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U.S. Citizens, Residents Remain Taxable on Worldwide Income Regardless of Stateside Presence

by Gary Lubowiecki, CPA

One of the most common misconceptions about the international aspects of U.S. individual income taxation is that income earned or received by an individual outside of the U.S. is not taxable for U.S. income tax purposes.

To the contrary, the U.S. stands alone among industrialized countries in taxing its citizens and residents on their worldwide income even if they are not present in their home country. The fact that the income may have been physically paid outside of the U.S. and never remitted into the U.S. makes no difference.

For example, a U.S. employer may send a U.S. citizen or permanent resident to work in a foreign country either on a temporary or permanent basis on an assignment either directly for the U.S. employer or for a foreign affiliate of the U.S. employer. Employers and employees are often surprised to learn that, as a U.S. citizen or resident alien, the employee remains subject to U.S. income tax on his worldwide income. They often are incorrectly under the impression that the income cannot be taxable for U.S. income tax purposes because the income was paid outside of the U.S. by a foreign affiliate, or that foreign income tax was paid on the income, or that the income was never brought into the U.S. These circumstances, however, do not change the fact that the income is taxable for U.S. income tax purposes and must be declared on an annual U.S. income tax return. While there are special rules allowing U.S. citizens working abroad to elect to exclude part or all of their compensation income from their gross income, that income must still be declared on an annual U.S. income tax return. For 2011, an eligible individual may elect to exclude up to $92,900 of foreign earned income from gross income, but the individual must still timely claim the exclusion on his return.

In addition to complying with all U.S. income tax rules, the employer must also be careful to comply with any foreign reporting and withholding requirements both on an individual and employer basis. Similarly, the fact that an employee may be paid from the U.S. does not automatically mean that the employee's compensation is not subject to foreign income or social taxes in the foreign country. Also, the corporate tax ramifications of employing an individual in a foreign country must be carefully reviewed.

Another common fact pattern is a teacher or entry-level employee working abroad. Sometimes such an individual assumes that he is simply not taxable for U.S. income tax purposes because he is living and working outside of the U.S. Alternatively, the individual may be aware of the foreign earned income exclusion and simply assume that he is not required to file a U.S. income tax return because his compensation is well below the maximum amount of the exclusion. As noted above, the foreign earned income exclusion is not automatic. The income must be declared and the exclusion claimed on a timely basis.

A third common situation is an individual who receives an inheritance from a foreign estate or receives income from a foreign trust. For example, a nonresident alien may die abroad leaving non U.S. situs property, such as an investment portfolio in foreign securities or a foreign rental property, to a U.S. citizen. The gross income that the property generates is taxable for U.S. income tax purposes. The fact that the income from the property may be in a foreign currency, or that the rental of the property results in a loss, does not change the fact that the income must be reported on a timely filed U.S. income tax return. Also, an individual may be the owner of a foreign trust or the recipient of income from a foreign trust. The income from the foreign trust must be reported on the individual's U.S. income tax return. In addition, there are information returns which must be filed regarding the ownership and/or receipt of income from foreign trusts and the failure to file the required information returns on a timely basis may result in the assessment of Draconian penalties. Even if an individual has no income from foreign sources, he or she may still be required to file Form 90-22.1, Report of Foreign Bank and Financial Accounts, if there is a financial interest in or signature authority over a foreign bank or financial account(s) which exceeded $10,000 in the aggregate at any time during the year. Form 8938, Statement of Specified Foreign Financial Assets, is brand new and generally must be filed by an individual living in the U.S. who has an interest in certain foreign financial assets which exceeded $50,000 on the last day of the tax year or $75,000 at any time during the tax year. The filing thresholds are increased to $100,000 and $150,000 for married taxpayers filing joint returns. There are also larger thresholds for individuals living outside of the U.S.

There are also individuals who deliberately fail to report their foreign source income on their returns. For example, U.S. persons hiding assets in Swiss bank accounts have received a great deal of publicity over the past few years. In any case where income has not been reported, legal counsel should be retained by the individual; in turn, qualified tax advisors, such as those at J.H. Cohn, can then be retained by legal counsel under what is known as a *Kovel* arrangement. Those accounting services are retained by legal counsel that allows any communications between the contracted tax advisors and the client to be protected under the attorney-client privilege.

Another common misconception regarding the international aspects of U.S. individual income taxation is that the income of non-U.S. citizens or residents is automatically not taxable for U.S. income tax purposes if it is paid or received outside of the U.S.

In certain limited situations, nonresident aliens are exempt from U.S. income tax on certain types of income. For example, a nonresident alien is not subject to U.S. income tax on interest income from U.S. bank deposits. Generally, the starting point to determine what income is subject to U.S. income tax by a nonresident alien is the premise that all U.S. source income is taxable for U.S. income tax purposes. The U.S. generally sources compensation income based upon where the services have been performed, not where the compensation is paid. Thus, a foreign national coming to the U.S. and working in the U.S. even for one day may be required to file a U.S. individual income tax return and pay U.S. income tax even though his salary is paid in foreign currency outside of the U.S. Non-U.S. employers are often surprised to learn that the place of payment is not outcome determinative and that even though the employee has remained on a foreign payroll the employee is subject to U.S. income tax. A non-U.S. employer may also incorrectly assume that because there is an income tax treaty between the home country and the U.S., the compensation income earned by the employee in the U.S. is exempt from U.S. income tax. While the U.S. has negotiated income tax treaties with many of its trading partners, the fact that the employee comes from a country with which the U.S. has an income tax treaty does not automatically mean that the employee is not subject to U.S. income tax. While treaties may be similar, each is unique and must be separately applied to the particular set of facts. In very general terms, treaties provide for an exemption from U.S. income tax for compensation paid to a nonresident alien by or on behalf of a non-U.S. employer where the employee is physically present in the U.S. for less

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than 183 days and the compensation income is not charged back to a permanent establishment held by the employer in the U.S. While it may initially appear that an employee may qualify for treaty relief, the provisions of the applicable treaty must be applied to the facts. For example, the individual must generally be an employee of the foreign company, not the U.S. company, to qualify for treaty relief. Also, the employee cannot be physically present in the U.S. for more than 183 days. Some treaties apply the 183-day-rule on a taxable (calendar) year basis while other treaties apply the 183-day-rule to any period of 12 consecutive months. Even if it is determined that an income tax treaty applies to a given situation, it is important to remember that the treaty may not always apply for state income tax purposes. For example, New Jersey does not generally recognize income tax treaties for purposes of the New Jersey gross income tax.

Non-U.S. employers must also comply with all U.S. reporting and withholding rules if they pay U.S. source compensation to an employee even if that compensation is paid outside of the U.S. The corporate tax ramifications of employing individuals in the United States must also be carefully reviewed.

In summary, U.S. citizens and permanent residents are taxable on their worldwide income even if that income is paid outside of the U.S. and not brought into the U.S. Unless exempt by treaty, nonresident aliens are generally subject to U.S. income tax on U.S. source income even if that income is paid outside of the U.S. ■

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