests do not both need to be met over the same 2-year period. Each of these two tests can be met at different times within the 5-year period ending on the date of the sale.¹²⁹ The property does not need to be the taxpayer's principal residence at the time of sale.

The flexibility in meeting the ownership and use tests is particularly useful for taxpayers who have had frequent, shorter-term employment-related trips abroad followed by a permanent job assignment outside the United States. However, U.S. citizens and RAs may find that they do not meet the use test if they have been outside the United States for an extended period of time prior to selling their home.

Example 11. Monica purchased and lived in her Boston home for 12 years before her employer sent her to New Zealand on a 5-year job assignment. She maintained her Boston home while in New Zealand. Once her New Zealand job assignment ended, her employer transferred her to the employer's headquarters in Seattle. Monica sold her Boston home and purchased a new home in Seattle. The sale of her Boston home does not qualify for the principal residence exclusion because Morgan did not use her Boston home for two of the five years before the sale.

Gain on the sale of a U.S. property interest by an NRA is generally treated as ECI.¹³⁰ However, an NRA selling a principal residence can benefit from the exclusion as long as all of the qualifications are met.¹³¹

Note. RAs who remain outside the United States for extended periods of time may lose LPR status. If this occurs, the RA becomes an NRA. However, this should not adversely affect the NRA's ability to use the principal residence exclusion as long as the tests for the exclusion are met.

Reduced Exclusion

Taxpayers who do not meet the ownership or use test or who have used the exclusion within the past two years may qualify for a reduced exclusion.¹³² To qualify for a reduced exclusion, the facts and circumstances surrounding the sale of the residence are considered. Qualifying reasons for the sale include a change in employment, health, or unforeseen circumstances. For taxpayers moving abroad, a change in employment is the most applicable of these reasons.

Taxpayers selling their homes due to a change in employment may benefit from the distance safe harbor test. Under this test, taxpayers qualify for a reduced exclusion automatically, without reference to any facts and circumstances, if **both** of the following apply.

1. The new place of employment is at least 50 miles further from the residence sold than the distance between that residence and the old place of employment.
2. The change of employment occurred when the taxpayer owned and used the property as a principal residence.¹³³

Note. This safe harbor test is particularly useful for taxpayers receiving foreign job assignments who have either used the principal residence exclusion within the past two years or who do not meet the ownership or use test for the entire 2-year period required for a full exclusion.

¹²⁷ Treas. Reg. §1.121-1(c).

¹²⁸ Treas. Reg. §1.121-1(c)(2).

¹²⁹ Treas. Reg. §1.121-1(c)(2)(1)XXX.

¹³⁰ IRC §§897(a)(1) and 871(b)(1).

¹³¹ See Chief Counsel Advice Memorandum CCA 003772 (Jan. 31, 2005).

¹³² Treas. Reg. §1.121-3.

¹³³ Treas. Reg. §1.121-3(c).

Amount of the Reduced Exclusion. Calculation of the reduced exclusion begins with the shortest of the following three time periods expressed in days.

1. Period of ownership of the home during the 5-year period ending on the sale date
2. Period of use of the home during the 5-year period ending on the sale date
3. Period of time between the last use of the exclusion and a current sale

The shortest of these time periods, expressed in days, is then divided by 730 days (which equates to two years). The result is multiplied by the normal exclusion amount of \$250,000 (or \$500,000 with qualifying joint filers).¹³⁴

Special Rules for Expatriates

As discussed earlier in this chapter, expatriations that took place **between June 3, 2004, and June 16, 2008**, are covered by IRC §877 for 10 years after expatriation. During these 10 years, only U.S. source income is taxed unless the expatriate is physically present in the United States for more than 30 days. Physical presence for more than 30 days within the taxable year causes the expatriate to be taxed for that year as a U.S. resident on worldwide income. However, the principal residence exclusion is specifically **denied** to expatriates who are subject to the §877 expatriate tax rules.¹³⁵

For those with expatriate dates **after June 16, 2008**, the mark to market provisions of IRC §877A apply. The principal residence is an asset, along with other capital assets, subject to the deemed sale rules mandated by §877A. The deemed disposition takes place on the date immediately before expatriation. It appears that there is no particular principal residence exclusion available to the expatriate. However, the expatriate will have the §877A exclusion amount (\$636,000 for 2011), which can be applied against the gain on a principal residence and the gain on other assets, if any.

Note. Whether an expatriate covered under §877A has a principal residence exclusion in addition to the \$636,000 exclusion amount is unclear. However, given the specific denial of the principal residence exclusion to expatriates covered under §877, it appears that the same denial exists for expatriates covered under §877A.

MISCELLANEOUS PROVISIONS

ELECTION TO TREAT SPOUSE AS RESIDENT ALIEN

Generally, spouses cannot file a joint return if either spouse is an NRA at any time during the taxable year.¹³⁶ A U.S. citizen or RA can elect jointly with an NRA spouse to have the NRA spouse treated as an RA for tax purposes.¹³⁷ This subjects the NRA spouse to the same U.S. worldwide income reporting requirements that are imposed on the U.S. citizen or RA spouse. This election can be made for any tax year that the NRA spouse has a spouse who is a U.S. citizen or RA at the end of the taxable year.¹³⁸

¹³⁴ Treas. Reg. §1.121-3(g).

¹³⁵ IRC §121(e).

¹³⁶ IRC §6013(a)(1).

¹³⁷ IRC §6013(g); Treas. Reg. §1.6013-6(a)(1).

¹³⁸ IRC §6013(g)(2).

This election is made by attaching a statement with a joint return for the first taxable year in which the election is to be effective.¹³⁹ The election can only be made with a joint return.¹⁴⁰ After making the election, the spouses can file separate returns for subsequent years after the year the election is made. The statement must include:

1. A declaration that the requirements for making the election as outlined in Treas. Reg. §1.6013-6(a)(1) are met;
2. The name, address, and taxpayer identification number of each spouse; and
3. The signatures of both spouses making the election.

If an executor or administrator makes this election for a deceased spouse,¹⁴¹ the statement must include their name and address.

Either spouse, or a spouse's executor or administrator, can revoke the election.¹⁴² The IRS can also terminate the election if the IRS deems either spouse's records are not adequate to ascertain tax liability.¹⁴³

FOREIGN CHARITABLE CONTRIBUTIONS

Generally, in order for charitable contributions to be tax deductible, the contributions must be made to a charity formed under U.S. laws.

Existing tax treaties between the United States and Mexico, Israel, and Canada may provide the U.S. taxpayer with a deduction for qualified charitable organizations in those countries. The qualifying charitable organizations are those that would qualify as exempt organizations under U.S. law. The qualifying organizations are listed in IRS Pub. 78, *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986*.

Each of these tax treaties outline the various rules and limitations on the deduction of charitable contributions made to the foreign charity.

For example, the United States-Canada income tax treaty provides a U.S. taxpayer with a deduction of charitable contributions to a qualified Canadian charity. The Canadian charitable contributions can only be claimed against Canadian source income earned by the U.S. taxpayer. The amount of the deduction is subject to the overall limitation and percentage limits associated with the U.S. charitable contribution rules. These limits apply to the Canadian source income. Contributions made to a Canadian college or university attended by the taxpayer or taxpayer's family member are not subject to the percentage limits.

SALE OF FOREIGN-OWNED REAL ESTATE

An NRA not engaged in a U.S. trade or business is not taxed on a U.S. source capital gain unless the NRA triggers tax on that gain under the 183-day rule.

However, a special law applies to the sale of U.S. real estate by an NRA. Under the Foreign Investment in Real Property Tax Act (FIRPTA)¹⁴⁴ of 1980, an NRA's gain or loss from the disposition of U.S. real estate is treated as ECI. This law covers sales, exchanges, and all other types of transfers of U.S. realty. Personal property associated with real property is also covered under FIRPTA.

¹³⁹ Treas. Reg. §1.6013-6(a)(4)(i).

¹⁴⁰ Ibid.

¹⁴¹ Treas. Reg. §1.6013-6(a)(4)(ii).

¹⁴² Treas. Reg. §1.6013-6(b)(1).

¹⁴³ Treas. Reg. §1.6013-6(b)(4).

¹⁴⁴ FIRPTA has been codified at IRC §897.

FIRPTA mandates special tax withholding rules when foreign-owned U.S. property is sold.¹⁴⁵ Unless an exemption applies, the purchaser of the property must deduct and withhold tax equal to 10% of the amount of the purchase price of the property.¹⁴⁶ There are provisions to obtain an agreement from the IRS to withhold a smaller amount. When the purchaser acquires a principal residence at a price of \$300,000 or less, the transaction is exempt from the 10% withholding requirement.¹⁴⁷ Several other exemptions to the withholding requirement exist.¹⁴⁸

Information return filing requirements are imposed upon the foreign person selling a U.S. property interest.¹⁴⁹ Penalties may be imposed for failure to file the necessary information returns.¹⁵⁰

Note. The terms of FIRPTA may be modified by an existing tax treaty between the United States and the NRA's country of residence.

MARRYING A NON-U.S. CITIZEN

A U.S. citizen or RA marrying an NRA implicates important immigration law and taxation law issues. Marriage itself does not provide the NRA spouse with LPR status or U.S. citizenship.

Fiancé(e) Visas

A U.S. citizen who intends to marry an NRA in the United States should apply for a K-1 visa. Application is made by submitting Form I-129F, *Petition for Alien Fiancé(e)*. The petitioner is the U.S. citizen who intends to marry the foreign fiancé(e). The petition must show that:

1. The petitioner is a U.S. citizen,
2. The petitioner intends to marry the fiancé(e) within 90 days of the fiancé(e) entering the United States, and
3. The couple met in person at least once during the two years prior to filing the petition. (Exceptions exist for cultural reasons or hardship.)

Once the K-1 visa is approved, the fiancé(e) is able to lawfully enter the United States for a period of 90 days for the marriage ceremony. After marriage, the fiancé(e) can subsequently apply for LPR status and remain in the United States while the application is pending.

Other Visas

U.S. citizens already married to an NRA spouse follow a different procedure. A K-3 visa must be obtained by filing Form I-130, *Petition for Alien Relative*. A copy of the USCIS response, which is a Form I-797, is subsequently sent with Form I-129F to the appropriate USCIS offices for approval. A K-4 visa is available for admittance of children of the NRA spouse into the United States.

There are procedures for RAs in similar circumstances. These procedures vary slightly from those for a U.S. citizen.

Note. The applicable forms, instructions, and necessary steps in connection with U.S. citizens or RAs marrying NRAs can be found on the USCIS website.¹⁵¹

¹⁴⁵. IRC §1445.

¹⁴⁶. IRC §1445(a).

¹⁴⁷. IRC §1445(b)(5).

¹⁴⁸. IRC §§1445(b)(2)–(6).

¹⁴⁹. IRC §6039C.

¹⁵⁰. IRC §6652(f).

¹⁵¹. [www.uscis.gov] Accessed on Jul. 21, 2011.

Tax Issues

The NRA fiancé(e) or spouse continues to be taxed as an NRA until they become an RA or obtain U.S. citizenship. Accordingly, immigration status determines tax status. As long as the foreign spouse remains an NRA, the couple **cannot file a joint return**. However, the U.S. citizen and NRA spouse can jointly elect to treat the NRA spouse as an RA, as noted earlier. This election is available in any year that the couple is married at the end of the taxable year. This election can be made even though the NRA spouse is not physically present in the United States. However, it is necessary for the RA spouse to obtain a valid tax identification number. Application for a tax identification number is made using Form W-7, *Application for IRS Individual Taxpayer Identification Number*.

TAX RETURNS

As a general rule, U.S. citizens and RAs file their returns using Form 1040. NRAs are generally not eligible to file a Form 1040. Instead, the NRA files Form 1040NR, *U.S. Nonresident Alien Income Tax Return*.

One major difference between the Form 1040 and Form 1040NR is that the Form 1040NR does not allow the NRA to claim the standard deduction. The Form 1040NR forces the NRA to itemize deductions each year on Schedule A. Schedule A must be used by the NRA regardless of the amount of total deductions that can be claimed. This means that the NRA may have total deductions that are less than the standard deduction amount available to U.S. citizens and RAs. As with the Form 1040, the Form 1040NR has an “EZ” version which can be used by certain NRAs who have no dependents.

Note. See **Example 4** in this chapter for a completed Form 1040NR.

NRAs who hold H-1B work visas¹⁵² permitting them to temporarily live and work in the United States are eligible to file a Form 1040 once they meet the substantial presence test. This allows them to take advantage of the standard deduction. NRAs are subject to the same worldwide reporting requirement as U.S. citizens and RAs.

Example 12. Frank holds an H-1B visa. He lives and works in the United States as a computer programmer. He enters the United States and begins working on October 1, 2010. He continues to work through the 2011 taxable year and into 2012.

For the 2010 tax year, he is only present in the United States for the last 92 days of the year. This falls short of the 183 days required to meet the substantial presence test. For the 2010 taxable year, Frank must file a Form 1040NR. He does not qualify to file a Form 1040.

However, he meets the substantial presence test for the 2011 tax year. In 2011, he can file a Form 1040 and take advantage of the standard deduction. He can continue filing a Form 1040 for each subsequent year in which he meets the substantial presence test.

Departing Aliens

With some exceptions, departing aliens must obtain a Certificate of Compliance from the IRS before departing the United States. This is accomplished by visiting a local IRS office and filing either a Form 1040-C, *U.S. Departing Alien Income Tax Return*, or the shorter Form 2063, *U.S. Departing Alien Income Tax Statement*. This should be accomplished no later than two weeks prior to the anticipated departure date. Other information, including documentation of the departure date, must accompany the Form 1040-C or Form 2063.¹⁵³

¹⁵² There are various categories of H-1B visas. Employer sponsorship is required to obtain such visas. More information on these visas can be found on the U.S. Citizenship and Immigration Services website [www.uscis.gov].

¹⁵³ A checklist of information to furnish the IRS can be found in the Instructions for Form 1040-C.

The Form 1040-C and Form 2063 are not substitutes for the required annual Form 1040 or Form 1040NR tax return, which also must be filed for the taxable year in which departure from the United States occurs. If the departing alien has not received a termination assessment, a Certificate of Compliance is generally issued without immediate payment of tax or the posting of any bond. A termination assessment is a demand from the IRS for immediate payment of tax from the departing alien. In addition, immediate payment of tax or posting of a bond is required if the area director of the local IRS office believes the alien's departure will jeopardize the collection of the outstanding tax amount. Once the tax is paid or appropriate bond posted, the Certificate of Compliance is issued. The Certificate of Compliance is not issued more than 30 days before an alien's departure date.

Form 2063 can be used instead of Form 1040-C if all required U.S. tax returns were filed and all taxes due were paid and the departing alien:

- Has no taxable income in the year of departure or the prior year, **or**
- Is a resident alien and the area director deems that departure will not jeopardize the collection of any taxes owing.

Certain departing aliens are excepted from the requirement of obtaining a Certificate of Compliance and do not need to file either Form 1040-C or Form 2063. Some of the aliens excepted from this requirement include the following.

- Foreign government representatives holding a diplomatic passport
- Certain employees of a foreign government representative holding a diplomatic passport
- Teachers, trainees, and students holding certain types of visas who meet various income tests¹⁵⁴
- Aliens in the United States on a pleasure trip holding a B-2 visa
- Business visitors to the United States holding a B-1 or combined B-1/B-2 visa who have been in the United States 90 days or less
- Residents of Canada or Mexico who regularly commute to the United States and receive U.S. wages subject to tax withholding¹⁵⁵

The Form 1040-C or Form 2063 represents the final tax filing for the departing alien. The Certificate of Compliance does not represent a final determination of tax liability. The departing alien remains liable for payment of any tax that the IRS determines is due after the issuance of the Certificate of Compliance.

SPECIAL RULES APPLICABLE TO MILITARY PERSONNEL

There are many special rules that apply to military personnel. This includes exceptions or exemptions noted previously in this chapter. While a full, comprehensive discussion of all tax rules applicable to military personnel is beyond the scope of this chapter, some of the more pertinent ones follow.

FOREIGN EARNED INCOME EXCLUSION (FEIE)

The FEIE **does not apply** to military wages paid to military personnel. However, if a service member or their spouse has another source of nonmilitary earned income, the FEIE can be used to exclude part or all of that income if the FEIE requirements are met.

¹⁵⁴. See Form 1040-C Instructions.

¹⁵⁵. Several other exceptions exist. See Form 1040-C Instructions.

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COMBAT PAY

An enlisted member, warrant officer, or commissioned warrant officer who serves in a combat zone during any part of a month can exclude all military pay for that month. Military pay can also be excluded for the time spent hospitalized for injuries or disease arising from duty in the combat zone. This hospitalization exclusion is limited to a maximum period of two years after the duty in the combat zone ended.¹⁵⁶ The amount of excludible combat pay is not included on Form W-2 for the armed forces member.

A commissioned officer is entitled to the same exclusions, subject to a limitation. The amount excluded is limited to the highest rate of enlisted pay, plus any imminent danger or hostile fire pay received by the commissioned officer.¹⁵⁷

OTHER SPECIAL PAY EXCLUSIONS

Several other forms of income can be excluded from gross income by military personnel. Some of the excludible items that relate to periods of duty outside the United States are as follows.

- Basic allowances for housing and subsistence
- Housing and cost-of-living allowances paid abroad by the U.S. or foreign government
- Overseas housing allowance
- State service pay for service in a combat zone¹⁵⁸

MOVING EXPENSES

Civilians must meet time and distance tests in order to deduct qualified moving costs. Military personnel can deduct moving expenses for qualifying moves pursuant to a military order without meeting these tests. Qualifying moves include a move:

- From home to the first post of active duty,
- From one post of duty to another, **or**
- From the last post of duty to home or a nearer point in the United States.

The following table summarizes the deductions available with applicable limitations.

Deductible Items	Limitations
Costs of moving household goods and personal effects	Cannot deduct the costs of moving goods obtained on the way from the old home to the new home.
Costs of storing household goods and personal effects	Can only deduct the costs of storage incurred in any continuous 30-day period while goods and effects are in transit from the old to the new home.
Travel costs, including lodging	Travel expenses only from the old to the new home are deductible. Can deduct either actual out-of-pocket expenses or the standard mileage rate. Meals are not deductible.

¹⁵⁶. IRS Pub. 3, *Armed Forces' Tax Guide*.

¹⁵⁷. *Ibid.*

¹⁵⁸. *Ibid.*

When a foreign move is involved, military personnel can deduct the following additional storage expenses.

- Expenses of moving household goods and effects to and from storage
- The cost of storing the items for part or all of the time worked at the new foreign location

For military personnel, a foreign move is a move:

- From the United States to a foreign country, **or**
- From one foreign country to another foreign country.

A move from a foreign country back to the United States does not constitute a foreign move.

Note. Additional information in connection with deductible or excludible moving expenses can be found in IRS Pub. 3, *Armed Forces' Tax Guide*.

SALE OF PRINCIPAL RESIDENCE

Taxpayers must meet an ownership and use test for two years within the 5-year period ending on the sale date of the residence to qualify for a full exclusion amount. However, military personnel can elect to **suspend** the 5-year period during which the 2-year ownership and use tests must be met.¹⁵⁹ The suspension is only available while either the service member or spouse is on qualified official extended duty. The maximum suspension period is 10 years.¹⁶⁰

Qualified extended duty is defined as any extended duty while:

- Serving at a duty station which is at least 50 miles from the residence, **or**
- Living in government quarters under government orders.¹⁶¹

Example 13. Major Albertson bought a home on January 1, 1997. He lived in the home for all of 1997 and 1998. At the beginning of 1999, he was stationed in Iraq. On January 1, 2003, Major Albertson sold his home. He only met the use test for one year out of the five years ending on the sale date. However, he can elect to suspend the 5-year period for the time he was in Iraq. With the election, the appropriate 5-year period is 1994 through 1998. With the suspension, his sale qualifies for a full exclusion.

Example 14. Sergeant Adams purchases a home in Colorado on January 1, 2004. He lives in the home for all of 2004, 2005, and 2006. From January 1, 2007, through 2015, he is on qualified extended duty in Germany. He sells the house in 2016. Sergeant Adams can make an election so that the nine years in Germany is not counted as part of the 5-year period in connection with the use test. With the election, the applicable 5-year period is 2002 through 2006. During this 5-year period, Sergeant Adams meets the ownership and use tests for more than two of these five years. He can use up to the maximum \$250,000 exclusion of gain on the sale of his home in 2016.

¹⁵⁹. IRC §121(d)(9).

¹⁶⁰. IRC §121(d)(9)(B).

¹⁶¹. IRC §121(d)(9)(C).

FILING DEADLINES

The normal April 15 filing deadline for military personnel is extended by at least 180 days¹⁶² beyond any of the following periods, if applicable.

- Any period of service in a combat zone
- Any period of hospitalization outside the United States as a result of combat zone service
- Any period of hospitalization in the United States due to combat zone service up to a maximum of five years

If there was unexpired time before the normal filing deadline when the taxpayer entered the combat zone, the filing deadline is extended by that unexpired time.¹⁶³

The spouse of a combat zone service member also is granted an extension. The spousal extension, however, does not apply to taxable years beginning more than two years after the date that combat ceased in the zone where the service member was stationed.¹⁶⁴ The period of U.S. hospitalization of the service member does not add to the spousal extension.¹⁶⁵

Combat zones that currently exist include Kosovo, the Persian Gulf, and Afghanistan. There are also designated qualified hazardous duty areas which are treated as equivalent to a combat zone for tax filing extension purposes.¹⁶⁶

A separate extension for filing is available for service members who are missing, missing in action, detained in a foreign country against their will, or captured at the time when a tax return is due.¹⁶⁷

BUSINESS ASPECTS OF INTERNATIONAL TAXATION

EMPLOYER RESPONSIBILITIES ASSOCIATED WITH FOREIGN WORKERS

The Immigration Reform and Control Act of 1986 (IRCA)¹⁶⁸ makes the employer a front-line enforcement agency in respect of immigration laws. The IRCA imposes specific duties on employers who hire new workers.

Verification of Identity and Eligibility

Under the IRCA, employers and employment agencies are required to verify the identity and employment eligibility of anyone hired. To accomplish this, the employer is required to complete Form I-9, *Employment Eligibility Verification Form*, for every employee. Form I-9 requires the employer to attest that documents from the employee have been examined to verify identity and employment eligibility. Form I-9 must be kept on file for the longer of three years or one year after the employee's employment ends.

Antidiscrimination Provisions

The IRCA has specific antidiscrimination provisions that employers must adhere to in the process of verifying employee identity and eligibility. Employers with four or more employees cannot discriminate on the basis of citizenship status. Adverse employment decisions cannot be made based upon real or perceived citizenship or immigration status. Employers with four or more employees also cannot engage in document discrimination. Document discrimination occurs when the employer requests that the applicant produce a specific document or different documents other than those required by law. Rejecting documents that appear genuine on their face also constitutes document discrimination. IRCA contains a prohibition against national origin discrimination in respect to employers with four to 14 employees.

¹⁶² IRC §7508(a).

¹⁶³ Rev. Rul. 76-425, 1976-2 CB 447.

¹⁶⁴ IRC §7508(c).

¹⁶⁵ IRC §7508(g).

¹⁶⁶ PL 104-117, Act §1 (Mar. 20, 1996).

¹⁶⁷ 5 USC §5568.

¹⁶⁸ The Immigration Reform and Control Act of 1986 is codified at 8 USC 1324a.

Enforcement and Penalties

The IRCA is enforced by the Department of Justice Office of Special Counsel for Immigration-Related Employment Practices, Civil Rights Division. Discrimination complaints for larger employers are addressed by the Equal Employment Opportunity Commission (EEOC).

There are civil penalties for failure to comply with employee verification requirements or for knowingly hiring or continuing to employ ineligible workers. For **each** undocumented worker, the penalties are:

- \$375 to \$3,200 for a first offense,
- \$3,200 to \$6,500 for a second offense, and
- \$4,300 to \$16,000 for subsequent offenses.

These penalties also apply for violation of the antidiscrimination provisions of the IRCA. Other civil penalties exist. Criminal penalties, including additional fines and incarceration, also are possible.

Additionally, employers must be aware of any state law regulation in connection with the hiring of undocumented workers. The Supreme Court recently held that the State of Arizona can sanction businesses that hire undocumented workers.¹⁶⁹ State regulation in this area was not preempted by federal regulation.

Note. Laws in this area are currently receiving increased enforcement efforts. Employers are well advised to observe their obligations very closely and document their compliance.

Hiring Foreign Workers

An employer seeking to hire a particular foreign worker must first act as a sponsor for the foreign worker. This requires knowledge of the specific visa requirements for the job available. Application must be made to the Department of Labor. The specific steps vary depending on the type of visa the job and worker require. If the application is approved, the employer is then **certified** to hire the foreign worker. The foreign worker must qualify for and obtain the needed visa to enter and work in the United States with the sponsoring employer.

There are numerous categories of work visas. Each visa has specific requirements that must be met by the foreign worker in order to receive the necessary visa to work in the United States. A visa may also have specific requirements for the employer. Many visas specifically relate to areas of work in the United States that are experiencing a shortage of available labor, talent, or skills.

An example of a work shortage industry is healthcare. Some hospitals may recruit foreign workers. An H1-C visa relates to the hiring of a registered nurse from a foreign country to work in the United States. In order to hire nurses with an H1-C visa, the employer must be a Subpart D hospital under the Social Security Act and must be located in a designated health professional shortage area. At least 190 acute care beds must exist within the employer's operation. Specific percentages of Medicare and Medicaid cases must exist. The foreign employee must be a registered nurse in the home country in which the nursing education was obtained or have received nursing education in the United States. Certain exams must be passed prior to obtaining the visa.

Note. Policies regarding shortage areas of labor or skills change frequently. This causes frequent changes in the availability and requirements of various types of visas. Many types of visas have quotas which limit the maximum number of such visas issued. Sponsoring employers must stay up-to-date on the frequent changes in this area and be prepared for processing times that can span months or even years depending upon the program and type of visa involved.

¹⁶⁹ *Chamber of Commerce v. Whiting*, Docket No. 09-115 (May 26, 2011). This case affirms the 9th Circuit decision.

TRANSFER PRICING AND MULTINATIONAL BUSINESSES

Multinational businesses most often operate as a group of business entities that span over several countries. These commonly controlled entities have the ability to determine the prices charged between entities for the goods or services provided to each other. These prices or charges between entities under common control are referred to as **transfer prices**. Examples include the cost of inventory for resale, the cost of labor or management from employees, licensing fees, financing costs, leasing costs, and supplies. These are costs of operating the overall multinational business. Management teams can allocate these costs across the entities that exist. The allocations are often accomplished with tax avoidance in mind. For example, higher expenses can be allocated to subsidiaries in jurisdictions that have higher tax rates in order to reduce taxable income.

Many governments, including the U.S. government, have adopted transfer pricing rules¹⁷⁰ that allow the country's tax authority to adjust the allocations made by management.

Arm's Length Standard

The U.S. transfer pricing rules are found in IRC §482 and the underlying regulations. These rules apply when a U.S. business entity enters into transactions with a related foreign entity. The U.S. entity and related foreign entities are a controlled group.

The IRS uses its broad authority to allocate gross income, deductions, credits, and allowances between controlled group entities under IRC §482 to make transfer pricing adjustments. The **arm's length standard** is the overriding principle of IRC §482. The arm's length standard is met if management's cost allocations are consistent with the results that would have been arrived at if arm's length entities not subject to common control had engaged in the same transaction under the same circumstances.

If necessary, charges and pricing among entities under common control are adjusted to arrive at a result consistent with the arm's length standard. The adjustments can dramatically affect the distribution of profits among entities in the group. Unique business circumstances of the controlled group and the type of business often make the arm's length standard extremely difficult to apply.

Note. Under the U.S. transfer pricing rules, the multinational business's intent to avoid or evade tax is not necessary for an adjustment of the transfer pricing used.

Methodology

Tax rules require that the controlled group use prices that would be paid in an arm's length situation. Further, tax rules in this area require the group to document the methods used to establish the pricing amounts used.

The regulations provide several methods that can be used by the controlled group to establish the prices. Each method provides a different way of comparing the controlled group's pricing with arm's length pricing. However, the arm's length transactions used for comparison must be comparable to the controlled group's transactions. The method that provides the most reliable indication of what an arm's length transaction is for the controlled group is the method that must be used. This is referred to as the **best method rule**.

The controlled group must document the comparisons and analysis established to arrive at the pricing established among the entities within the group.

¹⁷⁰ IRC §482 and the underlying regulations provide most of the transfer pricing rules for U.S. tax purposes.

Penalties

Substantial penalties can be assessed if the IRS adjusts the prices used by the controlled group. The amount of the penalties are in part based on how much of an adjustment was made.¹⁷¹ In addition, failure to properly document the transfer pricing analysis and transactions also can result in significant penalties.

To avoid transfer pricing penalties, businesses can enter into an advance pricing agreement (APA) with the IRS. An APA is an agreement between the controlled group and the IRS on the transfer pricing methodology to be used for a future period of time among the controlled group members. If the APA is adhered to by the controlled group, the IRS agrees not to challenge the transfer pricing methodology. APAs typically cover a 3- to 5-year period.

Note. At the time this workbook was published, Treasury Department officials were debating whether to move forward with a draft bill allowing companies to repatriate earnings at a lower tax rate than the current 35% corporate rate.

Pacific Association of Tax Administrators

The Pacific Association of Tax Administrators (PATA) includes the countries of Australia, Japan, Canada, and the United States. These nations have jointly developed the “PATA Documentation Package,” which a multinational business can use if it does business in these countries. The package allows use of a uniform method of documentation of transfer pricing calculations among these countries. This uniform method can be used to avoid penalties associated with lack of proper documentation. This process ensures that the requirements of each of these countries is met using one standardized method.

APPENDIX — CURRENCY CALCULATIONS WITH EXCHANGE RATES

All amounts on a U.S. tax return must be expressed in U.S. dollars. With international tax transactions, there is a frequent need to convert foreign currencies to U.S. dollars so that these foreign amounts can be properly reported on a U.S. tax return.

Before tax preparation season begins each year, the IRS makes available the yearly average exchange rates between the U.S. dollar and most other major foreign currencies. These exchange rates appear on the IRS website.

Example 15. In **Example 8**, Louise earned €60,000 (60,000 euros) from employment in France.

Note. Converting Louise’s 2011 income in Euros to U.S. dollars requires use of the 2011 yearly average exchange rate (YAER) between the Euro and U.S. dollar. Since the actual YAER for 2011 will not be known until January 2012, this exchange rate conversion example will use the 2010 rate. However, Louise is required to use the 2011 rate when it is available in early 2012.

Yearly Average Exchange Rates for Converting Foreign Currencies into U.S. Dollars (Partial Table)

Country	Currency	2010	2009	2008	2007	2006
Denmark	Krone	5.622	5.356	5.096	5.445	5.945
Egypt	Pound	5.681	5.601	5.495	5.720	5.818
Euro Zone	Euro	0.755	0.719	0.683	0.731	0.797
Hong Kong	Dollar	7.770	7.752	7.787	7.804	7.769
Hungary	Forint	208.253	202.368	172.696	184.019	210.830

¹⁷¹ IRC §§6662(e) and (h).

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The previous table from the IRS website¹⁷² shows that the exchange rate to convert euros into U.S. dollars is 0.755. This means that USD \$1 is equivalent to 0.755 euros.

Converting from Euros to U.S. Dollars

To convert from euros to U.S. dollars, the number of euros is **divided** by the above exchange rate to arrive at the equivalent amount expressed in U.S. dollars.

Therefore, $\text{€}60,000 \div 0.755 = \text{USD } \$79,470.20$.

Converting from U.S. dollars to Euros

To convert from U.S. dollars to euros, the number of U.S. dollars is **multiplied** by the exchange rate to arrive at the equivalent in euros.

Therefore, $\text{USD } \$79,470.20 \times .0755 = \text{€}60,000$.

Example 16. Linda spent four months in Australia and earned AUS \$22,000 while working there. She needs to calculate the U.S. dollar equivalent of AUS \$22,000 so that this amount can be properly reported on her U.S. tax return.

Using the IRS table, the yearly average exchange rate to convert Australian dollars to U.S. dollars is 1.091. This means that USD \$1 is equivalent to AUS \$1.091.

Yearly Average Exchange Rates for Converting Foreign Currencies into U.S. Dollars (Partial Table)

Country	Currency	2010	2009	2008	2007	2006
Algeria	Dinar	75.453	74.144	65.804	70.582	75.176
Argentina	Peso	3.921	3.739	3.171	3.122	3.091
Australia	Dollar	1.091	1.281	1.197	1.195	1.329
Bahrain	Dollar	0.379	0.379	0.379	0.379	0.380
Brazil	Real	1.767	2.008	1.840	1.952	2.180

To convert from Australian dollars to U.S. dollars, the number of Australian dollars is **divided** by the above exchange rate.

Therefore, $\text{AUS } \$22,000 \div 1.091 = \text{USD } \$20,164.99$. Linda's earnings in Australia equates to \$20,164.99 in U.S. currency. This is the amount she would report on her U.S. tax return for her earnings in Australia.

This answer can be checked by taking the U.S. dollar result and **multiplying** by the exchange rate. This converts the U.S. dollar amount calculated back to Australian dollars.

¹⁷². [www.irs.gov/businesses/small/international/article/0,,id=206089,00.html] Accessed on Aug. 19, 2011.