ELECTIONS MAKE QUICK WORK OF Nonresident Returns

By Peter James Lingane, EA, CFP

NONRESIDENTS OFTEN PAY MORE TAX THAN CITIZENS or residents because of limitations on filing status, exemptions, deductions, and credits. Consequently, the preparer needs to be aware of situations, elections, and treaty provisions which allow the taxpayer to be treated as a U.S. resident for income tax purposes. "U.S. residency" and "U.S.-sourced" have different meanings for income, gift, and estate taxes. State issues are addressed in the context of California.

Summary

There are three federal income tax systems:

1 Citizens and residents are taxed on worldwide income net of various deductions. There are a variety of credits against the tax liability and they may be able to exclude foreign income.

2 Nonresidents are only taxed on U.S.-sourced income. But nonresidents are denied Married Filing Jointly and Head of Household filing statuses, community property rights, the standard deduction, deductions for dependents, and most tax credits.

3 Part-year residents are taxed as nonresidents during the period of nonresidency. Part-year residents are taxed on worldwide income during residency but they may be able to exclude foreign income. Part-year residents are allowed deductions for dependents but they are denied Married Filing Jointly and Head of Household filing statuses, community property rights, the standard deduction, and most tax credits.

Because nonresidents with low to moderate income usually pay more tax than citizens or residents with similar incomes and since residency is required for the dependency exemption, it is fortunate that there are many circumstances in which a nonresident can be treated as a resident for income tax purposes.

Because few practitioners prepare enough nonresident returns to become conversant with the Form 1040NR, knowing when a nonresident can be treated as a resident has the additional advantage of converting a formidable return into a familiar one.

The preparer also needs to appreciate that "U.S. residency" and "U.S.-sourced" have different meanings for income, gift, and estate taxes.

Federal Income Taxation of Nonresident and Part-Year Resident Aliens

A U.S. person—that is, a U.S. citizen or full year resident—files a Form 1040. A nonresident files a Form 1040NR. A part-year resident files both a Form 1040 and a Form 1040NR.[1] A part-year resident is referred to as a "dual-status alien."

Nonresidents and dual-status aliens cannot file jointly or as head of household. Qualified widow(er) status is restricted.

A nonresident reports only U.S.-sourced income. Wages earned while in the U.S., income from a U.S. business or partnership, gains from the sale of U.S. real estate or business assets, and nonqualified scholarships from U.S. organizations are examples of U.S.-sourced income. Qualified scholarships are not taxed.

These examples also illustrate income which is "effectively connected" with a U.S. trade or business. Such income is reported on page one of the Form 1040NR and is taxed at the usual graduated rates. The personal exemption and any adjustments or itemized deductions reduce the amount of effectively connected income subject to tax.

Gross rents from U.S. real estate, interest, and dividends paid by U.S. entities; gains on the sale of U.S. securities; and 85% of Social Security benefits are also U.S.-sourced. These types of income are generally not effectively connected and are reported on page four of the Form 1040NR.

Nonresidents pay tax at 30%—or the treaty rate if lower—on not effectively connected income. Exemptions, adjustments, and itemized deductions do not reduce this income.

A nonresident person, as distinct from a nonresident business, is not taxed on interest paid by a U.S. bank or insurance company. Nonresidents are not taxed on gains on the sale of publicly traded U.S. securities if they are in the U.S. for less than 183 days in the relevant tax year. A student is likely to be taxed on a capital gain distribution from a U.S. mutual fund, even though he or she is a nonresident, because of this 183-day rule.

Dual-status aliens follow the nonresident income reporting rules during the period of nonresidency. They report worldwide income during the part-year residency period.

Ambrose enters the U.S. without benefit of a visa in June 2001. He subsequently earns $3500 in wages. Must Ambrose file a tax return?

Ambrose is a dual-status alien. He must file a tax return if he meets the filing requirements for either Form 1040NR or for a "short period" Form 1040.

A Form 1040NR is required if Ambrose has any income effectively connected with a U.S. trade or business, even if there is no net taxable income. This includes U.S. wages while a nonresident and everyone with a "J", "Q", "F", or "M" visa.

Ambrose must also file a Form 1040NR if insufficient tax was withheld on not effectively connected income.

Ambrose needs to file a Form 1040 if his worldwide gross income during the residency period exceeds the personal exemption amount.[2]

About the Author:

Peter James Lingane, EA, CFP practices in Lafayette, CA. His practice emphasizes planning and compliance for individuals, trusts, and estates. This article was stimulated by the author's experiences with the AARP Tax-Aide Program. Peter can be reached at peter@lingane.com or at (925) 299-0472.

Ambrose meets the last of these tests. Because he was a resident as of the end of the year, he files a Form 1040 reporting his wages and attaches a Form 1040NR or comparable statement indicating no U.S.-sourced income prior to residency.

The rules for splitting community income are largely ignored on the federal return if either spouse is a nonresident during the year.

Nonresidents and part-year residents are eligible for the §121 exclusion when selling a personal residence so long as they have not given up their citizenship or residency to escape U.S. income taxes. This exclusion is irrelevant for the nonresident who sells a home located outside the U.S. because the gain is not U.S.-sourced.

Adjustments to income are generally allowed for both nonresidents and part-year residents. The amount may be limited for married taxpayers by the requirement that they file separately. Adjustments are valueless for nonresidents without effectively connected income.

Nonresidents are generally denied the standard deduction. They are only allowed those itemized deductions which are related to effectively connected income. Nonresidents may deduct state income tax arising from wages, for example, but they are denied a deduction for state tax on dividend income. They are also denied itemized deductions for medical expenses, home mortgage interest, and personal property taxes.

Receipts from the rental of U.S. real property are not considered trade or business income. Consequently, deductions are not allowed for rental expenses on the Form 1040NR unless the nonresident elects to have the rental income reclassified as effectively connected income.[3]

Zachary, a nonresident, owns a vacation home in Florida which he rents a few months annually. Net rental income is zero. Must Zachary file a U.S. tax return?

Zachary must file a Form 1040NR unless tax was withheld on the rental receipts.

If Zachary elects to treat his rental as a U.S. business, there is no tax liability because the net rental income is zero. If Zachary neglects to file a timely return, his tax liability is based on the gross rental receipts because the effectively connected election is not allowed on a late return.[4]

Part-year residents are denied the standard deduction on the short period Form 1040 but they are entitled to the usual itemized deductions, even mortgage interest and real estate taxes on foreign residences.

Nonresidents are generally denied exemptions for their dependents.

Part-year residents are entitled to this exemption during the residency period. But dependents only qualify if they are citizens or residents of the U.S., Mexico, or Canada.

Husband and wife are dual-status aliens. They support two daughters who are college students in Hong Kong. Do the children qualify as their dependents?

The daughters are dependents if they were residents at some time during the calendar year.[5] If the children came to the U.S. and were issued Green Cards or gained residency under the substantial presence test, they are dependents. If the children have never been in the U.S., they are not dependents.[6]

Dual-status aliens pay tax at the usual graduated rates on income received during the residency period less the personal exemption and any adjustments, itemized deductions, and dependency exemptions.

Nonresidents and part-year residents are denied the Earned Income, Education, and Elderly Credits. This is a disadvantage for low income taxpayers.

Nonresidents and part-year residents are allowed the Child Tax Credit and the Child Care Credit but these credits are often disallowed in practice because the qualifying individual is not a dependent or because the taxpayer is filing separately.

Determining U.S. Residency

One establishes U.S. residency for income tax purposes on gaining a "Green Card" or by staying in the U.S.[7] long enough.

"Long enough" is determined by the substantial presence test. This test, which is well described in Publication 519, looks for 183 days in the U.S. during the past 3 years. Some days are counted, days in prior years are discounted, and some days are excluded. A regular commuter from Canada or Mexico does not count these days; crew on a foreign vessel do not count days in U.S. waters; changing planes in the U.S. does not count, but having a meeting at the airport between planes does; and someone with a medical condition might not have to count every day that he or she is in the U.S.

The substantial presence test does not count days when one is an exempt individual. Teachers, trainees, or students with a "J", "Q", "F", or "M" visa are exempt if they substantially comply[8] with their visa requirements. An accompanying spouse and unmarried child(ren) under age 21 might also be exempt.

One establishes ***U.S. residency for income tax purposes*** on gaining a "Green Card" or by staying in the U.S. long enough.

A woman entered the U.S. in October 1999 on an F-1 student visa. She left a husband and children at home in Mongolia. She worked at every job she could find because she said, "I am from a poor country." She earned $12,000 during 2001 and her W-2s showed withholding for FICA taxes. What is this woman's residency status?

A student is generally a nonresident and files Form 1040NR. However, this assumes that the student doesn't overstay his or her visa or accept unauthorized employment.[9]

Because this student accepted unauthorized employment, she is not exempt. At the same time, because she has been in the U.S. long enough, she is taxed as a U.S. resident. A student may have a lower tax liability by not complying with INS rules!

Travel in and out of the country complicates the substantial presence test, especially if the traveler maintains close ties with a foreign country.[10] Travel also affects the date from which residency is measured.

Because of these complications, the vignettes are limited to Green Card holders and to those who are in the U.S. without a visa or who have violated their visa.[11] I'm also going to assume that an immigrant stays in the U.S. after coming here.

If an immigrant becomes a resident under the substantial presence test, the residency starting date is the first day that they are present in the U.S. during that calendar year, assuming no travel in and out. An immigrant who enters the U.S. before July 2 will usually accumulate the 183 days needed for residency by year's end. He or she will be a nonresident before the immigration date and a resident thereafter.

An immigrant who enters the U.S. after July 1 cannot accumulate enough days for residency until the following year. They will be a nonresident in the immigration year and a resident as of January 1 the following year.

If an immigrant has a Green Card, the residency starting date is generally the latter of the date of entry or the date when the Green Card is issued. An immigrant with a Green Card is a dual-status alien in the immigration year unless he or she happens to enter on January 1.

If the immigrant meets the substantial presence test in the same year that the Green Card is issued, residency begins on the entry date if this is earlier than the Green Card date.

Charlie comes to the U.S. on April 1 and is issued a Green Card on June 1. What is his residency starting date?

Charlie satisfies the substantial presence test during the immigration year and is, therefore, a resident as of April 1, the earlier of the first entry or the Green Card dates.

One generally ceases to be a resident on the day after leaving the U.S. for the last time in the calendar year if one has a closer connection to a foreign country after leaving the U.S. and if one is not in the U.S. during the following year.[12]

Charlie abandons his Green Card and leaves for home on October 1. He returns for a holiday and departs again December 29. What is his residency termination date?

Charlie is a nonresident effective with the day after he leaves the U.S. for the last time. His final day of residency is, therefore, December 29.

The First-Year Election

Someone who enters the U.S. without a Green Card does not become a resident until he or she has been in the U.S. long enough to satisfy the substantial presence test. If entry is after July 1, residency cannot be established until the following year, at the earliest.

The first year choice[13] allows new arrivals to backdate residency to the year before the substantial presence test is satisfied. To be eligible for this election, they must enter the U.S. before December 2 and they must meet the substantial presence test in the following year.

An immigrant making this election is a dual-status alien in the immigration year and the period of residency is measured from the date of entry into the U.S., assuming no travel or other complications.

ELECTIONS MAKE QUICK WORK OF NONRESIDENT RETURNS

The mother of a U.S. person enters the U.S. in October on a visitor's visa but does not leave at the end of the visa period. The mother has no income and the U.S. person is her sole support. Does the mother qualify as a dependent in the year of entry?

The answer hinges on when the mother is a U.S. resident at the end of the year. The mother entered the U.S. after July 1 and she would normally become a resident, and a dependent, on January 1 of the year following entry.

The mother can elect the first year choice because she was in the U.S. 31 days or more in the year of entry and because she will satisfy the substantial presence test in the following year. With this election, she qualifies as a dependent in the entry year.

The first year choice can't be elected until the individual has been in the U.S. long enough to satisfy the substantial presence test. Since it is mathematically impossible to satisfy the substantial presence test prior to the April filing deadline, the return should be prepared on the basis of the first year choice; the tax liability should be paid by April 15; the time to file should be extended; and the taxpayer should be advised[14] to file the return on or after July 1.

How does the mother in the prior vignette elect the first year choice since her income is so low that she is not required to file a tax return? It may be acceptable to attach the election declaration to the return on which the mother is claimed as a dependent.

A parent may elect the first year choice for a dependent child if the parent is qualified to make an election on their own behalf, if the child qualifies for the election, and if the child is not required to file an income tax return for the year for which the election is to be effective. A dependent child for this purpose is a son or daughter (or a descendant of either), or a stepson or stepdaughter, and the usual requirement that a dependent be a resident or citizen does not apply.[15]

Full-Year Residency Elections

These elections require:

- Marriage to a U.S. citizen or U.S. resident as of the end of the year.
- A joint tax return reporting worldwide income for the year of the election.
- The same format.[16]

Neither spouse can make either election a second time, even if they remarry following the death of their spouse.

The election under §6013(h) allows a dual-status alien to be treated as a U.S. person during the dual-status year. Dual-status couples can make this election if both are residents as of the end of the year.

The election under §6013(g) is broader in that it applies to a nonresident spouse, even a spouse who lives outside the U.S., and the election remains in force until death, divorce, or revocation by the taxpayer or by the IRS. (The election is suspended in any year neither spouse is a U.S. person.) Although a joint return is required in the election year, separate returns are allowed in subsequent years.

A husband is a U.S. person with $12,000 in worldwide income. His spouse lives in Ethiopia and has little income. What are his filing options?

This taxpayer can file separately. Alternatively, he and his spouse can elect to file jointly under §6013(g). Filing jointly may require the nonresident spouse to obtain a tax identification number.[17] Filing jointly produces the lower federal tax liability.

State filing options may be different.[18]

Elections can be combined with powerful effect. Let's extend a prior vignette.

A U.S. person is the sole support of his parents. His mother establishes U.S. residency and is properly claimed as a dependent on her son's tax return. How might the father be claimed as a dependent?

The son can probably claim both parents as dependents if his resident mother and nonresident father elect under §6013(g) to be treated as U.S. residents and if the parents' worldwide income is low enough to satisfy the gross income test and if the couple does not have a filing requirement.[19]

One spouse is a resident the entire year. The other spouse and their child enter the U.S. during the year. What are the federal filing options?

The couple may elect to file jointly under §6013(g).

Absent this election, the resident spouse may file separately, or as head of household if the child lived with the resident spouse in the U.S. for at least half the year. (The resident spouse is considered unmarried for head of household purposes, even if they live with their spouse, because their spouse is a nonresident alien.)

Absent this election, the immigrating spouse files a dual-status return separately or a nonresident return separately depending on his or her residency status at year's end.

Travel in and out of the country complicates the substantial presence test, especially if the traveler maintains close ties with a foreign country.

Travel also affects the date from which residency is measured.

Who can claim the child in the previous vignette?
The child qualifies as a dependent if he or she is a resident of the U.S., Canada, or Mexico at some time during the year and if the other dependency tests are satisfied.

- The child can be claimed as a dependent by the resident spouse if the resident spouse, filing separately, provided more than half the support.
- The child can be claimed by the immigrating spouse, but only on the short period Form 1040, if the immigrating spouse provided more than half the support.
- The child may be claimed as a dependent if the parents elect to file jointly and if either or both parents provided more than half the support.

A couple and their high school aged daughter immigrated to the U.S. in March 2001. All have Green Cards. The parents earned $3,000 during 2001 before coming to the U.S. One spouse earned $8,000 and the other $6,000 after coming to the U.S. These wages are not community property. What is the best federal filing strategy?
If this couple elects to be taxed as U.S. residents rather than as dual-status aliens, they file a Form 1040 reporting worldwide income for the entire year. This approach entitles them to a $1,727 refund, plus any federal tax withheld, as shown by the computations in the "Residency Election" column of **Table 1**.

TABLE 1 Federal Options for Low Income Immigrants

	Residency Election	Dual-Status Spouse 1	Dual-Status Spouse 2
Filing Status	MFJ	MFS	MFS
U.S. Wages	14,000	8,000	6,000
Non-U.S. Wages	3,000		
AGI	17,000	8,000	6,000
Deductions	(7,600)		
Exemptions	(8,700)	(5,800)	(2,900)
Taxable Income	700	2,200	3,100
Tax Liability	107	332	469
Rate Reduction Credit	(35)	(110)	(155)
Earned Income Credit	(1,799)		
Tax Due	**$1,727 refund**	**$536 combined balance due**	

They could exclude the non-U.S. income from the joint return, as will be demonstrated in a subsequent vignette, but they would be unwise to do so because claiming the exclusion means that they forfeit the Earned Income Tax Credit.

Without an election to be treated as U.S. residents, each parent files as a dual-status alien. Filing as dual-status aliens produces a combined $536 balance due, less any federal tax withheld.

Electing to file as U.S. residents reduces the federal income tax by more than $2,000. This is a huge sum to a low income couple.

With or without the residency election, their daughter qualifies as a dependent because she is a U.S. resident for some part of the year.

Splitting Community Income

If someone is domiciled in a community property jurisdiction, their wages are generally community income. (You are a resident of the place where you live and domiciled in the place to which you intend to return.) Someone in the U.S. on a temporary visa is probably domiciled outside the U.S. Wages are probably not community income unless the individual happens to be from a community property jurisdiction such as France, Mexico, Spain, or the Philippines.

An immigrant, almost by definition, plans on remaining in the country he or she has come to. Wages of an immigrant to a community property jurisdiction such as California are generally community income.

The rules for community income are modified for federal income tax purposes when one or both spouses are nonresident aliens for part of the year.[20] Basically, wages are the separate property of the wage earner. California has not conformed.

California Return

Almost everyone, other than out-of-state military personnel, who is in California is considered a California resident.

Immigrants are generally California residents from the day they arrive. There is no waiting period or Green Card test and no visa or treaty considerations.

California residents are taxed on worldwide income. The tax liability of a part-year California resident is the tax on worldwide income reduced by the ratio of California-sourced AGI to worldwide AGI. Beginning in 2002, the reducing ratio is California-sourced taxable income to worldwide taxable income.

California generally allows all deductions and credits when computing the California tax on worldwide income.

The filing status on the California return must generally be the same as the status on the federal return.[21] That is, non-U.S. residents and part-year U.S. residents generally file separately if they are married and single if they are unmarried.

If a non-U.S. resident or dual-status alien elects to file a joint return with a U.S. resident spouse, he or she would normally file jointly for California under the same filing status rule. However, a California resident may file separately even if he or she elects a joint federal return so long as their spouse is a nonresident with no California-sourced income. This means no California wages, no income from California real estate, and, generally, that the resident spouse is not domiciled in California.

A couple and their dependent child immigrate to the U.S. They are not in the U.S. long enough to become residents during the immigration year but they are U.S. residents during the second year. What are their California filing options?

The first option is for each adult to file a nonresident federal return and a part-year resident California return using the Separate filing status.

Alternatively, if either spouse entered the U.S. before December 2, that spouse can elect the first year choice and will be treated as a dual-status alien in the immigration year. Since, because of the first year choice, one spouse is a U.S. resident at the end of the immigration year, both spouses can then elect to file a joint Form 1040 (and a joint California Form 540NR) for the immigration year.

Exclusion of Foreign Income

A married couple enters the U.S. and California on October 1, 2001. They have Green Cards. They are dual-status aliens and part-year California residents.

Income was $60,000 before entering the U.S. Each spouse earned $10,000 in wages after coming to the U.S.

What is the best filing strategy?

The couple could file separately as dual-status aliens or they could elect to be taxed jointly as U.S. residents.

TABLE 2 Exclusion of Foreign Income

	Dual-Status, Spouse 1	Dual-Status, Spouse 2	Residency Election
Filing Status	MFS	MFS	MFJ
U.S. Wages	10,000	10,000	20,000
Non-U.S. Wages			60,000
Form 2555 Exclusion[22]			(60,000)
AGI	10,000	10,000	20,000
Deductions			(7,600)
Exemptions	(2,900)	(2,900)	(5,800)
Taxable Income	7,100	7,100	6,600
Tax Liability	1,069	1,069	994
Rate Reduction Credit	(300)	(300)	(330)
Federal Tax Liability	**$1,538 combined**		**$664**

California has no foreign earned income exclusion but the non-U.S. income is discounted on the Form 540NR because it was earned prior to California residency. The couple's combined California tax liability is essentially unchanged if they elect to file a joint federal return.

TABLE 3 Effect of Residency on California Tax

	Dual-Status, Spouse 1	Dual-Status, Spouse 2	Residency Election
Filing Status	MFS	MFS	MFJ
Worldwide AGI	40,000	40,000	80,000
CA Standard Deduction	<2,960>	<2,960>	<5,920>
CA Taxable Income	37,040	37,040	74,080
Tentative Tax	1,603	1,603	3,214
Exemptions	<79>	<79>	<158>
Tax on Worldwide AGI	1,524	1,524	3,056
CA-sourced AGI	10,000	10,000	20,000
Reduction Ratio	0.2500	0.2500	0.2500
California Tax Liability	**$762 combined**		**$764**

The combined federal and California tax liability is less if they elect to be treated as U.S. residents.

Treaty Benefits

A Canadian entered California on May 1, 2001 with a temporary H-1 visa. The substantial presence test makes him a U.S. resident effective with his date of entry. He is also a Canadian citizen.

Article IV of the U.S.-Canadian income tax treaty says that a dual resident is treated as a Canadian resident if Canada is his permanent home. (There is a similar provision in the U.S.-Mexico treaty.)

This taxpayer earned $20,000 before coming to the U.S. and $60,000 while in California. His wife remained in Canada where she earns $20,000 annually. He paid $4,000 in California income tax withholding on his wages and the couple paid $10,000 in mortgage interest and property taxes on their home in Canada.

What is the best filing option for this couple?

The U.S.-Canadian treaty allows the husband to file as a non-U.S. resident. This would mean a Form 1040NR, Married Filing Separately, one personal exemption, California tax as the only itemized deduction, and no splitting of community income.

A taxpayer may choose to claim or not to claim treaty benefits.[23] Thus, another option is for the husband and wife to elect to be treated as U.S. residents for the entire year pursuant to §6013(g). The residency election substantially lowers their federal tax liability because they can exclude their Canadian wages,[24] claim mortgage interest and property tax[25] for their home in Canada, and benefit from joint tax rates and two personal exemptions.

TABLE 4 Effect of Treaty Provision

	Treaty Provision	Residency Election
Filing Status	MFS	MFJ
U.S. Wages	60,000	60,000
Foreign Wages		40,000
Form 2555 Exclusion		(40,000)
AGI	60,000	60,000
Deductions	(4,000)	(14,000)
Exemptions	(2,900)	(5,800)
Taxable Income	53,100	40,200
Tax Liability	11,784	6,034
Rate Reduction Credit	(300)	(600)
Federal Tax Liability	**$11,484**	**$5,434**

A third option is for the husband to ignore the treaty provision and to file separately as a dual-status alien. This option is not attractive.

If the couple elects a joint federal return, they would normally file a joint, part-year California return reporting $100,000 worldwide AGI; $74,000 California-sourced AGI; and $10,000 in itemized deductions.

TABLE 5 California Filing Options

	Jointly	Separately
Filing Status	**MFJ**	**MFS**
Worldwide AGI	100,000	80,000
CA Deductions[26]	<10,000>	<5,000>
CA Taxable Income	90,000	75,000
Tentative Tax	4,675	5,128
Exemptions	<158>	<79>
Tax on Worldwide AGI	4,517	5,049
CA-sourced AGI	74,000	60,000
Reduction Ratio	0.7400	0.8000
California Tax Liability	**$3,343**	**$4,039**

The husband may also file his part-year California return separately because his wife was a California nonresident for the entire year and she had no California-sourced income. (The husband's wages are not community income because he is not domiciled in California.) The California tax is somewhat higher if he files separately.

Gift and Estate Tax

Resident aliens file gift and estate tax returns under the same rules as U.S. citizens. Residency is not determined using the Green Card or substantial presence tests.

A "resident" decedent is a decedent who, at the time of his death, had his domicile in the U.S.... A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.[27]

Gift and estate taxes for nonresidents differ from the taxes for U.S. persons as follows:

- The gross estate includes all tangible and intangible property located in the U.S. Stocks and bonds issued by the U.S. and its political subdivisions; by U.S. corporations, partnerships, and trusts; and by U.S. citizens are considered property located in the U.S.[28] Life insurance proceeds, deposits in U.S. banks and

life insurance companies, certain tax exempt debt, and certain works of art are not included in the U.S. gross estate.

- Nonresidents are allowed the same deductions for administrative expenses, taxes, and indebtedness as are U.S. persons, but the deduction is limited by the ratio of the decedent's U.S. gross estate to their worldwide gross estate.
- Nonresidents are allowed deductions for charitable bequests if the donated property is included in the decedent's U.S. gross estate.
- Nonresidents are allowed the unlimited marital deduction if the surviving spouse is a U.S. citizen or becomes a citizen by the due date (including extensions) of the return or if the assets are left to a qualified domestic trust for the benefit of the surviving spouse or if the relevant treaty says so.
- Nonresidents are generally allowed a $13,000 credit against estate tax but check the treaty provisions. This corresponds to a $60,000 applicable exclusion amount, which is much smaller than the $1 million currently allowed U.S. persons. The filing requirement is generally a U.S. gross estate in excess of $60,000.

U.S. gift tax applies to a nonresident's gift of real estate or personal property located in the U.S. Stocks and bonds issued by U.S. citizens, corporations, and political subdivisions are considered property situated in the U.S.

The taxable gift is the value of the gift less the annual exclusion for gifts of a present interest. The annual exclusion is generally $10,000 but it is unlimited if the donee is a U.S. citizen spouse. (The exclusion is limited to $100,000 annually if the donee spouse is not a citizen.[29]) These amounts are adjusted for inflation and equal $11,000 and $110,000 respectively for calendar year 2002.[30]

The applicable exclusion amount does not apply to gifts by nonresidents.[31]

A nonresident who makes a gift of U.S. securities must pay gift tax on any value over the annual exclusion. It is often better to sell the securities and to gift the cash proceeds because any gain on the sale will generally be free of U.S. income tax. Cash gifts are not subject to U.S. gift tax and the donee gets a stepped-up basis. For similar reasons, there may be an incentive for a wealthy nonresident to liquidate U.S. securities when he or she becomes terminally ill.

For additional information

This article is not a complete discussion of the taxation of nonresidents and probably contains inadvertent errors. Confirm the conclusions herein with the referenced sources.

The IRS operates a hotline at (215) 516-2000 #1 #3. The call is not toll-free and the quality is uneven but the wait is short.

The tax treaties are available at the IRS Web site—www.irs.gov. Search on "treaty." **EA**

Footnotes

1. If the dual-status taxpayer is a resident at the end of the year, as in the year of immigration, he or she files a Form 1040 reporting worldwide income during the period of residency and a statement (Form 1040NR will serve this purpose) reporting U.S.-sourced income during the period of nonresidency.
   If the dual-status taxpayer is a nonresident at the end of the year, as in the year of emigration, the tax return is the Form 1040NR and the Form 1040 is the statement.

2. IRC §§6012(a) (1) (A) and 6012(a) (1) (C) (ii). The filing threshold for U.S. persons is generally the sum of the personal exemption and the standard deduction. See IRS Publication 17, Table 1-1.
   IRC §6012(c). Gross income is computed before the §121 exclusion of gain on the sale of a personal residence and before any exclusion of foreign income.

3. IRC §871(d)

4. IRC §874(

5. IRS Reg. 1.152-2(a) (1); Pub. 17, Fig. 3-A.

6. Rezazadeh v. Comm., 17 AFTR 2d 416 (356 F.2d 898), 03/01/1966. Children were granted lawful permanent residency status but they never came to the U.S. The Seventh Circuit Court of Appeals concluded that the children were not U.S. residents and upheld the denial of the dependency exemption.

7. The term "U.S." is defined as the 50 states, the District of Columbia, U.S. territorial waters, and the seabed over which the U.S. has exclusive mining rights under international law. The term does not include U.S. territories or possessions or U.S. airspace.
   This definition means that someone whose plane lands in St. Louis shortly after midnight is present in the U.S. from the day that they arrive while someone whose boat docks in New York shortly after midnight is present in the U.S. from the day before they arrive.
   One day more or less could affect eligibility for the EITC or the dependency exemption.

8. Reg §301.7701(b)-3. "An individual ... will be deemed to comply substantially with the visa requirements relevant to residence for tax purposes if the individual has not engaged in activities that are prohibited by the Immigration and Nationality Act and the regulations thereunder and could result in the loss of F, J, or M visa status. An individual will not be deemed to comply substantially with the visa requirements relevant to residence for tax purposes merely by showing that the individual's visa has not been revoked. An independent determination of substantial compliance may be made by the Internal Revenue Service... For example, if an individual with an F visa (student visa) is found to have accepted unauthorized employment or to have maintained

Nonresidents and part-year residents are denied the Earned Income, Education, and Elderly Credits. ***This is a disadvantage for low income taxpayers.***

a course of study that is not considered by the IRS to be full-time, the individual will not be considered to comply substantially with the individual's visa requirements regardless of whether the individual's visa has been revoked."

9. If a nonresident alien is granted permission to work on campus or for educational or hardship reasons, this is noted on the student's Arrival-Departure Record or on other INS documentation. As discussed in Pub. 519 Chapter 8, students are exempt from the withholding of Social Security and Medicare taxes when holding authorized employment. While not a foolproof indicator, the withholding of Social Security taxes should alert the preparer to ask about unauthorized employment.

10. If an individual can establish a closer presence with a foreign country and if he or she is in the U.S. less than 183 days, they file Form 8840 to be treated as a nonresident.

11. For visa requirements, see http://travel.state.gov/visa_services.html#niv or call (202) 663-1225.

12. §7701(b) (2) (B). Reg. §301.7701(b)-8 says that a filing is required by the due date of the tax return to establish a residency termination date.

13. IRC §7701(b) (4). To make the election, a signed statement is filed with the tax return declaring that:

- The taxpayer is making the "first-year election" for the current year.
- The taxpayer was not a resident in the previous year.
- The taxpayer is a resident under the substantial presence test in the following year.
- The number of days in the U.S. in the following year.
- The dates of a 31-day period of continuous presence in the U.S. in the current year. Because of this requirement, someone who enters the U.S. after December 1 is not eligible for the election.
- The dates of absence from the U.S. during the current year that are treated as days of presence.

One must remain in the U.S. 75% of the time after the beginning of the 31-day continuous presence to be eligible for the first-year election but one can treat up to 5 days of absence as days of presence. Suppose someone comes to the U.S. November 1, departs 31 days later on December 1, returns on December 20 and remains for the rest of the year. This individual is in the U.S. 43 days or 70% of the days from the beginning of the 31-day continuous interval. This fails the 75% test.

If 5 days of absence are reclassified as days of presence, the individual is in the U.S. for 48 days or 78% of the time, thereby satisfying the 75% test. Most low income immigrants meet the 75% test without having to reclassify any days.

- Taxpayer's name, address, and Social Security or tax identification number.

If the election is being made on behalf of dependent children, the statement must also include this information with respect to those children.

14. The substantial presence test will be satisfied sometime in the period between May 1 and late June, the exact date depending on the date of entry to the U.S. There is nothing to be gained by filing before July 1 if the tax liability was paid in April.

15. Reg. §301.7701(b)-4(c) (3) (v) (B).

16. Reg. §1.6013-6(a)(4) says that the elections are made by attaching a statement to the joint return, signed by both spouses, to the effect that one spouse is a nonresident alien and that the other is a U.S. citizen or resident and that both spouses elect to be taxed as residents. Include the names, addresses, and tax identification numbers of both spouses.

The election could be denied if the required statement is not attached to the return. However, this defect is easily remedied since either of these elections can be made on an amended return.

17. It is best to apply for the ITIN in person. If the applicant is outside the country, the Form W-7 and required documentation should be forwarded to the U.S. spouse for delivery to an IRS office in the U.S. It is prudent to extend the time for filing any tax return requiring a new ITIN.

The IRS revised Form W-7 in December 2002.

18. California requires a joint nonresident return because the nonresident spouse has California-sourced community income by virtue of her husband being domiciled in California.

19. Filing a joint return, when income is below the filing threshold, is considered a claim for refund rather than a tax return. See Rev. Rul. 65-34. Thus, the joint return test is inoperative.

The IRS might consider a joint return filed pursuant to a §6013(g) election as a tax return even if the gross income is below the filing threshold. In this case, neither parent would qualify as a dependent in the election year but both would qualify in subsequent years when no joint return is required.

20. IRC §879. See also IRS Pub. 519 and PLR 9104001. The private letter ruling concludes that the community property rules do not apply during the period of residency in a dual-status year. While such rulings are not binding in other situations, this ruling is drafted with a very confident tone.

21. CA Rev & Tax §18521. The exceptions are when an incorrect status was used on the federal return, certain military personnel, and when one spouse is a nonresident with no California income.

FTB Legal Ruling 95-1 addresses the California filing status of dual-status aliens.

22. Each spouse may exclude $78,000 of foreign income times the ratio 297/365, where 297 is the number of days in the qualifying period. The "qualifying period" is any continuous 12-month period beginning or ending in the tax year during which the taxpayer is outside the U.S. for 330 full days.

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ELECTIONS MAKE QUICK WORK OF NONRESIDENT RETURNS

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The 12-month period ending October 24, 2001, the 297th day of the calendar year, was chosen as the qualifying period because this provides the largest overlap with the 2001 tax year and hence the largest exclusion limit. Taxpayers were outside the U.S. for 330 full days from October 25, 2000 through September 30, 2001.

See Pub. 54 and the Form 2555 Instructions for additional requirements.

Foreign wages are included on Line 7 of the Form 1040 and the exclusion is a negative entry on line 21.

The maximum exclusion increased to $80,000 in 2002.

23. Reg. §301.7701(b)-7(e). "Example (4). The facts are the same as in Example 3, except that C does not choose to claim treaty benefits with respect to any items of income covered by the treaty (i.e., she files as a resident). Therefore, she is taxed as a resident under the Code and pays tax at graduated rates on her personal services, income, dividends, and interest. In addition, she is entitled to deduct her mortgage interest expenses and to take personal exemptions for her spouse and three children. C will be entitled to file a joint return with her spouse if he is a resident alien for 1985 or, if he is a nonresident alien, C and her spouse may elect to file a joint return pursuant to Section 6013." A taxpayer can choose some treaty provisions and ignore others. There is no need to be consistent.

24. The nonresident spouse was outside the U.S. for the entire year and she may exclude all of her wages up to the $78,000 maximum exclusion. The resident spouse may exclude his Canadian wages but the maximum exclusion is reduced by the ratio 154/365. (The qualifying period was chosen to be June 4, 2000 through June 3, 2001, the 154th day of the current tax year, since this provides both 330 days outside the U.S. and the largest overlap with the current tax year.)

25. Pub. 54, Chapter 5.

26. An aggressive taxpayer would likely claim the full $10,000 when filing separately. An aggressive auditor would likely respond that his wife paid these expenses and would limit the husband to the California standard deduction.

27. Reg. §20.0-1(b) (1).

28. IRC §2511.

29. IRC §2523(i).

30. Rev. Proc. 2001-59, December 10, 2001.

31. IRC §2505.