Working Abroad Can Yield Tax-Free Income

Article Highlights:

- Tax-Free Income from Working Abroad
- Foreign Earned Income & Housing Exclusions
- Foreign Self-Employment Income
- Claiming or Revoking the Exclusion

U.S. citizens and resident aliens are taxed on their worldwide income, whether the person lives inside or outside of the U.S. However, qualifying U.S. citizens and resident aliens who live and work abroad may be able to exclude from their income all or part of their foreign salary or wages, or amounts received as compensation for their personal services. In addition, they may also qualify to exclude or deduct certain foreign housing costs.

To qualify for the foreign earned income exclusion, a U.S. citizen or resident alien must:

- Have foreign earned income (income received for working in a foreign country);
- Have a tax home in a foreign country; and
- Meet either the bona fide residence test or the physical presence test.

The foreign earned income exclusion amount is adjusted annually for inflation. For 2015, the maximum foreign earned income exclusion is up to $100,800 per qualifying person. If taxpayers are married and both spouses (1) work abroad and (2) meet either the bona fide residence test or the physical presence test, each one can choose the foreign earned income exclusion. Together, they can exclude as much as $201,600 for the 2015 tax year, but if one spouse uses less than 100% of his or her exclusion, the unused amount cannot be transferred to the other spouse.

In addition to the foreign earned income exclusion, qualifying individuals may also choose to exclude or deduct from their foreign earned income a foreign housing amount. The amount of qualified housing expenses eligible for the housing exclusion and housing deduction is limited, generally, to 30% of the maximum foreign earned income exclusion. For 2015, the housing amount limitation is $30,240 for the tax year. However, the limit will vary depending on where the qualifying individual's foreign tax home is located and the number of qualifying days in the tax year. The foreign earned income exclusion is limited to the actual foreign earned income minus the foreign housing exclusion. Therefore, to exclude a foreign housing amount, the qualifying individual must first figure the foreign housing exclusion before determining the amount for the foreign earned income exclusion.

Before you become overly excited, foreign earned income does not include the following amounts:

- Pay received as a military or civilian employee of the U.S. Government or any of its agencies.
- Pay for services conducted in international waters (not a foreign country).
- Pay in specific combat zones, as designated by a Presidential Executive Order, that is excludable from income.
- Payments received after the end of the tax year following the year in which the services that earned the income were performed.

- The value of meals and lodging that are excluded from income because it was furnished for the convenience of the employer.
- Pension or annuity payments, including social security benefits.

A qualifying individual may also claim the foreign earned income exclusion on foreign earned self-employment income. The excluded amount will reduce his regular income tax, but will not reduce his self-employment tax. Also, the foreign housing deduction—instead of a foreign housing exclusion—may be claimed.

A qualifying individual claiming the foreign earned income exclusion, the housing exclusion, or both, must figure the tax on the remaining non-excluded income using the tax rates that would have applied had the individual not claimed the exclusions. In other words, the exclusion is off-the-bottom, not off-the-top.

Once the foreign earned income exclusion is chosen, a foreign tax credit, or deduction for taxes, cannot be claimed on the income that can be excluded. If a foreign tax credit or tax deduction is claimed for any of the foreign taxes on the excluded income, the foreign earned income exclusion may be considered revoked.

Other issues:

Earned income credit - Once the foreign earned income exclusion is claimed, the earned income credit cannot be claimed for that year.

Timing of election - Generally, a qualifying individual's initial choice of the foreign earned income exclusion must be made with one of the following income tax returns:

- A return filed by the due date (including any extensions);
- A return amending a timely-filed return;
- Amended returns generally must be filed by the later of 3 years after the filing date of the original return or 2 years after the tax is paid; or
- A return filed within 1 year from the original due date of the return (determined without regard to any extensions).

A qualifying individual can revoke an election to claim the foreign earned income exclusion for any year. This is done by attaching a statement to the tax return revoking one or more previously made choices. The statement must specify which choice(s) are being revoked, as the election to exclude foreign earned income and the election to exclude foreign housing amounts must be revoked separately. If an election is revoked, and within 5 years the qualifying individual wishes to again choose the same exclusion, he must apply for approval by requesting a ruling from the IRS.

Are you looking for foreign employment or has an opportunity already presented itself to you? Before you make your final decision, please call our office to learn more about the foreign earned income and housing allowance exclusions, or how to meet the bona fide residence or physical presence tests.