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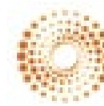

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Are You a U.S. Person Thinking of Accepting a Foreign Assignment?

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

By Marc J. Strohl (Protax Consulting Services Inc.)

This article provides a checklist of information for the U.S. person to consider prior to accepting an assignment outside the U.S.

General Concepts of U.S. Taxation versus Other Countries

All citizens and green card holders (U.S. resident aliens) are subject to U.S. Federal taxation on their worldwide calendar year[1] income for life, regardless of where the income is earned, the currency, or where the income is deposited.

For U.S. state tax purposes the requirements can be quite different and vary from state to state. Typically there are state-specific facts and circumstances tests regarding domicile in addition to statutory resident tests. These statutory resident tests are typically conjoined with a 183-days-of-presence rule and a permanent place of abode pretext, the latter of which is frequently vague. Additionally, some states could deem taxpayers to be continuing residents even while away on foreign assignments, if the ultimate intention is to return to the state after the foreign assignment.

The U.S. is the only country in the world that assesses tax liability based upon taxpayers' legal immigration status and "legal permanent residence" (or green card) and not based on their "tax residency," which is strictly a tax legal status. Therefore while U.S. taxpayers are resident abroad, they continue to be subject to U.S. taxation, in addition to taxation in their new country of residence. Other countries have a "tax residency" concept, where tax residency is severable and determined by a variety of tests or features, e.g., permanence of stay abroad, personal property and social ties, disposition of spouse, dependents and dwelling. In most other countries taxpayers can sever "tax residency" with no continuing filing obligations.

There are three ways to help avoid double taxation while abroad on assignment: the Foreign Earned Income Exclusion; the Foreign Housing Exclusion (if employed) or/and the Foreign Housing Deduction (if self-employed); and the Foreign Tax Credit.

Foreign Earned Income Exclusion and Form 2555

In an attempt to mitigate the double taxation inequity to U.S. persons abroad (the U.S. tax treatment of citizens and green card holders versus that of other countries) the U.S. introduced legislation that gave U.S. resident aliens (citizens and green card holders) a break on their income that they earned while residing abroad. The break is contained in Code Section 911, using IRS Form 2555—Foreign Earned Income Exclusion (FEIE)—currently set at $92,900 for 2011, which allows U.S. resident aliens the ability once the earned income is included in their tax return as either wage or self-employed income, to then exclude up to the first $92,900 for 2011 ($91,500 for 2010 and $91,400 for 2009) of foreign (non U.S.) earned income[2] in years in which they are residing abroad for a full year. The exclusion is pro-ratable in partial[3] years residing abroad, based on the number of days in that calendar year residing abroad over 365 days.

Effective in 2006 as amended by Code Section 515 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)—until December 31, 2005, the first $92,900

for 2011 ($91,500 for 2010 and $91,400 for 2009) 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 law provides for "stacking." Stacking results in the next dollar of income taxed at a much higher marginal rate of tax, as though it were the $92,901st dollar of income earned. Therefore this "stacking" feature assumes that the excluded income is actually present for tax calculation purposes, effectively using the tax bracket in which it would have been taxed had it actually been present, pushing the taxpayer into an initially higher starting tax bracket.

The implementation of the stacking mechanism results in two obvious factors: the effectiveness of both the foreign tax credit (FTC) and the FTC carryover are both diminished.

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 (a) the Bona Fide Residence test (BFR) or (b) the Physical Presence Test (PPT).

The THT requires taxpayers to have their "tax home" abroad for a full 12 month period. A tax home is a main place of business, employment or post of duty and is the place where taxpayers are permanently or indefinitely (in excess of one year) engaged to work as an employee or self-employed person.

It is prudent planning in the expatriating and repatriating years to limit the days back to the U.S.

The BFR is a strictly qualitative test for U.S. citizens or US resident aliens which are nationals of countries with whom have an income tax treaty with the U.S. BFR requires taxpayers to first be abroad for one full calendar year (i.e., January 1 to December 31).

The PPT is for U.S. citizens or U.S. resident aliens and is a strictly a quantitative test requiring 330 full days (a full day is a complete 24-hour period) of presence abroad out of any 12 month (365 day) fiscal consecutive period. Thus, this period can incorporate a non calendar period, or any fiscal period, for example, April 21, 2010 to April 20, 2011.

Taxpayers are not allowed to file Form 2555 or Form 1040 until they meet both the THT and either the BFR or PPT tests. Taxpayers may, therefore, be required to substantially delay filing until both tests are met.

Additionally IRS Form 673 (Statement for Claiming Benefits Provided by Section 911 of the Internal Revenue Code) may be used by expatriates as a payroll form to avoid the withholding of U.S. taxes on foreign earned and thus excludable income.

Typically the PPT is used in years of transition, that is, in both years of expatriation and in years of repatriation. PPT places an advantage over BFR in these transition years for two reasons:

1) if up to the point of expatriating or repatriating the taxpayer has not been in the U.S. for more than 35 days in the 12 month fiscal consecutive period under PPT, there is opportunity to use those 35 days (365 consecutive period less the 330 days

Form 2555 (FEIE, HE and HD), Form 1116 FTC, and General Facts

- The FEIE, HE and HD exclusions are elective and should not be used when they trigger income exclusion. This would occur when 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 all or nothing.
- If the taxpayer ends one foreign assignment and continues with another foreign assignment abroad, this will not affect either the tax home or BFR or PPT tests. However, if the taxpayer moves back to the U.S. for work during this interim period, then the taxpayer is in danger of forgoing either the tax home test or BFR tests, not to mention the PPT. And the taxpayer may need to re-qualify for these tests.
- The HE and HD are both subject to a base deduction or "Housing Norm" which for 2011 is $40.72 per day. So if in 2010 the taxpayer were abroad a full 365 calendar tax year, the taxpayer would first need to deduct $14,864 prior to any of the 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 FTC, the U.S. tax liability should be nil.
- Since U.S. taxpayers are taxed on their worldwide income, they are also able to deduct their worldwide deductions. This would include foreign mortgage interest, real estate taxes and other. However, as above, the ability to deduct foreign unreimbursed employee expenses on Schedule A is prevented when the FEIE is used and the income to which the deductions relate is excluded.
- 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 use, 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 is obviated. However, once the taxpayer elects the accrued method it must continue to be used indefinitely. Furthermore the accrued basis may be dangerous, because it creates a series of 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 year.

Continued next page

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- 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 social security contributions on earnings abroad in either the U.S. or foreign country.
- Taxpayers outside the U.S. on April 18 of any tax year automatically qualify for an extended filing deadline of two months.
- Although there is a statutory three-year limit with respect to claiming refunds, there is no statutory limit on the filing of an original claim of FEIE or to an amended filing where the FEIE is being claimed for the first time. For example, a taxpayer who failed to claim FEIE, HE or HD benefits 10 years ago may still make the claim.
- 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. ❑

required to meet the test) as slide days to increase the total days abroad for the purposes of calculating PPT. This is accomplished by either sliding the taxpayer back or ahead by those 35 days, depending on whether they are expatriating or repatriating. This is used, as above, in partial years abroad where the FEIE is prorated by those days abroad over 365.

Employees on foreign assignments have distinct advantages over being self-employed.

Therefore, using the PPT, the period covered by the FEIE may be extended by using the 35 slide days in a U.S. person's expatriating or repatriating years to increase the amount of the fractional exclusion that can be claimed. So it is prudent planning in the expatriating and repatriating years to limit the days back to the U.S., so that these 35 slide days can be optimized to obtain excess FEIE; and

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

Foreign Housing Exclusion or Deduction

In addition to the FEIE there is a 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 $92,900 for 2011, there is an opportunity to augment the basic earned income exclusion by an overseas taxpayer's reasonable qualified foreign housing expenses. Qualified foreign housing expenses are typically much higher than a taxpayer's taxable employer paid housing income/allowance, or quarters.

The nice feature of the HE or HD is that the qualified housing expenses are clear and well established: 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 truly astounding 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 expenses for determining the HE or HD. However, these costs may also need to be included in the taxpayer's employment income, if paid directly or reimbursed by the employer, since they are considered taxable compensation.

Effective January 1, 2006 as amended by Code Section 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 new base (or deductible) representing the amount that needs to be exceeded before any qualified housing costs are excluded or deducted, effective January 1, 2011 has risen from $40.11 per day or $14,640 for a full 365 days to $40.72 per day or $14,864 for a full 365 days, representing 16 percent of the amount of the FEIE or $92,900 for 2011.
2) further, TIPRA has placed an overall effective cap on the total qualified housing costs eligible for consideration for either the HE or HD, at 30 percent of the FEIE or $92,900 for 2011 or $27,870 (30 percent x $92,900) (for 2010, $27,450 = $91,500 x 30 percent). This cap had not existed prior to January 1, 2006.

Therefore the maximum excludable or deductible qualified housing expenses is the cap of $27,870 less the deductible of $14,864, which equals $13,006 or $35.63 per day.

Further to the ratification of TIPRA, the IRS issued Notice 2006-87, which allows for certain cities (of 52 countries worldwide) with very high housing costs a higher overall exclusion cap, effectively overriding the 30 percent limitation on the FEIE or $27,870 cap.

Employed versus Self-Employed

Generally, employees on foreign assignments have distinct advantages over being self-employed (SE).

Although foreign unreimbursed employee expenses will be excluded from Schedule A, this will not affect the FEIE claim; conversely, all overseas SE person's Schedule C foreign expenses and applicable foreign self-employed adjustments on IRS Form 1040 line(s) 23-32 (e.g., 1/2 the SE tax, the SEHI deduction, etc.) dollar for dollar reduce the amount of the $92,900 for 2011 FEIE available. This would also apply to any moving expenses whether employed or self-employed, if claimed and to the extent that they are considered foreign they would reduce the amount of the $92,900 for 2011 FEIE available, dollar for dollar. Moves back to the U.S. are *not* considered foreign.

Taxpayers must come forward and complete all filing requirements on or before August 31, 2011.

Additionally, as a SE person's net SE income is subject to U.S. FICA[4] taxes—Social Security[5] and Medicare[6] taxes, however SE persons additionally end up paying both the employee and employer portions. This effectively combines to 15.3 percent[7] FICA taxes for all SE persons reporting net income on Schedule C, which is always assessable if net income on Schedule C arises. Additionally these FICA taxes are not subject to the FEIE or HD and always remain assessable. 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.

What Happens when your FEI is in Excess of the $92,900 for 2011 plus the HE or/and HD?

Under U.S. domestic law Code Section 901 and also included in most federally negotiated international income tax treaties, there is a provision to avoid "double taxation." The provision is reportable on IRS Form 1116, Foreign Tax Credit (FTC). The FTC is a dollar-for-dollar reduction of U.S. tax in respect of non excluded foreign tax on non excluded foreign income. In other words, taxpayers are not allowed to take 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 excluded income. As a result of the FTC taxpayers are always protected and, theoretically, should never pay double tax on their worldwide income. However, as the FTC calculation is limited to the lower of the actual tax paid or the U.S. tax on that foreign income, if the U.S. tax on that income is less it is calculated using the average rate of U.S. tax. So if the average rate of U.S. tax is 28 percent, but the marginal tax rate (U.S. tax on the last dollar of income) is 35 percent then theoretically the avoidance of double tax using the FTC is not a perfect mechanism. For this reason this author suggests that it is always better to maximize the available exclusions prior to using the FTC.

Effective January 1, 2005 there is no longer a 90 percent 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.

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[1]The U.S. income tax period is a calendar year, regardless of the fiscal year period in the taxpayers' current country of residence.

[2]Wages or self-employed income, but not pension, annuity, social security benefit, or U.S. government wage income. Earned income may also include business profits, royalties and rents, but certainly excludes income from property such as interest, dividend and capital gain income, and other income such as alimony, prizes and gambling winnings.

[3]Non-full calendar.

[4]Federal Insurance Contributions Act.

[5]6.2 percent on the first $106,800 for 2010 (2009, $106,800) of wages.

[6]1.45 percent on all wages/net SE income.

[7]6.2 percent + 1.45 percent = 7.65 percent x 2. ❑