



# Federal Taxation of Aliens Working in the United States

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## Summary

A question that often arises is whether unauthorized aliens and other foreign nationals working in the United States are subject to U.S. taxes. The federal tax consequences for these individuals are dependent on (a) whether an individual is classified as a resident or nonresident alien and (b) whether a tax treaty or totalization agreement exists between the United States and the individual's home country.

In general, an individual is a resident alien if he or she is a lawful permanent U.S. resident or is in the United States for a substantial period of time during the current and past two years (the "substantial presence" test). Otherwise, he or she will typically be classified as a nonresident alien. Resident aliens are generally taxed in the same manner as U.S. citizens. Nonresident aliens are subject to different treatment, such as generally being taxed only on income from U.S. sources. Exceptions exist for aliens with specific types of visas or employment.

An individual who is in the country unlawfully is, like any other alien, classified as either a resident or nonresident alien. This classification is for tax purposes only, and it does not affect the individual's immigration status. These individuals' eligibility to claim the earned income tax credit is restricted because the tax code requires that taxpayers claiming the credit provide their Social Security number (SSN), as well as those of their spouse and dependents. Unauthorized aliens are ineligible for SSNs, and therefore file their tax returns using an individual taxpayer identification number (ITIN). In the 112<sup>th</sup> Congress, legislation has been introduced that would, with some differences, impose an SSN requirement for claiming the additional child tax credit (e.g., H.R. 3630, H.R. 5652, H.R. 3275, and H.R. 1956), for claiming any part of the child tax credit (H.R. 3444 and S. 577), or for claiming any credit or refund (e.g., H.R. 1196). Two of these bills—H.R. 3630 and H.R. 5652—have been passed by the House; however, H.R. 3630 was enacted into law (P.L. 112-96) without the provision.

Finally, the provisions of an income tax treaty or totalization agreement may reduce or eliminate taxes owed to the United States. An income tax treaty is a bilateral agreement between the United States and another country that addresses the income tax treatment of each country's residents while in the other country, primarily with the intent of reducing the incidence of double taxation. Totalization agreements are bilateral treaties that address social security taxes. In 2004, the United States signed a totalization agreement with Mexico, but it has not yet been transmitted to Congress for review. In the 112<sup>th</sup> Congress, the Consolidated Appropriations Act, 2012 prohibits the Social Security Commissioner or Social Security Administration (SSA) from using any of the funds appropriated by the act to pay compensation to SSA employees to administer Social Security benefit payments under any U.S.-Mexico totalization agreement that would not otherwise be payable. Other legislation has been introduced that would state it is the sense of the House that the U.S.-Mexico totalization agreement "is inappropriate public policy and should not take effect" (H.R. 1196), or address a constitutional issue with the manner in which totalization agreements are disapproved by Congress (S. 181).

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## Immigration Status

Under U.S. immigration law, foreign nationals are legally admitted into the United States as immigrants to live permanently or as nonimmigrants to stay on a temporary basis.<sup>1</sup> The terms “immigrant” and “nonimmigrant” are not used in the Internal Revenue Code (IRC). Instead, a foreign national, whether in the United States as an immigrant, nonimmigrant or unauthorized (illegal) alien, is classified as a resident or nonresident alien for federal tax purposes.

## Resident or Nonresident Alien

For federal tax purposes, alien individuals are classified as resident or nonresident aliens.<sup>2</sup> The classification has important consequences for determining whether income is subject to U.S. taxation, what is the appropriate tax rate, and whether an individual is covered by a tax treaty. In general, an individual is a nonresident alien unless he or she meets the qualifications under either residency test:

- Green card test: the individual is a lawful permanent resident of the United States at any time during the current year, or
- Substantial presence test: the individual is present in the United States for at least 31 days during the current year and at least 183 days during the current year and previous two years. For computing the 183 days, a formula is used that counts all the qualifying days in the current year, 1/3 of the qualifying days in the immediate preceding year, and 1/6 of the qualifying days in the second preceding year.<sup>3</sup>

There are several situations in which an individual may be classified as a nonresident alien even though he or she meets the substantial presence test. For example, an individual will be treated as a nonresident alien if he or she has a closer connection to a foreign country than to the United States, maintains a tax home in the foreign country, and is in the United States for fewer than 183 days during the year.<sup>4</sup> Another example is that an individual in the United States under an F-, J-, M-, or Q-visa<sup>5</sup> may be treated as a nonresident alien if he or she has substantially complied with

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<sup>1</sup> For more information, see CRS Report RS20916, *Immigration and Naturalization Fundamentals*, by Ruth Ellen Wasem.

<sup>2</sup> It is possible for an individual to be a resident alien and a nonresident alien during the same year. For an explanation of the rules on determining residency starting and termination dates and dual-status filing, see *IRS Publication 519: U.S. Tax Guide for Aliens*, which is available at [www.irs.gov].

<sup>3</sup> I.R.C. §§7701(b)(1)(A) and (b)(3). A nonresident alien may elect, under certain circumstances, to be treated as a resident alien if the substantial presence test is met in the year following the election. I.R.C. §7701(b)(4). A dual-status or nonresident alien married to a U.S. citizen or resident may qualify to be treated as a resident alien for the entire year. I.R.C. §§6013(g) and (h).

<sup>4</sup> I.R.C. §7701(b)(3)(B).

<sup>5</sup> These individuals are temporarily admitted into the United States as students, teachers, trainees, and cultural exchange visitors. The visa letter is derived from the subparagraph of Section 101(a)(15) of the Immigration and Nationality Act that describes the type of visa. For further information, see CRS Report RL31381, *U.S. Immigration Policy on Temporary Admissions*, by Ruth Ellen Wasem.

visa requirements.<sup>6</sup> Other individuals that may be treated as nonresident aliens even if they meet the substantial presence test include employees of foreign governments and international organizations, regular commuters from Canada or Mexico, aliens who are unable to leave the United States because of a medical condition, foreign vessel crew members, aliens in transit through the United States, and athletes participating in charitable sporting events.<sup>7</sup>

A residency definition in an income tax treaty will override these residency rules. If an individual is defined as a resident of a foreign country under a treaty, then he or she is a nonresident alien for purposes of determining his or her U.S. tax liability regardless of whether the “green card” or “substantial presence” test is met.<sup>8</sup>

## Unauthorized Aliens

The Internal Revenue Code (IRC) does not have a special classification for individuals who are in the United States without authorization (commonly referred to as “illegal aliens”). Instead, the Code treats these individuals in the same manner as other foreign nationals—they are subject to federal taxes and classified for tax purposes as either resident or nonresident aliens. An unauthorized individual who has been in the United States long enough to qualify under the “substantial presence” test is classified as a resident alien; otherwise, the individual is classified as a nonresident alien. This classification is for tax purposes only and does not affect the individual’s immigration status.

While most taxpayers file tax returns using their Social Security number (SSN) as an identifier, individuals who are ineligible to receive an SSN file their returns using an individual taxpayer identification number (ITIN). Thus, unauthorized aliens who file tax returns will generally use an ITIN. One consequence of this is that they will be ineligible to claim the earned income tax credit (EITC) since the IRC requires that taxpayers claiming the EITC provide SSNs for themselves, their spouses (if filing a joint return), and their qualifying children.<sup>9</sup> A similar rule applied to the temporary refundable tax credit (“recovery rebate”) provided under the Economic Stimulus Act of 2008.<sup>10</sup> Furthermore, in the 112<sup>th</sup> Congress, legislation has been introduced that would impose, with some differences, an SSN requirement for claiming the additional child tax credit,<sup>11</sup> any part

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<sup>6</sup> I.R.C. §7701(b)(5). There are limits on how long an individual may be exempt from the substantial presence test. For example, after five years, student F-, J-, M-, and Q-visa holders will only continue to receive the special treatment if they establish to the IRS that they do not intend to permanently reside in the United States and that they have substantially complied with their visa requirements.

<sup>7</sup> I.R.C. §§7701(b)(3)(D), (b)(5), and (b)(7).

<sup>8</sup> Treas. Reg. §301.7701(b)-7.

<sup>9</sup> I.R.C. §32(m). Some have raised the issue of whether the Personal Responsibility and Work Opportunity Reconciliation Act (P.L. 104-193) restricts the eligibility of unauthorized aliens to claim refundable tax credits or other tax benefits. For analysis of this issue, see CRS Congressional Distribution Memorandum, *Legal Analysis of Whether Any Refundable Tax Credits are “Federal Public Benefits” Under Section 401 of the Personal Responsibility and Work Opportunity Reconciliation Act*, July 29, 2009, on file with author.

<sup>10</sup> See P.L. 110-185, §101(a), *codified at* I.R.C. §6428.

<sup>11</sup> See, e.g., H.R. 3630, Tit. V, Sub. C, §5201 (“Middle Class Tax Relief and Job Creation Act of 2011,” as passed by the House) (SSN requirement for additional child tax credit); H.R. 5652, Tit. VI, Sub. B, §611 (“Sequester Replacement Reconciliation Act of 2012,” as passed by the House) (SSN requirement to claim additional child tax credit); H.R. 3275, §1 (SSN requirement to claim additional child tax credit); H.R. 1956, §2 (“Refundable Child Tax Credit Eligibility Verification Reform Act”) (SSN requirement for additional child tax credit).

of the child tax credit,<sup>12</sup> or any credit or refund (e.g., H.R. 1196).<sup>13</sup> Two of these bills—H.R. 3630 and H.R. 5652—have been passed by the House; however, H.R. 3630 was enacted into law (P.L. 112-96) without the SSN provision.

The mechanism of using an SSN requirement for restricting the eligibility of unauthorized aliens to claim tax credits may be imprecise. There remains the possibility that attempts to claim a credit could be made by resident aliens who legally received SSNs but are currently not legally present in the United States,<sup>14</sup> in addition to unauthorized aliens using fraudulent SSNs. At the same time, the SSN requirement may deny the credits to families that do not include any unauthorized aliens but have at least one member without an SSN. For example, after it came to light that overseas military members with foreign spouses would be ineligible for the 2008 recovery rebate, Congress exempted military members from the SSN requirement.<sup>15</sup>

## **Taxation of Income**

### **Resident Aliens**

Resident aliens are generally subject to the same federal income tax laws as citizens of the United States.<sup>16</sup> Like U.S. citizens, resident aliens are subject to tax on all income earned in the United States and abroad. Resident aliens file a tax return using the Form 1040 series, may claim deductions and credits, and are taxed at the same graduated rates as U.S. citizens. They are also subject to income tax withholding.

### **Nonresident Aliens**

Nonresident aliens are taxed on income from sources within the United States but generally not on income from foreign sources. Sections 861, 862, 863, 864, and 865 of the Internal Revenue Code define income that is from sources within and outside the United States. Compensation for services performed in the United States is U.S. source income.<sup>17</sup>

A nonresident alien's U.S. source income is taxed at different rates depending on whether it is "effectively connected" with a trade or business in the United States.<sup>18</sup> An individual must generally be engaged in a trade or business in the United States to have "effectively connected"

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<sup>12</sup> See, e.g., H.R. 3444, §2 and S. 577, §2 ("Child Tax Credit Integrity Preservation Act of 2011") (SSN requirement to claim child tax credit).

<sup>13</sup> See, e.g., H.R. 1196, §503 ("Loophole Elimination and Verification Enforcement Act" or "LEAVE Act") (SSN requirement to claim any federal income tax refund or credit).

<sup>14</sup> For information, see CRS Report RS22446, *Nonimmigrant Overstays: Brief Synthesis of the Issue*, by Ruth Ellen Wasem.

<sup>15</sup> I.R.C. §6428(h)(3)(added by the Heroes Earnings Assistance and Relief Tax Act of 2008, P.L. 110-245, §§101(a), 102(b)).

<sup>16</sup> One special rule is that resident aliens who are employees of foreign governments and international organizations may qualify to exempt their compensation from taxation. I.R.C. §893.

<sup>17</sup> I.R.C. §861(a)(3).

<sup>18</sup> I.R.C. §871.

income.<sup>19</sup> The term generally includes compensation for the performance of personal services in the United States. Nonresident aliens with F-, J-, M-, or Q-visas are considered to be engaged in a trade or business in the United States.<sup>20</sup>

Income that is effectively connected with a trade or business in the United States is generally taxed by the same rules and at the same graduated rates as the income of U.S. citizens and resident aliens.<sup>21</sup> In general, income that is not effectively connected may not be reduced by deductions and is subject to tax at a flat rate of 30%.<sup>22</sup> Nonresident aliens file a return using the Form 1040NR series and are subject to the same collection procedures as U.S. citizens and resident aliens. Furthermore, they are generally subject to withholding on personal service compensation and non-effectively connected income.<sup>23</sup>

There are limited circumstances in which a nonresident alien's U.S. source income is not subject to U.S. taxation. For example, some interest income that is not connected with a U.S. trade or business (e.g., portfolio interest) is exempt from U.S. tax.<sup>24</sup> Another example is that compensation for services performed in the United States is not subject to U.S. tax if the services are for a foreign employer or office, the alien is in the United States for not more than 90 days during the tax year, and the compensation does not exceed \$3000.<sup>25</sup> A nonresident alien with an F-, J-, or Q-visa is not taxed on compensation received from a foreign employer.<sup>26</sup> Employees of foreign governments and international organizations and crew members of foreign vessels and aircraft may qualify to exempt their compensation from tax.<sup>27</sup> Additionally, income may be exempt from U.S. tax under a treaty (see below).

## **Sailing Permit**

Aliens leaving the United States usually must obtain a certificate of compliance (“sailing permit”) from the IRS that shows he or she “has complied with all the obligations imposed upon him by the income tax laws.”<sup>28</sup> The IRS may subject aliens who attempt to leave without one to examination at the point of departure and require payment of any taxes whose collection would be jeopardized by the departure.

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<sup>19</sup> I.R.C. §864(c).

<sup>20</sup> I.R.C. §871(c).

<sup>21</sup> I.R.C. §§871(b) and 873.

<sup>22</sup> I.R.C. §§871(a) and 873.

<sup>23</sup> I.R.C. §§1441 and 3402; Treas. Reg. §1.1441-4(b)(1). The rate of withholding on compensation for personal services is generally the applicable graduated income tax rate, although self-employed individuals may be subject to withholding at a flat 30% rate. The rate of withholding on non-effectively connected U.S. source income is 30% unless (a) the 14% rate applies for qualifying income received by nonresident aliens with F-, J-, M-, and Q-visas or (b) there is a lower rate under an income tax treaty.

<sup>24</sup> I.R.C. §§871(h) and (i).

<sup>25</sup> I.R.C. §§861(a)(3) and 864(b)(1).

<sup>26</sup> I.R.C. §872(b)(3).

<sup>27</sup> I.R.C. §§861(a)(3), 872, and 893.

<sup>28</sup> I.R.C. §6851(d); Treas. Reg. §1.6851-2.

## **Tax Treaties**

Tax treaties provide benefits to nonresident aliens and, in certain situations, resident aliens. Benefits vary by treaty. Typical provisions include the reduction of the 30% flat rate applied to non-effectively connected U.S. source income and the exemption of gain from the sale of personal property. Treaties often exempt personal service compensation from taxation if a nonresident alien is in the United States for less than a stated period of time (e.g., 90, 180, or 183 days) or the compensation is less than a specified amount (generally between \$3,000 and \$10,000) and paid by a foreign employer. Treaty provisions may also exempt the compensation of specific groups of employees (e.g., students, teachers, athletes, and employees of foreign governments).

The United States has income tax treaties with Armenia, Australia, Austria, Azerbaijan, Bangladesh, Barbados, Belarus, Belgium, Bulgaria, Canada, China, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Luxembourg, Malta, Mexico, Moldova, Morocco, the Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovak Republic, Slovenia, South Africa, South Korea, Spain, Sri Lanka, Sweden, Switzerland, Tajikistan, Thailand, Trinidad, Tunisia, Turkey, Turkmenistan, Ukraine, the United Kingdom, Uzbekistan, and Venezuela.

## **Social Security and Medicare Taxes**

Resident aliens are subject to Social Security and Medicare taxes on wages (FICA taxes) and on self-employment income (SECA taxes) in the same manner as U.S. citizens.<sup>29</sup> In general, nonresident aliens are subject to FICA taxes on compensation from work within the United States under the rules applicable to U.S. citizens and resident aliens,<sup>30</sup> but are not subject to SECA taxes.<sup>31</sup> A list of exempted services in IRC §3121(b) is generally applicable to all who work in the United States. Examples include services performed by foreign workers temporarily admitted to the United States to perform agricultural labor and services performed by employees of foreign governments and qualifying international organizations. Also exempted are services performed by individuals with F-, J-, M-, or Q-visas that meet the purpose of admittance and services performed in Guam by H-2 visa holders who are residents of the Philippines.

## **Totalization Agreements**

The United States has entered into totalization agreements with numerous countries that have social security programs. The intent of these agreements is to provide individuals who work in two countries with the opportunity to qualify for social security benefits in one country<sup>32</sup> and to avoid double coverage and taxation. With respect to the issue of double coverage and taxation, agreements generally provide that individuals are only covered by the social security program

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<sup>29</sup> I.R.C. §§1402(b) and 3121(b).

<sup>30</sup> I.R.C. §3121(b).

<sup>31</sup> I.R.C. §1402(b).

<sup>32</sup> For more information, see CRS Report RL32004, *Social Security Benefits for Noncitizens*, by Dawn Nuschler and Alison Siskin.

(and therefore only subject to the program's taxes) in the country where they are working, although individuals who are covered in their home country and temporarily assigned by their employer to work in the other country are exempt from coverage in that country.<sup>33</sup> A self-employed individual generally is covered and pays social security taxes in the country where he or she resides.

The United States has entered into totalization agreements with Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, South Korea, Sweden, Switzerland, and the United Kingdom.<sup>34</sup>

In 2004, the United States signed an agreement with Mexico, which has been controversial. It has not yet been transmitted to Congress.<sup>35</sup> The Consolidated Appropriations Act, 2012 prohibits the Social Security Commissioner or Social Security Administration (SSA) from using any of the funds appropriated by the act to pay compensation to SSA employees to administer Social Security benefit payments under any U.S.-Mexico totalization agreement that would not otherwise be payable.<sup>36</sup> Other legislation has been introduced, the Loophole Elimination and Verification Enforcement Act (or LEAVE Act), that would state it is the sense of the House that the U.S.-Mexico totalization agreement "is inappropriate public policy and should not take effect."<sup>37</sup>

Another bill introduced in the 112<sup>th</sup> Congress would address a constitutional issue with the existing totalization agreement process. Under current law, once an agreement is transmitted to Congress, it becomes effective at the end of the period during which at least one house has been in session 60 days, unless either house adopts a resolution of disapproval.<sup>38</sup> This is a legislative veto, and the Supreme Court held such vetoes to be unconstitutional.<sup>39</sup> The Social Security Totalization Agreement Reform Act of 2011 (or STAR Act) would, among other things, address the legislative veto problem by implementing a new approval process.<sup>40</sup>

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<sup>33</sup> See also I.R.C. §§1401(c), 3101(c), and 3111(c).

<sup>34</sup> Texts of the agreements may be found at <http://www.ssa.gov/international>.

<sup>35</sup> For more information on the agreement with Mexico, see CRS Report RL32004, *Social Security Benefits for Noncitizens*, by Dawn Nuschler and Alison Siskin.

<sup>36</sup> P.L. 112-74, Tit. V, §521.

<sup>37</sup> H.R. 1196, Tit. V, §501.

<sup>38</sup> 42 U.S.C. §433(e)(2).

<sup>39</sup> See *INS v. Chadha*, 462 U.S. 919 (1983).

<sup>40</sup> S. 181, §2.