

Tax planning for U.S. citizens, resident aliens working abroad

Up close

Tax > International tax > Expatriate taxes

U.S. citizens working abroad remain subject to U.S. federal income tax and at times state and city income taxes. Generally this pertains to permanent residents of the U.S. as well (green card holders). Accordingly, U.S. citizens and resident aliens working abroad must continue filing tax returns in the United States.

Tax treatment of U.S. citizens and resident aliens

U.S. citizens and resident aliens are subject to tax at graduated rates on all income from worldwide sources.

Types of taxable compensation

Generally, the following types of compensation are taxable in the United States, but this list is not all inclusive.

- Base salary and bonuses
- Cost of living allowance
- Housing allowance
- Education allowance for children
- Home leave reimbursements
- Reimbursement of host/home country taxes
- Personal use of company car
- Certain moving allowances
- Stock options

Investment income

Investment income (interest, dividends, rents, royalties, etc.) received by a U.S. resident is subject to tax at graduated rates regardless of source with the exception of qualifying dividend income, which is generally taxed at 15 percent.

Capital gains

Capital gains from the sale of investment assets held for less than 12 months are taxed at the taxpayer's regular tax rates. Long-term capital gains (sale of investment assets) held for more than 12 months are generally taxed at 15 percent. Some exceptions apply.

Starting Jan. 1, 2009, gain from the sale of principal residence is not excluded from gross income for periods that the home was not used as the principal residence.

Capital gain is calculated based on a ratio of the number of days a seller physically used the property as their primary residence divided by the remainder of time the seller owned the property over a five-year period.

Deductions from income

Several deductions may be taken against gross income to arrive at an individual's taxable income. Taxpayers have the option

Contact information

Bruce K. Benesh
Partner, Practice Leader
T 803-231-3099
E Bruce.Benesh@gt.com

Linette Barclay
Senior Manager
T 832-476-3663
E Linette.Barclay@gt.com

Phil Geurkink
Senior Manager
T 312.602.8898
E Phil.Geurkink@gt.com

Beth Penfold
Senior Manager
T 312.602.8284
E Beth.Penfold@gt.com

Peter Sid
Senior Manager
T 212.542.9974
E Peter.Sid@gt.com

Jerry Zukauckas
Director
T 404.475.0070
E Jerry.Zukauckas@gt.com

www.GrantThornton.com/tax

In U.S. tax law, the term "alien" refers to a foreign national, i.e., an individual who is not a U.S. citizen.

of deducting the greater of the standard deduction or total itemized deductions. The standard deduction is a predetermined amount that varies according to an individual's filing status.

The standard deduction amounts for 2010 are as follows:

- Single – \$5,700
- Married filing jointly – \$11,400
- Married filing separately – \$5,700
- Head of household – \$8,400

Some examples of nonbusiness expenses referred to as itemized deductions include: state and local taxes, real and personal property taxes, interest on home mortgages (with restrictions) and contributions of cash or property to U.S. charities, up to statutory limitations.

In addition, a taxpayer may deduct a personal exemption for himself or herself, a spouse and their children if they qualify as dependents to the taxpayer. The amount of the exemption is predetermined and adjusted each year for inflation. The exemption amount for the 2010 tax year is \$3,650. Personal exemptions are phased out for taxpayers with an adjusted gross income in excess of certain thresholds.

Foreign earned income and housing exclusions

Many U.S. citizens and resident aliens who are working abroad are subject to tax in the foreign country in which they are working. In order to minimize the burden of double taxation, the U.S. tax system allows for foreign earned income (FEI) and housing exclusions as well as a credit or deduction for foreign taxes paid.

The FEI exclusion allows certain qualified U.S. citizens and green card holders to exclude from gross income up

to \$91,500 (2010 ceiling) of FEI (income related to services performed outside of the United States). In addition, a qualified taxpayer may also elect to exclude from gross income employer-provided foreign housing expenses to the extent the expenses exceed the base housing amount determined by the IRS.

In order to qualify for either of these exclusions, an individual's tax home must be in a foreign country. "Tax home" is generally defined as where an individual's principal place of business is located, regardless of where the family home is maintained.

In addition to having a tax home in a foreign country, the individual must also meet either the "bona fide residence" test or the "physical presence test."

Bona fide residence test

Generally, a citizen of the United States may meet the bona fide residence test if he or she resides in a foreign country for an uninterrupted period that includes one full calendar year. In determining whether or not an individual will meet the bona fide residence test, the taxpayer's particular facts and circumstances also need to be reviewed, including intentions related to the length and nature of the stay overseas.

Generally, a resident alien of the United States (non-U.S. citizen) must utilize the physical presence test in order to qualify for either the FEI or housing exclusions. However, citizens of certain foreign countries that have treaties with the United States may be able to utilize the bona fide residence test under the terms set forth in the treaties.

Physical presence test

A U.S. citizen or resident alien of the United States may qualify for the FEI and

housing exclusions under the physical presence test if he/she is present outside of the United States for 330 days out of any consecutive 12-month period.

Only whole days are considered for purposes of counting days outside of the United States under the physical presence test. A whole day is defined as a full 24-hour period beginning with midnight and ending with midnight. Therefore, days of arrival in or departure from the foreign country in relation to travel to and from the United States do not generally count as full days in the foreign country.

Electing the exclusions

An individual who qualifies under either the bona fide residence or physical presence tests must make separate elections with respect to the FEI exclusion and housing exclusion. These elections are made by filing Form 2555 with the taxpayer's federal income tax return.

Foreign tax deduction or credit

In addition to the FEI and housing exclusions, U.S. citizens and resident aliens are also allowed either a deduction or credit against U.S. income tax for qualified income taxes paid or accrued during the tax year to any foreign country or U.S. possession.

It is the taxpayer's choice to take a credit or deduction for foreign taxes paid or accrued during the tax year. Generally, it is more advantageous to the taxpayer to take a credit for the foreign taxes because the credit will reduce U.S. tax liability on a dollar-for-dollar basis. Individuals who choose to deduct foreign taxes must take them as itemized deductions, which will only reduce the taxpayer's income subject to U.S. tax.

In determining the amount of foreign tax credit allowed, the taxpayer is subject to an overall limitation that prevents them from taking a foreign tax credit against the portion of U.S. tax liability associated with U.S.-source income. Essentially, the foreign tax credit is limited to the portion of U.S. income tax related to foreign-source income (income associated with services performed outside the United States).

In addition, an individual claiming either the FEI exclusion or housing exclusion is not allowed to take a tax credit against the foreign-source income excluded from U.S. taxation as a result of these elections.

Taxpayers who are unable to utilize the full amount of foreign taxes available for credit due to limitation will carry back unused foreign taxes one year then carry forward for up to 10 years.

Due dates and extensions

U.S. citizens and resident aliens are required to file by April 15 following the end of the tax year (Dec. 31). For taxpayers who have a tax home outside the United States on April 15, the due date for filing and payment of any balances of tax due is automatically extended to June 15.

On or before April 15, a Form 4868—Automatic Extension of Time may be filed by the U.S. resident for a six-month extension to Oct. 15. On or before June 15, the taxpayer with his tax home outside the U.S. may file the same Form 4868 for an automatic four-month extension to Oct. 15. However, interest becomes payable on any balance due as from June 15.

The taxpayer residing abroad may request a discretionary two-month extension from Oct. 15 to Dec. 15, provided he or she sends a letter to the IRS by Oct. 15 stating the reasons why additional time to file to Dec. 15 is needed.

For the year of the move abroad, a taxpayer needing more time than provided with the automatic extension for purposes of meeting either the bona fide residence or physical presence tests may request an extension of time to file until 30 days after the date on which the individual expects to meet either of the two tests (Form 2350).

Federal tax rates

There are four categories of tax status that may apply to a taxpayer in the United States: single, married filing jointly/surviving spouse, married filing separately and head of household.

Federal income tax rates – 2010 (single)		
Taxable income (\$)	Rate (%)	Cumulative tax (\$)
0 – 8,375	10	—
8,376 – 34,000	15	837.50
34,001 – 82,400	25	4,681.25
82,400 – 171,850	28	16,781.25
171,851 – 373,650	33	41,827.25
Over 373,650	35	108,421.25

Federal income tax rates – 2010 (married filing jointly)		
Taxable income (\$)	Rate (%)	Cumulative tax (\$)
0 – 16,750	10	—
16,751 – 68,000	15	1,675.00
68,001 – 137,300	25	9,362.50
137,301 – 209,250	28	26,687.50
209,251 – 373,650	33	46,833.50
Over 373,650	35	101,085.50

Federal income tax rates – 2010 (married filing separately)		
Taxable income (\$)	Rate (%)	Cumulative tax (\$)
0 – 8,375	10	—
8,376 – 34,000	15	837.50
34,001 – 68,650	25	4,681.25
68,651 – 104,625	28	13,343.75
104,626 – 186,825	33	23,416.75
Over 186,826	35	50,542.75

Federal income tax rates – 2010 (head of household)		
Taxable income(\$)	Rate (%)	Cumulative tax (\$)
0 –11,950	10	—
11,951 – 45,550	15	1,195.00
45,551 – 117,650	25	6,235.00
117,651 – 190,550	28	24,260.00
190,551 – 373,650	33	44,672.00
Over 373,650	35	105,095.00

Social security taxes

As a general rule, social security tax (FICA) is charged on all compensation received for services performed within the United States regardless of citizenship or residence of the employee or employer, the number of days worked or the amount of wages earned. Nonresident aliens, however, may be exempt from FICA tax based on the type of visa they hold.

Social security taxes are assessed to individuals at a rate of 7.65 percent, which consists of a 6.2 percent component for old-age, survivors and disability insurance (OASDI) and 1.45 percent for Medicare. The 6.2 percent is capped at \$6,622 in 2010. The 1.45 percent Medicare component is uncapped. Employers are also required to make a matching contribution of social security taxes on behalf of employees at the same above-noted rates and thresholds.

A U.S. national working outside of the United States may be subject to the social security laws of both the United States and the host country. Totalization agreements are designed to alleviate this double taxation by allowing the individual to be covered under only under the home social security system. The specific totalization agreement should be reviewed to determine which country's social security system claims coverage.

State and local taxes

Most states in the United States, and many cities and towns, levy a separate income tax on individuals. The method that each state uses in determining tax liabilities varies, as do tax rates, extension procedures, residency rules and availability of foreign tax credits. In certain circumstances an individual may be able to break state tax residency as a result of an overseas assignment.

State income tax calculation

State income taxes are calculated separately from federal income taxes. The method for calculating the tax liability varies by state.

Tax professional standards statement

This document supports Grant Thornton LLP's marketing of professional services and is not written tax advice directed at the particular facts and circumstances of any person. If you are interested in the subject of this document we encourage you to contact us or an independent tax advisor to discuss the potential application to your particular situation. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed herein. To the extent this document may be considered to contain written tax advice, any written advice contained in, forwarded with, or attached to this document is not intended by Grant Thornton to be used, and cannot be used, by any person for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

Example individual income and social tax calculations

Federal income tax calculation	
Assume a married individual with two children is on an overseas assignment (residing outside an IRS high-cost city). This individual qualifies for both the FEI and housing exclusions for the full calendar year; 100% of his services were performed outside the U.S. during the year.	
Base salary	\$ 150,000
Bonus	20,000
Less 401(k) deduction	(16,500)
Cost-of-living allowance	25,000
Housing allowance	45,000
Foreign tax payment by employer	60,000
Interest income	800
Long-term capital gain	<u>8,000</u>
Total income	292,300
Less FEI (91,500) + housing exclusion	(104,310)
Adjusted gross income	\$ 187,990
Less personal exemptions	(14,600)
Less standard deduction	<u>(11,400)</u>
Taxable income	\$ 161,990
Federal tax	\$ 45,780
Less foreign tax credit	\$(37,924)
Total federal tax	\$ 7,856
Social tax calculation	
Total taxable compensation	\$ 283,500
Add back 401(k) contribution	16,500
Total compensation	\$ 300,000
OASDI (capped at \$106,800 * 6.2%)	\$ 6,622
Medicare (1.45% * \$300,000)	<u>4,350</u>
Total social tax	\$ 10,972

The impact of the U.S. tax system on any particular person depends on the particular facts and circumstances of that individual. This discussion is intended only as a limited information overview of certain aspects of the U.S. tax system. Please contact Grant Thornton LLP to discuss particular assistance regarding compliance with the U.S. tax system.