When Overseas Income Is Tax Free

By Robert W. Wood

As a U.S. citizen or permanent resident, you pay federal income tax on your worldwide income. 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? 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, a nice benefit of working overseas. For 2010, it was $91,500.

To claim the foreign earned income exclusion use IRS Form 2555 and attach it to your Form 1040. Some taxpayers can use a shorter Form 2555-EZ. Additionally, to be entitled to this tax benefit: Your "tax home" must be in a foreign country; you must have "foreign earned income"; and 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 U.S. 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.

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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.

For 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 U.S. You work a five-day week, for a total of 240 days a year, minus vacation. You also worked in the U.S. for six weeks (30 workdays). To figure your pay for work done in the U.S., take the number of days worked in the U.S. (30) / number of days paid (240) × 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.

You must also meet either a bona fide residence or a physical presence test. You can only claim to be a bona fide resident in your "tax home" throughout the year. Your tax home is your main place of business, employment or post of duty, regardless of where you maintain your family home. If you do not have a main place of business, your tax home may be the place you regularly live.

If your "abode" is in the U.S., you cannot 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.

For example: You are employed 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 U.S. during your off periods. Your abode is in the U.S., so you cannot claim the foreign earned income exclusion.

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 U.S., you do not 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.

Even if you are not 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 U.S., 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 U.S. to go directly to a foreign country or when you return directly to the U.S. from a foreign country, the time you spend over international waters does not count toward your 330-day total.

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 percent of the $91,500 exclusion, multiplied by the number of days you qualify — (16 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 as compensation for housing expenses.

Housing expenses include reasonable expenses incurred in a foreign country for you, your spouse and dependents who live with you. You can only count housing expenses when you also qualify for the foreign earned income exclusion, and only up to a limit generally equal to 30 percent 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.

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 do not end up worse off. Nevertheless, you should understand the basics since you can influence some of these rules.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

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