Bloomberg BNA
Tax and Accounting Center™

Tax Planning International Review: News Archive
2015
Latest Developments
Articles

A new series of articles—Uncle Sam Wants You (To Pay Tax)—will address U.S. tax considerations for U.S. expatriates. This first article highlights the federal income tax pitfalls facing U.S. taxpayers resident abroad.

Expatriation

Uncle Sam Wants You (To Pay Tax): Income Tax Pitfalls for Americans Living Abroad

Chris McLemore, Erin Fraser
Butler Snow LLP

Chris McLemore is Senior Counsel and Erin Fraser is Associate Attorney at Butler Snow LLP

I. Introduction

In an effort to crack down on individuals obtaining U.S. citizenship illegally, the U.S. Department of Justice recently raided several "maternity tourism" operations in Southern California. [1] These companies cater to wealthy foreigners seeking to give the gift of U.S. citizenship to their children. Since at least 1868, the most effective way of guaranteeing U.S. citizenship has been birth on U.S. soil. [2]

[1] CNN, Mar. 3, 2015, http://www.cnn.com/2015/03/03/us/maternity-tourism-raids-california/index.html.

[2] Section 1 of the Fourteenth Amendment to the Constitution provides, "All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside." *See also* 8 U.S.C. §1401 (2011) (clarifying the definition of terms in the Fourteenth Amendment).

If the rumors and anecdotes are believed, these maternity tourists return to their home country, tuck the baby's American passport away for a rainy day, and everyone forgets the whole thing happened. Yet for these young Americans living abroad—like those of us born in the U.S. and drawn overseas by a career, a loved one, or chance—American citizenship comes with substantial tax and compliance burdens.

In this article, we review some federal income tax pitfalls for Americans living abroad. This article is not meant to provide a comprehensive review of taxation for U.S. taxpayers abroad, but to highlight the potential burdens of multijurisdictional taxation. In an effort to narrow the scope of the article, we omit discussion of federal transfer taxes (i.e. estate, gift, and generation-skipping taxes), as well as of U.S. state and local taxes. These taxes deserve a full examination in their own rights, as all can provide traps for the uninformed.

II. U.S. Income Tax: A Brief Primer

The U.S. is notable for its citizenship based system of taxation. As a general rule, U.S. citizens, lawful permanent residents (i.e. green card holders), and U.S. residents are subject to U.S. federal income taxation on their worldwide income. [3] A combination of the "earned income exclusion", foreign tax credits and various income tax treaties are available to minimize or eliminate double taxation.

[3] Technically, the U.S. taxes "U.S. Persons" on a worldwide basis. The term "U.S. Person" refers to an individual who is either a U.S. Citizen or a U.S. federal income tax resident for U.S. federal income tax purposes. An individual who is not a U.S. citizen will be treated as a U.S. federal income tax resident (and thus a U.S. Person) with respect to any calendar year if (and only if), she meets one or more of the following requirements:

- She is a "lawful permanent resident" of the U.S. (i.e. she holds a U.S. "green card");

- She meets what is known as the "substantial presence test"; or

- She makes a special election to be treated as a U.S. federal income tax resident.

An individual can also be considered a US Federal income tax resident if he meets the "substantial presence test." *See* Treas. Reg. 301.7701(b)-1.

The first port of call for U.S. taxpayers abroad is the foreign earned income exclusion found in Section 911. A taxpayer may exclude up to $100,800 of foreign earned income each year from his or her gross income if the taxpayer is a qualified individual. [4] While the exclusion can be very beneficial to those living and working abroad, it is often misunderstood.

---

[4] *See* IRC §911(b)(2)(D)(i) (setting the exclusion at $80,000 per year). *See also* §911(b)(2)(D)(ii) (providing that the limitation on the exclusion be indexed for inflation); Rev. Proc. 2014-61, 2014-47 I.R.B. 860, at §3.32 (setting the 2015 exclusion amount to $100,800).

One of the most common misconceptions is that Section 911 applies automatically to every U.S. taxpayer. Income may be excluded only "[a]t the election of a qualified individual." [5] A taxpayer must elect (on his or her tax return) to exclude the income. Further, the election is only available for "qualified individuals." An individual is only qualified if she is a U.S. citizen who was a bona fide tax resident of another country (not the U.S.) for the entirety of the taxable year, or if she is a U.S. resident or citizen that spent at least 330 days outside the U.S. [6]

---

[5] IRC §911(a).

[6] IRC §911(d)(1); Treas. Reg. 1.911-2(a).

If a taxpayer is a "qualified individual," she may exclude foreign earned income, including wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered in a foreign country. [7] Pension income, dividends from a corporation (even if the corporation is the taxpayer's employer), and other unearned income cannot be excluded. [8]

---

[7] IRC §911(d)(2). *See also* Treas. Reg. 1.911-3.

[8] Treas. Reg. 1.911-3(a), (c).

It is important to note that even is a taxpayer is able to exclude all of her income, she is not relieved of her filing obligation. Even if a return with income properly excluded under Section 911 would yield taxable income of $0 (and $0 tax due), the return must be filed in most cases. [9]

---

[9] The filing requirement depends on a taxpayer's filing status and her income. *See* IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*, Dec. 4, 2014, *available at* http://www.irs.gov/pub/irs-pdf/p54.pdf.

Not surprisingly, most Americans will have more complex facts (and income) which will result in additional filings and potential tax exposure. Earned income in excess of the applicable exclusion amount ($108,000), and unearned or passive income (which is not excluded under Section 911) is taxable. U.S. taxpayers abroad will owe tax to the U.S. unless a foreign tax credit applies or there is a relevant provision under a tax treaty.

III. Gains on the Sale of a Primary Residence

Another potential pitfall is the disconnect between the U.S. and foreign countries with regard to the taxation of the sale of a principal residence. As the Mayor of London, Boris Johnson, recently discovered, the U.S. will assess capital gains tax on the sale of a primary residence if the U.S. taxpayer's share of the gain exceeds $250,000 or $500,000 for married U.S. taxpayers. [10] In the case of Mr. Johnson, a U.S. taxpayer by virtue of his birth in New York, the capital gain generated by the sale of his home was not subject to U.K. income tax. [11] Notwithstanding the fact that his property was located in the U.K. and Mr. Johnson is resident in the U.K., tax was due in the U.S. In what was the 21st century equivalent of the Boston Tea Party in reverse, Mr. Johnson swore he wouldn't make good with the IRS. However, he capitulated in less time than it would have taken the tea to steep in Boston Harbor, agreeing to pay the "outrageous" tax.

[10] The exclusion is $500,000 for married couples filing a joint U.S. return. *See* IRC §121(a), (b)(1)-(2).

[11] *See* George Parker and Vanessa Houlder, Financial Times, *London Mayor Bows to 'Outrageous' Demand to Pay US Tax Bill*, Jan. 21, 2015, *available at* http://www.ft.com/cms/s/0/149b859c-a15b-11e4-bd03-00144feab7de.html.

It can come as an unwelcome surprise for American citizens living in the U.K. (or many other jurisdictions) that the U.S. does not provide an unlimited exemption for gains on the sale of a principal residence. If the property was held for more than one year, the capital gain will be taxed under preferential long-term capital gains rates (currently 20%). [12] This will come as little consolation to a taxpayer who intended to use the proceeds from the sale of her principal residence to purchase a new home of comparable cost (and who must pay stamp duty land tax in the U.K. at the time of purchase, which cannot be used as a credit against the U.S. tax due).

[12] *See* IRC §1222(3) (capital assets held for more than one year are taxed as long term capital gain); §1(h)(1)(D) (imposing a maximum rate of 20%).

IV. Foreign Pension Schemes

Like individual retirement accounts ("IRAs") and 401(k) plans in the U.S., foreign countries often allow taxpayers to defer or avoid income tax on assets placed in designated retirement accounts. [13] In some jurisdictions, such as Singapore, contribution to a retirement savings plan is mandatory.

[13] For example, the U.K. allows after-tax contributions of up to 15,000 British pounds annually in individual savings accounts (ISAs). Gains from assets in an ISA are not taxed, similar to a Roth IRA. *See* GOV.UK, Individual Savings Accounts, https://www.gov.uk/individual-savings-accounts/print.

It is common for an account to be a tax-free retirement account abroad yet be fully taxable under U.S. law. Often taxpayers do not immediately think of a retirement savings account as a source of income, or as a foreign financial asset. Nonetheless, these accounts can result in underreporting of income to the U.S., not least because they often hold foreign mutual funds that are taxed under the complicated passive foreign investment company ("PFIC") rules discussed below.

For example, consider Singapore Central Provident Fund ("CPF") accounts. In Singapore, both the employee and her employer are required to contribute to a CPF account. These payments are made by withholding from the employee's pay. As the U.S. does not have an income tax treaty with Singapore, the Code and Treasury Regulations govern how the U.S. taxes CPF accounts for U.S. taxpayers. Any gains earned in a CPF account will be included in gross income for U.S. federal tax purposes. The IRS has also taken the view that mandatory employer contributions to a CPF are income to the employee. Although these payments are the inevitable result of the employee's services performed for the employer, the IRS does not treat employer CPF contributions as "earned income" for Section 911 purposes. Therefore, the contributions are income without the possibility of exclusion. [14]

[14] Complications arising from foreign savings accounts are often more subtle. *See* Barbara Felker, Legal Advice Issued to Program Manager Robert Uhar, *Singapore Central Provident Fund*, Oct. 10, 1997, *available at* http://www.irs.gov/pub/lanoa/pmta00173_6973.pdf.

In the U.K., employees will often benefit from an employer-provided pension plan and may also contribute to a Self-Invested Personal Pension ("SIPP"). Income arising in an employer-provided pension will often be tax deferred under the U.S.-U.K. income tax treaty. However, income arising in a SIPP is not as straightforward. Indeed, the U.S. tax treatment of SIPPs has long been debated in the practitioner community. Even if the income arising within the SIPP can benefit from a tax deferral in the U.S., the SIPP is likely to require special reporting (because the SIPP is likely to be viewed as a foreign trust for U.S. income tax purposes).

V. The (Overbroad) PFIC Regime

As mentioned above, taxpayers holding investments in passive foreign investment companies or controlled foreign corporations are subject to increased compliance burdens and an increased marginal rate on their investments.

Generally, a PFIC is any non-U.S. corporation that earns 75% or more of its annual gross income from passive income sources, so long as the majority of assets held by the corporation during the year are passive assets. [15] Although the acronym makes them sound quite exotic, PFICs can be as unassuming as a foreign mutual fund or pension.

---

[15] IRC § 1297(a).

The PFIC rules were (arguably) enacted to prevent U.S. taxpayers from socking money away in a foreign corporation to defer U.S. income tax. However, the broadly-written rules apply to many (or most) non-U.S. collective investments, such as non-U.S. mutual funds, hedge funds and other fairly standard investments. An investment portfolio consisting of mutual funds and ETFs may be entirely appropriate in the country of residence, but may be full of tax traps for an American taxpayer.

The consequence of owning a PFIC is two-fold. First, a higher rate of tax is imposed. Generally, gains from PFICs are taxed at the highest marginal rate for ordinary income (currently 39.6%), increased by any deferred tax amount and interest. [16] An American invested in a mutual fund that happens to be located outside the U.S. can expect to surrender an additional 19% of their gains via tax due to the IRS.

---

[16] *See generally* IRC §1291, *et seq*.

Second, reporting ownership and gains from PFICs can also be burdensome. The taxpayer will be required to maintain detailed records and file Form 8621 for each PFIC she owns, every year. [17] The Form 8621 must be included with the taxpayer's federal income tax return (Form 1040). [18] Although keeping some statements and filing one additional form may not appear to be terribly burdensome, the IRS estimates that the record keeping, requisite learning, and preparation of the Form 8621 will take 40 hours and 52 minutes. [19]

---

[17] *See* Treas. Reg. 1.1298-1T(b), (e).

[18] *See* Treas. Reg. 1.1298-1T(d).

[19] *See* IRS, *Instructions for Form 8621*, Dec. 2014, at 13, *available at* http://www.irs.gov/pub/irs-pdf/i8621.pdf.

Taxpayers that own part of a controlled foreign corporation ("CFC") face equally daunting tax and compliance burdens. [20] The CFC rules (often referred to as "Subpart F") were enacted to limit gain deferral on foreign earned income of U.S. corporations. However, the Code defines a CFC as any foreign corporation where "U.S. Shareholders" own (or are deemed to own) more than 50% of the votes and value of all classes of stock. [21] A shareholder is only a U.S. Shareholder if she owns (or is deemed to own) 10% or more of the voting power of the corporation, and is a U.S. person. [22]

---

[20] *See generally* IRC §§951-964.

[21] IRC §957(a). Attribution of stock and constructive ownership rules apply. *See* IRC §958(a), (b).

[22] IRC §951(b). *See also* IRC §957(c) (defining United States person for purposes of the CFC rules).

The increased ownership threshold of the CFC rules make it less likely that an American living abroad will stumble into an investment in a CFC than a PFIC. However, for owners of a CFC, the compliance burdens are onerous. Taxpayers must file Form 5471 annually. [23] The Form 5471 requires detailed financial information about the CFC, including completion of an income statement and balance sheet in accordance with U.S. GAAP. [24] The penalty for failing to file the information return is $10,000, though the penalty may be increased to as much as $50,000. [25]

---

[23] IRC §6046(a).

[24] *See* IRS, *Instructions for Form 5471*, Dec. 2014, *available at* http://www.irs.gov/pub/irs-pdf/i5471.pdf.

[25] IRC §6679(a)(1) (imposing a $10,000 failure to file penalty); IRC §6679(a)(2) (increasing the penalty for each 30-day period during which the failure to file continues after the IRS mails notice of the failure).

In addition to reporting CFC financial details, U.S. Shareholders are taxed on their pro rata share of certain types of the CFC's income (called "Subpart F income"), whether or not the U.S. Shareholder received a distribution of that income. [26] Investment income earned by a CFC generally falls within the definition of Subpart F income. [27] Subpart F income is taxed as ordinary income, even if the income would normally be taxed at a lower rate if held directly by an individual (e.g. qualified dividend income).

[26] IRC §951(a).

[27] *See generally* IRC §952(a).

Much like an interest in a partnership, an owner of a CFC may have so-called paper gains that result in tax, yet not have received distributions with which to pay the tax.

VI. Net Investment Income Tax—Not Creditable Against Foreign Tax

As of January 1, 2013, a net investment income tax ("NIIT") of 3.8% is imposed on individuals with "net investment income" and modified adjusted gross income ("modified AGI") of greater than $200,000; or married couples filing jointly with modified AGI of greater than $250,000. [28] As defined in the Code and Treasury Regulations, net investment income subject to the 3.8% tax includes what one might expect: gross income from interest, dividends, annuities, royalties, and rents, except to the extent excluded in the ordinary course of a trade or business. [29] However, net investment income also includes "net gain . . . attributable to the disposition of property." [30] The statute and regulations do not specify that the property must be held for investment; rather the NIIT applies to all dispositions of property that are otherwise included in gross income. For example, taxpayers with gain on the sale of their principal residence in excess of the $250,000 excluded amount, that excess gain will be subject to the NIIT (in addition to the long term capital gains rate). [31]

[28] IRC §1411(a), (b). These amounts are not indexed for inflation. *See* IRS, Questions and Answers on the Net Investment Income Tax, Nov. 13, 2014, at ¶3, http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs [hereinafter NIIT FAQs] (last accessed Mar. 17, 2015).

[29] Treas. Reg. 1.1411-4(a). *See also* IRC §1411(c)(1).

[30] IRC §1411(c)(1)(A)(iii). *See also* IRC §1411(c)(2) (carving out the trade and businesses for which a narrow exception applies).

[31] *See* NIIT FAQs *supra* note 16 at ¶11.

The NIIT is worse still for Americans working abroad in at least four notable ways. First, when calculating a taxpayer's modified AGI for purposes of the $200,000 NIIT threshold, foreign earned income excluded under Section 911 is added back. [32] Second, when calculating net investment income (i.e. the amount subject to the 3.8% tax), a taxpayer who claims a foreign tax credit must add back certain deductions that would reduce the amount of net investment income. [33] Third, taxpayers holding an interest in PFICs or CFCs must try their hand at understanding the verbose NIIT regulation on foreign company ownership. The applicable Treasury Regulation is more than double the length of this article.

[32] IRC §1411(d); Treas. Reg. 1.1411-2(c)(1).

[33] Treas. Reg. 1.1411-4(f)(3)(iii) ("Except to the extent specifically expected from section 275(a)(4), foreign income, war profits, and excess profit taxes are not allowed as deductions under section 164(a)(3) in determining net investment income if the taxpayer claims the benefit of the foreign tax credit under section 901 with respect to the same taxable year.")

Assuming the taxpayer can arrive at a figure for the amount of NIIT due, she faces a fourth bit of bad news. Treasury Regulations and guidance from the IRS provide that foreign tax credits cannot be used to offset tax the NIIT. [34] The result is a potential for double taxation. Taxpayers that pay a capital gains rate abroad that is higher than the rate in the U.S. (e.g. the U.K. where the capital gains rate can reach 28%), even where there is a tax treaty ostensibly limiting double taxation, will be forced to pay the NIIT. The effective tax rate for these taxpayers will be the sum of: the higher of the two nations' capital gains rates; and 3.8% (the NIIT).

[34] Treas. Reg. 1.1411-1(e); NIIT FAQs *supra* note 16 at ¶17.

VII. Tax-Free Income?

In addition to the retirement and real estate examples set out above, there are many other potential mismatches that can lead to tax in the U.S. where it would not apply in the country of residence. This can often be the result of tax driven by public policy considerations that differ across jurisdictions. For instance, tax-free investment accounts known as ISAs in the U.K. were created under the Thatcher government, in part, as a mechanism to encourage investment in the U.K. stock market by the middle class. Income in ISAs is earned free of tax in the U.K. and indeed the accounts do not even appear on a U.K. tax return. Yet ISA income is fully taxable by the U.S.

Americans that cash-in by wagering on the annual NCAA basketball tournament (affectionately known as March Madness) will be obliged to send a portion of their winnings to Uncle Sam. That is true even if the bet is laid in Macau, Dubai, or London where such winnings would not be taxed locally. [35]

---

[35] *See* IRS Publication 17, *Your Federal Income Tax*, Feb. 6, 2015, at 40, *available at* http://www.irs.gov/pub/irs-pdf/p17.pdf.

As a general matter, U.S. taxpayers should follow the rule that all income from any source worldwide will be taxed unless there is a specific provision which exempts that income. [36] Even treasure hunters (or rather, treasure finders) are obliged to share their loot with the IRS. [37]

---

[36] *See* IRC §61(a) (gross income includes income from whatever source derived).

[37] Treas. Reg 1.61-14(a); Rev Rul 61, 1953-1 CB 17. *See also* Cesarini v. United States, 428 F.2d 812 (6th Cir. 1970).

VIII. Conclusion

Although the compliance rates of U.S. taxpayers resident abroad have historically been low, the confluence of far-reaching legislation such as FATCA, more aggressive enforcement by the IRS and a string of voluntary disclosure initiatives has seen a rise of compliant expats. Although the potential pitfalls for Americans abroad can be a moveable feast, a well-informed taxpayer can anticipate and generally avoid the common missteps set out above.

For More Information

Chris McLemore is Senior Counsel and Erin Fraser is Associate Attorney at Butler Snow LLP.

ISSN 1947-3923