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U.S. Tax Code Offers Benefits, With Restrictions, for Expatriates

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Many industrialized countries provide tax benefits to their nationals working abroad; under the U.S. tax system, of course, U.S. citizens and residents are taxed on their worldwide income.

Although one typically can qualify for foreign tax credits upon paying income tax in foreign countries, receiving foreign tax credits one can use against the U.S. tax only helps to prevent the taxpayer from incurring double taxation (once in the foreign country, and once in the United States).

Furthermore, the foreign tax credit regime gives a dollar-for-dollar tax credit only to the extent the U.S. tax liability is attributable to foreign source income. This limit insures that the foreign tax credit cannot exceed the U.S. effective tax rate on foreign source income.

Thus, the combination of U.S. income taxes and foreign taxes (notwithstanding the U.S. foreign tax credit) almost invariably puts the U.S. expatriate at a marked disadvantage when it comes to net taxes paid.

The U.S. tax system has faced difficulty over how the United States taxes its citizens abroad for a number of years. In fact, many foreign companies see U.S. tax laws as a deterrent to hiring Americans overseas.

The fundamental problem is that the United States is the only major industrialized country taxing its citizens without regard to where they reside or work. Although there is a foreign earned income exclusion and a housing cost exclusion, they are of relatively limited value, and can be highly complex.

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How to Qualify

To qualify for the foreign earned income exclusion and the housing cost exclusion (or deduction), a U.S. citizen must live and work abroad.

Does this mean you can hop on a plane to London right now to gain these tax benefits? No, in order to receive the tax benefits of Internal Revenue Code Section 911, a U.S. citizen must have a ''tax home'' in a foreign country and either:

- be a ''bona fide resident'' of one or more foreign countries for at least one entire taxable year (known as the ''bona fide residence requirement''); or
- have spent at least 330 full days in foreign countries during a period of 12 consecutive months (known as the ''physical presence requirement'').[1]

Notably, time spent on or over international waters is not counted toward the physical presence test.[2] Thus, U.S. citizens serving in the merchant marine are generally not entitled to the exclusion under I.R.C. Section 911.

The combination of U.S. income taxes and foreign taxes (notwithstanding the U.S. foreign tax credit) almost invariably puts the U.S. expatriate at a marked disadvantage when it comes to net taxes paid.

The U.S. tax law's ''foreign earned income exclusion'' has been one of the staples of the U.S. expatriate community, and has made U.S. companies more able to succeed in sending talented employees outside the United States.

[1] I.R.C. Section 911(d)(1).

[2] Internal Revenue Service, ''The Foreign Earned Income Exclusion—Physical Presence Test,'' at http://www.irs.gov/businesses/small/international/article/0,,id=96968,00.html.

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Under I.R.C. Section 911, a U.S. citizen can exclude foreign earned income. For 2007, this foreign earned income exclusion amount (known as the ''exclusion amount'') can be as much as $85,700 (in 2006, the ceiling was $82,400). In subsequent years, the amount will be adjusted for inflation.

Foreign Income Defined

Foreign earned income is defined as earned income from sources within a foreign country attributable to services performed by the taxpayer during the qualifying period of physical presence overseas.[3]

Wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered are ''foreign earned income.''[4] Notably, foreign earned income does not include amounts received from a corporation as distributions of earnings and profits.[5]

The term ''foreign earned income'' also does not include amounts paid by the United States or an agency thereof to an employee of the United States or an agency thereof.[6]

Foreign Housing Expenses

Moreover, you may be able to either deduct part of your housing expenses from your income, or treat a limited amount of employer-provided housing benefits as not taxable by the Internal Revenue Service. Under I.R.C. Section 911(b), a U.S. citizen living abroad can exclude from gross income a ''housing cost amount'' (a limited amount of employer-provided housing benefits).

The excluded ''housing cost amount'' is defined as the excess of actual housing costs over 16 percent of the exclusion amount (computed on a daily basis) for the calendar year in which such taxable year begins multiplied by the number of days of that taxable year within the applicable period described in I.R.C. Section 911(d)(1).

The applicable period is the period during which the individual meets the tax home requirement and either the bona fide residence requirement or the physical presence requirement. Assuming the U.S. citizen lives and works in a foreign country for all of 2007, the amount the actual housing costs must exceed to be excluded for 2007 would be $13,712 ($85,700 × 0.16).

Furthermore, the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) added another limit to the amount of housing expenses taken into account. Under I.R.C. Section 911(c)(2)(A), the amount of housing expenses is limited to 30 percent of the exclusion amount (calculated daily) multiplied by the number of days of the applicable period.

Thus, for the year 2007, a qualified individual whose entire taxable year is within the applicable period is limited to maximum housing expenses of $25,710 ($85,700 × 0.3). Accordingly, the maximum housing cost amount a qualified individual may exclude from income in year 2007 is $11,998 ($25,710 − $13,712).

[3] I.R.C. Section 911(b)(1)(A).
[4] I.R.C. Section 911(d)(2).
[5] I.R.C. Section 911(d)(2).
[6] I.R.C. Section 911(b)(1)(B).

Effect of Weak Dollar

With the weakened dollar, chances are that if you live in a foreign city such as London or Hong Kong, your housing cost may be significantly higher than this $11,998 amount. Fortunately, TIPRA authorizes the Treasury Department to issue regulations to adjust the $25,710 housing cost limit.

Accordingly, IRS has released a table identifying locations within countries with high housing costs relative to the United States. The table also provides adjusted limitations on housing expenses (in lieu of the otherwise applicable limitation of $25,710).[7]

To give some idea of how this works, the housing expense limit in Hong Kong (which has the highest maximum housing exclusion) is $114,300. The floor of $13,712 is subtracted from this limit to arrive at the maximum housing cost amount a qualified individual living in Hong Kong may exclude from income in year 2007 ($114,300 − $13,712, or $100,588).

If you pay for your own housing while living abroad, you can deduct a portion of your housing expenses to the extent that your foreign earned income exceeds the exclusion amount under I.R.C. Section 911(c)(3). Any disallowed deduction of housing expenses can be carried forward to the succeeding tax year.

There is almost nothing simple about the way these rules operate. Missteps are common, and companies are effectively forced to provide tax and accounting services to their overseas employees in order to try to cope with the complexity.

In addition, I.R.C. Section 911(d)(7) prohibits the total amount excluded or deducted under I.R.C. Section 911 for the taxable year from exceeding the individual's foreign earned income for such year.

TIPRA also changed the tax law so that income above the exclusion amount would be taxed at the higher marginal tax rates that would have applied if the exclusion did not exist.

For example, Sam is a single individual who earns $100,000 in wages while living and working in Hong Kong during 2007. Sam has no other sources of income. Sam would exclude $85,700 of his wages from gross income. Thus, Sam would be taxed on the remaining $14,300.

Prior to 2006, to calculate his eventual tax liability from these wages, Sam would have multiplied the remaining $14,300 by the marginal tax rate for single individual taxpayers earning $14,300 (or 15 percent). Now, Sam is taxed on the remaining $14,300 at the marginal tax rate for a single individual taxpayer earning $100,000 (or 28 percent).

[7] IRS Notice 2006-87; 2006 IRB LEXIS 567; 2006-43 IRB 766 (Oct. 23, 2006).

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These and other complex computations undermine the fundamental fairness of the foreign earned income exclusion.

Conclusion

The very short version of all of this is that U.S. tax laws are somewhat punitive when it comes to workers serving abroad. There are limited benefits, both in the form of the foreign earned income exclusion and in the form of potential nontaxable housing allowances.

Yet there is almost nothing simple about the way these rules operate. Missteps are common, and companies are effectively forced to provide tax and accounting services to their overseas employees in order to try to cope with the complexity.

The larger question, about why U.S. tax laws effectively discriminate against expatriates and make it harder for U.S. companies to compete globally, remains extant.