

# CRS Report for Congress

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## Federal Taxation of Aliens Working in the United States

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### Summary

The federal tax consequences for foreign nationals working in the United States are dependent on (a) whether an individual is classified as a resident or nonresident alien and (b) whether a tax treaty or agreement exists between the United States and the alien's home country. Resident aliens are generally taxed in the same manner as U.S. citizens. Nonresident aliens are subject to different treatment, which includes being taxed only on income from U.S. sources. Exceptions from the general rules may exist for aliens with specific types of visas or employment. Finally, the provisions of a tax treaty or totalization agreement may reduce or eliminate taxes owed to the United States.

### Immigration Status

This report discusses the federal tax treatment of alien individuals, i.e., foreign nationals, who are working in the United States. Under U.S. immigration law, foreign nationals are legally admitted into United States as immigrants to live permanently or as nonimmigrants to stay on a temporary basis.<sup>1</sup> The terms "immigrant" and "nonimmigrant" are not used in the Internal Revenue Code. Instead, as discussed below, a foreign national, whether in the United States as an immigrant, nonimmigrant, or illegal alien, is classified as a resident or nonresident alien for federal tax purposes.

Certain exceptions to the general tax rules exist for aliens with a specific type of visa. These are almost exclusively for F-, J-, M-, and Q-visa holders who are temporarily admitted into the United States as foreign students, teachers, trainees, and exchange visitors.<sup>2</sup> Exceptions to the general tax rules also exist for employees of foreign

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<sup>1</sup> For more information, see CRS Report RS20916, *Immigration and Naturalization Fundamentals*, and CRS Report RL31512, *Visa Issuances: Policy, Issues, and Legislation*, by Ruth Ellen Wasem.

<sup>2</sup> The visa letter is derived from the subparagraph of section 101(a)(15) of the Immigration and Nationality Act that describes the type of visa. For further information, see CRS Report (continued...)

governments, business visitors and tourists, aliens in transit through the United States, crew members of ships and aircraft, and employees of international organizations. While these individuals are usually admitted into the United States under certain visas (A-, B-1 and B-2, C-, D-, and G-visas, respectively), these individuals generally qualify for the exceptions based on their employment, not visa category.

## Resident or Nonresident Alien

For federal income and employment taxation purposes, alien individuals are classified as resident or nonresident aliens.<sup>3</sup> The classification has important consequences for determining whether income is subject to U.S. taxation, the appropriate tax rate, and whether an individual is covered by a tax treaty. In general, an individual is a nonresident alien unless he or she meets the qualifications under either residency test:

- Green card test: the individual is a lawful permanent resident of the United States at any time during the current year (i.e., has an alien registration card), or
- Substantial presence test: the individual is present in the United States for at least 31 days during the current year and at least 183 days during the current year and previous two years. For computing the 183 days, a formula is used that counts all the qualifying days in the current year, 1/3 of the qualifying days in the immediate preceding year, and 1/6 of the qualifying days in the second preceding year.<sup>4</sup>

There are several situations in which an individual may be classified as a nonresident alien even though he or she meets the substantial presence test. For example, an individual will be treated as a nonresident alien if he or she has a closer connection to a foreign country than to the United States, maintains a tax home in the foreign country, and is in the United States for fewer than 183 days during the year.<sup>5</sup> Another example is that an individual in the United States under an F-, J-, M-, or Q-visa may be treated as a nonresident alien if he or she has substantially complied with visa requirements.<sup>6</sup> Other

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<sup>2</sup> (...continued)

RL31381, *U.S. Immigration Policy on Temporary Admissions*, by Ruth Ellen Wasem.

<sup>3</sup> It is possible for an individual to be a resident alien and a nonresident alien during the same year. For an explanation of the rules on determining residency starting and termination dates and on dual-status filing, see *IRS Publication 519: U.S. Tax Guide for Aliens*.

<sup>4</sup> IRC §§ 7701(b)(1)(A) and (b)(3). A nonresident alien may qualify to be treated as a resident alien if the substantial presence test is met in the year following the election. IRC § 7701(b)(4). A dual-status or nonresident alien married to a U.S. citizen or resident may qualify to be treated as a resident alien for the entire year. IRC §§ 6013(g) and (h).

<sup>5</sup> IRC § 7701(b)(3)(B).

<sup>6</sup> IRC § 7701(b)(5). There are limits on how long an individual may be exempt from the substantial presence test. Non-student J- or Q-visa holders are exempt for two or four years in a six-year period, depending on their source of income. After five years, student F-, J-, M-, or Q-visa holders must establish to the IRS that they do not intend to permanently reside in the

individuals that may be treated as nonresident aliens even if they meet the substantial presence test include employees of foreign governments and international organizations, regular commuters from Canada or Mexico, aliens who are unable to leave the United States because of a medical condition, foreign vessel crew members, aliens in transit through the United States, and athletes participating in charitable sporting events.<sup>7</sup>

The residency rules are overridden by a residency definition within an income tax treaty. If an individual is defined as a resident of a foreign country under a treaty, then he or she is a nonresident alien for purposes of determining his or her U.S. tax liability regardless of whether either residency test is met.<sup>8</sup>

## Taxation of Income

**Resident Aliens.** Resident aliens are subject to the same federal income tax laws as citizens of the United States.<sup>9</sup> Like U.S. citizens, resident aliens are subject to tax on all income earned in the United States and abroad. Resident aliens file a tax return using the Form 1040 series, may claim deductions and credits, and are taxed at the same graduated rates as U.S. citizens. They are also subject to the income tax withholding requirements.

**Nonresident Aliens.** Nonresident aliens are taxed on income from sources within the United States but generally not on income from foreign sources. Sections 861, 862, 863, 864, and 865 of the Internal Revenue Code define income that is from sources within and outside the United States. Compensation for services performed in the United States is U.S. source income.<sup>10</sup>

A nonresident alien's U.S. source income is taxed at different rates depending on whether it is "effectively connected" with a trade or business in the United States.<sup>11</sup> "Effectively connected" income is income received while engaging in a trade or business in the United States.<sup>12</sup> It includes compensation for the performance of personal services in the United States. Nonresident aliens with F-, J-, M-, and Q-visas are considered to be engaged in a trade or business in the United States.<sup>13</sup>

Income that is effectively connected with a trade or business in the United States is generally taxed by the same rules and at the same graduated rates as the income of U.S.

<sup>6</sup> (...continued)

United States in order to continue to be exempt.

<sup>7</sup> IRC §§ 7701(b)(3)(D), (b)(5), and (b)(7).

<sup>8</sup> 26 CFR § 301.7701(b)-7.

<sup>9</sup> Resident aliens who are employees of foreign governments and international organizations may qualify to exempt their compensation from taxation. IRC § 893.

<sup>10</sup> IRC § 861(a)(3).

<sup>11</sup> IRC § 871.

<sup>12</sup> IRC § 864(c).

<sup>13</sup> IRC § 871(c).

citizens and resident aliens.<sup>14</sup> Income that is not effectively connected may not be reduced by most deductions and is generally taxed at a flat rate of thirty percent.<sup>15</sup> Nonresident aliens file a return using the Form 1040NR series and are subject to the same collection procedures as U.S. citizens and resident aliens. Additionally, nonresident aliens are generally subject to withholding requirements on personal service compensation and non-effectively connected income.<sup>16</sup>

There are limited circumstances in which a nonresident alien's U.S. source income is not subject to U.S. taxation. For example, some interest income that is not effectively connected with a U.S. trade or business (e.g., foreign portfolio interest) is exempt from U.S. tax.<sup>17</sup> Compensation for services performed in the United States is not subject to U.S. tax if the services are for a foreign employer or office, the alien is in the United States for not more than 90 days during the tax year, and the compensation does not exceed \$3000.<sup>18</sup> A nonresident alien with an F-, J-, or Q-visa is not taxed on compensation received from a foreign employer.<sup>19</sup> Employees of foreign governments and international organizations and crew members of foreign vessels and aircraft may qualify to exempt their compensation from tax.<sup>20</sup> Furthermore, income may be exempt from U.S. tax under a treaty (see below).

**Sailing permit.** Aliens leaving the United States are generally required to obtain a certificate of compliance (i.e., a sailing permit) from the IRS that shows the individual "has complied with all the obligations imposed upon him by the income tax laws."<sup>21</sup> For aliens who attempt to leave without obtaining the permit, the IRS may subject them to examination at the point of departure and require payment of any tax due if its collection would be jeopardized by the departure. Aliens that may be exempt from the permit requirement include employees of international organizations and foreign governments; students and trainees with F-, H-, J-, and M-visas; military trainees; visitors, including those on B-1 or B-2 visas; aliens in transit through the United States on a C-1 visa; and commuters from Canada and Mexico.<sup>22</sup>

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<sup>14</sup> IRC §§ 871(b) and 873. Examples of nonresident aliens being subject to different rules than U.S. citizens and residents are that nonresident aliens may not claim the standard deduction, more than one personal exemption, or the earned income credit.

<sup>15</sup> IRC §§ 871(a) and 873.

<sup>16</sup> IRC §§ 1441 and 3402; 26 CFR § 1.1441-4(b)(1). The rate of withholding on compensation for personal services is the applicable graduated income tax rate, although self-employed individuals may be subject to withholding at a flat 30% rate. The rate of withholding on non-effectively connected U.S. source income is 30% unless (a) the 14% rate applies for qualifying income received by nonresident aliens with F-, J-, M-, and Q-visas or (b) there is a lower rate under an income tax treaty.

<sup>17</sup> IRC §§ 871(h) and (i).

<sup>18</sup> IRC §§ 861(a)(3) and 864(b)(1).

<sup>19</sup> IRC § 872(b)(3).

<sup>20</sup> IRC §§ 861(a)(3), 872, and 893.

<sup>21</sup> IRC § 6851(d).

<sup>22</sup> 26 CFR § 1.6851-2.

**Tax Treaties.** Tax treaties provide benefits to nonresident aliens and, in certain situations, resident aliens. Benefits vary by treaty and typical provisions include the reduction of the 30% flat rate applied to non-effectively connected U.S. source income and the exemption of gain from the sale of personal property. Treaties often exempt personal service compensation from taxation if a nonresident individual is in the United States for less than a stated period of time (e.g., 90, 180, or 183 days) or the compensation is less than a specified amount (generally between \$3000 and \$10,000) and paid by a foreign employer. Additionally, the compensation of specific groups of employees (e.g., students, teachers, athletes, and employees of foreign governments) is often exempted from U.S. tax.

The United States has tax treaties with the following countries:

Australia, Austria, Barbados, Belgium, Canada, China, the Commonwealth of Independent States, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Latvia, Lithuania, Luxembourg, Mexico, Morocco, the Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovak Republic, Slovenia, South Africa, South Korea, Spain, Sweden, Switzerland, Thailand, Trinidad and Tobago, Tunisia, Turkey, Ukraine, the United Kingdom, and Venezuela.

## Employment (i.e., Social Security and Medicare) Taxes

**Resident Aliens.** Resident aliens are subject to Social Security and Medicare taxes on wages (FICA taxes) and on self-employment income (SECA taxes) in the same manner as U.S. citizens.<sup>23</sup> A list of exempted services in section 3121(b) is generally applicable to all who work in the United States. Examples include services provided by employees of foreign governments and qualifying international organizations.

**Nonresident Aliens.** Nonresident aliens are subject to FICA taxes on compensation from work within the United States under the rules applicable to U.S. citizens and resident aliens.<sup>24</sup> A list of exempted services in section 3121(b) is generally applicable to all who work in the United States and includes services provided by employees of foreign governments and qualifying international organizations. Two exemptions apply only to nonresident aliens. First, a nonresident alien with a F-, J-, M-, or Q-visa is not subject to FICA taxes on income from the performance of services that meets the purpose of admittance. Second, a holder of an H-2 visa is exempt from FICA taxes for services performed in Guam if the individual is a resident of the Philippines.

Nonresident aliens are not subject to SECA taxes.<sup>25</sup>

**Totalization Agreements.** The United States has entered into totalization agreements with numerous countries that have social security programs. The intent of

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<sup>23</sup> IRC §§ 1402(b) and 3121(b).

<sup>24</sup> IRC § 3121(b).

<sup>25</sup> IRC § 1402(b).

these agreements is to provide individuals who work in two countries with the opportunity to qualify for social security benefits within one country and to avoid double taxation. Under an agreement, an alien who is sent by a foreign employer to work in the United States for less than five years will generally not be subject to FICA taxes upon proving that he or she is paying social security taxes to the home country.<sup>26</sup> Otherwise, the alien will pay FICA taxes and not be subject to taxes in the home country. A self-employed resident alien generally pays taxes in the country where he or she resides.

The United States has entered into totalization agreements with Australia, Austria, Belgium, Canada, Chile, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, South Korea, Sweden, Switzerland, and the United Kingdom.<sup>27</sup>

Finally, an income tax treaty may provide an exemption from Social Security and Medicare taxes. This is unusual, but an example is the treaty with the former Soviet Union that is now applicable to several former Soviet states and has been interpreted by the Treasury Department to include such a provision.<sup>28</sup>

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<sup>26</sup> IRC §§ 1401(c), 3101(c), and 3111(c).

<sup>27</sup> Texts of the agreements may be found on the website of the Social Security Administration [[www.ssa.gov/international](http://www.ssa.gov/international)]. According to the website, as visited on February 2, 2004, the United States is negotiating agreements with Argentina and Japan. The United States has also been negotiating an agreement with Mexico. *Social Security: Proposed Totalization Agreement with Mexico Presents Unique Challenges*, GAO-03-993 (September 2003).

<sup>28</sup> *Technical Explanation of the Convention Between the United States of America and the Union of Soviet Socialist Republics On Matters of Taxation, With Related Letters, Signed at Washington on June 20, 1973*, CCH Tax Treaties Rptr ¶10,630, Union of Soviet Socialist Republics.