

## EMPLOYEE BENEFITS

### THE IRS AND THE FICA, FUTA AND FEDERAL INCOME TAX TRAPS FOR EMPLOYERS WITH NON-RESIDENT ALIEN EMPLOYEES

by Eric W. Gregory

With all of the payroll complexities that employers face, it is no surprise that a special set of rules that applies to only a small category of employees is frequently overlooked. Often, to the surprise of payroll and human resources staff, special Federal Insurance Contributions Act ("FICA," composed of Social Security and Medicare taxes), Federal Unemployment Tax Act ("FUTA"), and federal income tax rules apply to non-resident alien employees in certain situations.

The IRS has updated its internal manual on this process, requiring agents to contact employers that have erroneously withheld tax from foreign individuals in these situations. There are steps that employers can take to help ensure the correct taxes are withheld and paid, and that the employer is protected from liability.

#### FICA Rules for Non-Resident Aliens in the U.S. Under F, J, M, or Q Visas

FICA is comprised of the following taxes: (1) 6.2% Social Security tax; (2) 1.45% Medicare tax (the "regular" Medicare tax); and (3) a 0.9% Medicare surtax when the employee earns over \$200,000. Employers must withhold these amounts from an employee's wages (the "employee portion").

There is also an employer portion of two of these taxes: (1) 6.2% Social Security tax; and (2) 1.45% Medicare tax.

#### Exempt Services

Services performed by a non-resident alien individual who is temporarily present in the U.S. under F, J, M, or Q visas are not considered "employment" for FICA tax purposes, if the services are performed to carry out a purpose for which the individual was admitted to the U.S. This means, subject to certain exceptions, students, scholars, professors, teachers, trainees, researchers, physicians, au pairs, and summer camp workers are exempt from FICA tax on wages paid to them for services performed within the U.S. as long as the services are allowed by U.S. Citizenship and Immigration Services ("USCIS") for these non-immigrant statuses, and the services are performed to carry out the purposes for which the visas were issued to them.

Therefore, for example, exempt employment would include the following for those on an F, J, M or Q visa:

- On-campus student employment up to 20 hours a week (40 hours during summer vacations);
- Off-campus student employment allowed by USCIS;
- Practical Training student employment on or off campus;
- Employment as professor, teacher or researcher; and

- Employment as a physician, au pair, or summer camp worker.

Frequently, this taxation rule becomes an issue for employers who have a small number of students or recently-graduated students on an F-1 visa. F-1 students are eligible for curricular practical training before completing their studies, as well as an additional 12 months of optional practical training, either before or following graduation, or a combination of the two. Additionally, students in "STEM" degree programs may be eligible for an additional 24 months of practical training, beyond the initial 12.

#### Losing the Non-Resident Exemption

If one of the above-identified visa holders becomes a "resident alien" under the Internal Revenue Code ("Code"), that individual loses the non-resident alien FICA exemption.

The term "resident" has its own definition under the Code, separate from immigration law. Under the Code definition, foreign non-resident students with F-1, J-1, M-1, Q-1 or Q-2 visas who have been in the U.S. less than five calendar years are still non-resident aliens and are still exempt from FICA taxes. When these students have been in the U.S. more than five years, they are resident aliens and are liable for FICA taxes.

Foreign scholars, teachers, researchers, trainees, physicians, au pairs, summer camp workers, and other non-students in J-1, Q-1 or Q-2 nonimmigrant status who have been in the U.S. less than two calendar years are still non-resident aliens and are still exempt from FICA taxes. When these individuals have been in the U.S. more than two years, they are resident aliens and are liable for FICA taxes.

When measuring an alien's date of entry for the purposes of determining the calendar years, the actual date of entry is not important. It is the calendar year of entry which is counted. For example, a student who entered the United States on December 31, 2017 on an F-1 visa counts 2017 as the first of the 5 years on an F-1 visa as an "exempt individual."

#### FUTA Rules for Non-Resident Aliens in the U.S. Under F, J, M, or Q Visas

FUTA is a tax paid by employers (but not employees). The rules for FUTA for foreign individuals are identical to FICA described above.

#### Tax Treaties: Federal Income Tax

Numerous tax treaties between the United States and other countries provide varying exemptions from income for workers. Typically, the taxation of these amounts is determined by and between the individual, the US Department of Treasury and the foreign taxing authority. However, employees may provide a Form 8233 "Exemption from Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual," to their employer to exempt the appropriate amount from withholding by the employer.

## Recent IRS Action and the Steps Employers Should Take

Frequently, employees discover the FICA exemption after the tax year in which they are paid. This leads them to contact the IRS to request a reimbursement of over-withheld FICA. In 2015, the IRS developed a new process to contact employers that have erroneously withheld FICA from their employees, requiring them to adjust their payroll report and adjust the employee's Form W-2. There is no penalty for the erroneous withholding, other than the administrative costs of having to correct it.

### *Correcting FICA and FUTA Errors*

For any employee who incorrectly had FICA withheld in a tax year open under the statute of limitations, payroll taxes can be corrected, allowing the employee to receive a refund of their portion of FICA, and the employer to receive a refund of the employer portion of FICA and FUTA.

### *Building a Compliance Program*

As a part of the on-boarding process for employees who may be subject to either the FICA exemption or income tax treaties, employers might consider having employees complete certifications to be kept in their payroll file that states the relevant dates so that payroll can track relevant limitations (i.e., the aggregate 2 or 5 year limit for the FICA exemption). Such certifications would generally not get passed on to the IRS, but would be helpful to the extent that there might be an audit to establish that the employee represented information on which the employer relied to make a determination.

## Conclusion

While there are some initial compliance hurdles in beginning to track and analyze whether employees are subject to FICA, FUTA and income tax withholding exemptions, doing so will save both employers and employees time and money in the future.

For more information on how to determine whether your employees qualify for a non-resident tax exemption, and with help on building a compliance program, please contact the author or any member of the Dickinson Wright employee benefits team.

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