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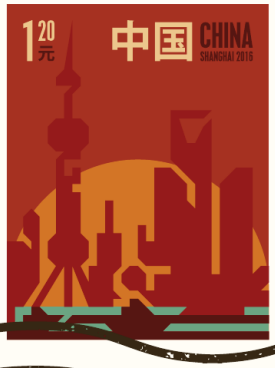

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FILING REQUIREMENTS OF AMERICANS ABROAD

BY RAINER FIEGE-KOLLMANN, EA

Do you have clients who live abroad or regularly work abroad? If so, you need to fully understand their filing obligations and how to keep them in compliance.

There are an estimated 9 million U.S. citizens living outside the United States. How many do you think have read the fine print in the back of their passport, which states, "All U.S. citizens working and residing abroad are required to file and report on their worldwide income"? In my experience, very few.

The penalties can be astronomical for failure to properly file international forms. Therefore, we, as tax professionals, need to be fully educated when dealing with such a tricky topic. It would be impossible to discuss all topics that relate to international taxpayers in this article, but there are some key items that can be emphasized.

Residency and Applicability

The U.S. tax system is quite unique in that it applies to individuals through citizenship and residency, while most countries only use place of residence to determine taxable status. The U.S. and Eritrea are the only two

sovereign countries that have a citizenship-based taxation system rather than the more common residency-based system. This means that the taxpayer does not need to live in the U.S. or have U.S.-sourced income to be subject to U.S. taxation.

For income tax purposes, a U.S. citizen is considered to be a "U.S. resident" for tax purposes even if he or she does not spend time in the U.S. or have an abode in the U.S. An individual cannot be a U.S. citizen and be classified as a nonresident alien for tax purposes. A taxpayer's tax status is generally determined on a year-by-year basis when determining residency; however, a taxpayer may be considered a dual-status resident if his or her status changed during the year; for example, he expatriated.

There are three general ways to become a U.S. resident for tax purposes: being a U.S. citizen, being a permanent resident (Green Card holder), or passing the substantial presence test. The first two are the simplest, as there are no calculations required; U.S. citizens and permanent residents are tax residents of the U.S. by default, regardless of the number of days spent in the U.S. A person does not need to hold a valid U.S. passport to be considered a U.S. citizen; they could have obtained it through a variety of methods (born on U.S. soil, birth to a U.S. parent, or naturalized). The substantial presence test is the most difficult to determine because it relies on a complex formula rather than a simple yes or no question. The substantial presence test formula is calculated by determining the total number of days spent in the U.S. during the current tax year in addition to the prior two tax years. If a person meets the substantial presence test, he or she is considered a resident alien for the tax year and has the same tax obligations as a U.S. citizen or permanent resident. Someone who is not a resident is considered a nonresident alien. Nonresident aliens may still have reporting requirements if they have U.S.-sourced income.

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Tax and Reporting Obligations

Income Tax

The filing requirements of Americans living abroad are the same as if they resided in the U.S., except for some minor differences such as the applicability of the foreign earned income exclusion or the filing thresholds of Form 8938 (Statement of Specified Foreign Financial Assets). All U.S. tax residents must report their worldwide income. In some cases, an individual may be below the filing threshold and not have a filing requirement. Even if someone does not have a filing requirement, I frequently advise someone in this situation to file anyway. This is often referred to as a "protective return" as it can help protect the taxpayer from future audits or IRS disputes by showing no liability.

There are some special considerations for taxpayers abroad that can be used to offset their tax liability. The two most common methods are the foreign earned income exclusion (Form 2555) and the foreign tax credit (Form 1116).

Foreign Earned Income Exclusion

The foreign earned income exclusion (FEIE) allows an individual to exclude foreign-earned income up to the exclusion amount, which is set annually by the IRS and is generally increased each year to adjust for inflation. The FEIE amount is $102,100 for 2017, which was increased from $101,300 for 2016. This FEIE can only be applied to "earned" income, such as wages or self-employment income. It cannot be applied toward any sort of passive income, such as dividends, interest, or royalties. The location of where the services were performed—not the source of payments—determines the "foreign" component of the FEIE; i.e. the services performed must have been performed in a foreign country. It is not possible to carry-forward or carryback any unused portion of the FEIE. It should also be noted that the FEIE cannot be used exclude income from self-employment tax; it can, however, be applied toward self-employment income. The FEIE is claimed by filing Form 2555.

A person's eligibility for the FEIE can be determined by passing one of two tests—the physical presence test or the bona fide residence test.

The physical presence test is based on the number of days a person was present in a foreign country during a 12-month period. While the 12-month period does not have to be a calendar year, the person does need to spend at least 330 days in a foreign country or countries during a 12-month period to qualify. A few nuances

worth mentioning are that an individual cannot count time spent in international waters or airspace toward the 330 days because it is not considered presence in a foreign country. A day that consists of time spent in a foreign country in combination with international waters or airspace does not count towards the 330 days. I have seen many clients complicate their lives by miscalculating their travel dates; therefore, I always recommend having them keep a detailed travel calendar to record their physical location.

The bona fide residence test is different than the physical presence test in that it does not involve a calculation, but rather looks at the specific facts of an individual's situation. The taxpayer must be a resident of a foreign country for an uninterrupted period that includes an entire tax year in order to qualify. It is generally not possible to qualify for this the first year abroad because people don't usually move abroad on January 1; however, it is usually the preferred choice over the physical presence test because of less restriction on travel. The bona fide residence test considers the intention or purpose of the trip, as well as the nature and length of the stay abroad. When claiming the FEIE pursuant to the bona fide residence test, the taxpayer must disclose his or her type of living quarters, visa status, contractual terms, and tax status in the country of residence. The IRS uses the information reported on Form 2555 to determine bona fide resident status. These determinations are made on a case-by-case basis. Generally speaking, someone with a permanent place of work and permanent residence in a foreign country should be able to qualify for the bona fide residence test; provided they have been a resident for at least an entire tax year.

Foreign Tax Credits

Foreign tax credits (FTCs) are available when income tax has been paid in a foreign country. The taxes must have been paid or accrued during the applicable tax year. FTCs are used to offset the taxpayer's U.S. tax liability. FTCs often offset the entire U.S. tax liability when the taxpayer has a higher tax rate of tax in his or her country of residence than in the U.S. The FTC method is an alternative to the FEIE (for earned income) because the FTCs cannot be used for any amounts excluded under the FEIE. FTCs can be used in addition to the FEIE when the taxpayer's income exceeds the FEIE. The FTC will only be applicable to the income in excess of the FEIE. Unlike the FEIE, unused FTCs can be carried forward 10 years and back one year.

FTCs exist in different categories, the most common being the general income and passive income categories. You can only apply FTCs within their respective baskets; for example, an individual cannot use FTCs for taxes paid on dividend income to offset self-employment income, because they are different categories.

An individual receives FTCs based on the amount of foreign taxes paid or accrued; therefore, the FTC method is more or less useless for individuals in tax-free jurisdictions unless they have FTC carryovers. In my experience, I have found the FTC method to be the preferable option when the taxpayer's foreign income tax paid exceeds their U.S. income tax, as it does not require as much information as Form 2555. There are no travel dates to track or residency requirements to determine when claiming the FTC.

In many cases, an individual can benefit from both the FTC and FEIE, but one option usually proves itself to be more beneficial than the other. The taxpayer's long-term plan should be evaluated when choosing which method to use. Once taxpayers begin using the FEIE method, they are considered to "revoke" their election once they switch to

the FTC method. Once the FEIE method has been revoked, a taxpayer needs to wait five years, or apply for IRS approval, to switch back to the exclusion. There are no such provisions to switch back to the FTC method.

Self-Employment Tax

The FEIE and FTC methods are powerful tools to help minimize a taxpayer's U.S. income tax liability, but neither can be used to offset the 15.3 percent self-employment tax. This is often a surprise to taxpayers because far fewer are familiar with self-employment tax in comparison to income tax. The U.S. does have a wide network of "totalization agreements" with foreign governments, which allow taxpayers to avoid U.S. self-employment tax when they are covered by another country's social system. In order to claim an exception from U.S. self-employment tax, a taxpayer must obtain a certificate of coverage from the foreign government under whose system they are covered. A copy of the certificate is submitted with the tax return as proof that the taxpayer is not required to pay the tax. Obtaining the certificate is not a quick process because it often takes some time for

the application to find its way to the correct staff member. There are generally very few employees in the foreign government who know how to process these applications; therefore, it can be helpful to call beforehand and get specific instructions before sending in the application.

Affordable Care Act

While the Affordable Care Act (ACA) is applicable to U.S. citizens living abroad, regulations have been put in place allowing certain individuals to be exempt. Americans which are a considered bona fide residents of a foreign country or pass the physical presence test are permitted to file Form 8965 (Health Coverage Exemptions) claiming such an ACA exemption. Taxpayers may be subject to ACA penalties if they do not have a qualified healthcare policy or qualify for one of the exemptions.

Foreign Accounts and Assets

FBAR

The Report of Foreign Bank and Financial Accounts (FBAR) requires U.S. persons to report signatory authority or financial interest in foreign bank and financial accounts. It is important to understand that the FBAR is not a tax return and does not involve reporting income or paying tax. The FBAR is not submitted to the IRS; it is submitted directly to the U.S. Department of the Treasury. The FBAR reports the taxpayer's foreign financial accounts' account number, institution details, and maximum account balance during the year. The reporting threshold is $10,000; this calculated by aggregating the values of all the taxpayer's foreign financial accounts. Some common examples of foreign financial accounts include, checking accounts, savings accounts, brokerage accounts, life insurance with cash value, and private pensions. Two commonly missed account types include security deposits on rental property and children's savings accounts, which parents have signatory authority over. Many practitioners struggle to understand the meaning of signatory authority since it can include accounts the taxpayer has no financial interest in; e.g. if a taxpayer has the power to sign on their employer's company account, a club account, or even an elderly parent's account, it needs to be reported. I encourage all practitioners to always check a client's FBAR requirements due to the high penalties that can apply for failure to disclose accounts. Penalties are levied per account per year, and be quite harsh. For example, there can be a $10,000 per account per year penalty, a penalty of 50% of the balance of the unreported accounts per year, as well as criminal charges.

Form 8938

When the Foreign Account Tax Compliance Act became law in March 2010, it introduced a plethora of new reporting requirements for individuals, entities, and foreign financial institutions. One of these new filing requirements for individuals was Form 8938. This form overlaps with the FBAR in several ways, but requires a wider range of assets to be reported. Not only do foreign financial accounts need to be reported, but also foreign stock and securities, ownership in foreign entities, financial instruments, and certain foreign insurance policies. There are different filing thresholds for Form 8938 depending on the taxpayer's filing status (single, married filing single, or married filing jointly) and place of residence (U.S. or foreign). A higher filing threshold exists for foreign residents who meet the bona fide residence or physical presence test. When a taxpayer is close to the threshold, the asset values at different points in the year must be carefully tracked to compare the end-of-year value against the maximum value during the year. It should also be noted that special rules for allocating asset ownership between joint owners, including spouses, need to be observed. Similar to the FBAR, failure to properly file the form can lead to extremely high penalties. In addition to penalties, failure to properly file Form 8938 can result in an unlimited extension of the statute of limitations; meaning the IRS could audit you 20 years from now.

Foreign Entities

Practitioners need to be cautious when preparing the returns of individuals with foreign entities. There are a series of international

information return forms that need to be filed to report foreign entities; such as, Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations) for foreign corporations, Form 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships) for foreign partnerships, Form 8858 (Information Return of U.S. Persons with Respect to Foreign Disregarded Entities) for foreign disregarded entities, and Forms 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts) and Form 3520-A (Annual Information Return of Foreign Trust with a U.S. Owner) for foreign trusts. Reporting requirements generally kick in once an individual or entity owns or acquires more than 10 percent of a foreign corporation or partnership. Do not forget that most foreign companies will maintain their financial statements according to international financial reporting standards (IFRS); however, this is not accepted for U.S. tax reporting purposes. Converting IFRS financials to U.S. generally accepted accounting principles (GAAP) can be a tedious and complex task for even the most experienced accountants.

Converting IFRS financials to U.S. generally accepted accounting principles can be a tedious and complex task for even the most experienced accountants.

Ownership of passive foreign investment company (PFIC) shares can easily be missed because their ownership is often hidden in security portfolio statements. A company is a PFIC by fulfilling one of two requirements; having at least 75 percent of its income be passive or having at least 50 percent of its assets be investments held for the production of passive income. Passive income includes, but is not limited to, interest, dividends, rents, royalties, and capital gains. PFICs are unique in that they have their own tax calculations, which are completed on Form 8621. The calculations are extremely tedious and require a high level of skill. Common examples include foreign mutual funds, exchange-traded funds, and hedge funds.

Dual-Status Taxpayers

In the unique situation that an individual's tax status changes during the tax year, he or she will need to complete and submit a dual-status tax return. Common scenarios requiring a dual-status tax return include: a nonresident alien moving to the U.S. and becoming a tax resident, a U.S. citizen renouncing U.S. citizenship, or someone abandoning his or her U.S. Green Card. The dual-status return consists of two components; the tax return and a dual-status statement. A person's status at the end of the tax year determines which form should be used as the tax return and which should be used for the dual-status statement.

The dual-status statement is covers the period prior to the taxpayer's change of status. I will use a hypothetical situation to illustrate. John is a U.S. citizen who lives in Germany. He relinquished his U.S. citizenship on October 15, 2016. Since John is no longer a U.S. citizen and does not meet the substantial presence test, he is no longer considered to be a U.S. resident for tax purposes. John needs to comply with his U.S. tax obligations, and report his worldwide income to the U.S. for the period he was a U.S. citizen. After his renunciation, John does not have any U.S.-sourced income; therefore, he has no obligation to report his post renunciation income to the U.S. In order to properly report his income to the U.S., John needs to file a dual-status tax return. He would file Form 1040NR (U.S. Nonresident Alien Income Tax Return) as the tax return portion because he was classified as a nonresident alien at the end of the 2016 tax year. John would also need to prepare a dual-status statement, which should be attached to the 1040NR. The dual-status statement reports John's taxable income during the time period he was a U.S. citizen. In John's case, he would also need to file Form 8854 (Initial and Annual Expatriation Statement) to inform the IRS of his relinquishment.

These amnesty programs are not permanent and may be changed or canceled at any time; therefore, it is wise to take advantage of them while they still exist.

Getting Compliant

The IRS currently has a variety of special amnesty programs that can be taken advantage of by taxpayers with unreported foreign income and/or assets who are looking for a path to compliance. These include the offshore voluntary disclosure program, the streamlined filing procedures, the delinquent FBAR submission procedure, and delinquent international information return submission procedure. Many of these programs allow taxpayers to come into compliance by filing or amending a few years of tax returns and/or FBARs. They will often be able to take advantage of reduced penalties, no penalties and protection from criminal prosecution. It is important to first fully understand a client's situation and history before recommending any specific program. These amnesty programs are not permanent and may be changed or canceled at any time; therefore, it is wise to take advantage of them while they still exist. **EA**

About the Author

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