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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by: Marc J. Strohl, CPA
Protax Consulting Services Inc.
www.protaxconsulting.com

The goal of this article is to provide a comprehensive checklist of information for the 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 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 United States (U.S.) citizens, green card holders 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 be met on an annual). All U.S. resident aliens are subject to U.S. Federal taxation on their worldwide calendar year income for life, regardless of which country their income is earned in, the currency it is paid in or which bank or country the income is deposited to.

The U.S. income tax reporting period is a calendar year- January 1 to December 31- inclusively, regardless of the fiscal year tax reporting period in your 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 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 defined based upon state jurisdiction and can be quite subjective or vague. Additionally some states could deem taxpayers to be a continuing tax residents even while away on foreign assignments, if the ultimate intention is to return to the state after the termination of the foreign assignment (basic domicile definition). For more information on state residency issues, please consult us separately.

The U.S. (and the Philippines) is one of few countries in the world that assess tax liability based upon taxpayers' legal immigration status as a citizen and "legal permanent residence" (or green card) and not based upon 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 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 & social ties, disposition of spouse, dependents and dwelling, etc…. Therefore in most countries it is possible to sever "tax residency" with no continuing filing obligations, unlike here in the U.S.

A "tax resident" is typically defined as taxable in that country on worldwide income, whereas a "tax non-residents" is typically defined as taxable in that country but only on income from that country and NOT on their worldwide income.

There are three 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:

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, green card holders and persons meeting the SPT) 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 $95,100 for 2012 ($92,900- for 2011 and $91,500- for 2010), 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 $95,100 for 2012 ($92,900- for 2011 and $91,500- for 2010) of foreign (non U.S.) earned (wages or self-employed income, but not pension, annuity, social security benefit, or U.S. 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 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 December 31, 2005 the first $95,100 for 2012 ($92,900- for 2011 and $91,500- for 2010) 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 were the $95,101st 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: 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 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 fiscal month period. A tax home is 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.

The BFR is a strictly qualitative test for U.S. citizens or U.S. 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. a January 1 to December 31).

The PPT is for U.S. citizens or U.S. resident aliens and is strictly a quantitative test requiring 330 full days (a full day is a complete twenty four hour period) of presence abroad 'in a foreign country' out of any 12 month (365 day) fiscal consecutive period. Thus, this period can incorporate a non calendar period, or any fiscal period, as for example April 21, 2011 to April 20, 2012. Please consult with us separately on the definition of a 'foreign country' for IRC Sec 911 purposes.

Taxpayers are not allowed to file Form 2555 or accompanying Form 1040 until they meet both the: 1) the THT and 2) either the a) the BFR or b) the PPT tests. Taxpayers may therefore, be required to substantially delay their U.S. tax filings until such time as both tests are met. Form 2350- Application for

Extension of Time to Filer U.S. 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 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 back to the U.S. PPT places an advantage over BFR in these transition years for two reasons:

1) if at to the point of the expatriating or repatriating fiscal period the taxpayer has been in a foreign country for more than a full 330 full days, there is opportunity to use those 35 days or less (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 or less, 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 the period covered by the FEIE maybe extended by using the 35 or less 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 potential 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.

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

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 $95,100 for 2012 ($92,900- for 2011 and $91,500- for 2010), 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 are quite exhaustive, 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 truly remarkable 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 whether the employer directly pays (or reimburses the employee) these above costs, these costs are still includable as qualified foreign housing costs for the purposes of 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 as they relate to personal living expenses.

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, 2012 has risen from $40.72 per day or $14,864 for a full 365 days to $41.69 per day or $15,216 for a full 365 days, representing 16% of the amount of the FEIE or $95,100 for 2012 ($92,900- for 2011 and $91,500- for 2010).

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 $95,100 for 2012 ($92,900- for 2011 and $91,500- for 2010) or for 2012 $28,530 (30% * $95,100) (for 2011- $27,870= $92,900* 30%). This cap had not existed prior to January 1, 2006.

Therefore the maximum excludable or deductible qualified housing expenses is the cap of $28,530 less the deductible of $15,216, which equals $13,314 or $36.48 per day.

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 $28,530 cap. Please consult us on a list of these cities and amounts separately.

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

Generally, if you are employed overseas you have two distinct advantages over self-employed (SE) individuals.

1) Although 'foreign' unreimbursed employee expenses are excluded from Schedule A and will not affect the amount of the FEIE claim; overseas SE person's using a Schedule C will find that all '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…) will dollar for dollar reduce the amount of the $95,100 for 2012 ($92,900- for 2011 and $91,500- for 2010) FEIE available for use. This would also apply to any 'foreign' moving expenses whether employed or self-employed, if claimed and to the extent that they are considered 'foreign' they would also reduce the amount of the $95,100 for 2012 ($92,900- for 2011 and $91,500- for 2010) FEIE available dollar for dollar. Moves back to the U.S. are ***not*** considered 'foreign.

2) Additionally, as a SE person net SE income is subject to U.S. FICA (Federal Insurance Contributions Act) taxes- social security (6.2% on the first $110,100- for 2012 (2011- $106,800) 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 <u>employed</u> abroad and NOT on U.S. payroll, but instead locally hired on a foreign payroll are not subject to U.S. employee FICA taxes <u>at all</u>. They would become subject to the social security tax regime of the respective country in which they work, if any.

To mitigate the above as the IRS views the 'substance over legal form' of the employee-employer/ master-servant relationship under common law and IRS Revenue Ruling 87-41, 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 or if the client is a foreign corporation with no U.S. SE 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 they may consider: 1) going on a foreign payroll or a third party payroll, 2) having the client put you on their payroll, 3) having a non-related person own a foreign entity that in turn pays them a wage or 4) a U.S. SE person abroad may 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 disregarded entity assuming a one member disregarded entity that defaults to report on Schedule C- Profit or Loss from a Business- on a cash basis. Assuming the foreign entity is an active business (no Sub Part F income- generally passive income) then we recognize for the shareholder/ owner corporate deferral reporting of 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 more than 10% 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 and 8858- Information Return of U.S. Persons with Respect to Certain Foreign Disregarded Entities - may come into play along with Form 926- Return of a U.S. Transferor of Property to a Foreign Corporation. The complexity of these respective forms and their instructions, including the need to apply U.S. Generally Accepted Accounting Principles (GAAP) 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.

What happens when your FEI is in excess of the $95,100- 2012 ($92,900- 2011) plus the HE or/ and HD?:

Under U.S. domestic law IRC Sec. 901- Foreign Tax Credit (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). In addition to the separate FTC for passive income, for general limitation income (wage/ SE income) 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 foreign tax paid or the U.S. tax on that foreign income, if the U.S. tax on that income is less then the U.S. tax is calculated using your average rate of U.S. tax. So if the average rate of U.S. tax is 28%, but the marginal tax rate (U.S. tax on your last dollar of income) is 35% then theoretically the avoidance of double tax using the FTC is not a perfect mechanism. For this reason the author suggests that it is always preferable to maximize the available exclusions prior to using the available 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 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.

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

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

2 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.

3 If the taxpayer ends one foreign assignment and continues with another foreign assignment abroad, then this will not affect either the tax home 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 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.

4 The HE and HD are both subject to a base deduction or "Housing Norm" which for 2012 is $41.69 per day (2011-$40.72 per day). So if in 2012 the taxpayer were abroad a full 365 calendar tax year the taxpayer would first need to deduct $15,216 prior to any of the Qualified Housing Costs counting towards the HE or HD.

5 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.

6 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 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.

7 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 is obviated. However, once elected to use the accrued method it must continue to used indefinitely. Furthermore the accrued basis may be dangerous, because it creates 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 year. So there are pros and cons to the accrued basis. Please also consider foreign tax credit carry back options also.

8 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 in to the U.S. or foreign social security system for a specified maximum number of years to receive full benefit for your 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.

9 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. You should write “Taxpayer Abroad on April 15” on the top of your extension Form 4868.

10 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 the benefits of the FEIE, HE or HD 10 years ago may still make the claim.

11 Sale of Principal residence: In the five year window prior to sale of 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. Both spouses must 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 year period prior to sale.

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

Obviously the 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 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%.

Marc J. Strohl, CPA is a Principal at Protax Consulting Services Inc
He may be reached at: Tel: (212) 714-9070, x. 100, Fax: (212) 714-6654
Email: mstrohl@protaxconsulting.com

Web site: www.protaxconsulting.com