

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 U.S.

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 U.S., but this list is not meant to be all inclusive.

- Base salary,
- Bonus,
- 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, and
- Stock options.

Investment income

Investment income (interest, dividends, rents, royalties, etc.) received by a resident of the U.S. 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.

If certain requirements are met, the gains on the sale of a personal residence may be excluded up to U.S. \$250,000 (U.S. \$500,000 married filing jointly).

Deductions from income

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

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

The standard deduction amounts for 2008 are as follows:

- Single – \$5,450,
- Married filing jointly – \$10,900,
- Married filing separately – \$5,450, and
- Head of household – \$8,000.

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 2008 tax year is \$3,500. 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 (see page 3).

The FEI exclusion allows certain qualified U.S. citizens and green card holders to exclude from gross income up to \$87,600 (2008 ceiling) of FEI (income related to services performed outside of the U.S.). In addition to the FEI exclusion, 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 U.S. 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 U.S. (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 U.S. 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 U.S. may qualify for the FEI and housing exclusions under the physical presence test if he/she is present outside of the U.S. for 330 days out of any consecutive 12-month period.

Only whole days are considered for purposes of counting days outside of the U.S. 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 U.S. 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 as to whether to take a credit or deduction for the 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 since the credit will reduce U.S. tax liability on a dollar-for-dollar basis. Individuals who choose to deduct the foreign taxes must take them as an itemized deduction, which will only reduce the taxpayer's income subject to U.S. tax.

In determining the amount of the foreign tax credit allowed, the taxpayer is subject to an overall limitation that prevents the taxpayer 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 U.S.).

In addition, an individual that claims 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 ten 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 U.S. 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 U.S.: single, married filing jointly/surviving spouse, married filing separately, and head of household.

Federal income tax rates – 2008 (single)		
Taxable income(\$)	Rate(%)	Cumulative tax
0 – 8,025	10	—
8,026 – 32,550	15	802.50
32,551 – 78,850	25	4,481.25
78,851 – 164,550	28	16,056.25
164,551 – 357,700	33	40,052.25
Over 357,700	35	103,791.75

Federal income tax rates – 2008 (married filing jointly)		
Taxable income(\$)	Rate(%)	Cumulative tax
0 – 16,050	10	—
16,051 – 65,100	15	1,605.00
65,101 – 131,450	25	8,962.50
131,451 – 200,300	28	25,550.00
200,301 – 357,700	33	44,828.00
Over 357,700	35	96,770.00

Federal income tax rates – 2008 (married filing separately)		
Taxable income(\$)	Rate(%)	Cumulative tax
0 – 8,025	10	—
8,026 – 32,550	15	802.50
32,551 – 65,725	25	4,481.25
65,726 – 100,150	28	12,775.00
100,151 – 178,850	33	22,414.00
Over 178,850	35	48,385.00

Federal income tax rates – 2008 (head of household)		
Taxable income(\$)	Rate(%)	Cumulative tax
0 – 11,450	10	—
11,451 – 43,650	15	1,145.00
43,651 – 112,650	25	5,975.00
112,651 – 182,400	28	23,225.00
182,401 – 357,700	33	42,755.00
Over 357,700	35	100,604.00

Social security taxes

As a general rule, social security tax (FICA) is charged on all compensation received for services performed within the U.S. 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 \$6,324 in 2008. 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 U.S. may be subject to the social security laws of both the U.S. 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 U.S., 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 the 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.

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 percent of his services were performed outside the U.S. during the year.	
Base salary	\$ 150,000
Bonus	20,000
Less 401(k) deduction	(15,500)
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	293,300
Less FEI (85,700) + housing exclusion	(99,864)
Adjusted gross income	\$ 193,43
Less personal exemptions	(14,000)
Less standard deduction	<u>(10,900)</u>
Taxable income	\$ 168,536
Federal tax	\$ 47,007
Federal tax on long-term cap gain (15%)	<u>1,200</u>
Federal tax liability	48,207
Less foreign tax credit	\$(38,939)
Total federal tax	9,268
Social tax calculation	
Total taxable compensation	\$ 284,500
Add back 401(k) contribution	15,500
Total compensation	\$ 300,000
OASDI (capped at \$102,000 * 6.2%)	\$ 6,324
Medicare (1.45% * \$300,000)	4,350
Total social tax	\$ 10,674

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.

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