

United States

Federal Taxation

Individual Taxation

Introduction

For tax purposes, the United States includes the 50 US states and the capital city of Washington, District of Columbia. The United States exercises sovereign jurisdiction over a number of possessions and territories, including Puerto Rico, the US Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. These possessions and territories are not subject to US tax legislation and are not parties to nor governed by US income tax treaties.

Due to the nature of the United States as a federal union, income and other taxes are imposed by both the federal government and the state governments and, in some cases, by municipalities.

Individuals are subject to federal income tax, estate tax, and gift tax. Individuals who are employees or who are self-employed must pay social security tax.

The tax administration agency in the United States is the Internal Revenue Service (IRS). The currency is the US dollar (USD).

1. Income Tax

The United States imposes a net income tax on individuals.

1.1. Taxable persons

US citizens and residents are subject to taxation on their worldwide income even if they reside outside the United States. Foreign nationals are subject to US income tax if they become US residents or if they derive certain types of income from US sources.

Foreign nationals are treated as US residents if they hold a US green card and have entered the United States or if they meet a substantial presence test. The substantial presence test is met if the person is present in the United States for (1) at least 31 days during the current calendar year, and (2) for at least 183 days during the current calendar year and prior 2 years determined by counting each day of presence in the current year as 1 day, each day of presence in the first prior year as one third of a day, and each day of presence in the second prior year as one sixth of a day. Exceptions apply to individuals in exempt categories (i.e. foreign government-related individuals, students, teachers, and trainees) and to individuals who have a closer connection to a home in a foreign country).

Married persons may elect to file either a separate income tax return reporting their own income and deduc-

tions or they may elect to file a joint tax return reporting the combined income and deductions of themselves and their spouse.

Unincorporated entities such as partnerships and limited liability companies (LLCs) may make a voluntary election under the Treasury Department's "check-the-box" regulations to be taxed as corporations or as pass-through (transparent) entities.

1.2. Taxable income

1.2.1. General

US citizens and residents are taxable on all income from whatever source received. This includes wages, salary, business income, and investment income. All types of income (with the exception of capital gains) are combined and taxed at the same rates. Capital gains are subject to special tax rates.

Taxable income is computed by: (1) determining gross income, (2) subtracting certain statutory deductions to arrive at adjusted gross income (AGI), and (3) subtracting (i) the standard deduction amount or the amount of itemized deductions and (ii) personal exemption amounts. The tax rates are applied to the taxpayer's taxable income as so computed, and the amount of tax owed may be offset by allowable credits.

The tax rates used depend on the return filing status of the taxpayer. There are four categories for individuals:

- (1) married persons filing joint tax returns that combine all their income and deductions;
- (2) heads of household, i.e. persons who maintain a household that is the principal place of abode of a dependent child or other dependent for at least one-half of the taxable year;
- (3) unmarried individuals, i.e. single taxpayers; and
- (4) married persons filing separate returns, with each spouse reporting their own income and deductions on a separate return.

Surviving spouses may file in the married joint return category for the taxable year in which their spouse dies and for the 2 succeeding taxable years if they maintain a household that is the principal place of abode of a dependent child.

Children are required to file an income tax return and pay tax on their own income. For the tax rates applicable to children who are under the age of 18 and who have unearned income above an annual threshold amount, and for an election by a parent to include the income of a child on the parent's income tax return, see 1.9.1.1.

1.2.2. Exempt income

Categories of income exempt from taxation include the following:

- amounts received under life insurance contracts;
- gifts and inheritances;
- interest on bonds issued by US states and municipalities for qualified public purposes;
- foreign earned income (see 6.1.1.); and
- certain amounts received as compensation for injuries or sickness.

An exclusion of USD 250,000 applies (USD 500,000 in the case of married persons filing a joint return) to gains from the sale of a home if it has been owned and occupied as the taxpayer's principal residence for at least 2 years during the 5-year period preceding the date of sale.

1.3. Employment income

1.3.1. Salary

Income received as salary and wages is subject to personal income tax. Expenses directly related to employment income and not reimbursed by the employer may be deducted. Commuting costs are not deductible.

Moving expenses are deductible if paid in connection with the commencement of work as an employee or as a self-employed individual at a new principal place of work. The new principal place of work must be at least 50 miles farther from the former residence than was the former principal place of work or, if there was no former place of work, at least 50 miles from the individual's former residence. In addition, time-in-employment requirements must be met at the new principal place of work.

1.3.2. Benefits in kind

1.3.2.1. Employer provided benefits

Benefits received in kind from an employer constitute taxable income unless expressly excluded by statutory provision. These benefits are referred to in the United States as fringe benefits. Exclusions are provided in the following cases:

- (1) services provided to the employee that are the same as that offered by the employer to customers in the ordinary course of the employer's business, if no substantial additional cost is incurred by the employer in providing such service to the employee;
- (2) qualified employee discounts in the purchase of goods or services sold by the employer;
- (3) benefits provided that are part of the working conditions, for example, the use of a company car for business purposes;
- (4) fringe benefits that are *de minimis* in value;
- (5) qualified transportation fringe benefits, for example transit passes or parking spaces that do not exceed in value specified monthly amounts;
- (6) reimbursed amounts for qualified moving expenses;
- (7) qualified educational tuition reductions;
- (8) meals and lodging furnished for the convenience of the employer; and

- (9) benefits provided under dependent care assistance programs.

1.3.2.2. Stock options

There are three types of stock options available to employees in the United States:

- (1) Qualified stock options (also referred to as Incentive Stock Options, or ISOs), which are non-taxable at the time of grant or exercise provided that the statutory requirements concerning the option plan and the options granted are satisfied. The employee will receive capital gain treatment if the stock is sold after being held for at least 2 years from the date the option is granted and at least 1 year from the date the stock is acquired.
- (2) Non-qualified options (also referred to as non-statutory options), which are non-taxable at the time of grant provided the option does not have a readily ascertainable fair market value on the date of grant. The employee will be taxed at ordinary income tax rates at the time the option is exercised if the fair market value of the stock exceeds the exercise price of the option. If the stock is held for more than 1 year after the option is exercised, the employee will receive capital gain treatment.
- (3) Options granted under employee stock purchase plans which meet certain statutory requirements are non-taxable at the time of grant or exercise provided that the statutory requirements concerning the option plan and the options granted are satisfied. If the stock is held by the employee for at least 2 years from the date the option is granted and at least 1 year from the date the stock is acquired, the employee will receive capital gain treatment when the stock is sold.

For all three types of stock options, the options can be exercised for the stock of the company issuing the option or for the stock of its parent or subsidiary corporation.

Incentive plans that function in a manner similar to stock options, such as stock appreciation rights (SARs) and phantom stock plans are also used in the United States.

1.3.3. Pension income

Pension income from qualified employer-sponsored pension plans, stock bonus plans and profit sharing plans is taxable income. Distributions are taxable in a manner similar to annuities, i.e. the pro rata amount of each payment that represents the employee's contribution to the plan, if any, can be excluded from taxation.

Individuals may establish an individual retirement account (IRA). The maximum amount that may be contributed to an IRA for the 2009 tax year is USD 5,000. Taxpayers who are aged 50 and over at the end of a taxable year are permitted to make an additional "catch-up" contribution of USD 1,000 (for 2006 and thereafter). If the individual is an active participant in a qualified employer plan, the IRA contribution limit is reduced to the extent that the taxpayer's adjusted gross income exceeds certain threshold amounts.

The taxation of distributions from an IRA depends on the type of IRA. In a “Regular IRA”, contributions by the individual are deductible for the taxable year they are made, and all distributions from the IRA are fully taxable. In a “Roth IRA”, the contributions are non-deductible, and distributions are not taxed provided they are made after the taxpayer has reached the age of 59 1/2 years or are made for certain qualified purposes. A 5-year holding period must also be met. The 5-year holding period requires that distributions should not be made until after the end of the 5-year period that begins with the first taxable year for which a contribution was made to the Roth IRA.

1.3.4. Directors’ remuneration

Remuneration received by members of a corporate board of directors is subject to personal income tax as compensation income. There are no special tax rules applicable to director’s income.

1.4. Business and professional income

Business and professional income is subject to personal income tax. Ordinary and necessary business expenses are deductible provided they are not reimbursed by the employer.

Restrictions apply to the deduction of entertainment expenses, expenses incurred to attend conferences or seminars outside the United States, and the business use of a home as an office.

1.5. Investment income

Individual taxpayers are taxable on investment income, including dividends and interest. Interest income is fully taxable unless it is received on bonds issued by the US states and municipalities for qualified public purposes. Such interest is exempt. Rental income from real property is fully taxable.

Dividends received by individuals are taxed at the same rates applicable to long-term capital gains, i.e. 15% (or 5% or 0% in the case of taxpayers in the 10% or 15% tax brackets for ordinary income, see 1.9.1.2.). The reduced rates are effective for dividends received in taxable years beginning after 31 December 2002 and on or before 31 December 2010.

The reduced rates apply to dividends received from domestic corporations and from qualifying foreign corporations. Dividends from foreign corporations are eligible for the reduced rates if the foreign corporation is eligible for benefits under a comprehensive income tax treaty with the United States (other than the treaty with Barbados) which the Treasury Department determines to be satisfactory and that includes an exchange of information programme. Dividends from a foreign corporation also qualify if its stock is readily tradeable on an established securities market in the United States. To qualify for the reduced rate, the shareholder must meet a holding period requirement. In the case of common stock and most preferred stock, the holding period requirement is that the stock must be held for at least 61 days during the 121-day period that commences 60 days prior to the date the

stock becomes ex-dividend (i.e. the date the stock is tradable without the right to the dividend attached). In the case of preferred stock paying a dividend attributable to periods in excess of 366 days, the required holding period is 91 days during the 181-day period that commences 90 days prior to the date the stock becomes ex-dividend. The reduced rate is not available to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Expenses related to the production of investment income are deductible to the extent of the income received. Expenses related to the production of tax-exempt income are non-deductible.

For the treatment of losses and credits from business activities in which the taxpayer does not materially participate, see 1.8.3. For the treatment of losses from activities subject to the “at risk” rules, see 1.8.4.

1.6. Capital gains

Gains and losses from the sale of capital assets are subject to special treatment. See 1.8.2. and 1.9.1.2.

Rollover relief is provided in the following circumstances:

- where business or investment property is exchanged for property of a like-kind (Section 1031 transactions), but this does not apply to stocks, securities or property held for sale; and
- where property which compulsorily or involuntarily converted (e.g. by eminent domain) into property which is similar or related in service or use (Section 1033 transactions).

In these transactions, the gain is deferred until the replacement property acquired in the transaction is disposed of. See 1.2.2. for the exclusion of gain from sale of a home used as a principal residence.

1.7. Personal deductions, allowances and credits

1.7.1. Deductions

Two types of deductions are permitted in computing taxable income: deductions that are taken from gross income to arrive at adjusted gross income (AGI), and deductions taken from AGI to arrive at taxable income.

1.7.1.1. Deductions from gross income

The principal categories of deductions that may be taken from gross income to arrive at adjusted gross income (AGI) are as follows:

- trade or business deductions, other than those incurred by an employee;
- trade or business deductions of an employee if reimbursed by the employer;
- losses from the sale or exchange of property;
- deductions, including depletion, attributable to property held for the production of income;
- contributions to a pension, profit-sharing, or annuity plan by a self-employed individual;
- contributions to a regular IRA (see 1.3.3.);