

THE F-1 VISA – PRIVILEGED U.S. TAX STATUS AND HOW TO KEEP IT

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Foreign students leaving their home country and arriving in the U.S. for higher education may come across many things that seem alien to them – like the accent, culture, (inexplicably large) food portions, etc. But one area where they are treated as the aliens is under U.S. Federal income tax law. Foreign students who arrive in the U.S. on an F-1 visa (*i.e.*, student visa) are treated as nonresident aliens and subject to special tax provisions. This article discusses the residency status of foreign students on an F-1 visa, Federal income tax consequences, and U.S. reporting requirements.

FOREIGN STUDENTS ARE PER-SE NONRESIDENT ALIENS IN THE U.S.

An individual is treated as a U.S. resident if he or she meets either the “Green Card Test” or “Substantial Presence Test.”¹

1. **Green Card Test**

An individual who holds a permanent resident card (more commonly known as a Green Card) is treated as a U.S. resident for Federal income tax purposes.²

2. **Substantial Presence Test**

An individual who is neither a U.S. citizen nor a Green Card holder is treated as a U.S. resident if he or she satisfies the Substantial Presence Test. The Substantial Presence Test is satisfied for a relevant year if the following conditions are met:³

- a. The individual is present for at least 31 days in the relevant year.
- b. The number of days of presence in the U.S. in the relevant year and the two preceding years equals or exceeds a weighted aggregate of 183 days.

For purposes of the weighted calculation, each day in the relevant year counts as one day, each day in the first preceding year counts as 1/3 of a day, and each day in the second preceding year counts as 1/6 of a day. An individual will be considered a resident alien under this test if he or she is present in the U.S. for 183 days or more in the relevant year.

¹ Code §7701(b)(1)(A).

² Code §7701(b)(1)(A)(i).

³ Code §7701(b)(3).

An individual who meets these requirements is treated as a U.S. resident and is therefore subject to U.S. Federal income tax on his or her worldwide income.

Foreign Students Are Exempt from the Substantial Presence Test

A foreign student's days of presence in the U.S. are not counted towards the Substantial Presence Test if the student qualifies as an exempt individual.⁴ A foreign student will be treated as an exempt individual if the following conditions are satisfied:

- The foreign student is temporarily present in the U.S. under an F-1 visa.
- The foreign student substantially complies with the visa requirements.⁵

A foreign student will be deemed to comply substantially with the visa requirements if the individual has not engaged in activities that are prohibited by the Immigration and Nationality Act and the regulations thereunder and could result in the loss of F-1 visa status. Further, a foreign student will not be deemed to comply substantially with the visa requirements merely by showing that his or her visa has not been revoked.⁶

Example 1

If an individual with an F-1 visa is found to have accepted unauthorized employment or to have maintained a course of study that is not considered by the I.R.S. to be full-time, the individual will not be considered to comply substantially with the individual's visa requirements whether or not the individual's visa has been revoked.⁷

Thus, unless the student infringes his or her F-1 visa requirements, the foreign student will not establish tax residency in the U.S.

Exempt Individual Status Comes with an Expiration Date

A foreign student's exempt individual status remains in effect only for a specified period of time. He or she may exclude the days of presence in the U.S. for any part of five or fewer calendar years.⁸ Notably, presence for as little as one day during a calendar year is treated as one full year. Further, the five-year period relates to the person's lifetime and need not be consecutive. In other words, once the five-year threshold is reached, a foreign person may never again qualify as an exempt student under this rule. An exception applies under the closer connection test for students ("Closer Connection Test")⁹ described in the following section.

Example 2

Mr. A, an F-1 visa holder, has never been an exempt individual. He arrives

⁴ Code §7701(b)(3)(D)(i); Code §7701(b)(5)(A)(iii).

⁵ Code §7701(b)(5)(D)(i)-(ii); Treas. Reg. §301.7701(b)-3(b)(4).

⁶ Treas. Reg. §301.7701(b)-3(b)(6).

⁷ *Id.*

⁸ Code §7701(b)(5)(E)(ii).

⁹ To be distinguished from the general closer connection test that is not limited to students.

in the U.S. for the first time on December 31, 2017. The year 2017 will be counted as one full year even though Mr. A was present in the U.S. for just one day in the year. He must count 2017 as his first year of exempt individual status. For the next four years, his days of U.S. presence will be not be counted towards the Substantial Presence Test. Thus, Mr. A will be treated as an exempt individual for 2017, 2018, 2019, 2020, and 2021. Effective January 1, 2022, his exempt individual status will terminate, and Mr. A must begin counting days towards the Substantial Presence Test unless he meets the requirements under the Closer Connection Test.

“A foreign student may enjoy exempt individual status even after being present in the U.S. for any part of five calendar years.”

In addition, days of presence in the U.S. as a trainee or a teacher (under a “J” or “Q” visa) are also included in the five-year period.¹⁰

Example 3

Mr. B is a citizen and resident of country A just prior to his arrival in the U.S. He arrives in the U.S. on August 15, 2013, as a researcher on a J-1 visa. Without leaving the U.S. he changes to F-1 visa status on August 10, 2014. His of presence in the U.S. under the J-1 visa will be included in the five-calendar-year period. Since Mr. B held his J-1 visa during 2013 and 2014, his status as an exempt individual under an F-1 visa can only continue through 2015, 2016, and 2017.

Five-Year Period May Be Extended if Closer Connection with Another Country Exists

A foreign student may enjoy exempt individual status even after being present in the U.S. for any part of five calendar years if it can be demonstrated to the satisfaction of the I.R.S. that he or she (i) does not intend to reside permanently in the U.S. and (ii) has substantially complied with the student visa requirements.¹¹ Deviating from the general closer connection exemption,¹² the Closer Connection Test for students does not provide for a 183-day threshold for the current year.

Whether an individual has demonstrated an intent to not reside permanently in the U.S. is based on the facts and circumstances, which include the following:¹³

- **Whether the Individual Has Maintained a Closer Connection with a Foreign Country**

An individual is treated as having a closer connection to a foreign country than to the U.S. if the individual maintains more significant contacts with the foreign country.¹⁴

The following factors that may be considered in making this determination:

- The location of the individual’s permanent home regardless of whether

¹⁰ Treas. Reg. §301.7701(b)-3(b)(7)(iii). Special rules apply to teachers and trainees (Treas. Reg. §301.7701(b)-3(b)(7)(ii)).

¹¹ Code §7701(b)(5)(E)(ii); Treas. Reg. §301.7701(b)-3(b)(7)(iii).

¹² Code §§7701(b)(3)(B) and (C); Treas. Reg. §301.7701(b)-2.

¹³ Treas. Reg. §301.7701(b)-3(b)(7)(iii).

¹⁴ Treas. Reg. §301.7701(b)-2(d)(1).

the home is owned or rented¹⁵

- The location of the individual's family
 - The location of the individual's personal belongings such as automobiles, furniture, clothing, and jewelry owned by the individual and his or her family
 - The location of social, political, cultural, or religious organizations with which the individual has a current relationship
 - The location where the individual conducts his or her routine personal banking activities
 - The location where the individual conducts business activities
 - The location of the jurisdiction in which the individual holds a driver's license
 - The location of the jurisdiction in which the individual votes
 - The country of residence designated by the individual on forms and documents
 - The types of official forms and documents filed by the individual, such as Form 1078, *Certificate of Alien Claiming Residence in the U.S.*, Form W-8, *Certificate of Foreign Status*, or Form W-9, *Payer's Request for Taxpayer Identification Number*
- *Whether the Individual Has Not Taken Affirmative Steps to Adjust the Individual's Status from Nonimmigrant to Lawful Permanent Resident*¹⁶

An affirmative step to change an individual's status to that of a permanent lawful resident includes the filing of certain forms with United States Citizenship and Immigration Services ("U.S.C.I.S."), such as an application for a Green Card.¹⁷

In order to claim this exception, Form 8843, *Statement for Exempt Individuals and Individuals With a Medical Condition*, must be filed with the I.R.S. If filing a U.S. Federal income tax return, Form 8843 must be attached to the income tax return. Thus, if these requirements are met, the student will be treated as an exempt individual notwithstanding the fact that he or she has been present in the U.S. for five calendar years. Accordingly, days of presence in the U.S. after the expiration of the five-year period will not be counted toward the 183 days of presence under the Substantial Presence Test.

TAXATION OF FOREIGN STUDENTS IN THE U.S.

A foreign student who arrives in the U.S. on an F-1 visa (and meets other conditions

¹⁵ It is material that the dwelling is available at all times, continuously, and not solely for stays of short duration.

¹⁶ Treas. Reg. §301.7701(b)-3(b)(7)(iii)(B).

¹⁷ Treas. Reg. §301.7701-2(f).



discussed above) is treated as a nonresident alien for five calendar years, or more if the Closer Connection Test is satisfied. Thus, barring a few exceptions, a foreign student is taxed in the same manner as a nonresident alien for U.S. Federal income tax purposes. Broadly speaking, a foreign student is taxed only on certain U.S.-source income that is not connected with a U.S. trade or business, namely Fixed or Determinable, Annual or Periodic (“F.D.A.P.”) Income,¹⁸ and income that is effectively connected with a U.S. trade or business (“E.C.I”).¹⁹

F.D.A.P. Income

F.D.A.P. Income includes U.S.-source dividends, certain interest, passive rents and royalties, non-qualified scholarships (see special rules below), compensation for services, and other “fixed or determinable, annual or periodical” income. Nonresident aliens, in general, – including students on an F-1 visa, in particular – who receive interest income from deposits with a U.S. bank, savings and loan institution, credit union, or insurance company, or who receive portfolio interest,²⁰ are exempt from taxation on this type of interest income as long as it is not effectively connected with a U.S. trade or business.

F.D.A.P. Income is taxed at a flat rate of 30% on gross income (*i.e.*, without any deduction or other allowance for costs incurred in earning the income). Tax is collected by means of withholding by the payor at the time of payment to the foreign student.²¹ The 30% withholding tax may be reduced or eliminated under an applicable income tax treaty.

E.C.I.

When a nonresident alien engages in a trade or business in the U.S., all income from sources within the U.S. connected with the conduct of that trade or business is considered to be E.C.I. A nonresident alien who performs personal services in the U.S. is treated as being engaged in a U.S. trade or business.²² Thus, a foreign student earning income by providing personal services in the U.S. will be treated as being engaged in a U.S. trade or business, and income earned therefrom will be treated as E.C.I. Such income is taxed on net basis (*i.e.*, after deduction of business expenses) at ordinary rates applicable to a U.S.-resident individual (ranging from 10% to 37% under current law).²³

Do Not Forget the Tax Treaty

Typically, U.S. income tax treaties provide for an exemption from tax on income

¹⁸ Code §871(a)(1).

¹⁹ Code §871(b).

²⁰ Code §871(h). In order for a debt instrument to qualify as portfolio debt, *inter alia*, it must be in registered form both as to principal and interest. In addition, a certification on the payee’s non-U.S. status (Form W-8) must be furnished to the withholding agent.

²¹ Code §1441(a).

²² Code §864(b).

²³ The income tax rates for individuals introduced under the 2017 Tax Cuts and Jobs Act are set to sunset end of 2025. Most recently, the administration indicated plans to make these changes permanent under a new bill expected for later in 2018.

earned by foreign students from the provision of personal services in the U.S. The income subject to exemption is usually limited to a dollar amount. Further, under most U.S. income tax treaties, the exemption is available for the first five years that the foreign student is present in the U.S.

Example 4

The U.S.-France Income Tax Treaty (the “Treaty”) provides for an exemption on the first \$5,000 earned by a French student from the provision of personal services in the U.S.²⁴ A French individual arriving in the U.S. on an F-1 visa will thus be eligible to this \$5,000 exemption under the Treaty. Accordingly, if he or she works, for example, as an intern in a U.S. law firm and earns \$50,000 in 2017, the first \$5,000 will be exempt from U.S. Federal income tax under the Treaty. The French student will be subject to U.S. Federal income tax on the remainder (*i.e.*, \$45,000).

Some Scholarships Are Taxed at a Reduced Rate of 14%

Typically, qualified scholarships received by an individual (whether or not a U.S. resident or citizen) are not subject to tax in the U.S. if the individual is a candidate for a degree at a qualified educational organization.²⁵ The term “qualified scholarship” is defined as any amount received by an individual as a scholarship granted for the payment of either (i) tuition and fees required for the enrollment or attendance at an educational organization or (ii) fees, books, supplies, and equipment required for courses of instruction at such an educational organization.²⁶

In comparison, non-qualified scholarships (*i.e.*, amounts received for other expenses, such as room and board or travel) are not excludible from income.²⁷ The amount of non-qualified scholarship is subject to withholding tax at a reduced tax rate of 14%.²⁸ However, the benefit of the reduced tax rate is available only to nonresident alien students. A student who is either a U.S. resident or citizen receiving a non-qualified scholarship is subject to tax on the non-qualified scholarship at ordinary tax rates, (*i.e.*, 10% to 37% depending on the tax bracket applicable to the individual).

Foreign Students Are Exempt from Social Security and Medicare Taxes

A foreign student who qualifies as a nonresident alien and is temporarily present in the U.S. on an F-1 visa is exempt from Social Security and Medicare taxes on the wages received for personal services performed within the U.S. as long as these services are allowed by the U.S.C.I.S. and are performed in line with the purposes for which such visa was issued.²⁹

Examples of personal services that are exempt from Social Security and Medicare Taxes under this rule include the following:

²⁴ Article 21(b)(iii) of the U.S.-France Income Tax Treaty.

²⁵ Code §117(a).

²⁶ Code §117(b)(2).

²⁷ U.S. Tax Guide for Aliens, Pub. 519 (Rev. February 28, 2018).

²⁸ Code §§1441(a) and (b).

²⁹ Code §3121(b)(19).

- On-campus student employment up to 20 hours per week (40 during summer vacations) (e.g., working as a research assistant of a professor at the school)
- Optional Practical Training allowed by the U.S.C.I.S.

In line with the principles outlined in the foregoing, the exemption does not apply if the F-1 visa student changes his or her status to non-exempt or if becomes a resident alien.

REPORTING REQUIREMENTS

Foreign students have special reporting requirements for U.S. Federal income tax purposes. The thresholds which exempt U.S. citizens or resident aliens from filing up to a certain dollar amount do not apply to foreign students. Thus, a foreign student who earns taxable U.S.-source income is required to file an income tax return regardless of the dollar amount of the income.

Form 1040NR or Form 1040NR-EZ

A nonresident alien student who has the following income is required to file Form 1040NR or Form 1040NR-EZ, *U.S. Nonresident Alien Income Tax Return*:

- A taxable scholarship (as discussed above)
- Income partially or totally exempt from tax under the terms of a tax treaty
- Any other income that is taxable under the Code

A nonresident alien student who has income only from the following sources is not required to file a U.S. income tax return:

- Income from foreign sources
- Interest income from³⁰
 - U.S. banks,
 - U.S. savings and loan institutions,
 - U.S. credit unions, or
 - U.S. insurance companies
- Investments that generate portfolio interest
- A qualifying scholarship that is entirely tax free (as discussed above)

Form 8233 if Claiming Treaty Benefits for Personal Services

In addition to Form 1040NR or Form 1040NR-EZ, a nonresident alien student who earns income from providing personal services in the U.S. and claims exemption from tax under the relevant tax treaty shall also file Form 8233, *Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*.

³⁰ Code §871(i).

“A foreign student who earns taxable U.S.-source income is required to file an income tax return regardless of the dollar amount of the income.”

Form 8833 if Claiming Treaty Benefits for Income Other than Income Earned from Providing Personal Services

A nonresident alien student who earns F.D.A.P. Income and claims a reduced tax rate under the applicable income tax treaty is required to report his or her treaty position by filing Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, attached to his or her U.S. Federal income tax return.

Form 8316 for Refund of Social Security and Medicare Taxes

A nonresident alien student can file Form 8316, *Information Regarding Request for Refund of Social Security Tax Erroneously Withheld on Wages Received by a Nonresident Alien on an F, J, or M Type Visa*, to claim a refund of Social Security and Medicare taxes if erroneously withheld by the employer.

Form 8843 to Inform the I.R.S. About Exempt Individual Status

A foreign student is required to submit Form 8843, *Statement for Exempt Individuals and Individuals with a Medical Condition*, to explain to the I.R.S. the basis for excluding days of presence in the U.S. for purposes of the Substantial Presence Test as an exempt individual. This form must be filed by a nonresident alien student whether or not he or she is required to file a Federal income tax return in the U.S. Thus, this form must be filed even if the nonresident alien student does not earn any income in the U.S. Failure to file this form may prevent the foreign student from excluding the days of presence in the U.S. and can thus result in the student being treated as a U.S. resident under the Substantial Presence Test.

CONCLUSION

Foreign students coming to the U.S. for higher education belong to a special group of taxpayers. Firstly, they are taxed only on certain U.S.-source income. Secondly, they are offered exemption from Social Security and Medicare taxes and a lower tax rate on non-qualified scholarships. However, this only holds true as long as they maintain their nonresident status. In order to do so, it is of utmost importance that students are aware of rules on tax residency and comply with their filing obligations. As a starting point, upon their arrival in the U.S., students should begin working with the International Student Advisor at their school and, if a need arises, engage a U.S. tax professional to help navigate the maze of complex rules under U.S. tax law.