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## U.S. PERSONS AND FOREIGN ASSIGNMENTS: MATTERS TO KNOW BEFORE ACCEPTANCE

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**All U.S. resident alien citizens and green card holders are subject to U.S. federal income taxation on their worldwide calendar-year income indefinitely.**

This article provides a comprehensive checklist of information for U.S. persons to consider prior to accepting an assignment outside the U.S. It is not intended to teach technical competence required to perform self-compliance but it will provide the information to determine if a U.S. tax preparer knows all that he should to provide technically competent professional services.

### General concepts of U.S. taxation vs. other countries

All U.S. citizens, green card holders (legal permanent residents)<sup>1</sup> 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 it annually and so are not the main focus for this article).

The U.S. income tax reporting period is calendar year January 1 to December 31 inclusively, regardless of the fiscal-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. There are typically state-specific facts-and-circumstance tests regarding domicile in addition to statutory resident tests. The 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. Also, 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 termination of their foreign assignment (basic domicile definition). Some states have domicile safe harbor tests.

The U.S. is one of few countries worldwide (the Philippines is another) that assesses tax liability based on a taxpayers’ legal immigration status as a U.S. citizen or U.S. green card holder and not on their “tax residency,” which is strictly a tax legal status or concept. Therefore, while U.S. taxpayers are resident abroad, they continue to be subject to worldwide U.S. income taxation regardless of and in addition to taxation in their new country of residence. Other countries have a “tax residency” concept, where “tax residency” may be severable and determined by an individual’s specific facts and circumstances, e.g., permanence of stay abroad, personal property and social ties, disposition of spouse, dependents, and dwelling in addition to

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establishing tax residence abroad. In most other countries, taxpayers can sever their “tax residency” with no continuing filing obligations, unlike 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, not on worldwide income. U.S. expatriates (expats) are U.S. resident alien individuals (U.S. citizens, green card holders, and persons meeting the SPT) living and working outside the U.S.

There are three ways that 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); the foreign housing deduction (HD) (if self-employed); and the foreign tax credit (FTC).

## FEIE and Form 2555

To mitigate the double taxation inequity to U.S. expats (the U.S. tax treatment of citizens and green card holders vs. that of other countries—see above), the U.S. introduced legislation that gave U.S. resident aliens (U.S. citizens, green card holders, and persons meeting the SPT) an elective per spouse tax break on their foreign income that they earned while residing and working abroad. The break is under Section 911, Citizens or residents of the United States living abroad, using Form 2555, Foreign Earned Income.

The exclusion is \$102,100 for 2017 per spouse, which allows U.S. expats, once the earned income is included in their tax return as either wages or self-employed income, to then elect to exclude up to the first \$102,100 (for 2017) of “foreign” (non U.S.) “earned income” (wages or self-employed income, but not pensions, annuities, social security benefits, or U.S. government wage income) in years in which they are residing abroad for a full year.<sup>2</sup>

“Earned income” may also include business profits, royalties, and rents, but certainly excludes income from property such as interest, dividends, and capital gains, and other income, e.g., alimony, prizes, and gambling winnings.

“Foreign” earned income is non-U.S.-sourced earned income. The sourcing of earned income depends on where the related services are performed physically, by workdays. Wages,

bonuses, and options are always allocable between U.S. and foreign workdays, whereas other types of compensation related specially to only foreign workdays are treated as 100% foreign always such as quarters (housing), home leave, education allowances, COLAs, moving expenses, and tax equalization or protection.<sup>3</sup>

In partial years residing abroad (years expatriating or repatriating), the exclusion is pro-ratable based on the number of days in that calendar year residing abroad over 365 (366 leap year) days. When determining total workdays, the general convention is that standard workdays are 20 per month and 240 per annum. This assumes standard vacation (14 workdays) and standard holiday (7 workdays) but no weekends worked. Therefore, adjustments may be required to obtain standard workdays. However, it is always strongly recommended that the taxpayer go through his or her calendar to determine actual workdays in case of an audit to lend credibility to the process.

Once an individual has elected the FEIE, he or she may revoke it (go back and cancel after first claiming) by an amended filing for any tax year, separately by year with a white paper statement. Certain positions are deemed revocations when in the past the FEIE was claimed, but in any succeeding tax year the FTC but no FEIE is claimed.<sup>4</sup> A revocation once made is effective for all subsequent tax years and the FEIE may not be claimed again without Commissioner’s consent until the sixth tax year following the tax year in which the revocation first became effective.

Effective for tax years beginning 1/1/06, section 515 of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222, 5/17/06) (TIPRA) modified Section 911.<sup>5</sup> The first \$102,100 (for 2017) of income earned overseas is 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.

The TIPRA rules provided for “stacking,” which results in the next dollar of income taxed at a much higher marginal tax rate, as though it were the \$102,101<sup>st</sup> dollar of income earned. Therefore, this stacking feature assumes that

<sup>1</sup> See Strohl, “Green Card Checklist,” 28 JOIT 56 (February 2017).

<sup>2</sup> For the 2017 amounts, see Notice 2017-21 2017-21 IRB 1026.

<sup>3</sup> See Rev. Rul. 69-238, 1969-1 CB 195.

<sup>4</sup> See Rev. Rul. 90-77, 1990-2 CB 183.

<sup>5</sup> See Mundaca, Wood, Murillo, and Fiorito, “TIPRA: A Mixed Bag For U.S. International Tax,” 17 JOIT 12 (August 2006).

the excluded foreign earned income is present for tax calculation purposes, effectively using the tax bracket in which it would have been taxed had it actually been present for tax calculation purposes. This results in the taxpayer being pushed into an initially higher starting tax bracket. The stacking mechanism results in two obvious factors, in addition to an additional tax grab: (1) the usefulness or effectiveness of the FTC and potential for the FTC carryover are both diminished; and (2) in very limited circumstances in high-tax foreign countries, it may be preferable to use the FTC alone.

**Who qualifies for the FEIE?** To qualify for the FEIE, a taxpayer must meet two tests: (1) the tax home test (THT); and (2) either the bona fide residence test (BFRT) or physical presence test (PPT).

**THT.** The THT requires taxpayers to have their “tax home” abroad in a foreign country for a full 12-month fiscal period. A tax home is: (1) a main place of business, employment, or post of duty and where the taxpayer is permanently or indefinitely (in excess of one fiscal year) engaged to work as an employee or self-employed person; (2) where the taxpayer lives regularly if he or she does not have a regular or main place of business due to the nature of his or her work; or (3) where the taxpayer works if he or she is itinerant, having neither a regular or main place of business nor a place where he or she lives regularly.

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 a U.S. abode could disqualify the THT. A taxpayer is not considered to have a tax home in a foreign country for any period of time in which his or her abode is in the U.S. An abode is a home, residence, domicile, or dwelling. The IRS has held that “alternating blocks of time” or “rotational XX days on/ XX days off scheduling” in the U.S. constitutes a U.S. abode.<sup>6</sup> A taxpayer does not have a U.S. abode while temporarily in the U.S. and his or her abode is not in the U.S. merely because he or she maintains a dwelling in the U.S. even if inhabited by his or her spouse and dependents.

**BFRT.** The BFRT is a strictly qualitative test for U.S. citizens (or U.S. resident aliens (in this sense, green card holders) who are nationals of countries that have an income tax treaty with the U.S. containing a nondiscrimination clause, without regard to any treaty savings clauses).<sup>7</sup> BFRT requires taxpayers to be “in a foreign country” for one full calendar year (January 1-December 31). BFR is not necessarily domicile, which is the taxpayer’s permanent home, the place to which he or she always intends to return.

Although qualitative, a taxpayer is not granted BFR status automatically by living or working in a foreign country for a particular job or for a specified period of one calendar year or longer. Length of stay and nature of the job are but two factors that are considered in meeting the BFRT. The IRS determines BFR case by case and also includes consideration of intention, purpose, nature, and length of stay. The IRS makes this determination based on the filing of Form 2555 and has the right, as indicated by court cases that the IRS cited in AM 2009-003, to restrict the use of the BFRT. The IRS may perform an analysis of the taxpayer’s specific facts and circumstances, since 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 residence in a foreign country as opposed to the lesser “preponderance of evidence” standard for proving “tax home” status.

*Schoneberger*,<sup>8</sup> is an example of such court opinions that have provided guidance for determining bona fide residence. The court focused on factors including 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 a 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 as 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.

<sup>6</sup> AM 2009-003.

<sup>7</sup> Rev. Rul. 91-58, 1991-2 CB 340.

<sup>8</sup> 74 TC 1016, 1024 (1980).

Once BFR is obtained, the taxpayer may leave the foreign country for brief or temporary trips to the U.S. but to maintain BFR status, he or she must have the clear intention of returning to his or her foreign country of BFR from such trips, without unreasonable delay. Therefore, the taxpayer should always consider purchasing a return ticket prior to departing for the U.S.

**PPT.** The PPT is a strictly quantitative test for U.S. citizens or U.S. resident aliens requiring 330 full days (a full day is a complete 24-hour period) of presence abroad “in a foreign country” out of any 12-month, 365-day (366 leap-year) fiscal consecutive period. Thus, this period can incorporate a non-calendar (fiscal) period, for example 4/21/17-4/20/18.

For purposes of THT, BFRT, and PPT, a “foreign country” for Section 911 purposes is any territory under the sovereignty of a government other than the U.S. “Foreign country” does not include:

- Ships or aircraft traveling in or above international waters.
- Offshore installations located outside the territorial waters of any individual nation.
- 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.
- Antarctica or U.S. possessions, e.g., 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 BFRT or PPT. Taxpayers may, therefore, be required to delay their U.S. income tax filings substantially until they meet both tests. Form 2350, Application for Extension of Time to File U.S. Income Tax Return, would be the form to use in these circumstances. It provides for an unlimited filing extension date until the prerequisite tests are met.

Also, expatriates may use Form 673, Statement for Claiming Exemption From Withholding on Foreign Earned Income Eligible for the Exclusion(s) Provided by Section 911, as a payroll form—similar to Form W-4, Employee’s Withholding Allowance Certificate—to avoid

the withholding of U.S. income taxes on foreign-earned and thus excludable income.

**Waiver of time requirements—Section 911(d)(4).**

Under extraordinary circumstances, Section 911(d)(4) allows both the BFRT and PPT minimum time requirements to be waived if an individual must leave a foreign country due to war, civil unrest, or similar adverse conditions. To apply, however, the individual must: (1) be able to show that he or she could reasonably have expected to meet the minimum time requirements if not for adverse conditions; (2) have his or her home in a foreign country at the time of such adverse conditions; and (3) 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.<sup>9</sup> While an individual who left one of the listed waiver countries may still qualify under BFRT or PPT without meeting the minimum time requirements, the exclusion is calculated using days of actual residence and an explanation statement must be attached.

**U.S. travel restrictions—Section 911(d)(8).**

If an individual is present in a foreign country in violation of U.S. law, his or her BFR, PP, FEIE, HE, and HD are treated as not existing. As of 2015, the only travel restriction country is Cuba (not the Guantanamo Bay U.S. Naval Base). Rev. Rul. 2005-3, 2005-1 CB 334, and Notice 2003-52, 2005-1 CB 895, removed Iraq and Libya from the U.S. travel restriction list.<sup>10</sup> At press time, there was no new Revenue Ruling removing Cuba from the list.

**PPT vs. BFRT.** The PPT is typically used in transition years, that is, in both years of expatriation and repatriation back to the U.S. PPT has advantages over BFRT in these transition years for the 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 35 (36 leap year) or fewer days (365 (366 leap year)) consecutive period less the 330 days required to meet the test) as slide days to increase the total days

<sup>9</sup> See Rev. Proc. 2017-26, 2017-13 IRB 1036.

<sup>10</sup> See “FTC and Foreign Earned Income Lists Updated to Reflect Removal of Iraq and Libya,” 16 JOIT 4 (March 2005).

abroad for purposes of calculating PPT. This is accomplished by either sliding the taxpayer back (expatriating) or ahead (repatriating) by those 35 (36 leap year) or fewer days. Therefore, using PPT, the period covered by the FEIE may be extended by using the 35 (36 leap year) or fewer 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 excess FEIE. This results in  $\$102,100$  (for 2017)/365 days  $\times$  35 days =  $\$9,790$  of extra FEIE.

2. In transition expatriating years, meeting the BFRT 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 tax return. Therefore, using the PPT may allow, if the qualifications are met, a U.S. tax filing in advance.
3. 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 nondiscrimination clause.

## Foreign housing exclusion or deduction (HD)

In addition to the FEIE, there is a little-known hidden jewel, the foreign housing exclusion (HE) for employed persons or foreign housing deduction (HD) for self-employed persons. There is an opportunity to augment the basic FEIE of  $\$102,100$  for 2017 by an overseas taxpayer's reasonable (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, the other simply an element of compensation.

The benefit of the HE/HD is that the list of qualified housing expenses is clear and well established and include rent; fair market value (FMV) of employer-provided housing; foreign

real estate or occupancy taxes; 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 stand-out feature of the HE/HD is that it does not matter who pays for these qualified housing expenses. Regardless of whether the employee pays for these costs directly or the employer pays directly or reimburses the employee, these costs are still includable as qualified foreign housing costs for determining the HE/HD. This is because employer costs paid directly or reimbursed 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. Housing costs for the convenience of the employer on the employer premises, such as a "man camp" (temporary employee housing), are not considered taxable compensation. These types of arrangements may also include a safety or security element.

Effective 1/1/06, section 515 of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222, 5/17/06) (TIPRA) amended Section 911. TIPRA provided for two changes regarding the HE and HD:

1. The base housing amount (or deductible) representing the amount that needs to be exceeded before any qualified housing costs are excluded or deducted was set at 16% of the amount of the FEIE. For 2017, based on the  $\$102,100$  FEIE, that would be  $\$44.76$  per day [ $(\$102,100 \times 16\%)/365$ ] or  $\$16,336$  for a full 365 days.
2. An overall effective cap on the total qualified housing costs eligible for consideration for either the HE or HD of 30% of the FEIE. For 2017, based on the  $\$102,100$  FEIE, that would be  $\$83.92$  per day [ $(\$102,100 \times 30\%)/365$ ] or  $\$30,630$  for a full 365 days. This cap did not exist prior to 1/1/06.

Therefore, the maximum excludable or deductible qualified housing expenses is the difference between the cap of  $\$30,630$  less the deductible base housing amount of  $\$16,336$ , which equals  $\$14,294$  or  $\$39.16$  per day for a full 365 days.

Further to the enactment TIPRA, the IRS identifies locations in countries with high housing costs compared with the U.S. and provides an adjusted limitation on housing expenses for qualified individuals incurring expenses in the

<sup>11</sup> For the table of adjusted limitations for 2017, see Notice 2017-21, *supra* note 2.

## Other points on Form 2555 (FEIE, HE/HD) and Form 1116 (FTC), and general facts

- North Atlantic Treaty Status of Forces Agreements (SOFAs)—an employee of a private company that in turn is under contract with the U.S. armed forces and covered by a SOFA<sup>12</sup> or a member of a “civilian component” of a SOFA has agreed that he or she is not resident of that foreign country. As a result of this agreement, he or she may not claim BFRT. The result is that on Form 2555, Part II, Question 13(a), he or she must check “No” and 13(b) will always be “No.” Thus, by default BFRT may not be used. However, PPT may be used to qualify for the FEIE.
- As a condition of employment, the taxpayer may have signed a closing agreement with his or her employer, wherein he or she agreed to waive his or her rights to elect the FEIE. This is common, for example, when the taxpayer works for a major defense contractor that in turn has executed an agreement with a foreign government and the U.S. Department of Defense and alerts the IRS that its employees are not subject to local-country tax. Under this condition, he or she may not claim the FEIE.
- FEIE and HE/HD are elective and should not be used when they trigger income inclusion. This would occur, e.g., when Schedule C expenses outstrip income and these expenses are added back to actually create income.
- The taxpayer cannot pick and choose income to exclude. It is all or nothing.
- If the taxpayer ends one foreign assignment and continues with another, this will not affect either the tax home or BFRT or PPT. However, if the taxpayer packs up his or her belongings and moves back to the U.S. (transferring his or her abode back to the U.S.) for work in the U.S. during this interim period, he or she is in danger of forgoing either the tax home test or BFRT, not to mention the PPT. Also, the taxpayer may need to re-qualify for these tests (see discussion on abode above, under “Who qualifies for the FEIE?”)
- The HE and HD are both subject to a base deduction or “housing norm,” which for 2017 is \$44.76 per day based on 365 days. So if in 2017 the taxpayer were abroad a full 365-day calendar tax year, he or she would first need to deduct \$16,336 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, using the FEIE, HE/HD, and FTC, his or her U.S. tax liability should be nil.
- Since U.S. resident aliens are taxable on their worldwide income, they can also claim their worldwide deductions. This would include foreign mortgage interest, real estate taxes, and other worldwide losses and expenses. However, foreign unreimbursed employee expenses cannot be deducted on Schedule A when the FEIE is used to the extent that the income to which the deductions relate is excluded.
- There is an option to use either accrued basis or paid basis to record foreign taxes in calculating the FTC. As a general rule, paid basis should be used if the foreign tax cycle is a calendar year analogous to the U.S., and 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 individual withholdings separately or allocate refunds received subsequently is obviated. However, once elected, the accrued method must continue to be used indefinitely. Further, accrued basis may be dangerous because it creates a series of mismatching or timing differences of foreign tax to foreign income. 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 accrued basis. Foreign tax credit carryback options also should be considered.
- If the U.S. has a federally negotiated Social Security/totalization agreement with the country where the taxpayer is employed or SE, there may be an opportunity to obtain a retroactive Certificate of Coverage to ensure that taxpayers can continue to pay in to 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.<sup>13</sup>

listed locations. This higher overall exclusion cap effectively overrides the 30% limitation on the FEIE (\$30,630 cap for 2017).<sup>11</sup>

### Moving expenses and employed vs. SE

Any moving expenses, whether the taxpayer is employed or self-employed (SE), if claimed and to the extent that they are considered foreign moving expenses, would reduce dollar for dollar

the amount of the \$102,100 FEIE available for 2017. Only U.S.-to-foreign country and foreign country-to-foreign country moves are considered foreign moves, and thus foreign moving related expenses.

<sup>12</sup> See Province, “Aggressive Foreign Tax Authorities and Military Agreements: Maintaining Tax Exemption in SOFAs to Protect Civilian Contractors From Local-Country Tax,” 27 JOIT 53 (March 2016).

<sup>13</sup> See [www.ssa.gov/international](http://www.ssa.gov/international) for whether such an agreement exists in a taxpayer’s particular 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 extension Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return.
- In addition to the automatic six-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 on claiming refunds (Section 6511), there is no statutory limitation on filing an original claim of FEIE or an amended filing when the FEIE is being claimed for the first time. For example, a taxpayer who failed to claim the benefits of the FEIE, or HE/HD ten years ago may still make the claim.
- Under Section 121 (Exclusion of gain from sale of principal residence), 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 gain exclusion.
- The two years for the owned-and-used test do not have to be the same two years within the five-year period prior to sale.
- Temporary absences, even if the residence is rented out, are counted as periods of use.
- This exclusion may be used only once every two years.
- If the taxpayer does not have the two years for both tests, he or she will not qualify for the exclusion unless he or she has one of three "primary reasons"—change in location of employment, health, or unforeseen circumstances.
- For each of the three "primary reasons," the taxpayer would look at either or both: (1) specific primary reason "safe harbors" and (2) individual facts and circumstances including such factors as close in time; owned and used at time of specific primary reason; primary reason not reasonably foreseeable; material impairment in taxpayer's financial ability to maintain; and use during ownership.
- Safe harbors for change in location of employment (the focal point of this article) (where employment includes new or continuing employment or SE) include when 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.
- A U.S. expatriate who moves to a foreign country and continues to maintain his or her 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 reason.
- The obvious handicap for expats is that although they usually meet the two-year test for ownership, they do not usually meet the two-year test for use. If the home is not the taxpayer's "main home" or principal residence or the taxpayer does not meet the above tests and has held the home for more than one year, the gain would be taxed at the current long-term capital gain rate (20%, 15%, or 0% depending on the income bracket—for tax years beginning after 2012, the 2012 Taxpayer Relief Act raised the top rate for capital gains to 20% (up from 15%) for certain high-income taxpayers).
- *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 nonqualified use in tax years 2009 or later, where neither the taxpayer nor 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 five-year period ending on the date of the sale or exchange after the last date that the taxpayer or spouse used the property as their main home. Practically, this means that if there is any rental use during the five-year window prior to sale, this rental period use is *not* considered nonqualified use and the gain would not have to be apportioned pro rata between qualified and nonqualified use.

Generally, employees on foreign assignments have distinct advantages over those SE. Foreign unreimbursed employee expenses will be excluded from Schedule A, therefore not affecting the amount of the FEIE claim. Conversely, all overseas SE persons' Schedule C, Profit or Loss From Business, foreign expenses and applicable foreign SE adjustments on Form 1040 lines 23-32 (e.g.,  $\frac{1}{2}$  the SE tax, the SEHI deduction) reduce dollar for dollar the \$102,100 FEIE available for 2017.

Also, as a SE person's net SE income is subject to U.S. FICA (Federal Insurance

Contributions Act) taxes (Social Security of 6.2% on the first \$127,200 for 2017 and Medicare of 1.45% on all wages or net SE income), SE persons end up paying both the employee and employer portions. This effectively combines to 15.3%  $[(6.2\% + 1.45\%) \times 2]$  FICA taxes for all SE persons reporting net income on Schedule C, which is always assessable if there is net income on Schedule C since SE FICA taxes are not affected by the FEIE and HD. However, persons employed abroad and not on U.S. payroll, but instead hired locally 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, if any, of the country where they work.

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, subject to the 20-point analysis in Rev. Rul. 87-41, 1987-1 CB 296, it may be possible to declare earnings on Form 1040 as line 7 wages (versus as an independent contractor or self-employed individual on Schedule C) and subject this wage income to only the employee one-half of the SE tax using Form 8919, Uncollected Social Security and Medicare Tax on Wages, when an individual works for a U.S. corporation issuing him wage income on Form 1099-MISC, as box 7 non-employee compensation. If he or she works for a foreign corporation, there are no U.S. SE or FICA tax implications.

When the individual clearly fails the common law employee-employer definition, or when it may be difficult to apply Rev. Rul. 87-41 to avoid U.S. FICA SE taxes, the employee may consider:

1. Social Security/totalization agreements between the U.S. and 25 countries that may alleviate U.S. SE FICA taxes, failing which:
2. Going on a foreign or third-party payroll.
3. Having their client put them on their payroll.
4. Having an unrelated person own a foreign entity that in turn pays them a wage.
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. Assuming that the foreign entity is an active business (no Subpart F income—generally passive income), shareholder or owner corporate deferral reporting of both salary and dividends is recognized on a cash-paid basis.

However, there are myriad onerous U.S. reporting requirements whenever a U.S. person owns directly or indirectly 10% or more of any foreign entity:

- Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations.
- Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships.

- Form 8858, Information Return of U.S. Persons with Respect to Certain Foreign Disregarded Entities.

These forms may come into play along with Form 926, Return of a U.S. Transferor of Property to a Foreign Corporation. The complexity of these forms and their instructions, including the need to apply U.S. generally accepted accounting principles (GAAP), makes the associated compliance even more burdensome. In the majority of cases, a U.S. CPA will not have the detailed information required for such compliance, so it is usually the foreign accountant or the clients themselves who must complete these forms.

### What happens when FEI exceeds \$102,100 for 2017 plus HE/HD?

Under Section 901 and also most federally negotiated international income tax treaties, there is a provision to avoid double taxation, the foreign tax credit (FTC), which is reportable on Form 1116, Foreign Tax Credit. There is a separate FTC for passive income and for general limitation (wage/SE) income when, for the general limitation income category, there needs to be a reduction or scale-down of both 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 foreign tax eligible for the FTC must also be scaled down for excluded income. As a result of the FTC, taxpayers are always protected and theoretically should never pay double tax on their worldwide income.

The FTC is limited to the lower of the actual foreign tax paid or the U.S. tax on that unexcluded foreign income. If the U.S. tax on that income is less, it is calculated using the average U.S. tax rate. Thus, if the average U.S. tax rate is 28%, but the marginal U.S. tax rate (U.S. tax on your last dollar of income) is 39.6%, the avoidance of double tax using the FTC is not always possible and no perfect mechanism exists. For this reason and “stacking” (see above), it is always preferable to maximize the available exclusions prior to using the available FTC. In very limited circumstances in high-tax foreign countries, it may be preferable to use the FTC alone.

Effective 1/1/05, 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. ■