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Foreign Earned Income Exclusion



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Foreign Earned Income Exclusion



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Foreign Earned Income Exclusion

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The information contained in this presentation is current as of the date it was presented. It should not be considered official guidance.

Objectives

- Define foreign earned income
- Explain the concept of tax home for foreign earned income exclusion
- Summarize the bona fide residence and physical presence tests
- Specify the effect of the foreign earned income exclusion on other credits and deductions

Foreign Earned Income Exclusion

- Available to U.S. citizens and resident aliens who live and work in a foreign country and meet the requirements.
- Not available to nonresident aliens.
- You claim it on Form 2555/2555-EZ.
- The exclusion amount is indexed annually for inflation.
- You may also be able to exclude (if an employee) or deduct (if self-employed) the cost of foreign housing.

Foreign Housing Costs

In addition to the foreign earned income exclusion you may be able to take a:

- Foreign housing exclusion (if an employee)
or
- Foreign housing deduction (if self-employed)

Note: Complete Part VI of Form 2555 to claim the foreign housing exclusion or deduction.



Foreign Earned Income Exclusion Requirements

To claim the foreign earned income exclusion, foreign housing exclusion, or foreign housing deduction, you must:

- have foreign earned income, and
- have a foreign tax home, and
- meet either the Bona Fide Residence Test or the Physical Presence Test, and
- make a valid election.



Polling Question

Which of the following is a requirement for an individual to claim the FEIE?

- a. The individual must pay foreign taxes on income earned outside the United States
- b. The individual must meet either the Bona Fide Residence Test or the Physical Presence Test
- c. The individual must be in a foreign country for at least 6 months during the year
- d. The individual cannot travel to the United States during the tax year



What Is Foreign Earned Income?

- Income for services performed in a foreign country
- What matters is where the services were performed, not when or where the income was received.



What Is Foreign Earned Income?

- If you are an employee:
 - Wages and salaries
 - Commissions
 - Bonuses
 - Tips
 - Allowances
 - Reimbursements
 - Other compensation
 - Noncash income such as lodging and meals



What Is Foreign Earned Income?

- If you are self-employed:
 - Professional fees
 - If capital is a material income producing factor, a reasonable allowance for compensation (but no more than 30% of net profits)



What Is Not Foreign Earned Income?

- Income paid by the United States or its agencies to government employees or to members of the U.S. armed forces, even if earned in a foreign country
- Income earned in a U.S. territory
- Income earned in Antarctica
- Income earned in international waters or airspace



What Is Not Foreign Earned Income?

- Pensions, annuities or social security benefits
- Value of meals and lodging furnished for convenience of employer
- Payment received after the end of the tax year following the tax year in which you performed the services that gave rise to the payment



Foreign Tax Home Requirement

- Your regular or main place of business, employment or post of duty must be in a foreign country or countries, and
- Your abode cannot be in the United States during the same period, unless – for tax years beginning after 12/31/17 – you were serving in support of the Armed Forces of the United States in an area designated as a combat zone.
- You can only have one tax home at any given time.



Location of Ties Determines Abode

- **Economic ties**, such as:
 - Locations of bank accounts
 - Locations of real and personal property owned
 - In some cases, whether “excess housing costs” were incurred



Location of Ties Determines Abode

- **Familial ties**, such as:
 - Location of immediate family (spouse, children, parents)
 - Cultural background



Location of Ties Determines Abode

- **Personal ties**, such as:
 - Jurisdiction in which the individual voted / held driver's license
 - Location of place of worship / social activities
 - Familiarity with language / extent of integration into the foreign culture



Bona Fide Residence Test

- You must be either:
 - a U.S. citizen, or
 - a U.S. resident alien who is a citizen or national of a country with which the U.S. has an income tax treaty in effect.
- You must be a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year (except for brief temporary visits to U.S. or elsewhere).



Bona Fide Residence Test: Factors to Consider

- Intent
- Establishment of home temporarily in the foreign country for an indefinite period
- Extent of assimilation into life and society of foreign country



Bona Fide Residence Test: Factors to Consider (cont'd)

- Physical presence in foreign country
- Nature, extent and reasons for temporary absences
- Whether paid taxes to foreign country
- Whether spouse and children also resided in the foreign country



Bona Fide Residence Test: Factors to Consider (cont'd)

- You are not considered a bona fide resident of a foreign country if
 - you submitted a statement to the authorities of that country claiming to be a nonresident of that country, and either
 - your income is not subject to tax in that country because you are a nonresident of that country, or
 - such a determination not yet been resolved.



Bona Fide Residence Test: Factors to Consider (cont'd)

- An income tax exemption provided in a treaty or other international agreement is not considered a statement of non-residency.



Physical Presence Test

- You must be physically present in a foreign country(s) for 330 full days during a period of 12 consecutive months.
- The 12-month period may begin with any day.
- The 330 days do not have to be consecutive, as long as they fall within a period of 12 consecutive months.



Physical Presence Test (cont'd)

- The number of qualifying days is based on the total number of days during the year in question that fall within your chosen 12-month measurement period.
- Presence in a foreign country or countries need not be for business. Days spent on vacation (or for any other purpose) in a foreign country are also counted, so long as your tax home is still in a foreign country.



Physical Presence Test: Number of Qualifying Days

- The 12-month period may begin before or after arrival in a foreign country, end before or after departure from a foreign country, and include days when you do not have a tax home in a foreign country.
- You may maximize the number of qualifying days in the tax year by sliding a 12-month period forward or backward up to 35 days, so long as it still contains 330 full days of presence in a foreign country or countries.



Physical Presence Test: Number of Qualifying Days (cont'd)

- Also, 12-month qualifying periods may overlap. Count each day in a given tax year only once, even if it falls within more than one qualifying period.



Waiver of Time Requirements

- The minimum time requirements can be waived if an individual must leave a foreign country because of war, civil unrest, or other adverse conditions.
- A list of countries which qualify for the waiver, and the departure dates, is published in an Internal Revenue Bulletin.



Polling Question

An individual moved to a foreign country in November of 2017 and had to leave in July of 2018 because the employer went out of business. Is this a situation that qualifies for a waiver?

- a. Yes
- b. No



Waiver of Time Requirements (cont'd)

You **must show that:**

- you had a tax home in the foreign country, and
- on or before the beginning date of the waiver, you reasonably could have been expected to meet the time requirements as a bona fide resident or under the physical presence test except for the adverse conditions.



Filing Requirements

- You must file a return even if you have no tax liability after claiming the exclusion.
- File Form 2555 or 2555-EZ with your U.S. Income Tax Return (Form 1040).



Polling Question

An individual must file a return even if there is no tax liability after claiming the foreign earned income exclusion.

- a. True
- b. False



Making a Valid IRC § 911 Election

- The election to exclude foreign earned income and the election to exclude the cost of foreign housing are separate elections.
- You may make one or both elections by attaching Form 2555/2555 EZ to tax return for the first year for which it is effective.



Making a Valid IRC § 911 Election

- Generally, the election(s) must be made with a:
 - Timely filed return (including any extensions),
 - Return amending a timely filed return during the claim period under IRC § 6511(a), or
 - Late-filed return within one year from the original due date of the return (without regard to extensions)



2018 Maximum Foreign Earned Income Exclusion

- If you qualify, you could exclude the lesser of:
 - \$103,900 (adjusted annually)
 - or
 - Your foreign earned income for 2018 minus your foreign housing exclusion, if any
- If your qualifying period is less than a year, the limitation amount must be prorated – qualifying days in tax year divided by 365 (366, if leap year), multiplied by exclusion amount



Effect on Credits or Deductions

- Cannot take foreign tax credit or deduction for taxes on the excluded income
- Not eligible for certain credits (such as the Earned Income Credit and the Additional Child Tax Credit)
- Must add back the excluded amount when computing modified adjusted gross income for some purposes



Exclusion Amount

Foreign earned income excluded
Minus deductions allowed in figuring AGI
allocable to the excluded income
Equals Schedule 1 (Form 1040), Line 21
Exclusion Amount



Foreign Housing Deduction

Lesser of :
Foreign Housing Cost Amount*
or:
Foreign earned income minus foreign earned
income exclusion minus foreign housing
exclusion, if any

* See the Form 2555 Instructions.



Sole Proprietor

In order to compute FEIE, one must determine:

- Foreign earned gross receipts
- Expenses definitely related to the foreign earned gross receipts
- The deduction for ½ self-employment tax



Sole Proprietor Example

Service Business – all business is foreign source:

Schedule C Gross Receipts	\$150,000
Schedule C Expenses	<u>50,000</u>
Schedule C Net Income	\$100,000
Self-Employment (SE) Tax	\$14,130
Deduction for ½ SE Tax	\$7,065



Sole Proprietor Example (cont'd)

Expenses Allocable to Excluded Income:

Schedule C Expenses	\$50,000
Plus Deduction for ½ SE Tax	<u>7,065</u>
	\$57,065

Multiplied by the ratio of Excluded
Gross Income to Total Gross Income:

$$\$57,065 \times (\$103,900/\$150,000) = \textbf{\$39,527}$$

The \$39,527 goes on Line 44 of Form 2555.



Sole Proprietor Example (cont'd)

Foreign earned income excluded on
Line 42 of the Form 2555: \$103,900

Minus expenses allocable to excluded
income (Line 44 of Form 2555): - 39,527

Equals amount to be included in
reductions to total income on Schedule 1
(Form 1040), Line 21, with notation
"Form 2555":

\$64,373



Claiming the Exclusion

- Both spouses may claim a foreign earned income exclusion and/or a housing exclusion/deduction, as long as each spouse meets the requirements.
- A separate Form 2555 or 2555-EZ must be filed for each spouse. credit



Polling Question

If both spouses work abroad and each spouse meets all of the requirements, together they can exclude as much as \$207,800.

- a. True
- b. False



Which Form – 2555 or 2555-EZ?

- You may use Form 2555-EZ if all these apply:
 - U.S. citizen or resident alien
 - Earned wages/salaries in foreign country
 - Total foreign earned income less than \$103,900
 - Reported total foreign earned income on Line 1 of your 2018 Form 1040



Which Form – 2555 or 2555-EZ? (cont'd)

- Filing calendar year return for 12-month period
- No self-employment income
- No business or moving expenses
- No foreign housing exclusion or deduction
- No foreign housing deduction carryover



Completing Form 2555-EZ

- Part I – Tests to See if You Can Take the Foreign Earned Income Exclusion
 - Bona Fide Residence Test
 - Physical Presence Test
 - Tax Home Test
- Part II – General Information
- Part III – Days Present in the United States
- Part IV – Figuring Your Foreign Earned Income Exclusion



Completing Form 2555

- Part I – General Information
- Part II – Bona Fide Residence Test
- Part III – Physical Presence Test
- Part IV – Total Foreign Earned Income
- Part V – Housing Exclusion or Deduction?



Completing Form 2555 (cont'd)

- Part VI – Housing Expenses
Calculating Housing Exclusion
- Part VII – Foreign Earned Income Exclusion
- Part VIII – Less Deductions Allocable to Excluded Income
- Part IX – Calculating Housing Deduction



Figuring Tax on Income Not Excluded

- Use the tax rates that would have applied if you had not claimed the exclusion(s).
- See instructions for Form 1040 and complete the Foreign Earned Income Tax Worksheet.
- If you must attach Form 6251, Alternative Minimum Tax—Individuals, use the worksheet in the Form 6251 instructions.



Paper Forms and Free File

- Form 2555, *Foreign Earned Income*, and its instructions
- Form 2555-EZ, *Foreign Earned Income*, and its instructions
- <https://www.irs.gov/uac/free-file-do-your-federal-taxes-for-free>



Resources

- Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*
- <https://www.irs.gov/Individuals/International-Taxpayers/Foreign-Earned-Income-Exclusion>
- Taxpayer Assistance: 1-800-829-1040
- Taxpayer Assistance Outside the United States: 00-1-267-941-1000



Practice Units

Available at:
<https://www.irs.gov/businesses/corporations/practice-units>

- Tax Home for Purposes of IRC Section 911
- Physical Presence Test for Purposes of Qualifying for IRC 911 Tax Benefits
- Bona Fide Residence Test for Purposes of Qualifying for IRC 911 Tax Benefits



Practice Units (cont'd)

- Calculating the Foreign Earned Income Exclusion – Employee
- Calculating the Foreign Earned Income Exclusion – Self-Employed Individual
- Calculating the Foreign Earned Income Exclusion – Partner in a Partnership with Foreign Earned Income



Practice Units (cont'd)

- IRC 911 Election and Revocation
- Foreign Housing Exclusion
- Foreign Housing Deduction



Key Points

- You must file a tax return to claim the foreign earned income exclusion, even if your foreign earnings are below the foreign earned income exclusion threshold.
- You are not considered to have a tax home in a foreign country for any period in which your abode is in the U.S. unless, for tax years beginning after 12/31/17, you were serving in support of the U.S. Armed Forces in a designated combat zone.



Key Points

- Your abode is the location where your economic, familial and personal ties are strongest.
- Once you choose to exclude foreign earned income, you cannot take a foreign tax credit or deduction for taxes on income you can exclude.



Key Points

- If you claim the foreign earned income exclusion, the housing exclusion, or both, you must figure the tax on your non-excluded income using the tax rates that would have applied had you not claimed the exclusions.



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