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INTERNATIONAL EXECUTIVE SERVICES

# U.S. Taxation of Americans Abroad

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# U.S. Taxation of Americans Abroad

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*The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.*

This booklet is a general guide to help U.S. citizens and resident aliens who live or work abroad to understand their U.S. income tax obligations.

U.S. tax rules are continually changing as a result of new legislation, judicial decisions, and administrative pronouncements. Many of the rules are complex and exceptions exist. This booklet reflects the U.S. income tax law (Internal Revenue Code as amended to date) as it applies to taxable years ending on or before December 31, 2010.

Providing U.S. tax services to U.S. citizens and resident aliens working abroad is an important part of our U.S. tax practice in the United States and in select jurisdictions overseas. For further information, please contact any of our International Executive Services (IES) practice offices in the United States listed in Appendix D of this publication.



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Our companion booklet, *U.S. Taxation of Foreign Citizens*, which deals with the U.S. taxation of foreign citizens working or living in the United States, is also available online or from your local KPMG IES contact.

KPMG LLP

August 2011



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## Chapter 1 – Taxation of Foreign Earnings and the Foreign Exclusions

Qualifying U.S. citizens and residents working outside the United States are permitted to elect to exclude a portion of their foreign earned income under Internal Revenue Code (I.R.C.) section 911. The general exclusion of foreign earned income is USD 91,500 for 2010 and USD 92,900 for 2011, and is indexed annually for inflation. In addition to (or in lieu of) the foreign earned income exclusion, qualifying individuals may elect to exclude from income (or, in the case of self-employed individuals, take as a deduction) a housing cost amount based on the individual's housing expenses.

### Qualifying for Exclusions

To qualify for the foreign earned income and housing cost exclusions, an individual must have foreign earned income, his or her tax home must be in a foreign country, and he or she must meet either of two tests:

- The bona fide residence test, which requires the individual to be a bona fide resident of a foreign country or countries for an uninterrupted period that includes a full tax year; or

- The physical presence test, which requires the individual to be present in a foreign country or countries at least 330 full days during any period of 12 consecutive months.

A U.S. citizen may qualify under either the bona fide residence or physical presence tests. A U.S. resident alien (i.e., greencard holder) working abroad can qualify under the physical presence test, and in certain limited cases, tax treaty non-discrimination rules may permit qualification under the bona fide residence test.

Other criteria for qualification are reviewed in detail below.

In general, income earned by U.S. citizens and residents working for the U.S. federal government, or working in Puerto Rico or the U.S. possessions, is not eligible for the exclusions under section 911. Such earned income may be eligible for other tax benefits, the discussion of which is beyond the scope of this publication.



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### *Bona Fide Residence Test*

Bona fide residence is determined based on a subjective review of individual facts and circumstances, including the nature of the international assignment and the length of stay in the foreign country. Foreign residence may be established even though the assignee will return to the United States when the work assignment is over. Bona fide residence is not the same as domicile, which is normally the individual's permanent home to which he or she eventually plans to return.

Generally, an employer can establish that an assignee is a bona fide resident of a foreign country if the move includes the assignee's family and if they intend to make the foreign country their home. The test of bona fide residence is primarily a factual one, requiring an analysis of all relevant facts and circumstances. Factors that might indicate that an assignee is a bona fide resident include:

- Acquisition of a home or long-term lease in the foreign country;
- Intent to become involved in the social life and culture of the foreign country; and
- The nature of any conditions or limitations concerning the employment agreement, as well as the type and term of the visa or residence permit.

Once residence is established, the individual must be a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire U.S. taxable year (normally the calendar year) to meet this test. An individual may move from one foreign country to another, or make temporary visits to the United States or elsewhere, without interfering with this test period, so long as he or she does not interrupt the qualifying period with an interval of U.S. residence.

It should be noted that taking inconsistent positions on residency for U.S. and foreign tax purposes can jeopardize the availability of the exclusions. If an individual submits a statement to the tax authorities of a foreign country claiming to be a nonresident of such country, and as a result is not taxed as a resident of that country, he or she is prohibited from qualifying under the bona fide residence test.

Comment:

Once an individual has been a bona fide resident for a full tax year, any part of a continuous bona fide residence period before or afterward will qualify under the



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test. Thus, in a year of transition to or from a foreign country, an individual may qualify under the test for a partial year, so long as his or her partial year of bona fide residence is followed or preceded by a period that includes a full tax year. For 2011, as the maximum foreign earned income general exclusion is USD 92,900, each day of qualification in a partial year would generate maximum exclusion of USD 254.52 per day (USD 92,900/365), plus the housing exclusion or deduction, if applicable.

*Example 1*

An individual moves from the United States to London, England and establishes bona fide residence there on August 1, 2011. Assuming the other requirements are met, he will qualify as a bona fide resident after December 31, 2012 (when he has been a resident of the United Kingdom for a full calendar year). As a result, he will qualify for the foreign earned income exclusion for all of 2012 and a prorated part of 2011, commencing with his date of arrival. His maximum exclusion (before taking into consideration the exclusion for housing costs) for 2011 would be USD 38,942 (153 days x USD 254.52).

### *Physical Presence Test*

This test requires that an assignee be physically present in a foreign country or countries for 330 full days during any consecutive 12-month period and that the assignee's tax home be in a foreign country or countries throughout the 330 full days of presence. This test is purely objective and requires counting only the qualifying days. No intention as to residence or any other factors need be considered.

Any period of 12 consecutive months may be used to determine eligibility under the physical presence test. The months need not be full calendar months, as long as they are consecutive. Two or more overlapping 12-month periods may be used in a single tax year to gain additional exclusion. For purposes of determining the number of eligible days, a full day is a 24-hour period commencing at midnight; thus, if a taxpayer is in the United States for part of a day, it will not qualify. Travel over international waters does not constitute presence in a foreign country for purposes of the test. However, if the travel is between two foreign points, the period of foreign physical presence is not interrupted if the travel over international waters or in the United States is for less than 24 hours.



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The 12-month period does not necessarily begin with the first qualifying day in a foreign country, nor does it necessarily end with the day of departure from a foreign country. It also is not required that it start on the first day of a month – any 365-day period is permissible. The 12-month period should be selected carefully to allow the largest exclusion. To determine the maximum exclusion for the year of one's move abroad, count forward 330 qualified foreign days after departure and then count backward 12 months from the 330th qualifying day to find the first day of the qualifying period. This can result in the qualifying period beginning as much as 35 days prior to leaving the United States if no subsequent U.S. visits are made, thereby providing an additional USD 8,908 (35 days x USD 254.52) of potential exclusion. The qualifying period in such case may begin before a foreign tax home is established, but the exclusion can be used only against foreign earned income, which by definition can be earned only while a foreign tax home exists.

*Example 2*
Julie, a U.S. citizen, begins her international assignment in Kazakhstan on March 1, 2011. She does not return to the U.S. for any reason after beginning her assignment. Her 330th day abroad is therefore January 24, 2012. Julie's qualifying period for 2011 applying the physical presence test, then, is the earliest possible 12-month period that contains 330 days abroad. Such a period begins on January 25, 2011. Her qualifying period contains 341 days, resulting in a pro-rated exclusion of USD 86,791 (341 days x USD 254.52). However, if Julie chose instead to apply the bona fide residence test in 2010, her qualifying period would begin on her first day of residence abroad, March 1, resulting in a smaller pro-rata exclusion for the year of USD 77,883 (306 days x USD 254.52).

*Note*: Income eligible for exclusion would include only that which was earned from March 1, 2011, since prior to that date, the individual's tax home was not in a foreign country.

Comment:
A taxpayer who qualifies under both the bona fide residence test and the physical presence test may use whichever test allows the taxpayer the larger exclusion. As demonstrated in the preceding example, the physical presence test might be preferable in the year of one's move abroad (and in the year of departure from a



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foreign country) because a larger exclusion may be obtained if little time is spent in the United States in the succeeding (or preceding) 12-month period.

### *Exceptions to Minimum Time Requirements*

An individual whose tax home is in a foreign country can waive the minimum time requirement of the bona fide residence and physical presence tests if he or she was forced to leave the foreign country because of war, civil unrest, or similar adverse conditions in that country (as determined by the U.S. Treasury Department). The time requirements are waived if these conditions are present and if the individual is prevented from conducting business due to such conditions. The individual must also establish that the minimum requirements of either test would have been met if he or she had not been forced to leave. A list of designated countries, and the periods for which the waiver applies, can be found in the instructions to IRS Form 2555. For purposes of calculating the foreign earned income exclusion and the base housing cost amount exclusion, however, a person will be treated as a qualified individual only for the *actual* period of residence.

### *Foreign Tax Home*

To qualify for the foreign earned income or housing cost exclusion, the individual's tax home must be in a foreign country throughout his or her period of residence or physical presence. However, an individual shall not be considered as having a tax home in a foreign country for any period during which his or her abode is in the United States. The term "tax home" generally means the location of a taxpayer's regular or principal place of business. Temporary presence or the maintenance of a dwelling in the United States does not necessarily mean that the individual's tax home is in the United States. This holds true regardless of whether this dwelling is used by the individual's spouse and dependents.

The Internal Revenue Service (IRS) has issued a ruling[1] which establishes guidelines for determining whether a work assignment away from the taxpayer's regular place of employment is temporary (so that his or her tax home is maintained) or is indefinite (so that the old tax home is relinquished). Under these guidelines, a taxpayer with an expected or actual assignment exceeding one year in a single location will be considered to have relinquished his or her old tax home. If

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[1] Rev. Rul. 93-86.



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the taxpayer realistically expects the employment away from home to last for one year or less, the employment is considered temporary.

Other guidelines[2] establish three factors for determining the taxpayer's place of abode, which is important for determining a tax home. These factors involve the following:

- Whether the individual's family accompanied him or her to the new location;
- Whether the individual was duplicating living expenses by maintaining his or her prior home; and
- Whether there was a preponderance of business contacts in the new location.

Although these guidelines do not deal specifically with a move abroad or with section 911 and do not reflect the current one-year statutory limitation on the deduction of travel expenses, they are useful for illustrating the principles generally followed by the IRS in determining one's tax home.

Comment:
It is imperative for individuals to document factors that indicate their intention to establish a tax home in the foreign country at the time of their moves abroad. The IRS may not consider temporary assignments abroad as grounds for establishing a tax home, even though the physical presence test may be met. However, individuals satisfying the bona fide residence test should be able to establish the foreign country as their tax home.

## Foreign Earned Income and Foreign Housing Cost Exclusions

Once an individual establishes a foreign tax home and qualifies under either the bona fide residence or physical presence tests, he or she is allowed to elect either or both of the annual foreign exclusions: the foreign earned income and housing cost exclusions.

As illustrated in the previous examples, the foreign earned income exclusion is computed on a daily basis for each qualifying day during either the bona fide residence period or the 12-month physical presence period.

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[2] Rev. Rul. 73-529.



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If less than the maximum available exclusion is used in a particular year, the remaining portion may be used against income that is attributable to services performed in that year (such as a bonus or tax equalization payment) but which is received in the following year (but not later).

In addition to (or in lieu of) the foreign earned income exclusion, qualified individuals may elect to exclude from income (or, in the case of self-employed individuals, take as a deduction) a housing cost amount based on the individual's housing expenses.  The housing cost amount exclusion applies to amounts considered paid for with employer-provided amounts. The housing cost amount deduction applies to amounts paid for with self-employment earnings (see separate section).

Housing expenses eligible for the exclusion are the reasonable expenses paid during the year by, or on behalf of, an individual for housing in a foreign country for that individual, his/her spouse, and dependents who live with them. Housing expenses include rent, utilities (other than telephone charges and cable television subscription fees), insurance, certain occupancy taxes, non-refundable fees paid for securing a leasehold, rental of furniture and accessories, non-capital household repairs, and automobile parking costs. Capital expenditures, the cost of purchasing furniture, and domestic labor do not qualify as housing expenses, nor do items such as mortgage interest and taxes that are otherwise deductible. Eligible housing costs do not include those that are "lavish or extravagant under the circumstances" (section 911 (c)(3)(A)).

The excludible housing cost amount is the individual's actual foreign housing expenses that exceed a base amount equal to 16 percent of the maximum foreign earned income exclusion, or USD 14,640 for 2010 and USD 14,864 for 2011. The housing cost amount is subject to a maximum calculated as 30 percent of the foreign earned income exclusion, or USD 27,450 in 2010 and USD 27,870 in 2011. Therefore, the maximum housing cost exclusion is USD 12,810 for 2010 and USD 13,006 for 2011.  This is calculated by subtracting the maximum amount from the base housing amount (USD 27,870 maximum less USD 14,864 base for 2011). In a partial year abroad, these percentage limitations are computed on a daily basis based on the number of qualifying days.



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However, in certain prescribed high-cost locations, the housing cost limitation is increased. Only specific locations on a list issued annually by the U.S. Treasury are afforded this special treatment. For example, the housing cost limitation for Tokyo, Japan (the highest amount on the list) for 2011 is USD 118,500 – resulting in a maximum potential housing cost exclusion of USD 103,636 (USD 118,500 less the USD 14,864 base amount).

The complete list of increased housing cost limitations is found in the instructions to IRS Form 2555.[3]

If elected, the housing exclusion is always claimed first, before the foreign earned income exclusion. As with the foreign earned income exclusion, any unused housing exclusion in a particular year may be used against income related to that year if it is received before the end of the following year. However, this rarely occurs because the housing exclusion is used first.

*Example 3*
An individual working outside the United States earns USD 100,000 in 2011, all of which qualifies as foreign earned income. His foreign housing expenses total USD 30,000, resulting in a maximum housing exclusion of USD 13,006 (the lesser of USD 27,870 or actual foreign housing expenses, less the base housing amount of USD 14,864). As the housing exclusion is claimed first, the remaining USD 86,994 (foreign earned income of USD 100,000, less the housing exclusion of USD 13,006) is available for exclusion in 2011 using the foreign earned income exclusion. Therefore, he will have an unused 2011 general exclusion of USD 5,906 (the USD 92,900 maximum exclusion for 2011 less USD 86,994) available for use against future income related to 2011, provided the income is received by December 31, 2012. In 2011, the individual will be able to exclude his entire earnings of USD 100,000, comprising a housing cost exclusion of USD 13,006 and a foreign earned income exclusion of USD 86,994.

## Calculation of U.S. Tax Liability ("Stacking Rule")

In general, exclusions and deductions cause net income to be subject to lower effective tax rates, due to the nature of progressive tax tables that subject higher levels of income to higher rates of tax. However, individuals who are earning

[3] Amounts for 2011 were made public in IRS Notice 2011-08.



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economically more gross income but have lower *taxable* income due to the foreign earned income and housing cost exclusions, must calculate their tax using the tax rates applicable to taxpayers with comparable levels of gross income. The "stacking rule" is employed so that taxpayers claiming the foreign earned income and/or housing cost amount exclusions are subject to the same marginal tax rates as taxpayers with the same level of income who are not eligible for (or do not elect to claim) the exclusions. This rule applies for both regular and alternative minimum tax purposes.

The stacking rule is applied by figuring the tax on the taxpayer's taxable income without taking the foreign earned income and housing cost exclusions into account. Next, the tax is figured on the amount of the taxpayer's total foreign earned income and housing cost exclusions (at the appropriate graduated tax rates and with no other deductions taken into account). The difference (if any) between the two amounts is the taxpayer's actual U.S. tax liability for the year.

*Example 4*
A taxpayer (single with no dependents) is on international assignment for all of 2011. Her total foreign earned income is USD 175,000. She has other income of USD 25,000, for total gross income of USD 200,000. Her allowable deductions and personal exemptions are USD 20,000, resulting in taxable income of USD 180,000, before taking the foreign earned income and housing cost exclusions into account. Her foreign housing expenses are USD 30,000. Her foreign earned income and housing cost exclusion is the maximum USD 105,906 (the foreign earned income exclusion of USD 92,900, plus the exclusion for housing costs of USD 13,006). Her 2011 tax liability is calculated by first figuring the U.S. tax on USD 180,000, which is USD 44,297. Next, the U.S. tax on her exclusions of USD 105,906 is calculated, which totals USD 23,271. The difference between the two amounts, or USD 21,026, is the taxpayer's U.S. tax liability (before tax credits) for 2011. Had the tax been calculated on USD 74,094 of taxable income after exclusions, her total tax for 2011 would have been USD 14,649, which is a difference of USD 6,377 in tax. (Note: alternative minimum tax is ignored for the purposes of this example.)

### *Qualified Second Household*

Expenses attributable to a second foreign household that is maintained for an assignee's family at a different foreign location may also qualify as housing



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expenses. If the assignee's family does not reside with the taxpayer because living conditions at the taxpayer's place of residence are dangerous, unhealthy, or otherwise adverse, qualified housing expenses may include expenses for both households. The eligible housing expenses are combined in computing the housing cost amount. Examples of adverse living conditions include a state of warfare or conditions under which it is not feasible to provide family housing (for instance, remote construction sites).

### *Two-Earner Families*

The foreign earned income exclusion is available to each spouse in a joint return, but only to the extent that each spouse actually earns qualifying income by performing services abroad. For purposes of determining the foreign earned income exclusion, community property laws are disregarded. The exclusions available to each spouse are based solely on income attributable to services performed by the respective spouse. The sum of each spouse's excluded income is determined separately and then aggregated for exclusion on a joint return. Thus, a couple may not use one spouse's unused exclusion against the foreign earned income of the other spouse. Assuming the spouses live together, the housing amount exclusion may be apportioned to the income of one spouse or split between the spouses, as they wish. Special rules apply if the spouses live apart.

*Example 5*

Molly and Desmond are a married couple who are both on international assignment for all of 2011. Molly's foreign earned income for 2011 is USD 121,000 (which includes reimbursed housing expenses of USD 28,000), while Desmond's is USD 80,000 (which does not include any reimbursed housing). Molly's foreign earned income exceeds the maximum exclusion of USD 105,906 (USD 92,900 plus the housing exclusion of USD 13,006). After claiming the entire exclusion, USD 15,094 of compensation will be subject to U.S. tax (USD 121,000 less USD 105,906). Desmond's foreign earned income is less than the maximum exclusion of USD 92,900. He may claim an exclusion of USD 80,000, leaving USD 12,900 of unused exclusion. Molly cannot use Desmond's unused exclusion against her foreign earned income. However, if in 2012, Desmond receives a bonus or other compensation that relates to 2011, he can use his unused 2011 exclusion to offset the bonus.



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Comment:
Where both spouses are able to claim the exclusions, and file a joint return, they may compute their housing cost amount either jointly or separately. If both have foreign earned income in excess of the maximum exclusions, it can be generally more beneficial for them to split their housing costs and compute the housing cost exclusions separately.

### *Foreign Earned Income*

Foreign earned income eligible for the exclusions includes income received for the performance of personal services in a foreign country (or countries) during the period when an individual qualifies under one of the two tests. The term "earned income" includes payments in cash or benefits-in-kind, including salaries, wages, bonuses, commissions, lodging, foreign incentive and cost-of-living allowances, tax reimbursements, home leave and educational reimbursements or allowances, and moving expense reimbursements. Earned income does not include income of a passive nature, such as interest, dividends, and annuity income. Foreign earned income eligible for the exclusion does not include amounts that were received more than one year after the close of the taxable year in which the related services were performed. Amounts paid by the United States or its agencies to government employees or members of the U.S. armed forces are not considered to be foreign earned income.

In calculating the amount of foreign earned income exclusion, the "source" of the earned income must first be determined, since only foreign source earned income may be excluded. The source of earned income is determined according to where the assignee performs the services for which he or she is compensated.

Thus, if an individual spends time in the United States on business during the year, compensation must be allocated to the days worked in the United States. The amount so allocated will constitute U.S. source income ineligible for exclusion or foreign tax credit relief. The determination of such income is generally based on the ratio of days worked in the United States to the total number of days worked in a year. The allocation of income based on U.S. days generally applies to total compensation; certain allowances and reimbursements paid by reason of the international assignment may be allocated on a geographic basis (i.e., allocated



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entirely as foreign source). Business trips to other foreign countries do not affect the amount of excludible income.

In addition to determining the source of earned income, it is necessary to determine the year to which foreign earned income is attributed. Foreign earned income is excludible only to the extent that the exclusion is available for the year in which the services that gave rise to the foreign earned income were performed. Tax equalization payments must be attributed to the year in which the services that led to the tax payment are performed (usually a prior year).

*Example 6*
In 2010, an American assignee who qualified as a bona fide resident of Spain for the entire year received USD 90,000 (including reimbursed housing expenses of USD 28,000) for services actually performed in Spain, all of which qualified as foreign earned income. In 2011, she received USD 95,000 (including reimbursed housing expenses of USD 28,500) of foreign earned income attributable to services performed in 2011, plus a USD 5,000 bonus and a USD 10,000 tax equalization payment related to 2010. Her earned income exclusions, both used and unused, for the two years are as follows:

| **2010** | **USD** |
|---|---|
| Foreign earned income | 90,000 |
| Maximum exclusion | 104,310 |
| Exclusion used in 2010 | (90,000) |
| Unused 2010 exclusion | 14,310 |
| **2011** | |
| Foreign earned income-2011 | 95,000 |
| Foreign earned income-2010 | 15,000 |
| Total income received in 2011 | 110,000 |
| Total exclusions claimed in 2011 return: | |
| Related to 2011 | 95,000 |
| Related to 2010 | 14,310 |
| Total exclusion in 2011 return | 109,310 |
| Maximum 2011 exclusion | 105,906 |



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| | |
|---|---|
| 2011 exclusion used | (95,000) |
| Unused 2011 exclusion (available in 2012) | 10,906 |

When unused exclusion exists for a given year, care should be taken to determine that payments related to that year are made before the end of the following year so that they qualify for the exclusion. Tax equalization payments, in particular, are often made after the year to which the payment is attributable; the exclusion could be permanently lost if such payments are delayed beyond the end of the following year. However, foreign income taxes may be available as a credit to offset U.S. tax on such payments.

### *Ordering of Exclusion Use*

Due to the rules attributing payments to services performed in a particular year, exclusions for a year may actually be claimed in the tax returns of other years. As illustrated previously, payments related to a prior year may be excluded if received within the following year. Similarly, payments made before services are rendered may qualify for exclusion attributable to the year when such services are performed. Thus, a payment in 2010 to an individual who agrees to continue an international assignment for two more years would be fully reported in the 2010 return. However, it could be offset by exclusion from both 2010 and 2011 (if unused exclusion exists).

Rules are provided for "ordering" exclusion use when income related to a particular year is received over several years. Amounts received in the exclusion year (the year in which services are performed) are excluded first. If unused exclusion exists, then payments for that year, received in either the prior year or the subsequent year, may be excluded. If unused exclusion still exists, it may then be used in the other year, but the exclusion may not be split between the years.

Comment:
Exclusions against advance payments cannot be claimed until the unused exclusion in the subsequent year is finally determined. In most cases, this means that exclusions against advance payments can only be claimed by filing an amended return.



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The selection of years may be changed by amended returns within the three-year statute of limitations.

### *Denial of Double Benefits*

If an individual elects to exclude foreign earned income or housing cost amounts, he or she may not deduct any item or claim any credit that is allocable to the excluded income. This rule applies only to deductions definitely related to the excluded earned income and does not apply to other deductions, such as those for medical expenses, mortgage interest, and real estate taxes on non-income-producing property, charitable contributions, alimony payments, and deductions for personal exemptions.

The disallowed portion of an expense is computed by applying the following formula:

$$\frac{\text{Excluded income less applicable deductions}}{\text{Total foreign earned income less applicable deductions}} \times \text{Expense} = \text{Disallowance}$$

The disallowance formula for credits is somewhat different.

The "denial of double benefits" rule primarily affects most assignees in the area of foreign tax credits. The rules affecting foreign tax credits are discussed in detail in later chapters.

## Electing and Revoking Exclusions

The foreign earned income and housing exclusions are elective. They are not automatically available; but must be elected by claiming them on a tax return. Each exclusion may be elected separately or in combination. The elections are made by completing the appropriate section of Form 2555 for the first year for which the election is to be effective, and by filing the form with the tax return (Form 1040). Each election remains in effect for that year and all future years, unless revoked. The initial election(s) should generally be made in a return that is filed on time (including extensions), but to protect taxpayers from undue hardship, the IRS will permit the election(s) to be made within one year of the original due date (generally



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April 15) of a late return. However, penalties may still be imposed if tax is due. The initial election(s) can be made on an amended return filed within the three-year statute of limitations period if the initial return was filed on time.

In addition, a qualified individual can make the elections to claim the foreign earned income and housing cost exclusions in two additional situations. If the taxpayer owes no federal income tax after taking into account the exclusions, the taxpayer may file a Form 1040 with a Form 2555 attached either before or after the IRS discovers that the taxpayer has failed to elect the exclusions. If, however, the taxpayer owes federal income tax after taking into account the exclusions, the taxpayer may obtain relief only if the return is filed before the IRS discovers that the taxpayer failed to elect the exclusions.

Failure to make the election(s) in a timely manner can result in an assignee's entire compensation (including allowances) being fully subject to U.S. tax (however, the foreign tax credit may still be available to offset that U.S. tax). Even though the IRS has simplified the method for claiming a late section 911 election, certain late elections may be permitted at the sole discretion of the IRS. It is important to consult a competent tax adviser to determine that the special procedures to request IRS permission to make late elections are followed.

*Revocation*

An individual may revoke either or both the foreign earned income or housing exclusion elections for any taxable year. The revocation can be made either in the tax return for the year it is to be effective or on an amended return for that year.

*Re-election*

Once an election is revoked, a taxpayer may not make the same election again until the sixth year following the taxable year for which the revocation was effective, unless the consent of the IRS is obtained. Certain changes in an individual's circumstances, such as moving to another country, a change in employer, or a "substantial change" in foreign tax laws, will be considered by the IRS in determining whether to permit re-election before the statutory period.

Comment:

A clear indication of conditions under which re-election may be allowed has not



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been provided. Therefore, careful consideration and planning should occur prior to revoking either or both of the exclusions.

## Making the Decision: To Elect or Not?

The potential benefits to be derived by electing the foreign earned income and housing cost exclusions should be carefully evaluated. Foreign taxes allocable to such excluded income are not available for credit against U.S. income tax (see detailed discussion below). Where the effective foreign income tax rate is higher than the U.S. income tax rate, electing to exclude income may result in a higher overall tax liability because it may be more beneficial to claim all of the foreign tax as a credit. In other cases, the net U.S. tax may be about the same with or without the exclusions. However, the excess foreign tax credit available for carryback or carryforward may be much higher if the exclusions are not claimed. Such carryforwards might be utilized after returning to the United States as a result of receiving a foreign source bonus or tax reimbursement, or against other foreign source income, such as from business trips overseas. Careful consideration should be given to the initial election, and prospects of eventually utilizing excess foreign tax credits should be evaluated.

Comment:
In making the election decision, consideration should be given not only to the result in the current tax year, but also to each succeeding year of the international assignment. An election that appears advantageous in a transfer year could prove costly over the remainder of the assignment or in a subsequent assignment.

## Special Exclusion for Meals and Lodging Provided by Employer

Under certain circumstances, the value of meals and lodging furnished to an employee by his or her employer may be excluded from taxable income.

### *General Rule*

An employee may exclude from his or her gross income the value of meals and lodging furnished to him or her by, or on behalf of, the employer if it is for the convenience of the employer. To qualify for exclusion, the meals and lodging must be provided on the business premises of the employer, and the employee must accept such lodging as a condition of employment. This general rule applies to employees in the United States, as well as to Americans overseas.



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### *Foreign Camp Exclusion*

A special, less restrictive exclusion of the value of such meals and lodging furnished to an employee is provided for Americans working overseas. This exclusion is provided if a taxpayer resides overseas in employer-provided housing that qualifies as a "camp."

To qualify as a camp, the following conditions must be met:

- The camp must be provided for the employer's convenience if the place of business is in a remote area where satisfactory housing on the open market is not otherwise available within a reasonable commuting distance of the work site;
- The camp must be located as near as practicable to the place of employment and be in a common area or enclave not available to the general public;
- The camp must normally accommodate 10 or more employees.

The employee must accept the foreign housing as a condition of his or her employment. Furthermore, he or she cannot have an option to accept additional compensation instead of housing and meals in-kind. The camp exclusion is separate from the general exclusion of meals and lodging discussed above. A taxpayer may claim the camp exclusion without meeting either the bona fide residence or physical presence tests.

It should be noted that any amount of lodging excluded from income under the above provisions is ineligible for treatment as a qualified housing expense when computing the foreign housing cost exclusion under section 911. Furthermore, the base housing amount is not prorated when an individual occupies a camp during part of the year and ordinary housing for the remainder. Thus, the benefits of the housing exclusion will be reduced in such a year.

*Example*

An individual resided in a qualified camp from January 1, 2010, through October 31, 2011, and excluded the value of his camp housing. From November 1, 2011 through December 31, 2011, he resided in ordinary foreign housing and incurred qualified housing expenses of USD 6,000. Since the base housing amount for 2011



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is USD 14,864, he will be unable to claim a foreign housing exclusion from taxable compensation.



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## Chapter 2 – Employment-Related Deductions

U.S. taxpayers, generally, are entitled to claim itemized deductions on their tax returns. As an alternative, U.S. citizens and full-year residents may claim the standard deduction, which may be higher than itemized deductions. Claiming deductions may reduce taxable income. If the taxpayer is eligible, deductible items include medical expenses, state and local income taxes (or, if more beneficial, sales taxes), property taxes, charitable contributions, and home mortgage interest, among others. Taxpayers should consult with their tax advisers about whether itemizing deductions or claiming the standard deduction is more advantageous.

Certain other deductions, such as moving expenses and contributions to retirement plans, may be deductible regardless of whether the taxpayer claims itemized deductions. This latter category includes many employment-related deductions.

### Moving Expenses

Reimbursed moving expenses of an employee are excluded from gross income. The definition of what constitutes "moving expenses" incurred in connection with moving to a new location for employment-related reasons is limited to the costs of moving household goods and personal effects to the new residence (including in-transit or foreign-move storage expenses), and travel and lodging costs during the move. The definition of "moving expenses" does not include:

- Meal expenses;
- Expenses incurred while searching for a new home after obtaining employment;
- The costs of selling the old residence (or settling a lease) or purchasing (or acquiring a lease on) a new home;
- Temporary lodging at the new location after obtaining employment;
- Any part of the purchase price of the new home;
- Automobile registration;
- Driver's license;



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- Expenses of obtaining or breaking a lease;
- Home improvements to help sell the house;
- Loss on the sale of the house;
- Losses from disposing of memberships in clubs;
- Mortgage penalties;
- Real estate taxes;
- Refitting of carpets and draperies;
- Security deposits (including any given up due to the move); or
- Storage charges except those incurred in-transit and for foreign moves.

Also, moving expense reimbursements are only excludible if the following two conditions apply:

- The taxpayer's new job location is at least 50 miles farther from the taxpayer's old residence than the old residence was from the former place of employment.
- The taxpayer is a full-time employee at the new location for at least 39 weeks during the 12-month period following the move, unless he or she is transferred, involuntarily terminated, becomes disabled, or dies. If the taxpayer is self-employed, he or she must work full time at the new location for at least 39 weeks during the first 12 months and a total of at least 78 weeks during the first 24 months following the move.

Unreimbursed moving expenses are a deduction in computing adjusted gross income (rather than an itemized deduction). Reimbursed moving expenses are not deductible. Moving expense reimbursements are excluded from income (unless the taxpayer previously deducted the expenses).



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### *Special Rules*

Although moving expenses are generally deductible or excludible only if incurred in connection with beginning work in a new location, exceptions are provided in two situations for individuals who return to the United States from abroad. An individual who retires from a principal place of work and residence outside the United States may deduct the cost of moving to the United States upon such retirement, even if he or she does not work in the new location. Furthermore, spouses and dependents of a decedent whose principal place of work at the time of death was outside the United States may deduct the cost of returning to the United States. To be deductible in such circumstances, the move must begin within six months after the death of the decedent and must be from a former home outside the United States, assuming this home was the residence of both the survivor and the decedent at the time of death. The survivor needs not work in the new location. It should be noted that both retirees and survivors are subject to all other rules; the only rule that is waived is the requirement that work commence in the new location.

Reasonable costs of storing household effects while on an international assignment are considered deductible moving expenses, even for years in which the individual resides abroad in a single location.

### *Allocation of Moving Expenses (Denial of Double Benefits)*

Generally, moving expenses incurred which are not reimbursed by an employer may be taken as a deduction from gross income. Expenses incurred in connection with the start of work in a new job location overseas are considered directly connected with the income earned in the foreign country, and are thus foreign source. The denial of double benefits provisions prevent an individual from 1) excluding income earned while on the international assignment as foreign earned income and 2) taking a deduction for expenses allocated to that income. Therefore, if all or part of income earned is excluded under the foreign earned income or housing exclusions, the portion of moving expenses allocable to the excluded income is not deductible.

This concept is relatively simple in a situation where the move relates to a single year and total income is excluded under the foreign earned income exclusion. In such case, all earned income would be excluded from taxable income, and,



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therefore, no moving expense deduction would be permitted. In cases where the foreign earned income exceeds the exclusion, a pro-rata share of the moving expenses would not be deductible.

### Travel Expenses

Individuals on relatively short-term international assignments may fail to qualify for the foreign earned income exclusion for a number of reasons: they do not qualify as bona fide residents of a foreign country; their days overseas do not qualify them under the physical presence test; or they are not considered as having a tax home in a foreign country. In such cases, loss of the foreign earned income and housing exclusions might be mitigated by claiming away-from-home travel expenses.

Under long-established domestic tax rules, individuals who are away from home on business are entitled to deduct from gross income their expenses for travel, meals, and lodging to the extent they are justified and reasonable. If the individual accounts to his or her employer for such expenses, and if he or she receives reimbursement for them, the individual may simply exclude the amounts from gross income. To be deductible, the individual must be traveling away from his or her tax home or principal place of employment for a period not exceeding one year. On short-term international assignments, it may be possible to retain the U.S. residence as a tax home. Strict substantiation rules are provided, and the burden is placed on the individual to maintain records and receipts in support of the deductions. Where the deduction is claimed for periods when an individual does not qualify for the foreign earned income and housing exclusions, the amounts are fully deductible to the extent they can be substantiated.

When an individual does qualify for the exclusions, deductions for away-from-home business expenses may nevertheless still be claimed to the extent they relate to travel away from the tax home (i.e., away from the foreign place of residence). However, the benefit of such deductions may be reduced under the denial of double benefits provisions in a manner similar to the rules for moving expenses.

Comments:

Employers must adequately document not only an employee's assignment that is initially expected to last one year or less, but also when the assignment is extended beyond one year. Where possible and supportable, employers may wish to



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consider scheduling assignments with a projected period of employment for as close to one year as possible, but not over one year.

*Example*
(a) If an assignment is scheduled to last six months, but during this period it is re-scheduled to last 14 months, the maximum deduction for away-from-home travel expenses would be limited to those expenses incurred during the period prior to re-scheduling (i.e., six months or less).

(b) However, assume that the assignment discussed in example (a) above is originally scheduled to last 10 months, but due to delays the assignment ultimately is 14 months in duration. Because the intent never changed to make the assignment last longer than a year, but it does in fact exceed that length of time, only the expenses related to the first 12 months can be deducted as away-from-home traveling expenses.

## Individual Retirement Accounts (IRAs)

Individuals are permitted to deduct up to USD 5,000 (USD 10,000 with a spousal account for married individuals filing jointly) for contributions to individual retirement accounts (IRAs) where neither the taxpayer nor the taxpayer's spouse is an active participant in an employer-sponsored retirement plan or a self-employed retirement plan (Keogh plan). The regular contribution limit is increased by USD 1,000 (for a total deduction of USD 6,000) for individuals who are age 50 or over at the close of the tax year. If either the taxpayer or the spouse is an active participant in an employer-sponsored plan, a deduction for contributions to an IRA may still be allowed; however, the maximum allowable deduction in that situation is phased out in 2011 where adjusted gross income is over USD 90,000 on a joint return, or USD 56,000 for an unmarried individual. For 2011; the deduction is fully eliminated when adjusted gross income reaches USD 110,000 on a joint return or USD 66,000 for an unmarried person. (The limits for 2010 are USD 89,000 on a joint return or USD 56,000 for an unmarried individual, fully eliminated at USD 109,000 and USD 66,000 respectively.) Adjusted gross income for this purpose is the amount computed before the section 911 exclusions and the IRA deduction.

To the extent an individual is ineligible to make a deductible contribution to an IRA, non-deductible contributions are allowed. The non-deductible contributions are subject to the same dollar limits as deductible contributions. Income in the account



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accumulates tax free until distributed. Non-deductible contributions are not taxed upon distribution.

A contribution to an IRA cannot exceed an individual's earned income. This limit applies to both deductible and non-deductible contributions. Earned income for purposes of the IRA limit is considered to be net earned income after the foreign earned income and housing exclusions. As a result, if an individual's earned income is fully excluded, he or she will not be able to make a contribution to an IRA. It is particularly important to note that if an individual does not have sufficient earned income, not only does he or she lose the right to deduct a contribution, but also any contribution made would be considered excessive and subject to penalties and special annual excise taxes until the amount is withdrawn. Generally, excessive contributions can be withdrawn by April 15 of the year following the year to which the contributions relate. Contributions for a particular year can be made at any time during the year or up to April 15 of the following year.

Generally, funds that are withdrawn from an IRA before retirement age of 59½ are subject to a 10-percent penalty tax, in addition to income tax. However, the below-noted instances of early withdrawals of IRA funds will not be subject to the 10-percent penalty tax.

1. Any payment or distribution received by an individual to the extent the payment or distribution is used to pay the qualified acquisition costs of acquiring the principal residence of a first-time home-buyer. The maximum withdrawal eligible cannot exceed USD 10,000. It is understood that the USD 10,000 applies per individual and, therefore, a husband and wife purchasing a first home can each withdraw up to USD 10,000 from their respective IRAs.

2. A distribution from an IRA if the individual uses the money to pay qualified higher education expenses. The education expenses can be incurred by the individual, the individual's spouse, or any child or grandchild of the individual or his/her spouse.

3. Distributions from an IRA to certain unemployed individuals that are used to pay qualified medical insurance premiums.



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Due to the numerous conditions associated with these two issues, it is recommended that an individual consult a professional adviser before withdrawing any amounts from an IRA.

## Roth Individual Retirement Accounts (Roth IRAs)

A Roth IRA is a private savings account which, unlike a standard IRA, results in no current tax benefit, but offers a greater future tax benefit. The general features of this retirement savings vehicle are noted below.

1. Annual contributions of up to USD 5,000 (USD 6,000 for individuals who are age 50 or over at the close of the tax year) per year may be made to the account subject to phase-out if adjusted gross income (AGI) in a particular year is above USD 177,000 for individuals filing a joint return, or USD 120,000 for unmarried persons in 2010. For 2011, the amounts are USD 179,000 and USD 122,000, respectively. For this purpose, AGI is determined without regard to the section 911 exclusion for foreign earned income. (Therefore, the reduction in income for the foreign exclusion cannot make an otherwise ineligible taxpayer eligible to contribute.)

2. Unlike regular IRAs, the contributions are made from post-tax income, so contributions are allowed even if the taxpayer or the taxpayer's spouse is a member of an employer qualified plan.

3. The USD 5,000 contribution limit is reduced by amounts contributed to a regular IRA. Therefore, total contributions to all of the taxpayer's IRAs and Roth IRAs together cannot exceed USD 5,000 (USD 6,000 for taxpayers age 50 or over) for the year.

4. Annual earnings (interest, dividends, etc.) in the account are not subject to tax.

5. Qualified distributions are distributed tax free, rather than being tax-deferred as in the case of regular IRAs and qualified retirement plans, such as 401(k) plans, established with an employer. Therefore, unlike other retirement savings provisions, such as 401(k) plans and regular IRAs, the earnings in the account are never subject to income tax.



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6. Qualified distributions are those made from earnings in the account after age 59½, on death or disability, or in a qualified first-time home-buyer distribution subject to a USD 10,000 lifetime limit.

Comment:
Assignees whose incomes are below the maximum foreign earned income exclusion (see discussion in Chapter 1) should exercise caution to avoid excessive contributions. However, it should not be assumed that a contribution is not allowed just because income is below the foreign earned income exclusion amount. Other factors, such as days worked in the United States that create income not eligible for exclusion, may result in earned income not being fully excluded. In this case, an IRA contribution might be possible.

Individuals who customarily make IRA contributions should consider making a contribution early in the year so as to benefit from the tax-free accumulation of earnings on the funds. The individual should then consult his or her tax adviser at year end to determine whether he or she is permitted to make the contribution. If the contribution is not permitted, or if the amount is excessive, the funds can be withdrawn by April 15 without adverse tax consequences other than income taxes in the year of withdrawal on the earnings accumulated on the contribution.

It should also be noted that the regulations stipulate that IRA contributions must be "sourced" for purposes of the foreign tax credit, based on total gross income that includes excluded income for this purpose. Finally, the regulations confirm that no disallowance of an otherwise allowable deduction for an IRA contribution will occur under the denial of double benefits provisions.

### Conversions from Traditional IRA to Roth IRA

Prior to 2010, existing traditional IRAs could be converted to Roth IRAs only if a taxpayer's AGI for the tax year did not exceed USD 100,000 (without regard to the section 911 exclusion and the value of the IRA included in AGI because of the conversion). The USD 100,000 limit applied to all filing statuses. This AGI limit was eliminated for tax years beginning after 2009, with the result that higher-income taxpayers may be able to convert traditional IRAs to Roth IRAs. A taxpayer filing a separate return is not permitted to convert an amount to a Roth IRA, regardless of the individual's modified adjusted gross income. Generally, the untaxed portion of the converted IRA must be included in the taxpayer's income in the year of



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conversion. The 10-percent penalty that generally applies to early withdrawals from IRAs will not apply as a result of the conversion.

A special income inclusion rule applies to 2010 conversions. Unless the taxpayer elects otherwise, the amount includible in gross income from a 2010 IRA conversion will be included in gross income in equal amounts in tax years 2011 and 2012 (*i.e.,* 50 percent each year). Alternatively, the taxpayer may elect to include the entire taxable amount in gross income in 2010. A taxpayer who makes this income inclusion election has until the due date for the tax year to change the election.

### Business and Professional Expenses

In addition to away-from-home travel expenses, individuals are entitled to deduct, as itemized deductions, certain employment- or professionally-related expenses, subject to limitations. (Details of these deductions are not discussed herein.) It should be noted that such expenses, if attributable to foreign earned income, must be partially disallowed under the denial of double benefits rules. Such deductions would be most beneficial to individuals who have substantial U.S. source income from employment or self-employment, or whose income significantly exceeds the foreign exclusions.



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## Chapter 3 – Other Income, Credits, and Deductions

U.S. citizens and resident aliens are subject to U.S. tax on worldwide income. The rules for taxing such income, other than for compensation and related items, generally do not change by virtue of overseas residence. An exception to this general rule may occur where income is taxed in a foreign country of residence. In such cases, it is possible that U.S. tax rules may be changed due to an income tax treaty with the foreign country. Tax treaties, therefore, should always be consulted when considering an assignee's tax status. Furthermore, although all items of income are still subject to taxation, and most deductions are generally allowed, tax planning considerations for an individual residing abroad could very well be different than if he or she is living in the United States. This is due to various factors, including the foreign earned income exclusions, the foreign tax credit, and local country taxes.

### Planning for Educational Costs

Educational incentives are provided to many taxpayers sending either themselves or their children to school. Some of these incentives are highlighted below.

- *American Opportunity Tax Credit* – The previously named Hope Credit has been modified and is called the American Opportunity Tax Credit. Originally intended to apply for tax years 2009 and 2010 only, the American Opportunity Tax Credit has been extended through 2012 by the Tax Relief, Employment Insurance Reauthorization and Job Creation Act of 2010. After 2012, the credit will revert to former law (the Hope Credit), when it covered only the first two years of post-secondary education, and provided for a lower maximum credit.

  This credit may be elected for qualified education expenses incurred during the first four years of the post-secondary education (i.e., after high school) of the taxpayer, spouse, or a dependent. The credit is non-refundable and is available for up to 100 percent of the first USD 2,000 and 25 percent of the next USD 2,000 of qualified expenses, i.e., a maximum allowable credit of USD 2,500 per student for each of the first four years of post-secondary education. The credit phases out for taxpayers with AGI in excess of USD 80,000 (USD 160,000 on a joint return). The credit is 40 percent refundable and can be claimed against the alternative minimum tax.



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- *Lifetime Learning Credit* – The Lifetime Learning Credit is available for education expenses incurred at any time to acquire or improve job skills. The credit equals 20 percent of up to USD 10,000 of expenses. The Lifetime Learning Credit is not indexed for inflation. This credit is phased out as modified AGI exceeds USD 50,000 in 2010 or USD 51,000 in 2011 (USD 100,000 in 2010 or USD 102,000 in 2011 on a joint return). For this purpose, modified AGI means AGI increased by amounts excluded under section 911.

These credits are not available to married taxpayers who file separate returns. The credit is denied to an individual who is a nonresident alien at any time during the year.

- *Coverdell Education Savings Accounts (formerly known as Education IRAs)* – In lieu of taking a credit, distributions from a Coverdell ESA are generally tax free to the distributee to the extent used to pay qualified education expenses, which include elementary and secondary school expenses, as well as the costs of college and graduate-level courses.

- *Deduction for Qualifying Tuition and Related Expenses* – A deduction is allowed for certain tuition and related expenses paid for post-secondary education for the taxpayer, spouse, or a dependent, for up to USD 4,000. The deduction phases out for modified AGI in excess of USD 65,000 (USD 130,000 on a joint return).

- *Deduction for Interest on Student Loans* – There is a deduction for interest of up to USD 2,500 on loans paid for education expenses incurred in attending qualified institutions. The deduction is phased out as modified AGI exceeds USD 60,000 (USD 120,000 on a joint return) in 2010.

The American Opportunity Tax Credit, the Lifetime Learning Credit, and the deduction for tuition and related expenses are mutually exclusive. The American Opportunity Tax Credit and the Lifetime Learning Credit cannot both be taken in the same year, and expenses for which a credit is claimed cannot also be taken as a deduction.

It is recommended that professional advice be sought due to the various conditions and limitations that apply in these cases.



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## Child Tax Credit

A taxpayer may claim a child tax credit for each qualifying child. A qualifying child is a child that is a U.S. citizen, national, or resident; is claimed as a dependent on the taxpayer's return; is the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (i.e., grandchild, niece, or nephew); is under 17 at the end of the tax year; did not provide over half of his or her own support for the tax year; and lived with the taxpayer for more than half the tax year.

The maximum amount of the credit is USD 1,000 for each qualifying child. The taxpayer's total child tax credit is phased out as modified AGI exceeds USD 75,000 for a single individual, USD 110,000 for a joint return, and USD 55,000 for a married filing separate return. Modified AGI is determined without regard to the section 911 exclusion for foreign earned income. For some taxpayers, a portion of the credit may be refundable (i.e., may result in a refund if the credit exceeds the taxpayer's tax liability).

## Passive Investment Income

### *Dividends and Interest*

Dividends and interest are subject to tax under the normal rules applicable to persons residing in the United States. Interest income is subject to tax unless it is from a qualified obligation of a state, county, city, or municipality in the United States. Interest or other earnings accumulating on IRAs or other qualified retirement plans are not subject to tax unless actually withdrawn from the plan.

Certain qualified dividend income received by U.S. citizens or residents is taxed at a maximum rate of 15 percent. Generally, qualified dividend income includes dividends received from U.S. corporations and certain qualified foreign corporations.

Comments:

1. Taxpayers who have investments in tax-free municipal bonds should consider whether their investment portfolios should be shifted to other forms of investment in conjunction with their move abroad. It has been observed that those who are in substantially lower U.S. tax brackets due to their overseas residence sometimes shift investments to higher-yielding taxable obligations in order to (potentially) achieve a greater after-tax net return. However, the



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impact of the stacking rule for calculating tax (see Chapter 1) and any tax equalization plan (see Chapter 8 for a discussion) on the investor should also be considered.

2. It should also be noted that an investment approach with respect to dividend- and interest-paying obligations should take account of the resident/assignment country tax treatment of the income. Many countries tax residents on worldwide income, and it would be unlikely that such countries would provide an exemption for interest on U.S. municipal bonds. Thus, the perceived U.S. tax benefit of investing in tax-exempt vehicles could be nullified by foreign tax on such income. It may be preferable, therefore, to select an investment that enhances the pre-tax yield.

### *Capital Gains*

Gains from the sale or exchange of capital assets are subject to the same tax rules that apply to such gains realized by individuals living in the United States. Capital gains are taxed at different rates, depending upon the holding period and the nature of the asset. Capital gains on assets held more than 12 months are generally taxed at a maximum rate of 15 percent (0 percent for individuals in the 10-percent and 15-percent tax brackets). (See Appendix C for tax rates.)

Capital losses are treated differently than ordinary losses. Capital losses are deductible in full against capital gains. If there is an overall net capital loss for a year, up to USD 3,000 of such net loss can be deducted against other income (USD 1,500 in a married, filing separately return). Net losses in excess of the USD 3,000 limitation may be carried forward indefinitely for use against future capital gains or against other income.

U.S. taxpayers who own interests in foreign corporations may be subject to special rules that treat gains resulting from the sale of such shares as ordinary income rather than as capital gain. These rules are complex and apply equally to U.S. citizens residing in the United States. A tax adviser should be consulted if an individual plans to sell shares in a foreign corporation.

### *Passive Foreign Investment Companies*

Any U.S. person who invests in a passive foreign investment company (PFIC), such as a foreign mutual fund, will pay tax and an interest charge on any gain derived



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from the sale of the investment or on an excess distribution from the PFIC. However, U.S. persons who own stock in a "qualified electing fund" PFIC are currently taxed on their share of the PFIC's annual undistributed earnings unless they elect to defer the tax. A qualified electing fund election is made by the U.S. stockholder. However, as part of the election, the PFIC must agree to disclose certain information on ownership and earnings to the IRS. Before investing in a PFIC, a U.S. person should consult a U.S. tax adviser.

### *Other Passive Business Activities*

Losses from passive business activities generally may not be deducted against other income such as salary, interest, dividends, and active business income. Moreover, these activities may not produce the desired benefit for individuals living overseas and should not be entered into without considering foreign country tax rules and the employer's tax equalization or tax protection plan.

## Residences

A primary consideration for any foreign move involves the tax implications of holding, renting, or selling the individual's principal U.S. residence. The tax rules that should be considered are described briefly in the following paragraphs.

### *Sale of Principal Residence*

A taxpayer may exclude USD 250,000 (USD 500,000 if married filing jointly) of gain upon the sale of a principal residence in a qualifying transaction.

To qualify for the exclusion, the following requirements generally must be met:

1. The taxpayer must have owned and used (occupied) the residence as a principal residence for at least two of the five years prior to the sale or exchange (the two years do not have to be in one consecutive period); and

2. During the two-year period ending on the date of the sale, the taxpayer did not exclude gain from the sale of another home.

However, in certain cases, a partial exclusion may be available even though one or neither of the "two-year tests" is met.

An individual who fails to meet either the "one sale every two years" rule or the "two out of five years ownership and use" requirement may qualify for a reduced



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exclusion, if the primary reason the individual sold the home was because of a change of place of employment, health, or unforeseen circumstances. Meeting one of these criteria qualifies the individual for a prorated exclusion. The individual must still meet the requirements for some lesser period of time within the immediately preceding five years. The period of time the requirements were met determines the amount of the allowable exclusion. The amount to be prorated is the USD 250,000 limitation (USD 500,000 if married filing jointly). For example, if Irwin, who is single, owns and occupies a home for 20 months, and then sells it due to a job transfer, then his maximum exclusion will be USD 208,333 (20 months / 2 years x USD 250,000). If his actual gain is less than the prorated amount, it will be fully excludible.

Any portion of the gain attributable to a "nonqualified use" of the property after January 1, 2009, is ineligible for the exclusion. Nonqualified use includes periods during which the property is not used as an individual's principal residence, such as periods when it is rented out.

Gain otherwise eligible for the exclusion (i.e., after any depreciation "recapture" – see Appendix C for a definition) is allocated to periods of nonqualified use based on the following ratio:

$$\frac{\text{Aggregate periods of nonqualified use during the period the property was owned by the taxpayer}}{\text{The period the property was owned by the taxpayer}}$$

There are three exceptions from nonqualified use, each independent of the others. First, nonqualified use does not include any portion of the five-year period preceding the sale or exchange that is after the last date that the property is used as the taxpayer's (or a spouse's) principal residence. Thus, a rental period that occurs within the five-year period ending on the date of sale is not nonqualified use if the rental period occurs after the last date the property was used by the taxpayer as a principal residence.

> *Example 1:* Assume a taxpayer accepts a three-year international assignment and rents his long-standing principal residence to an unrelated



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third party beginning March 1, 2009. After the assignment is completed, the taxpayer returns to the United States and does not reoccupy his former home, but sells the property on February 29, 2012. The rental period from March 1, 2009 through February 29, 2012 is not nonqualified use of the property. Any gain attributable to the three-year rental period (after subtracting depreciation recapture) is eligible for exclusion provided all other requirements for the section 121 exclusion (*e.g.,* ownership and use) are met.

*Example 2:* Assume a taxpayer buys a new home on January 1, 2006. He later moves into his vacation property and rents his principal residence to an unrelated third party from January 1, 2009 through December 31, 2011. The taxpayer reoccupies the home and sells the property on December 31, 2015, for a gain. The rental period January 1, 2009 through December 31, 2011, is nonqualified use. Thus, 30 percent[4] of the gain otherwise eligible for the exclusion (i.e., after any depreciation "recapture") is allocated to periods of nonqualified use and is not eligible for the section 121 exclusion.

A second exception is provided for any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty as a member of the uniformed services, the U.S. Foreign Service, or the intelligence community.

Finally, periods of nonqualified use do not include any other period of temporary absence (not to exceed an aggregate period of two years) due to change in place of employment, health conditions, or other unforeseen circumstances as may be specified by the IRS.

The exclusion cannot be used to offset any gain that is attributable to any depreciation allowed or allowable with respect to the rental or business use of the residence after May 6, 1997 ("depreciation recapture") (see Appendix C).

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[4] Calculated by applying the ratio stated above: 3 years of nonqualified use during the period the taxpayer owned the property (January 1, 2009 – December 31, 2011) / 10 years the taxpayer owned the property (January 1, 2006 – December 31, 2015).



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Comment:
As discussed, to be eligible for the exclusion, the taxpayer must have owned the residence and used it as a principal residence for at least two of the five years prior to the sale or exchange. Assignees especially may suffer adverse consequences as a result of this particular provision. Individuals on assignments overseas, of course, will not be occupying their residences during their assignments. It is not unusual for a two- or three-year assignment to be extended. It is also common for a returning assignee to accept another position with his or her employer in a different location. In these situations, it is possible that the taxpayer will not meet the two-out-of-five-years use requirement to exclude the gain on the sale of the home.

> *Example*
> A home rented out during the taxpayer's assignment (that began after May 6, 1997), on which depreciation is allowable in the amount of USD 20,000 over the duration of the assignment, is later disposed in a sale qualifying for the exclusion, with no periods of nonqualifying use. Assuming the sale resulted in a gain of USD 100,000, USD 80,000 of the gain could be excluded and USD 20,000 of gain would be recognized and subject to tax.
>
> The portion of gain attributable to depreciation is treated as ordinary income but is subject to a special maximum tax rate of 25 percent.

Thus, an assignee whose home is rented during an assignment may be required to recognize a portion of the gain from the sale of the home which otherwise qualified for the exclusion. Had the individual not gone on assignment (and therefore not rented and depreciated the home) no gain would have been recognized.[5]

Taxpayers may be faced with paying tax on gain in excess of the maximum exclusion (USD 250,000 or USD 500,000) upon the sale of their homes. Although the USD 250,000 or USD 500,000 limitation may appear adequate for many taxpayers, individuals who have owned one home or several homes that have appreciated substantially may exceed this limit. These amounts are not adjusted for inflation.

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[5] A taxpayer's adjusted basis in his or her home for purposes of the exclusion is the basis as adjusted for previous section 1034 deferrals; this provision would only apply if the last time the taxpayer sold a primary residence and purchased a new one was before May 6, 1997.



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Gain from the sale or exchange of a principal residence within five years of its acquisition in a like-kind exchange (under section 1031) does not qualify for the exclusion.

The exclusion does not apply to expatriators (i.e., former U.S. citizens and certain former long-term lawful permanent residents (greencard holders) who are subject to the expatriation rules).

### *Rental of Former Residence*

Assignees often prefer not to sell their U.S. principal residence and therefore decide to rent the property during the international assignment. In such case, the rental income must be reported on the individual's U.S. income tax return, and certain deductions relating to the rental property may be claimed against such income. These deductions include such items as mortgage interest, property taxes, insurance, agency commissions, and other operating expenses of the property. Depreciation may also be allowed on the cost of the building, improvements, and furnishings left in the house, but not on the portion of cost of the property that is attributable to land.

If the tax deductions related to the property, including depreciation, exceed rental income, generally, such losses may not be deducted against other ordinary income such as salary, interest, dividends and active business income. The losses are disallowed and carried forward to the next tax year.

Although losses from the rental of real estate generally may not be deducted currently against other ordinary income, a special rule provides that an individual can offset up to USD 25,000 of other income with losses from rental real estate in which the individual actively participates. Active participation requires that the taxpayer (and/or the taxpayer's spouse) own at least 10 percent of the property. Active participation can be satisfied by performing management functions such as approving new tenants, deciding on rental terms, and deciding on expenditures.

The USD 25,000 amount is phased out for taxpayers above certain income levels and is reduced by 50 percent of the amount by which the taxpayer's AGI exceeds USD 100,000 (USD 12,500 for married taxpayers filing separately, and the phase-out begins at AGI of USD 50,000). For this purpose, AGI is generally determined without regard to net losses from passive activities and any IRA deductions, but



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after the reduction for the foreign earned income and housing exclusions. Effectively, no deduction is allowed if AGI exceeds USD 150,000 (USD 75,000 on a married filing separate return).

Losses not available for current use are suspended and may be used against future rental income (net of deductions). In the year the property is disposed of, remaining suspended loss becomes fully deductible.

Comment:
These "passive activity loss limitation" rules, which apply not only to rental property but also to activities in which a taxpayer does not materially participate, are extremely complex. Competent tax advice should be obtained to analyze the effect of the rules on an international assignment.

Other rules may apply to limit deductible losses if the property is used by the taxpayer for personal purposes during the year. If a taxpayer used the property for personal purposes for more than the greater of 14 days or 10 percent of the home rental days during the tax year, any deductions related to the rental use (depreciation, insurance, maintenance, etc.) are limited to a portion of gross income from the rental activity. "Personal use" of a property includes occupancy by relatives. Losses may not be deducted from rental of a property unless an arm's-length rental is paid for use of the property. If personal use does not exceed the 14 days/10-percent limitation, then the rental may instead be subject to the passive activity loss limitation rules described above.

The "14 day/10 percent" rule may not apply where a taxpayer changes the use of the property from personal use to investment use, such as in the year when a taxpayer moves abroad. Thus, even though the taxpayer may occupy the property as a principal residence for the portion of the year prior to his or her move overseas, if the property is then rented (or held for rental) for 12 or more consecutive months, or until sold, the limitation on deduction described above for the rental period would not apply.

### *Foreign Properties*

The foregoing rules apply to personal residences and rental properties located in foreign countries, as well as those in the United States. However, special depreciation rules apply to such foreign properties. These rules generally provide



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longer useful lives than those allowed for domestic properties, and, therefore, they may make such investments less attractive from a tax standpoint.

## Itemized Deductions

Itemized deductions are generally allowable under the same rules that apply to taxpayers residing in the United States and will not be reviewed here in detail. It should be noted that foreign sales taxes and value-added taxes are not deductible. Similarly, contributions to foreign charities are not deductible unless the organization has obtained U.S. tax-exempt status.

Miscellaneous itemized deductions are deductible only to the extent that, in the aggregate, they exceed 2 percent of adjusted gross income. This category of deduction includes unreimbursed business expenses and investment expenses.

Comment:
Taxpayers living overseas may have itemized deductions lower than the standard deduction, and they may be tax equalized, in whole or in part, on their income by their employers. Thus, the tax benefits previously gained from deductions for charitable contributions and other itemized deductions are often eliminated or drastically reduced. Therefore, consideration should be given to reducing these deductions to the extent possible by deferring payment until after returning to the United States. Tax-equalized assignees should review their company's policy with respect to such deductions before reaching a conclusion.



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## Chapter 4 – Foreign Tax Credit

All or a portion of an assignee's income may be subject to tax in a foreign jurisdiction as a result of either the individual's residence or presence in the foreign country. Since U.S. citizens and residents are subject to U.S. tax on their worldwide income, the assignee may be subject to tax both in the foreign country and in the United States. To address the possible double taxation of foreign source income, a credit is allowed to reduce U.S. tax by qualifying foreign taxes. This credit is generally limited to the U.S. tax on the individual's foreign source income, and it cannot exceed the actual foreign tax paid or accrued.

It should always be kept in mind that double taxation relief is also provided in tax treaties. Individuals who incur tax in a country with which the United States has entered into a tax treaty should consider the relevant treaty provisions in addition to the Internal Revenue Code. A list of treaty countries is provided in Appendix A.

An individual may either deduct foreign taxes paid as an itemized deduction or elect to claim them as a credit. Generally, the credit option is more beneficial, since it can result in a dollar-for-dollar reduction in tax liability. However, since it is an annual option, the decision should be based on all the facts available and reviewed each year. The election to claim the foreign tax as a credit is made by completing Form 1116, *Computation of Foreign Tax Credit*, and including it with the tax return.

### Cash Versus Accrual Method

Although most individuals report income and deductions under the "cash receipts and disbursements" method ("cash method") when they file their returns, the foreign tax credit may be claimed using either the cash method or accrual method. If the cash (also known as "paid") method is elected, the foreign tax available for credit is the total amount of qualifying foreign taxes actually paid during the year. If the accrual method is elected, a taxpayer claims the foreign tax credit in the year the related income is reported and in which the foreign tax liability accrues, regardless of when it is actually paid. Once the accrual method is elected, it must be used in subsequent years.

Comment:

The accrual method of claiming the foreign tax credit may be beneficial if the taxpayer is residing in a country that does not require payment of tax until a year



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after the liability arises. Conversely, when an individual already has sufficient foreign tax credits, the cash method may be preferable to add an additional year or more to the foreign tax credit carryover period.

The foreign tax credit may not be claimed in the same year in which an itemized deduction for foreign taxes paid was taken on the U.S. tax return.

Some foreign tax jurisdictions determine taxable income using a year other than a calendar year. The IRS takes the position that foreign taxes accrue on the last day of the taxable year of such foreign jurisdictions. This may cause the accrual method of claiming foreign tax credits to be disadvantageous to individuals living in countries that have taxable years other than the calendar year.

*Example*
An individual moves from the United States to London, England on May 1, 2009. United Kingdom income taxes for individuals are determined based on a taxable period beginning April 6 of one year, and ending April 5 of the following year. For the year ended April 5, 2010, the individual incurs a U.K. tax liability of £15,000, none of which is paid during calendar year 2009. No foreign tax credit can be claimed in the individual's 2009 U.S. tax return because no tax was paid in 2009, and because the tax does not accrue for foreign tax credit purposes until April 5, 2010.

To address the outcome of the example above, individuals living in countries with fiscal year ends should generally utilize the cash method for claiming foreign tax credits and monitor their foreign tax payments to determine the amount paid during the U.S. return year (calendar year).

## Foreign Taxes Eligible for Credit

Foreign taxes eligible for the foreign tax credit include income taxes, war profits and excess profits taxes, and taxes paid in lieu of any of these. The tax must be imposed by a foreign country or its political subdivisions, or by a U.S. possession. The employee portion of foreign social security taxes is generally considered to be foreign income tax available for the credit. Social security taxes are not creditable, however, if paid to a country with which the United States has a social security totalization agreement (see Chapter 6 and Appendix B). Other foreign taxes, such as real estate taxes, sales taxes, luxury taxes, turnover taxes, value-added taxes,



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and wealth taxes, are not creditable. Determining whether a foreign tax is creditable or not may be difficult, and a competent tax adviser should be consulted to determine if the foreign tax qualifies for credit.

### Disallowance of Credit Allocable to Exempt Income

Otherwise-allowable foreign taxes paid or accrued cannot be claimed as credits (or deductions) to the extent that the foreign income tax was imposed on foreign source earned income excluded from gross income under section 911 (the foreign earned income exclusion and housing cost exclusion, discussed in Chapter 1). The theory of this statutorily-imposed denial of double benefits rule is that an individual should not be able to both exclude earned income from taxation and claim credit for foreign tax imposed on such income. The computation of the disallowance, or non-creditable tax, is as follows:

$$\frac{\text{Amounts excluded under section 911(a) less deductible expenses allocable to such amounts}}{\text{Foreign earned income less deductible expenses allocable to such income}} \times \text{Foreign taxes paid or accrued on foreign earned income}$$

*Examples*

1. For 2011, an American individual resident in Greece earns USD 100,000, and pays USD 8,000 in Greek tax on such income. She claims the foreign earned income and housing exclusions totaling USD 100,000. Her entire income is, therefore, exempt from tax. Accordingly, all of her Greek taxes are disallowed and therefore are ineligible for use as a foreign tax credit.

$$\frac{\text{Exempt income USD 100,000}}{\text{Total foreign earned income USD 100,000}} \times \text{USD 8,000 Foreign tax on earned income} = \text{USD 8,000 Disallowed foreign tax}$$



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2. The same individual does not claim the foreign housing exclusion but claims the foreign earned income exclusion of USD 92,900. Since not all of her income is exempt from U.S. taxation, the foreign tax credit disallowance is computed as follows:

$$\frac{\text{Exempt income USD 92,900}}{\text{Total foreign earned income USD 100,000}} \times \text{USD 8,000 Foreign tax on earned income} = \text{USD 7,432 Disallowed foreign tax}$$

Comment:
The foreign earnings exclusions were made elective so that individuals living in high-tax countries would not be penalized by the foreign tax credit disallowance rules. Individuals living in high-tax countries should consider not electing, or revoking (if previously elected), the foreign earned income and housing cost exclusions to potentially increase foreign tax credits and carryovers or carrybacks of such credits (discussed below).

If foreign tax is disallowed in any year due to its allocation to excluded income, the foreign tax credit for that foreign tax is forfeited and is not available for carryback or carryover.

## Limitation on Credit

The portion of the foreign taxes that is not disallowed can be claimed as a credit, subject to limitations. The amount of credit allowable in a taxable year is limited to the lesser of the actual foreign taxes paid or accrued (after disallowance) or the amount of U.S. tax on foreign source taxable income for the year. The amount of U.S. tax attributable to foreign source taxable income is determined as follows:

$$\frac{\text{Foreign taxable income before personal exemptions}}{\text{Total taxable income before personal exemptions}} \times \text{U.S. tax before credits} = \text{Maximum allowable foreign tax credit}$$



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Taxable income in this fraction does not reflect personal exemptions, but does reflect itemized or standard deductions.

Since the limitation is based on a calculated tax on "net" foreign source income, increasing foreign source income has the effect of increasing the limitation and reducing the U.S. tax (assuming sufficient credits are available). Foreign source income includes earnings from services performed abroad, moving expense reimbursements (under certain circumstances), and certain other kinds of income arising abroad, including dividends from some foreign corporations, foreign pensions, and annuities.

Special rules apply to capital gain income. Capital gains are generally sourced based on the location of the residence of the person realizing the gain. However, gain from a sale of personal property outside the United States by a U.S. citizen or resident alien will not be considered foreign source unless a foreign income tax of at least 10 percent of the gain is actually paid.

U.S. source deductions are also beneficial from the standpoint of both raising the limitation and the foreign tax credit. Most deductions are considered to be general in nature and therefore must be apportioned on a pro rata basis between foreign source and U.S. source income. However, deductions that are directly related to a class of income are allocated against such income. For example, investment advisory fees paid to manage a portfolio consisting entirely of U.S. securities would normally be considered to be a deduction directly allocable to U.S. source income.

The following is a simplified calculation of the foreign tax credit limitation.

*Example*
A married American assignee with two children lives in Brussels, Belgium. During 2011, he has USD 144,000 of compensation income, including allowances, and USD 6,000 of U.S. source interest income. As a result of spending a number of work days in the United States, USD 9,000 of his compensation income was allocated as U.S. source income. His Belgian tax liability for 2011 was USD 28,000, all attributable to salary, and USD 21,342 was disallowed as allocable to excluded income. His 2011 U.S. income tax and foreign tax credit would be computed as follows:



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| | Total (USD) | Foreign Source (USD) | U.S. Source (USD) |
|---|---|---|---|
| Earned income | 144,000 | 135,000 | 9,000 |
| Interest | 6,000 | | 6,000 |
| Gross income | 150,000 | 135,000 | 15,000 |
| Percentage of total | 100% | 90% | 10% |
| Foreign earned income exclusion | (92,900) | (92,900) | |
| Housing exclusion (assumed) | (10,000) | (10,000) | |
| Adjusted gross income | 47,100 | 32,100 | 15,000 |
| Itemized deductions (apportioned based on gross income percentages before exclusions) | (15,000) | (13,500) | (1,500) |
| Taxable income, before personal exemptions | 32,100 | 18,600 | 13,500 |
| Personal exemptions | (14,800) | | |
| Taxable income | 17,300 | | |
| U.S. tax, before credits (applying the "stacking rule" discussed in Chapter 1) | 4,325 | | |

The foreign tax credit would be calculated as the lesser of (1) actual foreign tax reduced by the scale-down for excluded income, in this example USD 28,000 reduced by USD 21,342 (= USD 6,658), or (2) the limitation, which would be computed as follows:

$$\frac{\text{Foreign source taxable income before personal exemptions}}{\text{Total taxable income before personal exemptions}} = \frac{\text{USD } 18{,}600}{\text{USD } 32{,}100} \times \text{USD } 4{,}325 \text{ U.S. tax} = \text{USD } 2{,}506$$



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The taxpayer's U.S. tax after the foreign tax credit and the status of his foreign tax credit are as follows:

| | USD |
|---|---|
| Gross U.S tax | 4,325 |
| Foreign tax credit | (2,506) |
| Net U.S. tax due | 1,819 |
| | |
| Foreign tax incurred | 28,000 |
| Disallowed (allocable to excluded income) | (21,342) |
| Used as a credit | (2,506) |
| Available for carryback and carryover | 4,152 |

## Carryback and Carryover of Unused Credits

Foreign tax credits that exceed the limitation may be carried back one tax year and forward 10 tax years. Foreign tax credits carried to a particular taxable year are treated as foreign taxes that are paid or accrued by the taxpayer in that year. While their use is subject to the limitation calculation for that year, foreign tax credits carried to another year are not attributable to foreign earned income excluded in that year. The carried over foreign tax credit, therefore, would not be subject to the disallowance formula in the carryover year.

## Planning for Use of Excess Credits

An assignee who was abroad for an extended period may have incurred excess foreign tax credits (credits that were not allowed in full, due to the limitation as explained above), resulting from international assignments in high tax countries. These excess credits may be used to reduce his or her U.S. tax liability if carried over to a year with foreign source income that was not taxed by a foreign country or that was taxed at a rate lower than the U.S. rate. The receipt of foreign source income within the carryforward period may occur after returning to live in the United States. Some possibilities for this occurring are noted below:

- Taxable pension and profit-sharing distributions attributable to employer contributions while services are performed abroad.



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- Stock option income attributable to periods of international assignment or business travel.
- Business trips abroad, either before or after moving to the location of the international assignment. Income would be attributed to the work days abroad and would be considered foreign source income and possibly not taxed in a foreign country.

It is important to note that generating foreign source income while living abroad may not necessarily benefit a taxpayer because the country of residence may tax the income at rates higher than in the United States. Local tax rules must always be considered if tax planning is contemplated and if it involves the use of excess foreign tax credits.



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## Chapter 5 – Special Rules for Self-Employed

As opposed to employees, self-employed taxpayers living abroad will generally find the special exclusions and deductions provided by I.R.C. section 911 to be less advantageous and more complex. The special rules for such individuals are highlighted in this chapter, but all self-employed individuals living abroad would be well advised to obtain competent professional advice concerning their specific situations before filing returns.

### Foreign Earned Income Exclusion

Self-employed taxpayers are permitted to elect the foreign earned income exclusion provided by section 911. The principles are the same as those provided in Chapter 1, but application of the principles and securing the benefits can be more complex.

Assuming that a self-employed taxpayer meets one of the eligibility tests (see Chapter 1), the question then arises whether he or she has foreign earned income that is eligible for exclusion. Such income must be both "foreign" and "earned." Determining these may depend on the nature of the business conducted by the taxpayer. If the business is a personal service business (doctor, lawyer, and so on), where capital is not a material income-producing factor, then all of the taxpayer's net income can be "earned income," and its source will be determined based on rules similar to those for employed taxpayers (i.e., the source is based on where the services are performed).

If capital is a material income-producing factor, such as in the case of a manufacturing business, then an allocation of net income must be made to determine the amount attributable to the taxpayer's personal services. Furthermore, the amount allocated to personal services, or earned income, cannot exceed 30 percent of the net profits from the trade or business. Thus, in such a case, even if the entire net income is from a foreign source, the maximum earned income exclusion under current law would be either USD 92,900 (for 2011) or 30 percent of net profits, whichever is lower.

### Disallowance of Business Expenses

The denial of double benefits rule discussed in Chapter 1 also restricts the benefits of the foreign earned income exclusion for self-employed taxpayers. The foreign



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earned income exclusion is applied against gross income from self-employment. A portion of all business expenses must be considered related to excluded income and therefore disallowed, based on the ratio of the foreign earned income exclusion to gross foreign earned income. Thus, a self-employed individual who engages in a personal service business and who nets an amount equal to the foreign earned income exclusion after expenses, may not then eliminate such income by claiming the foreign earned income exclusion.

*Example*
The foregoing principles are illustrated in the following examples of three foreign resident taxpayers. For 2011, each has net earnings of USD 92,900 that qualifies as foreign source income. Individual A is a salaried employee; individual B is a self-employed attorney; and individual C is a self-employed computer manufacturer.

| (All figures USD) | **A**<br>**Salaried Employee** | **B**<br>**Self-Employed Attorney** | **C**<br>**Self-Employed Manufacturer** |
|---|---|---|---|
| Gross income | 92,900 | 142,900 | 222,900 |
| Business expenses | 0 | (50,000) | (130,000) |
| Net income | 92,900 | 92,900 | 92,900 |
| Earned income exclusion | 92,900 | 92,900 | 27,870* |
| Disallowed expense: | 0 | (92,900 / 142,900 x 50,000) = 32,505 | (27,870/ 222,900 x 130,000) = 16,254 |
| **Calculation of taxable earnings:** | | | |
| Gross income | 92,900 | 142,900 | 222,900 |
| Earned income exclusion | (92,900) | (92,900) | (27,870) |
| Taxable gross income | 0 | 50,000 | 195,030 |



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| | | | |
|---|---|---|---|
| Business expenses | | 50,000 | 130,000 |
| Disallowed expenses | | (32,505) | (16,254) |
| Allowable expenses | | 17,495 | 113,746 |
| Net taxable earnings | 0 | 32,505 | 81,284 |

*Limited to reasonable "earned" income, up to a maximum of 30 percent of net income.

## Foreign Housing Cost Deduction

As indicated in Chapter 1, self-employed individuals may not claim the foreign housing cost exclusion. Instead, a deduction is provided that is computed in the same manner as the housing exclusion. The deduction is limited to foreign earned income in excess of any foreign earned income exclusion and housing cost exclusion (if applicable).

Any portion of the housing cost deduction that cannot be used in the current year because of the income limitation can be carried forward for one year and used in that subsequent year, subject to the income limitation. Unlike the foreign housing cost exclusion, the foreign housing deduction for self-employed individuals is not elective. It may be claimed where applicable.

Business expenses and moving expenses related to the foreign housing deduction are allowed, if they would otherwise be deductible. This is in contrast to expenses related to the foreign housing exclusion, which are disallowed under the denial of double benefits rules. (Note: See below for possible impact on the foreign tax credit disallowance.)

Finally, the foreign housing cost is fully deductible, limited to the foreign earned income in excess of exclusions, even if the earned income exclusion is claimed. In addition, the foreign housing cost deduction is not subject to the tax calculation stacking rule described in Chapter 1.

## Foreign Tax Credit

The foreign tax credit rules for self-employed individuals are similar to those described in Chapter 4. However, for self-employed taxpayers there are some aspects of the foreign tax credit calculation that merit special comment.



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As discussed in Chapter 4, the benefit of the foreign tax credit may be limited, or "scaled down," if the foreign taxes relate to income that has been excluded from U.S. tax due to the foreign earned income exclusion.  However, for self-employed individuals, the benefit of the foreign earned income exclusion may be limited because the exclusion is applied to gross income, not income after related business expenses (i.e., net income), and in some cases may be subject to a further limitation of 30 percent of net profits.  The foreign tax credit scale-down calculation takes these limitations into consideration, and may result in more foreign tax credits available.

### Self-Employment Tax

Self-employed U.S. taxpayers must continue to pay U.S. self-employment (social security) taxes while living abroad, even though they may also be subject to similar taxes in the country of residence. For 2010, such taxes are imposed at a rate of 15.3 percent on net earnings of up to the base amount (see Appendix C). Additionally, a 2.9-percent tax is imposed on earnings in excess of the base. A deduction is allowed, for purposes of determining the amount of earnings subject to self-employment tax, in the amount of 7.65 percent for 2010 and 5.65 percent for 2011 of the self-employment income. For 2011, a 2-percentage point reduction has been implemented, leaving the social security tax rate for self-employed individuals at 13.3 percent on net earnings of up to the base amount (see Appendix C) and an additional 2.9-percent tax on earnings in excess of that base. In effect, the self-employed person is paying both the employer and employee portions of the FICA-OASDI and Medicare taxes. For that reason, an income tax deduction may be claimed for 50 percent of the actual self-employment tax incurred, representing the employer's deduction for payroll tax paid. (For 2011 only, this deduction is figured as 59.6 percent of the portion of self-employment tax paid on self-employment income up to the base amount, and 50 percent of the self-employment tax paid on self-employment income in excess of the base amount.) It should be noted that social security totalization agreements have been concluded with some countries (see Chapter 6 and Appendix B), which may reduce or eliminate the U.S. self-employment tax.

Taxable income for purposes of the self-employment tax may not be reduced by the foreign earned income exclusion or housing cost amount deduction.



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Self-employment tax is computed on Schedule SE of Form 1040 and paid along with any income tax due on Form 1040. It may not be reduced by the foreign tax credit. However, if the taxpayer is also subject to social security tax in the host location, the foreign social security taxes paid may be claimed as a foreign tax credit for U.S. income tax purposes.

### Partnerships

Service partners in U.S. and foreign service partnerships are considered to be self-employed individuals for U.S. income tax purposes. As such, they are therefore subject to self-employment tax and the other rules discussed above. Gross income from the partnership may be offset by the foreign earned income exclusion, and allocable partnership expenses related to the excluded income should be disallowed. It should also be noted that the "source" of a partner's share of partnership income is usually determined according to the overall source of the partnership's income, not according to where the partner performs services. Thus, an overseas partner in a professional service partnership where capital is not a material income-producing factor, and that has U.S. source income, may find a significant part of his or her income is U.S. source income ineligible for the foreign earned income exclusion or foreign tax credit relief, even though the partner personally performs all services overseas.

The normal partnership source rule may become less relevant if a partner receives a "guaranteed payment" for services provided abroad, or receives a valid "special allocation" of overseas profits. The rules under these provisions are complex, and care must be exercised to determine that the payments qualify under the relevant I.R.C. section. Use of a guaranteed payment may also eliminate the possibility of underlying partnership expenses being disallowed as allocable to excluded income because guaranteed payments by their very nature are not related to or affected by partnership expenses.

Comment:

Overseas partners should consider obtaining a guaranteed payment for services performed overseas that is at least equal to the combined foreign earned income exclusion and housing cost amount deduction. The source of such payments should generally then be determined based on where the individual performed the



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services to earn the payments, even though in other respects the payments may be treated as a share of partnership earnings.

### *Partners in Foreign Partnerships*

The rules for taxation of U.S. partners in foreign partnerships are identical to those for partners in U.S. partnerships. It should be noted that special rules apply to partnerships with U.S. partners and certain transfers of interests in foreign partnerships by U.S. citizens or residents.



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## Chapter 6 – Other Tax Considerations of Overseas Residents

### Treaties

The United States has entered into numerous tax treaties with other countries for the purposes of clarifying jurisdiction to tax and avoiding double taxation of income. Appendix A lists the countries with which the United States has entered into income tax treaties. These treaties can provide U.S. citizens and residents with significant reductions in foreign income taxes. A reduction in U.S. tax is generally unavailable to U.S. citizens and residents under such treaties as a result of the inclusion of "tax saving" clauses that permit the United States to impose tax on U.S. citizens and tax residents as if the treaty were not in effect.

Notwithstanding the saving clause, treaties can provide a U.S. tax benefit. For example, individuals who are not U.S. citizens, but who qualify as U.S. tax residents, may invoke the treaty to use the bona fide residence test to claim the foreign earned income exclusion. If a taxpayer invokes a U.S. tax treaty to reduce U.S. tax, disclosure may have to be made in the U.S. tax return.

### Social Security Taxes

U.S. citizens and residents working overseas may be subject to both U.S. and foreign social security taxes. Such individuals employed by U.S. companies will continue to be subject to U.S. social security and Medicare tax (often called "FICA" tax) to the extent that their compensation is provided by the U.S. company.

Individuals employed by foreign corporations, including foreign subsidiaries of U.S. corporations, are generally not subject to U.S. FICA tax. However, a special election can be made by the U.S. parent company to continue coverage of all U.S. citizen employees of foreign affiliated companies. Furthermore, a FICA liability will apply when a U.S. citizen or resident is working abroad for a foreign employer that is a member of a U.S.-controlled group of entities, if he or she is performing services in connection with a contract with the U.S. government (or any instrumentality thereof).

The FICA tax is imposed at the same rate on both the employee and the employer, except in 2011. For 2010, the combined rate for each is 7.65 percent, which consists of 6.2 percent for old-age, survivors, and disability insurance (OASDI), and 1.45 percent for hospital insurance (Medicare). For 2011 only, the OASDI rate has



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been reduced from 6.2 percent to 4.2 percent for the employee (but not the employer). The OASDI rate applies to wages within the OASDI wage base, which is USD 106,800 for both 2010 and 2011. However, there is no ceiling on wages subject to the 1.45-percent Medicare tax. The employer is required to collect the employee's portion of the FICA tax by means of a payroll deduction and to remit this amount along with the employer's portion of the tax to the government. Taxable earnings for purposes of Social Security tax cannot be reduced by the foreign earned income and housing cost exclusions.

Since the U.S. assignee may be subject to both FICA and foreign social security tax if employed and paid by a U.S. company, social security totalization agreements have been concluded by the United States with a number of countries in order to eliminate double taxation and to provide integrated benefit coverage. Where such totalization agreements exist, social security taxes generally are paid only in one of the two countries, but each agreement must be reviewed to determine which country has the right to impose social security tax. Special procedures are often imposed to claim the benefit of such agreements, and they should be carefully reviewed. As indicated in Chapter 4, another country's social security taxes often qualify as creditable foreign taxes, but in no case may any foreign social security tax be considered a creditable income tax when the United States has concluded a totalization agreement with that country (see Appendix B).

### Foreign Currency Exchange Rules

Income and deductions must be reported on U.S. tax returns in U.S. dollars. Income received and expenses paid in a foreign currency should generally be converted to U.S. dollars using the exchange rate at the date of receipt or the date of payment, although under some specific circumstances it may be appropriate to use an average exchange rate for the year. In particular, it should be noted that securities transactions in foreign currencies must be converted at the exchange rates in effect on dates of purchase and dates of sale. Thus, a transaction that results in no gain or loss in the local currency could result in a taxable gain or loss when converted into U.S. dollars.

### Community Property Rules

Some U.S. states impose "community property" rules which provide that certain marital income and assets are the property of both spouses. Community property



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rules with respect to income are ignored in certain circumstances for U.S. income tax purposes. In particular, community property rules may not be used to attribute earned income of a taxpayer to a nonresident alien spouse who is not subject to U.S. income taxation. Passive investment income and securities transactions are generally reported following community property rules and therefore may be split between the two spouses if a joint return is not filed. Community property provisions and restrictions on such reporting are complex, and a tax adviser should be consulted in any situation where community income is involved.

### Alternative Minimum Tax

The United States also imposes an alternative minimum tax (AMT), which was devised to ensure that at least a minimum amount of income tax is paid by high-income taxpayers. The AMT functions as a recapture mechanism, reclaiming some of the tax breaks that were originally primarily available to high-income taxpayers, and represents an attempt to maintain tax equity.

The tax law provides for preferential treatment for certain income and allows special deductions and credits for certain expenses. Taxpayers who take advantage of these tax incentives may have to pay AMT. The AMT, a separate tax computation from regular income tax, eliminates some of the preferential tax breaks available under the regular tax regime, thereby increasing the U.S. tax liability of an individual who might otherwise pay less regular U.S. tax.

Technically, AMT is the amount by which a taxpayer's tentative minimum tax exceeds his or her regular tax liability. The tentative minimum tax is imposed on the portion of the taxpayer's alternative minimum taxable income (AMTI) in excess of the AMT exemption amount. The AMT rate is equal to 26 percent, with a second 28-percent bracket starting at USD 175,000, on AMTI in excess of the exemption (see Appendix C for the exemption amounts).

The tax base subject to AMT, or AMTI, is taxable income (before personal exemptions) re-computed to take into account certain adjustments and tax preference items. The AMT adjustments and tax preference items include, in part, certain itemized deductions (such as deductions for state and local income tax (or sales tax) and property taxes), taxable state and local tax refunds, accelerated depreciation of certain property, certain tax-exempt interest, and the difference



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between AMT and regular tax gain or loss on the sale of property, and the treatment of incentive stock options.

The foreign tax credit, with limitations re-calculated applying AMT rules, may be used to reduce the AMT.

### Minimum Tax Credit

A minimum tax credit (MTC) may be allowed for a taxable year in which AMT is not due but AMT was paid in prior years. The MTC is allowed only against the excess of the regular tax over the "tentative" minimum tax for the taxable year. The tentative minimum tax is 26 percent of AMTI over the exemption amount (28 percent to the extent that AMTI is greater than USD 175,000) reduced by the amount of foreign tax credit allowable against AMT.

The MTC is equal to the aggregate of the AMT paid in prior years over the AMT that would have been paid in each prior year had the AMT been computed taking into account only a limited number of the adjustments and tax preference items.

The MTC generally is reduced as it is offset against regular tax. Any excess MTC may be carried forward indefinitely as a credit against regular tax liability.

### Foreign Corporations – Owners, Officers, and Directors

U.S. citizen or resident owners, officers, or directors of foreign corporations should be aware that there may be a requirement to file Form 5471 with the IRS concerning such status. The form is generally required for these categories of individuals, and varying details may be required with respect to the foreign corporation, including notification of transfers of interest, acquisitions of interests, and nominations as officers or directors. In certain cases, balance sheets of the foreign corporations and lists of transactions between the foreign company and the individual from the United States may be required.

Individuals having any of the above positions with respect to foreign corporations or involvement with foreign partnerships or trusts should consult their tax advisers to determine the appropriate filing requirements. Substantial penalties may be imposed for failure to file this documentation.



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## State Income Taxes

A U.S. assignee may continue to be liable for state income taxes while residing in a foreign country. If permanent residence or domicile is retained in the state, he or she may be subject to taxation as a resident. Individual states differ widely in matters relating to residency, taxation of nonresidents, and the basis for taxation. Individual state requirements should be reviewed by each taxpayer upon his or her transfer overseas.

Comment:
If an individual is subject to state income taxation on a "resident" basis while abroad, the state's tax rules should be reviewed to determine whether relief might be provided through claiming the foreign earned income exclusion and / or the foreign tax credit. Many states' taxation starts with federal adjusted gross income. Therefore, if no specific law has been enacted to require an "add back" of the foreign earned income exclusion, they may effectively be allowable.

Due to the complexity of this area of the law, it is strongly recommended that professional advice be sought concerning the state income tax consequences of an international assignment.

## Foreign Tax Planning

The total cost of an international assignment may be reduced by pre-departure planning to reduce taxes in the country of assignment. This planning generally involves analyzing the various components that could make up the assignee's compensation package to consider potential tax incentives in the foreign jurisdiction.

For example, certain countries provide beneficial tax structures for assignees while other countries provide lower tax rates for certain benefits paid directly by an individual's employer.

The timing of arrival in or departure from the host country may also be important. Some tax treaties permit U.S. citizens or residents employed by a U.S. employer to avoid foreign tax in any foreign taxable year in which the employee is present in the host country for less than a stipulated number of days (usually 183). In addition, the timing of assignments should be considered in order to mitigate potential local taxes.



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To the extent an assignee is covered under a tax reimbursement plan (which generally protects an individual from incurring combined U.S. and foreign income taxes in excess of the U.S. tax he or she would have paid had the individual not relocated), the incentive to reduce foreign taxes will be with the employer. Assignees who are not covered under such plans should consider the possibility of higher tax costs when determining whether to accept an overseas position.

## Expatriation

An individual who relinquishes U.S. citizenship or ceases to be a long-term resident of the United States on or after June 17, 2008, may be subject to a special exit tax.

An individual who is subject to the exit tax is considered a "covered expatriate." All property (with certain exceptions) of a covered expatriate is treated as having been sold for its fair market value on the day before the covered expatriate's expatriation date. Any resulting gain is subject to tax to the extent it exceeds an exclusion amount of USD 627,000 for expatriations occurring in 2010, or USD 636,000 for expatriations occurring in 2011. Each individual is eligible for only one lifetime exclusion amount. Thus, if an individual expatriates for a second time, the exclusion amount available for the second expatriation is limited to any unused portion of the exclusion amount remaining after the first expatriation, as adjusted for inflation.

For the purposes of calculating this deemed gain, property that was owned by a covered expatriate when the individual first became a U.S. resident is treated as if it had been acquired at its fair market value on the date that such individual became a U.S. resident. Special rules apply to items of deferred compensation, certain tax-deferred accounts, and any interest in a nongrantor trust. An election is available to postpone payment of the exit tax on a given asset until that asset is actually sold, by posting adequate security and paying interest.

In addition, a U.S. citizen or resident who receives a gift or bequest from a covered expatriate is subject to a transfer tax on the fair market value of the property received at the highest U.S. gift or estate tax rate then in effect (35 percent in 2010 and 2011). The transfer tax does not apply if the property was included in a timely filed U.S. gift or estate tax return filed by the covered expatriate.



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In general, a "long-term resident" is a foreign citizen who was a lawful permanent resident of the United States (i.e., a greencard holder) "in" at least eight of the 15 taxable years ending with the year of expatriation. For the purpose of these rules, "expatriation" means ceasing to be a lawful permanent U.S. resident or commencing to be treated as a resident of a foreign country under a treaty residency rule.

The exit tax applies to any U.S. citizen or long-term resident whose expatriation date is on or after June 17, 2008, and:

- Whose average annual net income tax liability over the five years ending before expatriation is greater than USD 145,000 in 2010, USD 147,000 in 2011;
- Whose net worth is USD 2 million or more on the date of expatriation (not indexed for inflation); or
- Who fails to certify compliance with the U.S. tax laws for the five preceding tax years or who fails to submit such evidence of compliance as the IRS requires.

Narrow exceptions apply to certain U.S. citizens with dual nationality.

An individual who would be subject to the rules above but whose expatriation date is on or after June 3, 2004, but before June 17, 2008, is not subject to the exit tax, but is subject to tax on an expanded definition of U.S. source income and is required to recognize gain on what would otherwise be a tax-free exchange, for a 10-year period after expatriation. The tax is calculated using the graduated rates applicable to U.S. citizens, rather than rates applicable to other nonresidents. This special tax is known as the expatriation tax and is due if it is higher than the regular tax imposed on nonresidents.

Some taxpayers may be subject to the expatriation tax (not the exit tax), regardless of their date of expatriation, and regardless of whether they meet the three tests mentioned above. An individual who was a resident during any of three consecutive calendar years, who ceased to be a resident and subsequently becomes a U.S. resident again before the close of the third tax year after the initial period, will be taxable under the expatriation rules during the intervening period of non-residence.



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Stringent reporting requirements are imposed on those subject to the expatriation tax during the 10-year period following expatriation. In addition, there are restrictions on the number of days an individual subject to the expatriation tax can return to the United States without becoming subject to U.S. taxation as a resident. To partially offset some or all of the additional tax imposed, special foreign tax credits may be available.

Individuals who expatriated before June 4, 2004, should contact their U.S. tax advisers regarding the applicable law.

Due to the complexity of this area of the law, it is strongly recommended that professional advice be sought before an individual revokes U.S. citizenship or surrenders his or her greencard, to avoid or mitigate the many pitfalls and to better understand the potential tax implications. Immigration counsel should also be consulted as there are non-tax issues which need to be considered as well.

## Estate and Gift Taxation

The United States applies a unified gift and estate tax system to transfers of property made by an individual during life and at death.   In addition, some states impose an estate tax or inheritance tax upon the death of an individual.

One system of estate and gift taxation applies to U.S. citizens and to foreign citizens domiciled in the United States. A separate system applies to foreign citizens who are not domiciled in the United States. An individual is domiciled in the United States if he or she actually resides in the U.S. and has the intention to remain there indefinitely. Domicile is different from residency for income tax purposes. Whereas a foreign national with a greencard generally is regarded as domiciled in the United States for estate tax purposes, a foreign national who is a U.S. resident for income tax purposes under the substantial presence test may not necessarily be regarded as domiciled in the United States for estate tax purposes.

The United States has negotiated a number of treaties with respect to estate and gift taxes. Their provisions should be reviewed to determine potential eligibility for those benefits.

Important note: The estate tax (but not the gift tax) was repealed for the year 2010 only. The estate tax has been reinstated in 2011.



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*U.S. Citizens and U.S.-Domiciled Foreign Citizens*

A U.S. citizen or U.S.-domiciled foreign citizen is subject to gift tax on the fair market value of all gifts made during life unless an exclusion is available. Most notably, a donor is permitted to make tax-free gifts of up to USD 13,000, in both 2010 and 2011, annually to each donee. Married couples generally can treat such gifts as if each spouse made half of the gift, thereby doubling the amount that can pass tax free annually to any one donee. The ability to split the gifts is available only if both spouses are U.S. citizens or U.S.-domiciled foreign citizens.

In addition, each donor is allowed to transfer by gift up to USD 1,000,000 tax free by virtue of the applicable credit amount, to the extent that the credit has not been applied to taxable gifts made in prior years. Gifts of up to USD 134,000 in 2010 and USD 136,000 in 2011 to a spouse who is not a U.S. citizen (regardless of domicile) are exempt from gift tax. In contrast, gifts made to a spouse who is a U.S. citizen are generally not subject to gift tax by virtue of the unlimited marital deduction.

Upon the death of a U.S. citizen or U.S.-domiciled foreign individual, his or her taxable estate is subject to estate tax. The taxable estate includes the fair market value of all of a decedent's assets, wherever located, less certain deductions. Deductions are allowed for funeral and administration expenses, creditors' claims, certain transfers to spouses, charitable bequests, casualty losses, and other expenses.

During the individual's lifetime, current taxable gifts are added to all prior taxable gifts and a tentative tax is computed using the gift and estate tax rate table. The tentative tax is then reduced by any prior gift taxes paid and by the applicable credit amount. The applicable credit amount is the amount of tentative tax that would be computed on the applicable exclusion amount. The applicable exclusion amount for gift tax purposes is USD 1,000,000 in 2010, and USD 5,000,000 in 2011. The highest tax rate is 35 percent, which applies to gifts in excess of the exclusion amount.

At death, the taxable estate is added to all prior taxable gifts and the same tax calculation method is applied. The applicable exclusion amount for estate tax purposes is USD 5,000,000 for 2011. The highest tax rate in 2011 is 35 percent which applies on taxable transfers in excess of the applicable exclusion amount. Although the estate tax was repealed for 2010, an election can be made to apply



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the 2011 rules in 2010, which under certain circumstances can be more beneficial. This election does not affect the gift tax in 2010.

The most important estate tax deduction is the marital deduction, which generally permits all outright transfers of property to the decedent's spouse to be excluded from taxation, but only if the spouse is a U.S. citizen. Generally, no marital deduction is allowable for property passing outright to a spouse who is not a U.S. citizen. Relief, however, may be available under certain estate tax treaties. In addition, if the surviving spouse becomes a U.S. citizen before the federal estate tax return of the decedent is filed, property passing to the spouse can qualify for the marital deduction if the spouse was a U.S. resident at all times after the decedent's death and before becoming a U.S. citizen.

The estate tax marital deduction also is available for property passing to a qualified domestic trust (QDOT) for the benefit of a spouse who is not a U.S. citizen. A QDOT must satisfy the following conditions for the marital deduction to apply:

- The trust instrument must require that at least one trustee be a U.S. citizen or domestic corporation, and that no distribution from the trust (other than a distribution of income) may be made unless a trustee, who is a U.S. citizen or domestic corporation, has the right to withhold tax on the distribution;
- The trust must meet the requirements in the Treasury regulations to ensure the collection of the estate tax on a subsequent taxable event; and
- The executor must make an election to have the QDOT provisions apply.

(A tax adviser should be consulted to determine that the requisite conditions are satisfied.)

Property passing from the decedent to the surviving spouse outside of the probate estate will qualify for QDOT treatment if transferred to the QDOT by the due date of the decedent's estate tax return. A special rule (estate tax credit rule) is provided to coordinate the estate tax treatment of property passing to a non-U.S. citizen with the treatment of property passing to a U.S. citizen (which is eligible for the marital deduction). If the property passes to a non-U.S. citizen who later becomes a U.S. citizen or domiciliary and is later subject to U.S. estate tax, a credit will be



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permitted to the estate of the second spouse for estate tax paid by the decedent on such property. This rule, which applies regardless of whether a QDOT is used, results in only one level of taxation on the property transferred to a spouse, who is, or subsequently becomes, a U.S. citizen.



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## Chapter 7 – Procedural Aspects

U.S. taxpayers must comply with various filing and reporting requirements in order to avoid potential penalties and interest. Rules exist with respect to tax return completion, late filing, under-payment of taxes, and reporting of non-U.S. financial accounts. The rules on these tax and related procedural aspects applicable to American employees working overseas are discussed in this chapter.

### Tax Return Filing

#### *Where to File*

If a taxpayer is claiming the foreign earned income exclusion or the housing cost deduction, or if the taxpayer lives in a foreign country or U.S. possession and has no legal residence or principal place of business in the U.S., the income tax return must be filed with the Internal Revenue Center in Austin, Texas (or other Internal Revenue Center as specified in the tax form instructions).

The IRS has offices attached to U.S. embassies in a number of countries. Such IRS offices normally accept filing of U.S. income tax returns by delivery to their office for forwarding to Austin. Tax returns should not be filed at U.S. embassies or consulates without first ascertaining that there is an IRS office that accepts tax returns for filing.

#### *Due Dates and Extensions*

The ordinary due date for U.S. income tax returns of U.S. citizens and residents is April 15; however, a special two-month automatic extension of time for filing (to June 15) is provided to U.S. citizens and resident aliens who, on the normal due date of the return, are residing abroad. Individuals who qualify for this automatic extension need not file any form with the IRS to obtain the extension, but should simply attach a statement to their tax returns indicating that they qualify for the automatic two-month extension. It should be emphasized that the automatic extension of time for filing does not extend the time for payment of tax. Interest will be charged by the IRS on any unpaid balance of tax from the normal due date (April 15) until the date the return is filed, even if the due date is extended.

Individuals who are unable to complete their returns by April 15 (or June 15, if automatically extended) may obtain additional extensions of time to file. Generally, the initial extension request should be filed by April 15 (June 15, if automatically



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extended) on Form 4868, which provides an automatic extension of time for filing to October 15. Any unpaid tax should be remitted with Form 4868. Failure to provide a reasonable estimate of the tax liability may invalidate the extension. A payment need not be made with the Form 4868, however, interest and penalty charges may be assessed on any unpaid tax. If the form is filed on time, the extension is automatic; no approval is required from the IRS. A copy of Form 4868 must be retained by the taxpayer.

For U.S. citizens and residents who were residing abroad at April 15, an additional extension to December 15 may be requested from the IRS by filing a letter with the IRS Service Center in Austin, Texas, stating reasons for the extension in detail. Approval of such extensions is subject to the discretion of the IRS.

Finally, special procedures permit longer extensions of time for filing when the individual has not yet qualified for the foreign earned income and housing cost exclusions under the bona fide residence or physical presence tests. Under this procedure, an extension may be obtained to a date 30 days after the end of the qualifying periods (30 days after the end of the following year, if the bona fide residence test is being applied). The date may be further extended up to 90 days after the end of the following year for taxpayers required to allocate moving expenses between years (see Chapter 2). This extension is requested by filing Form 2350 by the original due date of the tax return (April 15 or June 15). The IRS will return the bottom portion (Notice to Applicant and Return Label) of the Form 2350 indicating whether the extension request is approved. A tax payment can be made, but need not be, with the Form 2350. Interest and penalty charges may be assessed on any unpaid tax (see below). The Notice to Applicant must be retained by the taxpayer.

Extension requests should be filed with the IRS office to which the return is to be sent (Austin, for overseas taxpayers). As with the automatic two-month extension, those obtained by filing Form 4868, an extension request letter, or Form 2350, do not prevent interest being charged from the original due date of the return on any balance of tax that is due with the return.

Individuals who cannot file their returns because they are awaiting qualification for the foreign earned income and housing cost exclusions, should calculate their estimated tax liability on the assumption that they will qualify for the exclusions,



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and pay the balance of tax due by April 15 of the year following the move in order to avoid interest charges.

### *Filing Status and Requirements*

U.S. citizens and aliens who retain their U.S. permanent residence status (greencard) must file U.S. income tax returns if gross income, disregarding foreign earned income exclusions, exceeds certain minimum levels, which change each year due to inflation adjustments. (See Appendix C for 2010 and 2011 minimum filing requirements.)

Married U.S. citizens or resident aliens may either file a joint return or separate returns using the applicable "married filing jointly" or "married filing separately" tax rates. A joint return is generally advantageous as compared to a separate filing, because the effective tax rates for those married, filing separately are higher than both the married filing jointly and single tax rates. The filing of a joint return does not prevent each spouse from calculating and claiming his or her own foreign earned income and housing cost exclusions, as explained in Chapter 1.

If either spouse is a nonresident alien at any time during the tax year, a joint return cannot be filed unless a special joint election is made (the election results in the nonresident alien spouse being treated as a full-year resident of the U.S. and therefore required to include all income in the U.S. income tax return). Once made, the election can be terminated in later years by death, separation, revocation, or by action of the IRS because of inadequate taxpayer information. If terminated, the election can never be made again by either individual. It should be noted that if separate returns are filed, foreign community property laws will not apply to attribute earned income of the U.S. spouse to the nonresident alien spouse.

A U.S. citizen who is married to a nonresident alien, and whose spouse does not elect to be included in a joint return, may not use single filer tax rates. In general, he or she must use the higher rates for married persons filing separately unless he or she qualifies as a "head of household." An individual married to a nonresident alien who does not choose to make the residency (joint return) election discussed above is considered "unmarried" for purposes of determining eligibility for head of household tax rates. This means that, rather than being forced to use the married, filing separately rates, such an individual may qualify for the lower head of



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household tax rates if he or she maintains a household for a dependent child or other qualifying dependent.

Individuals married to nonresident aliens should give careful consideration to their filing status. If the nonresident alien spouse has no significant personal income, it may be beneficial to elect to file a joint return. However, it should be remembered that once the election is made, it can be revoked only once and cannot be elected again. Spouses who have no current income may nevertheless expect to have taxable income in the future, such as from the sale of real estate or income resulting from a future inheritance. This possibility should be considered when evaluating filing status. If the U.S. citizen's earned income is fully eliminated by the foreign earned income and housing cost exclusions, then separate filing status may result in no greater income tax, and there would be no need to make a joint return election. Thus, comparative tax calculations should be made under separate and joint status before the initial decision is made.

### *Interest and Late Filing Penalties*

As indicated above, interest is charged by the IRS on any balance of tax due that is paid after the normal due date of a tax return (generally April 15). Special extensions available for individuals living overseas, including those moving abroad for the first time, do not abate charges of interest. Interest is compounded daily, and the rate is set by the IRS quarterly, based on the prevailing interest rate for short-term U.S. government obligations. It should also be noted that interest is charged on any deficiencies of tax assessed by the IRS as a result of tax return examinations or amended returns, including those required to adjust foreign tax credits. The interest charge dates back to the original due date of the return for the year in question. IRS interest charges are not deductible.

Significant penalties may be imposed for failure to file a tax return or to pay tax on time. Most of these penalties are based on the balance of tax due, and they range from 0.5 to 5 percent per month, up to a maximum of 25 percent of the tax payable with the return. It should also be noted that failure to file a return on time or to obtain extensions of time for such filing, may jeopardize a taxpayer's ability to claim the foreign earned income exclusion. Therefore, a significant balance of tax could be due with a return that would have had no tax liability if filed on time or by the



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extended due date. Penalties and interest, of course, would be computed on such balance as well.

### *Estimated Tax Payments*

Generally, 90 percent of the total tax liability for the year must be paid throughout the year in order to avoid significant penalties for under-payment of tax. To provide for current payment of income taxes not collected through withholding, the law generally requires that an individual pay an estimated tax if the total amount of taxes withheld from wages during the year will not be sufficient to avoid penalties for the under-payment of estimated tax. However, no penalty for under-payment of estimated tax is imposed if the tax liability for the year, less tax withheld from wages, is less than USD 1,000.

For a calendar-year taxpayer, the estimated tax installment payments generally must be made by April 15, June 15, and September 15 of the current tax year, and January 15 of the following year. Form 1040ES should be used for this purpose.

If the estimated tax paid in timely installments or withholding equals or exceeds the total income tax liability for the preceding year, no penalty will be imposed. However, if the individual's AGI exceeded USD 150,000 (USD 75,000 for married individuals filing separately) in the preceding taxable year, the estimated tax payments and withholding must equal or exceed 110 percent of the preceding year's tax liability. If no tax was due for the prior year, no current-year estimated tax payment is required if the individual was a U.S. citizen or resident for the entire current year and if the prior-year tax return covered a period of 12 months.

*Note*: Many expatriate taxpayers were not required to make estimated tax payments for taxable years before moving abroad because tax withheld from their wages exceeded their tax liability. Withholding for most taxpayers living abroad is substantially reduced or eliminated because of the foreign earned income and housing exclusions and the foreign tax credit. Therefore, such individuals may unexpectedly find that they have balances of tax due with their returns, on which under-payment penalties may be imposed.

## U.S. Withholding Taxes

Individuals working for U.S. employers are subject to federal income tax withholding while they live abroad. Individuals employed by foreign employers are



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generally not subject to U.S. withholding tax, but they may be required to file quarterly estimated tax payments (as discussed above). Withholding requirements may be reduced for taxpayers living abroad by going through a number of special procedures. In particular, withholding is not required on wages paid to U.S. citizens that are expected to be exempt from tax due to the foreign earned income and housing exclusions, if the individual files a signed statement (on Form 673) with the employer indicating that he or she expects to qualify. Income in excess of the foreign exclusions is still subject to U.S. withholding unless one of the other exceptions is met. Even if a U.S. citizen is employed by a U.S. employer, his or her wages are exempt from withholding if they are subject to mandatory income tax withholding in another country. For example, an individual employed by a U.S. company, and who lives and works in the United Kingdom, may be subject to P.A.Y.E., a withholding system in the United Kingdom that applies to both domestic and foreign employers. In such case, the individual would not be subject to U.S. income tax withholding.

If wages are subject to host country withholding, the exemption from U.S. withholding applies, regardless of the rate of host country withholding and ultimate tax. An individual whose earned income substantially exceeds the foreign earned income and housing exclusions, and who has U.S. business days or lives in a country with a low income tax but is subject to host country withholding, may find that he or she has a significant balance of tax due with the U.S. return because the foreign tax credit and earned income exclusions do not eliminate the U.S. tax due. In such case, the individual may be subject to penalty for failure to pay quarterly estimated taxes, even though his or her wages were exempt from U.S. withholding tax. Accordingly, quarterly estimated tax payments should be considered.

Where an individual is subject to another country's income taxes, but does not pay them through withholding against wages, he or she may nevertheless utilize a special procedure to take account of the expected foreign tax credit for such income taxes. Essentially, the foreign tax credits may be converted into federal withholding exemptions and claimed on Form W-4. This procedure is somewhat complex and generally would require professional assistance in calculating the number of withholding exemptions allowed.



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## Amended Returns

It is not uncommon for individuals living overseas to have to amend their U.S. income tax returns. These amendments may be required for a number of reasons, which have been discussed in detail in the preceding chapters, and which include the following: to claim additional foreign earned income and housing exclusions as a result of later qualification; to change the order of claiming exclusions by year; to claim carrybacks of excess foreign tax credits; and to adjust accruals of foreign tax credits to reflect the final host country tax assessment and exchange rate when paid.

Amended returns should be filed with the IRS office where the original return was filed. For Americans living overseas, this would generally be the IRS office in Austin. Most amended returns must be filed within three years from the due date of the tax return (including extensions), or two years from payment of tax, whichever is later. However, a special 10-year statute of limitations is provided to adjust foreign tax credits. This is intended to provide sufficient time for local tax authorities to audit and clear assessments of foreign taxes.

## Foreign Bank and Financial Account Reporting

Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*, must be filed by U.S. citizens and residents who have a financial interest in or signature authority over foreign bank, securities, or other financial accounts, both business and personal, that exceed USD 10,000 in aggregate value at any time during the calendar year. The report is filed separately from the income tax return, and is sent to the U.S. Treasury Department. The form must be filed no later than June 30 of the year following the tax year. Significant penalties may be assessed for failure to file.

## Creation of or Transfers to Certain Foreign Trusts

U.S. citizens or residents who create a foreign trust or transfer property to a foreign trust are required to file an information return, Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts,* within 90 days of the creation or transfer. Failure to file may result in civil penalties unless reasonable cause can be established.



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## Foreign Partnerships

Certain foreign partnerships with U.S. partners or U.S. operations must file U.S. partnership returns. Failure to file can result in the disallowance of losses and credits to the U.S. partners, including resident aliens.

## Currency Restrictions and Reporting

The United States imposes no restrictions on bringing money into or out of the country. However, FinCEN Form 105, *Report of International Transportation of Currency or Monetary Instruments*, must be filed within 15 days with the Customs officer in charge at any port of entry or departure or by mail with the Commissioner of Customs, Attention: Currency Transportation Reports, Washington, D.C. 20229 (follow the instructions on the Form) if currency or other monetary instrument totaling more than USD 10,000 is transported into or out of the United States on any one occasion by any individual. "Transportation" includes physically carrying currency as well as mailing, shipping, or causing currency to be carried, mailed, or shipped. An individual must also file FinCEN Form 105 if he or she is the recipient of transported currency or other monetary instruments totaling more than USD 10,000.

An exception to the filing requirements applies to funds transferred through normal banking procedures if no physical transportation of currency or monetary instruments is involved.



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## Chapter 8 – Employer Tax Reimbursement Policies

Most U.S. multinational employers have international assignment compensation policies designed to help ensure that American employees on international assignments receive total compensation comparable to what they would have earned had they remained in the United States, taking into account additional costs of living overseas, including host country income taxes. Income and social security taxes in many countries are higher than in the United States, particularly when considering that most countries tax the various allowances provided to assignees. Generally, the policy is designed such that the individual should not suffer combined taxes on income (U.S. and non-U.S. income and social security taxes) in excess of that which would have been paid if the individual were living in the United States. The method of accomplishing this objective may be either: (1) tax equalization or (2) tax protection. A brief explanation of the two types of tax reimbursement approaches, or methods, is provided below.

### Tax Equalization

Tax equalization aims to make taxes a neutral factor in an assignee's compensation package. The theory is that all assignees should continue to incur a tax burden equal to what they would incur if they were living in the United States. This holds true regardless of actual tax liabilities under local conditions. This permits other elements of compensation (cost of living and hardship allowances, education reimbursements, etc.) to be determined without regard to taxes. Under this method, any tax benefit resulting from low tax jurisdictions would be to the employer's advantage.

Administration of a tax equalization plan may be more complex than for a tax protection plan (described below). For example, a calculation will always be required to determine the benefit or detriment realized by each assignee. On the other hand, overall tax savings may be realized from such a plan since savings from individuals in low tax countries will offset extra costs incurred by individuals in high tax countries. Furthermore, taxes in high tax jurisdictions may be reduced by charging the assignee, as a reduction in monthly salary, the tax that he or she would pay if he or she were living in the United States. This saves current taxes because the payment is treated as a reduction of taxable salary. Furthermore, it offers the individual assignee a more manageable cash flow because his or her



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personal taxes are satisfied by the regular payment of "hypothetical taxes" (a theoretical tax amount calculated as if the assignee were living in the United States (see discussion below)).

### Tax Protection

The concept of tax protection is that the individual will be reimbursed to the extent that his or her combined total income and social security taxes (non-U.S. and U.S.) exceed the amount that he or she would have paid if living in the United States. If combined actual taxes are lower because of the international assignment (because host country taxes are low or non-existent and U.S. tax is reduced by the foreign exclusions), then the individual realizes a tax benefit from being overseas, and he or she is generally entitled to retain the benefit.

A disadvantage of tax protection is that it may restrict employee mobility. An assignee may be unwilling to move from a low tax host country to a high tax country because of the lost "tax benefit" that would result, even though he or she would pay no more tax in the new country than if he or she were living in the United States. Similarly, if the host country's tax laws change to increase taxation during an employee's assignment, the loss of the former "benefit" may cause economic difficulties to the employees and create morale problems, even though, in theory, they are no worse off than in the United States.

Comment:
Tax protection is most often used by employers having a small workforce of international assignees who go to an assignment country for a limited period of time and do not move from one host country to another. Effectively, the possibility of a tax benefit is considered an additional inducement for the international assignment.

### Hypothetical Taxes

A key element in any tax reimbursement plan, whether tax protection or tax equalization, is the determination of the tax that the assignee would have paid if he or she had stayed in the United States. This is generally referred to as the hypothetical tax. For example, when only one or a small number of assignees is involved, the amount may be determined relative to the individual assignee's circumstances, taking into account deductions in tax returns for periods prior to moving overseas. Because of complexities and "subjectivities" involved in



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administering such a plan, the hypothetical tax is typically computed on base salary and normal incentive compensation, using a formula that provides a standard allowance for deductions to be used in calculating the hypothetical tax. This allowance for deductions is intended to cover all types of normal deductions (home mortgage interest, state and local taxes, charities, etc.), and no reference is made to actual deductions incurred.

Comment:
If an assignee is tax equalized with a hypothetical tax computed under a standardized formula, deductions claimed on the assignee's actual tax return may provide no personal tax benefit to the assignee. Therefore, it may be advisable to defer deductions to the extent possible (such as for charitable contributions) until returning to the United States.

An important consideration in establishing a policy for hypothetical taxes is whether there should be a hypothetical state tax. Companies headquartered in a state with significant state and local taxes often include such taxes under the theory that individuals working at the head office would incur such taxes.

If state and local income taxes are included in the hypothetical tax, the allowance for itemized deductions in computing federal tax is normally higher than if such taxes are not part of the hypothetical tax.

### Personal Income and Losses

The basic objective of many employer tax reimbursement plans traditionally has been to relieve excessive taxation on employment income, including expatriate allowances. Many tax equalization and protection plans cover, therefore, only taxes on employment-related income.

However, many countries tax residents on their worldwide income, including personal income, at rates that, in many cases, are higher than in the United States. Individuals with significant personal income may therefore be penalized by virtue of their international assignments. To attract such individuals for international assignments, many companies include personal income, either in full or subject to limits, in tax equalization and protection plans. Individuals with significant tax deductions or tax losses related to personal investments or tax shelters may lose the benefits from the deductions while on international assignments because they



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are not allowable in foreign tax returns, and because there is little or no income for sheltering in their U.S. returns. Some employers have relieved this problem by equalizing "personal losses."

## Administration of Tax Equalization/Protection Plans

Many complex tax calculations are required to properly administer tax reimbursement policies for international assignees. Hypothetical taxes must be calculated, and actual foreign and U.S. taxes, either on company income or total income, must be verified. Exchange rates for conversion into dollars may vary when foreign taxes are finally paid, and foreign tax assessments may be incorrect and subject to challenge to prevent over-payment.

To determine that taxes are not over-paid and to preserve the confidentiality of employees' personal tax returns, many employers use independent tax accountants to prepare tax returns and calculate final tax equalization or protection payments.

## Conclusion

Employer tax reimbursement policies may be the single most important element of an international assignment compensation package. They can often be unsettling to an international assignee if not properly designed, communicated, and administered. A well-designed plan can reduce the employer's tax reimbursement outlays and administrative expenses. Each plan must necessarily be adapted specifically for each employer, and the foregoing comments should only be used as general guidelines.



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## Chapter 9 – Personal Planning for a Transfer Overseas

At the time of transfer overseas, there are many things to be considered regarding compensation and personal comfort for the international executive and family members. The factors affecting a successful and rewarding transfer are numerous; however, an organized approach can smooth the transition, curb surprises, and help realize the objectives of the executive and the company for the international assignment.

These considerations can generally be categorized as follows:

- Compensation factors;
- Pre-departure activities;
- Vital documents;
- Host country adjustment;
- Repatriation.

This chapter contains a brief overview of each of the above points. Check-lists are included in Appendix E and Appendix F to aid the international executive in planning a successful transfer.

(For more practical information, please refer to KPMG's country series, *Planning Your International Transfer*, available online on the IES global homepage on www.kpmg.com (under the link: "More articles and publications") or from your local KPMG IES professional.)

### Compensation Factors

Different approaches to the compensation package should be evaluated. If the company has a specific international assignment policy, this policy should be reviewed and understood by the executive well in advance of the transfer.

The basic objective of an organized approach is to foster a situation whereby the executive is, in fact, compensated at the agreed-upon level. A variety of things can significantly alter the actual value of compensation: different costs of living in



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different locations; different health, medical, pension, and life insurance benefits; different education costs for children; relocation costs; and different tax burdens.

### Pre-departure Activities

Pre-departure "activities" outlined in the check-lists (see Appendix E) prepare the executive and his or her family for leaving home and for their stay in the host country. Among other things, these activities clear the way for convenient financial transactions in the host country, such as establishing lines of credit, credit cards, and insurance policies, and can help the executive acclimate to a new position and life-style.

### Vital Documents

An important part of pre-departure activities is the preparation of vital documents. The preparation of vital documents, such as visas, wills, powers of attorney, and property deeds, can help assure the executive that all major concerns regarding legal status abroad and in the United States are properly handled, including the status of all possessions, guardians for children in case of emergency, and many other vital matters. (See Appendix F.) While this preparation might seem cumbersome, it can help protect the executive and alleviate certain concerns of both the executive and the family. It also allows maximum focus on the objectives of the assignment and enjoyment of the unique experiences available to international executives.

### Adjustment to the Host Country

Prior to departure from the United States, the executive should be sent or should otherwise obtain information on the overseas employer, as well as the country and city (through magazines and guidebooks, government literature, and Web sites) in which he or she will work and reside. Complementing the executive's self-preparation, the receiving company should prepare receptions and meetings, some of an informal nature, at which the executive, spouse, and children are introduced to their peers. References to doctors, publications, and home delivery services should also be prepared by the receiving company. Some of the everyday activities/amenities that a local resident may take for granted can prove unfamiliar and cause confusion and lost time for the transferring family (newspaper delivery, telephone and other utilities services, local customs, tipping guidelines, sales tax, retail merchants, local banks, mobile phone and Internet service providers, and so



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forth). The executive taking the assignment and the contact in the host country should communicate with one another and work in concert to acclimate the executive and his or her family in as comfortable and expeditious a manner as possible.

### Repatriation

Specific objectives for the return to the United States after the international assignment should be outlined and discussed when the international assignment is being planned. A mutual understanding of the company's and the executive's objectives at the outset will help in the repatriation process. These basic objectives should include the expected contribution that the executive will make to his or her department and the company after the international assignment. During the assignment, lines of communication between the executive and the home company should remain open with respect to larger corporate issues and on the executive's personal and professional development in areas that could prove valuable to the home company. Changes at the home company that can affect the executive should be routinely communicated. The executive can keep and provide status/progress reports to the home company, and where appropriate, revisions to original plans and goals can be made.

As noted above, Appendix E and Appendix F are check-lists to aid the transferring executive in preparing for an assignment in the host country.



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## Appendix A – List of U.S. Tax Treaty Countries

Information as of December 31, 2010

Armenia*
Australia
Austria
Azerbaijan*
Bangladesh
Barbados
Belarus*
Belgium
Bulgaria
Canada
Cyprus
Czech Republic
Denmark
Egypt
Estonia
Finland
France
Georgia*
Germany
Greece
Hungary
Iceland
India
Indonesia
Ireland
Israel
Italy
Jamaica
Japan
Kazakhstan
Kyrgyzstan*
Latvia
Lithuania
Luxembourg
Malta
Mexico
Moldova*
Morocco
Netherlands
New Zealand
Norway
Pakistan
People's Republic of China
Philippines
Poland
Portugal
Romania
Russia
Slovak Republic
Slovenia
South Africa
South Korea
Spain
Sri Lanka
Sweden
Switzerland
Tajikistan*
Thailand
Trinidad & Tobago
Tunisia
Turkey
Turkmenistan*
Ukraine
United Kingdom
Uzbekistan*
Venezuela

*Former republic of the U.S.S.R. and member of the Commonwealth of Independent States, covered by the U.S.-U.S.S.R. income tax treaty signed June 20, 1973. The U.S-U.S.S.R. income tax treaty contains no provisions for dividends, therefore the U.S. statutory withholding rate applies.



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## Appendix B – List of Social Security Totalization Agreement Countries

The United States has concluded social security totalization agreements with the following countries (as of December 31, 2010):

Australia
Austria
Belgium
Canada
Chile
Czech Republic
Denmark
Finland
France
Germany
Greece
Ireland
Italy
Japan
Luxembourg
The Netherlands
Norway
Poland
Portugal
South Korea
Spain
Sweden
Switzerland
United Kingdom

Agreements pending or under negotiation as of December 31, 2010:

- Mexico (agreement signed June 29, 2004, awaiting approval and entry into force).



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## Appendix C – U.S. Individual Income Tax Figures 2010 & 2011

### 2010 Tax Tables

| Married Individual Filing Jointly and Surviving Spouses | |
|---|---|
| **If taxable income (in USD) is:** | **The tax (in USD) is:** |
| Not over 16,750 | 10% of the taxable income |
| Over 16,750 but not over 68,000 | 1,675 plus 15% of excess over 16,750 |
| Over 68,000 but not over 137,300 | 9,362.50 plus 25% of excess over 68,000 |
| Over 137,300 but not over 209,250 | 26,687.50 plus 28% of excess over 137,300 |
| Over 209,250 but not over 373,650 | 46,833.50 plus 33% of excess over 209,250 |
| Over 373,650 | 101,085.50 plus 35% of excess over 373,650 |

| Single Individuals | |
|---|---|
| **If taxable income (in USD) is:** | **The tax (in USD) is:** |
| Not over 8,375 | 10% of the taxable income |
| Over 8,375 but not over 34,000 | 837.50 plus 15% of excess over 8,375 |
| Over 34,000 but not over 82,400 | 4,681.25 plus 25% of excess over 34,000 |
| Over 82,400 but not over 171,850 | 16,781.25 plus 28% of excess over 82,400 |
| Over 171,850 but not over 373,650 | 41,827.25 plus 33% of excess over 171,850 |
| Over 373,650 | 108,421.25 plus 35% of excess over 373,650 |



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| Married Individuals Filing Separately | |
|---|---|
| **If taxable income (in USD) is:** | **The tax (in USD) is:** |
| Not over 8,375 | 10% of the taxable income |
| Over 8,375 but not over 34,000 | 837.50 plus 15% of excess over 8,375 |
| Over 34,000 but not over 68,650 | 4,681.25 plus 25% of excess over 34,000 |
| Over 68,650 but not over 104,625 | 13,343.75 plus 28% of excess over 68,650 |
| Over 104,625 but not over 186,825 | 23,416.75 plus 33% of excess over 104,625 |
| Over 186,825 | 50,542.75 plus 35% of excess over 186,825 |

| Head of Household | |
|---|---|
| **If taxable income (in USD) is:** | **The tax (in USD) is:** |
| Not over 11,950 | 10% of the taxable income |
| Over 11,950 but not over 45,550 | 1,195 plus 15% of excess over 11,950 |
| Over 45,550 but not over 117,650 | 6,235 plus 25% of excess over 45,550 |
| Over 117,650 but not over 190,550 | 24,260 plus 28% of excess over 117,650 |
| Over 190,550 but not over 373,650 | 44,672 plus 33% of excess over 190,550 |
| Over 373,650 | 105,095 plus 35% of excess over 373,650 |



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## 2011 Tax Tables

| Married Individual Filing Jointly and Surviving Spouses | |
|---|---|
| **If taxable income (in USD) is:** | **The tax (in USD) is:** |
| Not over 17,000 | 10% of the taxable income |
| Over 17,000 but not over 69,000 | 1,700 plus 15% of excess over 17,000 |
| Over 69,000 but not over 139,350 | 9,500 plus 25% of excess over 69,000 |
| Over 139,350 but not over 212,300 | 27,087.50 plus 28% of excess over 139,350 |
| Over 212,300 but not over 379,150 | 47,513.50 plus 33% of excess over 212,300 |
| Over 379,150 | 102,574 plus 35% of excess over 379,150 |

| Single Individuals | |
|---|---|
| **If taxable income (in USD) is:** | **The tax (in USD) is:** |
| Not over 8,500 | 10% of the taxable income |
| Over 8,500 but not over 34,500 | 850 plus 15% of excess over 8,500 |
| Over 34,500 but not over 83,600 | 4,750 plus 25% of excess over 34,500 |
| Over 83,600 but not over 174,400 | 17,025 plus 28% of excess over 83,600 |
| Over 174,400 but not over 379,150 | 42,449 plus 33% of excess over 174,400 |
| Over 379,150 | 110,016.50 plus 35% of excess over 379,150 |



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| Married Individuals Filing Separately | |
|---|---|
| **If taxable income (in USD) is:** | **The tax (in USD) is:** |
| Not over 8,500 | 10% of the taxable income |
| Over 8,500 but not over 34,500 | 850 plus 15% of excess over 8,500 |
| Over 34,500 but not over 69,675 | 4,750 plus 25% of excess over 34,500 |
| Over 69,675 but not over 106,150 | 13,543.75 plus 28% of excess over 69,675 |
| Over 106,150 but not over 189,575 | 23,756.75 plus 33% of excess over 106,150 |
| Over 189,575 | 51,287 plus 35% of excess over 189,575 |

| Head of Household | |
|---|---|
| **If taxable income (in USD) is:** | **The tax (in USD) is:** |
| Not over 12,150 | 10% of the taxable income |
| Over 12,150 but not over 46,250 | 1,215 plus 15% of excess over 12,150 |
| Over 46,250 but not over 119,400 | 6,330 plus 25% of excess over 46,250 |
| Over 119,400 but not over 193,350 | 24,617.50 plus 28% of excess over 119,400 |
| Over 193,350 but not over 379,150 | 45,323.50 plus 33% of excess over 193,350 |
| Over 379,150 | 106,637.50 plus 35% of excess over 379,150 |



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## Standard Deduction

| Type of Return Filed | Standard Deduction (USD) | |
|---|---|---|
| | 2010 | 2011 |
| Joint Return or Surviving Spouse | 11,400 | 11,600 |
| Single (other than head of household or surviving spouse) | 5,700 | 5,800 |
| Head of Household | 8,400 | 8,500 |
| Married Filing Separately | 5,700 | 5,800 |

For an individual who can be claimed as a dependent on another person's return, the basic standard deduction applicable to the individual is the greater of USD 950 or the sum of USD 300 and the individual's earned income (these amounts are the same for 2010 and 2011).

The additional standard deduction for married taxpayers and surviving spouses who are age 65 or over or blind is USD 1,100 for 2010 and USD 1,150 for 2011. For a single taxpayer or head of household who is 65 or over or blind, the additional standard deduction is USD 1,400 for 2010 and USD 1,450 for 2011. In the case where the taxpayer is both 65 or older and blind, the additional standard deduction amount is doubled.

## Itemized Deduction Phase-out

Prior to 2010, itemized deductions were subject to phase-out for taxpayers whose AGI exceeded certain thresholds. For tax years 2006 through 2009, the phase-out was gradually reduced, and for tax years beginning after December 2009, the phase-out of itemized deductions no longer applies. This relief was extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010.

## Personal Exemptions

The personal exemption amount for the taxpayer and where qualified, the spouse and dependents, is USD 3,650 per exemption for 2010 and USD 3,700 for 2011. Prior to 2010, the deduction for personal exemptions could be reduced or eliminated for high-income taxpayers whose AGI exceeded certain threshold amounts (adjusted annually for inflation) based on filing status. As with itemized deductions, the phase-out of personal exemptions was repealed beginning in 2010, and that relief has been extended through 2012.



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### Alternative Minimum Tax Exemptions

| Type of Return Filed | 2010 Exemption (USD) | 2011 Exemption (USD) |
|---|---|---|
| Joint Return or Surviving Spouse | 72,450 | 74,450 |
| Single or Head of Household | 47,450 | 48,450 |
| Married Filing Separate | 36,225 | 37,225 |

The AMT exemption is reduced by 25 percent of the amount by which alternative minimum taxable income exceeds a certain amount. The amount is USD 150,000 for a married filing joint or surviving spouse return, USD 112,500 on a single or head of household return, and USD 75,000 on a married filing separate return. The exemption amounts are not automatically indexed for inflation, but in past years the U.S. Congress has acted annually to implement indexing.

### Minimum Filing Requirements

Taxpayers under age 65 are required to file a U.S. income tax return if their gross income, disregarding the foreign earned income and housing costs exclusions, exceeds the following amounts:

| Type of Return Filed | Threshold (USD) 2010 | Threshold (USD) 2011 |
|---|---|---|
| Joint Return | 18,700 | 19,000 |
| Head of Household | 12,050 | 12,200 |
| Single | 9,350 | 9,500 |
| Married Filing Separate | 3,650 | 3,700 |

Children and other dependents are required to file a U.S. income tax return if their gross income exceeds any of the following amounts:

| | 2010 (USD) | 2011 (USD) |
|---|---|---|
| Unearned income (interest, dividends, etc.) | 950 | 950 |
| Earned income | 5,700 | 5,800 |

Or, in light of the above amounts, the tax return must be filed if all income combined exceeds the larger of USD 950 in 2010 and 2011, or earned income up to USD 5,500 2010, plus USD 300.



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### Social Security and Self-Employment Wage Base Amount

| | 2010 | 2011 |
|---|---|---|
| Wage Base Amount | USD 106,800 | USD 106,800 |

### Capital Gains Tax Rates

***Ordinary Rates for Assets Held Not More than One Year (short-term capital gain)*** – The law requires a minimum one-year holding period for the first set of preferential tax rates. Gains on the disposition of capital assets held one year or less are taxed at the taxpayer's marginal tax rate based on his or her income and filing status, up to the current maximum rate of 35 percent.

***15 Percent for Assets Held More than 12 Months (long-term capital gain)*** – Gains on assets held for more than 12 months are taxed at a maximum rate of 15 percent. Taxpayers in the 10- and 15-percent marginal tax brackets are taxed on such gain at zero percent.

***Depreciation Recapture*** – Any part of a long-term capital gain on the sale or exchange of depreciable real property that represents prior depreciation is "recaptured" and taxed at a maximum tax rate of 25 percent. The depreciation recapture rule applies only for purposes of the tax rate; this portion of the gain is still treated as a capital gain for other purposes. Any long-term gain on real property in excess of prior depreciation is taxed at the capital gains rates of 15 (or zero) percent as described above.

### Section 911 Limitations

Maximum wage exclusion: USD 91,500 in 2010; USD 92,900 in 2011.

Maximum housing exclusion amount: USD 12,810 in 2010; USD 13,006 in 2011. (A higher housing cost exclusion limitation is allowed for certain high cost locations.)



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## Appendix D – List of KPMG IES Offices in the U.S.A.

### Atlanta
KPMG LLP
Suite 2000
303 Peachtree NE
Atlanta GA 30308-3210
Tel. +1 (404) 222-3000
Fax. +1 (404) 222-3050

### Boston
KPMG LLP
99 High Street
Boston MA 02110-2371
Tel. +1 (617) 988-1000
Fax. +1 (617) 507-8321

### Charlotte
KPMG LLP
Suite 3200
550 S. Tryon Street
Charlotte NC 28202-4214
Tel. +1 (704) 335-5300
Fax. +1 (704) 335-5373

### Chicago
KPMG LLP
303 East Wacker Drive
Chicago IL 60601-5255
Tel. +1 (312) 665-1000
Fax. +1 (312) 665-6000

### Cincinnati
KPMG LLP
Suite 3400
312 Walnut Street
Cincinnati OH 45202
Tel. +1 (513) 421-6430
Fax. +1 (513) 763-2690

### Dallas
KPMG LLP
Suite 3100
717 North Harwood Street
Dallas TX 75201-6585
Tel. +1 (214) 840-2000
Fax. +1 (214) 840-2297

### Denver
KPMG LLP
Suite 2700
707 17th Street
Denver CO 80202-3499
Tel. +1 (303) 296-2323
Fax. +1 (303) 295-8829

### Detroit
KPMG LLP
Suite 1200
150 West Jefferson
Detroit MI 48226-4429
Tel. +1 (313) 230-3000
Fax. +1 (313) 230-3001

### Ft. Lauderdale
KPMG LLP
Suite 750
400 E. Las Olas Boulevard
Fort Lauderdale FL 33301-4219
Tel. +1 (954) 524-6000
Fax. +1 (954) 462-4765



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**Houston**
KPMG LLP
Suite 4500
811 Main Street
Houston TX 77002
Tel. +1 (713) 319-2000
Fax. +1 (713) 319-2041

**Kansas City**
KPMG LLP
Suite 1000
1000 Walnut Street
Kansas City MO 64106-2162
Tel. +1 (816) 802-5200
Fax. +1 (816) 817-1960

**Minneapolis**
KPMG LLP
4200 Wells Fargo Center
90 South Seventh Street
Minneapolis MN 55402-3903
Tel. +1 (612) 305 5000
Fax. +1 (612) 305 5100

**New York**
KPMG LLP
757 Third Avenue
New York City NY 10017
Tel. +1 (212) 758-9700
Fax. +1 (212) 872-3311

**Northern Virginia**
KPMG LLP
1660 International Drive
McLean VA 22102
Tel. +1 (703) 286-8000
Fax. +1 (703) 286-8010

**Orange County**
KPMG LLP
Suite 700
20 Pacifica
Irvine CA 92618-3391
Tel. +1 (949) 885-5400
Fax. +1 (949) 861-9013

**Philadelphia**
KPMG LLP
1601 Market Street
Philadelphia PA 19103-2499
Tel. +1 (267) 256-7000
Fax. +1 (267) 256-7200

**Phoenix/Tempe**
KPMG LLP
Suite 800
60 E Rio Salado
Tempe AZ 85281-9102
Tel. +1 (480) 459-3500
Fax. +1 (480) 459-3550

**Portland**
KPMG LLP
Suite 3800
1300 SW Fifth Avenue
Portland OR 97201
Tel. +1 (503) 221-6500
Fax. +1 (503) 820-6565

**Seattle**
KPMG LLP
Suite 900
801 Second Avenue
Seattle WA 98104
Tel. +1 (206) 913-4000
Fax. +1 (206) 913-4444



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**Short Hills**
KPMG LLP
150 John F. Kennedy Parkway
Short Hills NJ 07078-2778
Tel. +1 (973) 467-9650
Fax. +1 (973) 561-1815

**Silicon Valley**
KPMG LLP
500 E Middlefield Rd
Mountain View CA 94043
Tel. +1 (650) 404-5000
Fax. +1 (650) 960-0566

**Stamford**
KPMG LLP
Stamford Square
3001 Summer Street
Stamford CT 06905-4317
Tel. +1 (203) 356-9800
Fax. +1 (203) 352-2002

**Washington, D.C.**
KPMG LLP
2001 M Street NW
Washington DC 20036
Tel. +1 (202) 533-3000
Fax. +1 (202) 533-8500



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## Appendix E – Pre-departure Activities Check-list

Action required:

1. Formulate a list of objectives for the international assignment.
2. Have a complete medical examination and receive necessary inoculations a month before departure.
3. Obtain required tests/inoculations and papers required to transport pet(s) to the host location.
4. Obtain medical and dental records for you and your family.
5. Attend language courses, if necessary.
6. Complete host country resource reading and company orientation material.
7. Investigate host location climate to determine suitable clothing.
8. Secure and familiarize yourself and family members with samples of foreign/host country currency.
9. Review guidance for visitors regarding host country customs and take appropriate action.
10. Draw up, or update, a will. Determine whether a will in the host location is advisable.
11. Make arrangements for a power-of-attorney.
12. Choose a legal guardian for children, and complete the necessary formalities. In case of your and your spouse's unexpected deaths, the legal guardian may be the only person permitted to take your child back to your home country.
13. Have any necessary adjustments made in insurance policies.
14. Notify local credit card and charge accounts of address change or have them canceled.



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15. Notify local post office of mailing address change (and provide six to eight weeks notice of change of address to journals/periodicals to which you subscribe).

16. Once departure date is known, inform home delivery services, utilities, etc.

17. Arrange for your sending office/company to send pertinent publications and communications to you on a timely basis.

18. Receive tax counseling from an experienced international tax adviser with U.S. and foreign location experience and knowledge.

19. Communicate with your receiving office as to your exact date of arrival in the host location and your starting date.

20. Make arrangements for support obligations of family members remaining in the home country.

21. Record vital documents on a check-list (see Appendix F). Give a copy of the vital documents check-list to a relative or friend in the U.S., and place a copy in your safe deposit box with originals or copies of the documents.

Secure the following:

1. Host location visas, residency permits, and/or work permits for yourself and all accompanying family members.

2. Separate passports for each family member.

3. Keep with your passport (and your family's passports) a written record of all immunizations and vaccinations with dates and physicians' signatures. School and local health authorities often require this information.

4. Birth certificates.

5. Marriage license.

6. Children's school records.

7. Letters of reference, credit rating, and competence.



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8. An international driver’s license, although you may be required to obtain a local driving permit.
9. Universally-accepted credit cards.
10. Travelers checks (in host and/or U.S. currency).
11. Critical financial records, including tax returns for prior three years.
12. Letter from current auto insurer referring to driving record and insurance history.
13. An account in a bank that has branches in the host location or an open transactional relationship with an overseas bank in the host location.
14. Safe deposit box (either at your home bank or your host country bank).
15. Copy of your most recent prescriptions for glasses, contact lenses, and medicines.
16. Spare pair of glasses/contact lenses.
17. Supply of prescription medicines adequate until local medical contacts can be established in your host location.



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## Appendix F – Vital Documents Check-list

| | Identification Number (Where Applicable) | Location | Date |
|---|---|---|---|
| Your Will | | | |
| Spouse's Will | | | |
| Guardianship Agreements | | | |
| Trust Agreements | | | |
| Mortgages | | | |
| Property Deeds | | | |
| Car Titles | | | |
| Stock Certificates | | | |
| Stock Purchase Agreements | | | |
| Bonds | | | |
| Checking Account(s) | | | |
| Savings Account(s) | | | |
| Other Financial/Brokerage Account(s) | | | |
| Life Insurance Policies | | | |
| Other Insurance Policies | | | |
| Contracts | | | |
| Set of Last Instructions | | | |
| Retirement Agreements | | | |
| Pension or Profit Sharing Plans | | | |
| Birth Certificates | | | |
| Marriage Licenses | | | |
| Divorce and Settlement Papers | | | |
| Notes Receivable | | | |
| Employment Contracts | | | |
| Income Tax Returns (Last 3 Years) | | | |
| Military Discharge and Documents | | | |
| Recurring Bills/Statements | | | |



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| | Identification Number (Where Applicable) | Location | Date |
|---|---|---|---|
| Credit Cards/Other Cards | | | |
| Frequent Flyer Program(s) | | | |
| Personal Computer Log on Name/Password | | | |
| Personal e-mail Account and Password | | | |
| Driver's License | | | |
| Passport(s) | | | |

### Attorney:

Name: ______________________

Address: ______________________

Phone Number: ______________________

### Personal/Family Physician:

Name: ______________________

Address: ______________________

Phone Number: ______________________

### Relative / Other Individual in Home Country (to contact in case of emergency):

Name: ______________________

Address: ______________________

Phone Number: ______________________



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