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## Trading One Danger for Another: Creating U.S. Tax Residency While Fleeing Violence at Home

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## TRADING ONE DANGER FOR ANOTHER: CREATING U.S. TAX RESIDENCY WHILE FLEEING VIOLENCE AT HOME

by

Mark S. Hoose\*

### ABSTRACT

*Recent levels of violence in Mexico have caused certain of its citizens who do not hold permanent U.S. residency status (and who may not intend to reside in the United States permanently) to spend more time in the United States. By doing so, these individuals create the risk that they will become U.S. residents for U.S. tax purposes, thereby subjecting their income to worldwide taxation by the United States (as well as creating potential U.S. estate and gift tax issues). This paper explores whether there is relief available to such individuals under U.S. domestic law (the “substantial presence” test and its various exceptions). It also explores whether Mexican nationals can obtain relief from U.S. residency under the terms of the United States-Mexico income tax treaty. The paper concludes that it is less than clear whether relief is available; in particular, it is not clear whether the tax authorities or the courts may consider violence in the person’s home country in determining whether the individual is a U.S. tax resident. The paper then goes on to propose various statutory changes to the law to allow the tax authorities to provide relief and certainty on the question of U.S. tax residency to individuals who are present in the United States merely to avoid violence at home. The paper argues for such relief on the basis that imposing worldwide U.S. taxation and tax reporting obligations on Mexican nationals present in the United States merely to avoid danger at home is inequitable given the contributions of U.S. policy to the violence in Mexico.*

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## I. INTRODUCTION

It is fairly well known, at least within tax circles, that the United States is unique in its approach to taxation of its citizens.<sup>1</sup> The United States is unique because it taxes its citizens on their worldwide income.<sup>2</sup> This means that income of a U.S. citizen is taxed by the United States regardless of where the income is earned and where the individual resides.<sup>3</sup> In addition to U.S. citizens (whether born or naturalized), this system also applies to lawful permanent residents (“green card” holders) of the United States, who are considered to be U.S. residents for U.S. federal income tax purposes.<sup>4</sup>

What is less well-known is that individuals who are neither citizens nor lawful permanent residents of the United States can also be considered to be U.S. residents for purposes of the U.S. federal income tax, and hence subject to U.S. tax on their worldwide income.<sup>5</sup> These individuals can create U.S. tax residency by satisfying the “substantial presence test,” which essentially provides that an individual who is “present” in the United States for a certain number of days over a given period can create U.S. tax residency by means of this “substantial presence.”<sup>6</sup> Accordingly, an individual who is not a citizen or permanent resident can nonetheless create U.S. tax residency merely by being present in the United States for a certain number of days over a given period.<sup>7</sup>

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1. See, e.g., Edward A. Zelinsky, *Citizenship and Worldwide Taxation: Citizenship as an Administrable Proxy for Domicile*, 96 IOWA L. REV. 1289, 1291 (2011).

2. Reg. § 1.1-1(b) (“[A]ll citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.”).

3. *Id.*; see also I.R.C. § 1.

4. I.R.C. § 7701(b)(1)(A)(i).

5. Residency may also create U.S. estate and gift tax consequences. See I.R.C. § 2001(a).

6. I.R.C. §§ 7701(b)(1)(A)(ii), 7701(b)(3). Other nations also tax individuals based on residency, which is a difficult determination to make and has vexed numerous policymakers. See, e.g., Adrian J. Sawyer, *The Mire of Tax Residency Determination in New Zealand*, TAX NOTES INT’L 737 (Dec. 5, 2011).

7. This is a different issue than the “accidental American” issue, where a long-term resident of a foreign country (such as Mexico or Canada) discovers later in life that she was born in the United States and hence has been a U.S. citizen (subject to U.S. worldwide taxation) since birth. Relief is now available in these situations.

This can be the case even if the individual is physically present in the United States merely to avoid either political or other dangers in the person's home country of citizenship or residency.<sup>8</sup> There is some evidence that this has become a substantial problem for certain citizens of the border regions of Mexico, who may currently find it difficult to remain in their home country due to increasing levels of violence.<sup>9</sup>

Take as an example an individual who is a citizen of Mexico but has family members (including perhaps a spouse) who reside in the United States. The individual may live in a border town such as Ciudad Juárez or Tijuana, where there has been a significant increase in violence since 2007.<sup>10</sup> The individual may have significant business interests in Mexico, but also business interests and other connections to the United States.<sup>11</sup> She may have her usual home in Mexico, but also a residence available to her in the United States, given that she has family in the United States. Due to the increase in violence in her hometown, she may feel that it is necessary to spend more time in the United States.<sup>12</sup> The U.S. tax question arises if she comes to the United States<sup>13</sup> in 2011, and due to conditions at home, she is required to stay in the United States for more than 183 days in 2011. The specific issue is whether she has inadvertently become a "resident alien" individual<sup>14</sup> for

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See Kristen A. Parillo, *IRS to Minimize Penalties on Dual U.S.-Canadian Citizens*, TAX NOTES INT'L 798 (Dec. 12, 2011).

8. See STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., GEN. EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 464 (JOINT COMM. PRINT 1984) [hereinafter JCT, GENERAL EXPLANATION].

9. See A "Green Zone" for Firms in Ciudad Juárez: Business on the Bloody Border, *ECONOMIST*, Nov. 26, 2011, at 76 (noting how Ciudad Juárez considered implementing a well-protected "Green Zone," in order to protect local entrepreneurs and reassure visitors).

10. See, e.g., *Mexico's Changing Drug War: Shifting Sands*, *ECONOMIST*, Nov. 26, 2011, at 48 (summarizing the "drug war" and the significant increases in violence in certain parts of Mexico during 2011).

11. The economic relationship between the United States and Mexico is the most important relationship, by a significant margin, for Mexico and its citizens. See M. ANGELES VILLARREAL, CONG. RESEARCH SERV., RL 32934, U.S.-MEXICO ECONOMIC RELATIONS: TRENDS, ISSUES, AND IMPLICATIONS (2005), <http://fpc.stat.gov/documents/organization/50161.pdf> [hereinafter VILLARREAL, U.S.-MEXICO RELATIONS].

12. See, e.g., Mary Beth Sheridan, *Drug War Sparks Exodus of Affluent Mexicans*, *WASH. POST*, Aug. 26, 2011, [http://www.washingtonpost.com/world/national-security/drug-war-sparks-exodus-of-affluent-mexicans/2011/08/19/gIQA6OR1gJ\\_story.html](http://www.washingtonpost.com/world/national-security/drug-war-sparks-exodus-of-affluent-mexicans/2011/08/19/gIQA6OR1gJ_story.html).

13. She may hold an "E-1" or "E-2" investment visa, which allows her to enter the United States. The number of such visas has increased by 73% from 2006 to 2010. *Id.*

14. I.R.C. § 7701(b).

U.S. tax purposes, and thus is subject to worldwide U.S. taxation on her income,<sup>15</sup> notwithstanding the fact that she remains a citizen of Mexico<sup>16</sup> and does not hold lawful permanent resident status<sup>17</sup> in the United States.

The remainder of this article will explore this problem further.<sup>18</sup> Part II will take an in-depth look at the “substantial presence” test and discuss the consequences of a U.S. residency determination under that test. Part III will then analyze whether relief may be available to such individuals under a U.S. tax treaty (for example, in the case of Mexico, the United States-Mexico income tax treaty). Part IV will then make the argument for an exception to the “substantial presence” test for individuals who can show that they are only present in the United States to avoid political or other dangers in their home countries. That Part will emphasize that the United States should particularly make such an exception with respect to nationals from Mexico, given the contributions of U.S. policy to the recently increased levels of violence in that country. This Part will also suggest that policymakers consider other alternatives (such as a joint ruling process) to give Mexican nationals more certainty as to whether their presence in the United States creates U.S. tax residency.

## II. U.S. TAX RESIDENCY UNDER STATUTORY LAW

To determine whether an individual is a U.S. resident, one must first consult the U.S. Internal Revenue Code for the relevant rules.<sup>19</sup> However, if the individual is found to be a resident under these rules, this is not the end of the analysis. If an individual is a foreign person who is also entitled to benefit from the provisions of a U.S. tax treaty, then the treaty must be consulted to determine whether the individual is truly a U.S. resident, or is a

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15. Reg. § 1.1-1(b).

16. As a citizen of Mexico, with a home in that country, she is likely to be considered a Mexican resident for Mexican income tax purposes. *See infra* note 178.

17. As noted, it may be that she entered the United States on either a “tourist” or “investor” visa. It will be seen that a person’s immigration status (short of lawful permanent residency) is generally not determinative in the analysis of whether the individual is a U.S. tax resident subject to worldwide taxation. *See* I.R.S. Tech. Adv. Mem. 75-08-291120A (Aug. 29, 1975) (finding that an individual who was in the United States illegally was nonetheless a resident of the United States for tax purposes (under the test for residency that appeared in the law prior to 1984’s introduction of the “substantial presence test”)).

18. Similar issues can arise for other individuals fleeing violence at home, such as Salvadorans fleeing violence in El Salvador. *See, e.g.,* Drew Combs, *Nixon Peabody Lawyer Wins Asylum for Salvadoran Teen Tormented by Gangs*, AM. LAW, Dec. 13, 2011, <http://www.law.com/jsp/article.jsp?id=1202535303729>. The focus of this article, however, will be on Mexico, given its proximity to the United States.

19. *See* I.R.C. § 1.

resident of the other country, for (at least some) purposes of U.S. taxation.<sup>20</sup> These rules are now discussed in turn (the treaty rules are discussed in Part III).

A. *Consequences of the U.S. Residency Determination*

Before proceeding to discuss U.S. residency rules in detail, it is worth evaluating the consequences of a U.S. residency determination. Also, it is useful to explore the differing tax treatment accorded to individuals who are not residents of the United States. Each will be discussed in turn.

1. *Consequences of U.S. Residency*

If an individual is determined to be a U.S. resident (specifically, a “resident alien individual”), then such individual is taxed by the United States on his or her worldwide income, no matter where earned.<sup>21</sup> Likewise, there may be gift and estate tax consequences to the determination.<sup>22</sup> Lastly, depending on the type of resident, there may be U.S. tax consequences upon the termination of U.S. residency status.<sup>23</sup>

In addition, there are numerous reporting requirements that are triggered by U.S. residency, including an obligation to report most foreign bank accounts,<sup>24</sup> certain ownership interests in foreign corporations and partnerships, and<sup>25</sup> interests in foreign trusts.<sup>26</sup> Further, as a U.S. resident, an

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20. See I.R.C. § 894(a), which states that U.S. domestic law shall be applied with “due regard” to any treaty obligation of the United States. The U.S. Supreme Court has generally stated that the “last expression of the sovereign will” shall prevail when a treaty (including a tax treaty) conflicts with U.S. domestic law, and hence a tax treaty may override a determination under domestic tax law. *Chae Chan Ping v. United States*, 130 U.S. 581, 600 (1889). For a general discussion of the treaty override issue, see Sung-Soo Han, *The Harmonization of Tax Treaties and Domestic Law*, 7 *BYU INT'L L. & MGMT. REV.* 29 (2011).

21. Reg. § 1.1-1(b). Worldwide taxation will result even if a foreign government also considers the individual to be a foreign resident and thus subject to foreign income taxation as well. In these situations, U.S. residents typically can take a credit against U.S. tax liability for any income taxes paid to a foreign government in order to mitigate the likelihood of double taxation. See I.R.C. § 901.

22. See, e.g., I.R.C. § 2001.

23. I.R.C. §§ 877, 7701(b)(10).

24. Transfer and Reorganization of Bank Secrecy Act Regulations, 75 Fed. Reg. 65806-01 (proposed Oct. 26, 2010) (to be codified at 31 C.F.R. § 103.24). This obligation is due to become more onerous once the new rules of the Foreign Account Tax Compliance Act (FATCA) come into effect in 2013 and 2014. See I.R.C. §§ 1471-1474 (effective for payments made after December 31, 2012).

25. See, e.g., I.R.C. § 6038.

individual is subject to the “Subpart F” regime, under which the income of certain foreign corporations that are “controlled” by the individual is subject to current U.S. taxation.<sup>27</sup>

However, there also may be taxpayer-positive effects to a determination of U.S. residency. For example, a U.S. resident taxpayer may be entitled to tax deductions (such as the deduction for mortgage interest paid) that are not available to nonresidents.<sup>28</sup> Further, a U.S. resident can be a shareholder in a Subchapter S corporation, while nonresidents cannot.<sup>29</sup> In general, Subchapter S treatment is a positive result for the entity and its shareholders, as it generally permits pass-through taxation and hence avoids the double taxation imposed on regular corporations under U.S. law.<sup>30</sup>

## 2. *Consequences of U.S. Nonresidency*

If, instead, an individual is determined to be a nonresident alien individual for the calendar year in question, then a different U.S. tax regime applies to the person.<sup>31</sup> This regime can be described as a form of a territorial regime, under which only income that bears some connection to the United States is subject to U.S. federal income taxation.<sup>32</sup> In particular, there is a thirty percent tax imposed on income “not connected with [a] United States business,” but only if such income is considered, in general, to be “fixed or determinable annual or periodical” (FDAP) income from sources within the United States.<sup>33</sup> Under these rules, capital gains (such as gains earned from

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26. I.R.C. § 6048.

27. I.R.C. §§ 951-965.

28. Generally, nonresidents are only permitted deductions that are connected with income that is “effectively connected” to a U.S. trade or business. I.R.C. § 873.

29. I.R.C. § 1361(b)(1)(c).

30. I.R.C. § 1368. Double taxation is imposed on Subchapter C corporations by treating the corporate entity itself as taxable, and by treating dividends paid by such corporations as taxable to their shareholders but not deductible by the paying corporation. *See generally* I.R.C. §§ 11, 301, 316. By contrast, an S corporation is generally not taxable on its income, and distributions by the S corporation are not taxable when received by shareholders. *See* I.R.C. § 1368.

31. *See* I.R.C. §§ 871-879.

32. JOSEPH ISENBERGH, *INTERNATIONAL TAXATION* 81-83 (3rd ed. 2010).

33. I.R.C. § 871(a). Such income, often referred to by the acronym “FDAP,” includes dividends and interest from U.S. sources (generally dividends paid by U.S. corporations or interest paid by U.S. persons). The thirty percent tax imposed by this section is collected via the mechanism of a withholding obligation imposed on the payors of such income. *See* I.R.C. §§ 1441-1445. However, gain from the disposition of property (such as corporate stock) is generally not taxable to foreign persons. *See* I.R.C. § 871(a)(2).

the disposition of corporate stock) earned by nonresidents are generally not subject to U.S. taxation.<sup>34</sup>

The other type of income taxable to nonresident aliens is any income that is “effectively connected” with a U.S. trade or business carried on by the nonresident alien.<sup>35</sup> As an extension of this rule, any gain or loss from the disposition of a “United States real property interest” by a nonresident alien is subject to U.S. taxation as though it were connected with a U.S. business.<sup>36</sup> These real estate rules are effectively exceptions to the general rule that gains earned by a nonresident alien are not subject to U.S. taxation and reflect a policy decision that real estate gains of foreign persons should be subject to U.S. taxation.<sup>37</sup>

Lastly, the impact of U.S. taxation on a nonresident alien can be altered and minimized by the application of a U.S. tax treaty with the alien’s country of residency.<sup>38</sup> For example, under the U.S.-Mexico income tax treaty, the U.S. tax imposed on U.S.-source interest and royalties (as well as certain dividends) is reduced from thirty percent to zero.<sup>39</sup> Likewise, the graduated tax imposed on business profits will only be imposed if the Mexican resident has a “permanent establishment” in the United States; not all U.S. businesses of a foreign person will rise to the level of a permanent establishment.<sup>40</sup>

### 3. *The Difference Between Residency and Nonresidency*

From these rules, it can be seen that the primary difference between U.S. residency and U.S. nonresidency is the taxation of income earned outside the United States. If an individual is a resident alien (i.e., a U.S.

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34. See I.R.C. § 871(a)(2), which imposes taxation upon the capital gains of nonresident aliens who are present in the United States 183 days or more in the year of disposition.

35. I.R.C. § 871(b). This income is taxed at the graduated rates applicable to U.S. residents. Also, business income that is taxable under this rule can include income earned by a partnership in which the nonresident alien is a partner, if the partnership is engaged in a U.S. trade or business. See I.R.C. § 875(1).

36. I.R.C. § 897(a). Thus, under this rule, any gain on the sale of U.S. real estate by a foreign person will be subject to taxation at the graduated rates applicable to U.S. residents.

37. See JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C1.06[1] (2011) [hereinafter KUNTZ & PERONI, U.S. INT’L TAXATION].

38. See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Mex., Sept. 18, 1992, S. Treaty Doc. No. 103-07, <http://www.irs.gov/businesses/international/article/0,,id=169680,00.html> [hereinafter U.S.-Mexico Treaty].

39. *Id.* art. 10, 11, 12.

40. *Id.* art. 7.

resident), then all income is subject to taxation, no matter where earned.<sup>41</sup> Nonresidents, by contrast, are generally taxed only on U.S.-connected income, which will include sales of U.S. real property.<sup>42</sup>

Thus, the practical difference will be U.S. taxation on non-U.S. income if the individual is found to be a U.S. resident. In other words, if the individual is a U.S. resident, the United States will impose income tax (with a provision of a credit for any foreign income taxes paid) on both the U.S. and non-U.S. income of the individual.<sup>43</sup> However, due to the application of a U.S. tax treaty to nonresidents only, U.S. residency status can also lead to U.S. taxation of U.S.-source passive income (such as interest and dividends) that would otherwise be exempt from U.S. taxation under the treaty, had the person been a U.S. nonresident and, instead, a resident of the other treaty country (e.g., Mexico).<sup>44</sup> Further, U.S. residency brings with it substantial tax reporting obligations, as described above.<sup>45</sup>

## B. U.S. Residency Under the Internal Revenue Code

### I. The Current Law Definition

The term “resident alien individual” is defined by section 7701(b) of the Internal Revenue Code.<sup>46</sup> Under this provision, an individual who is not a U.S. citizen can be a resident alien for a particular calendar year in one of three ways. First, an individual will be a resident alien if the person is a “lawful permanent resident” of the United States at any time during the calendar year.<sup>47</sup> A person is a lawful permanent resident if such person has been “lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws,” and such status has not been revoked or abandoned.<sup>48</sup> This is commonly referred to

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41. However, as noted, a U.S. resident is also entitled to more deductions than are typically available to a nonresident. Further, the U.S. resident should be entitled to a foreign tax credit for income taxes paid to foreign countries. *See* I.R.C. § 901.

42. I.R.C. § 897.

43. Reg. § 1.1-1(b). *See* I.R.C. § 901 for rules allowing U.S. residents a credit against U.S. tax liability for foreign income taxes paid.

44. *See* U.S.-Mexico Treaty, *supra* note 38, art. 10 (exempting from U.S. tax certain dividends received from U.S. sources by residents of Mexico).

45. *See* discussion *supra* note 24.

46. This paper will use the term “U.S. resident” interchangeably with “resident alien individual”; the meaning is the same. A person who is a U.S. citizen is automatically a U.S. resident for U.S. federal income tax purposes; hence, this discussion assumes that the individual in question is not a U.S. citizen.

47. I.R.C. § 7701(b)(1)(A)(i).

48. I.R.C. § 7701(b)(6).

as the “green card” test for establishing resident alien status (and hence becoming a U.S. tax resident).<sup>49</sup>

Second, an individual can be a resident alien by meeting the “substantial presence” test set forth in the statute.<sup>50</sup> The substantial presence test is described in greater detail below.

Lastly, an individual can become a resident alien by making the first year election provided in the statute.<sup>51</sup> For this election to be available, the individual must not have been a U.S. resident in either the current or the preceding tax year (either lawfully or under the substantial presence test).<sup>52</sup> The individual must also meet the substantial presence test in the subsequent calendar year.<sup>53</sup> Further, the individual must be present in the United States for a certain number of days during the election year.<sup>54</sup>

Accordingly, it can be seen from these rules that the only way a nonresident can “accidentally” create U.S. residency is by satisfying the substantial presence test, which is discussed below.<sup>55</sup>

## 2. *Some Historical Background*

U.S. law has long had to grapple with the issue of whether a foreign national is a “U.S. resident” for U.S. income tax purposes.<sup>56</sup> Prior to 1984, the U.S. residency of a foreign national was determined under a facts and circumstances analysis, which created a fairly substantial body of case law determining which factors were dispositive or important in determining the U.S. tax residency of a foreign national.<sup>57</sup> In particular, the relevant Treasury regulation at the time stated that if an individual was a mere sojourner in the

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49. Even the Internal Revenue Service (IRS) refers to this test as the “green card” test on its website. <http://www.irs.gov/businesses/small/international/article/0,,id=96314,00.html>.

50. I.R.C. § 7701(b)(1)(A)(ii).

51. I.R.C. § 7701(b)(1)(A)(iii).

52. I.R.C. § 7701(b)(4)(A)(i)–(ii).

53. I.R.C. § 7701(b)(4)(A)(iii).

54. I.R.C. § 7701(b)(4)(A)(iv). Individuals who are going to be subject to U.S. taxation in subsequent years may wish to make this election for the current year in order to avail themselves of the additional U.S. tax deductions available only to U.S. residents.

55. As noted previously, there are individuals who “accidentally” became U.S. citizens (due to birth in the United States). *Supra* note 7. These people are automatically U.S. residents for U.S. tax purposes (even if they are unaware of their U.S. citizenry), and hence the substantial presence test is not relevant to their cases (and they will not be discussed in this paper).

56. JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 6.6 (4th ed. 2011) [hereinafter ISENBERGH, U.S. TAXATION].

57. *Id.*

United States (i.e., had no intention to stay), then such person was not a U.S. tax resident.<sup>58</sup> Likewise, if the individual's stay in the United States was "limited to a definite period by the immigration laws," then such person was not a U.S. tax resident.<sup>59</sup>

Other factors considered by the courts included the individual's immigration status; whether (and to what extent) the foreign individual was actually present in the United States; and whether the foreign individual planned to stay in the United States either permanently or for an extended period.<sup>60</sup> Hence, the intentions of the individual (as to whether to stay in the United States or to return), as well as the situation in the individual's country of citizenship or prior residency, were considered important.

### 3. *The War Cases*

A relevant example of this analysis can be found in the case of *Nubar v. Commissioner*.<sup>61</sup> In that case, an Egyptian citizen found himself in the United States at the outbreak of World War II. The Tax Court described Nubar as a "man of great wealth" (whose grandfather was the Prime Minister of Egypt) who resided in Egypt until 1915, but then took an apartment in Paris, which he maintained continuously from 1915 to 1944.<sup>62</sup> Nubar arrived in the United States on August 1, 1939, on a three-month visitor's visa, evidently with the intention of seeing the New York World's Fair and also meeting with Albert Einstein.<sup>63</sup> However, the war broke out on September 1, 1939, making it difficult for him to return to Egypt. He sought an extension of his visa, which was eventually denied, and he was arrested by immigration authorities. Eventually, he was ordered to be deported, but the order was stayed until ninety days after termination of the war in Europe. Once the war ended, Nubar did indeed return to Europe, first to Switzerland, and then eventually to Paris.<sup>64</sup>

The Tax Court found that Nubar was not a U.S. resident because he had no intention to stay in the United States.<sup>65</sup> The Tax Court emphasized that Nubar came to the United States with minimal possessions and stayed in a hotel, all of his household goods and family remained in Europe, and he had a home in Switzerland to which he could return.<sup>66</sup> He also expressed an

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58. Reg. § 1.871-2(b) (1984).

59. *Id.*

60. ISENBERGH, U.S. TAXATION, *supra* note 56, at ¶ 6.6.

61. 13 T.C. 566 (1949), *rev'd*, 185 F.2d 584 (4th Cir. 1950).

62. *Id.* at 568.

63. *Id.* at 569.

64. *Id.*

65. *Id.* at 576.

66. *Id.*

intention to return to Europe, and then he indeed did return once the war ended.

However, on appeal, the Fourth Circuit reversed the Tax Court and held that Nubar was a U.S. tax resident.<sup>67</sup> The Fourth Circuit panel agreed that Nubar may have entered the United States with intentions to stay only temporarily, but the court emphasized that Nubar made significant profits trading on U.S. exchanges while under the protection of the laws of the United States.<sup>68</sup>

In other similar cases, the Tax Court found individuals to be nonresidents in very similar situations. In *Molnar v. Commissioner*, the taxpayer was a citizen of Hungary who was present in the United States from January 1940 through October 1943, on a series of visitor's visas that were extended periodically.<sup>69</sup> The Tax Court noted that the individual was only in the country for a definite and temporary period, in that he traveled on a round trip ticket, stayed in hotels, and did not engage in any business activity in the United States. Also, his only family and similar connections remained in Europe. Hence, he was found to be a nonresident of the United States for tax purposes.<sup>70</sup>

In *Constantinescu v. Commissioner*, the facts were similar to the situation in *Nubar*.<sup>71</sup> The taxpayer in this case, a citizen of Romania who resided in Paris, gained admission to the United States in 1939 on a temporary visitor's visa. After a few renewals of her visa, such renewal was finally denied in 1942, and the taxpayer was arrested in 1943 and ordered deported in 1944. Her deportation orders were eventually stayed, and she ultimately left the United States for Europe in late 1945.<sup>72</sup> The IRS asserted that she was a U.S. tax resident from 1944-1945, a time during which she was actually under arrest in the United States. The Tax Court did not agree, and held that the taxpayer was not a U.S. tax resident, applying the "facts and circumstances" test called for by the regulations in force at that time.<sup>73</sup>

In the post-war years, other transitory individuals (in one case, a flight attendant, and in another, an actor) succeeded in defeating U.S.

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67. *Commissioner v. Nubar*, 185 F.2d 584, 589 (4th Cir. 1950).

68. *Id.* at 586. This can be thought of as a "benefit" test, which is an oft-stated theoretical foundation for taxing non-citizens. See JCT, GENERAL EXPLANATION, *supra* note 8. Under this benefit test, taxation by the United States is deemed appropriate because the non-citizen is benefitting from the laws and protections of the United States.

69. 4 T.C.M. (CCH) 951 (1945).

70. *Id.*

71. 11 T.C. 37 (1948).

72. *Id.* at 38-39.

73. *Id.* at 42-44.

tax residency in court.<sup>74</sup> In addition, in the 1970's, the IRS dealt with this issue in tax rulings with inconsistent results.<sup>75</sup>

It can be seen from these cases and rulings that the “facts and circumstances” analysis of the prior regulations led to inconsistent application of the U.S. residency test to similarly situated taxpayers. In particular, there appears to be very little difference between the fact pattern in *Nubar* and the fact pattern in *Constantinescu* — in both cases, the taxpayer was forced to stay in the United States due to war conditions in Europe. Yet, in one case, the taxpayer was found (on appeal) to be a U.S. resident, while in the other, the taxpayer did not create U.S. tax residency. These fact patterns are also very similar to the fact pattern of the Mexican national mentioned in the introduction to this paper.

It was this inconsistent application of a vague standard, which focused primarily on the person's intention in creating U.S. residency, that led Congress to enact the substantial presence test in 1984, as described below.

#### 4. 1984 – The Substantial Presence Test

It was in an effort to bring objectivity to this area that Congress amended section 7701(b) in 1984.<sup>76</sup> First, as noted above, Congress implemented the “green card” test — if a person is a lawful permanent resident of the United States, then such person is a U.S. resident for tax purposes.<sup>77</sup> Additionally, Congress tried to bring further objectivity to the analysis through application of the mechanical “substantial presence” test.<sup>78</sup> However, due to the number of exceptions,<sup>79</sup> it is highly questionable whether this test is truly objective. The test, and its various exceptions, are discussed in detail below.

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74. See *Sanford v. Commissioner*, 27 T.C.M. (CCH) 266 (1968) (holding that a Honduran flight attendant who maintained some living quarters in New Orleans was not a U.S. tax resident); *Jellinek v. Commissioner*, 36 T.C. 826 (1961) (“stateless” actor who worked periodically in Hollywood was not a U.S. tax resident).

75. See I.R.S. Tech. Adv. Mem. 77-40-002 (Apr. 27, 1977) (employee of international organization who was present in the United States was a U.S. tax resident); I.R.S. Tech. Adv. Mem. 77-40-001 (Apr. 27, 1977) (student who became an employee of an international organization in the United States was held to be a U.S. resident).

76. See H.R. REP. NO. 98-861, at 181 (1984) (Conf. Rep.).

77. I.R.C. §§ 7701(b)(1)(A)(i), (b)(6).

78. I.R.C. § 7701(b)(3).

79. See I.R.C. §§ 7701(b)(5), (b)(7).

It is an interesting query as to whether Congress intended to overrule or abandon the prior case law when implementing the substantial presence test. Thus, the question is whether these old cases, relating to “intention” and danger in the individual’s home country, still have any relevance under either statute or treaty. The legislative history to the 1984 Tax Reform Act (which brought section 7701(b) into the Code) is silent on this topic.<sup>80</sup> However, the Staff of the Joint Committee on Taxation’s General Explanation of the 1984 Act [hereinafter 1984 Act JCT Explanation] gives some indication that the old case law may no longer be relevant.<sup>81</sup> In particular, the 1984 Act JCT Explanation states that Congress intended to create only limited exceptions for people in the United States to “teach or learn,”<sup>82</sup> as opposed to people in the United States merely to enjoy “political stability.”<sup>83</sup> This is evidence that the old “facts and circumstances” analysis was truly made irrelevant by the 1984 legislative change.

### C. *The Substantial Presence Test in Detail*

This section describes the substantial presence test in detail. The next subsection describes a major potential exception to U.S. tax residency under the Code, often called the “closer connection” exception.

#### 1. *The Test*

In order for an individual to be substantially present in the United States for a calendar year, and hence a U.S. tax resident for that year, the person must initially be physically present in the United States for at least thirty-one days in the calendar year in question.<sup>84</sup> Then, assuming this condition is met, the individual’s presence in the United States must be determined for each of the two preceding years.<sup>85</sup> The sum of the days present in the current year, plus the days present during the preceding two years (multiplied by a “multiplier”) must equal or exceed 183 days.<sup>86</sup> The “multiplier” for the first preceding year is one-third (i.e., the days actually

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80. See H.R. REP. NO. 98-861, *supra* note 76.

81. See JCT, GENERAL EXPLANATION, *supra* note 8, at 464.

82. *Id.* This is a reference to the statutory exceptions in I.R.C. § 7701(b)(5) for individuals in the United States merely as students or teachers, as discussed *infra* Part II.C.1.c.

83. JCT, GENERAL EXPLANATION, *supra* note 8, at 464.

84. I.R.C. § 7701(b)(3)(A)(i).

85. I.R.C. § 7701(b)(3)(A)(ii).

86. *Id.*

present in such preceding year are multiplied by one-third), and the multiplier for the second preceding year is one-sixth.<sup>87</sup>

By way of example, consider the following (taken from the Treasury regulations):

*Example 1.* B, an alien individual, is present in the United States for 122 days in the current year. He was present in the United States for 122 days in the first preceding calendar year and for 122 days in the second preceding calendar year. In determining his status for the current year, B counts all 122 days in the United States in the current year plus  $1/3$  of the 122 days in the United States in the first preceding calendar year ( $40 \frac{2}{3}$  days) and  $1/6$  of the 122 days in the United States during the second preceding calendar year ( $20 \frac{1}{3}$  days). The total of  $122 + 40 \frac{2}{3} + 20 \frac{1}{3}$  equals 183 days. B meets the substantial presence test and is a resident alien for the current year.<sup>88</sup>

a. *Meaning of “Present”*

In general, the term “present” encompasses any day that the individual is “physically present” in the United States any at time during such day.<sup>89</sup> Thus, whether the individual is in the United States legally or not is irrelevant for this purpose.<sup>90</sup> However, there are certain exceptions to the definition of “present” for certain days of actual presence and for certain individuals, as described below.

b. *Exception for Certain Days of Presence*

The statute makes certain exceptions for days of actual presence within the United States that will not count as days “present” for purposes of the substantial presence test. There are three types of days that will not count as presence. The first exception is for days during which an individual commutes from a residence in Canada or Mexico to a place of employment (or self-employment) within the United States.<sup>91</sup> Any day so commuting will not be considered a day of “presence” for purposes of the test.

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87. *Id.*

88. Reg. § 301.7701(b)-1(e), *Ex. 1.*

89. I.R.C. § 7701(b)(7)(A).

90. *See* I.R.S. Tech. Adv. Mem. 75-08-291120A (Aug. 29, 1975).

91. I.R.C. § 7701(b)(7)(B).

The second exception is for individuals who are in transit between two foreign points.<sup>92</sup> In order for this exception to apply, the individual must be present for less than twenty-four hours in the United States.<sup>93</sup> This exception is evidently intended for situations in which individuals are merely changing planes, for example, in New York while in transit between Mexico and Paris.

The third exception is for members of a crew of a “foreign vessel,” provided such individual is a regular member of such crew and is present in the United States solely as part of the crew of the vessel engaged in transportation between the United States and a foreign country (or U.S. possession).<sup>94</sup> Any days present in this capacity will not count as “presence” so long as the individual does not engage in any other U.S. business on such a day.<sup>95</sup>

Interestingly, there is no explicit exception for days of presence in the United States due solely to exigencies in the individual’s home country. As noted above, under the “facts and circumstances” analysis undertaken by the courts and the tax authority prior to 1984, there was some consideration given to this issue.<sup>96</sup>

*c. Exception for Exempt Individuals*

In addition to making exceptions for certain days of presence, the statute also makes exceptions for certain types of individuals who are actually present in the United States. If any person is an “exempt individual” on a particular day of presence in the United States, then such day shall not count as a day of “presence” for purposes of the test.<sup>97</sup>

The statute provides four categories of “exempt individuals” and one exception for certain medical conditions: (1) a foreign government-related individual; (2) a teacher or trainee; (3) a student; (4) a professional athlete temporarily in the United States to compete in a charitable sports event; or (5) a person unable to leave the United States due to a medical condition that arose while the individual was present in the United States.<sup>98</sup> Each of these will now be discussed in turn.

A foreign government-related individual includes a person who is temporarily in the United States under diplomatic status that is full time or

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92. I.R.C. § 7701(b)(7)(C).

93. *Id.*

94. I.R.C. § 7701(b)(7)(D).

95. *Id.*

96. *See, e.g., Nubar*, 13 T.C. at 579.

97. I.R.C. § 7701(b)(3)(D).

98. *Id.*; I.R.C. § 7701(b)(5)(A)-(E).

consular (under U.S. State Department rules).<sup>99</sup> This definition also includes an individual who is a full-time employee of an “international organization.”<sup>100</sup> Any immediate family members of either a diplomat or employee of an international organization also are included.<sup>101</sup>

The “teacher or trainee” category includes only individuals who hold a “J” visa or a “Q” visa and are in the United States in compliance with the requirements of those visa statuses (as potentially determined independently by the IRS).<sup>102</sup> There is, however, a time limit imposed on the teacher or trainee exception — if an individual qualified as an exempt teacher or trainee in any two of the preceding six calendar years, then the individual cannot so qualify for the current calendar year.<sup>103</sup>

A student is exempt if she is temporarily present in the United States under either an “F,” “M,” “J,” or “Q” visa and complies with the requirements of these visa statuses.<sup>104</sup> Similar to teachers and trainees, students are subject to a time limit — a student cannot qualify for exempt status in any year after the fifth calendar year in which the student first qualified, unless the student can establish that she does not intend to permanently reside in the United States.<sup>105</sup>

Professional athletes who are present in the United States merely to compete in a “charitable sports event” will not be counted as present in the United States for purposes of the test.<sup>106</sup> Likewise, individuals who are unable to leave the United States due to a “medical condition” that arose

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99. I.R.C. § 7701(b)(5)(B). Here, “temporarily” means a person who holds diplomatic status or works for an international organization (or is a family member) and does not have a “green card,” no matter how long the person has been in the United States. Reg. § 301.7701(b)-3(b)(2)(i).

100. I.R.C. § 7701(b)(5)(B)(ii). “International organization” means any organization that qualifies for benefits under the International Organizations Act, which should include the United Nations, World Bank, and International Monetary Fund. Reg. § 301.7701(b)-3(b)(2)(ii).

101. I.R.C. § 7701(b)(5)(B)(iii). Under the regulations, “immediate family” includes a spouse and unmarried children under the age of twenty-one, but not personal assistants. Reg. § 301.7701(b)-3(b)(8).

102. I.R.C. § 7701(b)(5)(C).

103. I.R.C. § 7701(b)(5)(E). This time limit effectively means that a teacher or trainee can only qualify as an exempt individual in two years out of any seven-year period.

104. I.R.C. § 7701(b)(5)(D).

105. I.R.C. § 7701(b)(5)(E).

106. I.R.C. § 7701(b)(5)(A)(iv). A “charitable sports event” is defined as an event for the benefit of a tax-exempt organization, where all the proceeds from the event go to the organization, and the event is staffed substantially by volunteers. *See* I.R.C. § 274(l)(1)(B).

while they were in the United States are not counted as “present” in the United States on any such day.<sup>107</sup>

There are a variety of disclosure requirements imposed by the IRS on the ability to utilize these exclusions (for example, the requirement to file Form 8843 with the IRS).<sup>108</sup>

*D. The “Closer Connection” Exception*

In addition to the exceptions for certain days of presence and certain exempt individuals (as described above), the statute also provides a separate exception for an individual who is present (after considering the exceptions noted above) in the United States for fewer than 183 days in the year in question, if such individual can establish that she has a “tax home” in a foreign country and a “closer connection” to such foreign country than to the United States.<sup>109</sup> Further, in order for this exception to apply, the individual must not have an application for “adjustment of status” pending during the year in question, and the individual must not have taken any other steps during the year to apply for status as a lawful permanent resident of the United States.<sup>110</sup> Lastly, certain reporting requirements will apply in order for an individual to qualify under this exception.<sup>111</sup>

*1. Definition of “Tax Home”*

Section 911 provides the definition of a “tax home”;<sup>112</sup> that section, in turn, refers to section 162(a)(2) for the definition.<sup>113</sup> Under section 162, the term “tax home” has a long history.<sup>114</sup> The term effectively refers to an individual’s main location or main place of employment or self-employment.<sup>115</sup> Under this case law, an individual who is transient may be

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107. I.R.C. § 7701(b)(3)(D)(ii). The exception will not apply if the medical condition arose prior to the individual’s arrival in the United States. Likewise, the exception will not apply if it is shown that the individual would have stayed in the United States had the medical condition not occurred. Reg. § 301.7701(b)-3(c).

108. *See generally* Reg. § 301.7701(b)-8.

109. I.R.C. § 7701(b)(3)(B).

110. I.R.C. § 7701(b)(3)(C)(i)–(ii). The regulations list the types of forms that constitute an “application for adjustment of status.” See Reg. § 301.7701(b)-2(f).

111. I.R.C. § 7701(b)(8).

112. I.R.C. § 911(d)(3).

113. *Id.* See also KUNTZ & PERONI, U.S. INT’L TAXATION, *supra* note 37, at ¶ B1.04[2][b][iii].

114. *See generally* JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION: CASES AND MATERIALS 374 (16th ed. 2011).

115. *See, e.g.,* Rosenspan v. United States, 438 F.2d 905, 912 (2d Cir. 1971).

considered to have no “tax home” at all.<sup>116</sup> Once an individual spends more than one year away from this main location of employment, she is deemed to have a new “tax home.”<sup>117</sup>

The regulations under section 7701 clarify that if an individual has no regular place of business (e.g., if the individual is retired), the individual’s “tax home” is her “regular place of abode in a real and substantial sense.”<sup>118</sup> Also, the regulations make clear that the “tax home” must be maintained, in the same foreign country, for the entire current year.<sup>119</sup> Thus, an alien who changes her home during a calendar year, even if moving from one foreign location to another, may not be eligible for the “closer connection” exception.<sup>120</sup>

It can be seen from this analysis that the determination of an individual’s “tax home” is fairly subjective and depends on the specific facts and circumstances of the individual’s case. It may be particularly difficult for a Mexican national who is fleeing violence to show that her “tax home” is in Mexico, as the violence may make it impossible for her to show that Mexico is her main place of employment or regular place of abode, as required by the rules discussed above.

## 2. Definition of “Closer Connection”

Assuming an individual can prove that she has a “tax home” in another country, she must also prove that she has a “closer connection” to such home.<sup>121</sup> The regulations provide a list of factors to consider in determining whether an individual has a closer connection to a tax home in a foreign country.<sup>122</sup> The list of factors include the individual’s “permanent home,”<sup>123</sup> the location of the person’s family, banking activities, driver’s license, voting activity, and personal effects, among other criteria.<sup>124</sup> It is clear that this list is subjective, yet it is less than clear whether danger in the person’s home country, or even the person’s intentions as to residency, may be considered. Thus, the relevancy of the pre-1984 case law, discussed

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116. *Id.*

117. Rev. Rul. 99-7, 1999-1 C.B. 361.

118. Reg. § 301.7701(b)-2(c)(1).

119. Reg. § 301.7701(b)-2(c)(2).

120. ISENBERGH, U.S. TAXATION, *supra* note 56, at ¶ 6.19.

121. I.R.C. § 7701(b)(3)(B)(ii).

122. Reg. § 301.7701(b)-2(d)(1).

123. Reg. § 301.7701(b)-2(d)(1)(i). The concept of an individual’s “permanent home” may differ from her “tax home.” The regulations make clear that a “permanent home” must be a residence of some sort that is available to the individually continuously. Reg. § 301.7701(b)-2(d)(2).

124. Reg. § 301.7701(b)-2(d)(1)(i)-(x).

above,<sup>125</sup> is also in question. Even if such case law, with its emphasis on intention, is relevant, this “closer connection” exception only applies if the individual in question is present in the United States for fewer than 183 days in the year in question.<sup>126</sup>

*E. Conclusion – Residency Under Domestic Law*

As can be seen from the analysis above, the determination of U.S. residency under the “substantial presence” test involves significant subjective analysis of various factors, despite a pretense of objectivity arising from the numerical requirements of the section.<sup>127</sup> As noted, creating U.S. residency under the test, initially, is not subjective — the test is based on the number of days present in the United States during the current year and the two preceding calendar years.<sup>128</sup> However, the large number of exceptions,<sup>129</sup> and their nature, creates what is in effect, in many situations, a subjective analysis to determine whether a foreign person is a U.S. resident under this test.

*1. Summary of Exceptions*

In summary, even if a foreign person is present the requisite number of days, the individual may be able to avoid U.S. residency in the ways described below.<sup>130</sup> These various exceptions undermine the objectivity of the substantial presence test, and yet none of the exceptions seems to provide explicit relief for individuals who are in the United States merely to avoid dangers in their home country. The exceptions can be categorized based on whether they require 183 days or fewer of presence in the United States in the year in question and are summarized below.

*a. More than 183 days*

If an individual is actually present in the United States for more than 183 days<sup>131</sup> in the year in question, the only way to avoid a U.S. residency determination under the substantial presence test is to fall under one of the following exceptions:

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125. *See supra* Part II.B.3.

126. I.R.C. § 7701(b)(3)(B)(i).

127. I.R.C. § 7701(b)(3)(A).

128. *Id.*

129. I.R.C. §§ 7701(b)(3)(B), (5), (7).

130. *Id.*

131. I.R.C. § 7701(b)(3)(A)(ii).

- i. *Commuter* – days spent commuting from Mexico or Canada to a job in the United States do not count;<sup>132</sup>
  - ii. *Transit* – a day spent in the United States in transit between two foreign locations does not count;<sup>133</sup>
  - iii. *Foreign Vessel* – days spent in the United States as a member of a crew of a foreign vessel do not count;<sup>134</sup>
  - iv. *Government* – days spent in the United States as a foreign government official do not count;<sup>135</sup>
  - v. *Student* – in certain limited circumstances, days spent in the United States under a student visa do not count;<sup>136</sup>
  - vi. *Teacher* – likewise, in limited circumstances, days spent in the United States as a teacher or trainee do not count;<sup>137</sup>
  - vii. *Professional Athlete* – days spent as a professional athlete participating in a charity event in the United States do not count;<sup>138</sup> and
  - viii. *Medical Condition* – days spent in the United States due to a medical condition that prevents the individual from leaving the United States do not count.<sup>139</sup>
- b. *Less than 183 days*

If the individual is in the United States less than 183 days (once the above-mentioned exceptions are taken into account),<sup>140</sup> then the individual can also avoid U.S. residency under the “closer connection” test described above.<sup>141</sup> Under this exception, the individual must effectively have business interests (or at least a regular place of abode) outside the United States, and must prove a closer connection to this particular place, under a subjective analysis.<sup>142</sup>

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132. I.R.C. § 7701(b)(7)(B).

133. I.R.C. § 7701(b)(7)(C).

134. I.R.C. § 7701(b)(7)(D).

135. I.R.C. § 7701(b)(5)(B).

136. I.R.C. § 7701(b)(5)(D).

137. I.R.C. § 7701(b)(5)(C).

138. I.R.C. § 7701(b)(5)(A)(iv).

139. I.R.C. § 7701(b)(3)(D)(ii).

140. See I.R.C. § 7701(b)(3)(B)(i). The closer connection exception only applies if an individual is “present” in the United States fewer than 183 days during the current year. By using the term “present,” presumably all the exceptions to days of presence (as well as the exempt individual rules) apply in determining whether an individual is present in the United States for fewer than 183 days in the current year in question.

141. *Supra* Part I.D.

142. Reg. § 301.7701(b)-2(d)(1).

## 2. *Is Danger at Home Relevant?*

What is not clear under this test is whether the authorities or courts may consider the situation in the individual's home country when determining whether an individual satisfies the substantial presence test and hence is a U.S. tax resident. Under the authorities from the period prior to 1984, it was clear that courts did consider dangers at home in making the U.S. tax residency determination.<sup>143</sup> However, under the mechanical test described above and its very specific statutory exceptions,<sup>144</sup> it appears that the authorities may not consider dangers in the person's home country in the analysis of whether an individual is an "exempt individual," or whether certain days of presence do not count for purposes of the test.

As to the "closer connection" exception, it is also not clear whether danger at home may be considered. It could be possible to satisfy the "closer connection" exception in the context of an individual who is in the United States merely to avoid danger at home, but the person would have to show a "tax home" (i.e., a place of business activity, or regular abode), in a foreign country, and also the person would have to show a "closer connection" to such home. However, in such a situation, danger at home may work against the foreign person, in that a dangerous situation in the home country may make it difficult for the person to prove that she has a "closer connection" to such country.<sup>145</sup> Also, as noted, this exception is only available to the person if she is "present" in the United States for fewer than 183 days in the year in question.<sup>146</sup>

## 3. *Conclusion – Individual Fleeing Danger*

Accordingly, with respect to a foreign national in the United States merely to avoid dangers in her home country (such as the Mexican national described in the introduction), it is clear that the only likely exception that

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143. *Nubar*, 13 T.C. 566 (1948), *rev'd*, 185 F.2d 584 (4th Cir. 1950).

144. The only exception that may apply is the "medical condition" exception, but this would be unlikely — essentially, the individual would have to argue that she was in the United States to prevent a medical condition from arising (due to violence) should she return home.

145. The dangers at home may make it difficult to show that such place is the location of her "cultural and social" activities if the situation there is so difficult as to make such activities nearly impossible. However, the analysis could cut the other way — but clearly danger at home is not explicitly a factor in making the closer connection determination.

146. I.R.C. § 7701(b)(3)(B)(i).

would apply here is the “closer connection” exception.<sup>147</sup> The problems with this exception are two-fold: first, an individual must be “present” in the United States for fewer than 183 days during the year in question for the exception to apply.<sup>148</sup> The second major issue is its subjectivity — unlike many of the other exceptions, there are no objective definitions of “tax home”<sup>149</sup> or “closer connection” upon which such a person may rely.<sup>150</sup> Accordingly, an individual who is in the United States merely to avoid dangers at home may not be able to obtain much comfort<sup>151</sup> that she can avoid U.S. tax residency under the substantial presence test.

In particular, it should be noted that the taxpayers in *Nubar* and *Constantinescu*, in which the fact patterns are similar to the Mexican national mentioned in the Introduction to this paper, would be considered to be U.S. residents under the substantial presence test had such test been in force during the World War II years. Both taxpayers were present for much longer than 183 days in the United States, and hence could not utilize the closer connection exception. Likewise, none of the other exceptions seems to apply to their cases. Hence, the substantial presence test would change the Tax Court result in each of those cases (in *Nubar*’s case, the Court of Appeals found him to be a U.S. tax resident even under the old standard).

### III. U.S. TAX RESIDENCY UNDER U.S. TAX TREATIES

If an individual is deemed to be a U.S. tax resident under the Internal Revenue Code, the analysis does not necessarily end at this point.<sup>152</sup> If the individual is entitled to the benefits of a tax treaty between her home country and the United States, then the person may be able to avoid U.S. tax residency status.<sup>153</sup>

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147. As noted, the other exceptions (for days of presence and for exempt individuals) do not seem to apply to an individual in the United States merely to avoid danger at home. See I.R.C. §§ 7701(b)(5), (7).

148. I.R.C. § 7701(b)(3)(B)(i).

149. See *supra* note 112–17 and accompanying text.

150. See Reg. § 301.7701(b)-2(d)(1) for the list of subjective factors to be considered in making the closer connection determination.

151. Advance comfort is probably impossible to obtain, as it is the policy of the IRS to not provide an advance ruling on whether an individual is or is not a U.S. resident (and in any event, given the time constraints, such a ruling would not be possible in time to be useful). See Rev. Proc. 2012-7, 2012-1 I.R.B. 232, § 3.01(6).

152. See I.R.C. §§ 894(a), 7852(d).

153. *Id.* See also *supra* text accompanying note 20. In addition, the legislative history to the 1984 Act made it clear that the “substantial presence” test was not intended to override U.S. tax treaty determination of residency. See H.R. REP. NO. 98-861, *supra* note 76, at 182.

The United States has entered into a number of income tax treaties with foreign countries,<sup>154</sup> the terms of which vary from treaty to treaty.<sup>155</sup> However, certain terms and provisions are fairly consistent across treaties, as reflected in the U.S. Treasury Department's U.S. Model Income Tax Convention of 2006,<sup>156</sup> which itself is based heavily on the Model Tax Convention developed by the Organization for Economic Cooperation and Development (OECD).<sup>157</sup> For purposes of the remainder of the paper, the U.S. tax treaty with Mexico will be analyzed, given that the issue identified (i.e., accidentally triggering U.S. tax residency due to being present in the United States to avoid dangers in another country) is likely most applicable to citizens of Mexico.<sup>158</sup>

A. *The U.S.-Mexico Tax Treaty in General*

The current U.S.-Mexico tax treaty was signed in 1992,<sup>159</sup> and follows (in broad form) the U.S. model tax treaty and the OECD model convention.<sup>160</sup> Under the treaty, the two "Contracting States" (i.e., the United States and Mexico) agree to alter their domestic tax laws as such laws are applied to residents of the other Contracting State;<sup>161</sup> in effect, the provisions of the treaty override the then-existing relevant domestic law on the topic.<sup>162</sup> Accordingly, the provisions of the U.S.-Mexico treaty have the potential to override a determination of U.S. tax residency under the substantial presence test, which is a U.S. domestic law provision.<sup>163</sup>

B. *Residency under the Treaty*

1. *The Test for Residency*

The definition of residency under the U.S.-Mexico Treaty looks first to the domestic law of each contracting state to determine an individual's

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154. The IRS website contains a list of U.S. tax treaties, which can be found online at: <http://www.irs.gov/businesses/international/article/0,,id=96739,00.html>.

155. RICHARD E. ANDERSEN, ANALYSIS OF UNITED STATES INCOME TAX TREATIES, ¶ 1.02[2] (2012) [hereinafter ANDERSEN TAX TREATIES].

156. *Id.* at ¶ 1.02[4].

157. *Id.* at ¶ 1.02[2].

158. *See supra* note 8–9 and accompanying text.

159. *See* U.S.-Mexico Treaty, *supra* note 38, Preamble.

160. For example, many of the basic provisions of the Mexico treaty, such as art. 4 (residency) are virtually identical to the provisions of the 2006 U.S. Model Treaty and the OECD Model Tax Convention.

161. *See* U.S.-Mexico Treaty, *supra* note 38, art. 1.

162. *See* I.R.C. § 894(a).

163. *Id.* *See also* Reg. § 301.7701(b)-7.

residency.<sup>164</sup> Thus, utilizing standard rules of treaty interpretation, the rules of the Internal Revenue Code (described in Part I above) will be applied to determine whether an individual is a U.S. resident. Likewise, Mexican tax law will be used to determine if an individual is a resident of Mexico.

Thus, due to this reliance on domestic law in the first instance to determine residency, there will be situations (perhaps often) where an individual is determined to be a resident of both the United States and Mexico. The treaty anticipates this potential result, and provides for a series of “tie-breakers” to determine the residency, for purposes of the treaty, of a particular individual.<sup>165</sup> The tie-breakers are to be applied in the order they appear; once a tie-breaker is satisfied, the analysis is stopped, and the residency of the individual is determined under that particular rule.<sup>166</sup>

It should be emphasized that the tie-breaker rules are applicable only for determining residency for purposes of applying the particular income tax treaty in question.<sup>167</sup> For years, there was some question as to the exact U.S. tax treatment of an individual who is a U.S. resident under U.S. domestic law but is considered to be a resident of a foreign country under the applicable tax treaty.<sup>168</sup> Possible interpretations included treating the individual as a nonresident for all U.S. tax purposes, or instead treating the person as a U.S. resident for most tax purposes, but allowing treaty benefits for specified types of income (such as dividends) called for by the treaty.<sup>169</sup>

This uncertainty was ultimately resolved by Treasury regulations. Under these regulations, for all other U.S. tax purposes, an individual’s residency is still determined under non-treaty U.S. rules (as discussed above).<sup>170</sup> However, the IRS has determined that a person, who is a U.S. resident under U.S. domestic law, but a non-resident under a treaty, will be treated as a non-resident for purposes of determining her U.S. income tax liability only.<sup>171</sup> For other purposes (such as determining whether a corporation is “controlled” by U.S. shareholders<sup>172</sup>), the individual is still treated as a U.S. person.<sup>173</sup> Thus the person is basically a “half-resident” —

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164. See U.S.-Mexico Treaty, *supra* note 38, art. 4(1).

165. See U.S.-Mexico Treaty, *supra* note 38, art. 4(2).

166. *Id.*

167. U.S.-Mexico Treaty, *supra* note 38, art. 4(1), makes it clear that Article 4 determines residency only “for purposes of this Convention.”

168. ISENBERGH, U.S. TAXATION, *supra* note 56, at ¶ 102.10.1

169. *Id.*

170. *Id.* at ¶ 102.10.2. Such other purposes include determination of whether a foreign corporation is a controlled foreign corporation under section 957. See Reg. § 301.7701(b)-7(a)(3).

171. Reg. § 301.7701(b)-7.

172. See I.R.C. § 957.

173. One prominent commentator has called these individuals “half resident aliens” because they are treated as U.S. residents for certain purposes, but as foreign

she is treated as a nonresident for determining her tax liability (and thus she is not subject to worldwide U.S. taxation), but for other U.S. purposes (particularly information reporting), she continues to be treated as a U.S. resident.<sup>174</sup> This is an odd combination, and though it provides relief from worldwide U.S. taxation, it still requires the person to report substantial information to the U.S. government.<sup>175</sup>

Lastly, before turning to the tie-breaker rules in detail, it should be noted that U.S. courts, as reflected in the Tax Court's decision in *Podd v. Commissioner*,<sup>176</sup> require proof that the individual in question is indeed a resident under the tax laws of the foreign country. Without such proof (the burden of which falls on the taxpayer), the courts will generally not consider the applicability of the treaty tie-breakers in determining residency.<sup>177</sup>

In the case of Mexico, an individual will generally be considered to be a resident of Mexico for tax purposes if she has established an "abode" in Mexico.<sup>178</sup> If the individual has an abode in more than one country (including Mexico), then the Mexican authorities will generally use the "center of vital interests" criteria (described immediately below) to determine the individual's residency.<sup>179</sup> Given the subjective nature of this test, there is a substantial risk that an individual with connections to both the United States and Mexico will be considered a resident of both countries prior to application of the treaty "tie-breakers" described below.

## 2. *First Tie-Breaker – "Center of Vital Interests"*

Assuming an individual is a resident of both the United States and Mexico under the domestic laws of the respective countries, then the "tie-breaker" provisions of the treaty will become applicable.

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residents for determination of U.S. tax liability. ISENERGH, U.S. TAXATION, *supra* note 56, at ¶ 102.10. One interesting question that arises is whether these "half resident aliens" are eligible shareholders in an S Corporation, which can only have domestic shareholders. *Id.* at ¶ 102.11

174. ISENERGH, U.S. TAXATION, *supra* note 56, at ¶ 102.10.2.

175. *See, e.g.*, I.R.C. § 6038 (requiring U.S. shareholders to report information regarding foreign corporations in which they own at least a 10% interest).

176. 76 T.C. Memo. (CCH) 906, 908 (1998).

177. *Id.*

178. Nicasio del Castillo, Manuel F. Solano, & Terri L. Grosselin, "Business Operations in Mexico," 972-4th Tax Mgmt. (BNA) Foreign Income, at VII.B (2011).

179. *Id.*

a. “Permanent Home”

The treaty’s first tie-breaker looks to the country in which the individual has a “permanent home.”<sup>180</sup> Thus, under the ordering rules contained in this residency section, if the individual has only one permanent home, then the country where such permanent home is located will be the person’s country of residence for purposes of the U.S.-Mexico Treaty.

There is little guidance under the treaty as to what constitutes a “permanent home.” The technical explanation to the U.S.-Mexico Treaty is silent on this topic, and makes reference to the model treaty put forth by the OECD.<sup>181</sup> The commentary to the OECD model treaty includes language similar to the definition of “permanent home” contained in the U.S. tax regulations.<sup>182</sup> Under that definition, a permanent home is one that is continuously available to the person; it does not matter whether such home is owned or rented, or whether it is a house or apartment.<sup>183</sup>

This guidance is vague, and in the context of a Mexican citizen with connections to both countries (i.e., a home in Mexico, but family and available space to stay in the United States), it is possible that the person will be considered to have a permanent home in both countries. Accordingly, this first tie-breaker may not settle residency, and the next tie-breaker must be considered.

b. “Center of Vital Interests”

If the person has a permanent home available to her in both Mexico and the United States, then the treaty will grant residency to the country where her “personal and economic relations” are closer. The treaty, parenthetically, calls this the “center of vital interests” test.<sup>184</sup>

According to the OECD commentary and other relevant authority, the center of vital interests test requires a weighing of various factors to determine where such center lies for the particular individual.<sup>185</sup> Factors to be considered include location of family and other social interests; location

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180. See U.S.-Mexico Treaty, *supra* note 38, art. 4(2)(a).

181. TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED MEXICAN STATES FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, ART. 4.

182. OECD: TECHNICAL EXPLANATION (2005 INCOME TAX TREATY), art. 4 [hereinafter OECD: TECHNICAL EXPLANATION].

183. Reg. § 301.7701(b)-2(d)(2).

184. See U.S.-Mexico Treaty, *supra* note 38, art. 4(2)(a).

185. OECD: TECHNICAL EXPLANATION, *supra* note 182.

of business activities; location of cultural activities; and place of administration of property.<sup>186</sup>

One prominent commentator has asserted that applicability of the center of vital interests test should consider U.S. law as it existed prior to introduction of the substantial presence test in 1984. If this is indeed the case, then perhaps the authorities can consider the situation in the person's home country when making the determination of the location of "center of vital interests."<sup>187</sup> Authorities would also be able to consider the person's intentions regarding residency, as well as many other relevant factors.

However, there is very little actual direct authority regarding how the IRS or U.S. courts would apply this test.<sup>188</sup> The only relevant case decided by a U.S. court appears to be a Tax Court memorandum decision from 1998.<sup>189</sup> In that case, the Tax Court held that there was "doubt" as to the taxpayer's center of vital interests, and hence did not draw a conclusion as to the location of such interests; instead, it moved on to the second tie-breaker (habitual abode) described below.<sup>190</sup>

It can be seen from this test (and the Tax Court's conclusion) that it is easy for an individual to have either no "center of vital interest" or for the question to be unclear.<sup>191</sup> In such a case, the person would be required to move on to the next tie-breaker.

### 3. *Second Tie-Breaker – "Habitual Abode"*

This tie-breaker looks to the location of the person's "habitual abode."<sup>192</sup> This term must mean something different than "permanent home," given that this term is also used in Article 4 of the U.S.-Mexico Treaty, though the exact meaning of habitual abode is unclear.

In the one relevant case, the Tax Court determined that habitual abode effectively means the country in which the individual stays most frequently during the year in question.<sup>193</sup> In making this determination, the court counted the number of days the individual was present in each country,

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186. *Id.*

187. ISENBERGH, U.S. TAXATION, *supra* note 56, at ¶ 102.8.2.

188. ANDERSEN, TAX TREATIES, *supra* note 155, at ¶ 2.01[4][b][i] (commenting that the term "center of vital interests" is not a well-developed concept under U.S. law).

189. *Podd*, 76 T.C. Memo. (CCH) 906 (1998).

190. *Id.* at 910.

191. Other countries have grappled with this language with some success. *See, e.g.,* Wolf v. the Queen, 2000 CanLII 178 (Can. Tax Ct.) (a Canadian court determined an individual to have his "center of vital interests" in the United States due to his lack of intention to remain in Canada).

192. *See* U.S.-Mexico Treaty, *supra* note 38, art. 4(2)(b).

193. *Podd*, T. C. Memo. (CCH) 906 at 910.

even if the individual did not stay at a “permanent home” in such country.<sup>194</sup> In the case, the court found that the individual spent more days in the United States than in Canada during the year in question, and hence was a U.S. resident for that particular year.<sup>195</sup>

It is questionable whether this is the right way to look at the “habitual abode” test. The treaty clearly contemplates a situation where a person has a “habitual abode” in both countries (otherwise, there is no reason to provide for a third tie-breaker). However, under the court’s interpretation, a person could only have a habitual abode in two countries in a situation where there was an exact tie in number of days spent in each country.

#### 4. *Third Tie-Breaker – National Status*

If the individual has a habitual abode in both countries, or does not have a habitual abode in either country, then the person’s residency is determined by reference to her nationality.<sup>196</sup>

#### 5. *Fourth Tie-Breaker – Competent Authority*

If national status does not break the tie (either because the individual is a citizen of both countries, or a citizen of neither), then the Competent Authorities of the United States and Mexico must decide the individual’s residency under the mutual agreement provisions of the U.S.-Mexico Treaty.<sup>197</sup>

### C. *Analysis – U.S. Residency under the Treaty*

Based on the *Podd* case, if an individual has a permanent home in both countries and her center of vital interests cannot be determined, residency may effectively come down to the country in which she spends more days during the year in question.<sup>198</sup> It is not clear that this is the real intended meaning of the treaty tie-breakers, but this case appears to be the only valid interpretation of a “close call” situation where permanent home and center of vital interests are too close to determine.

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194. *Id.*

195. *Id.*

196. *See* U.S.-Mexico Treaty, *supra* note 38, art. 4(2)(c).

197. U.S.-Mexico Treaty, *supra* note 38, art. 4(2)(d). In the situation being considered (that of a Mexican citizen in the United States merely to avoid violence in Mexico), this particular mechanism would not be invoked, as the individual’s residency would be settled by the third tie-breaker (nationality).

198. *Podd*, T.C. Memo. (CCH) 906 at 910.

It is evidently an open question as to whether a court similar to *Podd* may consider the violence in the individual's home country in making the residency determination. As noted above, the substantial presence test does not seem to permit consideration of the dangers in the individual's home country.<sup>199</sup> Likewise, it is not completely clear whether the series of tests under the treaty may permit consideration of violence at home, either. However, it should be noted that one prominent commentator believes that the authorities may consider the intentions of the individual (which obviously may be impacted by the situation in the individual's home country, as in *Nubar*),<sup>200</sup> using the pre-1984 caselaw, in making the "center of vital interests" determination.<sup>201</sup>

Accordingly, there may be situations where a Mexican national can show that her "center of vital interests" is indeed in Mexico and hence avoid U.S. worldwide taxation on her income, utilizing the U.S.-Mexico treaty. However, even in this situation, the individual will face significant U.S. tax reporting obligations.<sup>202</sup>

Even though situations can be envisioned where the individual will prevail under the "center of vital interests" test, it is clear that the analysis is very subjective and cannot give much comfort to a Mexican citizen facing this situation. Accordingly, legislative or regulatory change should be considered. Some suggested changes are now offered in the following section.

#### IV. PROPOSALS FOR CHANGE

As can be seen from the analysis above, the determination of U.S. residency is very subjective under either the substantial presence test<sup>203</sup> or the U.S.-Mexico treaty.<sup>204</sup> Under the substantial presence test, presence of 183 days or more in the current year will almost ensure U.S. residency, unless an individual is "exempt," or certain of the days of residency are excepted.<sup>205</sup> Under the U.S.-Mexico treaty, an individual who is otherwise present more than 183 days can avoid U.S. residency (at least for purposes of the person's U.S. tax liability) under one of the "tie-breakers" described above.<sup>206</sup> However, these mechanisms are also subjective.

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199. *Supra* Part II.E.2.

200. *Nubar*, 13 T.C. 566 (1949), *rev'd*, 185 F.2d 584 (4th Cir. 1950).

201. ISENBERGH, U.S. TAXATION, *supra* note 56, at ¶ 6.6.

202. Reg. § 301.7701(b)-7.

203. *Supra* Part II.

204. *Supra* Part III.

205. I.R.C. § 7701(b)(3).

206. U.S.-Mexico Treaty, *supra* note 38, art. 4(2).

Accordingly, Mexican citizens who are not U.S. citizens and do not hold “green cards”<sup>207</sup> are left with significant uncertainty in determining their U.S. tax status, if they are indeed present in the United States for periods during a particular calendar year. This is particularly the case for Mexican nationals who are in the United States only to avoid violence at home — it is obviously difficult for such individuals to return to Mexico (where they face potential harm), and it can also be difficult (and uncertain) for such individuals to avoid U.S. residency treatment because of their prolonged presence in the United States.

The following sections will first describe some rationales for changing the current approach in determining U.S. residency (at the very least, for Mexican nationals), and then will move on to summarize and then discuss in detail various proposals for change.

#### A. *Rationales for Change*

As noted, the substantial presence test was originally added to the Code in 1984 in order to bring objectivity to the analysis of whether a foreign national is a U.S. tax resident.<sup>208</sup> However, with its myriad of exceptions,<sup>209</sup> the test no longer fulfills this hope. This is particularly the case given the complexity added to the analysis by application of a U.S. tax treaty, and the potential for an individual to be a “half resident” for U.S. tax purposes.<sup>210</sup>

Objectivity has failed, and the attempt at objectivity reflected in the substantial presence test also has the potential impact of creating inequitable situations, such as the one under consideration here. Application of an objective test can create inequity when it is not clear whether the IRS and the courts are permitted to consider extenuating circumstances (other than those provided by the statute) in determining the U.S. tax residency of a foreign national.<sup>211</sup>

This inequity is particularly sharp in the case of Mexican nationals who are present in the United States only because of increased violence in Mexico, when such violence is, in large part, caused by drug cartels whose primary customers may reside in the United States.<sup>212</sup> The U.S. government, under President Obama, has gone some distance in acknowledging U.S.

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207. As noted, such individuals are automatically U.S. residents for tax purposes. I.R.C. § 7701(b)(1)(A)(i).

208. *Supra* Part II.B.4.

209. I.R.C. §§ 7701(b)(5), (7).

210. Reg. § 301.7701(b)-7.

211. *Supra* Parts I & II.

212. Aimee Rawlins, *Mexico’s Drug War*, Council on Foreign Relations (December 13, 2011), <http://www.cfr.org/mexico/mexicos-drug-war/p13689>.

contributions to the problem of violence in Mexico.<sup>213</sup> This acknowledgement should lead U.S. tax officials and rulemakers to the conclusion that some change needs to be made to the substantial presence test to relieve Mexican nationals of the risk of inadvertently creating U.S. tax residency while in the United States due to violence in Mexico.

This inequity is further illuminated when one looks to the purpose of treating individuals who are present in the United States as U.S. tax residents. The primary justification for treating such persons as U.S. residents is that they benefit from the laws of the United States while in the country.<sup>214</sup> For individuals who are present in the United States to avoid violence at home, one can argue that such individuals are indeed enjoying the benefits of protection of U.S. law. However, such arguments are significantly weakened when one considers the situation of Mexican nationals who are present in the United States only to avoid drug-related violence in Mexico, given the acknowledged contributions of U.S. policy to the violence in Mexico.<sup>215</sup>

Additionally, there is some rationale for treating Mexican nationals differently than nationals of other countries, due to the physical proximity of Mexico to the United States, the membership of Mexico in the North American Free Trade Agreement (“NAFTA”),<sup>216</sup> and the close economic ties between the United States and Mexico.<sup>217</sup> Mexico may also come in for special treatment given the history between the two nations.<sup>218</sup>

Accordingly, there is some rationale for abandoning the attempt at objectivity in determining U.S. tax residency, particularly when objectivity can lead to inequity, as in the case of Mexican nationals in the United States merely to avoid violence at home. Thus, consideration should be given to abandoning objectivity, at least with respect to Mexican nationals. Various proposals to accomplish this goal are summarized immediately below and then described in the following sections.

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213. *Partnership, and Its Obstacles*, ECONOMIST, Sept. 3, 2011, at 35 [hereinafter ECONOMIST].

214. *See, e.g., Nubar*, 13 T.C. at 586.

215. ECONOMIST, *supra* note 213.

216. North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289 (1993).

217. *See VILLAREAL*, U.S. -MEXICO RELATIONS, *supra* note 11.

218. Treaty of Peace, Friendship, Limits and Settlement between the United States of America and the Mexican Republic, U.S.-Mex., (Feb. 2, 1848), 9 Stat. 922 (ending the Mexican-American war and requiring a substantial concession of territory to the United States by the Republic of Mexico).

### B. *Overview of Proposals*

Thus, some proposals to change the U.S. residency determination rules, at least with respect to Mexican citizens, should be considered. The remainder of this paper will analyze proposals to change the residency determination rules in order to mitigate their impact on Mexican nationals fleeing violence at home.

These proposals call for specific statutory changes. It is certainly possible that the IRS, using its “prosecutorial discretion,”<sup>219</sup> could provide relief to Mexican nationals who are in the United States merely due to violence at home. However, in order to provide greater certainty in this area, statutory change should be considered.

As described in detail below, statutory change could be implemented by changing the substantial presence test to provide an exception for individuals fleeing danger. Conversely, the test could be modified to provide a “facts and circumstances” exception, to explicitly allow the IRS and the courts to consider an individual’s circumstances, as was the case prior to 1984, in determining residency.

A different change would be to repeal the substantial presence test, either entirely, or just with respect to nationals of Mexico (and perhaps also Canada, given its proximity to the United States).

Lastly, the United States could consider a joint tax ruling approach, under which the tax authorities of the United States and Mexico, upon application of a taxpayer, jointly determine the residency of the individual, which would then be binding for both U.S. and Mexican tax purposes. The ruling could be binding for a number of years, so long as the underlying factual situation did not change.

Each of these proposals is now discussed in turn in the following sections.

### C. *Substantial Presence Exception for Those Fleeing Danger*

One proposal would be to provide another exception to the substantial presence test for individuals who are fleeing danger in their home countries. As described above, the substantial presence test already includes numerous exceptions, such as those for commuters from Mexico and Canada, and also teachers and students (among others).<sup>220</sup> This proposal would be to add another category of exception. The exception could be legislatively added to section 7701(b) as either an exception for individuals

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219. *See, e.g.*, Notice 2012-12, 2012-6 I.R.B. 365 (human trafficking restitution payments do not constitute gross income for income tax purposes, without citation to any direct legislative or regulatory authority).

220. I.R.C. §§ 7701(b)(5), (7).

(an expansion of the “Exempt Individual” definition), or the exception could be added as an expansion of the exceptions to the definition of “presence” in the United States.

1. *Exempt Individual – Refugee from Violence?*

Currently, section 7701(b)(5) exempts certain individuals from U.S. residency determination under the substantial presence test.<sup>221</sup> This category of individuals could be expanded to include individuals from any country who were present in the United States, temporarily, only because of violence in their home countries.

Obvious interpretive issues arise in determining whether a particular foreign individual is present in the United States merely to avoid violence in his or her home country. One approach would be for the IRS to develop a list of countries, similar to the list described below in the context of section 911(d)(4), as noted below.

2. *Exception from Days of “Presence”*

A different, and perhaps better, approach could be to provide an exception to the definition of “presence” for any days spent in the United States by a foreign national while she was reasonably in fear of danger in her home country.

This exception could be based on the waiver contained in section 911(d)(4). Section 911 is applicable to U.S. citizens and residents who earn income outside the United States. Section 911 excludes certain foreign earned income from U.S. taxation, but only if the individual in question can show that he or she was resident in a foreign country during the year in question.<sup>222</sup> However, the statute provides an exception to this residency requirement in situations where the individual in question is forced to leave a foreign country due to war or civil unrest.<sup>223</sup> The IRS provides a list of such countries periodically.<sup>224</sup>

The proposed rule could provide an exception, for purpose of the substantial presence test, for days of presence in the United States if the individual in question were present in the United States solely because she was unable to return to one of the countries on the section 911(d)(4) list due to war or civil unrest in such country. The problem with this approach is that

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221. As described in Part II, these individuals include foreign government-related individuals, teachers, trainees, students, and certain professional athletes. *See* I.R.C. § 7701(b)(5).

222. I.R.C. § 911(d)(1).

223. I.R.C. § 911(d)(4).

224. *See, e.g.*, Rev. Proc. 2012-21, 2012-11 I.R.B 484.

the number of countries on this list is very small, and it does not currently include Mexico.<sup>225</sup> It is not clear why there are not more countries on this list; it may be that it is not politically possible for this list to cover a larger number of countries, particularly countries such as Mexico, which have close relations with the United States.<sup>226</sup>

Accordingly, an exception to the substantial presence test for either individuals fleeing danger, or for days spent in the United States fleeing danger, may be administratively and politically unworkable. Hence, other possible solutions should be considered.

### 3. A “Facts and Circumstances” Exception

Another approach would be for Congress to amend section 7701(b)(3) to explicitly allow the IRS and courts to consider the facts and circumstances, including the security situation in the person’s home country, in determining whether a person meets the substantial presence test. In this way, the substantial presence test could become merely a presumption of U.S. residency, which could be rebutted by the individual in question through a showing of equity or other factors. This would effectively return the determination of U.S. residency to its former form, but would retain the certainty contained in the “green card” test.

Another way to effectively achieve a “facts and circumstances” analysis for all foreign nationals would be to repeal the 183 day requirement contained in the “closer connection” exception.<sup>227</sup> The “closer connection” exception, which does take into account, to some degree, an individual’s intentions and the situation in the country of the “tax home” of the individual, would then be available to all foreign nationals no matter how many days actually present in the United States, thus expanding availability of this exception.

#### D. Repeal the Substantial Presence Test

Other options could involve either a complete or partial repeal of the substantial presence test. Complete repeal would be removal of section 7701(b)(3), while partial repeal could include the exclusion of Mexican citizens (or citizens of certain other countries) from the list of individuals

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225. *Id.* The current list includes just four countries: Egypt, Libya, Syria, and Yemen.

226. There may be reluctance to add Mexico to such a list given its cooperation in the “drug war” and the U.S. State Department’s evaluation of all countries on their efforts in combating illegal drugs. *See* UNITED STATES DEPARTMENT OF STATE, INTERNATIONAL NARCOTICS CONTROL STRATEGY REPORT (March 1, 2010), <http://www.state.gov/documents/organization/137411.pdf>.

227. I.R.C. § 7701(b)(3)(B)(i).

who are subject to the substantial presence test. This latter change could be made by adding Mexican citizens and nationals to the list of “exempt individuals” contained in section 7701(b)(5).

*I. Repeal of Substantial Presence Test*

One solution to the problem is to repeal the substantial presence test as it currently stands. In this case, both U.S. citizens and “green card” holders would continue to be considered U.S. residents subject to worldwide taxation.<sup>228</sup> However, all other individuals would only be U.S. residents under the “facts and circumstances” analysis that most other countries utilize to determine residency, which was the test utilized in the United States prior to 1984.<sup>229</sup>

One possible objection to this approach is that it is less objective than the current substantial presence test. However, the current test is full of exceptions, some of them subjective,<sup>230</sup> which undermine its objective nature. And, as applied to individuals such as those fleeing danger at home, it is too rigid. Prior law (as exemplified in the World War II cases)<sup>231</sup> allowed for flexibility and equity in making the U.S. residency determination. Repealing the substantial presence test would again introduce such equitable considerations into the analysis.

Repeal could be done in such a way as to indicate that the current exceptions (such as for students and teachers, as well as the “closer connection” exception, for example) should still be considered by the IRS and the courts when determining residency, even though such exceptions would no longer be contained in statutory law.<sup>232</sup> Further, if desired, repeal could be accompanied by a rule that presumes a foreign person to be a U.S. resident if the person is present in the United States for more than 183 days in the year in question.<sup>233</sup> It should be noted that retaining these concepts (perhaps in regulations) makes repeal of the substantial presence test very

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228. I.R.C. § 7701(b)(1)(A).

229. ISENBERGH, U.S. TAXATION, *supra* note 56, at ¶ 6.4.

230. *See, e.g.*, I.R.C. § 7701(b)(3)(B), the “closer connection” exception, which as noted above, is quite subjective. *See supra* Part II.D.

231. *See, e.g., Nubar*, 13 T.C. 506 (1949), *rev'd*, 185 F.2d 584 (4th Cir 1950).

232. These current exceptions could be encapsulated in regulations supporting the new “facts and circumstances” analysis.

233. Some foreign countries view 183 days as setting a standard for residency. *See* HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 431–34 (3d ed. 2010) [hereinafter AULT & ARNOLD, *COMPARATIVE INCOME TAXATION*].

similar to the suggestion above to introduce a “facts and circumstances” exception to the current substantial presence test.<sup>234</sup>

## 2. *Repeal for Nationals of Mexico*

A different approach would be to repeal the substantial presence test for nationals of Mexico, and perhaps the other contiguous country, Canada, as well. This could be accomplished by excluding Mexican citizens from the test by adding them to the list of exempt individuals in section 7701(b)(5).

Under such an approach, Mexican citizens would become U.S. tax residents only by obtaining lawful permanent residence (or by becoming U.S. citizens). Otherwise, they would remain residents of Mexico, and would not become U.S. tax residents, no matter how often they were present in the United States.<sup>235</sup>

The rationale for such an approach would be to further objectivity,<sup>236</sup> provide fairness in the case of Mexican nationals, reflect the free-trade concepts of NAFTA, and further promote cross-border trade.

There would likely be objections to the special treatment granted to Mexican nationals (from nationals of other nations) under such an approach.

## E. *The NAFTA Taxpayer*

Another reform proposal would be to take a holistic approach to the taxation of the citizens of the three countries that signed the North American Free Trade Agreement (NAFTA), which include the United States, Mexico, and Canada.<sup>237</sup> In the spirit of NAFTA, the authorities could take two possible approaches. One would be to develop a joint ruling process whereby the tax authorities of the member countries determine an individual’s tax residency in a joint ruling, similar conceptually to an Advanced Pricing Agreement (“APA”)<sup>238</sup> now available in the transfer pricing area. Another — more radical — approach is to move towards an apportionment tax regime for the income earned by individuals within NAFTA that has a significant cross-border element. Each is now discussed in some detail.

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234. *Supra* Part IV.C.3.

235. This new exception would be contingent on such individuals retaining and certifying tax residency in their country of citizenship, in order to avoid situations where Mexicans or Canadians use this rule to avoid residency in both the United States and their home country.

236. Under this approach, Mexican nationals would only create U.S. tax residency by obtaining U.S. legal residence (or becoming U.S. citizens), thus tying tax residency to immigration status. Hence the approach is more objective.

237. North American Free Trade Agreement, *supra* note 216.

238. Rev. Proc. 2006-9, 2006-1 C.B. 278.

### 1. Joint Tax Rulings

Currently, in the transfer pricing context, U.S. taxpayers (typically corporations) can obtain an APA from the IRS.<sup>239</sup> Such APAs can also arise in a bilateral manner, where the U.S. “Competent Authority” agrees with the tax authority of the other relevant nation (which has a tax treaty with the United States) as to the allocation of profits arising from intercompany transactions between related parties in the two countries.<sup>240</sup>

APAs are typically arrived at after much negotiation (and time) and provision of documents to the relevant tax authorities.<sup>241</sup> The APA is typically then valid for a number of years, assuming that the underlying facts and assumptions do not change.<sup>242</sup>

A similar concept could be envisioned for the determination of tax residency for individuals with significant cross-border activities. A set of facts or assumptions could be provided, and the tax authorities, working jointly, could determine the residency of the individual. Then, the country of residence would tax the entire income of the individual, and the other country would treat the individual as a nonresident, eligible for benefits under the tax treaty between the two nations. Once residency is determined, it would remain for the term of the agreement, unless facts and assumptions change.

This concept has the benefit of enhancing further joint workings between the U.S., Mexican, and Canadian tax authorities, which has long been a goal of the U.S. tax authorities.<sup>243</sup> It should also be noted that such a concept is essentially already contemplated as the final “tie-breaker” under the existing U.S.-Mexico Treaty, as discussed above.<sup>244</sup>

### 2. Income Apportionment

It has often been noted by scholars that the current international tax system, under which the allocation of cross-border taxable income between nations is determined by residency, “arm’s length transfer pricing,” and

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239. Rev. Proc. 2008-31, 2008-1 C.B. 1133.

240. *See, e.g.*, U.S.-Mexico Treaty, *supra* note 38, art. 26.

241. David D. Stewart, *New Director Seeks to Improve Transfer Pricing Practice*, 131 TAX NOTES 1136, (Jun. 13, 2011).

242. Rev. Proc. 2006-9, *supra* note 238, at § 4.07.

243. Anne O’Connell et al., *GW Conference Highlights Many Hot International Issues*, 1405 TAX NOTES (Dec. 16, 1996) (reporting on a conference where the tax authorities of the United States, Mexico, and Canada stressed the importance of cooperation between their nations in tax enforcement).

244. U.S.-Mexico Treaty, *supra* note 38, art. 4(2)(d).

allowance of foreign tax credits, is less than ideal.<sup>245</sup> Many commentators instead have argued that nations should apportion a cross-border taxpayer's taxable income among nations based on some formula.<sup>246</sup> Many U.S. states already do this by apportioning an entity's total taxable income to the state based on the relative percentage of the entity's payroll, sales, and property located in such state (often referred to as "3 factor" apportionment).<sup>247</sup>

This approach could be extended to taxpayers with significant cross-border income attributable to the United States, Mexico or Canada (Canada being included here due to its proximity to the United States and the significant amount of cross-border trade between the two nations). At a taxpayer's election, taxpayers could elect to have their income apportioned between the two or three countries, based perhaps on the "3 factors" or other factors that states currently use to apportion income of corporations in the United States.

Evidently, no other foreign countries do this, not even within the European Union, which still bases taxation on residence, notwithstanding the ability of people to move across national borders.<sup>248</sup> Further, this concept is typically applied, even at the U.S. state level, to corporations, rather than individuals.<sup>249</sup> However, apportionment is an idea whose time may be coming, and perhaps within NAFTA, the United States and Mexico could be on the vanguard of this movement.

### 3. Conclusion – NAFTA

Consideration should be given, at the very least, to a joint ruling process, whereby taxpayers can obtain certainty from the tax authorities, for a number of years, as to which country will treat them as a resident for tax purposes. This joint ruling process will enhance cooperation among tax authorities and pave the way for increased cross-border commerce in the U.S.-Mexico context.

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245. See, e.g., Rueven Avi-Yonah, Kimberly Clausing, & Michael Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).

246. See, e.g., Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593 (2010).

247. See, e.g., CALIFORNIA REVENUE AND TAXATION CODE, § 25128(c). See generally HELLERSTEIN & HELLERSTEIN, *STATE TAXATION*, ¶ 8.14 (2011).

248. AULT & ARNOLD, *COMPARATIVE INCOME TAXATION*, *supra* note 233, at 431.

249. CALIFORNIA REVENUE AND TAXATION CODE, § 17014.

## V. CONCLUSION

Citizens of Mexico face substantial uncertainty when they are present in the United States merely to avoid increasing violence and danger in their home country. They run the risk of creating U.S. tax residency, and the accompanying U.S. taxation of worldwide income (plus various and onerous tax return filing requirements), unless they can fit under an exception to the “substantial presence” test or utilize the U.S.-Mexico tax treaty to show that their true residency is in Mexico.<sup>250</sup>

However, as demonstrated, it is unclear whether the situation in an individual’s home country can be taken into consideration when applying either the exceptions to the “substantial presence” test, or when applying the “tie-breaker” provisions of the U.S.-Mexico treaty. This uncertainty, coupled with the general inability to obtain a tax ruling from U.S. tax authorities on this issue, creates problems for Mexicans who are present in the United States merely to avoid violence at home.

Hence, Congress should consider clarifications to the substantial presence test to allow the IRS and the courts to consider dangers in a person’s home country when determining whether the person is a U.S. tax resident. This can be done through clarifications or further exceptions to the substantial presence test, or by repealing it altogether, and thus returning the analysis to the “facts and circumstances” test that was the law before 1984. The simplest, best approach would be to provide by statute that the tax authorities may consider other facts and circumstances when determining whether an individual has indeed satisfied the substantial presence test.

Conversely, if the authorities desire to go further, the IRS and the Mexican (and perhaps Canadian) tax authorities could consider implementation of a joint ruling program, to allow individuals who often cross the U.S. border to have their tax residency determined by a joint ruling of the tax authorities, as described above.

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250. Even in this case, they will retain certain U.S. filing requirements, as they will be considered U.S. residents for U.S. tax purposes other than determination of their U.S. tax liability. *See* Reg. § 301.7701(b)-7.