

# Tax planning for employees coming to work in the U.S.

## Up close

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In U.S. tax law the term “alien” refers to a foreign national (an individual who is not a citizen of the United States). How an alien is taxed under U.S. income tax law depends upon whether the foreign national is considered a resident or a nonresident of the U.S. Two tests determine if an alien is a resident of the United States:

### The green card test

An alien who is admitted as a lawful permanent resident (green card holder) will generally be treated as a resident of the United States for income tax purposes. Residency status is effective from the first day the foreign national is present in the U.S. while possessing a “green card.” One remains a U.S. resident the entire time one possesses a green card even if the U.S. assignment ends and the person returns to the home country.

### Substantial presence test

The substantial presence test is based upon days of physical presence in the U.S. (part days count as full days). To meet the substantial presence test, an individual present in the U.S. for at least 31 days in the current year will be considered a resident alien if the sum of the following equals or exceeds 183 days: number of days

present in the U.S. in the current year + 1/3 of the days present during the first preceding year + 1/6 of the days present during the second preceding year.

### Planning

There are planning techniques and exceptions to the substantial presence test. The rules in this area are complex. Please contact your Grant Thornton advisor if you require more information.

### Residency start date

Generally, for an alien who becomes a resident during a tax year, tax residency begins:

- **Green card holder** – On the first day in the year on which the alien is present in the U.S. as a lawful permanent resident.
- **Substantial presence test** – On the first day of presence in the U.S. during that year. However, in determining the first day of presence under the substantial presence test an alien may be present in the U.S. for up to 10 prior days during the year without triggering the residency starting date.

### Residency end date

Residency under the substantial presence test continues until the foreign national no

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longer meets the test. The individual's residency terminates on the last day of the calendar year the test is met. U.S. residency will terminate at the time the individual moves away from the U.S., if at that time a tax home is established in another country and the individual has closer personal and business connections to that country. In addition, to break U.S. residency, the individual must remain a nonresident for the next calendar year.

#### Tax treatment of resident aliens

Resident aliens are taxed under the same rules as those that apply to U.S. citizens. They are subject to tax at graduated rates on all income from worldwide sources.

#### Types of taxable compensation

Generally, the following types of compensation are taxable in the U.S., but this list is not meant to be all inclusive.

- Base salary,
- Bonus,
- Cost of living allowance,
- Housing allowance,
- Education allowance for children,
- Home leave reimbursements,
- Reimbursement of host/home country taxes,
- Personal use of company car,
- Certain moving allowances, and
- Stock options.

#### Investment income

Investment income (interest, dividends, rents, royalties, etc.) received by a resident of the U.S. is subject to tax at graduated rates regardless of source with the exception of qualifying dividend income, which is generally taxed at 15 percent.

#### Capital gains

Capital gains from the sale of investment assets held for less than 12 months are taxed at the taxpayer's regular tax rates. Long-term capital gains (sale of investment assets) held for more than 12 months are generally taxed at 15 percent. Some exceptions apply. If certain requirements are met, the gains on the sale of a personal residence may be excluded up to U.S. \$250,000 (U.S. \$500,000 married filing jointly).

#### Deductions from income

As a U.S. resident, several deductions may be taken against gross income to arrive at an individual's taxable income. Unlike nonresident aliens who are limited to very few specific deductions, a U.S. resident has the option of deducting the greater of the standard deduction or total itemized deductions.

The standard deduction is a pre-determined amount that varies according to an individual's filing status. The standard deduction amounts for 2008 are as follows:

- Single – \$5,450,
- Married filing jointly – \$10,900,
- Married filing separately – \$5,450, and
- Head of household – \$8,000.

Some examples of nonbusiness expenses referred to as itemized deductions include: state and local taxes, real and personal property taxes, interest on home mortgages (with restrictions) and contributions of cash or property to U.S. charities, up to statutory limitations.

In addition, a taxpayer may deduct a personal exemption for him/herself, a spouse and their children if they qualify as dependents to the taxpayer. The amount of the exemption is predetermined and

adjusted each year for inflation. The exemption amount for the 2008 tax year is \$3,500. Personal exemptions are phased out for taxpayers with an adjusted gross income in excess of certain thresholds.

### Tax treatment of nonresident aliens

Nonresident aliens are taxed only on “U.S. source income,” which is categorized under two distinct definitions: income effectively connected with a U.S. trade or business (ECI), and income not effectively connected with a U.S. trade or business (non-ECI).

A nonresident alien’s ECI is taxed under rules similar to those which apply to U.S. citizens (i.e., income can be offset by certain deductions and personal exemptions and the resulting taxable income is taxed at normal graduated rates).

Depending on the length and terms of the U.S. assignment, tax relief may be available under the provisions of a bilateral tax treaty between the U.S. and the home country. Generally, treaty relief for compensation is only available if the individual is not present in the U.S. for more than 183 days during that year and the compensation is paid and borne by an offshore (i.e., non-U.S.) entity. It is critical that the treaty provisions of the particular country be examined.

Non-ECI (which typically includes investment income such as interest, dividends, rents and royalties) is taxed to the extent that it is deemed to be derived from U.S. sources. Non-ECI is taxed as gross income (i.e., no deductions are allowed), generally at a flat rate of 30 percent, but if the nonresident alien is resident in a country with which the U.S. has a tax treaty, a lower rate may apply.

### Filing status and tax return forms

- **Full-year nonresident** – For any year in which an alien is nonresident for the entire year, all income that is subject to U.S. tax must be reported and the tax thereon computed on Form 1040NR.
- **Full-year resident** – For any year in which an alien is resident for the entire year, all income must be reported and the tax computed on Form 1040.
- **Dual status** – It is possible for a foreign national to be both a nonresident and a resident in the initial year and final year of the U.S. assignment. This situation creates a “dual-status” taxpayer. U.S. tax laws applicable to resident and nonresident aliens must be considered. Generally, a “dual-status” taxpayer is subject to tax on worldwide income for the period of residency and only U.S.-source income for the period of nonresidency. In addition, there are elections that can be made that could significantly increase or decrease the U.S. tax liability.

### Due dates and extensions

#### Full-year resident and arrival year dual-status returns

U.S. citizens and resident aliens are required to file by April 15 following the end of the tax year (Dec. 31). For taxpayers who have a tax home outside the U.S. on April 15, the due date for filing and payment of any balances of tax due is automatically extended to June 15.

The extension will apply to an alien for a year in which he was a resident alien through Dec. 31, but who subsequently left and established a tax home and abode abroad prior to the April 15 filing deadline. It is also possible to obtain an additional extension to Oct. 15 (Form 4868).

Full-year nonresident and departure year dual-status returns  
Nonresident aliens are also required to file tax by April 15. The “taxpayer abroad” extension described above is not available to nonresident alien tax return filers, although Form 4868 can extend due date to Oct. 15 (Form 4868).

### Federal tax rates

There are four categories of tax status that may apply to a taxpayer in the U.S.: single, married filing jointly/surviving spouse, married filing separately and head of household.

If either spouse is a nonresident of the U.S. at any time during the tax year, married individuals generally will not be able to utilize the married filing jointly tax rates and will be required to use the married filing separately tax rates, which tend to be less favorable. However, it may be possible to make a special election to utilize the married filing jointly tax rates, which may or may not prove to be more favorable depending upon the situation.

Federal income tax rates – 2008 (single)		
Taxable income(\$)	Rate(%)	Cumulative tax
0 – 8,025	10	—
8,026 – 32,550	15	802.50
32,551 – 78,850	25	4,481.25
78,851 – 164,550	28	16,056.25
164,551 – 357,700	33	40,052.25
Over 357,700	35	103,791.75

Federal income tax rates – 2008 (married filing jointly)		
Taxable income(\$)	Rate(%)	Cumulative tax
0 – 16,050	10	—
16,051 – 65,100	15	1,605.00
65,101 – 131,450	25	8,962.50
131,451 – 200,300	28	25,550.00
200,301 – 357,700	33	44,828.00
Over 357,700	35	96,770.00

Federal income tax rates – 2008 (married filing separately)		
Taxable income(\$)	Rate(%)	Cumulative tax
0 – 8,025	10	—
8,026 – 32,550	15	802.50
32,551 – 65,725	25	4,481.25
65,726 – 100,150	28	12,775.00
100,151 – 178,850	33	22,414.00
Over 178,850	35	48,385.00

Federal income tax rates – 2008 (head of household)		
Taxable income(\$)	Rate(%)	Cumulative tax
0 – 11,450	10	—
11,451 – 43,650	15	1,145.00
43,651 – 112,650	25	5,975.00
112,651 – 182,400	28	23,225.00
182,401 – 357,700	33	42,755.00
Over 357,700	35	100,604.00

### Social security taxes

Social security tax (FICA) is charged on all compensation received for services performed within the U.S. regardless of citizenship or residence of the employee or employer, number of days worked or amount of wages earned. Nonresident aliens may be exempt based on visa type.

Social security taxes are assessed to individuals at a rate of 7.65 percent, which consists of a 6.2 percent component for old-age, survivors and disability insurance (OASDI) and 1.45 percent for Medicare. The 6.2 percent is capped at \$6,324 in 2008. The 1.45 percent Medicare rate is uncapped. Employers must make a matching contribution of social security taxes on behalf of employees at the same rates/thresholds.

A foreign national employed in the U.S. may be subject to the social security laws of both the U.S. and their home country. Totalization agreements are designed to alleviate this double taxation by allowing the foreign national to be covered under only under the home social security system.

## Example individual income and social tax calculations

<b>Federal income tax calculation (for U.S. resident only)</b>	
Assume a married individual with two children under 17 years old; all family members are considered tax residents of the U.S. for the entire tax year (2008).	
Base salary	\$ 100,000
Bonus	20,000
Cost-of-living allowance	10,000
Interest income	800
Long-term capital gain	<u>8,000</u>
<b>Total income</b>	<b>138,800</b>
Personal exemptions	(14,000)
Standard deduction	<u>(10,900)</u>
<b>Taxable income</b>	<b>\$ 113,900</b>
Federal tax	\$ 19,363
Federal tax on long-term cap gain (15%)	<u>1,200</u>
	\$ 20,363
Federal tax	\$ 20,363
Alternative minimum tax	\$ 23,508
<b>Total federal tax</b>	<b>\$ 23,508</b>
Child tax credit (after phase-out)	(550)
<b>Total federal tax after credits</b>	<b>\$ 22,958</b>
<b>Social tax calculation</b>	
Base salary	\$ 100,000
Bonus	20,000
Cost-of-living allowance	<u>10,000</u>
<b>Total compensation</b>	<b>\$ 130,000</b>
OASDI (capped)	\$ 6,324
Medicare (1.45%)	<u>1,885</u>
<b>Total social tax</b>	<b>\$ 8,209</b>

### State and local taxes

Most states in the U.S., and many cities and towns, levy a separate income tax on individuals. The method each state uses in determining tax liabilities varies, as do tax rates, extension procedures, residency rules and the availability of foreign tax credits.

### Estate and gift taxes

Residency rules for estate and gift taxes differ from those for income taxes. Estate

and gift taxes apply to foreign nationals who are domiciled in the U.S. or have certain types of property in the U.S. Obtaining a green card is evidence of domicile, but the substantial presence test does not apply to these transfer taxes. Nonresidents are only subject to tax on U.S. situs assets as defined by regulation and administrative interpretation.

*The impact of the U.S. tax system on any particular person depends on the particular facts and circumstances of that individual. This discussion is intended only as a limited information overview of certain aspects of the U.S. tax system. Please contact Grant Thornton LLP to discuss particular assistance regarding compliance with the U.S. tax system.*

### Tax professional standards statement

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