Mitigating The Unintended Tax Consequences Of Coronavirus

By **Seth Entin**

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With the unfortunate emergence and rapid spread of the coronavirus, there are many non-U.S. individuals who will be spending significantly longer than expected in the U.S. this year.

A critical question is whether these individuals will be classified as U.S. residents for U.S. federal income tax purposes, referred to as U.S. income tax residents. This article addresses certain of the basic ground rules under current law for determining whether an individual is a U.S. income tax resident relief that, depending on the circumstances, may be available.

Background

An individual who is not a U.S. citizen or a U.S. income tax resident is referred to as a nonresident alien. A nonresident alien is only subject to U.S. federal income tax on certain U.S. source income, and certain limited types of non-U.S. source income that are effectively connected with a trade or business of the nonresident alien in the U.S.

On the other hand, a U.S. citizen or a U.S. income tax resident is subject to U.S. federal income taxation on his or her worldwide income. In many cases, this may include the income of non-U.S. companies that the individual owns, even if those companies do not distribute their income to their shareholders.

Furthermore, a U.S. citizen or U.S. income tax resident is subject to extensive Internal Revenue Service and U.S. Department of the Treasury reporting requirements, such as reporting with respect to interests in non-U.S. companies, ownership of or distributions from non-U.S. trusts, gifts from nonresident aliens, ownership of non-U.S. financial assets, and ownership of or signature authority over non-U.S. financial accounts.

Definition of U.S. Income Tax Resident

In general, under the Internal Revenue Code, an individual is deemed to be a U.S. income tax resident if the individual either (1) holds a U.S. green card, or (2) meets the substantial presence test, sometimes referred to as the day-count test.

An individual meets the substantial presence test, subject to certain exceptions, if he or she is present in the U.S. for 183 days or more during the current calendar year.

An individual also meets the substantial presence test, subject to certain exceptions, if he or she is present in the U.S. for (1) at least 31 days during the current year, and (2) at least 183 days for the three-year period ending on the last day of the current year, using a weighted average formula. This weighted average formula equals the sum of:

- All of the number of days the individual is present in the U.S. during the current calendar year; plus

- One-third of the number of days the individual was present in the U.S. during the preceding year; plus

- One-sixth of the number of days the individual was present in the U.S. during the second preceding year.

Any day in which an individual is physically present in the U.S., even for a brief amount of time, counts as a day of presence in the U.S. for purposes of this formula, unless the individual is in transit between two non-U.S. points and certain requirements are met, or certain other very limited exceptions apply.

It is important to note that, under the substantial presence test, an individual's residency starting date, as a general rule, is the individual's first day of physical presence in the U.S. during the year, subject to a limited exception.

Closer Connection Exception

There are several exceptions to the substantial presence test. One exception that is of great importance to non-U.S. individuals who are compelled to spend more time in the U.S. due to the coronavirus is known as the closer connection exception.

This exception applies where an individual is present in the U.S. for less than 183 days during the current year, but the weighted average formula described above equals or exceeds 183 days, due to the individual's presence in the U.S. in the two preceding years.

For this exception to apply, it must be established that, for the current year, the individual has a (1) tax home in another country, and (2) closer connections to that country than to the U.S.

The Treasury regulations provide that an individual's tax home is the individual's regular or principal place of business. If the individual has no regular or principal place of business because of the nature of the individual's business, or because the individual is not engaged in carrying on a trade or business, the individual's tax home is his or her "regular place of abode in a real and substantial sense."

The regulations list 10 nonexclusive factors that are considered in determining whether a closer connection exists. These factors include the:

- Location of the individual's permanent home;

- Location of the individual's family;

- Location of personal belongings, such as automobiles, furniture, clothing, and jewelry owned by the individual;

- Location of social, political, cultural or religious organizations in which the individual has a current relationship;
- Location of the individual's personal bank accounts;
- Location where the individual conducts business activities other than those that constitute the individual's principal business;
- Type of driver's license held by the individual;
- Country of residence designated by the individual on forms and documents;
- Types of official forms and documents filed by the individual; and
- Where the individual votes.

As noted above, the closer connection exception will not apply if the individual is present in the U.S. for 183 days or more during the current year. This exception will also not apply if the individual is a lawful permanent resident of the U.S. — that is, a green card holder — or the individual has applied, or taken other affirmative steps to change their status to that of a lawful permanent resident during the current year or has an application pending for adjustment of status during the current year.

An individual must file a Closer Connection Exception Statement for Aliens, or IRS Form 8840, by the applicable deadline to claim this exception.

Treaty Tiebreaker Claim

Even if an individual meets the substantial presence test, and is therefore a U.S. income tax resident under the code, if the individual continues to also be a tax resident in a country that is party to an income tax treaty with the U.S., they may be able to avoid being taxed as a U.S. income tax resident under relief provided by the applicable treaty.

This relief provision, often referred to as a tiebreaker provision, allows an individual who is deemed a tax resident of both the U.S. and a treaty party country to only be subject to tax as a resident of one of the two countries, based on a set of rules that determine of which country the individual will be deemed a tax resident.

In order to obtain tiebreaker relief to be taxed as a resident of the treaty party country rather than the U.S., the individual would have to meet certain requirements set forth in the applicable treaty.

As an example, the following is a summary of the tiebreaker provision of the income tax treaty between the U.S. and Mexico:

- If an individual is a resident of both the U.S. and Mexico, the individual is deemed to be a resident of the country in which the individual has a permanent home available to him or her; in general, a permanent home is a dwelling that is available to the individual at all times.

- If an individual has a permanent home available to him in both the U.S. and Mexico, the individual is deemed to be a resident of the country "with which his personal and economic relations are closer (center of vital interests)." This may require a highly factual analysis.

- If an individual's center of vital interests cannot be determined, the individual is deemed a resident of the country in which he or she has a habitual abode.

- If an individual has a habitual abode in both the U.S. and Mexico, the individual is deemed a resident of the country of which he or she is a citizen.

If an individual were to claim tiebreaker relief, the individual would calculate their U.S. federal income tax liability as if they were a nonresident alien. This would potentially allow the individual to avoid worldwide U.S. federal income taxation.

However, unlike the closer connection exception, an individual who makes a treaty tiebreaker claim would have to file a U.S. Nonresident Alien Income Tax Return, or IRS Form 1040NR, and the individual is subject to many of the reporting requirements that are applicable to U.S. income tax residents — for example, the individual must report certain ownership of non-U.S. entities, financial interests or signature authority over non-U.S. financial accounts, gifts from a nonresident alien, etc..

The individual would also be required to file a Treaty-Based Return Position Disclosure, or IRS Form 8833, on which the individual would claim the tiebreaker position.

Medical Exception

The code provides for a medical exception from the substantial presence test. Unfortunately, however, the scope of individuals covered by this medical exception is somewhat limited.

Under the code, a day of presence in the U.S. is disregarded for purposes of the substantial presence test if the taxpayer is "unable to leave the U.S. on such day because of a medical condition which arose while such individual was present in the U.S."

The regulations go into further detail. They provide that this exception applies only if "the individual intends to leave and is unable to leave the U.S. because of a medical condition … that arose while the individual was present in the U.S."

According to the regulations, a day of presence will not be excluded if the individual, who was initially prevented from leaving, is subsequently able to leave the U.S. and then remains in the U.S. beyond a reasonable period for making arrangements to leave the U.S. Furthermore, even if an individual initially qualifies for the medical exemption, the medical exception ceases to apply.

Finally, the regulations state that the exemption does not apply if the "condition or problem existed prior to the individual's arrival in the U.S. [and] the individual was aware of the condition or problem, regardless of whether the individual required treatment for the condition or problem when the individual entered the U.S."

To claim the medical exception, an individual must file a Statement for Exempt Individuals and Individuals With a Medical Condition, or IRS Form 8843, by the applicable deadline.

It would be extremely helpful if the Treasury would expand the medical exception to cover individuals who themselves may not be infected by the coronavirus, but who are prevented from leaving the U.S. due to quarantines or inability to travel due to the coronavirus. Absent Treasury or congressional action, the medical exception may be of limited benefit to many individuals unable to leave the U.S. because of the coronavirus.

Practice Pointers

An individual who will meet the substantial presence test, but will not be physically present in the U.S. for 183 days or more during the year, should take objective steps to maintain their tax home in another country and their closer connection to that country, e.g., the closer connection factors set forth above. The steps should be carefully documented.

Similarly, an individual who will meet the substantial presence test but plans to make a treaty tiebreaker claim, that individual should take objective steps to maintain closer personal and economic connections to the treaty partner country. The steps should be carefully documented.

In the case of an individual who may claim the medical exception, either under the current regulations or potentially revised regulations, the individual should carefully document the days that the individual was ill and the individual's inability to leave the U.S., both from a medical standpoint and due to restrictions on travel.

Conclusion

It is critical for a non-U.S. individual who is at risk of becoming a U.S. income tax resident to carefully review his or her status and, if possible, take steps to avoid becoming a U.S. income tax resident. If the individual will become a U.S. income tax resident, careful tax analysis and planning is required to assess the situation and attempt to mitigate adverse consequences.

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