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The Expat's Guide to U.S. Taxes

Hands-On Help for Americans Overseas

by JANE A. BRUNO, J.D.

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Table of Contents

1. REPORTING FOREIGN EARNED INCOME 1
- **1.1 Foreign Earned Income Must Be Reported**
- **1.2 Penalty Provisions If You Don't File**
- **1.3 What To Do If You Haven't Filed And Don't Owe Tax**
- **1.4 What To Do If You Haven't Filed And Do Owe Tax**
- **1.5 What To Do If You Haven't Filed, You Owe Tax, And The IRS Knows This**
- **1.6 Use Of Foreign Tax Credit If Can't Use Foreign Earned Income Exclusion**

2. QUALIFYING TO EXCLUDE FOREIGN EARNED INCOME FROM TAX 5
- **2.1 Basic Criteria To Exclude Foreign Earned Income**
- **2.2 Bona Fide Residence Test**
- **2.3 Form 2555, *Foreign Earned Income,* And Bona Fide Residence Test**
- **2.4 Physical Presence Test**
- **2.5 Form 2555, *Foreign Earned Income,* And Physical Presence Test**

3. FOREIGN EARNED INCOME 13
- **3.1 Foreign Earned Income**
- **3.2 More On "Foreign Earned Income"**
- **3.3 Earned vs. Unearned Income**
- **3.4 Miscellaneous Types Of Income**
- **3.5 Property Provided By Employer And Included As Income**
- **3.6 Property Provided By Employer And *Not* Included As Income**
- **3.7 Allowances And Reimbursements By Employer**
- **3.8 Moving Expense Reimbursement**
- **3.9 How To Report Moving Expense Reimbursement That Is Considered Income**

4. CALCULATING HOW MUCH OF THE EXCLUSION TO TAKE 21
- **4.1 You Earn and Receive Less Than $85,700 For 2007 Of Foreign Income For The Tax Year**
- **4.2 You And Your Spouse Both Have Foreign Earned Income**
- **4.3 You Meet The Residency Test But Are Not In A Foreign Country For A Whole Tax Year**
- **4.4 Service In One Year And Payment In The Next**
- **4.5 Exception To Above Rule In Cases Of Year-End Payroll Period**
- **4.6 Income Earned Over More Than One Year**

5. THE FOREIGN HOUSING EXCLUSION/DEDUCTION 25
- **5.1 Housing Exclusion vs. Housing Deduction**
- **5.2 Important Terms**

5.3 Putting It All Together
5.4 Result When All Income Is From Employer
5.5 Example Showing Earned Income Exclusion And Foreign Housing Exclusion
5.6 Result When All Income Is From Self-Employment
5.7 Income From Employer And Self-Employment
5.8 Second Foreign Household
5.9 U.S. Government Allowance
5.10 Married Couples Living Apart
5.11 Married Couples Living Together
SAMPLE TAX FORMS

6. DEDUCTIONS YOU MAY BE ABLE TO TAKE 42
6.1 General Concepts
6.2 Contributions
6.3 Moving Expenses: Initial Concepts
6.4 Moving Expenses You Can Deduct
6.5 Moving Expenses You Cannot Deduct
6.6 Moves From Foreign Country To The U.S.
6.7 Moves From The U.S. To A Foreign Country
6.8 Income Earned In 2-Year Period
6.9 Special Situations And Moving
6.10 Itemized Deduction For Foreign Income Tax
6.11 Deduction For Other Foreign Taxes

7. WHERE AND HOW TO REPORT DEDUCTIONS 50
7.1 Itemized Deductions
7.2 Expenses Allowed In Figuring Adjusted Gross Income
7.3 Examples With Schedule A Deductions And Other Expenses

8. OTHER TAXES YOU MAY OWE BESIDES INCOME TAX 52
81. Social Security And Medicare Taxes (FICA Withholding)
8.2 Binational Social Security Agreements
8.3 Self-Employment Tax

9. TAXES YOU MAY THINK YOU OWE BUT DON'T 56
9.1 Withholding Tax On Paycheck
9.2 30% Flat Rate Withholding

10. THE FOREIGN TAX CREDIT 57
10.1 Basic Propositions
10.2 Source Of Income
10.3 Foreign Taxes For Which You Can Take A Credit
10.4 Credit Is For Taxes Paid Or Accrued
10.5 Foreign Taxes For Which You Cannot Take A Credit
10.6 Foreign Tax Credit vs. Foreign Tax Deduction
10.7 Limits On Foreign Tax Credit
10.8 Categories Of Income

10.9 Calculating The Limit
10.10 Foreign Currency
10.11 Foreign Tax Credit Instead Of The Foreign Earned Income Exclusion
10.12 Miscellaneous Considerations

11. TAX TREATIES 65
11.1 Common Tax Treaty Provisions
11.2 Treaties With Countries That Tax U.S.-Source Income
11.3 Competent Authority Assistance In Cases Of Double Taxation

12. CHOOSING THE EXCLUSION AND WHICH FORM TO USE 68
12.1 Choosing To Take The Foreign Earned Income Exclusion
12.2 Consequences Of Revoking The 2555 Election On Your Tax Return
12.3 Which Form — 2555 or 2555EZ?

13. PENALTIES AND HOW TO AVOID THEM 70
13.1 Penalties Generally Assessed As Percentage Of Tax Owed
13.2 Types Of Penalties
13.3 Penalties Abated For "Reasonable Cause"
13.4 Failure To File Or Late Filing Of Form TD F 90-22.1

14. IMPORTANT MISCELLANEOUS INFORMATION 75
14.1 Where, When, And How To File
14.2 Extensions Of Time For Filing
14.3 Change Of Address
14.4 Claim For Refund
14.5 Payment Of Tax
14.6 Estimated Tax
14.7 W-2—How To Stop Withholding Of Tax
14.8 Foreign Currency
14.9 Employee vs. Independent Contractor
14.10 Compensation Packages
14.11 Tax Equalization And Tax Protection
14.12 Foreign Business/Investments And Information Returns
14.13 Education Tax Credits/Deductions
14.14 Taxation Of Expatriates Who Give Up U.S. Citizenship
14.15 Reporting Of Foreign Accounts

15. RETIREMENT ISSUES 94
15.1 Saving With U.S. Employee Retirement Accounts
15.2 Saving With Non-U.S. Employee Retirement Accounts
15.3 Saving With Individual Retirement Accounts
15.4 Retirement Saving With Annuities
15.5 Taxation Of Retirement Income

16. RULES RELATING TO A PRINCIPAL RESIDENCE 98
16.1 Home Ownership While Living Overseas
16.2 Gain Exclusion On Sale Of Home
16.3 Use Of Home As Principal Residence For 2 Years Out Of 5

16.4 Exceptions To 2-Years-Out-Of-5 Rule
16.5 Tax On Depreciation
16.6 Over-55 Exclusion Eliminated

17. NONRESIDENT ALIEN SPOUSE TAX IMPLICATIONS 104
17.1 Treating Your Nonresident Alien Spouse As A U.S. Resident
17.2 Not Treating Your Nonresident Alien Spouse As U.S. Resident
17.3 How To Make The Choice
17.4 Ending The Choice
17.5 Death Of A U.S. Citizen With A Foreign Spouse
17.6 Transfers Or Gifts To Nonresident Alien Spouse

18. U.S. STATE TAXATION OF FOREIGN INCOME 107
18.1 Domicile
18.2 Residence
18.3 Tax Consequences Of "Domicile" And "Residence"
18.4 States With No Income Tax
18.5 States Where You Can Be Domiciled But Not Pay State Income Tax
18.6 States Where Domicile Equals Tax Liability

IRS INFORMATION 118
Addresses And Contacts
IRS Table: Limits On Housing Expenses List

CHAPTER 1

Reporting Foreign Earned Income

(and Solutions to the Problem if You Haven't Done So)

1.1 Foreign Earned Income Must Be Reported

The purpose of this book is to educate you about your U.S. tax responsibilities while you live overseas. If you are contemplating such a move or have already relocated, you may be aware that foreign income is not subject to U.S. tax if you meet certain specific time requirements outside the U.S. It then seems reasonable to conclude that if the income is not taxable, you don't need to file a U.S. tax return. Unfortunately, this is not the case for U.S citizens and residents. So, before you go any further, please read and understand the following basic principles:

1 If you are a U.S. citizen or resident alien, you are subject to U.S. income tax on your income, regardless of where you are living or where you received the income.

2 The fact that you are not living in the U.S. does not give you a break from tax return filing requirements. Your foreign salary clearly puts you in the category of those required to file — whether you owe tax and how much is another issue.

> **TAX TIP! EXCEPTION TO NO. 1 AND NO. 2:** If you earn less than amounts ranging from $8,950 to more than $20,000 (depending on age, marital status, number of dependents, etc. for 2008) you are not required to file a federal tax return at all because all of your income is offset by the standard deduction and personal exemptions. Most Americans living and working overseas do not fall into this category.

3 The only way to qualify to exclude the foreign income from U.S. tax is to FILE A TAX RETURN AND CLAIM THE FOREIGN EARNED INCOME EXCLUSION. Later chapters will elaborate on the details of doing this.

CONCLUSION: You may not have thought much about it, but the foreign earned income exclusion is one of the biggest tax savings you are ever likely to see. Consider that you would pay tax at a marginal rate of roughly 30% on the maximum exclusion of $87,600 for 2008. It is possible to pay $0 tax on that income for as many years as you choose to live out of the U.S. by meeting certain time requirements for being outside the U.S. and filing the correct IRS forms.

Imagine what a large tax savings you can achieve! It makes sense to file your federal tax return so that you can cash in on these savings, and at the same time, know that you have done your American duty!

NOTE: Under the tax law signed by President Bush in May 2006, the value of the foreign income exclusion has been diluted somewhat. The extent of the impact of this law depends a great deal on the particular circumstances of the taxpayer living overseas, BUT if you have income in addition to foreign earned income — such as dividends, interest, or a spouse earning income not eligible for the foreign exclusion (such as U.S. government employees) — and/or your income exceeds the exclusion amount of $87,600, the big change for you is that now your additional income is taxed at a marginal rate that INCLUDES the otherwise-excluded income. In effect, your tax rate on that income went from around 10-15% to nearly 30% overnight!

A simple example may help illustrate this:

Suppose Mr. Taxpayer has $85,000 of foreign income and is reimbursed $4,000 a month for his housing. (In this example, Mr. T. lives in a location where there is no adjustment for high housing costs. The IRS acknowledges cost-of-living differences and does allow a higher housing exclusion in some places.) His total income is $133,000 ($85,000 + $48,000). Under the old law, in effect in 2005, Mr. T. could exclude $80,000 in income and $36,106 in housing expense ($48,000 - $11,894 (the base housing amount in 2005)) for a total of $116,106.

Under the new law, same facts, Mr. T. could exclude $87,600 in income and $12,264 in housing exclusion (30% of $87,600 or $26,280 - 16% of $87,600 or $14,016) for a total of $99,864. This means Mr. T. will have to report an additional $16,242 in taxable income.

Under the old law, Mr. T. was subject to tax on $16,894 (the difference between $133,000 and $116,106). His marginal rate would be that of a taxpayer with $16,894 of income (around 10.6% for married, filing jointly). **Under the new law, Mr. T. would be taxed on $33,136 of income (the difference between $133,000 and $99,864) and that income would be taxed at the marginal rate of a $133,000 income taxpayer (around 28%).**

1.2 Penalty Provisions If You Don't File

NON-FILING PENALTY: The IRS is likely to get upset if it feels you should have filed and didn't. The array of weapons in its penalty arsenal include a non-filing penalty, a late filing penalty, and an underpayment penalty, in addition to interest on amounts due. Fortunately, these penalties are only imposed on amounts due — so if no tax is due, no penalty can accumulate. *(See Chapter 13, **Penalties And How To Avoid Them**, for more details).*

STATUTE OF LIMITATIONS: Before you get too complacent because you don't believe you owe tax, you need to realize there is **NO** Statute of Limitations (that is, there is not time beyond which the IRS can't legally pursue you to collect tax) in cases where a tax return is not filed. This means, in theory, that no matter when the IRS discovers you did not file a tax return, it can come after you to collect if it thinks you owe tax.

1.3 What To Do If You Haven't Filed And Don't Owe Tax

If you haven't reported foreign earned income for several years, the most important thing to do is to get back on track by filing those prior year returns as soon as possible. Fortunately, under a Treasury Decision issued in 1993, the exclusion is allowed for any tax year no matter when you file so long as no tax is owed. **If you plan to take advantage of this rule, you must put at the top of each Form 1040 the words: "FILED PURSUANT TO SEC. 1.911-7(a)(2)(i)(D).**"

Following this simple instruction allows you to get yourself back in the good graces of the IRS, probably without owing it a cent!

1.4 What To Do If You Haven't Filed And Do Owe Tax

If it turns out you owe tax, you can still file and take advantage of the exclusion so long as you do so *before* the IRS discovers you did not file in a timely fashion in the first place. Let's say, for example, that you earned $90,000 of foreign income in 2004 and never filed a tax return to report that money. You haven't heard anything from the IRS in years. What you need to do is file for 2004, keeping in mind the necessity of putting the magic words "Filed Pursuant to Sec. 1.911-7(a)(2)(i)(D)" at the top of the Form 1040. You will be able to exclude $80,000 of your income from U.S. tax (assuming you met the foreign residency requirements). The remaining $10,000 will be taxable so you have to calculate the amount due and send a check. You will almost certainly be assessed interest and some penalties on the amount due, but the IRS will calculate those amounts and send you a bill. Whatever the amount it is, you can be quite sure it will be considerably less than what you would have owed if you were taxed on the full $90,000.

Furthermore, the IRS is making a special effort to help people get back on track tax-wise. If you find you cannot immediately pay all the tax due, you can request to make payments under an installment agreement (*Use Form 9465, **Installment Agreement Request***). You can also seek to have penalties dropped because of special circumstances such as a death in the family or loss of financial records that may have caused you not to file. (*See Chapter 12 on **Penalties** for more details on abating penalties*.)

TAX TIP! If you are wondering how many years back to file, the rule of thumb is to begin by filing the current year's return and the preceding three years. If a tax liability is incurred for one of those years, then you should file for an additional two prior years (or a total of six years).

1.5 What To Do If You Haven't Filed, You Owe Tax And The IRS Knows This

If you didn't file on time and you owe money and the IRS discovers these facts, you can file, and pay the tax, penalties and interest or … you have the option of seeking a Private Letter Ruling wherein you ask the IRS to give you relief from the requirement to file on time because you had a good reason for not filing. Giving the excuse that "the dog ate my return" probably won't work, but if you can show that the return was so complex and/or the instructions so unclear that you could not figure out how to prepare the return, you may be able to convince the IRS to allow you to file late and still claim the foreign earned income exclusion.

The down side to this whole process is that the fee for a Private Letter Ruling is $500 if your income is less than $150,000 and $2,500 if your income exceeds $150,000. This amount goes to the IRS and, in addition, it is recommended that you retain a professional tax advisor to prepare the request for a Private Letter Ruling which further adds to the cost. Finally, there is no guarantee the ruling will be in your favor so you may end up having to pay the tax plus accrued interest and penalties in any case.

1.6 Use Of Foreign Tax Credit If Can't Use Foreign Earned Income Exclusion

You should be aware of an important alternative to the foreign earned income exclusion. If you pay income tax to a foreign country, in many cases that tax can be used as a direct credit against U.S. tax liability. Thus, if you find yourself in a situation where you haven't filed a U.S. tax return within the accepted filing time, you owe money, the IRS knows this, and you don't have a good reason for not filing — you very likely will *not* be permitted to exclude the foreign income from U.S. tax. This could result in a very large tax bill. But before you give in to despair, ask yourself (or the accountant who handles your affairs in the foreign country) if you have paid foreign tax on that income. If the answer is "yes", you may be able to apply a foreign tax credit against your U.S liability. In this situation, the credit will be used instead of the exclusion, but it will have the same effect of reducing your U.S. tax liability.

(See Chapter 10, ***The Foreign Tax Credit,*** *for more details).*

> **NOTE:** In some cases, a large foreign tax credit will trigger the Alternative Minimum Tax, a very complicated tax indeed. If you have a significant amount of foreign tax credit you wish to take, you should consult a tax professional to see if this tax applies.

CHAPTER 2

Qualifying To Exclude Foreign Earned Income From Tax

The foremost question in your mind at this point is whether you can take the foreign earned income exclusion? You already know you have to file a tax return, but that prospect is not so bad if you don't actually have to pay any tax!

2.1 Basic Criteria To Exclude Foreign Earned Income

1 **Earned income must be received for services performed in a foreign country. Earned income**" in this context is *pay for personal services performed in a foreign country*. It includes such sources of income as wages, salary and professional fees. A more comprehensive look at what qualifies as "foreign earned income" is presented in Chapter 3, ***Foreign Earned Income.*** However, you should realize it ***does not*** include pay received as a direct hire employee of the U.S. government or its agencies. This includes Armed Forces exchanges, officers' messes and State Department commissaries or State Department Employee Associations. On the other hand, if you are an *independent contractor* of the U.S. government, you may very well be able to exclude income you earn overseas working for the U.S. government. *(See section 14.9 in Chapter 14, **Important Miscellaneous Information**, on Independent Contractors).*

2 **Your tax home must be in a foreign country**. Your **"tax home**" is generally the place where you have your main place of business or employment. The focus here is on where you are permanently or indefinitely engaged to work, and is not necessarily the place that you consider your residence. This can be pretty confusing and the IRS does little to clear up the matter in its discussion of "tax home" in its publications. Before we go any further in an effort to understand "tax home", there are some terms that need to be defined:

abode: This term is defined by the IRS as one's home, residence, or place of dwelling. It is used in the sense of where you have domestic ties, rather than business ties. It does not have the same meaning as "tax home" for that reason, **but** you cannot have a *tax home* in a foreign country **if** you have an *abode* in the U.S. This seems to directly contradict the statement above that your tax home and residence do not have to be in the same place. However, the distinction can be seen in one of the examples used by the IRS in Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.* In the example, you are sent overseas by your employer for a period in excess of a year. You pack up the family and move them with you, but you keep your home in the U.S. and rent it to another family. You put all your belongings in storage. Once you are in the foreign country, you and your family establish ties there such as opening bank accounts, getting library cards, joining local clubs, etc. You are considered by the IRS to have your "abode" and your "tax home" in the foreign country even though you have retained your residence in the U.S. and will move back to it when your overseas assignment is finished.

indefinite assignment: The key here is how long you expect your assignment overseas to last. If you expect it to last for **more than one** year **or** the assignment is not for a specified period, it is an **"indefinite assignment**". In either of these cases, the new place of employment becomes your tax home (assuming your "abode" is not in the U.S.).

temporary assignment: If you expect your overseas assignment to last one year or less, and that actually happens, your assignment is considered temporary, unless facts or circumstances indicate otherwise. Unfortunately, the IRS doesn't give us any hints as to what those facts or circumstances might be. However, the tax consequences of having an indefinite versus a temporary assignment can be quite significant. This is because a **"temporary assignment**" overseas means you have not changed your tax home to a foreign country and thus cannot qualify to exclude foreign earned income from U.S. tax. However, you ***are*** able to deduct your expenses while away from home, including travel, food and lodging. For an extended stay overseas, these amounts can add up and take a significant chunk out of your taxable income in the form of legitimate business expense deductions. AND, if you pay foreign tax on your foreign income, you can still take the foreign tax credit. (See Chapter 10, Foreign Tax Credit.)

SUMMARY: Let's take a moment to re-cap the important elements of **"tax home**" and hopefully clear up any lingering questions. In order to have your **"tax home"** in a foreign country, you must have your main place of work or business in the foreign country, your **abode** must be outside of the U.S., and you must have an **indefinite assignment** to the foreign country that is for an indefinite period or that you expect to last for more than one year.

3 **Residency Tests:** If your tax home is in a foreign country, you must also meet either (a) **the bona fide residence test** or (b) **the physical presence test.** These two tests are quite different in their underlying rationales. The **bona fide residence** test requires that you establish "residence" in a foreign country and that determination will depend on the specific circumstances of your case, including your intention and the purpose of your stay. The **physical presence test**, on the other hand, is a test only of how many days you are physically present in a foreign country.

You may wonder which test you should "try" to meet. So long as you meet one or the other, it doesn't matter a bit. They are both riddled with exceptions and complications so, in the end, you may just be relieved that you qualify at all. Your individual situation will probably go a long way in determining which test works for you. The following explanations of the bona fide residence and physical presence tests will start with the basics and go on to outline some of the finer points that may apply to you.

4 **Residency Requirements for Married Couples Filing Jointly:** If you are married filing jointly, only the foreign wage earning spouse needs to meet the above criteria. Thus, for example, if the working spouse qualifies under the physical presence test, the non-working

spouse does **not** have to meet those same requirements for living out of the U.S. for 330 days in 12 consecutive months, but is free to come and go as he/she pleases.

2.2 Bona Fide Residence Test

SIMPLE DESCRIPTION: To qualify for the bona fide residence test, you must reside in a foreign country for an uninterrupted period that includes an entire tax year.

This sounds easy enough, but as you know by now, simple rules can generate volumes of explanatory text. The key words here are “bona fide residence”, “foreign country”, “uninterrupted period”, and “entire tax year” (which includes just about everything but prepositions and commas).

BONA FIDE RESIDENCE: To qualify as a bona fide resident, the IRS will look at the particular facts of your case, taking into account such things as your intention or the purpose of your trip as well as the nature and length of your stay abroad. It seems pretty obvious that the length will have to be at least one year since the definition of “bona fide residence” includes that time period. It also is quite apparent that you must be present in the foreign country with some business purpose (i.e., you are doing something that generates income) since you may only qualify to exclude foreign earned income for services performed. Thus, for example, you could not go to France as a tourist for a year and try to claim an exclusion for interest income earned on money you deposited in a French bank.

The IRS will make the ultimate determination whether you qualify as a bona fide resident for purposes of the earned income exclusion. It will base much of its decision on information you supply on Form 2555, *Foreign Earned Income*, that will be filed with your Form 1040. This form will be considered in detail later.

Bona Fide Residence NOT Inconsistent with Ties to U.S.

This rule does not require that you abandon all ties to the U.S. You may, in fact, retain your domicile in the U.S. (which is the place you consider your permanent home and to which you intend to return) and still have a bona fide residence in another country. It is only necessary that you plan to stay for an indefinite or extended period in the foreign location and that you actually set up permanent quarters there, as in the example cited in the discussion on tax home in Section 2.1(2).

You also do not lose the right to vote by absentee ballot in any U.S. elections just because you are considered a bona fide resident of a foreign country. (Just be sure answers to questions asked by local election officials are consistent with those given on Form 2555.)

Statement to Foreign Country

If you make a statement to authorities in a foreign country that you are not a bona fide resident of that country and, thereby, can avoid paying tax in that country, you will **not** be considered a bona

fide resident of that foreign country by the IRS Basically this means you **cannot** play both sides of the fence and only be a bona fide resident if and when it affords some tax advantage. On the other hand, being a bona fide resident of another country does not necessarily subject you to income tax in that country. It is entirely possible to be a bona fide resident of a foreign country, not pay income tax to that country and still take the foreign earned income exclusion.

Tax Treaties and Special Agreements

Some tax treaties the U.S. has with other countries and special international agreements (e.g., the North Atlantic Treaty Status of Forces Agreement, the Treaty of Mutual Cooperation and Security between the U.S. and Japan, etc.) have specific language about income tax exemption for various persons covered by the treaty/agreement. However, this does not mean you will automatically lose bona fide residence status. You will need to look at **all** the provisions of the treaty to make that determination. Thus, for example, if you are working as an official for the United Nations in Switzerland, you would be exempt from Swiss tax on your income by virtue of the agreement the U.N. has with Switzerland. However, you could still be considered a bona fide resident of Switzerland for purposes of the foreign earned income exclusion.

FOREIGN COUNTRY: A foreign country is any territory (including air space and territorial waters) under the sovereignty of a government other than the United States. The term does not include Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, the Virgin Islands, and U.S. possessions such as American Samoa. It also does not include the Antarctic region (and probably the space shuttle, though it hasn't been tested yet!)

> **NOTE:** Special rules apply to U.S. possessions and territories, including **Puerto Rico, the Virgin Islands, American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, and several other islands.** You should consult IRS Publication 570, *Tax Guide for Individuals with Income from U.S. Possessions*, for more information on how you will be taxed if you have income and/or are resident in one of these places.

UNINTERRUPTED PERIOD: The news here is not as grim as it might sound. It is not required that you stay put in the foreign country that you are trying to establish as your bona fide residence for the entire 365 days of your tax year. You may leave the foreign country to visit the U.S. or other countries for brief or temporary trips involving business or pleasure so long as you intend to return from those trips and do, in fact, return.

ENTIRE TAX YEAR: If you file your tax return on a calendar year basis (which most individuals do), then you must be in the foreign country as a bona fide resident from January 1 to December 31 for one year to take the foreign earned income exclusion.

Part-year situations: Once you are established as a bona fide resident, that status will be good for following years, even if you leave before December 31st in the last year of residence. Thus, for example, if you are a bona fide resident of England for all of 2006 and 2007, and you leave on July 1 of 2008, you will be considered a bona fide resident of England for 2008 tax purposes from January 1, 2008 through June 30, 2008. This will mean that you can take a pro rata share of the foreign

earned income exclusion for the part of the year that you are considered a bona fide resident because you had established your bona fide residence in 2006 and 2007.

Breaks in assignments: If your employer moves you around a lot, it is likely that you will have to move from one foreign post to another in the same tax year. Whether this will defeat your ability to claim bona fide foreign residence will depend on the facts of your particular situation. Generally, if the effect of the change in assignment is to move you directly from one foreign location to another, you will not lose bona fide residence status even if you take some time to go back to the U.S. (for vacation, business, etc.).

EXCEPTIONS: No rule is complete without its exceptions and there are two that apply here. **Note** that these exceptions also apply to the physical presence test (which will be described shortly).

Waiver of Time Requirements: This is in the "good news" category if you are unfortunate enough to be assigned to an unstable spot. If you must leave a country because of war, civil unrest or similar adverse conditions, the minimum time requirements of the bona fide residence or physical presence tests may be waived. It is only necessary to show that you could reasonably have been expected to meet the requirements otherwise.

To make it easy for you, the IRS has determined where sufficiently adverse conditions exist to permit a waiver and during what periods of time. A complete listing can be found in the *Internal Revenue Bulletin* at: www.irs.gov. The list is updated periodically.

Travel Restrictions: The flip side of this coin is that certain countries are off-limits to U.S. citizens. If you are present in those countries, you cannot qualify as a bona fide resident (or be considered "physically present" for tax purposes), and income earned there does not qualify as foreign earned income.

The country currently on the list is: **Cuba**. (This restriction does not apply to individuals working at the U.S. Naval Base at Guantanamo Bay.)

2.3 Form 2555, *Foreign Earned Income,* And Bona Fide Residence Test

Now that you have the theory, it is important to understand what information you are actually asked to give when you prepare the Form 2555. If you take a look at Form 2555, Part II, *Taxpayers Qualifying Under Bona Fide Residence Test* (www.irs.gov has the form if you can't get it elsewhere), you must tell the IRS when your residence began and ended (to satisfy the calendar year test). You must also tell about your living situation — what type of housing you have and who in your family lives with you (to determine if your abode is in the foreign country). You must indicate whether you claim to be a resident as far as the foreign government is concerned

and whether you pay foreign taxes (so you don't try to claim foreign residency for U.S. purposes, but not for the foreign country's purposes).

In the middle of Part II, you are asked to list dates you were in the U.S. and income earned while in the U.S. on business. This income will be taxed by the U.S. and does not qualify for the foreign earned income exclusion. If you receive a salary and traveled to the U.S. to perform work for your employer, you will need to determine what you are paid on a daily basis and multiply that by the number of days in the U.S. on business to get a figure for the amount earned in the U.S.

Finally, you are asked to list contractual terms relating to the length of your overseas employment as well as questions about the type of visa you have in order to work in the foreign country. The final question is whether you maintain a home in the U.S. These questions, obviously, are to determine the type of assignment you have in the foreign country — indefinite or temporary.

2.4 Physical Presence Test

For some people, meeting the physical presence test will seem a more straightforward proposition than the bona fide residence test. It may seem especially appealing if you aren't quite sure what your "intent" is yet, or you're not ready to approach the foreign government concerning your residency (and the likely resulting foreign government taxes). To help you decide, this discussion presents the pros and cons of the physical presence test:

DEFINITION: To meet the physical presence test, you must be physically present in a foreign country or countries for at least 330 full days during a period of 12 consecutive months.

As with the other test, you probably have more questions. The following explanations should help:

Physically present: This term basically means that the test is only concerned with how long you are in a foreign country or countries. It is not interested in the purpose for your stay abroad or your intention of returning to the U.S.

330 full days during a period of 12 consecutive months: The simplest part of this phrase is that the 12 months can be any consecutive 12 months even if they do not constitute a calendar year. From there, things can get complicated.

Full day: A full day is a period of 24 hours in a row, beginning at midnight. The full days must be spent in the foreign country — and traveling over international waters does not count. This means, for example, that when you fly to Italy to start your new job and leave the U.S. at 9 p.m. on August 4th, you will almost certainly be over international waters at 12 a.m. of August 5th. Assuming you arrive in Italy the morning of August 5th, you still cannot count your first full day in Italy until August 6th.

WHAT IFS:
Foreign country before midnight: If you leave the U.S. and pass over a foreign country before midnight of that departure day, the first day you will count as a "full day" is the day following your departure day. The fact that you passed over the foreign country at midnight lets you count that day as a "full day".

Travel between foreign countries: You can travel in a foreign country or between foreign countries without losing "full days" so long as the travel does not take you out of a foreign country for more than 24 hours. This would typically happen if you traveled by boat from one country to another and the trip took more than 24 hours. You would lose as "full days" any of the days you were on the water.

Presence in U.S.: If you are traveling between two foreign locations and happen to be in the U.S. for less than 24 hours, you are not treated as present in the U.S. for that time.

12 consecutive months: There is great flexibility in choosing the 12 months for which to claim the exclusion. You do not have to start with the day you arrive in the foreign country and end with the day you leave. Typically the 12 months will be selected that give you the greatest income exclusion. Thus, for example, if you spend 22 months in a foreign country, but the first and last months involve lots of travel to the U.S., the 330 qualifying days (and corresponding 12 months) may come in the middle of your stay.

You can also overlap 12-month periods: This usually will be necessary when you have interrupted your foreign stay with visits to the U.S. Suppose, for example, you worked in Ireland from January 1, 2007 through August 31, 2008, but you spent May of 2007 and April of 2008 in the U.S. You could use January 1, 2007 through December 31, 2007, as one 12-month qualifying period. The other qualifying period could be September 1, 2007 through August 31, 2008, even though it overlapped with the first 12-month period.

EXCEPTIONS TO RULE:

The Good News: As explained before, you may be able to claim an exception to the physical presence test if you must leave the country because of war or civil unrest.

The Bad News: If you must leave the country because of **illness** or **the job ends** or your **employer orders you to** and you have not met the time requirements, you **cannot** qualify under the physical presence test.

2.5 Form 2555, *Foreign Earned Income,* And Physical Presence Test

The questions you have to answer in Part III, *Taxpayers Qualifying Under Physical Presence Test*,

of Form 2555 are short and sweet. You simply have to give: (a) the 12-month period you use to qualify, (b) the country where you were employed, and (c) dates of travel to other countries, including the U.S., during the 12-month period. As in the bona fide residence test, any income earned while in the U.S. on business is not allowed to be excluded from U.S. tax. If, for example, you were in the U.S. for 2 weeks on business and earned $2,000, that should be shown on Line 7 of Form 1040 (where your salary and/or wages are reported), but that $2,000 would not be treated as foreign earned income. However, that income would be shown on Line 18 of Form 2555 as income earned in the U.S.

CHAPTER 3

Foreign Earned Income

Thus far you have learned enough to determine whether you qualify to exempt foreign earned income from federal income tax. Having survived that maze of possibilities and exceptions, you would like nothing more than to heave a sigh of relief, respond in the affirmative that you qualify, and file for your exclusion. Unfortunately, as you may have guessed, nothing with the IRS is that easy. The issue now becomes what and how much of your income qualifies as foreign earned income for purposes of the exclusion.

3.1 Foreign Earned Income

The simple definition is that this is income you receive for services you perform in a foreign country during a period that your tax home is in a foreign country and you meet either the bona fide residence or physical presence test. This income can be received in a number of forms outside of the traditional paycheck and includes any and all of the following:

- **Salaries and wages**
- **Commissions**
- **Bonuses**
- **Professional fees**
- **Tips**
- **The fair market value of property or facilities provided by employer for lodging, meals, car and other items**
- **Allowances or reimbursements for cost of living, overseas differential, family expenses, education, home leave, quarters, moving and other miscellaneous expenses**

Each of the listed possibilities comes with its own set of conditions and exceptions. Tedious as it may be, you should skim the following explanations in case something applies to you.

3.2 More on "Foreign Earned Income"

Foreign Income: To qualify as "foreign", the income has to be earned for personal services performed in a foreign country. It doesn't matter where or how you are paid for those services. Therefore, even if your employer is an American company and deposits your paycheck into an American bank, your income will qualify as "foreign" so long as the work you do is performed in a foreign country. The major exception, as stated in Chapter 1, is that American government employees **do not qualify** to exclude their income from U.S. tax even if it is earned overseas.

You may be faced with the sticky issue of what to do when some of your work is done in the U.S. and some in the foreign country. If you are able to apportion the work on some logical basis, you will need to report the U.S.-portion as U.S.-source income subject to tax while the rest is foreign-source income and thus eligible for the exclusion.

If all else fails, the income is best apportioned on a time-basis wherein you calculate the number of days worked in the U.S. and the number of days worked in the foreign country in the tax year in question. You then create two fractions: one being **U.S. work days/total work days** and the other being **foreign work days/total work days**. You now multiply the total income by each fraction to get U.S.-income and foreign-income respectively.

3.3 Earned vs. Unearned Income

This seemingly simple concept has a number of twists and turns that can become important for purposes of the exclusion (i.e., you can't exclude the unearned income!). Generally, if you think about it at all, you think of "earned" income as being wages, tips, commissions, etc., and "unearned" income as being dividends, interest, etc. Problems arise when you have a sole proprietorship, a partnership, or a corporation that gives out stock options. In those cases, the lines blur, so the IRS has developed a whole series of "tests" to help you decide what kind of income you have.

Sole Proprietor or Partnership: If you operate a small business in a foreign country (or anywhere else for that matter), you will usually have two elements that go into producing income: capital investment and your personal service. As a general proposition, if capital investment is an important part of producing the income, that income is considered "unearned". However, in deference to hard-working sole proprietors and partners, the IRS will let you treat part of the income as "earned" if your personal services are also an important part of the production of income. The **rule of thumb** is: you cannot count as "earned income" more than the smaller of these two items: **(1) the value of your personal service to the business, or (2) 30% of your share of net profits in the business.**

In plain English, this means you can't count more than 30% of your share of profits as "earned" income if capital **and** personal services go into producing the income. As you can imagine, there are as many possibilities for allocating the income as there are businesses, but some examples on either end of the spectrum may help clarify things.

Example with all income allocated to capital: Suppose you live in Germany and qualify under the physical presence test. You become a partner in a partnership producing bratwurst, but you perform no services for the partnership. Your entire share of profits at the end of the year is unearned income and thus not eligible for the exclusion.

Example with no income allocated to capital: Suppose this time that you and your friend have a partnership as tax consultants and live in London as bona fide residents. Since all of the income is from personal services and none is derived from capital, all the gross income from the

partnership is considered earned income.

Example with service portion being less than 30%: In this case, let's imagine you have a partnership in Budapest to manufacture canned goulash. Your share of the net profits is $90,000 for the year. You might think you automatically qualify to take one-third or $30,000 of that as earned income. However, let's also imagine you have several other businesses and can only devote a small amount of your time to the goulash business — amounting to $10,000 worth of services. In that case, your earned income will be limited to the value of your services or $10,000.

Example with net loss: This time around you gambled on the wrong idea and started a partnership to sell woolen socks in South Africa. You did have a gross profit but it was offset by losses, leaving you in a net loss situation. In that case, you will consider as earned income that part of the gross profit that represents a reasonable amount for personal services actually rendered. The 30% limit does not apply.

Corporation: The big question that has to be answered with regard to corporations is whether the salary received is reasonable compensation for the services performed. Any amount over what is considered a reasonable salary is not earned income. This situation would most often arise if you were an officer of a corporation and received a "salary", but do little or no work in connection with your office.

Stock Options*:* This area of the tax law is fairly complicated and may cause your eyes to glaze over just at the thought. Suffice it to say that there are situations where disposing of a stock that you got by exercising a stock option granted under an employee stock purchase plan could generate earned income (the other possibility being treating the gain as capital gain). If you end up having to treat the gain as earned income, any part of the gain that is due to services you performed outside the U.S. will be considered foreign earned income. It is recommended you consult your tax professional if you have questions in this area.

3.4 Miscellaneous Types Of Income

Pensions and annuities: This is easy, unfortunately — pensions and annuities **do not qualify** as earned income for purposes of the exclusion.

Royalties: Generally speaking royalties for writers are earned income (assuming the royalty is for a property right you transferred in your product or you are under a contract to write). Royalties from patents and the leasing of oil and mineral lands are not earned income.

Artist's income: You should treat this income as "earned" so long as you created the art yourself.

Rental income: In most cases, rental income is considered "unearned". However, if you can show you performed personal services in connection with generating the income, you can take up to 30% of net rental income as "earned" income.

3.5 Property Provided By Employer And Included As Income

If your employer supplies you with various "perks", such as a house, an automobile, meals, etc., you will in **most cases** be required to include the fair market value of those facilities or property of the employer that you are using as earned income. However, in cases where your employer either provides you with housing or makes payments to a third party for your housing, it is important to realize that you can take the **"foreign housing exclusion**". This exclusion is discussed more thoroughly in Chapter 5, ***The Foreign Housing Exclusion/Deduction.***

> **NOTE:** "Fair market value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being required to buy or sell, and both having reasonable knowledge of all necessary facts." This is actually the legal definition commonly used by the judicial system to determine value. How it would be applied in your situation would depend on the particular facts and circumstances — and may be one of those areas open to some "interpretation"!

3.6 Property Provided By Employer And *Not* Included As Income

You are naturally wondering about those "**cases**" referred to above where you don't have to include these fringe benefits. *Meals and lodging are not considered income if:*

- → **They are furnished at the employer's place of business.**
- → **They are furnished for the convenience of the employer.**
- → **With respect to lodging, you must accept the lodging to get the job (i.e., it is a condition of employment).**

To whom do these rules apply? Interestingly, this is one situation where the rules apply not just to you, the taxpayer, but to your whole family. Thus, you, your spouse, and your dependents could receive food and lodging under these circumstances and not have it counted as earned income.

What is "place of business"? This is fairly simple. The employer's place of business is usually your workplace. It can be the employer's home if you are the housekeeper, or a ranch if you are a ranch hand, or a camp provided by the employer because the area where you work is remote from satisfactory housing on the open market.

What is "employer's convenience"? This means there has to be a good business reason for the employer to supply these things, outside of his desire to give you more pay. Each case must be weighed on its own facts, but certain situations, such as a housekeeper living and eating at the house cared for, seem fairly straightforward.

3.7 Allowances And Reimbursements By Employer

If you are reimbursed or receive an allowance for certain family expenses because you live overseas, this amount *must* be included as earned income. Simple examples would be such things as receiving airline tickets from your employer to go visit your family in the U.S., or having your employer pay for your child to attend a boarding school because there isn't adequate schooling in the foreign country where you live.

The situation with reimbursements for expenses you incur on behalf of your employer is slightly more complicated. The basic proposition that applies to all employees (whether overseas or not) is this: if there is a plan whereby you account to your employer (meaning you keep records and submit some type of paperwork to get reimbursement) for expenses incurred on your employer's behalf, and you are reimbursed for that expense, you do not report the reimbursement as income. This is considered by the IRS to be "reimbursement under an accountable plan" and allows you to omit the reimbursement from your earned income up to the amount of expense incurred.

If, however, your expenses are **more** than the reimbursement, the excess is considered to have been incurred in producing earned income, and would normally be deductible.

THE CATCH IS THIS: If the excess business expense is totally attributable to excluded foreign income, you **cannot** deduct it at all. The reasoning follows the line of the old adage — you can't have your cake and eat it too. In other words, if you exclude all your foreign income from tax, you **can't turn around and also deduct expenses that are directly related to that income**. In the interests of complete fairness, though, the IRS **will** let you deduct any portion of the expense that can be allocated to U.S.-source income.

You can probably guess the final line to this story — if your reimbursement exceeds your expense, the excess must be included as earned income and is eligible for the exclusion.

3.8 Moving Expense Reimbursement

The old rule was that moving expense reimbursement had to be included in income. You could also then take a deduction for moving expenses, but often the deduction worked out to be less than the reimbursement leaving you in the unfair position of having to include as income, money that was actually spent to defray moving expenses

The rule now is that you will only include as income, moving expense reimbursement for:

- → Non-deductible moving expenses
- → Amounts that exceed your deductible expenses and that you don't return to your employer
- → Expenses claimed under a **nonaccountable** plan, even if they are for deductible expenses
- → Reimbursement of moving expenses you deducted in a prior year

To see a list of deductible and nondeductible moving expenses, please go to Chapter 6,

Deductions You May Be Able to Take.

With regard to "plans", an **accountable plan** is one where:

→ **Your expenses have a business connection,**
→ **You adequately account to your employer for expenses in a reasonable time and,**
→ **You return excess reimbursements in a reasonable time.**

Thus, under a **nonaccountable** plan, one or all of these elements would be missing.

3.9 How To Report Moving Expense Reimbursement That Is Considered Income

The rules for determining *when* a reimbursement that must be reported as income is considered earned and *where* it is considered earned are quite complicated.

It is important to understand that no matter *when* the reimbursement is considered earned, **you must report the reimbursement as income on your return in the year it is received**. If that is the case, you are probably thinking, why not just report it when received and forget about it. The reason you can't do that is because the *when* and *where* it is considered earned will determine whether it is taxable income or, in fact, may be excluded as foreign income.

If you have moving expense reimbursement that you need to treat as income, you should take a few moments to look at the following scenarios to determine which one describes your situation so that you will know how to characterize this income.

MOVE FROM U.S. TO FOREIGN COUNTRY

→ **120 days in foreign country as bona fide resident or physically present in first year of move.**

In moves from the U.S. to a foreign country, moving expense reimbursement is considered pay for services you will perform at some future point in the foreign country. If in the first year of the move, you qualify under the bona fide residence or physical presence test for at least 120 days, you will be able to treat the reimbursement as earned entirely in the year of the move.

Thus, for example, suppose you moved to Spain on January 15, 2008, and had $5,000 of nondeductible moving expenses reimbursed by your employer. You also had $50,000 of foreign earned income. You qualify to exclude your foreign income under the physical presence test and you were in Spain at least 120 days of tax year 2008. You therefore could exclude as foreign income the entire $55,000 of foreign income and moving expense reimbursement in 2008.

→ **Not in foreign country as bona fide resident or physically present for 120 days in first year of move.**

If you don't qualify as physically present or a bona fide resident for 120 days in the first year, you have to treat the reimbursement as earned in the year of the move and the following year.

To calculate how much to allocate to each year, you must create a fraction. For the first year, it is the number of days in your qualifying period that fall within that year divided by the total number of days in the year. You multiply that result by the reimbursement amount to get the part of the reimbursement that is allocated to the first year. The remaining reimbursement is allocated to the second year.

A simple example may help clarify this.

Suppose you moved overseas on December 1, 2007, and stayed overseas all of 2008. You received $2,000 in January of 2008 to help defray nondeductible moving expenses. You qualify under the physical presence test for 2007 and 2008. The part of the $2,000 moving expense reimbursement that must be allocated to 2007 since you were not in the foreign country for 120 days that year is 31/365 (number of days in 2007 in foreign country/number of days in year) x $2,000 or $170. The balance of $1,830 is allocated to 2008. The entire $2,000 will be reported on the 2008 tax return, but the part that is allocated to 2007 may be excluded from gross income for 2008 if it would have been excludable had you received it in 2007. In order to properly report it, you will need to attach a statement showing how you made your calculation. You will then enter the amount that would have been excludable in 2007 on Form 2555 to the left of line 43 of Form 2555. Next to the amount write "Exclusion of Income Earned in 2007". Include it in the total reported on line 43.

MOVE FROM FOREIGN COUNTRY TO U.S.

Generally, if you move from a foreign country back to the U.S., reimbursement for moving expenses that must be included in income is considered to be U.S.-source income. This means you cannot exclude it as foreign earned income, and thus, it will be fully taxable.

The exception to this is if you have a written agreement with your employer prior to the move or it is your employer's written policy that you will be reimbursed for your move back to the U.S. regardless of whether you continue to work for the employer. If this is the case, you can consider the reimbursement as compensation for past services performed in the foreign country.

If you have such a written agreement, you must then look at the timing of the move much as you did for a move from the U.S. to the foreign country.

Thus, if you qualified under the bona fide resident test or physical presence test for at least 120 days in the year of the move, the reimbursement is considered earned entirely in the year of the move. If you did not qualify for the 120 days in the year of the move, you have to allocate the reimbursement income between the year of the move and the immediately preceding year.

To figure the allocation, use the same reasoning followed in *(2) Not in Foreign Country as Bona Fide Resident or Physically Present for 120 days in First Year of Move.* The amount earned in the year immediately preceding the year of the move is the difference between the total includible reimbursement and the amount earned in the year of the move.

Again, you will report the income in the year received, but it will be allocated on the Form 2555 between the 2 years it is considered earned.

CHAPTER 4

Calculating How Much Of The Exclusion To Take

You now have accomplished the admirable goal of figuring out just how much earned income you have. You also know that you qualify to take an exclusion based on foreign residency or physical presence in a foreign country. As to the amount of the foreign earned income exclusion, the *maximum* amount increased from $70,000 in 1997 to $72,000 in 1998. From there it went up $2,000 per year until it reached $80,000 in 2002. In 2006, the Tax Increase Prevention Reconciliation Act of 2005 raised the exclusion to $82,400 for 2006. For 2007, the exclusion amount was increased to $85,700. For 2008, the amount of the maximum exclusion is $87,600.

For now, the question that must be answered is whether or not all of your income in any given year will qualify for the earned income exclusion. Let's start with the **EASY STUFF!**

4.1 You Earn And Receive Less Than $87,600 For 2008 Of Foreign Income For The Tax Year

The entire amount is excludable as foreign earned income, assuming you have a tax home in a foreign country and you meet the bona fide residence or physical presence test.

4.2. You And Your Spouse Both Have Foreign Earned Income

If you both have a tax home in a foreign country and you both meet either the bona fide residence or physical presence test, you can each exclude up to $87,600 for 2008 for a total of $175,200 for the year.

4.3 You Meet The Residency Test But Are Not In A Foreign Country For A Whole Tax Year

If you qualify for only part of a tax year, your maximum exclusion will be less than the applicable amount, and will quite logically be calculated as a percentage of the total year. Thus, in a simple example, if you qualify for six months (or 1/2) of 2008, your maximum exclusion will be 1/2 of $87,600 or $43,800.

Qualifying days in general: In order to do your calculations, you must count the number of **qualifying days** which are **the number of days within the tax year that you have your tax home in a foreign country and meet either the bona fide residence test or physical presence test.**

Qualifying days and bona fide resident: If you are a bona fide resident in one year and leave part-way through the next year, you can count those days of the second year that you were still a bona fide resident towards calculating how much of the exclusion you can take. Thus, for example, if you were a bona fide resident for 100 days in a tax year (and were a bona fide resident for the entire preceding year), you will create a fraction for the second year of the number of days you were a bona fide resident / the total number of days in the year or 100/365. This result is then multiplied by $87,600 to give you the maximum exclusion you could take for 2008.

Qualifying days and physical presence: The physical presence test can be manipulated (quite legitimately) to give you the maximum exclusion for several 12-month periods. The idea is that you can use ***any*** *12-month period* to qualify under this test, and you can count as qualifying days **all** days within a period of 12 consecutive months once you are physically present and have your tax home in a foreign country for 330 full days. Furthermore, the periods can be overlapped to give you the maximum benefit for each tax year. Even though it seems hopelessly confusing, this example may clarify the situation.

EXAMPLE: You are physically present in a foreign country for 18 months, from May 1, 2007 through October 31, 2008. You spend 20 days in the U.S. in December 2007. The problem is figuring the maximum exclusion for each year.

2007: You first count ***forward*** 330 days starting on May 1, 2007, (excluding the days spent in the U.S.). This puts you at April 15, 2008. Now count ***back*** 12 months to find the first day of the 12-month period which would be April 16, 2007. The 12-month period you have established is April 16, 2007 through April 15, 2008, but what you really want to know is how many days of that period are in 2007. It turns out to be 260 days or the number of days from April 16 through December 31. The fraction of 260/365 is multiplied by $85,700 which gives you $61,047, the maximum exclusion for 2007.

2008: This calculation operates in reverse. You count ***backward*** from the last full day, October 31, 2008, for 330 days. This puts you at November 16, 2007, (not including days in the U.S.) which is the first day of the 12-month period. Now count ***forward*** 12 months to November 15, 2008, which is the last day of the 12-month period. Then you figure the number of days in 2008 for the 12-month period, which is 319 days. Multiplying 319/365 by $87,600 gives you $76,560 which is the maximum exclusion you can take for 2008.

NOTE: You may notice that by doing these calculations, you are actually able to take days in the 12-month period that you are not physically present in the foreign country as qualifying days that count toward the exclusion. It may seem odd, but it is perfectly correct to do it.

NOT SO EASY STUFF

Incredible as it may seem, the above was the **easy** stuff! The following are rules relating to more unusual situations of payments over several years, etc.

4.4 Service In One Year And Payment In The Next

Normally, if you worked in one year, but did not get paid until the next, the income is considered earned in the year you worked for it. However, if you report income on the cash basis, you will report the income in the year received (i.e., the later year). But you can exclude it in that later year to the extent you would have been eligible to exclude it under the foreign earned income exclusion if it had been received in the year earned.

If this has you puzzled, consider the following:

EXAMPLE: You were physically present in Portugal in 2007 and 2008. You received $70,000 in salary in 2007 and excluded it all as foreign earned income for that year. In 2008, you received $120,000, with $20,000 of that amount being for services you performed in 2007. Since you had $15,700 left of the $85,700 exclusion for 2007, you can exclude that amount in 2008 (for 2007). The remaining $4,300 of the $20,000 must be included in 2008 income. As for the balance of your salary, $100,000 that was paid for services in 2008, only $87,600 can be excluded and the other $12,400 is taxable. The end result for 2008 is a combined exclusion of $103,300 of foreign income ($15,700 + $87,600). You would have a combined total of $16,700 of income that would be subject to U.S. tax ($4,300 for 2007 and $12,400 for 2008). The income would be reported on Form 1040 and Form 2555 for 2008. The section titled *Income Earned in Prior Year* in the Instructions for Form 2555 tells how to do this.

4.5 Exception To Above Rule In Cases Of Year-End Payroll Period

This exception normally applies if you are paid every two weeks and it so happens that the pay date for work performed in December falls in January (or, for non-calendar tax years, over the end of one tax year and the beginning of the next). If this is the case, and you are normally paid in this same manner, the income is considered earned entirely in the year you **receive it**, even though technically it was earned in the prior year.

4.6 Income Earned Over More Than One Year

If you receive income in one year for services that you performed over several years, you must figure what amount should be allocated to any given year. You do this by dividing the amount

received by the total number of months in the period during which you performed the services. This dollar figure per month is then multiplied by the number of months in any given year that you performed the services. The resulting amount is then subject to the exclusion limit for that tax year.

CHAPTER 5

The Foreign Housing Exclusion/Deduction

The foreign housing exclusion or deduction has always provided a little additional tax bonus for certain Americans living overseas. This is because it allowed those with high incomes and relatively high housing costs to exclude from federal tax even MORE than the foreign earned income exclusion using a formula that included actual housing expenses incurred during the tax year.

The underlying theory of the housing exclusion (or deduction) was that certain locations in the world had significantly higher housing costs than the U.S. The housing exclusion (or deduction) was a way of helping Americans overseas to offset those higher costs, thus putting them more on a par with domestic Americans from a tax standpoint. And, since the foreign income exclusion was, from the beginning, a way to encourage American involvement in foreign business activity, this additional benefit made perfect sense.

NOTE: As mentioned earlier, the housing exclusion (or deduction) can only be used by certain Americans overseas. IF your income is below the foreign earned income exclusion maximum ($87,600 for 2008), **you are not eligible to take a housing exclusion (or deduction) since all of your foreign income is already exempt from tax.**

And, even if your income is over the exclusion maximum of $87,600 for 2008, you will not benefit from the housing exclusion (or deduction) unless your housing expense is more than the "base amount" (explained later) of $14,016 for 2008.

SO BOTH OF THESE CONDITIONS MUST BE MET BEFORE YOU NEED TO CONSIDER THE RULES FOR HOUSING EXCLUSION (OR DEDUCTION).

FURTHERMORE: The Tax Increase Prevention Reconciliation Act of 2005 significantly limited this benefit and made it considerably more complicated to compute.

This chapter explains how the housing exclusion and housing deduction are calculated under the new rules effective starting in tax year 2006.

5.1 Housing Exclusion vs. Housing Deduction

Before studying the details, it would be helpful to understand the distinction between the **foreign housing exclusion** and the **foreign housing deduction**. The **exclusion** applies if you are employed by someone else and not considered self-employed. The **deduction** applies if you are self-employed. It is possible to take both if you have an employer plus a side business with self-employment income.

You are probably thinking how easy that section was. Before you get too complacent, let's get to the heart of the matter!

5.2 Important Terms

In order to do the calculations, you need to have a working knowledge of the following terms.

1 **Housing Expenses:** This term is fairly simple and includes, as you might expect, reasonable expenses paid or incurred for housing for you and your family (if they live with you) in a foreign country.

Expenses included: These would be rent (or the fair value of rent if your employer provides housing), repairs, utilities, real and personal property insurance, nondeductible occupancy taxes, rental of furniture and accessories, residential parking, nonrefundable fees for securing a lease, etc.

Expenses not included: You may not include the cost of telephone charges, pay television subscriptions, deductible interest and taxes, the cost of buying a property, the cost of domestic labor, purchased furniture, depreciation or amortization, improvements or other expenses that increase the value of the property. It also does not include expenses that are lavish or extravagant under the circumstances. (This wording comes direct from the IRS and probably could be the topic of a whole other book.)

2 **Employer-provided amounts:** This term is also mostly self-explanatory. It is any amount paid to you or paid on your behalf by your employer that is taxable foreign earned income (ignoring for a moment the foreign earned income exclusion). This general concept was discussed in Chapter 3, but in case you forgot, employer -provided amounts include:

→ **Your salary**
→ **Reimbursements for housing expenses**
→ **Amounts paid by your employer to a third party for housing**
→ **The fair rental value of company-owned housing given you (except in cases where it is for the convenience of the employer)**
→ **Amounts paid by your employer for the education of your dependents**
→ **Amounts paid by your employer as part of a tax equalization plan**

The only earnings you would have that are not employer-provided amounts are earnings from self-employment. If you have **only** self-employment earnings, you should skip ahead to

the section on the foreign housing deduction. But first read about the **base amount.**

3 **Base Amount:** This is a number that is artificially created by the IRS to take into account the fact that you would incur some basic housing expense if you lived in the U.S. for which you would receive no tax benefit. The base amount is 16% of the foreign earned income limitation, figured on a daily basis and then multiplied by the number of days in the year that you meet the bona fide residence or physical presence test.

Even though it sounds pretty scary, calculating the base amount is not nearly as bad as it seems. The Form 2555 that you must fill out to claim the exclusion will have the daily amount for any given year printed in the section where you calculate the foreign housing exclusion/deduction. All you need to do is multiply that number by the number of your qualifying days. The resulting product will be the **base amount.** Thus, in 2008, the foreign earned income limitation was $87,600, so 16% of that amount is $14,016 or $38.40 per day. If you were in the foreign country for the entire year, your base amount would be $14,016. Otherwise, multiply the number of days you were in the foreign country by $38.40.

4 **Limit on Housing Expenses:** This is where it gets a little tricky. Under the law prior to 2006, there was no limit. If you had $50,000 of housing expense, you simply took that number, subtracted the base amount (described above), and the result could be taken as additional foreign exclusion.

Under the current tax law, a limit has been set on the housing exclusion. It has been capped at 30% of the earned income exclusion. And, from that number, the base housing amount must be subtracted to get the amount of housing expense that can be excluded. This means that for most Americans overseas, the foreign housing exclusion cannot exceed 30% of $87,600 or $26,280 MINUS 16% of $87,600 or $14,016 (the "base amount") which equals $12,264.

HOWEVER (and this is BIG), Congress allowed for adjustments based on cost-of-living differences in various locations. A list of these locations is neatly codified in 8 pages added to the end of the instructions for Form 2555, Foreign Earned Income (see the IRS website – www.irs.gov). The following gives examples of some significantly higher limitations than the standard allowance.

Country	Location	Daily Limitation	Yearly Limitation
France	Paris	$273.50	$100,100
Germany	Berlin	$163.93	$60,000
Italy	Rome	$182.24	$66,700
Switzerland	Geneva	$229.78	$84,100
United Kingdom	London	$226.50	$82,900

These are just a few of the European cities listed. If one happens to live in one of these places, he will be able to take more in the way of housing exclusion — namely, the yearly limitation of say, $100,100 in Paris, France less the $14,016 noted above or $86,084 (versus a maximum of $12,264 for the regular housing exclusion). However, and this a big HOWEVER, if one lives in a locality not listed on the chart, his maximum housing expense is limited to $26,280 for the year no matter how high the actual cost is. And this translates, with the other provision of the law in

place, to a real maximum housing exclusion in 2008 of $12,264.

5.3 Putting It All Together

Although the terms have been defined, you may be wondering what to do with them. It is really quite simple. First, you determine the housing expenses that qualify for exclusion. Second, you determine, based on where you live, if your housing limit is $26,280 or some higher figure. Third, you subtract the base amount ($14,016 if you lived overseas the entire year) from the housing limit or the actual expense (whichever is smaller).

5.4 Result When All Income Is From Employer

Finally, after doing the calculations above, if you received all your income from an employer, you can take the entire amount figured above as your **housing exclusion**, up to the employer-provided amount. This exclusion is in addition to the foreign earned income exclusion, but the amount you can actually take as additional excluded foreign income will depend on your foreign income.

5.5 Example Showing Earned Income Exclusion And Foreign Housing Exclusion

It would surely be helpful at this point to see how you would report foreign earned income and the foreign housing exclusion on a real Form 2555. This example illustrates a number of points that have been discussed thus far, including calculating the foreign earned income exclusion, calculating the foreign housing exclusion, and calculating tax using the "stacking" rules under the 2005 tax law changes. The completed Form 1040 and Form 2555 for this example are at the end of this chapter.

FACTS: Let's suppose Tony and Tammy Taxpayer live and work in Kuwait City, Kuwait. Tony works for a local company and Tammy works as an employee of a U.S. government agency. They have been in Kuwait since July 1, 2005, and Tony qualifies for the foreign tax exclusion. They were in the U.S. for 2 weeks in July 2008 for vacation.

Tony earned $110,000 in Kuwait salary and Tammy earned $50,000 in U.S. government salary. She had $8,000 of tax withheld from her salary. In addition, the couple received $300 in interest income, $4,500 in dividends, and $1,000 in capaital gains from the sale of stock. The cost of their rental apartment in Kuwait was $4,000 per month, or $48,000 for the year. The couple does not pay foreign income tax.

Part I-Form 2555 — General Information: This section is pretty straightforward in that Tony Taxpayer simply fills in the blanks with information, including name, address, his employer and its address, etc. Note, however, that he needs to indicate if he has filed a Form 2555 prior to the tax year in question and if he has ever revoked either the foreign earned income exclusion or the foreign housing exclusion. He also needs to indicate his tax home — keeping in mind the earlier

discussion on that subject in 2.1, *Basic Criteria to Exclude Foreign Earned Income* — and the date it was established.

Part III-Form 2555 — Taxpayers Qualifying Under Physical Presence Test: Tony can skip ahead to Part III since he is qualifying under the physical presence test. He will indicate that the qualifying period is the entire tax year (January 1, 2008 - December 31, 2008) and the principal country of employment is the Kuwait. On the next line he will report that he was in the U.S. from July 1 - July 12, 2008, which counts as 10 full days. None of his income is allocated to the U.S.

Part IV-Form 2555 — All Taxpayers: In this section, Tony will report his salary of $110,000. This amount also gets reported in **Part V — All Taxpayers.**

Part VI-Form 2555 — For Taxpayers Claiming the Housing Exclusion And/Or Deduction: The first job here is to enter the amount of housing expense — $48,000. (Note that the fact that Tammy works for the U.S. government in Kuwait City does not preclude Tony from taking the foreign housing exclusion, provided the government is not providing housing for Tammy.) The next job is to determine the maximum housing exclusion for Kuwait City. On the list at the back of the Form 2555 instructions, it is $65,100 which is entered on line 29b. This amount is then compared to the actual housing expense of $48,000 and the smaller number (in this case, $48,000) is entered on line 30. Tony then calculates that since he was in Kuwait for the full 365-day year, he will enter the full "base amount" of $14,016 on line 32.

The next step is to subtract the base amount ($14,016) from the limit on housing expense ($48,000) and enter the result ($33,984) on line 33. This is the "tentative" amount of housing exclusion.

Finally, Tony needs to enter the "employer-provided" amount — which, generally speaking, is taxable compensation. This is compared to the amount reported as foreign earned income. If they are the same number — which they generally are when all the income is from one source and there is no additional self-employment income — then it is possible to take the entire foreign housing exclusion calculated. In this case, the amount would be $33,984.

Part VII — For Taxpayers Claiming the Foreign Earned Income Exclusion: This part is easy. Tony already knows he has 365 qualifying days in 2008 and the maximum exclusion is $87,600. So that amount is entered on line 40. But because Tony's foreign earned income exclusion is more than the maximum exclusion ($110,000 vs. $87,600), he must reduce the foreign income by the amount of housing exclusion. Thus, on line 41 he enters the difference between his actual income ($110,000) and the housing exclusion ($33,984), or $76,106.

Part VIII — For Taxpayers Claiming the Housing Exclusion, Foreign Earned Income Exclusion, or Both: This final part consists of adding up the earned income exclusion Tony is allowed to take ($76,016) and the foreign housing exclusion ($33,984), and entering the total — $110,000 in this case. If Tony had deductions allocable to the excluded income, they would be taken into consideration on line 42, but that is not the case in this example. Therefore, Tony will report $110,000 of excludable income on Form 1040.

Form 1040: There are a couple of things to point out here. First, note that Tony's foreign income

($110,000) and Tammy's U.S. government income ($50,000) are aggregated and both reported on line 7 of the form. Then other items of income (interest, dividends, and capital gains) are reported. The foreign excludable amount of $110,000 is then transferred from Form 2555 to line 21 of the Form 1040, and reported as a negative number. The total of all is then calculated and entered on line 22.

Second, it is important to realize that tax is calculated on a special worksheet called the "Foreign Earned Income Tax Worksheet." This form requires that the foreign excludable amount of $110,000 be added back in for purposes of calculating the tax on the other income (Tammy's income and the investment income). Even though the tax allocated to the foreign income will be subtracted from the total, it still means the other income is taxed at a much higher rate. To bring this point home, consider that the tax on exactly the same income using the same facts in 2005 would be $5,084. In 2008, that tax is a whopping $9,253!

Finally, as a result of this process known as "stacking" whereby the foreign income gets "stacked" on top of the other income to insure the other income is taxed at a higher rate, the tax withheld from Tammy's paycheck isn't enough to cover the tax due. This means not only will the Taxpayers owe tax when they file, but they will be assessed a penalty for "underwithholding." And, if they don't pay the tax by April 15, they will also have to pay interest on the amount due until it is paid. Therefore, it behooves all readers to take a look at their income situation to make sure they don't fall into this pit.

5.6 Result When All Income Is From Self-Employment

If all your income is from self-employment, you must take the foreign housing deduction and not the foreign housing exclusion. The way it works is that you are entitled to deduct the housing amount (which we figured above) from your adjusted gross income. The deduction will actually show up on Form 1040 as an adjustment to gross income, but the instructions on where to put it and how to figure it will be on Form 2555. You should be forewarned that Form 2555 is quite convoluted with respect to figuring the housing deduction — you have to use Part VI, Part VIII and Part IX (or almost the entire third page of the form), but the math is simple. If you just follow the directions for each line, you can successfully complete your calculation of the foreign housing deduction without undue stress!

LIMIT ON HOUSING DEDUCTION: As with most rules developed by the IRS, there are limits and the housing deduction is no exception. The maximum deduction cannot be more than your foreign earned income minus the total of your foreign earned income exclusion and the foreign housing exclusion (which you would only take if you had employer *and* self-employed income).

CARRYOVER: If you reach the limit described above, you can carry over the excess housing deduction to the next year only. If you cannot deduct it in that next year, you will lose it. And even in the one carryover year, you can deduct it in figuring adjusted gross income only to the extent that your foreign earned income for that year is more than the sum of your foreign earned income exclusion, housing exclusion and housing deduction for that year. Thus, for example, if your foreign earned income in 2008 exceeded your total earned income exclusion, housing exclusion and housing deduction by $5,000, you could deduct up to $5,000 of 2007

carry-over housing deduction in 2008.

5.7 Income From Employer And Self-Employment

If you have income from both these sources, you will take both a housing exclusion and housing deduction. To figure how to divide it, first find the housing amount. Then find the proportion of total income that is employer-provided by dividing the employer-provided amount by your total foreign earned income. This fraction is multiplied by the housing amount to give you the part of your housing amount that can be used for the housing exclusion. The balance of the housing amount will be used for the housing deduction (subject to the limit described above).

MISCELLANEOUS SITUATIONS

There are several other rules that need to be mentioned because you just may fall into one of these fairly unusual scenarios and may wonder how to handle it.

5.8 Second Foreign Household

If it becomes necessary for you to maintain a second household outside the U.S. for your family because of living conditions near your tax home, you may *include the expenses for that second household in your reasonable foreign housing expenses.* Living conditions that would qualify you to do this are those which are dangerous, unhealthful, in the midst of civil insurrection or war, or conditions under which it is not possible to have family housing (such as on a drilling rig). If you happen to have two foreign households and the living conditions are not adverse, you may only include as foreign housing expenses the costs for the household that bears the closest relationship (not necessarily geographic) to your tax home.

5.9 U.S. Government Allowance

If you or your spouse receive a nontaxable U.S. government or similar allowance intended to compensate you for housing costs, you must reduce your **housing amount** to the extent of the allowance.

5.10 Married Couples Living Apart

You may find these rules a bit complicated, but it's worth taking a look because you may find them quite financially advantageous. The key to being able to each take a housing exclusion or deduction is that you have different tax homes, live apart, and neither the tax homes nor residences of each spouse are within reasonable commuting distance of each other.

EXAMPLE: The husband works in the oil fields in Saudi Arabia and the wife is a teacher at an American school in Turkey.

If you find yourself in this situation, you and your spouse can both claim your own foreign housing exclusion or deduction, but neither can claim expenses of a second household maintained for the other spouse. **However,** if you **both** qualify for the exclusion or deduction, **one** of you can choose not to claim it in favor of letting the other spouse take the first spouse's housing expenses under the "second household" category of expense. This may be to your advantage because by using one housing exclusion or deduction *and* a second foreign household expense, you will only apply **one base amount** against the combined housing expenses.

5.11 Married Couples Living Together

You probably raised your eyebrows when you saw this category because it's a foregone conclusion that most married couples live together. However, in the convoluted world of overseas taxation, even living together as husband and wife can create a myriad of complications!

If you and your spouse live together and each of you can claim a foreign housing exclusion or deduction, you have several choices:

→ **You can file a joint return.** If you choose to do this, then you must decide whether to figure your housing amounts jointly or separately:

A. Figuring housing amount jointly: If you figure the housing amount jointly, you can combine your housing expenses and figure one base amount. Either you or your spouse can claim the exclusion or deduction, but only **one of you** can claim it. In the event that one spouse was a foreign resident longer than the other, and you decide to let the shorter-resident spouse claim the exclusion or deduction, you can only claim as housing expenses, the expenses for that shorter period.

B. Figuring housing amount separately: If you decide to go this route, you can allocate expenses between yourselves in any proportion you wish, but each spouse must use his or her full base amount. This provides a serious disincentive to use this method!

→ **You can file separate returns.** If you file separately, you must each take your full base amount against the housing expenses that you allocate between the two of you. Generally, you would only decide to do this is if there is some other compelling reason to file separately.

A Sample Tax Return Follows.

Form **1040** Department of the Treasury — Internal Revenue Service
U.S. Individual Income Tax Return 2008

(99) IRS Use Only — Do not write or staple in this space.

For the year Jan 1 - Dec 31, 2008, or other tax year beginning , 2008, ending , 20 — OMB No. 1545-0074

Label (See instructions.)

Use the IRS label. Otherwise, please print or type.

Field	Value
Your first name / MI / Last name	Tony Taxpayer
Your social security number	456-78-3455
If a joint return, spouse's first name / MI / Last name	Tammy Taxpayer
Spouse's social security number	234-56-7890
Home address (number and street). If you have a P.O. box, see instructions. Apartment no.	88 Express Road
City, town or post office. If you have a foreign address, see instructions. State ZIP code	Kuwait City, Kuwait

You **must** enter your social security number(s) above.

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund? (see instructions) — Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above & full name here
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here
5 ☐ Qualifying widow(er) with dependent child (see instructions)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a — Boxes checked on 6a and 6b: 2
b ☒ **Spouse**

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see instrs)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions.

No. of children on 6c who: • lived with you; • did not live with you due to divorce or separation (see instrs); Dependents on 6c not entered above; Add numbers on lines above

d Total number of exemptions claimed: 2

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

Line	Description	Amount
7	Wages, salaries, tips, etc. Attach Form(s) W-2	160,000.
8a	**Taxable** interest. Attach Schedule B if required	300.
8b	**Tax-exempt** interest. **Do not** include on line 8a	
9a	Ordinary dividends. Attach Schedule B if required	4,500.
9b	Qualified dividends (see instrs)	4,500.
10	Taxable refunds, credits, or offsets of state and local income taxes (see instructions)	
11	Alimony received	
12	Business income or (loss). Attach Schedule C or C-EZ	
13	Capital gain or (loss). Att Sch D if reqd. If not reqd, ck here ☐	1,000.
14	Other gains or (losses). Attach Form 4797	
15a / 15b	IRA distributions / **b** Taxable amount (see instrs)	
16a / 16b	Pensions and annuities / **b** Taxable amount (see instrs)	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	
18	Farm income or (loss). Attach Schedule F	
19	Unemployment compensation	
20a / 20b	Social security benefits / **b** Taxable amount (see instrs)	
21	Other income FORM 2555	-110,000.
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income**	55,800.

Adjusted Gross Income

Line	Description	Amount
23	Educator expenses (see instructions)	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	
25	Health savings account deduction. Attach Form 8889	
26	Moving expenses. Attach Form 3903	
27	One-half of self-employment tax. Attach Schedule SE	
28	Self-employed SEP, SIMPLE, and qualified plans	
29	Self-employed health insurance deduction (see instructions)	
30	Penalty on early withdrawal of savings	
31a	Alimony paid **b** Recipient's SSN	
32	IRA deduction (see instructions)	
33	Student loan interest deduction (see instructions)	
34	Tuition and fees deduction. Attach Form 8917	
35	Domestic production activities deduction. Attach Form 8903	
36	Add lines 23 - 31a and 32 - 35	
37	Subtract line 36 from line 22. This is your **adjusted gross income**	55,800.

Tax and Credits

Line	Description		Amount
38	Amount from line 37 (adjusted gross income)		55,800.
39a	Check if: ☐ **You** were born before January 2, 1944, ☐ Blind. ☐ **Spouse** was born before January 2, 1944, ☐ Blind. **Total boxes checked** ► 39a ☐		
b	If your spouse itemizes on a separate return, or you were a dual-status alien, see instrs and ck here ► 39b ☐		
c	Check if standard deduction includes real estate taxes or disaster loss (see instructions) ► 39c ☐		
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		10,900.
41	Subtract line 40 from line 38		44,900.
42	If line 38 is over $119,975, or you provided housing to a Midwestern displaced individual, see instructions. Otherwise, multiply $3,500 by the total number of exemptions claimed on line 6d		7,000.
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		37,900.
44	**Tax** (see instrs). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972		9,253.
45	**Alternative minimum tax** (see instructions). Attach Form 6251		
46	Add lines 44 and 45 ►		9,253.
47	Foreign tax credit. Attach Form 1116 if required		
48	Credit for child and dependent care expenses. Attach Form 2441		
49	Credit for the elderly or the disabled. Attach Schedule R		
50	Education credits. Attach Form 8863		
51	Retirement savings contributions credit. Attach Form 8880		
52	Child tax credit (see instructions). Attach Form 8901 if required		
53	Credits from Form: a ☐ 8396 b ☐ 8839 c ☐ 5695		
54	Other crs from Form: a ☐ 3800 b ☐ 8801 c ☐		
55	Add lines 47 through 54. These are your **total credits**		
56	Subtract line 55 from line 46. If line 55 is more than line 46, enter -0- ►		9,253.

Standard Deduction for —
- People who checked any box on line 39a, 39b, or 39c **or** who can be claimed as a dependent, see instructions.
- All others:

Single or Married filing separately, $5,450

Married filing jointly or Qualifying widow(er), $10,900

Head of household, $8,000

Other Taxes

Line	Description		Amount
57	Self-employment tax. Attach Schedule SE		
58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919		
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		
60	Additional taxes: a ☐ AEIC payments b ☐ Household employment taxes. Attach Schedule H		
61	Add lines 56-60. This is your **total tax** ►		9,253.

Payments

If you have a qualifying child, attach Schedule EIC.

Line	Description		Amount
62	Federal income tax withheld from Forms W-2 and 1099	8,000.	
63	2008 estimated tax payments and amount applied from 2007 return		
64a	**Earned income credit (EIC)**		
b	Nontaxable combat pay election ► 64b		
65	Excess social security and tier 1 RRTA tax withheld (see instructions)		
66	Additional child tax credit. Attach Form 8812		
67	Amount paid with request for extension to file (see instructions)		
68	Credits from Form: a ☐ 2439 b ☐ 4136 c ☐ 8801 d ☐ 8885		
69	First-time homebuyer credit. Attach Form 5405		
70	Recovery rebate credit (see worksheet)	600.	
71	Add lines 62 through 70. These are your **total payments** ►		8,600.

Refund

Direct deposit? See instructions and fill in 73b, 73c, and 73d or Form 8888.

Line	Description		Amount
72	If line 71 is more than line 61, subtract line 61 from line 71. This is the amount you **overpaid**		
73a	Amount of line 72 you want **refunded to you.** If Form 8888 is attached, check here ► ☐		
► b	Routing number XXXXXXXXX ► c Type: ☐ Checking ☐ Savings		
► d	Account number XXXXXXXXXXXXXXXXX		
74	Amount of line 72 you want **applied to your 2009 estimated tax** ►		

Amount You Owe

Line	Description		Amount
75	**Amount you owe.** Subtract line 71 from line 61. For details on how to pay, see instructions ►		653.
76	Estimated tax penalty (see instructions)		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete the following. [X] **No**

Designee's name ► Phone no. ► Personal identification number (PIN) ►

Sign Here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
		Manager	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	
		Manager	

Paid Preparer's Use Only

Preparer's signature ►	Date	Check if self-employed ☐
Preparer's SSN or PTIN	P00104624	
Firm's name (or yours if self-employed), address, and ZIP code	Oceanwaves, LLC 1082 Vintner Blvd. Palm Beach Gardens FL 33410	EIN 26-0103239 Phone no. (561) 625-6935

Name(s) shown on Form 1040.: Tony & Tammy Taxpayer

Your social security number: 456-78-3455

Schedule B — Interest and Ordinary Dividends

Attachment Sequence No. **08**

Part I Interest

(See instructions for Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

		Line	Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see the instructions and list this interest first. Also, show that buyer's social security number and address ►	1	
	Bank of America		300.
2	Add the amounts on line 1	2	300.
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ►	4	300.

Note. If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

(See instructions for Form 1040, line 9a.)

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

		Line	Amount
5	List name of payer ►	5	
	Schwab		4,500.
6	Add the amounts on line 5. Enter the total here and on Form 1040, line 9a ►	6	4,500.

Note. If line 6 is over $1,500, you must complete Part III.

Part III Foreign Accounts and Trusts

(See instructions.)

	You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; or **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.	Yes	No
7a	At any time during 2008, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See instructions for exceptions and filing requirements for Form TD F 90-22.1		X
b	If 'Yes,' enter the name of the foreign country ►		
8	During 2008, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If 'Yes,' you may have to file Form 3520. See instructions		X

SCHEDULE D
(Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

► **Attach to Form 1040 or Form 1040NR.** ► **See Instructions for Schedule D (Form 1040).**
► **Use Schedule D-1 to list additional transactions for lines 1 and 8.**

OMB No. 1545-0074

2008

Attachment Sequence No. **12**

Name(s) shown on return: Tony & Tammy Taxpayer

Your social security number: 456-78-3455

Part I Short-Term Capital Gains and Losses — Assets Held One Year or Less

	(a) Description of property (Example: 100 shares XYZ Co)	**(b)** Date acquired (Mo, day, yr)	**(c)** Date sold (Mo, day, yr)	**(d)** Sales price (see instructions)	**(e)** Cost or other basis (see instructions)	**(f) Gain or (loss)** Subtract (e) from (d)
1						

Line	Description	Box	Amount
2	Enter your short-term totals, if any, from Schedule D-1, line 2	2	
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)	3	
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)	7	

Part II Long-Term Capital Gains and Losses — Assets Held More Than One Year

	(a) Description of property (Example: 100 shares XYZ Co)	**(b)** Date acquired (Mo, day, yr)	**(c)** Date sold (Mo, day, yr)	**(d)** Sales price (see instructions)	**(e)** Cost or other basis (see instructions)	**(f) Gain or (loss)** Subtract (e) from (d)
8	1200.0000 sh. ABC, Inc.	01/02/05	06/08/08	12,000.	11,000.	1,000.

Line	Description	Box	Amount
9	Enter your long-term totals, if any, from Schedule D-1, line 9	9	
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)	10	12,000.
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13	Capital gain distributions. See instrs	13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** in the instructions	14	
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on page 2	15	1,000.

BAA For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions.

Part III Summary

16	Combine lines 7 and 15 and enter the result	16	1,000.

If line 16 is:

- A **gain,** enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.
- A **loss,** skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.
- **Zero,** skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then to go line 22.

17 Are lines 15 and 16 **both** gains?

[X] **Yes.** Go to line 18.

[ ] **No.** Skip lines 18 through 21, and go to line 22.

18	Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** in the instructions ►	18	
19	Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** in the instructions ►	19	

20 Are lines 18 and 19 **both** zero or blank?

[X] **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the Instructions for Form 1040 (or in the Instructions for Form 1040NR). **Do not** complete lines 21 and 22 below.

[ ] **No.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Schedule D Tax Worksheet** in the instructions. **Do not** complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of:

- The loss on line 16 or
- ($3,000), or if married filing separately, ($1,500)

21	

Note. When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?

[ ] **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the Instructions for Form 1040 (or in the Instructions for Form 1040NR).

[ ] **No.** Complete the rest of Form 1040 or Form 1040NR.

Form **2555**

Department of the Treasury
Internal Revenue Service

Foreign Earned Income

► **See separate instructions.** ► **Attach to Form 1040.**

OMB No. 1545-0074

2008

Attachment Sequence No. **34**

For Use by U.S. Citizens and Resident Aliens Only

Name shown on Form 1040: Tony Taxpayer

Your social security number: 456-78-3455

Part I General Information

1 Your foreign address (including country): 88 Express Road, Kuwait City, Kuwait

2 Your occupation: Manager

3 Employer's name ► 123 Company

4a Employer's U.S. address ►

b Employer's foreign address ► 357 Broad Street, Kuwait City, Kuwait

5 Employer is (check any that apply): ► **a** [X] A foreign entity **b** [ ] A U.S. company **c** [ ] Self **d** [ ] A foreign affiliate of a U.S. company **e** [ ] Other (specify) ►

6 a If, after 1981, you filed Form 2555 or Form 2555-EZ, enter the last year you filed the form ► 2007

b If you did not file Form 2555 or 2555-EZ after 1981 to claim either of the exclusions, check here ► [ ] and go to line 7.

c Have you ever revoked either of the exclusions? [ ] **Yes** [X] **No**

d If you answered 'Yes,' enter the type of exclusion and the tax year for which the revocation was effective ►

7 Of what country are you a citizen/national? ► US

8a Did you maintain a separate foreign residence for your family because of adverse living conditions at your tax home? See **Second foreign household** in the instructions [ ] **Yes** [X] **No**

b If 'Yes,' enter city and country of the separate foreign residence. Also, enter the number of days during your tax year that you maintained a second household at that address ►

9 List your tax home(s) during your tax year and date(s) established ► Kuwait 07/01/2005

Next, complete either Part II or Part III. If an item does not apply, enter 'NA.' If you do not give the information asked for, any exclusion or deduction you claim may be disallowed.

Part II Taxpayers Qualifying Under Bona Fide Residence Test (see instructions)

10 Date bona fide residence began ► , and ended ►

11 Kind of living quarters in foreign country ► **a** [ ] Purchased house **b** [ ] Rented house or apartment **c** [ ] Rented room **d** [ ] Quarters furnished by employer

12a Did any of your family live with you abroad during any part of the tax year? [ ] **Yes** [ ] **No**

b If 'Yes,' who & for what period? ►

13a Have you submitted a statement to the authorities of the foreign country where you claim bona fide residence that you are not a resident of that country? See instructions [ ] **Yes** [ ] **No**

b Are you required to pay income tax to the country where you claim bona fide residence? See instructions [ ] **Yes** [ ] **No**

If you answered 'Yes' to 13a and 'No' to 13b, you do not qualify as a bona fide resident. Do not complete the rest of this part.

14 If you were present in the United States or its possessions during the tax year, complete columns **(a) - (d)** below. **Do not** include the income from column **(d)** in Part IV, but report it on Form 1040.

(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)	(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

15a List any contractual terms or other conditions relating to the length of your employment abroad ►

b Enter type of visa under which you entered the foreign country ►

c Did your visa limit the length of your stay or employment in a foreign country? If 'Yes,' attach explanation [ ] **Yes** [ ] **No**

d Did you maintain a home in the United States while living abroad? [ ] **Yes** [ ] **No**

e If 'Yes,' enter address of your home, whether it was rented, the names of the occupants, and their relationship to you ►

Part III Taxpayers Qualifying Under Physical Presence Test (see instructions)

16 The physical presence test is based on the 12-month period from ► 01/01/2008 through ► 12/31/2008

17 Enter your principal country of employment during your tax year . ► Kuwait

18 If you traveled abroad during the 12-month period entered on line 16, complete columns **(a) - (f)** below. Exclude travel between foreign countries that did not involve travel on or over international waters, or in or over the United States, for 24 hours or more. If you have no travel to report during the period, enter 'Physically present in a foreign country or countries for the entire 12-month period.' **Do not** include the income from column **(f)** below in Part IV, but report it on Form 1040.

(a) Name of country (including U.S.)	**(b)** Date arrived	**(c)** Date left	**(d)** Full days present in country	**(e)** Number of days in U.S. on business	**(f)** Income earned in U.S. on business (attach computation)
US	07/01/2008	07/12/2008	10	0	0.

Part IV All Taxpayers

Note: *Enter on lines 19 through 23 all income, including noncash income, you earned and actually or constructively received during your 2008 tax year for services you performed in a foreign country. If any of the foreign earned income received this tax year was earned in a prior tax year, or will be earned in a later tax year (such as a bonus), see the instructions.* ***Do not*** *include income from line 14, column* ***(d),*** *or line 18, column* ***(f).*** *Report amounts in U.S. dollars, using the exchange rates in effect when you actually or constructively received the income.*

If you are a cash basis taxpayer, report on Form 1040 all income you received in 2008, no matter when you performed the service.

2008 Foreign Earned Income			**Amount (in U.S. dollars)**
19 Total wages, salaries, bonuses, commissions, etc		**19**	110,000.
20 Allowable share of income for personal services performed (see instructions): **a** In a business (including farming) or profession		**20a**	
b In a partnership. List partnership's name and address and type of income ►		**20b**	
21 Noncash income (market value of property or facilities furnished by employer — attach statement showing how it was determined): **a** Home (lodging)		**21a**	
b Meals		**21b**	
c Car		**21c**	
d Other property or facilities. List type and amount ►		**21d**	
22 Allowances, reimbursements, or expenses paid on your behalf for services you performed:			
a Cost of living and overseas differential	**22a**		
b Family	**22b**		
c Education	**22c**		
d Home leave	**22d**		
e Quarters	**22e**		
f For any other purpose. List type and amount ►	**22f**		
g Add lines 22a through 22f		**22g**	
23 Other foreign earned income. List type and amount ►		**23**	
24 Add lines 19 through 21d, line 22g, and line 23		**24**	110,000.
25 Total amount of meals and lodging included on line 24 that is excludable (see instructions)		**25**	
26 Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your **2008 foreign earned income** ►		**26**	110,000.

Part V — All Taxpayers

Line	Description		Amount
27	Enter the amount from line 26	27	110,000.

Are you claiming the housing exclusion or housing deduction?

- [X] **Yes.** Complete Part VI.
- [ ] **No.** Go to Part VII.

Part VI — Taxpayers Claiming the Housing Exclusion and/or Deduction

Line	Description		Amount
28	Qualified housing expenses for the tax year (see instructions)	28	48,000.
29a	Enter location where housing expenses incurred (see instructions) ► Kuwait-Kuwait City		
b	Enter limit on housing expenses (see instructions)	29b	65,100.
30	Enter the **smaller** of line 28 or line 29b	30	48,000.
31	Number of days in your qualifying period that fall within your 2008 tax year (see instructions) — 31: 366 **days**		
32	Multiply $38.30 by the number of days on line 31. If 366 is entered on line 31, enter $14,016.00 here	32	14,016.
33	Subtract line 32 from line 30. If the result is zero or less, do not complete the rest of this part or any of Part IX	33	33,984.
34	Enter employer-provided amounts (see instructions) — 34: 110,000.		
35	Divide line 34 by line 27. Enter the result as a decimal (rounded to at least three places), but do not enter more than '1.000'	35	x 1.000
36	**Housing exclusion.** Multiply line 33 by line 35. Enter the result but do not enter more than the amount on line 34. Also, complete Part VIII ►	36	33,984.

Note: *The housing deduction is figured in Part IX. If you choose to claim the foreign earned income exclusion, complete Parts VII and VIII before Part IX.*

Part VII — Taxpayers Claiming the Foreign Earned Income Exclusion

Line	Description		Amount
37	Maximum foreign earned income exclusion	37	$87,600.
38	• If you completed Part VI, enter the number from line 31. • All others, enter the number of days in your qualifying period that fall within your 2008 tax year (see the instructions for line 31). — 38: 366 **days**		
39	• If line 38 and the number of days in your 2008 tax year (usually 366) are the same, enter '1.000.' • Otherwise, divide line 38 by the number of days in your 2008 tax year and enter the result as a decimal (rounded to at least three places).	39	x 1.000
40	Multiply line 37 by line 39	40	87,600.
41	Subtract line 36 from line 27	41	76,016.
42	**Foreign earned income exclusion.** Enter the **smaller** of line 40 or line 41. Also, complete Part VIII ►	42	76,016.

Part VIII — Taxpayers Claiming the Housing Exclusion, Foreign Earned Income Exclusion, or Both

Line	Description		Amount
43	Add lines 36 and 42	43	110,000.
44	Deductions allowed in figuring your adjusted gross income (Form 1040, line 37) that are allocable to the excluded income. See instructions and attach computation	44	
45	Subtract line 44 from line 43. Enter the result here and in parentheses on **Form 1040, line 21.** Next to the amount enter 'Form 2555.' On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ►	45	110,000.

Part IX — Taxpayers Claiming the Housing Deduction — Complete this part only if (a) line 33 is more than line 36 and (b) line 27 is more than line 43.

Line	Description		Amount
46	Subtract line 36 from line 33	46	
47	Subtract line 43 from line 27	47	
48	Enter the **smaller** of line 46 or line 47	48	
	Note: *If line 47 is* ***more than*** *line 48 and you could not deduct all of your 2007 housing deduction because of the 2007 limit, use the worksheet in the instructions to figure the amount to enter on line 49. Otherwise, go to line 50.*		
49	Housing deduction carryover from 2007 (from worksheet in the instructions)	49	
50	**Housing deduction.** Add lines 48 and 49. Enter the total here and on Form 1040 to the left of line 36. Next to the amount on Form 1040, enter 'Form 2555.' Add it to the total adjustments reported on that line ►	50	

Form 1040
Line 44

Foreign Earned Income Tax Worksheet

► Keep for your records

2008

Name(s) Shown on Return	Social Security Number
Tony & Tammy Taxpayer	456-78-3455

Part I Computation of Tax

1	Enter amount from Form 1040, line 43	1	37,900.
2	Enter the amount from your (and your spouse's if filing jointly) Form 2555, line 45	2	110,000.
3	Add lines 1 and 2	3	147,900.
4	Tax on amount on line 3:		
a	[ ] Tax table		
b	[ ] Tax Computation Worksheet 30,156.		
c	[X] Schedule D Tax Worksheet 29,441.		
d	[ ] Form 8615, Tax for Certain Children		
	Applicable tax on amount on line 3	4	29,441.
5	Tax on amount on line 2	5	20,188.
6	Subtract line 5 from line 4. Include this amount on Form 1040, line 44	6	9,253.

Part II Computation of Capital Gain Excess

1	Not applicable	1	
2	Enter your qualified dividends from Form 1040, line 9b	2	4,500.
3	Enter the amount from Form 4952, line 4g	3	
4	Enter the amount from Form 4952, line 4e	4	
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	0.
6	Subtract line 5 from line 2. If zero or less, enter -0-	6	4,500.
7	Enter the **smaller** of line 15 or line 16 of Schedule D	7	1,000.
8	Enter the **smaller** of line 3 or line 4	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-	9	1,000.
10	Add lines 6 and 9	10	5,500.
11	Enter the amount from Form 1040, line 43	11	37,900.
12	**Capital gain excess.** Subtract line 11 from line 10.	12	0.
13	Capital gain excess attributable to capital gain	13	0.
14	Capital gain excess attributable to qualified dividends	14	0.

CHAPTER 6

Deductions You May Be Able To Take

The rule in this area is pretty straightforward: if you don't take income into account for tax purposes, you can't take deductions associated with that income. Of course, you know by now that it's not quite that simple, but that gives you a general base from which to operate.

In the following, you will learn about some specific situations and the rules on how to report deductions.

6.1 General Concepts

Items definitely related to excluded income: As stated above, you cannot deduct any expense, loss or other normally deductible item that is allocated or connected 100% to excluded income. This would include such things as business expenses related to the foreign business, unreimbursed travel expenses, etc. if the income generated thereby is encompassed by the foreign earned income exclusion.

Items not definitely related to any gross income: Deductions for things such as mortgage interest payments on your residence, charitable contributions, alimony payments, medical expenses, etc. are not definitely related to any particular source of income, so it may be possible to deduct part of these items if you have both foreign-source and U.S. -source income. The section on "*How to Report Deductions*" will give you the details on how to figure the allocation.

Income received in later year: If you receive foreign income in a year after the year in which you earned it (as in the case of a bonus), you may want to amend the return for the earlier year to adjust for a change in the allocation of deductions. This would normally arise if the bonus caused you to exceed the maximum exclusion. You could then amend the earlier year return to take advantage of the deductions that are allocable to the part of the foreign income exceeding the yearly exclusion limit.

Since this is probably as clear as mud, look at this simple example: You excluded $85,700 of foreign income in 2007. In 2008, you receive a bonus of $20,000 for work performed in 2007. You couldn't claim any deductions in 2007 since all of your income was excluded from tax, but in 2008 you can amend the 2007 return and claim 19/100 of your allocable deductions. This is because you now have $20,000 of income that is taxable out of a total of $105,700.

6.2 Contributions

You can only deduct contributions to U.S. organizations and then only under the allocation rules discussed in Chapter 7, ***Where And How to Report Deductions***. If the U.S. organization to which you donate transfers funds to a foreign charity, you can still deduct the contribution if the U.S. charity controls the use of funds by the foreign charity or if the foreign organization is just the administrative arm of the U.S. organization. Contributions made directly to foreign charities are **not** deductible, unless made to certain Canadian, Mexican, or Israeli organizations.

If you want to contribute to a Canadian, Mexican, or Israeli charity, that charity should be able to tell you if it qualifies as a deductible contribution in the U.S.

For general information on contributing to charities in these three countries, you can contact the IRS at: Internal Revenue Service, International Returns Section, P.O. Box 920, Bensalem, PA 19020-8518. For information specifically on Canadian contributions, you can take a look at IRS Pub. 597, *Information on the U.S.-Canada Income Tax Treaty*.

6.3 Moving Expenses: Initial Concepts

The concept of "over-complication" takes on new meaning with foreign moving expenses! Maybe you will be lucky and fall into the category of people with fairly simple moving expenses or all your expenses will be reimbursed by your employer so no deduction would be in order. If this is not the case, this section will try to break all the elements into understandable pieces.

Basic Criteria for Deducting Moving Expenses

To even get to the point where you have to worry about when and what to deduct, your move must meet the following conditions:

1 **The moving expenses must be related, both in time and place, to you starting work at a new job location**. With regard to time, generally moving expenses incurred within one year from the date you first start to work are considered closely enough related in time to qualify as "moving expenses". With regard to place, a move is considered closely related in place to the start of work if the distance from your new home to the new job is not more than the distance from your former home to the new job. In the event the distance is greater, you can still say the expenses are related to the new job if you must live at the new job location as a condition of employment or if you will spend less time or money getting from the new home to the new job.

2 **You must work full time at least 39 weeks during the 12 months right after you move whether you are self-employed or not**. If you are self-employed, you must work full time at least 39 weeks during the first 12 months and a total of 78 weeks out of 24 months right after you move.

Exceptions: The time test does not have to be met if your job ends because of disability, you are transferred for your employer's benefit, you are laid off or fired for reasons other than wilful misconduct, or you are filing for a deceased person.

3 **The location of your new job must be at least 50 miles farther from your former home than was your old job location**. If there is no former job, your new job location must be at least 50 miles from your former home.

4 **Your expenses must be reasonable**. This means, for example, the cost of getting from your old home to the new one should be by the most direct route using conventional means of getting there.

6.4 Moving Expenses You Can Deduct

If you meet all the above requirements, you then have the task of figuring out which expenses can be included. It is quite straightforward these days since tax law changes have eliminated many expenses that used to qualify. In general, you can take:

- → **The reasonable cost of moving household goods and personal effects for you and members of your household.** This includes the cost of packing, crating, intransit storage and insurance. **Household member** includes anyone who lives in the former and the new home, excluding a tenant or employee unless you claim that person as a dependent.

- → **Transportation and lodging costs for one trip by you and your household from the old home to the new home.**

6.5 Moving Expenses You Cannot Deduct

These items may not be deducted as moving expenses (though at one time many of them were allowable):

- → **Pre-move house-hunting expenses**
- → **Temporary living expenses**
- → **Meal Expenses**
- → **Expenses of buying or selling a home**
- → **Expenses of getting or breaking a lease**
- → **Home improvements to help sell your home**
- → **Loss on the sale of your home**

- → **Mortgage penalties**
- → **Any part of the purchase price of your home**
- → **Losses from disposing of club memberships**
- → **Real estate taxes, car tags, driver's license**
- → **Refitting carpets and draperies**
- → **Storage fees except if incurred in transit and foreign moves**

6.6 Moves From Foreign Country To The U.S.

Now you know if you qualify to take moving expenses and which ones to take as a deduction. At this point, things start to get even more complicated. However, as between moves from a foreign country to the U.S. or moves from the U.S. to a foreign country, the former is a bit simpler so we'll start there.

In case you haven't thought about it before, it may be helpful to point out that much of the complication of moving expenses arises if you are in one of three situations:

- → **You pay for the move entirely yourself with no reimbursement from an employer.**
- → **You are only partially reimbursed by your employer.**
- → **You are fully reimbursed by your employer *and* the reimbursement was included in income.**

With moves back to the U.S., the unreimbursed moving expenses or reimbursed expenses included in income should be fully deductible so long as they are connected with income earned in the U.S that is fully taxable. For these moves, you will file Form 3903, *Moving Expenses.* (NOTE: If the reimbursement included in income is treated as excludable foreign earned income, it will *not* be deductible.)

6.7 Moves From The U.S. To A Foreign Country

Deduction of foreign moving expenses is a decidedly tricky business. By the time you get done reading this, you may wish you had stayed home! However, since you probably will already be overseas at this stage, every effort will be made to present this as clearly as possible.

What form to fill out: This is easy! Even if you are moving to a foreign country, you will fill out Form 3903, *Moving Expenses*. If you must reduce moving expenses because they are allocated to foreign income and thus are not deductible, it helps to attach a statement showing your calculations.

How much can you deduct?: This is not so easy. However, if you recall the earlier discussion about allocation of deductions connected with foreign income, you will have a sense of what is to come. The reasoning is as follows:

STEP ONE: Allocating to Foreign Income

To qualify as deductible, moving expenses must be incurred in connection with working at a new location. If your new work location is in a foreign country, then your moving expenses must be directly connected with income earned in that foreign country. **If some or all of that foreign income is excluded from tax, then the part of the unreimbursed moving expense (or reimbursed moving expense included in income) allocated to the excluded income cannot be taken as a deduction**.

You have now taken the first step! You know that if you are able to exclude some of your foreign income and you have moving expenses, you will have to do some calculations. If, alternatively, you are not able to exclude any of the foreign income, the moving expenses are all deductible (subject to the limits described earlier in Section 6.4, *Moving Expenses You Can Deduct*). And, just to be sure we cover all bases, if you are able to exclude all the foreign income, none of the moving expense related to that income is deductible.

STEP TWO: Year or Years Income is Earned

The IRS takes a rather complicated view of the relationship between the moving expense and the income earned in connection with it. (You may recall a similar convoluted situation with moving expense reimbursement in Chapter 3, ***Foreign Earned Income***). The IRS looks at how many days you are in the foreign country the first year. This will determine whether moving expenses will be allocated only to income earned in that first year, or, in the alternative, if they will be allocated to income earned over a 2-year period. This is how it works:

Income earned in year of move**:** If, in the year of the move, you qualify for at least 120 days under the bona fide residence or physical presence test, then the moving expense is connected entirely with income earned in that year. You will then perform the following simple calculation to see what part of the unreimbursed moving expense (or reimbursed expense included in income) is not deductible:

1 Create a fraction with the top number being your excluded foreign income and the bottom number being your total foreign income for the year of the move.

2 Multiply the total unreimbursed moving expense (or reimbursed expense included in income) by this fraction.

3 The result is the amount of moving expense you may not deduct because it is allocable to the excluded foreign earned income.

6.8 Income Earned In 2-Year Period

If you do not qualify under either residency test for at least 120 days in the first year of the move, the expense is considered to be connected with earning income in 2 years. The years you use will depend on whether you move to or from the U.S.

If you move **from the U.S. to a foreign country**, you will look at the year of the move and the following year.

If you move **to the U.S. from a foreign country**, you will look at the year of the move and the preceding year.

Calculations If You Move From The U.S. To A Foreign Country And Must Count 2 Years

The calculation you will perform to determine how much of your moving expense is deductible is relatively simple. The problem is you need to use numbers that are derived from your income in 2 different years. Thus, you either have to wait until the end of the second year to do the computations or you have to do the computations for the first year based on the available figures and then adjust that computation at the end of the second year. Either way you slice it, the whole process is not something you will relish!

Let's suppose you decide to wait until the end of the second year to calculate the moving expense deduction and have requested an extension of time to file for that reason. And, to make it all more concrete, let's use some real numbers: You moved to Argentina on October 1, 2007 to start a new job. In that year you paid $5,000 to move and earned $25,000 of income from your South American employer. In 2008, you worked the entire year in Argentina and earned $90,000. The burning question is how much of the $5,000 in moving expenses you can deduct. You will use the following steps to find the answer:

Figure your total foreign earned income for the 2 years — $25,000 + $90,000= $115,000.

Figure the income in 2007 that is excludable — $85,700 multiplied by the fraction of 92 qualifying physical presence days (Oct.1-Dec.31) divided by 365 days in the year (85,700 x 92/365=21,601). This amount, $21,601, is the maximum amount you can exclude for 2007 even though your salary exceeded that.

Figure the income in 2008 that is excludable — This is easy because you can only exclude up to $87,600 if you are in the foreign country for the entire year.

Figure the total amount of income that is excluded for the two years of 2007 and 2008 — That would be the sum of $21,601 and $87,600 or $109,201.

Figure the part of the moving expense that is not deductible by multiplying the moving expense ($5,000) by the fraction: total excluded foreign income/total foreign income or $109,201/$115,000. This result, which is $4,748, is the amount of moving expense that **cannot** be deducted. The balance of $252 **can** be deducted.

> **SUMMARY:** The bottom line goes back to the basic proposition stated earlier that you cannot take as a deduction expenses that are attributed to excluded foreign income.

TECHNICALITIES:

Getting an extension and filing after the end of 2 years: As to the amount you can deduct, you may wonder how you go about doing it since you have 2 tax years involved. If you waited, as in our example, until the end of the second year to file, you will use the numbers collected from those 2 years to make the calculation, *but the deduction will actually be reported in the year in which you made the move (or 2007 in the example).*

Recapture: If you don't get an extension of time to file and just use the income and expense numbers for the first year, you will have to recalculate everything at the end of the second year when you have those numbers. Thus, in our example, for 2007 you would figure the allowable moving deduction by multiplying the moving cost ($5,000) by the fraction of excluded foreign income for 2007/total foreign income ($21,601/$25,000). This result of $4,320 would be the moving expense ***not*** deductible and you take the balance of $680 as a deduction in 2007. At the end of 2008, the income figures for that year would be used in the calculations outlined in the preceding section. Because the end result is a ***lower*** deduction ($252 vs. $680), you would have to recapture the difference ($428) as income on your 2008 tax return. This would be accomplished by reducing your foreign income exclusion to the extent of the deduction you are not allowed to take. If the end result was a higher deduction with the actual numbers, you would have to amend the 2007 return to reflect the change.

> **EXAMPLE:** You took a moving expense deduction of $4,000 in 2007 without getting an extension. When you calculated all the numbers in 2008, you realized you were only entitled to deduct $2,000 in moving expenses. Thus, to correct the problem, you would subtract $2,000 from your foreign income exclusion in 2008 — if you could take $87,600, you will now exclude only $85,600.

Calculations If You Move From A Foreign Country To The U.S And Must Count 2 Years

This scenario is much simpler to deal with because it uses the year of the move and the **preceding year** as the 2 years for calculations **assuming** you did **not** qualify under the physical presence or bona fide residence for at least 120 days in the second year. In this situation, at the end of the second year (which is when you make the move), you will have all the numbers you need to make the calculation, and you will not need to amend or recapture anything.

6.9 Special Situations And Moving

Retirees: If you lived and worked outside the U.S., but decide to return home to retire permanently, the IRS will welcome you with open arms! Well, that may be a bit of an exaggeration, but the IRS will let you deduct the cost of the move back and it is not necessary that you meet the time test relating to work since, obviously, work is what you are retiring from. However, you must meet the other requirements such as distance, reasonableness of expenses, etc.

Survivors: You will also get special consideration if you are the spouse or dependent of an employee who dies while living and working overseas. Two special conditions apply in this case: (a) the move has to be within 6 months after the death of the employee, and (b) the spouse or dependent must have lived with the employee outside the U.S. at the time of death. If those conditions are met, the move will be deductible and, as with retirees, it is not necessary to meet the time test. However, the other requirements must be met.

6.10 Itemized Deduction For Foreign Income Tax

The IRS will permit you to take foreign income taxes as an itemized deduction. You would do this in place of taking a foreign tax credit for those same taxes. The deduction is allowed only for taxes paid on income that is subject to U.S. tax, and thus, can't be used for foreign tax paid on income that qualifies for the foreign earned income exclusion. As a practical matter, it almost never makes sense to takes these taxes as a deduction instead of a credit because the deduction only reduces your U.S. taxes on a roughly $0.30 to $1.00 basis. On the other hand, a foreign tax credit reduces your U.S. tax on a $1.00 for $1.00 basis. (See Chapter 10, ***The Foreign Tax Credit***).

6.11 Deduction For Other Foreign Taxes

If you pay real property taxes to a foreign country, you can deduct them on Schedule A. Other foreign taxes, such as personal property taxes, are **not** deductible unless you incur the expenses as part of your trade or business, or in the production of income.

CHAPTER 7

Where And How To Report Deductions

Your mind is probably reeling from all the math you have had to do in the last chapter, but the problems arising from deductions aren't over yet! Assuming you get to take any deductions, you have to decide where to put them on the tax return. This will depend on whether the deductible expenses are **itemized deductions** or **allowed in figuring adjusted gross income**. The distinction between these 2 is important because it will make a difference in where and how you report the numbers.

7.1 Itemized Deductions

If the expenses are treated as itemized deductions, you will only report on Schedule A the part of the expense that is related to income included for tax purposes. This means you do **not** report expenses that are related to excluded foreign income. It helps to attach a statement with your tax return showing how you made your calculations. The examples later in this chapter will provide a guide for preparing the explanatory statement.

7.2 Expenses Allowed In Figuring Adjusted Gross Income

In this case, you will report the whole amount of the expense on the 1040 (or appropriate schedule). You will then prepare Form 2555 and reduce the excluded income by the amount of the expense that is attributable to that income. This has the effect of reducing the amount of the expense that is allowed, though in a definitely circuitous way. The examples below may help to illustrate.

7.3 Examples With Schedule A Deductions And Other Expenses

Schedule A Expenses: The usual scenario here is that you are an employee and have unreimbursed business expenses. (Keep in mind you have to meet all the *other* tax rules relating to these type expenses, *in addition to* the rules on allocating between included and excluded income.) It will be assumed that you meet the residency requirements so you can exclude up to $87,600 of your foreign earned income.

In 2008, you had $110,000 of foreign earned income, $87,600 of which was excludable. You had $3,000 of unreimbursed business expenses incurred in earning this money, of which $1,000 was for meals and entertainment. You also had $700 of expenses in connection with managing your investments.

The first thing you should do is break down these various expenses. The $700 to manage your investments is not related to earning foreign income and therefore will be entered in its entirety on Schedule A.

For the unreimbursed business expenses, you must go to Form 2106, *Employee Business Expenses*. Since you can only take 50% of meal and entertainment expenses no matter where you live, you first have to reduce the $1,000 expense for those items to $500. This gives you a grand total of $2,500 in potentially deductible business expenses ($2,000 general expenses plus $500 for meals and entertainment) for Form 2106. However, since 79.64% of your income is excluded from tax ($87,600/$110,000), you must reduce your expenses by that percentage. Thus, only $509 (20.36% of $2,500) will be deductible on Schedule A.

The final step in the process will be to calculate whether business deductions exceed the 2% limit. Again, this is a rule that applies to all taxpayers. In your case, you would take 2% of your taxable income of $22,400 (0.02 x $22,400 = $448). The $448 is then compared to your total deductible business expenses of $1,209 ($509 + $700). You will be allowed to **actually deduct $761**, the amount by which your actual deductible expenses ($1,209) exceed $448 (2% of your adjusted gross income).

Expenses Used in Figuring AGI: In most cases to qualify for this situation, you will be operating your own business and will file a Schedule C, *Profit or Loss from Business,* to report your income. (When you use a Schedule C, the income and expenses are netted and the final result goes on Form 1040.) What is interesting here is that the Schedule C will be used to report all the income and expenses, while the Form 2555 will be used to separate out the percentage of the expenses that are not allowed to offset income because the income is excluded from tax.

In this example, you are self-employed in a foreign country and meet the physical presence test. You had $120,000 of income and $60,000 of expenses, leaving you with a net income of $60,000. However, in reporting income on Form 2555, you will report the full amount of $120,000 so it will be to your advantage to take the $87,600 exclusion.

The two forms that apply to this situation are Schedule C and Form 2555. Your first task will be to fill out Schedule C without regard to your overseas status. Thus, you will show the income and expenses listed above with the final result ($60,000 net income) being reported on the Form 1040. You then prepare Form 2555, reporting the full $120,000 of gross income and excluding $87,600 of it. The next step is to calculate what percentage of your income was excluded. This is $87,600/$120,000 or 73% of $120,000. Since you excluded 73% of income, you also have to exclude 73% of expenses or $43,800 (73% of $60,000). This will have the effect of reducing the amount of income you can exclude on Form 2555 to $43,800 ($87,600 - $43,800).

The final step will be to transfer the final calculations from Schedule C and Form 2555 to Form 1040. You will show net income from Schedule C as $60,000 on Form 1040 and net excluded income from Form 2555 as $43,800 on Form 1040. The difference of these 2, which is $16,200, will be the taxable income.

CHAPTER 8

Other Taxes You May Owe

There is little doubt the IRS spends a great deal of time and energy collecting income tax. You may be surprised to learn that it also has the responsibility to collect a variety of other taxes, such as Medicare, social security, etc. Unfortunately, rules regarding foreign earned income as related to these taxes can be quite different from the ones described in the preceding chapters for income tax. Painful as it is, you really should read on to see what, if anything, might apply to you!

8.1 Social Security And Medicare Taxes (FICA Withholding)

Generally speaking, if you work for a foreign company with no ties to the U.S. or if you work for a foreign government, U.S. social security and Medicare taxes (also known as FICA tax) do not apply to your wages and will not be withheld. If that is your situation, you can stop reading this section and go on to see if there are any other unpleasant surprises in the next sections!

However, if you fall into one of the other situations described below, social security and Medicare taxes should be withheld and paid *even* if the work you performed was outside the U.S.

American employer: If you work outside the U.S. for an American employer, your wages are subject to social security and Medicare tax (FICA). Thus, in general, if an American company sends you overseas, you will continue to have these taxes withheld from your paycheck. A more technical definition of *American Employer* includes:

- The U.S. government and its instrumentalities (a fancy word for agencies, etc.)
- A person who is resident in the U.S. (even if not a citizen)
- A partnership if at least two-thirds of the partners are U.S. residents
- A trust if all the trustees are U.S. residents
- A corporation that is organized under U.S. law, state law or the laws of a U.S. territory

American vessel or aircraft: If you work outside the U.S. either on or in connection with a U.S. vessel or aircraft and your employment contract was entered into in the U.S. or the vessel or aircraft comes to a U.S. port while you are working on it, your wages are subject to social security and Medicare taxes.

NOTE: *American aircraft* — defined as any aircraft registered under U.S. laws. *American vessel* — defined as either any vessel numbered or documented under U.S. law or one whose crew is employed solely by a U.S. citizen(s), resident(s), or corporation.

Foreign Affiliate: If you work outside the U.S. for a foreign affiliate of an American employer, your wages will be subject to social security and Medicare taxes if the American employer and the Treasury Department entered into a voluntary agreement to that effect. This is normally done to insure that American employees will have retained the benefits provided by social security and Medicare when they return to the U.S. For this purpose, a *foreign affiliate* exists if the American employer has at least a 10% interest, directly or indirectly, in the foreign entity. Form 2032, *Contract Coverage Under Title II of the Social Security Act*, is used by American employers to cover U.S. citizens working for foreign affiliates abroad.

8.2 Binational Social Security Agreements

If you work outside the U.S. in a country that has a binational social security agreement (also known as a *totalization* agreement) with the U.S., your wages will be subject to social security taxes, **but only in one country**. The idea is to eliminate dual social security coverage which would occur if you were required to pay social security taxes to more than one country on the same earnings. Each agreement includes rules intended to assign your coverage to the country where you have the greater economic attachment. There are currently 22 countries with which the U.S. has totalization agreements, mostly in Europe and with Canada. Details on who gets paid what will depend on the agreement with each country. You should contact the U.S. Social Security Administration, Office of International Programs, P.O. Box 17741, Baltimore, MD 21235, for more information. Or go to this website: www.socialsecurity.gov/international/payments.

NOTE: The countries with which the U.S. has totalization agreements include: Australia, Austria, Belgium, Canada, Chile, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Portugal, South Korea, Spain, Sweden, Switzerland, and the United Kingdom.

TAX TIP! You or your employer will want to get a written statement from both the U.S. (contact the Office of International Programs, Social Security Administration) and the country where work is performed (if possible), establishing which country has the right to withhold social security tax, so you are assured of getting all proper benefits when you retire.

8.3 Self-Employment Tax

If you work overseas in a self-employed status, you may still have to pay self-employment tax even though you might otherwise qualify for the foreign earned income exclusion. Generally, you are considered "self-employed" if you are a sole proprietor of a business or a professional in your own practice. You will file a Schedule C, *Profit or Loss from Business,* to report self-employment income. In paying self-employment tax, you pay both the employer and the employee share of social security and Medicare taxes on your net income. However, you are able to deduct one-half of the tax from your income on Form 1040. **The only situations where you will not owe this tax is if you are employed as an independent contractor by an international organization or a foreign government, or if you work in a country with a binational social security agreement with the U.S. (see below).**

Income Subject To Self-Employment Tax

Net income of $400 or more up to a maximum of $102,000 (in 2008) is subject to social security tax. The tax is at a rate of 15.3% on 92.35% of your net earnings (business income minus business deductions).

All **net earnings** in excess of $400 are subject to the Medicare tax at a rate of 2.9%.

Form To File

If you need to pay self-employment tax, you will file Schedule SE, *Self Employment Tax.* The form is relatively simple and will guide you through a series of calculations to arrive at the proper tax. It will also calculate the applicable deduction for self-employment tax and show you where to put it on Form 1040.

Totalization Or Binational Social Security Agreements

If you work in a country that has a totalization agreement (described in 8.2, *Binational Social Security Agreements*), you will only be subject to the taxes imposed by the social security system of one country. You should check with the Social Security Administration at the address indicated in Section 8.2 to see how you would be affected.

Generally, you will need to get a statement from one country or the other (or both) clarifying who will impose social security tax. This statement should be attached to your tax return each year along with an indication in the line for self-employment tax that you are exempt if you pay tax in the foreign country.

If you take the position that you should only pay U.S. self-employment tax and not foreign social security tax, you can ask the Social Security Administration, Office of International Policy, (*see address in 8.2)* to give you a certificate of coverage that will exempt you from the foreign social security tax.

Members Of The Clergy And Other U.S. Church Employees

If you are a member of the clergy, you must pay self-employment tax even though you may be considered an employee for other purposes. **Special rules may apply if you oppose public insurance for religious reasons and file the appropriate application for exemption from the tax.**

If you are employed by a U.S. church, you will pay self-employment tax if your church had elected to be exempt from paying social security and Medicare taxes. **Again, if you are a member of a qualifying religious sect, you may be able to apply for exemption from these taxes.**

CHAPTER 9

Taxes You May Think You Owe, But Don't

It's always refreshing to find out you may have done something for the IRS that you really didn't need to do! In the foreign income context, this would normally arise in one of **two** situations:

9.1 Withholding Tax On Paycheck

Since U.S. employers are required to withhold federal income tax from their employees' paychecks, it sometimes happens that tax is withheld on foreign earned income. If this happens to you, be sure to hasten to your employer and point out that he, she, or it is **not required to withhold income tax for you to the extent of the foreign earned income exclusion and foreign housing exclusion**. If there seems to be a question about whether you qualify for these exclusions, you should submit a written statement **to your employer** (not the IRS) to the effect that you meet either the physical presence test or the bona fide residence test for the tax year in question. (Ditto for the foreign housing exclusion if you plan to take advantage of it.) The IRS has conveniently prepared a form to do the job described above if you don't feel up to it: Form 673, *Statement for Claiming Benefits Provided by Section 911 of the Internal Revenue Code* (found online at www.irs.gov). This statement should be sufficient authority for your employer to stop withholding tax, except on amounts you earned in the U.S.

9.2 30% Flat Rate Withholding

This tax normally comes into play on certain investment income and is applied to nonresident aliens. The IRS wants to make sure it collects tax on these investment earnings. To accomplish this, the institution paying the foreign investor must send 30% of that payment to the IRS and the balance to the investor. If you have a foreign address, the investing institution may assume you are a foreign person (i.e., nonresident alien) and withhold 30% of your earnings for the IRS. If this happens, you should send a statement **in duplicate** to the paying institution to the effect that you are a U.S. citizen or resident alien. This should be sufficient to stop the withholding. If it is not and withholding continues, **be sure to take credit for the tax already paid when you file your tax return.**

CHAPTER 10

The Foreign Tax Credit

The foreign tax credit is designed to relieve U.S. taxpayers of having to pay taxes twice if their foreign source income is taxed by both the U.S. and the foreign country. Unlike the foreign earned income exclusion, you do not have to live overseas to qualify for the foreign tax credit. However, if you do live overseas, you pay foreign tax, and your income exceeds the exclusion limit, you should definitely keep reading.

10.1 Basic Propositions

There are 3 things you should realize from the start:

- **You must pay foreign tax to qualify for this credit.**
- **The foreign tax credit carries its own unique brand of complications that may lead you to conclude that you should have gone for an advanced degree in taxation rather than your chosen profession.**
- **If you take a foreign tax credit, you may be liable for the Alternative Minimum Tax which requires filling out the tax form from hell, Form 6251, and possibly paying additional tax.**

With those happy thoughts in mind, let’s start with some simple concepts.

10.2 Source Of Income

Generally speaking, you can only take a foreign tax credit for tax paid on income from a source outside the U.S. This could include such items as payment for services performed outside the U.S. (foreign earned income), interest from a payor located outside the U.S., dividends paid by a foreign corporation, and gain on the sale of nondepreciable personal property if you live outside the U.S. (if the tax you paid is at least 10% of the amount of the gain).

10.3 Foreign Taxes for Which You Can Take a Credit

Not all foreign tax qualifies for a credit. The tax imposed must either be an **income tax** or **a tax in lieu of an income tax**. It may seem elementary, but an **income tax** is only an **income tax** for these purposes if you are required to pay it without getting any particular economic benefit (such as goods or services or some other benefit from the foreign country) **and** it is imposed on income in the general sense of such a tax in the U.S. (even if items of income and deduction are different

in the foreign country). Normally, foreign tax paid on wages, dividends, interest, royalties, etc. qualify for the foreign tax credit. However, foreign sales taxes, transaction taxes, and taxes based on the value of assets, such as real estate taxes, do not qualify. Also, you may not take a credit or deduction for **social security** taxes paid to a country with which the U.S. has a social security agreement. *(See Chapter 8.)*

When determining if you can take a foreign tax credit, keep in mind that the credit applies for income tax paid to a **foreign country** (which is any foreign state or political subdivision of it) as well as income tax paid to **U.S. possessions including Puerto Rico, Guam, the Northern Mariana Islands, and American Samoa.**

A **tax in lieu of an income tax** is pretty much just what it says — it is a tax imposed in place of, or instead of, an income tax. It can be based on gross income or gross sales or even the number of units of a product made. If you happen to live in a foreign country that imposes tax, but doesn't call it **income tax**, you are advised to consult a tax professional or the IRS to see if you can take a credit for this tax.

10.4 Credit Is For Taxes Paid Or Accrued

Cash Basis: If you are a cash basis taxpayer, meaning you report all income in the year it is received and expenses in the year paid, you can take the foreign tax credit in the year it is paid or in the year it is accrued.

If you are a cash basis taxpayer and decide to take a credit for foreign taxes in the year they accrue (meaning all the events needed to determine the amount of tax to be paid and your liability to pay it have taken place), you must elect to do this by checking the appropriate box on the Form 1116. Once you make the choice, you must follow it in all later years **and** you must follow it for **all** foreign taxes that are **creditable** (no matter into what category they fall). If it turns out that the actual amount you pay differs from the amount you reported as accrued, you will have to adjust your U.S. tax return to reflect the difference. This is normally done by filing an amended return.

If you have been taking the foreign tax credit using the cash method and switch to the accrual method, you can take a credit for both the taxes paid and the taxes accrued in the year in which you make the switch.

Accrual Basis: If you use the accrual method to report income, you can only claim the foreign tax credit in the year it accrues. As stated earlier, it may be necessary to adjust your U.S. return if the amount paid differs from the amount accrued. This is true whether the difference results from a re-determination of liability or a fluctuation in currency.

If it turns out you have to pay a larger foreign tax than the credit which you claimed, you may be entitled to a refund of U.S. tax. If this is the case, you have 10 years from the regular filing due date of the original tax return to file a claim for refund.

10.5 Foreign Taxes For Which You Cannot Take A Credit

- Taxes paid to a foreign country on income that is excluded under the foreign earned income exclusion. NOTE: This is probably the category you fall into. It means you can only consider the foreign tax credit if you earn more than $87,600 and pay foreign income tax.

- Taxes paid to a foreign country if those taxes would be refunded if you made a claim for refund.

- Taxes paid to a foreign country that are returned in the form of a subsidy, which can include such things as refunds, credits, deductions, etc., that are based, directly or indirectly, on the amount of tax imposed.

- Taxes paid on income earned in certain foreign countries with which the U.S. does not have diplomatic relations, which the Secretary of State has designated as countries that support international terrorism, or whose governments the U.S. does not recognize. Those countries include Cuba, Iran, North Korea, Sudan, and Syria in the IRS current listings. (Consult the State Department website at www.state.gov for any additions or changes to their list.) Besides not being able to take a foreign tax credit in the year the tax was paid, you also cannot carry back or carry forward the foreign tax. You can, however, **deduct** any amount you cannot take as a foreign tax credit.

- Taxes paid to a foreign country for certain oil-related income. If you even think you might fall into this category, you are encouraged to consult your tax adviser.

10.6 Foreign Tax Credit vs. Foreign Tax Deduction

Even though you can choose to take a foreign tax deduction rather than a foreign tax credit, there are several advantages to the foreign tax credit:

- The credit reduces actual U.S. tax on a dollar-for-dollar basis while the deduction only reduces the amount of income subject to tax. This means that, depending on your tax bracket, the deduction only saves you about $0.30 on the $1.00 while the credit saves you $1.00 on the $1.00.

- Even if you don't itemize deductions, you can take the foreign tax credit. This means you can take advantage of the standard deduction **and** take the foreign tax credit. In the case of the foreign tax deduction, it would become part of your overall itemized deductions.

- Even if you can't use all the foreign tax credit you have available in any given year, it is possible to carry over or carry back the excess to other years.

It is important to realize 2 other items in this area:

If you take a credit for any foreign tax, you must take it for all foreign tax (with some limited exceptions listed in Pub. 514, *Foreign Tax Credit for Individuals*). Conversely, if you deduct any foreign tax, you must deduct it all.

You can either **make** or **change** your choice to claim a foreign tax credit or deduction **within 10 years** from the due date of the return. You would do this by filing an amended return. This is an extraordinarily long time that the IRS gives you to decide if you want to take a foreign tax credit or deduction – or change a foreign tax deduction to a foreign tax credit – and allows you a great deal of flexibility in this area for doing what makes the most sense from a tax-savings standpoint.

MORE COMPLICATED CONCEPTS

While every effort will be made to keep it simple, the fact is that the foreign tax credit involves a few complex ideas that, while not necessarily understood, must be employed in preparing the Form 1116, *Foreign Tax Credit*. These include:

10.7 Limits On Foreign Tax Credit

There are 2 limits of which you must be aware. Once you calculate them, the foreign tax credit cannot exceed the smaller of the two:

→ **The foreign tax credit you take cannot be more than the actual foreign tax you paid**.

→ **Your credit is limited to the part of your total U.S. tax that is in proportion to taxable foreign source income compared to total taxable income.**

To calculate this limitation, you will use a formula that will be examined in more detail later. But it may be helpful to realize that this limitation represents the percentage that foreign income bears to total income multiplied by U.S. tax. It is used to prevent you from claiming more than the effective U.S. tax rate on your foreign income.

10.8 Categories Of Income

Different countries tax their people in different ways. Each country has the authority to determine who will be taxed, the type of income subject to tax, allowable deductions, etc. The result is that various types of income you receive from overseas sources may be taxed differently from the U.S. method. If all the income was combined and the foreign tax credit applied to the total, the differences in the taxing systems would not be taken into account. Thus, Congress has created various categories of income in an effort to isolate foreign tax paid on different types of foreign income.

Before 2007, there were 7 categories of income. Starting in 2007, there are 5 categories: **general**

limitation income, passive income, section 910(j) income, certain income re-sourced by treaty, and lump sum distribution.

The “catch-all” category is **general limitation income** which includes **foreign source wages, salaries, and overseas allowances**. The **passive income** category includes dividends, interest, pensions, rent, royalties, annuities, etc. Descriptions of the other 3 categories are in the *Instructions for Form 1116* or Publication 514, but generally don’t concern us here.

If you only have foreign income from your job overseas, you will only need to fill out one Form 1116 which will be a relatively simple matter. However, the limit described above has to be figured separately for a different category of income and you must complete a separate Form 1116 for each category. As shown later, you will total all the results of the Forms 1116 on one of them for final transfer to Form 1040.

10.9 Calculating The Limit

This will seem like a daunting task when you read the description. However, lest you get too discouraged, it helps to keep in mind that Form 1116 will guide you through the calculations step-by-step. Thus, you should get the correct result even if you don’t completely grasp the underlying principles.

The basic idea is that you have to figure taxable income in each income category. For that purpose you will only include income that would be reported as income on your U.S. tax return. **If you are claiming the foreign earned income exclusion, you will not include this income as it is not subject to U.S. tax.** Keeping that in mind, you will need to determine the amount of gross foreign source income subject to U.S. tax in each category of income.

From the gross income, you must then deduct applicable expenses. This will prevent you from claiming a deduction and a credit on the same income. However, it can get a little tricky since there are 2 kinds of expenses for purposes of this discussion:

1. **Those that you can attribute 100% to the foreign income because they are definitely related to the foreign income, and**

2. **Those that are not definitely related to the foreign income such as medical expenses, charitable contributions, or if you don’t itemize, the standard deduction.**

If you have expenses that are **not definitely related**, you must figure out how much can be taken against the foreign source income. You will do that by creating a formula:

$$\frac{\textbf{gross foreign income in category}}{\textbf{gross income from all sources *}} \times \textbf{expense or deduction} = \textbf{share allocated to foreign sources}$$

* *Includes income excluded under foreign earned income provisions.*

You are now at the point that you have figured out your gross foreign income in each category and subtracted from it the definitely related and not definitely related deductions. The result is your

taxable income from foreign sources in each category. This number will be used in still another fraction to give you the final result you really want which is: **the upper limit on the amount of foreign tax credit you can take.**

The final fraction can be written as:

$$\frac{\textbf{taxable foreign income in category}}{\textbf{total taxable income from all domestic and foreign sources}} \times \textbf{total U.S. tax from 1040} = \textbf{maximum credit}$$

10.10 Foreign Currency

Generally speaking you will need to convert the tax paid in a foreign currency to U.S. dollars for purposes of Form 1116. You are supposed to translate the foreign currency value into U.S. dollars at the rate of exchange prevailing when you actually paid the tax. You are also supposed to be able to justify the rate you used — for example, by explaining you used the official market rate or the open market rate, etc. As a practical matter, you often don't know exactly when the tax was paid or the prevailing rate on that day. Local banks and even the IRS offices overseas should be able to give you an average rate for the year for any given country's currency to be used in these calculations. Or, better yet, you can refer to a currency conversion website such as www.oanda.com.

10.11 Foreign Tax Credit Instead of the Foreign Earned Income Exclusion

There may be situations where it is to your advantage to take the foreign tax credit instead of the foreign earned income exclusion. The following lists some of those situations. If you have any doubts, it is worth it to prepare your tax return using both methods and see which results in the lower tax.

1 **Contribution to IRA** — In order to contribute to an IRA, you must report "taxable compensation". If all your income is excluded as foreign earned income, you will not be able to contribute to an IRA because the exclusion means it does not fall into the category of "taxable compensation". Note, however, that if your income was in excess of $87,600 so that you took both the foreign earned income exclusion and a foreign tax credit on the excess, you will have "taxable compensation" for IRS purposes to the extent of the excess.

2 **Additional Child Tax Credit** — This credit may be available if you have a child (or children) under the age of 17 that lives with you. The credit can be up to $1,000 per child, and is sometimes available even if no tax is owed. However, you DO have to have taxable income. AND, if all your foreign income is excluded, there is no taxable income. SO, using the foreign tax credit, you report "taxable income", offset the U.S. tax with the foreign tax AND receive the child tax credit. The operative forms to study here are Publication 972, Child Tax Credit, and Form 8812, Additional Child Tax Credit.

3 **Not Meeting Time Tests for the Exclusion** — It may happen that you work overseas, but do not qualify under either the bona fide residence or the physical presence test to take the foreign income exclusion. If you pay foreign tax on that income, you can still take the foreign tax credit-there are no time strings attached to the credit.

NOTE: There is a potential downside to taking the foreign tax credit. If you have taken the foreign income exclusion in the past, that is treated as an "election". If you decide, going forward from 2008, to take the foreign tax credit instead, that will be treated as a revocation of the foreign income exclusion. Once you revoke the exclusion, you cannot use it again for 5 years unless you get a ruling from the IRS. Be advised that getting such a ruling is a complex process and may require a tax professional to help. So you will want to consider not only your current situation, but where you will be in the next 5 years (are you moving from a country with high tax to a country with no tax?) before deciding to take the foreign tax credit and revoke the foreign income exclusion.

10.12 Miscellaneous Considerations

Before this chapter ends, there are a few items that need to be mentioned. They generally will only affect a small number of taxpayers, but you just might be one of them.

Carryover And Carryback

If you are not able to take a credit for all the foreign tax you paid in one year because it exceeds your maximum limitation, you are allowed a 1-year carryback and then a 10-year carryover of the unused taxes. You can treat the *unused* portion of your foreign tax for that year as if were paid (or accrued) in the preceding 1 year or succeeding 10 years *up to the amount of any excess limit in those years.* Carryovers and carrybacks are calculated separately for each income category. If you are going to carryback a unused tax credit, you will need to file an amended return for the year to which you are carrying the unused credit and attach a revised Form 1116.

The ***unused foreign tax*** is the excess of qualified taxes paid (or accrued) in a category over the amount of the limit for that category.

The ***excess limit*** for each category is the amount by which the limit exceeds the qualified taxes paid (or accrued) for that category.

EXAMPLE: Suppose you paid $25,000 of foreign tax in 2007 and had a maximum limit of $30,000. In 2008, you paid $35,000 of foreign tax, but your maximum limit that year was $30,000, leaving you with *unused foreign tax* of $5,000. Because you have an *excess limit* of $5,000 in 2007, you can carryback your $5,000 of unused foreign taxes in 2008 to be used in 2007.

Losses

The rules relating to the proper handling of foreign losses are quite complicated and beyond the scope of this book. If you find yourself in that unfortunate situation, you need to consult a tax adviser.

Foreign Source Capital Gains And Losses: This is a very complicated area of tax law and use of a tax adviser is recommended. The basic proposition is that, under current law, a capital gain or loss requires the taxpayer to use a special worksheet, *The Capital Gain Tax Worksheet,* to calculate the tax owed. When a **foreign** capital gain or loss is in the picture as well, you will need to use some additional worksheets to adjust the gain or loss on your 1040. Those worksheets can be found in the *Instructions for Form 1116*.

Alternative Minimum Tax

The alternative minimum tax (AMT) was created by Congress to ensure that some high-income individuals that use a combination of deductions and exemptions to avoid paying taxes would at least pay a minimum amount. Unfortunately for you, when you calculate the foreign tax credit, you must also calculate an AMT foreign tax credit. And even worse, this credit has limits so that you may find yourself having to pay AMT even though you would not otherwise pay tax. It is beyond the scope of this book to go into the gory details of AMT.

Time Limit To Claim Foreign Tax Credit

Don't forget that you can **make** or **change** your choice to claim the foreign tax credit or deduction any time within 10 years after the due date of the return for which you wish to make the claim. This means you can change your mind and take a foreign tax **credit** instead of a foreign tax **deduction** by filing an amended return for the year in question. And, it also means you can file an amended return to take a foreign tax credit that you had not previously claimed – perhaps because you didn't realize you could, or you didn't know how to calculate it.

CHAPTER 11

Tax Treaties

The U.S. has income tax treaties or conventions with a number of countries. The purpose of these treaties generally is to insure against double taxation of citizens or residents of the U.S and the other country as well as to provide certain benefits in terms of credits or reduced rates of tax. Therefore, if you are paying tax in a foreign country, you should check first to see if the U.S. has a treaty with that country and second, if that treaty offers you some benefit.

A current list of treaties to which the U.S. is a party and the complete text of each treaty can be found at the IRS website, www.irs.gov/businesses/international. If you want to order the text of a treaty, you can write to: Department of Treasury, Office of Public Correspondence; 1500 Pennsylvania Ave., NW, Room 3419; Washington, DC 20220.

11.1 Common Tax Treaty Provisions

Although each tax treaty is unique, most share certain common features of which you should be aware. In many cases, tax treaty benefits are not available to U.S. citizens residing overseas., but you should carefully check the treaty the U.S. has with the country you live in to make sure you are not missing out on any benefits. The following list gives you an idea of what to expect.

Limited stay in foreign country: Many treaties provide that if you continue to reside in the U.S. and perform services in the foreign country for only a limited period (usually less than 183 days), you will not be taxed in that foreign country on the income earned there. There may be other requirements you have to meet as well so check the specific treaty provisions.

Teachers: Most treaties have special rules for teachers and professors whereby the pay you receive in the first 2-3 years that you teach or do research in the foreign country is not taxed by that country.

Students and trainees: If you go to a foreign country to study, do research, receive technical training, etc., and receive pay from the U.S. to do so, that pay may well be exempt from tax in the foreign country. This is even more likely to be the case if you have received a grant or allowance from the government or a non-profit organization. Be sure to check the treaty provisions if you are a student or engaged in any kind of training.

Pensions and annuities: Many treaties have provisions exempting nongovernment pensions and annuities you might receive from the U.S. from tax in the foreign country. There are usually separate rules governing the tax treatment of government pensions and annuities, but they are often tax-exempt as well.

Nondiscrimination provisions: These treaty provisions are designed to insure that the tax burden imposed on you by the foreign country where you are resident is not greater than the burden imposed on its own citizens under the same circumstances. If you think you have been unfairly treated, you should go to Section 11.3, *Competent Authority Assistance In Cases of Double Taxation.*

Savings Clause: The U.S. always puts a "savings clause" in its tax treaties whereby it retains the right to tax its U.S. citizens and residents. As a result, treaty benefits often only apply to U.S. citizens who are not resident in a foreign country, but derive income from that country in some other way. However, there are exceptions to some savings clauses, so it is worth your while to check the clause in the treaty that applies to you.

NOTE: IRS Pub 901, *U.S. Tax Treaties*, provides a brief discussion, on a country-by-country basis, of how each type of income is treated.

11.2 Treaties With Countries That Tax U.S.-Source Income

There are several countries that have decided to impose tax on your income that the IRS considers to be U.S.-sourced. This may have the effect of imposing double taxation on U.S.-sourced income, which is a problem the foreign tax credit is not designed to handle. Therefore, tax treaties between the U.S. and these particular countries have special provisions whereby you can take an additional credit for the foreign tax imposed on the U.S.-source income (over and above the foreign tax credit). If you have a situation where the U.S. and one of these countries both assert a right to tax this income, you will need to consult the treaty.

The countries in question are Australia, Austria, Canada, Finland, France, Germany, Ireland, Israel, Mexico, the Netherlands, New Zealand, Portugal, South Africa, Sweden, and Switzerland. To calculate the additional credit you will use a worksheet, *Additional Foreign Tax Credit on U.S. Income*. It is an amazingly obtuse and difficult worksheet, so, if necessary, you can also contact the IRS representative at the American Embassy near you for help in figuring this credit. Don't be too surprised if the IRS employee is puzzled by the worksheet too! (By the way, this worksheet cannot be used for the treaties with Australia and New Zealand).

11.3 Competent Authority Assistance In Cases Of Double Taxation

In cases where you think you have been subject to double taxation (for example, your U.S.-source retirement income is taxed by the foreign country where you live and the U.S.), or you think the U.S. or the other treaty country (or both) acted in a way contrary to a treaty, you need to contact the U.S. competent authority which is your main source of assistance in these matters. It is very important that you present your concerns as soon as possible after you have been subjected to

double taxation or denied treaty benefits as the process of the U.S. competent authority consulting with the competent authority of the other country can be quite lengthy.

For more information on how to start the process, see *Revenue Procedure 2006-54* at the IRS website, www.irs.gov. To further protect yourself, you should:

- → File a timely protective claim for credit or refund of U.S. taxes on Form 1040X in case you do not qualify for the treaty benefit you claim, but could get a foreign tax credit.
- → Take the necessary steps under the law of the foreign country to protect your right of appeal under the country's income tax laws.

The address to which you send your request for competent authority assistance is:

Director, International
Attn: Office of Tax Treaty
Internal Revenue Service
1111 Constitution Ave., NW
Washington, D.C. 20224

CHAPTER 12

Choosing The Foreign Earned Income Exclusion And Which Form To Use

You now have lots of information about the foreign earned income exclusion, the foreign housing exclusion, and the foreign tax credit. One of the most important things you have learned is that you cannot take the exclusion and the foreign tax credit on the same dollar of foreign earned income. This suggests that a choice may be involved as to how you treat the income, and that is exactly how the IRS views the situation. Generally there is no problem regarding your choice *unless you change your mind.*

12.1 Choosing To Take The Foreign Earned Income Exclusion On Your Tax Return

The way it works is this: When you file a Form 2555 to take the foreign earned income exclusion, you have made a voluntary choice to exclude foreign income. This choice will remain in effect for that year and all later years **unless you revoke it.**

There are two ways to revoke the choice, one of which may occur without you realizing what you did! The first way is straightforward: You revoke your choice to take the foreign income exclusion by attaching a statement that you are doing so to the tax return for the first year that you do not want to claim the exclusion. (If you have previously chosen to take foreign housing amounts, you must revoke that choice separately).

The second way to revoke your choice is to take the foreign tax credit for tax on income **you could have excluded under your election to exclude foreign earned income or foreign housing costs.** If you take the foreign tax credit, these elections may be considered revoked.

12.2 Consequences Of Revoking The 2555 Election

You may be thinking to yourself, "So what? I can just elect the 2555 exclusion again next year." ***WRONG!*** Once you revoke the election to exclude foreign income, you may not use it again for the next 5 years unless you apply for and receive IRS approval. To do this, you must request a ruling from: Associate Chief Counsel (International), Internal Revenue Service, Attn: CC:PA:LPD:RU, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Bear in mind that the IRS charges a fee for issuing these rulings.

In deciding on the ruling, the IRS will consider such things as the period of U.S. residence, whether you moved from one foreign country to another foreign country because of differing tax rates, a change

of employer, and whether the foreign country you live in may have changed its tax rules substantially. *In other words, don't revoke your 2555 election by taking a foreign tax credit* ***unless you have a very good reason***!

12.3 Which Form — 2555 Or 2555EZ?

The Form 2555 is 3 pages long and must be prepared *in addition* to the Form 1040 and any other tax forms that fit your situation. Recognizing the complexity of the 2555, a few years ago the IRS introduced the Form 2555EZ which is only 2 pages long and much easier to prepare. By all means, use Form 2555EZ if you meet the following conditions:

→ **You are a U.S. citizen or resident alien and your foreign salary is $87,600 or less. You cannot use this form if you have self-employment income because that requires a Schedule C.**
→ **The return is filed for a full calendar year.**
→ **You do not claim the foreign housing deduction or housing exclusion and you do not have a housing deduction carryover.**
→ **You do not have business or moving expenses.**
→ **You meet either the bona fide residence or physical presence test and the tax home test.**

NOTE: With Form 2555EZ you will still have to provide information about your employer's name and addresses (foreign and U.S., if applicable) as well as establish that you met the physical presence or bona fide residence test.

CHAPTER 13

Penalties And How To Avoid Them

If you encounter delays in filing your tax return, make mistakes in preparation of the return, or fail to give the IRS some information it requested, you may find that the IRS expresses its displeasure by assessing you a penalty. Actually, the possibilities are quite extensive and you will find that penalties exist for the following transgressions:

- **Paying Tax Late**
- **Filing Late**
- **Underpayment of Tax Due to Negligence or Disregard of Rules**
- **Substantial Understatement of Income Tax**
- **Frivolous Return**
- **Fraud**
- **Failure to Supply Social Security Number**
- **Failure to Furnish Tax Shelter Registration Number**
- **Underpayment Penalty**
- **Failure to File or Late Filing of Form TD F 90-22.1**

> **IMPORTANT UPDATE:** In early 2007, the IRS issued *Notice 2007-16* – available online at www.irs.gov/irb/2007-08_IRB/ar06.html – which waives the penalty for overseas taxpayers who may have underpaid their estimated taxes as a result of the foreign housing allowance. This waiver will apply for tax year 2006.

As you can imagine, there are detailed explanations for how each of these penalties is incurred and the dollar amount involved. You can also be assured that the list is not complete and is added to almost yearly as new efforts are made to collect revenue and/or halt some real or perceived effort to circumvent the tax system.

13.1 Penalties Generally Assessed As Percentage Of Tax Owed

Many penalties (but not all) are assessed as a percentage of tax owed. Therefore, if no tax is owed, no penalty is assessed. This is not the case for frivolous returns, failure to supply a Social Security number, or failure to furnish a tax shelter registration number.

13.2 Types Of Penalties

Late Payment Penalty: If you pay your taxes late, there is a monthly penalty of 1/2 of 1% imposed on the net amount of tax due and unpaid on the due date. The penalty, however, cannot exceed 25% of the tax due. This penalty is in addition to interest charged on the tax due. You can be excused from paying this penalty if you can show you had reasonable cause for not paying it. It would not apply in cases where no tax is due such as when all income was excluded under the foreign earned income exclusion. Also, if you filed for an extension with Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return,* and you paid at least 90% of your tax liability before the original due date of your return, the penalty will not apply during the extension period.

Late Filing Penalty: You can be charged a penalty of 5% of the net tax due for each month the return is late if you file late without reasonable cause. The maximum penalty here is also 25% of the tax due. In cases where the return is more than 60 days late (counting from the due date or extended due date), the penalty is not less than the smaller of $100 or 100% of the tax due. As discussed in Chapter 1, if you were late in filing your tax return, but no tax is due because all your income is excluded under the foreign earned income exclusion, you will not be assessed this penalty. This proposition was actually tested when the IRS tried to charge a taxpayer the minimum penalty even though the taxpayer did not owe tax (in this case because her withholding exceeded her liability). The Tax Court ruled in favor of the taxpayer on the grounds that the penalty does not apply unless tax is owed. You will also not have to pay this penalty if you can show you had a good reason for not filing on time.

Combined Penalties: If you both file late and pay tax late, you can get stuck with both penalties at the same time. The IRS gives you one tiny break however — if both penalties apply in any 1 month, the failure-to-file penalty (5%) will be reduced by the failure-to-pay penalty (0.5%) meaning your combined penalty will be 5% (4.5% + 0.5%=5%). Keep in mind, though, if you file your return more than 60 days after the due date (with extensions), you must pay a minimum penalty of $100 or 100% of the unpaid tax.

Underpayment Of Tax Due To Negligence Or Disregard Of IRS Rules: There is a penalty of 20% applied to any portion of underpayment of tax that can be attributed to negligence or a disregard of IRS rules and regulations.

> ***Negligence***: This term is defined as failing to make a reasonable attempt to comply with the law. Negligence is *not* presumed, and you can avoid the penalty if you can show good faith and a reasonable cause for the underpayment. **However, if you claim a deduction or credit that seems "too good to be true" under the circumstances, it will be very hard to convince the IRS you were not negligent. You will have to show all attempts made to verify the correctness of the position.**

> ***Disregard Of IRS Rules:*** This term encompasses careless, intentional or reckless disregard of IRS rules and regulations. **You may be able to avoid this penalty by attaching a statement to your return in which you try to show that your position has some reasonable basis. You can use Form 8275, *Disclosure Statement* for this purpose.**

Substantial Understatement Of Income Tax: If you show less tax on your return than the correct amount of tax, this is considered an "understatement of tax". If that amount exceeds the larger of these two numbers — $5,000 or 10% of the correct tax — it is considered substantial. The penalty for substantial understatement is 20% of the underpayment attributable to the understatement.

There are two ways to avoid this penalty (except in cases of tax shelters):

→ Use Form 8275, *Disclosure Statement*, to show the relevant facts about your tax treatment of an item and to show you had a reasonable basis for your position.
→ Show that you had "substantial authority" to support your position. You can use court opinions, Treasury regulations, revenue rulings, revenue procedures, etc.

> **NOTE:** If you find yourself in this territory, you would be well-advised to retain professional tax assistance.

Frivolous Return: This penalty applies if you do such things as alter the forms so they are hard to read or include clearly incorrect information. The IRS is looking to see if you exhibit an intent to interfere with the administration of the tax laws. If it finds such to be the case, the penalty is hefty — $500 — and is in addition to other penalties imposed. **Note, also, that this penalty applies whether or not tax is otherwise due.**

Fraud Penalty: If you fail to file because of fraud, the penalty is 15% per month of the tax not paid by the due date (without regard to extensions) for each month the return is late up to a maximum of 75%. If your tax underpayment is due to fraud, you will be assessed a penalty of 75%. Generally, if any part of the underpayment is due to fraud, the whole underpayment will be so considered unless you can prove otherwise.

Failure To Supply Social Security Number: There is a $50 penalty each time you fail to supply a Social Security number where it is required on a tax form or other tax statement. This applies to both your Social Security number and those of your dependents. The penalty also applies if you fail to give a Social Security number to another party, such as a bank, that needs it for tax purposes. This penalty is not dependent on tax due so you would have to pay this penalty even if tax is not owed.

Failure To Furnish Tax Shelter Registration Number: There is a penalty of $250 if you don't attach a Form 8271, *Investor Reporting of Tax Shelter Registration Number*, along with said number any time you claim any tax benefit because of a tax shelter. The person who sold you the interest in the tax shelter has an obligation to provide you with the tax shelter number or he/she will also face a penalty. If you can show a good reason for not reporting the number (like the tax shelter never sent it to you), you may be able to avoid this penalty.

Underpayment Penalty: This penalty is imposed if you did not pay enough tax either through withholding or estimated tax payments. The reasoning behind this is that you are supposed to pay tax on moneyas it is earned throughout the year. Failure to do so results in the penalty. The

penalty is actually calculated on a quarterly basis and thus a minimum amount is required to be paid in each quarter. The penalty applies from the date the tax for that quarter is considered due until the date it is paid.

You will **not** have to pay a penalty if one of the following applies:

- → Your total withholding and estimated tax paid for 2007 is at least as much as your 2006 tax (or 110% of 2006 tax if your AGI was more than $150,000).
- → You did not owe any tax in the previous year.
- → Your total tax due minus withholding is less than $1,000.
- → Your tax balance is not more than 10% of your 2007 tax and all estimated payments were made on time.

You will be happy to know you do not have to figure this penalty on Form 2210 by yourself — the IRS will do all the calculations for you if the penalty applies. However, if you do not receive your income evenly throughout the year, you will want to prepare Form 2210 as you may be able to lower or eliminate your penalty by using the *annualized income installment method.* You can ask the IRS to waive this penalty by filing a Form 2210 and claiming one of the following:

- → You didn't make a payment because of a disaster or other unusual circumstance, and it would be unfair to impose the penalty.
- → You retired (after age 62) or became disabled during the year or a preceding year and both of the following are true: (a) you had a good reason for not making the payment, and (b) the underpayment was not due to wilful neglect.

13.3 Penalties Abated For "Reasonable Cause"

Generally speaking, the following reasons, when presented to the IRS in writing, will incline it toward abating a penalty. You can attach a statement of reasonable cause to your return or you can respond after notice of assessment.

- **Death, serious illness, or unavoidable absence of you (as the taxpayer) or the death or serious illness of a member of your immediate family.** You should provide information as to the relationship of the persons involved, date of death or date and nature of illness or absence, and how the event prevented compliance.

- **Fire or other casualty destroyed your tax records or prevented compliance in some other way.** You would need to provide the date and description of the event, an explanation of how the event hindered compliance, and what other means were explored to get the needed information. Also, any supporting documents such as a copy of the police, fire, or insurance report should be submitted.

- **Inability to obtain records necessary to comply with a tax requirement**. You will need to explain why the records were needed, why they were not available, and steps taken to obtain them, other means explored to secure the information, and any

supporting documents you might have.

- **Reliance on the incorrect advice of a competent tax advisor, including a tax attorney, certified or licensed public accountant, or enrolled agent.** You would need to show when and how you became aware of the mistake, that you actually provided complete and accurate information to the tax advisor and then relied on his/her advice, and supporting documents such as a copy of the advice requested and the advice received.

- **Erroneous oral advice from the IRS.** You would need to show that you provided the IRS with complete and accurate information and that you used ordinary business care and prudence in relying on the advice. You would also need to show which IRS office was consulted and how the advice was obtained (i.e., phone call, visit to office, etc.), the date the advice was provided, and the name of the employee providing the information.

- **Erroneous written advice from the IRS.** If you can show the information you supplied was adequate and accurate, you made a specific written request, and you relied on the advice, the IRS is required to abate any portion of the penalty attributable to the erroneous written advice.

13.4 Failure to File or Late Filing of Form TD F 90-22.1

The Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, is actually a reporting form that is sent to the Treasury Department. (See Chapter 14 for more detailed information on this form.) Its purpose is to give the government information about financial holdings Americans may have outside the U.S. and to make sure that any earnings on such holdings are reported. The form is required to be filed if the aggregate value of your foreign accounts exceeds $10,000 at any time during the tax year.

The penalty for failing to file this form is SEVERE. In the case of non-willful failure to file, the penalty can be as much as $10,000. In addition, the government can go back 6 years to see if you should have filed. If it determines you should have, the $10,000 penalty can be assessed for EACH year of non-filing.

In cases of willful failure to file, the penalty is significantly more — $100,000 or 50% of the amount of the value of the unreported accounts-whichever is greater. Civil penalties can be assessed anytime up to 6 years after the date of violation. There are also criminal penalties for willfully not filing.

It appears that in cases of non-willful failure to file, the penalty may be waived if any income from the foreign accounts was properly reported on your federal income tax return AND there was reasonable cause for not filing. However, the IRS is reported as taking the position that not knowing about the form is no longer considered a “reasonable cause” for not filing. This position has not been tested in court as of this writing.

The “reasonable cause” argument is not available at all in the case of willful failure to file.

CHAPTER 14

Important Miscellaneous Information

This chapter will cover a number of unrelated, but very important, aspects of your tax return, including:

- **Where, When, and How to File**
- **Extensions of Time for Filing**
- **Change of Address**
- **Claim for Refund**
- **Payment of Tax**
- **Estimated Tax**
- **W-2 — How to Stop Withholding of Tax**
- **Foreign Currency**
- **Employee vs. Independent Contractor**
- **Compensation Packages**
- **Foreign Business/Investments and Information Returns**
- **Tax Equalization and TaxProtection**
- **Education Tax Credits and Deductions**
- **Taxation of Expatriates Who Give Up U.S. Citizenship**
- **Reporting Foreign Accounts**

14.1 Where, When, And How To File

The **"where"** part of this is fairly straightforward. If you live overseas and have no principal place of business in the U.S., you can file with the Internal Revenue Service Center, Austin, TX 73301-0215 unless you are a bona fide resident of the Virgin Islands or a resident of Guam on the last day of your tax year.

If you are a bona fide resident of the **Virgin Islands** on the last day of the tax year, file your return with: Virgin Islands Bureau of Internal Revenue, 9601 Estate Thomas, Charlotte Amalie, St. Thomas, Virgin Islands 00802. If you are a resident of **Guam** on the last day of the tax year, file your return with: Department of Revenue and Taxation, Government of Guam, P.O. Box 23607, GMF, Guam 96921.

NOTE: The IRS would actually prefer you to file electronically rather than send a paper return. But not all returns from Americans overseas are accepted as e-Files so you need to be aware of the paper option.

As to the **"when"**, you doubtless know the due date for filing your return is normally April 15 following the close of your tax year (assuming you file on a calendar year basis). However, if you have both your tax home and your abode outside the U.S. and Puerto Rico on the due date of the return, you automatically get a 2-month extension to file your return and pay any tax due. For most Americans living overseas, this means you need to have your return postmarked no later than midnight of June 15th of the year following your tax year.

> **NOTE:** If you use the 2-month extension, you will need to attach a statement to your return showing that you qualify for it. If you owe tax and don't pay it until you file in June, you will owe interest on the amount of tax owed from the original due date (April 15) until the tax is paid.

The **"how"** part is evolving as private delvery services increase in popularity. You can now use the followng services (in addition to the Postal Service) to meet the "timely mailing as timely filing/paying" rule for tax returns and payments:

- DHL Express: DHL Same Day Service, DHL Next Day 10:30 A.M., DHL Next Day 12:00 P.M., DHL Next Day 3:00 P.M., and DHL 2nd Day Service.
- FedEx: FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First.
- United Parcel Service: UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

The address to use if you engage a private delivery service is: Internal Revenue Service Center; 3651 South Interregional Highway #35; Austin, TX 78741. Telephone: (800) 829-1040.

E-Filing: Electronic filing is actually the method the IRS prefers for filing your tax return. It is now possible to e-file even with a foreign address. There are 3 ways to e-file: using an authorized IRS e-file provider, using your personal computer, or using a telephone. Detailed instructions for e-filing can be obtained at the IRS website (www.irs.gov) or you can consult your tax preparer to see if you meet all the criteria for e-filing.

14.2 Extensions Of Time For Filing

There are three types of extensions you can get if the need arises:

AUTOMATIC 6-MONTH EXTENSION

This extension gives you an extra 6 months from the regular filing date of April 15th and is obtained by filing a Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, by the due date of the return (April 15). The IRS allows either paper filings or e-filings of this form. In either case, if you file this form by April 15, you are

basically letting the IRS know that you are aware of your obligation to file, and the IRS will not charge you a penalty for failure to file if you do not pay all the tax you owe when you request the extension. (However, you will have to pay interest and possibly a late payment penalty if you have not paid at least 90% of your tax by April 15.)

EXTENSION IF YOU HAVE NOT MET THE PHYSICAL PRESENCE OR BONA FIDE RESIDENCE TEST

If you live in a foreign country and expect to meet one of these two tests, but haven't done so by the time of the other extension deadlines, you can request an extension for up to 30 days beyond when you expect to qualify. The form you file is Form 2350, *Application for Extension of Time to File U.S Individual Income Tax Return.* This should be filed in duplicate with the IRS in Austin or a local IRS representative as it requires the permission of the IRS. As with the automatic extension, the Form 2350 must be filed by the due date of the return (April 15th). However, you are encouraged to file this request early so that if it is denied, you will still have a chance to file on time.

If you know that you will owe some tax, you can pay the estimated amount due with the Form 2350 request for extension. The biggest incentive to do this is the fact that you will otherwise be charged interest on the unpaid tax from the regular due date of the return to the date the tax is paid **plus** you could be hit with a **penalty for failure to pay tax** (which is half of one percent of any additional tax due for each month or part of a month the tax remains unpaid beyond the due date).

ADDITIONAL EXTENSION OF TIME FOR TAXPAYERS OUT OF THE COUNTRY

In addition to the 6-month extension, you can request a discretionary 2-month additional extension of time to file if you are overseas (December 15 for calendar year taxpayers). You will need to send a letter to the IRS explaining why you need the additional time, and this letter must be sent by the extended due date (October 15).

The address to use for your request for extension is:

Department of the Treasury
Internal Revenue Service Center
Austin, TX 73301-0215

You will NOT receive any notification from the IRS unless your request is denied for being untimely. That means that, as long as you get the request in by October 15, you should get the additional 2 months to file.

NOTE: You cannot get this particular extension if you have already gotten an approved extension on Form 2350 (explained above).

14.3 Change Of Address

Whenever you move, you should notify the IRS of your change of address. The notification should be sent to the IRS Service Center where you filed your last return. You can use Form 8822, *Change of Address,* to supply all the pertinent details.

14.4 Claim For Refund

If you are unable to get the Form 2350 extension, you will have to file a tax return that includes income from both U.S. and foreign sources — and you will have to pay tax on all that income. If you later qualify to exclude the foreign income under the bona fide residence or physical presence test, you can make a claim for refund using a Form 1040X. You must file the Form 1040X within 3 years from the time you filed your original return or within 2 years from the date you paid the tax for that year, whichever date is later. You would file with the IRS office where you filed your original return.

> **NOTE:** The "Claim for Refund" option would only be recommended as a last resort both because of the potential for an administrative nightmare and the fact that you have to pay all that tax up front on income that most likely is excludable from tax as foreign earned income.

14.5 Payment Of Tax

The IRS now allows payments of tax both by credit card and electronic transfer from your bank.

CREDIT CARDS

You can use Visa, American Express, Discover Card, or MasterCard to pay your tax bill. The way it works is that you will contact one of the service providers (listed below) either by toll-free number or by Internet. Instructions will be provided after you make contact.

Official Payments Corporation
(Credit Card option)
1-800-2PAY-TAX (1-800-272-9829)
1-877-754-4413 (Customer Service)
www.officialpayments.com

Official Payments Corporation
(ATM/Debit Card option)
1-866-4PAY-TAX (1-866-472-9829)
1-877-754-4413 (Customer Service)
www.officialpaymentsdebit.com

LINK2GOV Corporation
1-888-PAY1040 (1-888-729-1040)
1-888-658-5465 (Customer Service)
www.pay1040.com

NOTE: There will be a convenience fee charged for using your credit card and the amount will be based on the amount you are paying. As of this writing, the fee is $3.95 for an ATM/Debit card payment and 2.49% for credit card payments. The convenience fee can be deducted as a business expense.

If you pay by credit card, you need to indicate that by entering, on the upper left corner of Form 1040, the **confirmation number** you are given by the service provider as well as the amount you charged (not including the convenience fee).

ELECTRONIC PAYMENT

You can also choose to pay your taxes either by direct debit from your bank account or by electronic payment with a credit card when you e-file your tax return.

Direct Debit – This method is free and convenient. It's available through most tax preparation software, tax professionals, or e-filing by telephone. It also allows you to file early and schedule an electronic payment for a future date – up to and including the due date of the return. You will need to know your bank account numer and your financial institution's routing transit number. Also, you should check with your financial institution to confirm that it will allow an electronic debit.

Credit Card – If you e-file, you can also choose to pay electronically by credit card at the time of e-filing. To do this, you will need an appropriate tax preparation software or a tax professional that offers the service. You will be charged a service fee as described in the previous section. However, you are entitled to earn miles, points, rewards, or money back from the credit card issuer.

For more details on these methods of payment, you are referred to www.irs.gov under "Electronic Payment Options for Individuals".

14.6 Estimated Tax

If all of your income is from foreign sources and you can either exclude under the earned income exclusion or you can take advantage of the foreign tax credit, you do not need to worry about paying estimated tax. However, if you expect your tax liability to be at least $1,000, you must make estimated tax payments for the coming year if you have not paid the smaller of:

→ **90% of the actual tax for the coming year, or**
→ **100% of the tax shown on your prior year's return (110% of the tax if your adjusted gross income is over $150,000; $75,000 if you are married and file separately).**

The first installment of estimated tax is usually due on April 15 of the tax year with additional installments on June 15, September 15, and January 15 of the following year. Obviously, this whole scenario assumes that you have a fairly good idea of what your income for the entire year will be by the end of the first quarter. If you receive income unevenly throughout the year, you may be able to lower or eliminate the amount of the required estimated tax payment for one or more periods by using the annualized income installment method. To follow this route, see IRS Pub. 505, *Tax Withholding and Estimated Tax*, or your tax advisor for details.

EXAMPLE: As you shake your head in wonder at this new complication, it may be helpful to picture an example. Let's suppose that in 2007 you worked in the U.S., had tax withheld all year, and filed a normal return wherein you got a refund. In 2008, you moved overseas and qualified for the earned income exclusion. However, you had substantial dividend and interest income resulting in federal tax in excess of $1,000. However, no tax has been withheld on that income. Because your withholding and credits are $0.00, they are obviously less than either 90% of your 2008 tax **or** 100% of your 2007 tax. This means you will need to file a Form 1040-ES, *Estimated Tax for Individuals,* besides calculating and paying the estimated tax you owe.

14.7 W-2 — How To Stop Withholding Of Tax

As a working American, you are used to seeing a large chunk of your salary disappear each pay period into the dark hole known as "withholding". However, when you move overseas to work, the situation changes, even if you continue to work for an American employer. Your employer is not required to withhold U.S. income tax from your wages earned abroad to the extent of the foreign earned income exclusion and the foreign housing exclusion if the employer has good reason to believe you will qualify for the exclusions.

The easiest way to convince your employer to not withhold is to submit Form 673, *Statement For Claiming Benefits Provided by Section 911 of the Internal Revenue Code*. This form goes to the employer and **not** the IRS The form basically allows you to show under which test you will qualify (bona fide residence or physical presence) and whether (and to what extent) you plan to take the foreign housing exclusion. Form 673 can be found on the IRS website (www.irs.gov), but you can also prepare your own signed statement if you wish.

14.8 Foreign Currency

The general rule is that amounts reported on your federal tax return must be in U.S. dollars. If you are paid in another currency, you must convert it into U.S. dollars. How you do this will depend on which currency is your "functional currency". For the vast majority of taxpayers, the U.S. dollar is the functional currency. (Only some qualified business units would have a foreign currency as the functional currency.) If your functional currency is the U.S. dollar, you are supposed to immediately convert into dollars all items of income, expense, etc. as it comes in, using the prevailing exchange rate at the time of the transaction.

As a practical matter, you probably will not be able to keep track of the exchange rate on a daily or transactional basis. One possibility, therefore, is to use the average exchange rate for the year (which is usually available from banks or U.S. embassies) and simply convert all your numbers to U.S. dollars when you prepare your tax return. A good website for currency conversion is www.oanda.com.

If you owe tax, it generally must be paid in U.S. dollars when it is due. There are only two exceptions to this rule:

Fulbright Grant: If you have a Fulbright grant and at least 70% of it has been paid in nonconvertible foreign currency, you may use that foreign currency to pay the part of your U.S. tax that is attributable to the foreign currency payments you received under the grant.

Blocked Income: If it is not possible to readily convert your income into U.S. dollars (or other money or property that can be converted to U.S. dollars) because of restrictions in the foreign country, that income is considered "blocked" or "deferrable".

Unless you want to go ahead and report this "blocked" income and pay tax on it with U.S. dollars from another source, you can choose to postpone the reporting of this income until it becomes unblocked. In order for the postponement to be valid, you need to file an information return with your Form 1040 which will actually be another Form 1040 labeled *Report of Deferrable Foreign Income pursuant to Rev. Rul. 74-351.* In this form you must declare the deferrable income will be included as taxable income in the year it becomes unblocked. You also lose any right to claim that the deferrable income was includible in income for any earlier year. Income on this information return should be reported in the foreign currency in which it was received.

If and when the income becomes convertible to dollars or, in fact, is converted or is used for personal expenses (or otherwise disposed of by gift or bequest), it is considered "unblocked" and must be reported. Of course, at that point, the tax on it must be paid as well.

14.9 Employee vs. Independent Contractor

The vast majority of taxpayers never have to wrangle with the question of whether they are employees or independent contractors. However, there are some work situations that fall into a "gray" area and it is not at all clear how you should be classified. In the area of taxation, the determination can make a huge difference in your tax liability, and this is even more significant with taxpayers living overseas. The reason: **independent contractors** are responsible for paying 100% of their social security and Medicare taxes (commonly known as the "self-employment tax"), while **employees** only pay 50% with the employer picking up the other half. As seen in Chapter 8, *Other Taxes You May Owe Besides Income Tax,* **the self-employment tax is due on income that is otherwise excluded from U.S. tax as foreign earned income.** There are certain redeeming features to being an independent contractor, including the ability to deduct expenses such as a home office or a computer.

If you are worried about your status, you need to know how to distinguish an employee from an

independent contractor. The IRS, in its infinite wisdom, has published a 20-point test that includes all the points it generally will consider. This has proven to be so cumbersome and unclear that tax advisers and other experts in the field instead focus almost exclusively on the following criteria:

→ **Do you or your employer control how the job is accomplished?** If you are told what to do and when to do it (i.e., the employer sets your hours), you are probably an employee.
→ **Do you provide your own supplies, work materials and/or office space?** If you work in someone else's office and use his/her equipment, you are probably an employee.
→ **Do you have more than one client?** This works in favor of independent contractor status.

This gives you a working knowledge of the distinction between an employee and an independent contractor. If you prefer to be classified as one or the other for tax (or other reasons), you can take steps to shore up your position. For example, if you prefer the independent contractor classification, you might make sure you have other clients, work off the company's premises, set your own hours, etc. If you have already been classified by the IRS and feel it is incorrect, you can file a form SS-8, *Determination of Employee Work Status,* which requires the IRS to look at your work situation and rule whether you should be considered an employee or not. It can take several months for this form to be processed.

Note to Government Workers: The general rule, as stated in Chapter 1, is that U.S. government employees are not entitled to take a foreign earned income exclusion, even if all overseas residency requirements, etc. are met. **However, if you are an independent contractor for the U.S. government and work overseas, this restriction does not apply.** It should be immediately apparent that the distinction between employee and contractor can have an enormous tax consequence in this situation. You should do everything in your power to ensure that the employment contract you have with the U.S. government leans heavily toward giving you control over your working conditions and the details of your work. If you are able to establish you are an independent contractor, you will be able to exclude up to $87,600 as foreign earned income, assuming you meet the tax home and residency requirements of the previous chapters. On the down side, you will still have to pay self-employment tax, but the tax impact is enormously less than paying income tax on all that income!

14.10 Compensation Packages

If you are new to the idea of living overseas, you may not have yet encountered the term, "compensation package". If you are an experienced expat, you may be familiar with the term, but not fully understand what it means. This section aims to give you a basic understanding of how this term is used by employers so that in negotiations for salary, etc., you will be operating from a position of strength based on knowledge rather than simply having to accept blindly the terms that are presented to you.

COMPENSATION PACKAGES

When you decide to move overseas, you will learn rather quickly that it is a complicated and expensive process. For starters, there are substantial moving costs, the question of whether to sell or rent out your home, what type of lodging will be provided overseas, where your children will attend school, whether you get trips home to visit family, etc. In addition, you may discover that the country you are moving to has a higher tax rate than the U.S. so that, even with the earned income exclusion, you will be paying more income tax than if you had stayed at home.

Many companies are aware of these additional costs and will offer extra compensation to offset them. Other companies, with little or no overseas exposure, either do not understand these costs or are not prepared to absorb the expense on behalf of the employee. Indeed, the additional outlay can be substantial. In general, it costs three to five time an employee's U.S. compensation to send him/her overseas and have the net income to the employee remain the same!

You may be wondering how this can be (as may your employer). Consider a simple example: You had $100,000 of income in the U.S. When you moved overseas, you got moving expenses, housing and schooling totaling $50,000 for the year. These additional benefits are all taxed to you as income by the country where you now live. That country taxes your income at a top rate of 65%. You would have to be paid $285,000 in that country to end up with $100,000 of income — just looking at the foreign tax and not the U.S. tax implications.

Armed with these chilling facts, you want to discuss the following issues with your employer before you accept a position overseas:

- **What is included in your compensation package?**
  Items you might look for, in addition to salary, are reimbursement of moving expenses, arrangement for suitable schooling for your children at employer expense, housing (either employer provided or subsidized), payment by employer for at least one trip a year to visit family in the U.S., a "cost of living" allowance if that is appropriate for the country where you are moving, transportation expenses (either in the form of car for your use or payment for use of mass transit), etc. You also want to make sure that you have retained health benefits appropriate to the area where you will live as well as a retirement plan that includes social security either through the U.S. or the plan in force in the other country.

- **How much of this compensation is taxable in the U.S. and the other country?**
  And, what will the total tax cost be, given the tax rates in each country and taking into account the foreign earned income exclusion, foreign housing exclusion, and foreign tax credit in the U.S.?

- **How will your employer handle the additional tax cost?**
  Will compensation be increased to offset it, has your employer made an arrangement with the foreign country to pay tax on behalf of all its employees, or does the employer see this issue as your responsibility?

NOTE: Be sure to take into account that the new tax law INCLUDES foreign income for purposes of determining the marginal tax rate on other taxable income. **This may significantly increase your total U.S. tax bill.** *(See example in Chapter 5.)*

You might want to calculate some different salary/tax scenarios before taking this matter up with your employer. The first thing you should do as you embark on this process is get as much information as you can about the tax rates in the country where you will be assigned. In addition, make sure you understand what elements of your compensation package will be taxed. For example, some countries don't treat as taxable to you the money paid by your company to send you back to the U.S. for family visits. Similarly, some countries will not treat as taxable an automobile provided to you by an employer. Once you have this information, you can estimate your tax liability in the foreign country, and, using the information gleaned from this book, your tax liability in the U.S. This can be compared to your tax liability on the same net income if you had stayed in the U.S. Don't forget to factor your state tax liability into your calculations.

14.11 Tax Equalization And Tax Protection

A move overseas changes many things in your life, including your tax situation. In an effort to minimize the tax consequences of a foreign move, many employers offer special tax packages – either **tax equalization** or **tax protection.**

TAX EQUALIZATION

This tax plan is based on the idea that you will not have to pay more tax by living overseas than if you had stayed in the U.S. The employer calculates what the total U.S. tax liability would be if you had stayed home and deducts that amount from your salary, much like normal withholding of income tax. This is called "hypothetical income tax". The employer then pays your actual federal, state, and foreign tax incurred while you live overseas. When you file your U.S. tax return, the employer will prepare a "tax equalization calculation" to determine your final tax obligation to that employer. This calculation is based only on items of income and expense that you would have had if you had remained in the U.S. This amount of tax is compared to the actual tax you owed while overseas plus the amount of hypothetical tax paid. The "tax equalization settlement" is the net amount either owed from or due to the employer.

It is important to understand your employer's tax equalization policy. You especially want to know how state taxes are handled (i.e., are you still treated as a resident of your former state for income tax purposes), how itemized deductions are handled (i.e., does the plan account for your particular mix of itemized deductions), and how outside income is handled (i.e., if you have a spouse with significant earnings, is that tax equalized as well).

Note that tax equalization, while allowing consistency in treatment of employees, may not always be of benefit to you. If, for example, you move to a country with little or no income tax and all

your income qualifies for the foreign income exclusion, you could be in a position of owing a very small amount of tax on your income. However, if you are in a tax equalization plan, you will have to pay tax as if you had remained in the U.S. – you will not get the benefit of the lower foreign tax rate or the foreign earned income exclusion.

TAX PROTECTION

As the name implies, this plan is designed to protect you from excess taxes as a result of living overseas, but it also allows you to retain the benefit if you live in a low-tax country. The mechanics of the plan are also less complex. You will just file your U.S. and foreign tax returns and pay any taxes due. Your employer will then do a "tax protection calculation". If the total tax paid is more than the tax you would have paid had you remained in the U.S., you will get the difference back from the employer. If the total tax is less, you are entitled to keep the difference. However, once again you will want to understand the details of the plan so you know how the employer will calculate your "hypothetical" U.S. tax liability.

14.12 Foreign Business/Investments And Information Returns

Over the years, American taxpayers have sought ways to reduce their U.S. tax liability by moving their businesses and investments overseas. In response to these moves, the IRS has tightened its reporting requirements for offshore activities in its ongoing effort to insure that American citizens and resident aliens are taxed on their worldwide income. It is beyond the scope of this book to discuss the considerable "in and outs" of offshore investing, but you should be aware of the kinds of activities that may require information returns.

Foreign Activities That May Require Information Returns:

- **Owning a controlling interest in a foreign corporation**
- **Acquiring or disposing of foreign corporation stock**
- **Acquiring or disposing of an interest in a foreign partnership**
- **Transferring property to a foreign trust**
- **Shipping currency to or from the U.S.**
- **Having an interest in a foreign bank or financial account** ***(See more on this in section 14.15.)***

Information Returns Or Reports That May Be Required:

- **IRS Form 5471,** ***Informational Return on U.S. Persons with Respect to Certain Foreign Corporations*** **– requires you to disclose 10% or greater interest in a foreign corporation or partnership. The interest can be attributed through a trust.**
- **IRS Form 8865,** ***Returns of U.S. Persons with Respect to Certain Foreign Partnerships*** **– required if you acquire a foreign partnership interest, dispose of a foreign partnership interest, or your proportional interest in a foreign partnership has changed. If this form is required you must attach it to your tax return when you file.**

- **IRS Form 3520,** ***Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*** **– requires disclosure of the names of trust beneficiaries and other information about them.**
- **IRS Form 3520-A,** ***Annual Report of Foreign Trust with U.S. Beneficiarie*****s.**
- **IRS Form 926,** ***Return by a Transferor of Property to a Foreign Corporation, Foreign Estate or Trust, or Foreign Partnership*** **– this may result in imposition of an excise tax if the assets transferred have appreciated in value.**
- **Customs Form 4790,** ***Report of International Transportation of Currency or Money Instruments*** **– reports importing or exporting of $10,000 or more of currency or other monetary instruments.**
- **Treasury Form TD 90-22.1,** ***Report of Foreign Bank and Financial Account*** **– requires reporting of financial interest or signatory authority over financial account(s) in foreign countries that have, singly or in combination, a value of more than $10,000 at any time during the year.**

14.13 Education Tax Credits/Deductions

HOPE SCHOLARSHIP CREDIT

The Hope Scholarship Credit can be claimed for qualified tuition and related expenses of each student in your family, including you, your spouse, and any eligible dependent. The student has to be enrolled at least half-time in one of the first 2 years of postsecondary education and must be in a program leading to a degree, certificate, or other recognized educational credential.

The term "qualified tuition and related expenses" really only means tuition and fees related to enrolling and attending the institution. It *does not* include fees for room, board, student activities, transportation, etc.

As far as eligibility of the educational institution, the new law requires that the college, university, vocational school, etc., be one described in section 481 of the Higher Education Act of 1965 and thus entitled to use financial aid programs of the Department of Education. The IRS commentary on the Hope Scholarship Credit indicates this would include virtually every accredited postsecondary institution in the U.S.

With regard to foreign educational institutions, you will need to check with the Department of Education which keeps a list of those that qualify for U.S. financial aid purposes. You can do that by calling the Department at (202) 401-2000 and connecting with Student Financial Aid or calling directly at (800) 433-3243.

The credit is equal to 100% of the first $1,200 of expenses you paid for the student's tuition and related expenses plus 50% of the next $1,200 paid for such expenses. Thus, the maximum credit you can take is $1,800 per student for the year times the number of students in the family meeting the above criteria.

Even if your student is attending an educational insitution in the U.S., there are two more limitations to this credit that may render it effectively worthless for many Americans living overseas:

➢ The amount you can take as a credit decreases gradually if your income is between $96,000 and $116,000, you are married and you file jointly ($48,000-$58,000 if you are single). If your income is over $116,000 (married, filing jointly) or $58,000 (single), you may not claim the Hope Scholarship Credit at all. Also, if you are married, and file separately, you may not claim this credit.

➢The "income" amount that you must use to determine eligibility for the Hope credit is your "Modified Adjusted Gross Income" which includes amounts you earn abroad. This means you must add back to your adjusted gross income reported on your Form 1040 any amount that you excluded as foreign earned income on Form 2555. This "add-back" provision may result in your income exceeding the amount you can earn and still be entitled to the credit.

LIFETIME LEARNING CREDIT

The Lifetime Learning Credit gives you a credit of up to $2,000 of tuition expenses or 20% of the first $10,000 in payments. ("Tuition expense" has the same definition as with the Hope Scholarship Credit.) This credit can be used for any postsecondary education for you, your spouse, or your dependent, including college, graduate school, or job-related classes. It is not necessary that the student attend full or even half-time, or that a degree of any kind be sought. This very flexible credit can thus be used for your dependent's last 2 years of college (when the Hope Scholarship Credit no longer applies) or for you to attend one or more job-related classes or both. However, the credit limit of $2,000 is a one per-family per-year credit so any combination of education expenses will not yield more than $2,000 of credit. However, the credit can be used each year for the indefinite future (until Congress changes its mind).

Limitations on the Lifetime Learning Credit include:

→You may not claim both a Hope Scholarship Credit and a Lifetime Learning Credit on the same student's school expenses in the same year.
→The income phase-out limits are the same as for the Hope Scholarship Credit (see above).
→You must include otherwise-excluded foreign income when you figure your Modified Adjusted Gross Income, just as with the Hope Scholarship Credit.

CHILD TAX CREDIT

The child tax credit allows you to take a $1,000-per-child tax credit for each child you have under the age of 17. The Working Families Tax Relief Act extends this credit through 2009. *(A "child" is defined here as a dependent under the age of 17 that is a natural or adopted son, daughter, grandson, or granddaughter.)*

As with the other credits, there are phase-out rules. In this case, the credit phases out by $50 for each $1,000 of modified adjusted gross income in excess of $110,000 if you file jointly ($75,000 for single filers and $55,000 for married, filing separate). Also, as with the other credits, your MAGI includes your otherwise excludable foreign income. (See *Pub. 972, Child Tax Credit*, for more details.)

ADOPTION CREDIT

The Adoption Credit is quite large and relatively unknown. It actually became available in 1997 and now allows a $11,650 (for 2008) credit per child adopted, generally taken in the year after the expenses are paid or incurred or in the year the adoption of an "eligible child" becomes final. If you adopt a foreign child, you can only take a credit when the adoption is final. Qualified expenses include necessary adoption fees, attorney fees and court costs, travel expenses while away from home, etc.

An "eligible child" is one that is under 18 years of age and is physically or mentally incapable of caring for himself or herself.

As with most credits, there is an income phase-out. If your Modified Adjusted Gross Income is less than $174,730, you can take full advantage of the credit. If it exceeds $174,730, the credit will be phased out, and it is not allowed at all past income of $214,730. Again, foreign income must be included for purposes of these calculations. For more information on this credit, refer to IRS Form 8839 and accompanying instructions.

For 2009, the maximum credit is $12,150. The credit phases out for income between $182,180 and $222,180.

STUDENT LOAN INTEREST DEDUCTION

If you have to borrow money to pay for the cost of you, your spouse, or your child attending school, you may be able to deduct the interest you pay on the loan. The maximum deduction is $2,500 per year and applies to most costs of attending school, including tuition, fees, room, board, books, equipment, etc.

In this case, the student must be enrolled at least half-time in a program leading to a degree or certificate, including graduate school. The qualifying schools are the same as those to which the Hope credit and Lifetime Learning credit apply.

As with most of these provisions, there are income limits on eligibility. If your income as a joint filer is above $115,000, the deduction phases out until income reaches $145,000 and then the deduction is not available at all. (The phase-out for single filers is $55,000-$70,000). If you file separately, you may not use this deduction at all. Remember to include foreign income in determining your Modified Adjusted Gross Income.

14.14 Taxation Of Expatriates Who Give Up U.S. Citizenship

If you are considering living overseas permanently and giving up your U.S. citizenship, you should be aware of some very tough tax consequences that can result.

BE SURE TO THOROUGHLY INVESTIGATE THIS BEFORE PROCEEDING. You'll see why as you read on.

Congress passed legislation in 1999 that strengthens the already harsh rules imposed on U.S. citizens that expatriate for the purpose of avoiding U.S. tax. Then in 2004, the American Jobs Creation Act (AJCA) changed the expatriation rules further. The 2004 changes resulted in two different sets of rules that apply depending on the date of expatriation.

EXPATRIATION AFTER JUNE 3, 2004

In general, expatriation by a U.S. citizen requires you to:

→ Renounce your U.S. citizenship following certain rules set out by federal law; and

→ Notify the Department of State or the Department of Homeland Security of your expatriating act.

CRITERIA FOR STILL PAYING TAX

However, these acts alone may not relieve you of the obligation to pay U.S. tax under IRC Sec. 877. You will still be subject to tax if **any** of these apply to you:

→ **Your average anual net income tax liability for the 5 years ending before the date of expatriation is more than $124,000 if you expatriated in 2004, more than $127,000 if you expatriated in 2005, more than $131,000 if you expatriated in 2006, and more than $136,000 if you expatriated in 2007. (These amounts are subject to annual cost-of-living adjustments.)**

→ **Your net worth is $2 million or more on the date of your expatriation.**

→ **You fail to certify on Form 8854 that you complied with all your U.S. federal tax obligations for the 5 years preceding the date of expatriation.**

WHAT TAX YOU WILL OWE

If you are subject to tax under IRC 877, this generally means you must report the relevant income on Form 1040NR, whether or not it is effectively connected with the conduct of a trade or business in the U.S., and you are not permitted to exclude certain types of income that normally are exempt from tax for other nonresident aliens.

PRESENCE IN THE U.S. — TAX CONSEQUENCES

If you decide to expatriate, you must understand that returning to the U.S. can have dire tax consequences. Specifically, if you are in the U.S. for more than 30 days in any year during the 10-year period following expatriation, you will be subject to tax on your **entire worldwide income.**

There are a couple of convoluted exception to this rule that are spelled out in the instructions to Form 8854, *Initial and Annual Expatriation Information Statement*. (See www.irs.gov.)

FORM 8854

Speaking of Form 8854, it will need to be filed in the year you expatriate to establish the expatriation and every year thereafter for 9 years.

You will need to answer a lot of questions about your new location, current citizenship, etc. as well as list your assets and liabilities, and complete an income statement. The penalty for not filing, failing to give information, or giving incorrect information is a whopping $10,000 for each year you commit one of these infractions!

EXCEPTIONS: The only bright spot in this picture are two exceptions that apply to those with birth connections to another country. You will not be subject to tax under IRC Sec. 877 if you certify you have met your tax obligations for the 5 years prior to expatriation AND one of the following applies:

→ **At birth you were a U.S. citizen and the citizen of another country, you continue to be a citizen of that other country, and you have no substantial ties to the U.S.; or**

→ **At birth you were a U.S. citizen, but neither of your parents were, you are expatriating before the age of 18-1/2, and you were not present in the U.S. for more than 30 days during any of the 10 years preceding expatriation.**

EXPATRIATION BEFORE JUNE 3, 2004

For the details on this, refer to Publication 519, *Tax Guide for Aliens*.

14.15 Reporting Foreign Accounts

On Schedule B, which is used to report dividends and interest, there is a small section at the bottom where you are required to indicate if you have an interest in certain foreign financial

accounts. If you do have such an interest, then you must also complete Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts. The IRS has determined that some Americans are "hiding" money in foreign accounts and is increasingly determined to stop that practice. Therefore, it has stepped up enforcement efforts with regard to the filing of this form. If you have any money in a foreign account, please read on.

WHAT IS THE BASIC RULE FOR REPORTING FOREIGN ACCOUNTS?

If you are a U.S. person, AND you have a financial interest in, or signature or other authority over, any financial accounts in a foreign country, AND the aggregate value of the accounts exceeded $10,000 at any time during the filing year, a Form TD F 90-22.1 must be filed.

WHO IS A "U.S. PERSON"?

Obviously, this term includes individual taxpayers who are citizens or residents of the U.S., but it also encompasses U.S. corporations, partnerships, estates, and trusts – and a person in or doing business in the U.S.

WHAT IS "A FINANCIAL INTEREST IN OR SIGNATURE OR OTHER AUTHORITY OVER"?

This phrase has a broad sweep that will cover, in addition to direct owners, many officers, directors, shareholders, members, managers, and partners of entities with foreign financial accounts as well as trustees, beneficiaries, and protectors of trusts.

If you are any of the above-named, apart from a direct owner, you should consult a tax professional to see if you need to file this form.

WHAT IS A "FINANCIAL ACCOUNT" FOR PURPOSES OF THIS FORM?

This term includes bank accounts, investment accounts, mutual funds, securities and other brokerage accounts, cash value life insurance policies, cash value annuities, AND retirement savings accounts that are owned and controlled by you, the taxpayer.

You do not need to report a foreign pension account that is owned and controlled by your employer or by a foreign government. And the assets in such accounts do not count toward your $10,000 aggregate.

Likewise, you do not need to report accounts held at U.S. military banking facilities, accounts held at banks located in Guam, Puerto Rico, and the U.S. Virgin Islands, or U.S.-based accounts held by a branch or division of a foreign bank.

WHAT FORMS NEED TO BE FILED – AND WHEN – AND WHERE?

If you happen to have at any time during the course of the year a total of more than $10,000 in the accounts described above (even if you don't have that much at the end of the filing year),

you will need to do TWO things:

(1) Fill in Part III of Form 1040, Schedule B, Interest and Ordinary Dividends (or the corresponding form for a corporation) – and file that schedule with your federal tax return. You MUST file Schedule B even if you would not otherwise be required to file it to report interest and dividends. AND if you don't include Schedule B, it is considered to be a failure to file a complete return.

(2) Prepare TD F 90-22.1 (the 2008 revised version can be found at www.irs.gov). You will have to include certain information about yourself, such as name, address, taxpayer identification number, as well as specifics about each account, including the location of the account, the account number, and a general range of its value.

This form MUST be filed by June 30th of the year following the tax year (2009 for the 2008 tax year). You cannot get an extension of time to file this form and electronic filing of this form is not possible. It should be printed, completed, signed, and mailed to:

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

WHAT HAPPENS IF YOU DON'T FILE?

The penalty for failing to file is SEVERE, to say the least. In the case of a non-willful failure to file, the penalty can be as much as $10,000 – and the government can go back 6 years to see if you should have filed, and assess that amount for each year.

In cases of willful failure to file, the penalty is significantly more – $100,000 or 50% of the amount of the value of the unreported accounts, whichever is greater. Civil penalties can be assessed anytime up to 6 years after the date of the violation. There are also criminal penalties for willfully not filing.

CAN A PENALTY BE WAIVED?

It appears that in cases of non-willful failure to file, the penalty may be waived if any income from the foreign accounts was properly reported on your federal income tax return AND there was reasonable cause for not filing. However, the IRS is reported as taking the position that not knowing about the form is no longer considered a "reasonable cause" for not filing.

The "reasonable cause" argument is not available at all in the case of willful failure to file.

WHAT IF YOU MISSED THE DEADLINE?

You should go ahead and file for the year(s) that you have missed. Be sure to attach a statement with a brief explanation of why you are filing late. By filing, even late, you can avoid the penalty for willful failure to file.

WHAT If YOU WANT TO CHANGE THE INFORMATION YOU REPORTED?

You can amend a previously filed Form TD F 90-22.1 by completing a new one, writing the word "Amended" at the top, and stapling it to a copy of the original form.

WHY DOES THIS FORM EXIST?

Form TD F 90-22.1 was developed under the Bank Secrecy Act in an effort to locate Americans using foreign bank accounts to commit tax evasion. It is therefore not a federal income tax form – although enforcement is carried out by the IRS.

CHAPTER 15

Retirement Issues

There are two major considerations related to retiring and living overseas:

- **How do you save for retirement if you are still working?, and**
- **How is retirement income taxed if you are an American citizen residing in a foreign country?**

15.1 Saving With U.S. Employee Retirement Accounts

If you work for an American employer overseas you can continue to contribute to a 401(k) retirement plan or similar plan without regard to the fact that some or all of your income is excluded as foreign earned income. Interestingly, this is also true if you are self-employed and want to contribute to a Keogh or similar self-employed retirement plan. The Internal Revenue Code [Sec. 415(C)(3)(B)] says that compensation for purposes of contribution to a Keogh is earned income determined without regard to the Section 911 exclusion. This means you can exclude all your income as foreign earned income for purposes of income tax and still have compensation for purposes of contributing to a Keogh, SEP-IRA, etc.

15.2 Saving With Non-U.S. Employee Retirement Accounts

If you work for a foreign employer, you are free to contribute part of your salary to that employer's retirement plan. However, keep in mind that foreign retirement plans normally wouldn't meet the IRS criteria for a "qualified" retirement and thus would not be deductible from your salary. This means that when you report foreign income, you should include as gross income the part of your salary that was contributed to the plan.

15.3 Saving With Individual Retirement Accounts

CONTRIBUTIONS TO REGULAR IRAS

Your ability to contribute to an IRA depends on having compensation that is includible in gross income for the tax year. **If you take the foreign earned income exclusion and the foreign housing exclusion, that compensation is not considered to be included in gross income for IRA purposes**. Thus, if your only compensation is foreign earned and it is all excludable, you may not contribute to an IRA.

If you exceed the $87,600 limit for excluding foreign compensation, take the foreign tax credit, or do a combination of both, amounts that end up being included in gross income will "count" for purposes of determining if you can contribute to an IRA. Thus, for example, if you earned $90,000 of foreign income and you take the $87,600 earned income exclusion, you still have $2,400 that is included in gross income. This is true even if you take the foreign tax credit on that excess $2,400. You could therefore contribute up to $2,400 to your IRA for that tax year.

NOTE: The maximum annual contributions to traditional IRAs and Roth IRAs were increased starting in 2002 until they reach $5,000 in 2008 (with inflation adjustments thereafter). In 2008, a maximum of $5,000 can be contributed to a regular IRA or a Roth IRA ($6,000 if you are 50 or older before 2009).

You also should realize that under rules that became effective in 1997, each spouse can contribute up to $5,000 to his or her IRA for 2008 ($6,000 if age 50 or older) so long as the combined compensation of both spouses for the year is at least $10,000. This means a non-working spouse can contribute up to $5,000 to his/her IRA as long as the combined income is at least $10,000 ($11,000 if one is 50 or older and $12,000 if both are 50 or older).

There are income limits for regular IRA contributions if you or your spouse are covered by a retirement plan at work. The exact amounts can be found at IRS Publication 590. **REMEMBER**, your foreign income **is** included.

DEDUCTIONS WITH REGULAR IRAS

The flip side of this coin is whether you can deduct your IRA contribution. These rules get very complicated, but you should keep in mind two things. If either one of them applies to you, you can forget all other rules of deductibility.

- **No taxable income means no deduction.** If your situation is similar to the one described above, in which all the potentially taxable income is offset by the standard or itemized deductions, personal exemptions and the foreign tax credit, you have no IRA deduction. This is because the taxable income has been reduced to $0 so there is nothing against which to take a deduction. Therefore, you won't have to worry about whether you meet the income limits for deductibility.

- **Foreign employer with no qualified retirement plan means full deduction.** Limitations on the deductibility of an IRA only apply if you are covered by a qualified retirement plan that your employer has set up for the benefit of its employees and that meets Internal Revenue Code requirements. This means that, if you work for a foreign employer, you are not covered by such a qualified plan (even though your employer may have its own retirement plan). Thus, there are no limits on the deductibility of your IRA. No matter what your income is, your IRA is fully deductible, so long as there is income against which to deduct it.

If neither of the above situations applies to you and you are an active participant in a qualified retirement plan, you will need to look at the rules for deductibility.

In this regard, it is important to keep in mind that your excluded foreign earned income must be included back in when you do these calculations. Thus, for example, if you have $90,000 of foreign income and are able to exclude $87,600 of it, you must still consider your income as being the full $90,000 for purposes of calculating if the IRA is deductible.

ROTH IRAS

The Roth IRA, created in the tax legislation of 1997, allows you to contribute up to $5,000 ($6,000 if age 50 or older) in 2008 out of earnings just like the regular IRA. There are two big differences though:

1. **You cannot deduct the contributions from earnings, as you may be able to do with regular IRAs, but**

2. **You can withdraw the earnings tax free if you hold the IRA for at least 5 years and meet one of the following requirements: you are over 59 1/2 years old, you are disabled, or you want to take out up to $10,000 to buy your first home.**

You are allowed to make a full contribution to a Roth IRA if you are single, head of household, or married and filing separately, and your adjusted gross income is less than $101,000, or if you are married and your adjusted gross income is less than $159,000. Partial contributions phase out completely after a single income, head of household, or separate filing, of $116,000 and a married, joint income of $169,000.

Two especially nice features about the Roth IRA, over and above the non-taxable aspect, are (1) you can withdraw your own contributions at any time, tax free (although it's better not to from an investment standpoint), and (2) you can make contributions for as long as you work, but you are not required to start withdrawing the money at a particular age, as you are with a regular IRA. Thus, if you don't need the money, you can simply leave the Roth IRA to your heirs, tax free.

If you want to convert your regular IRA to a Roth IRA, you can do so as long as your adjusted gross income doesn't exceed $100,000 in the year of the move. You will have to pay income tax on the funds you move, but not the 10% penalty that is normally applied to early withdrawals.

If you decide to switch your regular IRA to a Roth IRA, it is recommended that you not use IRA money to pay the taxes. The growth of your investment, tax-free, will soon exceed the amount of tax you paid.

NOTE: For more detailed information on IRAs, see IRS Publication 590, *Individual Retirement Arrangements.*

15.4 Retirement Saving With Annuities

If you don't contribute to U.S. or foreign employer retirement plans, you might want to consider annuities as a form of retirement planning. An annuity is an account with a life insurance company. Dollars you invest will accumulate and compound tax-free under current law. When you withdraw funds (usually at retirement), your earnings will be taxed as ordinary income when you will likely be in a lower tax bracket. Generally, if you withdraw funds prior to age 59 1/2, you will be subject to a 10% early withdrawal penalty plus ordinary income tax. For details on retirement planning with annuities, you should consult an investment professional.

15.5 Taxation Of Retirement Income

The most important advice you can get in this area is: **DO YOUR HOMEWORK!**

You already know that the U.S. expects you to file a tax return, even if you live overseas and are retired. So, the question becomes: how will the foreign country tax you? You need to research the tax laws of your chosen country, as well as the U.S. tax treaty with that country (if there is one), to see how pensions, annuities, investment income, etc. for foreign residents will be taxed. Most countries have a government website on the Internet so that is a good place to start your research.

If you will be receiving social security benefits, some of those benefits may be taxed if you have other income. IRS Pub 915, *Social Security and Equivalent Railroad Retirement Benefits*, is a good source of information on this subject. And, the country you live in may also claim the right to tax social security so be sure to check the treaty in this regard as well.

CHAPTER 16

Rules Relating To A Principal Residence

Ownership of a personal residence while living overseas is an area of great confusion to many. In truth, the IRS has not done a great deal to clarify some of the issues that have arisen, and the result is that decisions set forth in old legal cases are often relied on with varying degrees of success. Furthermore, the tax provisions signed into law by President Clinton on August 5, 1997 make significant changes in the rules applying to the sale of a personal residence. This chapter will first outline several tax scenarios of home ownership while overseas. It will then detail the major provisions of the tax law relating to sale of your home.

16.1 Home Ownership While Living Overseas

Let's consider some possible scenarios and see what possibilities you have:

Personal residence in a foreign country: It is perfectly acceptable for you to purchase and live in a dwelling you consider your "personal residence", even if it is located in a foreign country. You will be entitled to all the tax benefits, such as deducting home mortgage interest and property taxes, that would be available to a homeowner in the U.S. The only problem you might face is that, if all your income is excluded as foreign-source, there may be nothing against which to deduct these expenses. Thus, if your taxable income is $0.00 to start with, $10,000 of deductible mortgage interest doesn't do you much good! However, if the home appreciates in value, then when you sell it, you can exclude from income up to $500,000 ($250,000 for a single taxpayer) in gain from the sale, under the tax law. **However, you must be aware that to qualify for the exclusion, you must have owned and used the property as a principal residence for at least 2 of the 5 years preceding the sale.** ***Please see Sections 16.3 and 16.4.***

Personal residence converted to rental property in the U.S.: A very common scenario is for you to take a job overseas, and decide not to sell your home in the U.S. You reason it makes sense to rent it out rather than letting it stand vacant. Under IRS regulations, you are allowed to convert a home to a rental property. If it happens at any time other than the beginning of the tax year, you will have to divide the expenses between personal and rental use for that tax year. Starting in the initial transition year, you will need to file a Schedule E, *Supplemental Income and Loss,* to report income and expenses, including depreciation. If you end up with a net gain, you will have to report it as income on the Form 1040. If you have a net loss, you may be able to deduct the loss against other income. NOTE: Your losses may be limited or disallowed if the losses exceed $25,000 per year or your income exceeds certain limits. You should consult a tax professional in this case.

Rental property re-converted to personal residence: This situation arises when you are ready to return to the U.S. and plan to live in your "old" house. There is absolutely no problem, as far as the IRS is concerned, with having it again become your personal residence. However, you must keep in mind that, if you took depreciation on the house while it was rented, the basis of the house has been reduced to the extent of the depreciation. When you finally sell the house, gain will be calculated using the depreciated basis **and** you need to be aware that you will be taxed on gain to the extent of the depreciation you took or could have taken. *See Section 16.5, Tax on Depreciation, for more details on how this works.* **You should also keep in mind the provisions requiring you to own and use the property for at least 2 of the 5 years preceding the sale.** *Please see Sections 16.3 and 16.4.*

Rental property sold and new personal residence purchased: It often happens that the "old" house doesn't meet your needs anymore and you don't want to live in it when you return to the U.S. It may be that it is too small because you have added children to the family while overseas, or you are moving to a different part of the U.S. and need to purchase a home there. Your objective is to have the best of both worlds: i.e., treat the old house as a rental property when that was lucrative and as a personal residence when you want tax savings. (As stated before, the tax savings connected with treating the house as a personal residence arises from the fact that, under the new law, up to $500,000 of gain is excluded from tax.) It seems possible to do this under current rules so long as you owned and used the property for at least 2 of the 5 years preceding the sale. Thus, in a simple example, suppose you and your spouse bought a house on January 1, 2004, and lived in it until December 31, 2006. You then move overseas and rent out the house. In January 2008, you return to the U.S. and sell your house without re-occupying it. Under current law, if you were married, filing jointly, you could exclude up to $500,000 of gain on the sale from tax because you met the "2-years-out-of-5" ownership and use test. However, don't forget the special rules relating to depreciation described in Section 16.5, *Tax on Depreciation.*

Tax-deferred exchange of rental house: Another option you have is to treat the sale as a tax-deferred property exchange which will give you basically the same advantage of deferring tax on your gain if you sell your real estate. **The basic idea is that one property that is used for rental purposes can be exchanged for another rental property**. The theory is that a simultaneous trade of investments will occur, but in actual fact, most owners first sell their property, put the proceeds in escrow, identify the replacement property they want in 45 days, and settle on that new property within 180 days using the money held in escrow as partial payment. Because the IRS rules on this subject are quite complex and must be followed very carefully, it is essential that you contact a lawyer or other professional familiar with like-kind exchanges before you attempt such a feat!

FOREIGN CURRENCY AND FOREIGN MORTGAGES

If you buy a home overseas and finance it with a foreign mortgage, you need to read this section! The tax rules in this area can have a very harsh result for U.S. taxpayers, because of foreign currency fluctuations that may give you unintended foreign currency gain or unusable foreign currency loss. The leading case in this area is *Quijano V. United States of America*, a U.S. Court of Appeals case decided in 1996 in favor of the IRS position on these matters.

There are normally two foreign currency elements to the purchase and sale of a home in a foreign country: (1) the foreign currency gain or loss between the time of purchase and the time of sale,

and (2) the foreign currency gain or loss between the date of the loan and the date of its repayment.

FOREIGN CURRENCY CALCULATIONS ON PURCHASE AND SALE

The rule is that if you buy a house in a foreign currency, you must convert the purchase price into U.S. dollars ($US) using the exchange rate in effect at the time of purchase. This determines your basis for purposes of calculating gain or loss on the sale. When you sell the house, you convert the sale price into $US using the exchange rate in effect at the time of sale. If there are wild fluctuations in the value of the foreign currency, you could end up with a foreign currency gain while actually experiencing a loss in value on the sale of the home. Suppose, for example, you buy a house in France for 300,000 euros when the exchange rate is 1.10E to $1. The cost of the house to you is $272,727. Ten years later you sell the house for 275,000 euros when the exchange rate is 0.90E to $1. The sale price is $305,555. This results in a potentially taxable gain on the sale of the house in the amount of $32,828 even though the value of house has dropped in France.

Likewise, it is possible that a gain on the sale will be exaggerated due to foreign currency fluctuations. In the example above, suppose you bought the house for 300,000 euros with an exchange rate of 0.90E to $1. The purchase price is $333,333. Ten years later you sell the house for 400,000 euros. If the exchange rate is still 0.90E to $1, your sales price is $444,444 and your gain is $111,111. However, if the euro is now at a rate of 1.10E to $1, your sales price is $363,636 and your gain is $30,303.

FOREIGN CURRENCY AND MORTGAGE REPAYMENT

You can also have a foreign currency gain or loss in connection with a mortgage repayment. Let's suppose you borrow 300,000 euros to finance your home in France. The exchange rate at the time is 1.10E to $1. Several years later, you pay off the loan on which you now owe 250,000 euros. The exchange rate is 0.90E to $1. The 250,000 euros at the time of the loan was worth $181,818. At the time of pay-off, it is worth $222,222. This means it is costing you $222,222 to pay off a $181,818 debt. What can you do with this loss from a tax standpoint? Unfortunately, nothing. The IRS will not allow you to net your foreign currency loss on the repayment of the mortgage with your foreign currency gain on the sale of the house, even though you might (logically) tend to view these as integrated transactions. And, moreover, you will not be allowed to take this loss as a deduction against other income.

16.2 Gain Exclusion On Sale Of Home

If you sell your home on or after May 7, 1997 and are married, filing jointly, you can exclude from income up to $500,000 ($250,000 for a single taxpayer) in gain from the sale or exchange of that home. This is a permanent exclusion, not just a deferral or rollover of gain until a later time. And it is not required that you reinvest in another home or that a new home, if you buy one, cost more than the old one. (See IRS Publication 523 for a complete review of rules on home sales.)

16.3 Use Of Home As Principal Residence For 2 Years Out Of 5

The home sale law requires that you **own and use** the property as a principal residence for at least 2 of the 5 years preceding the sale or exchange. If you are married and file jointly, *either* you or your spouse can meet the "ownership" requirements with respect to the property — meaning only one of you must own it for the 2-year period. However, you *both* must meet the "use" requirements — meaning you both must use the house for 2 years — in order to take the $500,000 exclusion. If only one of you meets the use test, only $250,000 of exclusion will be allowed. (Note: Special rules will apply if you get a divorce, have a separation agreement, or get married during the period that you own the house.)

Furthermore, the exclusion may be claimed only once every 2 years. This means that, if, during the 2-year period that ends on the date of sale of the house, you had a sale of another house that was your residence, you cannot take the $500,000 ($250,000 for single taxpayers) exclusion.

The "2-years-out-of-5" rule could have a negative impact on Americans living overseas. This is because, under the old law, if you lived overseas, you could continue to treat your home in the U.S. as your principal residence provided you intended to return to it at some point. If the job situation prevented that return, you could usually sell the house (even if it had been rented for an extended period) and roll the gain over into a new home without incurring the wrath of the IRS . Under the "2-years-out-of-5" law, periods of rental will not count as periods of "use". This means that, before accepting an assignment overseas, you will need to consider how long you have owned and used the house, and how long you will be away from it.

If you meet the test now, but may not meet it later because of an extended stay overseas, you might choose to sell the house to be sure you can take the gain exclusion. This could be costly, taking into account market conditions and the cost of sale, and may not be what you want to do if you are especially fond of the house. However, the alternative may be that you fail to qualify for the exclusion if you stay overseas too long or for some other reason, cannot return to the house. In a "worst case" scenario, you could owe tax on as much as $500,000 of gain (for married, filing jointly) that you wouldn't otherwise owe.

16.4 Exceptions To 2-Years-Out-Of-5 Rule

As you know only too well by now, Congress loves to makes exceptions to its rules lest it be accused of creating a hardship on the American people. In the case of home sales, there are several exceptions (although none of them address the problems described above):

CHANGE IN CIRCUMSTANCE

If you cannot meet the ownership and use requirements (2 out of 5 years preceding the sale) **or** you have more than one sale of a home within 2 years **and** you sell your home because of a change in employment, because of health conditions, or because of "unforeseen circumstances", you will be able to still take an exclusion — although the amount will be reduced. The amount you can exclude will be determined by a simple formula. You will look at the total time during

the 5-year period preceding the sale that you met the ownership and use requirements. You will then create a fraction with the top number being that number (in months) and the bottom number being 24 (the number of months in 2 years). You multiply this fraction by the amount you would have been able to exclude if you had met the "ownership and use" test ($500,000 for married and $250,000 for single) to arrive at the maximum amount you can exclude from tax.

Example: You sell your house to take a job in another city. On the date of sale, you have owned and used your residence for the last 12 months. If you had owned and used it for 2 out of 5 years prior to sale, you could have excluded up to $250,000 of gain (you are single). Since you did not meet the use and ownership requirements, you do the following calculation to see how much gain you can exclude:

> $250,000 (maximum gain to exclude) x 12 months (actual use and ownership)/24 months (required 2-year period of ownership and use) = **$250,000 x 12/24 = $125,000 — the maximum amount of gain you can exclude on sale.**

SURVIVING SPOUSE OR DIVORCEE

If you are a spouse, surviving spouse, or divorced person, you may be able to exclude the gain even though you do not personally meet the ownership and use requirements. The idea here is that the ownership and occupancy by your deceased spouse or former spouse will be considered ownership and occupancy by you. If you find yourself in this situation, you should consult a tax professional.

EXCEPTION FOR MILITARY AND FOREIGN SERVICE PERSONNEL

On November 11, 2003, a law went into effect that provides relief from the "2-years-out-of-5" rule described above. The law applies to members of the uniformed services, the Foreign Service of the United States, and employees of the intelligence community who are on "qualified official extended duty". (See Pub. 523, *Selling Your Home*.)

If an election is made, the 5-year period is suspended during the time the taxpayer or his or her spouse is serving on qualified official extended duty. The period of suspension cannot be extended more than 10 years. Together, the 10-year suspension and 5-year test period can be as long as, but no longer than, 15 years.

A simple example may clarify this law: Fred and Joan Winters purchased a home on January 18, 2000. On March 6, 2002, Fred was assigned to active duty in Germany where he lives with his wife in base housing. The couple rented their home until November 4, 2007 when it was sold. Prior to the law change, the Winters could not have met the 2-year use test because they've been out of the home for more than 3 years. Under the new law, they may suspend the 5-year test period for the 3 years, 7 months they were on qualified official extended duty. The 5-year test

period will consist of the 5 years before the Winters went overseas. Because they meet the 2-year use test for the period that is counted, they may exclude the gain on the sale of their home under the usual rules.

EXCLUSION NOT MANDATORY

The exclusion is not mandatory. You can choose not to take the exclusion on one principal residence if you have a second "principal residence" that you plan to sell within the 2-year period required between exclusions, and it makes sense tax-wise to save the exclusion for the other residence.

16.5 Tax On Depreciation

If you have used all or part of your home as a rental property or for other business purposes and taken depreciation deductions, you need to be aware of special rules that will apply on the sale of your home. Specifically, you cannot exclude from tax any gain up to the amount of depreciation taken (or allowed to be taken) for any business or rental usage after May 6, 1997. To put this in plain English, let's suppose you bought a residence in July 2003, and then moved overseas in July 2005. You rented the property out from July 2005 until September 2006, and took depreciation of $10,000 during that time. You then moved back into the property and sold it in December 2008. ***You will have to pay tax on the $10,000 of depreciation as if it were gain even if you otherwise are below the maximum excludable gain of $250,000 ($500,000 for married, filing jointly).***

16.6 Over-55 Exclusion Eliminated

This provision, which allowed an individual, on a one-time basis, to exclude up to $125,000 of gain on the sale of his home if he had attained the age of 55 and had used the home as his residence for 3 or more of the 5 years preceding sale, has been eliminated.

CHAPTER 17

Nonresident Alien Spouse Tax Implications

If you are married to someone who is not a U.S. citizen and you are living overseas, you should understand your various options with regard to how your spouse can be treated for tax purposes. Interestingly, the **IRS will let you treat your nonresident alien spouse as a U.S. resident if you want.** The rule is that if you or your spouse was a nonresident alien during *any part* of the year, a **joint return** may be filed only if you *both* make a special election to be taxed on your worldwide income.

17.1 Treating Your Nonresident Alien Spouse As A U.S. Resident

The major reason to make this choice is that you can then file a joint income tax return which will give you a **higher standard deduction** and **two personal exemptions**. The law requires that you file jointly in the year you make the choice, but you can file joint or separate returns in later years.

17.2 Not Treating Your Nonresident Alien Spouse As A U.S. Resident

There are two major reasons why you may not want to treat your nonresident spouse as a U.S. resident, both of which can be quite significant. However, you can still take a tax exemption for your spouse, as you will see if you keep reading:

- **If your spouse is considered a resident of the U.S, his or her worldwide income must be reported, whether it be salary, interest, dividends, or whatever.** On the plus side, since the spouse is treated as a U.S. resident alien for tax purposes, he or she could take advantage of the earned income exclusion.

- **This choice precludes you or your spouse from claiming tax treaty benefits as a resident of a foreign country**. You would have to consider the actual treaty provisions of the country in question to determine how important a consideration this would be. Also, keep in mind this does not preclude you from claiming "bona fide residence" in a foreign country for purposes of the foreign earned income exclusion.

TAX EXEMPTION FOR SPOUSE IS STILL AVAILABLE IF TREATED AS A NONRESIDENT ALIEN

Even if you do not choose to treat your nonresident alien spouse as a resident alien for tax purposes, you can still claim an exemption for your spouse on your separate return so long as

your spouse has no gross U.S. income and your spouse is not the dependent of another U.S. taxpayer. You will still need to get a Social Security number or Individual Taxpayer Identification Number in the next section.

Furthermore, if you have other U.S. dependents and you decide to not use “resident alien” status for your “nonresident” alien spouse, you can file as “Head of Household”. You must have dependents or relatives other than your spouse that you are supporting and you must pay more than half the cost of maintaining the household. You should look at IRS Pub. 501, *Exemptions, Standard Deduction and Filing Information*, for more details on this subject.

17.3 How To Make The Choice

If you make the choice to treat your nonresident alien spouse as a U.S. resident alien and your spouse does not have a U.S. Social Security number, you must:

→ **Obtain an Individual Taxpayer Identification Number for your spouse.** So long as you and your spouse live overseas, he/she will not qualify for a Social Security number. However, the IRS will issue an Individual Taxpayer Identification Number (ITIN) that can be used for filing tax documents. The form to be completed is Form W-7 and requires the following information:

Name
Address
Date of Birth
City and Country of Birth
Certified or Notarized Copy of a Valid Passport

Note that there are 8 categories of applicants and you will check box “e” – *Spouse of U.S. citizen/resident alien.*

The completed Form W-7 will be attached to the tax return for the year you are filing jointly, along with the statement election to make this choice. (See below.)

Note: If you don’t know if your spouse qualifies for a Social Security card, go to www.ssa.gov (the Social Security website) and click on “Requesting a Social Security card.”

→ **Prepare a statement to the effect that you are choosing to treat your nonresident alien spouse as a U.S. resident for the tax year and that you were a U.S. citizen or resident alien on the last day of the tax year**. You also need to provide you and your spouse’s name, address, and Social Security (or ITIN) numbers. This statement should be attached to your joint tax return the first year you file this way.

17.4 Ending The Choice

Suspension: The choice will automatically be suspended if neither spouse is a U.S. citizen or resident alien at any time during the tax year.

Death: If either spouse dies, the choice will end beginning with the first year after the spouse dies (unless the surviving spouse qualifies for joint tax rates as a surviving spouse).

Legal Separation: If you are legally separated under a decree of divorce or a separate maintenance order, the choice will end as of the beginning of the tax year in which the separation occurs.

Revocation: Either you or your spouse can revoke the choice in any year so long as a signed statement is prepared by the revoking spouse and filed by the due date of the tax return for that tax year. The statement must include the name, address, and Social Security (or ITIN) number of each spouse along with a list of any state, foreign countries, or possessions that have community property laws in which either spouse is domiciled or where real property is located from which either spouse receives income. The statement should be attached to the tax return if one is filed, and if not, sent to the Internal Revenue Service Center where the last joint return was filed.

17.5 Death Of A U.S. Citizen With A Foreign Spouse

If you are a foreign spouse of a U.S. citizen that dies, you can file a joint return with the deceased U.S. citizen for the year in which he/she passed away. After that year, you will file a Form 1040 NR, *U.S. Nonresident Alien Income Tax Return*, assuming you have U.S. income to report and you do not live in the U.S.

17.6 Transfers Or Gifts To Nonresident Alien Spouse

Ordinarily, spouses can freely transfer property to each other with no tax consequence. This, however, is not the case if one spouse is a nonresident alien. If that is the case, the transfer is considered taxable under Section 1041 of the Internal Revenue Code, and gain or loss, if any, must be recognized. Furthermore, if an American spouse dies and leaves his/her estate to a spouse who is not a U.S. citizen, the tax laws can impose a heavy U.S. tax obligation. Because estate and gift tax laws are outside the scope of this book, you are advised to consult a tax professional if you are considering transfers of this nature.

CHAPTER 18

U.S. State Taxation Of Foreign Income

The first time you move overseas, you are almost certainly moving from some state in the U.S. that considers you a resident to your overseas location. If the state assesses income tax, you were probably filing a return each year you lived there. Thus, the question arises as to whether you must continue to pay income tax to that state. There are probably as many answers to that question as there are Americans moving overseas.

However, to help clarify this issue, let's start with some basic definitions of terms that arise in this context.

18.1 Domicile

The technical definition of "domicile" is a residence or physical presence at a particular place accompanied by proof of an intention to remain there for an unlimited time. In general, you must do two things concurrently to establish domicile in a particular place:

→ Be resident at that place, and
→ Intend to remain there for an indefinite period of time. It is the place where you have a settled connection for legal purposes, either because your home is there, or because the place is assigned to you by law.

With that in mind, you need to understand three more interesting things about domicile:

→ You must have a domicile somewhere,
→ You can only have one domicile at a time, and
→ In order to change your domicile, you must not only move your residence to a new locality, **but you must also intend to remain in that new locality**. Until the new domicile is acquired, the old one remains. And simply changing your residence, without more, does not change your domicile. The element of "intent" will be determined by looking at all the circumstances surrounding your move and then drawing a reasonable inference. Therefore, you cannot establish domicile in a particular place simply by declaring that you regard that place as your domicile if your acts or other facts are inconsistent with that declaration. Some of the pro-active things you can do to establish "domicile" in a particular state are registering to vote, getting a driver's license, and opening a bank account. However, if another state claims you are still domiciled there, those indicia of intent may not be sufficient alone to satisfy the state that you have a new domicile elsewhere. States will also look at such things as where you have family ties, where you own property and have other financial holdings,

where is your principal place of business or work, and where you maintain memberships in a church or synagogue or fraternal organizations or clubs. Thus, your goal is to show that not only do you intend to change your domicile to another state or even another country, but to take actions that back up that intent.

18.2 Residence

A "residence" is defined as a place of abode, a dwelling, the act of abiding in a place for some amount of time. It is distinguished from "domicile" in that you can have a residence in more than one place, *and* you can be resident in a place without being domiciled there. Thus, in a very simple example, it should be apparent that you could be resident in France while retaining your domicile in New Jersey.

18.3 Tax Consequences Of "Domicile" And "Residence"

You may be thoroughly confused by the "legalese" of the above sections, but if you are reading this chapter at all, it is probably because you have some concern about state tax liability. This is because many states, once they have their "tax hooks" in you, don't want to let go. Unless they are satisfied you are no longer domiciled in their state, they may pursue you, even overseas, in an effort to collect tax.

Other states, interestingly, are quite generous in this regard. They will allow you to still be considered domiciled in their state, but will not tax you on your foreign income so long as you meet certain requirements. Still other states, bless their hearts, have no income tax at all so it becomes very attractive to be domiciled in those states.

Many states have a provision where you will be taxed as a resident of the state if you are physically present in that state for a specified number of days in the tax year (usually around 183). This rule looks only to physical presence — not domicile. Therefore, it is possible that you will be domiciled in one state and subject to tax there at the same time that you are physically present in another state and thus subject to tax by that state as well. In most cases, you will need to file a tax return in each state and try to get a credit in one state for the tax paid in the other state. Which state actually gets your tax dollar will depend on the states involved. To complicate matters even further, some states will give you a credit for *foreign* tax paid!

If you move overseas mid-year and qualify as "physically present" in a particular state for the tax year, you should file a part-year return with that state, assuming you are not also domiciled in that state. If you have a domicile elsewhere (say in a no-tax state), you can indicate that on the return.

Finally, most states have tax rules for nonresidents. A "nonresident" is generally defined as an individual who earns income or interest in the specific state, but does not live there or lives there less than the time required to be a "resident" (usually 183 days in the tax year). You will need to file a "nonresident" return in that state if you meet this definition, and your income is above the filing threshold for the state. Suppose, for example, you owned a rental property in Virginia as well as had

money deposited in several Virginia banks. Your net income from these investments was $8,000. Even if you lived overseas for the last 2 years and considered yourself to be domiciled in Florida, you would still need to file a nonresident return for Virginia and pay Virginia tax on the $8,000.

One final note: Most states have a filing threshold meaning that, if you make less than a certain amount, you don't need to file. However, if you fall below that threshold because of the foreign income exclusion, you are still better off to file and report the income. This preventive measure not only establishes your domicile in that state, but protects you from non-filing penalties or other possible claims by the state.

18.4 States With No Income Tax

There are only a handful of states with no income tax. If you are domiciled in one of these states, you have significantly less tax worries in you life!

Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming

In addition, **New Hampshire** and **Tennessee** do not tax personal income, but they do tax profits from in-state sources, including the sale of bonds and property. If you are domiciled or resident in either state, you need to check the filing rules very carefully. **New Hampshire** can be contacted by writing: NH DRA, PO Box 637, Concord, NH 03302-0637, or www.state.nh.gov. **Tennessee** can be contacted at: Department of Revenue, Andrew Jackson Bldg., 500 Deaderick St., Nashville, TN 37242, or www.state.tn.us, or telephone: (615) 253-0600.

Note that **Florida** has an intangible property tax effective for years before January 1, 2007. More information is online at dor.myflorida.com.

18.5 States Where You Can Be Domiciled But Not Pay State Income Tax

A very few states allow you to remain domiciled in their state, but not pay tax on your out-of-state income if you meet certain requirements. Those states are listed below with a brief summary of their particular rules as well as a contact address.

If you are domiciled in one of these states or are considering establishing domicile there, you should contact that state for details and to see how each state defines such terms as "permanent residence", "permanent place of abode", "domicile", etc.

You should also keep in mind a trap that can catch you unawares. If you live overseas and meet the time requirements, as far as the states listed below are concerned, you are considered domiciled but not resident in those states. **Because you are nonresident, you are not required to file an income tax return in that state.** This is all very fine until another state claims you are domiciled there (perhaps because you own property there, lived there at one time, etc.). When you make the argument that you are domiciled in California, for example, the other state will ask

to see a copy of your tax return filed with California. Of course, you won't have one because California says you don't need one. At this point, if you're lucky, the other state will agree with you and leave you alone. If you're not, it will ask for proof of domicile in California and perhaps insist you owe tax to it. You may be able to avoid this pitfall by filing a nonresident tax return each year with California (or whichever state you claim as your domicile) and attaching a statement as to why you are filing (i.e., you are domiciled there but the special state rules for foreign assignments let you be treated as a nonresident for tax purposes). This gives you a paper trail you can present to the other state that should be persuasive on the issue of domicile.

California: If you are domiciled in California and worked outside of California for an uninterrupted period of at least 546 consecutive days under an employment contract, you are considered a nonresident provided you are not in California for more than 45 days in any tax year covered by the contract. If you are nonresident, you will only be taxed on income from California sources. In a recent change of law, this law also applies to U.S. Foreign Service offcers domiciled in California. Refer to FTB Pub. 1031, *Determining Resident Status,* for more details. If you are in the military, you should get FTB Pub. 1032, *Tax Information for Military Personnel*, for specific guidelines on the taxation of your income.

Contact: State of California, Franchise Tax Board, P.O. Box 942840, Sacramento, CA 94240-0070; www.ftb.ca.gov; (800) 852-5711 or (916) 845-6600 (Outside U.S.) (Fast Answers about State Taxes).

Connecticut: If you are domiciled in Connecticut, you will be treated as a nonresident if you meet all of the following conditions: (1) you maintained no permanent place of abode in Connecticut for the entire taxable year; (2) you maintained a permanent place of abode outside of Connecticut for the entire taxable year; and (3) you spent no more than 30 days in Connecticut during the taxable year. Again, you are taxed only on income from Connecticut sources.

If you have a permanent residence in Connecticut but live in a foreign country for 450 days out of 548 days, you have no tax liability in Connecticut provided you do not spend more than 90 days in the state during that time.

A "permanent place of abode" is a residence that you permanently maintain, whether or not you own it. An abode is not deemed permanent if it is maintained only during a temporary stay for the accomplishment of a particular purpose.

Contact: Department of Revenue Services, Taxpayer Services Division, 25 Sigourney Street, Hartford, CT 06106-5032; www.ct.gov/drs; (860) 297-5962 (Taxpayer Assistance) or (800) 382-9463.

Delaware: If you maintain a domicile in Delaware, you are considered a nonresident if you were out of the United States for at least 495 days in the last 18 consecutive months, and you did not have a permanent place of abode in Delaware for you, your spouse, your children or your parents at which you were present for more than 45 days. This does not apply to members of the Armed Forces or employees of the United States, its agencies or instrumentalities, which means that they are still required to file as residents of Delaware even if they live overseas so long as they are domiciled in Delaware.

Contact: Division of Revenue, State Office Building, 9th& French Streets, Wilmington, DE 19801; www.revenue.delaware.gov; (302) 577-8200 (Tax Assistance).

Idaho: Although you are domiciled in Idaho, you will not be considered an Idaho resident for income tax purposes if you are absent from the state at least 445 days during a 15-month period. The period begins when you leave the state and during that time, you may not:

- → Be present in Idaho for more than 60 days in the calendar year after the first 15-month period;
- → Maintain a personal residence in Idaho for yourself or your family;
- → Claim Idaho as your federal tax home;
- → Be employed on the staff of a U.S. Senator or Representative; or
- → Hold an elective office of the U.S. Government other than the Armed Forces or career appointees in the U.S. Foreign Service.

Contact: Idaho State Tax Commission, P. O. Box 36, Boise, ID 83722-0410; www.tax.idaho.gov; (208) 334-7660 (Tax Information) or (800) 972-7660.

Illinois: Generally, you are domiciled in Illinois if you reside there and intend to return there after temporary absences, including residence in a foreign country. However, if your are absent from Illinois for one year or more, you are presumed to be a nonresident of Illinois.

Contact: Illinois Department of Revenue, P.O. Box 19044, Springfield, IL 62794-9044; www.revenue.state.il.us; (217) 782-3336 (Tax Assistance) or (800) 732-8866.

Missouri: If you maintain a domicile in Missouri, you are considered a nonresident if you did not maintain permanent living quarters in Missouri, did maintain them elsewhere, and did not spend more than 30 days during the tax year in Missouri. You are only taxed on income from Missouri sources.

Contact: Missouri Department of Revenue, Jefferson City, MO 65105-2200; www.mo.gov; (800) 877-6881 (Forms), (573) 751-4800 (Forms by FAX), (573) 751-7191 (Taxpayer Assistance).

New Jersey: If you maintain a domicile in New Jersey, but have no permanent residence there, have a permanent residence elsewhere, and are not physically present for more than 30 days during the tax year, you do not have liability for out-of-state income.

Contact: Department of the Treasury, Division of Taxation, PO Box 266, Trenton, NJ 08625-0269; www.state.nj.us/treasury/taxation/; (609) 292-6400 (Tax Assistance).

New York: If you are domiciled in New York, you will be considered a nonresident if you meet all 3 of the conditions outlined for *either* Group A or Group B:

GROUP A

- →You did not maintain a permanent place of abode in New York during the tax year.
- →You maintained a permanent place of abode outside of New York during the tax year.
- →You spent 30 days or less in New York during the tax year.

GROUP B

→You were in a foreign country for at least 450 days during a period of 548 consecutive days.

→During the 548-day period, you were not in New York more than 90 days and you did not have a permanent abode in New York.

→During the nonresident part of the tax year in which the 548-day period either begins or ends, you were in New York for no more than the number of days that bears the same ratio to 90 as the number of days in such portion of the tax year bears to 548. Use the following formula:

$$\frac{\text{Number of days in nonresident portion}}{548} \times 90 = \text{maximum days allowed in NY}$$

Filing requirements: If you were in a foreign country for an entire tax year and you meet all the conditions of Group A, you are considered a nonresident of New York for that year. If you meet the conditions of Group B, you must file Form IT-203 for the tax year in which the 548-day period began. For the part-year resident period, include items of income, gain, loss or deduction up to the time you changed residence. For the nonresident period, you must also include these items if they are derived from New York sources.

If you can take the earned income exclusion, you can also claim it on the New York State income tax return in the federal amount column. Be sure to attach a copy of the Form 2555 to the New York return.

Contact: NYS Tax Department, Taxpayer Assistance Bureau, W.A. Harriman Campus, Albany, NY 12227; www.tax.state.ny.us; (518) 457-5181 or (518) 485-6800 (Outside U.S.).

Oregon: If you are domiciled in Oregon, you will be considered a nonresident for the tax year if all the following are true:

→You lived outside Oregon the entire year.

→You didn't keep a home in Oregon during any part of the year.

→You spent less than 31 days in Oregon during the year.

If the above 3 conditions are met, you are taxed only on your income from Oregon sources. Generally if you qualify for the foreign earned income exclusion, you are considered a nonresident.

Contact: Oregon Department of Revenue, 955 Center Street, NE, Salem, OR 97310-2551; www.oregon.gov/DOR/; (503) 378-4988 (Taxpayer Assistance) or (800) 356-4222.

Pennsylvania: If you are domiciled in Pennsylvania, you can be considered a nonresident if you meet all 3 of the following conditions:

→You did not maintain a permanent abode in Pennsylvania for yourself or your family.

→You did maintain a permanent abode outside Pennsylvania for the entire year.

→You did not spend more than 30 days of the year in Pennsylvania.

Note: If you are a Foreign Service Officer who is resident in Pennsylvania, you will still need to file a resident tax return as Pennsylvania does not consider government quarters overseas to be "a

permanent place of abode elsewhere.”

Contact: Commonwealth of Pennsylvania, Department of Revenue, Taxpayer Services, Harrisburg, PA 17128-1061; www.revenue.state.pa.us; (717) 787-8201.

West Virginia: If you are domiciled in West Virginia, you will be considered nonresident for the tax year if the following are true:

→You have a permanent residence elsewhere.
→You have no permanent residence in West Virginia.
→You spend no more than 30 days of the tax year in West Virginia.

Contact: The Department of Tax and Revenue, Taxpayer Services Division, P.O. Box 3784, Charleston, WV 25337-3784; www.state.wv.us/taxdiv; (304) 558-3333 or (800) 982-8297.

18.6 States Where Domicile Equals Tax Liability

The remaining states will generally tax you on worldwide income (although many allow you to take the foreign earned income exclusion) if you are domiciled in the state, even though you may not be resident there.

As you recall from earlier in this chapter, simply leaving the state and establishing residence elsewhere is not enough to change your domicile. You must also intend to remain in that new locality and takes steps to change it to your new domicile. Each state has developed its own statutory and case law on what you must do to change domicile.

If you have questions about your status, you should contact the state taxing authority or a tax professional in that state for advice.

The following list details how you may contact each state for more information and gives you a general range of the tax rates imposed by each state. Keep in mind that these tax rates are subject to change as state budgets and legislatures change, and therefore you may find the actual tax is somewhat higher or lower than indicated here.

You should also realize that there are a few states that do not allow you to exclude foreign income from state tax. Among these are ALABAMA, MASSACHUSETTS, and MISSISSIPPI. Most other states will use your federal adjusted gross income as a starting point for state tax calculation. This means that the foreign income exclusion is taken into account. However, in the case of these states just mentioned, you will need to add back your foreign income for purposes of state tax.

Alabama: Alabama’s tax rate ranges from 2% to 5%. Remember that Alabama is one of those states that does not permit you to exclude foreign income from tax so check the rules carefully before you file.
Contact: Alabama Department of Revenue, Individual and Corporate Tax Division, P.O. Box 327460, Montgomery, AL 36132-7460; www.revenue.alabama.gov/incometax; (334) 242-1170 (Tax Information).

Arizona: Arizona's tax rate ranges from 2.87% to 5.04%.
Contact: Arizona Department of Revenue, P.O. Box 29002, Phoenix, AZ 85038-9002; www.revenue.state.az.us; (602) 542-4260 (Form Orders), (602) 255-3381 (Tax Information).

Arkansas: Arkansas's tax rate ranges from 1% to 7%.
Contact: Dept. of Finance and Administration, Income Tax Forms Division, P.O. Box 3628, Little Rock, AK 72203-3628; www.state.ar.us/dfa; (501) 682-1100 (Tax Information).

Colorado: Colorado's tax rate is 4.63% on all taxable income.
Contact: Colorado Department of Revenue, 1375 Sherman Street, Denver, CO 80261; www.revenue.state.co.us; (303) 238-7378 (Tax Assistance).

District of Columbia: The District of Columbia's tax rate ranges from 6% to 9.5%. The District has some unique tax laws because of the number of government employees in the area. Generally speaking, if you are a D.C. resident or your permanent home is in the District, you must file a D.C. tax return (even if you are posted overseas temporarily). If you happen to be an officer of the executive branch of the U.S. government, you are appointed by the President and confirmed by the Senate, you are exempted from paying District income tax so long as you are not domiciled in the District. In the past, this meant that Foreign Service Officers with career appointments did not have to pay income tax in the District when they were living there during an assignment to the State Department-Washington, D.C. offices. This rule changed effective 1988 pursuant to Public Law 100-204, Sec. 179 which states that, "Section 301(d)(3) of the Foreign Service Act of 1980 (22 U.S.C. 3941(d)(3) is amended by adding at the end thereof 'Foreign Service employees serving as career candidates or career members of the Service shall not represent to the income tax authorities of the District of Columbia or any other state of locality that they are exempt from income taxation on the basis of holding a Presidential appointment subject to Senate confirmation. …'"
Contact: Office of Tax & Revenue, 941 N. Capitol Street, NE, Washington, DC 20002; www.cfo.dc.gov; (202) 727-4TAX (4829) (Tax Assistance).

Georgia: Georgia's tax rate ranges from 1% to 6%.
Contact: State of Georgia, Department of Revenue, Income Tax Division, 1800 Century Center Blvd, NE, Atlanta, GA 30345; www.etax.dor.ga.gov; (404) 417-2300 or (877) 602-8477.

Hawaii: The rate of tax in Hawaii ranges from 1.6% to 8.75%.
Contact: State of Hawaii, Dept. of Taxation, P.O. Box 3559, Honolulu, HI 96811-3559; www.state.hi.us/tax; (808) 587-4242 (Taxpayer Services), (808) 587-1488 (Forms by FAX).

Indiana: Indiana's tax rate is 3.4%. There may also be a county tax depending on the county of your domicile.
Contact: Indiana Department of Revenue, 100 N. Senate Ave., Indianapolis, IN 46204-2253; www.in.gov/dor/; (317) 232-2240.

Iowa: Iowa's tax rate is 0.36% to 8.98% with additional surtaxes imposed by some counties.
Contact: State of Iowa, Department of Revenue and Finance, Hoover State Office Building, Des Moines, IA 50319; www.state.ia.us/tax; (515) 281-7239 (Forms), (515) 281-3114 (Tax Specialists).

Kansas: The rate of tax in Kansas ranges from 3.5% to 6.45%.
Contact: Kansas Taxpayer Assistance Bureau, 915 S.W. Harrison, Topeka, KS 66625-0001; www.ksrevenue.org; (785) 368-8222 (Tax Assistance) or (785) 296-4937 (Tax Forms).

Kentucky: Kentucky's tax rate ranges from 2% to 6%.
Contact: Kentucky Revenue Cabinet, P.O. Box 181, Frankfort, KY 40602; www.revenue.ky.gov; (502) 564-4581.

Louisiana: Louisiana's tax rate ranges from 2% to 6%.
Contact: Dept. of Revenue and Taxation, Forms Division, P.O. Box 201, Baton Rouge, LA 70821-0201; www.rev.state.la.us; (225) 219-0102.

Maine: The rate of tax in Maine ranges from 2% to 8.5%.
Contact: Maine Revenue Services, 24 State House Station, Augusta, ME 04333-0024; www.maine.gov/revenue/; (207) 626-8475 (Tax Assistance), (207) 624-7894 (Forms Orders).

Maryland: Maryland's tax rate goes to a maximum of 4.85%. In addition, a county tax is imposed which is a percentage of the state income tax liability.
Contact: Revenue Administration, Income Tax Division, Annapolis, MD 21411; www.marylandtaxes.com; (410) 260-7980 (Tax Assistance).

Massachusetts: Income is Massachusetts is taxed at 5.85% while dividends, some interest, and capital gains are taxed at 12%. Remember, this is a state that taxes foreign income, but you can take the foreign income as a deduction.
Contact: Department of Revenue, 100 Cambridge Street, Boston, MA 02204; www.dor.state.ma.us; (617) 887-MDOR (Tax Information).

Michigan: The rate of tax in Michigan is a flat 4.2%. You may have to pay an income tax to a Michigan city for which you can get a credit.
Contact: Michigan Department of Treasury, Treasury Building, Lansing, MI 48922; www.michigan.gov/treasury; (800) 827-4000 (Tax Assistance), (800) 827-4000 (select option 2 for Forms).

Minnesota: The rate of tax in Minnesota ranges from 5.35% to 7.85%.
Contact: Minnesota Dept. of Revenue, Mail Station 5510, St. Paul, MN 55146-2220; www.taxes.state.mn.us; (651) 296-3781 or (800) 652-9094 (Tax Information).

Mississippi: Mississippi's tax rate ranges from 3% to 5%. Remember, this is a state that taxes foreign income, but you can take the foreign income as a deduction.
Contact: Bureau of Revenue, P.O. Box 23050, Jackson, MS 39255-3050; www.mstc.state.ms.us/; (601) 923-7000 (Tax Assistance).

Montana: Montana's tax rate ranges from 2% to 11%.
Contact: Income Tax Division, Montana Department of Revenue, P.O. Box 5805, Helena, MT 59604-5805; www..mt.gov/revenue; (406) 444-6900.

Nebraska: Nebraska's tax rate ranges from 2% to 6.68%.
Contact: Nebraska Department of Revenue, Nebraska State Office Building, 301 Centennial Mall South, Lincoln, NE 68509-4818; www.revenue.state.ne.us; (402) 471-5729.

New Mexico: The rate of tax in New Mexico ranges from 1.7% to 8.5%.
Contact: Taxpayer Information Unit, Taxation and Revenue Department, P.O. Box 630, Santa Fe, NM 87504-0630; www.state.nm.us/tax/; (505) 827-0700.

North Carolina: The tax rate in North Carolina ranges from 6% to 7.75%.
Contact: Dept. of Revenue, Taxpayer Services Dept., Revenue Building, Raleigh, NC 27640; www.dor.state.nc.us; (877) 252-4052 (Tax Assistance), (877) 252-3052 (Forms), (252) 467-9000 (international callers).

North Dakota: Oddly enough, North Dakota uses 2 forms with different rates of tax and you are free to use the form that gives you the lowest total tax.
Contact: Office of State Tax Commissioner, State Capitol, 16th floor, 600 E. Boulevard Ave., Bismarck, ND 58505-0599; www.nd.gov/tax/; (701) 328-2770.

Ohio: The tax rate in Ohio ranges from 0.743 % to 7.5%.
Contact: Ohio Department of Taxation, Taxpayer Services, 800 Freeway Drive, N., Columbus, OH 43329; www.tax.ohio.gov; (614) 466-2166 or (800) 282-1780 (Tax Information).

Oklahoma: The rate of tax in Oklahoma ranges from 1% to 10%.
Contact: Oklahoma Tax Commission, 2501 North Lincoln Blvd., Oklahoma City, OK 73194; www.oktax.state.ok.us; (405) 521-3160 (Tax Assistance).

Rhode Island: Rhode Island's tax rate ranges from 3.75% to 9.90%.
Contact: State of Rhode Island, Division of Taxation, One Capitol Hill, Providence, RI 02908-5801; www.tax.state.ri.us; (401) 222-1040.

South Carolina: South Carolina's tax rate ranges from 2% to 7%.
Contact: Department of Revenue, 301 Gervais Street, P.O. Box 125, Columbia, SC 29214; www.sctax.org; (803) 898-5040 (Tax Information).

Utah: Utah's tax rate ranges from 2.3% to 7%.
Contact: Utah State Tax Commission, 210 North 1950 West, Salt Lake City, UT 84134; www.utah.gov/residents/taxes.html; (801) 297-2200 (Tax Assistance).

Vermont: Tax rates can be obtained from the Vermont tax tables.
Contact: Vermont Dept. of Taxes, Taxpayer Services, Pavilion Office Bldg., Montpelier, VT 05609-1401; www.state.vt.us/tax; (802) 828-2865 (Taxpayer Assistance).

Virginia: Virginia's tax rate ranges from 2% to 5.75%.
Contact: Virginia Department of Taxation, Taxpayer Services Division, P.O. Box 1115, Richmond, VA 23218; www.tax.virginia.gov; (804) 367-8031 (Tax Assistance) or (804) 440-2541 (Tax Forms).

Wisconsin: Wisconsin's rate of tax ranges from 4.73% to 6.75%.
Contact: Wisconsin Dept. of Revenue, P.O. Box 8903, Madison, WI 53708-8903; www.dor.state.wi.us; (608) 266-2772 (Tax Information).

IRS Information
Addresses And Contacts

On The Internet: www.irs.gov

- **Forms and Instructions**
- **Publications**
- **IRS Press Releases and Fact Sheets**
- **Info for International Taxpayers under "Individual" Tab**

TELEPHONE for forms, instructions, and publications: (800) 829-3676

INTERNET for forms and publications: www.irs.gov/formspubs

REFUND INFORMATION: Call (800) 829-4477 and press 1. You will need your Social Security number, filing status, and exact amount of refund.

INTERNATIONAL ASSISTANCE

Tax forms and publications can be obtained from U.S. Embassies and consolates during tax season. You can request Package 1040-7 which has special forms and publications for overseas filers. Also check to see if a taxpayer assistance program will be offered in your area.

There are 3 IRS offices in Europe where you can get assistance:

- **London** Telephone: [44] (20) 7894-0477
- **Paris** Telephone: [33] (1) 4312-2555
- **Frankfurt** Telephone: [49] (69) 7535-3834

You can also call (215) 516-2000 in the U.S. for overseas tax help.

From **Guam, the Bahamas, U.S. Virgin Islands, or Puerto Rico**: telephone Puerto Rico at (800) 829-1040.

- **Answers to Technical or Account Questions:**

  Internal Revenue Service
  International Section
  PO Box 920
  Bensalem, PA 19020-8518

- **Competent Authority Assistance:**

  Deputy Commissioner (Intl)
  Large & Mid-Size Business Division
  Attn: Office of Tax Treaty
  IRS
  1111 Constitution Ave., NW
  Routing MA3-322A
  Washington, DC 20224

- **Copies of Tax Treaties:**

  Dept. of Treasury
  Office of Public Correspondence
  1500 Pennsylvania Ave., NW, Rm. 3419
  Washington, DC 20220

- **Filing Address for Overseas Filers:**

  Internal Revenue Service Center
  Austin, TX 73301-0215

  (For Private Delivery Service)
  Internal Revenue Submission Processing Center
  3651 South Interregional Highway 35
  Austin, TX 78741
  Telephone: (800) 829-1040

- **Address to Order Forms and Publications:**

Be sure to include your name, address, and name or number of form requested. If your mailing address is in a foreign country, mail the order to:

National Distribution Center
PO Box 8903
Bloomington, IL 61702-8903

- **Taxpayer Advocate Services:**

If you have been unsuccessful in resolving a problem with the IRS, you should contact the Taxpayer Advocate Services Program:

Website: www.irs.gov/advocate.

Call toll-free: (787) 622-8940 if you live outside the U.S.
Call toll-free: (877) 777-4778 if you live inside the U.S.

Fax: (787) 622-8933

By Mail:

Internal Revenue Service
Taxpayer Advocate
P.O. Box 193479
San Juan, PR 00919

2008 Limits on Housing Expenses			
Country	City or Other Location	Limit on Housing Expenses (daily)	Limit on Housing Expenses (full year)
Argentina	Buenos Aires	125.96	46,100
Australia	Brisbane	81.42	29,800
	Canberra	76.50	28,000
	Gold Coast	81.42	29,800
	Melbourne	78.96	28,900
	Oakey	81.42	29,800
	Perth	118.85	43,500
	Toowoomba	81.42	29,800
Austria	Vienna	96.72	35,400
Bahamas, The	Nassau	135.79	49,700
Bahrain		120.22	44,000
Barbados		103.01	37,700
Belgium	Antwerp	116.67	42,700
	Brussels	157.65	57,700
	Gosselies	110.11	40,300
	Hoogbuul	116.67	42,700
	Mons	110.11	40,300
	SHAPE/Chievres	110.11	40,300
Bermuda		245.90	90,000
Bosnia-Herzegovina	Sarajevo	89.89	32,900
Brazil	Brasilia	121.31	44,400
	Rio de Janeiro	95.90	35,100
	Sao Paulo	127.05	46,500
Canada	Calgary	110.93	40,600
	Dartmouth	95.63	35,000
	Edmonton	100.82	36,900
	Halifax	95.63	35,000
	London, Ontario	81.42	29,800
	Montreal	158.20	57,900
	Ottawa	130.87	47,900
	Toronto	129.78	47,500
	Vancouver	125.68	46,000
	Victoria	95.08	34,800
	Winnipeg	82.51	30,200
Cayman Islands	Grand Cayman	131.15	48,000
Chile	Santiago	124.32	45,500
China	Beijing	134.25	49,137
	Hong Kong	312.30	114,300
	Shanghai	155.74	57,001
Colombia	Bogota	147.81	54,100
	All cities other than Bogota and Barranquilla	122.68	44,900
Denmark	Copenhagen	119.41	43,704
Dominican Republic	Santo Domingo	124.32	45,500
Ecuador	Guayaquil	84.15	30,800
	Quito	83.33	30,500
Egypt	Cairo	74.43	27,240
Estonia	Tallinn	127.32	46,600
France	Garches	273.50	100,100
	Le Havre	114.75	42,000

2008 Limits on Housing Expenses			
Country	**City or Other Location**	**Limit on Housing Expenses (daily)**	**Limit on Housing Expenses (full year)**
France (*Continued*)	Lyon	155.46	56,900
	Marseille	143.17	52,400
	Montpellier	126.78	46,400
	Paris	273.50	100,100
	Sevres	273.50	100,100
	Suresnes	273.50	100,100
	Versailles	273.50	100,100
Germany	Babenhausen	134.15	49,100
	Bad Aibling	114.48	41,900
	Bad Nauheim	107.10	39,200
	Baumholder	121.86	44,600
	Berlin	163.93	60,000
	Birkenfeld	121.86	44,600
	Boeblingen	145.90	53,400
	Butzbach	104.92	38,400
	Darmstadt	134.15	49,100
	Erlangen	84.97	31,100
	Frankfurt am Main	139.89	51,200
	Friedberg	107.10	39,200
	Fuerth	84.97	31,100
	Garmisch-Partenkirchen	115.85	42,400
	Geilenkirchen	92.35	33,800
	Gelnhausen	145.08	53,100
	Germersheim	101.91	37,300
	Giebelstadt	116.39	42,600
	Giessen	104.92	38,400
	Grafenwoehr	114.48	41,900
	Hanau	145.08	53,100
	Hannover	100.00	36,600
	Heidelberg	133.88	49,000
	Idar-Oberstein	121.86	44,600
	Ingolstadt	169.40	62,000
	Kaiserslautern, Landkreis	149.18	54,600
	Kitzingen	116.39	42,600
	Leimen	133.88	49,000
	Ludwigsburg	145.90	53,400
	Mainz	164.48	60,200
	Mannheim	133.88	49,000
	Munich	169.40	62,000
	Nellingen	145.90	53,400
	Neubruecke	121.86	44,600
	Nuernberg	84.97	31,100
	Ober Ramstadt	134.15	49,100
	Oberammergau	115.85	42,400
	Pirmasens	149.18	54,600
	Rheinau	133.88	49,000
	Schwabach	84.97	31,100
	Schwetzingen	133.88	49,000
	Seckenheim	133.88	49,000
	Sembach	149.18	54,600

2008 Limits on Housing Expenses			
Country	**City or Other Location**	**Limit on Housing Expenses (daily)**	**Limit on Housing Expenses (full year)**
Germany (*Continued*)	Stuttgart	145.90	53,400
	Wertheim	116.39	42,600
	Wiesbaden	164.48	60,200
	Wuerzburg	116.39	42,600
	Zirndorf	84.97	31,100
	Zweibrueken	149.18	54,600
	All cities other than Augsburg, Babenhausen, Bad Aibling, Bad Kreuznach, Bad Nauheim, Baumholder, Berchtesgaden, Berlin, Birkenfeld, Boeblingen, Bonn, Bremen, Bremerhaven, Butzbach, Cologne, Darmstadt, Delmenhorst, Duesseldorf, Erlangen, Flensburg, Frankfurt am Main, Friedberg, Fuerth, Garlstedt, Garmisch-Partenkirchen, Geilenkirchen, Gelnhausen, Germersheim, Giebelstadt, Giessen, Grafenwoehr, Grefrath, Greven, Gruenstadt, Hamburg, Hanau, Handorf, Hannover, Heidelberg, Heilbronn, Herongen, Idar-Oberstein, Ingolstadt, Kaiserslautern, Landkreis, Kalkar, Karlsruhe, Kerpen, Kitzingen, Koblenz, Leimen, Leipzig, Ludwigsburg, Mainz, Mannheim, Mayen, Moenchen-Gladbach, Muenster, Munich, Nellingen, Neubruecke, Noervenich, Nuernberg, Ober Ramstadt, Oberammergau, Osterholz-Scharmbeck, Pirmasens, Rheinau, Rheinberg, Schwabach, Schwetzingen, Seckenheim, Sembach, Stuttgart, Twisteden, Wahn, Wertheim, Wiesbaden, Worms, Wuerzburg, Zirndorf, and Zweibrueken	125.41	45,900
Greece	Argyroupolis	104.64	38,300
	Athens	107.92	39,500
	Elefsis	107.92	39,500
	Ellinikon	107.92	39,500
	Mt. Hortiatis	104.64	38,300
	Mt. Parnis	107.92	39,500
	Mt. Pateras	107.92	39,500
	Nea Makri	107.92	39,500
	Perivolaki	104.64	38,300
	Piraeus	107.92	39,500
	Souda Bay (Crete)	83.61	30,600
	Tanagra	107.92	39,500
	Thessaloniki	104.64	38,300
Guatemala	Guatemala City	102.73	37,600
Holy See, The		182.24	66,700
Hungary	Budapest	88.80	32,500
India	Mumbai	185.57	67,920
	New Delhi	82.66	30,252
Indonesia	Jakarta	103.21	37,776
Ireland	Dublin	158.20	57,900
	Limerick	89.34	32,700
	Shannon Area	89.34	32,700

2008 Limits on Housing Expenses			
Country	City or Other Location	Limit on Housing Expenses (daily)	Limit on Housing Expenses (full year)
Italy	Catania	106.56	39,000
	Gaeta	77.05	28,200
	Genoa	110.38	40,400
	Gioia Tauro	85.25	31,200
	La Spezia	110.38	40,400
	Leghorn	114.21	41,800
	Milan	272.13	99,600
	Naples	150.27	55,000
	Pisa	114.21	41,800
	Pordenone-Aviano	125.68	46,000
	Rome	182.24	66,700
	Sardinia	93.44	34,200
	Sigonella	106.56	39,000
	Turin	136.07	49,800
	Verona	86.89	31,800
	Vicenza	126.78	46,400
	All cities other than Avellino, Brindisi, Catania, Florence, Gaeta, Genoa, Gioia Tauro, La Spezia, Leghorn, Milan, Mount Vergine, Naples, Nettuno, Pisa, Pordenone-Aviano, Rome, Sardinia, Sigonella, Turin, Verona, and Vicenza	104.64	38,300
Jamaica	Kingston	112.57	41,200
Japan	Akashi	86.07	31,500
	Akizuki	75.68	27,700
	Atsugi	108.47	39,700
	Camp Zama	108.47	39,700
	Chiba-Ken	108.47	39,700
	Fussa	108.47	39,700
	Gifu	79.78	29,200
	Gotemba	81.97	30,000
	Haneda	108.47	39,700
	Kanagawa-Ken	108.47	39,700
	Komaki	79.78	29,200
	Machida-Shi	108.47	39,700
	Misawa	78.96	28,900
	Nagoya	103.24	37,786
	Okinawa Prefecture	133.06	48,700
	Osaka-Kobe	144.91	53,036
	Sagamihara	108.47	39,700
	Saitama-Ken	108.47	39,700
	Sasebo	81.42	29,800
	Tachikawa	108.47	39,700
	Tokyo	257.38	94,200
	Tokyo-to	108.47	39,700
	Yokohama	138.25	50,600
	Yokosuka	118.58	43,400
	Yokota	108.47	39,700
Kazakhstan	Almaty	131.15	48,000
Korea	Camp Carroll	80.05	29,300
	Camp Colbern	178.69	65,400

2008 Limits on Housing Expenses			
Country	**City or Other Location**	**Limit on Housing Expenses (daily)**	**Limit on Housing Expenses (full year)**
Korea (*Continued*)	Camp Market	178.69	65,400
	Camp Mercer	178.69	65,400
	Chinhae	82.79	30,300
	Chunchon	76.78	28,100
	K-16	178.69	65,400
	Kimhae	85.79	31,400
	Kimpo Airfield	178.69	65,400
	Kwangju	81.97	30,000
	Munsan	75.41	27,600
	Osan AB	93.17	34,100
	Pusan	85.79	31,400
	Pyongtaek	93.17	34,100
	Seoul	178.69	65,400
	Suwon	178.69	65,400
	Taegu	100.00	36,600
	Tongduchon	75.41	27,600
	Uijongbu	106.56	39,000
	Waegwan	80.05	29,300
	All cities other than Ammo Depot #9, Camp Carroll, Camp Colbern, Camp Market, Camp Mercer, Changwon, Chinhae, Chunchon, K-16, Kimhae, Kimpo Airfield, Kunsan, Kwangju, Munsan, Osan AB, Pusan, Pyongtaek, Seoul, Suwon, Taegu, Tongduchon, Uijongbu, and Waegwan	87.16	31,900
Kuwait	Kuwait City	177.87	65,100
	All cities other than Kuwait City	159.29	58,300
Luxembourg		149.45	54,700
Macedonia	Skopje	96.72	35,400
Malaysia	Kuala Lumpur	138.80	50,800
	All cities other than Kuala Lumpur	92.08	33,700
Malta		122.95	45,000
Mexico	Hermosillo	98.36	36,000
	Mazatlan	88.52	32,400
	Merida	103.55	37,900
	Mexico City	125.41	45,900
	Monterrey	117.21	42,900
	All cities other than Ciudad Juarez, Cuernavaca, Guadalajara, Hermosillo, Matamoros, Mazatlan, Merida, Metapa, Mexico City, Monterrey, Nogales, Nuevo Laredo, Tapachula, Tijuana, Tuxtla Gutierrez, and Veracruz	107.65	39,400
Micronesia	Pohnpei	75.14	27,500
Netherlands	Amsterdam	144.54	52,900
	Aruba	98.36	36,000
	Brunssum	103.28	37,800
	Eygelshoven	103.28	37,800
	Hague, The	187.16	68,500
	Heerlen	103.28	37,800
	Hoensbroek	103.28	37,800

2008 Limits on Housing Expenses			
Country	**City or Other Location**	**Limit on Housing Expenses (daily)**	**Limit on Housing Expenses (full year)**
Netherlands (*Continued*)	Hulsberg	103.28	37,800
	Kerkrade	103.28	37,800
	Landgraaf	103.28	37,800
	Maastricht	103.28	37,800
	Papendrecht	130.87	47,900
	Rotterdam	130.87	47,900
	Schaesburg	103.28	37,800
	Schinnen	103.28	37,800
	Schiphol	144.54	52,900
	Ypenburg	187.16	68,500
	All cities other than Amsterdam, Aruba, Brunssum, Coevorden, Eygelshoven, The Hague, Heerlen, Hoensbroek, Hulsberg, Kerkrade, Landgraaf, Maastricht, Margraten, Papendrecht, Rotterdam, Schaesburg, Schinnen, Schiphol, and Ypenburg	95.63	35,000
Netherlands Antilles	Curacao	101.91	37,300
New Zealand	Auckland	97.54	35,700
	Wellington	92.35	33,800
Nicaragua	Managua	86.89	31,800
Norway	Oslo	159.29	58,300
	Stavanger	108.20	39,600
	All cities other than Oslo and Stavanger	103.01	37,700
Panama	Panama City	96.99	35,500
Peru	Lima	74.59	27,300
Philippines	Cavite	98.36	36,000
	Manila	98.36	36,000
	All cities other than Cavite and Manila	76.23	27,900
Poland		80.33	29,400
Portugal	Alverca	166.67	61,000
	Lajes Field	82.24	30,100
	Lisbon	166.67	61,000
Qatar	Doha	99.08	36,264
	All cities other than Doha	88.52	32,400
Russia	Moscow	248.36	90,900
	Saint Petersburg	119.67	43,800
	Sakhalin Island	211.75	77,500
	Vladivostok	211.75	77,500
	Yekaterinburg	129.51	47,400
Rwanda	Kigali	86.07	31,500
Saudi Arabia	Jeddah	83.79	30,667
	Riyadh	87.43	32,000
Singapore		176.23	64,500
South Africa	Pretoria	109.84	40,200
Spain	Barcelona	110.93	40,600
	Madrid	123.50	45,200
	Rota	106.01	38,800
	Valencia	127.60	46,700

2008 Limits on Housing Expenses			
Country	**City or Other Location**	**Limit on Housing Expenses (daily)**	**Limit on Housing Expenses (full year)**
Spain (*Continued*)	All cities other than Barcelona, Madrid, Rota, and Valencia	76.23	27,900
Switzerland	Bern	162.30	59,400
	Geneva	229.78	84,100
	Zurich	107.16	39,219
	All cities other than Bern, Geneva, and Zurich	89.89	32,900
Taiwan	Taipei	126.20	46,188
Thailand	Bangkok	139.62	51,100
Turkey	Ankara	88.80	32,500
	Elmadag	88.80	32,500
	Izmir-Cigli	86.34	31,600
	Manzarali	88.80	32,500
	Yamanlar	86.34	31,600
Ukraine	Kiev	196.72	72,000
United Arab Emirates	Abu Dhabi	135.76	49,687
	Dubai	156.21	57,174
United Kingdom	Basingstoke	112.29	41,099
	Bath	112.02	41,000
	Bracknell	169.67	62,100
	Bristol	105.74	38,700
	Cambridge	117.49	43,000
	Caversham	201.64	73,800
	Cheltenham	127.87	46,800
	Chicksands	72.40	26,500
	Croughton	117.76	43,100
	Fairford	112.02	41,000
	Farnborough	149.45	54,700
	Felixstowe	122.95	45,000
	Gibraltar	121.90	44,616
	Harrogate	126.78	46,400
	High Wycombe	169.67	62,100
	Kemble	112.02	41,000
	Lakenheath	150.55	55,100
	Liverpool	106.01	38,800
	London	226.50	82,900
	Loudwater	173.50	63,500
	Menwith Hill	126.78	46,400
	Mildenhall	150.55	55,100
	Oxfordshire	117.76	43,100
	Plymouth	117.76	43,100
	Portsmouth	117.76	43,100
	Reading	169.67	62,100
	Rochester	109.02	39,900
	Southampton	120.77	44,200
	Surrey	132.25	48,402
	Waterbeach	119.95	43,900
	West Byfleet	72.13	26,400
	Wiltshire	113.66	41,600

2008 Limits on Housing Expenses			
Country	**City or Other Location**	**Limit on Housing Expenses (daily)**	**Limit on Housing Expenses (full year)**
United Kingdom (*Continued*)	All cities other than Basingstoke, Bath, Belfast, Birmingham, Bracknell, Bristol, Brough, Bude, Cambridge, Caversham, Chelmsford, Cheltenham, Chicksands, Croughton, Dunstable, Edinburgh, Edzell, Fairford, Farnborough, Felixstowe, Ft. Halstead, Gibraltar, Glenrothes, Greenham Common, Harrogate, High Wycombe, Hythe, Kemble, Lakenheath, Liverpool, London, Loudwater, Menwith Hill, Mildenhall, Nottingham, Oxfordshire, Plymouth, Portsmouth, Reading, Rochester, Southampton, Surrey, Waterbeach, Welford, West Byfleet, and Wiltshire	113.93	41,700
Venezuela	Caracas	155.74	57,000
Vietnam	Hanoi	127.87	46,800
	Ho Chi Minh City	114.75	42,000

The End

To the Reader: Congratulations! You have made your way through some very complicated tax concepts. Hopefully, this book has helped you to understand how you are affected by the U.S. tax laws relating to Americans living overseas. Even if you don't fully comprehend everything that was written, you should know enough now to ask the important questions that can save you many, many tax dollars.