INTERNATIONAL EXECUTIVE SERVICES

U.S. Taxation of Foreign Citizens

TAX

AUDIT ▪ TAX ▪ ADVISORY

U.S. Taxation of Foreign Citizens

This booklet is designed to assist foreign citizens and nationals who work or live in the United States to understand U.S. tax law as it applies to them. Becoming familiar with U.S. income tax rules should enable foreign individuals to take advantage of the tax planning opportunities available.

Many of the rules are complex and exceptions exist. U.S. and foreign tax advice should be obtained before arriving in the United States and again before returning to the home country for purposes of considering U.S. and foreign tax planning opportunities and other relevant issues that relate to the moves.

Coordination between employer and employee is essential to achieving overall income tax savings when transferring individuals to the United States. This booklet is designed to assist the individual employed in the United States, as well as his or her employer, in obtaining the appropriate benefits from U.S. income tax provisions.

The tax rules in the United States are continually changing as a result of new legislation, judicial decisions, and administrative interpretations. This booklet reflects U.S. income tax law as it applies to taxable years as of December 31, 2004.

For further information, please contact your local KPMG office (listed in Appendix E of this booklet). The information contained in this publication is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax adviser.

KPMG LLP

December 31, 2004

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Table of Contents

Introduction 6
Chapter 1 -- Determination of Resident or Nonresident Status 7
Resident Alien and Nonresident Alien 7
Immigration Laws and Visas 11
Chapter 2 -- Taxation of Resident Aliens 15
Gross Income 15
Compensation for Personal Services 15
Business Deductions and Exclusions 21
Capital Gains and Other Gross Income 23
Passive Loss Limitations 24
Adjustments to Gross Income 25
Itemized Deductions 26
Personal Exemptions 28
Rates and Filing Status 28
Residency Election by Married Taxpayers 29
Tax Credits 31
Alternative Minimum Tax 31
Minimum Tax Credit 32
Community Property 33
Taxable Year 33
Imputed Income from Certain Foreign Corporations 34
Withholding on Certain Payments by Resident Alien Individuals 34
Chapter 3 -- Taxation of Nonresident Aliens 35
Gross Income 35
Income from U.S. Sources 35
Certain Investments and Other Passive Income 36
Business Income 37
Partnership Income 39
Real Property Income 39

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Sale or Exchange of Capital Assets 40
Sale or Exchange of U.S. Real Property Interests 41
Deductions and Personal Exemptions 43
Rates and Filing Status 44
Tax Credits 44
Community Property 45
Taxable Year 45
Chapter 4 -- Taxation of Dual-Status Aliens 46
Full-Year Residency Election 47
First-Year Residency Election 49
Moving Expenses 50
Deductions and Personal Exemptions 51
Tax Rates and Filing Status 52
Chapter 5 -- Planning for a Transfer 53
Timing the Transfer 53
Timing of Receipt of Income 53
Timing of the Payment of Deductible Expenses 54
Sale of a Principal Residence 54
Sale of Other Capital Assets 55
Pre-residency Appreciation of Capital Assets 56
Foreign Corporations 57
Exercise of Stock Options 57
Deduction for Travel Expenses 57
Chapter 6 -- Tax Treaty Benefits 59
Applying Treaties 59
Expatriation 62
Foreign Trust/Gift Reporting Requirements 63
Chapter 7 -- Payment of Tax 64
Withholding of Taxes 64
Estimated Tax 64
Penalties and Interest 65
Chapter 8 -- Other Taxes 66
Social Security Tax 66
Estate and Gift Taxation 68
State and Local Taxes 72

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 9 -- Filing and Reporting Requirements ____ 73
U.S. Individual Income Tax Return ____ 73
Taxpayer Identification Number ____ 75
Departing Aliens and the Sailing Permit ____ 76
Information Returns ____ 77
Foreign Partnerships ____ 78
Creation of or Transfers to Certain Foreign Trusts ____ 78
Currency Restrictions and Reporting ____ 78
Chapter 10 -- Personal Planning for a Transfer to the United States ____ 79
Compensation Factors ____ 79
Pre-departure Activities ____ 79
Vital Documents ____ 80
Adjustment to the United States ____ 80
Repatriation ____ 80
Appendix A – Pre-departure Activities Checklist ____ 82
Action required: ____ 82
Secure the following: ____ 83
Appendix B – Vital Documents Checklist ____ 85
Attorney: ____ 85
Appendix C – Treaty Withholding Tax Rates (in percentages) ____ 86
Appendix D – U.S. Individual Income Tax Figures 2005 ____ 89
2005 Standard Deduction ____ 90
2005 Itemized Deduction Phaseout ____ 91
Type of Return Filed ____ 91
Threshold (USD) ____ 91
2005 Personal Exemptions ____ 91
2005 Alternative Minimum Tax Exemptions ____ 92
2005 Social Security and Self-Employment Wage Base Amount ____ 92
2005 Capital Gains Tax Rates ____ 92
Appendix E – List of KPMG IES Offices in the U.S.A. ____ 93
KPMG Washington National Tax ____ 93
Atlanta ____ 93
Boise ____ 93
Boston ____ 93
Charlotte ____ 93
Chicago ____ 93

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Cincinnati ____ 93
Cleveland ____ 93
Columbus ____ 93
Dallas ____ 93
Denver ____ 94
Detroit ____ 94
Houston ____ 94
Kansas City ____ 94
Miami ____ 94
Minneapolis ____ 94
New York ____ 94
Northern Virginia ____ 94
Orange County ____ 94
Philadelphia ____ 94
Phoenix ____ 95
Portland (Oregon) ____ 95
Richmond ____ 95
San Diego ____ 95
San Francisco ____ 95
Seattle ____ 95
Short Hills ____ 95
Silicon Valley ____ 95
Stamford ____ 95

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Introduction

Under United States (U.S.) income tax law, a foreign citizen or national (alien) is subject to U.S. tax in different ways depending on whether he or she is a resident or a nonresident. A resident alien is taxed on worldwide income in much the same manner as a U.S. citizen. When computing taxable income, a resident alien is generally entitled to claim the same deductions and personal exemptions available to a U.S. citizen.

Nonresident aliens generally are taxed only on their income from U.S. sources, with some exceptions. As a result of limited exposure to U.S. tax, deductions, and exemptions available to nonresident aliens are limited.

In a year in which an individual arrives in the United States or departs from the United States, the individual may be both a nonresident alien and a resident alien during the same tax year. A foreign citizen with this dual status will be taxed as a resident alien for part of the year and as a nonresident alien for the other part of the year.

The United States has a self-assessing tax system. As a result, individuals generally prepare tax returns and compute their taxes. Any tax owed, less any withholding tax and estimated tax payments, is due with the tax return without assessment by the government. The federal tax authority is the Internal Revenue Service (IRS), a part of the U.S. Treasury Department. Most states and some cities also impose income taxes, which are separately administered.

Special rules apply to certain employees of foreign governments and certain international organizations, students, teachers, and residents of Puerto Rico, Guam, American Samoa, the Northern Mariana Islands, and the U.S. Virgin Islands. The discussion of these special rules is beyond the scope of this booklet.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 1 -- Determination of Resident or Nonresident Status

Resident Alien and Nonresident Alien

As a general rule, a foreign citizen is treated as a nonresident alien unless he or she qualifies as a resident alien. A "U.S. resident" is defined as a foreign citizen or national who meets either of two tests, the lawful permanent resident test or the substantial presence test. This definition applies only for purposes of determining a foreign individual's U.S. income tax liability. It does not, for example, apply for estate and gift tax purposes.

Lawful Permanent Resident Test (The "Green Card" Test)

An alien who is a lawful permanent resident (green card holder) under the immigration laws is considered a resident for U.S. income tax purposes. The lawful permanent resident test is based on the legal authority for an alien's presence in the United States, not on his or her physical presence in the United States. Therefore, a green card holder will continue to be treated as a U.S. resident (whether or not physically present in the United States) until such time as his or her permanent resident alien status under U.S. immigration law is officially revoked or abandoned. To obtain or renew a green card, a foreign citizen will have to file an information return that will be used by the Internal Revenue Service (IRS) to identify individuals who do not file U.S. income tax returns. (It should be noted that the green card is no longer green.)

Substantial Presence Test

Unlike the lawful permanent resident test, the substantial presence test focuses on physical presence in the United States. Under the substantial presence test, an alien will be considered a U.S. resident for tax purposes if:

- The alien is present in the United States for at least 31 days during the current calendar year; and
- The sum of the number of days of U.S. presence during the current calendar year, plus one-third of the U.S. days during the first preceding calendar year, plus one-sixth of the U.S. days during the second preceding calendar year, equals or exceeds 183 days.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Example

J, a Japanese executive employed by a U.S. company, is present in the United States for 130 days during 2005, 120 days during 2004, and 120 days during 2003. He is not a green card holder. J is a resident alien for 2005, since he is present in the United States on at least 31 days in 2005, and for at least 183 equivalent days during the applicable three-year period, computed as follows:

Year	Actual Days	Equivalent Days
2005	130 x 1	130
2004	120 x 1/3	40
2003	120 x 1/6	20
Total		190

An alien will be treated as being present in the United States on any day if he or she is physically present in the United States at any time during such day. However, exceptions to this rule exist for residents of Canada and Mexico who commute to and from employment in the United States, individuals who are present in the United States less than 24 hours while in transit between two points outside of the United States, and individuals who were unable to leave the United States because of medical conditions that arose while the individuals were present in the United States. The law treats presence in the United States for these reasons as non-U.S. days.

Exceptions to Substantial Presence

There are two main exceptions to the substantial presence test: the exempt-individual exception and the closer connection- to-a-foreign-country exception. Under the exempt-individual exception, an alien will not be treated as being present in the United States on any day in which the alien is considered an exempt individual. Except as noted below, an exempt individual is anyone temporarily present in the United States as a foreign government-related individual, a teacher or trainee who holds a "J" or "Q" visa, a student holding either an "F," "J," "M," or "Q" visa, or a professional athlete temporarily in the United States to compete in a charitable sports event. A foreign government-related individual will remain a nonresident alien regardless of how long he or she resides in the United States. The law, however, provides time limits for teachers, trainees, or students. A teacher or trainee will not be treated as an exempt individual for the current year if,

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

for any two of the last six calendar years, such person was previously considered an exempt teacher, trainee, or student. In certain cases, this period is extended to four of the last six calendar years. Similarly, the exemption for students is generally limited to students who have not been present in the United States for more than five calendar years as either a student, teacher, or trainee. However, an alien may continue to be exempt as a student beyond the fifth year if the student can satisfy the IRS that he or she has substantially complied with the terms of the student visa and does not intend to permanently reside in the United States.

Under the closer-connection-to-a-foreign-country exception, an alien who would otherwise meet the substantial presence test is treated as not meeting the test for the current calendar year if:

- The alien is present in the United States for fewer than 183 days during the current year;
- The alien maintains a tax home in a foreign country during the current year; and
- The alien has a closer connection during the current year to a single foreign country in which he or she maintains a tax home than to the United States.

An alien may generally establish that his or her tax home is in a foreign country by showing that his or her principal place of business and/or abode are located in such foreign country. The determination of whether the alien has a closer connection to such foreign country will generally be made by weighing the individual's contacts with the United States against those with the foreign country. Both the tax-home and closer-connection determinations are factual issues and are therefore subject to some degree of uncertainty. An alien should thus rely on the closer connection-to-a-foreign-country exception only when none of the other exceptions applies. Further, this exception to the substantial presence test will not apply for any year during which the individual has an application pending for adjustment to permanent resident status or has taken other affirmative steps to apply for status as a lawful permanent resident of the United States.

Dual Status Aliens

It is possible for an alien to be both a nonresident alien and a resident alien during the same tax year. This dual status usually occurs in the year in which a foreign

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

citizen arrives in or departs from the United States. The U.S. residency starting and ending dates depend on whether the individual qualifies as a U.S. resident under the lawful permanent resident test or the substantial presence test, or both. The U.S. residency starting date for an alien who meets only the lawful permanent resident test is the first day during the calendar year in which the alien is physically present in the United States as a lawful permanent resident (i.e., with a valid green card). The residency starting date for an individual qualifying as a U.S. resident under the substantial presence test is generally the first day during the year in which the individual is physically present in the United States. Individuals who qualify under the substantial presence test may qualify for a nominal presence exception, which allows an individual to be present in the United States for short periods of up to 10 days in total (for example, for business or house-hunting trips) without starting his or her U.S. residency for tax purposes.

Dual status may also occur during the individual's last year of U.S. residency. An alien who qualifies as a U.S. resident under the lawful permanent resident test, generally, will cease to be a U.S. resident on the day his or her status as a lawful permanent resident is officially terminated. An alien who meets the substantial presence test will generally not be treated as a U.S. resident during the part of the year following the individual's last day of physical presence in the United States. Subsequent short periods (up to 10 days in total) of presence in the United States may be disregarded. An individual will be treated as a nonresident for the latter part of the year if such individual has a closer connection to a foreign country than to the United States during that part of the year, the individual maintains a tax home in the foreign country for the remainder of the year, and the individual is not a U.S. resident at any time during the next calendar year.

No-Lapse Rule

A "no-lapse" rule will apply for aliens who were U.S. residents for any part of two consecutive years. An alien who was a U.S. resident during any part of the preceding calendar year and who is a U.S. resident for any part of the current year will be considered to be taxable as a resident at the beginning of the current year. Similarly, an alien who is a U.S. resident for any part of the current year and who is also a U.S. resident for any part of the following year (regardless of whether the individual has a closer connection with a foreign country) will be taxable as a resident through the end of the current year.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Treaty Rules

The rules for determining U.S. residency do not override tax-treaty residency rules. Thus, if an alien is a U.S. resident under the Internal Revenue Code but is treated as a resident of a treaty country under the tiebreaker provisions of an income tax treaty, the alien may elect to be treated as a nonresident of the United States for matters within the scope of the treaty. (See Chapter 6 for a discussion of tax treaty benefits.)

Immigration Laws and Visas

A nonresident alien who wishes to work or do business in the United States must consider the immigration laws of the United States. The Immigration and Nationality Act contains the rules relating to the entry of aliens and is administered by the Department of Homeland Security (DHS) (through its bureau, U.S. Citizen and Immigration Services (USCIS)), and by the Department of State (through U.S. consulates abroad). The general rules applicable to nonresident aliens who wish to do business in the United States are briefly discussed below. As the rules in this area are complex and involve non-tax legal issues, individuals should consult with immigration counsel to determine the appropriate course of action for their particular circumstances.

An "alien" under the immigration laws is any person who is not a citizen or national of the United States. A national of the United States is a person who, although not a U.S. citizen, owes permanent allegiance to the United States. Immigrants are aliens who seek to enter the United States on a permanent basis, while non-immigrants seek admittance on a temporary basis. Certain numerical limitations applicable to immigrants do not apply to nonimmigrants. In preparing for a journey to the United States, an alien, if not exempt from the visa requirement, should apply abroad to a U.S. consular official for an appropriate visa. A visa may not be granted until satisfactory evidence is submitted to show that the alien will be able to proceed to the United States. This includes assurance that the alien will obtain any exit permits and visas that may be needed for transit to the port of embarkation.

Set forth below is a partial listing of the visa classifications for non-immigrants. (For further information, visit the visas Web page for the Department of State at http://unitedstatesvisas.gov.)

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

"A" visas apply to foreign government officials, such as ambassadors, public ministers, or diplomatic or consular officers and their immediate families. This visa classification also applies, upon the basis of reciprocity, to certain other officials and employees of foreign governments, as well as to the attendants and personal employees of these officials.

"B" visas are granted to aliens having residence in foreign countries that they do not intend to abandon and who are visiting the United States temporarily for business or pleasure. The B-l visa is assigned to temporary visitors for business, and the holder thereof may engage in legitimate commercial or professional activities; however, such holders may not engage in purely local employment or labor of hire. These B-1 visas are generally valid for periods not exceeding one year. The B-2 visa is a tourist visa and is to be used for pleasure trips. It is generally valid for a minimum of six months but not more than one year.

"E" visas are granted to non-immigrant treaty-traders and treaty-investors. These are aliens who enter the United States to carry on substantial trade between the United States and the foreign state of which they are nationals, or who enter the United States to develop and direct enterprise in which an alien has invested or is actively in the process of investing a substantial amount of capital pursuant to a treaty of friendship, commerce, and navigation. Such visas are also applicable to the spouses and unmarried children under age 21 accompanying the treaty-trader or treaty-investor.

"F" visas generally apply to alien students, their spouses, and their children, and are generally granted to nonimmigrant students enrolled in U.S. colleges, universities, seminaries, language training programs, etc.

"G" visas are generally granted to certain representatives of international organizations and members of their immediate families. Aliens holding G visas generally must be employed by the foreign government entity or the international organization sponsoring their assignment to the United States.

"H" visas apply to temporary workers or trainees who are generally authorized to come to the United States temporarily to perform services or labor for, or to receive training from, certain employers. H visas also apply to aliens of

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

distinguished merit and ability in the fields of arts, entertainment, athletics, and fashion modeling.

"J" visas are granted to alien students, scholars, trainees, teachers, professors, or others of similar description, and their spouses and children for the purpose of teaching, instructing, lecturing, studying, observing, etc. J visas generally apply to exchange aliens who have acquired exchange-visitor status under the U.S. Information and Education Exchange Act.

"L" visas are designed to enable firms to transfer alien employees to the United States for continued employment in the United States by the same or an affiliated enterprise. The alien must have been employed continuously for one year by a firm, corporation, or other legal entity, or an affiliate or subsidiary thereof, and must serve in a managerial or executive capacity or possess specialized knowledge. A recipient of an L visa may be admitted for an initial period of three years and may be granted extensions until the duties are completed. The DHS and the Department of State, however, may restrict renewals. The holder of an L visa is permitted to have his or her spouse and unmarried children join him or her in the United States.

"M" visas apply to aliens, their spouses, and their minor children who temporarily enter the United States solely for the purpose of pursuing a full course of study at an established vocational or other recognized nonacademic institution (other than in a language training program).

"O" visas are granted to aliens with extraordinary ability in the sciences, arts, education, business, or athletics which has been demonstrated by sustained national or international acclaim; their spouses; their children; and limited assistants who seek to enter the United States to continue work in the area of extraordinary ability.

"P" visas apply to alien artists, entertainers, or athletes who seek to enter the United States solely for the purpose of performing as such; their spouses; their children; and certain other aliens who are integral to such performances.

"Q" visas apply to aliens having residence in a foreign country, which they have no intention of abandoning, who are coming temporarily (for a period not to exceed 15 months) to the United States as participants in an international cultural exchange

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

program for the purpose of providing practical training, employment, and the sharing of the history, culture, and traditions of the country of the aliens' nationality and who will be employed under the same wages and working conditions as domestic workers.

"TN" (Trade NAFTA) visas apply to nonimmigrant citizens of Mexico and Canada who seek temporary entry into the United States to perform business activities for self-employed individuals. Spouses and dependent children can accompany such individuals under the "TD" status (Trade Dependent).

Generally, aliens must possess valid, unexpired visas and passports to enter the United States. In lieu of a visa, a returning U.S. resident may present a reentry permit. An alien admitted as a nonimmigrant cannot remain permanently in the United States under that status. An alien who fails to maintain the nonimmigrant status under which admitted, or to which changed, under the Immigration and Nationality Act or who fails to comply with the conditions of such status may be subject to deportation. An alien who entered as a nonimmigrant is also subject to deportation if it is established that the alien was inadmissible at the time of entry.

As stated above, immigrants seek to enter the United States on a permanent basis. Aliens applying for immigrant status are generally subject to quotas restricting the number of such individuals who may enter the United States during the calendar year. The spouse, minor children, and parents of a citizen of the United States and special immigrants (generally immigrants lawfully admitted to the United States for permanent residence who are returning from temporary visits abroad) are exempt from the quotas.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 2 -- Taxation of Resident Aliens

Gross Income

Gross income of a resident alien includes income from all sources and wherever earned throughout the world. Thus, a resident alien's gross income can include: salaries; other compensation; interest and dividend income (wherever paid); net income from carrying on any trade or business (that is, gross income less expenses incurred to earn that income); capital gains or losses (subject to limitations); and income (less expenses) from partnerships and rental properties, annuities, pensions, and other miscellaneous sources, including reimbursed business expenses in excess of expenses reported to the employer. Gross income, however, does not include income received while the individual was a nonresident alien. (See Chapter 4).

Certain items are excluded by statute from gross income. These items include: interest received on certain state and local obligations; gifts and inheritances; compensation for injuries or sickness; amounts received under accident and health plans; contributions by employers to accident and health plans; and qualified scholarships.

Compensation for Personal Services

In General

A resident alien is taxed on his or her worldwide compensation regardless of where or for whom the services are performed.

Compensation includes:

- Salaries, bonuses, and commissions;
- Fringe benefits;
- Deferred compensation;
- Employer stock and other property;
- Stock-option income;
- Pensions and other retirement income;
- The benefit of loans with below-market interest;

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

- Foreign service allowances;
- Cost-of-living allowances;
- Housing costs paid for by an employer;
- The value of the use of employer-provided housing;
- Reimbursements for U.S. or foreign taxes;
- School tuition for an employee's children;
- Home-leave allowances;
- Use of a company car for personal purposes;
- The value of servants provided by an employer;
- Reimbursement of moving expenses; and
- The value of employer-provided tax return preparation services.

Compensation includes cash remuneration and the fair market value of property or services received. All compensation is taxable unless excluded by law.

Deferred Compensation

Generally, deferred compensation is not taxable until the compensation is received if it is based on an unfunded and unsecured promise to pay compensation in the future for present services (a completely different rule applies to tax-exempt organizations, such as charities). Under newly effective deferred compensation rules, if compensation has already been earned, an individual generally cannot avoid current taxation by asking to defer the receipt of the compensation. To be effective, a deferred compensation agreement must generally be made in the year before the services are to performed. For example, if a bonus will be earned in 2006 and payable in 2007, an election to defer a portion of the bonus (if any is paid) may have to be made in 2005. An employee can make an election with respect to an incentive program after the period of service has started *if* the amount being earned is subject to a substantial performance condition. If the payment will not be made unless the performance conditions are satisfied (and the performance testing

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

period is at least 12 months), the employee can elect to defer at least six months before the amount would otherwise be payable (if the performance requirements are satisfied).

New rules also require that the deferral election specifically state when the distribution will be made, and limit the choices and flexibility. An employee can elect distributions on separation from service, retirement, death, disability, unforeseeable emergency, change in control, or a date stated in the original deferral election. The election must also state the method of distribution (lump sum or the number of years for periodic payments). An employee cannot generally ask for the payment any sooner than provided in the original election. Subsequent deferrals can be permitted by a plan, but an employee must elect to put off the distribution for at least five years.

Significant tax penalties apply if the deferral does not satisfy the new rules, including inclusion of the deferral (once no longer subject to any substantial risk of forfeiture) and an additional 20-percent income tax. As a general rule, the employer is required to withhold federal income tax on the amount included and the additional 20-percent tax. Additional underpayment of interest may apply from the date the substantial risk of forfeiture lapses.

Compensation earned by a foreign citizen as a resident alien in the United States, but received when a nonresident alien, will generally be taxed at the regular U.S. graduated tax rates in the year received. However, it is a good idea to check the treaty provisions if the compensation was set aside in a broad-based pension plan of the home country while the employee was a U.S. resident alien.

Employer Stock and Other Property

Compensation in the form of employer stock or other property generally is taxable when received. The amount of compensation is the excess of the fair market value of the property over the amount (if any) the recipient pays for the property. However, if such property is not freely transferable or is subject to a substantial risk of forfeiture, income is not recognized until the restrictions are removed. Property is subject to a substantial risk of forfeiture if the recipient's rights to full enjoyment of such property (for example, the right to sell the property) are conditioned on the future performance of substantial services.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

An individual who receives property that is not otherwise currently taxable as compensation may elect to treat the property as compensation in the year received. The election must be made within 30 days after the transfer. This election may be desirable if the property is expected to appreciate substantially in value. However, no deduction is allowed if the property is subsequently forfeited.

Stock Options

The taxation of stock options to an individual depends on whether the options are incentive stock options or nonqualified options. A stock option is the right granted to an employee or to an independent contractor (for example, company director), in consideration for the performance of services, to purchase shares in a corporate employer or related company. The option agreement usually specifies the purchase price and time period during which the option may be exercised.

An incentive stock option (ISO) is an option that meets certain statutory requirements, including the following.

- The option price must be at least the fair market value of the stock at the time of the grant (or at least 110 percent of fair market value if granted to a 10-percent, or greater, shareholder).

- The fair market value of the stock with respect to which the ISOs are exercisable for the first time by an individual cannot exceed USD 100,000 a year.

- The option must not be exercisable more than 10 years after the date of grant (five years if granted to a 10-percent, or greater, shareholder).

An individual is not taxed on the grant or exercise of an incentive stock option. However, the excess of the fair market value of the stock option over the actual purchase price must be added back as an adjustment to taxable income for alternative minimum tax purposes (discussed later in this chapter). Additionally, a foreign national may be able to avoid foreign tax by exercising the stock option while he or she is a resident of the United States.

The subsequent sale of the stock obtained by exercise of an ISO will result in a capital gain or loss if sold more than two years after grant and one year after

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

exercise and if certain employment requirements are met. In determining gain or loss, the basis in the option stock is its purchase price.

A nonqualified stock option is generally any option other than an ISO that is granted, in connection with the performance of services, to acquire employer stock. Unless the option has an ascertainable fair market value, an individual is not taxed when granted a nonqualified stock option. Upon the exercise of the stock option, the individual is treated as receiving taxable compensation measured by the excess of the fair market value of the stock received over its purchase price. The exercise of a nonqualified option does not give rise to an adjustment to taxable income for alternative minimum tax purposes. The subsequent sale of the option stock will result in a capital gain or loss. In determining gain or loss, the basis of the option stock is the purchase price plus the compensation recognized at exercise.

If an option has a readily ascertainable fair market value, the individual recognizes income at the time of grant instead of at the time of exercise of the option. To have a readily ascertainable fair market value, an option must be actively traded on an established securities market, or its value must be otherwise measurable with reasonable accuracy based on certain tests. It is uncommon for employee stock options to have a readily ascertainable value.

Other rules apply to stock acquired by exercise of options under employee stock purchase plans.

Pension and Other Retirement Income

Pensions and other retirement allowances received under U.S. or foreign plans generally are taxable. If the employee did not contribute to the cost of the pension, the full amount received generally is taxable. If the employee did so contribute, a portion of pension amounts received is excluded from gross income. Special rules apply for determining a plan participant's basis in the pension plan. Special taxing rules apply to certain pension and other retirement benefits received as a lump-sum distribution.

Pension benefits are foreign source income to the extent that they are attributable to services performed abroad. Accordingly, the U.S. tax on these benefits can be offset in whole or in part by foreign tax credits.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Income tax treaties may affect the taxation of pension benefits. Many U.S. treaties provide that a resident of the United States may be taxed on pension benefits only by the United States.

Foreign nationals on international assignment in the United States who continue to participate in a pension plan in their home country may be taxed on their contribution while on assignment.

A foreign national, resident or nonresident, who is assigned to the United States may be taxed on the value of his or her accruals under U.S. tax rules applicable to nonqualified plans, if he or she continues to participate in a foreign pension plan. This occurs because foreign pension plans do not enjoy the benefit of U.S. tax qualifications, the benefit being that taxation of the contributions is usually deferred until distribution. Foreign plan benefits will be subject to U.S. tax provided: (1) the plan is funded for U.S. tax purposes and (2) the foreign national's interest in the plan is vested in whole or in part.

Loans with Below-Market Interest

Compensation includes imputed interest on loans from an employer with no interest payable or with interest payable at below-market rates.

Loans subject to interest imputation include any below-market interest loan that is (l) a compensation-related loan between an employer and an employee, (2) a corporation-shareholder loan, or (3) a loan with tax avoidance as one of its principal purposes. The tax consequences of a below-market demand loan focus on the amount of "foregone interest." This is the excess of the amount of interest that would be payable on the loan during the taxable year, if accrued at the applicable federal rate, over the amount actually payable during the taxable period. The amount of foregone interest is treated as transferred from the lender to the borrower and characterized as compensation, dividend, or other payment, depending on the relation between the lender and borrower. In addition, the amount is treated as re-transferred from the borrower to the lender and treated as interest income to the lender and interest expense to the borrower. This imputed interest expense of an individual could be subject to the limitations on the deduction of personal interest.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

The treatment of a below-market term loan is slightly different. With respect to a non-gift term loan, the lender is treated as transferring and the borrower is treated as receiving the excess of the actual loan amount over the present value of all payments required to be made under the terms of the loan. The excess is then treated in accordance with the relationship of the lender and borrower. In addition, the excess is considered to be original issue discount such that the lender has income and the borrower has interest expense in an amount tied to imputed daily discount.

There are a number of exceptions, the most important being the USD 10,000 minimum exception that applies in certain circumstances. For any day in which the total loan between lender and borrower is less than USD 10,000, interest income and expense generally will not be imputed. Furthermore, IRS regulations exempt below-market loans where both the lender and borrower are foreign persons or where the lender is a foreign person and the borrower is a U.S. person (other than a compensation-related loan) from the imputed-interest requirements, unless the interest income imputed to the lender would be effectively connected with a U.S. trade or business and not exempt under a tax treaty. A resident alien is a U.S. person.

Business Deductions and Exclusions

In General

Ordinary and necessary business expenses generally are deductible from gross income. However, employee business expenses are fully deductible only to the extent they are reimbursed by an employer. Such expenses and reimbursements need not be reported on an employee's tax return if he or she fully accounts to the employer for such expenses under a reimbursement or other expense allowance arrangement. (See Chapter 5). Unreimbursed employee business expenses are deductible as miscellaneous itemized deductions, which are deductible only to the extent that miscellaneous itemized deductions in total exceed 2 percent of adjusted gross income.

Travel Expenses

If a resident alien is in the United States for a temporary assignment, certain U.S. away-from-home expenses such as travel, meals, and lodging may be deductible. The resident alien must be temporarily away from his or her foreign principal place of employment (that is, tax home), and the stay in the United States must not be

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

indefinite. No away-from-home living expenses paid or incurred are deductible if the resident alien's period away from his or her tax home is expected to be more than one year at a single location. The deductibility of expenses for assignments of one year or less depends on the facts and circumstances of each case; however, the expenses would generally be deductible.

If employer-furnished accommodations are provided on the employer's business premises for the convenience of the employer and the employee is required to accept them as a condition of employment, the value of such lodging may be excluded from the taxable income of the employee. Similarly, the value of meals provided by the employer is not taxable if they are provided on the employer's business premises and for the convenience of the employer.

Planning Points:

1. Employers must adequately document not only an employee's assignment that is initially expected to last one year or less, but also when the assignment is extended beyond one year.

2. Where possible, assignments should be scheduled with a projected period of employment for as close to one year as possible, but not over one year.

Example

(a) If an assignment is scheduled to last six months, but during this period it is rescheduled to last 14 months, the maximum deduction for away-from-home travel expenses would be limited to those expenses incurred during the period prior to rescheduling (i.e., six months or less).

(b) Assume the assignment discussed in example (a) is originally scheduled to last 12 months, but during this period it is rescheduled to last 14 months. In this situation, the maximum deduction for away-from-home expenses would still be limited to those expenses incurred during the period prior to rescheduling, but this period could possibly include all 12 months. If the assignment does in fact last six months, as originally planned in example (a), the related away-from-home expenses would still be deductible.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Foreign Earned Income Exclusion

A resident alien who has his or her tax home in a foreign country and who is physically present in a foreign country or several foreign countries for at least 330 full days during any period of 12 consecutive months may qualify to exclude up to USD 80,000 (for 2005, to be adjusted for inflation in the case of any tax year beginning in a calendar year after 2007) of foreign earned income from his or her gross income. In addition to (or in lieu of) the foreign earned income exclusion, qualifying resident aliens may elect to exclude from income, or in some cases to deduct from income, a housing cost amount based on the individual's actual housing expenses in the foreign country. A resident alien may also qualify for these foreign exclusions if he or she is a bona fide resident of a foreign country and if he or she is a citizen or national of a country with which the United States has an income tax treaty.

A resident alien who is a lawful permanent resident of the United States and who elects these foreign exclusions should consider consulting a U.S. immigration attorney with respect to the impact of the elections on his or her U.S. immigration status.

Capital Gains and Other Gross Income

Capital gains include the gains from the sale of investment assets, personal assets, and certain business assets. Short-term capital gains are taxed at the taxpayer's marginal tax rate based on his or her income and filing status up to a maximum rate of 35 percent. Short-term capital gains arise from assets held less than one year. Long-term capital gains are taxed at a maximum rate of 15 percent. To qualify for long-term capital gain rates, assets must have been held for more than 12 months before disposition. See Appendix D for tax rates. Net capital losses may be deducted against ordinary income up to USD 3,000 annually. Unused losses can be carried over indefinitely and used in later years until exhausted.

Gain of USD 250,000 (USD 500,000 in the case of married filing jointly) on the disposal of a principal residence can be excluded if certain requirements are met. (See "Sale of a Principal Residence", Chapter 5).

Gross income of a resident alien can also include his or her share of the undistributed income of certain foreign corporations. These corporations are controlled foreign corporations with tax haven (subpart F) income, and certain

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

passive foreign investment companies. This topic is discussed at the end of the chapter.

Passive Loss Limitations

Deductions from passive trade or business activities, to the extent that they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income such as salary, interest, dividends, and active business income. Credits from passive activities generally will be limited to the tax allocable to the passive activities.

Losses arising from a passive activity generally will be deductible only against income from other passive activities. Unusable passive activity losses will be carried forward indefinitely (but not carried back), generally to be applied against passive activity income in subsequent years.

A passive activity includes the conduct of any trade or business in which the taxpayer does not materially participate throughout the year and, generally, any rental activity, regardless of whether the taxpayer materially participates. A limited partnership interest is generally treated as intrinsically passive. A taxpayer will most likely be considered to participate materially in an activity if the activity is the taxpayer's principal business.

An individual is allowed annually to offset up to USD 25,000 of non-passive income with losses and credits from rental real estate activities with respect to which the individual actively participates. The USD 25,000 amount is phased out for taxpayers above certain income levels. The active participation standard requires less involvement than the material participation standard and generally will not require regular, continuous, and substantial involvement in operations.

Working interests in oil and gas property held in a manner that does not limit liability are exempted from the passive-loss rules, regardless of the level of a taxpayer's participation. In general, a working interest is an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property.

Rental of Former Residence

Foreign nationals often prefer not to sell their former foreign residence and therefore rent the property during the U.S. assignment. In such case, the resident

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

may be taxed on the rental income less applicable deductions such as mortgage interest, property taxes, insurance, agency commissions, and other ongoing operating expenses of the property. Depreciation may also be permitted on the building cost (excluding the portion attributable to land) and improvements and furnishings left in the house. Depreciation must be calculated according to U.S. rules. Additionally, qualified residence interest payments can be deducted in full. Interest payments on a principal residence are excluded from the passive activity determination and are not subject to the passive loss limitations.

If the principal residence is rented for less than 15 days during the year, the rental income and associated deductions, other than interest and taxes, are ignored in determining taxable income.

Special rules also apply to limit deductible losses if property is used by the taxpayer for personal purposes during the year. No loss deduction is allowed if the taxpayer used the property for personal purposes for more than the greater of 14 days or 10 percent of the number of days the house was actually rented during the tax year. "Personal use" of a property includes occupancy by friends or relatives. If personal use does not exceed this limitation, a deductible loss is allowed that is proportionately based on the rental percentage. It should also be noted that losses from rental of a property to a family member may not be deducted, unless an arm's-length rent is paid.

Foreign nationals who elect to rent their former foreign residences may have to compute net gain or loss from the property in the foreign functional currency as a qualified business unit ("QBU"). The annual income or loss would be translated into U.S. dollars at the average exchange rate for the year, rather than on the date of receipt or payment by the taxpayer. Under QBU treatment, gain attributable to foreign currency fluctuation upon the sale or other disposition of the property may be minimized.

Adjustments to Gross Income

Certain expenses are deductible even if the flat standard deduction is claimed. These deductions are subtractions from gross income to compute adjusted gross income. The following are some of the deductions available:

- Employee business expense to extent reimbursed by an employer;

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

- Trade or business expenses other than employee business expenses;
- Individual retirement account (IRA) contributions up to the lesser of USD 4,000 in 2005 (USD 8,000 for a spousal IRA) or compensation included in income (the maximum deduction, however, is phased out where adjusted gross income exceeds certain limitations);
- Health savings account deduction;
- Unreimbursed qualified moving expenses;
- One-half of self-employment tax paid, for certain self-employed individuals;
- Certain self-employed health insurance payments for certain self-employed individuals;
- Keogh and certain other retirement plan contributions, within limitations, for self-employed individuals;
- Forfeited interest penalty on early withdrawal of savings from time deposits;
- Alimony paid;
- Qualified student loan interest.

Itemized Deductions

After computing adjusted gross income, resident aliens may elect to claim the same non-business deductions as a U.S. citizen. The non-business deductions include, but are not limited to, the following:

- Medical expenses, including insulin and prescription drugs, to the extent that such expenses exceed 7.5 percent of adjusted gross income.
- State and local taxes on income, real property, and personal property; foreign real property taxes; and foreign income taxes, provided that foreign income taxes are not claimed as a credit. State and local general sales taxes may be deductible for tax years 2005 and 2006.
- Contributions to qualified U.S. charities (with limitations).

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

- Interest on home mortgages and certain other interest on debt secured by a principal or a second residence. However, the deduction is generally limited to interest amounts paid on the first USD 1 million of debt incurred to acquire, construct, or substantially improve the residence and up to USD 100,000 of other debt that is secured by the residence. Any interest paid in excess of the limits is treated as personal interest and is not deductible. For debt that was incurred and secured by the residence on or before October 13, 1987, and at all times thereafter, the USD 1 million limitation is inapplicable.

- Certain miscellaneous deductions for union dues, casualty losses (within limits), tax return preparation fees, unreimbursed employee business expenses, and others, to the extent that these deductions in total exceed 2 percent of adjusted gross income.

A deduction for investment interest expense is limited to net investment income, that is, gross investment income less expenses incurred to earn such income, such as the cost of investment advice and consulting fees. Investment interest expense includes interest incurred to earn investment income (for example, dividends, portfolio interest, capital gains, and so forth). It does not include any interest that is taken into account in computing income or loss from a passive activity. Amounts disallowed under this provision may be carried forward indefinitely and deducted in future years, subject to the annual limitation.

A deduction for personal interest is not allowed. Personal interest includes interest paid on automobile loans, credit card interest incurred for personal purposes, and interest paid on tax deficiencies. An individual whose adjusted gross income exceeds a threshold amount is required to reduce the amount of allowable itemized deductions by 3 percent of the excess over the threshold amount. This amount is USD 145,950 for 2005, except that for married persons filing separately for whom the amount is USD 72,975. The reduction, however, may never be more than 80 percent of allowable deductions, excluding deductions for medical expenses; investment interest; and casualty, theft, or wagering losses. The limitation is applied after any disallowance of miscellaneous itemized deductions subject to the 2 percent floor has been taken into account.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

In lieu of the foregoing itemized deductions, an individual who has been a resident alien for the entire taxable year (or who has elected to be treated as a resident for the entire taxable year) may claim the flat standard deduction.

Personal Exemptions

In addition to the foregoing deductions, resident aliens may claim a personal exemption and exemptions for dependents according to the dependency rules for U.S. citizens. On a joint return, exemptions for both spouses are allowed. If a joint return is not filed, a spouse may be claimed as an exemption if the spouse had no gross income for U.S. tax purposes and was not a dependent of another taxpayer. The exemption may be claimed even if the spouse was not a resident alien for a full tax year or is an alien who has not come to the United States. In addition, an exemption can be claimed for each person who qualifies as a dependent according to the rules for U.S. citizens. To qualify as a dependent, an individual must be a citizen, national, or resident of the United States, or a resident of Canada or Mexico, at some time during the calendar year in which the year of the taxpayer begins. The dependent must also receive more than half of his or her support from the taxpayer and be either related to the taxpayer or a member of his or her household.

Each exemption is adjusted for inflation. The deduction for personal exemptions may be reduced or eliminated for high-income taxpayers whose adjusted gross income exceeds certain threshold amounts, based on filing status. The deduction for exemptions is reduced by 2 percent for each USD 2,500 (USD 1,250 for a married person filing separately) or fraction thereof by which adjusted gross income exceeds the threshold amount. See Appendix D for 2005 threshold amounts.

Rates and Filing Status

The United States has a graduated income tax rate structure; the income tax rates increase as taxable income rises, with a maximum tax rate of 35 percent. Tax rate schedules for 2005 are set forth in Appendix D.

The United States has six basic tax rate brackets applicable to individual taxpayers: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent. The phase-outs for high income taxpayers of personal exemptions and itemized deductions are additional adjustments apart from the tax rate structure.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

The tax liability of a resident alien is computed by first determining taxable income and then using the applicable tax rate schedule and subtracting allowable credits. Taxable income is gross income less deductions and exemptions. The United States has the following four basic tax rate schedules for individuals:

- Married individuals (and certain surviving spouses) filing joint returns;
- Heads of households;
- Single individuals; and
- Married individuals filing separate returns.

It is crucial to know which schedule should be used, since the tax burden increases from the first to the last listed schedule. Depending on their marital status, resident aliens use one of the rate schedules listed above. A resident alien may file a joint tax return only if both spouses were residents of the United States for the entire taxable year or if they both elect to be treated as resident aliens for the entire taxable year.

If married foreign citizens are not treated as residents for the entire taxable year, the couple cannot file a joint income tax return and generally must use the rates applicable to married individuals filing separate returns (usually the least desirable status).

The head-of-household rates are applicable to an unmarried alien who maintains as his or her home a household that constitutes the principal place of abode for a related dependent. In addition, a married resident alien may qualify for the head-of-household rates if he or she maintains a household for a relative other than his or her spouse (for example, for a child) if the spouse is a nonresident alien at any time during the year. The taxpayer, generally, cannot use the head-of-household rates if he or she is a nonresident alien at any time during the year.

Residency Election by Married Taxpayers

Two elections are available to married resident aliens enabling them to file a joint return and qualify for the preferential "married filing jointly" tax rates.

A nonresident alien who is married to an individual who is either a citizen or resident alien of the United States at year end may elect to be treated as a resident

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

for the entire tax year. Both spouses must make the election, which applies to the year made and all subsequent years until terminated. The election, however, will not cause foreign citizens to be treated as U.S. residents for any taxable year if neither spouse is a citizen or resident of the United States at any time during the taxable year.

If this election is made, a joint return may be filed, but the worldwide income of both spouses for the entire taxable year will be subject to tax. A foreign tax credit is available to offset the U.S. tax on foreign source income if foreign taxes were paid. Additionally, the standard deduction is permitted, according to case law.

The election is made by attaching a statement, signed by both spouses, to the joint return for the first year in which the election applies. While the election is normally made with the return, it can be made with an amended return.

The election is terminated by:

- Revocation by either spouse;
- Death of either spouse;
- Legal separation; or
- Inadequate record keeping (as determined by the Internal Revenue Service).

Once terminated for any of these reasons, neither spouse may make the election in a later year.

Planning Point:

1. Careful consideration of the available alternatives and their tax consequences must be undertaken before any election should be made. The election is usually beneficial if the tax savings from using joint tax rates and itemizing deductions is greater than the additional U.S. tax, net of the foreign tax credit, on income earned during the nonresidency period that otherwise would be exempt from U.S. taxation. Since the election also applies to subsequent years unless revoked, projected future income must also be considered.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

2. A similar election is available if an individual is a nonresident alien at the beginning of the taxable year but a resident of the United States at the end of the year and is married to an individual who is either a citizen or resident of the United States at year end. (See Chapter 4 for a discussion of this election).

Tax Credits

A credit against U.S. income tax liability for foreign income taxes paid by a resident alien is allowed, subject to limitations. Such credit is limited to the U.S. income tax on foreign source taxable income.

Limitations are computed separately for income in different categories, such as interest income subject to foreign withholding tax of at least 5 percent, certain passive income (for example, dividends, certain interest, rents, and so forth), and other income (compensation, etc.). The credit cannot be claimed if foreign income taxes are claimed as a deduction, but it may be claimed if the taxpayer claims the standard deduction in lieu of itemized deductions. Foreign income taxes that cannot be claimed as a credit due to the limitation may be carried back one year and carried forward 10 years to offset the U.S. income tax on foreign source taxable income for such years, subject to the limitations that apply to those years.

Additional credits are available, with limitations, for child and disabled dependent care expenses.

Alternative Minimum Tax

The United States also imposes an alternative minimum tax (AMT), which was devised to ensure that at least a minimum amount of income tax is paid by high-income taxpayers. The AMT functions as a recapture mechanism, reclaiming some of the tax breaks primarily available to high-income taxpayers, and represents an attempt to maintain tax equity.

The individual AMT rate is 26 percent, of the first USD 175,000 of alternative minimum taxable income in excess of the exemption, plus 28 percent on any excess. There is no surtax on AMT liability.

The exemptions are phased out for taxpayers with taxable income in excess of certain levels. See Appendix D for exemption amounts. The taxable base subject to the AMT is taxable income (before personal exemptions) increased by the following adjustments: the standard deduction (if any), certain medical expenses, certain

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

miscellaneous itemized deductions, certain taxes, investment interest expense, certain depreciation, certain research and experimental expenditures, passive activity losses, certain home mortgage interest, and various other deductions and losses. The taxable base is also increased by certain tax preference items, which include the following:

- Tax-exempt interest on certain non-governmental-purpose bonds;
- The bargain element on the exercise of incentive stock options;
- Accelerated depreciation or amortization on certain property;
- Excess intangible drilling costs;
- Depletion (excess of deduction over basis), and
- Gain on sale of qualified business stock.

The alternative minimum foreign tax credit may be used to reduce the AMT, subject to special limitation rules.

Minimum Tax Credit

A minimum tax credit (MTC) may be allowed for a taxable year in which regular tax is due and AMT was paid in prior years. The MTC is allowed only against the excess of the regular tax over the "tentative" minimum tax for the taxable year. The tentative minimum tax is 26 percent of alternative minimum taxable income over the exemption amount (28 percent to the extent that alternative minimum taxable income is greater than USD 175,000) reduced by the amount of foreign tax credit allowable against AMT.

The MTC is equal to the aggregate of the AMT paid in prior years over the AMT that would have been paid in each prior year had the AMT been computed on certain exclusion preference and adjustment items only, and the foreign tax credit limitation had not applied.

The MTC generally is reduced as it is offset against regular tax. Any excess MTC may be carried forward indefinitely as a credit against regular tax liability.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Community Property

In the case of a married couple, one or both of whom are nonresident aliens, who are domiciled in a country with community property laws, any community property income will be taxed as follows:

- Earned income is treated as the income of the spouse whose services produced the income, and all of it must be reported on that individual's separate return;
- Trade or business income is treated as income of the husband unless the wife exercises substantially all of the management and control over the business;
- Partnership income is treated as the income of the partner;
- Income from the separate property of one spouse is treated as the income of the spouse owning the property as determined by the community property laws;
- All other community income is treated as the income of the spouse who has a vested interest in the income under the community property laws.

These rules apply whether domestic or foreign community property laws are in effect. However, these rules are not relevant when a joint return is filed, since incomes of the spouses are combined.

Certain community property laws are disregarded if both spouses were nonresident aliens, or if one spouse is a nonresident alien and the other is a U.S. citizen or resident and they do not choose to be treated as U.S. residents. In these cases, each spouse cannot report one-half of the types of community income on separate returns. Instead, any community property income will be taxed as outlined above.

Taxable Year

A foreign citizen must use the calendar year as his or her U.S. taxable year unless another fiscal year had been established as the taxable year before the individual became subject to U.S. taxation as a resident or a nonresident. A calendar year is 12 consecutive months ending on December 31.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Imputed Income from Certain Foreign Corporations

A resident alien may be subject to current taxation on his or her share of some or all of the income of certain closely held foreign corporations, even though such income is undistributed. These corporations include controlled foreign corporations with tax haven (subpart F) income. A corporation generally is a controlled foreign corporation if more than 50 percent of its voting power or value is owned by U.S. persons (including resident aliens) that each own at least 10 percent of that voting power. Constructive ownership rules apply.

A foreign citizen who invests in a passive foreign investment company (PFIC) must pay an interest charge, in addition to the tax, on any gain derived from the disposition of the investment or on an excess distribution from the PFIC while he or she is a resident alien. Alternatively, the resident alien can elect to be taxed currently on his or her share of the annual earnings of a PFIC by treating the PFIC as a qualified electing fund. A foreign corporation generally is treated as a PFIC if at least 75 percent of its gross income consists of passive income or if at least 50 percent of its assets produce, or are held for the production of, passive income. Proposed IRS regulations would treat the termination of U.S. residency as a disposition of stock in a PFIC. Therefore, the individual would be subject to the interest charge in addition to the tax on the entire amount of gain recognized, not just gain attributable to residency years.

The information reporting requirements with respect to foreign corporations are discussed in Chapter 9.

Withholding on Certain Payments by Resident Alien Individuals

It may be necessary for U.S. resident aliens to withhold U.S. tax on certain payments to foreign persons. If a U.S. resident alien pays alimony to a nonresident alien, the alimony payments may be subject to withholding requirements, and the U.S. resident payor would be expected to act as the withholding agent. The same rule applies to certain mortgage interest payments made to a foreign lender by a resident alien. Any such payments would be subject to a 30-percent withholding tax (or a lower treaty rate). Treaty relief may be available to a foreign lender if the mortgage loan was not made by a U.S. branch (permanent establishment) of the foreign lender. Penalties could apply for noncompliance with the withholding requirements.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 3 -- Taxation of Nonresident Aliens

Gross Income

A nonresident alien is generally subject to U.S. tax on income from U.S. sources, with exceptions. This income is divided into two categories:

- Certain investment and other passive income: certain U.S. source income that is not effectively connected with a U.S. trade or business.
- Business income: income that is effectively connected with a U.S. trade or business, including compensation for services performed in the U.S.

Each category is taxed separately. U.S. source gross income that is not effectively connected with a U.S. trade or business (e.g., investment income) is taxed at a flat 30-percent rate or at a lower treaty rate. Gross income that is effectively connected with a U.S. trade or business, less allowable deductions, is taxed at the regular graduated rates that apply to U.S. citizens and resident aliens.

Certain items are excluded from the gross income of all individuals. These exclusions are discussed in Chapter 2 covering the taxation of resident aliens.

Income from U.S. Sources

Income treated as U.S. source generally includes the following:

- Interest paid by U.S. residents, with exceptions;
- Dividends paid by U.S. corporations, with exceptions;
- Compensation for personal services performed in the United States, including stock option income;
- Rents and royalties for property located or used in the United States;
- Gains from the disposition of U.S. real property interests;
- Income from the sale or exchange of personal property by an individual, including a nonresident alien, who has a tax home in the United States;
- Income from the sale or exchange of personal property, including inventory, through a U.S. office or fixed place of business of the seller, except for

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

inventory sold for use outside the United States if a foreign office of the seller materially participates in the sale;

- Alimony paid by U.S. residents; and
- U.S. Social Security benefits.

Certain Investments and Other Passive Income

Tax at 30 percent (or lower treaty rate) applies to certain U.S. source income that is not effectively connected with a U.S. trade or business. The tax applies to gross income, without deductions. Items of gross income subject to tax include the following:

- Dividends;
- Certain interest, including original issue discount;
- Rents and royalties;
- Alimony;
- Certain capital gains; and
- Half of U.S. Social Security benefits.

Certain investment income is exempt from U.S. taxation, including:

- Interest received on deposits with banks and certain other financial institutions.
- Interest received on certain portfolio obligations issued after July 18, 1984. Portfolio interest does not include interest received on debt when the recipient is a 10 percent or more shareholder of the payer.
- Original issue discount issued on a debt obligation that matures within 183 days of original issue.
- Certain capital gains (discussed below).

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Business Income

Income effectively connected with a U.S. trade or business is taxed at the regular graduated tax rates. This income generally includes:

- Compensation for personal services performed in the United States;
- Profits from the operation of a business in the United States;
- Income of a partner from a partnership engaged in a U.S. trade or business;
- Income from real property operated as a business;
- Income from real property held for investment if an election is made to treat the income as effectively connected with a U.S. trade or business;
- Income from the sale or certain other dispositions of U.S. real property interests;
- Income from the sale of certain business-related capital assets;
- Interest, dividends, and so forth, derived from assets or activities of a U.S. trade or business; and
- Foreign source income in limited circumstances.

Certain income of a foreign citizen for any taxable year, which is attributable to another taxable year, will be treated as effectively connected income if it would have been so treated if it had been taxable in that other taxable year. This income includes income that is attributable to the sale or exchange of property or the performance of services. Thus, deferring the recognition of income (for example, bonuses) until a later taxable year will not change the manner in which the income is taxed.

Certain compensation is exempt from U.S. taxation. Generally, if a nonresident alien is in the United States for 90 days or less during a year, performs services for a foreign employer that is not engaged in a U.S. trade or business, and earns USD 3,000 or less for such U.S. services, this compensation is not subject to U.S. tax. Many treaties provide more generous exemptions from U.S. tax for income earned by nonresident aliens during short periods in the United States of up to 183 days

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

during a taxable year. It should be noted that a direct charge-back of a foreign employee's compensation to a U.S. company could cause the loss of the treaty exemption.

Gross income of foreign exchange students, certain trainees, and other cultural-exchange visitors holding an F, J, or Q visa does not include compensation paid by a foreign employer (including an office or place of business maintained in a foreign country by a U.S. corporation, partnership, or citizen) for the period they are temporarily present in the United States. (See Chapter 1 for a description of F, J, and Q visas.) Nonresident aliens in the United States under certain business and other training programs may qualify for this exemption.

Trading in stock, securities, or commodities in the United States for one's own account, except in the case of a dealer, does not constitute engaging in a trade or business. The volume of such transactions does not have any bearing on whether the nonresident is engaged in a U.S. trade or business. For this reason, a foreign investor is free to invest in the United States and trade for his or her own account through a resident broker, even one with discretionary authority, without fear of being engaged in a trade or business in the United States.

In general, a nonresident alien is taxable on effectively connected income only from U.S. sources. However, certain income from sources outside the United States will be treated as effectively connected with the conduct of a U.S. trade or business when the nonresident alien has an office or other fixed place of business in the United States to which the income is attributable. The types of income are:

- Rents and royalties for the use of intangible property derived from the conduct of a licensing or similar business;
- Dividends, interest, or gains from stocks, bonds, or debt obligations derived in the active conduct of a banking, financing, or similar business; and
- Income from the sale of inventory property outside of the United States unless the property is sold for use outside of the United States and a foreign office of the taxpayer materially participates in the sale.

All other foreign source income is not taxable to a nonresident alien.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Partnership Income

If a domestic or foreign partnership is engaged in a U.S. trade or business, a nonresident alien partner will be taxed on his or her distributive share of the effectively connected income. The taxability of this income is the same regardless of whether the nonresident alien is a general or a limited partner.

The Internal Revenue Code generally requires a domestic or a foreign partnership that has income or losses effectively connected with a U.S. trade or business to withhold tax at the top individual tax rate on such income that is allocable to individual foreign partners. Certain interest, dividends, and other passive income of the partnership that is not effectively connected with a U.S. trade or business is subject to U.S. withholding tax at 30 percent or at a lower treaty rate.

Chapter 2 contains a discussion of limitations on the deduction of losses from passive activities. Such activities include losses from a trade or business in which the taxpayer does not materially participate.

Real Property Income

Nonresident aliens deriving income from U.S. real property held for investment (or from an interest in such property) may elect to treat such income as effectively connected with the conduct of a U.S. trade or business. This permits the nonresident alien to reduce gross income by deductions for depreciation, real estate taxes, interest charges, and other expenses, with the result that the U.S. income tax at the regular graduated rates is levied only on net income from these sources. If this election is made, it applies to all the nonresident alien's income from U.S. real property for the taxable year that is not otherwise effectively connected with the conduct of a U.S. trade or business. Such income includes rents and royalties from real property and natural resources. Capital gains from the sale of such property are subject to U.S. tax as effectively connected income whether or not the election is made. (The taxation of these gains is discussed later in this chapter.) Furthermore, this election applies to all subsequent taxable years until revoked, and revocation can occur only with the consent of the IRS. Once revoked, a new election may not be made for five years without the consent of the IRS. This election is available to all nonresident aliens, whether or not they are engaged in a trade or business in the United States during a taxable year for which the election is made. Similar annual elections are permitted by some treaties. Not included in the election are interest income on a debt obligation secured by a

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

mortgage of real property, any distributions by real estate investment trusts, income from real property (such as a personal residence) that is not held for the production of income, rental income from personal property, and royalties from intangible property.

Chapter 2 contains a discussion of limitations on the deduction of losses from passive activities, including rental activities.

Planning Point:

This election is usually beneficial since gross rents from investment real estate generally are taxed at 30 percent, with no deductions allowed. Gains from the subsequent sale of U.S. real estate will be taxable, regardless of whether the election is made.

Sale or Exchange of Capital Assets

A nonresident alien generally is not taxable on the sale or exchange of capital assets unless the capital assets are U.S. business assets or U.S. real property interests.

Gains from the sale or exchange of capital assets are exempt from U.S. taxation if the gains are foreign source. Gains from the sale of foreign real estate are foreign source. Sales of securities and other personal property generally are foreign source if sold by a nonresident alien who does not have a tax home in the United States. A nonresident alien has a tax home in the United States generally if his or her principal place of employment or business is in the United States. If a nonresident alien has a tax home in the United States, income from the sale of capital assets generally is U.S. source. However, capital gains from U.S. sources are exempt from tax if the nonresident alien is present in the United States for less than 183 days during the taxable year unless the gains are effectively connected with a U.S. trade or business or are treated as such (for example, gains from the sale of U.S. real property interests). If the nonresident is present in the United States for 183 days or more during the year, the excess of U.S. source gains over U.S. source losses is taxed at the 30 percent or lower treaty rate. All gains and losses from U.S. sources are taken into account for this purpose. Losses in excess of gains are not allowed. With limited exceptions, a foreign citizen who is present in the United States for 183 days or more during the taxable year will be a resident alien, not a nonresident. The limited exceptions are for certain foreign citizens who can be present in the

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

United States for longer periods as nonresident aliens, including certain diplomats, employees of international organizations (e.g., the United Nations), teachers, trainers, students, and professional athletes. Although a foreign citizen can be a nonresident alien present in the United States for 183 days or more during his or her first or last year of U.S. residency, he or she will not be subject to U.S. taxation on foreign source capital gains arising during the nonresidency period if he or she does not have a U.S. tax home during this period.

Gains and losses from the sale or exchange of capital assets connected with a U.S. trade or business are taxed under the rules that apply to citizens and residents.

Sale or Exchange of U.S. Real Property Interests

Gains and losses from the sale or other disposition of a U.S. real property interest (USRPI) by a nonresident alien are taxed as income effectively connected with a U.S. trade or business, even if the foreign citizen has never been in the United States. A USRPI is:

- Any interest in real property located in the United States or the U.S. Virgin Islands; or
- Any interest in any domestic corporation, unless the taxpayer establishes that such corporation was at no time a U.S. real property holding corporation during the preceding five-year period (or, if shorter, the period during which the taxpayer held the interest).

Generally, a domestic corporation will be considered a U.S. real property holding corporation if the fair market value of its USRPIs equals or exceeds 50 percent of the sum of its worldwide real property assets and any other assets used in its trade or business.

The following corporations, however, are not USRPIs:

- A domestic corporation that is no longer a USRPI because the corporation has disposed of all of its USRPIs in fully taxable transactions;
- A domestic corporation the shares of which are regularly traded on an established securities market, except for shareholders who own more than 5 percent of a class of regularly traded shares.;

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

- A domestically controlled real estate investment trust (REIT);
- A foreign corporation, unless it has elected to be taxed as a domestic corporation for purposes of taxation of gains on the sale or other disposition of USRPIs.

Dispositions that are taxable events are broadly defined and include the following:

- Sales, exchanges, distributions, tax-free exchanges, certain gifts, and so forth, of USRPIs;
- Sales of interests in partnerships, trusts, and estates that have USRPIs;
- Contributions to capital of a foreign corporation.

The following transactions, however, generally are not taxable since U.S. tax is only deferred and not avoided:

- A distribution of a USRPI by a foreign corporation in liquidation or otherwise if the distributee would be subject to U.S. tax on a subsequent disposition of the USRPI and there has been no tax-free increase in the tax basis of the USRPI;
- An exchange of a USRPI in a non-recognition transaction for another ownership interest if the subsequent sale of such interest would be subject to U.S. tax and there has been no tax-free increase in the tax basis of such ownership interest.

A minimum tax is imposed on nonresident aliens with a net gain from the disposition of USRPIs. The tax cannot be less than 26 percent (28 percent to the extent the net gain exceeds USD 175,000) of the lesser of:

- The individual's alternative minimum taxable income for the year; or
- The individual's net U.S. real property gain for the taxable year.

In general, the buyer (or other transferee of the property) is required to withhold 10 percent of the amount realized (net proceeds) on the disposition. For distributions by foreign corporations, withholding is required at a higher rate on the amount of the gain instead of on the amount realized. Similarly, higher withholding is required

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

on dispositions of USRPIs by domestic partnerships, estates, and trusts to the extent that gain is allocable to a foreign partner or beneficiary. No withholding, however, is required under the following circumstances:

- The transferor (for example, seller) furnishes an affidavit that he or she is not a foreign person;
- The disposition is of shares of a corporation that are regularly traded on an established securities market;
- The disposition is of shares of a domestic corporation that furnishes an affidavit that it has not been a U.S. real property holding corporation during the testing period;
- A personal residence is acquired by an individual for use as his or her residence and the amount realized does not exceed USD 300,000.

Reduced withholding can be achieved in appropriate circumstances upon application to the IRS. Early refunds of excessive withholding tax can also be obtained.

Deductions and Personal Exemptions

Generally, nonresident aliens are only entitled to deductions from income that is effectively connected with their U.S. trade or business. In addition, the following deductions may be claimed against effectively connected income:

- Certain casualty losses to property located in the United States; and
- Contributions to U.S. charities.

The IRS requires that foreign persons file tax returns within specified time periods in order to claim certain deductions. If a tax return for a taxable year is not filed by the last-chance deadline (generally within 16 months of the original due date), the IRS may compute the taxpayer's U.S. tax liability based on gross income, generally without the benefit of any deductions.

The standard deduction is not available to a nonresident alien. Furthermore, no deductions are allowed against income that is not effectively connected with a U.S. trade or business.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Nonresident aliens with higher incomes may not be able to deduct all of their itemized deductions; otherwise allowable itemized deductions will be reduced if an individual's adjusted gross income exceeds certain levels.

A nonresident engaged in a trade or business in the United States generally is allowed only one personal exemption unless he or she is a resident of Mexico, Canada, South Korea, or Japan, or is a national of the United States. (Under the U.S.-Japan income tax treaty that entered into force on March 30, 2004, this exemption is not available. However, certain taxpayers may elect to apply the old treaty in its entirety for an additional 12-month period from January 1, 2005). If a nonresident alien has adjusted gross income in excess of certain levels, the allowable exemptions will be phased out.

Rates and Filing Status

Income received during the tax year that is effectively connected with a U.S. trade or business is taxed, after the allowable deductions, at the same graduated rates that apply to U.S. citizens and residents. A nonresident alien is required to compute tax at single rates unless married, in which case rates applicable to married individuals filing separately must be used. A nonresident alien married to a U.S. citizen or resident may be able to elect to file a joint return with his or her spouse. (See Chapter 2 on the taxation of resident aliens.) The U.S. individual income tax rates for 2005 are set forth in Appendix D.

A nonresident alien who earns taxable U.S. source income that is not effectively connected with a U.S. trade or business is taxed at a flat 30-percent or lower treaty rate on such income. The tax is imposed on the gross amounts of income subject to tax, and deductions cannot be taken against this income. Withholding rates as of December 31, 2004, for dividends, interest, and royalties under income tax treaties are set forth in Appendix C.

Tax Credits

A nonresident alien is generally entitled to the same tax credits as U.S. citizens. (See Chapter 2.) A nonresident alien can claim a foreign tax credit for foreign taxes paid on foreign source income that is effectively connected with a U.S. trade or business.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Community Property

In the case of a married couple where one or both of whom are nonresident aliens, any community property income is taxed to the individual who earned it or under the foreign community property law. (See Chapter 2.)

Taxable Year

A foreign citizen must use the calendar year as his or her taxable year unless another fiscal year was established as the taxable year before the individual became subject to U.S. taxation as a resident or nonresident alien.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 4 -- Taxation of Dual-Status Aliens

A foreign citizen is a dual-status alien if in one taxable year he or she is both a resident alien and a nonresident alien. The most common dual-status taxable years are the year of arrival in the United States and the year of departure from the United States. In the year of arrival, an individual is a nonresident alien for the part of the taxable year before arrival. For the part of the year after arrival, the individual can be taxed as either a nonresident alien or a resident alien depending on the circumstances. Similarly, in the year of departure, a resident alien generally will continue to be treated as a resident alien until final departure from the United States. Generally, if the lawful permanent resident test is met, U.S. residency begins on the first day the alien is present in the United States as a lawful permanent resident with a valid green card and ceases on the day his or her lawful permanent status is officially terminated. If the substantial presence test is met, qualification as a U.S resident begins on the first day during the taxable year in which the individual is physically present in the United States and ceases on the last day of physical presence in the United States, provided that the individual has a closer connection to a foreign country than to the United States during that part of the year after departure, maintains a tax home in the foreign country for the remainder of the year, and is not a U.S. resident at any time during the next calendar year. Under certain circumstances, up to 10 days of U.S. presence may be disregarded in determining residency starting and ending dates. (For a further discussion of the residency starting and ending dates, see Chapter 1.)

The income of a dual-status alien is segregated into two categories, each of which is taxed separately. A foreign citizen is taxed at graduated rates on his or her worldwide income during the part of the year in which he or she is treated as a resident alien. Additionally, he or she is taxed generally on income only from U.S. sources during the part of the year in which he or she is a nonresident alien. U.S. source gross income that is not effectively connected with a U.S. trade or business (for example, certain U.S. source dividends and interest) is taxed at a flat 30-percent rate or at a lower treaty rate. Income that is effectively connected with a U.S. trade or business (for example, compensation for services performed in the United States) is combined with income from the residency period and taxed at graduated rates.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Income is generally taxable to individuals when received and not when earned or accrued. Thus, foreign source income (for example, compensation for services performed abroad) is not subject to U.S. tax if earned and received before a foreign citizen becomes a U.S. resident. However, this foreign source income would be subject to U.S. tax if received after an individual becomes a resident alien, even though earned when the individual was a nonresident alien. Similarly, foreign source income is generally exempt from U.S. tax if earned and received after a foreign citizen has departed from the United States and becomes a nonresident alien. This income would be taxable in the United States if received while the individual was still a resident alien.

U.S. source income that a departing foreign citizen receives after becoming a nonresident alien is generally taxed at 30 percent or lower treaty rate. However, certain deferred income, such as deferred compensation for services performed in the United States, will be taxed at the regular graduated tax rates regardless of when received.

An individual is treated as receiving income when he or she actually or constructively receives it. For example, if a foreign citizen is entitled to receive a check for income while a resident alien, he or she has constructively received it. The income would be subject to U.S. tax even if the actual receipt and cashing of the check is deferred until the individual has departed the United States.

Full-Year Residency Election

An election to be taxed as a resident alien for the entire taxable year may be made by an individual who is a nonresident alien at the beginning of the year and a resident alien at the end of the year and who is married to an individual who is either a citizen or resident of the United States at year end. Thus, this election can be made by a foreign married couple who arrive in the United States during the taxable year and who are resident aliens at year end.

The principal reason for making the full-year residency election is to be eligible to file a joint U.S. tax return. A joint return cannot be filed if either the husband or the wife, at any time during the taxable year, is a nonresident alien. The election removes the nonresident alien status for filing purposes.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

If the full-year residency election is made, a joint return may be filed to use the lower joint tax rates, but the worldwide income of both spouses for the entire taxable year will be subject to U.S. tax. The foreign tax credit can offset the U.S. tax on foreign source income, subject to the foreign tax credit limitation rules.

Planning Points:

1. The benefits and detriments of making the residency election must be carefully evaluated. The election is usually beneficial if the tax benefit from using joint tax rates and itemizing deductions for the full year is greater than the additional U.S. tax, net of the foreign tax credit, on income earned during the non-residency period that otherwise would not be subject to U.S. taxation. The date of arrival in the United States will bear heavily on the election decision because compensation earned after arrival will be subject to U.S. tax regardless of whether the individual is a resident or nonresident alien. Therefore, a foreign citizen who arrives early in the year may not be subjecting a large amount of additional income to U.S. taxation by making the election.

The election is made by attaching a statement signed by both spouses to the joint return for the taxable year to which the election applies. The election applies only to this one year. Moreover, the two spouses are ineligible to make another such election in any later year.

See Chapter 2 for a similar election that is available to a U.S. citizen or resident who is married to a nonresident alien at year end.

2. If a foreign couple is eligible to make either full-year residency election, it may be more beneficial to make the election discussed in Chapter 2 since that election applies for subsequent years unless terminated or suspended. As a result, the foreign couple would be considered full-year U.S. residents in the year of departure from the United States and may be able to file a joint U.S. return for that year.

It is important to note that foreign citizens who are not resident aliens at year end are ineligible to make this election to be taxed as full-year residents. Therefore, foreign individuals who are not resident aliens at year end generally cannot file a joint return in the year of arrival. However, they may file a joint return if they make the first-year residency election, discussed below.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

First-Year Residency Election

A qualifying foreign citizen may elect to be treated as a resident alien for a calendar year in which the individual is not otherwise treated as a U.S. resident because he or she does not meet either the lawful permanent resident test or the substantial presence test.

A qualifying alien individual is one who:

- Was not a resident alien during the preceding year;
- Meets the requirements of the substantial presence test for residency in the following calendar year;
- Is present in the United States for at least 31 consecutive days during the election year;
- Is present in the United States during the period beginning with the first day of such 31-day period and ending with the last day of the election year (for example, December 31) for a number of days equal to or exceeding 75 percent of the number of days in such period. In applying this 75-percent test, an individual may treat up to five days of absence from the United States as days of presence in the United States.

A foreign citizen who makes the first-year election will be treated as a U.S. resident only for that portion of the year that begins on the first day of the earliest-presence period for which the individual can satisfy both the 31- day and the 75-percent tests. For purposes of these tests, an individual will not be treated as present in the United States on any days in which the foreign citizen is an exempt individual for purposes of the substantial presence test (for example, diplomats, certain students and teachers). The first-year election allows the taxpayer to claim the spousal exemption and greater itemized deductions. Additionally, foreign tax credits and foreign losses incurred during the residency period are allowed. However, foreign income earned during residency is subject to tax.

A qualifying alien must make the election on his or her tax return for the election year. However, the election may not be made before the individual has actually met the substantial presence test for the following year. Once made, the election cannot be revoked without the consent of the IRS.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

A qualifying alien is also allowed to make the residency election for his or her dependent children. This may allow the dependency exemption for nonresident dependent children who would not otherwise qualify. This first-year residency election may be made for dependent children on the parents' tax return for the election year. It is not necessary to file a separate tax return for each dependent child in order to make a valid election.

Example

A foreign citizen vacations in the United States from January 1 through January 31, 2005. She returns to the United States on October 15, 2005, and begins working for a U.S. company on a three-year assignment. For the remainder of 2005, she is absent from the United States for 10 days (from December 20 through December 29). She satisfies the substantial presence test as a resident alien for 2006. She was not a resident alien in 2004. The individual may make a first-year election to be taxed as a resident alien starting on October 15, 2005. The January presence is not included since the 75-percent test is not satisfied for the period beginning January 1.

Planning Point:

A foreign citizen may make the full-year residency election in conjunction with the first-year residency election. As a result, a married foreign citizen and his or her spouse may file a joint return for the year of arrival in the United States even if they are not treated as resident aliens under the lawful permanent resident or substantial presence tests. Furthermore, the electing foreign national may make the residency election for his or her dependent children on the same tax return.

Moving Expenses

Reimbursed moving expenses of an employee are excluded from gross income. The definition of what constitutes "moving expenses" incurred in connection with moving to a new location for employment-related reasons is limited to the costs of moving household goods and personal effects to the new residence, and travel and lodging costs during the move. The definition of "moving expenses" does not include:

- Meal expenses;

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

- Expenses incurred while searching for a new home after obtaining employment;
- The costs of selling the old residence (or settling a lease) or purchasing (or acquiring a lease on) a new home; or
- Temporary lodging after obtaining employment.

Also, moving expense reimbursements are only excludable provided:

- The taxpayer's new job location is at least 50 miles farther from the taxpayer's old residence than the old residence was from the former place of employment; and
- The taxpayer is a full-time employee at the new location for at least 39 weeks during the 12-month period following the move. If the taxpayer is self-employed, he or she must work full time at the new location for at least 39 weeks during the first 12 months and a total of at least 78 weeks during the first 24 months right after the move.

Moving expense reimbursements are excluded from income (unless the taxpayer previously deducted them), and unreimbursed moving expenses are a deduction in computing adjusted gross income rather than an itemized deduction. Reimbursed moving expenses are not deductible.

A nonresident alien may generally deduct moving expenses incurred only on a move to the United States.

Deductions and Personal Exemptions

A dual-status alien may take itemized deductions in computing taxable income related to the period during which he or she is taxed as a resident alien. According to the IRS, he or she may not use the standard deduction that other taxpayers may generally elect in lieu of itemizing deductions. However, at least one court decision allows a dual-status alien to claim the standard deduction against income earned during the residency period (Nico v. Commissioner, 67 T.C. 647 (1977)).

A dual-status alien is entitled to personal exemptions for himself or herself, his or her spouse, and dependents in computing taxable income for the residency part of the taxable year. The deduction for these exemptions, however, is generally limited

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

to taxable income before exemptions for the part of the year that the foreign citizen is a resident alien.

Tax Rates and Filing Status

An unmarried dual-status alien must use the tax rates for single taxpayers in computing his or her tax at graduated rates. He or she may not file as head of household.

A married dual-status alien must generally use the tax rates applicable to married taxpayers filing separately. However, he or she may use the joint rates if the individual and his or her spouse elect to be taxed as full-year residents.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 5 -- Planning for a Transfer

Timing the Transfer

A foreign citizen cannot generally file a joint tax return with his or her spouse unless both spouses have been residents of the United States for the entire taxable year. Since the "married filing jointly" tax rates are usually more beneficial than the "married filing separately" rates, it may be advantageous for a married foreign citizen who moves to the United States to elect to file a joint return with his or her spouse for the year of arrival. In order to make this joint return election, however, the individual must be a citizen or resident of the United States at the end of the taxable year. Accordingly, if the foreign citizen wants to make this election, he or she must time the move to the United States in order to qualify as a resident under the lawful permanent resident or substantial presence tests for the year of the move, or to qualify to make the first-year residency election. (See Chapter 4.)

A foreign married couple generally cannot file a joint U.S. tax return if either the husband or the wife is a nonresident alien at the end of the taxable year. Accordingly, married resident aliens should consider postponing departures planned for late in the year until early in the subsequent year. Alternatively, resident aliens can avoid terminating their U.S. residency by avoiding the creation of a closer connection to a foreign country than to the United States after departure from the United States. Moreover, a full-year residency election as discussed in Chapter 2 made for a prior year (or the current year if either the husband or wife is a U.S. resident at year end) may enable the couple to file a joint U.S. return for the year of departure from the United States.

Proper timing of the arrival or departure can also provide a foreign citizen the benefit of the lower-bracket U.S. tax rates. Thus, arrival in the United States late in a year or departure early in a year may minimize the effective U.S. tax on income earned in these transition years.

Timing of Receipt of Income

Income is generally taxable to individuals when received and not when earned or accrued. It may be beneficial for a foreign citizen to receive foreign source income earned while a nonresident before he or she becomes a resident alien so that such income will be exempt from U.S. tax. However, the timing of the receipt of income has implications for the non-U.S. tax treatment of such income – this also needs to

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

be considered. For example, it may be better to receive income during the U.S. residency period if the U.S. tax on such income would be less than the foreign tax would be if received while a foreign resident.

Foreign citizens receiving bonuses and other compensation after leaving the United States, may be taxed at lower tax rates. Proper planning is required to ensure the deferral of taxation and to avoid earlier taxation of income constructively received.

Timing of the Payment of Deductible Expenses

A foreign citizen should consider deferring the payment of certain expenses (for example, certain interest) until after becoming a resident alien. This action will be beneficial if the expenses are deductible for U.S. tax purposes but not deductible for non-U.S. tax purposes.

Sale of a Principal Residence

A taxpayer may exclude USD 250,000 (USD 500,000 if married filing jointly) of gain immediately upon the sale of a principal residence in a qualifying transaction.

To qualify for the exclusion, the following requirements must generally be met:

1. The taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange.

2. During the two-year period ending on the date of the sale, the taxpayer did not exclude gain from the sale of another home.

However, in certain cases, a partial exclusion may be available even though one or neither of the "two-year tests" are met.

An individual who fails to meet either the “one sale every two years” rule or the “two out of five year ownership and use” requirement may qualify for a reduced exclusion, if the primary reason the individual sold the home was because of a change of place of employment, health, or unforeseen circumstances.

Meeting one of the three above criteria qualifies the individual for a prorated exclusion. The individual must still meet the "two year" requirements for some lesser period of time within the last five years. The period of time the requirements were met determines the amount of the allowable exclusion.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

The law requires that the amount to be prorated is the USD 250,000 limitation (USD 500,000 if married filing jointly), even if the gain realized on the sale of the principal residence is less than the limitation amount.

The law provides that gain will be recognized to the extent of any depreciation allowable with respect to the rental or business use of the residence after May 6, 1997.

Comment

Nonresident alien taxpayers are not precluded from claiming the exclusion. However, nonresident aliens permanently leaving the U.S. who wish to qualify for the exclusion on a U.S. home should be advised to sell their home soon enough after departure to satisfy the occupancy requirement (i.e., two out of five years).

Nevertheless, departing foreign citizens who are married may need to sell their U.S. residences, while full-year U.S. residents since the full USD 500,000 exclusion is available only to taxpayers who file joint returns. U.S. nonresidents or dual status taxpayers may not file joint returns. However, if a husband and wife own the principal residence jointly, each may be able to qualify for his or her own USD 250,000 exclusion.

There is no requirement that the residence be located in the U.S.

The exclusion, however, does not apply to the gain on the repayment of a foreign currency denominated mortgage and this will continue to be problematic.

Gain from the sale or exchange of a principal residence within five years of its acquisition in a like-kind exchange does not qualify for the exclusion.

The exclusion does not apply to expatriators (i.e., former U.S. citizens and certain former resident aliens who have green cards and who are subject to the expatriation rules). A qualifying sale under the exclusion occurring within five years of an individual's expatriation would not be captured under the expatriation lookback rules because it is not an exchange of property.

Sale of Other Capital Assets

A nonresident alien who is not present in the United States for at least 183 days during a taxable year is not subject to U.S. tax on capital gains (except for the gains

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

on the sale of U.S. real property interests ('USRPIs') or gains that are effectively connected with a U.S. trade or business). Accordingly, it may be possible for a foreign citizen to avoid both U.S. and foreign tax on capital gains if properly timed. If the individual has moved to the United States, he or she may no longer be subject to tax in the country of his or her former foreign residence. At the same time, he or she may not be subject to U.S. tax on the capital gain if he or she is treated as a nonresident alien and is present in the United States for less than 183 days during the taxable year. (See Chapter 3.)

With appropriate planning, a foreign citizen may be able to avoid U.S. taxation on some or all of the gain from an installment sale of certain assets. Proceeds, other than interest, received by a resident alien generally are not subject to U.S. tax if an installment sale of capital assets (other than USRPIs) was made while the individual was a nonresident alien. Moreover, proceeds received by a nonresident alien from an installment sale of assets (other than USRPIs or assets effectively connected with a U.S. trade or business) generally are not subject to U.S. tax even if the installment sale was made while the individual was a resident alien.

Pre-residency Appreciation of Capital Assets

In determining the U.S. tax basis of assets acquired by a foreign citizen, historical cost is used (as in the case of a U.S. citizen). If the historical cost is denominated in a foreign currency, the equivalent U.S. dollar amount is determined by using the foreign exchange rate at the time the asset was purchased. The full gain on the sale of an asset by a resident alien is thus subject to U.S. tax, including appreciation that occurred before the foreign citizen became a U.S. resident. If the asset sold is part of a qualified business unit, the gain or loss may be computed in the foreign functional currency and translated into U.S. dollars, thereby potentially minimizing the effect of foreign currency fluctuations. Certain foreign securities brokerage accounts and foreign rental properties can qualify as a qualified business unit. Accordingly, before establishing U.S. residence, a foreign individual should consider selling appreciated assets and reinvesting the proceeds in new assets that would have a higher basis. The home country's tax rules should be considered; however, in many countries, gains on the sale of capital assets are not taxable. In contrast, if the assets have depreciated, it may be beneficial to dispose of the assets after establishing residence in the United States to obtain the benefit of the loss for U.S. purposes.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Foreign Corporations

Resident aliens who own shares of certain foreign corporations may be taxed currently on their share of the corporate income even though undistributed. Moreover, resident aliens may have to file information returns on these corporations. (See Chapter 9). To avoid these situations, foreign citizens should consider reducing or eliminating their ownership in these types of foreign corporations before moving to the United States.

The relevant foreign corporations include controlled foreign corporations with tax haven (subpart F) income and certain passive foreign investment companies. Foreign citizens with investments in foreign corporations should consult a U.S. tax adviser before moving to the United States.

Exercise of Stock Options

Foreign citizens who have stock options should consider exercising the options before becoming U.S. residents. Exercise of the stock options after establishing residency may result in U.S. tax on the full spread even though most or all of the gain may have accrued while the individual was a nonresident alien. An election may be available to recognize income on transfers of property in connection with the performance of services (for example, restricted stock).

Deduction for Travel Expenses

A foreign citizen who is in the United States on business for a limited period of time may be considered temporarily away from home. If so, he or she can deduct the cost of meals, lodging, and other travel expenses while present in the United States. However, business travel expenses are not deductible for assignments that will last more than one year in a single location. Accordingly, it may be beneficial to limit the length of an assignment in order to be able to deduct travel expenses.

Employer reimbursements of travel expenses, including direct payment of these expenses by the employer, generally are includible in taxable income as compensation. The employee can deduct travel expenses as miscellaneous itemized deductions on his or her tax return. Travel expenses may not be fully deductible since miscellaneous itemized deductions are deductible only to the extent that, in total, they exceed 2 percent of adjusted gross income. However, if the employee accounts to his or her employer for fully deductible travel expenses and receives an exact reimbursement under a reimbursement or other expense

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

allowance arrangement with the employer, the employee may exclude both the reimbursement and the expenses in computing his or her taxable income. An arrangement is not a "reimbursement or other expense allowance arrangement" unless it requires the employee to substantiate expenses covered by the arrangement and denies the employee the right to retain amounts in excess of the substantiated expenses.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 6 -- Tax Treaty Benefits

Applying Treaties

Nonresident aliens from countries with which the United States has an income tax treaty may qualify for certain benefits if they meet treaty requirements. Most treaty provisions require that the alien be a resident of the treaty country to qualify. However, some treaty provisions require that the alien be a national or citizen of the treaty country. Generally, most treaties provide a lower rate of withholding tax on certain income, including dividends, interest, and royalties. Withholding tax rates under treaties as of December 31, 2004, for dividends, interest, and royalties are set forth in Appendix C.

Many tax treaties provide that a treaty-country resident will not be taxed on compensation for services rendered in the United States if he or she is present in the United States for a short period of time (generally not more than 183 days during a taxable year or twelve month period) and is paid by and is rendering services for a foreign employer, provided that the employee's remuneration is not borne by a U.S. permanent establishment (for example, a U.S. branch) of the foreign employer. The treaties may also require that the compensation be less than a specified amount.

Other types of income received by nonresident aliens that may be exempt under such treaties are: (1) remuneration of professors and teachers who teach in the United States for a limited period of time; (2) amounts received from abroad for the maintenance, education, and training of foreign students and business apprentices who are in the United States for study or experience; (3) wages, salaries, and pensions received by an alien from employment with a foreign government while he or she is in the United States; and (4) certain capital gains from the sale or exchange of certain capital assets by nonresident aliens under certain conditions.

A foreign citizen may be able to invoke a treaty between the United States and a foreign country if he or she is treated as a resident of both the United States and the foreign country under the domestic laws of the two countries. If the treaty contains a residency tie-breaker provision, the determination of residency under the treaty will override determinations under the domestic laws of the two countries. Treaty tie-breaker provisions base the residency determination on such factors as the location of a permanent home or the location of the individual's economic and personal relations. If a foreign national determines his or her U.S. tax liability as if

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

he or she were a nonresident alien pursuant to the tie-breaker provision in a treaty, he or she must timely file a U.S. tax return as a nonresident alien and attach a statement disclosing the facts relied upon to support the position. A foreign citizen who has a U.S. green card but wants to invoke the tie-breaker provisions of a treaty to be treated as a nonresident alien for U.S. tax purposes should consider consulting a U.S. immigration attorney with respect to the impact of the treaty election on his or her U.S. immigration status. IRS regulations indicate that a foreign national who elects to be treated as a nonresident under a tie-breaker provision in a treaty may affect the determination by the USCIS and State Department as to whether the individual qualifies to maintain a permanent residency visa (green card). Moreover, a foreign citizen with a green card may subject himself/herself to the U.S. expatriation rules invoking a treaty tie-breaker provision so as to be treated as a nonresident alien for U.S. tax purposes.

Resident aliens generally can invoke tax treaties between the United States and foreign countries to reduce foreign taxation in the same manner as available to U.S. citizens. Resident aliens, however, generally cannot invoke tax treaties to reduce U.S. taxation since such treaties generally allow the United States to tax its citizens and residents as though the tax treaty did not exist. An exception exists if there is a treaty between the United States and the foreign individual's country of citizenship, and such treaty contains a non-discrimination clause which prohibits the United States from subjecting citizens of the treaty country to more burdensome taxation than it subjects U.S. citizens in like circumstances.

The treaty rules will prevail only for tax situations within the scope of the treaty. Thus, income tax treaties do not affect U.S. social security taxation, estate and gift taxation, and state income taxation for states that have not adopted federal rules as the starting point for state taxation.

In addition to income tax treaties, the United States has a number of gift and estate tax treaties in effect with foreign countries.

The United States has also concluded social security totalization agreements with several foreign countries. The purpose of these agreements is to prevent the duplication of social security taxes and to provide retirement and other benefits based on the combined work time of eligible workers in both the United States and the foreign country. (See the section on social security taxes in Chapter 8.)

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Foreign citizens generally need not invoke a treaty if it would be more beneficial to be taxed under the rules of U.S. domestic law.

The IRS requires a taxpayer who takes a tax return position in which a U.S. treaty overrules, or otherwise modifies, an Internal Revenue law to disclose that position by attaching Form 8833 to the individual's tax return. Substantial penalties are imposed for noncompliance. Generally, disclosure is required if the individual's tax liability would have been different if the relevant treaty position did not exist.

Disclosure of a treaty-based return position is required in the following situations:

- The residency of an individual is determined under a treaty and apart from the Internal Revenue Code if the amount of income reportable under the disclosure rules exceeds USD 100,000;
- The non-discrimination provision of a treaty precludes the application of any otherwise applicable Internal Revenue law;
- The treaty reduces or modifies the taxation of gain or loss from the disposition of a U.S. real property interest;
- The treaty alters the source of any item of income or deduction; or
- The treaty grants a credit for a specific foreign tax for which a foreign tax credit would not be allowed by the Internal Revenue Code (I.R.C.).

Individuals required to file a return using Form 1040 or 1040NR must attach the necessary statements to their return for the taxable year for which the statement is relevant. Individuals who are not required to file either Form 1040 or 1040NR must complete the necessary statement and submit it to the IRS on or before the date prescribed by law (including extensions) for filing an income tax return as a nonresident for the calendar year for which the statement applies.

Certain treaty positions are specifically exempted from the reporting requirements. These include the following:

- The residency of an individual is determined under a treaty and apart from the I.R.C. if the amount of income reportable under the disclosure rules does not exceed USD 100,000;

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

- A reduced rate of withholding tax is determined under a treaty on interest, dividends, rent, royalties, or other fixed or determinable annual or periodic income ordinarily subject to the 30-percent rate;
- A treaty reduces or modifies the taxation of income derived from dependent personal services, pensions, annuities, social security and other public pensions, or income derived by artists, athletes, students, trainees, or teachers;
- A social security totalization agreement reduces or modifies the taxation of income derived by the taxpayer; or
- The income of an individual is resourced under a treaty provision relating to elimination of double taxation.

Expatriation

An individual who relinquishes U.S. citizenship or ceases to be a long-term resident is subject to tax on an expanded definition of U.S. source income at graduated rates applicable to U.S. citizens, rather than rates applicable to other nonresidents, for a 10-year period after expatriation, if higher tax results.

In general, a "long-term resident" is a foreign citizen who had been a lawful permanent resident of the United States (*i.e.*, a green card holder) "in" at least eight of the 15 taxable years ending with the year of the expatriation. For the purpose of these rules, "expatriation" means ceasing to be a lawful permanent U.S. resident or commencing to be treated as a resident of a foreign country under a treaty residence rule.

The expatriation provisions apply to any U.S. citizen or long-term resident who expatriates after June 3, 2004, and:

- Whose average annual net income tax liability over the five years ending before expatriation is greater than USD 124,000 (indexed for inflation, for 2005 the amount is USD 127,000);
- Whose net worth is USD 2 million or more; or

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

- Who fails to certify compliance with the U.S. tax laws for the five preceding tax years or who fails to submit such evidence of compliance as the IRS requires.

Individuals expatriating before June 4, 2004, should contact their U.S. tax advisor regarding the applicable law.

Tax treaties conflicting with these rules are expressly overridden. Stringent reporting requirements are also imposed. To partially offset some or all of the additional tax imposed, special foreign tax credits may be available.

Due to the complexity of this area of the law, it is strongly recommended that professional advice be sought before an individual revokes U.S. citizenship or revokes his or her green card, to avoid or mitigate the many pitfalls and to take advantage of planning opportunities. Immigration counsel should be consulted as there are non-tax issues which need to be considered as well.

Foreign Trust/Gift Reporting Requirements

The language of the statute requires reporting gifts received from foreign sources if in any year the aggregate value of foreign gifts received exceeds USD 12,375 (for 2005).

Beneficiaries or settlors of foreign trusts potentially have reporting requirements concerning certain transfers, distributions, and provisions of an annual statement of the foreign trust's assets and income. Due to the complexity of this issue, it is strongly recommended that professional advice be sought concerning any reporting aspects of foreign trusts and foreign gifts.

A foreign trust for these purposes is defined as any trust where a court within the U.S. is not able to exercise primary supervision over the administration of the trust or no U.S. persons have the authority to control all substantial decisions of the trust. This is a very complex area and, therefore, professional advice should be sought where the creation of a trust is being considered or where trusts already exist and the foreign national is due to begin an assignment to the United States.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 7 -- Payment of Tax

Withholding of Taxes

Employers are generally required to withhold federal income tax from an employee's compensation and to pay the withheld tax to the government. The employee then claims the withheld tax as a credit on his or her federal income tax return. The employer must provide the employee with Form W-2, which shows the compensation paid and tax withheld during the calendar year.

Resident aliens generally are subject to withholding on compensation in the same manner as U.S. citizens. Compensation paid to nonresident aliens for services performed in the United States is subject to the same rules, unless the compensation is exempt by treaty.

Additionally, employers may be required to withhold other taxes, including U.S. social security tax and state income tax.

Compensation paid to nonresident aliens for independent personal services and dividends, interest, and certain other passive income are generally subject to U.S. withholding tax at 30 percent if such items are from U.S. sources.

Estimated Tax

To provide for current payment of income taxes not collected through withholding, the law generally requires that an individual pay an estimated tax if the total amount of taxes withheld from wages during the year will not be sufficient to avoid penalties for the underpayment of estimated tax.

The required installment payments of estimated tax are reduced by amounts withheld from wages during the current year. However, no penalty for underpayment of estimated tax is imposed if the tax for the year, less tax withheld from wages, is less than USD 1,000.

For a calendar-year taxpayer, the estimated tax installment payments generally must be made by April 15, June 15, September 15 of the current year, and January 15 of the following year.

Nonresident aliens who are not employees with wages subject to U.S. withholding are allowed to make their estimated tax payments by June 15 and September 15 of

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

the current year, and January 15 of the following year. In such a case, 50 percent of the annual requirement must be paid with the June 15 installment.

Individuals with adjusted gross income (AGI) of more than USD 150,000 (USD 75,000 for married individuals filing separately) in the preceding taxable year can, as a safe harbor, base their estimated tax payments on 110 percent of their preceding year's tax liability. Individuals with a preceding-year AGI of USD 150,000 or less can use a safe harbor of the lesser of 100 percent of the prior year's tax liability or 90 percent of the current year's liability, using actual or annualized tax liability.

Penalties and Interest

If income tax is not paid when due, a taxpayer is subject to a penalty of generally one-half of 1 percent of the tax not paid for each month (or part of a month) it remains unpaid, up to a maximum of 25 percent of the unpaid amount. In addition, interest on taxes not paid by their due date, compounded daily, is assessed at a rate that is adjusted quarterly based on the average market yield on short-term U.S. Treasury obligations plus 3 percentage points.

If a taxpayer fails to file an income tax return, he or she is usually subject to a penalty of 5 percent of the tax due but not paid for each month (or portion of a month) that the return is late. The penalty cannot exceed 25 percent of the tax due and is generally decreased by the penalty for failure to pay tax for any month in which both penalties apply. If the tax return is filed more than 60 days after the due date, including extensions, the minimum penalty is USD 100 or the amount of any tax owed, whichever is smaller.

These penalties can be abated if the taxpayer can show that the failure to file the return or pay the tax on time was due to reasonable cause and not willful neglect.

Individuals who are required to make estimated tax payments, but who underpay the amount due, are subject to a penalty at a rate that is equal to the short-term federal rate plus 3 percentage points.

Other penalties apply to the failure to file returns or pay tax in specific circumstances.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 8 -- Other Taxes

Social Security Tax

The U.S. social security system provides a wide array of benefits to eligible individuals. The system provides old age and disability benefits to workers, benefits to dependents and survivors of retired and disabled workers, and medical benefits to the elderly. In addition, unemployment insurance is provided by the states to compensate workers for loss of income during periods of unemployment. Workers' compensation programs provide payments for employment-related injuries or death and are generally funded through insurance maintained by employers.

There are no citizenship or residency requirements imposed for an individual to receive social security retirement, survivor, or dependency benefits. However, benefits paid to an alien, or a dependent or survivor of a covered employee, will be suspended when the alien has been outside the United States for six consecutive months except where the relationship upon which the benefit is based lasted at least five years.

The social security tax is imposed on employers and employees under the Federal Insurance Contribution Act (FICA). The FICA tax is based on wages with respect to employment, generally including all remuneration from employment. Remuneration in excess of an annually adjusted earnings ceiling and certain non-cash and indirect payments are excluded from the definition of wages. Employment means services of any type performed by an employee for his or her employer regardless of the citizenship of either, performed within the United States, performed on an American-registered vessel under specified circumstances, or performed outside the United States by a U.S. citizen as an employee of a U.S. employer. Some exceptions to the definition of employment are provided. The FICA tax is imposed at the same rate on both the employee and the employer. As of December 31, 2004, the combined rate is 7.65 percent, which consists of 6.2 percent for old-age, survivors, and disability insurance (OASDI), and 1.45 percent for hospital insurance (Medicare). The OASDI rate of 6.2 percent applies to wages within the OASDI wage base, which is USD 90,000 for 2005. However, employees and employers are subject to the 1.45 percent tax on all wages. The employer is required to collect the employee's portion of the tax by means of a payroll deduction and to remit this amount along with the employer's portion of the tax to the government.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

The social security tax is imposed on self-employed individuals under the Self Employment Contribution Act (SECA). This self-employment tax is imposed on the self-employment income of self-employed individuals if such earnings exceed USD 400 for the taxable year. Earnings subject to the tax are limited by the same annual earnings ceiling that limits the FICA tax. The self-employment tax is not imposed on nonresident aliens. This tax is paid as an addition to the income tax. Net earnings from self-employment include gross income derived from a trade or business, less trade or business expenses (excluding the net operating loss deduction), plus the individual's distributive share of income or loss from a business carried on as a partnership. Certain items are specifically excluded from self-employment income: interest, dividends, capital gains, and rentals (and associated deductions) from real property and personal property leased with real estate unless they are received by the individual in the course of his or her business as a real estate dealer. For 2005, the rate of self-employment tax is 15.3 percent on net earnings of up to the base amount of USD 90,000, with an additional 2.9 percent on earnings which are more than the base. A self-employed person may deduct one-half of his or her self-employment tax for the year as a business expense in arriving at adjusted gross income.

The United States has entered into international social security agreements (totalization agreements) with Australia, Austria, Belgium, Canada, Chile, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, South Korea, Spain, Sweden, Switzerland, and the United Kingdom. The agreements provide relief from double social security taxation. Thus, only one country, not both, will impose its social security tax, eliminating double social security taxation where an individual would otherwise be subject to tax under both systems. Generally, under these agreements, an individual will be subject to social security taxes in the country in which the individual is working.

However, if the individual is temporarily sent to work in another country, and his or her pay would normally be subject to social security taxes in both countries, the totalization agreement may provide that the individual can remain covered only by the social security system of the country from which he or she was sent. To establish that an individual's compensation is subject only to foreign social security taxes and is exempt from U.S. social security taxes (including the Medicare tax) as a result of a totalization agreement, the individual or his or her employer should

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

request a statement (certificate of coverage) from the appropriate agency of the foreign country.

The agreements also provide for totalized benefits where coverage under both systems is combined, so that an individual could qualify for benefits under one or both systems. Under U.S. law, an alien may not elect totalized U.S. benefits unless the alien has six quarters of actual coverage under the U.S. social security system. U.S. totalization agreements do not apply to Medicare benefits. U.S. citizens or residents are prohibited from taking a credit or deduction for foreign social security taxes paid if a totalization agreement is in effect with that particular foreign country.

The United States has signed an agreement with Japan and Mexico, however, the agreements are not expected to enter into force until late 2005.

Estate and Gift Taxation

The United States has a unified gift and estate tax system that applies to taxable gifts of property made by an individual during life and taxable bequests made at death. In addition, some states impose an estate tax or inheritance tax upon the death of an individual.

One system of estate and gift taxation applies to U.S. citizens and to foreign citizens domiciled in the United States. A separate system applies to foreign citizens who are not domiciled in the United States. An individual is domiciled in the United States if he or she actually resides here and has the intention to remain in the United States indefinitely. A foreign national with a green card generally is domiciled in the United States. Domicile is different from residency for income tax purposes. A foreign individual domiciled in the United States may thus be either a resident alien or a nonresident alien for U.S. income tax purposes.

U.S. Citizens and U.S. Domiciled Foreign Citizens

A U.S. citizen or U.S. domiciled foreign citizen is subject to gift tax on the fair market value of all gifts made during life unless an exclusion exists. Most notably, a donor is permitted to make tax-free gifts of up to USD 11,000 annually to each donee. Married couples generally can treat such gifts as if each made half, thereby doubling the amount that can pass tax free annually to any one donee. The ability to split the gifts is available only if both spouses are U.S. citizens or U.S. domiciled foreign citizens. Gifts to the individual’s spouse qualify for special treatment. All

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

gifts made to a spouse who is a U.S. citizen are exempt from gift tax. In contrast, for 2005, annual gifts of up to USD 117,000 to a spouse who is not a U.S. citizen are exempt from gift tax.

Upon the death of a U.S. citizen or U.S. domiciled foreign individual, his or her taxable estate is subject to estate tax. The taxable estate includes the fair market value of all of a decedent's assets, wherever located, less certain deductions. Deductions are permitted for funeral and administration expenses, creditors' claims, charitable bequests, casualty losses, and other expenses.

During the individual's lifetime, current taxable gifts are added to all prior taxable gifts. At death, the taxable estate is added to all prior taxable gifts. In either situation, the tentative tax is computed using the same tax rate table. The highest tax rate in 2005 is 47 percent on taxable transfers in excess of USD 2,000,000. The tentative tax is then reduced by any prior gift taxes paid and by the applicable credit amount. The applicable credit amount excludes the equivalent of USD 1,000,000 of taxable gifts from gift tax. Upon death, the applicable credit amount for 2005 excludes USD 1,500,000 from estate taxes. For decedents who die in 2006-2008, the applicable credit amount will exclude the equivalent of USD 2,000,000. To the extent a decedent has made no taxable gifts, the entire applicable credit amount will be available to reduce the estate tax. Even if the decedent has used the USD 1,000,000 applicable credit amount against gift taxes, an additional USD 500,000, will be available to reduce the estate tax for a decedent who dies in 2005 and an additional USD 1,000,000 will be available for a decedent who dies in 2006-2008.

The most important estate tax deduction is the marital deduction, which generally permits all transfers of property to the decedent's spouse to be excluded from taxation but only if the spouse is a U.S. citizen. Generally, no marital deduction is allowable for property passing outright to a spouse who is not a U.S. citizen. Relief, however, may be available under certain estate tax treaties. In addition, if the surviving spouse becomes a U.S. citizen before the federal estate tax return of the decedent is filed, property passing to the spouse can qualify for the marital deduction if the spouse was a U.S. resident at all times after the decedent's death and before becoming a U.S. citizen.

The marital deduction, however, is available for property passing to a qualified domestic trust (QDOT) for the benefit of a spouse who is not a U.S. citizen.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

A QDOT must satisfy the following conditions:

- The trust instrument must require that at least one trustee be a U.S. citizen or domestic corporation, and that no distribution from the trust may be made without the approval of this trustee;
- The trust must meet the requirements in the Treasury regulations to ensure the collection of the estate tax on a subsequent taxable event; and
- The executor must make an election to have the QDOT provisions apply. (Your tax adviser should be consulted to determine that the requisite conditions are satisfied.)

Property passing from the decedent to the surviving spouse outside of the probate estate will qualify for QDOT treatment if transferred to the QDOT by the due date of the decedent's estate tax return. A special rule (estate tax credit rule) is provided to coordinate the estate tax treatment of property passing to a non-U.S. citizen with the treatment of property passing to a U.S. citizen (which is eligible for the marital deduction). If the property passes to a non-U.S. citizen who later becomes a U.S. citizen or domiciliary and is later subject to U.S. estate tax, a credit will be permitted to the estate of the second spouse for estate tax paid by the first spouse on such property. This rule, which applies regardless of whether a QDOT is used, results in only one level of taxation on the property transferred to a spouse. If the surviving spouse has not become a U.S. citizen or domiciliary, a credit may nevertheless be permitted, but the amount is subject to phase-out based on the period of time elapsing between the deaths of the spouses.

Estate tax on property placed in a QDOT may be deferred until (1) the 15th day of the fourth month after the calendar year in which property is removed from the QDOT before the spouse's death, or (2) the end of the ninth month following the date the spouse dies, or certain provisions of the trust instrument are violated. The estate tax imposed upon one of these events is equal to the amount that would have been imposed if the property subject to the tax were included in the decedent's estate. No interest is charged on the tax deferral.

Non-domiciled Foreign Citizens

Most gifts made by non-domiciled foreign citizens ("NDFC") are exempt from U.S. gift taxes. These individuals are subject to U.S. gift tax on gifts of real property and

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

on tangible personal property located within the United States. Gifts of intangible property are generally not subject to the gift tax even if the intangibles are U.S. assets (for example, U.S. stocks and bonds). Gifts by a NDFC to his or her spouse are treated the same as gifts by U.S. citizens. Thus, gifts qualify for the unlimited marital deduction if the spouse is a U.S. citizen and for the USD 117,000 annual exclusion if the spouse is not a U.S. citizen. The USD 11,000 annual exclusion per donee is allowed, but gift-splitting between spouses is not available. The gift tax rates for NDFCs are generally the same as for gifts made by U.S. citizens and U.S. domiciled foreign citizens, except that the applicable credit amount is not available.

The taxable estate of a NDFC is limited to certain tangible and intangible property situated in the United States. For example, stocks and bonds of U.S. corporations or real property located in the United States are included in the U.S. estate of a NDFC. However, deposits with a U.S. branch of a U.S. or foreign bank, deposits with a foreign branch of a U.S. bank, portfolio debt obligations (the interest income on which is not taxable to nonresident aliens), and proceeds from a life insurance policy on the life of a deceased NDCF are not considered to be property situated in the United States and, therefore, are not included in the NDFC's gross estate.

The estate tax rates that apply to the estates of NDFCs are the same rates applicable to the estates of U.S. citizens and U.S. domiciled foreign citizens. A special unified credit of USD 13,000 is provided for NDFCs that will exempt the first USD 60,000 of the U.S. taxable estate from U.S. estate tax. Foreign citizens domiciled in certain countries that have estate tax treaties with the United States are allowed to claim the credit allowed to a U.S. citizen (USD 555,800 for 2005) multiplied by the proportion of the NDFC’s total gross estate situated in the United States. The United States has negotiated a number of treaties with respect to estate and gift taxes of foreign citizens. Their provisions should also be reviewed to obtain any available benefits.

Planning Points:

1. Married couples (where one spouse is a non-U.S. citizen) should consider the following planning points when reviewing their estate plans:

- Estate and gift planning should take place before the death of the U.S. citizen spouse, since the non- U.S. citizen surviving spouse will not be able to reduce

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

or eliminate estate tax paid by the decedent on the transferred assets. (Use of a QDOT will only defer tax.)

- The USD 117,000 annual exclusion for gifts to non-U.S. citizen spouses may be used to reduce or eliminate the U.S. gift and estate taxes.

State and Local Taxes

Most of the 50 states, the District of Columbia, and a number of municipalities tax residents and nonresidents on income earned from sources within their jurisdictions. In many cases, the states' rules for determining residence may be similar to the federal rules. However, a foreign citizen's federal tax status does not generally control his or her state tax status. States will generally tax their residents on worldwide income and nonresidents on income from sources within the state. Treaties the United States has with foreign countries have no direct control over state taxation. States that have adopted the federal tax base, however, will generally exempt income that is exempt by treaty from federal taxation. Certain states impose taxes on intangible property in lieu of or in addition to income taxes. Moreover, many states also impose estate or inheritance taxes, which can be greater than the federal estate tax.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 9 -- Filing and Reporting Requirements

U.S. Individual Income Tax Return

A resident alien is required to file a U.S. income tax return, which is due on the 15th day of the fourth month following the close of the taxpayer's taxable year (April 15 for calendar-year taxpayers). The return is filed using Form 1040 or, for simple returns, using Form 1040A or Form 1040EZ. A foreign citizen who becomes a U.S. resident alien during the year (dual-status taxpayer) must file Form 1040 to report all income earned while a resident alien and must attach a statement (or Form 1040NR as a statement) to report U.S. source income earned while a nonresident alien. Similarly, a foreign citizen who is no longer a resident alien at year end must file Form 1040NR to report U.S. source income earned while a nonresident alien and must attach a statement (or Form 1040 as a statement) to report all income earned while a resident alien.

Additionally, foreign nationals engaged in, or considered to be engaged in, a trade or business in the United States during the tax year may file Form 1040NR-EZ provided the filing criteria are met. Ten factors determine the taxpayer's eligibility to file the simplified tax return form. Most notably, taxable income may not exceed USD 100,000 (taxpayers with taxable interest or dividend income are prohibited from using the form); no exemption for a spouse or dependents may be claimed; if the taxpayer itemizes deductions, only state and local income taxes may be claimed (no tax credit is allowed). For a complete list of the eligibility factors, refer to the Instructions for Form 1040NR-EZ.

An automatic extension of four months for filing the return may be obtained by filing Form 4868 with the IRS by the original due date of the return. An additional two-month extension may be obtained for good cause by filing Form 2688. A citizen or resident alien who is residing outside the United States on the normal due date of the return is granted an automatic two-month extension of time to file the return. A statement should be attached to the return stating that the taxpayer qualifies for this automatic extension.

Generally, the IRS will not extend the due date of an income tax return for more than six months. This includes the four extra months automatically allowed by Form 4868. There is an exception for certain individuals residing outside the United States. Although the return may be filed by the extended due date, interest is charged on any amount of tax that is not paid by the original filing due date.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Moreover, a penalty of generally one-half of one percent per month may be assessed on the unpaid tax. (See Chapter 7.)

Nonresident aliens must file an income tax return, on Form 1040NR, with the Internal Revenue Service Center in Philadelphia, Pennsylvania, on or before the 15th day of the sixth month following the close of the taxable year (June 15 for calendar-year taxpayers). However, if a nonresident alien receives wages subject to withholding, Form 1040NR is due on the fifteenth day of the fourth month following the close of the taxable year (April 15 for calendar-year taxpayers). No return is required if a nonresident alien's tax has been fully satisfied by tax withholding at source, he or she does not have effectively connected income (through employment, sale of a USRPI, or otherwise) during the year, and he or she has no treaty-based return position to disclose. No return is required in some circumstances for a nonresident alien present in the U.S. with a F, J, M, and Q visa if he or she has no income subject to U.S. taxation.

If the individual is unable to file Form 1040NR by the due date, an automatic extension of time to file the return of four months may be obtained by filing Form 4868 with the IRS by the original due date of the return. An additional two-month extension may be obtained for good cause by filing Form 2688. The extensions of time to file the return (Forms 4868 and 2688) do not extend the time to pay the income tax. Any unpaid tax should be remitted with Form 4868. Failure to remit a reasonable estimate of the unpaid tax may invalidate the extension. Interest will be charged on any amount of tax that is unpaid by the original filing date. A penalty may also be assessed on the unpaid tax.

For the year of arrival in the United States, a dual-status alien must comply with the filing dates for resident aliens. For the year of departure, the dual-status alien must use the filing dates for nonresident aliens.

The IRS requires foreign persons to file tax returns within specified time periods in order to claim certain deductions. If a tax return for a taxable year is not filed by the last-chance deadline, the IRS may compute the taxpayer's U.S. tax liability based on gross income, generally without the benefit of any deductions. The last chance deadline generally is 16 months after the original due date of the return. In some cases, the deadline is earlier if the IRS sends the taxpayer a notice of non-filing.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Even if no U.S. tax return is required to be filed, various statements may need to be filed:

- To exclude days under the substantial presence test as an exempt individual (i.e., teacher, trainee, student, professional athlete);
- To exclude days under the substantial presence test as an individual with a medical condition;
- To disregard a period of de minimis presence of 10 or fewer days for purposes of the individual's residency starting or termination date;
- To claim a closer connection to a foreign country;
- To claim a residency termination date; or
- To determine residency under a tie-breaker provision in a treaty.

Taxpayer Identification Number

The IRS requires that all persons, U.S. or foreign, who file a U.S. tax return provide a valid taxpayer identification number on their U.S. tax return. A valid taxpayer identification number includes a Social Security Number ("SSN"), or an Individual Taxpayer U.S. Identification Number ("ITIN"). Individuals who qualify for SSNs include United States citizens and foreign individuals who have permission to work or reside permanently in the United States from the USCIS and Department of State. These designated individuals may obtain SSNs by filing Form SS-5 with the Social Security Administration.

Individuals who are not eligible to receive SSNs may apply for ITINs. The ITIN is issued for tax processing purposes only and does not entitle the recipient to social security benefits or change the holder's employment or immigration status under U.S. law. A taxpayer may apply for an ITIN by completing Form W-7, *Application for IRS Individual Taxpayer Identification Number*, attaching the form to the tax return and mailing or taking the form and tax return to the Internal Revenue Service. Original or certified copies of documentation substantiating the information provided on Form W-7 (e.g., passport, birth certificate, driver's license, identity card, or U.S. visa) must be included with the form. Original documents will be returned.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Each foreign national must use an identification number (either SSN or ITIN) on any U.S. tax return or refund claim filed. This would include:

- Filing a U.S. tax return to report U.S. source income;
- Filing a U.S. tax return only to claim a refund of tax withheld;
- Being the spouse of a U.S. citizen or resident who elects to file a joint U.S. tax return;
- Being claimed as a spouse for an exemption on a U.S. tax return; or
- Being claimed as a dependent on another person's U.S. tax return.

Departing Aliens and the Sailing Permit

Most foreign citizens, regardless of their resident status, must obtain a certificate of compliance before permanently departing from the United States. This document, which is normally referred to as a "departure permit" or "sailing permit," indicates the taxpayer's compliance with all obligations imposed by U.S. income tax laws. The permit is part of Form 1040C or Form 2063, which must be filed before leaving.

Certain classes of aliens are exempt from obtaining sailing permits, including diplomats, alien students, industrial trainees, exchange visitors, and others who generally have no income subject to U.S. tax.

Generally, all U.S. income tax due on income subject to U.S. tax during the tax year, up to the date of departure, must be paid when an individual files the sailing permit. Any taxes due for past years will also have to be paid at that time. In some situations, however, if it can be demonstrated to the IRS that the collection of tax due is in no way endangered by the alien's departure, a sailing permit may be received without paying tax at that time. If an individual tries to leave the United States without a sailing or departure permit and cannot show that he or she qualifies to leave without it, the individual may be subject to an income tax examination by an IRS employee and may be denied permission to leave the country at the point of departure (e.g., the airport).

Form 2063 is a short information form that can be used by the following aliens in obtaining their sailing permits:

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

- Aliens, resident or nonresident, who have had no taxable income for the year of the departure and for the preceding year, if the period for filing that return has not expired;
- Resident aliens who intend to continue their resident status in the United States; or
- Resident aliens who have received taxable income during the tax year or the preceding year and whose departure will not hinder the collection of any tax.

Form 1040C is required for departing aliens who do not qualify to file Form 2063. Income for the tax year, up to the date of departure, is reported on Form 1040C, and the tax on the income must be paid. The sailing permit is issued once the taxpayer has complied with these requirements. A regular income tax return is still required for the year of departure, and the tax paid with Form 1040C is taken as a credit against the tax liability for the entire taxable year.

Information Returns

Information returns must be filed to disclose relationships and transactions with certain foreign entities. Severe penalties can be imposed in some cases for failure to comply. The required information returns include the following:

- Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*, must be filed by U.S. residents who have a financial interest in or signature authority over foreign bank, securities, or other financial accounts, both business and personal, whose total value exceeds USD 10,000.
- Form 5471, *Information Return with Respect to a Foreign Corporation*, may have to be filed, in certain circumstances, by U.S. resident aliens who own 10 percent (5 percent before 1998) or more of the stock of a foreign corporation or who acquire or dispose of stock in the corporation. For this purpose, an individual is considered to own the stock owned by certain related persons. Moreover, certain officers and directors of foreign corporations may have to file Form 5471.
- Form 5713, *International Boycott Report*, must be filed by U.S. residents who, directly or indirectly, have operations in certain countries that participate in an international boycott.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

- Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, must be filed by U.S. residents who own, directly or indirectly, stock in a passive foreign investment company.

Foreign Partnerships

Certain foreign partnerships with U.S. partners or U.S. operations must file U.S. partnership returns. Failure to file can result in the disallowance of losses and credits to the U.S. partners, including resident aliens.

Creation of or Transfers to Certain Foreign Trusts

U.S. citizens or residents who create a foreign trust or transfer property to a foreign trust are required to file an information return, Form 3520, within 90 days of creation or transfer. Failure to file may result in civil penalties unless reasonable cause can be established.

Currency Restrictions and Reporting

The United States imposes no restrictions on bringing money into or out of the country. Form 4790, *Report of International Transportation of Currency or Monetary Instruments*, must be filed with the Commissioner of Customs if a total amount of currency exceeding USD 10,000 is transported into or out of the United States on any one occasion by any individual. An exception applies to funds transferred through normal banking procedures if no physical transportation of currency or monetary instruments is involved.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Chapter 10 -- Personal Planning for a Transfer to the United States

At the time of transfer to the United States, there are many things to be considered regarding compensation and personal comfort, for the international executive and family members. Although the factors affecting a successful and rewarding transfer are numerous, an organized approach can smooth the transition, reduce surprises, and help realize the objectives of the executive and the company.

These considerations can generally be categorized as follows:

- Compensation factors;
- Pre-departure activities;
- Vital documents;
- U.S. adjustment;
- Repatriation.

This chapter contains a brief review of each of the above points. Checklists are included in Appendix A and Appendix B to aid the international executive in planning a successful transfer.

Compensation Factors

Different approaches to the compensation package should be evaluated. If the company has a specific international assignment policy, this policy should be identified and understood by the executive well in advance of the transfer.

The basic objective of an organized approach is to ensure that the executive is, in fact, compensated at the agreed-upon level. A variety of things can significantly alter the actual value of compensation: different costs of living in different cities; different health, medical, pension, and life insurance benefits; different education costs for children; relocation costs; and different tax burdens.

Pre-departure Activities

Pre-departure “activities” outlined in the checklists (see Appendix A) prepare the executive and his or her family for leaving home and for their stay in the United States. Among other things, these activities clear the way for convenient financial transactions in the United States, such as establishing lines of credit, credit cards,

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

and insurance policies, and can help the executive acclimate to a new position and lifestyle.

Vital Documents

An important part of pre-departure activities is the preparation of vital documents. The preparation of vital documents, such as visas, wills, and property deeds, assures the executive that all major concerns regarding legal status at home and in the United States are properly handled, including the status of all possessions, guardians for children in case of emergency, and many other vital matters. While this preparation may seem cumbersome, it protects the executive and frees both the executive and the family from unnecessary concerns. It also allows maximum focus on the objectives of the assignment and enjoyment of the unique experiences available to international executives. (See Appendix B.)

Adjustment to the United States

Prior to departure from the home country, the executive should be sent or should obtain information on the U.S. company, as well as the city (through U.S. magazines and guidebooks, government literature, and Web sites) in which residence will be taken. Complementing the executive's self-preparation, the receiving company should prepare receptions and meetings, some of an informal nature, at which the executive, spouse, and children are introduced to their peers. References to doctors, U.S. publications, and home delivery services should also be prepared by the receiving company. Some of the everyday activities that go unnoticed by the U.S. resident can prove unfamiliar and cause confusion and lost time for the new transferring family (newspaper delivery, telephone and other utilities services, customs, tipping, sales tax, and so forth). Both the executive and the contact on the U.S. side should think and work together to acclimate the family in as comfortable a manner as possible.

Repatriation

Specific objectives for the return to the home country after the U.S. assignment should be outlined and discussed when the U.S. assignment is being planned. A mutual understanding of the company's and the executive's objectives at the outset will help in the repatriation process. These basic objectives should include the expected contribution that the executive will make after the U.S. assignment. During the assignment, lines of communication between the executive and the home company should remain open, both on larger corporate issues and on the

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

executive's development of personal expertise valuable to the home company. Changes at home that will affect the executive should be routinely communicated, and status reports can be kept by the executive to make revisions in original plans as necessary and to gauge progress during the assignment.

As noted above, Appendix A and Appendix B are checklists to aid the transferring executive in preparing for an assignment in the United States.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Appendix A – Pre-departure Activities Checklist

Action required:

1 Formulate a list of objectives for transfer.

2 Have a complete medical examination and receive required inoculations a month before departure.

3 Attend language courses, if required.

4 Complete host country resource reading and company orientation material.

5 Make arrangements for a power of attorney.

6 Have any necessary adjustments made in insurance policies.

7 Notify local charge accounts of address change or have them canceled.

8 Notify local post office of mailing address change and provide six to eight weeks notice of change to magazines.

9 Once departure is known, inform home delivery services, utilities, etc.

10 Investigate host location climate to secure suitable clothing.

11 Secure and become familiar with samples of U.S. currency. Familiarize family members.

12 Review U.S. customs tips for visitors and take appropriate action.

13 Arrange for your home company to send pertinent publications and communications to you on a timely basis.

14 Receive tax counseling from an experienced international tax adviser with U.S. expertise.

15 Communicate with your receiving office as to your exact date of arrival in the United States and your starting date.

16 Obtain required test/inoculations and papers required to transport pet(s) to the United States.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

17 Obtain medical and dental records for you and your family.

18 Obtain original or certified copies (translated) of your university diploma(s) and transcripts (record of grades). Certification can be done by bringing your original documents to any U.S. consulate. These documents will be required if you plan to attend a U.S. university.

19 Draw up a will.

20 Make arrangements for support obligations of family members remaining at home.

21 For children, choose a legal guardian. In case of you and your spouse's unexpected deaths, the legal guardian will be the only one permitted to take your child back to your home country.

22 Record vital documents on a checklist with a separate record kept for them. Give a copy of the record to a home country relative or friend, and place a copy in your safe deposit box with originals or copies of documents.

Secure the following:

1 Keep with your passport a written record of all immunizations and vaccinations with dates and physicians' signatures. School and local health authorities often require this information.

2 Separate passports for each family member.

3 U.S. visa at a U.S. embassy or consulate.

4 Birth certificates.

5 Marriage license.

6 Children's school records.

7 Letters of reference, credit rating, and competence.

8 An international driver's license, although in most states you will be required to take a local driving test within two months of arrival.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

9. Universally-accepted credit cards, such as American Express, that can be transferred to a dollar based account.
10. Travelers checks (in home and U.S. currency).
11. Letter from current auto insurer referring to driving record and insurance history.
12. An account in a bank that has U.S. branches or an open transactional relationship with a U.S. bank.
13. Safe deposit box.
14. Copy of your most recent prescriptions for glasses, contact lenses, and medicines.
15. Spare pair of glasses/contact lenses.
16. Supply of prescription medicines adequate until local medical contacts can be established.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Appendix B – Vital Documents Checklist

Identification Number (Where Applicable)	Location	Date
Your will		
Spouse's will		
Guardianship Agreements		
Trust Agreements		
Mortgages		
Property Deeds		
Car Titles		
Stock Certificates		
Stock Purchase Agreements		
Bonds		
Checking Account		
Savings Account		
Life Insurance Policies		
Other Insurance Policies		
Contracts		
Set of Last Instructions		
Retirement Agreements		
Pension or Profit Sharing Plans		
Birth Certificates		
Marriage Licenses		
Divorce and Settlement Papers		
Notes Receivable		
Employment Contracts		
Income Tax Returns (Last 3 Years)		
Military Discharge and Documents		
Other Cards		
Passport(s)		

Attorney:

Name: ________________________________

Address: ________________________________

Phone Number: ________________________________

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Appendix C – Treaty Withholding Tax Rates (in percentages)

Information as of May 2004[1]

Country	Dividends[a]	Interest[b]	Royalties[c]
Australia	15	10	0
Austria	15	0	0
Barbados	15	5	5
Belgium	15	15	0
Canada	15	10	0
Commonwealth of Independent States[d]	30	0	0
Cyprus	15	10	0
Czech Republic	15	0	10
Denmark	15	0	0
Egypt	15	15	0
Estonia	15	10	5
Finland	15	0	5
France	15	0	5
Germany	15	0	0
Greece	30	0	0
Hungary	15	0	0
Iceland	15	0	0
India	25	15	10
Indonesia	15	10	10
Ireland	15	0	0
Israel	25	17.5	15
Italy	15	15	10
Jamaica	15	12.5	10
Japan	10	10	0
Kazakhstan	15	10	10
Latvia	15	10	5
Lithuania	15	10	5
Luxembourg	15	0	0
Mexico	10	15	10
Morocco	15	15	10
Netherlands	15	0	0
New Zealand	15	10	10
Norway	15	0	0

[1] Source: IRS Publication 901, U.S. Tax Treaties (Rev. May 2004).

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Country	Dividends[a]	Interest[b]	Royalties[c]
Pakistan	30	30	0
People's Rep. Of China	10	10	10
Philippines	25	15	15
Poland	15	0	10
Portugal	15	10	10
Romania	10	10	15
Russia	10	0	0
Slovak Republic	15	0	10
South Africa	15	0	0
South Korea	15	12	15
Spain	15	10	8
Sweden	15	0	0
Switzerland	15	0	0
Thailand	15	15	8
Trinidad & Tobago	30	30	15
Tunisia	20	15	10
Turkey	20	15	5
Ukraine	15	0	10
United Kingdom	15	0	0
Venezuela	15	10	5

[a]Other rates may apply to dividends paid to corporations with substantial ownership.

[b]Other rates may apply to interest paid on real property mortgages or paid to a controlling corporation. Portfolio interest is exempt from withholding tax.

[c]Royalties for the purposes of this appendix will be industrial royalties generally defined as payment for the use of or right to use cinematographic films, or tapes for television or broadcasting, patents, designs, models, plans, secret processes or formulas, trademarks or other like property or rights and payment of any kind made in consideration for supplying scientific, technical, industrial or commercial knowledge or information.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

[d]The CIS is an alliance of 12 of the 15 former republics of the U.S.S.R. Separate treaties have been concluded with Ukraine, Russia, and Kazakhstan. The U.S.-U.S.S.R. income tax treaty signed June 20, 1973, applies to the countries of Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan. The U.S-U.S.S.R. income tax treaty contains no provisions for dividends, therefore the U.S. statutory withholding rate applies.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Appendix D – U.S. Individual Income Tax Figures 2005

Married Individual Filing Jointly and Surviving Spouses	
If taxable income (USD) is:	**The tax is:**
Not over 14,600	10% of taxable income
Over 14,600 but not over 59,400	USD 1,460.00 + 15% of the excess over USD 14,600
Over 59,400 but not over 119,950	USD 8,180.00 + 25% of the excess over USD 59,400
Over 119,950 but not over 182,800	USD 23,317.50 + 28% of the excess over USD 119,950
Over 182,800 but not over 326,450	USD 40,915.50+ 33% of the excess over USD 182,800
Over 326,450	USD 88,320.00 + 35% of the excess over USD 326,450

Single Individuals	
If taxable income (USD) is:	**The tax is:**
Not over 7,300	10% of taxable income
Over 7,300 but not over 29,700	USD 730.00 + 15% of the excess over USD 7,300
Over 29,700 but not over 71,950	USD 4,090.00 + 25% of the excess over USD 29,700
Over 71,950 but not over 150,150	USD 14,652.50 + 28% of the excess over USD 71,950
Over 150,150 but not over 326,450	USD 36,548.50 + 33% of the excess over USD 150,150
Over 326,450	USD 92,727.50 + 35% of the excess over USD 326,450

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Married Individuals Filing Separately	
If taxable income (USD) is:	**The tax is:**
Not over 7,300	10% of taxable income
Over 7,300 but not over 29,700	USD 730.00 + 15% of the excess over USD 7,300
Over 29,700 but not over 59,975	USD 4,090.00 + 25% of the excess over USD 29,700
Over 59,975 but not over 91,400	USD 11,658.75 + 28% of the excess over USD 59,975
Over 91,400 but not over 163,225	USD 20,457.75 + 33% of the excess over USD 91,400
Over 163,225	USD 44,160.00 + 35% of the excess over USD 163,225

Head of Household	
If taxable income (USD) is:	**The tax is:**
Not over 10,450	10% of taxable income
Over 10,450 but not over 39,800	USD 1,045.00 + 15% of the excess over USD 10,450
Over 39,800 but not over 102,800	USD 5,447.50 + 25% of the excess over USD 39,800
Over 102,800 but not over 166,450	USD 21,197.50 + 28% of the excess over USD 102,800
Over 166,450 but not over 326,450	USD 39,019.50 + 33% of the excess over USD 166,450
Over 326,450	USD 91,819.50 + 35% of the excess over USD 326,450

2005 Standard Deduction

Type of Return Filed	Standard Deduction (USD)
Joint Return or Surviving Spouse	10,000
Single (other than head of household or surviving spouse)	5,000
Head of Household	7,300
Married Filing Separately	5,000

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

For an individual who can be claimed as a dependent on another return, the basic standard deduction applicable to the individual for 2005, is the greater of USD 800 or the sum of USD 250 and the individual's earned income.

The additional standard deduction for married taxpayers who are 65 or over or blind is USD 1,000. For a single taxpayer or head of household who is over 65 or over or blind, the additional standard deduction is USD 1,250.

2005 Itemized Deduction Phaseout

An individual whose adjusted gross income exceeds a threshold amount is required to reduce the amount of the allocable itemized deductions by 3 percent of the excess over the threshold amount. The 2005 threshold amounts are:

Type of Return Filed	Threshold (USD)
Married Filing Separate Returns	72,975
All Other Returns	145,950

Note, however, that the reduction amount may never be more than 80 percent of allocable deductions, excluding certain deductions for medical expenses, investment interest, and casualty, theft, or wagering losses.

2005 Personal Exemptions

The personal exemption amount for 2005 is USD 3,200 per exemption.

The deduction for personal exemptions may be reduced or eliminated for higher-income taxpayers. The exemption for taxpayers whose adjusted gross income exceeds the set threshold amount, based on filing status, is reduced by two percent for each USD 2,500 (USD 1,250 for a married person filing separately) or fraction thereof by which adjusted gross income exceeds the threshold amount. The threshold amounts for 2005 are:

Type of Return Filed	Threshold (USD)
Joint Return or Surviving Spouse	218,950
Head of Household	182,450
Single	145,950
Married Filing Separate	109,475

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

2005 Alternative Minimum Tax Exemptions

Type of Return Filed	Exemption (USD)
Joint Return or Surviving Spouse	58,000
Single or Head of Household	40,250
Married Filing Separate	29,000

2005 Social Security and Self-Employment Wage Base Amount

- Wage Base Amount : USD 90,000

2005 Capital Gains Tax Rates

Ordinary Rates for Assets Held Not More than One Year – The law requires a minimum one-year holding period for the first set of preferential tax rates. Capital assets held one year or less are taxed at the taxpayer's marginal tax rate based on his income and filing status, up to a current maximum rate of 35 percent.

15 Percent for Assets Held More than 12 Months – Assets held for more than 12 months are taxed at a maximum rate of 15 percent. (Taxpayers in the 10- and 15-percent marginal bracket and holding assets for more than 12 months are taxed at 5 percent.)

Depreciation Recapture – Any part of a gain on a sale or exchange of depreciable real property that represents prior depreciation is "recaptured" and taxed at a maximum tax rate of 25 percent. The depreciation recapture rule applies only for purposes of the tax rate; this portion of the gain is still treated as a capital gain for other purposes. Any gain on real property in excess of prior depreciation is taxed at the capital gains rates of 15 (and 5) percent.

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Appendix E – List of KPMG IES Offices in the U.S.A.

KPMG Washington National Tax
KPMG
2001 M Street NW
Washington DC 20036-3310
Tel: 1 (202) 533-3000
Fax: 1 (202) 533-8500

Atlanta
KPMG
Suite 2000
303 Peachtree NE
Atlanta GA 30308
Tel: 1 (404) 222-3000
Fax: 1 (404) 222-3050

Boise
KPMG
205 North 10th Street
Boise ID 83702
Tel: 1 (208) 389-6500
Fax: 1 (208) 389-6565

Boston
KPMG
99 High Street
Boston MA 02110-2371
Tel: 1 (617) 988-1000
Fax: 1 (617) 988-0800

Charlotte
KPMG
401 S. Tryon Street, Suite 2300
Charlotte NC 28282-8290
Tel: 1 (704) 335-5300
Fax: 1 (704) 335-5354

Chicago
KPMG
303 East Wacker Drive
Chicago IL 60601-5255
Tel: 1 (312) 665-1000
Fax: 1 (312) 665-6000

Cincinnati
KPMG
1600 PNC Center
201 East Fifth Street
Cincinnati OH 45202-4116
Tel: 1 (513) 421-6430
Fax: 1 (513) 763-2690

Cleveland
KPMG LLP
One Cleveland Center
1375 East Ninth Street, Suite 2600
Cleveland OH 44114-3495
Tel: 1 (216) 696-9100
Fax: 1 (216) 696-7792

Columbus
KPMG LLP
Suite 500
191 West Nationwide Boulevard
Columbus OH 43215-2568
Tel: 1 (614) 249-2300
Fax: 1 (614) 249-2348

Dallas
KPMG LLP
Suite 3100
717 North Harwood Street
Dallas TX 75201-1885
Tel: 1 (214) 840-2000
Fax: 1 (214) 840-2297

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Denver

KPMG LLP
707 17th Street, Suite 2700
Denver CO 80202-3499
Tel: 1 (303) 296-2323
Fax: 1 (303) 295-8829

Detroit

KPMG
Suite 1200
150 West Jefferson
Detroit MI 48226-4429
Tel: 1 (313) 983-0200
Fax: 1 (313) 983-0008

Houston

KPMG
700 Louisiana Street
Houston TX 77002
Tel: 1 (713) 319-2000
Fax: 1 (713) 319-2395

Kansas City

KPMG
Suite 1600
1000 Walnut Street
Kansas City MO 64106-3127
Tel: 1 (816) 474-6480
Fax: 1 (816) 556-9652

Miami

KPMG
One Biscayne Tower
2 South Biscayne Boulevard
Miami FL 33131
Tel: 1 (305) 358-2300
Fax: 1 (305) 913-3626

Minneapolis

KPMG
4200 Wells Fargo Center
90 South Seventh Street
Minneapolis MN 55402-3900
Tel: 1 (612) 305 5000
Fax: 1 (612) 305 5039

New York

KPMG
345 Park Avenue
New York City NY 10154-0102
Tel: 1 (212) 758-9700
Fax: 1 (212) 758-9819

Northern Virginia

KPMG
Tyson's Tower
1660 International Drive
McLean VA 22102-4828
Tel: 1 (703) 286-8000
Fax: 1 (703) 286-8010

Orange County

KPMG
Plaza Tower
600 Anton Blvd., Suite 700
Costa Mesa CA 92626
Tel: 1 (714) 850-4300
Fax: 1 (714) 850-4488

Philadelphia

KPMG
1601 Market Street
Philadelphia PA 19103-7222
Tel: 1 (267) 256-7000
Fax: 1 (267) 256-7200

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

Phoenix

KPMG
Suite 1100
400 E Van Buren Street
Phoenix AZ 85004-4594
Tel: 1 (602) 253-2000
Fax: 1 (602) 252-0011

Portland (Oregon)

KPMG LLP
Suite 3800
1300 South West Fifth Avenue
Portland OR 97201
Tel: 1 (503) 221-6500
Fax: 1 (503) 820-6565

Richmond

KPMG LLP
Suite 2000
1021 East Cary Street
Richmond VA 23219-4023
Tel: 1 (804) 782-4200
Fax: 1 (804) 782-4300

San Diego

KPMG LLP
Suite 1500
750 B Street
San Diego CA 92101-8191
Tel: 1 (619) 233-8000
Fax: 1 (619) 696-8672

San Francisco

KPMG LLP
Suite 1400
55 Second Street
San Francisco CA 94105
Tel: 1 (415) 963-5100
Fax: 1 (415) 963-8100

Seattle

KPMG LLP
Suite 900
801 Second Avenue
Seattle WA 98104
Tel: 1 (206) 913-4000
Fax: 1 (206) 913-4444

Short Hills

KPMG
150 John F. Kennedy Parkway
Short Hills NJ 07078-2778
Tel: 1 (973) 467-9650
Fax: 1 (973) 467-7930

Silicon Valley

KPMG LLP
501 E Middlefield Road
Mountain View CA 94043
Tel: 1 (650) 404-5000
Fax: 1 (650) 960-0566

Stamford

KPMG
Stamford Square
3001 Summer Street
Stamford CT 06905-4317
Tel: 1 (203) 356-9800
Fax: 1 (203) 967-3503

© 2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation,

© 2005 KPMG, the U.S. member firm of KPMG International, a Swiss cooperative. All rights reserved.

KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative.