Collateral Damage: Covid-19 and its Unintended Effect on U.S. Residency

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The novel COVID-19 virus has been ravaging the world for the last several months and lately the United States, creating economic and psychological tension. The world-wide travel restrictions and mandated quarantine in parts of the world has left many persons stranded in foreign countries with no means to return to their homes. However, choosing (or being forced) to weather the COVID-19 quarantine in the United States might lead to an unexpected consequence of which non-U.S. citizens or non-green card holders may be unaware: U.S. tax on worldwide income.

Countries generally tax based on residence and source. A person who spends greater than six months (roughly 183 days) in a country will generally be subject to tax there. But the United States takes it several steps further, applying an expansive test to determine residency. It employs a formula that looks at the days spent in the United States in the present year plus the two preceding years to determine residency. Under this "substantial presence" test, a person becomes a U.S. resident if he/she is physically present in the United States at least: 1) 31 days during the current year, and 2) 183 days using the formula. When calculating the 183 days, the United States counts all the days present in the United States in the current year, 1/3 of the days present in the United States in the first preceding year, and 1/6 of the days present in the United States in the second preceding year. Generally, even one moment spent on U.S. soil constitutes a "day" for purposes of the substantial presence test. Therefore, a person who spends far less than half the year in the United States in 2020 can still be found caught in the U.S. residency net. Unless a person holds a certain class of visa that exempts its holder from the substantial presence test (and complies with the terms of such visa), spending as little as 31 days in 2020 in the United States may subject persons who logically believe they are "foreign" to presumptive U.S. residency.

Unless official relief guidance is provided, the fact that the world is experiencing a global pandemic is immaterial. Days spent in the United States simply because a person deems it imprudent to return to their home country during the pandemic are not exempt. Only days that a person is unable to leave the United States due to illness (with COVID-19 or another illness) that arose while person was in the United States are exempted from inclusion in the substantial presence test, and only if the individual can establish they intended to leave, but could not. The exemption is limited to the individual actually suffering from the illness; it does not extend to caretakers or even to immediate family members, including spouses or parents of ailing minor children. Also, the exemption ends as soon as the person recovers and is "able" to leave the United States. Therefore, this exemption is of little use to the vast majority of non-U.S. people who may find themselves sheltering in the United States at present.

Once the threshold into presumptive residency is crossed, the person must report all worldwide income on Form 1040, and the definition of "income" may lead to yet additional surprises. Income under the U.S. laws does not necessarily mean monies actually received by the individual. Certain individuals who are settlors or beneficiaries of certain foreign trusts must personally report the income earned by the trust, even if it is not distributed. Further, owners of certain foreign companies may also find themselves taxed on income earned by the company even when not distributed. Even individuals whose activity only extends to investment in foreign mutual funds may potentially receive a hefty U.S. tax bill if investments are sold during the year of U.S. residency. Lastly, U.S. residents must also complete exhaustive (and intrusive) information returns detailing worldwide assets and economic activity. The penalties for non-compliance, even though there may not be any tax associated with these forms, can be severe. It is important for any non-U.S. person staying in the United States for any length of time in 2020 to consult a professional regarding available options. The substantial presence test creates a presumption of residency that, depending on individual facts and circumstances, may be completely or partially defeated.

If a foreign person satisfies the substantial presence test but was physically present in the United States for less than 183 days in the current year, he/she may qualify for the "closer connection" exception. To qualify, the person must have both a "tax home" in a foreign country and a "closer connection" – established through facts and circumstances – to such tax home. Satisfaction of the closer connection exception exempts the person from being classified as a U.S. resident, thus excusing any information return filing obligations or worldwide income reporting. The closer connection exception must be affirmatively claimed on a form attached to a *timely* filed Form 1040-NR. Failure to timely claim this exception generally precludes its availability.

Alternatively, if a non-U.S. person is physically present in the United States for more than 183 days, but is a citizen or resident of a country with which the United States has an income tax treaty, such individual may avoid U.S. tax on his/her worldwide income under the residency article of such treaty. This so-called "treaty tie-break" position permits a person who is entitled to treaty benefits and is considered a resident of the U.S. and its treaty partner to "elect" to be taxed as a resident of only one country under the rules provided in the treaty. The Service expects the treaty tie-break position to be claimed on a timely-filed tax return. While the tie-break may allow a person to once again escape U.S. tax on worldwide income, it does not excuse him/her from the obligation to file certain information returns detailing worldwide economic holdings. The failure to file such returns can lead to punitive penalties. Lack of knowledge regarding those returns, or even lack of knowledge that one has inadvertently become a U.S. resident, does not constitute reasonable cause to excuse these (and other) tax penalties.

Attorneys in Caplin & Drysdale's Private Client and Tax Controversy groups have decades of experience helping individuals navigate the complex rules governing U.S. residency matters. Our attorneys will continue to monitor federal and state policies intended to help taxpayers during the COVID-19 crisis.

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