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Federal Taxation of Aliens Working in the United States and Selected Legislation

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Summary

A question that often arises is whether illegal aliens and other foreign nationals working in the United States are subject to U.S. taxes. The federal tax consequences for these individuals 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 individual's home country. Resident aliens are generally taxed in the same manner as U.S. citizens. Nonresident aliens are subject to different treatment, such as generally being taxed only on income from U.S. sources. Exceptions exist for aliens with specific types of visas or employment, and the provisions of a tax treaty or totalization agreement may reduce or eliminate taxes owed to the United States. Under H.R. 5140 (Economic Stimulus Act of 2008), which was signed into law on February 13, 2008, qualifying U.S. citizens and resident aliens may receive rebate checks so long as they provide Social Security numbers for themselves, their spouses (if filing a joint return), and any qualifying children. Other bills affecting the tax treatment of aliens include H.R. 279 and S. 43, both of which would address the unconstitutional manner in which totalization agreements are disapproved by Congress.

Immigration Status

Under U.S. immigration law, foreign nationals are legally admitted into the United States as immigrants to live permanently or as nonimmigrants to stay on a temporary basis.[1] The terms "immigrant" and "nonimmigrant" are not used in the Internal Revenue Code. Instead, a foreign national, whether in the United States as an immigrant, nonimmigrant or unauthorized (illegal) alien, is classified as a resident or nonresident alien for federal tax purposes.

[1] For more information, see CRS Report RS20916, *Immigration and Naturalization Fundamentals*, and CRS Report RL31512, *Visa Issuances: Policy, Issues, and Legislation*, both by Ruth Ellen Wasem.

Resident or Nonresident Alien

For federal tax purposes, alien individuals are classified as resident or nonresident aliens.[2] The classification has important consequences for determining whether income is subject to U.S. taxation, what is 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, 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.[3]

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.[4] Another example is that an individual in the United States under an F-, J-, M-, or Q-visa[5] may be treated as a nonresident alien if he or she has substantially complied with visa requirements.[6] Other 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 the leave the United

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[2] 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 dual-status filing, see *IRS Publication 519: U.S. Tax Guide for Aliens*, which is available at [www.irs.gov].

[3] I.R.C. §§ 7701(b)(1)(A) and (b)(3). A nonresident alien may elect, under certain circumstances, to be treated as a resident alien if the substantial presence test is met in the year following the election. I.R.C. § 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. I.R.C. §§ 6013(g) and (h).

[4] I.R.C. § 7701(b)(3)(B).

[5] These individuals are temporarily admitted into the United States as students, teachers, trainees, and cultural exchange visitors. 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 RL31381, *U.S. Immigration Policy on Temporary Admissions*, by Chad C. Haddal and Ruth Ellen Wasem.

[6] I.R.C. § 7701(b)(5). There are limits on how long an individual may be exempt from the substantial presence test. For example, after five years, student F-, J-, M-, and Q-visa holders will only continue to receive the special treatment if they establish to the IRS that they do not intend to permanently reside in the United States and that they have substantially complied with their visa requirements.

States because of a medical condition, foreign vessel crew members, aliens in transit through the United States, and athletes participating in charitable sporting events.[7]

A residency definition in an income tax treaty will override these residency rules. 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 the "green card" or "substantial presence" test is met.[8]

Unauthorized Aliens. The Internal Revenue Code does not have a special classification for individuals who are in the United States without authorization (commonly referred to as "illegal aliens"). Instead, the Code treats these individuals in the same manner as other foreign nationals — they are subject to federal taxes and classified for tax purposes as either resident or nonresident aliens. An unauthorized individual who has been in the United States long enough to qualify under the "substantial presence" test is classified as a resident alien; otherwise, the individual is classified as a nonresident alien. This classification is for tax purposes only and does not affect the individual's immigration status.

H.R. 5140. Section 101 H.R. 5140, of the Economic Stimulus Act of 2008 creates a refundable tax credit that may be claimed by qualified individuals. Individuals who meet the criteria will receive the credit in the form of a rebate check from the IRS. Resident aliens, but not nonresident aliens, are eligible to claim the credit. The final version of the bill, which was passed by both the House and Senate on February 7, 2008, requires that taxpayers provide Social Security numbers (SSNs) for themselves, their spouses (if filing a joint return), and their qualifying children. This provision limits the ability of unauthorized resident aliens to claim the credit or receive the rebate checks.[9] President Bush signed the bill into law on February 13, 2008.

Taxation of Income

Resident Aliens. Resident aliens are generally subject to the same federal income tax laws as citizens of the United States.[10] 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 income tax withholding.

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[7] I.R.C. §§ 7701(b)(3)(D), (b)(5), and (b)(7).

[8] Treas. Reg. § 301.7701(b)-7.

[9] There remains the possibility that attempts to claim the credit could be made by unauthorized aliens using fraudulent SSNs or by resident aliens who legally received SSNs but are currently not legally present in the United States. For information on the latter category of individuals, see CRS Report RS22446, *Nonimmigrant Overstays: Brief Synthesis of the Issue*, by Ruth Ellen Wasem.

[10] One special rule is that resident aliens who are employees of foreign governments and international organizations may qualify to exempt their compensation from taxation. I.R.C. § 893.

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.[11]

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.[12] An individual must generally be engaged in a trade or business in the United States to have "effectively connected" income.[13] The term generally includes compensation for the performance of personal services in the United States. Nonresident aliens with F-, J-, M-, or Q-visas are considered to be engaged in a trade or business in the United States.[14]

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. citizens and resident aliens.[15] In general, income that is not effectively connected may not be reduced by deductions and is subject to tax at a flat rate of 30%.[16] 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. Furthermore, they are generally subject to withholding on personal service compensation and non-effectively connected income.[17]

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 connected with a U.S. trade or business (e.g., portfolio interest) is exempt from U.S. tax.[18] Another example is that 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.[19] A nonresident alien with an F-, J-, or Q-visa is not taxed on compensation received from a foreign employer.[20] Employees of foreign governments and international organizations and crew members of foreign vessels and aircraft may

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[11] I.R.C. § 861(a)(3).

[12] I.R.C. § 871.

[13] I.R.C. § 864(c).

[14] I.R.C. § 871(c).

[15] I.R.C. §§ 871(b) and 873.

[16] I.R.C. §§ 871(a) and 873.

[17] I.R.C. §§ 1441 and 3402; Treas. Reg. § 1.1441-4(b)(1). The rate of withholding on compensation for personal services is generally 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.

[18] I.R.C. §§ 871(h) and (i).

[19] I.R.C. §§ 861(a)(3) and 864(b)(1).

[20] I.R.C. § 872(b)(3).

qualify to exempt their compensation from tax.[21] Additionally, income may be exempt from U.S. tax under a treaty (see below).

Sailing Permit. Aliens leaving the United States usually must obtain a certificate of compliance ("sailing permit") from the IRS that shows he or she "has complied with all the obligations imposed upon him by the income tax laws."[22] The IRS may subject aliens who attempt to leave without one to examination at the point of departure and require payment of any taxes whose collection would be jeopardized by the departure.

Tax Treaties. Tax treaties provide benefits to nonresident aliens and, in certain situations, resident aliens. Benefits vary by treaty. 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 alien 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 $3,000 and $10,000) and paid by a foreign employer. Treaty provisions may also exempt the compensation of specific groups of employees (e.g., students, teachers, athletes, and employees of foreign governments).

The United States has income tax treaties with Australia, Austria, Bangladesh, 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, Sri Lanka, Sweden, Switzerland, Thailand, Trinidad and Tobago, Tunisia, Turkey, Ukraine, the United Kingdom, and Venezuela.

Social Security and Medicare Taxes

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.[23] In general, 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,[24] but are not subject to SECA taxes.[25] A list of exempted services in IRC § 3121(b) is generally applicable to all who work in the United States. Examples include services performed by foreign workers temporarily admitted to the United States to perform agricultural labor and services performed by employees of foreign governments and qualifying international organizations. Also exempted are services performed by individuals with F-, J-, M-, or Q-visas that meet the purpose of admittance and services performed in Guam by H-2 visa holders who are residents of the Philippines.

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[21] I.R.C. §§ 861(a)(3), 872, and 893.

[22] I.R.C. § 6851(d); Treas. Reg. § 1.6851-2.

[23] I.R.C. §§ 1402(b) and 3121(b).

[24] I.R.C. § 3121(b).

[25] I.R.C. § 1402(b).

Totalization Agreements. The United States has entered into totalization agreements with numerous countries that have social security programs. The intent of these agreements is to provide individuals who work in two countries with the opportunity to qualify for social security benefits in one country[26] and to avoid double coverage and taxation. With respect to the issue of double coverage and taxation, agreements generally provide that individuals are only covered by the social security program (and therefore only subject to the program's taxes) in the country where they are working, although individuals who are covered in their home country and temporarily assigned by their employer to work in the other country are exempt from coverage in that country.[27] A self-employed individual generally is covered and pays social security 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, Japan, Luxembourg, the Netherlands, Norway, Portugal, Spain, South Korea, Sweden, Switzerland, and the United Kingdom.[28] The United States has begun discussing an agreement with Poland and has signed agreements with the Czech Republic, Denmark, and Mexico, but they have not been transmitted to Congress.[29] The agreements with the Czech Republic and Denmark were signed in 2007, while the agreement with Mexico, which has been controversial, was signed in 2004.[30] Under 42 U.S.C. § 433(e)(2), once an agreement is transmitted to Congress, it becomes effective at the end of the period during which at least one House has been in session 60 days, unless either House adopts a resolution of disapproval. This is a legislative veto, and the Supreme Court held such vetoes to be unconstitutional in *INS v. Chadha*, 462 U.S. 919 (1983). H.R. 279 (Social Security Totalization Agreement Reform Act of 2007) and S. 43 (STAR Act) would, among other things, address the legislative veto problem by implementing a new approval process.

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[26] For more information, see CRS Report RL32004, *Social Security Benefits for Noncitizens: Current Policy and Legislation*, by Dawn Nuschler and Alison Siskin.

[27] *See also* I.R.C. §§ 1401(c), 3101(c), and 3111(c).

[28] Texts of the agreements may be found at [http://www.ssa.gov/international].

[29] [http://www.ssa.gov/international/status.html].

[30] For more information on the agreement with Mexico, see CRS Report RL32004, *Social Security Benefits for Noncitizens: Current Policy and Legislation*, by Dawn Nuschler and Alison Siskin.