BY ROBERT W. WOOD

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Big Tax Perk for Working Overseas

As a U.S. citizen or permanent resident, you pay federal income tax on your worldwide income. However, if you are paying taxes in multiple countries, you may be entitled to a foreign tax credit against your U.S. income tax. You may even qualify for benefits under tax treaties. But can you ever exclude some of your income earned overseas from your U.S. taxes? Yes, sometimes you can. A U.S. citizen or resident alien – the latter means you hold a green card – living and working abroad may be entitled to a foreign earned income exclusion, and housing benefits as well. The maximum exclusion is adjusted annually for inflation. For 2011, you can exclude up to $92,900 from your U.S. income, constituting a nice benefit of working overseas. For 2010, it was $91,500.

To claim the foreign earned income exclusion, you must use IRS Form 2555 and attach it to your Form 1040. Some taxpayers can use a shorter Form 2555-EZ.

To be entitled to this tax benefit: (1) your "tax home" must be in a foreign country; (2) you must have "foreign earned income"; and (3) you must be either a U.S. citizen who is a bona fide resident of a foreign country for the entire year, a U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty and who is a bona fide resident of a foreign country for the entire year, or a U.S. citizen or a U.S. resident alien who is physically present in a foreign country for at least 330 full days during any 12 consecutive months.

Each of these hurdles has traps. Only *earned* income qualifies, meaning salary, wages, commissions, bonuses, professional fees and tips. Plus, the pay must be for your *foreign* work only, not pay you receive for services in the United States.

Example

You are a U.S. citizen and bona fide resident of Kazakhstan, working there all year. Your salary is $76,800 a year, plus a $6,000 cost-of-living allowance and a $6,000 education allowance. Your employment contract does not state that you are entitled to these allowances only while outside the United States. You work a five-day week, and after subtracting vacation, work a total of 240 days a year. You worked in the United States for six weeks (30 workdays). To figure your pay for work done in the United States, take the number of days worked in the United States (30) divided by the number of days paid (240) and multiplied by the total income ($88,800) = $11,100. Your U.S. source earned income is $11,100, and that amount does not qualify for the exclusion. The rest of your pay does.

If you claim the foreign earned income exclusion, you can't claim a foreign tax credit or deduction on the same income, even though you may be paying foreign taxes on it. In fact, if you claim a foreign tax credit or deduction for foreign taxes on the excluded income, the foreign earned income exclusion may be considered revoked. How do you decide whether you get a larger tax benefit out of the exclusion or credit? You should crunch the numbers both ways. But here's a guide: if you pay no foreign tax, claim the foreign earned income exclusion; if your foreign tax rate is lower than your U.S. rate, you should usually claim the exclusion; and if your foreign tax rate is higher than your U.S. rate, you should probably claim the foreign tax credit instead.

Home vs. Abode

You must meet *either* a bona fide residence or a physical presence test. You can only claim you're a bona fide resident in your "tax home." Your tax home is your main place of business, employment or post of duty, regardless of where you maintain your family home. If you don't have a main place of business (maybe you're on the road most of the time or work out of your apartment), your tax home may be the place you regularly live.

If your "abode" is in the United States, you can't have a tax home in a

foreign country. Your "abode" is your home, residence, domicile, or place of dwelling. "Abode" has a domestic meaning, unlike your "tax home" where you do business. Your abode depends on where you maintain economic, family, and personal ties.

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Example 1
You work on an offshore oil rig in the territorial waters of Nigeria and work 28 days on, 28 days off. You return to your family residence in the United States during your off periods. Your abode is in the United States; therefore, you cannot claim the foreign earned income exclusion.

Example 2
You work for a manufacturer in Ohio. Your employer transfers you to London for at least 18 months. You distribute business cards showing your business and home address in London, and you rent your Ohio home and put your car in storage. You move your family, furniture, and pets to a home your employer rents for you in London. You lease a car and get a British driving license, open London bank accounts, join a local business league, etc. Your abode and tax home are both in London.

The location of your tax home depends on whether your assignment is temporary or indefinite. If you are *temporarily* absent from your tax home in the United States, you don't qualify for the foreign earned income exclusion. If your work assignment abroad is "indefinite," your new place of employment becomes your tax home, allowing a foreign earned income exclusion. But expectations change.

If you expect your employment abroad to last one year or less (and it does) it is likely "temporary." If you expect it to last more than a year, it is "indefinite." If you expect it to last for a year or less, but later revise your expectations to more than a year, it becomes indefinite.

Physical Presence

Even if you aren't a bona fide resident of a foreign country, you can *still* qualify for the exclusion if you meet the physical presence test. You must be physically present in a foreign country for 330 full days during 12 consecutive months. A full day is 24 consecutive hours beginning at midnight. You can count days you spent abroad for any reason, even days on vacation!

Notably, the 330 days need not be consecutive. They are based purely on length of stay, not what kind of residence you establish, your intentions about returning, or the nature or purpose of your stay abroad. But if you have fewer than 330 days abroad even for good reasons – illness, family problems, vacation back in the United States, or your employer's orders – that's tough. The only exception is if you fall below the 330 days because war or civil unrest requires you to leave the country.

When you leave the United States to go directly to a foreign country or when you return directly to the United States from a foreign country, the time you spend over international waters doesn't count toward your 330-day total.

Housing Costs

In addition to the foreign earned income exclusion, you can claim an exclusion or deduction for housing. The housing *exclusion* applies to amounts you receive from your employer, while the *deduction* applies to amounts you pay with self-employment earnings. Your housing exclusion/deduction is your total housing expenses minus a base housing amount.

The base housing amount is 16% of the $91,500 exclusion, multiplied by the number of days you qualify. Sixteen percent of $91,500 is $14,640, or $40.11 per day. Multiply $40.11 by the number of days and subtract it from your total housing expenses to find your housing amount. However, you must reduce your housing amount by any U.S. government (or similar nontaxable) allowance you receive to compensate you for housing expenses.

Housing expenses include reasonable expenses for housing in a foreign country for you, your spouse and dependents that live with you. You can count housing expenses only for the part of the year you qualify for the foreign earned income exclusion, and only up to a limit generally equal to 30% of the maximum foreign earned income exclusion. For 2010, this means an annual limit of $27,450, or about $75.21 per day. However, the actual limit may be higher depending on the location of your foreign tax home. Housing expenses include: rent; the fair rental value of housing provided in kind by your employer; repairs; utilities (but not telephone charges); insurance; nondeductible occupancy taxes; nonrefundable fees to secure a leasehold; furniture rental; and residential parking. Housing expenses do not include: lavish or extravagant expenses; deductible interest and taxes; costs of buying property, including principal payments on a mortgage; costs of maids, nannies, gardeners, etc.; pay television subscriptions; improvements that increase the value or prolong the life of property; purchased furniture; or depreciation or amortization of property or improvements.

Conclusion

If you work abroad, you probably have a tax adviser who keeps these rules straight. Companies sending workers overseas usually have an accounting firm handle U.S. and foreign tax return filings for employees, and may have a tax equalization program to ensure that employees taking foreign assignments don't end up worse off. Nevertheless, you should understand the basics because you can influence some of these rules. ■