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THE TAXMAN COMETH: WHEN TAKING A FOREIGN EARNED INCOME EXCLUSION ON YOUR TAX RETURN CAN HURT YOUR ABILITY TO NATURALIZE

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By Gary Endelman and Cyrus D. Mehta

Maintaining continuity of residence is paramount if one wants to naturalize and become a US citizen. For an in depth discussion, we refer you to our prior blog Naturalization In A Flat World and Gary Endelman's recent article, The Enigma of Disruption: What Continuity of Residence In Naturalization Really Means, 17 Bender's Immigration Bulletin 1437, August 1, 2012. Even though a naturalization applicant meets all the eligibility criteria, an examiner can still deny an application for failure to maintain the continuous residence requirement. Tax issues can further trip up the applicant, especially when one is trying to shield foreign earned income from US taxation, which this blog will focus on.

But before we do so, we provide the basic eligibility criteria for naturalization.

An applicant must meet certain threshold eligibility criteria in order to become a US citizen. Pursuant to § 316(a) of the Immigration & Naturalization Act (INA), the applicant must establish that immediately preceding the filing of the application, he or she has resided continuously within the US for at least five years after being lawfully admitted for permanent residence. If the applicant has been in marital union with a US citizen spouse for three years, the continuous residence requirement is three years instead of five years. Moreover, under INA § 316(a), the applicant must also establish that he or she has been physically present in the US for periods totaling at least half of that time and has resided within the State or district of the Service where the applicant filed the application for at least three months.

Furthermore, INA § 316(a)(2) also requires the applicant to establish that he or she has resided continuously within the US from the date of the application up to the time of citizenship. INA § 316(a)(3) requires the applicant to establish, inter alia, that he or she is still a person of good moral character during the relevant 5 or 3-year period.

INA § 316(b) states that an absence from the US of more than six months but less than one year during the 5-year period immediately preceding the filing of the application may break the continuity of such residence. INA § 316(b) notes that should such a presumption arise, it may be rebutted if the applicant can establish that he or she in fact did not abandon his or her residence during such period.

What precisely is continuous residence? INA § 101(a)(33) defines residence as follows: "The term 'residence' means the place of general abode; the place of general abode of a person means his principal, actual dwelling place in fact, without regard to intent." But that only tells us what residence means, not continuous residence. The regulation, on the other hand, at 8 C.F.R. §316.5(c)(1)(i) tells us what is not continuous residence. It says that an absence of between six months and one year shall disrupt the continuity of residence unless the applicant can establish otherwise to the satisfaction of the Service. Thus, unless the applicant was outside the US for six months or more but less than a year, he or she should argue that there was no disruption of continuous residence. Yet the authors have known of naturalization examiners improperly clubbing two back to back lengthy trips although each one was less than 180 days.

If an applicant is out of the US for more than 180 days but less than one year, it will cause a disruption of continuity of residence but there is still hope. 8 C.F.R. § 316.5(c)(1)(i) provides examples of the types of documentation which may establish that the applicant did not disrupt the continuity of his or her residence. Specifically, the regulation provides the following examples that an applicant can submit to rebut an allegation of disruption of continuity of residence:

(A) The applicant did not terminate his or her employment in the US;

(B) The applicant's immediate family remained in the US;

(C) The applicant retained full access to his or her US abode; or

(D) The applicant did not obtain employment while abroad.

While one is already treading on thin ice while trying to demonstrate continuous residence, shielding foreign-earned income from US taxation can create yet another chink in one's armor when trying to rebut an allegation of disruption of continuity of residence. Many accountants may not know this, but tread with caution if you wish to naturalize and are planning to shield foreign earned income from US taxation that can protect you up to $92,900.

There are two different ways in which one can file for earned foreign income exclusion through filing IRS Form 2555. One way is by claiming to be a bona fide resident of a foreign country for an entire tax year or by declaring physical presence there for a minimum of 330 days over 12 consecutive months. The filing of Form 2555 may be viewed as further evidence of failing to satisfy the continuous residence for naturalization. One potential point for advocacy is that the filing of an IRS 2555 based on spending 330 days outside the US is more benign than claiming you were a bona fide resident of a foreign country. The former is a mechanical application of the earned income exclusion, and if the applicant can independently establish eligibility for naturalization despite being out for 330 days, we do not see why an IRS 2555 filed on the 330 days exemption should adversely impact the applicant. Even the USCIS Adjudicator Field Manual in Chapter 74 clearly makes a distinction between the bona fide resident exemption and the physical presence exemption, and supports our argument.

Of course, the cautious immigration lawyer may suggest to the client to simply pay foreign tax and deduct rather than protect one's foreign income up to $92,900. This may work where you need to pay a foreign tax that is comparable to the US tax rate, but in some countries like Hong Kong or Dubai, the tax rate is much lower or next to nothing. Or you can be working for a UN or international organization where you are totally exempt from taxes. Under such circumstances, the $92,900 deduction would benefit the applicant and may outweigh the marginal risk in the event of an abandonment claim or naturalization denial.

But this may not be the end of the argument in favor of shielding foreign earned income based on the 330 days out of the US exemption. Look at "Home on the Range: Establishing Continuous Residence and Physical Presence for Naturalization Purposes" by Julie G. Muniz and Lyndsey Yoshino, Immigration

Practice Pointers 2012-2013 Ed. (AILA) where they point out that one of the requirements for IRS 2555 is to have a tax home in a foreign country. This is in addition to meeting either bona fide residence test or physical presence test. This is what Muniz and Yoshino say:

"Even if an LPR can meet the physical presence test... the "tax home" requirement could be fatal to continuous residence. If an LPR has a tax home in the United States, she is precluded from claiming the foreign earned income credit. However, if she claims the credit, she is implicitly indicating that she has interrupted her continuous residence, as it could appear inconsistent to both allege a foreign tax home and claim continuity of residence."

Under IRS definitions, your tax home is generally your regular place of business or post of duty, regardless of where you maintain your family home. Your tax home is the place where you are permanently or indefinitely engaged to work as an employee or self-employed individual. If your abode is in the US, then it is not possible to claim a tax home overseas.

Although the Muniz & Yoshino article makes a good point about cautioning against claiming a tax home overseas, it can be argued that maintaining a "tax home" in a foreign country ought not to be conflated each time with the establishment of a bona fide residence in that country. If that is the case, any tax home in a foreign country, as the AILA article claims, is inconsistent with maintaining continuous residence in the US. For instance, even if one is out for more than 180 days but less than one year, due to a work assignment overseas, the applicant would have in any event broken continuity of residence regardless of the overseas tax home, but can still rebut the presumption under 8 CFR §316.5(c)(1)(i)(A)–(D). The tax home overseas should not in itself be an aggravating factor. What indeed could be more perilous is when one takes a foreign earned income exclusion based on foreign residence rather than physical presence, as also indicated in the Adjudicator's Field Manual at 74 (g)(9)(B):

If the legal permanent resident declared himself or herself to be a bona fide resident of a foreign country on IRS Form 2555, that means the alien declared to the IRS that he or she went abroad for an indefinite or extended period. He or she intended to establish permanent quarters outside of the United States and he or she openly declared residence in a foreign country. The applicant applying for naturalization after openly declaring residence in a foreign country on an official United States

Government form will most likely be unable to fulfill the residence requirement for naturalization (see 8 CFR 316(c)(2)).

If the legal permanent resident declared himself or herself to be physically present in a foreign country on IRS Form 2555, it only means that the applicant met the IRS's physical presence test to have a proportion of his or her income excluded form United States taxes. The applicant has not declared residence in a foreign country. Eligibility for naturalization purposes may be affected if the applicant fails to establish that he or she meets the physical presence requirements or fails to establish that the absence of more than six months but less than one a year did not result in abandonment of LPR status. If the applicant applying for naturalization has sufficient physical presence in the United States for naturalization purposes or can establish that his or her LPR status was not abandoned, then the applicant can still be eligible for naturalization (see Part 3 of the Form N-400).

Think of IRS 2555 as a warning sign whose presence on your tax return will trigger a red flag when applying for naturalization during the period when the applicant needs to maintain continuous residence. This does not mean that it will always be fatal if one tries to shield foreign income from US taxation. Any tax election should only be made by permanent resident aliens after consultation with competent immigration counsel. All those who hold "green card" status should make certain that they understand what their tax obligations are and should refer to the IRS publication concerning the tax treatment for US citizens and resident aliens abroad. Always look for the presence of those factors with the potential to demonstrate that the applicant has never disrupted continuous residence. Our blog points out how you can defend yourself if you have based the Form 2555 filing on physical presence overseas rather than a foreign residence. Do not be discouraged if you find this hard to understand. So did Albert Einstein who famously remarked that "This is too difficult for a mathematician. It takes a philosopher."