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Spidell's Elder Client Letter

Tax issues for nonresident aliens (Part II)

TAX: Rates differ depending on whether the income is effectively connected to the U.S.

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It is important to distinguish between U.S. citizen and resident alien taxpayers (residents) and non-resident aliens (NRAs) who are required to report only U.S.-source income. Residency status is determined using the "green card" or substantial presence tests.¹

NRA income is either effectively or not effectively connected to the U.S., depending on whether it is derived from a U.S. trade or business. Revenue that is effectively connected is reported on Page 1 of Form 1040NR and can be reduced by personal exemptions and itemized deductions. Net taxable income is then subject to the same graduated tax rates currently in effect for U.S. residents.

Income that is not effectively connected is reported on Page 4 of Form 1040NR and cannot be reduced by exemptions and deductions. It is, in its entirety, subject to a flat tax of 30% (unless a lower treaty rate applies).²

Effectively connected income

One of two tests may be used to determine if income is effectively connected:

1. The asset-use test seeks to establish whether income is derived from assets used in the conduct of a U.S.-based business.
2. The business-activities test focuses on the activities of the U.S. business and whether these activities are a material factor in the realization of income.³

Income which is fixed, determinable or periodic — such as interest, dividends, rents, royalties and annuities — is, by definition, not effectively connected.

Effectively Connected (taxed at graduated rates)	Not Effectively Connected (taxed at 30% rate)
<ul style="list-style-type: none"> • Wages earned in U.S. • Nonqualified scholarships • Business income, including foreign-source income if fixed place of business in U.S. and produced in ordinary course of business • U.S. partnership income • Gains on sale of U.S. real estate and business assets • Pension income • Transportation income if fixed place of business in U.S. and 	<ul style="list-style-type: none"> • Interest income (subject to certain limitations, discussed later) • Dividends • Rental income • Royalty income • Capital gains (exempt if taxpayer in U.S. fewer than 183 days)⁵ • Social Security benefits (85% includable unless exempt under treaty)⁶ • Transportation income earned

at least 90% attributable to regularly scheduled transportation⁴

for travel that begins or ends in U.S. but does not meet fixed place and 90% tests (taxed at 4% flat rate)⁷

As you can see, several planning opportunities present themselves. For instance, because the NRA is taxed on capital gains only if present more than 183 days in the tax year, he or she may — prior to immigrating — sell all U.S.-sited assets to an offshore entity, realizing gains (and a stepped-up basis) not yet subject to U.S. taxation. The NRA could then sell the asset with its stepped-up basis in the year that he or she becomes a U.S. resident, avoiding most, if not all, taxable gains.

Since rental income is not effectively connected, it cannot be reduced by deductions typically applicable to the maintenance and management of rental property. Thus, the NRA is taxed on the gross rental revenue unless he or she elects to treat the rental income as effectively connected.⁸ He or she can then deduct rental expenses and would, therefore, be taxed only on net rental income.

Example: Manel is an NRA who owns a single-family house in the U.S. that she rents out. Since rental income is considered to be not effectively connected, it is subject to tax at a 30% rate. Manel receives Form 1042S, Foreign Person's U.S. Source Income Subject to Withholding, showing that her tenants properly withheld this tax from the rental income. She does not have to file a U.S. tax return because her U.S. tax liability is satisfied by the withholdings.

However, if Manel instead elects to treat the rental income as effectively connected, she can offset her revenues by allowable rental expenses. The resulting net income is then taxed at the usual graduated rates.

Income not deemed to be U.S.-source — and, therefore, non-taxable to the NRA — includes:

- Interest paid by a U.S. corporation, if at least 80% of the company's gross income is derived from sources outside the U.S.⁹ due to active conduct of business in a foreign country in the preceding three years;
- Interest income, if funds are deposited into a foreign branch of a domestic commercial bank;
- Corporate dividends received from a foreign corporation, if more than 25% of the company's gross income is effectively connected with business in the U.S.;¹⁰
- Gain on sale of personal property, including furniture and equipment, as long as the taxpayer's tax home is not in the U.S.;
- Revenues from the sale of inventory are sourced where the property is sold regardless of where the items were originally purchased, but can be pro-rated if the items were produced in the U.S. and sold abroad;¹¹
- Gain on sale in excess of allowable depreciation can be pro-rated based on the amount of the depreciation taken in the U.S. versus abroad;¹² and
- Personal service compensation received for work performed outside the U.S. However, personal service income received for work performed in the U.S. must be pro-rated based on the percentage of time worked in the U.S. and included in U.S.-source income.

Example: Jean, an NRA, is a professional hockey player with a U.S. hockey club. Under Jean's contract, he received \$98,500 for 242 days of play during the year. This includes days spent at pre-season training camp, days during the regular season, and playoff game days. Of the 242 days, Jean spent 194 days performing services in the U.S. and 48 days playing hockey in Canada. Jean's U.S.-source income is figured as follows: $(194 \div 242 \text{ days}) \times \$98,500 = \$78,963$.

Although U.S.-source, certain income is nevertheless excludable from the NRA's taxable income:

- Interest income received on deposits with U.S. banks, credit unions, and insurance companies, if it is not effectively connected with the conduct of a U.S. trade or business;¹³
- Interest that is not "original issue discount," resulting from the excess of a debt instrument's value at maturity over its issue price;¹⁴
- Interest from state or local bonds, unless private activity municipal bonds;¹⁵
- Portfolio interest, unless the NRA recipient is a large shareholder who owns more than 10% of the outstanding stock;¹⁶ and
- U.S.-source employee compensation, if the NRA worked for a foreign company, was only temporarily present in the U.S. for periods not exceeding a total of 90 days during the taxable year, and the wages received were less than \$3,000 in total.¹⁷

Tax deductions for NRAs

Unlike U.S. residents, NRAs are not entitled to claim the standard deduction and must, therefore, itemize. (Strangely, students and business apprentices from India may use the standard deduction!)¹⁸

Since all allowable deductions must be related to effectively connected income,¹⁹ state, local, and real estate taxes paid may be deducted, but medical, personal property taxes, and mortgage interest may not. On the other hand, items that may be deducted include charitable contributions to qualified U.S. (not foreign) organizations, casualty losses and unreimbursed employee expenses.

Additionally, an NRA may make contributions to IRAs and other qualified retirement plans under the same rules which apply to U.S. residents.

An NRA may claim moving expenses for coming to the U.S. under the same rules applicable to U.S. residents, but may not deduct the expenses related to a move which returns the NRA to his or her foreign home.

In other words, incoming moving expenses are deductible and outgoing expenses are not. The NRA may deduct student loan interest and even penalties on early withdrawals of savings if the interest income is effectively connected.²⁰

Tax credits for NRAs

NRAs with effectively connected income are eligible to claim only some of the credits available to U.S. residents, subject to certain restrictions. For example:

- Child and Dependent Care, Education, Adoption, and Earned Income credits may only be claimed by the married NRA if he or she elects to file jointly with a U.S. citizen spouse;²¹
- The Child Tax Credit may be claimed if the NRA has a qualifying child who is a U.S. citizen or resident and is claimed as a dependent on the tax return; and
- The Foreign Tax Credit may be claimed by the NRA for income taxes paid to a foreign

country on income from foreign sources which is effectively connected to the U.S.

About the author

Monica Haven, E.A., J.D., has a Masters in Taxation and decades-long experience as a solo practitioner with a burgeoning practice in Southern California. She is an alum and former faculty member of the National Tax Practice Institute, a recognized speaker on the "professional" circuit, and a guest lecturer on college campuses. Monica is also part-owner of an investment advisory firm and a practicing financial planner. Always eager to share her expertise, Monica may be contacted at mhaven@pobox.com. Her website is www.mhaven.net.

- ¹ IRC §7701(b)(1)
- ² IRC §871(a)
- ³ Treas. Regs. §1.864-4(c)(1)(i)
- ⁴ IRC §863(c)(2)(A)
- ⁵ IRC §871(a)(2)
- ⁶ IRC §871(a)(3)
- ⁷ IRC §887(c)
- ⁸ Treas. Regs. §1.871-10(d)(1)(ii)
- ⁹ IRC §871(i)(2)(B)
- ¹⁰ IRC §861(a)(2)
- ¹¹ IRC §865(b)
- ¹² IRC §865(c)
- ¹³ IRC §871(a)(1)(A)
- ¹⁴ IRC §1273
- ¹⁵ IRC §103
- ¹⁶ IRC §861(h)
- ¹⁷ IRC §861(a)(3)
- ¹⁸ Article 21(2) of the U.S.-India Income Tax Treaty
- ¹⁹ IRC §873(a)
- ²⁰ Reg. §1.882-5
- ²¹ IRC §6013(g)

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