EXPAT TAX HANDBOOK

Understanding the U.S. Tax Basics

Tax Year 2018
The Expat Tax Handbook – Understanding the U.S. Tax Basics*

Straightforward Explanations with Helpful Expat Tax Tips

* Please note that this year’s Expat Tax Handbook has been updated specifically to include relevant changes for U.S. expats made by the Tax Cuts and Jobs Act of 2017 (referred to herein as the “Trump Tax Reform”).

Table of Contents:

Federal Income Tax Filing Obligations / 2
Income Exclusions and Tax Credits Related to Foreign Income / 6
U.S. Tax Treaties / 9
Issues Relevant to Specific Types of Income / 11
State Income Tax Filing Obligations / 14
Self-Employment Taxes / 15
FATCA / 16
Reporting of Foreign Accounts and Assets / 17
Due Dates / 20
Delinquent Taxpayers – Late Filers / 21
Audits / 23
Surrendering U.S. Citizenship and the Exit Tax / 24
1. Federal Income Tax Filing Obligations

Who Needs to File?

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. **Green card holders** also have the status of U.S. tax residents, even if living abroad. Therefore, they are also required to file a return annually (regardless of their country of residence) and report their worldwide income.

A U.S. tax treaty, if applicable, may give a green card holder the option to elect non-resident alien ("NRA") status and thereby be released from U.S.-tax-resident status. This type of position is often very tricky and requires a detailed technical analysis by a competent tax professional.

Perhaps it is less well known that one may also be considered a U.S. tax resident if the **substantial presence test** is met for the calendar year. Under this test, one must be physically present in the United States on at least: (a) 31 days during the current calendar year; and (b) a total of 183 days during the current year and the 2 preceding years, counting all the days of physical presence in the current year, but only one-third the number of days of presence in the first preceding year, and only one-sixth the number of days in the second preceding year.

**Expat Tax Tip #1** – If you are a U.S. citizen, green card holder, or meet the substantial presence test, you are generally required to file a U.S. income tax return, even if you are living abroad. This is true whether or not you owe taxes and whether or not you are filing a foreign country income tax return.

You are treated as present in the United States for purposes of the substantial presence test on any day you are physically present in the country, at any time during the day. However, there are exceptions to this rule. Examples of days of presence that are not counted for the substantial presence test include:

- days you are in the United States for less than 24 hours, when you are in transit between two places outside the United States; and
- days you are an exempt individual (which includes certain teachers, students, and professional athletes)

**Expat Tax Tip #2** – If you are a NRA who is claiming that you can exclude days of presence in the United States for purposes of the substantial presence test, then you may need to file Form 8843 to explain the basis of your claim.
Example – John, a Canadian citizen, was physically present in the United States for 150 days in each of the years 2010, 2011, and 2012. For the last year (2012), John held a business visa, while for the first and second years (2010 and 2011), he held a teacher’s visa. At the outset, John would fail the substantial presence test, because the 150 days of presence in 2012, 50 days in 2011 (1/3 of 150), and 25 days in 2010 (1/6 of 150), together total 225 days, which is greater than the 183-day threshold. However, since John held a teacher’s visa in 2010 and 2011, his days of presence in the United States during those years are not counted. As such, John should not be considered a U.S. tax resident under the substantial presence test for 2012.

Additional exceptions to the substantial presence test include:

- **The closer connection test** – Under U.S. tax law, even if you fail the substantial presence test, you can still be treated as a NRA if you maintain a “tax home” in a foreign country during the year and have a “closer connection” during the year to one foreign country in which you have a tax home than to the United States.

- **Treaty relief** – Under an applicable U.S. tax treaty, an individual may be subject to a less onerous test than the substantial presence test.

It is important to note that there are specific filing requirements associated with each of the above exceptions (e.g., **Form 8840** for the closer connection test and **Form 8833** for treaty relief). An expat tax professional should be consulted to ensure that the proper filings are executed, otherwise these important exceptions may otherwise be unavailable.

**What Types of Income Are Reportable?**

Expats must annually report all of their worldwide income, i.e., whether the income is U.S. source or foreign source. This means that in addition to your U.S. source income, your U.S. income tax return should also include, among other things:

- Wages from your foreign employer
- Self-employment income earned abroad
- Foreign dividends and interest income
- Rental income from foreign properties
- Foreign royalties
- Foreign capital gains or losses on stocks, bonds, real estate
- Foreign pension and social security benefits
- Exercise of certain stock options
Tax Filing Status

Your federal income **tax filing status** affects the tax rate applicable to your income as well as the availability of deductions and credits to reduce your taxable income or offset your income tax. Taxpayers must use one of five filing statuses:

- Married Filing Jointly
- Qualifying Widow(er) with Dependent Child
- Head of Household
- Single
- Married Filing Separately

In the case of a U.S. tax resident that is married to a NRA, the default status of the U.S. resident filer is often married filing separately, which can be the least desirous filing status. Special rules and options are available for shifting one’s status to a more advantageous category. An expat tax professional should be consulted to ensure that the ideal status is utilized in this type of situation.

Federal Income Tax Rates

In general, the **tax rate** applicable to your income will depend on your tax filing status and your taxable income amount. Beneficial rates may apply to certain types of income, for example, capital gains and qualifying dividends. The Trump Tax Reform generally reduced the federal income tax rates for the 2018 tax year (with the top rate, for example, being reduced from 39.6% to 37%). The IRS publication official announcing the new rates can be found here:


It is important to note that for certain high-income taxpayers, a so-called **alternative minimum tax** (“AMT”) may apply. This additional tax is calculated separately from a taxpayer's regular tax and is paid in addition to the regular tax if certain criteria are met. AMT is intended to ensure that high-income taxpayers pay a minimum amount of income tax (e.g., in the case where the taxpayer’s income is otherwise reduced due to available deductions and credits).

---

**Expat Tax Tip #3** – The filing status of a taxpayer can affect the extent to which the alternative minimum tax applies to such taxpayer’s income. An expat tax professional should be consulted with respect to one’s filing status to mitigate AMT exposure.
Net Investment Income Tax

If an individual has income from investments, the individual may be subject to a 3.8 percent Net Investment Income Tax (“NIIT”) on the lesser of their net investment income (such as interest, dividends, capital gains, rental and royalty income, among others), or the amount by which their modified adjusted gross income exceeds the statutory threshold amount based on their filing status. The current thresholds are $250,000 (married filing jointly), $125,000 (married filing separately), or $200,000 (single or head of household). In general, NRAs and NRA spouses are not subject to the NIIT.

Filing Minimum Thresholds

In some cases, if your income is below a certain threshold amount, you may not be required to file a federal income tax return. The draft Form 1040 Instructions currently include a chart that lists the new minimum thresholds under the Trump Tax Reform. Gross income is defined generally as all income you receive in the form of money, goods, property, and services that is not exempt from tax.

<table>
<thead>
<tr>
<th>IF your filing status is. . .</th>
<th>AND at the end of 2018 you were. . .</th>
<th>THEN file a return if your gross income was at least. . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>under 65</td>
<td>$12,000</td>
</tr>
<tr>
<td></td>
<td>65 or older</td>
<td>$13,600</td>
</tr>
<tr>
<td>Head of household</td>
<td>under 65</td>
<td>$18,000</td>
</tr>
<tr>
<td></td>
<td>65 or older</td>
<td>$19,600</td>
</tr>
<tr>
<td>Married filing jointly</td>
<td>under 65 (both spouses)</td>
<td>$24,000</td>
</tr>
<tr>
<td></td>
<td>65 or older (one spouse)</td>
<td>$25,300</td>
</tr>
<tr>
<td></td>
<td>65 or older (both spouses)</td>
<td>$26,600</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>any age</td>
<td>$5</td>
</tr>
</tbody>
</table>

The IRS advises that if you qualify for a refundable credit (such as the earned income credit or the additional child tax credit), you should file a return to get a refund even if you are not otherwise required to file a return.

**Expat Tax Tip #4** – Even if you are not required to file a U.S. income tax return, e.g., you fall below the minimum filing threshold, you may still want to file a return if you qualify for a refundable credit. The IRS may have money waiting for you!
2. Income Exclusions and Tax Credits Related to Foreign Income

Foreign Earned Income Exclusion

Provided an individual is able to establish that his tax home is outside the U.S., and can satisfy either the bona fide residence test or the physical presence test, such individual can exclude from income a portion of their income earned overseas. The foreign earned income exclusion ("FEIE") amount is adjusted annually for inflation. For tax year 2018, the maximum foreign earned income exclusion is up to $103,900 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 $207,800 for the 2018 tax year.

In order to claim this exclusion, an individual must file a U.S. federal income tax return (Form 1040). To claim the FEIE, an individual must file Form 2555 with their U.S. federal income tax return.

**Tax Home** - Your tax home is the general area of your main place of business, employment, or post of duty, 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. You are not, however, considered to have a tax home in a foreign country for any period in which your “abode” is in the United States. “Abode” has been variously defined as one’s home, habitation, residence, domicile, or place of dwelling. The location of your abode often will depend on where you maintain your economic, family, and personal ties.

**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 presence 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.
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.

Expat Tax Tip #5 – 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.

Amounts Earned Over More Than 1 Year - Regardless of when you actually receive income, you must apply it to the year in which you earned it in figuring your excludable amount for that year.

Example – Karen was a bona fide resident of the United Kingdom for all of 2013 and 2014. In 2013, she earned $87,600 in wages from her UK employer. She excluded all of the $87,600 from her income in 2013. In 2014, she received a $20,000 bonus for work she did in 2013. She can exclude $10,000 of the $20,000 from her income in 2014. This is the $97,600 maximum foreign earned income exclusion in 2013 minus the $87,600 actually excluded in that year. She must include the remaining $10,000 in income in 2014 ($20,000 - $10,000), because she could not have excluded that income in 2013 if she had received it in that year.

Foreign Housing Exclusion/Deduction

In addition to the FEIE, a U.S. expat can also exclude or deduct from their gross income their housing cost amount in a foreign country provided they qualify under the bona fide residence or physical presence tests. The exclusion is applicable whenever an individual has wages. The deduction is applicable whenever the individual is self-employed.

However, the housing cost amount is subject to certain limitations that are adjusted based on geographical location. Without any adjustments to the limitations, the maximum foreign housing exclusion for 2018 is $14,546. Adjustments vary from city to city and are based on the cost of living in each city. The IRS publishes an updated table with the relevant limitations each year. In order to claim the foreign house exclusion/deduction, an individual must file Form 2555.
Foreign Tax Credits

As an alternative to (and for higher income earners, in complement to) the FEIE and foreign housing exclusion/deduction, a U.S. expat can claim a foreign tax credit ("FTC") for foreign income taxes paid.

Expat Tax Tip #6 – The U.S. tax system offers two key methods for preventing “double taxation” (i.e., tax in both your new host country and in the United States) – (1) the FEIE and foreign housing exclusion/deduction, and (2) the foreign tax credit. In certain instances, both methods may be utilized, and in other instances, one method may be preferable to the other. It is best to consult an expat tax professional to determine the most effective utilization of these methods.

Foreign taxes eligible for the foreign tax credit are generally limited to income taxes imposed by a foreign country. It is important to note that often certain foreign taxes may appear as income taxes but will not qualify as income taxes for purposes of taking the foreign tax credit. For instance, foreign real estate taxes, sales taxes, luxury taxes, turnover taxes, value-added taxes, and wealth taxes, are generally not creditable.

The employee portion of foreign social security taxes is generally considered a foreign income tax available for the foreign tax credit. Social security taxes are not creditable, however, if paid to a country with which the United States has a so-called totalization agreement (See Section 3 of this Tax Handbook for a further discussion regarding social security totalization agreements). Determining whether a foreign tax is creditable can at times be difficult, and an expat tax professional should be consulted to determine foreign tax credit eligibility.

The amount of foreign tax credits that may be taken is limited to the amount of foreign source taxable income and cannot be used to offset U.S. source income. Aside from specific situations, in order to claim a foreign tax credit, an individual must file Form 1116 with their U.S. federal income tax return.

The foreign tax credit, with limitations re-calculated applying AMT rules, may be used to reduce the alternative minimum tax (See Section 1 of this Tax Handbook for a brief overview of the alternative minimum).

It is important to note that in accordance with Treasury regulations, the foreign tax credit cannot be used to reduce the NIIT (See Section 1 of this Tax Handbook for a description of the NIIT). Consequently, a U.S. expat who otherwise has 100% foreign source income and sufficient foreign tax credits to credit against such income, can still end up paying U.S. federal income taxes.
3. U.S. Tax Treaties and Other International Agreements

Many countries have signed treaties and other international agreements with the U.S. whereby certain benefits are available to U.S. expats residing in a particular foreign country, for instance in order to protect them from double taxation, both in the U.S. and in their country of residence.

Important treaties and agreements include:

- **Income Tax Treaties** – These treaties are generally designed to mitigate the effects of double income taxation. Generally, under an income tax treaty with the U.S., U.S. expats may be entitled to certain credits, deductions, exemptions and reductions in the rate of income taxes of the foreign country in which they reside. Resourcing of income is also a major beneficial feature of such treaties. In most cases, a treaty position needs to be disclosed to the IRS on a Form 8833, which is included in the federal income tax return. Failure to disclose a treaty-based return position may result in a penalty of $1,000 for an individual ($10,000 in the case of a corporation).

- **Estate and Gift Tax Treaties** – These treaties establish tiebreaker rules for dual-domiciled decedents and gift transferors. Also, when an individual is domiciled in one country but has property located in another country, these treaties allow only the country of domicile to tax the worldwide transfers of such individuals.

- **Totalization Agreements** – These agreements affect tax payments and benefits under social security systems. They minimize the burden of double social security taxation. In many cases, these agreements allow individuals to continue paying social security taxes in their home countries and exempt them from social security taxation in the country where they are temporarily employed.

- **Intergovernmental Agreements** – These agreements make it easier for countries to comply with the provisions of FATCA (see Section 7 of this Tax Handbook for a discussion of FATCA). Under these agreements, foreign financial institutions in partner jurisdictions are able to report information on U.S. account holders directly to their national tax authorities, who in turn report the information to the IRS.

**Expat Tax Tip #7** – Many U.S. tax treaties entitle U.S. expats to exemptions and reductions in the rate of income taxes of the foreign partner country. For instance, income earned by a teacher or professor working in a foreign country may be exempt from tax in the foreign country for up to 3 years.
**Income Tax Treaties**

The following is a list of countries that have income tax treaties with the U.S. that are currently in force:

<table>
<thead>
<tr>
<th>Armenia</th>
<th>Germany</th>
<th>Malta</th>
<th>Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Greece</td>
<td>Mexico</td>
<td>Switzerland</td>
</tr>
<tr>
<td>Austria</td>
<td>Hungary</td>
<td>Morocco</td>
<td>Tajikistan</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>Iceland</td>
<td>Netherlands</td>
<td>Thailand</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>India</td>
<td>New Zealand</td>
<td>Trinidad</td>
</tr>
<tr>
<td>Barbados</td>
<td>Indonesia</td>
<td>Norway</td>
<td>Tunisia</td>
</tr>
<tr>
<td>Belarus</td>
<td>Ireland</td>
<td>Pakistan</td>
<td>Turkey</td>
</tr>
<tr>
<td>Belgium</td>
<td>Israel</td>
<td>Philippines</td>
<td>Turkmenistan</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Italy</td>
<td>Poland</td>
<td>Ukraine</td>
</tr>
<tr>
<td>Canada</td>
<td>Jamaica</td>
<td>Portugal</td>
<td>USSR</td>
</tr>
<tr>
<td>China</td>
<td>Japan</td>
<td>Romania</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>Cyprus</td>
<td>Kazakhstan</td>
<td>Russia</td>
<td>Uzbekistan</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Korea</td>
<td>Slovak Republic</td>
<td>Venezuela</td>
</tr>
<tr>
<td>Denmark</td>
<td>Kyrgyzstan</td>
<td>Slovenia</td>
<td></td>
</tr>
<tr>
<td>Egypt</td>
<td>Latvia</td>
<td>South Africa</td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>Lithuania</td>
<td>Spain</td>
<td></td>
</tr>
<tr>
<td>Finland</td>
<td>Luxembourg</td>
<td>Sri Lanka</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Estate and Gift Tax Treaties**

The following is a list of countries that have estate and gift tax treaties with the U.S. that are currently in force:

<table>
<thead>
<tr>
<th>Australia</th>
<th>Ireland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>Italy</td>
</tr>
<tr>
<td>Belgium</td>
<td>Japan</td>
</tr>
<tr>
<td>Canada</td>
<td>Netherlands</td>
</tr>
<tr>
<td>Denmark</td>
<td>Norway</td>
</tr>
<tr>
<td>Finland</td>
<td>South Africa</td>
</tr>
<tr>
<td>France</td>
<td>Sweden</td>
</tr>
<tr>
<td>Germany</td>
<td>Switzerland</td>
</tr>
<tr>
<td>Greece</td>
<td>United Kingdom</td>
</tr>
</tbody>
</table>
4. **Issues Relevant to Specific Types of Income**

With each item of income that an expat earns, special considerations need to be addressed. The following are some of the considerations associated with three common types of income earned abroad: (1) income from the sale of real estate property, (2) pensions and social security benefits, and (3) income realized from investments in so-called passive foreign investment companies (“PFICs”).

**Real Estate Transactions (Primary Residence)**

With respect to purchasing real estate, an individual that buys a primary residence overseas is generally entitled to the same U.S. tax benefits as a homeowner in the U.S. As such, you can deduct mortgage interest, property taxes, and certain other items on your personal income tax return.

With respect selling real estate, the **primary residence exclusion rule** may apply. Under this rule, an individual can exclude a gain of up to $250,000 realized from the sale of his or her home ($500,000 if married and filing jointly), provided they meet the “ownership test” and “use test.” This exclusion is not limited to homes in the U.S.

**Expat Tax Tip #8** – Provided certain requirements are met, gain of up to $250,000 realized from the sale of a primary residence can be excluded from your taxable income ($500,000 if married and filing jointly). This exclusion is **not** limited to homes in the U.S.

**The Ownership Test** - If you owned the home for at least 24 months (2 years) during the last 5 years leading up to the date of sale (date of the closing), you meet the ownership test.

**The Use Test** - If your home was your residence for at least 24 of the months you owned the home during the 5 years leading up to the date of sale, you meet the residence requirement. The 24 months of residence can fall anywhere within the 5-year period. It doesn't even have to be a single block of time. All you need is a total of 24 months (730 days) of residence during the 5-year period.

**Expat Tax Tip #9** – If you do not fulfill the ownership and use tests, you still may be eligible for a partial exclusion if you can show the main reason you sold your home was because of a change in workplace location (even within the U.S.), for health reasons, or because of an unforeseeable event.
It is important to note that any exclusion afforded under U.S. tax law does not release you from your obligation to file or pay tax in your foreign country of residence. You could still end up paying tax on the gains in your country of residence while excluding all the gains from U.S. tax under the primary residence exclusion rule.

In many cases, however, the opposite tax scenario unfolds. Meaning, a U.S. expat’s country of residence will exempt the entire consideration from the sale of a primary residence, whereas the U.S. will tax the sale amount above the primary residence exclusion.

Gain realized from the sale of a personal residence in excess of the exclusion amount is subject to U.S. tax and cannot be excluded under the foreign earned income exclusion (See Section 2 of this Tax Handbook for a further description of the FEIE). However, the gain can be reduced by using foreign tax credits.

Consideration should also be given to the tax consequences associated with currency exchange differences if the real estate was bought and/or sold using foreign currency.

An important point worth noting is that under the new Net Investment Income Tax regime, gain realized from the sale of a home and which is excluded under the primary residence rule, will not be subject to the NIIT (See Section 1 of this Tax Handbook for a further description the NIIT).

Real Estate Transactions (Investment Property)

If you own business or investment property, which does not qualify for the primary residence exclusion, there are several methods for gain deferral, the most common of which is the like-kind exchange. To defer gain from a like-kind exchange, you must have exchanged investment property for investment property of a like kind. Gain from a like-kind exchange is not taxable at the time of the exchange, but rather is taxable when you sell or otherwise dispose of the property that you receive.

The Trump Tax Reform makes two significant changes to the rule allowing for the deferral of realized gain on like-kind exchanges. First, the rule is modified to allow for like-kind exchanges only with respect to real property that is not held primarily for sale. Second, real property located in the United States and real property located outside the United States are no longer considered property of a like kind.

For situations where the tax burden associated with a real estate taxation is significant enough, many U.S. expats have considered renouncing their U.S. citizenship as a potential solution. Although renouncing one’s U.S. citizenship may sound appealing, it does not come without its own set of tax considerations. For a
further discussion regarding the advantages and disadvantages of renouncing one’s U.S. citizenship, see Section 12 of this Tax Handbook.

Pensions and Social Security Benefits

Contributions to foreign pension plans generally do not qualify for the beneficial tax-deferral treatment afforded to certain U.S. pension plans under Section 401 of the Internal Revenue Code (e.g., a 401(k) plan). As such, employer contributions and plan earnings may be subject to U.S. tax on a current basis and required to be reported on the individual’s U.S. income tax return. In the case of a foreign pension plan that qualifies as an “employees’ trust” within the meaning of Section 402(b) of the Code, employer contributions are taxed currently but plan earnings may be tax deferred until retirement assuming certain conditions are met.

Example – An Australian superannuation fund is a retirement fund that is similar to a traditional 401(k) plan in the United States. However, this fund is not considered a qualified retirement plan by the IRS and, therefore, employer contributions to this fund are currently taxable in the U.S. (i.e., they’re not tax deferred until retirement). One saving grace is that any amount included in income gives the taxpayer basis in the fund, which lowers the taxable amount of the eventual distributions from the fund.

Consideration should be given to U.S. tax treaties, which can significantly modify the U.S. tax treatment. The requirements and parameters of this type of benefit can be very treaty specific. Therefore, it is best to consult a tax professional with tax treaty experience in order to best understand and benefit from the provisions of an applicable tax treaty.

Passive Foreign Investment Companies

A number of foreign investment products are classified as PFICs for U.S. federal tax purposes. Technically, a PFIC is a foreign corporation that has one of the following attributes: (i) At least 75% of its income is considered "passive" (e.g., interest, dividends, royalties), or (ii) At least 50% of its assets are passive-income producing assets.

Most foreign mutual funds fall within the definition of a PFIC. This can be the case even if such funds are held through a tax-deferred savings account (e.g., U.K. individual savings accounts (“ISAs”) and Canadian tax-free savings accounts (“TFSAs”)) or a non-qualified pension and retirement account.

PFIC investment income is generally subject to highly punitive U.S. federal tax rates. A non-deductible penalty interest charge can also compound regularly while holding an interest in a PFIC. Several elections are available to mitigate the more
onerous aspects of PFIC taxation (e.g., a so-called “QEF election” or “mark-to-market” election).

Expat Tax Tip #10 – U.S. expats considering an investment in a foreign mutual fund should proceed with caution because this type of investment is often subject to the onerous PFIC regime. With the right advice from an expat tax professional, the tax burdens associated with PFIC status can be significantly mitigated.

5. State Income Tax Filing Obligations

Generally, states impose tax only on individuals who are residents of the state. If an individual is a resident of a particular state and then moves abroad, such individual will most likely be treated as a part-year resident for the year of the move and will most likely be required to pay tax at least on the portion of income allocated to the period in which they were a resident.

However, with respect to the remainder of the year (and subsequent years), the critical question is whether such individual is still considered “domiciled” in such state under the state’s tax rules. Many people often think that if they no longer live in the state, then they’re not considered residents of the state for purposes of filing an income tax return. Although this conclusion may sound logical, it is not always correct. For example, in many states (such as California), 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.

Often, individuals may receive income from the sale of a company and such income may be paid out in installments. Meaning, a portion of their income may be placed in an escrow account and partially released each year. In these cases, issues arise when a transaction is consummated while the individual is a resident of the state and then receives future installment payments once they are no longer a resident. In this respect, it is important to note that the tax treatment of installment sales varies from state to state and is often very different from the federal income tax treatment.
6. Self-Employment Taxes

If you are a self-employed U.S. citizen or green card holder living abroad, the rules for paying self-employment tax are generally the same as for U.S. residents. The self-employment tax is a social security and Medicare tax on net earnings from self-employment. This tax applies in addition to your U.S. income tax, not in lieu of it.

You must pay self-employment tax if your net earnings from self-employment are at least $400. This is true even if one’s income amount is below the general income thresholds discussed in Section 1 of this Tax Handbook.

For 2018, the maximum amount of net earnings from self-employment that is subject to the social security portion of the tax is $128,400. All net earnings are subject to the Medicare portion of the tax. For 2018, the Social Security tax is 12.4%, and the Medicare tax is 2.9%. There is also a Medicare surtax that applies to higher income taxpayers.

You must take all of your self-employment income into account in figuring your net earnings from self-employment, even income that is exempt from income tax because of the foreign earned income exclusion.

Example – You are in business abroad as a consultant and qualify for the foreign earned income exclusion (FEIE). Your foreign earned income is $95,000, your business deductions total $27,000, and your net profit is therefore $68,000. You must pay self-employment tax on all of your net profit, including the amount you can exclude from income.

In general, a shareholder interest in a foreign corporation that generates income won’t trigger the self-employment tax. It should be noted, however, that the U.S. tax law has specific rules for defining entities for tax purposes. A particular entity may be classified as corporation in a foreign jurisdiction but may be disregarded under U.S. tax law. If such is the case, an entity’s income may be viewed for U.S. income tax purposes as the self-employment income of the entity’s owner.

In order to avoid paying self-employment taxes in both the U.S. and the foreign country, U.S. expats may be able to rely on a social security totalization agreement between the U.S. and the foreign country.

Expat Tax Tip #11 – It is often the case that the benefits of a treaty or other international agreement may not be available to avoid double taxation on self-employment income. In such case, certain other planning opportunities may be available to mitigate double taxation. An expat tax professional should be consulted with respect to such opportunities.
7. FATCA

FATCA stands for the “Foreign Account Tax Compliance Act.” FATCA is a relatively new law that was enacted in 2010 as part of the HIRE Act. The objective behind FATCA is to combat offshore tax evasion by requiring U.S. citizens to report their holdings in foreign financial accounts and their foreign assets on an annual basis to the IRS. As part of the implementation of FATCA, starting with the 2011 tax season, the IRS requires certain U.S. citizens to report the total value of their “foreign financial assets.” FATCA reporting is further discussed in Section 8 of this Tax Handbook.

In order to further enforce FATCA reporting, starting on January 1, 2014, foreign financial institutions (“FFIs”) (which include just about every foreign bank, investment house and even some foreign insurance companies) became required to report the balances in the accounts held by customers who are U.S. citizens. To date, we have seen several large foreign banks require that all U.S. citizens who maintain accounts with them provide a Form W-9 (declaring their status as U.S. citizens) and sign a waiver of confidentiality agreement whereby they allow the bank to provide information about their account to the IRS. In some cases, foreign banks have closed the accounts of U.S. expats who refuse to cooperate with these requests.

It is this renewed effort by the U.S. government to combat offshore tax evasion through FATCA that has led to a recent surge in tax compliance efforts by U.S. expats.
8. Reporting of Foreign Accounts and Assets

U.S. expats that hold accounts or assets overseas are subject to a number of specific filing requirements in the form of informational forms. Some of these forms are submitted to the IRS as attachments to the personal income tax return, while others are submitted to other governmental departments. The failure to file any of the below forms can result in severe civil penalties, such as a $10,000 penalty per form per year. Additionally, in certain extreme cases, criminal penalties, including fines and incarceration, may apply if the reporting delinquency is shown to be willful.

The following is a brief description of some of the more common informational forms that apply to U.S. expats.

Reporting to the IRS

Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations:

Certain U.S. individuals who own more than 10% of stock in a foreign corporation must include this form with their federal tax return. It is important to keep in mind that entities that are not considered corporations under foreign law may be considered corporations for U.S. tax purposes and thus may fall within the U.S. tax rules related to foreign corporations (e.g., Australian unit trusts).

There are also several other similar categories of filers that must file this form. Special attribution rules (which include attribution between spouses) may apply to expand the scope of such categories. It is important for U.S. individuals who own shares in a foreign corporation to determine if they fall into any of such categories.

In general, Form 5471 assists the IRS with gaging the scope of a U.S. taxpayer's foreign holdings that may facilitate U.S. tax deferral. The form is useful for keeping track of the earnings and profits of foreign corporations, determining whether a foreign entity is a controlled foreign corporation (“CFC”) generating so-called “subpart F income” (generally passive-type income that a 10% U.S. shareholder must include currently in gross income) or so-called “global intangible low taxed income” (a new anti-deferral concept under the Trump Tax Reform), and tracking possible IRC Section 956 inclusions (i.e., investments in U.S. property by CFCs that can trigger a current inclusion in a 10% U.S. shareholder’s gross income).

Expat Tax Tip #12 – Under the U.S. tax deferral rules, a loan from a controlled foreign corporation to a U.S. shareholder can trigger a current income inclusion for such shareholder. This and other anti-deferral rules are highly complex and require the expert analysis of an expat tax professional.
Form 8938 (FATCA Reporting), Statement of Specified Foreign Financial Assets:

If you reside outside the U.S. and have a bank account or investment account in a foreign financial institution, you are generally required to include Form 8938 with your U.S. federal income tax return if you meet the following thresholds:

- You are filing a return other than a joint return and the total value of your specified foreign assets is more than $200,000 on the last day of the tax year or more than $300,000 at any time during the year; or
- You are filing a joint return and the value of your specified foreign asset is more than $400,000 on the last day of the tax year or more than $600,000 at any time during the year.

In addition to listing the accounts and their maximum values during the tax year, the form requires the taxpayer to list income reported on the tax return relating to the accounts. Various tax items must be specified (interest, dividends, etc.), the amount reported must be provided, and the corresponding reporting on the tax return must be provided (i.e., which form and line or which schedule and line).

Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts:

Form 3520 involves perhaps the most complex information reporting of all the information returns. In brief, owners of foreign trusts must report on Form 3520 whether or not there are specific transactions during the tax year. Certain transactions between a foreign trust and a U.S. person need to be reported on Form 3520, and the trust itself may be required to file Form 3520-A.

As many foreign retirement savings plans are deemed to be custodial “grantor trusts,” this means that the plan (or its owner) may be required to file Form 3520A and contributions to the plan may be required to be reported by the person making the contribution on Form 3520. In addition, many taxpayers set up trusts as local planning tools and need to file Form 3520 as a result.

Also required to be reported on Form 3520 is the receipt of certain large gifts or bequests (more than $100,000) from a NRA or foreign estate to a U.S. person. The threshold amount is significantly lower for a gift from a foreign corporation or a foreign partnership (more than $16,111 in 2018).

Other Informational Forms

- Form 8621: must be filed by certain shareholders of passive foreign investment companies (such as foreign mutual funds)
- Form 8865: must be filed for each controlled foreign partnership in which the taxpayer is a 10% or more partner
• Form 8858: must be filed for each wholly owned foreign entity for which a "check the box" election (i.e., an entity classification election) has been made.

**Reporting to the Treasury and Commerce Departments**

**Foreign Bank and Financial Account Report**

The Foreign Bank and Financial Account Report ("FBAR") is not a tax form and it is not filed with the IRS. Instead, it is an informational report that is submitted with the Treasury Department. The IRS is responsible, however, for assessing and collecting civil penalties for FBAR delinquencies.

Any U.S. account holder (person or entity) with a financial interest in or signature authority over one or more foreign financial accounts, with more than $10,000 in aggregate value in a calendar year, must file the FBAR annually with the Treasury Department.

**Example** – Alan, a U.S. citizen, moved abroad in 2018 and opened a checking account at a local bank. During the same year, he opened a savings account at a separate local bank. He first funded the checking account with $5,000 and then funded the savings account with $6,000, the balance of which was reduced to $4,000 by year-end. Although Alan did not have any single account with $10,000 in value and although the aggregate account value of his two accounts did not exceed $10,000 at year-end, Alan would be required to file a 2018 FBAR, because during the 2018 year, the aggregate maximum account value of Alan’s two accounts was more than $10,000 (i.e., $11,000).

The FBAR due date is April 15, but with a maximum extension for a 6-month period ending on October 15.

The FBAR form (FinCEN Form 114) must be filed electronically using the BSA E-Filing System maintained by the U.S. Department of the Treasury’s Financial Crimes Enforcement Network ("FinCEN").

Further information on the FBAR can be found at the following link:

9. Due Dates

U.S. expats are generally required to file their returns by April 15 of the following year, just like U.S. residents. However, if you live outside the U.S. on April 15, you are entitled to an automatic extension (without the filing of an extension form) until June 17 (the regular June 15 due date was delayed to due falling out on a weekend in 2019).

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 15 to avoid paying interest on your late payment (late payment penalties do not commence until June 17). An automatic extension can also be filed resulting in additional time to file until October 15.

An even further extension may be granted if October 15 does not provide sufficient time to file the tax return. An Expat Tax Professional should be consulted to discuss this extension option.

Expat Tax Tip #13 – If you live outside the U.S. on April 15, you are entitled to an automatic extension until June 17. This extension applies to the filing itself, but not to the payment if tax is due.

Several options are available for making payments to the IRS. More information regarding payment options can be found at the following link:

http://www.irs.gov/Payments
10. Delinquent Taxpayers – Late Filers

Since the enactment of FATCA (See Section 7 of this Tax Handbook for an overview of FATCA), foreign banks have begun reporting the account balances of their U.S. citizen customers to the IRS (either directly or to the local tax authority that then reports the information to the IRS under an IGA). As a result, the risk of U.S. expats being detected by the IRS has increased significantly. Therefore, it is highly recommended that U.S. expats who are delinquent on their U.S. tax return filings, come forward and seek the help of a qualified tax professional in order to take advantage of the programs currently available.

U.S. expats who are delinquent on their U.S. income tax returns can face serious penalties such as: (i) failure to file penalties; (ii) failure to pay penalties; (iii) accuracy-related penalties; (iv) failure to file information return penalties; and (v) failure to file FBAR penalties. In addition, interest is applied to taxes overdue.

Expat Tax Tip #14 – Since the enactment of FATCA, U.S. expats who are delinquent in their tax filing obligations are more susceptible than ever to detection by the IRS.

The IRS currently offers the following three options for U.S. expats to address previous failures to comply with U.S. tax and information return obligations with respect to foreign investments:

(i) Streamlined Filing Compliance Procedures

The streamlined procedures can generally can be used if: (1) the taxpayer has failed to report income from a foreign financial asset and failed to pay the required tax, and may have failed to file a required FBAR; (2) the taxpayer has committed the failures due to non-willful conduct; and (3) the taxpayer is not under a civil examination or a criminal investigation by the IRS. U.S. expats are required to delinquent file tax returns, with all required information returns, for the prior 3 years, and file any delinquent FBARs for the prior 6 years.

A taxpayer who complies with these procedures will have to pay previously unpaid taxes with interest, but will not be subject to failure-to-file and failure-to-pay penalties, accuracy-related penalties, information return penalties, or FBAR penalties.

There are two types of Streamlined Procedures, one for U.S. taxpayers residing outside the United States (the “Foreign Offshore Procedures”), and the other for U.S. taxpayers residing in the United States (the “Domestic Offshore Procedures”).
The Domestic Offshore Procedures differ from the Foreign Offshore Procedures in two main ways:

1. A domestic resident taxpayer that has failed to file a U.S. income tax return in any of the three most recent tax years cannot participate in the domestic offshore procedures (while a foreign resident taxpayer that has been similarly delinquent can participate in the foreign offshore procedures).

2. Further, even if the taxpayers qualify, the domestic offshore procedures bear a 5% penalty on the highest aggregate balance/value of one’s foreign financial assets (while the foreign offshore procedures have no such penalty).

(ii) Delinquent FBAR Submission Procedures (“DFSP”)

The DFSP offers delinquent taxpayers an easy process through which they can submit missing FBARs without being subject to penalties. Under the program, one would be required to submit missing FBARs going back six years while including a brief statement explaining why the FBARs were filed late.

In order to be eligible for the program, the taxpayer would need to meet the following criteria: (1) the taxpayer is not required to submit missing or amended tax returns (because all income was properly reported on the taxpayer’s original returns); (2) the taxpayer is not under a civil examination or a criminal investigation by the IRS; and (3) the taxpayer has not already been contacted by the IRS regarding their delinquent FBARs.

Assuming the taxpayer meets the above criteria, the IRS has stated that it will not impose a penalty for failure to file the delinquent FBARs.

(iii) Delinquent International Information Return Submission Procedures

These procedures offer an easy process for those who do not need to use the Streamlined Procedures to file delinquent or amended tax returns to report and pay additional tax, but who: (1) have not filed one or more required international information returns; (2) have reasonable cause for not timely filing the information returns; (3) are not under a civil examination or a criminal investigation by the IRS; and (4) have not already been contacted by the IRS about the delinquent information returns.

Under these procedures, the taxpayer must file the delinquent information returns with a statement of all facts establishing reasonable cause for the failure to file. Assuming the taxpayer meets these criteria, the IRS will not impose a penalty for failure to file the delinquent information returns.
11. Audits

In the past, the chances of a U.S. expat being audited by the IRS were very low. However, given the high importance placed on combatting offshore tax evasion, the IRS has recently been taking a more aggressive approach to enforcing U.S. tax compliance among U.S. expats.

Typically, the audit of a U.S. expat will focus on the classic benefits claimed by expats, such as the foreign earned income exclusion and foreign tax credits. In many audits, the IRS agent will ask the taxpayer to prove his income is in fact “earned” (as opposed to passive investment income). In these cases, the taxpayer will need to provide a translated version of their foreign W-2 equivalent in order to establish their earned income. In addition, if a child tax credit is claimed, the IRS will typically request documentation supporting the claim that such children are the taxpayer’s dependent. Generally, a letter from the family doctor will suffice.

From our experience, we have seen many audits recently where the IRS has made very aggressive claims against U.S. expats. For example, in some cases, the auditor has assumed zero earned income, zero foreign tax credits and denied all dependents. Often, these audits can become very technical and complex. As such, it is highly recommended that you seek the advice of a qualified tax professional.

Expat Tax Tip #15 – Due to the highly technical and complex nature of tax audits and the associated tax issues that may be addressed, it is highly recommended that you seek the advice of a qualified tax professional in the case that the IRS seeks to audit your tax return.
12. Surrendering U.S. Citizenship and the Exit Tax

There has been a recent upsurge in U.S. expats who are surrendering their U.S. citizenships. In many cases, such individuals no longer want to deal with the seemingly complicated U.S. tax paperwork. In other cases, renouncing citizenship can be an important planning tool for U.S. expats who are trying to reduce the adverse U.S. federal income tax consequences associated with transactions abroad (e.g., real estate transactions that are exempt from tax in a foreign country but are nevertheless subject to U.S. federal income taxation).

Although renouncing one’s U.S. citizenship may sound appealing, it does not come without its own set of tax considerations. The U.S. Tax Code (under Section 877A) imposes an “exit tax” on U.S. citizens who renounce their U.S. citizenship. Under the exit tax rules, a U.S. citizen is deemed to have sold all of his assets on the day they renounce their citizenship (“mark-to-market tax”). The deemed gain is taxed in the U.S. as capital gains (the current maximum rate of which is 20%). Given the fiction behind this deemed sale, the IRS is gracious enough to allow the tax bill to be deferred until the underlying property is sold. However, deferring the tax payment will result in the imposition of interest as the need to post a “security” with the IRS as well as the waiver of any rights under an international tax treaty with respect to the deemed income.

The exit tax under Section 877A will apply, however, only if:

(i) the average annual net income tax of the individual for the period of 5 taxable years ending before the date of the loss of United States citizenship is greater than $124,000 (adjusted each year for inflation – the 2018 amount is $165,000);

(ii) the net worth of the individual as of such date is $2,000,000 or more, or

(iii) the individual fails to certify under penalties of perjury that he or she has complied with all U.S. federal tax obligations during the preceding 5 years.

The exit tax under Section 877A will also apply to green card holders who relinquish their green cards (including by taking treaty positions) if they held their green card for a period of 8 years during the last 15 years.

Expat Tax Tip #16 – Certain planning techniques are available to reduce the risk that a green card holder will be subject to the exit tax under the 8-out-of-15 year rule. For those planning to relinquish their green cards, it is best to consult an experienced expat tax professional about such tax planning techniques.