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Ten Things You Should Know About Excluding Income Earned Overseas

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The foreign earned income exclusion may not be the most widely confused provision in the behemoth that is now the Internal Revenue Code—after all, it applies only to people working overseas and companies sending workers overseas usually have an accounting firm handle U.S. and foreign tax return filings for employees, and may have a tax equalization program to ensure that employees taking foreign assignments do not end up worse off.

Nevertheless, for those who work abroad, did so within the last few years, or might do so in the future, here are 10 things you should know.

1. Benefits Are Limited To U.S. Citizens and Resident Aliens

You do not qualify unless you are a U.S. citizen or resident alien—the latter means you hold a green card. As such, you must file U.S. tax returns and report your worldwide income. But if you are living and working abroad you may be entitled to a foreign earned income exclusion (and housing benefits as well).

The maximum exclusion is adjusted annually for inflation. For 2010, you can exclude up to $91,500 from your U.S. income, a nice benefit of working overseas.

To claim the foreign earned income exclusion (or housing exclusion or deduction described in point Nos. 9 and 10 below), use Internal Revenue Service Form 2555 and attach it to your Form 1040. Some taxpayers can use a shorter Form 2555-EZ.

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

2. You Must Meet Three Basic Rules

To be entitled to this tax benefit, your ''tax home'' must be in a foreign country, you must have ''foreign earned income,'' and you must be:

- a U.S. citizen who is a bona fide resident of a foreign country for the entire year;
- a U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty, and who is a bona fide resident of a foreign country for the entire year; or
- a U.S. citizen or a U.S. resident alien who is physically present in a foreign country for at least 330 full days during any 12 consecutive months.

Each of these hurdles has traps.

3. The Income Must Be 'Earned'

Only ''earned'' income qualifies, meaning salary, wages, commissions, bonuses, professional fees, and tips. Plus, the pay must be for your foreign work only, not pay you receive for services in the United States.

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Example. You are a U.S. citizen and bona fide resident of Kazakhstan, working there all year. Your salary is $76,800 a year, plus a $6,000 cost of living allowance, and a $6,000 education allowance. Your employment contract does not state that you are entitled to these allowances only while outside the United States. You work a five-day week, and after subtracting vacation, work 240 days a year. You worked in the United States for 6 weeks (30 workdays). To figure your pay for work done in the United States, take the number of days

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worked in the United States (30) ÷ number of days paid (240) x total income ($88,800) = $11,100. Your U.S. source earned income is $11,100, and that amount does not qualify for the exclusion. The rest of your pay does.

4. You Forgo the Foreign Tax Credit

If you claim the foreign earned income exclusion, you cannot claim a foreign tax credit (or deduction) on the same income, even though you may be paying foreign taxes on it. In fact, if you claim a foreign tax credit or deduction for foreign taxes on the excluded income, the foreign earned income exclusion may be considered revoked.

How do you decide whether you get more mileage out of the exclusion or credit? You should crunch the numbers both ways, but here is a guide:

- If you pay no foreign tax, claim the foreign earned income exclusion.
- If your foreign tax rate is lower than your U.S. rate, you should usually claim the exclusion.
- If your foreign tax rate is higher than your U.S. rate, you should probably claim the foreign tax credit instead.

5. Bona Fide Residence And 'Home' Versus 'Abode'

You must meet either a bona fide residence or physical presence test (see point Nos. 7 and 8 for physical presence). You can only claim you are a bona fide resident in your ''tax home'' throughout the year. Your tax home is your main place of business, employment, or post of duty, regardless of where you maintain your family home.

If you do not have a main place of business (maybe you are on the road most of the time or work out of your apartment), your tax home may be the place you regularly live.

If your ''abode'' is in the United States, you cannot have a tax home in a foreign country. Your ''abode'' is your home, residence, domicile, or place of dwelling.

''Abode'' has a domestic meaning, unlike your ''tax home'' where you do business. Your abode depends on where you maintain economic, family, and personal ties.

Example 1. You work on an offshore oil rig in the territorial waters of Nigeria and work 28 days on, 28 days off. You return to your family residence in the United States during your off periods. Your abode is in the United States, so you cannot claim the foreign earned income exclusion.

Example 2. You work for a manufacturer in Ohio. Your employer transfers you to London for at least 18 months. You distribute business cards showing your business and home address in London, rent your Ohio home, and put your car in storage. You move your family, furniture, and pets to a home your employer rents for you in London. You lease a car and get a British driving license, open London bank accounts, join a local business league, etc. Your abode and tax home are both in London.

6. Your Assignment Cannot Be 'Temporary'

The location of your tax home depends on whether your assignment is temporary or indefinite. In this context, ''temporary'' is bad: If you are ''temporarily'' absent from your tax home in the United States, you do not qualify for the foreign earned income exclusion. If your work assignment abroad is ''indefinite,'' your new place of employment becomes your tax home, allowing a foreign earned income exclusion. But expectations change.

If you expect your employment abroad to last one year or less (and it does) it is likely ''temporary.'' If you expect it to last more than a year, it is ''indefinite.'' If you expect it to last for a year or less, but later revise your expectations to more than a year, it becomes indefinite.

7. You Might Still Qualify Based on Physical Presence

Up to now you might be wondering if all of this is worth the effort. Fortunately, even if you are not a bona fide resident of a foreign country, you can still qualify for the exclusion if you meet the physical presence test. You must be physically present in a foreign country for 330 full days during 12 consecutive months. A full day is 24 consecutive hours beginning at midnight. You can count days you spent abroad for any reason, even days on vacation!

Notably, the 330 days do not have to be consecutive. They are based purely on length of stay, not what kind of residence you establish, your intentions about returning, or the nature or purpose of your stay abroad.

If you have fewer than 330 days abroad even for good reasons—illness, family problems, vacation back in the United States, or your employer's orders—that is tough. The only exception is if you fall below the 330 days because war or civil unrest requires you to leave the country.

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8. Travel Days Do Not Count

When you leave the United States to go directly to a foreign country or when you return directly to the United States from a foreign country, the time you spend over international waters does not count toward your 330-day total.

Example. You fly from the United States to France on June 10, arriving in France at 9 a.m. June 11. Your first full day of physical presence in France is June 12. But if you passed over a foreign country before midnight the day you left the United States, you can count June 11 toward the 330-day total.

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9. You Might Be Entitled To Housing Costs Too

In addition to the foreign earned income exclusion, you can claim an exclusion or deduction for housing. The housing exclusion applies to amounts you receive from your employer, while the deduction applies to amounts you pay with self-employment earnings. Your housing exclusion/deduction is your total housing expenses (subject to limits—see point No. 10) minus a base housing amount.

The base housing amount is 16 percent of the $91,500 exclusion, multiplied by the number of days you qualify. Sixteen percent of $91,500 is $14,640, or $40.11 per day. Multiply $40.11 by the number of days and subtract it from your total housing expenses to find your housing amount. However, you must reduce your housing amount by any U.S. government (or similar nontaxable) allowance you receive to compensate you for housing expenses.

10. What Qualifies as Housing Expenses?

Housing expenses include reasonable expenses for housing in a foreign country for you, your spouse, and dependents who live with you.

You can only count housing expenses for the part of the year you qualify for the foreign earned income exclusion, and only up to a limit generally equal to 30 percent of the maximum foreign earned income exclusion. For 2010, this means an annual limit of $27,450, or about $75.21 per day. However, the actual limit may be higher depending on the location of your foreign tax home.

Housing expenses include:

- rent;
- the fair rental value of housing provided in kind by your employer;
- repairs;
- utilities (but not telephone charges);
- insurance;
- nondeductible occupancy taxes;
- nonrefundable fees to secure a leasehold;
- furniture rental; and
- residential parking.

Housing expenses do not include:

- lavish or extravagant expenses;
- deductible interest and taxes;
- costs of buying property, including principal payments on a mortgage;
- costs of maids, nannies, gardeners, etc.;
- pay television subscriptions;
- improvements that increase the value or prolong the life of property;
- purchased furniture; or
- depreciation or amortization of property or improvements.

Conclusion

If you work abroad, you probably have a tax adviser who keeps these rules straight. Nevertheless, you should understand the basic mechanics and calculations, particularly since you can influence some of these rules. For more information about the foreign earned income exclusion see Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*, and the instructions for Form 2555 or Form 2555-EZ. Forms and publications are available at http://www.irs.gov.