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## Foreign Student Tax Filing Rules: Better, But an Urban Myth Persists

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taxpayer must offset the carryforward against long-term capital gains, the tax on the dividend in 2007 may not exceed 5 percent, while the future benefit of the capital loss will be at 15 percent (or 25 percent or 28 percent if the taxpayer does not have any other 15 percent eligible capital gain and has gain subject to the 25 percent or 28 percent rates). There also, of course, is the possibility that after 2010 the 15 percent rate might be allowed to revert to the 20 percent rate on adjusted net capital gains. While there certainly can be no guarantees, there is a decent chance that the present value of the future tax benefit will exceed the cost of paying tax on the dividend in 2007.

An alternative but potentially riskier strategy might involve attempting to avoid kiddie tax status altogether in some future years. For example, those 18- to 22-year-olds fortunate enough to have employment opportunities with the family business (or others who can structure their affairs this way) may want to consider deferred compensation arrangements beginning next year. These arrangements may need to be put in place before the end of this year. Let's assume that any payment made is equal to the value of the services provided. As indicated above, 18- to 23-year-olds otherwise subject to the kiddie tax can avoid it if they have earned income exceeding half of their own support. By bunching the income from two or more years into a single year, it might be possible for those taxpayers to meet the test and not be subject to the kiddie tax in a particular year. Depending on how the numbers work out, it might then be possible for such a taxpayer to recognize adjusted net capital gain in such a year and perhaps have it taxed at a rate below 15 percent (perhaps even 0 percent in 2008-2010). Earned income is not subject to the kiddie tax and can be sheltered by a regular standard deduction, so those taxpayers may want to leave enough earned income in the years in which they are subject to the kiddie tax to use up the standard deduction and perhaps at the same time fund a Roth IRA with income that was not taxed. The value of this benefit would have to be compared with the loss of the \$850 standard deduction that would otherwise be available to shelter unearned income. Some of the risks here are that the taxpayer is left open to the possibility of a future change in legislation and that the taxpayer must comply with the new complicated rules on deferred compensation in section 409A.

As usual, the more complicated things become, the more likely it is that planning opportunities will arise.

## Foreign Student Tax Filing Rules: Better, but an Urban Myth Persists

By John A. Bogdanski

John A. Bogdanski is a professor of law at Lewis & Clark Law School in Portland, Ore. He directs a volunteer program in which students at that law school assist international undergraduate students at Lewis & Clark College with their U.S. tax-filing obligations.

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The holidays bring with them many rituals. At U.S. colleges and universities, it is a time of cross-cultural discovery and celebration for hundreds of thousands of foreign students and scholars who come to this country each year for study, research, and teaching. Meanwhile, at the IRS, it is a time to circulate the forms that will extend a different type of greeting to the international students and scholars next spring, when income tax returns for the current year are due.

In recent years, the tax return filing burdens on international guests at U.S. institutions of higher learning have lessened, at least somewhat. At one time, the IRS foolishly required every foreign student and scholar to file both a U.S. income tax return and a supplemental form regarding residency every year, even if the visitor had no income from sources in the United States, or indeed from anywhere in the world.<sup>1</sup> Beginning in 1997, that requirement was changed, so that income tax returns were due only from those who had received some amount of U.S.-source income during the year.<sup>2</sup>

And in late 2005, the rules were relaxed even further, so that students and scholars whose only U.S.-source income is a small amount of wages (and interest on a U.S. bank account, if they have one<sup>3</sup>) need not file a return. For the 2006 tax year, the first year to which the new rules applied, an international student or scholar could earn up to \$3,300 (the amount of one personal exemption) in U.S. wages without having to file a tax return. If income was below that threshold, a foreign visitor had to file a tax return only if she was seeking a refund of taxes that had been withheld from her pay — and only if the amount of the refund seemed worth the hassle.<sup>4</sup>

<sup>1</sup>See Bogdanski, "The IRS Imposes a Ridiculous Burden on Foreign Students," *The Chronicle of Higher Education*, May 2, 1997; Kenny and Bogdanski (letter to the editor), "Foreign Students in United States Face Ridiculous Filing Requirements," *Tax Notes*, Mar. 18, 1999, p. 1697, Doc 96-8209, 96 TNT 57-117.

<sup>2</sup>See Bogdanski, "The IRS and Foreign Students: Common Sense Prevails," *The Chronicle of Higher Education*, Feb. 13, 1998.

<sup>3</sup>For a nonresident alien, such interest is excluded from gross income, unless it is effectively connected with a U.S. trade or business, by section 871(i).

<sup>4</sup>See Notice 2005-77, 2005-2 C.B. 951, Doc 2005-22062, 2005 TNT 210-14.

The recent amendments to the rules have been beneficial. For example, no longer do international students and scholars with no income have to waste time filling out tax returns by writing zero on every line. However, there is some confusion about how much of a tax filing burden remains. One relatively obscure IRS publication asserts — and many schools' international student advisers repeat, on the internet and otherwise — that every nonresident student and scholar in the country must file a residency statement with the IRS each year, regardless of whether she has any income.<sup>5</sup>

The soundness of this assertion is open to serious question. The better view appears to be that for a foreign student with little or no income, nothing at all must be filed with the IRS. Thus, a significant portion of the tax form filing that is being churned out by international students and their host institutions across the country each year may not be legally required.

### The Income Tax Return

In the parlance of the tax code, individuals who are neither citizens nor residents of the United States are "nonresident aliens." As will be seen shortly, most foreign students and scholars are "nonresident aliens" for tax purposes. Nonresident aliens must file U.S. tax returns under various circumstances, including if they have U.S.-source investment-type income (other than from a bank account) and tax is not withheld from it; or if they are engaged in a "trade or business" in the United States. Most foreign students and scholars do not have taxable investment income for purposes of those rules, but unfortunately they are automatically treated by the tax law as engaged in a U.S. trade or business just by virtue of studying, researching, or teaching here.<sup>6</sup>

Thus, it was a great relief to those students and scholars, and the international exchange administrators who work with them, when the IRS issued Notice 2005-77 in November 2005.<sup>7</sup> That notice announced the IRS's intention to amend the applicable regulations "to eliminate the Form 1040NR [tax return] filing requirement for a nonresident alien individual who earns less than the amount of one personal exemption as United States source wages that are effectively connected with a United States trade or business . . . and who is required to file a United States income tax return because of those wages."<sup>8</sup> For most students and scholars — those without U.S. investment income beyond bank account interest — this means that unless they earn more than \$3,400 at their U.S. jobs in 2007, they need not file a U.S. tax return except to get a refund of overwithholding.

So far, so good — indeed, very good. But the fly in the ointment is a lingering doubt over whether a low-income

(or no-income) foreign student or scholar must file a different IRS form every year — the much discussed, but far less understood, Form 8843,<sup>9</sup> which deals with an alien's nonresident status for tax purposes.

### The Residency Statement

A discussion of Form 8843 inevitably begins with a basic truth about the U.S. income tax system: U.S. citizens and residents are taxable in the United States on their worldwide income, whereas "nonresident aliens" are taxable in the United States only on their U.S.-source income. "Residency" for this purpose is not necessarily the same as one's immigration status. A noncitizen without a green card is nonetheless generally treated as a "resident" if her physical presence in the country exceeds a certain number of days during the tax year and the two preceding years.<sup>10</sup> If one has ever wondered why the Rolling Stones would rehearse in Canada when they toured the United States, one should consider a likely purpose for that practice — to avoid U.S. taxation on their income from sources outside the United States that year.

Most foreign students and scholars would be residents under this test, known as the "substantial presence" test, but for an exception provided in the tax law. The exception states that individuals present in the United States on F or J visas — the kind most students and scholars hold — are not treated as residents despite their continuous presence in the country.<sup>11</sup> The exception lasts only a limited period of time — five years for students, two years for teachers — after which those who are in the United States for a substantial portion of any year are presumed to be tax residents.<sup>12</sup>

The rules in this area, and the government's attitude toward enforcing them, have the high-income individual in mind. The system seems principally concerned with foreign scholars who spend long periods of time performing research and teaching in the United States, enjoying many of the benefits of living here, but avoiding U.S. tax on large amounts of foreign-source income. The "substantial presence" test casts a dragnet to ensure that the long-staying visitor's foreign income is caught and subjected to U.S. taxation, just as it is for U.S. citizens and green card holders. (If also taxed in the country of its source, the foreign income would likely be eligible for a foreign tax credit in the United States.<sup>13</sup>)

In the case of most foreign students and scholars, however, the U.S. system's mindset is incongruous. For one thing, the typical visiting student has no foreign-source income for the United States to tax. But more importantly, for most students and scholars, if they *were* to be "caught" as residents by the tax law dragnet, they would actually pay *less* U.S. tax and file fewer forms, because residents are entitled to a standard deduction

<sup>5</sup>See IRS 2007 Pub. 678-FS, discussed *infra*.

<sup>6</sup>See section 871(c).

<sup>7</sup>Notice 2005-77, *supra* note 4.

<sup>8</sup>*Id.*, section 3 (first sentence). The notice goes on to state that the new exception "would apply even if the nonresident alien individual also has United States source fixed or determinable annual or periodical gains, profits, or income . . . provided that his United States tax liability for such income is fully satisfied by the withholding of tax at source." *Id.* (fourth sentence).

<sup>9</sup>IRS 2007 Form 8843, "Statement for Exempt Individuals and Individuals With a Medical Condition."

<sup>10</sup>See section 7701(b)(3).

<sup>11</sup>See section 7701(b)(5)(A)(iii) and (D).

<sup>12</sup>See section 7701(b)(5)(E).

<sup>13</sup>See sections 901 et seq.; J. Kuntz and R. Peroni, *U.S. International Taxation*, chapter B4 (2007).

(this year, \$5,350) on top of their \$3,400 exemption. Moreover, a resident need not file a tax return unless she has more than \$8,750 of worldwide income in a given year, whereas a "nonresident" must file a tax return once she has more than \$3,400 of U.S. wages in a year.<sup>14</sup>

The function of Form 8843 is best understood in the context of the prevailing emphasis of the system. The form is designed to make sure that those who are claiming the student and scholar (F and J visa holder) exception to the substantial presence test are indeed entitled to it and are not overstaying it. (The form also applies to a few other situations, rarely involving students and scholars, to which other exceptions apply.) The form requires those who are claiming the exception to step up and declare they are doing so, providing sufficient information for the IRS to see whether their claim is facially valid.<sup>15</sup>

Completing the form is quite a chore for foreign students and scholars; it demands a detailed accounting of their visa status and comings and goings from U.S. shores over a five-year period. And it asks a legal question about the substantial presence test that few students and scholars of any nationality could understand, much less answer, without learned guidance.<sup>16</sup>

What about the student or scholar with so little income that he need not file an income tax return? Is such a visitor required to file a Form 8843 anyway? Here is where the confusion sets in.

#### A Meaningless Gesture

Assuming that an international student or scholar has little or no taxable U.S.-source income, and that whatever U.S. income she might have is wages or interest on a bank account, filing Form 8843 by itself makes sense only in a small minority of cases — those in which the foreign visitor has substantial foreign-source income. In any other case involving low levels of U.S. income, the form is not necessary, because *regardless* of the student's resident or nonresident status, no U.S. tax is owed, and no return is required.

For example, take an unmarried foreign student with \$3,000 of 2007 income from an on-campus job at her U.S. college or university. If those wages and a modest amount of interest from a U.S. bank account are the student's only income in the world, then regardless of her residency for tax purposes, no tax is owed and no return is required. As a "nonresident," the student owes no tax by virtue of the \$3,400 personal exemption, and as a resident, she would owe no tax by virtue of the same exemption plus a \$5,350 standard deduction. Moreover, the rules for residents and nonresidents both excuse the

student from filing a tax return. Thus, there is no meaningful claim to any particular residency status at work in this example, and no Form 8843 need be filed to support a nonexistent claim.

However, if that student also had, say, \$6,000 of foreign-source income for the year, it would be a different story. In that case, if the student were a resident, U.S. tax would indeed be applicable, and a U.S. tax return would have to be filed, whereas as a nonresident, the student would owe no U.S. tax and need not file a U.S. tax return by virtue of Notice 2005-77. In this case, a Form 8843 alone must be filed to explain the claim to the F or J visa holder exception.

Of the two examples just discussed, the former is far more typical. International students and scholars at U.S. colleges and universities usually do not have significant income from foreign sources. Many live on gifts from relatives, but gifts are not income under the U.S. tax laws, and neither are loans or most scholarships. Thus, the situations in which the residency statement must be filed on its own, without a tax return, are relatively few.

#### The Urban Myth

Alas, the IRS has issued one document that confuses this issue substantially. This is an otherwise helpful and instructive training manual for those who try to help international students and scholars understand and fulfill their U.S. tax filing obligations. Like all IRS publications, it has a number: Publication 678-FS.<sup>17</sup>

Over the years, that publication has continuously asserted that every foreign student and scholar in the United States must file Form 8843 every year, regardless of income or lack thereof.<sup>18</sup> Many college and university administrators appear to accept the statement in the training manual without question. A Google search for "Form 8843" turns up several Web sites in which institutions instruct their international visitors that they must all file the form with the IRS every year, regardless of income or lack thereof.<sup>19</sup>

No one has ever offered credible authority for this contention. Indeed, at one point, the unnamed authors of the training manual, seemingly grasping for a reason for the supposed requirement, surmised that the U.S. government was using the information from the forms to keep a census of foreign students and scholars. After I challenged that assertion,<sup>20</sup> however, that stated reason

<sup>17</sup>IRS 2007 Pub. 678-FS, VITA/TCE — *Foreign Student and Scholar Text* (rev. 2007).

<sup>18</sup>See *id.* at 6-1 (second paragraph) ("Even a student or scholar who had no income must still file Form 8843.")

<sup>19</sup>A Google search on Dec. 12, 2007, found such statements on the Web sites of many institutions, including Columbia University, Yale University, Harvard University, the University of California at Berkeley, the University of Pennsylvania, Howard University, the University of Texas, and the University of Miami.

<sup>20</sup>See Bogdanski, "Is the IRS the New Federal Watchdog Over Foreign Students?" *Tax Notes*, Apr. 8, 2002, p. 261, Doc 2002-8391, 2002 TNT 68-22.

<sup>14</sup>See generally Outslay, "The U.S. Taxation of International Students: An Analysis and Call for Reform," *Tax Notes*, July 29, 2002, p. 723, Doc 2002-17448, 2002 TNT 146-36.

<sup>15</sup>See Instructions, IRS 2007 Form 8843, at 3 ("If you are an alien individual, you must file Form 8843 to explain the basis of your claim that you can exclude days of presence in the United States for purposes of the substantial presence test.")

<sup>16</sup>IRS 2007 Form 8843, Part I, line 4b ("Enter the number of days in 2007 you claim you can exclude for purposes of the substantial presence test.")

for the supposed rule was dropped in the following year's edition of the manual.<sup>21</sup>

The latest edition of the publication continues to insist that the form be filed regardless of income. But when it comes to the potential consequences of *not* filing, it offers only this: "There is no monetary penalty for failure to file, but days of presence can't be excluded from the substantial presence test unless Form 8843 is filed."<sup>22</sup> As has already been seen, if a student or scholar has only a small amount of income from anywhere in the world — this year, less than the \$3,400 personal exemption — there is no reason to care whether the F or J visa holder exclusion applies. Regardless of its applicability, no U.S. tax is owed, and no U.S. tax return need be filed.

There appears to be no law, regulation, or form instruction that contains any requirement of a pointless filing in this context. Therefore, the training manual's treatment of the form is misleading at best. If a student or scholar's worldwide income is low enough to place him below both the resident and nonresident tax return filing thresholds, under current law no tax form of any kind need be filed.

<sup>21</sup>See Bogdanski, "IRS Drops Claim That It's Keeping a Foreign Student Census," *Tax Notes*, Apr. 7, 2003, p. 137, Doc 2003-8727, 2003 TNT 67-25.

<sup>22</sup>IRS 2007 Pub. 678-FS, at 6-1 (second paragraph).

### Recommendations

At this writing, the IRS has not gotten around to finalizing in formal regulations the relaxed return filing principles announced in its 2005 notice. It has told foreign visitors that they can rely on the notice pending the development of the regulations,<sup>23</sup> but those regulations have not yet been released, even in proposed form.

As part of the process of generating them, the IRS should clarify that Form 8843 should be filed only when the foreign visitor's status as a resident or nonresident has an actual effect on the amount of her U.S. tax, or on her obligation to file a U.S. tax return. For students and scholars with little or no income, that status has no such effect. The contrary suggestion in the publication — the urban myth that every foreign student and scholar must file Form 8843, regardless of income — should be withdrawn and replaced with a formal ruling that clarifies that the burdensome paperwork of that form is required only when it actually serves some rational purpose.

In the meantime, colleges and universities that have accepted and perpetuated the myth ought to subject it to closer examination. If institutional resources are being used up by helping with tax documents that are not necessary, perhaps the energy could be redirected to some of the many other administrative tasks that come with extending hospitality in an uncertain world.

<sup>23</sup>Notice 2005-77, *supra* note 4, section 4.

### SUBMISSIONS TO TAX NOTES

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