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Working Abroad Has Huge U.S. Tax Benefits

Article Highlights:

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

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

This exclusion applies to both employees and self-employed individuals. In addition to the excludable income, this can also be an attractive option to individuals who wish to travel the world. Today's digital world allows individuals, armed with their computer and a Wi-Fi connection, to work from anywhere.

So, for example, if you would like to be a digital wanderer and your employer approves or you are self-employed, you can travel the world while earning income from your employer or your self-employment clients. Some employers may nix the idea because they don't want their business to be entangled in foreign taxes, and you should check into what your tax filing responsibility will be with any foreign country where you are thinking of working.

If you do work abroad for a U.S. firm, you can still have payroll disbursements (and client payments if you are self-employed) deposited in your U.S. bank account, charge expenses on your credit card, and use online banking to make credit card payments, thus avoiding any foreign bank account reporting.

You will still have to file a U.S. 1040 tax return and report your income the same way as if you were living and working in the U.S., except if you meet certain requirements, you will be able to exclude some or all of your foreign earnings from income tax.

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

- Have foreign earned income (income received for working in a foreign country, including payroll disbursements from a U.S. employer and self-employment income);

- Have a tax home in a foreign country; and

- Meet either the bona fide residence test or the physical presence test.

The foreign earned income exclusion amount is adjusted annually for inflation. For 2022, the maximum is up to $112,000 per qualifying person. If you are married and both you and your spouse (1) work abroad and (2) meet either the bona fide residence test or the physical presence test, each of you can choose the foreign earned income exclusion. Together, you can exclude as much as $224,000 for the 2022 tax year, but if one of you uses less than 100% of their exclusion, the unused amount cannot be transferred to the other spouse.

In addition to the foreign earned income exclusion, qualifying individuals may also choose to exclude or deduct a foreign housing amount from their foreign earned income. The amount of qualified housing expenses eligible for the housing exclusion and housing deduction is generally limited to 30% of the maximum foreign earned income exclusion. The housing amount limitation is $33,600 for the 2022 tax year. However, the limit will vary depending on where the qualifying individual's foreign tax home is located and the number of qualifying days in the tax year. The foreign earned income exclusion is limited to the actual foreign earned income minus the foreign housing exclusion. Therefore, to exclude a foreign housing amount, the qualifying individual must first figure the foreign housing exclusion before determining the amount for the foreign earned income exclusion.

Before you become overly excited about working from some exotic foreign locale, foreign earned income does not include the following amounts:

- Pay received as a military or civilian employee of the U.S. Government or any of its agencies.
- Pay for services conducted in international waters (not a foreign country).
- Pay in specific combat zones, as designated by a Presidential Executive Order, that is excludable from income.
- Payments received after the end of the tax year when the services were performed to earn the income.
- The value of meals and lodging that are excluded from income because they were furnished for the employer's convenience.
- Pension or annuity payments, including Social Security benefits.

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

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

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

Other issues:

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

Timing of election – Generally, a qualifying individual must initially choose the foreign earned income exclusion with one of the following income tax returns:

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

A qualifying individual can revoke an election to claim the foreign earned income exclusion for any year.

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

State Tax – If your U.S. state of residence when departing the U.S. is one with state income tax, you may be required to report all of the foreign income on the state tax return, unless there is an exception.

If you are considering foreign employment or traveling abroad while working, before you make your final decision, please call our office to learn more about the foreign earned income and housing allowance exclusions, or about how to meet the bona fide residence or physical presence tests.