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Snowbirds Flying Blind: Beware the US Residence Trap

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INTRODUCTION

When a foreign individual becomes a US resident,[1] bad things happen. For example, the individual's investments retain their historic tax basis, so that a subsequent sale triggers US tax on gain accrued prior to immigration. Moreover, a variety of onerous special rules may subject the individual's income to tax at confiscatory rates and impose complex, frequently duplicative reporting requirements, with draconian penalties for even inadvertent non-compliance. Worse yet, an individual can accidentally become a US resident if he or she does not understand the US residence rules. Indeed, under a common fact pattern, the mere failure to timely file a certain disclosure with the US Internal Revenue Service (IRS) may preclude an individual from claiming nonresident status. This is particularly applicable to Canadian snowbirds.

INCOME TAX RULES APPLICABLE TO US RESIDENTS

A nonresident alien of the United States is subject to US federal income tax only on:

1. income that is considered to be effectively connected with the conduct of a trade or business in the United States ("effectively connected income"),[2] and
2. any fixed or determinable annual or periodical income that has a US source and does not constitute effectively connected income (FDAP income).[3]

By contrast, a US resident individual is subject to US federal income tax on worldwide income. Under current law, income is taxed at a maximum federal income tax rate of 39.6 percent in the case of ordinary income and short-term capital gains, and at a maximum federal income tax rate of 20 percent in the case of long-term capital gains.[4] Certain investment income may also be subject to a 3.8 percent federal Medicare tax.[5] State and local income taxes may apply as well.

A number of anti-deferral rules apply to foreign investments. For example, under the Subpart F rules, a "United States shareholder" of a "controlled foreign corporation" (CFC) is subject to current tax, at ordinary income rates, on any "Subpart F income" earned by the CFC. A foreign corporation is a CFC if United States shareholders own in the aggregate (directly, indirectly, or through application of certain constructive ownership rules) stock possessing more than 50 percent of the total voting power or total value of all outstanding shares.[6] For these purposes, a US person is a United States shareholder if such US person owns (directly, indirectly, or through application of certain constructive ownership rules) stock possessing 10 percent or more of the total voting power of all outstanding shares.[7] Subpart F income generally includes, among other things, most passive investment income, such as interest, dividends, rents, royalties, and capital gains, unless an exception applies.[8]

In addition, a US person who sells stock of (or receives an "excess distribution" from) a "passive foreign investment company" (PFIC) generally is subject to a punitive regime that, among other things, treats all of the gain (or excess distribution) as ordinary income and imposes an interest charge based on the period in which the stock of the PFIC was owned.[9] Virtually any foreign mutual fund, hedge fund, or private equity fund will be classified as a PFIC and thus subject to these rules. In certain circumstances, one or more tax elections may be available to avoid certain of these consequences, but typically the tax consequences are still unfavorable, and in many circumstances the desired election may be unavailable.

Moreover, numerous disclosure requirements apply to foreign accounts, interests in foreign entities, and other foreign financial assets, as well as certain other transactions involving a foreign element.[10] These requirements include, among others, the obligation to file the following forms (as applicable):

- FinCEN Report 114, "Report of Foreign Bank and Financial Accounts" (commonly referred to as a foreign bank account report, or FBAR), to disclose foreign financial accounts and certain other assets classified (somewhat loosely) as accounts for this purpose
- Form 8938, "Statement of Specified Foreign Financial Assets," to disclose a variety of interests in foreign entities and other foreign assets
- Form 5471, "Information Return of US Persons with Respect to Certain Foreign Corporations," to disclose, among other things, certain interests in foreign corporations
- Form 926, "Return by a US Transferor of Property to a Foreign Corporation," to disclose certain transfers of cash or other property to foreign corporations
- Form 8865, "Return of U.S. Persons with Respect to Certain Foreign Partnerships," to disclose, among other things, certain interests in foreign partnerships
- Form 8858, "Information Return of U.S. Persons with Respect to Foreign Disregarded Entities," to disclose ownership of a foreign disregarded entity
- Form 3520, "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts," to disclose, among other things, certain interests in foreign trusts and certain gifts from foreign individuals or entities
- Form 3520-A, "Annual Information Return of Foreign Trust with a U.S. Owner," to disclose ownership of a foreign trust that is considered a "grantor trust" under the US tax rules.

Some of these filing obligations are duplicative, and the penalties for even inadvertent non-compliance can be outlandish. For example, absent a showing of reasonable cause, the unintentional failure to disclose ownership of a foreign corporation with two foreign bank accounts may result in penalties of US$40,000, consisting of:

1. one US$10,000 penalty for failure to file Form 5471,
2. one US$10,000 penalty for failure to file Form 8938, and
3. two US$10,000 penalties for failure to disclose the two foreign accounts on the FBAR.[11]

Such penalties may be imposed even if there was no unreported income with respect to the foreign corporation.

In other circumstances, the failure to report certain receipts may be subject to a penalty equal to a substantial percentage of the receipt (even if there is no unreported income). For example, the failure to report a distribution from a foreign trust is subject to a penalty equal to 35 percent of the distribution.[12] Similarly, the failure to report a foreign gift exceeding a specified threshold may be subject to a penalty equal to 25 percent of the gift.[13]

SPECIAL CONSIDERATIONS APPLICABLE TO IMMIGRANTS

When a foreign individual becomes a US resident alien (or a US citizen), he or she becomes subject to worldwide taxation, and worldwide disclosure, under the rules referred to above. In many cases, the impact can be extremely harsh.

One reason is that, unlike many other countries, the United States does not provide a basis step-up to fair market value when immigrants arrive with appreciated assets. For example, suppose that Fred purchased stock of Kodak for US$1 million many years ago. Fred decides to move to the United States, and on the date of his arrival, the Kodak stock is worth US$5 million. The next day, Fred sells the stock for US$5 million, realizing a capital gain of US $4 million (all of which accrued while he was a nonresident), which will be subject to US tax. Alternatively, suppose that Fred's investment is not stock of Kodak but stock of a foreign hedge fund classified as a PFIC. In this case, the gain will not only be subject to US tax, but will be taxed at ordinary income rates under the PFIC rules described above.

Another way the US rules can be particularly harsh is that the United States is largely indifferent to the eligibility of a particular investment for tax-free treatment elsewhere. For example, suppose that Wilma moves to the United States with an interest in a foreign retirement plan that is not taxed under the tax laws of her home country until distributions are received. That's all very interesting, but the exempt status of Wilma's plan for foreign tax purposes generally is irrelevant under the US tax laws.[14] Depending on the circumstances, the United States may tax Wilma on the income from the assets held for her benefit within the plan.

Yet another example pertains to the US grantor trust rules. Suppose that Barney, a nonresident alien, has transferred assets to an irrevocable foreign trust. The primary beneficiaries of the trust are his wife and children, but the trustee (an independent company not subject to Barney's control) has the discretion to make distributions to Barney if, contrary to all expectations, he falls on hard times. Upon Barney's becoming a US resident, the trust will become a grantor trust and Barney will be taxed currently on all of the income earned within the trust, even if the trust makes no distributions to Barney (or anyone else).

Alternatively, suppose that Betty, who has also just moved to the United States, receives substantial distributions from a trust established for her benefit 40 years ago by her grandmother, who has at all times been a nonresident alien of the United States. All or nearly all of the trust distributions may be treated as income to Betty, and moreover Betty may be subject to a substantial interest charge based on the period of time over which income accumulated within the trust.

Accordingly, even for an individual with full knowledge of the US tax and reporting rules, the impact of becoming a US resident can be quite dramatic. If one becomes a US resident inadvertently, and thus is not aware of these rules, their effect can be all the more severe. As indicated previously, the penalties for even innocent noncompliance can be outlandish.

US RESIDENCE RULES

OVERVIEW

An individual generally will be a US resident for US federal income tax purposes if he or she:

1. is a US citizen,
2. is a lawful permanent resident of the United States (commonly referred to as a green-card holder), or
3. satisfies a “substantial presence” test.[15]

As a general rule, an individual satisfies the substantial presence test for a taxable year if:

1. the individual is physically present in the United States for at least 31 days in that year, and
2. the total number of “days” spent in the United States during a three-year period is equal to or greater than 183.[16]

For the purposes of the 183-day test, each day in the year being tested counts as a full day; each day in the preceding year counts as one-third of a day; and each day in the second preceding year counts as one-sixth of a day.

For example, suppose that an individual is present in the United States for 132 days in each of 2011, 2012, and 2013. The 31-day requirement for 2013 is obviously met. The total number of “days” spent in the United States for the purposes of the 183-day test is:

$$126 + (126 \times 1/3) + (126 \times 1/6) = 126 + 42 + 21 = 189.$$

On these facts, the individual would normally satisfy the substantial presence test and thus be classified as a US resident for 2013.

CLOSER CONNECTION EXCEPTION

An exception to the substantial presence test applies in the case of an individual who satisfies all of the following requirements:[17]

1. The individual is physically present in the United States for fewer than 183 days during that year. (Days spent in the United States during the two preceding years are not relevant for this purpose.)
2. The individual has a “tax home” (generally, one’s principal place of business) in a foreign country for the *entire* year.

3. The individual has a "closer connection" to the same foreign country in which the individual's tax home is located than to the United States.[18] Application of the closer connection requirement is based on whether the individual has maintained more significant contacts with the foreign country than with the United States. Among the factors considered for the purposes of this determination are:
   a. the location of the individual's permanent home;
   b. the location of the individual's family;
   c. the location of the individual's personal belongings (for example, automobiles, furniture, clothing, jewelry);
   d. the location of the social, political, cultural, or religious organizations with which the individual has a current relationship;
   e. the location where the individual conducts his or her routine personal banking activities;
   f. the location where the individual conducts business activities (other than those that constitute the tax home);
   g. the jurisdiction in which the individual holds a driver's license;
   h. the jurisdiction in which the individual votes;
   i. the country of residence designated by the individual on forms and documents; and
   j. the types of official forms and documents filed by the individual for tax purposes, such as certifications of US or non-US status.
4. The individual must not have applied for, or taken certain affirmative steps to apply for, lawful permanent resident status (that is, a green card).
5. The individual must file Form 8840, "Closer Connection Exception Statement for Aliens."

Among other things, Form 8840 sets forth the basis for an individual's position that he or she satisfies the closer connection exception. If the individual is required to file a US nonresident income tax return, Form 8840 must be attached to that return. If the individual is not required to file a return, Form 8840 must be filed separately (by the due date, including extensions, for filing a nonresident income tax return).[19]

The applicable regulations provide that, if an individual is required to file Form 8840 and fails to do so by the prescribed deadline, "the individual will not be eligible for the closer connection exception."[20] This penalty is subject to a limited exception, "if the individual can show by *clear and convincing evidence* that he or she took *reasonable actions* to become aware of the filing requirements and took *significant affirmative steps* to comply with those requirements."[21] The bar for satisfying this exception appears to be quite high. An individual who was simply unaware of the need to file Form 8840 may well fail to qualify.

Draconian penalties are, of course, nothing new to the US tax laws, but this provision of the regulations seems particularly ill considered.[22] Moreover, there is a very real question as to the validity of this particular provision. Nothing in the substantial presence test, as set forth in the Code, provides any indication that the filing of a form to claim the closer connection exception is a substantive requirement. The Code directs the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 7701(b) (defining the terms "resident" and "nonresident alien"), but whether this permits the Treasury department to read the closer connection exception out of the Code entirely for taxpayers who fail to satisfy a filing requirement is an open question.

TREATY TIEBREAKER

Even if the closer connection test is not satisfied (or unavailable by reason of a failure to timely file Form 8840), an individual who is both a US resident and a resident of a country with which the United States has an income tax treaty (a "dual resident") may be treated as a nonresident of the United States for certain purposes under the tiebreaker provisions of the treaty.[23]

For example, article IV(2) of the Canada-US Treaty provides as follows:

> Where by reason of the provisions of paragraph 1 [of article IV] an individual is a resident of both Contracting States, then his status shall be determined as follows:
>
> (a) He shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him; if he has a permanent home available to him in both States or in neither State, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (center of vital interests);
>
> (b) If the Contracting State in which he has his center of vital interests cannot be determined, he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;
>
> (c) If he has an habitual abode in both States or in neither State, he shall be deemed to be a resident of the Contracting State of which he is a citizen; and
>
> (d) If he is a citizen of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

Thus, for example, a Canadian individual who has permanent homes in both Canada and the United States generally will be treated as Canadian, for the purposes of the Canada-US Treaty, if his or her "center of vital interests" is determined to be in Canada and not in the United States. There is a requirement to disclose reliance on the treaty tiebreaker, using Form 8833 ("Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)"), but in contrast to the closer connection rule, there does not appear to be any rule precluding access to the treaty tiebreaker where the form is not timely filed.

A dual resident who qualifies as a nonresident under a treaty tiebreaker may nevertheless be subject to burdensome filing obligations and possible penalties for non-compliance. The applicable Treasury regulations generally provide that a "tiebreaker individual" is still treated as a US resident for all purposes of the Code other than computation of the individual's income tax liability. Therefore, such individual must at least arguably comply with all of the otherwise applicable reporting requirements, including, without limitation, the filing (in appropriate circumstances) of Form 5471 (to report certain interests in foreign corporations), Form 8865 (to report certain interests in foreign partnerships), Form 3520 (to report certain distributions from foreign trusts), Form 8938 (to report a whole host of foreign assets), and the FBAR (to report foreign financial accounts).

A policy argument can be made for relieving a tiebreaker individual of the obligation to comply with these burdensome reporting obligations, since they presumably exist for the primary or sole purpose of supporting the reporting of a *resident* taxpayer's proper tax liability. However, there is no rule expressly providing for such an exception. Moreover, while guidance is limited, the US government apparently believes tiebreaker individuals to be subject to the full panoply of reporting obligations that would apply in the absence of a treaty tiebreaker.

For example, the Treasury regulations governing the requirement to file Form 5471 with respect to certain interests in a foreign corporation specifically permit certain tiebreaker individuals to provide audited financial statements in lieu of certain, more detailed financial information.[24] Thus, the regulation rests upon the implicit assumption that a tiebreaker individual must file Form 5471. If this assumption is correct, it is not clear on what basis the other IRS forms would be distinguished from Form 5471.[25]

The fact that a tiebreaker individual is a US resident under the Code may also have adverse consequences for innocent third parties. For example, the Treasury regulations point out that such an individual "shall be treated as a United States resident for purposes of determining whether a foreign corporation is a controlled foreign corporation under section 957."[26] Thus, for example, if a tiebreaker individual and an "ordinary" US person each own 50 percent of the stock of a foreign corporation, the foreign corporation will be a CFC. So, even though the tiebreaker individual is not taxed as a resident, he or she can act as a "carrier" of deadly US tax consequences.

APPLICATION TO SNOWBIRDS

Many Canadians, widely referred to as snowbirds, enjoy spending about three to six months each year in the United States. If they think to inquire about US taxes at all, they are often told, "Don't worry," or "No problem so long as you stay under 183 days." Unfortunately, as the reader should now anticipate, this advice isn't quite right.[27]

As indicated above, the substantial presence test normally is satisfied, causing an individual to be a US resident, if the total number of "days" over a three-year period equals or exceeds 183, where each day during the year being tested counts as a full day, each day during the preceding year counts as one-third of a day, and each day during the second preceding year counts as one-sixth of a day. Under this formula, a Canadian who spends substantially less than half the year in the United States can satisfy the 183-day test. Absent an exception, the snowbird would then become a US resident.

As discussed above, there is a closer connection exception that may be satisfied if, among other requirements, the individual has spent fewer than 183 days in the United States during the year at issue. However, as also noted above, the Treasury regulations require the filing of Form 8840 to claim the exception, and purport to deny the exception if the form is not timely filed.

Accordingly, a snowbird who satisfies the 183-day test should timely file Form 8840, so as to preserve his or her right to avoid classification as a US resident under the substantial presence test.

But what is to be done if it's too late to timely file Form 8840 for a given year? There are a number of possible approaches. One approach would be to do absolutely nothing. Another possible approach is to file Form 8840 as soon as the problem is discovered. There is not necessarily any approach that is clearly correct in all circumstances.

Presumably the IRS would like Canadians in this situation to file a Form 8840 as soon as practicable after the error is discovered. However, the preference of the IRS is not tantamount to a legal requirement.[28] A snowbird who discovers that she has a US residence problem by reason of having failed to file Form 8840 may reasonably decide, in appropriate circumstances, that the risk of attracting unwanted IRS scrutiny with a late filing outweighs any risk that the IRS will discover the issue on its own. In the event of an IRS audit, the snowbird could still assert the closer connection exception at that time, on the ground that the regulations' timely-filing requirement is invalid. Furthermore, she could rely on the tiebreaker provisions of the Canada-US Treaty as a fallback, keeping in mind, however, that a tiebreaker individual may be required to file the same disclosures as other US residents, and may therefore be exposed to penalties for failing to satisfy such requirements.

Whether the IRS would seek to impose penalties in such circumstances is an interesting question. And at least equally interesting are how penalties might be collected and whether the Canadian government would object to its residents being fleeced through a technicality of doubtful validity and even less merit from a policy perspective.

On the other hand, a snowbird may decide for various reasons that filing a Form 8840 is desirable. For example, it's entirely possible that the IRS would accept the late filing without objection. As noted above, an exception to the regulation's punitive general rule applies "if the individual can show by *clear and convincing evidence* that he or she took *reasonable actions* to become aware of the filing requirements and took *significant affirmative steps* to comply with those requirements."[29] If a snowbird comes forward in advance of any audit to file a delinquent Form 8840, the IRS may consider this sufficient to meet the requirements of the exception.[30]

Moreover, some individuals are simply unable to live with the stress of playing the audit lottery, even where doing so is perfectly legal and the odds are in their favor. In such circumstances, filing the form to achieve resolution as quickly as possible may be desirable.

Finally, as indicated above, at the time of writing, the IRS has an offshore voluntary disclosure program (OVDP) in place, as well as certain streamlined filing procedures. Depending on the circumstances, the OVDP or streamlined procedures may permit penalties to be avoided or greatly reduced.

In any event, Canadian snowbirds who spend significant time in the United States are well advised to be careful about their day counts. Flying blind into the US residence trap is not recommended.

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[1] With apologies to Canadian readers, in the context of this article, the term "foreign" means non-US.

[2] For this purpose, gain from the disposition of a "United States real property interest" is treated as effectively connected income: section 897(a) of the Internal Revenue Code of 1986, as amended (herein referred to as "the Code"). Unless otherwise stated, all "Section" references in this article are to the Code. Effectively connected income is normally taxed on a net basis, but a punitive exception may apply if the nonresident alien fails to file a federal income tax return: section 874(a). The applicable regulations specify certain "drop-dead dates" by which returns must be filed in order to avoid such loss of deductions, and the validity of those regulations has been the subject of some litigation. See *Swallows Holding, Ltd.*, 126 TC 96 (2006), vacated and remanded, 515 F. 3d 162 (3d Cir. 2008).

[3] Subject to certain exceptions, such income is normally taxed on a gross basis at a 30 percent rate (unless a treaty provides for an exemption or a lower tax rate). Nonresident aliens may elect to treat rent that otherwise constitutes FDAP income as effectively connected income (so as to be taxed on a net basis), and when well advised, they typically make this election. Section 871(d).

[4] See section 1. Depreciation recapture is taxed at a maximum rate of 25 percent. Section 1250.

[5] Section 1411.

[6] Section 957(a)

[7] Section 951(b).

[8] See Sections 952 and 954.

[9] Section 1291.

[10] It should be emphasized that, while such investments or transactions are viewed as foreign and complicated from a US perspective, they may be extraordinarily common, straightforward transactions in the country in which they occur.

[11] The IRS takes the position that a separate penalty may be imposed with respect to each account that is not disclosed on the FBAR, but it is not clear that this is the correct interpretation of the law. In addition, the IRS has the discretion to impose a lesser penalty (or no penalty at all) if it sees fit to do so.

[12] Section 6677.

[13] Section 6039F(c). In each case, the penalty may be avoided if the taxpayer can demonstrate reasonable cause. In addition, the IRS presently has in place an Offshore Voluntary Disclosure Program (OVDP), as well as certain streamlined filing procedures. Depending upon the circumstances, the OVDP or streamlined procedures may permit penalties to be avoided or greatly reduced.

[14] A more favorable result may be available under a US income tax treaty. See, for example, article XVIII of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US Treaty").

[15] Section 7701(b).

[16] Section 7701(b)(3)(A). Any portion of a day counts as a full day for this purpose. For example, an individual who lands at JFK Airport at 11:59 p.m. Friday evening and departs at 12:01 a.m. Sunday morning, will be considered to have spent three days in the United States, even though the time spent is only 24 hours and 2 minutes.

[17] Section 7701(b)(3)(B).

[18] In certain circumstances, this closer connection may be to more than one foreign country.

[19] Treas. reg. section 301.7701(b)-8(c). Unless an extension is obtained, a nonresident alien individual's income tax return for the year (Form 1040NR, "U.S. Nonresident Alien Income Tax Return" or form 1040NR-EZ, "U.S. Income Tax Return for Certain Nonresident Aliens with No Dependents") must be filed by April 15 of the following year if the individual earned wages subject to US income tax withholding; otherwise, the return must be filed by June 15 of the following year.

[20] Treas. reg. section 301.7701(b)-8(d)(1).

[21] Treas. reg. section 301.7701(b)-8(d)(2) (emphasis added). The regulations also allow the IRS to disregard an individual's failure to file such statement when it is in the best interests of the government to do so. It appears that this rule is intended to operate solely for the government's benefit—for example, if the individual incurred a net operating loss for the year.

[22] While there certainly may be some situations in which the rule would promote compliance, the far greater likelihood is that the effect of the rule would be to needlessly inflict punishment on individuals who had no idea any filing was required.

[23] Note that pursuant to the "savings clause" included in most, if not all, US income tax treaties, a US citizen would in any event be ineligible for taxation on a nonresident basis.

[24] Treas. reg. section 1.6038-2(j)(2)(ii).

[25] For a thorough discussion of this issue, see Michael J.A. Karlin, "Now You See Them: U.S. Reporting Requirements for Tax Treaty Nonresidents" (2012) 67:3 *Tax Notes International* 267-75.

[26] Treas. reg. section 301.7701(b)-7(a)(3).

[27] It should be kept in mind that the person providing this advice typically has no expertise in tax matters and may stand to earn a commission if a US vacation home is purchased.

[28] Indeed, in the context of US taxpayers who discover errors on their personal income tax returns, the case law clearly indicates that there is no obligation to amend (although there are more than a few US tax advisers who believe otherwise).

[29] Treas. reg. section 301.7701(b)-8(d)(2) (emphasis added).

[30] It is also possible that the individual, if any, reviewing the late filing will not be aware of the rule.