**Tax Jurisdiction**

1. Jurisdictional Issues
   1. Bases for asserting jurisdiction
      1. Two basic questions in determining *how* to tax international transactions
         1. First, which persons should be taxed?

Bases upon which countries assert tax jurisdiction

First, a *personal* relationship between TP and the country

E.g., a country may wish to tax any person who is either a *citizen* or a *resident* of the country

Second, an *economic* relationship between TP and the country

Exists whenever a person derives income from property or activities that are located *w/in* a country’s borders

The set of persons deriving income from sources w/in a country includes n/ only citizens and residents, but also foreign persons

* + - 1. Second, what income is subject to tax?
    1. Current U.S. system
       1. *Personal relationships* are the basis for taxing the following individuals:
          1. U.S. citizens,
          2. Resident aliens, and
          3. Domestic corporations
       2. *Source of income* is the basis for taxing the following individuals:
          1. Nonresident aliens, and
          2. Foreign corporations
  1. Territorial versus Credit systems
     1. The Problem

A double taxation problem arises when a taxpayer who has a personal relationship with one country (home country) derives income from sources within another country (host country). The host country usually will assert jurisdiction on the basis of its economic relationship with the taxpayer.

The home country may assert jurisdiction over the income on the basis of its personal relationship with the taxpayer. The countries involved must decide whether and how to adjust their tax systems so as to avoid international double taxation.

* + 1. The Traditional Solution

Traditionally, it has been up to the home country (U.S.) to solve the double taxation problems of its citizens and residents

To accomplish this, the home country (U.S.) forfeits part or all of its jurisdictional claim over the foreign-source income of its citizens under a territorial system or a credit system

* + 1. Territorial System

Under a territorial system, the home country taxes citizens and residents only on income derived from sources within its own borders. These citizens and residents are allowed to exclude from taxation all income derived from foreign sources. For example, the home country would tax a citizen’s wages that were earned domestically. However, it would exempt from tax any wages earned abroad.

This leaves only the host country to tax the citizen’s foreign source income. Under a territorial system, the foreign income of a citizen or resident is taxed only once at the host country’s rate.

* + 1. Credit System

Under a credit system, the home country taxes the foreign income of its citizens and residents. However, it allows a credit for any foreign taxes paid on that income. In other words, the home country asserts secondary jurisdiction over the foreign income of its citizens and residents. The net result is that foreign income is taxed only once at the higher of the host country’s rate or the home country’s rate.

* + 1. Example: Host country tax rate is *lower* than home country rate
       1. Facts: ABC Corp. has taxable income of $ 100, all of which is derived from *foreign* sources. Assume the home country tax rate is 35% and the foreign tax rate is 25%
       2. Scenario # 1 – No mechanism for mitigating double taxation
          1. If the home country provides *no* mechanism for mitigating international double taxation, the total tax on ABC’s $ 100 of foreign-source income is $ 60 [$ 35 home country tax + $ 25 host country tax], computed as follows:
          2. Home Country Tax Return

Taxable income: $ 100

Tax rate: 35%

Tax: $ 35

* + - * 1. Foreign Tax Return

Taxable income: $ 100

Tax rate: 25%

Tax: $ 25

* + - 1. Scenario # 2 – Territorial System
         1. Under a territorial system, the total tax on ABC’s foreign-source income is $ 25 [$ 0 home country tax + $ 25 foreign tax], computed as follows:
         2. Home country tax return

Taxable income: $ 0

Tax rate: 35%

Tax: $ 0

* + - * 1. Foreign tax return

Taxable income: $ 100

Tax rate: 25%

Tax: $ 25

* + - 1. Scenario # 3 – Credit system
         1. Under a credit system, the total tax on ABC’s foreign source income is $ 35 [$ 25 host country tax + $ 10 home country tax], computed as follows:
         2. Foreign tax return

Taxable income: $ 100

Tax rate: 25%

Tax: $ 25

* + - * 1. Home country tax return

Taxable income: $ 100

Tax rate: 35%

Pre-credit tax: $ 35

Foreign tax credit: ($ 25) (TP gets a credit for the taxes paid to the foreign government)

Tax: $ 10

* + - 1. The Takeaway From This Example

Under a credit system, TP pays not only the host country tax, but also any home country tax *in excess* of the lower host country tax

A credit system and a territorial system both solve ABC’s double taxation problem, but they do so in different ways. A territorial system eliminates the $ 35 home country tax on ABC’s foreign source income, resulting in taxation once at the lower foreign rate. In contrast, a credit system eliminates the $ 25 foreign tax on ABC’s foreign source income, resulting in taxation once at the *higher* home country rate

* + 1. Example # 2: Host country tax rate is *higher* than home country rate
       1. When the host country tax rate is higher than the home country rate, territorial and credit systems produce equivalent results. Assume the same facts as above, except that the foreign tax rate is now 40%.
       2. Scenario # 1 – Territorial System
          1. Under a territorial system, the total tax on ABC’s foreign-source income is $ 40 [$ 0 home country tax + $ 40 foreign tax], computed as follows:
          2. Home country tax return

Taxable income: $ 0

Tax rate: 35%

Tax: $ 0

* + - * 1. Foreign tax return

Taxable income: $ 100

Tax rate: 40%

Tax: $ 40

* + - * 1. Analysis: Under a territorial system, foreign source income is taxed once at the higher foreign rate.
      1. Scenario # 2 – Credit system
         1. Under a credit system, the total tax on ABC’s foreign source income is also $ 40 [$ 0 home country tax + $ 40 foreign tax], computed as follows
         2. Foreign tax return

Taxable income: $ 100

Tax rate: 40%

Tax: $ 40

* + - * 1. Home country tax return

Taxable income: $ 100

Tax rate: 35%

Pre-credit tax: $ 35

Foreign tax credit: ($ 35)

Tax: $ 0

* + - * 1. A credit system results in taxation once at the higher foreign rate because the foreign tax credit completely offsets the pre-credit home country tax on the foreign source income.
      1. The Takeaway From This Example

No home country tax is collected on the high tax foreign source income under either system.

* 1. Tax treaties
     1. Territorial and credit systems represent *unilateral* solutions to the international double taxation problem b/c they are created by individual countries
     2. Tax treaties, on the other hand, represent *bilateral* solutions to the international tax problem b/c they are created by and apply to *both* of the countries that are parties to the agreement
     3. How do tax treaties mitigate double taxation? Through *reciprocal* tax exemptions and lower tax rates for income derived by residents of one treaty country from sources w/in the other treaty country
     4. Example: Under the income tax treaty between the U.S. and the U.K., the U.K. agrees NOT to tax U.S. residents on any *interest* derived from sources w/in the U.K. In exchange, the U.S. agrees NOT to tax U.K. residents on any *interest* derived from sources w/in the U.S.

1. Overview of U.S. Jurisdictional System
   1. Foreign Activities of U.S. Persons
      1. The U.S. taxes *U.S. persons* on their worldwide income
      2. *U.S. persons* include the following:
         1. **U.S. citizens**,
         2. **Resident aliens**: Citizens of foreign countries who meet either:
            1. The green card test, or
            2. The substantial presence test
         3. **Domestic corporations**: Corporations created or organized under the laws of one of the 50 states or the District of Columbia
         4. **Domestic partnerships**
         5. **Any estate other than a foreign estate**
         6. **Any trust if**:
            1. A U.S. court can exercise primary supervision over the administration of the trust, and
            2. One or more U.S. persons have the authority to control all substantial decisions of the trust
      3. U.S. uses a credit system to mitigate international double taxation
         1. A U.S. person can claim a credit for the foreign income taxes imposed on foreign source income (901(a))
         2. Under this credit system, foreign source income is taxed once at the *higher* of:
            1. The U.S. tax rate, or
            2. The foreign rate
         3. If the U.S. tax rate (35%) is *higher* than the foreign rate (25%), the U.S. collects any residual U.S. tax due on foreign source income ($ 10) that the host country taxes at a *lower* rate than the U.S. rate
            1. F rate < U.S. rate

|  |  |
| --- | --- |
| Territorial | Lower F rate |
| Credit | Higher U.S. rate |

* + - 1. If the foreign tax rate (40%) exceeds the U.S. rate (35%), no U.S. tax is collected on that foreign source income b/c the available foreign tax credits are more than sufficient to offset the pre-credit U.S. tax on that income
         1. F rate > U.S. rate

|  |  |
| --- | --- |
| Territorial | Higher F rate |
| Credit | High F rate |

* + 1. Foreign tax credit limitation
       1. Key feature of the U.S. credit system
       2. Restricts the credit to the portion of the pre-credit U.S. tax that is attributable to foreign source income
       3. Purpose: To confine the effects of the credit to mitigating double taxation of *foreign source income*. The limitation accomplishes this by preventing U.S. persons operating in high tax foreign countries (e.g., 40%) from offsetting those higher foreign taxes against U.S. taxes on U.S. source income
       4. Example: USAco is a domestic corporation. It has $ 200 of U.S. source income and $ 100 of foreign source income. Assume that the foreign tax rate is 40% and the U.S. tax rate is 35%
          1. Case 1 – Credit is limited

If the foreign tax credit is *limited* to the U.S. tax on foreign source income (e.g., 35% x $ 100 = $ 35), the total tax on USAco’s $ 300 of worldwide income is $110 [$ 70 U.S. tax + $ 40 foreign tax], computed as follows:

Foreign tax return

Taxable income: $ 100

Foreign tax rate: 40%

Foreign tax: $ 40

U.S. tax return

Taxable income: $ 300

U.S. tax rate: 35%

Pre-credit tax: $ 105

Foreign tax credit: ($ 35)

U.S. tax: $ 70

Analysis: W/ the limitation, the net U.S. tax on the $ 100 of foreign source income is $ 0

U.S. tax return

Taxable income: $ 100

U.S. tax rate: 35%

Pre-credit tax: $ 35

Foreign tax credit: ($ 35)

U.S. tax: $ 0

* + - * 1. Case 2 – No limitation

If there were no limitation on the foreign tax credit, the total tax on USAco’s $ 300 of worldwide income would drop from $ 110 to $ 105 [$ 65 U.S. tax + $ 40 foreign tax], computed as follows:

Foreign tax return

Taxable income: $ 100

Foreign tax rate: 40%

Foreign tax: $ 40

U.S. tax return

Taxable income: $ 300

U.S. tax rate: 35%

Pre-credit tax: $ 105

Foreign tax credit: ($ 40)

U.S. tax: $ 65

Analysis: W/o the limitation, the net U.S. tax on the $ 100 of foreign source income is negative $ 5, which reduces the U.S. tax on USAco’s domestic profits from $ 70 in Case 1 to $ 65 in Case 2

U.S. tax return

Taxable income: $ 100

Tax rate: 35%

Pre-credit tax: $ 35

Foreign tax credit: ($ 40). Calculated as follows: 40% x $ 100

Tax: ($ 5)

* + 1. Exceptions to the U.S. credit system
       1. Deferral privilege
          1. Rule: The U.S. does n/ tax *foreign* source income earned by a U.S. person through a *foreign* corporation until those profits are *repatriated* by the domestic SH through a *dividend* distribution
          2. The deferral privilege is the result of two primary features of U.S. tax law

First, the earnings of a regular corporation are NOT taxed to its SHs until distributed as a *dividend*

Second, the U.S. does n/ tax the foreign source income of foreign corporations

* + - * 1. Therefore, as long as a foreign subsidiary derives only foreign source income, those earnings will n/ enter the U.S. tax base until they are distributed to the U.S. parent corp. as a dividend
        2. Example

Facts: USAco is a domestic corp. It owns 100% of FORco, a foreign corp. FORco operates a factory in a country that has granted FORco a 10-year tax holiday. In its first year of operations, FORco has $ 10 million of foreign source income and repatriates $ 5 million of those earnings to USAco through a dividend distribution

Analysis: B/c FORco is a *foreign* corp., the U.S. does n/ tax FORco on its $ 10 million of *foreign* source income. However, the U.S. does tax USAco on the $ 5 million dividend that it receives from FORco

* + - * 1. Policy rationale for deferral: Allows U.S. companies to compete in foreign markets on a tax parity w/ their foreign competitors
        2. Anti-deferral provisions: Deferral also opens the door to tax avoidance. Therefore, Congress has enacted a variety of anti-deferral provisions
      1. Foreign earned income exclusion
         1. The U.S. taxes U.S. citizens and resident aliens on their *worldwide* income, even when they live and work abroad for extended periods of time
         2. To provide some relief, a U.S. expatriate who meets certain requirements can exclude from U.S. taxation a limited amount of foreign earned income plus a housing cost amount
  1. U.S. Activities of Foreign Persons
     1. There is a two-pronged territorial system for taxing the U.S. source income of foreign persons
     2. Foreign persons include the following:
        1. **Nonresident alien individuals**: Individuals who are neither citizens nor residents of the U.S.
        2. **Foreign corporations**: Corporations created or organized under the laws of a foreign country or U.S. possession
        3. **Foreign partnerships**: Partnerships created or organized under the laws of a foreign country or U.S. possession
        4. **Foreign estate**
        5. **Foreign trust**
     3. How does the U.S. tax foreign persons?
        1. At **graduated** rates, and
           1. On what type of income? The net amount of income effectively connected w/ the *conduct of a trade or business w/in the U.S.*
        2. At a **flat rate** of 30%
           1. On what type of income? The gross amount of a foreign person’s U.S.-source nonbusiness income (or investment-type)
           2. The U.S. person controlling the payment of the U.S.-source nonbusiness income to a foreign person must deduct and withhold the 30% U.S. tax. Why? B/c it is the only sure way to collect taxes from passive offshore investors
     4. Exceptions to the general rules for taxing foreign persons
        1. Tax treaties reduce the withholding tax rate on interest, dividend, and royalty income from the statutory rate of 30% to 15% or less
        2. U.S. generally exempts from taxation portfolio interest income
        3. Capital gains are exempt from U.S. taxation, except for gains from the sale of U.S. real property

1. Definition of Resident Alien
   1. General
      1. Resident aliens
         1. The U.S. taxes ***resident* aliens** on their *worldwide* income
      2. Nonresident aliens
         1. The U.S. taxes ***nonresident* aliens** only on their *U.S.-source* income
         2. As a result, most nonresident aliens prefer to remain that way and not become U.S. residents
         3. However, there is one situation where people want to be U.S. residents for tax purposes: Owners of S Corporations. S status for a corporation terminates when a nonresident alien is an owner
         4. Example: Mike is the owner of an S Corporation. In year one, he is a resident alien. In year two, Mike is a nonresident alien. S Corporation will lose its S status
      3. As a consequence, the taxation of aliens depends on whether the person is considered a U.S. resident
      4. An alien is treated as a U.S. resident in any calendar year that he meets either:
         1. The green card test, or
         2. The substantial presence test
   2. Green Card Test
      1. Under the **green card test**, an alien individual is treated as a U.S. resident for a calendar year if, at *any* time during that calendar year, the individual is a *lawful permanent resident* of the U.S.
      2. An alien qualifies as a *lawful permanent resident* of the U.S. if he has been granted the privilege of living in the U.S. *permanently* as an immigrant
      3. Such green card holders are treated as U.S. residents for tax purposes, regardless of whether they are actually physically present in the U.S. during the year
      4. This rule forces aliens who have obtained a green card but have n/ yet moved to the U.S. on a permanent basis to pay U.S. taxes on their worldwide income
   3. Substantial Presence Test
      1. An alien who does n/ hold a green card may still be considered a U.S. resident for a calendar year
      2. How? If the alien is *physically* present in the U.S. for *183 or more days* during a calendar year
      3. Rationale: Spending more than half of a year in the U.S. establishes a stronger connection w/ the U.S. than w/ any other country for that year
      4. Example
         1. Facts: T is n/ a U.S. citizen and does n/ hold a green card. However, T is physically present in the U.S. from January 1 through September 30 of the current year
         2. Analysis: T is a U.S. resident for that year b/c she is physically present in the U.S. for 270 days (9 months), which is greater than 183 days
      5. What constitutes a day of U.S. presence?
         1. A day is counted as a day of U.S. presence if the alien is physically present in the U.S. *at any time* during that day
         2. Example: Presence for part of a day, such as the day of arrival or departure from the U.S., counts as a full day
         3. Types of U.S. presence that are disregarded (i.e., days in the U.S. don’t count)
            1. Commuters from Mexico or Canada
            2. Travelers between two foreign points

Example: TP is a national of Canada and wants to fly to Mexico City. There are very few direct flights. Typically, TP will fly through Chicago O’Hare Airport. That day isn’t counted b/c TP isn’t trying to come to the U.S.

* + - * 1. Medical conditions

Rule: Don’t count days in the U.S. that are related to an *unforeseen* medical condition

Example: NRA comes to the U.S. and has a heart attack resulting in hospitalization. That results in NRA staying in the U.S. more than 183 days. Those days don’t count

Example: NRA is extremely overweight, has high cholesterol, and has high blood pressure. NRA’s sole goal is to come to Chicago b/c Chicago has so many McDonald’s restaurants and he loves the Big Mac. If NRA has a heart attack, that is likely foreseen! Thus, days are counted

* + - * 1. Students
        2. Teachers
  1. Carryover days test – A variation of the substantial presence test
     1. A.K.A. Weighted average test
     2. Extends U.S. residence to aliens whose stay in the U.S. is prolonged, but is *less* than 183 days in any given calendar year
     3. Example: Alien is physically present in the U.S. for the *last* 182 days of 2010. Alien is physically present in the U.S. for the *first* 182 days of 2011. Thus, Alien is in the U.S. for a total of 364 *consecutive* days. Under the general rule, Alien is not a U.S. resident b/c he did n/ stay in the U.S. for at least 183 days in either year
     4. The carryover days test addresses this situation by taking into account days spent in the U.S. during the two preceding calendar years
     5. Under this test, the 183-day standard is applied by counting a day of presence during the current year as a full day, a day of presence during the first preceding year as 1/3 of a day, and a day of presence during the second preceding year as 1/6 of a day

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| --- | --- |
| Current year | Full day |
| Last year | 1/3 day |
| Two years ago | 1/6 day |

* + 1. In all cases, an individual must be present in the U.S. for *at least 31 days* during the current calendar year to be considered a resident for that year
    2. In the Rob Misey world, every month has thirty days
    3. Example
       1. Facts: T is n/ a U.S. citizen and does n/ hold a green card. However, T was physically present in the U.S. for 90 days during year 1 (2009), 150 days during year 2 (2010), and 120 days during year 3 (2011)
       2. Issue: Does T satisfy the 183-day test or the carryover days test?
       3. Part one of Analysis: The primary 183-day test is n/ met in any year of the three years b/c T did n/ spend at least 183 days in the U.S. in any given year
          1. Issue # 1: In year one, is T a resident? No, b/c he only spent 90 days in the U.S. and 90 is less than 183 days
          2. Issue # 2: In year two, is T a resident? No, b/c he only spent 150 days in the U.S. and 150 days is less than 183 days
          3. Issue # 3: In year three, is a T a resident? No, b/c he only spent 120 days in the U.S. and 120 days is less than 183 days
       4. Part two of Analysis: The carryover days test is satisfied for the *first* time in year 3. Thus, T is a resident in year 3
          1. Issue # 1: Was T present in the U.S. for at least 31 days during year 3 (2011), the current calendar year? Yes
          2. Issue # 2: How many days did T spend in the U.S. in each year under the carryover days test?

Year 3 (2011)

Year 3: Current year. As such, must count each day that NRA spent in the U.S. during year 3 as a *full* day

Number of days that NRA spent in the U.S. in year 3: 120 days

Number of days under the carryover days test: 120 days x 1 = 120 days

Year 2 (2010)

Year 2: First preceding year. As such, must count each day that NRA spent in the U.S. during year 2 as 1/3 of a day

Number of days that NRA spent in the U.S. in year 2: 150 days

Number of days under the carryover days test: 150 days x 1/3 = 50 days

Year 1 (2009)

Year 1: Second preceding year. As such, must count each day that NRA spent in the U.S. in year 1 as 1/6 of a day

Number of days that NRA spent in the U.S. in year 1: 90 days

Number of days under the carryover days test: 90 days x 1/6 = 15 days

* + - * 1. Adding it all up

Year 3: 120 days

Year 2: 50 days

Year 1: 15 days

Total: 185 days

* + 1. Exception to the carryover days test

An alien is *exempted* from the carryover days test if:

* + - * 1. The alien is present in the U.S. for *less* than 183 days during the *current* year,
        2. The alien’s tax home (i.e., principal or regular place of business) for the current year is in a foreign country, and
        3. The alien has a *closer connection* to that foreign country than to the U.S.

Must consider all of the facts and circumstances, such as:

Location of the individual’s family, permanent residence, and personal belongings; and

Location of the individual’s social, political, cultural, and religious relationships

* 1. First Year of Residency
     1. An individual is generally treated as a **nonresident alien** for the portion of the calendar year *preceding* the residency starting date
     2. An individual is generally treated as a **resident alien** for the remainder of the year
     3. An alien’s U.S. residency *starting* date depends on whether residency is established under the green card test or the substantial presence test
     4. If residency is established under the **substantial presence test**
        1. … the residency starting date is the first day TP is *physically present* in the U.S.
        2. Example
           1. Facts: T is a NRA. He lives in France from January 1 to May 31. He then lives in the U.S. from June 1 to December 31



* + - * 1. Analysis: T is a U.S. resident b/c he is in the U.S. for 210 days, twenty-seven days *longer* than the 183-day minimum. When does T’s year of residency begin? On June 1, the first day that T was physically present in the U.S. T must file a 1040-NR w/ respect to any U.S. income earned through May 31. But for *any* income earned *after* June 1, T must file a 1040 b/c he is a U.S. resident and thus is taxed on his worldwide income
    1. If residency is established under the **green card test**
       1. … the residency starting date is the *first* day TP is physically present in the U.S. with a green card
       2. Example
          1. Facts: Don is a citizen of Great Britain and a famous race car driver. He decides to come to the U.S. to open a car dealership in Detroit. Dan doesn’t obtain citizenship, but he *procures a green card on June 30, 2011*. He is in the U.S. during the following periods: (1) 2010: April 1 through August 1 (121 days) and (2) 2011: June 1 through August 1 (61 days)
          2. Is Don a U.S. resident in 2010? No
          3. Is Don a U.S. resident in 2011? No. 61 days + 1/3 (121 days) = 61 days + 40 1/3 = 101 1/3
          4. Analysis: Don acquired a green card on June 30, 2011. Thus, Don is a *resident* beginning on June 30, 2011. Don must file a 1040-NR as a *non*resident for any U.S. income earned *through* June 29, 2011. Then he must file a 1040 for any income earned from June 30 onward. Why? As a U.S. resident, Don is taxed on his worldwide income
    2. If the requirements of both residency tests are satisfied in the first year of residency, the residency starting date is the *earlier* of the two starting dates
    3. If TP is a resident in two consecutive years, TP’s second year of residency begins on January 1 in the second year
  1. Last Year of Residency
     1. An alien’s U.S. residency termination date depends on whether the alien qualified as a resident for the current year under the green card test or the substantial presence test
     2. If the alien qualified as a U.S. resident under the **substantial presence test**
        1. … the residency period extends until 12/31
        2. *Unless* an exception applies
           1. Under the exception, the residency termination date is the *last day* of the year on which the individual *was physically present in the U.S.* (i.e., the day that TP leaves the U.S.), provided that for the remainder of the year, TP had a closer connection to, and a tax home in, a *foreign* country
           2. If this exception applies, the alien is taxed as a *U.S. resident* from January 1 to the residency termination date and as a nonresident for the remainder of the year
     3. If the alien qualified as a U.S. resident under the **green card test**
        1. … the residency period extends until December 31
        2. *Unless* an exception applies
           1. Under the exception, the residency termination date is the *first day* during the year that the individual is *no longer a green card holder* (i.e., the day that TP gives up his green card), provided that for the remainder of the year, TP had a closer connection to, and a tax home in, a foreign country
     4. If an alien qualifies as a resident during the current year under both the green card and the substantial presence tests, the residency termination date is the *later* of:
        1. The termination date under the green card residency test, or
        2. The termination date under the substantial presence residency test
  2. Filing a Joint Return: A married couple is n/ eligible to file a joint return for a given taxable year if, at any time during that year, one or both spouses was a nonresident alien

1. Exclusion for Foreign Earned Income
   1. General
      1. The U.S. ordinarily taxes U.S. citizens and resident aliens on their worldwide income, even when they live and work abroad *for* *an extended period of time*
      2. To provide some relief, the U.S. cedes taxing jurisdiction on its people (i.e., citizens and residents) to a foreign country. Under the foreign earned income exclusion, a U.S. citizen or resident who meets certain requirements can elect to *exclude* from U.S. taxation a limited amount of foreign earned income (plus a housing cost amount). The foreign earned income exclusion in 2011 is $ 91,500
      3. Policy: Imperialism. The U.S. government wants U.S. companies to go abroad and make money. If these companies need U.S. workers to succeed, the U.S. government doesn’t want them to incur double tax
      4. A double tax benefit is n/ allowed! In other words, TP cannot claim a *credit* for foreign income taxes related to *excluded* income
   2. Exclusion versus Credit
      1. B/c the foreign earned income exclusion is *elective*, an expatriate must decide whether to (a) elect the exclusion or (b) rely on the foreign tax credit. An expatriate cannot take both the exclusion and the credit on the *first* $ 91,500 of income. To the extent that TP has income *above* $ 91,500, he can take a credit for the amount in excess of $ 91,500 and still take the exclusion on the first $ 91,500
      2. In deciding which option is more advantageous, a key factor is the relative amounts of U.S. and foreign taxes imposed on the foreign earned income *before* the exclusion or credit
      3. Exclusion v. Credit
         1. Exclusion completely eliminates the U.S. income tax on the qualifying amount of foreign earned income
            1. This allows expatriates who work in *low* tax countries or who qualify for special tax exemptions in the countries in which they work to benefit from the lower foreign tax rates
            2. In contrast, under the foreign tax credit option, the U.S. collects any residual U.S. tax on lightly taxed foreign income and the expatriate derives no benefit from the lower foreign rates
         2. Exclusion eliminates the U.S. tax on the qualifying amount of foreign earned income derived by an expatriate working in a *high-tax* foreign jurisdiction
            1. Foreign tax credit option goes further!

Achieves same result b/c the higher foreign taxes fully offset the U.S. tax on the foreign earned income

In addition, the expatriate receives an added benefit in the form of a foreign tax credit carryover (i.e., can carry back and carry forward the credit)

* + 1. Exclusion or Credit?
       1. Foreign rate > U.S. rate: Take the credit
       2. Foreign rate < U.S. rate: Take the exclusion
  1. Qualified Individuals
     1. The foreign earned income exclusion is available only to U.S. citizens or resident aliens who satisfy the following requirements:
        1. The individual is either:
           1. **Physically present** in a foreign country for *at least* 330 full days during *any* 12-month period, or

Every full day in a foreign country is counted. Therefore, a series of foreign stays, including foreign vacations, can be pieced together to meet the 330-day test

Example: Loyal worker for big oil company is sent abroad from July 1, 2011 to June 30, 2012. During this time, he lives and works on an oil rig. He is entitled to the foreign earned income exclusion b/c he lives in a foreign country for 330 days during a 12-month period

Advice: Tell you clients to plan for the 330-day test b/c it is an objective test

* + - * 1. A **bona fide** resident of a foreign country for an uninterrupted period that includes an entire taxable year, **and**

Subjective test (very ambiguous)

Whether an individual is a bona fide foreign resident is determined by his intentions w/ regard to the length and nature of the stay

Factors include:

The presence of family,

The acquisition of a foreign home, and

Involvement in the social life of the foreign country

Example: Former collegiate basketball player signs a contract to play for a professional basketball team in Europe. He is in Europe from early October 2010 to the end of April 2011. After the season ends, he returns to the U.S. In year two, he arrives in Europe in October 2011. In year two, is TP a bona fide resident for an entire taxable year? No. TP was only in Europe for seven months. He is not is a bona resident

* + - 1. The individual’s tax home is in a *foreign* country
         1. An individual’s tax home is his principal or regular place of business, provided that he does n/ have a tax home in a foreign country during any time that he has an abode in the U.S.
         2. Example: Big oil companies send their workers to oil rich nations to work on oil rigs. These companies wanted to create a tax advantage for their workers as a way of inducing them to live abroad
    1. Simplifying test – Qualifying
       1. Tax home in a foreign country, and
       2. Either
          1. Physical presence in foreign country for 330 days during a 12-month period, or
          2. Bona fide resident of foreign country for an entire taxable year
  1. Computing the Exclusion
     1. The annual exclusion is prorated for the number of qualifying days in a taxable year
     2. Facts: During 2007, T satisfies the requirement for claiming a foreign earned income exclusion and has 292 qualifying days for the year. For 2007, the amount was $ 85,700
     3. Issue: What is T’s maximum earned income exclusion?
        1. $ 85,700 x (292 days/365 days) = $ 68,560
     4. Analysis: The exclusion is available only for foreign-source income that was *earned* during the period in which T meets (1) the foreign tax home requirement and either (2) the bona fide foreign resident or (3) 330-day physical presence test. Therefore, when identifying compensation that qualifies for the exclusion, the determinative factor is whether a reimbursement is attributable to *services performed* during the qualifying period, not whether the expatriate actually *received the compensation* during that period
     5. What types of reimbursements represent compensation for services performed abroad during a qualifying period?
        1. Why relevant: These things qualify for the exclusion
        2. Employment related allowance, such as *foreign housing and automobile allowances*
        3. Example: Any taxable *reimbursements* received for expenses incurred in moving from the U.S. to a foreign country are treated as compensation for services performed abroad
     6. Any deductions allocable to *excluded* foreign earned income are **disallowed** (e.g., unreimbursed employee business expenses)
  2. Housing Cost Allowance
     1. An expatriate that qualifies for the foreign earned income exclusion can claim an exclusion for the housing cost amount. Generally speaking, it must be temporary in nature
     2. Eligible housing expenses include:
        1. Rent,
        2. Utilities,
        3. Property insurance,
        4. Occupancy taxes,
        5. Nonrefundable security deposits,
        6. Furniture rental,
        7. Household repairs,
        8. Residential parking
     3. Housing expenses do n/ include:
        1. Costs of purchasing or making *improvements* to a house,
        2. Mortgage interest and real estate taxes,
        3. Purchase furniture,
        4. Pay television subscriptions,
        5. Domestic help
  3. Electing the Exclusion

1. The election to claim the foreign earned income exclusion and housing cost amount is made by timely filing Form 2555, Foreign Earned Income Exclusion, and remains in effect until revoked by TP. Timely filed means by April 15 with TP’s return
2. TP can revoke an exclusion election, but must then wait five years to reinstate the exclusion
3. Renouncing citizenship or residency
   1. Argument: “I don’t want to be taxed on my worldwide income!”
   2. Congress requires such people to pay an exit tax on their built-in gains
   3. TP must pay an exit tax on built-in gain if:
      1. The average tax obligation for the past five years *exceeds* $ 147,000,
      2. TP’s net worth *exceeds* $ 2 million, or
      3. TP fails to certify compliance with the IRS rules for five years
   4. TP is still entitled to an exclusion in the amount of $ 636,000
   5. Example
      1. Facts: BA, a U.S. person, owns marketable securities
      2. Analysis: Here, there is a built-in gain of $ 10 million. Must subtract exclusion of $ 636,000. BA will pay tax on $ 9,364,000. This applies if the average tax liability of BA for the last five years exceeds $ 147K or BA’s net worth exceeded $ 2 million or BA failed to certify compliance for five years
4. Problems
   1. (1) USAco is a domestic corporation that sells products in both the U.S. and abroad. During the current year, USAco derives net income of $ 10 million, which includes $ 1 million of net *foreign* source income derived from a foreign country sales office that is considered an unincorporated branch for U.S. tax purposes. The foreign country’s corporate income tax rate is 50% and the U.S. corporate income tax rate is 35%
      1. (a) What would be the world-wide effective tax rate of USAco, assuming the U.S. taxes the world-wide income of domestic corporations and allows an *unlimited* credit for foreign income taxes?
         1. USAco has $ 9 million of income earned in the U.S. taxed at a 35% rate
         2. USAco has $ 1 million of income earned abroad that is taxed at a 50% rate
         3. Analysis: We have tax of $ 500K abroad (.5 x $ 1 million). We get an unlimited credit for that. Worldwide income is $ 10 million ($ 9 million in the U.S. and $ 1 million abroad). Pre-credit U.S. tax is $ 3.5 million (.35 x $ 10 million). USAco pays only $ 3.0 million of U.S. taxes because it gets a foreign tax credit of $ 500K. USAco paid $ 3 million of taxes to the U.S. and $ .5 million to the foreign country for a total of $ 3.5 million. The effective rate of tax is 35%
         4. Foreign tax return
            1. Taxable income: $ 1 million
            2. Foreign tax rate: 50%
            3. Foreign tax: $ .5 million
         5. U.S. tax return
            1. Taxable income: $ 10 million
            2. U.S. tax rate: 35%
            3. Pre-credit tax: $ 3.5 million
            4. Foreign tax credit: ($ .5 million)
            5. U.S. tax: $ 3.0 million
      2. (b) What would be the world-wide effective tax rate of USAco, assuming the U.S. taxes the world-wide income of domestic corporations and allows a credit for foreign income taxes, but the credit is *limited* to U.S. tax attributable to any foreign-source income?
         1. Query: What is the U.S. tax attributable to foreign source income? Foreign source income is $ 1 million. The U.S. rate of tax is 35%. $ 350,000 is the U.S. tax attributable to foreign source income
         2. Foreign tax return
            1. Taxable income: $ 1 million
            2. Foreign tax rate: 50%
            3. Foreign tax: $ .5 million
         3. U.S. tax return
            1. Taxable income: $ 10 million
            2. U.S. tax rate: 35%
            3. Pre-credit tax: $ 3.5 million
            4. Foreign tax credit: ($ 350K)
            5. U.S. tax: $ 3,150,000
         4. Analysis: Even though USAco paid $ 500,000 in taxes to the foreign country, it only gets a $ 350,000 credit. USAco paid $ 3,150,000 to the IRS and $ 500,000 to the foreign government for a total of $ 3,650,000. That’s 36.5%. There is a higher overall effective rate
      3. (c) How would your answer to part (b) change if the foreign country’s corporate tax rate was 30% rather than 50%?
         1. In that situation, pre-credit U.S. tax is still $ 3.5 million. But the foreign tax credit is $ 300,000
         2. Foreign tax return
            1. Taxable income: $ 1 million
            2. Foreign tax rate: 30%
            3. Foreign tax: $ 300,000
         3. U.S. tax return
            1. Taxable income: $ 10 million
            2. U.S. tax rate: 35%
            3. Pre-credit tax: $ 3.5 million
            4. Foreign tax credit: ($ 300K)
            5. U.S. tax: $ 3,200,000
         4. Analysis: USAco paid $ 3.2 million in taxes to the U.S. and $ 300,000 abroad for a total of $ 3.5 million. Effective rate of tax is 35%
   2. (2) Abdul is a citizen of Saudi Arabia who lives there most of the year. Abdul has never been to the U.S. He receives significant annual income from his family’s substantial oil holdings in Saudi Arabia
      1. Abdul comes to the U.S. in year one, from April 1 through July 30 (4 months x 30 days/month = 120 days)

* + 1. In year two, having met a new lady friend in the U.S., Abdul comes to the U.S. from February 1 through June 20 [(4 months x 30 days/month) + 20 days = 140]
    2. Abdul’s new girlfriend invites him to her hometown in the U.S. for Thanksgiving week (5 days) to meet the parents
    3. Q1: As Abdul’s tax attorney, should he go to the U.S. for Thanksgiving (assume that Abdul does not meet the closer connection exception)?
       1. Analyze under the substantial presence test
          1. Year one: Abdul is in the U.S. for 120 days. Is Abdul a resident in year one? No
          2. Year two

First part is 2/1 to 6/20. That is 140 days. Is Abdul a resident in year two under the 183-day test? No. Is Abdul a resident in year two under the weighted average test? In year one, each of those days is counted as 1/3. 120 days x 1/3 = 40 days. In year two, every day is counted: 140 days. 140 days (year 2) + 40 days (year 1) = 180 days. The magic number is 183. This is too close for comfort.

Abdul should n/ go to the U.S. for Thanksgiving b/c if he spends five more days in the U.S. he will be a resident b/c he will be in the U.S. for a total of 185 days. Thus, he will be considered a U.S. resident

* + 1. Q2: Would your answer change if Abdul held a green card?
       1. Yes, why not come? Abdul is a resident. The 183-day test does n/ apply
  1. (3) Assume Abdul came to the U.S. for Thanksgiving in year 2. In year 3, he comes to the U.S. from April 1 through April 30 for his bachelor party and June 1 through August 30 for his wedding and honeymoon. Is Abdul a resident alien in year 3? Why or why not? Assume that the closer connection exception does n/ apply
     1. Year 1
        1. April 1 through July 30 (4 months x 30 days/month = 120 days)
        2. Is Abdul a resident in year one? No
     2. Year 2
        1. February 1 through June 20 [(4 months x 30 days/month) + 20 days = 140]
        2. Thanksgiving week: 5 days
        3. Total: 145 days
        4. Is Abdul a resident in year three? Under the carryover days test, Abdul is a resident in year three
     3. Year 3
        1. April 1 to April 30: 30 days
        2. June 1 to August 30: 90 days
        3. Total: 120 days
        4. Is Abdul a resident in year three?
     4. Is Abdul a resident in year three under the carryover days test? Yes
        1. Year 3: 120 days x 1 = 120 days
        2. Year 2: 145 days x 1/3 = 48 1/3
        3. Year 1: 120 days x 1/6 = 20 days
        4. TOTAL: 120 days + 48 1/3 days + 20 days = 188 1/3 days