

# Tax Tips for H1-B Employees

By L.S.P. PRABHU, CPA CA MPHIL (CANTAB) AND G.E.B. KENNEDY, JD, LL.M (CANTAB)

**IMPORTANT NOTICE:** *This article is intended as a general-purpose discussion of tax topics relevant to foreign individuals working in the US. It does not constitute the rendering of legal, accounting or other professional services and the authors disclaim any implied or actual warranties as to any materials herein and disclaim any liability with respect thereto.*

Tax time—that dreaded time of year—is rapidly approaching, so we've put together some pointers to help you navigate the US tax system. We will cover some of the issues commonly faced by Indian nationals working in the US under an H1-B visa.

As a starting point, we assume you earned income in 2001 from either a US employer or from services performed in the US on behalf of a foreign employer. Under US tax rules, there is no distinction between the two – both types of income are subject to tax in the US. The only exception is if you earned less than \$3,000 and this amount was paid directly by a foreign employer for services rendered in the US, and that employer doesn't maintain a US presence, and your stay in the US was less than 90 days. In this case, the amount earned is not considered US-source income and is therefore not subject to US tax. If all 3 conditions are not met, then the entire amount received is considered US-source income.

To determine the extent of your tax liabilities, you need to consider your position under US tax rules, Indian tax rules, and the US-India tax treaty.

## **PART 1 – DETERMINING YOUR US TAX STATUS**

### NON-RESIDENT ALIEN VS. RESIDENT ALIEN

The IRS classifies foreign citizens as "Aliens" and this may not be too far from the truth in certain parts of Sunnyvale... All kidding aside, the first distinction to make is between a Nonresident Alien ("NRA") and Resident Alien ("RA"). This difference is critical because:

- NRAs are taxed solely on their US source income, and file their returns on Form 1040NR. Different forms of income (eg. passive investment income vs. active personal services income) are treated differently. The US-India tax treaty (discussed in Part 3 below) is an important document for determining your NRA tax liabilities in the US. NRA income is divided into 2 separate categories:
  1. Income that is effectively connected with a trade or business in the US (eg. active income earned by providing your services). Such income is subject to US tax at the same (graduated) tax rates as for US citizens.
  2. Income that is not effectively connected with a trade or business in the US (eg. passive income such as dividends, interest, and royalties). Such income is generally subject to a withholding tax at the source of payment, generally at a maximum rate of 30% unless reduced by a tax treaty (see Part 3 below).
- RAs are subject to US tax on their worldwide income and report their income on the standard Form 1040. In all material respects they are treated as US citizens for income tax purposes.

These rules are separate from your immigration status although, in certain cases, actions you might have taken during the year to change your immigration status in the US may effect whether you are considered an NRA or RA.

### Here's How to Determine Your Status:

#### General Rule

If you are not a US citizen, you are considered an NRA unless you pass the Green Card Test or the Substantial Presence Test, or make a first-year election to be treated as a RA.

1. Green Card Test: You pass the Green Card test if you possess an alien registration card ("Green Card") issued by the US INS. If you obtained a Green Card during 2001, see below under "Dual-Status Tax Year".
2. Substantial Presence Test: You have a "Substantial Presence" in the US if you were physically present in the US on at least 31 days during the current calendar year (2001), and 183 "days" over the last three years (1999, 2000, and 2001). The 183 "days" are calculated on a weighted basis as follows: full weight for 2001, 1/3 weight for 2000, and 1/6 weight for 1999.
  - Students: Students under F, J, M, or Q visas are considered exempt individuals for purposes of the Substantial Presence Test; therefore, days spent in the US under such status need not be included in the above calculations of days present.

#### Closer Connection to Another Country

Notwithstanding whether you fall under the Green Card and Substantial Presence tests, you may still qualify for NRA treatment if you: (a) are present in the US for less than 183 days in the current year, (b) maintain a "tax home" in a foreign country during the year, and (c) have a closer connection to that "tax home" than to the US.

#### 3. First-year Election to be Treated as a Resident

For new residents of the US, there is a special provision allowing you to elect treatment as an RA, even though you may not meet the Substantial Presence test in your first year of US residence. This election can be beneficial in reducing your overall tax bill because RAs are allowed more liberal deductions/allowances (such as for dependents, mortgage interest, moving expenses, eligible to file joint returns, etc.), otherwise unavailable to NRAs.

You may qualify for this election if you meet all of these conditions:

1. You are present in the US for 31 consecutive days
2. You are present in the US for at least 75% of the days in the remainder the year, starting with the first of the 31 consecutive days in condition (1)
3. You meet the Substantial Presence test in the following year

Because of condition (3), in order to claim this election you'll have to request an extension of your tax filing date or else file a revised tax return. If you make this election, it is effective for that part of the year beginning with the first of the 31 days.

## DUAL-STATUS TAX YEAR

If you were both an NRA and RA during 2001, you are considered a "Dual-Status" taxpayer, with the following consequences:

### a) Inbound Moves

#### Residency Starting Date

In the first year in which you meet either the Green Card or Substantial Presence test, you must determine your "residency starting date". After this date, your income will be taxed on the same basis as a US citizen – your worldwide income must be declared in the US.

If you met the Substantial Presence criteria for the first time in 2001, your "residency starting date" is generally the first day in 2001 in which you are present in the US. However, under certain circumstances you may be able to exclude up to 10 days of temporary residence in the US in determining your "residency starting date". This could be invoked, for instance, if you had a temporary business trip (of under 10 days) to the US in early 2001, and then took up residence in the US during a later part of the year.

If you do not meet the Substantial Presence test but do meet the Green Card test, your residency starting date is the first day on which you are present in the US as a lawful permanent resident.

If you meet both the Green Card and Substantial Presence tests, your "residency starting date" is the earlier of the two.

#### Restricted Deductions

A "Dual-Status" filer is subject to a number of restrictions on the amount of deductions and exemptions he may claim. For example:

- You must itemize deductions
- You cannot file a joint return
- You cannot take advantage of the lower tax rates for married joint filers or heads of households
- You may be restricted in the amount of exemptions you can claim for your spouse and dependents

#### First Year Choice

Given these restrictions, you may find it advantageous to elect RA treatment for the entire first year in which you become an RA (see discussion in Part 1).

#### Filing Requirements

If you attained RA status in 2001, you must file the standard IRS Form 1040 declaring your income for the part of the year you were an RA. In addition, you must attach a separate statement to your IRS Form 1040 declaring the amount of income you earned in 2001 as an NRA.

b) Outbound Moves

If you left the US during 2001, your "residency termination date" determines when you cease to become an RA. In the year you leave, you must declare and file a return. In addition, you must file a statement with the IRS stating your departure details, new tax home, etc., which will serve document your residency termination date.

Filing Requirements

If you left the US in 2001, you must file IRS Form 1040NR. In addition, you must attach a separate statement to your IRS Form 1040NR declaring the amount of income you earned in 2001 as an RA.

**PART 2 – DETERMINING YOUR INDIAN TAX STATUS**

You're not in the clear yet! You also need to determine your residency status under India's tax rules. Under India's Income-tax Act, 1961 individuals are categorized into 3 principal classes of taxpayers:

**RESIDENT****General Criteria**

Present in India  
 - for 182 days or more in the previous year, or  
 - for 60 days or more in the previous year and 365 days or more in the 4 years preceding the previous year; except, that Indian citizens or persons of Indian origin who are visitors to India may stay for up to 181 days over this 4-year period without being considered Resident

**Tax Liability**

Taxable on worldwide income

**NOT ORDINARILY RESIDENT****General Criteria**

- Not resident in India for 9 out of the 10 previous years, or  
 - Not present in India for 730 days or more in the past 7 years

**Tax Liability**

Taxable on income earned in India and certain income outside India (i.e. if that income is connected with a business controlled in, or a profession set up, in India).

**NON-RESIDENT****General Criteria**

Individual who does not meet the Resident or Not Ordinarily Resident Criteria

**Tax Liability**

Taxable on income earned in India.

You should also note that these determinations are made on a 'tax year', not a 'calendar year'. The tax year in India runs from April 1–March 31.

Non-Resident Indians ("NRIs")

Chapter XII-A of the Income-tax Act, 1961 sets out preferential tax and filing rules for income earned by Non-Resident Indians, defined as non-residents who are Indian citizens or

of "Indian origin". You are considered to be of "Indian origin" under the Act if you or either of your parents or grandparents were born in undivided India.

**Income exempt from income tax**

- interest on securities or bonds notified by the Central government
- interest on money standing to the credit of a NRE account or FCNR account
- interest from notified savings certificates and subscribed to in convertible foreign exchange

**Concessional income tax rates on**

- investment income on designated foreign exchange assets
- certain long-term capital gains on transfer of foreign exchange assets

Filing Requirements

As an NRI you are not required to file an income tax returns if your income consisted solely of investment income and/or capital gains, and the appropriate withholding (if any) was made at source.

**PART 3 – US-INDIA TAX TREATY**

Residency Rules

If you qualify as a resident of both the US and India, you need to refer to the US-India tax treaty to determine your residence status.

The US-India tax treaty came into effect in 1991 and sets out rules providing relief from double taxation, as well as reduced rates of withholding tax on various categories of payments to non-residents. There are also provisions for sharing taxpayer information between the tax authorities of the two countries, a typical feature of a tax treaty.

Article 4(2) of the treaty sets out rules to determine which country will 'claim' you as a resident.

- In the first instance, you are considered resident where you maintain a permanent home.
  - If you have permanent homes in both countries, the treaty then seeks to determine your "center of vital interests" by reference to where your personal and economic interests are closer.
  - If this secondary screen is still unclear indeterminable, or you don't have a permanent home in either the US or India, the treaty looks to where you maintain your "habitual abode".
  - If you have a habitual abode in neither or both countries, then your nationality will determine your state of residence.
  - If you are a national of neither the US nor India, then your residency will be determined by mutual agreement between tax authorities of both countries.

Treatment of Income and other Payments

The US-India tax treaty also governs the rates of withholding and tax inclusion.

Withholding tax is 25% for portfolio dividends, and 15% for interest and royalty income.

Of interest to H1-B consultants is Article 16 "Dependent Personal Services" which states that if the services are performed in the U.S., then they are taxable in the U.S. regardless of whether the employer of record is an Indian company.

#### Filing Requirements

If you are claiming tax treaty benefits you may also need to file IRS Form 8833 in addition to your 1040NR.

=====

The above discussion is a necessarily restricted treatment of a complex but commonplace situation. It is not meant to provide definitive advice in any particular tax situation, but rather to highlight issues you may want to investigate further with your professional tax advisor.

*The authors are partners in Interstice Consulting Corporation, an international financial and legal consultancy.*