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From: Steve Leimberg's International Tax Planning Newsletter
Subject: The *International Quarterly* by Scott Bowman & Marianne Kayan: A New Year's Guide to US Income Tax Residency for the Global Client

LISI is pleased to announce a new addition to the family: our "*International Quarterly*." It is no secret to **LISI** members that global trends are increasingly requiring estate planning professionals to become better versed in the complex cross-border issues clients face. To help members sharpen their skills and stay up to date, authors **Scott A. Bowman** and **Marianne R. Kayan** will provide members with four annual installments covering interesting developments, hot topics, planning techniques and fundamentals in the area of international estate planning. Scott and Marianne invite you to test your "IQ" with any questions or topics you would like to see addressed in their commentary. We look forward to many more editions of *International Quarterly* to come.[i]

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Marianne Kayan is a member of **EY's National Tax Department's Private Client Services** practice. She currently co-chairs the International Tax Planning Committee of the ABA RPTE Section and is a board member of STEP Mid Atlantic. In 2014, she co-authored the chapter on *International Compliance Considerations for the Individual Client* in the treatise A Guide to International Estate Planning, published by the ABA RPTE Section. For EY she annually co-authors the U.S. chapter of the Worldwide Estate and

Inheritance Tax Guide and the income tax publication the Ernst & Young Tax Guide. Marianne received her B.A. in Business and Economics, Accounting emphasis from Hendrix College, J.D. from the University of Arkansas at Little Rock Bowen School of Law, and LL.M in Taxation with a Certificate in Estate Planning from Georgetown University Law Center. Marianne is based in EY's Washington, DC office.

Here is their commentary:

EXECUTIVE SUMMARY:

While 2016 marks the start of a new year, for US advisors with global clients, it also marks the opportunity to become reacquainted with the many US income tax rules that impact these clients. As clients begin to track their days of US presence in 2016, advisors have the opportunity to learn about new laws as well as to refresh our understanding of the technical US income tax residency rules.

For example, when an individual is commencing or terminating US residency, careful consideration of the US day-count ramifications is warranted. Individuals who frequently travel to the US, whether for business, temporary work assignments, or extended vacations, may unintentionally become "US residents," subject to the US worldwide tax net and information reporting regimes. Additionally, certain long-term green card holders who terminate residency may be subject to the US exit tax when they leave the US. Careful planning is imperative to ensure a client understands the implications of a residency change. This newsletter discusses some of the top issues that practitioners need to be aware of in order to advise their global clients on US income tax residency rules.

COMMENT:

There is a critical distinction in the US tax law between a US resident and a non-US resident ("NRA"). The US taxes the worldwide income of US citizens and residents, regardless of source.[ii] The US also subjects them to extensive informational reporting requirements, including the obligation to report certain foreign assets to the IRS, often adding substantial financial and administrative burdens. In contrast, the US only taxes an NRA on US source income and imposes no informational reporting obligations.[iii]

An individual who is not a US citizen is treated as a US resident if such individual meets the requirements of one of the following objective tests: (1) the green card test;[iv] (2) the "substantial presence test" ("SPT");[v] or (3) by affirmatively electing to be treated as a US resident.[vi]

If an individual is a US resident under either the green card test or the SPT, then such individual may be able to claim NRA status by applying the statutory "closer connection exception" or by claiming to be a non-US resident under an applicable income tax treaty – each having different tax and informational return obligations.

Green Card Test

Generally, the residency start date for an individual with a green card ("green card holder") is the first day during that calendar year that the person spends in the US as a lawful permanent resident.[vii] However, if the individual also satisfies the SPT, then the residency start day for the first year of residence is the earlier of the first day the individual is physically present in the U.S. as a lawful permanent resident or the first day during the year that the individual is present for purposes of the SPT.[viii]

Long-term residents of the US need to be aware that if they cease to be a US resident, an exit tax may apply.[ix] Generally, a long-term resident is an individual who held a green card during any part of 8 or more of the past 15 tax years. If the residency ceases by relinquishment or revocation of the green card or by invoking an applicable treaty tie-breaker provision, but not mere expiration of a green card, the expatriation exit tax[x]applies if the person is a "covered expatriate."[xi]

To determine the 8 years for long-term resident status, use a calendar year, e.g., Year 1 A obtains a green card on December 1, holds for 6 full years, and then relinquishes green card on January 15 of Year 8, this person is considered a long-term resident for purposes of the exit tax. However, it is possible for an individual to exclude year(s) for purposes of the long-term resident test if the individual was properly treated as a resident of a foreign country under an applicable treaty tie-breaker provision.[xii] Exclusion of years is available as long as an individual has not already met the 8-year threshold. Use of a treaty-tie breaker provision requires careful planning and execution to avoid unintended tax and immigration consequences, including expatriation.[xiii]

A long term green card holder who relinquishes his or her green card will be a "covered expatriate" for exit tax purposes if the individual falls within: (1) the tax liability test ("average annual net income tax" for the five taxable years ending before the expatriation date is more than $161,000 (as adjusted for inflation in 2016); (2) the net worth test (net worth exceeds $2 million); or (3) the tax compliance test (fail to certify under penalties of perjury 5 years of US tax compliance).[xiv] Covered expatriates are subject to the exit tax, and US person beneficiaries of a covered expatriate's gifts or bequest are subject to the Section 2801 tax on the receipt of a covered gift or bequest, paying the highest marginal gift or estate tax rate on the transferred asset.[xv] As such, covered expatriate status presents significant tax exposure.

An individual who does not meet the definition of a long-term resident will not be subject to the exit tax. If a client is approaching the long-term residency threshold, counseling on action steps with an eye toward minimizing the exit tax burdens is proper. If a green card holder becomes a long-term resident, all hope of tax planning is not lost. A green card holder who would otherwise be considered a covered expatriate may have opportunities to mitigate the risk of being subject to the exit tax, e.g., including determination of an exception to the general rules, pre-expatriation gifting, basis analysis, determination of ownership in deferred compensation and nongrantor trusts.

Substantial Presence Test

The SPT is a days-counting exercise. A non-US citizen must closely monitor days of US presence, as US residency can occur unintentionally after a certain threshold of days of presence in the US is met. US residency under the SPT test generally treats an individual as present in the US beginning on the first day of US presence in a given calendar year – often creating partial year resident status in the US and another country.[xvi]

We commonly see individuals operate under the mistaken belief that they will not have to pay US income tax if they are in the US for less than half of the year. However, a non-US citizen is considered a US resident under the SPT if: (1) the individual was physically present in the US for at least 31 days during the current year; and (2) the sum of the days the individual was present in the US in the current and two preceding tax years equals or exceeds 183 days, calculated using a weighted average.[xvii]

The aggregate number of days an individual is present for determining US

residency in the current year is comprised of: (1) the total number of days of presence in the US in the current year; plus (2) one-third of the days in the US in the immediately preceding year; plus (3) one-sixth of the days in the US in the second preceding year.[xviii] If the calculation equals or exceeds 183 days, the foreign individual is considered to be a US resident in the current year.[xix]

An unofficial safe harbor exists that allows an individual to be present in the US for a maximum of 121 days each year without triggering residency under the SPT.[xx] The 121-day safe harbor is illustrated below.

Year	Actual Days of Presence	Multiplier	Days of Presence for SPT
Current Year	121	1	121
1st Preceding Year	121	1/3	40.33333
2nd Preceding Year	121	1/6	20.166667
Total			181.5 (under SPT, do not round fractional days to nearest whole number)[xxi]

However, as a result of the danger of miscounting, individuals seeking to avoid classifying as US residents are advised to avoid being in the US more than 120 days on an annual basis. Generally, to determine an individual's actual days of presence in the US, each day, including fractions of a day, an individual is present in the US is counted.[xxii] For example, if an individual enters the US on a US-bound flight at 11:50 pm on January 1, she must count January 1 as a day of presence.[xxiii] We recommend that our clients keep careful records of their US days in order to substantiate their SPT position.

There is an exception to the SPT for some teachers/trainees, students, professional athletes, or patients with a medical condition. Form 8843, "Statement for Exempt Individuals and Individuals with a Medical Condition," is used to exclude days of presence from counting toward the residency requirements based on the SPT.

Form 8843 must be filed with the individual's Form 1040NR or, if the individual is not required to file Form 1040NR, filed alone by the due date for filing Form 1040NR. Failure to timely file Form 8843 prevents professional athletes and individuals with a medical condition from excluding their days of presence. In contrast, this rule regarding failure to file does not apply to

teachers and students, and these individuals may be able to exclude days of presence in a particular year by filing a Form 8843 after the due date for the return.

Key considerations with respect to Form 8843 include: (1) exempt persons should file a timely Form 8843 if they intend to be treated as nonresident aliens; (2) teachers, trainees, and students are limited with regard to the total number of years they may claim to be exempt from the substantial presence test; and (3) individuals with a medical condition must consider whether their condition was preexisting prior to coming to the US. The medical exemption is only available to an individual who was prepared to leave the US and then became unable to leave due to a medical condition that arose while the individual was present in the US.

Closer Connection Exception

Individuals who are US residents under the SPT but are present in the US for fewer than 183 days in the current year, have a tax home in a foreign country, and have a closer connection to that foreign country than to the US may still be considered NRAs if they satisfy the closer connection exception.[xxiv] It is essential to note that the closer connection exception is not available if an individual exceeds 182 days of US presence in the current year.[xxv]

One's tax home is an elusive concept that requires examining the facts and circumstances of the taxpayer's life to determine the location of her "regular or principal place of business."[xxvi] If the individual has no principal place of business because of the nature of her business, then her "regular place of abode in the real and substantial sense" shall be considered her tax home.[xxvii] A tax home does not necessarily require an individual to be a tax resident of a particular country, but actually being deemed a tax resident of a country is a factor in favor of a finding that the foreign country is the taxpayer's tax home.

In addition to establishing a tax home in a foreign country for the current year, a foreign individual must also establish a "closer connection" to that foreign country than to the US.[xxviii] A closer connection is established if the individual maintains more significant contacts with a foreign country than with the US. For example, the Treasury regulations provide the following nonexclusive list of contacts to consider, including the location of the individual's:

(1) permanent home;

(2) family;

(3) personal belongings, such as automobiles, furniture, clothing, and jewelry owned by the individual and her family;

(4) social, political, cultural, or religious organizations with which the individual has a current relationship;

(5) banks with which the individual conducts her routine banking activities;

(6) business activities other than those that give rise to a tax home;

(7) driver's license;

(8) jurisdiction where the individual votes;

(9) country of residence designated by the individual on forms and documents; and

(10) official forms and documents filed by the individual with the US tax authorities.[xxix]

Foreign individuals treated as NRAs, because of the closer connection exception, have minimal US tax compliance requirements, unlike treaty-tie breaking which is discussed below. However, they will have to file Form 8840, *Closer Connection Exception Statement for Aliens,* for each year that they claim the exception. Form 8840 is filed separately if no Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, is required, or filed along with Form 1040NR if the individual has US source income. No US informational returns are required.[xxx]

Treaty Residency

Residency status can be determined or altered under an income tax treaty, if applicable. Individuals who are dual-resident taxpayers under the laws of the US and a foreign country with which the US has an income tax treaty in force may be treated as NRAs under treaty "tie-breaker" provisions. Generally, treaty tie-breaker provisions are similar to factors considered for the closer

connection exception, but the tie-breaker provisions of each treaty is unique.

A US resident must file Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, or a similar statement, along with Form 1040NR to claim the benefit of treaty tie-breaker provisions. This allows the individual to be treated as an NRA for purposes of computing US income tax, but unlike a closer connection exception, for all other purposes the individual will be considered a US resident and will be subject to foreign information reporting requirements applicable to US residents. Compliance with the various reporting requirements can be onerous for foreign individuals with substantial foreign assets. Therefore, if an exception is required, the preferable option is for an individual to use the statutory closer connection exception when available.

Conclusion

Managing green card status and days of presence in the US is imperative and failing to plan appropriately and counsel clients on the parameters to consider and the implications for commencing or terminating US tax residency can result in extreme time and economic expenditures. Remember these key tips when attacking residency issues:

(1) Direct clients to track days of US presence on an ongoing basis versus trying to piece the puzzle together at the end of the year; helpful tracking tools are available, but maintaining calendars and flight logs can be sufficient.

(2) Be sure you and your team understand the application of the 3-year weighted average under the SPT.

(3) Counsel green card holders on the ongoing income tax, information reporting, and possible exit tax burdens that come along with US residency.

(4) Remember that the closer connection exception to US residency under the SPT is more taxpayer favorable – primarily in removing informational reporting obligations – but requires more substantial connections to a foreign country.

(5) If the closer connection exception is not available to SPT residents, US income tax treaties provide tie-breaker exceptions to US residency that

minimize tax burdens, but do not remove informational filing obligations.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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[ii] Section 61 (2015); Treas. Reg. § 1.1-1(b). Unless otherwise noted, all references to "Code" or "Section" citations herein are references to the Internal

Revenue Code of 1986 and the Regulations thereto, as amended.

[iii] Sections 881, 882.

[iv] Section 7701(b)(1)(A)(i).

[v] Section 7701(b)(1)(A)(ii).

[vi] Section 7701(b)(1)(A)(iii).

[vii] Section 7701(b)(2)(A)(ii); Treas. Reg. § 301.7701(b)-4(a).

[viii]*Id.*

[ix] Very generally, the US exit tax applies a deemed sale regime on an individual's worldwide assets on the day prior to the expatriation date. Section 877A. For more information on the U.S. expatriation tax regime see Estate Planning Newsletter #2343 (September 14, 2015).

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[xi] Section 877A(g)(2).

[xii] Section 877(e)(2) "[A]n individual shall not be treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for the taxable year under the provisions of a tax treaty between the United States and the foreign country and does not waive the benefits of such treaty applicable to residents of the foreign country."

[xiii] Section 877(e)(2).

[xiv] Sections 877(a)(2), 877A(g)(1)(A).

[xv] Section 2801(a); Prop. Reg. §§ 28.2801-1 through -7 (liability for tax under Section 2801 is suspended until final regulations are issued).

[xvi] Section 7701(b)(2)(A)(iii).

[xvii] Section 7701(b)(3).

[xviii]*Id*.

[xix]*Id*.

[xx]*See* Treas. Reg. § 301-7701(b)-1(e), Examples 1-3.

[xxi]*See* Treas. Reg. § 301.7701(b)-1(c)(1).

[xxii] Treas. Reg. § 301.7701(b)-1(c)(2)(i).

[xxiii]*Id.*

[xxiv] Treas. Reg. § 301.7701(b)-2.

[xxv] Treas. Reg. § 301.7701(b)-2(a)(1).

[xxvi] Treas. Reg. § 301.7701(b)-2(c).

[xxvii]*Id*.

[xxviii] Treas. Reg. § 301.7701(b)-2(d).

[xxix] Treas. Reg. § 301.7701(b)-2(d)(1).

[xxx] No US informational returns are required where an individual is treated as a non-US resident for purposes of Section 7701, which provides the basis for informational filing requirements. *See, e.g.,* Preamble to regulations under Section 6038D: "For section 6038D purposes, a specified individual is a U.S. citizen, a residentalien of the United States (as determined under Section 7701(b) andTreas. Reg. §§301.7701(b)-1 through 301.7701(b)-9 of this chapter), or anonresident alien who has elected under section 6013(g) or (h) tobe taxed as a U.S. resident. *A resident alien who elects to betaxed as a resident of a foreign country pursuant to a U.S. incometax treaty's residency tie-breaker rules is a specified individual for purposes of Section 6038D and the regulations."* T.D. 9567, issued on Feb. 21, 2012.