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International Tax ADVISORY ■

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# Back to School: Recent Cases Offer Lessons in International Tax “Basics”

## U.S. Tax Residency Primer

In *Li v. Commissioner* (T.C. Summ. 2016-49), the taxpayer, appearing pro se, claimed he was entitled to education credits under Section 25A. The Tax Court disagreed, finding that the taxpayer’s U.S. residency start date made him ineligible for the credits. The amount at issue was relatively small, the parties basically agreed on the facts and the relevant law was clear. Though the Tax Court did not break new ground, its decision reviewed a number of U.S. tax residency provisions – the somewhat tedious, procedural rules that may seem minor but that in fact can have major consequences on an individual’s U.S. tax liability.

The taxpayer, a Canadian citizen, was a full-time student at the University of Waterloo in Ontario, Canada, from 2008 to June 2012. With the encouragement of the university, the taxpayer took short-term paid internships in the U.S. during 2010 and 2011. He was present in the U.S. during these internships for 120 days in 2010 and 117 days in 2011. In 2012, the taxpayer was present in the U.S. for 190 days, six days in February and March for job interviews and 184 days after accepting a full-time offer. The taxpayer filed U.S. tax returns as a nonresident for 2010 and 2011 and as a resident for 2012.

Eligible to participate in the Federal Family Education Loan program by the U.S. Department of Education, the University of Waterloo provided the taxpayer with a form showing that he had paid $5,123 in education expenses in 2012. On his 2012 tax return, the taxpayer claimed American Opportunity and Lifetime Learning credits under Section 25A for his qualified tuition expenses. The IRS asserted that the taxpayer was not entitled to the credits because the taxpayer had not been a U.S. resident for the entire tax year. The taxpayer contended that he was entitled to the credits since he met the substantial presence test in 2012. The Tax Court held that the taxpayer, though “substantially present” in the U.S. in 2012, did not meet the requirements of Section 25A(g)(7) to claim the education credits.

Section 25A(g)(7) provides that the education credits are not allowed to an individual who is a nonresident alien for any portion of the taxable year unless the individual is treated as a resident alien pursuant to an election under Section 6013(g) or (h). Those elective provisions permit nonresident alien spouses of U.S. citizens or residents to be treated as U.S. residents, including for the purpose of filing joint U.S. tax returns. The taxpayer was unmarried during 2012, though, so the elections were unavailable to him. Instead, the taxpayer’s eligibility for the education credits hinged on the date in 2012 that his U.S. tax residency began.

The taxpayer clearly met the substantial presence test since he was present in the U.S. for more than 183 days in 2012. Because the taxpayer was not a U.S. resident in 2011, however, his 2012 U.S. tax residency did not begin until his "residency start date." The residency start date for an individual who meets the substantial presence test (and not the green card test) and who was not a resident during any part of the preceding year is the first day he is physically present in the U.S. For the taxpayer, that date was February 22, 2012. Thus, he was a nonresident for the period January 1 through February 21, 2012, and ineligible for the Section 25A credits. (The taxpayer could not make a "first-year election" under Section 7701(b) to be treated as a U.S. resident for all of 2012 because he met the substantial presence test in 2012.)

Regulations under Section 871 provide that, for an individual who is a nonresident at the beginning of a year but a resident at the end of that year, the tax year is effectively split into a nonresident period and a resident period. Moreover, such an individual's income tax liability is generally determined under the rules applicable to nonresidents and residents for the respective portions of the year. This framework can allow prospective U.S. residents to implement pre-arrival tax planning. Determining the proper residency starting date is critical to assessing whether and when a person should accelerate income, defer loss, undertake basis step-up transactions, dispose of stock in would-be controlled foreign corporations or passive foreign investment companies, make check-the-box elections, etc. On the flipside, the residency termination date rules can facilitate planning for an individual's U.S. departure (though green card holders also must be mindful of the expatriation tax rules of Section 877A).

## Foreign Tax Credit Fundamentals

In *Vento v. Commissioner* (147 T.C. No. 7), three sisters, all U.S. citizens, sought credits under Section 901 for taxes paid to the U.S. Virgin Islands. During the year in issue, 2001, the taxpayers lived in the United States (in California, Nevada and Colorado). The taxpayers made estimated tax payments to the U.S. Treasury for the year but did not file U.S. income tax returns. Instead, they filed territorial income tax returns, including tax payments, with the Virgin Islands authorities. This course followed that of their parents, who were bona fide residents of the Virgin Islands at the end of 2001 (as confirmed by the Third Circuit in a separate proceeding). Because the taxpayers filed territorial tax returns, the IRS transferred their estimated payments to the Virgin Islands tax authorities under Section 7654. The IRS later issued notices of deficiency on the basis that none of the taxpayers was a bona fide resident of the Virgin Islands in 2001.

The Virgin Islands, though a U.S. territory, generally is not part of the United States for income tax purposes. Consequently, a taxpayer may claim a Section 901 credit for taxes paid to the Virgin Islands. Section 932 coordinates the U.S. and Virgin Islands tax systems, providing rules for U.S. citizens or residents who are bona fide residents of the Virgin Islands or who are not bona fide residents of the Virgin Islands but have income from sources or business activities there. The taxpayers in *Vento* conceded that they were not bona fide residents of the Virgin Islands, had no Virgin Islands source income and had not worked or conducted business there. (The Third Circuit, in the separate proceeding involving the taxpayers' parents, had also affirmed a lower court decision that the taxpayers were not bona fide residents of the Virgin Islands.)

The Code and regulations place strict limitations on the ability to claim foreign tax credits. First, the credit is allowed only for "taxes paid," meaning compulsory amounts. The IRS argued that the taxpayers were not legally obligated to pay taxes to the Virgin Islands. The regulations also require a taxpayer to "exhaust all effective and practical remedies" to reduce their foreign tax liabilities. According to the IRS, the taxpayers' proper recourse to avoid double taxation was to seek refunds from the Virgin Islands. In sum, the sisters' payments were not compulsory taxes and therefore ineligible for credit. Section 904 further limits the foreign tax credit to the amount of U.S. tax on foreign source income. Because the sisters did not have income from the Virgin Islands, the IRS contended that each should be treated as having a Section 904 limitation of zero, meaning that they could not have claimed a credit for the amounts paid anyway.

The Tax Court sided with the IRS, denying the credits because the taxpayers failed to establish that the amounts at issue were compulsory. Specifically, the court concluded that the taxpayers' return position that they were bona fide residents of the Virgin Islands was not based on a "reasonable interpretation" of applicable law and that the taxpayers had failed to show that they exhausted their remedy to seek refunds from the Virgin Islands. The Tax Court also rejected the taxpayers' argument that the Section 904 limitation did not apply to taxes paid to the Virgin Islands. The court also proffered a "more fundamental point" supporting its decision: Congress did not intend taxes paid to the Virgin Islands by U.S. taxpayers to be creditable under Section 901 given the coordination scheme of Section 932.

Notwithstanding the court's ancillary comments on the "fundamental" question of whether Virgin Islands taxes were intended to be creditable under Section 901, *Vento* was ultimately decided based on basic, long-standing principles of the foreign tax credit. Setting aside the wrinkle of territorial tax rules, all taxpayers should understand that the availability of foreign tax credits against U.S. tax is not a given. Claiming foreign tax credits requires a taxpayer to reasonably assess their foreign income tax liability, including taking all practical and effective steps to reduce it. And even assuming those criteria are met, Section 904 and other provisions may restrict the amount of credit that can offset U.S. tax.

Here endeth the lesson.

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