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The Rules Governing Taxation of Foreign Nationals

1. Residence of Individuals

Residence is the bedrock upon which U.S. taxation for foreign nationals lies. Residence is a "measure of the extent and permanence of an individual's presence in a given place." See "International Taxation," Joseph Isenbergh, Foundation Press, Second Edition, at p. 20.

Foreign nationals can be subject to one of two forms of taxation depending on whether they reside in the U.S. (i.e., "resident aliens") or reside outside of the U.S. (i.e., "nonresident aliens"). Id., supra, at p. 20. The United States taxes its resident aliens on their *worldwide* income but only taxes its nonresident aliens on the income that they earn within the United States (i.e., source-based taxation). Id., supra.

2. Resident Aliens (Section 7701(b))

An "arithmetic statutory definition" of "resident alien" was added to the Code in 1984. See "International Taxation," Joseph Isenbergh, Foundation Press, Second Edition, at p. 21. The definition of resident alien in section 7701(b) "applies only to foreign nationals." Id., supra, at p. 22.

Under section 7701(b), U.S. residence is intricately tied to two "objective elements": first, "the immigration status of foreign nationals" and second, "the amount of time they spend in the United States." Id., supra. Section 7701(b) is by no means a "bright-line provision." Id., supra. At its core is a balancing of the individual facts and circumstances. Id., supra.

a. Immigration Status: Lawful Permanent Residence

First, a foreign national who is a "lawful permanent resident of the United States" during a calendar year is a resident of the United States in that year.[i] A lawful permanent resident, also known as a "green card" holder, is "an individual entitled to remain permanently in the United States." See "International Taxation," Joseph Isenbergh, Foundation Press, Second Edition, at p. 22.

Immigration status and tax status are inextricably tied. Id., supra. Therefore, no one admitted to the United States as a permanent resident can avoid tax residence, no matter how "little time he spends in the United States." Id., supra.

b. Substantial Presence in the United States

The second major test of residence is "physical presence in the United States." See "International Taxation," Joseph Isenbergh, Foundation Press, Second Edition, at p. 22. "A foreign national who is present in the United States for *183 or more days* during a calendar year is a United States resident in that year."[ii]

The philosophy behind the 183-day rule is straightforward: "183 days is more (by a few hours) than half of a year." Id., supra. A foreign national who is in the United States for that period of time during a year "establishes a lengthier connection with the United States than with any other country in that year." Id., supra.

The 183-day rule is referred to in some circles as the "substantial presence" test. Id., supra, at p. 23. The substantial presence test has two forms, one of which can be viewed as the "strong form of the test" and the other which can be viewed as a looser form of the test. Id., supra.

Under the strong form, "U.S. residence results from an individual's actual presence in the United States for *183 days or more* during a calendar year." Id., supra. Actual presence establishes United States residence for the calendar year, and "this determination [supersedes] any showing of a contrary intention or of a stronger or more permanent connection to another country."[iii]

This form of the substantial presence test is a veritable straightjacket provision because an individual who is in the United States for at least 183 days during a calendar year is automatically deemed to be a U.S. resident. See "International Taxation," Joseph Isenbergh, Foundation Press, Second Edition, at p. 23. A taxpayer's intentions regarding U.S. presence are meaningless. Id., supra. For example, "a foreign national serving a prison term in the United States and wishing every minute that he were back home, is nonetheless a U.S. resident under this test." Id., supra.

If residence in the United States came down to nothing more than physical presence for 183 days in a given year, it would be relatively easy to circumvent this test. Id., supra. For example, an individual could "maintain a substantial connection with the United States by spending 180 days there for several years in a row and still avoid being [classified] as a U.S. resident." Id., supra.

Similarly, a stay of 182 days at the end of year one followed by a stay equal to the same number of days in the beginning of year two would amount to nearly one full year in the United States without establishing U.S. residence. Id., supra. "With this much flexibility, the careful timing of gains and losses could significantly reduce the tax cost of U.S. residence." Id., supra.

The second part of the substantial presence test eliminates this possibility altogether by taking into consideration "not only time spent in the United States during the current calendar year, but also days spent in the United States during the *two* preceding calendar years." Id., supra.

The latter – i.e., days spent in the two preceding calendar years – is added to days spent in the U.S. in the most recent calendar year in order to calculate substantial presence. The practical effect of this is "to include periods of protracted … connection with the United States as periods of U.S. residence." Id., supra, at p. 24.

Here, an important distinction must be made. Days from the preceding two years are given "*less* weight in arriving at the total than days of the actual calendar year." Id., supra. Specifically, days spent in the United States are given the following weight:

- "Days from the current year are counted at their full value;
- Days from the first preceding calendar year are counted as 1/3 of a day; and
- Days from the second preceding calendar year are counted as 1/6 of a day."

[Id., supra.]

Consider the following example. It is based on a similar example that comes from the creative genius of Joseph Isenbergh in his bestseller, *International Taxation*, Second Edition, Foundation Press (2005). Pierre is a foreign national who has never been to the United States. For ease in demonstrating the carrying over of days, assume that every month has thirty days.

Pierre arrives in the United States on September 1, 2000 and leaves on November 30, 2000, staying a total of ninety days. He returns to the United States on March 1, 2001 and leaves on July 30, 2001, staying a total of one hundred and fifty days. He returns to the United States on May 1, 2002 and leaves on August 30, 2002, staying a total of one hundred and twenty days.

Below are the number of days that Pierre stayed in the U.S. each year:

YEAR	DAYS
2000	90
2001	150
2002	120

After applying the substantial presence test, how many days has Pierre spent in the United States in 2001 and in 2002? Let's begin with 2001. Pierre is treated as having spent 180 days in the United States in year 2001. The calculation is as follows: 150 days actually spent in 2001 (+) 1/3 of the 90 days spent in 2000 = 150 days (+) 30 days = 180 days. Because he has not crossed the 183-day threshold, he does not satisfy the substantial presence test. And because he does not pass the substantial presence test, he is *not* a resident alien in 2001. Therefore, Pierre can breathe a sigh of relief as he will not be taxed by the U.S. on his worldwide income.

Unfortunately, 2002 is not as kind a year to Pierre. In 2002, Pierre is treated as having spent 185 days in the United States. The calculation is as follows: 120 days actually spent in 2002 (+) 1/3 of the 150 days spent in 2001 (+) 1/6 of the 90 days spent in 2000 = 120 (+) 50 (+) 15 = 185 days. Therefore, Pierre is a resident alien in year 2002 because he crossed the 183-day threshold requirement of the substantial presence test. And because he is a resident alien, he is subject to U.S. taxation on his worldwide income.

The greatest number of consecutive days that Pierre can spend in the United States without triggering United States residence is 121. Repeated annual stays of 121 days eventually become measured as 181 ½ under this extended substantial presence test – which still falls below the 183-day threshold.

A word of caution is in order. “United States residence cannot result entirely from days carried forward from earlier years. A minimum physical presence of at least 31 days in the United States is required before substantial presence is ever triggered.” See “International Taxation,” Joseph Isenbergh, Foundation Press, Second Edition, at p. 24.

What this version of the substantial presence test means to foreign nationals is that they can still be classified as U.S. residents even if they have spent *less* than 183 days in the United States in a given year. Id., supra, at p. 25. Thankfully, there are two conditions that prevent this nightmare scenario from being absolute. They are found in section 7701(b)(3)(B).

Under section 7701(b)(3)(B), an individual who is present in the United States for fewer than 183 days during a calendar year – despite an extended count of days exceeding 183 – is *not* treated as a U.S. resident for that year if: (1) the individual has a “tax home” in a foreign country and (2) the individual has a “closer connection” to that foreign country than to the United States.

While the count of days “creates a presumption of U.S. residence,” it can be rebutted by evidence that establishes that the individual’s tax home is in a foreign country and that the individual has a “closer connection” to that country than to the United States. Id., supra, at p. 25.

Determining the country to which an individual has a “closer connection” is not an exact science. Instead, it requires balancing such factors as “the individual’s principal place of residence and where he maintains the strongest social, economic, and family ties.” Id., supra, at p. 25.

c. Protected groups of individuals who are excluded from the substantial presence test

Certain groups of individuals are excluded from the substantial presence test. These are foreign nationals whose presence in the United States, no matter how long, is generally *not*

permanent. See "International Taxation," Joseph Isenbergh, Foundation Press, Second Edition, at p. 25.

Among the protected groups are "full-time diplomats along with teachers and students." See IRC Section 7701(b)(5)(A). Also excluded from the count are "days spent in the United States by an individual unable to leave due to a medical condition that arose while he or she was there." See IRC Section 7701(b)(3)(D)(ii).

3. Two Examples of Residency vis-à-vis U.S.C. § 7701(b)

Below are two examples:

- Example # 1: Matt is a citizen of Argentina. He has lived in the U.S. every day for the last three years. Because Matt is considered a resident by application of the rules under § 7701(b), he must file an FBAR.

- Example # 2: Kyle is a permanent resident of the U.S. He is a citizen of the UK. Under a tax treaty, Kyle is a tax resident of the UK and elects to be taxed as a resident of the UK. Kyle must file an FBAR. Tax treaties with the U.S. do not exempt such individuals from filing FBARs.

Endnotes:

[i] § 7701(b)(1)(A)(i).
[ii] § 7701(b)(3).
[iii] §§ 7701(b)(1)(A)(ii), 7701(b)(3).