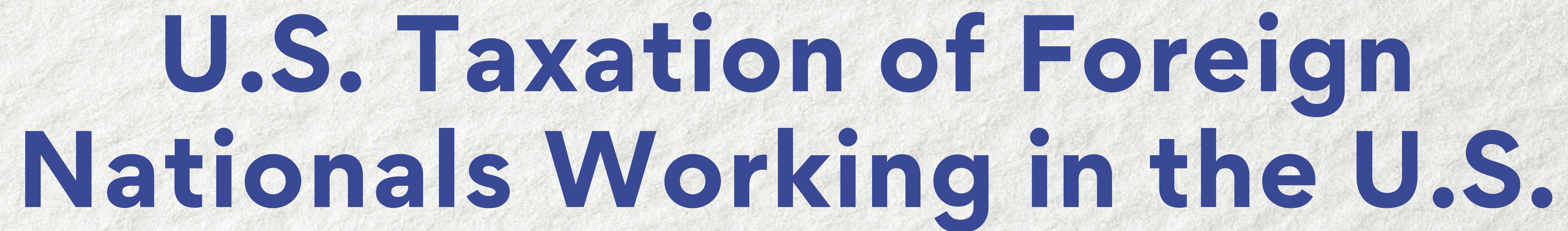

U.S. Taxation of Foreign
Nationals Working in the U.S.

Including Planning Opportunities

U.S. Taxation of Foreign Nationals - Overview

- Global Mobility
- Tax Residency Status
- Income Taxation of Residents
- Sourcing Rules
- Income Taxation of Nonresidents
- Foreign Tax Credits
- Treaties
- Preimmigration Planning

- Global mobility is an effective tool to help talent management (and HR) to achieve their goals and to support the goals of the company's leadership

- Enables company to become the best in the industry and be future proof by recruiting and retaining the best talent available

- Benefits of a well designed global mobility plan:

  - Better talent and talent in the right place
  - Access to top talent, often at lower price-point
  - Knowledge exchange
  - Greater diversity
  - Increase loyalty
  - Recruitment costs and fee savings
  - Savings from onboarding and retraining

- Work closely with the HR department of corporations

- Identify best visas for employee to be eligible to work in the U.S.

- Typical visas and type of workers

U.S. Tax Residency Status

- Tax Residency Status
  - U.S. tax residents are subject to income tax on their worldwide income
  - NonU.S. tax residents are subject to tax on income effectively connected to a U.S. trade or business and U.S. source income that is fixed, determinable, annual, or periodic (FDAP)

- Determination of tax residency status may not bear any relationship to the foreigners legal or immigration status

- There are two tests to determine U.S. tax resident status:
  - The lawful permanent resident test
  - The substantial presence test

U.S. Tax Residency Status

- Lawful Permanent Resident Test
  - A foreign national is considered a U.S. lawful permanent resident if he or she has been issued the official privilege of residing in the U.S. permanently
  - This occurs when the foreign national receives an alien registration card or "green card"
  - In the initial year that a "green card" is issued, the individual becomes a U.S. tax resident from the first day of actual presence in the U.S. after issuance of the green card

- Lawful permanent resident status continues until one of the following occurs:
  - The individual voluntarily surrenders the green card to immigration authorities; or
  - The U.S. immigration authorities revoke the green card; or
  - A judicial body officially finds that the individual no longer qualifies as a lawful permanent resident under the immigration laws

- If the green card is revoked under one of the tests and the individual does not meet one of the residency tests the next year, the general rule is the individual is a U.S. tax resident until the last day of the tax year in which the revocation event occurs

U.S. Tax Residency Status

- Substantial Presence Test
  - The substantial presence test measures the days that an individual is physically present in the U.S. for any purpose over a three-year period of time
  - If the number of days physically present in the U.S. equals or exceeds 183 days in the current year, or 183 days during the three-year period (under fractional day count for the prior two years), then the individual is a U.S. tax resident
- The 183 days or more for the prior three years is computed as follows:
  - For the current year, all of the days physically present in the U.S. are counted;
  - For the year immediately preceding the current year, 1/3 of each day physically present in the U.S. is counted;
  - For the second year immediately preceding the current year, 1/6 of each day physically present in the U.S. is counted.
- For this purpose, a day of actual presence in the U.S. is any day that the individual spends any amount of time in the U.S. Days of arrival and departure in the U.S. each count as a full day of presence in the U.S. Under limited circumstances, certain days of presence in the U.S. are excluded
- 31-Day Exception
  - If an individual is present in the U.S. for less than 31 days in the current year, the substantial present test is not applied to determine residency

U.S. Tax Residency Status

- Substantial Presence Test
  - Closer Connection Exception: If an individual meets the substantial presence test it is possible to claim nonresident status for the whole year if the following conditions are satisfied:
    - The individual is present in the U.S. for fewer than 183 days in the current year; and
    - The individual maintains a “tax home” in another country during the entire year; and
    - The individual maintains a closer connection to the foreign country in which they have a tax home during the year.
- Tax Residency Starting Date
  - If an individual qualifies as a resident under the substantial presence test in the current year and the individual was not a tax resident in the prior year, their U.S. tax residency generally starts on the first day they are physically present in the U.S.
- Tax Residency Ending Date
  - Like the lawful permanent resident test, the general rule for termination of U.S. tax residency is the last day of the calendar year where the individual meets the substantial presence test
  - There is an exception where the last day of U.S. tax residency will be the day the individual moves from the U.S. and establishes a residence in another country. The individual must establish a tax home in the other country and a closer connection to that country from that day forward

U.S. Tax Residency Status

- First Year Election
  - Tax may be minimized by being treated as a U.S. tax resident in a year the individual does not meet the requirements of one of the U.S. tax residency tests
  - In order to make the first-year election the individual must meet the following test:
    - They must have been a non-resident in the year immediately proceeding the initial year of the U.S. assignment;
    - They must satisfy the substantial presence test in the year following the initial year of the U.S. assignment;
    - They must be present in the U.S. for at least 31 consecutive days in the initial year of U.S. assignment; and
    - During the initial year, the individual must be present in the U.S. for at least 75% of the days from the start of the 31-consecutive-day period through the end of the year

U.S. Income Taxation of Tax Residents

- U.S. tax residents are subject to tax on their worldwide income

- Gross income includes income from what ever source derived including but not limited to:

  - Wages, salaries, and other compensation
  - Interest and dividends
  - State income tax refund
  - Income from a business or profession
  - Alimony received
  - Rents and royalties
  - Gains on the sale of property
  - S corporation, trust, and partnership income

U.S. Income Taxation of Tax Residents

- Foreign Tax Credits
  - The U.S. allows for a credit against U.S. income tax paid on income that is also subject to foreign income tax – this is referred to as the foreign tax credit (FTC)
  - To qualify for the FTC, the foreign tax must be levied on income and the income must be foreign source
  - The FTC is limited to the lesser of the actual foreign tax paid or accrued or the U.S. tax liability associated with the foreign source income
  - The FTC is further divided into the following baskets:
    - General
    - Passive
    - Income resourced by treaty
  - Cannot receive FTCs for taxes paid by a foreign corporation on Subpart F income or GILTI income unless a special election is made to treat the income as if it was earned by a domestic corporation
    - Dividends from the foreign corporation are then subject to U.S. tax
    - Will need to determine whether the election will result in more or less tax overall

U.S. Income Sourcing Rules

- Personal service income: Location where services are performed
- Interest Income: Location of the payor
- Dividend Income: Location of corporation paying the dividend
- Rental and Royalty Income: Location of property generating the income
- Income from the Sale of Personal Property: Residence of the seller
- Sale of Real Property: Location of the real property

U.S. Taxation of Foreign Retirement Accounts

- The general rule is that the U.S. does not recognize retirement accounts in other countries unless there is a specific income tax treaty with that country – only about 5 income tax treaties have such a provision

- Key considerations for determining the U.S. tax treatment of foreign retirement plans are: (1) who is funding the plan; (2) is the plan a foreign employer pension plan; (3) elective personal pension; or (iv) public pension

- If there is a treaty position that exempts a foreign retirement plan from current income taxation, then the foreign national/U.S. tax resident is generally subject to income tax when they receive distributions from the foreign retirement plan

- A foreign pension would be a defined benefits pension plan if the distributions are not based on the return of a separate investment account of the participant and the payout by the employer is based on some factor of years of service and compensation. A U.S. tax resident would not be subject to tax until distributions are received from defined benefits pension plan

U.S. Taxation of Foreign Retirement Accounts

- For all other types of foreign retirement plans, the next consideration is whether the foreign retirement plan is a IRC 402(b) employee's benefit trust or grantor trust for U.S. tax purposes

- A foreign retirement plan will be an IRC 402(b) trust if the employer made 50 percent or more of the contributions to the foreign retirement plan at all times. Tax treatment changes if the retirement plan was rolled over or transferred to another account after employment was terminated

- IRC 402(b) employee's benefit trust

  - Employer contributions to a 402(b) trust are included in the employee's U.S. taxable income in the year of contribution
  - Employee contributions are not tax deductible
  - Income that accrues in this type of trust are taxed deferred until distributions are received
  - Tracking tax basis is important
  - Tax basis when individual becomes U.S. tax resident will depend on whether the individual was subject to income tax in the country where the retirement plan is located
  - No PFIC concerns or 3520 or 3520A filings

U.S. Taxation of Foreign Retirement Accounts

- Foreign retirement accounts taxed as Grantor Trusts:
  - The income of the foreign retirement account is currently taxable to the beneficiary even though there are no distributions
  - No deductions for contributions to the foreign retirement account
  - Investments of the foreign retirement will be taxed in the same manner as if the beneficiary directly held the assets
    - Mutual funds will be subject to passive foreign investment tax treatment (PFIC) requiring extensive reporting and possible punitive taxes
  - Mismatch of timing of U.S. taxation and foreign countries taxation of retirement plan resulting in double taxation as the tax event in the foreign country will be delayed until distribution whereas the U.S. is currently taxing the retirement plan, typically no ability to claim foreign tax credits in the U.S.
  - Usually no Form 3520 or 3520A reporting pursuant to Revenue Procedure 2020-17

- Generally, foreign retirement accounts that are similar to 401K plans in the U.S. are 402(b) trusts; and foreign retirement plans that are similar to IRAs are taxed under the grantor trust rules

Other Special Considerations for U.S. Tax Residents

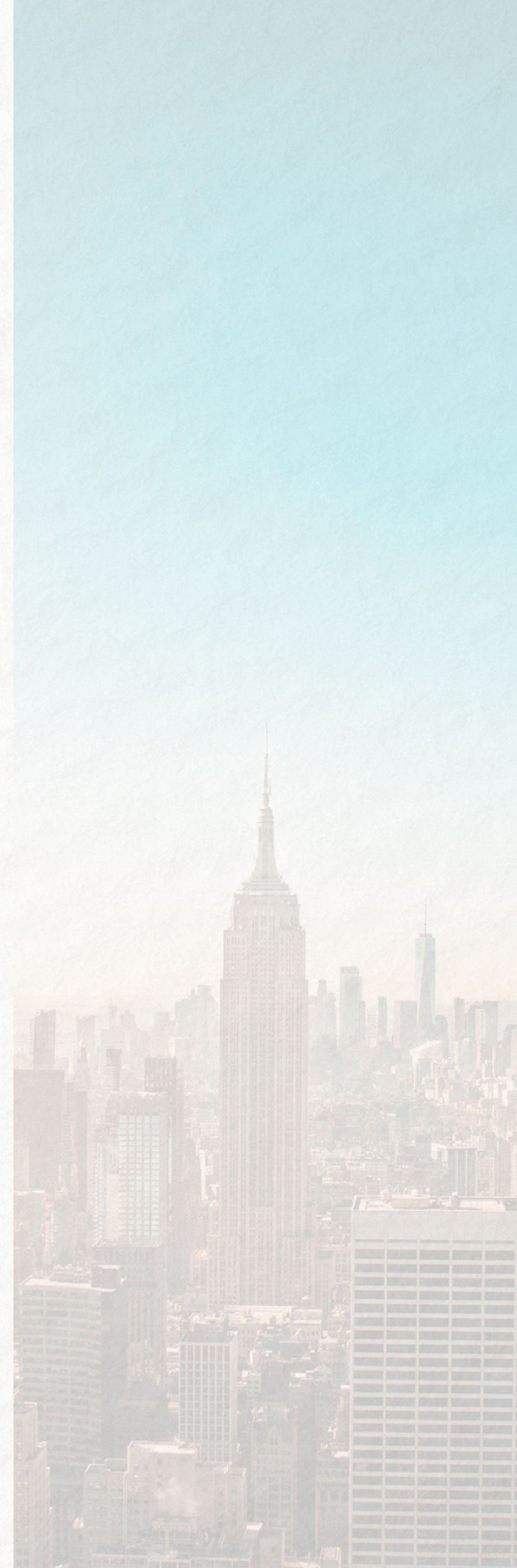
- Controlled foreign corporations
- Passive foreign investment companies
- Executive compensation
- Fincen 114 – foreign bank account reports (FBARs)
- Foreign Account Tax Compliance Act (FATCA)
- International informational form filings (Form 5471, 8621, 8865, 8858, 3520/A)

U.S. Income Taxation of Nonresidents

- Nonresident aliens individuals (NRAs) are subject to federal income tax on the following types of income:
  - Fixed, determinable, annual, or periodic (FDAP) income (generally from U.S. source dividends, interest, rents, royalties, and other portfolio income, as well as certain types of service income), which is subject to 30% withholding tax at source on a gross basis with no offsetting deductions (tax rates may be reduced by income tax treaties)
  - Income that is effectively connected to a U.S. trade or business (ECI), which is taxed at graduated rates up to 37%. ECI from a qualified trade or business potentially may be eligible for the 20% pass-through deduction
  - State income tax regimes vary, but most states tax nonresidents (if at all) only on income from sources within the state

U.S. Income Taxation of Nonresidents

- NRAs reduce rates or exemptions on certain types of income:
  - “Portfolio interest” is exempt from taxation
  - ECI that is not attributable to a “permanent establishment” in the U.S. may be excluded under an income tax treaty
  - The 3.8% Medicare tax on net investment income of high-income earners does not apply to NRAs
  - Capital gains (other than the sale of certain U.S. real property and partnership interests) generally are exempt from federal income tax



Income Tax Treaties

- Tax treaties function to reduce a country's taxing authority in situations covered by the treaty provisions
  - Income Tax Treaties: If income is earned in country A by a (qualified) resident of country B, country A agrees to modify its default tax rule for the income item
    - §Goal with treaties is to reduce double taxation
  - The treaties will allow residents of a treaty country to be taxed at reduced rates or exempted from tax on certain income from the other country
  - **Treaties either provide an increased standard for the imposition of tax by the U.S. (permanent establishment instead of ECI) or reduce the rate of tax**

Totalization Agreements

- Totalization has two principal purposes:
  - Relief from double taxation of social security type taxes
  - Coordination of benefits through combined coverage credits

U.S. Estate and Gift Taxation of U.S. Citizens and Domiciliaries

- U.S. citizens and domiciliaries are subject to estate tax at rates up to 40% on their worldwide assets wherever situated
- The gift tax is imposed at a rate of 40% on assets wherever situated
- U.S. persons have a lifetime credit against estate, gift, and generation skipping transfer (GST) taxes equivalent to a lifetime exemption of $12.92 million for 2023
- An unlimited marital deduction is available only if the spouse is a U.S. citizen

U.S. Estate and Gift Taxation of NRAs

- Estates of NRAs
  - NRAs are subject to estate tax only with respect to assets situated in the U.S. (U.S. situs assets"). The situs rules may be modified by an applicable estate tax treaty
  - Exemption from estate tax is only $60,000. Estate tax rate up to 40%
  - Domiciliaries of estate tax treaty jurisdictions may be entitled to a prorated share of the U.S. persons exemption based on the ratio of U.S. situs assets to worldwide assets
  - The unlimited marital deduction is not available unless the surviving spouse is a U.S. citizen

U.S. Estate and Gift Taxation of NRAs

- Gift Taxation of NRAs
  - NRAs are subject to gift tax only with respect to gifts of real and tangible personal property situated in the U.S.
  - The gift tax exemption is $0. Gift tax rate up to 40%
  - There is a $17,000 annual exclusion from gift tax for 2023 ($175,000 on transfers to noncitizen spouses) for gifts of present interests (per donee)
  - The unlimited marital deduction applies to transfers to a U.S. citizen spouse

ABOUT CHRISTOPHER M. KLUG

Christopher Klug serves clients with domestic and international taxation, tax controversy, corporate/business planning, mergers and acquisitions, cross-border transactions, and domestic and international estate planning needs. Chris is the founder of Klug Counsel PLLC in Washington DC.

Website: www.klugcounsel.com
Email:cklug@klugcounsel.com
Phone Number: +1 202-980-4788