FOREIGN PERSONS WITH CERTAIN VISAS AND THEIR CALIFORNIA EMPLOYERS BEWARE: NON-CONFORMITY OF FEDERAL AND CALIFORNIA EMPLOYMENT TAX RULES

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This article briefly comments on how the California Unemployment Insurance Code ("UIC") which contains the State Unemployment Insurance ("SUI") and the State Disability Insurance ("SDI") applies to "F", "H-2A," "J," "M," and "Q" visa holders. The rules are quite different from the federal employment tax rules and not well understood by California employers nor non-U.S. citizens who are temporarily living and working in the U.S. with one of these visas.

The reason this issue is of particular importance to these visa holders, is that these foreign individuals (except the H-2A visa holders) **are** accustomed to being treated as non-residents for federal income tax purposes, while living in the U.S., and hence having favorable income tax treatment. A foreign individual who has a valid F, J, M or Q visa will generally not be considered a U.S. income tax resident, regardless of the number of days residing in the U.S.[1] This is because the number of days these individuals are in the U.S. are not applied toward the "substantial presence test" described below.[2]

I. FEDERAL TAX RESIDENCY AND FICA-FUTA TAXES OVERVIEW -

A nonresident alien, for income tax purposes, is any person who is not (i) a U.S. citizen or (ii) a resident alien.[3] A resident alien[4] is anyone satisfying any of the following tests:

- Who is entitled to lawful permanent residency status in the U.S., i.e., who holds a "green card" whether or not valid for immigration law purposes;"[5] or
- Who was physically present in the U.S. for 183 days or more during the calendar year; or
- Who was physically present in the U.S. for 31 days or more during the most recent calendar year plus a number of days during the immediately preceding two years-multiplied by a factor of 1/3 and 1/6, respectively (whereby the sum of the three equals 183 days or more).[6] This is referred to as the "substantial presence" test; or
- Who makes an election to be treated as a resident alien and satisfies the so-called "minimum presence" test.[7]

Since F, J M and Q visa holders normally are not treated as resident aliens (irrespective of the number of days they reside in the U.S.), there are some strange rules and results that follow from these rules. For instance, a federal income tax regulation provides that J and F visa holders are treated as being engaged in a U.S. trade or business, if they are actually not engaged in a trade or business.[8]

a. BACKGROUND: EXCHANGE VISITOR (J-1 VISA)

From an immigration law perspective, an exchange visitor is defined as a person having a residence abroad in a foreign country which he has no intention of abandoning, who is a *bona fide* student, scholar, trainee, teacher, professor, research assistant, specialist, or leader in a field of specialized knowledge or skill, or other person of similar description. For immigration law purposes, the person must be coming temporarily to the U.S. as a participant in a program designated by the Director of the United States Information Agency, for the purpose of teaching, instructing or lecturing, studying, observing, conducting research, consulting, demonstrating special skills, or receiving training.[9]

Generally, this category is intended (for immigration policy purposes) to enhance the visitor's skills in her or his specialty or non-specialty occupation through participation in a structured training program conducted by the selecting sponsor. The sponsor can be a U.S. local, state or federal government agency; an international agency or organization of which the U.S. is a member and which has an office in the United States; among other categories.[10]

b. BACKGROUND: TRAINEE (F VISA)

Similar to the F category, the J visa allows limited employment in the form of practical training. Since the purpose of this article is not to discuss in detail the immigration law requirements of these visa holders, a table is attached at the end of this article briefly summarizing each of the above visa categories.

c. FEDERAL EMPLOYMENT TAXES – FICA & FUTA

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The federal tax rules often diverge from California tax law, which is certainly the case with F, J, H-2A, M and Q visa holders who are not U.S. citizens, but can and might perform services in the United State. This non-conformity is both in the income tax residency rules as well as the employment tax rules.

The federal employment taxes imposed in the U.S. can be significant and generally equal approximately 15.3 percent of an individual's employment (directly and indirectly) and self-employment compensation. For persons who receive employment compensation of US$ 87,000 in a calendar year, the total employment taxes can equal approximately US$13,311 and the amounts are therefore rather significant. These employment taxes, however, are only imposed upon U.S. and certain non-U.S. persons (sometimes referred to as nonresident aliens) who are employed within the U.S. or by a U.S. employer. The regulatory definition of "wages" for employment tax purposes, exempts from employment taxes any remuneration for services performed by a nonresident alien individual outside the U.S.[11]

Most importantly, the statutory definition of "wages" includes only "remuneration . . . for services performed by an **employee** for his **employer.**"[12] Therefore, remuneration received by a nonresident alien that is not employment compensation (but rather compensation for independent contractor services and not as "wages") is exempt from U.S. employment taxes (social security tax/FICA, federal unemployment tax/FUTA, and Medicare tax) provided the "remuneration" for the services would not constitute "wages" as defined in the statute and regulations.[13]

A nonresident individual, who receives income from services provided on an "independent contractor basis" as opposed to income from an "employment" relationship, receives that income exempt from employment taxes even when those services are performed in the U.S. The analysis of when services are provided as an independent contractor versus as an employee is explained below in the footnote.[14] See for example, *Ringling Bros. Barnum and Bailey Combined Shows, Inc. v. Higgins*, 189 F. 2d 865 (2d Cir. 1951). This determination is a factual one.

In contrast, an employee of an U.S. employer (e.g., a California corporation based in Los Angeles which also operates through a branch office in Los Cabos, Baja California Norte, Mexico) is subject to U.S. employment taxes, irrespective of the place that employment services are performed absent a statutory exception.[15]

In short, FUTA and FICA normally applies to any employee of a U.S. employer. There are special exemptions from FICA and FUTA tax for certain employees from countries with international social security agreements (known as a "Totalization Agreement") in force between the U.S. and the other country. In those cases, there are additional exemptions from taxes imposed by FICA and FUTA if an individual's earnings are otherwise subject to taxes or contributions of the foreign country (which is not the case for F, J, H-2A, M and Q visa holders) and meet certain other requirements.[16]

Curiously, FICA or FUTA tax does not apply to employees of U.S. employers if the compensation is for "service . . . performed by a nonresident alien individual for the period he .. . [was] temporarily present in the United States as a nonimmigrant under subparagraph (F), (J), (M), or (Q) of section 101(a)(15) of the Immigration and Nationality Act, as amended, and which is performed to carry out the purpose specified in subparagraph (F), (J), (M), or (Q) . . . "[17]

Another unique example exists for example to a non-U.S. citizen worker performing agricultural labor in the United States on an H-2A visa who will not be subject to FUTA tax.[18] As to Social Security and Medicare Taxes ("FICA"), services provided by foreign agricultural workers lawfully admitted to the United States from any foreign country on a temporary basis for the purpose of performing agricultural labor is also excluded from covered employment.[19] This exemption from FICA, however, only applies to workers who hold an H-2A visa.[20] Also, H-2A workers are not subject to income tax withholding. Specifically, remuneration earned through agricultural labor is subject to income tax withholding only if the remuneration is subject to FICA tax.[21] Since compensation/remuneration paid to an H-2A worker is not subject to FICA withholding, as discussed above, it is also not subject to income tax withholding.[22]

Those are some of the unique federal rules. What happens in California?

II. California State Unemployment and Disability Insurance

The UIC has comprehensive rules regarding California unemployment and disability insurance (SUI and SDI, respectively).

A. Federal Employment Taxes – FICA & FUTA

Specifically, the UIC provides that all employers (defined as any individual or organization which has in its employ one or more individuals performing services for it within California)[23], are subject to the payment of contributions to the Unemployment Fund with respect to wages paid for "employment" (Section 976 UIC).

An employee is defined under UIC Section 621, *inter alias*, as any individual who under the usual common law rules applicable in determining the employer–employee relationship has the status of an employee. See endnote 14. No exclusion is granted to F, J, M, Q or H-2 visa holders, therefore these individuals would qualify as employees for this

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purpose.[24]

Moreover, UIC Section 601 defines "employment" as those services performed by an employee, including services in interstate commerce, for wages or under any contract of hire, written or oral, express or implied. There is not any exemption related to services provided by F, J, M, Q or H-2 visa holders or any other type of visa holder. Article 2 of the UIC (Sections 625 trough 656) list a series of exemptions or excluded services that would not be considered to fall within the concept of "employment". Nevertheless, no express exclusion is included any type of visa holder.

Albeit no express exemption is provided for such nonresidents, there are certain services that could be performed by these visa holders, which might be exempted from SUI. The exemption is not with regard to the immigration status of an individual but rather arising out of the type and the nature of the service performed.

These services are as set forth below:

Services performed for public entities and services performed as part of an unemployment work relief or work training program assisted or financed in whole or in part by any federal agency or an agency of a state or political subdivision (Sec. 634.5).

a) Services performed in the employ of any organization exempt from federal income tax under Section 501(a) of the IRC (Sec. 641).

b) Service performed in the employ of a school, college or university by a student (Sec. 642).[25]

c) Service performed as a student nurse in the employment of a hospital or a nurses' training school by an individual enrolled and regularly attending classes in a nurses' training school chartered or approved pursuant to state law. And services performed as an intern in the employ of a hospital by an individual who has completed a four years' course in a medical school chartered or approved pursuant to state law (Sec. 645).

d) Service performed by an individual under the age of 22 who is enrolled at a nonprofit or public educational institution (Sec. 646).[26]

Except for the above type of services, all other employment services performed in California by an F, J, H-2A, M or Q visa holder would generally be subject to SUI.[27]

B. CALIFORNIA STATE DISABILITY INSURANCE

California SDI contributions are imposed indirectly against employees on a withholding basis, which must be paid by the employer[28]. Under UIC, every employer paying wages to a non-resident employee for services performed in California is subject to the obligation of applying this withholding tax (Sec.13020).

For these purposes, "employee" means both resident individuals receiving remuneration for services performed within or without California and those non-resident individuals receiving remuneration for services performed in California. There is no other exemption to F, J, H-2A, M or Q visa holders or any other specific type of visa holder (Sec. 13004).

Moreover, the term "wages" is defined under UIC Section 13009 as *"all remuneration (other than fees paid to a public official) for services performed by an employee for his or her employer including all remuneration paid to a nonresident employee for services performed in this state,…"*. Under this provision certain items are excluded, such as those "*services performed by a nonresident alien individual as designated by regulations prescribed by the department*".

The UIC Regulation 4309-2 lists all exclusions from wages and only excludes remuneration paid to residents in Canada and Mexico who enter and leave California at frequent intervals and in the event of remuneration paid to residents in Mexico or Canada for transportation services. The regulation does not address F, J, H-2A, M or Q visa or any other type of visa holders.

III. Conclusion

In conclusion, employment services provided by an F, J, H-2A, M or Q visa holders are generally subject to both California SUI and SDI unless one of the exemptions explained above applies.[29] At the same time, FICA or FUTA tax will not apply to the employee compensation paid by the U.S./California employer. California employers rarely understand how to properly apply these rules and regularly withholding both California SUI and SDI and federal FICA and FUTA taxes (even if not applicable). The non-U.S. citizen employees are usually none the wiser in these circumstances and go away back to their home country unaware that they paid (via their employer) too much tax to the U.S. federal government.

Accordingly, California employers and their payroll departments and payroll service companies should take great care to exclude from FICA and FUTA withholding taxes the compensation earned by employees who hold F, J, H-2A, M or Q visas. At the same time, the same compensation will likely be subject to California SUI and SDI. Incidentally, if a California employer (or any U.S. employer, whether in New York, Florida, Texas, etc.) erroneously withholds the FICA and FUTA tax in these cases (which is not uncommon based upon the authors experience), the visa holder can make a claim for refund

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and file (i) IRS Form 843 - *Claim for Refund and Request for Abatement* along with (ii) *Form 8316 - Information Regarding Request for Refund of Social Security Tax Erroneously Withheld on Wages Received by a Nonresident Alien* on an F, J, H-2A, M or Q Type Visa.

IMMIGRATION STATUS/ VISA TYPE		**PURPOSE**	**DESCRIPTION**	**EFFECTS U.S. INCOME TAX RESIDENCY?**	**EFFECTS U.S. ESTATE AND GIFT TAX DOMICILE?**
BUSINESS PERSONEL					
	Q	Cultural Exchange	Program must take place where American public is exposed to aspects of a foreign culture as part of a structured program	**Yes – if "student", "teacher" or "trainee"	*No
STUDENTS & TRAINEES					
	F	Student	A student qualified to pursue a full course of study at an established institution	**Yes – if "student"	*No
	J	Exchange Visitor	To participate in an exchange visitor program that has been designated with the purpose of teaching, studying, observing, conducting research, consulting, receiving training.	**Yes – if "student", "teacher" or "trainee"	*No
	M	Vocational Students	Student in community/junior college for 12 semester leading to a specific educational objective	**Yes – if "student"	*No
	H-2A	Temporary Agricultural workers	Temporary workers performing "agricultural labor or services of a temporary or seasonal nature"	No	*No

*The visa, in and of itself, has no impact on domicile for U.S. estate and gift tax purposes.

**Various procedural requirements must be satisfied to "substantially comply" with the statute. Additionally, various time limits apply to limit the non-resident alien status. *See* I.R.C. Section 7701(b)(5)(C), (D) and (E).

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[1] *There is a time limit normally of five years of U.S. residency that can be utilized to avoid U.S. income tax residency by qualifying students.*

[2] *There are several exceptions to the substantial presence test that permit certain categories of aliens (i.e., non U.S. citizens) to be ignored for applying the substantial presence test (i.e., based upon the number of days an individual is physically present in the U.S.) for the current year, such as:*

Foreign government-related individuals (I.R.C. Section 7701(b)(5)(B));

Teachers and trainees (I.R.C. Section 7701(b)(5)(C));

Students (I.R.C. Section 7701(b)(5)(D));

Professional athletes temporarily in the United States to compete in a charitable sports event (I.R.C. Section 7701(b)(5)(A)(iv));

Aliens who are unable to leave the United States because of a medical condition that arose while they were in the United States (I.R.C. Section 7701(b)(3)(D)(ii));

Regular commuters from Canada and Mexico (I.R.C. Section 7701(b)(7)(B));

Certain aliens who are in transit through the United States (I.R.C. Section 7701(b)(7)(C)) and

Certain crewmembers of foreign vessels that are engaged in international transportation services (I.R.C. Section 7701(b)(7)(D)).

[3] *See I.R.C. § §865(b) and 7701(b).*

[4] *Excluded from this definition are certain teachers, trainees, students, professional athletes, family members and persons with pre-existing medical conditions.*

[5] *This means that the non-U.S. citizen (e.g., a citizen of Mexico or Belgian) must be lawfully accorded the privilege of residing permanently in the U.S. as an immigrant in accordance with the U.S. federal immigration laws. For this rule to be effective, the "green card" must not be revoked administratively by the BCIS or by a U.S. court. See I.R.C. §7701(b)(1)(A)(i).*

[6] *See I.R.C. § 7701(b)(7)(B).*

[7] *To meet this requirement, the person cannot be a green card holder, cannot meet the substantial presence test, and must be physically present in the U.S. for a period of at least 31 consecutive days and meet a 75 percent test. See I.R.C. §7701(b)(1)(A)(iii).*

[8] *See Treas. Reg. Section 1.871-9.(a) which provides in relevant part as follows:*

" . . . a nonresident alien individual who is temporarily present in the United States during the taxable year as a nonimmigrant under subparagraph (F) (relating to the admission of students into the United States) or subparagraph (J) (relating to the admission of teachers, trainees, specialists, etc., into the United States) of section 101(a)(15) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15) (F) or (J)), and who without regard to this paragraph is not engaged in trade or business in the United States during such year, shall be deemed to be engaged in trade or business in the United States during the taxable year . . .

[9] *Immigration and Nationality Act ("INA"), Section 101(a)(15(j).*

[10] *22 C.F.R. 514.5.*

[11] *Treas. Reg. 31.3401(a)(6)-1.*

[12] *I.R.C. Section 3401(a).*

[13] *See, Treas. Reg. Sections 31.3401(a)(6)-1(a)(1) and 31.3401(a)-1. There is also another regulatory exemption from employment taxes regarding Mexican and Canadian employees that regularly travel to and from the U.S. as part of transportation services and certain international projects. Treas. Reg. 31.3401(a)(6)-1(c)(1) and (2).*

[14] *The IRS has explained the distinction between independent contractor and an employee as follows (IRS PLR 9738015):*

The question of whether an individual is an independent contractor or employee is one of fact to be determined upon consideration of the facts and application of the law and regulations in a particular case. Guides for determining the existence of that status are found in three substantially similar sections of the Employment Tax Regulations; namely, Code Sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1 relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding on wages at source, respectively.

Code Section 31.3121(d)-1(c)(2) provides that generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the results to be accomplished by the work, but also as to the details and means by which the result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done, but also as to how it shall be done. . . In determining whether an individual is an employee or an independent contractor under the common law, all evidence of control and autonomy must be considered. Facts which illustrate whether there is a right to direct or control how the worker performs the specific tasks for which he or she is hired, whether there is a right to direct or control how the financial aspects of the worker's activities are conducted, and how the parties perceive their relationship provide evidence of the degree of control and autonomy. Code Section 31.3121(d)-1(a)(3) provides that if the relationship of an employer and employee exists, the designation or description of the parties as anything other than that of an employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.

[15] *For a more detailed discussion see Michael Lewis, Comment: Addressing Inequities in the Collection of Social Security Taxes for U.S. Citizens Working Abroad, 37 San Diego L. Rev. 853 (2000).*

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[16] *The United States currently has twenty Totalization Agreements in effect with the following countries; Italy November 1, 1978, Germany December 1, 1979, Switzerland November 1, 1980, Belgium July 1, 1984, Norway July 1, 1984, Canada August 1, 1984, United Kingdom January 1, 1985, Sweden January 1, 1987, Spain April 1, 1988, France July 1, 1988, Portugal August 1, 1989, Netherlands November 1, 1990, Austria November 1, 1991, Finland November 1, 1992, Ireland September 1, 1993, Luxembourg November 1, 1993, Greece September 1, 1994, South Korea April 1, 2001, Chile December 1, 2001 and Australia October 1, 2002. http://www.ssa.gov/international/agreements_overview.html*

[17] *See I.R.C. §§ 3121(a)(19), 3231(e)(1).*

[18] *See I.R.C. § 3306(c)(1).*

[19] *See I.R.C. § 3121(b)(1); Treas. Reg. § 31.3121(b)(1)-1(c).*

[20] *See, Moorhead v. United States, 774 F.2d 936 (9th Cir. 1985)*

[21] *See, I.R.C. § 3401(a)(2); Treas. Reg. § 31.3401(a)(2)-1.*

[22] *See also IRS Pub. 51, Circular A, p.19.*

[23] *UIC Section 135.*

[24] *The only exclusion is for those director of a corporation or association performing services in his or her capacity as a director (Sec. 622)*

[25] *This only applies if the service is performed by a student enrolled and regularly attending classes at such school, college or university. This rule is extended to services performed by the spouse of such student complying with these rules.*

[26] *Such institution shall normally maintain a regular faculty and curriculum and normally shall have a regularly organized body of students in attendance at the place where the individual educational activities are carried on as a student in a full–time program, taken for credit at such institution, which combines academic instruction with work experience, if such service is an integral part of such program, and such institution has so certified to the employer. This shall not apply to services performed in a program established for or on behalf of an employer or group of employees.*

[27] *The Employment and Development Department notifies employers of their rate each December. Generally, a new employers tax rate is 3.4 percent for the first three years.*

[28] *The term "Employer" means any individual, person corporation, association or partnership doing business in the State of California deriving income form sources within such state or in any manner whatsoever subject to the laws of such state and making payment of wages to employees fore services performed within this state.*

[29] *The 2005 SDI tax rate is 1.08 percent*

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