Don't Forget "Closer Connection" and "Tie-Breaker" Exceptions for U.S. Tax Residency

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As most immigration, private client attorneys and other advisors know, a foreign citizen or national is considered a U.S. tax resident if he or she meets the "green card test" or the "substantial presence test." But the analysis doesn't stop there. One should also consider whether the individual avoids U.S. tax residency through the "closer connection" exception to the substantial presence test or its close cousin, the "tie-breaker" provisions of tax treaties.

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Why it Matters

Obviously, whether a foreign citizen is a U.S. tax resident is an important determination. U.S. tax residents pay U.S. taxes on their worldwide income, while non-residents generally pay U.S. tax only on U.S.-source income. For an individual with income from non-U.S. sources (e.g., pensions, investment income, compensation for foreign employment) who otherwise would pay lower tax rates in a different nation, U.S. tax residency may have a significant price tag. Plus, after eight years, U.S. tax residency becomes like the Hotel California. The Internal Revenue Code is programmed to receive: you can check out any time you like, but you can't necessarily leave.

Substantial Presence and the "Closer Connection" Exception

Although "183 days per year" is a well-known touchstone of the substantial presence test, its true threshold is lower than that. Because days present in the U.S. in the preceding year

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count as 1/3 of a day, and in the second preceding year count as 1/6 of a day, spending an average of 122 days per year in the U.S. will make one a tax resident.

Enter the closer connection exception. Notwithstanding the substantial presence test, and assuming no green card or green card application, an individual will not be a U.S. tax resident if he or she: (1) spends fewer than 183 days in the U.S. in the current year; and (2) has a "tax home" and a "closer connection" in another country.

For this purpose, an individual's "tax home" is considered to be his or her main place of business, employment or post of duty. If none of these apply, the tax home will be where the individual resides for a majority of the time. Whether an individual has "closer connection" with a foreign country is based on all the facts and circumstances, including the residence claimed on official documents, place of voter registration and driver's license, where he or she derives a majority of income, and the location of family, permanent home, personal belongings, furniture, cars, banks, and personal, financial and legal documents.

Treaty Tie-Breaker for Dual Residents

If an individual cannot satisfy the closer connection exception (e.g., he or she spends 183 days or more in the U.S. during the year), there may still be hope under an income tax treaty's "tie-breaker" provisions.

The U.S. has tax treaties with dozens of foreign countries, principally intended to help residents of one country avoid being taxed by the other country based on temporary travel or business connections. For instance, tax treaties typically prevent a country from taxing business profits or compensation earned by the other's residents unless the income is connected to some non-temporary physical presence, termed a "permanent establishment" or "fixed base."

Sometimes, an individual is a "dual resident," i.e., the individual qualifies as a resident of both countries under their respective tax laws. For example, an individual may meet the substantial presence test in the U.S. but also spend enough time in the other country to be treated as a resident under its own laws. Enter the "tie-breaker," which in most treaties reads like this:

Where…an individual is a resident of both Contracting States, then his status shall be determined as follows:

a. he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State in which his personal and economic relations are closer (center of vital interests);
b. if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
c. if he has an habitual abode in both States or in neither of the, the competent authorities of the Contracting States shall endeavor to settle the question by mutual agreement.

Note how the tie-breaker resembles the closer connection analysis, especially with respect to determining where "personal

and economic relations are closer) center of vital interests." Once again, driver's licenses and the location of family and bank accounts will be part of the discussion.

Some words of caution. For the tie-breaker to apply, the individual must be a "resident" of the other country under that country's domestic tax laws. This may not be obvious, particularly because unlike the U.S., most countries do not automatically treat their citizens as tax residents. Consultation with a tax advisor from the individual's home country may be necessary.

Moreover, the tie-breaker governs the dual resident's residency only for purposes of determining the individual's U.S. tax liability. It does not absolve the individual of U.S. tax reporting obligations. The individual must still file Form 1040NR to report U.S.-source income and Form 8833 to claim treaty benefits. Form TD F 90-22.1, to report foreign bank accounts, and Form 8938, to report other foreign assets, may also be required. A tax return preparer with experience working with nonresidents is highly recommended.

Furthermore, a dual resident will still be treated as a U.S. resident in determining *another person's* tax liability. For instance, a dual resident may still be counted as a U.S. shareholder in determining whether a foreign corporation is a "controlled foreign corporation" whose "subpart F income" is immediately taxable to other U.S. shareholders.

U.S. Citizens and Green Card Holders

Neither the closer connection exception nor a treaty's tie-breaker provisions are of any help to a U.S. citizen, including a dual citizen. The Internal Revenue Code treats citizens as *per se* tax residents, and U.S. tax treaties contain a "savings clause" reserving the IRS's right to tax U.S. citizens.

Like citizens, green card holders are *per se* residents under U.S. tax law, meaning the closer connection exception does not apply. But nothing in a tax treaty precludes green card holders from availing themselves of a tie-breaker provision. That said, U.S. immigration law may treat a claim of nonresidency (even one solely for tax purposes) as a constructive surrender of one's green card. Tread *very* lightly and consult a good immigration attorney.

Takeaways

Just because a foreign citizen or national meets the substantial presence test, the individual is not necessarily a U.S. tax resident. Always consider whether the closer connection exception or tie-breaker provisions of a tax treaty apply. With respect to tie-breakers, one must further consider the individual's remaining U.S. tax reporting obligations and the effect of filing a Form 1040NR on the individual's immigration status.

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