

Are You A US Person Thinking Of Accepting A Foreign Assignment?

Some US 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 US person to consider prior to accepting an assignment outside the US. This article is not designed to teach you the technical competence required to perform self compliance; however it will certainly arm you with the knowledge to determine if your US tax preparer knows all that they should know to provide you with technically competent professional services.

General concepts of US taxation versus other countries:

All United States (US) citizens, green card holders and persons meeting the Substantial Presence Test (SPT) are considered US resident aliens. The third category, or SPT, is irrelevant for these discussions as the SPT test must continue to be met on an annual basis. All citizens and green card holders (US resident aliens) are subject to US Federal taxation on their worldwide calendar year income for life, regardless of where their income is earned, what currency it is in or where the income is deposited to.

The US income tax period is a calendar year- January 1 to December 31- inclusively, regardless of the fiscal year period in your current country of residence.

For 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 typically vague. Additionally some states could hold you to be a continuing resident even while away on a foreign assignment, if your ultimate intention is to return to that state after the termination of your foreign assignment. For more information on state residency issues, please consult us separately.

In fact the US is the **ONLY** country in the world to tax its people based upon their legal immigration status as a citizenship and “legal permanent residence” (or green card) and not based upon their “tax residency” which is strictly a tax legal status. Therefore while a US person is resident abroad, they continue to be subject to US 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 unique to each country’s tax system- e.g.: permanence of stay abroad, personal property & social ties, disposition of spouse, dependents and dwelling, etc.... Therefore it is possible in these respective countries to sever “tax residency” with no continuing filing obligations, unlike here in the US. The overriding tax principle of a “tax resident” is that tax residents of a particular country are taxed in that country on their worldwide income and tax non-residents of a particular country are taxed in that country only on income from that country and **NOT** on their worldwide income.

There are three (3) ways to help avoid double taxation while abroad on 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).

The Foreign Earned Income Exclusion and Form 2555:

Many years ago in an attempt to help mitigate the above double taxation inequity to US persons abroad (the US tax treatment of citizens and green card holders versus that of other countries, as above) the US introduced legislation that would give US resident aliens (citizens and green card holders) a break on their income that they earned while residing abroad. The break is contained in the Internal Revenue Code (IRC) Sec. 911, using IRS Form 2555- Foreign Earned Income Exclusion- (FEIE) currently set at \$91,400- for 2009 (2008- \$87,600), which allows US 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 \$91,400- for 2009 (2008- \$87,600) of foreign (non US) earned (wages or self-employed income, but not pension, annuity, social security benefit, or US government wage income) income in years in which they are residing abroad for a full year. The exclusion is pro-ratable in partial (non full calendar years) years residing abroad, based upon the number of days in that calendar year residing abroad over 365 days. 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.

Effective January 1, 2006 as amended by IRC Sec. 515 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)- until January 1, 2006 the first \$91,400- for 2009 (2008- \$87,600) of income earned overseas was excluded from US 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 were the \$91,401st 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 you into an initially higher starting tax bracket.

This resulting increase tax grab from ‘stacking’ results in two obvious factors: 1) The usefulness or effectiveness of the foreign tax credit (FTC) and 2) the potential for the FTC carryover are both diminished.

Who qualifies for the FEIE:

To qualify for the FEIE you 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 you to have your ‘tax home’ abroad for a full 12 month period. Your tax home is generally perceived as your 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 year) are engaged to work as an employee or self-employed person.

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

The PPT is for US citizens or US resident aliens and is a strictly a quantitative test requiring 330 full days (a full day is a complete twenty four hour period) of presence abroad out of any 12 month (365 day) fiscal consecutive period. Thus, this can incorporate a non calendar period, or any fiscal period, as for example April 21, 2009 to April 20, 2010.

You are not allowed to file Form 2555 or Form 1040 until meeting both of the above two tests: 1) the THT and 2) either the a) the BFR or b) the PPT tests. You may therefore, be required to substantially delay your filing until such time as both tests are met. Form 2350- Application for Extension of Time to Filer US Income Tax Return- would be the correct extension form to employ in these circumstances.

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

Typically the PPT is used in years of transition, that is in both years of expatriation -abroad out of the US and in years of repatriation- back to the US. 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 back to the US in excess of 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 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 respectively 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. Therefore, using the PPT we may be able extend the period covered by the FEIE using the 35 slide days in a US persons expatriating or repatriating years to increase the amount of the fractional exclusion that we claim on their behalf. So it is prudent planning in the expatriating and repatriating years to limit your days back to the US, such that we can optimize these 35 slide days to obtain excess FEIE, and
- 2) in transition expatriating years meeting the BFR test will encompass waiting for a full calendar tax year to elapse subsequent to the of US departure and prior to filing that years tax return. Whereas using the PPT test, if the qualifications are met may allow for a US tax filing in advance.

The Foreign Housing Exclusion (HE) or Deduction (HD):

In addition to the FEIE there is a little known about 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 \$91,400 for 2009 (2008- \$87,600), there is an opportunity to augment this 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 list of qualified housing costs is very exhaustive: 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 you the employee pay directly for these costs or whether your employer directly pays or reimburses you for these above costs, these costs are still includable as qualified foreign housing costs for determining the HE or HD. However, these costs may also need to be included in your employment income, that is if paid directly or reimbursed by your employer as they are considered taxable compensation.

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 new base (or deductible) representing the amount that needs to be exceeded before any qualified housing costs are excluded or deducted, effective January 1, 2009 has risen from \$38.30 per day or \$14,016 for a full 366 days to \$40.07 per day or \$14,624 for a full 365 days, representing 16% of the amount of the FEIE or \$91,400-for 2009 (2008- \$87,600).
- 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% of the FEIE of \$91,400- for 2009 (\$87,600 for 2008) or \$27,420 (30% * \$91,400) (for 2008- \$26,280= \$87,600* 30%). This cap had not existed prior to January 1, 2006.

Therefore the maximum excludable or deductible qualified housing expenses is the cap of \$27,420 less the deductible of \$14,624, which equals \$12,796, as stated above.

Further to the ratification of TIPRA, the IRS issued IRS 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% limitation on the FEIE or \$27,420 cap. Please consult us on a list of these cities and amounts separately.

To Be Employed Versus Self-Employed (SE):

Generally it is the author's opinion that if you are employed and you go overseas you have a distinct advantage over being self-employed (SE) overseas:

Although your 'foreign' unreimbursed employee expenses will be excluded from Schedule A it 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. ½ the SE tax, the SEHI deduction, etc...) dollar for dollar reduce the amount of the \$91,400- for 2009 (2008- \$87,600) 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 \$91,400- for 2009 (2008- \$87,600) FEIE available dollar for dollar. Moves back to the US are NOT considered foreign.

Additionally, as a SE person net SE income is subject to US FICA (Federal Insurance Contributions Act) taxes- social security (6.2% on the first \$106,800- for 2009 (2008- \$102,000) of wages) and Medicare (1.45% on all wages/ net SE income) taxes, however SE persons additionally end up paying both the employee and employer portions. This effectively combines to 15.3% (6.2% + 1.45% = 7.65% 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. Additionally these FICA taxes are NOT subject to the FEIE or HD and always remain assessable. However persons employed abroad and NOT on US payroll, but instead locally hired on a foreign payroll are NOT subject to US 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.

There is a way however, that SE persons can avoid US FICA SE taxes. Any "Foreign Controlled Corporation" FCC (where foreign is non US) is deemed to have all of its income earned directly by the controlling US person. So the ability for the deferral of income in a FCC is impossible. However, FCC's have one interesting feature, wherein if all of the net income of an FCC is waged out to the controlling shareholder so as to avoid the above deemed income rule those wages would NOT be subject to the US FICA SE taxes of 15.3%!! This is an option available to US SE persons abroad, that is to do business through an FCC to avoid US FICA SE taxes. However there are onerous US reporting requirements whenever a US person owns directly or indirectly more than 10% of this foreign entity. Additionally you must consider the implications of the host country's social security regime, which might make this suggestion more costly.

As above an additional consideration to enacting an FCC are the myriad of IRS reporting requirements associated with foreign entities, including: Form(s) 5471, 8865 and 8858- dealing with Information Returns of US Persons with respect to Certain Foreign Corporations, Partnerships and/ or Disregarded Entities. The complexity of these respective forms and their instructions and the need to apply US Generally Accepted Accounting Principles (GAAP) in answering these respective forms questions, makes the associated compliance efforts onerous. Further in the majority of cases the author does not have the detailed information required for such compliance. As such usually it is the foreign accountant or client themselves whom completes these forms.

It therefore, may be easier to have your client put you on payroll as an employee to avoid the FCC issues. As the IRS views the 'substance over legal form' of the employee-employer/ master-servant relationship, it may be possible to declare the earnings on IRS Form 1040, line 7 (versus as an independent contractor/ self-employed on IRS Form 1040- Schedule C) as wages and subject this income to ½ of the SE tax if the client is a US corporation issuing you an IRS Form 1099-MISC. For non US employers there would be no US FICA taxes.

What happens when your FEI is in excess of the \$91,400- 2009 (2008- \$87,600) plus the HE or/ and HD?:

Under US domestic law IRC Sec. 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 US tax in respect of non excluded foreign tax on non excluded foreign income. In other words, you are NOT allowed to take a FTC credit on income that has already been excluded on Form 2555 re IRC Sec. 911 and the amount of foreign tax eligible for the FTC must also be scaled down for excluded income. As a result of the FTC you are always protected and theoretically should NEVER pay double tax on your worldwide income. However, as the FTC calculation is limited to the lower of the actual tax you pay or the US tax on that foreign income, if the US tax on that income is less it is calculated using your average rate of US tax. So if your average rate of US tax is 28%, but your marginal tax rate (US tax on your last dollar of income) is 35% then theoretically the avoidance of double tax using the FTC is not a perfect mechanism. It is for this reason that given the choice we will ALWAYS prefer to maximize on your available exclusions prior to using the FTC.

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 US FTC against US income tax and reduce the US tax liability to NIL when there is no US source income.

Other Interesting Form 2555- FEIE, HE and HD, Form 1116- FTC and General Facts:

- These exclusions are elected and voluntary, so in cases where claiming the election results in exclusion income they should not be elected. This would occur where Schedule C expenses outstrip income and these expenses are added back actually creating 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 deal.
- If you end your foreign assignment and continue with another foreign assignment abroad, then this will NOT affect either the tax home or BFR or PPT tests. However, if you happen to pack up your belongings and move back to the US for work in the US during this interim period then you are in danger of forgoing either the tax home test or BFR tests, not to mention the PPT and you may need to re-qualify for these tests.
- The HE and HD are both subject to a base deduction or “Housing Norm” which for 2009 is \$40.07 per day (2008- \$38.30 per day). So if in 2009 you were abroad a full 365 calendar tax year you would first need to deduct \$14,624 prior to any of your Qualified Housing Costs counting towards the HE or HD.
- Theoretically if you have no US source income then using the FEIE, HE, HD and FTC your US tax liability should be NIL.
- As a US resident alien since you are taxable on your worldwide income you are also able to deduct your 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 or Paid basis to record foreign taxes for the purposes of calculating the FTC. Generally we would use the paid basis if the foreign tax cycle is a calendar year tax cycle analogous to the US and we use the accrued basis if the foreign tax cycle is a fiscal tax year, unlike the US tax system. The accrued election makes us recognize the foreign taxes for US tax purposes by looking at the US 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 elected to use the accrued method you must continue to use it going forward indefinitely. Furthermore using the accrued basis may be dangerous as although it may give a tax disincentive in the first year abroad; however, providing relief in the last assignment year abroad it does create a series of mismatching or a timing differences of foreign tax to foreign income. So there are pros and cons to the accrued basis
- If the US has federally negotiated a Totalization or Social Security Agreement with the country abroad that you are currently either employed or self-employed in, there may be an opportunity to obtain a retroactive Certificate of Coverage to ensure that you continue to pay in to the US or foreign social security system for a specified maximum number of years to ensure that you receive full benefit for your social security contributions on earnings abroad in either the the US or foreign country. Please visit <http://www.ssa.gov/international/> to determine if such an agreement exists in your circumstances.
- If you are outside the US on April 15 of any tax year, you automatically qualify for an extended filing deadline of two months. You should write "Taxpayer Abroad on April 15" on the top of your extension Form 4868.
- Although there is a statutory three year limit with respect to claiming refunds, there is no statutory limit to go back and either fix or claim the use of the FEIE. This means, for example, that should you have 10 years ago NOT claimed the benefits of the FEIE, HE or HD when you were entitled to you have an unlimited period of time to go back and make your claim.
- Sale of Principal residence: In the five year window prior to sale of your principal residence you must have: 1) owned and 2) used or lived in the home for at least two years= 24 months = 730 days both spouses to qualify for the \$250,000 per spouse exclusion. The two years for the owned and use test do not have to be the same two years within the five years prior to sale.

If you do not have the two years for both tests you will not qualify for the exclusion unless: you have a change in location of employment, health reasons or for unforeseen circumstances.

Obviously the handicap for expats is that although they usually meet the two year test of ownership they DO NOT meet the test on use.

If the home is NOT your "main home" or principal residence or you do not meet the above tests and you have held it for more than one year then the gain would be taxed at the current long term capital gain rate, which is currently 15%.

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