A VIEW FROM THE CROW'S NEST

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Ten Common Tax Return Errors Foreign Nationals Should Avoid

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Many foreign nationals submit incorrect tax returns (or do not submit at all) because of a lack of awareness of the different rules that can apply to foreign nationals' returns. This is the case whether the returns are prepared by paid preparers or by the foreign nationals themselves. Because of the new IRS focus on international tax compliance and the new paid preparer penalties, foreign nationals and their tax return preparers should expect the IRS to scrutinize their returns. They should also expect the immigration service to review their returns more closely when they are requesting future immigration benefits.

Ten Common Mistakes to Avoid
The following are ten common tax return mistakes that foreign nationals need 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 foreign workers not in the United States a full calendar year, submit a Form 1040 claiming deductions such as the standard deduction, which 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. Those foreign nationals who use e-filing, therefore, frequently submit the wrong return.

2. Filing using married filing jointly status incorrectly
A nonresident married to a U.S. citizen or resident alien as of December 31st may elect to file as a resident jointly with his or her spouse. Residents include a spouse who made a first-year choice election to be a part-year resident. However, two married nonresident aliens may not make the election to file jointly as residents. They must file as nonresident aliens using married filing separately rates, which are 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 (though in limited circumstances they may still be entitled to tax treaty benefits). 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 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

4. Claiming incorrect personal exemptions
In order to claim more than one personal exemption amount, nonresident alien taxpayers must be U.S. nationals or residents of Canada, Mexico, or Korea (South). Nonresident alien students and business apprentices from India may claim a spousal exemption (if the spouse meets certain restrictions) and exemptions for children who are U.S. citizens or resident aliens.

In order for a dependent to be claimed for a personal exemption by a resident alien taxpayer, the dependent must be a U.S. citizen, resident alien, or U.S. national, or a resident of Canada or Mexico at some point during the tax year in question.

5. Incorrectly claiming a tax treaty benefit
The United States 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 resident in the United States.

6. Claiming improper temporarily-away-from-home expense deductions
Taxpayers who have been providing services who 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 as compensation in gross income on Form W-2, 1042-S or 1099-MISC.

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 source or
- The capital gain is U.S. source, but the recipient is in the United States for less than 183 days in the tax year.

Foreign nationals in nonimmigrant categories such as A (diplomats), G (employees of international organizations), F, J, and M (students) and J and Q (nonstudents) typically remain nonresidents for a number of calendar years under the 183-day residency formula, but are physically present for purposes of the 183-day capital gain.

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

- 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 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 required 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 8891 to report income being deferred on certain Canadian Registered Retirement Plans
- Form 8898 to report the beginning or ending of bona fide residence in a U.S. possession

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 (required annually for certain U.S. citizens) 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 United States to be U.S.-source income (regardless of the currency or location of the payment)
- Payers neglect to send them required income statements so they are unaware of their tax return filing obligations

Nonresident aliens who fail to timely file their nonresident tax return can lose deductions and credits to which they would otherwise be entitled.

10. Failing to file a state income tax return
Whether foreign nationals have a state income tax filing obligation depends upon whether they are state residents (under the state's rules) or whether, as nonresidents, they earn income from certain sources in a state that imposes income taxes on individuals, and whether their income meets the state's filing threshold. 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 that prepare nonresident federal returns do not prepare state income tax returns.