

WHAT DO YOU NEED TO KNOW ABOUT TAXES, NOW THAT YOU ARE ABOUT TO BE AN EXPATRIATE?

U. S. citizens and resident aliens ("Green Card" holders) living or traveling outside the United States generally are required to file income tax returns, estate tax returns, and gift tax returns and pay estimated tax in the same way as those residing in the United States.

Even though the United States is one of the few countries in the world that requires its citizens to file an annual tax return no matter where in the world they are living and/or working, there are some tax advantages available to those taxpayers working outside of the U.S. These tax breaks are:

1. Foreign Earned Income Exclusion of up to \$85,700 for 2007 and indexed yearly
2. Foreign Housing Exclusion or Deduction which now is capped at \$11,998 and is indexed.
3. Foreign Tax Credits.

Foreign Earned Income Exclusion

If you meet certain requirements, you may qualify for the foreign earned income and foreign housing exclusions and the foreign housing deduction (also known as Section 911 Exclusion). If you are a U.S. citizen or a resident alien of the United States and live abroad, you are taxed on your worldwide income. However, you may qualify to exclude up to \$85,700 of your foreign earned income. In addition, you can exclude or deduct certain foreign housing amounts.

To claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, you must have foreign earned income, your tax home must be in a foreign country, and you must be one of the following:

Bona Fide Residence Test:

1. A U. S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year (January 1 through December 31),
2. A U.S. resident alien who is a citizen or national of a country with the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, or

Physical Presence Test:

3. A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.
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The Physical Presence Test is often used most advantageously for the beginning and ending years of Foreign Service for those who qualify for bona fide residence during full calendar years overseas.

If you qualify under either the bona fide residence test or the physical presence test for only part of the tax year, you must adjust the maximum exclusion limit based on the number of qualifying days in your tax year. The number of qualifying days in your tax year is the number of days within the period you have your tax home in a foreign country and meet either test.

To figure your maximum exclusion, multiply \$85,700 by the number of your qualifying days in the year, and then divide the result by the number of days in your tax year (usually 365).

Example. You report your income on the calendar-year basis and qualify under the bona fide residence test for only 75 days during 2007. You can exclude a maximum of $75/365$ of \$85,700 or \$17,610 of your foreign earned income for the year. If you qualify under the bona fide residence test for all of 2007, you can exclude your foreign earned income up to the full \$85,700 limit for 2007.

To claim the Foreign Earned Income Exclusion and Foreign Housing Exclusion, you must file Form 2555, *Foreign Earned Income* with your tax return. All tax returns that contain a Form 2555 must be filed with the **Internal Revenue Service Center, Austin TX 73301.**

Travel Calendar

It is important to keep a travel calendar starting with the first day you leave the United States. This travel calendar is essential to determine when or if you have qualified for the foreign earned income exclusion under the physical presence test. A small pocket calendar is the easiest to use.

You need to know the exact dates you arrived in the foreign country and left the foreign country including any vacation days. Full days in country, for the IRS, means from 12 midnight to 12 midnight. If you make a trip to the U.S. for business during your foreign assignment, you will also need to keep track of work days in the U.S. versus in the foreign country. Income from days worked in the U.S. on a business trip while on a foreign assignment; do not qualify for the foreign earned income exclusion.

Attached is a sample of the travel calendar and required information that is often included in the Organizer your Enrolled Agent will send you to report your annual tax information.

Foreign Housing Exclusion or Deduction

In addition to the foreign earned income exclusion, you can also separately claim an exclusion or a deduction from gross income for your housing amount if your tax home is in a foreign country and you qualify under either the bona fide residence test or the physical presence test.

The housing exclusion applies only to amounts considered paid for with employer-provided amounts. The housing deduction applies only to amounts paid for with the proceeds of self-employment.

Foreign Housing Exclusion

If you have no self-employment income, your entire housing amount is considered paid for with employer-provided amounts. This means that you can exclude (up to the limits) the entire amount. Employer-provided amounts include any amounts paid to you or paid or incurred on your behalf by your employer that is taxable foreign earned income (without regard to the foreign earned income exclusion) to you for the tax year. This includes:

1. Your salary,
2. Any reimbursement for housing expenses,
3. Amounts your employer pays to a third party for your housing,
4. The fair rental value of company-owned housing furnished you unless that value is excluded from your income because it is provided for your employer's convenience,
5. Amounts paid to you by your employer as part of a tax equalization plan, and
6. Amounts paid to you or a third party by your employer for the education of your dependents.

Your only earnings that are not employer-provided amounts are earnings from self-employment.

Foreign Housing Deduction

If none of your housing amount is considered paid for with employer-provided amounts, such as when all of your income is from self-employment, you can deduct your housing amount, subject to an annually determined limit, in figuring your adjusted gross income. Beginning with tax year 2007, Housing is limited, first to a maximum of \$22,024 and then further reduced by \$37.57 for each qualifying day.

Qualified Housing

Allowed Expenses

Rent
Utilities (except telephone)
Occupancy taxes and rates
Household repairs
Insurance (real and personal property)
Fair Rental Value of housing in kind by employer
Non-refundable fees paid for securing a leasehold
Rental of furniture and accessories

Disallowed Expenses

House purchase cost
Capital expenditures
Cost of purchased furniture
Improvements
Domestic labor (maids, gardeners, etc.)
Telephone charges
Lavish or extravagant expenses

- Interest
- Cable television subscription
- Expenses of more than one foreign household
- Amortized payments of principal with respect to indebtedness secured by mortgage or taxpayer's housing
- Depreciation of housing owned by taxpayer
- Amortization or depreciation of capital improvements made to housing leased by the taxpayer
- Taxes deductible as real estate taxes
- Any amount allowable as a deduction by a tenant-stockholder in connection with cooperative housing
- "Poll Tax" in United Kingdom

Certain other "gray-area" expenses may or may not be allowed, or may be reduced depending on the circumstances. Some expenses are incurred because they are an explicit part of the lease agreement, such as gardening, janitorial, security, utilities, repairs, professional fees, pest eradication, and consumable supplies.

Foreign Tax Credit and Foreign Taxes Paid or Accrued

Generally speaking, you are allowed a credit against your U.S. income tax for all or part of the income taxes you pay to foreign countries. In some countries, payment of Social Security-type taxes are also required.

If you take the foreign tax credit, you must file Form 1116, *Foreign Tax Credit*, with Form 1040. Form 1116 enables you figure the amount of foreign tax paid or accrued that you can claim as a foreign tax credit. Do not include the amount of foreign tax paid or accrued as withheld federal income taxes on Form 1040, line 51.

The foreign tax credit is limited to the part of your total U.S. tax that is in proportion to your taxable income from sources outside the United States compared to your total taxable income. The allowable foreign tax credit may not be more than your actual foreign tax liability. The total of foreign taxes paid is reduced proportionally to the for tax exclusion taken.

Example

Total Foreign Exclusion:	85,700	Total Foreign Taxes Paid	\$10,000
Total Foreign Income	100,000	Total FTC Reduction	-8,570
Total allowable Foreign Tax Credits			\$ 1,430

Instead of taking the foreign tax credit, you can deduct foreign income taxes as an itemized deduction on Schedule A (Form 1040). Again, reduced by the tax attributable excluded income. This is usually not advantageous; taking the foreign tax credit is usually more effective in reducing your tax liability, particularly if your itemized deductions are subject to the phase-out rules for high adjusted gross income.

You can claim a deduction only for those foreign income taxes paid on income that is subject to U.S. tax. You cannot claim a deduction for foreign taxes paid on income excluded under the foreign earned income or housing exclusions.

Deduction for Other Foreign Taxes

You can deduct real property taxes you pay that are imposed on you by a foreign country. You take this deduction on Schedule A (Form 1040). You cannot deduct other foreign taxes, such as personal property taxes, unless you incurred the expenses in a trade or business or in the production of income.

The deduction for foreign taxes other than foreign income taxes is not related to the foreign tax credit. You can take deductions for these miscellaneous foreign taxes and also claim the foreign tax credit for income taxes imposed by a foreign country.

Extensions

2-Month Extension

If you are a U.S. citizen or resident alien and both your tax home and your abode are outside the United States and Puerto Rico on the regular due date of your return (April 15), you are automatically granted a 2-month extension **to file your return and pay any tax due (June 15)**.

Your return is considered filed on time if it is postmarked on or before midnight of the due date for filing the return (including any extensions). None of the dates for filing returns or paying taxes is extended due to foreign holidays.

If you use the 2-month extension discussed above, you must attach a statement to your return showing that you qualify for it. Write or type the following at the top of the first page of the Form 1040 and on the bottom of the second page of the Form 1040:

"Extension automatically granted to June 15, 2__ pursuant to Reg. 1.6081-5."

6-Month Extension

You can also get an automatic 4-month extension of time to file your return from the regular due date (April 15) by filing Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*. This extension allows your return to be filed by August 15.

9-Month Extension

You should request an extension of time to file your income tax return if all three of the following apply:

1. You are a U.S. citizen or resident;
2. You expect to meet either the bona fide residence test or the physical presence test, but not until after your Form 1040 is due; and
3. Your tax home is in a foreign country (or countries) throughout your period of bona fide residence or physical presence, whichever applies.

Generally if you are granted an extension it will be for 30 days beyond the date on which you can reasonably expect to qualify under either the bona fide residence test or the physical presence test. To obtain an extension for qualifying under the physical presence test or the bona fide residence test, you should file Form 2350, *Application for Extension of Time to File U.S. Individual Income Tax Return*, with the **Internal Revenue Service Center, Austin TX 73301**

Example. If you begin your foreign assignment on October 1, 2007, your physical presence qualification period would end on September 30, 2008. Since this is later than the 4-month extension would allow for filing your return, filing Form 2350 would allow you to request an extension to October 30, 2008 to file your 2007 return.

If you do not qualify under the physical presence test, you can still try to qualify under the bona fide residence test which requires one full calendar year in the foreign location. On the Form 2350, you would request an extension to January 30, 2009 to file your 2007 return.

In either case, the Form 2350 must be filed by June 15, in order to be valid.

OTHER "NON-EARNED" INCOME

Foreign Bank Account

If you have funds in a foreign bank, you are required to file Treasury Form, 90-22.1, but only if your funds exceed \$10,000. If you have a foreign account, but the balance does not exceed \$10,000 during the calendar year, then instead of filing Treasury Form 90-22.1, at the bottom of Schedule B, Interest Income, the question "Do you have a foreign bank account?" will be answered "No".

Dividend Income from Foreign Sources

If your stocks are held by a brokerage house, you should report the name of the brokerage house rather than the individual companies. The 1099 form you receive from the brokerage house should show how much of your dividend income qualifies as a capital gain distribution. Most 1099 forms include the capital gain distribution in the total listed for gross income or dividends, and then list the capital gain amount separately.

Non-taxable distributions reduce the basis of your stock and are not taxable until your basis in the stock is fully recovered. U.S. Federal and state withholding on dividend income should also be reported on the 1099 form.

Interest Income Foreign Sources

You must report interest received from a foreign bank as interest income. If the amount reported is in the foreign currency, it must be converted to U.S. dollars. The exchange rate used should be the exchange rate on the date the interest was paid but if this is not available, the monthly average exchange rate should be used. If foreign taxes have been paid or withheld on this interest income, you will need to provide the gross total interest earned and the foreign taxes paid.

Sharon H Hinchman, EA

Born and raised in San Francisco, Sharon attended City College of San Francisco and San Francisco State University, majoring in Chemistry. While taking a tax class at Golden Gate University she found a new passion and a new carrier path unfolded.

Sharon was Enrolled to Practice before the IRS in 1980 and became a Fellow, National Tax Practice Institute in 2000.

Shortly after receiving her EA, Sharon joined the Chevron Expatriate Tax Department, where her duties over the years included: tax preparer and reviewer, technical support coordinator, staff trainer and audit representation. To this day, she still maintains a 95% success rate in audit and has negotiated settlements with both IRS and the FTB totaling more than two million dollars in tax savings. In one case with the FTB, she settled one issue involving 19 clients with a total of 27 tax returns and produced five hundred thousand in tax savings.

Sharon later joined KPMG Peat Marwick as Manager, Expatriate Executive Tax Group.

Sharon has seen many changes in tax law in her 32 years in the industry. Located in Alamo California since 1995, Sharon is a Principle, Abacus Financial Group, LLC, and Managing Partner, Abacus Tax Service. Her practice still deals with both expatriates and non-resident aliens, merchant marines, and many other unique tax specialties.