Taxation of:
U.S. Citizens & Residents Living Abroad

2017 Edition
The information contained in this publication is provided for general informational purposes only and is based on U.S. income tax law applicable to taxable years ending on or before December 31, 2016. It is not intended to be and should not be construed as “written advice concerning one or more federal tax matters” subject to the requirements of Section 10.37(a)(2) of Treasury Department Circular 230.

Since tax laws change frequently, the application of the information contained within this publication to specific situations should only be determined through consultation with your tax advisor. You are strongly encouraged to consult with your tax advisor prior to undertaking any significant financial transactions.

Zander Sterling, LLC is a CPA firm focused exclusively on global mobility tax matters impacting employers and employees. Accordingly, it does not provide legal services.
Introduction

When U.S. citizens or residents reside or conduct business outside the United States of America, they - and their employers – are confronted with many complex issues involving nearly every aspect of their professional and personal lives. Income and social taxes are one of these issues. In the domestic context alone, understanding a complying with complex U.S. tax laws is challenging enough. In the international context, it can be genuinely daunting.

Unlike nearly every other country in the world, the United States taxes its citizens and resident aliens on their worldwide income. Items such living outside the U.S., having a non-U.S. employer, not rendering services within the U.S. and being domiciled outside the U.S. do not alter this worldwide scope of taxation.

Accordingly, U.S. citizens and residents are required to file annual U.S. income tax returns and on those returns they must declare their worldwide income. They are, of course, also permitted to claim qualifying deductions from worldwide sources.

Since U.S. citizens or residents working and/or residing in a foreign country will generally be subject to taxation in that country, the potential for double taxation presents itself.

This publication is designed to provide a general understanding of the personal income and social tax provisions that either reduce or eliminate double taxation. It also provides useful information on other tax matters and filing procedures U.S. taxpayers are likely to encounter.

Due to the complexity of the U.S. income and social tax laws - and the number of exceptions within them - the primary scope of information provided within this publication has been limited to those areas of federal-level taxation most frequently of interest to individuals relocating from the United States to another country.

**Note:** If you are participating in a corporate-sponsored international assignment program, you may be covered by either a “tax equalization” or “tax protection” policy. While these types of policies are conceptually similar from one company to the next, the details surrounding tax computations, payment of taxes, and administrative responsibilities can vary a great deal. Accordingly, you should obtain and review the details of any such policy with your employer, if applicable, to ensure you have a complete understanding of how your personal tax obligations will be computed and managed.
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Chapter 1 – Foreign Earned Income & Housing Exclusions

Qualifying U.S. taxpayers with a tax home outside the United States are entitled to elect two exclusions to reduce their U.S. taxable income: the foreign earned income and the foreign housing cost exclusions. The exclusions are available only if the taxpayer maintains a foreign tax home and meets either the bona fide residence or physical presence test requirements.

Foreign Earned Income Exclusion

Is allowed in full only if the taxpayer remains qualified during the entire tax year. Otherwise, the exclusion is reduced proportionately for the number of days during the tax year that the taxpayer does not qualify for the exclusion. The full, annual exclusion is capped at $102,100 for calendar year 2017.

Two-Earner Families

Married taxpayers may each claim the foreign earned income exclusion, but each must qualify separately. If one spouse has any unused exclusion, the other spouse may not use it. If married taxpayers reside in a community property state/country, community property law is generally disregarded in determining the amount of foreign earned income attributable to each spouse.

Foreign Housing Exclusion

Qualifying taxpayers may make an additional election to exclude from their gross income an amount equal to certain housing costs, as long as these costs are not “lavish or extravagant under the circumstances”. This election is available only to those who have received foreign earned income (defined later) as an employee.

Qualifying housing expenses include the following:

- Fair rental value of housing provided in the foreign country by the employer
- Household repairs
- Nonrefundable fees paid for securing the leasehold
- Qualifying housing expenses paid by an employer
- Real and personal property insurance
- Rent
- Rental of furniture and household accessories
- Residential parking
- Utilities (other than telephone charges)

Qualifying housing expenses exclude the following:

- Amounts deductible by a tenant-stockholder in connection with cooperative housing
• Cost of a pay television  
• Cost of buying or improving a house  
• Cost of purchased furniture or household accessories  
• Deductible interest and taxes (e.g., mortgage interest, real estate taxes)  
• Depreciation expenses  
• Domestic labor expenses (e.g., maids, gardeners)  
• Principal payments on a mortgage

In addition, if the taxpayer’s family is required to reside in a separate abode overseas due to the “dangerous, unhealthful, or otherwise adverse living conditions” existing where the taxpayer is employed, the reasonable housing expenses of maintaining the second foreign household may be eligible for the housing cost exclusion.

The housing cost exclusion is equal to the excess of the "qualifying housing expenses" (generally capped at 30% of the maximum foreign earned income exclusion) over a “base housing amount”. The "base housing amount" is calculated as 16 percent of the maximum foreign earned income exclusion limitation.

If the housing expenses are incurred in a year in which the taxpayer begins or completes the foreign assignment, the limit on qualifying housing expenses and the base housing amount are reduced proportionately. Also, assuming both exclusions have been elected, the housing cost exclusion must be calculated first.

**Married Taxpayers**  
If both the taxpayer and spouse qualify for the foreign housing exclusion, properly figuring the benefits depends on whether separate households are maintained by the taxpayer and spouse.

**Separate Households.** If the taxpayer and spouse live apart and maintain separate households, both can claim the foreign housing exclusion if both of the following conditions are met:

- Taxpayer and spouse have different tax homes that are not within reasonable commuting distance of each other and,
- Neither spouse’s residence is within reasonable commuting distance of the other spouse’s tax home.

Each spouse claiming a housing exclusion must figure separately the part of the housing amount that is attributable to employer-provided amounts, based on his or her separate foreign earned income.

If the spouses’ tax homes, or one spouse’s residence and the other spouse’s tax home, are within a reasonable commuting distance of each other, only one spouse may exclude his or her housing
cost amount. Regardless of whether the spouses file joint or separate returns, the amount of the housing cost exclusion must be determined separately for each spouse.

**One Household.** If the spouses reside together, and file a joint return, they may compute their housing cost exclusion either jointly or separately. If the spouses compute their housing cost exclusions separately, they may allocate the qualifying housing expenses to either of them or between them for the purpose of calculating separate housing cost exclusion, but each spouse claiming a housing cost exclusion must use his or her full base housing amount in such computation. If the spouses compute their housing cost exclusion jointly, then only one of the spouses may claim the housing cost exclusion.

Also, if the taxpayer and spouse have different periods of residence or presence and the one with the shorter period of residence or presence claims the exclusion or deduction, only the expenses attributable to that shorter period may be claimed.

If the spouses reside together and file separate returns, they must compute their housing cost exclusions separately.

**Qualifying for the Exclusions**

A U.S. citizen may qualify for the exclusions in two ways:

1. By establishing himself or herself as a bona fide foreign resident for an uninterrupted period that includes an entire calendar year, or

2. By being physically present in one or more foreign countries for 330 full days in any consecutive twelve-month period. In many cases, only the physical presence test is available to U.S. resident aliens (“green card” holders) since they are, by nature, bona fide residents of the United States.

The Internal Revenue Service can waive the time requirement for either the bona fide resident or physical presence test for those who must leave a foreign country due to “war, civil unrest or similar conditions precluding the normal conduct of business.” The list of countries to which this exception applies is strictly limited. A special provision denies the exclusions to individuals violating federal travel restrictions.

**Foreign “Tax Home”**

A prerequisite for either the bona fide residence or the physical presence test is that the taxpayer must establish a foreign tax home. A person’s tax home is generally defined as the location of his or her principal place of business rather than his or her abode or residence. A tax home normally must be established and maintained solely for reasons of employment. If a person has no principal place of business, his or her tax home is considered to be his or her regular abode. A taxpayer is not considered to have a foreign tax home for any period during which his or her abode remains in the United States. For example, a taxpayer who lives in Detroit but commutes daily to work in Windsor, Ontario, would ordinarily have his or her tax home in Windsor. Because
the abode continues to be located in the United States, however, he or she would be ineligible for the exclusions. The Internal Revenue Service considers a new tax home to have been established if the taxpayer actually stays at the new place of employment for at least one year.

Equally important as the establishment of a foreign tax home and foreign place of employment is the taxpayer’s demonstration that he or she has established a foreign abode. “Abode” has been variously defined as one's home, habitation, residence, domicile, or place of dwelling. It does not mean your principal place of business. "Abode" has a domestic rather than a vocational meaning and does not mean the same as "tax home." The location of a taxpayer’s abode often will depend on where economic, family, and personal ties are maintained.

If a person meets the tests for establishing a foreign tax home and maintains his or her principal dwelling abroad, merely retaining ownership of the former U.S. residence will not cause him or her to have a U.S. abode for purposes of this rule. The result is the same even if the individual's spouse or dependents continue to reside in the U.S. house. A final determination would depend on all other facts and circumstances. It should be noted that once a foreign tax home has been established, any reimbursements for housing or living expenses in that location may not be treated as “away from home” business expenses. Therefore, it is not possible to claim the exclusions for a period of time in which housing or living expenses reimbursements are taking place unless these reimbursements are included in the taxable compensation of the employee.

The lack of a precise definition of foreign tax home makes it very important that taxpayers document factors in their personal situation that support the establishment of a foreign tax home. As previously mentioned, a foreign tax home is absolutely necessary to qualify for the exclusions.

The term foreign country for purposes of the physical presence and bona fide foreign residence tests includes any territory under the sovereignty of a government other than that of the United States. It includes the territorial waters of the foreign country, as they are defined under U.S. laws, and the air space over the foreign country. U.S. possessions and territories are not considered foreign countries, nor are international waters.

**Bona Fide Resident Test**

To qualify as a bona fide foreign resident, a U.S. citizen must reside in a foreign country for at least an entire tax year—for a calendar-year taxpayer, one beginning before 1 January and ending after 31 December of the same year. For purposes of the bona fide residence test, it is crucial that the taxpayer establish foreign residence before 1 January. Being on the foreign company’s payroll is not sufficient; residency begins only when the taxpayer arrives in the foreign country with a genuine intent to establish a foreign residence.

The bona fide residence test requires that the taxpayer have an intent to reside in a foreign country, as supported by the related facts and circumstances. A person who travels abroad for a temporary period of time for a specific purpose is not usually considered a bona fide residence. Merely being in a foreign country for the required length of time is not sufficient; the required intent must exist. In determining a taxpayer’s intent to establish a foreign residence, U.S. courts have
considered factors such as the duration and nature of the stay; whether the taxpayer’s U.S. house was sold, leased, or abandoned in favor of one in the foreign country; whether the taxpayer was accompanied by his or her family; the type of foreign visa obtained; the nature and degree of the taxpayer’s participation in the foreign community; the taxpayer’s command of the foreign language; and the location of the taxpayer’s economic interests. The fact that a taxpayer intends to return to the United States when the foreign assignment is over does not prevent his or her qualification as a bona fide residence.

Being considered a nonresident under foreign tax laws should not preclude a taxpayer from applying the bona fide residence test. Also, the possession of a tourist visa, with its implications that one is not a resident of the country under local immigration laws, does not in itself cause one to fail the bona fide residence test.

Being exempt from a foreign country’s income tax due to provisions of a tax treaty or international agreement does not alone disqualify a taxpayer from bona fide residence status. However, treaty provisions granting a U.S. person special privileges and immunities may so distinguish a U.S. citizen from other residents in the foreign country that they prevent the U.S. citizen from qualifying as a bona fide residence.

Another determining factor may be the manner in which the taxpayer presents his or her status to the foreign tax authorities. If the taxpayer gives a statement to the foreign tax authorities seeking exemption from the foreign country’s tax on the grounds that the taxpayer is not a resident of the foreign country, and if the tax authorities of the foreign country agree with the claim for exemption, then the taxpayer will not qualify under the bona fide residence test.

A change of foreign residence from one foreign country to another does not affect bona fide residence status. However, even temporary residence in the United States between foreign assignments can terminate bona fide residence status. Consequently, a taxpayer should maintain his or her foreign residence status until becoming a resident in a new foreign country.

**Physical Presence Test**

To qualify for the special foreign exclusion under the physical presence test, a U.S. citizen or resident alien must be physically present in a foreign country for 330 full days within any consecutive twelve-month period. A full day is a twenty-four-hour period beginning at midnight. Also, the taxpayer must have established a foreign tax home and a foreign abode as of that day. The time spent on or over international waters is not considered when counting the days a taxpayer was physically present in a foreign country unless the points of departure and arrival are both foreign countries. During such a trip, a person may visit the United States and, provided that the U.S. presence is for less than twenty-four hours, the day in the United States will still qualify as one of foreign physical presence.

The intent to establish a foreign residence is irrelevant for purposes of the physical presence test.
All that is required is that the taxpayer actually be present on foreign soil and be able to claim that his or her tax home and abode are outside the United States during the time of foreign presence.

An individual may qualify under the physical presence test regardless of whether he/she is subject to income tax in the foreign country.

Time spent in a foreign country in the employment of the U.S. government will count toward satisfaction of the 330-day requirement. However, income earned from the U.S. government may not be excluded.

**Electing the Exclusions**

The exclusions for foreign earned income and for housing costs are elective by the taxpayer.

Both elections are made on a federal tax return with Form 2555 attached that is filed no later than one year after the original due date. This due date will be determined without respect to the extension of time to file. As a result, a person may elect the exclusions for 2017 on a 2017 tax return filed no later than 15 April 2019. This special-election deadline does not extend the tax return’s due date or the time period for other provisions in the tax law.

Either of the elections may also be made on an amended tax return if the original return was filed on time. An amended tax return may be filed up to three years following the extended due date of the original return.

Either election may also be made on a late return filed after one year of its original due date provided one of the following conditions is met:

- The taxpayer owes no federal income tax after taking into account the exclusion and files Form 1040 with Form 2555, *Foreign Earned Income*, attached before or after the Internal Revenue Service discovers that the taxpayer failed to elect the exclusion.

- The taxpayer owes federal income tax after taking into account the exclusion and files Form 1040 with Form 2555 attached *before* the Internal Revenue Service discovers that the taxpayer failed to elect the exclusion.

A taxpayer must make separate elections for the first year he or she intends to exclude foreign earned income or qualified housing expenses. Each election may be made regardless of whether the other is made.

**Note:** It may not always be to the taxpayer’s advantage to elect one or both of the exclusions. *However, once elected, the exclusions must be applied in all later years unless they are revoked.*
Revoking & Reelecting the Exclusions

A taxpayer may revoke either election in the current tax year or use an amended return to revoke elections made in previous years. However, this will also revoke the exclusion claimed in any intermediate year.

Should a taxpayer return to the United States and become a U.S. resident and then, a number of years later, move abroad again, the elections previously made would remain in effect. Should he or she decide in a later year to revoke either election, the revocation would be binding for that year and at least five (5) subsequent tax years.

A taxpayer can, however, reelect either exclusion within this six-year period by obtaining the Internal Revenue Service’s consent. In deciding whether to consent to a reelection, the Internal Revenue Service considers the period of the taxpayer’s U.S. residence, whether the individual moved from one foreign country to another with differing tax rates, and other relevant facts and circumstances. Internal Revenue Service consent is obtained by filing a request for a private letter ruling with the IRS National Office of Chief Counsel, a process which can be time-consuming and financially expensive.

Whether to make or revoke either exclusion should be discussed with a qualified tax professional before proceeding.

Foreign Earned Income

The basis for calculating the foreign earned income exclusion is the taxpayer’s foreign earned income for the year.

The tax law defines earned income as “wages, salaries, professional fees, and other amounts received as compensation” for rendering personal services. It includes all types of reimbursements, allowances, commissions, and in-kind payments associated with the provision of services, such as:

- Incentive payments relating to foreign assignments
- Cost-of-living and housing allowances
- Market value of employer-provided housing, automobiles, financial services, and so forth
- Dependent education
- Home leave
- U.S., state, and foreign income tax allowances
- Certain employer payment/reimbursement of expenses related to family members

Special rules exist for the following types of taxpayers:

- Operates as a sole proprietor or professional
• Members of foreign partnerships
• Artists, athletes and scientists
• Employees of the U.S. government

In order for earned income to be considered “foreign” it must be from sources within a foreign country that is earned during a period for which the individual qualifies to make an election (i.e., either the foreign earned income or foreign housing cost exclusions). Earned income is from sources within a foreign country if it is attributable to services performed by an individual in a foreign country or countries.

Foreign source income does not include items such as pension or annuity income, income paid to an employee by an employer which is the U.S. government or any U.S. government agency or instrumentality, income from a “nonexempt trust” or “nonqualified annuity,” interest, ordinary dividends, capital gains, or alimony.

Also, to qualify as foreign earned income, the income must not be received later than the end of the year following the year in which the services were performed. Consequently, payments for an employee’s salary, expense reimbursements, or tax equalization will not qualify for the exclusion if paid later than one year after the year in which the services were performed.

Foreign-Source Income

As noted above, to exclude the income from U.S. taxation, not only does it have to be earned income, the taxpayer must also establish that the income is from a foreign source. The source of compensation for the performance of personal services is determined on the basis of the place where the services are performed. Factors such as the place from which payment is made, the location of the employer, and the employee's home base are not relevant.

Based on IRS-issued regulations, the source of compensation should be determined based on either a "time" or "geographical" basis.

The time basis requires all compensation other than certain listed fringe benefits (listed below) to be sourced based on days worked during the tax year. This category of income would include, among other items, salary, incentive compensation, equity-based compensation and taxable group term life insurance. This income would be sourced based on the ratio of foreign workdays over total workdays for the year.

The geographic basis sources income received in the form of certain fringe benefits based on the geographical work location for which it relates. The regulations list certain fringe benefits that should be sourced geographically, and set forth the following sourcing provisions:

• Housing: Sourced on the location of the individual's principal place of work.
• Education: Sourced on the location of the individual's principal place of work.
• Local transportation: Sourced on the location of the individual’s principal place of work.
• Foreign tax reimbursements: Sourced on the location of the jurisdiction that imposed the tax.
• Hazardous or hardship duty pay: Sourced based on the duty zone for which the fringe benefit was paid.
• Taxable moving expenses: Sourced on the location of the employee’s new principal place of work or former place of work if certain conditions are met.

Alternatively, a "facts and circumstances" basis may be used if it can be shown to the satisfaction of the Commissioner that this basis is more appropriate. This may occur, for example, when an employee's compensation is tied to the performance of a specific action rather than earned ratably over a specific time period.

Some states have also published rules on sourcing which need to be considered in applying state income tax withholding rules and preparing state income tax returns.

**Critical:** Because accurate attribution and sourcing of a taxpayer's income is a critical step in determining the amount of earned income eligible to be excluded from U.S. taxation, taxpayers must maintain a daily record (commonly referred to as a “Travel Calendar” or “Calendar”) of their physical whereabouts (i.e. country or countries of presence) and activity (i.e., working or not working) for each day of the tax year. This same daily activity record is also required to properly compute the amount of foreign tax credit, if any, a taxpayer may claim either in addition to - or in lieu of - the foreign exclusions. The Foreign Tax Credit & Deduction are discussed in Chapter 2.

**Tax Treaty – Resourcing of Compensation**

The U.S. has concluded income tax treaties with a number of other countries. Many of these treaties contain a provision within them that permit a taxpayer to “re-source” as foreign income that would otherwise be U.S.-source income using normal sourcing rules. The intent of this provision is to help avoid double taxation of the same income by the U.S. and the foreign country.
Chapter 2 – Foreign Tax Credit & Deduction

A U.S. citizen or resident taxpayer living and working in a foreign country may be subject to that country’s income taxes in addition to remaining subject to U.S. federal income tax on the taxpayer’s worldwide income. This could result in some or all of the taxpayer’s income being subjected to taxation in both countries. To reduce the possibility of double taxation, the U.S. tax code permits a U.S. citizen or resident to either:

1. Deduct foreign income taxes paid in arriving at taxable income (i.e., claim as an Itemized deduction), OR
2. Claim foreign income taxes (paid or accrued) as a credit against U.S. income tax.

The use of a foreign tax credit usually results in lower taxes than does the deduction of foreign income taxes since it permits a dollar-for-dollar offset of foreign income taxes against U.S. income taxes.

A U.S. taxpayer may credit taxes legally imposed by a foreign country, its political subdivisions, or a U.S. possessions (i.e., Puerto Rico and American Samoa). Income, war profits, and excess profits taxes, as well as taxes paid in lieu of income taxes, can be claimed as foreign tax credits. Some foreign social security taxes are also creditable. Social security taxes paid to a foreign country that has entered into a “totalization agreement” with the United States are not, however, creditable or deductible when such social taxes on covered by such agreement.

Each year, an individual must either deduct all allowable foreign income taxes or take a credit for them. Switching between deductions and credits from year to year is permitted and may enable a taxpayer to reduce his or her income tax to the lowest level possible.

Once the taxpayer makes the election to deduct or credit foreign taxes, he or she may revoke the election any time before the period to file a claim for a refund expires (i.e., usually three years from the tax return due date, including valid extensions).

Disallowance of Foreign Tax Credit / Deduction (Denial of Double Benefit)

Foreign income taxes are disallowed as a credit and deduction to the extent that the taxes relate to earned income that has been excluded under the special foreign exclusions discussed earlier in this publication.

A taxpayer may therefore decide not to elect the foreign earned income or housing cost exclusions for the years that he or she is subject to foreign taxes on earned income. This decision may make sense in a year in which the foreign income tax rate exceeds the taxpayer’s U.S. tax rate.

If foreign taxes are considered related to excluded earned income, they are permanently disallowed as foreign tax credits or deductions. To determine the amount disallowed, an apportionment of the foreign tax is made using the following scale-back ratio:
Excluded foreign net earned income subject to the foreign tax
Total foreign net earned income subject to the foreign tax

If the foreign tax was imposed on earned income and some other income, and the taxes on the other income cannot be segregated, then the denominator of the scale-back ratio equals all amounts subject to tax less allocated deductions. When foreign net income is calculated, foreign income is decreased by any expenses considered directly related to that income (e.g., employee business expenses).

The calculation for disallowing the foreign tax credit assumes that foreign taxes on earned income accrue ratably as the income is earned. Foreign taxes are attributed to a given U.S. tax year and then scaled-back (i.e., disallowed) based on that tax year’s scale-back ratio. As a result, a foreign country’s different tax year or the taxpayer’s election to claim the credit on either the cash or accrual method will not affect a foreign credit disallowance.

Limitation of Foreign Tax Credit

The amount of foreign income taxes that may be credited in a particular year is further limited to the lesser of:

1. The allowable foreign taxes paid or accrued, OR
2. The amount of the applicable limitation.

The limitation is equal to that part of the gross U.S. tax (before the foreign tax credit) that applies to the taxable income from foreign sources. The following formula is used to calculate the limitation:

\[
\frac{\text{Foreign-Source Taxable Income}}{\text{Total Taxable Income}} \times \text{Gross U.S. Tax} = \text{Foreign Tax Credit Limitation}
\]

Taxable income for this purpose is not reduced by a deduction for personal exemptions. If the taxpayer has received foreign income from more than one country, the income and taxes are combined from all foreign sources, and one calculation is made to determine the foreign tax credit limitation for taxes paid to different countries.

To maximize the foreign tax credit, one must maximize the taxpayer’s income that is considered foreign-source taxable income. Only the foreign- and U.S.-source income subject to U.S. tax is included in the limitation fraction.

Critical: Because accurate attribution and sourcing of income is a critical step in determining the amount of foreign tax credit that may be claimed, taxpayers must maintain a daily record (commonly referred to as a “Travel Calendar” or “Calendar”) of their physical whereabouts (i.e., country or countries of presence) and activity (i.e., working or not working) for each day of the tax
year. This same daily activity record is also required to properly compute the amount of foreign earned income and housing exclusions, if any, a taxpayer may claim either in addition to - or in lieu of - the foreign tax credit. The Foreign Earned Income and Housing Exclusions are discussed in Section 1.

Since the foreign tax credit could be increased by simply shifting the source of investment income from U.S. to foreign sources, thus increasing the numerator of the limitation formula, the law provides for separate credit limitations for different categories of income.

Currently there are five (5) categories of income:

1. Passive,
2. General,
3. Section 901(j) income,
4. Certain income re-sourced by treaty and,
5. Lump-sum distribution.

Since the Passive and General categories include the most common sources of income encountered by U.S. citizens and resident individuals living abroad, we have limited our discussion in this publication to these two categories.

The passive income basket includes dividends, rents, royalties, gains from the sale of non-inventory property, annuities, interest subject to withholding of less than 5%, and several other kinds of passive income. Certain passive income may be reclassified into the general limitation basket if subject to foreign taxes above a certain level.

The general income basket includes sources of income that are not passive or do not fall into one of the other separate limit classifications. Examples include wages, salary, and overseas allowances, income earned in the active conduct of a trade or business and, gains from the sale of inventory.

The calculation of foreign taxable income requires that foreign-source gross income be reduced by:

1. Special foreign exclusions and deductions claimed,
2. Expenses directly related to the foreign income and,
3. A ratable portion of other deductions.

In addition to the special foreign exclusions and deductions, items deducted in arriving at adjusted gross income generally relate to a specific item of income. Consequently, there is usually little question as to whether the item should be allocated to U.S. or foreign income.
Itemized deductions that do not generally relate to a specific source of income, such as medical expenses and qualified residential interest, are ratably apportioned to U.S. and foreign-source income on the basis of gross income. Certain interest incurred to acquire passive or portfolio assets is apportioned according to the adjusted basis of the taxpayer's U.S. and foreign assets. This apportionment of interest is not required, however, if the individual's foreign-source income does not exceed $5,000. Charitable contributions are allocated only to U.S. source income.

Taxpayers who do not itemize their deductions must apportion their standard deduction on the basis of gross income.

**Carryback/Carry Forward and Use of Previously Unused Foreign Tax Credits**

The decision to elect or revoke the foreign exclusions becomes more complex because of the foreign tax credit carryover rules. Foreign income taxes that cannot be credited in a particular year because they exceed the applicable limitation may be carried back 1-year and forward 10-years, in that order. Any such carryovers are subject, of course, to the limitation formula for the year to which they are carried.

**Paid or Accrual Basis for Claiming Foreign Tax Credits**

Most individuals use the cash basis to file income tax returns and would thus normally credit foreign taxes in the year in which they were paid or withheld. *Taxpayers may, however, credit foreign taxes on the accrual basis even though they use the cash basis for all other purposes.*

*Once the accrual method is elected, it must be used in future years unless permission to change back to the cash method is obtained from the Internal Revenue Service.*

Taxpayers sometimes find it advantageous to accrue foreign income taxes. Using the accrual method for foreign taxes may accelerate the use of a tax credit when foreign taxes accruing to a given year have not been fully paid prior to 31 December of that year. If the accrual method is chosen, the foreign tax is deemed to have been paid at the end of the foreign tax year. If the foreign tax year does not end on the same date as does the taxpayer’s U.S. tax year (for most taxpayers the U.S. tax year is the calendar year), the use of the accrual method may create timing differences. Although the foreign tax credit carryover rules will solve most problems created by these timing differences, a taxpayer may nonetheless experience temporary cash flow problems and be required to file amended tax returns. Because of these issues, a taxpayer with different U.S. and foreign tax years may find it more convenient to be on the cash method for foreign tax credit purposes.

**Change / Redetermination of Foreign Tax**

If a foreign tax redetermination (i.e., change) occurs after a taxpayer has already claimed a deduction or credit for foreign taxes previously incurred, the taxpayer is required to re-determine his or her U.S. tax liability. This may require a taxpayer to notify the Internal Revenue Service...
and/or file an amended U.S. income tax return in order to correct the amount of deduction or credit claimed based on the re-determined foreign tax.
Chapter 3 – Payroll Taxes

Federal Income Tax Withholding

Generally, a U.S. employer is required to withhold U.S. income taxes from U.S. citizens and residents regardless of where the services are performed. However, a U.S. employer is not required to withhold U.S. income tax on foreign earned income under the following circumstances:

1. If the income is earned in a foreign country or U.S. possession and, under the law of that country or U.S. possession, the employer must withhold foreign income taxes on that income.

2. To the extent that it may be reasonably anticipated that the income will be excluded under the special foreign exclusion rules.

3. If the income was earned in Puerto Rico and it is reasonable to expect that the employee, who is a U.S. citizen, will be considered a bona fide resident of Puerto Rico during the calendar year.

4. If it is reasonable to expect that at least 80% of the remuneration paid to a U.S. citizen during the calendar year will be for services performed within certain U.S. possessions.

Under the second exception listed above, an employer may presume that an employee will meet the physical presence or bona fide foreign residence test if the employee submits a statement to the employer and the employer has no cause to believe that the employee will not satisfy the relevant test. The statement must, according to Internal Revenue Service regulations, contain certain factual representations and commitments and contain a declaration that the statement is made under penalty of perjury. Employees typically fulfill these requirements by filing IRS Form 673 Statement for Claiming Exemption from Withholding on Foreign Earned Income Eligible for the Exclusion(s) Provided by Section 911.

U.S. income tax withholding is required to the extent that a taxpayer’s compensation is not covered by any of the above exceptions. This will happen, for example, if the employee’s foreign earned income exceeds the allowable foreign income exclusion or if he or she rendered services in the United States. The total withholding for the year may be estimated and withheld ratably throughout the year.

In calculating the tax to be withheld, the employee may take into consideration anticipated deductions, such as interest, contributions, losses, and personal exemptions, as well as credits, such as the foreign tax credit. Determination of the tax to be withheld is made on Form W-4 Employee’s Withholding Allowance Certificate.

State Income Tax Withholding

Tax withholding laws vary greatly from state to state and include income sourcing provisions that can be complex. Therefore, a proper determination of whether or not an employee remains subject to state-level income tax withholding can only be made after careful examination of the specific employee’s facts and circumstances with a qualified tax advisor. It’s important to understand that simply because an employee is not subject to state-level income tax withholding
at source doesn’t necessarily mean that same employee isn’t subject to state-level income tax on some portion of his or her employer-related and/or personal income.

**U.S. Social Security Tax Withholding**

**Employees**

U.S. citizens or residents employed by a U.S. employer are covered by U.S. social security (FICA) and subject to social security tax, whether working in the U.S. or abroad. In contrast, U.S. taxpayers employed by foreign employers are usually not eligible for U.S. social security coverage.

Special rules exist for U.S. taxpayers employed by foreign affiliates of U.S. corporations that allow a U.S. employer to extend U.S. social security tax coverage to U.S. citizens and residents employed by a qualified foreign affiliate if so desired. Such coverage is elective by the U.S. employer, not “automatic”. Once made, the election may not be terminated. Because these elective agreements are irrevocable and cover ALL U.S. citizens and residents that may work for the covered foreign affiliate (i.e., not just employee’s sent on temporary assignments), these elections are rare in practice.

**Self-Employed**

Individuals who are self-employed and reside abroad are subject to self-employment taxes (in accordance with the Self-Employment Contributions Act (SECA) of 1954) as though they had remained in the United States. U.S. citizens working abroad must compute their earnings from self-employment without respect to any amount qualifying for the foreign earned income exclusions.

**Note**: U.S. taxpayers abroad who are not covered by U.S. social security (FICA) and are not self-employed cannot cover themselves for social security purposes by voluntarily paying self-employment taxes.

**Totalization Agreements**

The United States has entered into bi-lateral social security agreements (commonly referred to as Totalization Agreements) with a number of foreign countries. The intent of these agreements is to eliminate dual social security coverage and dual social taxation for individuals who work in the United States and in those foreign countries. Both the employer’s and the employee’s contributions come within a totalization agreement, when one applies.

These agreements have provisions that address not only the tax on employers and employees but also the way an employee who has worked in two countries can qualify for benefits. The agreements:

- Determine which country’s social security tax applies in normal foreign assignments
- Determine where a person qualifies for benefits when he or she has worked in both countries and paid tax to both social security systems
- Provide for a continuation of U.S. social security coverage in some cases
• Provide administrative rules, such as automatic applications for foreign pensions when the U.S. employee applies for social security

Totalization agreements let U.S. employees overseas keep U.S. social security coverage on most temporary foreign assignments (usually less than five years long). But they eliminate only dual coverage; they do not grant total exemptions from social security. If an employee is not subject to U.S. coverage, he or she cannot be exempt from foreign coverage under a totalization agreement. In fact, totalization agreements go to some lengths to ensure that an employee will be covered by at least one system.

Totalization agreements usually apply only to pension or disability coverage, not medical insurance. However, the foreign country often will exempt a U.S. employee from medical coverage. This practice can make medical insurance for a foreign assignment worth investigating.

**Unemployment Tax Withholding**

Generally, payments under the Federal Unemployment Tax Act (FUTA) are required for U.S. taxpayers working for a U.S. employer outside the United States. A U.S. employer for FUTA purposes, however, does not include the U.S. government or its instrumentalities. Furthermore, services performed by a U.S. taxpayer for a U.S. employer in Canada need not be covered for FUTA purposes. There is no FUTA equivalent of the extension of FICA coverage to employees of foreign affiliates of American corporations. Therefore, while these companies are able to extend FICA coverage to their employees, they are not subject to FUTA coverage for the otherwise uncovered employees of their foreign affiliates.

As is the case with state-level income taxes, each state must be reviewed for determining the application of the State Unemployment Tax Act (SUTA). Some states request that the employer continue to contribute to its state unemployment fund if the employee’s last U.S. location was within that state. Other states require that the employer contribute to that state’s fund for all employees on foreign assignment if the company’s U.S. headquarters are within that state. This requirement applies regardless of where the employee had been last working or to which state the employer was contributing before the employee took the assignment.
Chapter 4 – Principal Residence

Exclusion of Gain from Sale

Qualifying taxpayers are eligible to exclude gain realized from the sale of a principal residence up to a maximum of $250,000 ($500,000 for married taxpayers filing a joint income tax return) for each residence sale. Any such gain realized is no longer required to be reinvested (i.e., rolled over) in a new principal residence.

In order to qualify for the exclusion, a taxpayer must have owned and occupied the residence as a principal residence for at least two (in aggregate) of the five years preceding the sale.

The exclusion may be claimed once every two years.

Taxpayers who fail to meet the two-year requirement because of a change in place of employment, health, or other unforeseen circumstances (described below) may be eligible for a portion of the exclusion based on the ratio of their own qualifying period to the two-year period. For example, a taxpayer who has owned and occupied a residence for one year and is then transferred abroad will be entitled to one-half of the exclusion (see Partial Exclusion, below, for more details).

Regulations help to define what is considered a sale by reason of unforeseen circumstances. The regulations state that a sale is by reason of unforeseen circumstances if the primary reason for the sale is the occurrence of an event that could not reasonably have been anticipated before purchasing and occupying the residence. Examples provided include the involuntary conversion of the residence, a natural or man-made disaster or acts of war or terrorism resulting in a casualty to the residence, or for the owner's death, cessation of employment for which the individual is eligible for unemployment compensation, a change in employment status so that the individual can no longer pay housing costs and reasonable basic living expenses, a divorce or legal separation, or multiple births from the same pregnancy. Preference for a different residence or an improvement in financial circumstances is not considered an unforeseen circumstance that would allow for the reduced maximum exclusion.

Under prior rules, depreciation claimed during a period when the residence was rented was eligible for rollover into a new residence, and thus in principle was eligible for coverage under the once-in-a-lifetime exclusion. Under the new rules, depreciation is treated separately from gain and is not excludable, but is instead subject to a special recapture tax of 25%. This provision is important if a taxpayer chooses to rent his principal residence while serving on an international assignment.

Note: Under IRC Section 877, the exclusion is generally not available to individuals who are deemed to have expatriated to avoid U.S. tax (i.e., former long-term residents or former U.S. citizens).
Partial Exclusion

If a taxpayer has owned and occupied a residence as a primary residence for fewer than two of the five years preceding sale, but has sold the residence because of a change of place of employment or health or other unforeseen circumstances, the taxpayer is entitled to a pro-rata portion of the exclusion.

Planning Tips. Employees who will take, or have taken, a foreign assignment should consider the possible effects of the new rules on gains that they might realize from their U.S. residences. A couple common planning possibilities include:

• An employee who cannot yet meet the two-year ownership and use requirements might attempt to delay the foreign assignment until the requirements are met.

• An employee who has owned and occupied the house for the two years immediately preceding foreign assignment will have a foreign assignment “window” of three years at the end of which the employee would still be entitled to the full exclusion, since at that point (but not beyond it) the employee will have owned and occupied the residence for precisely two of the preceding five years.

• An employee who is uncertain whether the foreign assignment may extend sufficiently to impair access to the full exclusion, or who is uncertain about repatriating to the same U.S. location at the conclusion of the foreign assignment, may want to sell the residence before taking up the assignment.

• An employee who, as a result of a foreign assignment, will at the conclusion of that assignment not meet the two-year test may wish to avoid repatriating to a different U.S. location, so that the residence may be reoccupied and re-qualified for the exclusion.

It is strongly recommended that planning regarding the disposition of a home be carried out with the assistance of a qualified tax adviser.

Foreign Residences

The Internal Revenue Code does not restrict the exclusion to gain from the sale of a principal residence in the United States; a foreign principal residence may also qualify. There are, however, several issues that should be carefully considered before a foreign residence is purchased.

First, the purchase of a residence in the foreign location may affect the taxpayer’s status under the tax laws of the foreign country. A number of countries maintain special tax regimes for expatriates assigned temporarily, and the purchase of a residence may jeopardize a taxpayer’s opportunity to take advantage of such a regime.

Second, a taxpayer who rents a home abroad may be entitled to a housing cost exclusion. The foreign housing cost exclusion is not available, however, for costs associated with a home that is purchased abroad.
Third, the purchase of a home abroad may give rise to a foreign currency exchange gain when the home is sold and a mortgage retired, because of a change in the exchange rate between the time of purchase/mortgage acquisition and sale/mortgage retirement. In fact, it is possible that the sale of a foreign home will give rise to a (nondeductible personal) loss on the sale of the home itself, and at the same time a (taxable) exchange gain on the retirement of the mortgage.

Example:

Smith, a U.S. citizen, relocates temporarily to Japan and purchases a home on 1 January 2015 for ¥ 30,000,000, when the exchange rate is US$1 = ¥110.00. The home is used as his principal residence. The purchase is effected by a down payment of ¥6,000,000, and a mortgage of ¥24,000,000.

On 1 July 2017, Smith sells the home for ¥30,000,000, when the value of the Japanese yen against the U.S. dollar has declined to US$1 = ¥ 120.00. During his period of ownership, Smith paid off ¥1,000,000 of the mortgage, leaving a remaining mortgage of ¥ 23,000,000 on the date of sale.

In Japanese currency, there has been neither a gain nor a loss on the house sale.

However, in U.S. currency the value of the home has declined from US$272,727 (30,000,000 / 110) to US$250,000. The loss of US$22,727 is a nondeductible personal loss. Moreover, there has been a gain on the retirement of the mortgage. The remaining mortgage of ¥23,000,000 was valued at US$209,091 at the time it was issued, but at only US$191,667 at the time it was paid off. In other words, the debt is settled for US$17,424 less than its value at issue, and this $17,424 represents a taxable gain on Smith’s U.S. federal income tax return that cannot be offset by the loss suffered on the sale of the home itself.

Renting the U.S. Principal Residence

If a taxpayer rents the former principal residence during the period of a foreign assignment, the net rental income or loss is reported on the U.S. income tax return. Expenses considered necessary for earning the income are deducted in determining the net amount. If the taxpayer intends to return to the U.S. residence, renting it will not necessarily disqualify any later gain on its sale, although the taxpayer will still have to meet the ownership and use requirements for the exclusion.

Deductibility of rental losses, if any, may be restricted in several ways.

First, if a taxpayer’s modified adjusted gross income does not exceed $100,000, the taxpayer can deduct up to $25,000 of annual passive losses. Any such deductible losses are reduced by one (1) dollar for every two (2) dollars the taxpayer’s adjusted gross income exceeds $100,000. Thus, for taxpayers having modified adjusted gross income of at least $150,000, no loss will be currently deductible.
Second, if a taxpayer uses the residence for personal purposes for the greater of fourteen days or 10% of the number of days during which the house is rented during a given year, no loss may be deducted. This loss restriction, however, does not apply to mortgage interest or real estate tax charges. If personal use does not exceed the limits, a deduction is allowable for a proportionate share of other expenses, including depreciation, attributable to rental of the unit.

If a taxpayer rents the U.S. residence during the foreign assignment period but does not return to live in it, there is a chance the U.S. residence will be considered by the tax authorities to have been converted to business or income property. Relevant case law indicates that such conversion will not be considered to have occurred if the taxpayer can adequately demonstrate the rental activity was temporary, was necessary owing to a difficult real estate market, coincided with sales efforts, or arose owing to uncertainties concerning future employment plans.
Chapter 5 – Moving Expense Reimbursements and Deduction

Moving Expense Reimbursements

Moving expenses that are incurred by an employee but either paid or reimbursed by an employer are excludable from an employee’s gross income as a non-taxable fringe benefit to the extent they meet the requirements for qualified moving expense reimbursements.

Qualified moving expense reimbursements include any amount received, directly or indirectly, by an employee from an employer as a payment for, or a reimbursement of, expenses that would be deductible as a moving expense if directly paid or incurred by the employee. (See Moving Expense Deduction).

Nonqualified moving expense reimbursements will be included in gross income as compensation for services and are neither deductible nor excludable as a qualified moving expense.

Other examples of nonqualified moving expense reimbursements include:

- Meal expenses
- Expenses incurred while searching for a new home after obtaining employment
- The costs of selling the old residence (or settling a lease) or purchasing (or acquiring a lease on) a new home
- Temporary lodging at the new location after obtaining employment
- Any part of the purchase price of the new home
- The cost of automobile registration
- The cost of obtaining a driver’s license in the new location
- Expenses of obtaining or breaking a lease
- Home improvements to help sell the old house
- Loss on the sale of a house
- Losses from disposing of memberships in clubs
- Mortgage penalties
- Real estate taxes
- Refitting of carpets and draperies
- Security deposits (including any given up due to the move)
- Storage charges except those incurred in-transit and for foreign moves
Source of Moving Expense Reimbursements.

The sourcing of reimbursements of moving expenses applies only to nonqualified moving expense reimbursements, since qualified moving expense reimbursements will not be reportable as gross income to the employee but will instead be excludable as a non-taxable fringe benefit.

A reimbursement for a move to a foreign country will generally be considered foreign-source income and will therefore qualify for the foreign earned income exclusion. A reimbursement for moving expenses incurred to return to the United States will generally be considered U.S.-source income, since it is deemed to be paid for future services to be performed in the United States.

However, a reimbursement for the return move will be considered foreign-source income if it is made under a written agreement prepared before the move to the foreign country as an inducement for the move. The agreement must state that the employer will reimburse the employee for moving expenses incurred to return the employee to his or her former principal place of work regardless of whether or not the employee continues to work for the same employer after returning to that location.

Attributing Moving Expense Reimbursements.

When an individual does not qualify for the foreign earned income exclusion for the entire tax year of the move, the portion of the nonqualified moving expense reimbursement that qualifies for the exclusion in that year is based on the number of days the taxpayer resided abroad in the tax year of the move. However, the nonqualified moving expense reimbursement is attributable entirely to the year of the move, as long as the individual has a qualifying period of at least 120 days in the year of the move.

If the individual does not have a qualifying period of at least 120 days, he or she must attribute the moving expense reimbursement both to the year of the move and to the succeeding year, on the basis of the following ratio:

\[
\frac{\text{Number of qualifying days for year of move}}{\text{Total number of days in the year}}
\]

Moving Expense Deduction

An individual may become eligible for a moving expense deduction if:

- Following an employment-related move, the individual’s new place of work is at least fifty miles farther from his or her old home than was the former place of work and,

- After moving, the individual must generally continue to work as a full-time employee in the new location for at least thirty-nine weeks during the twelve months after the move (or seventy-eight weeks during the subsequent twenty-four months, if self-employed).
A person who meets these tests may claim a full deduction for eligible moving costs incurred such as transportation of household goods and personal transportation.

Qualified moving expenses may be deducted only if taxpayers incur the expenses themselves (i.e., such expenses are neither paid nor reimbursed by another person or persons).

**Special Rules for Return Moves to the U.S.**

Although qualified moving expenses are generally deductible or excludible only if incurred in connection with beginning work in a new location, exceptions are provided in two situations for individuals who return to the United States from abroad as follows:

1. If a taxpayer retires and his or her principal place of work and residence are outside the United States, the taxpayer may deduct the cost of moving to the United States upon retirement, even if he or she does not work in the new location.

2. The spouse and dependents of a taxpayer who dies, whose principal place of work at the time of death was outside the United States, may deduct the cost of returning to the United States. To be deductible in such circumstances, the move must begin within six months after the death of the taxpayer and must be from a former home outside the United States, assuming this home was the residence of both the surviving spouse and the deceased at the time of death. The surviving spouse need not work in the new location.

**Special Rules for Foreign Moves.**

A foreign move is one that meets the general rules for deductibility of moving expenses but involves only moves from the United States to a foreign location or from one foreign location to another. It does not include a move to the United States from abroad. Certain storage expenses associated with foreign moves are deductible, which is not the case for moves to or within the United States.

**Storage Expenses**

When it is not practical to transport household goods to the new foreign location, an individual might instead send the goods to a warehouse in the United States for storage until he or she is transferred back. In such cases, a deduction may be taken for the reasonable cost of:

- Moving household goods and personal effects to and from storage and/or,
- Storing the goods and effects while the principal place of work is at a foreign location

These expenses are considered direct moving expenses and are not subject to a specific dollar limitation. Usually, storage expenses will extend over several years, giving rise to a moving expense deduction in more than one year’s tax return. These expenses are considered qualified moving expenses and as such, if reimbursed by the employer, are excludable from the employee’s income and therefore not deductible on the employee’s return.
Allocation of Moving Expenses (No dual benefit permitted)

Qualified moving expenses connected to a move to a foreign work location are considered to be attributable to the foreign income earned there. Therefore, to the extent some or all of the foreign earnings are excluded from gross income, an equal proportion of unreimbursed qualified moving expenses cannot be deducted against gross income.
Chapter 6 – Other Tax Considerations & Filings

State & Local Income Tax

An individual residing abroad may still be subject to state income taxes. Such liability can occur when the person returns to work in that state on business trips, continues to maintain a home in that state, or, under some state laws, is considered by the state to retain his or her residence there. In the last case, the individual may be considered a resident if he or she retains an intent to return to the home state on completing an assignment. Finally, some states tax the gain on the sale of a residence even if the seller is considered a resident abroad. Certain local jurisdictions may follow similar rules with respect to determining residence.

Form 8938, Statement of Specified Foreign Financial Assets

Background

In the Hiring Incentives to Restore Employment Act, enacted in 2010, Congress legislated that U.S. taxpayers meeting certain requirements would be required to report foreign financial assets to the IRS for tax years beginning after March 18, 2010. Form 8938, Statement of Foreign Financial Assets was created for taxpayers to use in reporting such assets when required.

The underlying rules that govern the proper completion of Form 8938 are highly complex and lengthy. As a result, this publication only provides general guidance on this important disclosure form. Taxpayers should seek qualified, professional advice when determining if they are required to file this form and, if so, the specific information required to be disclosed.

IRS Form 8938 must be filed by a taxpayer if he or she is considered a “specified individual” that has an interest in specified foreign financial assets and the total value of those assets is more than the applicable “reporting threshold”.

Specified Individual

A “specified individual” includes:

1. A U.S. citizen,
2. A resident alien of the United States for any part of the tax year,
3. A nonresident alien who makes an election to be treated as a resident alien for purposes of filing a joint income tax return and,
4. A nonresident alien who is a bona fide resident of American Samoa or Puerto Rico.

Form 8938 is typically part of a taxpayer’s annual U.S. federal income tax return filing and is filed by the due date (including extensions) for that return. If a taxpayer is not required to file a U.S. income tax return (i.e., Form 1040 or Form 1040NR) but satisfies the filing requirements for Form 8938, he or she must still file Form 8938.
Reporting Thresholds
Form 8938 “reporting thresholds” are as follows:

A. If specified individual lives in the United States:

<table>
<thead>
<tr>
<th>Taxpayer’s Filing Status on U.S. Federal Income Tax Return</th>
<th>Unmarried</th>
<th>Married</th>
<th>Married</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Value of Specified Individual’s Specified Foreign Financial Assets Exceed the Noted Amounts…</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>On the last day of the tax year</td>
<td>US$50,000</td>
<td>US$100,000</td>
<td>US$50,000</td>
</tr>
<tr>
<td>OR</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Any time during the tax year</td>
<td>US$75,000</td>
<td>US$150,000</td>
<td>US$75,000</td>
</tr>
</tbody>
</table>

B. If specified individual lives outside the U.S., has a tax home in a foreign country, meets either the bona fide resident or physical presence test, and no exceptions apply:

<table>
<thead>
<tr>
<th>Taxpayer’s Filing Status on U.S. Federal Income Tax Return</th>
<th>Unmarried</th>
<th>Married</th>
<th>Married</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Value of Specified Individual’s Specified Foreign Financial Assets Exceed the Noted Amounts…</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>On the last day of the tax year</td>
<td>US$200,000</td>
<td>US$400,000</td>
<td>US$200,000</td>
</tr>
<tr>
<td>OR</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Any time during the tax year</td>
<td>US$300,000</td>
<td>US$600,000</td>
<td>US$300,000</td>
</tr>
</tbody>
</table>

Penalties

Taxpayers may be subject to severe penalties if they fail to timely file a correct Form 8938 or if they have an understatement of tax relating to an undisclosed specified foreign financial asset.

While there are other potential penalties (civil and criminal) associated with Form 8938 non-compliance, the most common penalties are for failing to file the form and continued failure to file.

Failure-to-File Penalty

If a taxpayer is required to file Form 8938 but do not file a complete and correct Form 8938 by the due date (including extensions), the taxpayer may be subject to a penalty of $10,000.
Continuing Failure to File

If a taxpayer does not file a correct and complete Form 8938 within 90 days after the IRS mails the taxpayer a notice of the failure to file, the taxpayer may be subject to an additional penalty of $10,000 for each 30-day period (or part of a period) during which the taxpayer continues to fail to file Form 8938 after the 90-day period has expired. The maximum additional penalty for a continuing failure to file Form 8938 is $50,000.

Note: Filing IRS Form 8938 does not relieve a taxpayer of the requirement to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). FinCEN Form 114 is discussed in Chapter 8 of this publication.

U.S. Qualified Retirement Plans

A common concern of many outbound U.S. citizens and residents is whether they can continue to participate in a U.S. tax-qualified retirement plan while working outside of the United States on a foreign assignment.

Addressing this concern requires an accurate understanding which entity is considered the legal employer of the employee during the period of foreign assignment.

U.S. Employers

U.S. citizens or residents employed by a U.S. employer may continue to participate in the employer’s tax-qualified retirement plan provided such participation is permitted by the terms of the plan document. If an employee is sent on international assignment and, as a result, severs his or her legal employment status with the U.S. employer, continued participation in the former U.S. employer’s qualified retirement plan is generally not allowed because the employee technically is no longer an “employee” of the entity (i.e., U.S. employer) that sponsors the retirement plan. There is an exception to this general “non-participation” rule for transfers occurring within “Controlled Groups”. The financial results differ in such instances, however, and should be reviewed with a qualified tax advisor.

Non-U.S. Employers

Under Internal Revenue Code Section 406, U.S. citizens and residents employed by a qualifying foreign affiliate of an American employer will be treated as employed by the American employer for purposes of the American employer’s tax-qualified retirement plan if certain requirements are met. In general, the requirements are:

1. The American employer agrees to extend U.S. Social Security coverage to all of the foreign affiliate’s employees who are U.S. citizens or residents by means of a Section 3121(l) agreement filed with the IRS,

2. The tax-qualified retirement plan expressly provides for contributions or benefits for U.S. citizen and resident employees of the foreign affiliate to which a Section 3121(l) agreement applies and,
3. No contributions are made to any other (including non-U.S.) funded deferred compensation plan (whether or not tax-qualified) on behalf of the employees who are U.S. citizens or residents based on the compensation of such employees from the foreign affiliate.

In practice, companies do not extend coverage of tax-qualified retirement plans in this manner due to a number of disadvantages associated with doing so.

**Estate & Gift Taxes**

U.S. citizens and U.S. resident aliens living abroad are generally subject to estate and gift taxes under the same rules that apply to those living in the United States. Wills and estate plans should adopt all necessary provisions to ensure that tax advantages are obtained. U.S. citizens married to non-U.S. citizens must pay particular attention to this area due to tax laws that severely limit the availability of marital deductions when property passes to a non-citizen spouse.

In addition to U.S. and state laws affecting estates and gifts, foreign country laws imposing estate and gift taxes may affect U.S. taxpayers residing there. Although the United States has concluded several treaties providing for relief from double taxation of estates and gifts, in some cases, both U.S. and foreign estate taxes will apply. Double taxation can sometimes be avoided or minimized with appropriate planning, but tax and legal advisers should be consulted before any action is taken in this area.

**Net Investment Income**

The Net Investment Income Tax (NIIT) is assessed in addition to the regular federal income tax on the net unearned income (i.e., investment income plus other sources of passive income such as rental properties) of taxpayers whose modified adjusted gross income exceeds thresholds. The tax rate is flat at 3.8%. While this tax may not apply to a taxpayer prior to working on international assignment (because income falls below stipulated threshold) it may apply once on assignment due to assignment-related allowances provided by the employer.

**Foreign Corporations and Other Foreign Entities – Officers, Directors or Shareholders**

U.S. citizen or resident taxpayers who are an owner, officer or director of a foreign corporation may be required to file a special information report with their annual U.S. federal income tax return: Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. This special filing is complex, time-consuming and requires taxpayers to provide a great deal of financial accounting information related to each foreign corporation in which an interest is held.

*The financial penalties assessed by the Internal Revenue Service for failing to file this report can be substantial so taxpayers should review their foreign investments with their tax advisor.*
Foreign Trusts & Large Gifts or Bequests from Certain Foreign Persons

U.S. citizen and resident taxpayers are required to file an information return with their annual U.S. federal income tax return - Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts – if any of the following apply during the tax year:

1. Undertake certain transactions with foreign trusts,
2. Hold ownership interest in certain foreign trusts or,
3. Receive certain large gifts or bequests from certain foreign persons.

A separate Form 3520 must be filed for transactions with each foreign trust. This is yet another potentially complex and time-consuming filing that taxpayers should discuss with their tax advisor, if applicable, to help ensure compliance obligations are met.

Penalties for failure to file Form 3520 - or if the information is incomplete or incorrect - apply and can be substantial.

Foreign Currency Exchange Rules

Taxpayers are required to report income and deductions on their U.S. tax returns in U.S. dollars. Income and expenses paid in a foreign currency should generally be converted to U.S. dollars using the exchange rate on the date of receipt or the date of payment. In some circumstances, the most accurate exchange rate to use is an average exchange rate for the year. When calculating capital gains (e.g., from sale of home, stock, etc.), taxpayers are required to use historical exchange rates which may result in a foreign currency gain or loss in U.S. dollars.

Currency Restrictions & Reporting

The United States imposes no restrictions on bringing money into or out of the country. However, if a taxpayer transports or receives more than US$10,000 of cash or monetary instruments in or out of the United States at one time, it must be reported. FinCEN Form 105, Report of International Transportation of Currency or Monetary Instruments is used for reporting. The due date for filing FinCEN Form 105 varies depending on how the money is physically transported.

Note: If money is transferred using normal banking procedures (i.e., not physically transported into or out of the U.S.), reporting is not required.

Passive Foreign Investment Company (PFIC)

If a taxpayer has an ownership interest in a passive foreign investment company (PFIC), such as a foreign mutual fund, such interest must be reported annually using Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund. Form 8621 is filed as part of a taxpayer’s annual U.S. federal income tax return. Unlike other information returns covered in this publication, Form 8621 can result in tax and interest being owed by the taxpayer. Special elections may apply that mitigate the tax and interest.
The tax rules governing PFICs are extremely complex. Accordingly, taxpayers should consult with a qualified tax advisor prior to investing in any foreign entity.

Amended Income Tax Returns

The need to file amended U.S. federal and/or state income tax returns is fairly common for U.S. taxpayers residing outside the United States due to a number of factors including the complexity of tax laws involved, relocation dates to/from the United States, retroactive elections, corrected payroll information and carryback or forward of unused foreign tax credits. Contrary to popular belief, the filing of an amended tax return in and of itself does not increase the risk of audit by tax authorities since in many cases such filings are the only correct means of arriving at the proper amount of tax due at the right time. Amending a tax return can be just as complex and take just as much time to complete as the original income tax return. In general, amended tax returns must be filed within three years of either the tax return’s original due date or the date on which the tax return was timely filed, if the original filing due date was properly extended.

Community Property Rules (U.S. States)

Several U.S. states have adopted community property rules which provide that most marital income and assets belong to both spouses equally, regardless of which spouse earned the income or acquired the asset. These rules can have a significant (usually negative) impact on the tax liability of married couples that file separate returns. It’s important to note the income-allocating rules of community property states are not applied when computing the foreign earned income exclusion or if either spouse is a non-resident alien of the U.S. The rules and associated income tax computations are complex and should be reviewed with a qualified tax advisor in order to understand their application and implications to a specific set of facts.

Tax Treaties

The U.S. has ratified tax treaties with a number of foreign countries. These bi-lateral agreements provide guidance on how to properly address certain tax-related matters that arise between the tax systems of the two treaty countries. The provisions within these treaties are intended to provide tax relief, especially the avoidance of tax increases and double taxation of the same income. Reliance on an income tax treaty is normally required to be disclosed by a taxpayer. The disclosure requirement is most commonly met by attaching Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b) to the taxpayer’s federal income tax return.

Tax treaties are between the U.S. federal government and foreign countries. As such, they do not provide direct tax benefits at the U.S. state level of taxation.
Chapter 7 – Income Tax Return Reporting & Filing Procedures

Who Must File

While residing in foreign countries, U.S. citizens and aliens considered U.S. residents must continue to follow the standard rules and income thresholds for filing U.S. income tax returns.

In determining whether or not an individual meets the income filing thresholds, all compensation earned abroad is included in gross income; income that is excludable for other reasons, such as interest on tax-free municipal bonds, is not included in gross income.

A tax return must be filed even when the taxpayer’s foreign exclusions or deductions equal or exceed gross income, or when credits, such as the foreign tax credit, completely eliminate U.S. tax liability.

Joint vs. Separate Tax Returns

A U.S. citizen or resident alien may file a joint return with a spouse. If the spouse is a nonresident alien, however, the couple can elect to file a joint return only if the nonresident spouse agrees to be subject to U.S. tax on his or her worldwide income for the entire year. The election to be treated as a U.S. resident may be advantageous when the nonresident alien spouse has little or no income or has foreign-source income that is taxed at a higher rate overseas than in the United States. The use of a standard deduction for married individuals filing jointly may also make the election beneficial. If made, this election remains in effect for all future tax years until terminated by death, revocation, or separation.

If the election is made, the nonresident alien spouse is taxed on worldwide income and may be entitled to the special foreign earned income exclusions. If the election is not made, a nonresident alien spouse who has no U.S.-source gross income may qualify to be claimed as an exemption on the resident spouse’s federal tax return.

When to File U.S. Tax Returns

Tax returns for individuals are due on the fifteenth day of the fourth month following the close of the tax year (15 April for calendar-year taxpayers). However, taxpayers who are U.S. citizens or residents and whose tax home and abode are outside the United States and Puerto Rico on the regular due date have an automatic extension of two months (to 15 June for calendar-year taxpayers) for filing. While no formal request for this additional time is necessary, the taxpayer’s return must include a statement that his/her tax home and abode were outside the United States and Puerto Rico on the regular due date. If a joint return is filed, only one spouse must reside outside the United States in order to obtain the automatic two month extension.

This postponement of the due date does not relieve taxpayers from paying any interest due on the unpaid portion of their ultimate tax liability. The tax liability is still due on 15 April and interest
is calculated from such date (without extension) until payment is received by the Internal Revenue Service.

An additional automatic extension of four months, to 15 October, is available by filing Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. This extension will not excuse the taxpayer from interest unless he/she has paid at least 100% of his or her ultimate U.S. tax liability by the time the extension is filed.

If the due date for filing a return (including the automatic extension) falls on a Saturday, Sunday, or national holiday, the due date is the next business day.

A federal return mailed from a foreign country will be accepted as filed on time if there is an official postmark dated on or before the last day for filing, including extensions. Tax returns filed by a private mail service must reach the Internal Revenue Service office by the required due date. However, returns filed express, overnight or next day air with certain designated private delivery services (i.e., DHL, FedEx and UPS) will be considered to have been filed when they are given to the delivery service.

If a tax return is mailed after its original or extended due date, it is not considered filed until actually received by the Internal Revenue Service.

Interest Charges on Balances Owed

A properly filed extension relieves the taxpayer from a late filing penalty on the net tax due. It does not, however, eliminate the liability for interest that is charged by tax authorities on any unpaid tax from the original due date of a tax return. Therefore, taxpayers should endeavor to pay 100% of the tax believed owed no later than April 15, even if the due date for filing the finalized income tax return is not until a later date.

Special First-Year Filing Procedures

Taxpayers who expect to qualify for the special foreign exclusions but are required to file a return before qualifying may either obtain an additional extension to defer filing until they qualify or file the return without claiming any foreign exclusion, pay any tax due, and file an amended return to apply for a refund when the requirements are met. The IRS will grant an extension until thirty days after the date on which either the bona fide foreign residence test or physical presence test is expected to be met.

The extension applications may be filed with either the Internal Revenue Service Center in Austin, TX on Form 2350, or with an IRS office located in a major U.S. embassy in another country. A copy of the approved application should be attached to the return when it is filed to help minimize IRS processing delays.

Filing a U.S. tax return without claiming the special foreign exclusions may require payment of U.S. taxes, particularly when the taxpayer’s compensation has not been subject to foreign taxation.
and/or U.S. income tax withholding. Although all or a portion of these taxes may be refunded at a later date (i.e., when the return is subsequently amended to claim the foreign earned income and housing cost exclusions), it is usually advantageous to obtain the extension and file the return when the special foreign exclusions can be claimed.

A taxpayer who is already entitled to a refund may consider it worthwhile to file by the original due date and obtain a refund. At a later date, he or she may file an amended return (Form 1040X) to obtain an additional refund because of the special foreign exclusions. This situation commonly arises when a foreign assignment begins late in the year.

Where to File Tax Returns

Federal Tax Return
Taxpayers who claim the special foreign exclusions or reside outside the United States should file their federal tax return with the appropriate office of Internal Revenue Service. Since the correct IRS office changes from time-to-time, taxpayers should reference the latest filing information available from the IRS related to taxpayers who live abroad.

Claims for refund or amended tax returns should be filed in the district where the original return was filed.

State Tax Return
Each state has its own directions and location/address for filing. Taxpayers should reference the latest directions each year to ensure their return is filed properly.

Payment of Tax

Taxes are payable in U.S. dollars; foreign bank checks must be drawn on U.S.-dollar accounts.
Chapter 8 – FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR)

Background

The mandates of the Currency and Foreign Transactions Reporting Act of 1970 (a.k.a., "Bank Secrecy Act" or "BSA") are carried out by the Financial Crimes Enforcement Network (FinCEN), a bureau within the U.S. Department of the Treasury.

The BSA requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering. It also places complex reporting responsibilities on taxpayers related to foreign bank and financial accounts they have a financial interest in or have signature authority over. FinCEN Form 114 (more commonly known as FBAR), is used to report such accounts.

Who Must File

A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds US$10,000 at any time during the calendar year. The definition of a “United States person” includes U.S. citizens and residents.

Filing Exception for Certain Accounts Jointly Owned by Spouses

The spouse of an individual who files an FBAR is not required to file a separate FBAR if the following conditions are met:

1. All the financial accounts that the non-filing spouse is required to report are jointly owned with the filing spouse,
2. The filing spouse reports the jointly owned accounts on a timely filed FBAR electronically signed and,
3. The filers have completed and signed Form 114a, “Record of Authorization to Electronically File FBAR’s” (maintained with the filers’ records).

If all three conditions are not met, both spouses are required to file separate FBARs, and each spouse must report the entire value of the jointly owned accounts.

Responsibility for Child’s FBAR

Generally, a child is responsible for filing his or her own FBAR report. If a child cannot file his or her own FBAR for any reason, such as age, the child’s parent, guardian, or other legally responsible person must file it for the child. If the child cannot sign his or her FBAR, a parent or guardian must electronically sign the child's FBAR.
Filing Due Date and Procedure

The FBAR is a separate, annual filing from a taxpayer's federal income tax return. If a taxpayer is required to file this form, it must be filed electronically through FinCEN's BSA E-Filing System and received by the Department of the Treasury on or before June 30 of the year immediately following the calendar year being reported. The June 30 filing date may not be extended. Extending the filing due date of a taxpayer's annual U.S. income tax return does not extend the due date for filing the FBAR.

Note: Effective with 2016 FBAR filings (due in calendar year 2017), the due date for filing the FBAR is April 15. An extension of time to file will also be allowed.

Penalties for Non-Compliance

A person who is required to file an FBAR and fails to properly file may be subject to a civil penalty not to exceed US$10,000 per violation (e.g., for each account a taxpayer fails to report regardless of the amount in the account). A person who willfully fails to report an account or account identifying information may be subject to a civil monetary penalty equal to the greater of $100,000 or 50 percent of the balance in the account at the time of the violation. Criminal penalties may also be imposed.
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