

TAXATION OF U.S. EXPATRIATES



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C O N T E N T S

1	Introduction	1
2	Case Study Facts	2
3	U.S. Income Taxation	
	• Overview	4
	• Federal income tax calculation	5
	• Foreign earned income and housing exclusions	16
	• Foreign tax credit	21
	• Expatriate allowances and expense reimbursements	26
	• Moving expenses	26
	• Tax impact of home ownership and the sale of a home	29
	• Rental of principal residence	33
	• Alternative minimum tax (AMT)	34
	• Exchange rate issues	35
	• Short-term versus long-term assignments	35
	• State taxation	35
	• Sourcing of income	38
	• Form 5471	40
	• Passive Foreign Investment Corporations (PFICs)	40
4	Social Security and Other Benefits	
	• General application of social security tax	41
	• Totalization agreements	41
	• Other benefits	42
5	U.S. Filing Requirements and Administrative Requirements	
	• Income tax returns	42
	• Keeping a calendar	43
	• Extensions of time to file income tax returns	43
	• Late filing and the foreign earned income exclusion	44
	• Withholding taxes	45
	• Estimated tax payments	45
	• Bank account information	46
	• Records retention	46
6	Foreign Country Taxation	
	• Overview	47
	• Resident versus nonresident status	47
	• Short-term business trips	48
	• Tax treaty benefits	48
	• Foreign tax planning techniques	49

7 Tax Equalization and Tax Protection Policies	
• Tax equalization	50
• Mechanics of tax equalization	51
• Tax protection	53
• The final tax gross-up	53
8 Exit Interview	
• Tax matters before you leave the U.S.	54
• Tax information you should take on assignment	55
• Tax information you should keep during the foreign assignment	55
• Time tracking during the foreign assignment	56
• Foreign tax matters	56

This booklet is based upon tax law in effect as of December 31, 2009, including updates for the American Recovery and Reinvestment Act of 2009. The information contained in this booklet is general in nature, and is not a substitute for professional advice about individual tax situations. Please consult with a professional tax advisor whenever specific questions arise.

Any U.S. tax advice contained in the body of this booklet was not intended or written to be used, and cannot be used, by the recipient for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions. Our advice in this booklet is limited to the conclusions specifically set forth herein and is based on the completeness and accuracy of the facts and assumptions as stated. Our advice may consider tax authorities that are subject to change, retroactively and/or prospectively. Such changes could affect the validity of our advice. Our advice will not be updated for subsequent changes or modifications to applicable law and regulations, or to the judicial and administrative interpretations thereof.

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1. Introduction

U.S. citizens and residents face a number of challenges when they accept a foreign assignment. One of the most significant challenges is understanding the application of U.S. and foreign tax laws. This booklet is designed to help U.S. citizens and residents gain a general understanding of the unique tax provisions that apply to them while they are on foreign assignment.

If you are part of a corporate international assignment program, your employer may have a policy that ensures you are not disadvantaged from a tax perspective due to your foreign assignment. These employer tax policies are generally referred to as “Tax Equalization” or “Tax Protection” policies. This booklet discusses the general application of these policies. If your company has a tax equalization or tax protection policy, you should work with your company to obtain specific details.

U.S. expatriates will usually discover that their tax matters become extremely complex. Your taxable income may increase substantially due to assignment related expenses paid or reimbursed by your employer and tax returns are required in the U.S. and the foreign country. You may also encounter tax issues relating to the sale or rental of your home, moving expenses, state residency issues, foreign earned income and housing exclusions, foreign tax credit, foreign tax planning, tax equalization, and much more.

This booklet is based on tax law as of December 31, 2009. Due to the complexity of expatriate tax matters and the ever-changing U.S. and foreign tax laws, you should seek assistance from tax professionals in the U.S. and the host country when analyzing your tax situation.

Global Tax Network US, LLC (GTN) provides expatriate tax preparation and consulting services. Contact us at help@GTN.com if you have any questions or need tax advice. You can also visit our website at www.GTN.com for a full description of our services.

2. Case Study Facts

This booklet will provide examples of how your taxes will be calculated and reported during the foreign assignment. In order to provide you with a thorough understanding, the examples used throughout this booklet are designed around the facts of a “typical” expatriate assignment.



IN OUR CASE STUDY, Joe Smith and his family began a 3-year assignment to work for ABC Company in Tokyo on March 1, 2009. Joe was employed by a U.S. subsidiary of ABC Company during the foreign assignment. Joe is married to Mary and has 2 children (John 12 and Amy 17). Joe and his family lived in San Francisco prior to accepting the foreign assignment.

Mary did not work in 2009. Joe and Mary have decided to rent out their home in San Francisco during the assignment. Joe and Mary earned \$22,000 of rent and incurred rental expenses of \$29,502 in 2009. Joe and Mary owned the home for 2 years prior to the foreign assignment. ABC Company has arranged for an apartment in Tokyo during Joe’s assignment. Other than the rental income, the Smith’s only other 2009 non-wage income was \$12,000 of interest income earned from U.S. bank accounts.

Joe is eligible to receive ABC Company’s full expatriate package. His living expenses are being equalized to the typical costs incurred by a family of four in San Francisco. Joe’s compensation from ABC Company during 2009 consists of the following amounts:

Base Wages	\$100,000
Housing	48,000
Housing Norm	(20,000)
Cost-of-Living Allowance	15,000
Education Exp.	20,000
Home Leave Trips	20,000
Taxable Moving Expense	30,000
Tax Payments	60,000
Hypothetical Withholding	<u>(20,000)</u>
Total Salary Income	<u>\$253,000</u>

The \$60,000 of tax payments by ABC Company on Joe’s behalf are Japanese income tax payments. ABC Company was not required to withhold any U.S. federal or state income tax from Joe’s wages (see page 45). Joe also earned \$20,000 from his former employer during

the pre-assignment period of January 1 to February 15, 2009. Joe was on vacation from February 16 to February 28, 2009. His former employer withheld \$5,000 of federal income tax and \$2,500 of California income tax from his salary.

Joe and Mary paid the following expenses in 2009 that may provide tax benefits:

	Personal Deductions	Allocated to Rental (Starting 3/1/09)	Total
State Income Taxes	\$2,500	-	\$ 2,500
Real Estate Taxes	1,000	\$ 5,000	6,000
Mortgage Interest	3,333	16,667	20,000
Charitable Contributions	4,600	-	4,600
Depreciation on house	-	6,250	6,250
Foreign housing utilities	<u>2,200</u>	<u>-</u>	<u>2,200</u>
Total	<u>\$13,633</u>	<u>\$27,917</u>	<u>\$41,550</u>

Based on the advice of his tax advisor, Joe maintained a calendar that tracked where he was and what he did on each day in 2009. A summary of this information is shown below:

	U.S. Non-work	U.S. Work	Japan Non-work	Japan 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	10	20	30
July	10	0	5	16	31
August	0	0	10	21	31
September	0	0	10	20	30
October	0	7	8	16	31
November	0	0	10	20	30
December	<u>10</u>	<u>5</u>	<u>2</u>	<u>14</u>	<u>31</u>
Total	<u>47</u>	<u>49</u>	<u>84</u>	<u>185</u>	<u>365</u>

All of Joe's 2009 U.S. work and U.S. non-work days were spent in California. Joe spent no days in the U.S. during 2010.

3. U.S. Income Taxation

Overview

A U.S. expatriate is a citizen or resident of the U.S. who lives outside the U.S. and Puerto Rico for more than one year. U.S. citizens or residents on business trips of one year or less are referred to as short-term assignees. Short-term assignees must also consider the U.S. and foreign tax consequences related to a foreign assignment. This booklet focuses primarily on the tax consequences to the U.S. expatriate, but it also covers certain tax issues that are encountered by a short-term assignee.

U.S. citizens and residents must report 100% of their worldwide income on their U.S. individual income tax return, regardless of where they live and regardless of where the income is paid. As such, U.S. expatriates must continue to file U.S. tax returns and in many cases owe U.S. tax during their foreign assignments. There are two special tax provisions used by U.S. expatriates to reduce their federal income tax liability while on foreign assignment. These provisions are:

FOREIGN TAX CREDIT

The foreign tax credit can reduce U.S. federal, and in some cases, state individual income tax. The foreign tax credit is designed to help minimize double taxation of income..

EXCLUSIONS FROM INCOME

A U.S. citizen or resident who establishes a tax home in a foreign country and who meets either the bona fide residence test or the physical presence test (both tests are discussed later in detail) may elect to exclude two items from gross income:

- Foreign earned income of up to \$91,400 in 2009, and
- Foreign housing costs limited to 30% of the maximum foreign earned exclusion (with possible adjustment based upon geographic location), reduced by a base amount of \$14,624.

The exclusions are elective and an individual may elect either or both exclusions. These elections are available to each individual taxpayer, so, if eligible, each spouse may claim the exclusions even if a couple files a joint tax return.

An 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 subjects the U.S. expatriate to income tax. As such, the exclusions from income can be very beneficial where the foreign tax obligation of an expatriate is low.

An expatriate may not claim both the foreign tax credit and exclusions from income on the same dollar of income. No double benefits are allowed. This concept is explained under Denial of Double Benefits on page 18.

OTHER U.S. TAX ISSUES

In addition to the special tax provisions that apply to U.S. expatriates, an expatriate is still subject to the normal U.S. tax laws with respect to all other items of income, expenses, and credits. Other common federal tax issues that arise due to a foreign assignment include:

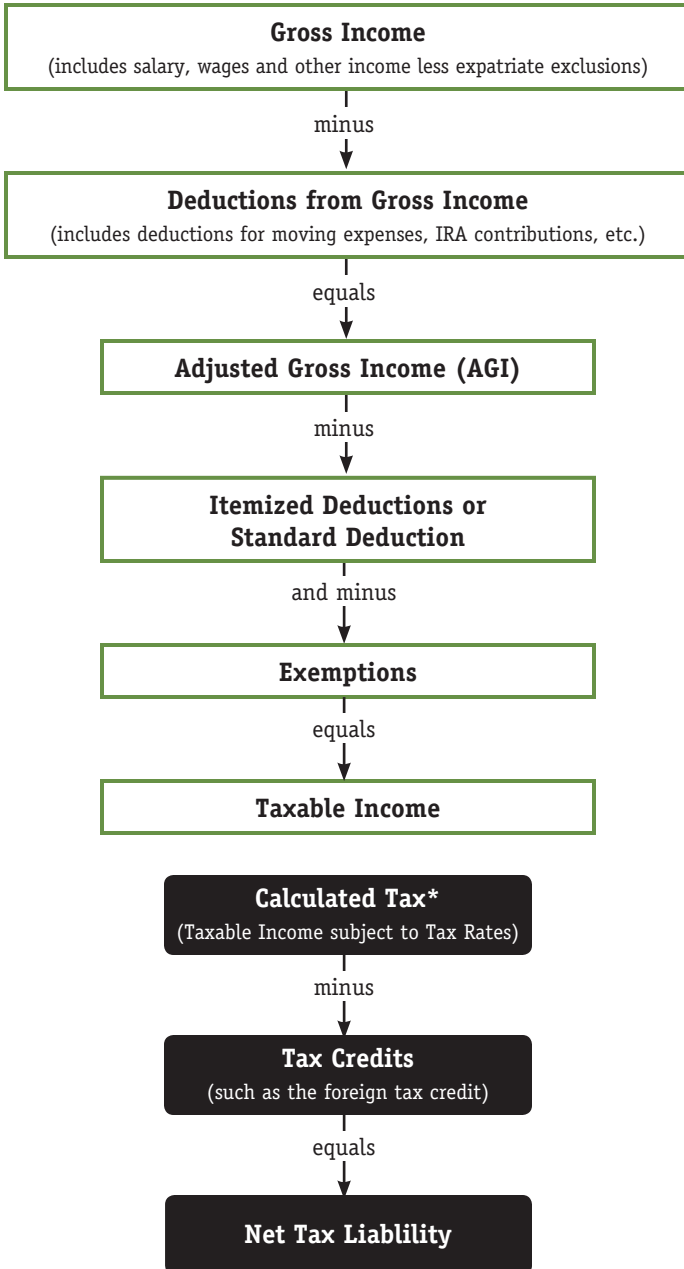
- Treatment of employer-provided allowances and reimbursements
- Moving expenses
- Rental of principal residence
- Sale of principal residence
- Exchange gains and losses
- Short-term versus long-term assignments
- Social security taxes

Federal Income Tax Calculation

The flowchart that follows provides a brief description of the calculation of taxable income and federal income tax. More detailed discussions of the tax issues specifically related to expatriates are provided in later chapters.

This booklet also discusses state taxation issues starting on page 35. It is important to note that most states base their calculation of taxable income on federal tax law. A typical state income tax return starts with federal adjusted gross income and then adjustments are made to arrive at state taxable income. Therefore, many of the topics covered in the federal income tax discussion may also impact your state tax situation.

The flowchart below outlines the major steps in calculating federal taxable income and the federal tax liability for an expatriate taxpayer:



*It is important to note that under the new tax laws, the tax is computed after adding back the section 911 exclusion, so the higher income tax rates apply.

Filing Status

Your filing status affects many items that impact your ultimate tax liability. These items include the amount of standard deduction available to you, the phase-out of itemized deductions, exemptions and certain credits, as well as the tax rate schedule that dictates your marginal tax bracket. These are the possible filing statuses:

- Single Individual
- Married Filing Jointly
- Married Filing Separately
- Head of Household



IN OUR CASE STUDY, Joe and Mary will file their U.S. federal income tax returns using a 'married filing jointly' filing status.

Gross Income

Gross income consists of all income, regardless of its source, except for those items specifically excluded by law. Gross income includes:

- Wages, salaries, and other compensation
- Interest and dividends
- State income tax refund (if claimed as an itemized deduction in prior year)
- Income from a business or profession
- Alimony received
- Rents and royalties
- Gains on sales of property
- S Corporation, trust, and partnership income
- Less: Foreign Earned Income Exclusion
- Less: Foreign Housing Exclusion



IN OUR CASE STUDY, Joe and Mary’s gross income for 2009 is calculated as follows:

Wages	\$273,000	(\$253,000 plus \$20,000, former employer)
Interest	12,000	
Rental Loss	(5,917)	
Disallowed Rental Loss	5,917	
FEIE	(76,626)	(Calculated on Page 20 and 21)
Housing Exclusion	(37,939)	(Calculated on Page 20 and 21)
Gross Income	<u>\$170,435</u>	

Deductions from Gross Income

Deductions from gross income reduce your gross income to arrive at adjusted gross income (AGI). These deductions apply even if you elect to use the standard deduction rather than itemize your deductions. Your AGI will be important in many of the phase-out calculations we will discuss later. Allowable deductions from gross income include:

- Housing deduction (self-employed expatriates)
- IRA contribution deduction
- Student loan and interest deduction
- Tuition and fees deduction
- Medical and health savings account contribution deduction
- Penalty incurred on early withdrawal of savings
- Alimony paid
- Unreimbursed deductible moving expenses
- Self-employed health insurance
- Self-employed SEP, SIMPLE, and qualified plans
- One half of self-employment tax



IN OUR CASE STUDY, Joe and Mary do not have any deductions from gross income. As such, their AGI is \$170,435.

Itemized Deductions or Standard Deduction

Taxpayers may reduce AGI by the greater of the appropriate standard deduction or their allowable itemized deductions. The amount of the standard deduction varies depending on your filing status. For 2009, the standard deduction amounts are as follows:

- Single Individual \$5,700
- Married Filing Jointly.....\$11,400
- Married Filing Separately \$5,700
- Head of Household \$8,350

If the sum of your allowable itemized deductions is greater than the standard deduction allowed based on your filing status, you should itemize. The following are examples of amounts which can qualify as itemized deductions:

- State and local income taxes
- Foreign taxes (if you elect to deduct rather than take a credit)
- Real estate taxes
- Personal property taxes
- Qualified home mortgage interest and points
- Investment interest, if applicable
- Charitable contributions to qualified U.S. charities
- Unreimbursed employee expenses
- Miscellaneous expenses

It is usually (but not always) more advantageous for homeowners to itemize. Renters, on the other hand, will often find that the standard deduction produces a greater benefit.

If individuals can not itemize deductions, they can (by completing Schedule L) increase their standard deduction by the amount of qualified real estate taxes paid. This is limited to an additional \$1,000 for “Married Filing Jointly” and \$500 for “Single” taxpayers.



IN OUR CASE STUDY, Joe and Mary’s itemized deductions are as follows:

State income taxes	\$2,500
Real estate taxes	1,000
Mortgage interest	3,333
Charitable contributions	<u>4,600</u>
Total itemized deductions	<u>\$11,433</u>

Please note that expenses allocated to a rental activity cannot be claimed as itemized deductions. Since Joe and Mary’s total itemized deductions (\$11,433) exceed the standard deduction (\$11,400) it appears that Joe and Mary 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.

PHASE-OUT OF ITEMIZED DEDUCTIONS

If your AGI exceeds a threshold amount, you are required to reduce your allowable itemized deductions by 3% of the excess over the threshold amount. This phase-out of allowable itemized deductions is slated for repeal in 2010. For 2009, the reduction cannot exceed 80% of allowable itemized deductions and you will lose only one third of the normal phase out. For 2009, the threshold amount is \$83,400 for married filing separately, and \$166,800 for all other filing statuses.



IN OUR CASE STUDY, Joe and Mary's AGI is \$170,435, so they must reduce their allowable itemized deductions by \$36 ($\$170,435$ less $\$166,800$ times 3% times 1/3). After the phase-out, Joe and Mary's allowable itemized deductions total \$11,397. After considering this limitation, it is more beneficial for Joe and Mary to claim the \$11,400 standard deduction rather than itemize. However, with the Schedule L calculation, the standard deduction is increased to \$12,400.

Disallowance of Itemized Deductions Attributable to Excluded Income

In addition to the phase-out limitation covered above, certain itemized deductions can be disallowed if a taxpayer elects to claim the foreign earned income exclusion (FEIE) and/or housing exclusion. The FEIE and housing exclusion are discussed on page 16. Certain deductions related to the realization of foreign earned income, such as employee business expenses and deductible moving expenses, are not allowed to the extent they are properly allocable to excluded income.



IN OUR CASE STUDY, although Joe has elected to take the FEIE, Joe and Mary have no itemized deductions or deductions from gross income which are subject to this disallowance. Therefore, no adjustment is necessary in our case study.

Exemptions

In 2009, you can deduct \$3,650 for each allowed exemption. You are allowed one exemption for yourself, and if you are married and file a joint tax return, one exemption for your spouse. You are also allowed one exemption for each person you are able to claim as a dependent.

Certain dependency tests need to be met for each dependent you claim:

- You must have furnished over half of their total support for the calendar year,
- They must have less than \$3,650 of gross income, unless they are a child under age 19 or a full-time student under age 24,
- They must live with you for the entire year or be related to you,
- A related individual must have lived with you for more than half of 2009,
- They cannot file a joint tax return with their spouse, and
- They must be a citizen, national, or resident of the United States, Canada, or Mexico.



IN OUR CASE STUDY, Joe and Mary may claim four exemptions totaling \$14,600 before phase-outs.

PHASE-OUT OF EXEMPTIONS

Similar to the phase-out limitation on itemized deductions which we just discussed, a phase-out also applies to exemptions. This phase-out is applied when your AGI exceeds a threshold amount. Again, the threshold amount varies depending on your filing status. The 2009 threshold amounts begin at the following:

- Single Individual \$166,800
- Married Filing Jointly..... \$250,200
- Married Filing Separately..... \$125,100
- Head of Household \$208,500

If your AGI exceeds the applicable threshold amount, you must reduce your exemptions by 2% for each \$2,500, or part of \$2,500, of this excess (for each \$1,250 or part of \$1,250 if married filing separately). However, you can lose no more than 1/3 of the dollar amount of your exemptions. In other words, each exemption cannot be reduced to less than \$2,433.



IN OUR CASE STUDY, the exemption phase-outs do not affect Joe and Mary since their AGI (\$170,435) is less than the “married filing jointly” threshold of \$250,200.

2009 Federal Tax Rate Schedules

SINGLE INDIVIDUALS

TAXABLE INCOME					
If Over	But Not Over	Tax Is	+	% on Excess	of the Amount Over
\$ 0	\$ 8,350	\$ 0		10%	\$ 0
8,350	33,950	835.00		15%	8,350
33,950	82,250	4,675.00		25%	33,950
82,250	171,550	16,750.00		28%	82,250
171,550	372,950	41,754.00		33%	171,550
372,950	no limit	108,216.00		35%	372,950

MARRIED FILING JOINTLY

TAXABLE INCOME					
If Over	But Not Over	Tax Is	+	% on Excess	of the Amount Over
\$ 0	\$ 16,700	\$ 0		10%	\$ 0
16,700	67,900	1,670.00		15%	16,700
67,900	137,050	9,350.00		25%	67,900
137,050	208,850	26,637.50		28%	137,050
208,850	372,950	46,741.50		33%	208,850
372,950	no limit	108,894.50		35%	372,950

MARRIED FILING SEPARATELY

TAXABLE INCOME					
If Over	But Not Over	Tax Is	+	% on Excess	of the Amount Over
\$ 0	\$ 8,350	\$ 0		10%	\$ 0
8,350	33,950	835.00		15%	8,350
33,950	68,525	4,675.00		25%	33,950
68,525	104,425	13,318.75		28%	68,525
104,425	186,475	23,370.75		33%	104,425
186,475	no limit	50,447.25		35%	186,475

HEAD OF HOUSEHOLD

TAXABLE INCOME					
If Over	But Not Over	Tax Is	+	% on Excess	of the Amount Over
\$ 0	\$ 11,950	\$ 0		10%	\$ 0
11,950	45,500	1,195.00		15%	11,950
45,500	117,450	6,227.50		25%	45,500
117,450	190,200	24,215.00		28%	117,450
190,200	372,950	44,585.00		33%	190,200
372,950	no limit	104,892.50		35%	372,950



Case Study • Taxable Income Summary

- Adjusted Gross Income \$170,435
- Less: Standard Deduction..... (12,400)
- Less: Exemptions..... (14,600)
- Taxable Income..... \$143,435



IN OUR CASE STUDY, Joe and Mary’s tentative federal tax liability amounts to \$41,945 which is based on the “married filing jointly” tax rates applied to their taxable income of \$143,435. This amount is tentative because we have yet to consider the impact of the foreign tax credit or other credits which might be available to Joe and Mary.

Foreign Tax Credit

The foreign tax credit is a dollar-for-dollar reduction of tax which generally alleviates the double taxation of income. Double taxation occurs when a foreign country and the U.S. tax the same income. A detailed discussion of the foreign tax credit is provided on page 21.



IN OUR CASE STUDY, Joe and Mary may claim a credit of \$28,606. See the foreign tax credit discussion on page 21 and the foreign tax credit calculation on page 24.

Child Tax Credit and Additional Child Tax Credit

During 2009, you may be entitled to a child tax credit of \$1,000 for each of your qualifying children. To qualify, the child:

- must be under age 17,
- must be a citizen or resident of the U.S.,
- must be someone you can claim as a dependent,
- must be your child, stepchild, grandchild or eligible foster child
- did not provide over half of their own support, and
- must have lived with you for more than half of 2009.

PHASE-OUT OF CHILD TAX CREDIT

The amount of your child tax credit starts to phase-out once your AGI exceeds a threshold amount for your filing status. The threshold amounts for 2009 are as follows:

- Single individuals\$75,000
- Married filing jointly..... \$110,000
- Married filing separately..... \$ 55,000
- Head of household.....\$75,000

If your modified AGI is above the threshold amount for your filing status, you must reduce your credit by \$50 for each \$1,000, or part of \$1,000, that your modified AGI exceeds the threshold amount. Unlike other phase-outs in the tax law, the income level at which the child tax credit is completely phased out is higher for each additional child. For the additional child tax credit, if the usable child tax credit is greater than your tax liability and taxable income is greater than \$3,000, or if you have three or more children, and the Social Security and Medicare tax you paid is more than your Earned Income Credit, a portion of the credit may be refundable.

IN OUR CASE STUDY, based on Joe and Mary’s 2009 modified AGI of \$285,000, the child tax credit for each of their two children cannot be claimed due to the phase-out rules.



Higher Education Tax Credits

For 2009 and 2010, there is a new education credit called the American Opportunity tax credit (AOC). This is a modification of the HOPE Credit.

- The maximum amount of AOC is \$2,500 per student. The credit is phased out (gradually reduced) if your modified adjusted gross income (AGI) is between \$80,000 and \$90,000 (\$160,000 and \$180,000 if you file a joint return).
- The credit can be claimed for the first four years of post-secondary education. Previously, the credit could be claimed for only the first two years of post-secondary education.
- Generally, 40% of the AOC is now a refundable credit for most taxpayers, which means that you can receive up to \$1,000 even if you owe no taxes.

- The term “qualified tuition and related expenses” has been expanded to include expenditures for “course materials.” For this purpose, the term “course materials” means books, supplies, and equipment needed for a course of study, whether or not the materials must be purchased from the educational institution as a condition of enrollment or attendance.

The **Lifetime Learning** credit is not limited to students in the first four years of post-secondary education. Qualified expenses for this credit include the cost of instruction taken at a qualified educational institution to acquire or improve existing job skills. The amount of the credit is 20% of the first \$10,000 you pay for qualified expenses. The maximum Lifetime Learning credit you can claim per year is \$2,000 (20% x \$10,000).

PHASE-OUT OF HIGHER EDUCATION TAX CREDITS

The allowable credits are reduced for taxpayers who have AGI above certain amounts. For 2009, the phase-out begins for single individuals, and head of household filing statuses when modified AGI reaches \$48,000; the credits are completely phased-out when modified AGI reaches \$58,000. For “married filing jointly” taxpayers, the phase-out range is \$96,000 to \$116,000.



IN OUR CASE STUDY, Joe and Mary do not qualify for the higher education tax credits.



Case Study • Federal Tax Summary

Federal Income Tax before credits	\$41,945
Less: Foreign Tax Credits	(28,606)
Net Federal Income Tax	13,339
Less: Tax payments	(5,000)
Federal tax due or (refund).....	<u>\$8,339</u>

Since Joe is part of the ABC Company tax equalization policy, ABC Company will pay the federal taxes that are due with Joe and Mary’s 2009 federal tax return (see the discussion of tax equalization in Chapter 7).

Foreign Earned Income and Housing Exclusions

Both the foreign earned income exclusion (FEIE) and the housing exclusion are unique to U.S. expatriates. In order to qualify for either of these exclusions, an individual must meet either the bona fide residence test or the physical presence test. If either test is met, an individual may elect to claim either or both exclusions. Once an election is made, it remains in effect until revoked.

Foreign Earned Income Exclusion

The FEIE allows a qualifying individual to claim an exclusion of “foreign earned income” up to the lesser of \$91,400 per calendar year or the individual’s foreign earned income for such year. For those periods which are less than a full calendar year (typically, the first and last years of an expatriate’s foreign assignment), the \$91,400 limit is scaled back to reflect the number of qualifying days within the calendar year. Each qualifying spouse may claim the FEIE.

The FEIE is an adjustment or deduction from gross income. Only foreign earned income may be excluded. Foreign earned income is income that an individual earns performing services outside the U.S. (see the sourcing of income description on page 38 for a more thorough analysis of foreign source income). To be considered eligible for the FEIE, the foreign earned income must be received no later than the year after the year in which the services are performed.

For compensation that is partially related to services performed outside the U.S. and partially related to services performed in the U.S., an allocation of the income must be made to determine the foreign earned income component. This allocation is generally based on relative business days spent inside and outside the U.S. In the case study, Joe kept a log of where he worked so that this allocation could be made on his tax return.

Housing Exclusion and Deduction

A qualifying taxpayer can claim an exclusion for eligible foreign housing costs but the exclusion is generally limited to 30% of the maximum foreign earned income exclusion (\$27,450 [30% x \$91,400]). This limitation amount will be adjusted to the extent that qualifying taxpayer resides in a high-cost geographic area. In our example, Tokyo foreign housing exclusion maximum is \$85,700 annually.

Housing costs include rent, utilities (except phone), insurance, residential parking, and repairs related to maintaining your foreign home. Housing costs do not include mortgage interest, real estate

taxes, or any other expenses directly or indirectly related to your home. Housing costs may be claimed regardless of whether you or your employer paid the costs. The total of the housing exclusion or deduction plus the FEIE may not exceed your “foreign earned income” for the year.

Qualifying for the Exclusions

To claim the FEIE or housing exclusion, an individual must establish a tax home in a foreign country and meet either the bona fide residence test or the physical presence test for the tax year or part of a tax year.

Tax Home

The first hurdle that must be cleared to qualify for the FEIE and the housing exclusion is the tax home requirement. The determination of a tax home depends on where an individual primarily conducts his or her business. If you can demonstrate that this primary place is in a foreign country, your tax home is in that country. As a general rule, most U.S. citizens or residents who accept a foreign assignment which lasts longer than one year will meet the tax home requirement.

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, January 1 through December 31. For example, a U.S. citizen who relocates in February of year one would not meet the bona fide residence test until December 31 of the following year. A special extension of time for filing is available to meet this test (see page 43). The bona fide residence test requires that a person has a tax home outside the U.S. and the person is considered a resident of the foreign country. This test can be met if a person goes to a foreign country to work for a period of time, sets up a place to live, and otherwise becomes established in the local community. The intention to return to the U.S. does not prohibit an expatriate from being a bona fide resident.

Temporary visits back to the U.S. after establishing a bona fide residence do not affect qualification. Also, an individual may move to another foreign residence without affecting qualification. A non-citizen resident of the U.S. (green card holder) generally cannot claim the bona fide residence test, but a special tax treaty position may be available to allow a green card holder to utilize the bona fide residence test.

An individual is not a bona fide resident of a country if:

- A statement is made to the authorities of the foreign country that the individual is not a resident of such country, and
- The individual is not subject, by reason of nonresidency in the foreign country, to the income tax of the foreign country.

Physical Presence Test

The physical presence test requires that a U.S. citizen or resident be physically present in one or more foreign countries for at least 330 days during any 12-month period. The 330 days do not need to be continuous. Further, the individual's tax home (principal place of business or employment) must be in a foreign country during the 330 day period.

The 330 day rule is very exact. An individual must keep track of all U.S. and foreign days to properly claim the exclusions based on the physical presence test. Any partial days in the U.S. are treated as full U.S. days for purposes of this test.

Election of FEIE and Housing Exclusion

It is best to elect these exclusions on a timely filed tax return or an amended return. If a taxpayer does not file a tax return on a timely basis, the taxpayer can elect to claim the exclusions if no tax is due (after taking into account the exclusions). If tax is owed after accounting for the exclusions, a taxpayer can still make the elections on a delinquent return only if the return is filed before the IRS contacts the taxpayer regarding the failure to file a timely return.

If you have not filed tax returns and the exclusions apply to you, it is better to voluntarily file any outstanding returns rather than wait for the IRS to contact you.

Denial of Double Benefits

Due to the unique nature of the FEIE and the housing exclusion, there are several calculations taxpayers must make to ensure that they are not obtaining a double tax benefit on the same item of income. For instance, a taxpayer may claim the FEIE and housing exclusion and also be eligible for the foreign tax credit as well as deductions for items attributable to foreign earned income. In order to prevent taxpayers from realizing double tax benefits, there are rules which disallow certain deductions and credits when taxpayers claim the FEIE or housing exclusion.

- Deductions Subject to Disallowance - As mentioned earlier, deductions related to the realization of foreign earned income, such as employee business expenses and deductible moving expenses, are not allowed to the extent they are allocated to excluded income. This disallowance is calculated according to the following formula:

$$\frac{\text{Excluded foreign earned income}}{\text{Foreign earned income}} \times \text{Deductions related to foreign earned income} = \text{Disallowed deductions}$$

- Foreign Tax Credit Disallowance - A portion of the foreign taxes paid or accrued during the year are disallowed. The calculation of the disallowed foreign tax credits is made according to the following formula:

$$\frac{\text{Excluded foreign earned income less disallowed deductions}}{\text{Foreign earned income less expenses allocable to this income}} \times \text{Foreign Taxes (Paid or Accrued)} = \text{Disallowed Foreign Taxes}$$



IN OUR CASE STUDY, Joe and Mary have no deductions that would be subject to the disallowance. However, Joe and Mary have decided to claim the foreign tax credit and must reduce the foreign taxes that may be claimed as a foreign tax credit because of the double benefit disallowance rule. See page 23 for the case study foreign tax credit disallowance calculation.



The Case Study

QUALIFICATION AND AMOUNT OF EXCLUSIONS

IN OUR CASE STUDY, we must first determine whether Joe qualifies for the FEIE or housing exclusion in 2009. Joe started his assignment on March 1, 2009 and maintained a tax home in Tokyo from this date. Joe would meet the bona fide residence test beginning March 1, 2009 since he spent the entire 2010 calendar year outside the U.S.

Joe could also qualify under the physical presence test. However, the 2009 period during which he meets the physical presence test would be shorter than the 2009 qualifying period resulting from the bona fide residence test. During 2009, Joe spent 37 days in the U.S. after March 1. Joe spent no days in the U.S. in 2010. The earliest day when Joe 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 12-month period outside the U.S. As a result Joe is better off electing the exclusions based on the bona fide residence test rather than under the physical presence test.

Now that we know Joe qualifies for the exclusions, we can calculate the amount of the exclusions. First, we know that Joe's salary income during the qualifying period from March 1, 2009 to December 31, 2009 was \$253,000. Is the entire \$253,000 considered "foreign earned income"? No, because Joe 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 Joe's salary must be evaluated to determine whether it is entirely foreign source or whether it should be allocated based on relative work days. 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, Joe's foreign earned income is \$231,708 ($\$253,000 \times 91.6\%$ [185 foreign work days/202 total work days while on foreign assignment]).

Joe's foreign earned income exceeds the annual limitation of \$91,400. Does this mean that Joe can claim the entire \$91,400 as his FEIE? No, because this is the first year of Joe's assignment and his qualifying period is shorter than an entire calendar year. Therefore, the \$91,400

limitation amount must be scaled back to reflect this shorter qualifying period. Under the more beneficial test (the bona-fide residence test), Joe qualifies for the exclusions from March 1, 2009. This amounts to 306 qualifying days in calendar year 2009. Therefore, Joe's FEIE for 2009 is \$76,626 (\$91,400 X 306 / 365).

In addition to the FEIE, Joe can also elect the foreign housing exclusion. Joe's housing exclusion calculated by comparing the qualified housing expenses paid, with the maximum allowed of \$27,450. However, because Tokyo is a specific location that allows a higher housing deduction, Joe can use \$85,700 instead of \$27,450 for the comparison. Since his actual expense of \$50,200 is less than the \$85,700, his calculation begins with the \$50,200 amount. From this amount, the base housing amount of \$14,624* is prorated by 306/365 to arrive at \$12,261. This amount is then subtracted from the \$50,200. His foreign housing exclusion is \$37,939.

Joe's total 2009 exclusions equal \$114,565 (\$76,626 plus \$37,939).

**2009 base amount.*

Foreign Tax Credit

The foreign tax credit is one of the primary tools used by U.S. taxpayers to avoid double taxation 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 (please see page 38 for a discussion of 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 carryover from prior tax years of foreign taxes.

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 (in the case study we referred to this as the tentative tax liability). This is then plugged into the following equation:

$$\frac{\text{Foreign source taxable income}}{\text{Total taxable income before exemptions}} \times \text{U.S. Tax} = \text{U.S. tax on foreign source taxable income}$$

This formula has to be applied separately to each category of foreign source income. Note that passive income such as interest and dividends falls into a different category than wage income.

A taxpayer must also prepare separate foreign tax credit calculations to determine the Alternative Minimum Tax (AMT). The AMT is a separate tax calculation intended to ensure that higher income taxpayers pay at least a “minimum” tax. The AMT ignores certain exclusions, deductions and credits which are allowed under the regular tax regime. The AMT often applies to high income expatriate taxpayers.

Foreign Taxes Paid or Accrued

A taxpayer must elect to use either the “paid” or “accrued” method for determining foreign tax credits. The “accrued” method election 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 that is subject to U.S. tax on a current basis. In many cases, expatriates may not pay a foreign tax liability until after the year in which the income is earned. In these cases, the “paid” method can provide for significant mismatching when preparing the foreign tax credit calculation. However, the mismatching can sometimes be minimized through foreign tax credit carrybacks and carryforwards. You will have to amend your prior year(s) tax returns to carryback foreign tax credits.

Regardless of the method used, the foreign taxes must be reported on your U.S. tax return in U.S. dollars. For expatriates on the “paid” method, taxes paid in a foreign currency are converted to U.S. dollars on the date paid using the spot exchange rate on that date. For expatriates on the “accrued” method, the foreign tax liability is generally converted to U.S. dollars based on the average exchange rate for the tax year to which the taxes relate.

Foreign Tax Credit Disallowance

A foreign tax credit or deduction is not available for foreign taxes attributable to income that has been excluded as part of the foreign earned income exclusion (FEIE) or housing exclusion.

A portion of the foreign taxes paid or accrued during the year are disallowed. The calculation of the disallowed foreign tax is made according to the following formula:

$$\frac{\text{Excluded foreign earned income less disallowed deductions}}{\text{Foreign earned income less expenses allocable to this income}} \times \text{Foreign Taxes (Paid or Accrued)} = \text{Disallowed Foreign Taxes}$$



IN OUR CASE STUDY, Joe and Mary had excluded foreign income less applicable deductions of \$114,565. Their total foreign earned income less applicable deductions was \$222,350 (\$231,708 less \$9,358 [see page 24]) and the total foreign taxes paid amounted to \$60,000. Inserting these amounts into the disallowance calculation results in \$30,610 of disallowed foreign taxes. As such, the amount of foreign taxes available for credit which can be claimed by Joe and Mary is as follows:

Total foreign taxes paid.....	\$60,000
Less disallowed portion	<u>(30,610)</u>
Creditable taxes.....	<u>\$29,390</u>

Carryback and Carryover of Unused Credits

The amount of foreign taxes paid or accrued in any year that exceeds the U.S. tax on foreign source earnings must first be carried back to the previous tax year and then carried forward for up to ten years. Any disallowed foreign taxes (due to the disallowance calculated above) are not allowed as a credit carryover.

Deduction Versus Credit

Taxpayers may elect to deduct foreign taxes paid as an itemized deduction rather than electing the foreign tax credit. Generally, the foreign tax credit is much more beneficial because it provides a dollar-for-dollar reduction in tax. However, there are limited situations where deducting foreign taxes provides a greater benefit than taking the credit. Any disallowed foreign taxes (see page 22 - Foreign Tax Credit Disallowance) are not allowed as deductions. You should consult your tax advisor before claiming a credit or deducting your foreign taxes to ensure that you maximize the benefit.



Foreign Tax Credit Calculation

Joe and Mary Smith

INCOME	TOTAL	U.S. SOURCE	FOREIGN SOURCE
Compensation	\$ 273,000	\$ 41,292	\$ 231,708
Interest	12,000	12,000	0
Rental Income	22,000	22,000	0
Total Income	\$ 307,000	\$ 75,292	\$ 231,708

DEDUCTIONS AND EXCLUSIONS

Housing Exclusion	\$ (37,939)	\$ 0	\$ (37,939)
Foreign Earned Income Exclusion	(76,626)	0	(76,626)
Rental Deductions	(22,000)	(22,000)	0
Standard Deduction	(12,400)	(3,042)	(9,358)
Total Deductions and Exclusions	\$(148,965)	\$(25,042)	\$(123,923)

Taxable Income Before Exemptions	\$ 158,035	\$ 50,250	\$ 107,785
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Exemptions	(14,600)		
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U.S. Taxable Income	\$ 143,435		
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U.S. Tax Before Credits	\$ 41,945		
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Less: Foreign Tax Credit	(28,606)		
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Net U.S. Tax Liability	\$ 13,339		
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FOREIGN TAX CREDIT

Foreign Source Taxable Income*	107,785		
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Divided by Total Taxable Income*	158,035		
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Equals	68.2%		
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Times U.S. Tax	\$ 41,945		
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Foreign Tax Credit Limit	\$ 28,606		
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* Before exemptions

(continues)

(continued from page 24)

U.S. SOURCE WAGES	TOTAL
January 1 - February 28	\$ 20,000
March 1 - December 31	<u>21,292</u> \$253,000* (17 U.S. work days / 202 total work days)
Total	<u>\$ 41,292</u>

**STANDARD DEDUCTION
ALLOCATED TO U.S. SOURCE INCOME**

U.S. gross income	\$ 75,292
Divided by total gross income	307,000
Equals	24.53%
Times Standard Deduction	<u>(12,400)</u>
Equals U.S. source standard deduction	<u>\$ (3,402)</u>

FOREIGN TAXES WHICH CAN BE CREDITED

Foreign taxes paid	\$ 60,000
Less disallowed due to exclusions	<u>(30,610)</u>
Equals net foreign taxes paid	<u>29,390</u> (maximum foreign tax credit)
Foreign tax credit carryforward	\$ <u>784</u> (\$29,390 – Foreign Tax Credit Limit of \$28,606)



IN OUR CASE STUDY, Joe and Mary can claim a foreign tax credit of \$28,606 to reduce their federal tax liability. Because Joe and Mary paid \$29,390 of creditable foreign taxes, there are \$784 in foreign tax credits that can be carried back or carried forward. Note that it may be possible for Joe and Mary to carry forward excess foreign tax credits from 2009 to reduce their 2010 tax liability.

Expatriate Allowances and Expense Reimbursements

Expatriates participating in a corporate program will often receive a number of expatriate allowances and expense reimbursements in addition to their normal compensation. These additional payments from the employer may include housing expenses, cost-of-living adjustments, foreign service premiums, tax payments, educational expenses, home leave expenses, moving expenses, automobiles and other benefits.

Regardless of whether these employer payments are made directly to you or to a vendor, they generally are considered taxable wages as long as they provide you with a personal benefit. The following types of payments made by your employer may be excluded from taxable wages:

- Nontaxable moving expense payments or reimbursements (see below for more detail)
- Business expense reimbursements

There may be some other unusual adjustments to your taxable wages caused by your foreign assignment. Normally, your employer will deduct from your base wages “stay-at-home” or “hypothetical” amounts for housing and taxes during your foreign assignment. These employer deductions will reduce the taxable wages reported on your Form W-2.

In any case, your Form W-2 will likely not look the same after you begin your foreign assignment. If possible, you should take the time to understand the differences. You may need to track many of these taxable compensation items on your own, especially if you are not employed by a U.S. company during your foreign assignment. Wage statements provided by your foreign employer may not include all of the items that the U.S. considers to be taxable compensation.



IN OUR CASE STUDY, Joe’s taxable wages were adjusted for reimbursements and allowances as well as reduced for amounts that Joe paid to his company for housing allowances and hypothetical income tax withholding (see Case Study Facts on page 2). Joe’s U.S. taxable wages from ABC Company were \$253,000 in 2007.

Moving Expenses

In order for expenses paid or reimbursed to qualify as moving expenses, the move must satisfy certain requirements which involve work, distance, and time.

WORK RELATED TEST

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 principal place of work and your old residence must be at least 50 miles greater than the distance between your old principal place of work and your old residence. In other words, assuming you still lived in your old residence, your commuting distance must have increased by at least 50 miles. Expatriates usually do not have any problems meeting the distance test.

TIME TEST

In the 12 month period following the move, you must be a full-time employee for at least 39 weeks. This test can be waived due to disability or death, if there is an involuntary separation from service (other than for willful misconduct), or if you are transferred again for the benefit of your employer.

Deductible Moving Expenses

If your move meets the requirements above, you will be able to deduct the expenses you paid for:

- Transportation of your household goods and personal effects (including in-transit storage and insurance expenses) from your old residence to your new residence. The costs of moving automobiles and pets are included in this category.
- Storage fees related to moving overseas including moving household goods and personal effects to and from storage, and storing such goods for part or all of the period of the foreign assignment.
- Travel expenses from your old residence to your new residence. These expenses include lodging, but not meals, during the trip. Expenses are allowable for the taxpayer and members of his or her household. It is not necessary that all members of the household travel together or at the same time.

You can deduct only expenses that are reasonable for the circumstances of your move. For example, the cost of traveling from your old residence to your new residence should be by the shortest and most direct route available.

Deductible moving expenses are allowed as an above-the-line deduction from gross income in arriving at Adjustable Gross Income (AGI).

Excludable Reimbursements

Generally, if an employer pays or reimburses an employee for personal expenses, the payments or reimbursements are considered taxable compensation to the employee. However, there is a special exception for reimbursed “deductible moving expenses.”

If you are reimbursed for deductible moving expenses by your employer, or if these deductible moving expenses are paid directly by your employer, they are not included in your taxable compensation. These reimbursements are considered “excludable.” The excludable amounts will have no effect on your federal taxable income or your federal tax. Consequently, these reimbursements will not show up as taxable compensation on your Form W-2. You should not deduct excluded moving expenses on your tax return.

Taxable Moving Expense Reimbursements

All moving expenses that a company reimburses directly to the employee or pays on behalf of the employee, other than the “excludable reimbursements,” will be included in the employee’s gross income as taxable wages.

Some of the common taxable moving expense reimbursements include:

- Househunting expenses
- Temporary living expenses
- Expenses for meals
- Expenses of selling or buying a home
- Reimbursement of loss on the sale of your home
- Spousal assistance programs
- Tax assistance or gross-up payments

Note that you may deduct some of the taxable reimbursed moving expenses on your tax return as itemized deductions or as adjustments to the gain on the sale of your home. You should consult your tax advisor regarding these matters.

Taxable moving expense reimbursements will be reported in Box 1 of your Form W-2.

Lump Sum Payments

Some companies will pay you a lump sum from which you must pay your own moving expenses. In this case, the entire lump sum payment is included in your taxable wages and you must keep track of your deductible moving expenses. The deductible moving expenses are reported on Form 3903.



IN OUR CASE STUDY, all of Joe's moving expenses to Tokyo were paid by ABC Company. As such, Joe can not deduct any moving expenses on his U.S. tax return (the deductible reimbursements were already excluded from his wages by ABC Company).

Tax Impact of Home Ownership and the Sale of a Home

Tax Benefits of Home Ownership

In addition to providing a place for you and your family to live, owning a home can provide you with numerous tax advantages. Some of these are current advantages such as deductions you can use to reduce your current tax liability while others result when you sell your home.

In order to deduct certain expenses related to owning your home, you will need to itemize your deductions on Schedule A of your federal tax return.

Home Mortgage Interest

Most homeowners take out a mortgage to buy their home. Home mortgage interest is deductible, subject to certain limitations. The deductions may be limited if your total mortgage balance is greater than \$1 million, or if you took out a loan for reasons other than to buy, build, or improve your home. To be deductible, the interest paid must be for a loan secured by your main home or second home. A first or second mortgage, home improvement loan, or a home equity loan can qualify. The aggregate amount of home equity loans cannot exceed \$100,000 in order for all of the interest paid on the home equity loan to be deductible. As such, \$1.1 million is the maximum indebtedness on which deductible mortgage interest can be paid. Total mortgage interest paid to a U.S. financial institution should be reported to you on Form 1098.

Points Paid on Purchase of Your Home

The term "points" is used to describe certain charges paid by a borrower to obtain a mortgage loan. They may also be called loan origination fees, loan discount, or discount points.

In order to be fully deductible in the year paid, the loan must be secured by your principal residence, the payment of points must be an established practice in your area, and the amount of points charged cannot be more than is generally charged in your area. The points must be paid by funds provided by you, not derived from loan proceeds. Points paid on loans other than the above discussed home mortgage loans are deducted over the life of the loan. This means that if you pay \$2,000 in points for a 15-year loan, you can only deduct \$133.33 in each of the next 15 tax years rather than claiming a \$2,000 deduction in the year you paid the points.

The term “points” includes loan placement fees that the seller may pay to the lender to arrange financing for the buyer. The seller cannot deduct these payments as interest, but they are treated as a selling expense. The buyer can deduct the payments as points. The buyer must also reduce the adjusted basis of the home by the amount of the seller-paid points. Points paid on refinancing are not usually deductible.

Real Estate Taxes

Many state and local governments charge an annual tax on the value of real property. In order to be deductible, the taxes charged must be at a uniform rate for all property in the taxing jurisdiction and the taxes must be for general public welfare. The deduction is allowed in the year paid.

If you pay a monthly amount in escrow for real estate taxes as part of your monthly mortgage payment, you will be able to take a deduction for the real estate taxes when the mortgage holder pays the taxes to the taxing authority. They are not deductible at the time you make the payments into escrow.

Gain on Sale

One of the most difficult decisions an expatriate must make is what to do with a personal residence while on foreign assignment. You must weigh personal choices, market conditions, employer policies, and tax considerations. The primary options are to sell the home, rent the home, or retain the home without renting.

For sales after May 6, 1997, gain on the sale of a principal residence constitutes taxable income. However, the U.S. grants an exclusion from income for gain up to \$500,000 on the sale of a principal residence if you meet the following conditions:

- You file a joint return with your spouse in the year of the sale
- You have owned the home for two of the last five years prior to the date of the sale
- You have occupied the home as your primary residence for two of the last five years prior to the date of the sale
- During the entire period you have owned the property, it has not been used for business purposes (such as office-in-home) or as a rental property
- You or your spouse have not claimed this exclusion on the sale of another home within two years prior to the date of the sale of the current home

Please note that if any of the conditions above are not met it may still be possible to claim a pro-rated portion of the \$500,000 (\$250,000 if you are filing other than “married filing jointly”) maximum exclusion amount. It may also be possible (depending on your exact circumstances) to fully exclude the entire gain, if the gain is less than \$500,000.

If a taxpayer rents his or her home during a foreign assignment and later sells the home, a portion of the gain can still qualify for the exclusion provided the two out of five year test is met. This may require the expatriate to reoccupy the home to meet the two out of five year test. You should contact your tax advisor regarding home sales after completing a foreign assignment. Note that the gain related to the recapture of depreciation during a rental period cannot be excluded and may be subject to tax at graduated tax rates, with a maximum rate of 25%.

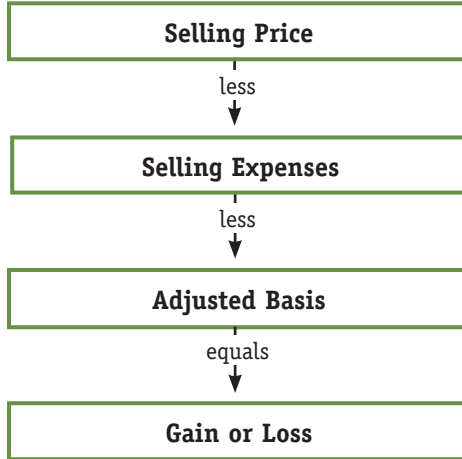
For assignments that will last more than 2 or 3 years, you might consider selling your home near the start of your assignment to avoid the potential loss of the home sale gain exclusion. You should consult a tax advisor before undertaking any large capital transaction.

Loss on Sale

If you have a loss on the sale of a principal residence, it is not deductible for tax purposes. It is considered a personal loss.

Any employer reimbursements for a loss on the sale of your principal residence will be included in your taxable wages on Form W-2.

Calculating the Gain or Loss



Selling Price

Selling price is the total amount you receive for your home. It can include money, notes, mortgages, or other debts assumed by the buyer as part of the sale.

Selling Expenses

Selling expenses are the expenses you incur on the sale of your home. They reduce any gain you may have on the sale. Examples of typical selling expenses are:

- Realtor commissions
- Advertising fees
- Legal fees

Adjusted Basis

Your adjusted basis is used when figuring a gain or loss on the sale of your principal residence. If you buy or build your home, your purchase price is the cost of your home (initial basis). You may add certain items to your initial basis to arrive at your adjusted basis when you sell your home. Improvements, settlement fees, and closing costs are examples of items that increase your adjusted basis.

Recordkeeping

As a result of the laws regarding the exclusion of gain on the sale of your principal residence, you may not need to keep detailed records of every home improvement.

However, at a minimum, you should maintain a copy of your closing statement on the purchase of your home, information on the cost of major improvements, and copies of any previously filed Forms 2119 (e.g., relating to old “roll-over” rules).

Rental of Principal Residence

If you decide to retain and rent your U.S. residence, the rental income must be included in the U.S. tax return on Schedule E. Further, the foreign country may also require you to report the rental income on your foreign income tax return.

For U.S. tax purposes, the rental income may be reduced by deductions such as repairs, depreciation, maintenance, taxes, insurance, interest, and management fees. Note that interest and real estate taxes may have to be allocated between Schedule A (itemized deductions) and Schedule E (rental activities) during tax years when your principal residence is both occupied by you and rented. Only the cost of the U.S. home and improvements may be depreciated (not land) over 27.5 years. Frequently, the rental of a home creates a tax loss that can offset other types of income. Note that losses from rental activities are subject to many limitations including the passive loss rules. The limit for deducting losses from rental real estate is \$25,000 per year. However, the \$25,000 limit may be reduced if your modified adjusted gross income is more than \$100,000 and is completely phased out if your modified adjusted gross income exceeds \$150,000. Disallowed losses can be carried forward and used against future rental income, or are released upon sale of the property.

A taxpayer who rents his or her home during the foreign assignment must consider the effect on the two out of five year test to exclude gain on the sale of the principal residence (see above).

A taxpayer must also consider the effects of the rental activity on tax equalization calculations and foreign tax liabilities. We suggest speaking with your tax advisor regarding these matters.



IN OUR CASE STUDY, Joe and Mary rented out their U.S. home during the foreign assignment. Joe and Mary's 2009 loss from the rental is calculated as follows:

Rental Income	\$22,000
Less: Real Estate Taxes	(5,000)
Less: Interest	(16,667)
Less: Depreciation	<u>(6,250)</u>
Net Rental Loss	<u>\$ (5,917)</u>

Joe and Mary 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.

Alternative Minimum Tax

It is not uncommon for the alternative minimum tax (AMT) to apply to expatriate taxpayers. The AMT is a separate tax calculation from the regular tax calculation discussed throughout this booklet. The purpose of the AMT is to ensure that taxpayers that have substantial itemized deductions, or enjoy other preferential tax treatment, pay at least a minimum amount of federal income tax.

The AMT is only payable if it exceeds a taxpayer's "regular" tax liability. The AMT is calculated by starting with taxable income for regular tax and then adding or subtracting certain preferential tax items. The major preferential items which usually affect expatriate taxpayers include income from incentive stock options, state and local taxes, and real estate taxes. Foreign tax credits are available against AMT.

A full discussion of the AMT is beyond the scope of this booklet. However, if you are a high income taxpayer (taxable income of \$150,000 or more), you should consult with your tax advisor regarding the AMT and its potential effect on your tax situation.



IN OUR CASE STUDY, Joe and Mary are not subject to the AMT.

Exchange Rate Issues

When a U.S. citizen or resident prepares a U.S. tax return, the income and expenses on the tax return must be stated in U.S. dollars regardless of the currency in which the income was earned or the expenses were paid. As such, it is important that a U.S. expatriate track taxable income and deductible expenses that are paid in anything other than U.S. dollars. We recommend tracking the amounts paid in foreign currency and the date paid so that your tax advisor can accurately prepare your U.S. tax returns utilizing the proper exchange rates.

Further, when a U.S. citizen or resident enters into lending arrangements, purchases, sales, or other agreements that are denominated in a currency other than the U.S. dollar, taxable exchange gains or non-deductible exchange losses may result. These taxable gains and non-deductible losses can arise due to changes in the relative value of currencies. You should consult your tax advisor if you enter into a large transaction that is denominated in foreign currency, particularly the purchase of a foreign home and/or mortgage.

Short-Term Versus Long-Term Assignments

Not all U.S. citizens or residents who accept a foreign assignment establish a tax home in a foreign country. In those cases where no foreign tax home exists, the individual is classified for tax purposes as being on a “temporary assignment.” A temporary assignment is defined as an assignment where the tax home (principal place of work or employment) does not change. If the intent of the assignment is to return to the original work location within one year, the assignment is considered a temporary assignment (all other assignments are considered long-term).

In many cases 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 certain other items related to the assignment may not be considered taxable wages to the employee. In the case of a long-term assignment, these items are typically considered taxable wages.

State Taxation

You may continue to be liable for state income taxes as a resident of your former state even though you are living abroad. Whether an expatriate continues to be liable for state income tax during the foreign assignment period varies from state to state. Most states follow a residency or domicile approach to taxation. You should consult with your tax advisor to determine if you are subject to state income tax while on foreign assignment.

Residency Approach

Some states will not tax you as a resident if you do not maintain a residence (home or place to stay) within the state and spend no more than a certain number of days in the state (generally, 183 days).

Domicile Approach

Other states will tax you if you are domiciled within the state. Generally, you have a domicile in a state by living there with no definite intent on moving from the state permanently. Intent is determined based on the facts and circumstances of each individual situation. Additionally, certain states have adopted the approach that your domicile remains in that state until you repatriate and establish domicile in another state. Thus, breaking residency may prove difficult to accomplish.

As a general rule, maintaining a home, business affiliations, social affiliations, bank accounts, driver's license, and voter registration within a state are all factors which may indicate that you still have a domicile in that state. A list of steps that you can take to try to mitigate exposure are detailed below.

State Residency Checklist

Set forth below is a summary of actions you can take to try to break your domicile or residency with a state. Note that the applicable actions may vary by state, and this is only intended to be a general guide.

1. Do not have a home available to you in the former state during the assignment. Either sell your home or lease it to a third-party.
2. Revoke your driver's license. Get a driver's license in another state or country. International drivers licenses are also available.
3. Revoke your voting registration or vote in national elections only.
4. Change your banking relationships to another state.
5. Break as many business relationships as possible in the former state.
6. Break as many social and religious connections as possible in the former state.
7. Do not store all your personal property in your former state.
8. Your spouse and children should not remain in your former state.
9. You should not make political or charitable contributions to organizations in your former state.

10. Your will or other estate documents should not list your former state as your residence.
11. Your doctor and dentist should not be in your former state.
12. Your investments and loans should not be with companies in your former state.
13. Your insurance should not be with a company in your former state.
14. Your accountants and lawyers should not be located in your former state.

The most important factor is the first. However, it is important to reiterate that domicile is based on all of the relevant facts and circumstances.

Part Year State Tax Returns

If you are successfully able to break residency with your former state, you will still have to file a part-year state income tax return for the year when you leave on foreign assignment and the year that you return from assignment. In most states, you allocate your income and deductions to the part of the year when you were considered a resident and are taxed only on these allocated amounts, or if you receive income from real estate situated in that state.

Also, even though you may not be a resident of a state, you may owe tax as a nonresident if you earn wage income for services performed in the state during your foreign assignment.



IN OUR CASE STUDY, Joe and Mary are residents of California through February 28, 2009 and are taxable in California on all income earned up to that date. Also, Joe and Mary may owe California income tax as California nonresidents after February 28, 2009 due to Joe's business trips to California after this date. The rental activity associated with the rental of their home will also have to be reported.

Expatriate Exclusions

If you remain a resident of your state during the foreign assignment, most states follow federal tax law when determining taxable income and allow the FEIE and housing exclusion when determining taxable state income. However, not all states allow deductions for these exclusions.

There may also be other differences between calculating state and federal taxable income including moving expenses and foreign tax credits. You should consult your tax advisor regarding these issues.

State Income Tax Withholding

If you are not a resident of your former state during your foreign assignment, your employer should cease your state income tax withholding. If you remain a resident of your state during your foreign assignment and your employer does not withhold state income taxes, you may need to make estimated state income tax payments. You should consult your tax advisor in this situation.

Sourcing of Income

Up to this point we have not provided much detail on how to determine foreign source income for purposes of the foreign tax credit and foreign earned income and housing exclusions. This chapter will review the sourcing rules for the most common types of income.

Income for Personal Services

This category of income includes wages, salary, bonuses, and deferred compensation such as pensions that are paid by an employer. It also includes fees and other compensation earned by self-employed individuals from services that they perform.

The determining factor for the source of this type of income is **where** the services are performed. Compensation earned for services performed in the United States is considered U.S. source income. Compensation for services performed outside the United States is considered foreign source income. Compensation that relates to services which were performed both within and outside the U.S. is allocated between U.S. and foreign source income by a ratio of relative work days (i.e., time basis).

Certain assignment allowances and fringe benefits may qualify for treatment as wholly foreign sourced income provided certain criteria are met. These include housing (e.g., rent, utilities for gas and electric, personal property insurance, etc.), education, local transportation, non-U.S. tax reimbursements, hazardous or hardship duty pay, and moving expense reimbursements.

The sourcing for stock options and other forms of deferred compensation is complicated and is generally based upon facts and circumstances. Stock option income, for example, is generally allocated on a time basis over the period between date of grant and date of vest.

In order to properly “source” compensation, you must allocate your compensation into its various components. These components include base salary, bonuses, moving expense reimbursements, housing costs, cost-of-living adjustments, etc. After classifying the various compensation components, you must classify each component as to whether it is wholly-U.S. source, wholly-foreign source, or partially U.S. and foreign source. A misclassification may limit your ability to claim the foreign earned income exclusion or foreign tax credit.

Interest Income

The general criteria used to determine the source of interest income is the residence of the payer. Interest which is paid by a U.S. resident, partnership, or corporation is generally deemed to be U.S. source income. Interest paid on obligations issued by the U.S. government or by any political subdivision in the United States such as a state government is also considered to be U.S. source income. Interest paid by a non-U.S. company, partnership or other person is considered foreign source income.

Dividends

Similar to interest, the general criteria for sourcing dividends is the residence of the corporation paying the dividend. If the dividend is paid by a U.S. corporation, the dividend is deemed to be U.S. source income. Conversely, dividends paid by a foreign corporation are deemed to be foreign source income.

Rental and Royalty Income

The source of rentals and royalties depends on the location of the property which generates the payment. If the property is located outside the United States then the rental or royalty payment is deemed to be foreign source income.

Income from the Sale of Personal Property

Income generated from the sale of personal property is sourced according to the residence of the seller. Personal property includes both tangible and intangible property.

Income from the Sale of Real Property

The source of this type of income depends on the location of the property. Gain on the sale of real property which is located in the United States is considered to be U.S. source income irrespective of the residency of the seller. On the other hand, gain from the sale of real property located outside the U.S. will be treated as foreign source income.

Form 5471

“Information Return of U.S. Persons With Respect to Certain Foreign Corporations”

If you are an officer, director, or greater than 5% shareholder in a foreign (non-U.S.) corporation, you may have to file Form 5471 with your individual income tax return. This is an informational form which discloses certain information about the foreign corporation, your relationship to the foreign corporation, and any transactions which occurred between you and the foreign corporation. If you think this requirement might apply to you, check with your tax advisor to determine if disclosure is necessary and what information needs to be disclosed given your specific situation. If required, Form 5471 should be attached to your U.S. individual income tax return.

Passive Foreign Investment Corporations (PFICs)

A Passive Foreign Investment Corporation (PFIC) is a non-US company that derives income from investments (passive income). A PFIC is defined as a company where 75% or more of the company's income is passive, or where more than 50% of the company's assets are in investments earning interest, dividends, and/or capital gains.

A US citizen, green card holder or resident who holds shares in a PFIC is subject to arduous reporting and taxation rules on their share of the income within the PFIC. These rules can be mitigated by making an appropriate election (QEF election). This election enables the individual to report their share of the company's income on a year on year basis. Unfortunately, many foreign companies are unwilling or unable to provide the necessary information to allow the election to be made.

The most commonly seen PFICs are non-US based mutual funds. There will often be a notice on such funds that they are not open to US residents for these very reasons. This does not, however, provide protection for the non-US individual who becomes a US resident after investing in such a fund.

It is beyond the remit of this document to provide a full description of the tax implications of PFICs. If you believe you are invested in a PFIC, you should contact your tax advisor to discuss your options.

4. Social Security and Other Benefits

General Application of Social Security Tax

Expatriates who are employed by a U.S. employer during the foreign assignment generally remain subject to U.S. social security taxes. Social security taxes will continue to be withheld from compensation, including the expatriate allowances and reimbursements that are included in taxable wages.

Expatriates who are employed by a foreign corporation are not subject to U.S. social security taxes (except in rare situations), but are usually subject to social security taxes of the country in which they are working.

If an expatriate is employed by a U.S. employer and is subject to U.S. social security, it is also possible for the expatriate to be subject to foreign social security taxes. The application of foreign social security taxes must be determined on a country-by-country basis. In order to avoid double social security tax obligations, the U.S. has entered into Social Security Totalization Agreements (“Totalization Agreements”) with a number of foreign countries.

Totalization Agreements

Totalization agreements have two principal purposes:

- **Relief from double taxation** - The agreements provide that a taxpayer is subject to social security tax in one of the two countries that are party to the agreement. Generally, if you are employed by a U.S. employer, you will only be subject to U.S. social security tax while on your foreign assignment. In order to claim benefits under a totalization agreement, you must request coverage from the Social Security Administration. Your employer and tax advisors can help with these matters.
- **Coordination of benefits** - The agreements provide that if you pay social security tax in one country but you claim benefits in the other country, then you can count coverage periods in the other country when determining your benefits.

At present, the U.S. has totalization agreements with Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Poland, Portugal, South Korea, Spain, Sweden, Switzerland, and the United Kingdom.

Other Benefits

Expatriates must also consider the effect of their foreign assignment on benefits other than social security. Similar to social security taxes, the determination of the other benefits that apply to you depends primarily on the company for which you work.

Generally, expatriates on assignment will remain on the payroll of a U.S. company so that they can continue to participate in the U.S. benefit plans including 401(k) plans, pension plans, stock option plans, health and dental plans, life insurance, etc. Employers may also supplement health and dental plans to ensure that the expatriate has access to health and dental care in the foreign country.

Note that benefit plans that have tax deferred status in the U.S., such as the 401(k) plan, may be subject to foreign tax on a current basis.

If you are on the payroll of a foreign corporation, you will be subject to the benefit plans of the foreign corporation. These benefit plans may be substantially different than common U.S. benefit plans and could be part of the social security scheme. Most countries will have retirement savings plans similar to the 401(k) plan. These retirement savings plans receive tax advantaged status for tax purposes in the foreign country, but may be taxable in the U.S. on a current basis.

You should consult with your employer to understand the benefits that apply to you while you are on foreign assignment and how such benefits are taxed while on assignment.

5. U.S. Filing Requirements and Administrative Requirements

Income Tax Returns

The U.S. income tax filing requirements for U.S. citizens and residents living or working in foreign countries are similar to the filing requirements before becoming an expatriate. As a U.S. citizen or resident, you are always required to file a U.S. tax return (Form 1040) and report your worldwide income to the Internal Revenue Service (IRS).

However, your U.S. income tax returns will be substantially more complex during your foreign assignment. Most expatriates will need to file the following additional forms and schedules with their Form 1040:

- **Form 2555** - To claim the foreign earned income (FEIE) and housing exclusions.
- **Form 1116** - To claim a foreign tax credit.
- **Schedule E** - To report rental income or loss from the rental of your home.

The location where you file your federal tax return will change while you are on foreign assignment. U.S. citizens or residents who have foreign addresses or who claim the foreign earned income exclusion should file their federal tax return at the following address:

**Internal Revenue Service
Philadelphia, PA 19255**

Keeping a Calendar

One of the most important matters which you need to be aware of during your foreign assignment is keeping track of where you are on each day and whether it is a work, vacation, or other non-work day. As you may have noticed from the discussions of the various tax rules that apply to expatriates, the FEIE and housing exclusion requirements and calculations depend on the number of days spent outside the U.S. Also, the foreign tax credit, and in many cases your foreign tax liability, are determined based on where and how you spent your days. You should keep a calendar and provide the calendar to your tax advisor.

Extensions of Time to File Income Tax Returns

While you are on foreign assignment, you or your tax advisor will most likely extend the time for filing your tax return. Note that as a U.S. expatriate your federal tax return is automatically extended to June 15 of the year following the tax year if you are living outside the United States on the regular due date of your return. Expatriates often file additional extensions beyond June 15 for two reasons:

- Additional time is needed to properly qualify for the foreign earned income and housing exclusions under the physical presence or bona fide residence tests.
- Additional time is needed to accumulate information needed to file the tax returns due to the distance from the U.S.

The following special extensions for filing are available to expatriates:

- **Automatic Extension** - U.S. citizens or residents living abroad on April 15th are granted an automatic extension until June 15th to file their returns and pay any balance due.

Note that if you wait until June 15 to pay all taxes that are due, the IRS will charge interest from April 15 to June 15; however, you will not be subject to late payment or filing penalties.

- **Form 4868** - Automatically extends the filing of the tax return until October 15th. To the extent a taxpayer, who is residing outside the United States needs additional time to file a return, a written request for extension until December 15th may be granted, but only in certain limited situations.
- **Form 2350** - In the year of transfer abroad, you can file Form 2350 which allows you to extend your time for filing until 30 days after you meet the requirements for the bona fide residence or physical presence test. Form 2350 can extend your time for filing until January 30th of the second year following your tax year (this will be necessary if you use the bona fide residence test to qualify).

Most states accept federal extension forms as a valid extension for state income tax filings, but you should check with your tax advisor to ensure compliance with state law.

Late Filing and the Foreign Earned Income Exclusion

The foreign earned income and housing exclusions may only be elected on a timely filed tax return. The exclusion may not be elected on a return that is filed late unless the taxpayer meets one of the following exceptions:

- The taxpayer owes no federal tax after taking into account the exclusion and elects the exclusion either before or after the IRS discovers the failure to elect the exclusion.
- The taxpayer owes federal tax after taking into account the exclusion and elects the exclusion before the IRS discovers the failure to elect the exclusion.
- The taxpayer obtains a ruling from the IRS which allows the taxpayer to claim the exclusion. Obtaining a ruling can be expensive and time consuming.

Withholding Taxes

Every U.S. employer paying wages is required to withhold federal income tax. However, certain exceptions apply to U.S. expatriates:

- Foreign Withholding - Compensation that is subject to foreign income tax is not subject to federal income tax withholding.
- Foreign Earned Income Exclusions - Compensation paid for services performed by an expatriate outside the U.S. are not subject to withholding if the employee files a Form 673 with the employer. Compensation is only exempt from withholding to the extent that the employee can claim the exclusions.
- Foreign Tax Credit - The employee may claim additional withholding allowances for foreign tax credits. The additional allowances may be claimed on Form W-4 which the employee files with the employer.
- No Prior Year Liability - A taxpayer who had no income tax liability for the prior year and expects none in the current year may claim full exemption from withholding on Form W-4.

Expatriates must also consider the need for state income tax withholding. Your employer will usually cease state income tax withholding when you break state residency. However, your employer may withhold state income tax if you spend a substantial amount of time working in the U.S. during your foreign assignment.

Estimated Tax Payments

You may be required to make estimated U.S. tax payments during a foreign assignment. Estimated tax payments may be required in any of the following situations:

- You have substantial investment income, gains from sales, or S corporation or partnership income.
- You are located in a country that has lower tax rates than the U.S.
- The foreign earned income and housing exclusions will not offset all of your income.
- You are subject to alternative minimum tax.

An underpayment penalty based on current statutory interest rates is 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 year U.S. tax liability on a quarterly basis (110% of prior year tax liability if prior year adjusted gross income exceeded \$150,000 or \$75,000 if married filing separate).

Estimated tax payments are made by filing Form 1040-ES on the following dates during the tax year:

- April 15
- June 15
- September 15
- January 15 (of the year following the tax year)

You must also consider the need for state estimated income tax payments if you did not break state residency or if you worked in a state for substantial periods during the tax year, and your employer does not withhold state income taxes. The estimated tax payment rules vary by state.

Bank Account Information

Any U.S. person having an interest in a foreign bank account or other foreign financial account during the year is required to report that interest on Form TD F 90-22.1 by June 30th of the following year. This filing requirement does not apply if the highest aggregate value of all accounts at any time during the year is less than \$10,000. The form is required to be filed with:

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

It is important to comply with this requirement if you are required to do so. Potential penalties for failing to comply can be very severe.

Records Retention

At a minimum, you are required to retain your tax records for three years from the later of the date that your tax returns were filed, or the due date of the returns. Note that some states may impose a longer retention requirement due to a longer statute of limitations requirement. As long as you act in good faith and you do not omit any substantial items (by accident or otherwise), the IRS may not assess additional tax for the tax year after the three-year statute of limitations has expired.

Although the next two situations rarely occur, you should be aware that the retention of records for longer periods may be required. If you omit an amount properly includible in gross income, which is in excess of 25% of the amount of gross income shown on the return, the IRS may assess additional tax any time within six years from the filing

date. Further, if you file a false return, willfully attempt to evade tax, or do not file a tax return, the IRS may assess additional tax at any time (no statute of limitations applies).

Regardless of the IRS rules for record retention, you may want to retain your tax records for longer periods of time for financial or personal reasons. Information supporting the adjusted basis of your principal residence should be retained as long as you own the home and for at least three years after you file your tax return for the year of sale.

6. Foreign Country Taxation

Overview

Once you establish a residence in a foreign country, you will most likely be subject to income tax in the foreign country on all or a portion of your income. Most countries impose income tax on individuals either working in or deriving income from within their borders. As an expatriate, you will want to focus on ways to reduce your foreign tax obligation since you or your company (if you are tax equalized) will derive cost savings from the foreign tax reductions.

You should obtain a basic understanding of the foreign tax system from your foreign tax advisor. Tax laws vary significantly country-by-country and it is beyond the scope of this booklet to discuss the tax law for each country. Instead, this booklet provides an overview of some of the foreign tax concepts that are commonly encountered. We recommend that you meet or speak with your foreign tax advisor so that you can structure your foreign assignment and compensation in a manner that minimizes your foreign tax obligation.

Resident Versus Nonresident Status

In order to determine your foreign country tax situation, you must first determine whether you are considered a resident or nonresident of the foreign country. Generally, foreign countries will tax residents on worldwide income and tax nonresidents only on income earned in such country.

In order to be classified as a nonresident in a foreign country, you will need to limit your contact with the country. This may include spending less than 183 days in such country during the applicable tax year (note that some countries have tax years that differ from the calendar year) and not having a permanent place to live available to you in the foreign country. Nonresident status is usually possible when you take short-term business trips to a foreign country. You may also benefit from tax treaty provisions related to compensation income.

Resident status is usually achieved by spending more than 183 days in the foreign country during a tax year and/or maintaining a home in the country. Most expatriates will become tax residents in their respective country of assignment.

Short-Term Business Trips

Expatriates who are physically present in a foreign country for less than 183 days in a tax year may be able to exclude compensation income from foreign taxation. This exclusion from taxation is available under most tax treaties that the U.S. has executed with foreign countries. In most situations, you must be paid by a U.S. company, you must be a nonresident of the foreign country, and your salary must not be charged to a branch of your employer in the foreign country to claim this treaty benefit. However, the rules can differ depending on the specific tax treaty.

Similar exclusions may be available based on the domestic law in the foreign country in which you are working. In either case, you should consult with your tax advisor to see if you can take advantage of short-term business trip tax benefits.

Tax Treaty Benefits

The U.S. has tax treaties with many countries under which U.S. citizens or residents may be able to receive favorable tax treatment. The purpose of a tax treaty is to ensure that citizens or residents of the two treaty countries are not taxed by both countries on the same income. Tax treaties often provide benefits to expatriates in the following cases:

- Compensation from short-term business trips may be excluded from taxation in the foreign country (see above).
- When the U.S. and the foreign country both consider you a tax resident, treaties outline tie-breaker rules to determine which country can treat you as a resident for tax purposes.
- When you are subject to double taxation, tax treaties may provide full or limited relief in calculating foreign tax credits.
- If you are subject to withholding taxes on passive income, tax treaties can reduce the withholding tax rate.

The U.S. currently has income tax treaties with 65 countries. Your tax advisor can help you with tax treaty planning as part of your assignment planning process.

Foreign Tax Planning Techniques

Although foreign tax planning opportunities vary significantly in each country, there are common techniques used throughout the world to reduce foreign tax. At a minimum, you should explore the following techniques with your foreign tax advisor to ensure you (or your company, if you are tax equalized) pay the lowest foreign tax possible:

- Duration of assignment, arrival and departure dates, and tax treaty protection - By limiting your time in a country or by timing your arrival and departure dates appropriately, you may be able to claim foreign country tax benefits or tax treaty protection.
- Frequent Travel/Employment Contracts - Many countries allow you to exclude or partially exclude compensation income arising from work performed outside such country (your country of residence). Sometimes, you may need a separate employment contract for the work you are performing outside the country.
- Relocation Expenses - In many countries, relocation expenses incurred by you or your employer are deductible for tax purposes.
- Non-cash benefits - In many countries, employer provided housing, cars and other non-cash benefits are not taxed or are only partially taxable.
- Stock options - As a general rule, you will want to carefully consider and plan for exercising stock options while on foreign assignment because the exercise may create taxable income in the foreign country.
- Other gains from sales - You should also carefully consider and plan for selling stock or other assets (such as homes, etc.) while you are a resident of a foreign country. Any gain on the sale of assets may be taxable in the foreign country.

7. Tax Equalization and Tax Protection Policies

Tax Equalization

Tax equalization is a concept designed to protect an expatriate employee from any adverse tax consequences resulting from foreign assignment. Under a typical tax equalization policy, the employer guarantees to the expatriate employee that he or she will pay the same amount of tax while on foreign assignment as the employee would have paid had he or she remained in the U.S. The underlying theory of tax equalization is that the expatriate assignment should be tax neutral (no tax benefit or detriment) to the employee. Many companies establish tax equalization policies so that all employees are treated fairly and consistently. Tax equalization also allows companies to standardize and streamline administrative practices.

Tax equalization policies provide that you pay the company income taxes on the income you would have earned had you stayed in the U.S. (hypothetical income tax). In return, the company will pay all the actual U.S. and foreign income taxes you owe during the foreign assignment. The hypothetical income tax is withheld from your compensation during your assignment. After you file your U.S. tax return, a tax equalization calculation is prepared to determine the final hypothetical tax obligation to the company and the final settlement to or from the company.

Expatriates are subject to a worldwide tax burden during their foreign assignment that is either higher or lower than what they would have paid had they not left the U.S. The reasons for their worldwide tax burden being higher or lower may include:

- Higher tax base - The additional allowances and reimbursements received by expatriates during the foreign assignment increase taxable income for both U.S. and foreign tax purposes.
- Foreign tax rates - Depending on the country, foreign tax rates may be significantly higher or lower than the U.S. tax rates.
- U.S. Expatriate Exclusions - The foreign earned income and housing exclusions reduce the U.S. tax base (regardless of whether the foreign country taxes the expatriate's income).

Mechanics of Tax Equalization

A tax equalization calculation is prepared after the U.S. tax return has been filed for the tax year. The tax equalization calculation is not a tax return, but a tax calculation prepared by your employer (or the employer's tax advisor). The tax equalization calculation only takes into account those items of income and expense that you would have earned or paid had you remained in the U.S. The tax which results from this calculation is compared to the actual taxes that you paid to the tax authorities plus amounts that you paid as "hypothetical withholding" to your employer. The net owed to or from you is generally referred to as the tax equalization settlement.

Note that while you are on foreign assignment your normal U.S. (and sometimes state) tax withholding ceases. However, if you are part of a tax equalization program your employer reduces your pay by "hypothetical withholding." Hypothetical withholding is calculated much like your normal withholding, but is designed so that you and your employer do not have to settle your entire hypothetical tax liability at one time. Generally, your employer will pay all actual U.S. and foreign taxes on your behalf during the foreign assignment.

Many tax equalization policies are similar, but you will want to read your employer's tax equalization policy closely. In particular, you should understand the following points from your tax equalization policy:

- Will my employer tax equalize me to my former state of residence? If not, what is my employer's policy for state taxes?
- How are my itemized deductions calculated in the tax equalization calculation? Expatriates that sell or rent their home should pay particular attention to this matter.
- Does my employer tax equalize all income or just my income earned from employment? There may be policy limits on how much non-compensation income or spousal income can be subjected to tax equalization.
- How does the policy treat rental and/or sale of a home?
- If you receive hardship allowances or foreign service premiums, are such amounts subject to tax equalization?

IN OUR CASE STUDY, Joe and Mary were subject to the following tax equalization settlement after their 2009 U.S. tax returns were filed.

Tax Equalization

<u>INCOME</u>	<u>U.S. TAX RETURN</u>	<u>HYPOTHETICAL INCOME TAX</u>
Base Wages	\$ 120,000	\$ 120,000
Housing	28,000	
Cost-of-Living Allowance	15,000	
Education Expenses	20,000	
Home Leave Trips	20,000	
Taxable Moving Expenses	30,000	
Tax Payments	40,000	
Interest Income	12,000	12,000
Net Rental Loss	(5,917)	(5,917) ⁽³⁾
Disallowed Rental Loss	5,917	
Housing Exclusion	(37,939)	
Foreign Earned Income Exclusion	(76,626)	
Adjusted Gross Income	170,435	126,083
Less: Standard Deduction, or		
Less: Itemized Deductions ⁽²⁾	(12,400)	(13,935) ⁽³⁾
Less: Exemptions	(14,600)	(14,600)
Taxable Income	<u>143,435</u>	<u>97,548</u>
Federal Tax Before Credits	41,945	16,762
Less:		
• Foreign Tax Credit	(28,606)	0
• Child Tax Credit	0	(1,150)
• Making Work Pay Credit	0	(800)
Net Federal Tax Due	13,339	14,812
Net State Tax Due ⁽¹⁾	2,500	5,002
Total Net Taxes Due	<u>15,839</u>	<u>19,814</u>
Taxes Paid:		
• Actual Federal Taxes Paid by Employee	(5,000)	(5,000)
• Actual State Taxes Paid by Employee	(2,500)	(2,500)
• Hypothetical Withholding		<u>(20,000)</u>
Tax Equalization Settlement to Employee		<u>\$ (7,686)</u>
Amount Due to Governments		
(Payable by Company).....	<u>\$ 8,339</u>	

Notes:

1. Employer policy provides for a 5% hypothetical state tax.
2. Employer 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. Phaseouts and limitations, under most policies, are recalculated based on “hypothetical” adjusted gross income; thus, Joe and Mary are allowed the rental losses and actual itemized deductions in the hypothetical income tax calculation.



IN OUR CASE STUDY, ABC Company would owe Joe \$7,686 to settle the final tax equalization obligation. In addition, ABC Company would owe tax payments of \$8,339 with the U.S. tax returns filed by Joe. Note that Joe does not get the benefit of the FEIE, housing exclusion, or foreign tax credit for hypothetical tax purposes. These tax benefits are only available for foreign assignments and not for hypothetical tax purposes. Joe is not considered on foreign assignment in the hypothetical income tax calculation.

Tax Protection

Tax protection policies are very similar to tax equalization policies except for one major difference. If the employee’s worldwide tax burden is less than what he or she would have paid had he or she not gone on foreign assignment, the resulting tax benefit is retained by the employee. Tax protection policies are less common than tax equalization policies.

The mechanics of tax protection policies are also different from tax equalization policies. Generally, employers will not withhold hypothetical withholding from an employee’s wages and the expatriate will pay all U.S. and foreign taxes during the assignment. Then, after the U.S. and foreign tax returns are filed, a tax protection calculation is prepared. If the actual taxes paid by the expatriate are greater than the taxes that the expatriate would have paid had he or she remained in the U.S., the employer will pay the expatriate the difference.

The Final Tax Gross-Up

A final tax gross-up is the final tax settlement between you and the company related to your expatriate assignment. After you physically return to the U.S., your employer may still be paying expenses related to your assignment including moving expenses, foreign tax payments, tax equalization settlements, etc. When your employer makes these

payments, they are considered additional taxable compensation to you. Instead of continuing the tax equalization calculation process, your employer will usually gross-up these payments to reimburse you for the additional U.S. taxes that you will owe on the additional assignment-related compensation. You may want to check with your employer to understand how your company determines the amount of your final tax gross-up.

Your employer should calculate the tax gross-up at the time expenses are paid on your behalf. Instead of giving you a larger pay check, your employer will generally withhold these amounts and deposit them with the tax authorities on your behalf.

8. Exit Interview

Tax Matters Before You Leave the U.S.

- You should complete Form 673 and Form W-4 with the help of your tax advisor. These forms will reduce or stop the withholding of federal income tax during your foreign assignment.
- You should ensure that your employer ceases state income tax withholding (if you break your resident status with the state—see the state residency checklist on Page 36).
- Your employer should complete a “Request for Social Security Certificate of Coverage” so that you are not subject to social security taxes in the foreign country (this assumes you remain on the U.S. payroll and you are assigned to a country that maintains a Social Security Totalization Agreement with the U.S.). Your employer can request a social security certificate at www.ssa.gov/international.
- You should obtain an understanding of how you will be taxed from a U.S. tax perspective, how your company’s tax equalization policy works (a written copy or explanation is best), and an overview of the tax regime in the foreign country.
- You should discuss U.S. and foreign tax planning opportunities with your U.S. and foreign tax advisors. Your U.S. and foreign tax advisors can often help you identify possible U.S. and foreign tax planning opportunities.
- You should discuss time tracking and record keeping during your foreign assignment with your U.S. tax advisor.
- You should also make arrangements to meet or speak with your foreign tax advisors upon arriving in the foreign country.

Tax Information You Should Take on Assignment

While you are on a foreign assignment, you or your tax advisor may need to refer to certain tax documents. You should either take these items with you and keep them in an accessible place or you should provide your U.S. tax advisor with copies of these items before you leave. These documents include:

- Copies of your federal and state tax returns for the prior three years.
- Copies of U.S. social security cards for all members of the family (you should take these with you).
- Records of the cost basis of your home, stocks owned, and other assets that you may sell (or rent) during the foreign assignment.
- Closing statements from the sale of your home.
- Records of all outstanding loans, including the principal balance.

Tax Information You Should Keep During the Foreign Assignment

During the foreign assignment, the task of gathering your tax information will take longer than it did when you resided in the U.S. First, there are a number of special provisions that require additional information to be gathered for your U.S. tax return. Second, you may need additional information to prepare your foreign tax return. In any case, these are some of the items that you will need to track during your foreign assignment:

- Dates of all travel during and after your assignment with a breakdown by business and vacation days (see further discussion below).
- Receipts for all expenses related to your foreign housing costs; including rent, utilities, parking fees, and minor repairs and maintenance.
- Records of all relocation expenses, including those not reimbursed by your employer.
- Receipts or other evidence of foreign income taxes, social security taxes and real estate taxes paid (in many cases your employer will pay these costs).
- Details of any income or deductible expenses earned or paid in a foreign currency. You should note the amount of the payment, currency, and the date received or paid.
- Complete records of all your outside income and related expenses earned or paid during the tax year.

Time Tracking During The Foreign Assignment

Tracking your time during the assignment is one of the most important tasks for you to perform during the assignment because many of the U.S. tax calculations and benefits for expatriates are based upon:

- Your location during each day of your assignment, and
- Whether the day was a work, vacation, or non-work day.

We recommend that you keep a log of all your travels during the assignment.

Try to keep track of these matters on a regular basis to ensure accuracy.

Foreign Tax Matters

We advise that you meet or speak with your foreign tax advisor immediately after your arrival in the foreign country. Your U.S. tax advisor can help you with introductions or your company may already have hired a foreign tax advisor for you. When you meet or speak with your foreign tax advisor, you should come away with answers to the following questions:

- When is my foreign tax return due? Are extensions for filing available?
- Do I need to register with the tax authorities in this country?
If so, obtain a copy of the appropriate form.
- What are the basics of the foreign individual tax system in the country, including income tax rates, etc.?
- Am I subject to social taxes?
- Are there common tax planning techniques that I can use to reduce my foreign tax burden? See page 47 for some ideas.
- What information does the foreign tax advisor need to prepare the foreign tax return? When does the foreign tax advisor need to receive the information?
- If you are married, does your spouse need to file a separate tax return?
- Is my employer required to withhold foreign income taxes from my wages or do I need to make estimated tax payments?
- When my assignment ends, do I need to tell the tax authorities before I leave the country?