

HOW TO HANDLE DUAL RESIDENTS: THE I.R.S. VIEW ON TREATY TIE-BREAKER RULES

Authors

Fanny Karaman
Beate Erwin

Tags

I.P.U.
I.R.S.
LB&I
Residency
Tax Treaties

The first step in advising a foreign individual who is neither a U.S. citizen nor a green card holder on U.S. income tax laws is to determine the person's residence for income tax purposes. But what is to be done when the individual is resident in multiple jurisdictions? For this purpose, U.S. domestic law, foreign law, and residency rules under any applicable income tax treaty must be looked at.

One useful resource is the International Practice Units published by the I.R.S. Large Business and International Division ("LB&I"). These training aids for examiners provide taxpayers with some insights into the areas on which the I.R.S. will focus during an examination. However, they cannot be used or cited by taxpayers as precedent.

The Practice Unit "Determining an Individual's Residency for Treaty Purposes" was published on July 3, 2018. It provides guidance on how to determine tax residency under an applicable U.S. income tax treaty.

Treaties generally have a provision for determining residency in the case of dual residency in both the U.S. and the treaty partner country. These rules are often referred to as the Tie-Breaker Rules.

The Practice Unit summarizes the steps for applying the Tie-Breaker Rules as follows:

1. Determine whether the individual properly claimed to be a U.S. resident under domestic U.S. tax law.
2. Determine whether the individual properly claimed to be a resident of a treaty partner.
3. Apply the treaty Tie-Breaker Rules in a case of dual residency.

The Practice Unit uses Article 4, the Residency Article, of the 2006 U.S. Model Income Tax Convention ("2006 U.S. Model Treaty")¹ for illustration purposes and explicitly advises that every treaty is different and will thus have to be analyzed separately. Further, it advises to carefully review any additions or governmental comments on a treaty.²

¹ The most recent version of the U.S. Model Income Tax Convention was released on February 17, 2016. However, as of this publication, no technical explanation of the treaty have been published.

² The I.R.S. expressly refers to treaty protocols, memoranda of understanding or exchanges of notes, technical explanations from the Treasury Department, Joint Committee on Taxation reports on a treaty, Senate Foreign Relations Committee report on a treaty, relevant case law, competent authority agreements, and guidance issued by the I.R.S.

STEP 1 – U.S. RESIDENCY CLAIM

The Practice Unit starts by reminding that, under U.S. domestic law, a person is a U.S. resident if such person (i) is a U.S. citizen, (ii) is a U.S. green card holder, (iii) is a U.S. resident under the Substantial Presence Test,³ or (iv) makes a first-year election to be treated as a U.S.-resident individual.

In addition to Code §7701(b)(1), which contains the definitions of resident and non-resident aliens, the Practice Unit surprisingly quotes *Lujan v. Comm’r.*⁴ and I.R.S. Info. Letter 2013-0021⁵ instead of simply referencing the Treasury Regulations under §7701(b)(1).

- In *Lujan v. Comm’r.*, the Tax Court dealt with the Substantial Presence Test and concluded, in relevant part, that the taxpayer incorrectly failed to include the date of exit from the U.S. and the date of entry into the U.S. for purposes of the test.
- I.R.S. Info. Letter 2013-0021 examines the residency rules of the U.S.-German Income Tax Treaty. (That treaty’s Residency Article is the same as Article 4 the 2006 U.S. Model Treaty.) The letter then turns to Code §7701(b)(1) and the regulations thereunder to determine U.S. residency.

The letter constitutes a comprehensive tool for I.R.S. agents applying the Substantial Presence Test. It (i) lays out the general definition of U.S. residents, (ii) looks at the general Substantial Presence Test rules, (iii) explains the Closer Connection Test exception, (iv) cites the rules that disregard certain days of presence under the Substantial Presence Test because the individual is either an “exempt individual” or continues to stay in the U.S. because of a medical condition preventing him or her from leaving, and (v) looks at the first-year election.

I.R.S. agents are instructed to look for U.S. residency indicia by proceeding as follows:

- When an individual files a Form 1040 NR, *U.S. Nonresident Alien Income Tax Return*, the Practice Unit points out that a closer look at items B to H of Schedule OI (Other Information) can help I.R.S. agents determine U.S. residency.
- Agents are also instructed to look for Form I-551, *Alien Registration Receipt Card*, also known as the green card.

The Practice Unit provides residency starting date and ending date guidelines for green card holders and for Substantial Presence Test purposes. For green card holders, I.R.S. agents are reminded that green card status is ended

³ Generally, a foreign individual is treated as a U.S. resident for income tax purposes if he or she is present in the U.S. 183 days or more during a rolling three-year period. However, an exception may apply (e.g., the Closer Connection Test) under U.S. domestic law.

⁴ T.C. Memo 2000-365.

⁵ I.R.S. Info. Letter 2013-0021 (March 28, 2013).

- by filing either (i) U.S.C.I.S. Form I-407 or (ii) a letter stating the taxpayer's intent to abandon his or her green card along with U.S.C.I.S. Form I-551 with a U.S.C.I.S. or consular officer, or
- pursuant to Code §7701(b)(6), if the taxpayer (i) starts to be treated as a resident of a country other than the U.S. under a tax treaty, (ii) does not waive treaty benefits, and (iii) notifies the I.R.S. of his or her residency status by filing a Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*.

With respect to the latter, notably, taxpayers should be careful about filing a treaty return position claiming non-U.S. residency when they hold a green card, since this could trigger an exit tax exposure. Towards the end of the Practice Unit, this potential exit tax exposure is explicitly pointed out.

For treaty purposes, the Practice Unit states that, pursuant to Article 4 of the 2006 U.S. Model Treaty and the Treasury explanations thereunder, a U.S.-resident individual is defined the same way as under U.S. domestic law with one exception: A non-U.S. person married to a U.S. citizen or U.S. resident can elect to be treated as a U.S. resident for income tax purposes. Such an election disqualifies the individual from claiming the benefit of the Tie-Breaker Rules.⁶

Finally, the Practice Unit cautions that certain treaties require additional tests to be met in order for a U.S. citizen or green card holder to be considered as a U.S. resident. For example, the individual may be required to

- have a substantial presence, permanent home, or habitual abode in the U.S. and not be treated as a resident of a third country under a treaty between the other contracting state and that third country, or
- have a substantial presence in the U.S. or be a resident of the U.S. and not a resident of the third country under the Tie-Breaker Rules.

The Practice Unit cites the U.S.-U.K. and U.S.-France treaties as examples in this context.

The Practice Unit concludes that for purposes of Step 1, the agent must determine whether the individual is a U.S. resident both under U.S. domestic law and under the treaty.

STEP 2 – TREATY COUNTRY RESIDENCY CLAIM

In order to determine whether an individual properly claimed residence in a treaty country, the Practice Unit advises that I.R.S. agents should look for the following:

- Information on tax returns, e.g., responses on Schedule OI of Form 1040NR
- Responses on Form 9210, *Alien Status Questionnaire*
- The exchange of information provisions available under the treaty, or tax information exchange agreements, that can be used to receive information from outside the U.S.

⁶ Treas. Reg. §1.6013-6(a)(2)(v).

“Taxpayers should be careful about filing a treaty return position claiming non-U.S. residency when they hold a green card, since this could trigger an exit tax exposure.”

- A foreign equivalent to a certificate of residency⁷
- The presence of a “*forfait*” or another fixed-fee regime⁸

STEP 3 – TREATY TIE-BREAKER RULES

I.R.S. agents move to Step 3 if they determine that the individual is a resident of the other country for treaty purposes and also a resident of the U.S. If not, the agents are asked to skip Step 3 and go to the section entitled “Other Considerations or Impact to Audit.”

The Tie-Breaker Rules are used to determine a single country of residence in a case of dual residency. Citing the 2006 U.S. Model Treaty, the Practice Unit provides that the Tie-Breaker Rules generally look at the following factors:

1. The existence and location of a permanent home
2. The center of vital interests
3. The individual’s habitual abode
4. Nationality⁹

The Tie-Breaker Rules test these factors in the stated order. Once an element has been satisfied with respect to the U.S. or the treaty country, residency is attributed accordingly. If the test is met for both countries, the next factor is tested.

The I.R.S. cautions that not all treaties have Tie-Breaker Rules and cites the U.S.-China and the U.S.-Pakistan treaties as examples. While not stated in the Practice Unit, residency would, in these cases, be determined under a competent authority procedure (*i.e.*, in consultations between the competent authorities of the two countries in issue).¹⁰

Permanent Home

Under the Tie-Breaker Rules, an individual has a permanent home in the U.S. if

- the individual (i) purchased a home in the U.S., (ii) intended to reside in that home for an indefinite time, and (iii) actually did reside in that home; or

⁷ In this respect, the I.R.S. cautions that the certificate can only be relied on if a reasonably prudent person would not doubt the certificate. Absent such a certificate, the Practice Unit requires agents to (i) consider the other country’s domestic laws of residency and (ii) evaluate the individual’s specific facts in light of those rules. It recommends using the BNA Tax Management Portfolios and the information found on the websites of accounting firms.

⁸ Here, the I.R.S. gives Switzerland and Ireland as examples.

⁹ Note that a similar test exists under U.S. domestic law as an exception to the Substantial Presence Test (Treas. Reg. §§301-7701(b)-2(a)(1)). If the taxpayer can substantiate closer connections to a single foreign country in line with the rules of the domestic Closer Connection Test, residency will be assigned to the foreign country. This test does not apply if the taxpayer has been in the U.S. for 183 days or more in the current year.

¹⁰ Cf. U.S.-China Income Tax Treaty, art. 4(2) for dual resident individuals and art. 4(3) for dual resident corporations.

- the individual (i) has a room or apartment continuously available, (ii) stores personal property (e.g., automobiles or personal belongings) at the dwelling, and (iii) conducts business (e.g., maintaining an office, registering a telephone), including using the address for insurance and a driver's license.

Certain treaties look at an individual's family life to determine a permanent home. The Practice Unit cites the U.S.-Australia, U.S.-Indonesia, and U.S.-Korea treaties.

If the individual has only one permanent home, the application of the Tie-Breaker Rules ends there. If the individual has a permanent home in both treaty countries, the individual's center of vital interests must be determined.

Center of Vital Interests

To determine an individual's center of vital interests, one must look at their personal, community, and economic relations. The following factors are not exclusive. Rather, all facts and circumstances are relevant and must be evaluated in their entirety.

- An individual's personal relations can be identified (i) by such individual's family location, including parents and siblings, and where the individual spent his or her childhood, or (ii) in the case of a person's recent relocation, by whether the family moved from their permanent home to join the individual or the individual located to a second state. However, certain treaties, like the U.S.-Israel treaty, have a different definition of the center of vital interests.
- An individual's community relations are determined by the location of the individual's (i) health insurance, (ii) medical and dental professionals, (iii) driver's license or motor vehicle registration, (iv) health club membership, (v) political and cultural activities, and (vi) ownership of bank accounts.
- A person's economic relations are identified by where the individual (i) keeps his or her investments or conducts business, (ii) incorporated a business, and (iii) retains professional advisors (e.g., attorneys, agents, and accountants).



Habitual Abode

An individual's habitual abode is the place where the individual has a greater presence during the calendar year.

Nationality

An individual's nationality is determined by their citizenship or state of nationality. An individual is unlikely to be a U.S. national if they are not a U.S. citizen.

To determine the individual's state of nationality, agents should look to passports and/or U.S.C.I.S. Forms I-94, and reconcile these documents with the individual's Form 1040NR, Schedule OI, Item A, which inquires about the filer's citizenship. An exchange of information request may also be submitted.

BEYOND STEP 3

If, after applying these tests, the individual still has dual residency, the competent authorities will try to assign a residency country by means of mutual agreement.