



# Ten Common Tax Return Errors and the Foreign Nationals Who Make Them

By Paula N. Singer, Esq.

With the dramatic increase in international business and personnel exchange, many tax preparers are now encountering foreign national clients. Foreign nationals who are resident aliens, either because they are U.S. Lawful Permanent Residents (“green card” holders) or because they are “substantially present” under the 183-day U.S. residency formula, are taxed on their worldwide income under the same rules that apply to U.S. citizens. However, foreign nationals who are not resident aliens (called “nonresident aliens”) are only subject to U.S. tax on gross U.S.-sourced fixed or determinable income (such as dividends, rents, and royalties) and on income effectively connected to a U.S. trade or business that is taxed after limited deductions at either single or married filing separately rates. Foreign nationals who are both a resident alien and a nonresident alien in the calendar year are subject to tax under the rules for dual-status taxpayers.

## New IRS Compliance Initiatives

Marti Sartipi, International Policy Program Manager, Small Business/Self-Employed Division announced on the IRS TaxTalkToday.tv webcast, “International Issues and U.S. Taxpayers,” that they now have 300 personnel trained in

international compliance matters and are in the process of hiring and training 100 more. Sartipi also announced that the IRS international compliance initiatives include:

- Automated processes to assist in identifying nonfilers;
- Planned audits of 10,000 tax returns with international issues (foreign nationals working in the United States and U.S. citizens and residents working abroad); and
- Imposition of penalties for failure to submit required disclosure documents.

The failure to file required disclosure documents can result in significant penalties. For example, failure to file a Form TD F90.22-1, *Report of Foreign Bank and Financial Accounts* (called an FBAR), can result in civil penalties, criminal penalties, or both. An FBAR is required for each account in which a resident alien has an interest or signatory authority if the aggregate value of a resident’s financial accounts exceeds \$10,000 at any time in the calendar year. Civil penalties can vary greatly:

- \$500 for a negligent violation;
- Up to \$10,000 for a nonwillful violation;
- Up to \$50,000 for a pattern of negligent activity; and
- \$100,000 or 50% of the account for willful failure.

The IRS has also announced a new Compliance Initiative Plan (CIP) for audits of accounts payable transactions with foreign vendors, including foreign national payees. This CIP is an outgrowth of results of the IRS's Voluntary Compliance Program (VCP) for U.S.-sourced income payments to foreign persons originally directed toward the financial industries. Generally, U.S.-sourced income payments to foreign persons are subject to 30 percent withholding unless an exception, such as reduction under a tax law or treaty, applies. However, proper paperwork must be submitted prior to payment for a withholding exception to be valid. Payers (called "withholding agents" because of their withholding obligations) who fail to withhold and pay over the taxes timely, or who allow exemptions from withholding without collecting the proper paperwork, are liable for the taxes, penalties, and interest. The IRS stated that the results of the VCP were "enormously successful."

Much to the Service's surprise, of the 400 companies making VCP submissions, 25 percent were multinational companies (MNCs) including all of the major accounting firms and many large law firms. The focus of the new audits on accounts payable transactions includes fees for personal services and royalty and license fees that may have service components. The new initiative has the potential of identifying foreign national nonfilers, as well as nonresident employees paid through accounts payable who should be paid on payroll. This includes some who are working in the U.S. without work authorization. The types of companies at the focus of these audits are pharmaceuticals, publishing, high tech, law firms, accounting firms, and entertainment industry companies.

The recent interest of members of Congress in international tax compliance should result in still more international compliance initiatives. In a correspondence to IRS Commissioner Mark Everson, the Senate's two top tax writers, Senate Finance Committee Chair Chuck Grassley (R-Iowa) and ranking minority member Max Baucus (D-Montana), chastised the IRS for failure to make good use of information about investment income earned abroad by U.S. citizens and residents under the automatic exchange of information agreements with U.S. treaty partners. According to a U.S. government report, between 1999 and 2003, U.S. residents' foreign investments increased from \$2.6 trillion to \$7.2 trillion. The Senators are concerned because GAO-recommended system modifications, which would cost very little and could result in additional revenue of millions of dollars, have gone unheeded.

These IRS international compliance initiatives have the potential for identifying foreign nationals failing to submit their U.S. tax returns, or submitting incorrect returns. When U.S. citizens submit tax returns prepared in error, or fail to report all of their taxable income, the results can be penalties and interest (assuming the error was unintentional). However, tax returns prepared in error for, or by, foreign nationals can be much more costly because foreign nationals may lose immigration benefits if the errors come to light in an immigration proceeding.

## Impact on Immigration Benefits

Foreign nationals are entitled to immigration benefits, such as authorization to work in the United States, based on their current immigration status. Nonimmigrants may be accorded future immigration benefits, such as an opportunity to become a Lawful Permanent Resident (LPR). LPRs who meet certain criteria may be eligible for immigration benefits, such as supporting immigration petitions for relatives or applying for U.S. citizenship.

Foreign nationals who submit tax returns that result in lower taxes than their tax obligation were they to file correctly may be found not to be "of good moral character" in immigration proceedings. These lower taxes can result from:

- Deductions for which they do not qualify (the standard deduction);
- Incorrect personal exemptions;
- The wrong return (1040 instead of 1040NR); or
- The wrong filing status (married filing jointly instead of married filing separately).

Foreign nationals who submit the wrong return may jeopardize an application for future immigration benefits, such as an application to adjust to LPR status. The three most recent U.S. tax returns are required to be submitted for this immigration process. Foreign nationals submitting a Form 1040NR when they should have submitted a Form 1040, or submitting a Form 1040 when they should have submitted a Form 1040NR, could face problems with this process if it resulted in lower U.S. taxes.

Foreign nationals who are LPRs relocating to work abroad for a period of time face the most serious problems. Like U.S. citizens, LPRs must continue to submit U.S. tax returns as residents while living and working abroad. Non-immigrant foreign nationals include those who are "lawfully admitted for permanent residence," which is defined as "the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, such status not having changed." LPRs residing abroad, typically while on assignment for an American employer, are "special immigrants" returning to "an unrelinquished lawful permanent residence in the United States." LPRs who fail to preserve their LPR status are considered to have abandoned it and may have their LPR status revoked.

Certain tax return filings can evidence an intention to abandon LPR status. For example, LPRs who are residents of a country with which the U.S. has an income tax treaty may qualify as a nonresident for U.S. tax purposes under the tiebreaker rule of the residency article of the treaty. However, an LPR who submits a Form 1040NR or 1040NR-EZ is deemed to have abandoned their LPR status. Also, a claim of bona fide residence in a foreign country for purposes of claiming §911 foreign-earned income exclusions could be viewed as abandonment of LPR status. (Only LPRs who are nationals of a tax treaty country can use the bona fide residence test because of the nondiscrimination clause of the treaty.) This can occur because the facts supporting bona fide residence in the foreign country follow the same criteria used to prove that they have a permanent U.S. residence.

Before filing Form N-400, *Application for Naturalization*, applicants must have resided in the U.S. as an LPR for at least five years (three years if married to a U.S. citizen). Part C, Continuous Residence, asks the following questions on Lines 13 and 14: "Since becoming a Lawful Permanent Resident of the United States:

- Have you EVER called yourself a 'nonresident' on a federal, state, or local tax return?
- Have you EVER failed to file a federal, state, or local tax return because you considered yourself to be a 'nonresident'?"

(The emphasis on EVER is in the form.)

An LPR who has submitted a Form 1040NR or 1040NR-EZ tax return since becoming an LPR must answer "yes" to Question 13.

Most states impose residency taxation based on domicile in the state. Tax preparers frequently encourage taxpayers who relocate abroad to take the position that they are no longer domiciled in their home state to save taxes. However, states with domicile rules take the position that if the individual cannot show the establishment of a new domicile in the new location, or they have facts indicating that they intend to return to the state, or both, they continue to be treated as domiciled in the home state. LPRs who have taken the position that they are no longer domiciled in their home state, and as a result submit a nonresident state tax return, must answer "yes" to Question 13. LPRs failing to submit a state tax return because they considered themselves to be nonresidents of the state and had no income sourced in the state, must also answer "yes" to Question 14. The immigration service can use the answers to those questions to claim that LPR status was abandoned and that the continuous residency requirement in support of the application for U.S. citizenship, therefore, has not been satisfied.

## Summary

Many foreign nationals submit incorrect income tax returns either because they prepare their own return without any awareness of the special tax rules that may apply to their return or because they use a paid preparer who is unaware of these rules. Foreign nationals need to avoid the ten common tax return errors for two reasons. First, because of new IRS initiatives, incorrect tax returns have a higher risk of being caught, as do foreign nationals failing to file their required returns. This can result in penalties and interest. Second, incorrectly prepared returns have the potential for causing problems with immigration proceedings. Such incorrect tax returns cannot always be corrected because of the three-year statute of limitations that applies to most returns. Foreign nationals need to comply correctly with their tax return obligations in this new compliance environment. ♦

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## Ten Common Mistakes to Avoid

**1. Filing the wrong tax return.** Foreign nationals can be nonresident aliens (Form 1040NR or 1040NR-EZ), resident aliens (Form 1040 or 1040EZ), or dual-status taxpayers (Form 1040 with a Form 1040NR statement for those arriving, or Form 1040NR with a Form 1040 statement for those departing, who elect dual-status treatment.) Many foreign nationals, particularly foreign students and exchange visitors, who remain nonresident aliens for a period of years under the 183-day residency formula, and arriving aliens not in the U.S. a full calendar year, submit a Form 1040 claiming deductions (such as the standard deduction) that are not available to nonresident aliens or dual-status taxpayers.

Currently e-filing is not available for Forms 1040NR, 1040NR-EZ, or dual-status tax returns. The majority of foreign nationals who e-file returns typically are filing the wrong return. Some foreign nationals who have a nonresident return prepared correctly for them may choose instead to e-file because it results in a higher refund (because of the standard deduction).

**2. Filing using married filing jointly status incorrectly.** A nonresident married to a U.S. citizen or resident alien as of December 31 may elect to file as a resident jointly with their spouse. A resident alien spouse includes one who made a part-year residency election in their year of arrival. However, two married nonresident aliens may not make this election to file jointly as residents. They must file as nonresident aliens using married filing separately rates, which happen to be the highest rates.

**3. Failing to include all income in the return.** Foreign nationals who are resident aliens are subject to U.S. income tax on worldwide income in the same manner as U.S. citizens. Foreign nationals who elect to file as a resident with a U.S. citizen or resident spouse must include their worldwide income in their U.S. return.

Resident aliens frequently fail to include foreign income in their U.S. return for a variety of reasons:

- Foreign investment income is taxed at its source so they think they have no obligation to include it in their U.S. tax return.
- They know that their foreign investment income should be included in their U.S. return but rules,





such as foreign tax credits, are too complicated for them to deal with.

- Their capital transactions are not taxed in their home country and they expect that the transactions are not taxable in the U.S. either.
- Their tax preparer never asked them about income from abroad, so they did not know that it was income for U.S. tax purposes.
- They fail to mention income earned abroad because they think it should not be taxed in the U.S. and they do not expect to be caught for not reporting the income.

**4. Claiming incorrect personal exemptions.** In order for a dependent to be claimed for a personal exemption, the dependent must be a U.S. citizen or resident alien unless an exception applies. There are exceptions for dependents who are U.S. nationals or residents of Canada or Mexico. Nonresidents who are residents of South Korea, within certain restrictions, can claim dependent exemptions. (A similar rule for residents of Japan was eliminated by the new treaty with Japan.) Nonresident business apprentices and students from India can claim a dependent exemption for their spouse.

**5. Incorrectly claiming a tax treaty benefit.** The U.S. has income tax treaties with over 60 countries. Many foreign nationals, particularly foreign students and scholars, may be eligible for treaty exemptions from tax. Eligibility for treaty benefits is based on tax residency (not citizenship) in the treaty country as described by the treaty article under which a benefit is claimed.

Treaty benefits for income such as dividends, interest, rents, and royalties require the taxpayer to be a resident of the treaty country and not a resident of the United States when the income is paid. Generally, tax treaty provisions for students, trainees, teachers, and researchers allow the taxpayer to keep the treaty benefits even if they are no longer tax residents of the treaty country and/or have become tax residents in the U.S. (These benefits are preserved even if the recipient elects to file jointly with a U.S. citizen or resident spouse.) However, students, trainees, teachers, and researchers who are no longer residents of the treaty country frequently claim tax treaty benefits on their U.S. investment income for which they are no longer eligible.

**6. Claiming improper temporarily-away-from-home expense deductions.** Taxpayers who have been providing

services and are temporarily away from their tax home may claim deductions for their travel, meals, and lodging. (Expenses related to their family members are generally not deductible.) To be temporarily away, taxpayers must be at their temporary work location for a period anticipated to be a year or less. Their tax home is their principal place of business. A short absence of a few months between visits is not sufficient to restart the clock for purposes of these deductions. If travel, food, and lodging have been paid or reimbursed by their employer, deductions may only be claimed if the amounts are included in their Form W-2 gross income.

These rules also apply to foreign students and scholars in F, J, M, or Q nonimmigrant status who are recipients of taxable grants because the tax law deems them to be engaged in a U.S. trade or business. Foreign students and scholars who have temporarily-away-from-home deductions for their taxable grants should not claim them on Form 2106 because they are not employees. They must attach a statement reducing their taxable scholarship by the actual expenses and record the net taxable scholarship on their return.

**7. Excluding certain taxable capital gains on stock sales on Form 1040NR.** Capital gains on property other than real estate are fixed or determinable annual or periodic income subject to 30-percent tax on the net gain (reportable on page 4 of Form 1040NR) unless an exception applies. Nonresident aliens can exclude their capital gains on property, such as stock, if:

- The capital gain is foreign-sourced; or
- The capital gain is U.S.-sourced but the recipient is in the U.S. for less than 183 days in the tax year.

Capital gains are U.S.-sourced income if the recipient has a tax home in the United States. Generally, if a taxpayer is here for a period anticipated to be longer than one year, the United States is considered to be his or her tax home.

Foreign nationals in certain nonimmigrant categories typically remain nonresidents for a number of calendar years under the 183-day residency formula: F, J, and M students (five calendar years); J and Q nonstudents (two calendar years out of the most recent seven); and A diplomats and G international organization employees (indefinitely). (Diplomats and employees of international organizations are not exempt from tax on their investment income.)





Many of these taxpayers have U.S.-sourced gains subject to 30-percent tax that are never reported on their U.S. tax returns because of misunderstandings about these rules.

**8. Failing to file disclosure forms.** Foreign nationals becoming resident aliens who maintain income-producing assets overseas, who transfer assets to foreign entities, who are grantors or recipients of income from foreign trusts, or who are recipients of certain gifts or bequests from abroad, may be required to submit disclosure forms. These may include:

- Form TD F 90-22.1 to report a financial interest in or signatory authority over a financial account(s) in a foreign country.
- Form 926 to report cash and other transfers to a foreign corporation owned by the taxpayer.
- Form 3520 to report transactions to or from, and/or ownership of, foreign trusts, and/or gifts from foreign donors, or bequests from foreign decedents.
- Form 3520-A to report on foreign trusts with a U.S. owner.
- Form 5471 to report U.S. shareholders of foreign corporations (and to determine deemed dividend income subject to current taxation).
- Form 5472 to report foreign shareholders of certain U.S. corporations.
- Form 8833 to report certain income tax treaty claims.
- Form 8621 to report U.S. shareholders of a Passive Foreign Investment Company (PFIC) and to make a Qualified Electing Fund (QEF) election.
- Form 8858 to report U.S. persons owning foreign disregarded entities.
- Form 8865 to report transactions with controlled foreign partnerships.
- Form 8891 to report income being deferred on certain Canadian-registered retirement plans.

Foreign nationals who are nonresident aliens may be required to submit one of the following disclosure forms:

- Form 8840 to report facts supporting a claim of nonresidency status based on a closer connection to a foreign country or countries.
- Form 8843 to report U.S. days that do not count for residency determination purposes.
- Form 8854 to report information required annually of former U.S. citizens and long-term U.S. lawful permanent residents.

**9. Failing to file a federal tax return.** Foreign nationals fail to file U.S. tax returns for a variety of reasons:

- Their income was exempt from withholding taxes under a tax treaty and they are unaware of the requirement to file a return for the treaty claim.
- Their U.S. income has not been subject to U.S. withholding taxes, as is typical with rents paid to nonresident alien landlords, and the taxpayers are unaware of the obligation to file a tax return to claim offsetting deductions.
- All of their income was paid abroad and they are unaware of the sourcing rules that can cause income such as compensation for services in the U.S. to be U.S.-sourced income (regardless of the currency or location of the payment).
- They are living and working temporarily overseas and are unaware of the requirement to submit a U.S. tax return either because they remain a resident alien from frequent travel to the U.S. or they are an LPR. (This filing lapse is common with U.S. citizens living and working overseas as well.)

Nonresident aliens who fail to timely file their nonresident tax return can lose deductions and credits to which they would otherwise be entitled if they fail to correct the lapse in filing voluntarily before being contacted by the IRS. Generally, timely filing for purposes of this rule is 16 months from the original due date of the return. LPRs working temporarily abroad who fail to timely submit their tax return may lose eligibility for the §911 foreign earned income exclusions if they are contacted by the IRS regarding this lapse before voluntarily filing. Timely filing for purposes of this rule is 12 months from the original due date of the return.

**10. Failing to file a state income tax return.** Foreign nationals who prepare their own tax returns frequently fail to submit a required state income tax return. In fact, a number of Internet sites and special tax preparation software packages that prepare nonresident returns do not prepare state income tax returns. Whether foreign nationals have a state income tax filing obligation depends upon whether they are resident in (under the state's rules) or earn income from certain sources in a state that imposes income taxes on individuals, and whether their income meets the filing threshold.

