To Be Or Not To Be a Resident - Tax Is the Question

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TO BE OR NOT TO BE A RESIDENT—TAX IS THE QUESTION

Nonresident aliens have varying degrees of activity in the United States because of business, family, or tourism. When the level of activity is of the requisite nature, an alien can be classified as a resident for United States income tax purposes. Different treatment under the tax laws of residents and nonresidents makes the distinction important. This Comment addresses income tax planning for the nonresident alien who is married to a citizen or resident of the United States and for the nonresident alien who is about to become or who has become a resident alien and who has nonresident family members.¹

INTRODUCTION

Nonresident aliens, not immigration laws, are the central concern of this Comment. Specifically, income tax planning for nonresident aliens, including nonresident alien spouses of citizens or residents of the United States, will be discussed.² At the present time, the Internal Revenue Service (IRS) has determined that 10,000 nonresident couples have filed tax returns.³ It is likely,

1. For purposes of this Comment, a “nonresident couple” refers to a couple in which one spouse is a nonresident alien and the other spouse is a citizen or a resident of the United States. An immigrant or nonimmigrant visa holder can be in either spousal position and can be classified as a nonresident.

2. Income tax planning analysis for the nonresident alien about to become or who has become a resident alien and has nonresident family members is substantially similar to the planning for “nonresident couples.” There are two major differences. First, the nonresident couple has an additional planning vehicle under I.R.C. § 6013 which permits the couple to elect to treat the nonresident as a resident and thereby file a joint return. Second, the single nonresident cannot transfer assets to U.S. residents as easily and with the security that the nonresident couple can. These differences are reflected in the Tax Planning section of this Comment.

3. [1980] 6 STAND. FED. TAX REP. (CCH) ¶ 4170C.01. This data can be separated into four categories:

   (1) U.S. citizen living in a foreign country and married to a native of such country;

   (2) U.S. citizen or resident living in the U.S. and married to a nonimmigrant visa holder;
however, that the number is much higher because there is no regular interchange of information between the Immigration and Naturalization Service (INS) and the IRS. For example, an income earner who enters the United States for a few months on a nonimmigrant visa and thereafter obtains an extension is not reported to the IRS. In addition, the IRS does not know when a person has been present in the United States several months per year on a regular basis. Whether an alien is a resident is important because of the relative impact of United States income taxation.

The Tax Reform Act of 1976 made changes in the tax laws that affect the tax treatment of nonresident couples. Prior to this Act, a married couple in which one spouse was a nonresident at any time during the year was disadvantaged by not being allowed to file a joint return. Both spouses had to be residents of the United States for the entire year in order to file a joint return. These couples were further disadvantaged because other benefits were denied to married couples who filed separately. Unavailable benefits include the maximum tax on earned income, the earned income credit, the credit for the purchase of a new residence, the limitation on the investment credit, the limitation on interest on investment indebtedness, the losses deduction, the de-

(3) Immigrant living in the U.S. without his or her spouse, who is a nonresident;
(4) Nonimmigrant visa holder living in the U.S. without his or her spouse, who is a nonresident.

This number will increase as communication between the INS and the IRS improves. Also note that the number of aliens about to become or who have become residents and have nonresident family members is undetermined. The number is potentially very high. For example, all nonresidents with nonresident family members may consider becoming U.S. residents; therefore, the income tax consequences and income planning are of importance to them.

5. Id.
7. Pub. L. No. 94-455, § 1012, 90 Stat. 1612 (codified at I.R.C. §§ 879, 6013(g), (h)).
8. I.R.C. §§ 6013(g), (h), 679.
11. I.R.C. § 1348(c).
12. Id. § 43(d).
13. Id. § 44(b)(3).
14. Id. § 45(c)(2)(B).
15. Id. § 163(d)(1)(A).
16. Id. § 165(c)(3).
duction for moving expenses,17 and the capital losses deduction.18 However, the Tax Reform Act of 1976 promulgated Internal Revenue Code section 6013 (g) and (h),19 which allows a nonresident couple the option of treating the nonresident spouse as a resident for income tax purposes20 and thereby the option of filing a joint return if desired. If the election is not made, Internal Revenue Code section 879, which attributes certain community income of nonresident couples to the spouse whose efforts and skills earned it, becomes operative.21

The objective of this Comment is threefold: first, to examine the potential for being classified as a United States resident for income tax purposes; second, to discuss the significance of such status; and third, to provide tax planning techniques for nonresi-

17. Id. § 217(b)(3)(B).
18. Id. § 1211(b)(2).
19. Id. § 6013(g), (h).
20. Id.
21. Id. § 879.

TAX TREATMENT OF CERTAIN COMMUNITY INCOME IN THE CASE OF A RESIDENT OR CITIZEN OF THE UNITED STATES WHO IS MARRIED TO A NONRESIDENT ALIEN INDIVIDUAL.

(a) General Rule.—In the case of a citizen or resident of the United States who is married to a nonresident alien individual and who has community income for the taxable year, such community income shall be treated as follows:

(1) Earned income (within the meaning of section 911(b)), other than trade or business income and a partner’s distributive share of partnership income, shall be treated as the income of the spouse who rendered the personal services;

(2) Trade or business income, and a partner’s distributive share of partnership income, shall be treated as provided in section 1402(a)(5);

(3) Community income not described in paragraph (1) or (2) which is derived from the separate property (as determined under the applicable community property law) of one spouse shall be treated as the income of such spouse; and

(4) All other such community income shall be treated as provided in the applicable community property law.

(b) Exception Where Election Under Section 6013(g) is in Effect.—Subsection (a) shall not apply for any taxable year for which an election under subsection (g) or (h) of section 6013 (relating to election to treat nonresident alien individual as resident of the United States) is in effect.

(c) Definitions and Special Rules.—For purposes of this section—

(1) Community income.—The term “community income” means income which, under applicable community property laws, is treated as community income.

(2) Community property laws.—The term “community property laws” means the community property laws of a State, a foreign country, or a possession of the United States.

(3) Determination of marital status.—The determination of marital status shall be made under section 143(a).
dent couples and the nonresident alien about to become or who has become a resident alien and who has nonresident family members. Finally, seven goals will be utilized to illustrate innovative income tax planning under the Tax Reform Act of 1976.

RESIDENCY FOR UNITED STATES INCOME TAX PURPOSES

Although an alien’s status as either a resident or a nonresident for federal income tax purposes is governed by United States tax law, 22 the term “resident” is not specifically defined in the Code 23 and has been given different meanings in different contexts. 24 Guidelines are contained in two Treasury Regulations. Treasury Regulation section 1.871-2(b) provides that an alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States absent exceptional circumstances. Entrance into the United States on a nonimmigrant visa limits an alien’s stay to a definite period. 25 However, exceptional circumstances that vitiate the effect of a “definite period” include living in an apartment for over twenty years on an apparently permanent basis, 26 remaining in the United States continuously for almost five years under extensions of stay granted because of unsettled conditions in the Orient, 27 and conducting a business in the United States for five years and interrupted by a maximum of three departures from the United States. 28

Treasury Regulation section 1.871-4(b) provides that an alien, by reason of his alienage, is presumed to be a nonresident. If the presumption is rebutted, the IRS will presume that an alien present in the United States for one year or more is a resident for United States income tax purposes. 29 This presumption is rebutted when the alien files a declaration of his intention to become a

25. Rev. Rul. 71-565, 1971-2 C.B. 266 (holds in effect that the phrase “definite period” appearing in § 1.871-2(b) means the same as “duration of the employee’s status as an employee”).
27. Marsman v. Commissioner, 205 F.2d 335 (4th Cir. 1953).
citizen of the United States under the naturalization laws, files a Form 1078 or its equivalent, engages in acts or makes statements indicating a definite intention to acquire residence, or stays in the United States for such an extended time as to qualify as a resident. Similarly, where a mother lived in Florida with her children for forty weeks each year while her children attended school, had a Florida-licensed car and Florida bank and savings accounts, the presumption of nonresidency was rebutted. Nevertheless, when a plausible explanation is made regarding acts or statements of the alien, the presumption under Treasury Regulation section 1.871-4(b) prevails. For example, execution of an application for a United States immigrant visa (so the alien's children would be able to attend Florida public schools), of a Florida manifestation of domicile (same explanation), or of a Florida homestead exemption (to obtain a local tax benefit) were held to be plausible explanations.

It is apparent that extended physical presence in the United States coupled with a manifestation of an intent to reside in the United States is required to constitute residency, rather than mere statements made or documents executed which indicate an intent to reside in the United States. From these regulations and cases, various informal guidelines to maintain nonresident status can be drawn. For example, the maintenance of a nonimmigrant visa or presence in the United States for not more than one year are two factors indicative of nonresident classification. Other factors that increase the probability of nonresident classification are: (1) intent, (2) presence in the United States, (3)

34. Id. at 360.
35. Id. at 361.
39. Brittingham v. Commissioner, 66 T.C. 373 (1976) (20 years of almost continuous presence is sufficiently permanent to classify an alien as resident). See also
visa classification, (4) the alien’s own statements, (5) the alien’s home, (6) marital status and residence of family, (7) community involvement, and (8) payment of taxes. Although

Escobar v. Commissioner, 68 T.C. 304 (1977); Sanford v. Commissioner, 27 T.C.M. (CCH) 266 (1968) (mere physical presence, even for an extended period of time, is not of itself sufficient to establish residence); Adams v. Commissioner, 46 T.C. 352 (1966), acq. 1967-2 C.B. 1 (inquiry must be made as to the continuity of presence in U.S. over a number of years plus intent of the alien as evidenced by objective factors); Jellinek v. Commissioner, 36 T.C. 826 (1961), acq. 1964-1 C.B., pt. I, at 4 (the unexplained continued presence of an alien in a country for a prolonged period is strong evidence of an intent to make that place one’s residence); De la Begassiere v. Commissioner, 31 T.C. 1031, aff’d per curiam, 272 F.2d 709 (5th Cir. 1959) (for residence there must be an act or fact of being present, of dwelling, of making one’s home in the U.S. for some time; some permanence of living within the borders is necessary); Christina de Bourbon Patino v. Commissioner, 13 T.C. 816 (1949), aff’d, 186 F.2d 962 (4th Cir. 1950); Rev. Rul. 54-87, 1954-1 C.B. 155, amplified by Rev. Rul. 67-159, 1967-1 C.B. 280 (foreign student studying in U.S. for a degree which requires temporary residence in U.S. for minimum of two years classified as resident alien); cf. Rev. Rul. 54-485, 1954-2 C.B. 244 (IRS held that a student studying for a degree in U.S. who remains in U.S. only during school year and returns home or goes elsewhere during summer is nonresident alien).

40. Escobar v. Commissioner, 68 T.C. 304 (1977); Marsh v. Commissioner, 68 T.C. 68 (1977); Brittingham v. Commissioner, 66 T.C. 373 (1976); Ermogeni v. Commissioner, 33 T.C.M. (CCH) 870 (1976) (an alien’s visa classification is not determinative of an alien’s status as a resident or nonresident alien for tax purposes, although it is evidence of intent, purpose, and activity). Regarding nonimmigrant visa, see Treas. Reg. § 1.871-2(b) (1969), which states “[a]n alien whose stay in U.S. is limited to a definite period by immigration laws is not a resident absent exceptional circumstances.” E.g., Marsman v. Commissioner, 205 F.2d 335 (4th Cir. 1953) (attempts to achieve naturalization and persistent attempts to obtain a permanent visa were exceptional circumstances); Escobar v. Commissioner, 68 T.C. 304 (1977) (continuing presence in the U.S. and community involvement therein constituted residence). See Internal Revenue Service, Dep’t of the Treasury, Publication No. 519, United States Tax Guide for Aliens 2 (1979) (alien present in U.S. under nonimmigrant visa may be classified as a resident if accomplishment of his purpose requires extended stay and to that end he has made his home temporarily in the U.S., provided he can obtain the necessary visa extensions to lengthen his stay); Rev. Rul. 73-578, 1973-2 C.B. 39 (alien held resident where visa extended in order to remain in U.S. additional 14 months); Rev. Rul. 69-611, 1969-2 C.B. 150 (IRS will presume that any alien who has been residing in U.S. for one year or more is a resident for federal income tax purposes). Regarding immigrant visas, see Ermogeni v. Commissioner, 35 T.C.M. (CCH) 870 (1976) (though not determinative, the visa classification is given great weight). But see Tiburn v. Commissioner, 14 T.C.M. (CCH) 950 (1955) (giving immigrant visas lesser weight); Rev. Rul. 72-297, 1972-1 C.B. 212; Rev. Rul. 72-140, 1972-1 C.B. 211. See generally Harlee, U.S. Income Tax of Aliens on Current and Deferred Compensation, 37th Ann. N.Y.U. Inst. Fed. Tax. 1021 (1979); Langer, When Does a Nonresident Alien Become a Resident for U.S. Tax Purposes?, 44 J. Tax. 220 (1976). See also Rev. Rul. 76-83, 1976-1 C.B. 192 (citizen residents of Canada or Mexico who commute to work in U.S. on daily or seasonal basis, although treated as immigrants lawfully admitted to U.S. for permanent residence for immigration purposes, are treated as nonresident aliens for federal income tax purposes).

none of the above factors are dispositive of the residency issue, various combinations have given rise to resident status.\textsuperscript{46}

**Significance of Residency on Income Tax Liability**

*Nonsresident Alien's Taxable Income and Deductions*

Nonresident aliens are subject to income tax only on United States source income\textsuperscript{47} and income which is considered effec-

\textsuperscript{46} See, e.g., Escobar v. Commissioner, 68 T.C. 304 (1977) (community involvement and family residence); Brittingham v. Commissioner, 66 T.C. 373 (1978) (intent and physical presence).

\textsuperscript{47} I.R.C. § 861 provides that the following items of gross income shall be treated as income from sources within the United States:

1. Interest from the U.S. or District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise. However, not including interest received from a foreign entity if such interest is not effectively received from a foreign entity if such interest is not effectively connected with the conduct of a U.S. trade or business, interest received from a resident alien individual or a domestic corporation when less than twenty percent of the gross income from all sources has been derived from sources within the U.S. for the three-year period ending with the close of the taxable year preceding payment of such interest, interest from a foreign corporation when less than fifty percent of the gross income from all sources for the three-year period preceding the payment of such interest was effectively connected with the conduct of a trade or business within the U.S., however, interest derived by a foreign central bank of issue from bankers' acceptances, and interest on deposits with a foreign branch of a domestic corporation or a domestic partnership, if such branch is engaged in the commercial banking business.

2. Dividends received from a domestic corporation other than a corporation less than twenty percent of whose gross income is derived from sources within the U.S. for the three-year period ending with the close of the taxable year preceding the declaration of such dividend, or from a foreign corporation unless less than fifty percent of the gross income from all sources for the three-year period ending with the close of its taxable year preceding the declaration of such dividends was effectively connected with the conduct of a trade or business within the U.S., but the dividends from a foreign corporation are recognized only in an amount which bear the same ratio to such dividends as the gross income of the corporation for such period which was effectively connected with the conduct of a trade or business within the U.S. bears to its gross income from all sources.

3. Compensation for labor or personal services performed in the U.S. except compensation for services performed in the U.S. shall not be deemed to be income from sources within the U.S. if a nonresident performs services while not in the U.S. for more than ninety days during the taxable year, compensation does not exceed $3,000, and the compensation is performed as an employee of or under contract with a nonresident alien, foreign partnership or foreign corporation not engaged in a trade or business within the U.S. or an individual who is a citizen or resident of the
tively connected with a United States trade or business. The nonresident alien's United States source income and effectively connected income will fall into one of the following three categories: passive income (including capital gains), business income, and compensation for personal services. Each of these categories is subject to different rules.

Passive income includes interest, dividends, rents, premiums, annuities, remunerations, and emoluments. Passive income and capital gains are taxed at an annual rate of thirty percent of gross income. However, if the nonresident is present in the United States less than 183 days in the taxable year, the capital gains are tax free.

Business income is net income effectively connected with a United States trade or business. "Engaged in a trade or business" is not specifically defined in the Internal Revenue Code. However, the common inquiry made when discussing the "engaged in a trade or business" issue is whether the taxpayer availed himself of the privileges of business activity and the protection of the law to such a degree that he should pay for those

U.S., a domestic corporation, or domestic partnership if such work is performed for an office maintained in a foreign country.

(4) Rentals or royalties from property located in the U.S. or from any interest in such property.
(5) Gains, profits and income from the sale or exchange of real property located in the U.S.
(6) Gains, profits and income from the purchase of property without the U.S. and sale or exchange within the U.S.

The concept was developed to give statutory direction to taxpayers as they tried to determine whether or not income received within the U.S. was taxable at the flat 30% rate or at normal rates applicable to U.S. citizens and residents. A taxpayer can be taxed at the 30% rate on passive income in the same year that his effectively connected income is taxed at normal rates. The income which is effectively connected must be derived from a U.S. trade or business engaged in by the nonresident. R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS 2-117 to 18 (1979).

I.R.C. § 871(a), (b).

A nonresident alien acquires passive income from U.S. sources when the income is characterized as fixed or determinable annually or periodically and the alien is not engaged in a U.S. trade or business. This includes dividends, interest, wages, salaries, rents, compensation, and various other gains to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property. Treas. Reg. § 1.1441-2(b), T.D. 6908, 1967-1 C.B. 222. I.R.C. § 871(a)(1).

52. See id. § 871.
53. Id. § 871(a)(1).
54. Id. § 871(a)(2).
55. Id. § 871(a)(1)(2).
56. Id. § 871(c)(2).
57. Id. § 874(c)(1)(4).
privileges and that protection. In addition, the taxpayer must be active in some definable way to be engaged in a trade or business. Once the taxpayer is engaged in a trade or business, the effectively connected tests must be met. The tests are referred to as the "asset use" test and the "business activities" test. When the taxpayer is engaged in a trade or business at any time during the taxable year, all income, unless it is passive income and independent of the trade or business, is automatically treated as effectively connected. All income effectively connected with a United States trade or business is taxed at graduated rates.

Compensation for personal services performed in the United States constitutes United States source income. This income falls into the passive income category and, therefore, is subject to a thirty percent tax. In addition, Internal Revenue Code section 864(b) provides that the performance of personal services within the United States constitutes engaging in a trade or business within the United States. Thus, the compensation for personal services will be income effectively connected with a trade or business and taxed at graduated rates. However, when the compensation is less than $3,000, the alien is not present in the United States more than ninety days, and the services are performed on behalf of a foreign entity or a foreign office of a United States entity, the income is deemed not from sources within the United States and the services do not constitute a United States trade

59. Id. at 2-126.3.
60. I.R.C. § 864(c)(2)(A) states that in considering whether income is effectively connected with the taxpayer's trade or business, a determination of whether the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business must be made. See Treas. Reg. § 1.864-4(c)(2), T.D. 7332, 1975-1 C.B. 204.
61. I.R.C. § 864(c)(2)(B) states the activities of such trade or business were a material factor in the realization of income, gain, or loss. See Treas. Reg. § 1.864-4(c)(1), (3), T.D. 7332, 1975-1 C.B. 204.
63. I.R.C. § 871(b).
64. Id. § 861(a)(3).
65. Id. § 871(a)(1)(A).
66. Id. § 864(b). See also id. § 871(c), which provides that a nonresident alien holding an "F" or a "J" visa (certain students, professors, etc.) will be deemed to be engaged in a trade or business in the U.S. § U.S.C. § 1101(a)(15) (1976) (types of nonimmigrant visas).
or business.68 Furthermore, if no trade or business is conducted within the United States during the year the income is received, the income is not effectively connected.69

There are significant differences between the deductions and tax breaks available to nonresidents and those available to residents.70 A nonresident alien can take deductions to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States.71 In addition, the following deductions can be taken whether or not connected to income which is effectively connected with a United States trade or business: (1) losses allowed under section 165(c)(3),72 (2) charitable contributions allowed by section 170,73 and (3) one personal exemption.74

Resident's Taxable Income and Deductions

Resident aliens of the United States, like citizens, are subject to income taxation on worldwide income.75 In addition to exposing more income to United States taxation, the resident status may activate other sections of the Code.76 For example, an individual's change of status may cause an entity, if classified as a corporation owned in part or entirely by a new resident alien, to be classified as either a foreign personal holding company,77 a controlled foreign corporation,78 or a foreign investment company.79 Therefore, the change in status of an individual may have wider effects than merely recharacterizing individual income. Also, a resident is taxed at graduated rates on gross income less certain deductions.80 However, the deductions available to residents are not so limited as the deductions nonresidents are permitted to take.81

68. Id. § 864(b).
69. Id. § 864(c)(1)(B) (deferred compensation is one way to obviate the complexities inherent in the taxation of compensation for personal services). For a detailed discussion of compensation for personal service, see Harlee, U.S. Income Taxation of Aliens on Current and Deferred Compensation, 37th ANN. N.Y.U. INST. FED. TAX. 21-1 to 21-3 (1979).
70. See text accompanying notes 81-86 infra.
71. I.R.C. § 873(a).
72. Id. § 873(b)(1) (e.g., theft loss, casualty loss).
73. Id. § 873(b)(2) (e.g., charitable contributions and gifts).
74. Id. § 873(b)(3).
77. I.R.C. § 552(a).
78. Id. § 951(a).
79. Id. § 1246.
80. Id. §§ 63, 1.
81. See I.R.C. ch. 1, subchapter 8, pts. III, V, VI, VII (e.g., §§ 101 (certain death death (e.g., §§ 101 (certain death
For example, residents may deduct moving expenses,62 medical expenses,63 taxes,64 and interest65 from gross income. In addition, there is no limitation on the number of personal exemptions a resident taxpayer may claim.66

The Nonresident’s Position

Thus, the type of income, rates of taxation, and available deductions differ substantially between residents and nonresidents. In many situations, the result is a greater relative income tax liability for nonresident aliens. Income tax planning can mitigate the financial impact for nonresident couples and for nonresidents who are about to become or who have become residents and who have nonresident family members. Various methods can achieve this end. Special attention will be given to the method prescribed within section 6013 because this election by the nonresident couple to treat the nonresident spouse as a resident affords a new vehicle for income tax planning for the nonresident couple.

Methods for Reducing Income Tax Liability

In view of this change in the tax law, these are several tax planning methods that can be used to minimize United States income tax liability.

Election Under Internal Revenue Code Section 6013(g) and (h)

Internal Revenue Code section 6013(g) permits the nonresident couple to treat the nonresident spouse as a resident and thereby file a joint return if desired.87 The nonresident must be married to a citizen or a resident at the time of the election.88 The election applies to the taxable year for which it is made and to all subsequent years until terminated.89 Termination may occur by revocation by either spouse, death of either spouse, or legal payments), 163 (interest), 164 (taxes), 166 (bad debts), 215 (alimony), 219 (retirement savings)). See text accompanying notes 70-74 supra.

82. I.R.C. § 417.
83. Id. § 213.
84. Id. § 164.
85. Id. § 163.
86. Id. § 151.
87. Id. § 6013(a)(1).
88. Id. § 6013(g)(2).
89. Id. § 6013(g)(3).
separation of the spouses. In addition, the election terminates if the IRS determines that either spouse has failed to keep sufficient books and records, to grant access to such books and records to the IRS, or to supply such other information necessary to ascertain the income tax liability of either spouse. Once an election is terminated, neither spouse is permitted to make another election for any subsequent year.

Under section 6013(h), the nonresident couple may elect to treat as a resident the nonresident alien who has become a United States resident during the year. Both spouses will be treated as residents for the entire taxable year and thus be eligible to file a joint return. This election is effective for the year made. In subsequent years, the new resident alien is treated as a resident for purposes of income tax. However, if either spouse, in any subsequent year, is not a resident for the entire taxable year, the election cannot be made.

**Nontaxable Transfers**

Nontaxable transfers are transactions in which the gain (or loss) is not immediately recognized for tax purposes. The intent of the law in nontaxable exchanges is to provide for a postponement of income tax rather than an exemption. This is accomplished through provisions which require that a taxpayer assume a carryover tax basis in any property acquired in a nontaxable exchange. However, there are many exceptions to this rule because of the many exceptions to the taxation of gain rule. For example, if the owner dies without selling the property received...

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90. Id. § 6013(g)(4).
91. Id. §§ 6013(g)(4), (5).
92. Id. § 6013(g)(6).
93. Id. § 6013(a)(1).
94. Id. § 6013(h)(1).
95. Id. § 6013(g).
96. Id. § 6013(h)(2).
97. Id. §§ 1031-1033, 1035-1037.
98. Id. § 1101(d); 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 20.135, 20.649 (1977).
99. I.R.C. § 1031(d). Carryover basis is the taxpayer's retention of the basis he had in the property disposed of, which he then uses as the basis for the property acquired in the nontaxable exchange. J. CHOMMIE, FEDERAL INCOME TAXATION 232 (1974).
100. I.R.C. §§ 1031(d), 1033(b) (the underlying assumption is that the property will eventually be sold and the taxpayer will report the difference between the basis carried over and the value received).
101. The following Code sections deal with nonrecognition of gain or loss: id. §§ 121 (one-time exclusion for gain or sale or residence), 332 (complete liquidation of subsidiary), 354, 355 (corporate reorganizations), 712, 722, 723 (contribution to partnership), 1031-1033, 1035-1037 (nontaxable exchanges), 1071 (exchanges to facilitate F.C.C.), 1081 (exchanges to facilitate S.E.C.).
in the exchange, the deferred gain will not be recognized. The current tax basis rules for inherited property allow the unrealized gain of the decedent to pass to his heir or devisee.\textsuperscript{102} Therefore, a person may avoid paying taxes on property which has appreciated by exchanging but never selling it. However, the return required from a new investment after a taxable event will apparently depend on: (1) the absolute amount of the potential gain, (2) the marginal tax rate applied to that gain, and (3) the percent return on the reinvested proceeds. As (1) and (2) increase, so must the return from the new investment.

Section 1031 provides that no gain or loss shall be recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.\textsuperscript{103} An exchange is within the provisions of subsection (a) of 1031 if the property received in exchange consists of property of a like kind. Furthermore, gain is recognized only to the extent that some property not of a “like kind” is received.\textsuperscript{104} This property, which is not of a like kind, is often referred to as “boot.”\textsuperscript{105}

Phrases in section 1031 such as “held for productive use,” “like kind,” “investment,” “trade or business,” “held primarily for sale,” and “solely” may cause interpretive problems. This section requires that the property received actually be “held for productive use or investment” subsequent to the exchange. An exchange and subsequent sale will not qualify under section 1031 because the property is actually held for resale.\textsuperscript{106} “Like kind” refers to

\textsuperscript{102} Id. §§ 1014(a), 1023(a), (h).
\textsuperscript{103} Id. § 1031(a).
\textsuperscript{104} Im. § 1031(b).
\textsuperscript{105} “Boot” is defined as a shorthand expression for cash or property which is received (not given) other than that qualifying for nonrecognition treatment. J. Chommie, Federal Income Taxation 299 (1974).
\textsuperscript{106} Regals Realty v. Commissioner, 127 F.2d 931 (2d Cir. 1942).
the nature or character of the property and not to its grade or quality. Different classes of property may not be exchanged. For example, a leasehold interest cannot be exchanged for a fee title tax free unless the lease is for thirty years or more. If section 1031 is utilized, the specific requirements must be met; otherwise, substantial tax consequences are likely to result.

Gifts

Another method used to reduce income tax liability of the non-resident about to become a resident and the resident is a gift between family members. Thus, if the transferor is about to become a resident or is a resident, the dollar amount of gifts made reduces his taxable income. The recipient is not subject to income tax on the value of the property transferred. In addition, the nonresident alien is subject to gift tax only if the gift property is real estate or tangible personal property and is situated in the United States at the time of the gift.

Income Tax Planning for the Nonresident Couple and the Nonresident About to Become or Who Has Become a Resident of the United States

Numerous variables determine the course of action to minimize tax liability. Critical factors in defining the goals include the flexibility surrounding the operation of a United States trade or business, the exact nature of the income which the nonresident receives, and the quantity of income from sources outside the United States. Seven independent goals will be used to illustrate the tax planning potentials for nonresident couples. When it is relevant, the goal includes the nonresident who is about to become a resident and who has nonresident family members. The methods outlined above can be used in conjunction with each other or independently. The election under section 6013 will be utilized whenever feasible to take advantage of the Tax Reform Act of 1976. Assume the nonresident is not engaged in a United States trade or business unless otherwise stated.

109. For detailed analysis of requirements of § 1031, see Donald & Giljum, Tax-free Exchanges under Section 1031, in RESEARCH INST. OF AMERICA TAX COORDINATION 2d 61-3RD TAX MNG’T (BNA) 28130 (1979).
111. Id. § 102(a).
112. Id. §§ 2501(a), 2511(a); Treas. Reg. §§ 25.2511-1(b), 25.2511-3(a) (1958).
113. I.R.C. § 6013(g), (h).
Goal 1

The first goal of the nonresident, the resident alien, and the nonresident couple is to maintain tax-free income. Income earned by nonresidents from sources outside the United States is not taxed. Internal Revenue Code sections 861 and 862 and the applicable Treasury Regulations set forth the source of income rules. These rules can be misleading. Normally, interest from a domestic corporation is United States source income. However, when less than twenty percent of gross income from all sources is from sources within the United States during the three-year period ending with the close of the corporate tax year, interest income is deemed from sources without the United States. Therefore, the nonresident can retain tax-free income by maintaining his nonresident status and by receiving only income from sources without the United States.

A resident or a nonresident alien about to become a resident who has income from sources without the United States may take advantage of his nonresident spouse's or nonresident family members' status. Assets which generate income from sources without the United States and which are held as separate property by the nonresident spouse or nonresident family member are not taxed. Even if the nonresident spouse is a resident of a community property country, the income will be attributed to the spouse who earns it. The transfer of the asset to the nonresident spouse or nonresident family member may be achieved by either a tax-free exchange or a gift.

Assume the resident alien holds property for investment which generates income from sources without the United States, and the nonresident family member holds property for investment which is subject to United States income tax. A gift by the resident alien of his asset to the nonresident family member is advantageous because the nonresident will not be subject to United States income tax on the gift. However, the resident alien will be

114. Id. § 862.
115. Id. § 871.
118. Id. § 861(a)(1).
119. Id. § 879.
120. Id. § 1031.
121. Id. § 2501.
subject to a gift tax.\textsuperscript{122} If the statutory requirements of section 1031 cannot be met, the use of a gift to effect the transfer would probably still result in a tax saving.\textsuperscript{123} The gift tax will be offset by the income tax saving because of the transfer.\textsuperscript{124} A section 1031 exchange of the resident's asset that produces income from without the United States for the nonresident's asset that produces income from within the United States is more effective than a gift for two reasons. First, it accomplishes the same transfer without subjecting the resident spouse to a gift tax. Second, the nonresident relinquishes ownership of an asset subject to United States income tax. Therefore, the overall income tax of the two related parties is reduced.

An election under section 6013 to treat a nonresident as a resident is self-defeating because residents of the United States are subject to income tax on worldwide income.\textsuperscript{125} However, the possibility exists that the overall income tax liability of the nonresident couple can decrease if such an election is made. The determinate factor of whether to elect to treat the nonresident as a resident is whether the overall tax saving outweighs the disadvantage of subjecting the nonresident spouse's income from sources without the United States to United States income tax.\textsuperscript{126}

\textit{Goal 2}

The second goal of the nonresident couple is to reduce the effective tax rate below the thirty percent level imposed on United States source income of the nonresident spouse not connected with a United States trade or business.\textsuperscript{127} The form of this United States source income is dividends from stocks and bonds\textsuperscript{128} and interest.\textsuperscript{129}

The first method to achieve this goal is an election by the nonresident couple to treat the nonresident spouse as a resident under section 6013(g) or (h). The primary tax decision whether

\begin{itemize}
\item \textsuperscript{122} \textit{Id.}
\item \textsuperscript{123} See text accompanying notes 103-04 \textit{supra.}
\item \textsuperscript{124} The resident spouse paid income tax on income from the asset which is now the property of the nonresident spouse who pays no U.S. tax on it.
\item \textsuperscript{125} Treas. Reg. \textsection 1.1-1(b) (1954). \textit{Contra}, Rev. Rul. 79-246, 1979-33 I.R.B. 11, which provides that an election to file a joint return under \textsection 6013(g) of the Code is not a waiver of the privileges provided by \textsection 893(a) of the Code, which exempts from U.S. income tax amounts received as compensation for services to an international organization by an employee if (1) such employee is not a citizen of the U.S.
\item \textsuperscript{126} This factor is fully examined under Goal 2. See text accompanying notes 130-49 \textit{infra.}
\item \textsuperscript{127} \textit{I.R.C.} \textsection 871.
\item \textsuperscript{128} \textit{Id.} \textsection 861(a)(2).
\item \textsuperscript{129} \textit{Id.} \textsection 861(a)(1).
\end{itemize}
to make the election would rest on a comparison of the tax savings available to the married couple who makes the election and thus can file a joint return, with the tax savings that result from the exemption for nonresidents of tax on foreign source income. In addition to reducing the income tax liability on a nonresident's United States source income from thirty percent of gross income to the graduated rates on net income, benefits available to the couple who elect under section 6013 and file jointly include: (1) fifty percent maximum tax on personal service income, (2) joint return rates, (3) income averaging, (4) zero bracket amount, (5) higher limitations on capital loss, (6) credit for the elderly, (7) general tax credit, (8) earned income credit, (9) credit for child care expenses, (10) eligibility for sick pay exclusion, and (11) a higher limit on moving expenses.

The following are the consequences of the election decision. Assume the nonresident receives only United States source income (interest, dividends) and anticipates receiving no income from without the United States in the future. The trade-off between tax benefits because of the election to be treated as a resident and subjecting worldwide income to United States taxation is in favor of the election for two reasons. First, the nonresident exposes no new income to tax. Second, the nonresident couple can invoke the joint return rates as well as the benefits enumerated previously. At the other end of the scale is the nonresident who receives United States source income and substantial income from sources without the United States. An election sub-

131. I.R.C. § 1348.
132. Id. §§ 6013, 1.
133. Id. § 1303.
134. Id. § 65(d)(1)(A).
135. Id. § 1211(b)(2), (c).
136. Id. § 37(d).
137. Id. § 42(d).
138. Id. § 43(d).
139. Id. § 44(A)(F)(2).
140. Id. § 105(d)(4).
141. Id. § 217(b)(3)(A).
142. Id. § 1(a).
143. See text accompanying notes 116-26 supra (benefits of election).
jects the nonresident spouse's worldwide income to tax. Ultimately, the level of income of each spouse will determine the feasibility of the election. However, it appears the new tax liability may be greater than the saving as a result of being a United States resident when the nonresident spouse receives substantial income from sources without the United States. In that case, the election should not be made.

When the analysis of the election decision is made, the critical factor is the overall effective tax rate of the nonresident couple. For example, if the nonresident couple has taxable income from passive sources of $28,000 after the benefits of the election and the resident spouse accounts for $24,600, the additional income of the new resident alien is taxed at the thirty-two percent rate. However, that alone should not deter the election, as the effective tax rate is below the thirty percent level. If the nonresident couple has income of $80,000 from passive sources and the resident spouse accounts for $60,000, the effective tax rate on the $60,000 is approximately thirty-three percent. The $20,000 is taxed at fifty-four percent which raises the overall effective tax rate to approximately thirty-eight percent. The thirty-eight percent rate deters the election. The precise quantities of income of each spouse are determinative of the section 6013 election decision.

When no election under Internal Revenue Code section 6013(g) or (h) is made, taxation of a resident spouse's income is governed by Code section 879. The effect of this provision is to preempt community property laws and avoid the deflection of income from one spouse to the other. For example, a resident spouse who earns income from a foreign source cannot attribute one half to the nonresident spouse under community property law of the state in which the resident resides. The spouse who used his services, skills, or separate property is taxed on the income procured therefrom.

Another method to reduce the rate of tax below thirty percent is to make a gift of the income-producing property to the resident spouse. The resident spouse will be taxed on the income the gift

145. The effective tax rate is the average rate of tax on all income. As our system taxes income in increments of increasing rates, the effective rate is determined by dividing the total amount of tax by the total income.
146. I.R.C. § 1(a).
147. Id. ($5,593 is the tax on $28,000, which is below 30%; $5,593 equals $4,505 plus 32% of income over $24,600).
148. Id. ($19,678 is approximately 33% of $60,000).
149. Id. ($30,478 is approximately 38% of $80,000; $30,478 equals $19,678 plus 54% of $20,000).
150. Id. § 879. See note 21 supra.
generates, but not on the value of the gift.151 If the resident's effective tax rate is below thirty percent, the gift is advantageous. However, the future income of the resident spouse is important. Projections of the resident's effective tax rate will indicate the long-term effect of the gift.

In addition, a section 1031 exchange can be utilized to achieve a reduction in the thirty percent tax imposed on United States source income of a nonresident spouse. The effective tax rate of the resident spouse, in addition to the source of the income from the property to be transferred to the nonresident spouse, is determinative of the decision to make a section 1031 exchange because of the tax savings each permits. When the resident's effective tax rate is below thirty percent, there is an immediate saving on the tax incurred on the property transferred to him. That amount is equal to the difference between his tax rate and the thirty percent rate imposed on the property when it is held by the nonresident. If the resident spouse transfers property that is subject to United States income tax to a nonresident in whose hands the property is not subject to United States income tax because it produces income from sources without the United States, the nonresident has effectuated his goal. The nonresident spouse now holds property of a comparable value to the property held before the exchange;152 however, no income tax liability is incurred on the exchanged property.

Goal 3

The third goal of the nonresident alien is to reduce the tax rate of thirty percent imposed on the receipt of rental income from real property situated in the United States.153 Methods which might be utilized to achieve this goal include the election to treat the nonresident as a resident under section 6013, a gift of the property to the resident spouse, a section 1031 exchange, and an election by the nonresident to treat real property income as income connected with a United States trade or business under Code section 871(d).154 The analysis under Goal 2 of the determi-

151. I.R.C. § 1002. See text accompanying notes 110-12 supra.
152. I.R.C. § 1031.
153. Id. § 871(a)(1).
154. Id. § 871(d).
     (d) Election to treat real property income as income connected with United States business.—
native factors concerning a section 6013 election and a gift of
depository real estate.

The nonresident spouse can exchange the income-producing
real estate for unimproved real estate held by the resident spouse
for investment. The tax on the income-producing real estate,
now held by the resident spouse, is on net income rather than on
gross income. The presumption is that the resident spouse's
tax bracket is low enough to reduce the rate of taxation below
the thirty percent level. However, even if the tax rate is the same for
the resident spouse and the nonresident spouse, the tax liability
is lower because the amount of taxable income is less than when
the nonresident held the property. Once the transaction is com-
pleted, the nonresident spouse holds the real estate as an invest-
ment. Therefore, a tax is imposed only upon the disposition of
the property when the nonresident is present within the United
States for 183 days or more.

Finally, the nonresident alien, in an effort to reduce the effec-

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(1) In general.—A nonresident alien individual who during the taxable year derives any income—
(A) from real property held for the production of income and located in the United States, or from any interest in such real property, including (i) gains from the sale or exchange of such real property or an interest therein, (ii) rents or royalties from mines, wells, or other natural deposits, and (iii) gains described in section 631(b) or (c), and
(B) which, but for this subsection, would not be treated as income which is effectively connected with the conduct of a trade or business within the United States,
may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary with respect to any taxable year.

(2) Election after revocation.—If an election has been made under paragraph (1) and such election has been revoked, a new election may not be made under such paragraph for any taxable year before the fifth taxable year which begins after the first taxable year for which such revocation is effective, unless the Secretary consents to such new election.

(3) Form and time of election and revocation.—An election under paragraph (1), and any revocation of such an election, may be made only in such manner and at such time as the Secretary may by regulations prescribe.

156. I.R.C. § 861(a)(4) (taxation of rental income received by a nonresident is a tax on the gross amount received).
157. Id. § 1221.
158. Id. § 871(a)(2).
tive tax rate to below the thirty percent level on rental income from property within the United States, may elect to treat real property income as income connected with a United States trade or business. The income will be subjected to a net tax at graduated rates as compared to a thirty percent tax on gross income. The election decision is determined by a comparison of the tax liability before and after the election, with emphasis upon the deductions available if the election to treat the income as connected with a United States trade or business is made. For example, the nonresident receives $100,000 of gross rental income from real property. Before the election, the tax liability is $30,000. If the election is made and after deductions the taxable income is $80,000, the tax liability for a married individual filing separately is $39,964. The election under section 871(d) is not advantageous because the tax liability is increased. This method is more advantageous to a nonresident not married to a citizen or resident of the United States because the limitations imposed upon a married individual filing separately increase that individual's tax liability. In addition, the unmarried nonresident is taxed at a lower rate than a married individual filing separately. The election under section 871(d) is the only available means for a nonresident to reduce the thirty percent tax rate imposed on rental income from real property not connected with a United States trade or business and situated in the United States.

Goal 4

The fourth goal of the nonresident alien is to avoid taxation on the proceeds from the sale of real estate situated in the United States. Two requirements must be met. The nonresident must not be present in the United States for more than 183 days. In addition, the real estate must qualify as a capital asset regardless of the holding period. If this provision is not applicable, alter-

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159. Id. § 871(d) (note the election is in effect for all real property owned by the nonresident).
160. Id. § 871(a).
161. Id. §§ 161, 162, 212.
162. Id. § 1(d) [23,772 + (54% of $25,300)].
163. See text accompanying notes 11-18 supra.
164. Compare I.R.C. § 1(c), with id. § 1(d).
165. Id. § 861(a)(5).
166. Id. § 871(a)(2).
167. Id. § 1221. Capital assets are all property held by the taxpayer except in-
native approaches available are an exchange pursuant to section 1031 or a gift of the property to the resident spouse.

Goal 5

The fifth goal of the nonresident alien is to obviate taxation on the income received as compensation for personal services performed in the United States.\footnote{Id. § 861(a)(4).} Section 861(a)(3) provides that compensation for personal services performed in the United States will not be United States source income if (1) the nonresident is not present in the United States for more than ninety days; (2) the compensation does not exceed $3,000; and (3) the services are performed as an employee of or under contract with a foreign individual or entity not engaged in a United States trade or business or with a United States individual or entity if such labor or services are performed for an office or place of business outside the United States.\footnote{Id. § 861(a)(3).} Factors which do not affect whether compensation for personal services is United States source income are the residence of the payer, the place in which the contract for service was made, and the place or time of payment.\footnote{Treas. Reg. § 1.861-4(a)(1) (1954).}

Goal 6

The sixth goal of the nonresident couple is to reduce taxes on United States source income that is compensation for personal services performed in the United States by the nonresident spouse. Personal services performed within the United States constitute a trade or business.\footnote{I.R.C. § 864(b) (unless the compensation is less than $3,000 and the alien is not present in the U.S. more than 90 days).} Therefore, the income generated therefrom is effectively connected and is taxed at graduated rates.\footnote{Id. § 871(b).} An election to treat the nonresident spouse as a resident under section 6013 is the only method available to reduce taxes on compensation for personal services performed in the United States.\footnote{See text accompanying notes 130-49 supra.} If the election to treat the nonresident spouse as a resident is not made, then section 879 is operative and income will be attributed to the spouse who earns it. Therefore, transfers to elude income taxation of compensation for personal services are obviated by the Internal Revenue Code.

\footnote{168. Id. § 861(a)(4).} \footnote{169. Id. § 861(a)(3).} \footnote{170. Treas. Reg. § 1.861-4(a)(1) (1954).} \footnote{171. I.R.C. § 864(b) (unless the compensation is less than $3,000 and the alien is not present in the U.S. more than 90 days).} \footnote{172. Id. § 871(b).} \footnote{173. See text accompanying notes 130-49 supra.}
Goal 7

The final goal of the nonresident couple is to reduce the graduated tax levied upon income effectively connected with a United States trade or business. The impact of an election to treat the nonresident spouse as a resident under section 6013 is reduced by section 873. Section 873 authorizes deductions for expenses which are connected with a United States trade or business. In addition, section 873 authorizes deductions for losses, charitable contributions, and one personal exemption, whether or not those expenses are connected with a United States trade or business. Therefore, net income as compared to gross income is subject to tax. However, the savings and benefits pursuant to the election as compared to the tax effect of subjecting worldwide income to United States taxation must be determined as the tax liability may or may not be further reduced.

If the section 6013 election is not made, then section 879 is operative. Therefore, treating the United States business as community property will not reduce the tax liability of the nonresident. All the income will still be attributed to the spouse who rendered the services to earn the income. To accomplish the objective of reducing the tax liability of the nonresident, a gift of the entire business to the resident spouse may be made. This decision will rest upon the respective tax rates of each spouse. The income is taxed at graduated rates; therefore, if one spouse is in a higher tax bracket, the tax liability increases. In addition, the resident spouse may own other businesses that have losses that will offset the gains of the transferred business.

CONCLUSION

“Residence for United States income tax purposes has an evasive way about it, with as many colors as Joseph’s coat.” Immigrants and nonimmigrant visa holders have been classified as residents in varying circumstances. The facts and circumstances of each case will be determinative of whether an alien is classified as a resident. The impact of such a characterization is dramatic

175. See text accompanying notes 130-49 supra.
176. Id. § 879(a).
177. Id. §§ 172, 269, 382.
178. Weible v. United States, 244 F.2d 158, 163 (9th Cir. 1957).
because of the comprehensive nature of the United States income taxation of residents. However, the adverse impact of United States income tax laws upon the nonresident couple and the nonresident who is about to become or who has become a resident may be lessened.

Measures can be taken to avoid United States income taxation if a tax advisor is informed far enough in advance that a nonresident will become a United States resident. For example, a resident of a country that does not impose any tax on capital gains should realize capital gains on assets from without the United States before establishing residency in the United States. If United States capital assets are held, they should be sold prior to the change to United States resident status, with care taken to avoid the 183-day rule.\(^7\) Once residency is established, income received is taxed regardless of when it was earned.\(^8\) Pensions\(^9\) and commissions\(^10\) earned abroad but received while one is a United States resident are subject to United States income taxation. Therefore, receipt of ordinary income, pensions, and commissions earned by the nonresident should occur before the change to United States resident status.

The Tax Reform Act of 1976 made changes which broaden the scope of tax planning. A nonresident couple is permitted to elect to treat the nonresident spouse as a resident and take advantage of the benefits of filing a joint return. Additional methods are also available to reduce taxes for resident aliens and for nonresidents who are about to become residents and who have nonresident family members. In this area, the potential benefits of careful income tax planning are substantial and, as yet, largely unexplored.

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\(^7\) See text accompanying notes 166-67 supra. See also Spuehler, The Foreign Client—A Transactional Approach with Special Emphasis on Nonbusiness Activities, 24 Major Tax Plan. 254 (1972).


\(^9\) Stanford v. Commissioner, 34 T.C. 1150 (1960), aff'd, 297 F.2d 298 (9th Cir. 1961).