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U.S. Tax Implications of Working Overseas – What You Need to Know

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Clients are often surprised when we inform them that although they will be living and working abroad, they must continue to file U.S. income tax returns and report their worldwide income as American citizens. This is true for U.S. permanent residents—"green card holders"—as well. Because they will still be responsible for U.S. reporting, clients must consider several tax planning and compliance implications. This article will touch on some of the key issues.

As mentioned above, all U.S. citizens and residents are taxed on their worldwide income and must continue to file personal income tax returns even if living abroad. The form they file is the usual Form 1040 individual income tax return; however, depending on their financial situation, individuals may need to complete and attach additional forms to their Form 1040 or file other returns. Examples of additional forms and returns include:

- FinCEN Form 114 – Report of Foreign Bank and Financial Accounts (commonly referred to as the FBAR form)
- Form 1116 – Foreign Tax Credit
- Form 2106 – Employee Business Expenses
- Form 2555 – Foreign Earned Income
- Form 3520 – Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts
- Form 3520-A – Annual Return of Foreign Trust with U.S. Owner
- Form 3903 – Moving Expenses
- Form 5471 – Information Return of U.S. Persons with Respect to Foreign Certain Corporations
- Form 8621 – Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund
- Form 8865 – Return of U.S. Persons with Respect to Certain Foreign Partnerships
- Form 8938 – Statement of Specified Foreign Financial Assets

Although worldwide income must be reported on the U.S. return, both taxpayer and spouse may be eligible to exclude up to $101,300 of their foreign earned income if they meet either the physical presence test or the bona fide residence test *and* their tax home is in the foreign country. The tax home requirement is critical but often overlooked. Even if a taxpayer is in a foreign country for 330 full days out of a 365-day period and therefore meets the physical presence test, he or she is not eligible for the exclusion if he or she cannot show that his or her tax home was in a foreign country.

An individual's regular or principal place of employment determines tax home location. Usually, taxpayers live and work in the same vicinity—so tax home location typically is not an issue. But what if a professor takes sabbatical leave from his or her American university to work, for example, at the University of Oxford? Does a change in the professor's tax home occur? In general, the location of an individual's tax home will not change if the assignment is temporary (defined as one year or less). Thus, establishing a foreign tax home typically requires living and working abroad for longer than one year. Although a taxpayer can maintain a dwelling in the United States, if the taxpayer's abode—the place where economic, personal, and family ties are closest—remains in the United States, he or she is not considered to have a tax home in a foreign country. Unfortunately, there is no one objective test; tax home and abode are based on all the facts and circumstances of a taxpayer's situation.

So what about the professor on sabbatical leave? If the assignment at Oxford is for one year or less, then the professor will not be able to establish a foreign tax home. If the assignment is intended to be longer than a year, and he or she is accompanied by family members and makes minimal trips back to the United States, a change in tax home can likely be substantiated. If all other requirements for the foreign earned income exclusion are met, then the professor will be eligible to exclude up to $101,300 of earned income.

Note that the $101,300 of exclusion is an annual amount and must be pro-rated if the taxpayer is not eligible for the earned income exclusion the entire tax year. This can occur, for example, if the taxpayer moves abroad mid-year and on a prospective basis meets the foreign earned income exclusion requirements. For taxpayers eligible for the foreign earned income exclusion, an additional exclusion may be available for certain qualified housing costs.

For any income not subject to the foreign earned income exclusion, a credit is available against an individual's U.S. tax liability for taxes owed and paid to a foreign government on foreign-sourced income. This would include taxes paid on foreign-source earned income in excess of any amounts excluded under the foreign earned income exclusion, as well as taxes paid on other types of foreign-sourced income. The rules for sourcing income as either foreign-sourced or U.S.-sourced can be complicated and may be modified by treaty provisions. Care must be taken when determining eligibility for the foreign tax credit.

If income is sourced to the United States, the client should consult with his or her foreign tax advisor, as the client may be eligible for a credit against foreign taxes for the taxes paid to the United States. Under most circumstances, a client should not be subject to double taxation on his or her income, but it might take a bit of analysis to determine which country gets to collect the tax.

Making use of the foreign earned income exclusion is optional. In many cases, foregoing the exclusion and taking a foreign tax credit based on all foreign-earned income will result in a lower tax liability. This analysis can be completed each year, but if a client chooses the foreign earned income exclusion for a particular tax year and decides in a later year not to continue using the exclusion, he or she will be precluded for five years from changing back to the exclusion.

In general, U.S. citizens and permanent residents will be subject to self-employment tax on any self-employment income earned, even if the income is foreign-sourced income. However, if the United States and the individual's new country of residency have a totalization treaty, that individual can avoid paying social security–type taxes to both countries. Typically, the taxpayer must apply to his or her country of residency for a certificate of residency, which is then used to claim a waiver of U.S. self-employment taxes.

A client's employer may be making retirement plan contributions to a foreign plan on behalf of the client, or the client may be making his or her own contributions to some type of foreign tax-deferred plan. Although the foreign country may consider these contributions "pre-tax" (or eligible for a tax deduction), that will not necessarily be the case for U.S. purposes. The earnings of the plan may also be taxable for U.S. purposes. The rules regarding the U.S. treatment of foreign retirement plans are not for the faint of heart. A good understanding of the plan, the U.S. guidance available, and the applicable treaty provisions is required. Certain arrangements may necessitate the filing of a U.S. return for the client's plan assets.

If the client is on a temporary work assignment overseas (generally less than one year in duration), then the client's living expenses should qualify as deductible employee business expenses, subject to the regular rules for deducting away-from-home expenses. The client should keep adequate records for lodging and travel costs, as well as an itinerary of his or her whereabouts. There are special per diem rates for meals and incidental expenses that depend on location.

Assuming the professor's sabbatical leave at Oxford was for only nine months, he or she could deduct rent, utilities, transportation expenses, and a per diem rate (as listed in the OCONUS tables for Oxford, U.K.) for meals and incidental expenses. Note that any costs related to family members accompanying the professor would not be deductible. If, for example, an apartment large enough to accommodate additional family members was rented, not all of that lodging expense would be deductible, although it is not necessary to pro-rate based on family size. It is sufficient to estimate what the cost would have been had a smaller apartment suitable for a single occupant had been rented.

If the move is permanent in nature and for business purposes, then the cost of the move abroad would be deductible as a moving expense. The client would have to meet the same time and distance tests required for all moving expense deductions.

There are a number of informational forms and returns to disclose the ownership of—or authority over—foreign financial assets. Ownership can be direct, constructive, or indirect, depending on the form being filed. Although these disclosure forms apply to all U.S. citizens and

residents whether they live in the United States or abroad, there is a greater chance that a client will need to file one or more of these disclosure forms if residing abroad.

Don't forget to review the applicable tax treaty when a client is living or working abroad. As discussed above, tax treaty provisions may determine how income is sourced. They may also provide for reduced rates of tax or tax exemptions. As an example, under Article 20A of the U.K. treaty, the professor on a nine-month sabbatical leave in the United Kingdom would likely be exempt from U.K. tax on his or her income from the University of Oxford.

Last but not least, clients with permanent resident status should consult with an immigration attorney before leaving the United States for an extended period of time. There are limitations as to how long one can be out of the United States and still retain permanent resident status, although there are waivers available. Clients should seek the advice of competent counsel prior to the move to avoid any undesired and unexpected consequences.

A client's move abroad should be an exciting and culturally enriching experience. Proper planning well in advance of the move can ensure that the experience is not diminished by unforeseen tax problems.

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