Are You A U.S. Person Thinking Of Accepting A Foreign Assignment?

Some U.S. Tax Matters You Should Know Before You Accept!

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The goal of this article is to provide a comprehensive checklist of information for the United States (U.S.) person to consider prior to accepting an assignment outside the U.S. This article is not designed to teach you the technical competence required to perform self compliance; however it will certainly arm you with the technical knowledge to determine if your U.S. tax preparer knows all that they should know to provide you with technically competent professional services.

General concepts of U.S. taxation versus other countries:

All U.S. citizens, Green Card Holders (Lawful Permanent Residents) and individuals meeting the Substantial Presence Test (SPT) are considered U.S. resident aliens (the last category of resident aliens, those meeting the SPT must continue to meet SPT on an annual basis and are therefore not the main focus for this article).

All resident alien U.S. citizens and green card holders are subject to U.S. Federal income taxation on their worldwide calendar year income *indefinitely*, regardless of which country their income is earned in, the currency, bank or country the income is deposited.

The U.S. income tax reporting period is the calendar year- January 1 to December 31- inclusively, regardless of the fiscal or calendar year tax reporting period in the other current country of residence.

For U.S. state tax purposes, the requirements can be quite different and vary from state to state. Typically, there are state-specific subjective facts and circumstance tests regarding Domicile in addition to objective Statutory Resident tests. These Statutory Resident tests are typically conjoined with a 183 days of presence rule and a Permanent Place of Abode requirement, the latter of which is state specific, subjective and/ or vague.

Additionally, some states could deem taxpayers to be continuing tax residents even while away on foreign assignments, if their ultimate intention is to return to the state after the termination of their foreign assignment (basic domicile definition). Some states have Domicile Safe Harbor tests, allowing for the severing of Domicile, while the taxpayer is away on foreign assignment. For more information on state residency issues, please consult us separately.

The U.S. (and the Philippines, Eritrea) is one of few countries worldwide that assess income tax liability based upon a taxpayers' legal immigration status as either a U.S. citizen or U.S. Green Card Holder and not based upon their "tax residency", which is strictly a tax legal status or concept found in other countries. Therefore, while U.S. taxpayers reside abroad, they continue to file U.S. tax returns and be subject to U.S. income taxation on worldwide income regardless, in addition to taxation in their new country of residence as applicable. Most other countries have a "tax residency" concept, where "tax residency" may be severable and determinable by an individual's specific set of facts and circumstances (similar to Domicile for State purposes, as above), e.g.: in Canada these facts and circumstances include permanence and purpose of stay abroad, personal property & social ties, disposition of spouse, dependents and dwelling in addition to establishing tax residence abroad. In most other countries taxpayers can sever this "tax residency" with no continuing tax return filing obligations assuming no local source income, unlike here in the U.S.

"Tax residents" of a country are typically defined as persons taxable in that country on worldwide income, whereas "tax non-residents" of a country are typically defined as persons taxable in that country, but only on income specifically sourced to or from that country and not on worldwide income. U.S. expatriates (Expats) is a term used for U.S. resident alien (U.S. citizens, Green Card Holders and persons meeting the SPT) individuals living and working outside the U.S.

There are three ways U.S. expats can avoid double taxation while abroad on a foreign assignment: The Foreign Earned Income Exclusion (FEIE); the Foreign Housing Exclusion (HE)- (if employed) or/ and the Foreign Housing Deduction (HD)- (if self-employed); and the Foreign Tax Credit (FTC).

<u>The Foreign Earned Income Exclusion (FEIE) and Form 2555:</u>

In an attempt to mitigate the double taxation inequity to U.S. expats (the U.S. tax treatment of U.S. citizens and Green Card Holders versus that of other countries, as above), the U.S. introduced legislation that gave U.S. resident aliens an *elective, per spouse* tax break on the '*foreign income'* that they '*earned'* while residing and working abroad. This break is called the *Foreign Earned Income Exclusion (FEIE)*.

The break is contained in the Internal Revenue Code (IRC) Sec. 911, Citizens or Residents of the U.S. Living Abroad, is accomplished using Internal Revenue Service (IRS) Form 2555, Foreign Earned Income, currently set at $112,00 for 2022 ($108,700 for 2021, $107,600 for 2020, $105,900 for 2019, $103,900 for 2018, $102,100 for 2017, $101,300 for 2016, $100,800 for 2015, $99,200 for 2014, $97,600 for 2013, $95,100 for 2012, $92,900 for 2011 and $91,500 for 2010) *per spouse*, which allows U.S. expats the ability once the foreign earned income is included in their tax return as either wage or self-employed income, to then *elect* to exclude up to the first $112,000 for 2022 ($108,700 for 2021, $107,600 for 2020, $105,900 for 2019, $103,900 for 2018, $102,100 for 2017, $101,300 for 2016, $100,800 for 2015, $99,200 for 2014, $97,600 for 2013, and $95,100 for 2012) of '*foreign'* (non U.S.) '*earned income'* (generally wages or self-employed income, but not pension, annuity, social security benefit, or U.S. government wage income) in tax years in which they are residing abroad for a full year.

Note that in partial years residing abroad- years expatriating or repatriating- the exclusion is pro-ratable based upon the number of days in that calendar year the taxpayer is residing abroad over 365 (366 leap year) days. These days are called the Qualifying Period.

'Earned income' for purposes of the FEIE again as above is generally wages or self-employed income, but not pension, annuity, social security benefit, or U.S. government wage income. But may also include business profits, royalties and rents, but certainly excludes income from property such as interest, dividend and capital gain income, and excludes other income such as alimony (under the TCJA legislation of 2017 for agreements entered into or modified before December 31, 2018), prizes and gambling winnings.

'Foreign' earned income is non- U.S. sourced earned income. The sourcing of *Earned income* is dependent on where the related services are physically performed, by workdays. Wages, bonuses and options are *always* allocable between U.S. and Foreign workdays, whereas other certain other types of compensation items specifically related to only foreign workdays are treated as 100% foreign always (IRS Revenue Ruling 69-238), such as: Quarters (Housing), Home Leave, Education Allowances, Cola's, Moving expenses and Tax Equalization or Protection.

When determining total workdays, the general convention is that standard workdays are 20 per month and 240 workdays per annum. This assumes standard vacation (14 workdays) and standard holidays (7 workdays), but no weekends worked. Adjustments may therefore be required to standard workdays. However, it is always 'strongly' recommended if not required that the taxpayer go through their work calendars or time records or time sheets to determine *actual* workdays in case of an audit to lend credibility to the process. The IRS dislikes the use of estimates in these instances.

Once elected an individual may revoke the FEIE (go back and cancel after first claiming) by an amended filing for any tax year, separately by year with a white paper statement. Additionally, certain positions are deemed revocations. See Rev. Ruling 90-77 when in the past the FEIE was claimed, but then in any succeeding tax year the Foreign Tax Credit (FTC) is claimed in place of the FEIE. A revocation once made, is effective for all subsequent tax years and the FEIE may not be claimed again without IRS Commissioner's consent until the sixth calendar tax year following the tax year in which the revocation first became effective.

Effective January 1, 2006 as amended by IRC Sec. 515 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)- until December 31, 2005 the first $112,000 for 2022 ($108,700 for 2021, $107,600 for 2020, $105,900 for 2019, $103,900 for 2018, $102,100 for 2017, $101,300 for 2016, $100,800 for 2015, $99,200 for 2014, $97,600 for 2013, and $95,100 for 2012) of income earned overseas was excluded from U.S. taxation, with the next dollar earned overseas treated as though it were the first dollar of income and taxed at the very lowest tax bracket. This new law provides for "stacking". "Stacking" results in the next dollar of income taxed at a much higher marginal rate of tax, as though it was the $112,001st dollar of income earned. Therefore this “stacking” feature assumes that the excluded foreign earned income is actually present for tax calculation purposes, effectively using the tax bracket in which it would have been taxed had the excluded foreign earned income actually been present for tax calculation purposes. This results in the taxpayer being pushed into an initially higher starting tax bracket at higher tax rates on that first dollar of unexcluded income.

The implementation of the “stacking” mechanism results in three obvious factors, in addition to an additional tax grab: 1) The usefulness or effectiveness of the FTC and 2) the potential for the FTC carryover are both diminished, in addition 3) in the case of high tax foreign countries, it may be preferable to use the FTC alone. Protax continually optimizes and tests for these factors. Keeping in mind the deemed revocation implications, weighing the alternatives both quantitively and qualitatively.

<u>Who qualifies for the FEIE:</u>

To qualify for the FEIE, a taxpayer must meet two tests: 1) the Tax Home Test (THT) and 2) either a) the Bona Fide Residence Test (BFR) <u>or</u> b) the Physical Presence Test (PPT).

<u>THT</u>- The THT requires taxpayers to have their ‘tax home’ abroad in a foreign country (defined later) for a full uninterrupted 12 fiscal month period. A tax home is: 1) a main place of business, employment or post of duty and is the place where you are permanently or indefinitely (must be in excess of one fiscal year) engaged to work as an employee or self-employed person, or 2) where you regularly live- if you do not have a regular or main place of business due to the nature of your work, or 3) where you work- if you are *itinerant*- having neither a regular or main place of business nor a place where you regularly live.

Although a tax home and residence or domicile may all mean something different for tax purposes, they are connected by the definition of *abode*, where the maintenance a U.S. abode could disqualify the THT. *You are not considered to have a tax home in a foreign country for any period of time in which your abode is in the U.S.*

An "*abode*" has been variously defined as one's home, habitation, residence, domicile, or place of dwelling. It does not mean your principal place of business. "Abode" has a domestic rather than a vocational meaning and does not mean the same as "tax home." The location of your abode often will depend on where you maintain your economic, family, and personal ties.

The IRS has held that "alternating blocks of time" or "a rotational days on and days off scheduling" in the U.S. constitutes a U.S. abode.

You do not have a U.S. abode while temporarily in the U.S., and your abode is not in the U.S. merely because you maintain a dwelling in the U.S. even if inhabited by your family- spouse and dependents.

<u>BFR-</u> The BFR is a strictly *qualitative test* for U.S. citizens (<u>or</u> U.S. resident aliens (in this context Green Card Holders) who are nationals of countries with whom have an income tax treaty with the U.S. containing a non-discrimination clause, without regard to any treaty savings clauses (Rev. Ruling 91-58)). BFR requires taxpayers to be 'in a foreign country' (defined later) for one *full calendar year* (i.e. January 1 to December 31) all-inclusive. BFR is not necessarily your domicile, where domicile is your permanent home, the place that you always intend to return.

Although qualitative in nature, you are not automatically granted BFR status by living or working in a foreign country(s) for a particular job for a specified period of time of one calendar year or longer. Length of stay, nature of the job, intention and purpose are all factors that are considered in meeting BFR. BFR is determined by the IRS on a case-by-case basis.

The IRS makes this determination based upon the filing of Form 2555, Foreign Earned Income, and does have the right as displayed by court cases as explained in IRS Technical Memorandum, number AM2009-003 release date 2/13/09, to restrict the use of BFR. The IRS may perform an analysis of the taxpayer’s specific facts and circumstances, since IRC Section 911(d)(1)(A) requires that a taxpayer establish bona fide residence to the “satisfaction of the secretary”. Courts have construed this statutory language as imposing a “strong proof” standard on taxpayers to demonstrate Bona Fide Residence in a foreign country as opposed to the lesser preponderance of evidence standard for proving ‘tax home’ status.

In Schoneberger v. Commissioner, 74 T.C. 1016, 1024 (1980) as an example of such Court opinions that have provided guidance for determining Bona Fide Residence, the court focused on variety factors, such as: Taxpayer intentions; Establishment of a home temporarily in the foreign country for an indefinite period; Participation in community activities on a social and cultural level, general assimilation; Physical presence in foreign country consistent with employment; Nature, extent and reasons for temporary absences from foreign home; Assumption of economic burdens and payment of foreign taxes; Status of a resident of the foreign country as contrasted to that of a transient or sojourner; Treatment of taxpayer's income tax status by employer; Marital status and residence of family; Nature and duration of employment; Prompt accomplishment within definite or specified time; and Good faith of making trip abroad or tax evasion.

Once BFR status is obtained you may leave the foreign country for brief or temporary trips back to the U.S. However, *to maintain BFR status you must have the clear intention of returning to your foreign country of BFR from such trips without unreasonable delay*. Therefore, we always recommend the taxpayer consider purchasing a return ticket prior to departing for the U.S to meet this presumption.

PPT- The PPT is a strictly *quantitative test* for U.S. citizens or U.S. resident aliens (namely Green Card Holders) requiring 330 full days (a full day is a complete twenty four hour period) of presence abroad 'in a foreign country' (defined later) out of any 12 month, 365 day (366 leap-year) fiscal consecutive period.

Thus, this period can incorporate a non calendar (fiscal) period, as for example April 21, 2021 to April 20, 2022.

Foreign Country re IRC Sec 911- A 'foreign country' for the purposes of IRC Sec 911 is defined as any territory under the sovereignty of a government other than the United States. 'Foreign country' does not include ships or aircraft traveling in or above international waters. Nor does 'foreign country' include offshore installations, which are located outside the territorial waters of any individual nation.

Additionally, the term 'foreign country' does include the country's airspace and territorial waters, in addition to the seabed and subsoil of those submarine areas adjacent to the country's territorial waters over which it has exclusive rights under international law to explore and exploit the natural resources. The term 'foreign country' does not include the Antarctica (a Continent not a foreign country) or U.S. possessions, such as Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, the U.S. Virgin Islands and Johnston Island.

Taxpayers are not allowed to file Form 2555 with Form 1040 until they meet both the THT and either the BFR or PPT tests. Taxpayers may, therefore, be required to substantially delay the filing of their U.S. income tax returns until such time as the tests are met. Form 2350, Application for Extension of Time to File U.S. Income Tax Return, would be the extension form to employ under these circumstances, it provides for an unlimited filing extension date until such time as the prerequisite tests explained above are met. Further it is the only individual extension that requires a signature and IRS approval.

Additionally, IRS Form 673, Statement for Claiming Exemption From Withholding on Foreign Earned Income Eligible for the Exclusion(s) Provided by Section 911, may be used by U.S. expats as a payroll form- similar to Form W-4 to avoid the excess withholding of U.S. income taxes on foreign earned and thus excludable income.

Waiver of Time Requirements- IRC Sec 911(d)(4):

Under extraordinary circumstances IRC Sec 911(d)(4) allows both the BFR and PPT minimum time requirements to be waived if you must leave a foreign country due to war, civil unrest or similar adverse conditions. However to apply you (i) must be able to show that you could reasonably have expected to meet the minimum time requirements if not for the adverse conditions, (ii) you must have your home in a foreign country at the time of such adverse conditions and finally (iii) you must be a bona fide resident of or physically present in the foreign country on or before the beginning of the waiver.

The IRS publishes a list of the countries that qualify for this waiver of time requirement and effective dates that the waiver applies to. While if you left one of those listed waiver countries you may still qualify under BFR or PPT without meeting the minimum time requirements, the exclusion is calculated using days of actual residence only by the attachment of a white paper explanation statement.

On April 27, 2020 in light of the Covid-19 pandemic Congress passed Rev Proc 2020-27 invoking IRC Sec 911(d)(4)- Waiver of Time Requirements- with respect to the PPT and BFR tests deeming the Covid-19 epidemic to qualify as Adverse Conditions for the countries of China (excluding HK and Macau) from December 1, 2019 and Globally from February 1, 2020 until July 15, 2020.

As above stated you must be able to show that you could reasonably have expected to meet the minimum time requirements if not for the Covid-19 epidemic, have your home in a foreign country and be a bona fide resident of or physically present in the foreign country on or before the beginning of December 1, 2019 or February 1, 2020 respectively. Again, the exclusions are calculated using days of actual residence only.

U.S. Travel Restrictions- IRC Sec 911(d)(8):

If you are present in a foreign country in violation of U.S. law, then your BFR, PPT FEIE, HE and HD are treated as not existing. As of 2021 for all of 2021 the only travel restricted country is Cuba (not the Guantanamo Bay U.S. Naval Base). Revenue Ruling 2005-3 and Notice 2003-52 removed Iraq and Libya from the U.S. travel restriction list.

PPT versus BFR:

Typically, the PPT is used in years of transition, that is, in both years of expatriation and repatriation back to the U.S. PPT places advantages over BFR in these transition years for the following three main reasons:

1) if up to the point of expatriating or repatriating the taxpayer has been in a foreign country for more than 330 full days in the 12 month fiscal consecutive period under PPT, there is opportunity to use those excess 35 (36 leap year) or less days in the 365 (366 leap year) consecutive period less the 330 days required to meet PPT, as slide days to increase the PPT Qualifying Period.

   This is accomplished by either sliding the taxpayer back (expatriating) or ahead (repatriating) respectively by those 35 (36 leap year) or less days slide days. Therefore, using PPT, the period covered by the FEIE may be extended by using the 35 (36 leap year) or less slide days in a U.S. person's expatriating or repatriating years to increase the amount of fractional exclusion that can be claimed.

   It is, therefore, prudent planning in the expatriating and repatriating tax years to limit the days back to the U.S., so that these potential 35 (36 leap year) slide days can be optimized to obtain additional FEIE. This results in a potential of $112,000 for 2022/ 365 days x 35 days= $10,740 of extra FEIE;

2) in transition expatriating years, meeting the BFR test will encompass waiting for a full calendar tax year to elapse subsequent to the date of U.S. departure and prior to filing that year's U.S. income tax return. Therefore, using the PPT test may allow, if the qualifications are met a U.S. tax filing in advance, and

3) in cases where the taxpayer is not a U.S. citizen and not a U.S. resident alien Green Card Holder who is a national of a country that has an income tax treaty with the U.S. that contains a non-discrimination clause, PPT may be the only option.

The Foreign Housing Exclusion (HE) or Deduction (HD)/ Qualified Foreign Housing Expenses (QFHE):

In addition to the FEIE, there is a little-known hidden jewel, the Foreign Housing Exclusion (HE) for employed persons or the Foreign Housing Deduction (HD) for self-employed persons. In addition to the above FEIE of $112,000 for 2022 ($108,700 for 2021, $107,600 for 2020, $105,900 for 2019, $103,900 for 2018, $102,100 for 2017, $101,300 for 2016, $100,800 for 2015, $99,200 for 2014, $97,600 for 2013, and $95,100 for 2012), there is also an opportunity to augment this basic earned income exclusion (FEIE) by an overseas taxpayer's reasonable (but not lavish or extravagant) Qualified Foreign Housing Expenses. Qualified Foreign Housing expenses are typically much higher than a taxpayer's taxable employer paid housing income, allowance, or quarters.

Further 'actual' Qualified Foreign Housing Expenses should never be confused with employer paid housing income, allowances or quarters. One is an actual expense or outlay, the other simply an element of compensation.

The nice feature of the HE or HD is that the list of Qualified Foreign Housing Expenses are clear and well established and include: Rent, Fair Market Value (FMV) of employer provided housing, foreign real-estate or occupancy taxes (now more relevant with the elimination of the deduction of such expenses on Schedule A as a result of the Tax Cuts and Jobs Act of 2017 (TCJA 2017)), TV taxes, utilities (but not telephone), real or personal property insurance, "key" money or other similar nonrefundable deposits paid to secure a lease, repairs and maintenance, furniture rental, temporary living expenses and residential parking.

However, the truly astonishing feature about the HE or HD is that it does *not* matter who pays for these qualified housing expenses. Regardless of whether the employee directly pays for these costs or the employer directly pays (or reimburses the employee), these costs are still includable as Qualified Foreign Housing costs for determining the HE or HD. This is due to the fact that employer directly paid or reimbursed costs may need to be included in the taxpayer's employment income, since they are considered an element of taxable compensation as they relate to personal living expenses.

However, housing costs for the 'convenience of the employer' on the employer premises such as in a man camp are not considered taxable compensation. These types of arrangements may also include a safety or security or remoteness element.

Effective January 1, 2006, as amended by IRC Sec. 515 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), this new law provides for two changes regarding the HE and HD:

1) the base housing amount (otherwise known as 'Housing Norm', which acts like a deductible) representing the amount that needs to be exceeded before any qualified housing costs are excluded or deducted, effective January 1, 2022, has risen from $47.65 per day or $17,392 for a full 365 days for 2021 *to* $49.10 per day or $17,920 for a full 365 days for 2022, representing 16% of the amount of the FEIE or $112,000 for 2022 ($108,700 for 2021).

2) further TIPRA has placed an overall effective cap on the total Qualified Housing Expenses eligible for consideration for either the HE or HD, at 30% of the FEIE of $112,000 for 2022 ($108,700 for 2021) or for 2022 $92.05 per day or $33,600 for a full 365 days (30% * $112,000). For 2021- $89.34 per day or $32,610 for a full 365 days (30% * $108,700). This cap had not existed prior to January 1, 2006.

Therefore, the maximum excludable or deductible Qualified Housing Expenses is the difference between the cap of $33,600 less the deductible base housing amount of $17,920 which equals $15,680 or $42.96 per day for a full 365 days.

Further to the ratification of TIPRA, the IRS continues to issue IRS Notice(s) for 2021 Notice 2021-18 (issued March 1, 2021) (2020 Notice 2020-13 (issued February 21, 2020)) which allows for certain cities (of 52 countries worldwide) with very high housing costs a higher overall exclusion cap, effectively overriding the 2022 30% limitation on the FEIE or $33,600 cap. Until the 2022 IRS Notice is issued assumingly in March or April of 2022 for the 2022 tax year, we will continue to apply the 2021 Notice to 2021 tax year. When the 2022 Notice is issued, we may elect to apply the 2022 Notice adjustments to the 2021 tax year in lieu of the adjusted 2021 Notice adjustments (Notice 2021-18) if the 2022 Notice limitations are higher. Please consult us on a list of these cities and amounts separately.

<u>Moving Expenses and Employed Versus Self-Employed (SE):</u>

Effective as per the TCJA 2017 Moving Expense and Schedule A- Itemized Deductions- tier 2 (those subject to the 2% of AGI threshold) Unreimbursed Employee Expense (UREE) deductions have been eliminated. Therefore, all Moving Expense and UREE Schedule A discussions in relation to the 2021 FEIE claim are now suspended until the TCJA 2017 sunsets in 2025.

Eliminated under TCJA 2017~~- Any moving expenses whether employed or self-employed, if claimed and to the extent that they are considered *foreign* moving expenses would reduce dollar for dollar the amount of the $104,100 for 2018 ($102,100 for 2017, $101,300 for 2016, $100,800 for 2015, $99,200 for 2014, $97,600 for 2013, $95,100 for 2012, $92,900 for 2011 and $91,500 for 2010) FEIE available. Only moves from the U.S. to foreign countries and foreign to foreign countries are considered *foreign* moves, and thus *foreign* moving related expenses.~~

Generally, employees on foreign assignments have some advantages over those self-employed (SE). Although some of these other advantages were eliminated under TCJA 2017, as emphasized below.

Eliminated under TCJA 2017- ~~Although *foreign* UREE will be excluded from Schedule A, therefore not affecting the amount of the FEIE claim; conversely.~~ However well worth noting although the TCJA 2017 eliminated UREE, it does not affect Schedule C expense claims of SE persons placing a new advantage for SE persons.

All overseas SE person's Schedule C *foreign* expenses and applicable *foreign* self-employed adjustments on 2021 IRS Form 1040 Schedule 1-Part II- Adjustments to Income line(s) 11-24z (e.g. ½ the SE tax, the SEHI deduction, etc…) dollar for dollar reduce the amount of the $112,000 for 2022 ($108,700 for 2021, $107,600 for 2020, $105,900 for 2019, $103,900 for 2018, $102,100 for 2017, $101,300 for 2016, $100,800 for 2015, $99,200 for 2014, $97,600 for 2013, and $95,100 for 2012) FEIE available.

Additionally, as a SE person's net SE income is subject to U.S. FICA (Federal Insurance Contributions Act) taxes- social security 6.2 percent on the first 147,000 for 2022 ($142,800 for 2021) of wages and Medicare (1.45 percent on all wages or net SE income) taxes, SE persons additionally end up paying both the employee and employer portions. This effectively combines to 15.3 percent (6.2 percent + 1.45 percent = 7.65 percent x 2) FICA taxes for all SE persons reporting net income on Schedule C, which is always assessable if net income on Schedule C arises, since SE FICA taxes are *not* affected by the FEIE and HD.

However, persons *employed* abroad and not on U.S. payroll, but instead locally hired on a foreign payroll are not subject to U.S. employee FICA taxes at all. They would become subject to the social security tax regime of the respective country in which they work, if any.

To mitigate the above, the IRS always views the *substance over legal form* of an employee-employer or master-servant relationship under common law definition to hold. Further, IRS Revenue Ruling 87-41 dictates that subject to a twenty point analysis it may be possible to declare earnings on IRS Form 1040 as line 1 wages (versus as an independent contractor or self-employed individual on IRS Form 1040- Schedule C) and subject this wage income to only the employee ½ of the SE tax using Form 8919, Uncollected Social Security and Medicare Tax on Wages, where an individual works for a U.S. corporation issuing them wage income on Form 1099-MISC, as box 7- Nonemployee Compensation. If they work for a foreign corporation then there are no U.S. SE or FICA tax implications.

Where clearly the individual fails the common law employee-employer definition or it may be difficult to apply IRS Revenue Ruling 87-41 to avoid U.S. FICA SE taxes then the self-employed taxpayer may consider: 1) Totalization/ Social Security Agreements reached between the U.S. and thirty (30) countries that may alleviate U.S. SE FICA taxes, failing which, 2) going on a foreign or a third party payroll PEO type arrangement, 3) having their client put them on payroll, 4) having a non-related person own a foreign entity that in turn pays them a wage, or 5) a U.S. SE person doing business abroad may also do business directly through a foreign entity to avoid U.S. FICA SE taxes, where they have not checked the box on Form 8832 (Entity Classification Election) to be treated as a one-member disregarded entity that automatically defaults to a Schedule C (Profit or Loss from a Business). Assuming the foreign entity is an active business (no Sub Part F income- generally passive income), then we recognize shareholder or owner corporate deferral reporting of both salary and dividends on a cash paid basis.

However, there are a myriad of onerous U.S. reporting requirements whenever a U.S. person owns directly or indirectly 10% or more of any foreign entity. Form(s) 5471- Information Return of U.S. Persons with Respect to Certain Foreign Corporations, 8865- Return of U.S. Persons with Respect to Certain Foreign Partnerships (or where the U.S. person invests more than $100,00 USD in the case of a foreign partnership) and 8858- Information Return of U.S. Persons with Respect to Certain Foreign Disregarded Entities - may come into play along and in the case of a foreign corporation only Form 926- Return of a U.S. Transferor of Property to a Foreign Corporation. The complexity of these respective forms, their instructions, including the need to apply U.S. Generally Accepted Accounting Principles (G.A.A.P.) makes the associated compliance further burdensome. Further in the majority of cases the U.S. CPA will not have the detailed information required for such compliance. As such usually it is the foreign accountant or client themselves whom must complete these forms.

Further the TCJA of 2017 imposed not only a one time "deemed repatriation tax" or 'transition tax' of 15.5% on untaxed foreign earnings or business profits accumulated overseas from 1986- December 31, 2017 held in cash or cash-equivalents and 8% for profits held in non-cash form, but also starting for the 2018 income tax year forward under IRC Sec 951(A) imposed an annual GILTI (Global Intangible Low

Tax Income) inclusion for individuals on Form 8992- U.S. Shareholder Calculation of Global Intangible Low-Taxes Income (GILTI). The GILTI would be taxed at ordinary U.S. income tax rates.

As in the case of the one-time 2017 'Repatriation" IRC Sec 965 tax, this would apply whether or not the funds had been repatriated by deeming these earnings to be repatriated, for any U.S. persons (U.S. individuals, domestic corporations, partnerships, trusts and estates) owning more than 10% of a controlled foreign corporation (CFC), where a CFC is a foreign corporation in which US persons control more than 50%.

<u>What happens when FEI exceeds the $112,000 for 2022 ($108,700 for 2021) plus the HE or/ and HD:</u>

Under U.S. domestic law IRC Sec. 901- (Foreign Tax Credit) (FTC) and also included in most federally negotiated international income tax treaties, there is a provision to avoid "double taxation" the Foreign Tax Credit. The provision is reportable on IRS Form- 1116, Foreign Tax Credit. There is a separate FTC for passive income and for general limitation income (wage/ SE income), where for the general limitation income category there needs to be a reduction or scale down in respect both of excluded foreign tax and excluded foreign income. In other words, taxpayers may not claim a FTC on income that has already been excluded on Form 2555 and the amount of foreign tax eligible for the FTC must also be scaled down for the portion of foreign tax related pro rata to the excluded income.

As a result of the FTC, taxpayers are always protected and *theoretically* should never pay double tax on their worldwide income.

There is an option to use either the accrued basis or paid basis to record foreign taxes for the purposes of calculating the FTC. As a general rule use the paid basis if the foreign tax cycle is a calendar year tax cycle analogous to the U.S., and the accrued basis if the foreign tax cycle is a fiscal tax year, unlike the U.S. tax system. The accrued election forces recognition of the foreign taxes for U.S. tax purposes by looking at the U.S. calendar year in which the foreign fiscal year-ends. Thus, the need to calculate the individual withholdings separately or allocate subsequently received refunds or payments made is obviated.

However, once elected the accrued method must continue to be used indefinitely. Furthermore, the accrued basis may be dangerous, because it creates a series of mismatching or timing differences of foreign tax to foreign income in the first year of use. While it provides tax relief in the last assignment year abroad, it can be tax costly in the first assignment year. So there are pros and cons to using the accrued basis. Please also consider foreign tax credit carry back option.

As the FTC calculation is limited to the lesser of the actual foreign tax paid or the U.S. tax on that unexcluded foreign income, if the U.S. tax on that unexcluded foreign income is less than it is calculated on Form 1116 using the average rate of U.S. tax. As such if the average rate of U.S. tax is 28%, but the marginal rate of U.S. tax (U.S. tax on your last dollar of income) is 37% then the avoidance of double tax using the FTC is not always possible and no perfect mechanism exists. For this reason and "stacking" (explained above), the author suggests that it is always preferable to maximize the available exclusions prior to using the available FTC. In limited circumstances as in high tax foreign countries, it may be preferable to use the FTC alone.

Please see discussion on the effects of "Stacking" above, under- "The Foreign Earned Income Exclusion and Form 2555:", where the 'stacking" mechanism in addition to a tax grab results in: 1) The usefulness or effectiveness of the foreign tax credit (FTC), and 2) the potential for the FTC carryover are both diminished, in addition 3) in the case of high tax foreign countries, it may be preferable to use the FTC alone.

Effective January 1, 2005 there is no longer a 90% limitation on the Alternative Minimum Tax (AMT) FTC. Therefore, when in AMT, it is now possible to achieve a full U.S. FTC against U.S. income tax and reduce the U.S. tax liability to nil when there is no U.S. source income.

<u>Other Interesting Form 2555- FEIE, HE and HD, Form 1116- FTC and General Facts:</u>

- SOFA- North Atlantic Treaty Status of Forces Agreement- as an employee of a private company that in turn is under contract with the U.S. Armed Forces and covered by SOFA or a member of a "Civilian Component" of SOFA, under SOFA you have agreed that you are not resident of that foreign country. As a result of this agreement, you may not claim BFR. The result is that on

Form 2555- Part II- Question 13(a) you must check *No* and 13(b) will always be *No*, as such by default BFR may not be used. However, PPT may still be used to qualify for the FEIE.

- As a condition of employment, the taxpayer may have signed a 'closing agreement' with their employer, wherein which they have agreed to waive their rights to elect the FEIE. Common where the taxpayer works for a major defense contractor who in turn has executed an agreement with a foreign government and the U.S. Department of Defense whom in turn alerts the IRS that their employees are not subject to local country tax. As such in this condition they may not claim the FEIE at all.

- These exclusions- FEIE, HE and HD are elective, and should not be used when they trigger income inclusion. This would occur, for example where Schedule C expenses outstrip income and these expenses are added back to actually create income.

- You cannot pick and choose income that you wish to exclude and income for which you elect not to exclude. It is an all or nothing approach.

- If the taxpayer ends one foreign assignment and continues with another foreign assignment abroad, then this will not affect either the THT or BFR or PPT tests. However, if the taxpayer happens to pack up their belongings and move back to the U.S. (transferring their abode back to the U.S.) for work in the U.S. during this interim period, then the taxpayer has forgone either the THT or BFR tests, not to mention the PPT. The taxpayer may need to re-qualify for these tests. Please see discussion on Abode above, "Who qualifies for the FEIE".

- The HE and HD are both subject to a base deduction or "Housing Norm" which for 2022 is $49.10 per day based upon 365 days (2021 is $47.65 per day based upon 365 days). So, if in 2021 the taxpayer was abroad a full 365 calendar tax year the taxpayer would first need to deduct $17,920 prior to any of the Foreign Qualified Housing Costs counting towards the HE or HD.

- Theoretically, if the taxpayer has no U.S. source income, then using the FEIE, HE, HD and/ or FTC, their U.S. tax liability should be NIL. This assumes that the taxpayer is resident in a country that has an income tax and that that foreign income tax is at least as high as U.S. income tax. Otherwise if the taxpayer uses the FEIE and HE and/ or HD and in addition requires the use of the FTC in a hybrid situation, the taxpayer will end up paying the higher of either the U.S. income tax or the foreign income tax on that unexcluded earned income requiring the FTC.

- Since U.S. resident aliens are taxable on their worldwide income, they are also able to deduct their worldwide deductions. This would include foreign mortgage interest, ~~real estate taxes~~ (Foreign Real estate tax deductions were eliminated under the TCJA 2017) and other worldwide losses and expenses. ~~However, as above, the ability to deduct foreign UREE on Schedule A is prevented when the FEIE is used to the extent the income to which the deductions relate are excluded.~~ (tier 2 - Schedule A Unreimbursed Employee Expense deductions were eliminated under the TCJA 2017.)

- If the U.S. has federally negotiated a Totalization or Social Security Agreement with the country wherein the taxpayer is employed or self-employed, there may be an opportunity to obtain a retroactive Certificate of Coverage to ensure that taxpayers can continue to pay into the U.S. or foreign social security system for a specified maximum number of years to receive full benefit for their social security contributions on earnings abroad in either the U.S. or foreign country. Please visit http://www.ssa.gov/international/ to determine if such an agreement exists in your circumstances.

- Taxpayers outside the U.S. on April 15 of any tax year automatically qualify for an extended filing deadline of two months to June 15. They should write "Taxpayer Abroad on April 15" on the top of their extension Form 4868- Application for Automatic Extension of Time To File U.S. Individual Income Tax Returns.

- In addition to the automatic 6-month extension to October 15, taxpayers who reside outside the U.S. may request by application to the IRS (by the extended October 15 due date) a discretionary extended filing deadline of an additional two months to December 15.

- Although there is a statutory three-year limit with respect to claiming refunds, there is no statutory limitation on the filing of an original claim of FEIE or to amend a filing where the FEIE is being claimed for the first time. For example, a taxpayer who failed to claim the benefits of the FEIE, HE or HD 10 years ago may still make the claim.

- Under IRC Sec. 121- Sale of Principal residence: - - If the home is your "main home" or principal residence (defined by facts and circumstances test- where you live, where you spend most of your time, similar to domicile) in the five year window prior to sale of a principal residence the taxpayer must have: 1) owned *and* 2) used or lived in the home for at least two years = 24 months = 730 days for both spouses to qualify for the $250,000 per spouse exclusion of gain.

  The two years for the owned and use test do not have to be the same two years within the five-year period prior to sale.

  Temporary absences even if rented out are counted as periods of use.

  This exclusion may only be used once every two years.

  If the taxpayer does not have the two years for both tests they will not qualify for the exclusion unless: they have one of three 'primary reasons' that includes: change in location of employment, health reasons or unforeseen circumstances.

  For each of the three 'primary reasons' the taxpayer would look at i) specific primary reason "safe harbors" and/ or ii) individual facts and circumstances for each of the primary reason, including such factors as: close in time, owned & used at time of specific primary reason, primary reason not reasonably foreseeable, material change in impairment of financial ability to maintain, and use during ownership.

  Safe harbors for change in location of employment (focal point of this article) (where employment includes new or continuing employment or self-employment) include where the change occurred during the period of ownership and use of the main home and the new place of employment is at least 50 miles farther from the home sold than was the former place of employment.

  As such a U.S. expatriate taxpayer who moves to a foreign country and continues to maintain their U.S. main home subsequently renting it out and selling it years after expatriating abroad, will still qualify under the change in location of employment primary exception as long as they have usage (versus ownership) in the five-year window prior to sale.

  The obvious handicap for expats is that although they usually meet the two-year test for ownership, they may not meet the two-year test for use.

  If the home is *not* the taxpayers "main home" or principal residence or the taxpayer does not meet the above tests and they have held the home for more than one year then the gain would be taxed at the current long-term capital gain rate, which is currently 15% and maybe 20% for taxpayers in the 37% bracket.

  Non-qualified use-In the calculation of the gain from the sale or exchange of the principal residence, the pro-rata portion of the gain attributable to non-qualified use in tax years 2009 or later where neither you nor your spouse used the property as a main home within certain exceptions will not be excludable under the above rules.

  An exception, however, to the above is any portion of the 5-year period ending on the date of the sale or exchange after the last date you or your spouse used the property as your main home. In practicality what this means is that if there is any rental use (or non-qualified use) during the 5-year window prior to sale, this rental period use is NOT considered non-qualified use and the gain would not have to be pro-rata apportioned between qualified and non-qualified use.

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