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EXPAT TAX HANDBOOK

Tax Considerations For Remote Workers Living Abroad

Tax Year 2017

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Table of Contents:

Introduction / **3**

U.S. Federal Income Tax Basics / **4**

The Foreign Earned Income Exclusion / **4**

The Availability of Tax Deductions / **9**

U.S. State and Local Tax Considerations / **10**

I. Introduction

In today's age of "digital nomads," working remotely overseas has become increasingly popular. More companies are adding remote working options in order to benefit from a broader talent pool and give employees more lifestyle choices.

New programs, such as Remote Year, have further facilitated overseas commuting by organizing year-long trips for employees and freelancers to live in multiple cities abroad. Participants, for example, travel in groups to live in multiple cities throughout Europe, Asia and South America, for one month each over a year period.

Working abroad in this fashion presents a number of unique U.S. income tax issues and opportunities for U.S. individuals. Of particular importance is the issue of whether individuals qualify for the Foreign Earned Income Exclusion ("FEIE"), which allows U.S. citizens living abroad to exclude their foreign earned income from U.S. federal taxation. If the FEIE is not available to fully exclude foreign earned income, the availability of deductions to reduce taxable income earned abroad becomes a further relevant consideration.

In this tax guide, we describe the various requirements for FEIE qualification and apply them in the context of the digital nomad working abroad. We also include a brief discussion regarding potential deductions that may be available to reduce one's taxable income if the FEIE is not available. We include certain planning opportunities that may be available to remote workers, taking into account the tax reform legislation signed into law by President Trump at the end of 2017. To round out the discussion, we include a brief summary of the relevance of state and local income taxes for digital nomads during their time abroad.

CAVEAT

This document does not represent the rendering of U.S. tax advice by Expat Tax Professionals or Remote Year. It is intended to provide a high-level summary of certain complex U.S. federal income tax concepts and rules. Each participant should seek the advice of a tax professional in order to understand the U.S. tax implications associated with his or her particular facts and circumstances.

II. U.S. Federal Income Tax Basics

As a basic rule, U.S. citizens, even those residing outside the United States, are considered to be U.S. residents for tax purposes and are therefore subject to U.S. tax reporting on their worldwide income.

U.S. citizens living abroad must annually report all of their worldwide income, i.e., whether the income is U.S. source or foreign source.

Like U.S. residents, U.S. citizens living abroad are generally required to file federal income tax returns (Form 1040) by April 15th of the following year. (Due to the weekend and a holiday, the due date for the 2017 tax return is moved to April 17, 2018.) However, if you live outside the U.S. on April 15th, you are entitled to an automatic extension (without the filing of an extension form) until June 15th.

It should be noted that if you owe tax, the extension applies only to the tax return filing and not the tax payment. Therefore, you must still submit your payment by April 15th to avoid paying interest on your late payment (late payment penalties do not commence until June 15th). An automatic extension can also be filed resulting in additional time to file until October 15th.

III. The Foreign Earned Income Exclusion

Provided that an individual can satisfy either the **bona fide residence test** or the **physical presence test**, and is able to establish a **tax home** in a foreign country, such individual can exclude from income a portion of his or her foreign earned income. Foreign earned income is generally pay for personal services performed overseas, such as wages, salaries, or professional fees. It does not include passive income items, such as dividends, royalties, rent, pensions, and capital gains.

The foreign earned income exclusion amount is adjusted annually for inflation. For tax year 2017, the maximum foreign earned income exclusion is up to $102,100 per qualifying person. If filing individuals are married and both work abroad and meet either the bona fide residence test or physical presence test, each one can choose the foreign earned income exclusion. Together, they can exclude as much as $204,200 for the 2017 tax year.

An individual's tax on any foreign earned income above the exclusion amount and on any unearned income is computed as if the foreign earned income exclusion was not claimed. Foreign tax credits may be available to reduce the tax on such excess amount.

In order to claim the exclusion, an individual taxpayer must properly file a U.S. Federal Income Tax Return (**IRS Form 1040**), and must file a Foreign Earned Income form (**IRS Form 2555**) with their tax return.

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Overview of the FEIE Requirements

1. Bona Fide Residence Test / Physical Presence Test

In order for an individual to qualify for the FEIE, he or she must pass either the bona fide residence test or physical presence test. Below are summary explanations of the two tests:

Physical presence test – An individual will qualify under the physical presence test if they are present in a foreign country for 330 full days during any period of 12 consecutive months. The 330 days do not need to be consecutive. The physical presence test of the FEIE is determined for any period of 12 consecutive months, not necessarily during the same calendar year. This feature of the FEIE allows for planning techniques that can be implemented to maximize the utilization of the FEIE within the overall context of a U.S. federal income tax return.

Bona fide residence test – A U.S. citizen will satisfy the bona fide residence test if they reside in a foreign country for an uninterrupted period that includes the entire tax year. It is important to keep in mind that merely being in a foreign country for one full year does not automatically qualify an individual. The test is based on facts and circumstances. For example, if an individual relocates to a foreign country in order to work on a particular job for a specified period of time, he or she will not satisfy the bona fide residence test despite presence in the foreign country for more than one year fulfilling the work assignment. The length of your stay overseas and its nature are only two of several factors the IRS will examine. Other factors include whether you purchased a home overseas, any declaration you may have made to the foreign authority indicating that you are not a resident of the country, and whether your family lives with you abroad.

2. Tax Home

In order for an individual to qualify for the FEIE, his or her "**tax home**" must be in a foreign country. The general rule is that a "tax home" is located in the vicinity of the taxpayer's regular or principal (if more than one regular) place of business or employment, regardless of where you maintain your family home.

Your tax home is the place where you are "permanently" or "indefinitely" engaged to work as an employee or self-employed individual. If you do not have a regular or principal place of business because of the nature of your work, your tax home may be the place where you regularly live. If you have neither (no regular place of business or living), then you are considered an "**itinerant**" and your tax home is wherever you work.

If you have a permanent place of employment in the U.S. but then are put on assignment abroad, the location of your tax home depends greatly on whether your assignment is temporary (precluding the FEIE) or indefinite (allowing the FEIE). If you expect your employment away

from home in a single location to last, and it does last, for 1 year or less, it is temporary unless the facts indicate otherwise. If you expect it to last for more than 1 year, it is indefinite.

Employees may not considered to be on assignment, however, if they choose to move and work remotely from abroad simply for personal reasons, i.e., the employer does not require the move abroad nor benefit from such an arrangement. In such case, the taxpayer's pre-move place of business (the United States) may be considered his or her tax home, regardless of the length of time working abroad. An employee's tax home is more likely to remain in the U.S. if his or her ordinary responsibilities are limited or restricted while working abroad (for example, the taxpayer is not allowed to solicit clients while overseas).

Example -

Taxpayer A was regularly employed in the United States. In 2017, A accepted a work assignment from his employer in the United Kingdom. A realistically expected the work in the UK to be completed in 13 months and planned to return to the United States after that time. The employment did in fact last 13 months, after which time A returned to the United States.

In such case, the United Kingdom became A's tax home during his time working there, because the assignment was for more than 1 year. A may qualify for the FEIE for the 2017 tax year, assuming the other requirements of the FEIE are met.

3. Abode in the United States

The "tax home" rule is subject to an important overriding exception – an individual is not considered to have a tax home in a foreign country for any period during which the individual's "**abode**" is in the United States. "Abode" has been variously defined as one's home, habitation, residence, domicile, or place of dwelling. Thus, in contrast to "tax home," "abode" has a domestic rather than vocational meaning. The location of your abode often will depend on where you maintain your economic, family, and personal ties.

Tax Case Example #1

A taxpayer worked alternating 28-day periods on and off duty for an oil company in Tunisia. The taxpayer was a resident of Louisiana, was registered to vote in Louisiana, possessed a Louisiana driver's license, and had a Louisiana bank account. He maintained a home in Louisiana, where his wife and daughter lived, and he spent roughly half his time in Louisiana with them. The U.S. Tax Court held in this case that the taxpayer was ineligible for the FEIE. It reasoned that the taxpayer's economic, family, and personal ties to the U.S. were sufficiently strong to create an "abode" in the United States. [Lemay v. Commissioner, T.C. Memo., aff'd, 837 F.2d 681 (5th Cir. 1988)]

Tax Case Example #2

The taxpayer was a crew member for Japan Air Lines (JAL) who moved with his family to Japan upon commencing employment. When JAL reassigned him to Alaska, its only U.S. base, his family moved there; when JAL reassigned him to Japan, his family could have joined him but decided not to. He paid for his own housing in Tokyo and lived there except when traveling for the airline or on vacation. He paid for his own meals and for his vacation travel to the United States. The U.S. Tax Court of Appeals held in this case that the taxpayer was eligible for the FEIE. The Court reasoned that the facts collectively were sufficient to establish that his "abode" was in Japan rather than in the United States. [Jones v. Commissioner, 927 F.2d 849 (5th Cir. 1991)]

Working Remotely Abroad

In the case of the digital nomad working abroad, assuming the individual satisfies the bona fide residence test or physical presence test (often the latter test is satisfied so an inquiry into the former is not necessary), the critical tax issues with respect to qualification for the FEIE then become the "tax home" and "no abode in the U.S." requirements.

With respect to "tax home," it may be difficult to establish that the individual has established a home in any particular foreign country if, for instance, he or she works in multiple countries during a year abroad. The claim of a tax home abroad could be strengthened if the taxpayer stayed in a single location for more than a year on a work assignment, if it were shown that the move were employer-motivated and not solely for personal reasons. Alternatively, taxpayers who are permanently on the move may be able to argue that they are "itinerant" workers whose tax home follows them to wherever they work. This may be particularly apt in the case of a freelancer, as opposed to an employee who works at a specific location in the U.S. both prior to and subsequent to spending a year working abroad.

With respect to "no abode in the U.S.", an individual's claim will be strengthened if they can show that they have weakened their economic, family, and personal ties to the United States and strengthened such ties abroad. This may prove challenging for those spending just a year working abroad before returning the United States. The strength of the position will depend on the particular facts and circumstances.

It's important to point out that every case is unique and should be analyzed as such. There is no guarantee that any certain set of facts in the context of working remotely abroad will satisfy the "tax home" and "no abode in the U.S." requirements. There is also no guarantee that a position taken by an individual taxpayer won't be challenged by the IRS or, if challenged, will be affirmed in a U.S. court of law if the issue is litigated. In addition to requiring a repayment of the unpaid tax with interest, the IRS may also seek to impose civil penalties, calculated as a portion of the unpaid tax.

In light of the above, the following is a checklist of facts and circumstances which, based on U.S. case law and IRS guidance, tend to support the argument that an individual working remotely abroad has a tax home in a foreign country and does not have an abode in the United States. None of the items on this list are dispositive, nor should they be construed as carrying any particular weight over any other item.

Working Remotely Abroad: The FEIE Tax Home Checklist

- Employment abroad is in one foreign country and lasts for more than 1 year (preferably documented in a written agreement with the employer);
- Taxpayer frequently moves locations in the U.S. and abroad, especially if such movement is due to the nature of the Taxpayer's work;
- Taxpayer pays for own housing, meals, transportation, and vacation travel while working in the foreign country;
- Family of Taxpayer resides in the foreign country (or at least is not precluded from doing so by contract or by law);
- If the Taxpayer owns or rents a house in the U.S., then Taxpayer leases or sublets the property while abroad;
- If the Taxpayer owns a motor vehicle in the U.S., then Taxpayer puts the car is storage while abroad;
- Taxpayer opens a bank account in the foreign country;
- Taxpayer closes or suspends bank account in the U.S.;
- Taxpayer does not designate relative or other to take care of affairs in the U.S. on his or her behalf;
- Taxpayer uses business cards with an address in the foreign country;
- Taxpayer gets driver's license in the foreign country;
- Taxpayer does not register to vote in the U.S.;
- Taxpayer loses social ties with the U.S. (e.g., charities, club memberships) and establishes social ties in the foreign country;
- Travel to the U.S. should be limited to the extent possible;
- Taxpayer should keep records, if relevant, of the above circumstances (note – if the IRS challenges the taxpayer's position, the taxpayer has the burden of proof that he or she qualifies for the FEIE).

Caveat to the Tax Home Checklist

In respect of the above, Expat Tax Professionals takes no position that a taxpayer will satisfy the FEIE if all or any of the above circumstances are satisfied. As a matter of recommendation,

because these issues are complex and highly fact-sensitive, U.S. taxpayers should consider having their employer fully withhold U.S. tax on their income earned while working remotely abroad, and then subsequently asking the IRS for a refund by claiming the FEIE on their tax return. The IRS can then decide initially whether to grant or deny such refund.

III. The Availability of Tax Deductions

Due to the limitations of the FEIE, it's not uncommon for U.S. citizens working abroad to utilize tax deductions to reduce their taxable income. The availability of deductions related specifically to remote year programs will depend greatly on whether the remote worker is an employee or is self-employed.

1. Employed Individuals

In the case of employees, the availability of work-related tax deductions became greatly limited by the Tax Cuts and Jobs Act (the "TCJA"), signed into law by President Trump at the end of 2017. For tax years up to tax year 2017, employees have been able to generally deduct non-reimbursed business expenses. Also, for instance, employees could deduct certain job-related moving expenses or exclude moving expense employer reimbursements.

Under the TCJA, starting with tax year 2018, these deductions will no longer available. They are essentially replaced with a larger standard deduction of $12,000 for individuals and $24,000 for married couples filing jointly.

2. Self-employed Individuals

For self-employed individuals (e.g., freelancers), work-related expenses can be deducted to the extent they are considered "ordinary and necessary" business expenses, so unlike employees, the prospect of deductible expenses associated with a year-abroad program is more viable. Again, this assumes that the self-employed individual was not able to utilize the FEIE to eliminate his or her taxable income.

In a typical year-long program abroad, participants will pay a fee to the program, which can be broken down, for instance, into: (i) a portion allocated to the co-working space being used; and (ii) a portion allocated to travel from location to location. While the deductibility of the fee portions will depend on the facts of a particular case, the portion allocated to the co-working space should seemingly be a deductible expense if it qualifies as an ordinary and necessary business expense of the individual. The travel expenses, however, would seemingly not be deductible, since the IRS requires travel to be away from one's tax home, and as discussed above, individuals utilizing the FEIE typically must take the position that their tax home follows them from location to location.

3. Structuring and Planning Opportunities

While the elimination of many tax deductions is one of the tax-unfriendly aspects of the TCJA, the tax reform does come with a number of provisions that may be beneficial to the self-employed individual, especially those planning to return to work in the United States after their year abroad.

One of the more significant provisions in this regard is the new 20% deduction for so-called "pass through" income. Under previous law, income earned through pass-through businesses, such as sole proprietorships, partnerships, limited liability companies (LLCs), and S corporations, was effectively subject to individual income tax rates. Under the TCJA, a deduction of up to 20% can now be taken against income that is effectively connected with a U.S. trade or business, depending on the amount of income earned and subject to certain limitations.

Careful consideration should be given to structuring one's business to take advantage of the new 20% deduction but not lose out on other available tax benefits. For instance, doing business through an S corporation is a great planning technique for minimizing self-employment taxes. However, now when using an S corporation, some optimization will be needed. On the one hand, you may want to reduce salary amounts paid from the company in order to minimize self-employment taxes, but on the other hand, you may want to increase salary amounts paid so as not to limit the scope of the 20% deduction.

In order to get it right, you should consult with a tax advisor who can weigh the various options depending on your particular circumstances. Should you chose to establish a U.S. entity such as an S corporation or LLC for your business, Expat Tax Professionals can assist you with the formation of your company and with subsequent tax filings.

IV. U.S. State and Local Taxation Considerations

1. General

Generally, states impose tax only on individuals who are "**residents**" of the state. Most states use some definition of "**domicile**" to determine if a taxpayer is a resident. In general, for state tax purposes, an individual may have many residences, or physical dwellings in which he resides, but will have only one domicile, or that permanent residence to which he or she intends to return.

If you move out of your state of residence and it is for a short time only, your domicile normally does not change. A short time can be anywhere from a month or two or up to a year or more. To make a change in domicile permanent, you must combine the acts of making a change in domicile along with the intent to change your domicile. In many states, the requirements for breaking residency are fairly strict and require not only that one move out of the state but also

sever other ties they have with the state. Such ties include selling property owned in the state, closing bank accounts, and even relinquishing a state issued driver's licenses.

It should be noted that in general five states are known to be the most aggressive in trying to tax U.S. citizens moving abroad by making it very difficult to "break" ties with the state. These states are: California, New York, New Mexico, South Carolina, and Virginia. On the other end of the spectrum, there are some states that do not impose an income tax on individuals.

For digital nomad employees working abroad for only a year and then returning to their state of residence, it may prove challenging to show an intent to change your domicile in many states. Each state has its own particular rules, so it is important to understand these rules and how they apply to your particular facts.

2. Availability of the FEIE

In the case where an individual is subject to state taxation, an important issue becomes whether the relevant state allows a foreign earned income exclusion. The fact that the FEIE is available under the federal rules does not necessarily mean that all states will follow the federal approach.

Many states allow the foreign earned income exclusion, while others will make you "add back" the federally excluded income before calculating the state taxable income. If no exclusion is allowed, the state may provide a safe harbor, a credit for taxes paid to a foreign country, or a deduction of foreign taxes paid as part of the state itemized deductions to provide relief from double taxation.

The states that do not automatically allow the FEIE include California (which has a limited safe harbor), Massachusetts (which allows a credit for foreign taxes paid), New Jersey, and Pennsylvania.

It is therefore important to check your state's federal coordination rules to see if you can take the foreign exclusion, credit or deduction when you have used the FEIE for federal income tax purposes.