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Wanted: 'Check-the-Box' Residency for Foreign Students

By John A. Bogdanski

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In the U.S. tax system, foreign students are treated as nonresidents, which perhaps unintentionally places many of them at a disadvantage. This article presents a modest proposal for a new regime under which nonresident alien students may elect to be treated as residents of the United States for federal income tax purposes.

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The United States taxes its residents and citizens on their worldwide income, whereas it taxes nonresident aliens only on their U.S.-source income. Moreover, many nonresident aliens enjoy benefits under tax treaties between the United States and the countries of their residence. And so, when Congress classifies foreign students at U.S. colleges and universities as nonresidents, the students should be grateful, right?

Well, often they aren't. Although not taxed in the United States on foreign-source income, nonresident aliens experience several important disadvantages under the U.S. tax system. With few exceptions, they are denied the standard deduction, dependency exemptions, education credits, child credit, and earned income tax credit. If married, they are not permitted to file joint tax returns with their spouses. Thus, unless they have a great deal of foreign-source income or income shielded by treaty benefits, noncitizens would usually be better off if treated as residents for U.S. tax purposes.

So it is with many foreign visitors studying in the United States. Whatever income they have is typically from U.S. sources: an on-campus job or, if they are extremely fortunate, a U.S. scholarship that is partially taxable. Thus, they receive no benefit by being able to exclude foreign-source income. Meanwhile, their inability to claim a standard deduction forces them to file a tax return and pay U.S. tax when their income exceeds their personal exemption — a mere \$3,700 in 2011 — even though no one is permitted to claim them as a dependent on a U.S. tax return. If they are not from a country with a U.S. tax treaty favorable to students — and many, if not

most, are not — then being a nonresident results in a higher tax burden than if they were a resident.

The mechanics of compliance with the U.S. tax law are no picnic for nonresidents, either. Among other wrinkles, determining whether they are residents or nonresidents in any given year requires tallying up their days of physical presence in the country and applying the "substantial presence test" under section 7701(b)(3). Under that test, an alien becomes a resident for tax purposes if she stays in the country more than a specified number of days. But under a special exception, days spent as a student do not count as days of physical presence for purposes of the test. Unless the student spends parts of more than five calendar years in the United States, at which point she becomes fully subject to the test, days of physical presence as a student are excluded.

The IRS adopts the attitude that excluding student days from the substantial presence test — thereby making the student a nonresident — is something the taxpayer should welcome. The IRS form on which a noncitizen documents student status, Form 8843, reflects this view. The form directs: "Enter the number of days in 2010 you claim you can exclude for purposes of the substantial presence test." And in explaining the ramifications of failing to file the form, the instructions state: "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." The student is characterized as making a "claim," which implies that nonresident status is to her advantage. In many cases, the opposite is true.

The instructions go on to state:

Penalty for Not Filing Form 8843

If you do not file Form 8843 on time, you may not exclude the days you were present in the United States. . . . Failure to exclude days of presence in the United States could result in your being considered a U.S. resident under the substantial presence test.

Because many international students would greatly prefer resident status to nonresident status, this is a "penalty" they would gladly suffer. It would save them hundreds of dollars in tax, allow them to use the several simple and cheap (or even free) tools that low-income U.S. citizens can use to file their tax returns, and in some cases even let them avoid dealing with taxes entirely.

Could a foreign student merely forgo her "claim" to nonresident status and take the position that because of her physical presence in the country she is a U.S. resident for tax purposes? Under current law, this is impermissible, even if the student is present in the country the whole year. Section

7701(b)(1)(A) treats a noncitizen as a resident “if (and only if)” she falls into one of three categories: (1) a green card holder, which international students are not; (2) a taxpayer making a special first-year election (discussed later) for which, practically speaking, students are ineligible; or (3) a person meeting the substantial presence test. For purposes of the substantial presence test, section 7701(b)(3)(D) states that “an individual shall not be treated as being present in the United States on any day if . . . such individual is an exempt individual for such day,” and section 7701(b)(5) defines exempt individual to include a student. Thus, there is no room under the code for foreign students to count their days of physical presence under the substantial presence test, declare themselves residents, and avail themselves of the tax benefits and simpler compliance enjoyed by U.S. citizens. They are nonresidents, whether they like it or not.

But why shouldn't they be able to make a choice? Does the United States really gain much by forcing them to be treated as nonresidents? The amount of income that a typical student earns, if it exceeds her personal exemption, usually does not do so by much. And the costs of collecting the small amounts of tax owed are relatively high.

Denying the student a standard deduction means that she must file a nonresident alien tax return — currently required to be filed on paper with the IRS in Austin, Texas, and processed by IRS personnel in Philadelphia — when as a resident, she might not be required to file at all. (The filing threshold for a single resident who is not a dependent is currently \$9,500.) The nonresident return form calls for all sorts of information that the resident return does not — including amounts of nontaxable scholarships, numbers of days spent in the country over the three most recent calendar years, and the exact dates of one's coming and going to and from the country for the current year. Assuming that the IRS cares about these entries, there is invariably more to examine on a nonresident return than on a resident return.

Moreover, given the complexity of the tax rules applicable to nonresidents, and foreign guests' unfamiliarity with the U.S. tax system, it is likely that there are as many errors and processing issues on nonresident returns as there are on resident returns. All told, one intuits that on a per-return basis, the amount of IRS resources absorbed by a nonresident alien student's return is substantially greater than that spent on the average U.S. citizen's return. Indeed, the current administrative cost to the IRS of requiring international students to file as nonresidents may well be as great as the revenue that might be lost by allowing them to elect to be treated

as residents. Any reform that would reduce the numbers of those returns that the IRS must open, key in by hand, and examine, seems a policy plus. And certainly, from the students' perspective, the compliance burden is greater as a nonresident than as a resident. In sum, a check-the-box residency election would have administrative benefits for both taxpayers and the government.

There is precedent for a check-the-box regime for determining residency for U.S. tax purposes. Under section 7701(b)(4), a nonresident alien who becomes a resident alien can, in some circumstances, elect to be treated as a resident for the year immediately preceding her first year of actual residence. For that preceding year, the noncitizen has her choice of status. Another check-the-box residency context is a nonresident alien spouse of a resident taxpayer: Under section 6013(g) and (h), the couple is allowed to elect that they both be taxed as residents for one year or for the indefinite future. By virtue of the election, the couple can treat the nonresident spouse either way — as resident or nonresident.

When they make those elections, foreign taxpayers agree to be taxed in the United States on their worldwide income and to forgo any tax treaty benefits to which they might otherwise have been entitled. (They also lose the nonresident taxpayer's right to exclude from gross income interest earned on deposits in U.S. banks, which for students is typically a trifling amount.) As already mentioned, many foreign students would happily consent to the same treatment.

Congress should create a new election whereby a nonresident alien who is a full-time student at a college or university can choose to be treated as a resident for U.S. tax purposes for any tax year in which the person is studying in the United States. Wary of gamesmanship, Congress could make the election available only for the student's entire U.S. academic career, as opposed to providing a year-by-year option. But in reality, there is little incentive for gaming. As a group, international students have little foreign-source income to shield from the IRS. Many, if not most, would gladly check the box and take the simpler, cheaper route of joining the ranks of resident taxpayers.

There would be far less paperwork for the IRS to process, and the resulting decrease in tax dollars collected would not be great. Perhaps most importantly, the students could spend less time grappling with complex nonresident forms, meaninglessly tallying days of physical presence in the country and finding and copying documents relating to their nontaxable scholarships. They could spend that time doing something more productive — perhaps even studying.