U.S. Expatriates: Tax Considerations & Planning Tips

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This book is intended for U.S. citizens and "Green Card" holders (permanent residents) living and working outside of the U.S. It is also designed to assist multinational employers in planning expatriate assignments for their U.S. employees. It is not intended for use by U.S. citizens or "Green Card" holders employed abroad by the U.S. Government or for those individuals in U.S. territories or possessions such as the U.S. Virgin Islands, Puerto Rico, Guam, Wake Island or American Samoa.

This book is based upon the U.S. tax laws and regulations in effect as of December 15, 2004. Users are reminded that specific rules, including court decisions and IRS announcements should always be reviewed prior to implementing tax-planning strategies. Thus, a competent tax advisor should always be consulted.

Contact Us

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Please visit our websites to learn more about us:

www.demostax.com – for all your tax consulting and preparation needs.

www.expatriatehelp.com – a web portal for all things expatriate.

Introduction

As an American Expatriate you will find numerous challenges that await you upon accepting your foreign assignment. Understanding both your U.S. and foreign tax obligations is one of the most challenging.

This book is broken down into four main categories:

1. General U.S. Tax Information and Considerations
2. Expatriate Tax Considerations and Planning
3. Case Studies to assist in you learning
4. Sample Forms and a listing of useful websites

Throughout the book we will refer to the current year (2004) as 200C and the prior two years (2002 and 2003) as 200A and 200B, respectively. Future years such 2005 and 2006 will be referred to as 200D and 200E, respectively.

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SECTION I

General U.S. Tax Information and Considerations

The U.S. Tax System is a complex one based on laws and regulations as well as the interpretation of the laws and regulations through court cases. However, a rather simple diagram that follows the format of a tax return can express its principals visually:

Gross Income
less
Adjustments (from Gross Income)
equals
Adjusted Gross Income
less
Deductions (Standard or Itemized)
less
Exemptions
equals
Taxable Income

Base Tax calculated on your Taxable Income
less
Tax Credits
equals
Net Tax Liability

Filing Status

The first item the U.S. Government takes into consideration when determining your taxes is your filing status. This status impacts such items as the Standard Deduction for which you qualify and when phase-outs begin for itemized deductions, exemptions and certain credits (ex: child care). Your status will also dictate which tax rate schedule applies to you.

The five filing statuses are:

- Single
- Married filing jointly
- Married filing separately
- Head of Household
- Qualifying widow(er) – generally treated the same as Married Filing Jointly

Gross Income

Gross Income is the totality of all income; from whatever source it is derived. Losses are also included in the gross income category, but the amount allowed may be limited.

Gross Income includes, but is not limited to:

- Wages, salaries and other earned compensation
- Interest, dividends and capital gains
- State income tax refunds (when applicable)
- Alimony received
- Income from a business, profession, partnership or trust
- Rental properties
- Retirement Plan distributions (ex: IRAs, Pensions, Social Security)
- Unemployment
- Other income, losses or exclusions

Adjustments to Gross Income

- Education related (educator expenses, tuition and fees, student loan interest)
- Retirement related (IRAs, SEP, SIMPLE etc,)
- Medical Saving Account
- Alimony Paid
- Self-employment related (one-half of the S.E. tax, S.E. health insurance deduction, etc)
- Moving expenses
- Penalty on early withdrawal of savings
- Certain business expenses of reservists, performing artists, fee basis government officials

Gross Income less these adjustments equals **Adjusted Gross Income**.

Deductions – Standard versus Itemized

You may reduce your Adjusted Gross Income by the greater of the appropriate standard deduction or your allowable itemized deductions.

The Standard Deductions for 2004 are as follows:

- $4,850 - Single
- $9,700 - Married filing jointly, Qualifying Widow(er)
- $4,850 - Married filing separately
- $7,150 - Head of Household

Tax Tip: You may now deduct your actual state and local general sales taxes paid or use a standard amount from the IRS table if you elect to do so in lieu of state income taxes. This election is most beneficial to taxpayers in no or low income tax states with high sales taxes.

Itemized Deductions are broken into seven main categories:

- Medical and dental expenses
- Taxes (State and local income tax (or sales tax), real estate, personal property)
- Interest you paid (qualifying mortgage interest, points, investment interest)
- Charitable contributions
- Casualty and theft losses
- Miscellaneous expenses subject to 2% limitation
- Other miscellaneous expenses not subject to 2% limit

Itemized Deduction Phase-out

If your Adjusted Gross Income exceeds the threshold amount of $142,700 (except married filing separately), you must reduce your itemized deductions by 3% of the excess over the threshold amount. If your status is married filing separately, your threshold amount is $71,350.

Itemized Deduction Tip

It may be beneficial to pay your real estate taxes, car excise taxes and/or state income taxes for the next year (200D) during the current year (200C). In the right situation, this "bunching" of expenses allows you to maximize your deductions in 200C and take the standard deduction in 200D.

For example: Paul has itemized deductions that are similar year after year.

	200C	*200D*	*Total for two years*
State income tax	$ 400	$ 400	$ 800
Real estate tax	1,600	1,600	3,200
Car excise tax	200	200	400
Mortgage interest	3,300	3,300	6,600
Charitable contributions	500	500	1,000
Total	$6,000	$6,000	$12,000
Deduction taken	**$6,000**	**$6,000**	**$12,000**

Over a two-year period he will get $12,000 in deductions ($6,000 for 200C & $6,000 for 200D).

By prepaying real estate and car excise taxes for 200D in 200C, Paul will have $7,800 of itemized deductions in 200C and $4,200 of itemized deductions in 200D. However, since the single standard deduction ($4,800) is more that his itemized deductions in 200D ($4,200), he will elect the standard deduction in 200D. Thus, his total deduction for the two years is $12,650 ($7,800 for 200C plus $4,850 for 200D).

	200C	*200D*	*Total for two years*
State income tax	$ 400	$ 400	$ 800
Real estate tax	3,200	0	3,200
Car excise tax	400	0	400
Mortgage interest	3,300	3,300	6,600
Charitable contributions	500	500	1,000
Total	$7,800	$4,200	$12,000
Deduction taken	**$7,800**	**$4,850**	**$12,650**

Exemptions

In 2004, you can deduct $3,100 for each exemption claimed. You can claim yourself, your spouse (if filing jointly), and any dependents you may have.

To claim someone as dependent, each dependent must meet five dependency tests:

1. Support – you must have furnished over half of their total support for the calendar year
2. Income – they must have less than $3,100 of gross income unless they are under age 19 or a full time student under age 24
3. They must live with you for the entire year or be related to you
4. They cannot file a joint return with a spouse
5. They must be a citizen, national or resident of the U.S., Canada, or Mexico

Phase-Out

When your adjusted gross income exceeds certain threshold amounts (see below), a phase-out applies to your exemptions. You must reduce your exemptions by 2% for each $2,500 or part thereof, of the excess. For each $1,250 or part thereof if married filing separately.

- $142,700 - Single
- $214,050 - Married filing jointly, Qualifying Widow(er)
- $107,025 - Married filing separately
- $178,350 - Head of household

Credits

There are a variety of tax credits available to individuals in the U.S. tax system. The most popular are:

- The foreign tax credit
- Child related (child and dependent care expenses, child tax credit, adoption expenses)
- Education Credits (Lifetime Learning Credit, Hope Credit)
- Credit for the elderly or disabled

Foreign Tax Credit (FTC)

The foreign tax credit is designed to alleviate the double taxation of the same income by the U.S. and foreign country. Generally, this is a dollar for dollar credit, but it does have limitations. For most people, this relates to taxes paid on foreign dividends. A more detailed discussion of the FTC takes place in Section II of our books on U.S Expatriates and Foreign Nationals.

Child Tax Credit and Additional Child Tax Credit

You may be entitled to a credit for each ***qualifying*** child. To qualify for the credit:

- the child must be under 17
- a citizen or resident of the U.S.
- someone you claim as a dependent
- your child, stepchild, grandchild or eligible foster child

Phase-Out

A phase-out of the Child Tax Credit begins when you pass an AGI threshold. For every $1,000 or part thereof that your AGI exceeds this threshold, you must reduce your credit by $50.

- $75,000 - Single, Qualifying Widow(er)
- $110,000 - Married filing jointly
- $55,000 - Married filing separately
- $75,000 - Head of household

Note: The child tax credit cannot reduce your liability to less than zero. However, unlike most tax credits, the additional child tax credit is refundable, meaning that it can actually reduce your tax liability to less than zero. You may get more money refunded than you had withheld.

Higher Education Tax Credits

There are two credits (Hope and LLC) for higher education expenses. Qualified expenses include tuition and other expenses required for enrollment at an eligible institution. Expenses that do not qualify are books, room and board, and activity fees.

Hope
The Hope credit is for full time students enrolled in their first or second year of post secondary education. The Hope credit is calculated as 100% of the first $1,000 of qualified expenses plus 50% of the next $1,000 of qualified expenses, for a maximum of $1,500 per year per student.

Lifetime Learning Credit (LLC)
The Lifetime Learning Credit is not limited to first or second year students of post secondary education. Qualified expenses for the LLC include the cost of instruction taken at a qualified educational institution or to acquire or improve existing job skills. The amount of the credit is 20% of the first $10,000 of qualified expenses for a maximum of $2,000 per year.

Please note that there is a phase-out based on your modified adjusted gross income. For a deeper understanding of the phase-outs on these credits, please consult a tax advisor.

Moving Expenses

Moving expenses incurred or reimbursed may qualify as deductible moving expenses provided that the move satisfies certain requirements involving work, distance and time.

- Work Related Test – The date of the move must be closely related in both time and place to the start of work at a new job location.
- Distance Test – The distance between your new primary place of work and your old residence must be at least 50 miles greater than the distance between you old primary place of work and your old residence. In other words, had you remained in your old home, your commute must be at least 50 miles longer each way.
- Time Test – In the 12-month period immediately after the move, you must work full time for at least 39 weeks. This test may be waived if the failure to meet it is due to death, disability or an involuntary separation from employment, or if you get transferred again for the benefit of your employer.

Deductible Moving Expenses

Expenses that may be deducted must have been paid by you and not reimbursed by your employer. The expenses must be reasonable for the circumstances of your move.

If your move meets the three tests, you will be allowed to deduct the expenses you incurred for:
- Transportation of household goods and personal effects.
- Travel expenses from your old home to your new home during the trip.

Employer Provided Moving Expense Reimbursements

All moving expenses that your employer either directly reimburses, or pays on behalf of the employee (other than certain "excludable" reimbursements) will be included in the employee's gross income as compensation.

Some of the most common taxable reimbursements include:
- Temporary living expenses
- House hunting expenses
- Meals
- Expenses related to selling or purchasing a home
- Reimbursement for loss on the sale of your home
- Spousal assistance program
- Tax assistance or gross-up payments

Tax Tip
Some of the taxable reimbursements may be deducted as itemized deductions. Generally, these are points paid on the purchase of your new house, mortgage interest, real estate and state and local income taxes. For a more complete discussion consult a tax advisor.

"Excludable" Reimbursements

An excludable reimbursement occurs when an employer pays for expenses, which qualify as deductible moving expenses, whether paid directly to third party or reimbursed to the employee. These payments are excluded from your taxable compensation. As these reimbursements are excluded from your compensation, they are not allowed as a deductible moving expense on your return.

Lump Sum Payments

It is up to you to keep track of your deductible moving expenses. Quite often an employer may offer a lump sum payment program to cover your moving expenses. Generally, the full amount is included in your taxable income. To help keep track of your expenses, and categorize them into deductible and nondeductible, we have provided you with a moving expense worksheet below.

DEDUCTIBLE Moving Expenses	**$ Amount**
Transportation of Household Goods and other Personal Effects	
Transportation of Household Goods including packing fees	
Storage & Insurance, in-transit – 30 day maximum	
Shipment of your vehicles	
Cost of transporting pets	
Disconnection and connection of utilities fees	
Misc. deductible costs to move the household goods, including gratuities	
Travel Expenses from Old home to NEW Home	
Public forms of transportation (planes, trains, etc)	
Mileage calculation or actual automobile expenses (gas, etc)	
Parking fees and tolls	
Hotels/lodging expenses during trip, including day of arrival	
Other deductible travel expenses	
Total DEDUCTIBLE Moving Expenses	
NONDEDUCTIBLE Moving Expenses	
Pre-move house hunting Trip	
Temporary living expenses	
Meals	
Storage and Insurance costs beyond 30 days	
Closing costs from sale or old home and/or purchase of new home	
Losses, if any, on the sale of old home	
Expenses related to buying or selling your home	
Expenses of breaking a lease or security deposits forfeited due to move	
Fixing-up expenses to sell old home	
Misc. nondeductible expenses	
Total NONDEDUCTIBLE Moving Expenses	

Alternative Minimum Tax

The Alternative minimum tax may be triggered when individuals have substantial itemized deductions and/or income that receives preferential treatment. Some of the more common "tax preference items" that may trigger Alternative minimum tax are incentive stock option income, passive losses, certain tax-exempt interest, foreign tax credit, and accelerated depreciation or depreciation methods.

The concept of alternative minimum tax is to ensure that all taxpayers pay at least a minimum amount of tax. While the alternative minimum tax was initially designed to apply to the highest bracket taxpayers, many middle class taxpayers are now triggering the alternative minimum tax.

Alternative minimum tax is a separate tax that is payable only if it exceeds a person's "regular tax". The most common alternative minimum tax factor, which affects expatriates, is the Alternative minimum tax foreign tax limitation. This limits the Foreign Tax Credit on your tax return to 90% of your pre-credit Alternative minimum tax liability.

A complete description of alternative minimum tax and its complex provisions is beyond the scope of this book. A basic discussion is provided. Beyond this taxpayers should seek tax advice regarding the alternative minimum tax and their circumstances.

Filing Requirements and Administrative Tips

All U.S. citizens and residents are required to file a U.S. tax return in which they report their worldwide income on an annual basis.

- Travel Calendar – is a must for people who work in multiple states, travel on business or are sent by their employer on short- or long-term assignments away from their home state. Keeping track of your workdays and non-workdays by location helps your tax advisor to correctly prepare your tax return.

Statute of Limitations

The IRS has a statute of limitations in which it may audit a taxpayer's return. Generally, it is three years from the later of:

- The date the tax return was due; or
- The date the return was actually filed

In other words, if you never file a return, then the IRS has an unlimited amount of time to assess the tax or to audit your records related to that return. If your Gross Income shown on the return is understated by at least 25%, the assessment period is six years. The statute of limitations does not apply to returns the government can prove are fraudulent.

You must retain your records for three years, but it is recommended that you retain them for six years prior to shredding them.

Report of Foreign Bank and Financial Accounts

If you have a financial interest in, or a signatory authority over a foreign bank account or other foreign financial accounts(s) that exceeds in the aggregate $10,000 at **ANY** time during the calendar year, you must file Form 90-22.1 with the U.S. Treasury Department by June 30th of the following year. A copy of this form is in Section IV.

Mail the completed form to:

Department of the Treasury
P.O. Box 32621
Detroit, MI 48232-0621

Foreign Tax Credit Documents

If you claim a Foreign Tax Credit on your return, you must maintain receipts and other evidence such as Broker statements and foreign tax returns evidencing the foreign tax paid to support the credit claimed. While there is no requirement to attach such documents to the U.S. return, it is normally requested by the IRS during audits.

Extensions

While your tax returns are due by April 15th of the following year, there are options to extend the date by which you must file your return.

- **Form 4868** - must be filed by April 15th and will extend your return due date for four months until August 15th. This is an automatic extension and does not require a reason.
- **Form 2688** - is used to extend the due date of your returns by an additional two months to October 15th. This form requires that you filed Form 4868 in a timely manner and requires an explanation such as "Additional time is needed to accumulate the information needed to file a complete and accurate return".
- **Form 2350** - People on foreign assignments who are waiting to qualify for the Bona fide Residence Test or Physical Presence Test use form 2350. It can extend your due date to as far as January 30th of the 2nd year following your tax year. Example: Tax year is 200C. Form 2350 extends your due date until January 30, 200E, rather than April 15, 200D.

Note: While most filing extensions gives you more time in which to send your return to the government, it does not extend your time to pay your tax liability. It is advisable to make a payment with your 4868 unless you know you are in a refundable position.

While most states will accept the federal extension, many require you to file a copy with them or their own extension forms. Check with a tax advisor for the legal requirements in your state(s).

Warning: Filing an extension but not having your tax liability fully paid up may result in the assessment of Interest and Penalties by the IRS or state taxing authority.

Estimated Tax Payments

Generally speaking, you will be required to make estimated U.S. tax payments if you have any of the following situations:

- Self Employment Income
- Substantial passive income
- Substantial capital gains
- You are a high net worth taxpayer

An underpayment penalty may be imposed if you have not paid at least:
90% of the current year U.S. tax liability on a quarterly basis; or
100% of the prior years U.S. tax liability on a quarterly basis
If your adjusted gross income for the prior year exceeded $150,000 ($75,000 if MFS), then you must pay in at least 110% of your prior year tax liability

Federal estimated tax payments are filed on Form 1040ES and are due by April 15th, June 15th, September 15th, and January 15th of the following year. If the 15th falls on the weekend, then the payment is due on the following Monday.

State estimated tax rules vary. Check with your tax advisor to see whether or not your state follows the Federal rules or has their own.

Social Security Taxes

Anyone earning wages or self-employment income from U.S. work or employment is potentially subject to U.S. social security taxes. This includes nonresidents and residents alike. The U.S. social security system is made up of two components, the OASDI (old age, survivors and disability insurance) tax and the Medicare tax. These taxes are imposed on both the employer and the employee. Self-employed individuals pay both portions (employer and employee) of their social tax burden. OASDI is levied on annual wages up to $87,900 (for 2004) and is collected from the employee through withholding. The employee and employer each pay a 6.2% tax to social security on qualifying wages. The medicare tax is also collected through withholding and is levied at a rate 1.45% of qualifying wages on both the employer and employee. However, unlike OASDI, there is no ceiling on the total annual wages subject to this tax. Both taxes combined are often referred to as FICA and frequently show up on your wage statements under that heading.

Home Ownership Related Issues

Tax Benefits

When a person decides on a place to live, they must make a decision to either buy or rent. Quite often, people choose the option that is cheapest for them overall. However, not everyone takes the tax benefits of home ownership into account when making this decision. There are two ways that you may benefit by owning a home: the deductions taken on your return may be higher, resulting in a lower tax liability now and later on, upon the sale of the home, you may be eligible to exclude most if not all of the capital gain.

Itemized Deductions

The itemized deductions related to home ownership are: Real Estate Taxes; Home Mortgage Interest; Points Paid on the purchase of your home and Points Paid on refinancing your mortgage.

Real Estate Taxes

It is quite common for a state or local government to charge an annual tax on the value of real property within its jurisdiction. In order for these taxes to be deductible, they must be imposed in a uniform manner against all property (based on assessed value) in the jurisdiction and used for the benefit of the community or governmental purposes. Real estate taxes almost always meet this requirement for deductibility.

There are two ways to pay your real estate taxes: either your mortgage payment includes a portion that is paid into an escrow account and the mortgage company remits the payments to the appropriate authority in a timely manner **or** you pay the taxes to the appropriate authority directly, usually on a semi-annual basis. If you pay your real estate taxes directly, you will need to keep track of these payments for deduction purposes. However, if your mortgage payment includes a portion for real estate taxes, your mortgage company should give you an annual statement (Form 1098) notifying you as to the deductible amount for that year.

Home Mortgage Interest

Before we can discuss deductible mortgage interest let's first define what is a home mortgage. A home mortgage for tax purposes is any loan that is secured by either your primary residence or secondary home (usually a vacation home) including first and second mortgages, equity loans and refinanced mortgages.

For your average person, all of the mortgage interest is deductible. However, if the balance of your mortgage(s) is greater than $1 million, or if you took out the loan for a reason other than buying, building or improving your home, then your deduction will be limited. Figures A & B as well as Tables 1 and 2 from IRS Publication 936 detailing the limitations and deductibility of various forms of mortgage interest have been provided for your reference in Section IV.

Points

The term “points” is generic term used to describe loan origination fees, loan discounts, discount points and other forms of prepaid interest used to obtain a loan. They are usually found as a separate line item on your closing statement. Points are most often incurred on refinancing loans are deducted ratably over the term of the loan and not fully deducted in the year incurred.

Tax Tip!
If you paid points on a mortgage and have been amortizing it over the life of the loan **and** you pay that mortgage off early, you may deduct *all of the remaining points* in the year the loan is retired

Tax Tip!
If your loan is secured by your principal residence *and* if the payment of points is an established practice in your area *and* the amount of points charged is reasonable for your area *and* the points are computed as a percentage of principal amount *and* the points were paid by you (not from the loan proceeds) *then* you may be able to deduct **ALL** of the points you paid on that year's return.

Sale of Your Home

Under current tax law, you are allowed to exclude up to $250,000 ($500,000 if married filing jointly) of capital gain on the sale of your principle residence provided that you meet the ownership and use tests. To exclude the gain, you must have owned **and** used the home as your primary residence for at least two of the past five years prior to the sale. You cannot use the exclusion more than once every two years.

Tax Tip!
The two year period in which you both owned and used the home as your principle residence does not need to be a continuous 24 months. For example, Kate buys a home and moves into it on January 1, 2001. On July 2nd 2001 she is relocated for a work assignment. On July 1 2004 she moves back into her old home and uses it as her principle residence through the end of 2005. If Kate sells her home at any time during 2006, she will meet both the owned and use tests. She will have owned the home for a total of five years and used it as her principle residence for two.

A partial exclusion may be available if you fail to meet the two out of five year requirement due to health reasons, required job relocation or other unforeseen circumstances.

Unfortunately, if you have a loss on the sale of your principle residence, it is not deductible for tax purposes as it is considered a personal loss, not a capital one.

In section IV, we have added worksheets 1-3 from IRS Publication 523. These worksheets walk you through how your adjusted basis is calculated, what the gain or loss on the sale of your home should be and how to prorate the exclusion if you qualify for the reduced exclusion.

SECTION II – Expatriate Tax Considerations & Planning Tips

The term expatriate as used in this section refers to a U.S. citizen or U.S. permanent resident (green card holder) who lives (and usually works) outside the U.S. for one year or more. A short-term assignee is a U.S. citizen or permanent resident who is sent overseas on a business assignment of less than one year. This primary focus of this book is the tax implications of being a U.S. expatriate, but it also covers tax issues that are encountered by short-term assignees.

Many Americans are under the misconception that if they are not living in the U.S. then they have no tax-filing obligation. This is incorrect. In fact, the requirement for a U.S. Citizen or permanent resident ("green card" holder) is the same no matter where in the world they choose to live. You must always report your worldwide income to the IRS on an annual basis.

During your assignment, your U.S. income tax returns will be substantially more complex. There are a variety of forms that they may not have filed in the past but are required to do so now. The most common of these are:

- **Form 2555** – To claim the foreign earned income and housing exclusions.
- **Form 1116** – To claim a foreign tax credit on their earnings.
- **Schedule E** – To report rental income or loss from the rental of their U.S. home.

Short-Term Versus Long-Term Assignments

Due to the length of their stay, not all U.S. citizens or residents who accept a foreign assignment establish a tax home in a foreign country. In those cases, when no foreign tax home exists, the individual is considered to be on a "temporary assignment" for tax purposes. A temporary assignment is defined as one in which the tax home (principal place for employment) does not shift away from the current tax home (usually the U.S.). If your intent is to return to the original work location within a year, the assignment is considered to be a temporary, "short" assignment.

Individuals on short-term assignments will not qualify for the FEIE and housing exclusions, as they never established a foreign tax home. There are times when it may be more beneficial to be treated as being on temporary assignment for U.S. tax purposes. The tax advantage of a temporary assignment is that employer-provided benefits such as lodging, meals, travel, and other items related to the assignment will usually not be considered taxable wages to the employee. Generally speaking, these items are typically considered taxable wages during a long-term assignment. No matter the length of your assignment, with proper planning, you can use the incentives offered by the tax code to your advantage.

What You Should Know BEFORE You Go on Assignment

Ideally, you should schedule a pre-assignment consultation with a tax professional that specializes in U.S. expatriate tax matters prior to going on assignment. Such a meeting allows you to get a better understanding of the topics discussed in this book. Your tax consultant will also advise you on matters that he/she expect will impact you directly and what planning opportunities exist for you based on their understanding of your tax situation (usually based on your prior year returns and the discussion itself).

Administrative Matters

Fill out and give Form 673 (Statement for Claiming Exemption from Withholding) and a new Form W-4 (Employee's Withholding Allowance Certificate) to your employer. This will allow them to withhold less, and possibly no federal income taxes from your pay while you are on assignment. If you are able to break your state residency (discussed later) then you should ask your employer what forms if any are necessary to cease your state income tax withholding. If you remain resident in a state for tax purposes, your employer should continue withholding state income taxes from your pay. For those who are tax equalized, your employer may withhold "hypothetical" taxes from you. We will discuss tax equalization later.

Provided you remain on your employer's U.S. payroll and are assigned to a country that has a social tax treaty with the U.S. (also called a Totalization Agreement) you will need to fill out a form and request a "Social Security Certificate of Coverage" so that you are not subjected to the social security tax system in your foreign home. To request a certificate of coverage go to the social security administration website: http://www.ssa.gov/international/CoC_link.html

Upon arrival in the foreign country, you should find a tax consultant to advise and assist you with local tax matters.

Record keeping and Time Tracking (travel calendar) are a must while on an international assignment. You should keep good records for all of the following items:

- A travel calendar breaking down work and non-work days by date and location.
- Foreign housing costs including utilities (other than phone)
- All move related expenses including those no reimbursed by your employer.
- All foreign tax (income, social or other) related returns and receipts
- Personal source income (interest, dividends, earnings from self-employment, etc)
- For reportable income and deductible expenses received or paid in a foreign currency you must record the amount of payment in the foreign currency, the date paid or received to properly convert it into U.S. Dollars on your Federal return.

Note: An accurate travel calendar is critical to sourcing and reporting your income for exclusion, foreign tax credit and income tax planning purposes.

In addition to the record keeping previously mentioned, it is advisable to have in your possession certain documents that will assist you or your tax advisors. As digital technology has become commonplace, we suggest that you have the following documents scanned into a pdf format and saved on a CD-Rom (or bring the originals with you):

- Copies of your prior years Federal & State returns (the past 3 years is ideal)
- Copies of your social security cards (you will want to keep your originals in a secure place).
- Closing statements from the purchase and sale of your home.
- Records of all financial assets (stocks, bonds, etc) that you own.
- Records of all financial loans and mortgages.

Foreign Tax Advisors

As mentioned earlier, we highly recommend you meet with a foreign tax advisor as soon as possible once you have accepted the assignment. He/she will be able to answer all of your concerns related to the tax system of your new country. We have provided a listing of common questions you should ask.

- When is my foreign tax return due? Are provincial returns required? Are extensions available?
- Do I need to register with the tax authorities in this country and if so, how?
- Can you give me an overview of the income and social tax systems as they apply to me?
- Are there common tax planning techniques that I can use to reduce my foreign tax liability?
- What information do you need from me to prepare my foreign returns?
- Do I need to make estimated tax payments based on my personal income?
- Will my employer withhold and remit taxes on my behalf?
- When my assignment ends, do the tax authorities need to be notified prior to my departure?

Basic Foreign Tax Planning Techniques

While the specific tax planning opportunities vary widely from country to country, there are some basic methods used throughout the world to minimize your tax burden. You should at least discuss the following techniques, as they apply to you with your foreign tax advisor.

- Assignment timing - plan your arrival and departure dates as well as the duration of your assignment to maximize any tax benefits available.
- Temporary business trips - income earned in other countries may be excludable from taxation.
- Non-cash benefits - vary widely in their taxability. Proper planning will allow you to reap the most benefit for the least burden.
- Stock options and other deferred income components - are usually taxable during your resident period, so you may want to wait until you return home to exercise them or receive payment.
- Relocation related expenses – vary in definition but are usually deductible for tax purposes.
- Gains on the sale of personal and real property – while resident in a country is usually taxable by that country. Understanding the tax rates related to capital transaction and any related treaty provisions should allow you to minimize your burden on this type of income.

Foreign Earned Income and Housing Exclusions

The foreign earned income exclusion (FEIE) and the housing exclusion/deduction are usually only taken by U.S. expatriates. Some non-U.S. citizens may qualify to take them by invoking a treaty non-discrimination clause. For a discussion of that topic, please see our book concentrating on Foreign Nationals. In order to qualify for either exclusion, an individual must meet one of two time tests, either the bona fide residence test or the physical presence test *and* must have established a tax home in a foreign country. Once either time test is met, an individual may elect to claim either or both exclusions. Once an election is made, it remains in effect until revoked or the expatriate no longer meets either test.

Tax Home
A person's tax home is the country in which an individual primarily conducts his or her business. If you can demonstrate that this primary place of business is in a foreign country, your tax home has shifted from the U.S. to that country. As a general rule, U.S. persons who accept a foreign assignment, which lasts longer than one year, will meet the tax home requirement.

Physical Presence Test
To meet the physical presence test, a U.S. citizen/permanent resident must be physically present in one or more foreign countries for at least 330 days during any continuous 365-day period.
The 330 days themselves do not need to be continuous. Further, the individual's tax home (principal place of business or employment) must have shifted to a foreign country during the 330-day period.

The 330-day rule is very strict one. An individual must keep track of all U.S. and foreign days to properly qualify for the exclusions based on the physical presence test. Any partial days in the U.S., even as short as a minute, are treated as full U.S. days for purposes of this test.

Bona Fide Residence Test
The bona fide residence test is met when a U.S. citizen establishes a bona fide residence in a foreign country or countries for an uninterrupted period that includes an entire calendar year. For example, a U.S. citizen who relocates in February of 200A would not meet the bona fide residence test until December 31 of 200B. A special extension (Form 2350) is used to extend one's time for filing in order to meet this test. Similar to the physical presence test, the bona fide residence test requires that a person's home is outside the U.S. and the person is considered a resident in a foreign country.

Temporary visits back to the U.S. after establishing bona fide residence do not impact one's status as a bona fide resident. In fact, a person may move from one foreign residence to another residence without affecting their qualification.

A U.S. permanent resident (green card holder) generally cannot claim the exclusions based on the bona fide residence test. However, a tax treaty "non-discrimination" position may be available to allow green card holders to use the bona fide resident test.

An individual will **not** be considered a bona fide resident of a country if either:

> A statement is made to the authorities of the foreign country that the individual is not a resident of such country, or
>
> The individual is not subject to the income tax rules of the foreign country. For example, they are considered to be a nontaxable nonresident in that country.

Foreign Earned Income Exclusion

Once you have established a tax home in a foreign country, been subjected to the tax system of that country and met either the bona fide residence test or the physical presence test, you may choose to elect:

- The foreign earned income exclusion up to $80,000 per year (prorated in short years)
- The foreign housing costs deduction/exclusion

The exclusions are elective and an individual may elect either or both exclusions. These elections are available to each qualifying individual who has income earned overseas.

The most important difference between the foreign tax credit and the exclusions from income is that the U.S. expatriate may claim the exclusions from income regardless of whether a foreign country imposes an income tax on the expatriate's earnings. As such, the exclusions can be very beneficial where the expatriate resides in a low tax or no tax country.

You **cannot** get a double benefit by claiming both the foreign tax credit and the exclusions on the same dollar of income. A competent tax professional can assist you in figuring out the proper interplay between these two concepts to get you the best tax answer available to you.

Foreign Housing Exclusion or Deduction

In addition to the FEIE, expatriates may claim to elect the housing exclusion (for employees) or the foreign housing deduction (for self-employed persons). We will generally refer to this as the housing exclusion. It is calculated by taking the sum of all your housing costs and subtracting from that figure a standard housing norm as determined by the U.S. government. For 2004 the base amount is $11,581 for the year or $31.64 per day your tax home is overseas. Housing costs include: rent, utilities (other than phones), insurances residential parking fees and minor repairs related to maintaining your foreign apartment. Mortgage interest, real estate taxes and other expenses related to home ownership are not allowed in determining your housing exclusion, to do so would be to give you a double benefit.

Note: The combined value of the Foreign earned Income Exclusion and the Foreign Housing Exclusion cannot exceed your "foreign earned income" for that year

WARNING! Failure to elect the exclusions *and* file the related returns in a timely manner may result in your losing the ability to claim the exclusions!

Denial of Double Benefits

While the U.S. government has decided to offer the benefit of the foreign earned income and housing exclusions to U.S. expatriates, it does not allow you to "double up" your tax benefits by utilizing the exclusions and other sections of the tax code on the same item of income, expense or credit. In those circumstances, one of the tax benefits must be reduced or not taken. For example, if you were able to count mortgage interest towards your housing cost for exclusion

purposes you would reap a double benefit as the expense gets deducted on schedule A and as a housing exclusion. To ensure that does not happen, mortgage interest is specifically forbidden from being taken as part of your foreign housing cost for exclusionary purposes. That is one of the simple denials of double benefit. The others are expressed formulaically.

Deductions Subject to Disallowance – As previously mentioned, deductions related to the making of foreign earned income, such as employee business expenses and deductible moving expenses, are not allowed to the extent they are allocable to excluded income This disallowance is calculated as follows:

Excluded Foreign Earned Income / Foreign Earned Income	X	Deductions related to the Foreign Earned Income	=	Disallowed Deductions

Foreign Tax Credit Disallowance – Some, maybe even all, of the foreign taxes paid or accrued during the year will be disallowed. They are disallowed to the extent they relate to excluded income. To calculate the disallowed foreign tax credits, use the following formula:

Excluded foreign earned income less disallowed deductions / Foreign earned income less expenses allocable to this income	X	Foreign Taxes (Paid or accrued)	=	Disallowed Foreign Taxes

Foreign Tax Credit

The foreign tax credit is the primary tool used by U.S. taxpayers to avoid double taxation (by the U.S. and another country) on foreign source income. The foreign tax credit allows U.S. taxpayers to claim a dollar-for-dollar tax credit against the U.S. tax that is due on foreign source income

The foreign tax credit is limited to the lesser of the following two amounts:

- The U.S. tax on the net foreign source earnings, or
- The foreign taxes paid or accrued by the U.S. taxpayer during the year plus carryovers of foreign taxes from prior tax years.

To arrive at the U.S. tax on net foreign source earnings, a taxpayer must first calculate the total U.S. tax liability before credits. We then use the following equation:

Foreign Source Taxable Income / Total Taxable Income	X	U.S. Tax before Credits	=	U.S. Tax on foreign source Taxable income

This formula has to be applied separately to each category of foreign source income.

Also, a taxpayer must prepare separate foreign tax credit calculations related to the Alternative Minimum Tax (AMT). AMT often applies to high-income expatriate taxpayers and was discussed back in Section I.

Foreign Taxes Paid vs. Accrued

When your assignment started, which country your tax home is in and when it's tax returns are due are all factors in determining whether you should choose the paid or the accrued method for reporting your foreign tax credits. Once an "accrued" method election is made, it is binding for all future years.

Many expatriates use the "accrued" method to calculate foreign tax credits because it allows the taxpayer to match foreign taxes payable with foreign income being subjected to U.S. tax whereas the paid method is simple that, they are deducted in the year you paid them regardless of the income to which they are related. In many cases, expatriates may not pay a foreign tax liability for a year or more after the year in which the income is earned; because of this most use the accrued method. The paid method may create a significant mismatching of foreign income on the return and the foreign taxes taken when preparing the foreign tax credit calculation. However, this mismatching tends to work itself out over time through the use of foreign tax credit carry backs and carry forwards. If utilizing carry backs, you will need to amend the returns to which you carried back the unused foreign tax credits.

Regardless of the method used, foreign taxes must be reported on your U.S. tax return in U.S. dollars. If the taxes were paid as estimated payments or balances due on specific dates, then the spot rates on each date should be used when converting the currency to U.S. dollars. If your taxes were withheld on an even and consistent basis throughout the year then you may use the average exchange rate for the year. Taxes not yet paid but accrued are also converted at the average rate for the year.

Carry back and Carry forward of Unused Credits

The amount of foreign taxes paid or accrued in any year that exceeds the us tax on foreign source earnings must be carried back to the two previous tax years if applicable and then carried forward for as many as five years or until completely used. Any disallowed foreign taxes are not allowed as a credit carryover.

Deduction Versus Credit

Sometimes it makes economic sense to elect taking your foreign taxes paid as an itemized deduction rather than taking the foreign tax credit. In general, the foreign tax credit is more advantageous because it provides a dollar-for-dollar reduction in tax. However, there are those rare occasions where deducting foreign taxes provides a greater benefit than taking the credit. Any disallowed foreign taxes are not allowed as deductions. Your tax advisor will help you understand which method of utilizing your foreign taxes offers you the greatest benefit in any given year as well as how making such a choice impact future tax years.

Sourcing Rules

How does one determine what constitutes U.S. source income versus that which is treated as foreign source income? We will now go over the sourcing rules for the more common types of income.

Personal Services Income

This income category includes wages, salaries, bonuses, and deferred compensation such as pensions that are paid by an employer. It also includes compensation earned by self-employed individuals.

The location in which the services are physically performed determines the source. Earnings for services physically performed in the United States are considered U.S. source income. Compensation for services physically performed outside the United States is considered as foreign source income. If the compensation is related to the work performed in both the U.S. and outside the U.S., the compensation is sourced based on the workdays in the various locations. For example, if you worked 40% of the time in the U.S., then 40% of your compensation would be U.S. source income.

Interest Income

Generally, interest income is sourced based on the residence of the payer. Interest that is paid by a U.S. resident, partnership, or corporation is deemed to be U.S. source in nature. Interest paid on obligations issued by the U.S. government or by any political subdivision in the United States such as a state or city government is also considered to be U.S. source income.

Interest paid by a foreign entity (corporation, partnership, individual, government, etc.) is typically considered foreign source income.

Dividend Income

Similar to interest, the general rule for dividends is based on the residence of the entity paying the dividend. If the dividend is paid by a U.S. based corporation it is deemed to be U.S. source income. Dividends paid by a foreign-based corporation are deemed to be foreign source income.

Rental Income

The source of rental income depends on the physical location of the property that generates it. If the property is located in the United States, the rental income is deemed to be U.S. sourced. For property that is located outside the U.S., this income is treated as foreign sourced.

Income from the Sale of Personal Property

Income generated from the sale of personal property is sourced according to the residency of the seller. Personal property includes assets such as stocks, cars, computers, furniture and other personal effects. Residency for this purpose is based on the "tax home" concept, which was discussed earlier.

Income from the Sale of Real Property (Realty)

Sourcing of Realty is determined by the location of the property. Real Property generally includes land, buildings and permanent fixtures. Gain on the sale of realty located in the United States is considered to be U.S. source income *regardless* of the residency of the seller. The sale of real property located outside the United States generates foreign source income.

Partnerships

If you own an interest in a partnership, the source of the income is determined at the partnership level. Partnerships operating in multiple locations may generate tax liabilities in multiple jurisdictions. The income retains its source when it flows into your individual tax return(s).

Other U.S. Tax Issues

In addition to the exclusions and foreign taxes, the more common federal tax issues that arise due to a foreign assignment are:

- Moving expenses (discussed in section I)
- Temporary versus long-term assignments (discussed earlier in this Section)
- Treatment of employer-provided allowances and reimbursements
- Rental of principal residence vs. Sale of principal residence
- Exchange rate issues - gains and losses (discussed in Section I)
- Social security taxes
- State tax issues – breaking residency

Expatriate Allowances and Expense Reimbursements

If you have accepted a job overseas as a local hire then you are unlikely to have any expatriate allowance and expense reimbursements. However, if you are a participant in a corporate program will often receive a number of expatriate allowances and expense reimbursements in addition to your normal compensation. These additional payments from the employer may include housing expenses, cost-of living adjustments (positive or negative), language lessons, tax payments, educational expenses, home leave expenses, moving expenses, automobiles and other incentives to get you to accept the assignment.

These benefits, as long as they are to your personal benefit (or your family's), are considered to be taxable wage compensation to you regardless of whether they were paid to you directly or to a

third party on your behalf. However, the following payments by your employer may be excluded from taxable wages:

- Nontaxable moving expense payments or reimbursements (as discussed in section Il)
- Business expense reimbursements

Note: If your employer is not a U.S. based company, you may need to track many of these taxable compensation items on your own as the wage statements provided by your foreign employer may not include all of the items that the U.S. considers to be taxable compensation.

Rental of Principal Residence vs. Sale of Principle Residence

When you own your home, you have 3 basic choices of what to do with it while on assignment: sell it, rent it or keep it but leave it empty. Some of the factors you need to consider when weighing your choices and going overseas are: your personal preferences, current realty market conditions, employer policies and of course the tax considerations.

If you decide to keep and rent your U.S. home, the rental income must be reported on your U.S. tax return on Schedule E. As most countries tax their residents on their worldwide income, it is likely this income will need to be reported on your foreign tax return as well.

For U.S. tax purposes, the rental income may be reduced by deductions such as management fees, mortgage interest, real estate taxes, repairs, depreciation, maintenance, insurance and other related expenses. As land is considered a non-depreciable asset, only the cost allocated to the U.S. home and improvements may be depreciated over 27.5 years. Frequently, the rental of a home creates a tax loss that can offset other types of income. The passive loss rules may impose limitations on the losses generated by your rental activities. The limit for deducting losses from rented real estate is $25,000 per year. This limit may be further reduced if your modified adjusted gross income is more than $100,000. The allowable loss is completely phased out if your modified adjusted gross income exceeds $150,000. For taxpayers filing Married Filing Separately, the AGI thresholds are $50,000 and $75,000 respectively.

Note: Mortgage interest and real estate taxes may need to be allocated between Schedules A (itemized deductions) and E (rental activities) during your transition years where your principal residence is both occupied by you for part of the year and rented for the other part.

A taxpayer who rents his or her home during the foreign assignment must consider its effect on quite a few tax issues:

- will he/she still meet the two out of five year test to exclude gain on the sale of the principal residence? (See Section I).

- will keeping the home, impact the ability to break state residency? (Discussed later)

- how will this rental impact my tax equalization calculations?

• how will this rental activity impact my foreign tax liabilities?

We suggest speaking with your tax advisor to get a better understanding of the impact regarding these matters. A well-informed person is more likely to make the best decision in their situation.

Impact of Exchange Rates

All income and expenses reported on a U.S. tax return must be reported in U.S. Dollars regardless of the currency from which the income was originally derived or the expenses paid. As such, it is important that you track your taxable income and your deductible expenses that are paid in anything other than the U.S. dollar. Ideally, you should be keeping track of the amount of income received or expense paid, the date on which it was received or paid, the currency to which it relates, and the exchange rate on that date. Keeping a spreadsheet of this type of information is useful and saves you time spent with your tax advisor and saves them time in preparing accurate U.S. tax returns using the proper exchange rates.

Further, when a U.S. expatriate enters into an arrangement (ex. mortgage, purchase, sale, etc.) denominated in a currency other than the U.S. dollar, and if there are any changes in the relative value of the currencies (highly likely) a currency gain or loss is likely to occur. If you end up with a gain based on the currency exchange, this is taxable for U.S. purposes while any losses on the currency exchange are considered nondeductible. You should consult your tax advisor if you enter into a large transaction that you expect to be denominated in a foreign currency, particularly the purchase or sale of a foreign home or payment of a foreign mortgage.

State Taxation

Even though you are now living abroad, you may still have a filing obligation and tax liability owed to your former state of residence unless you can "break residency." Whether this is the case or not depends on which state you resided in prior to going overseas and the facts and circumstances relevant to meeting that state's definition of a resident or non-resident.

All of the states approach their residency determinations differently, yet they all ascribe to one of two philosophies: The Resident State philosophy and the Domicile State Philosophy.

The R*esident State* philosophy follows the logic that you are not a resident if you do not maintain a residence within that state and spend no more than a certain number of days in the state. To be considered non-resident, the number usually must be less than 183 days during the calendar year. All others are residents. Owning real property may force you to maintain your resident status.

The *Domicile State* philosophy follows the logic of intent. You are considered to be domiciled in a state if you either live or have lived there with no definite intention of moving from the state permanently. Intent is based on the facts and circumstances unique to your situation and determined by a preponderance of the evidence shown by certain factors indicating intent to return or not. Some factors included in this determination are the locations of: realty owned by you, your business affiliations, social club memberships, bank accounts, driver's license and voter's registration.

It is harder to break residency in domicile states, but it can be done. When trying to break residency you have to weigh the factors relevant to that state's residency rules. These vary dramatically from state to state and a detailed discussion of each states rules in this regard is beyond the scope of this book. However, we have listed some of the most common factors you should consider when looking to break residency for tax purposes. We have listed them in an order we feel are highest to lowest in importance. Remember you want the majority of these factors to weigh in your favor or else you will remain domiciled in that state and owe a tax obligation there every year for the length of your foreign assignment.

1. Intent to return to the state as a resident, even if this is after a 20 year assignment, such an intent may keep you resident of that state.
2. Do you still own a home there? If so, you may wish to sell it or lease it to a 3rd party.
3. Your family, spouse and children should not remain or intend to return to that state.
4. Your driver's license. Get an international drivers license and turn your old one in.
5. Send a letter to the town in which you were registered to vote, rescinding your registration there. You can still vote in national elections.
6. Change your banking relationships to either an international bank or a state that follows the residency philosophy.
7. Formally break ties to any business, religious and social organizations as much as possible in your former state.
8. If you must put your personal property into storage, try to use a facility that is near a relative or friend in another state.
9. Try not to make political or charitable contributions to organizations within that state.
10. Modify your wills and trust documents to read your former state is not your resident state.
11. You may wish to sever ties with your doctors, dentists, lawyers and CPAs in that state.
12. You may wish to move your insurances, investments and loans to companies elsewhere.

Part-Year State Resident

If you succeed in breaking your state residency, you will still have to file a final part-year tax return for the year of your departure. You will need to allocate your earned and unearned income components into resident and non-resident amounts. You will be expected to report both to the state taxing authority but will only be taxed on the income related to your residency period. It is possible to also have a liability as a non-resident if you continue to have an occasional work day there or own rental properties within that state.

Other State Issues for those Unable to Break Residency

If you are unable to break your state's residency rules and are forced to remain a resident for tax purposes, you may be able to use the Foreign Earned Income and Housing Exclusions. This is because most states follow along the same lines as the Federal income tax laws. Some states may not offer you the ability to utilize these exclusions, while others may even offer you the ability to get a credit for taxes paid to your foreign country, a foreign tax credit on the state level.

As discussed earlier, it is common for your employer to cease actual withholding taxes while you are on assignment. In cases where you fail to break residency, either you or your employer should remit quarterly estimated payments to the state taxing authority. Should you have any questions on these issues, we recommend that you consult a tax professional familiar with expatriate taxation and its impact on your resident state tax liability.

Foreign Country Taxation

Covering even a basic understanding of the tax laws of each country in the world is well beyond the scope of this book. We will provide a brief overview of the elements that are common to most tax systems around the globe. You should always try to gain a basic understanding of the tax concepts in a country prior to relocating there. By contacting and speaking to a foreign tax advisor in a timely manner, you may be able to structure your compensation and/or foreign allowances in a tax beneficial manner. For example some countries will not tax housing payments made directly by an employer to a landlord whereas they would indeed tax that same item if you paid it and your employer reimbursed you or gave you a lump sum payment directly. Tax minimization while on assignment is critical. Remember, as a local hire, each dollar saved in taxes is an extra dollar in your pocket. Additionally, for those people who are tax equalized, each dollar saved in taxes helps their employer defray the cost of the assignment.

Foreign Residency Status

In the first year of your assignment it may be possible for you to remain a non-resident of your assigned country by staying physically present in that country for less than 183 days during their tax year (some are fiscal, not calendar based). By remaining a non-resident, you may be able to exclude compensation earned there from taxation in that country. As most foreign countries only tax residents, it is common for this to be the case based on the domestic tax laws of that specific country. In cases where the earned income may indeed be taxable and you have maintained a home in that country or been physically present there for a period of less than 183 days, it may be possible to invoke a tax treaty clause exempting some, if not all the compensation earned in that country form taxation there. These rules also apply to other countries you may visit on short-term business trips.

Should you be found to be a resident or part year resident of your assignment country, it is likely that they will tax you on your worldwide income from any source derived during such resident period. In some countries, treaties may be invoked to minimize your foreign tax obligations.

Tax Treaties

The United States has treaties with many nations. We have included a link to IRS Publication 901, which lists the Tax Treaties the U.S. currently has in force with other countries. Through the use of these treaties, U.S. Citizens or residents may be able to receive beneficial tax treatment. In addition to eliminating the double taxation of the same income by two countries, treaties may:

- Exempt wages earned by non-residents on short term business trips to the other country.

- Provide guidance on the treatment of foreign tax credits.
- Reduced withholding tax rate on passive income received by a resident of the other country.
- Through the use of the treaty tie-breaker clause, determine which country has the right to tax a person as a resident when they qualify as such in both countries.

Tax treaty implications are usually quite complex. We recommend you consult a tax advisor familiar with tax treaty issues for clarifications on how they may apply to you and your assignment.

Social Tax Issues

While resident in another country, it is likely that you will be subjected to their social tax system and have an obligation to pay into it. This is true regardless of whether or not you remain in the U.S. social tax system.

Note: If you remain on your employer's U.S. payroll, Social Security Taxes will continue to be withheld on all your earnings. If a foreign corporation employs you, you are unlikely to be required to pay into the U.S. Social Security System.

The U.S. has entered into social tax treaties with several nations; these are generally referred to as totalization agreements. The intent of these treaties is twofold:

- Relief from double taxation – the agreements provide that a taxpayer will only be subject to social taxes in one of the two countries party to the agreement. Which country has this right is decided by the terms of agreement. Generally, the employee is subject to the social taxes in his/her resident country.

- Coordination of benefits – the agreements may also provide that if you pay social taxes in one country, but you claim benefits in the other country, you can count coverage periods in the other country when determining your benefits.

Currently, the U.S. has totalization agreements with Australia, Austria, Belgium, Canada, Chile, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, South Korea, Spain, Sweden, Switzerland, and the United Kingdom. If you are a former resident of one of these countries and are near retirement you should consult with a tax advisor about the potential benefits of the totalization agreement and how to apply for them.

Tax Equalization

When companies first started sending people on overseas assignments, the concepts of tax protection and equalization were born. Tax Equalization occurs when your employer guarantees you that your worldwide tax liability will not be detrimental to you while on assignment, your taxes will remain the same as though you had "stayed at home" creating a neutral tax situation to the employee (no benefit or detriment).

When a tax equalized person is assigned to a country whose taxes are higher than that of their home country (U.S.) then the employer bears this additional tax burden. When the tax equalized person is in a country that has no income taxes or lower rates than the home country (U.S.) then the employer reaps a benefit, which they typically use to offset other costs and allowances, related to the assignment. This was done so that employees were treated in a fair and consistent manner. It was also meant to ensure that people would not scramble to get assigned to low tax countries while leaving a need for expatriates in the higher tax countries in which the employer operates. Tax Protection occurs when your employer allows you to keep any windfalls created by being assigned to a lower tax country.

As the world has become a much smaller place, international assignments have become more commonplace and in some industries, even required, to advance one's career. These concepts have fallen out of favor. Few, if any, companies still offer Tax Protection. Those that do so are most likely keeping their obligation to a few long-term expatriates they sent on assignment long ago. Tax Equalization has also fallen out of favor with most large employers who prefer to send people on assignment with "local hire" packages, which may or may not include allowances. For those employers, offering tax equalization, having a consistent policy allows them to standardize and streamline the administrative processes related to their expatriate population. If you are a local hire, you do not need to read up on this topic other than for your own education.
.
It is common for your worldwide tax liability to change dramatically while on assignment relative to what you would have paid had you remained in your U.S. home. Some of the reasons for this change in tax burden are:

Higher taxable income - The addition of all your allowances and reimbursements, most of which are taxable in at least one if not both countries will increase your overall income usually driving you into higher marginal tax brackets for both U.S. and Foreign tax purposes.

Foreign tax rates - These run the gamut from no tax and low tax (10%) countries to tax rates similar to our own to very high tax rates (70+% in some cases). Your location determines how much this impacts you.

Foreign Earned Income and Housing Exclusions - May dramatically affect the outcome of your U.S. liability.

Tax equalization policies are designed so that you pay the company an amount equal to the income taxes you would have paid based on the income you would have earned had you stayed at home and not gone on assignment. The amount they withhold from you paychecks or *you pay* to the company is called a "*hypo tax*" or hypothetical tax. Depending on the policy, you may have Federal, State Local and Social Security hypo taxes. In return, the *company pays* all of your *actual* U.S. and Foreign Income Tax Liabilities while you are on assignment. After your tax returns related to the year are finalized and filed, a tax equalization calculation is done. First, all income and expense items directly related to your assignment, that you would not have received or incurred had you stayed at home, are ignored. Then all other relevant data from your tax returns is used to determine what your hypothetical stay at home taxes would have been. This is compared to what was withheld from you and what was paid by the company on your

behalf. After taking all these factors into account a settlement figure is determined. About half of the time, some of the refunds from the returns you actually filed is owed back to the company. Conversely, half the time, the company owes you a small settlement.

Note: As part of your actual refunds may belong to your employer, we recommend that you put all refunds received into a savings account until after you have received your tax equalization calculation. This way, *if* you owe anything back to your employer, the money has been set aside.

Understanding Tax Equalization Policies

As stated earlier, while you are on assignment your actual Federal and usually State taxes stop being withheld from your pay and remitted to the proper authority. What does in fact happen is that you employer will withhold from you a hypothetical tax (discussed earlier), usually the same way as they did your actual taxes. This spreads out the payment of the hypothetical tax to your employer in an easy and efficient manner so you do not have to settle your entire tax liability all at once. Your employer will usually pay all of your actual U.S. and foreign taxes on your behalf for the length of your assignment.

While there are common "best practices" to tax equalization policies, you will still want to read your employer's tax equalization policy thoroughly. If it seems confusing to you, get someone who understands the policy to clarify the issues with which you are concerned. Key points to understand are:

- How does the policy treat the sale or rental of my home?

- Am I equalized on all of my income, just my income from employment, or my employment income with limitations on my personal income, including my spouse's wages?

- How are my itemized deductions affected? Is this based on actual deductions or a percentage?

- Will I be equalized to my former home state (and localities) of residence, no state or an arbitrary state chosen by my employer for all assignees?

The FINAL Tax Equalization (Gross-Up)

Once your assignment has ended and your final tax returns relating to your foreign assignment have been prepared, finalized and filed, a final calculation is made to "keep you whole" and ensure you are kept tax neutral in relation to the tax impact of your assignment. This may occur some time after you have returned from overseas, two years later is not unusual. Remember that various expenses related to your assignment may have continued even after you returned and were then included in your compensation and tax equalized. Instead of continuing the tax equalization process in perpetuity, your employer will ask for a final gross-up tax equalization to be performed. This calculation taxes the amount of your final settlement, which of course is taxable compensation to you, and grosses it up meaning that a new number is determined that

factors in this new tax on the tax imposed on the settlement. A simple example would be Bob; a Texan (no income tax state) has a final settlement from his employer in the amount of $4,000. Bob's highest marginal tax bracket is 25%. To gross up his final payment we use the following formula:

$$\frac{\text{Final Settlement owed to Bob}}{1 - \text{Bob's highest marginal rate(s)}} \qquad \frac{\$4{,}000}{1\text{-}.25} = \frac{\$4{,}000}{0.75} = \$5{,}333$$

Therefore, Bob should receive a total final Gross-up payment from his employer for $5,333. To double-check this lets multiply it out. Bob gets $5,333 and pays 25% of that in taxes or $1,333 leaving him his $4,000 net settlement.

It is rare, but sometimes after a final gross-up has been calculated and paid, additional expenses related to the assignment are found and paid by the employer. At this point, the employer will usually perform a gross-up calculation on the amount of the expense and then remit the tax portion directly to the proper authorities on behalf of the employee. The employee will not see this happen other than as a few line items on their pay stub and W-2.

SECTION III – CASE STUDY

The following case study is for illustrative purposes only! The deductions, exemptions, phase-outs and taxes as calculated in this study do not reflect current tax laws. The intent of the case study is to reinforce the principles and concepts previously discussed in the book.

The current year in this case study is referred to as 200C, while the next year is 200D.

Expatriate Assignment of the Smith family

Paul Smith and his family began a 3-year assignment to work for WXYZ Company in Shanghai on March 1, 200C. Paul is employed by a U.S. subsidiary of WXYZ Company during the foreign assignment. He is married to Lori and has two children (Sean 12 and Lisl 17). Paul and his family lived in Boston prior to accepting the foreign assignment.

Lori did not work in 200C. The Smiths have decided to rent out their home in Boston during the assignment. They earned $18,000 of rent and incurred rental expenses of $25,000 in 200C. The Smiths owned the home for two years prior to the foreign assignment. WXYZ Company has arranged for an apartment in Shanghai during Paul's assignment. Other than the rental income, the Smith's only other 200C non-wage income was $2,000 of interest income earned from U.S. bank accounts.

Paul was sent by WXYZ Company on a full expatriate package. His living expenses are being equalized to the typical costs incurred by a family of four in Boston. Paul's compensation from WXYZ during 200C consists of:

	Gross Amount	Stay-at Home Amounts	Net Payments
Base Wages	$100,000	-	$100,000
Housing	48,000	($10,000)	38,000
Cost-of-Living Allowance	12,000	-	12,000
Education Expenses	13,000	-	13,000
Home Leave Trips	15,000	-	15,000
Taxable Moving Expense	35,000	-	35,000
Tax Payments	55,000	($15,000)	40,000
Total Salary Income	$278,000	($25,000)	$253,000

The $55,000 of tax payments by WXYZ Company on Paul's behalf are Chinese income tax payments. WXYZ was not required to withhold any U.S. or state income tax from Paul's wages. Paul also earned $20,000 from a previous employer during the pre-assignment period of January 1 to February 16, 200C. Paul was on vacation from February 17 to February 28, 200C. His

former employer withheld $5,000 of federal income tax and $2,000 of Massachusetts income tax from his salary.

The Smiths incurred the following expenses in 200C that may provide tax benefits:

	Personal Deductions	**Allocated to Rental (Starting 3/1/200C)**	**Total**
State Income Taxes	$4,500	-	$ 4,500
Real Estate Taxes	417	$ 2,083	2,500
Mortgage Interest	3,333	16,667	20,000
Charitable Contributions	2,000	-	2,000
Depreciation on house	-	6,250	6,250
Foreign housing utilities	2,086	-	2,086
Total	$12,336	$25,000	$37,336

Based on the advice of his tax advisor, Paul maintained a calendar that tracked where he was and what he did on each day in 200C. A summary of this information is shown below:

	U.S. Non-work	**U.S. Work**	**Foreign Non-work**	**Foreign Work**	**Total Days**
January	9	22	0	0	31
February	18	10	0	0	28
March	0	0	10	21	31
April	0	0	10	20	30
May	0	5	9	17	31
June	0	0	9	21	30
July	10	0	6	15	31
August	0	0	11	20	31
September	0	0	10	20	30
October	0	7	7	17	31
November	0	0	10	20	30
December	10	5	2	14	31
Total	47	49	84	185	365

Qualification and Amount of Exclusions

We must first determine whether Paul qualifies for the FEIE or housing exclusion in 200C. Paul started his assignment on March 1, 200C and maintained a tax home in Shanghai from this date. Paul would meet the bona fide residence test beginning March 1, 200C since he spent the entire 200D calendar year outside the U.S.

Paul could also qualify under the physical presence test. However, he may reap less exclusion by doing so. During 200C, Paul spent 37 days in the U.S. after March 1 and he spent no days in the U.S. in 200D. The earliest day when Paul could have met the physical presence test was May 3rd because that is the earliest date when he could show that he spent 330 days out of a 365-day period outside the U.S. As a result, Paul is better off electing the exclusion based on the bona fide residence test not the physical presence test.

Now that we know Paul qualifies for the exclusions, we can calculate their amount. First, we know that Paul's salary income during the qualifying period from March 1 to December 31, 200D was $253,000. Is the entire $253,000 considered "foreign earned income"? No, because Paul worked both in the U.S. and outside the U.S. during this period so we must allocate certain components of the earned income based on a ratio of business days. Each item of Paul's salary must be evaluated to determine whether it is entirely foreign source or whether it should be allocated based on relative workdays. For the sake of simplicity, we will calculate the foreign earned income by using the business day allocation for all items of compensation (note that this is the least aggressive approach and you should consult a tax advisor regarding more beneficial positions). Accordingly, Paul's foreign earned income is $231,708 ($253,000 times 91.6% [185 foreign work days/202 total work days while on foreign assignment]).

Paul's foreign earned income exceeds the annual limitation of $80,000. However, this does not mean that Paul can claim the entire $80,000 in 200C, as his qualifying period for that year is shorter than the entire calendar year. The $80,000 must be prorated to reflect this shorter qualifying period. Under the more beneficial test (the bona-fide residence test), Paul qualifies for the exclusions from March 1, 200C. As he has 306 qualifying days in the calendar year, his FEIE equals $67,068 ($80,000 X 306 / 365).

In addition to the FEIE, Paul can also elect the foreign housing exclusion. Paul's housing exclusion is $40,411 ($50,120 [$48,000 plus $2,086] of actual housing costs less the $9,709 ([$11,581* / 365] X 306) of prorated base amount

Paul's total 200C exclusions equal $107,479 ($67,068 plus $40,411).

*200C base amount.

All of Paul's 200C U.S. work and U.S. non-work days were spent in Massachusetts. He spent no days in the U.S. during 200D. The Smiths will file their U.S. federal tax returns using a 'married filing jointly' status. Their gross income for 200C is calculated as follows:

Wages	$273,000	($253,000 plus $20,000)
Interest	2,000	
Rental Loss	(0)	(the $7,000 loss was disallowed)
FEIE	(67,068)	
Housing Exclusion	(40,411)	
Gross Income	$167,521	

The Smiths don't have any adjustments to gross income. As such, their AGI is $167,521.

Their itemized deductions are as follows:

State income taxes	$4,500
Real estate taxes	417
Mortgage interest	3,333
Charitable contributions	2,000
Total itemized deductions	$10,250

Please note that expenses allocated to a rental activity may not be claimed as itemized deductions.

Since their total itemized deductions ($10,250) exceed the standard deduction ($9,700) it appears that the Smiths will be better off itemizing their deductions. However, before a final decision can be made it is necessary to consider the phase-out reduction that applies to itemized deductions.

Their AGI is $167,521, so they must reduce their allowable itemized deductions by $745 ($167,521 less $142,700 times 3%). After the phase-out, their allowable itemized deductions total $9,505. After considering this limitation, it is more beneficial for the Smiths to claim the $9,700 standard deduction rather than itemize.

Although Paul has elected to take the FEIE, the Smiths have no itemized deductions or deductions from gross income that are subject to disallowance. Therefore, no adjustment is necessary in our case study.

The Smiths may claim four exemptions totaling $12,400 before phase-outs.

The exemption phase-outs do not impact the Smiths since their AGI ($167,521) is less than the "married filing jointly" threshold of $214,050.

Taxable Income Summary

- Adjusted Gross Income……………………………………………………..$167,521
- Less: Standard Deduction…………………………...…………………...(9,700)
- Less: Exemptions……………………………………………………….(12,400)
- Taxable Income………………………………………………………...$145,421

Their federal tax liability amount to $30,675, which is based, on the "married filing jointly" tax rates applied to their taxable income of $145,421. This amount is tentative because we have yet to consider the impact of credits, such as the foreign tax credit, which may be available to the Smiths.

Because their modified AGI is $257,000, the child tax credit may not be claimed for either child due to the phase-out rules.

As Paul is subject to his employer's tax equalization policy, WXYZ will pay the federal taxes that are due with Paul's 200C federal tax return.

Foreign Tax Credits

The Smiths had excluded foreign income less applicable deductions of $107,479. Their total foreign earned income less applicable deductions was $225,500 ($231,708 less $7,671 and the total foreign taxes paid amounted to $60,000. Inserting these amounts into the disallowance calculation results in $28,598 of disallowed foreign taxes. As such, the amount of foreign taxes available for credit that may be claimed by the Smiths is as follows:

Total foreign taxes paid…………	$60,000
Less disallowed portion…………	(28,598)
Creditable taxes…………	$31,402

Foreign Tax Credit Calculation

The Smiths have decided to claim the foreign tax credit. Therefore, they must reduce the foreign taxes that may be claimed due to the impact of the expatriate exclusions and the disallowance of double benefits principle. The Smiths may claim a credit of $65,659.

Income	Total	U.S. Source	Foreign Source
Compensation	$273,000	$ 41,292	$231,708
Interest	2,000	2,000	0
Rental Income	18,000	18,000	0
Total Income	$293,000	$ 61,292	$231,708
Deductions and Exclusions			
Housing Exclusion	$ (40,411)	$ 0	$ (40,411)
Foreign Earned Income Exclusion	(67,068)	0	(67,068)
Rental Deductions	(18,000)	(18,000)	0
Standard Deduction	(9,700)	(2,029)	(7,671)
Total Deductions and Exclusions	$(135,179)	$(20,029)	$(115,150)
Taxable income Before Exemptions	$ 157,821	$ 41,263	$ 116,558
Exemptions	(12,400)		
U.S, Taxable Income	$ 145,421		

U.S. Tax Before Credits	$ 30,675
Less: Foreign Tax Credit	(22,654)
Net U.S. Tax Liability	$ 8,021

Foreign Tax Credit

Foreign Source Taxable Income*	116,558
Divided by Total Taxable Income*	157,821
Equals	73.85%
Times U.S. Tax	$ 30,675
Foreign Tax Credit Limit	$ 22,654

* Before Exemptions

U.S. Source Wages	**Total**	
January 1 – February 28	$ 20,000	
March 1 – December 31	21,292	$253,000* (17 U.S. work days/202 total work days)
Total	$ 41,292	

Standard Deduction
Allocated to U.S. Source Income

U.S. gross income	$ 61,292
Divided by total gross income	293,000
Equals	20,92%
Times Standard Deduction	(9,700)
Equals U.S. source standard deduction	$ (2,029)

Foreign Taxes Which Can Be Credited

Foreign taxes paid	$ 60,000	
Less disallowed due to exclusions	(28,598)	
Equals net foreign taxes paid	31,402	
Foreign tax credit carryforward	$ 8,748	($31,402 less $22,654)

The Smiths can claim a foreign tax credit of $22,654 to reduce their federal tax liability. Because they paid $31,402 of creditable foreign taxes, $8,748 of the unused foreign tax credits should be carried back to the two previous years and then forward for the next five years or until used.

Paul’s taxable wages were adjusted for reimbursements and allowances as well as reduced for amounts that Paul paid to his company for housing allowances and hypothetical income tax withholding. Paul’s U.S. taxable wages from WXYZ were $253,000 in 200C.

All of Paul's moving expenses to Shanghai were paid by WXYZ Company. As such, Paul may not deduct any moving expenses on his U.S. tax return as the deductible reimbursements were already excluded from his wages by WXYZ.

The Smiths rented out their U.S. home during the foreign assignment. Their 200C loss from the rental is calculated as follows:

Rental Income	$18,000
Less: Real Estate Taxes	(2,083)
Less: Interest	(16,667)
Less: Depreciation	(6,250)
Net Rental Loss	$ (7,000)

The Smiths actively participated in the rental activity; however, as their adjusted gross income exceeded $150,000, the $25,000 limit is completely phased out and none of their rental loss is allowed. The Smiths are not subject to the AMT,

The Smiths are residents of Massachusetts through February 28, 200C and are taxable in Massachusetts on all income earned up to that date. Also, The Smiths may owe Massachusetts income tax as Massachusetts nonresidents after February 28, 200C due to Paul's business trips to Massachusetts after this date.

The Smiths were subject to the following tax equalization settlement *after* their 200C U.S. tax returns were filed (see next page).

Notes related to tax equalization calculation on the following page:

1. WXYZ's policy provides for a 5% hypothetical state tax.
2. WXYZ's policy provides that the hypothetical itemized deductions are equal to itemized deductions claimed on the actual U.S. tax return for such year. Many tax equalization policies provide for the use of formulas or other methods to determine hypothetical itemized deductions.
3. Phase-outs and limitations, under most policies, are recalculated based on "hypothetical" adjusted gross income; thus, the Smiths are allowed the rental losses and actual itemized deductions in the hypothetical income tax calculation.

WXYZ Company owes Paul $3,733 to settle the final tax equalization obligation. In addition, WXYZ Company owes tax payments of $4,053 with the U.S. tax returns filed by Paul. Note that Paul does not get the benefit of the FEIE, housing exclusion, and foreign tax credit for hypothetical tax purposes. These tax benefits belong to the employer and are not included for hypothetical tax purposes.

Tax Equalization

Income	**U.S. Tax Return**	**Hypothetical Income Tax**
Base Wages	$ 120,000	$ 120,000
Housing	38,000	
Cost-of-Living Allowance	12,000	
Education Expenses	13,000	
Home Leave Trips	15,000	
Taxable Moving Expenses	35,000	
Tax Payments	40,000	
Interest Income	2,000	2,000
Net Rental Loss	(7,000)	(7,000) (3)
Disallowed Rental Loss	7,000	
Housing Exclusion	(40,411)	
Foreign Earned Income Exclusion	(67,068)	
Adjusted Gross Income	167,521	115,000
Less: Standard Deduction, or Less: Itemized Deductions (2)	(9,700)	(10,250) (3)
Less: Exemptions	(12,400)	(12,400)
Taxable Income	145,421	92,350
Federal Tax Before Credits	30,675	16,569
Less:		
● Foreign Tax Credit	(22,654)	0
● Child Tax Credit	0	(1,000)
Net Federal Tax Due	8,021	15,569
Net State Tax Due (1)	4,500	4,618
Total Net Taxes Due	12,521	20,187
Taxes Paid:		
● Actual Federal Taxes Paid by Employer	(5,000)	(0)
● Actual State Taxes Paid by Employee	(4,500)	(4,500)
● Hypothetical Withholding		(20,000)
Tax Equalization Settlement to Employee………………….		$ (4,313)
Amount Due to Governments (Payable by Company) ……………………	3,021	

Section IV - Sample Forms & Listing of Useful Websites

Links are provided on our electronic PDF version to minimize document size. The printed version of our booklet contains actual copies of these forms.

http://www.demostax.com

Form 1040 - US Resident Return
http://www.irs.gov/pub/irs-pdf/f1040.pdf

Schedule A - Itemized Deductions & Schedule B - Interest and Dividends
http://www.irs.gov/pub/irs-pdf/f1040sab.pdf

Schedule D - Capital Gains
http://www.irs.gov/pub/irs-pdf/f1040sd.pdf

Form 1116 - Foreign Tax Credit
http://www.irs.gov/pub/irs-pdf/f1116.pdf

Form 2555 - Foreign Earned Income Exclusion
http://www.irs.gov/pub/irs-pdf/f2555.pdf

Form 3903 - Moving Expenses
http://www.irs.gov/pub/irs-pdf/f3903.pdf

Form TDF 90.22-1 Report of Foreign Financial Accounts
http://www.irs.gov/pub/irs-pdf/f9022-1.pdf
dean@demostax.com

http://www.irs.gov/pub/irs-pdf/f1040es.pdf

Worksheet 1 of Pub 523 - Adjusted Basis of Home Sold (Page 11)
Worksheet 2 of Pub 523 - Calculation of Exclusion and Taxable Gains, if any (Page 12)
Worksheet 3 of Pub 523 - Reduced Maximum Exclusion (Page 15)
http://www.irs.gov/pub/irs-pdf/p523.pdf

Link Topic

Demos Tax Consulting - We Take Your Tax Headache Away!
http://www.demostax.com

Moving Expenses - Pub 521
http://www.irs.gov/pub/irs-pdf/f1040.pdf

Tax Treaties - Pub 901
http://www.irs.gov/pub/irs-pdf/f1040sab.pdf

US Citizens Abroad - Pub 54
http://www.irs.gov/pub/irs-pdf/p54.pdf

Alien Tax Guide - pub 519
http://www.irs.gov/pub/irs-pdf/p519.pdf

Totalization Agreements
http://www.irs.gov/businesses/small/international/article/0,,id=105254,00.html

Mobility Tax.Com - Our favorite site for helping you understand relocation better!
http://www.mobilitytax.com

ExpatriateHelp.Com - The best site of its type for International Assignees Into and Out of the U.S.
A web portal with links to everything you expat related.
dean@demostax.com