Foreign Tax Credit

If you paid or accrued foreign taxes to a foreign country on foreign source income and are subject to U.S. tax on the same income, you may be able to take either a credit or an itemized deduction for those taxes.

Taken as a deduction, foreign income taxes reduce your U.S. taxable income. Taken as a credit, foreign income taxes reduce your U.S. tax liability. In most cases, it is to your advantage to take foreign income taxes as a tax credit.

Once you choose to exclude either foreign earned income or foreign housing costs, you cannot take a foreign tax credit for taxes on income you can exclude. If you do take the credit, one or both of the choices may be considered revoked.

Why Choose the Credit?

The foreign tax credit is intended to relieve you of the double tax burden when your foreign source income is taxed by both the United States and the foreign country.

The foreign tax credit can only reduce U.S. taxes on foreign source income; it cannot reduce U.S. taxes on U.S. source income.

It is generally better to take a credit for qualified foreign taxes than to deduct them as an itemized deduction. This is because:

1. A credit reduces your actual U.S. income tax on a dollar-for-dollar basis, while a deduction reduces only your income subject to tax,

2. You can choose to take the foreign tax credit even if you do not itemize your deductions. You then are allowed the standard deduction in addition to the credit, and

3. If you choose to take the foreign tax credit, and the taxes paid or accrued exceed the credit limit for the tax year, you may be able to carry over or carry back the excess to another tax year.

What Foreign Taxes Qualify for the Foreign Tax Credit?

Generally, the following four tests must be met for any foreign tax to qualify for the credit:

1. The tax must be imposed on you
2. You must have paid or accrued the tax
3. The tax must be the legal and actual foreign tax liability
4. The tax must be an income tax (or a tax in lieu of an income tax).

In a nutshell…expatriate employees' tax options:

The tax option chosen by the expatriate employee will depend upon whether the employee fits the requirements and elects the Foreign Earned Income and/or Foreign Housing Exclusions, or whether the employee qualifies for and chooses to file for a foreign tax credit.

- **Foreign Earned Income Exclusion –** to qualify, must meet the criteria outlined above and in IRS Publication 54.
  - Submit IRS Form 673 or similar statement to the University's Payroll Services to stop withholding income tax on excluded income. The 2010 exclusion limit is $91,500
  - Complete and submit IRS Form 2555 or 2555-EZ with your form 1040 tax return.
    - ✓ Form 2555-EZ is only used if you do not claim the Foreign Housing Exclusion
- **Foreign Tax Credit –** Cannot be used if you claim the Foreign Earned Income Exclusion
  - Four tests must be met to claim the Foreign Tax Credit. See above and IRS publication 514 for more information.
  - Complete and submit a new Form W-4 to claim additional allowances for the foreign tax credit.

See IRS Publication 919 "How Do I Adjust My Tax Withholding?" for information on how to "convert credits to withholding allowances."

Not Foreign Earned Income: 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 an Executive Order from the President that is excludable from income

•Payments received after the end of the tax year following the year in which the services that earned the income were performed

•The value of meals and lodging that are excluded from income because it was furnished for the convenience of the employer

•Pension or annuity payments, including social security benefits

Eligible to Claim Either the Exclusion?

1) Do you have foreign earned income?
   a) Yes. Go to question 2.
   b) No. You CANNOT claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction.

2) Is your tax home in a foreign country?
   a) Yes. Go to question 3.
   b) No. You CANNOT claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction.

3) Are you a U.S. citizen?
   a) Yes. Go to question 4.
   b) No. Are you a U.S. resident alien?
      i) Yes. Are you a citizen or national of a country with which the United States has an income tax treaty in effect?
         (1) Yes. Go to question 4.
         (2) No. Go to question 5.
      ii) No. You CANNOT claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction.

4) Were you a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year?

a) Yes. You CAN claim the foreign earned income exclusion and the foreign housing exclusion or the foreign housing deduction.
b) No. Go to question 5.

5) <u>Were you physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months</u>?
a) Yes. You CAN claim the foreign earned income exclusion and the foreign housing exclusion or the foreign housing deduction.
b) No. You CANNOT claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction.

1. **The Foreign Earned Income Exclusion:** United States citizens and resident aliens who live and work abroad may be able to exclude all or part of their foreign salary or wages from their income when filing their U.S. federal tax return. They may also qualify to exclude compensation for their personal services or certain foreign housing costs.

2. **The General Rules:** To qualify for the foreign earned income exclusion, a U.S. citizen or resident alien must have a tax home in a foreign country and income received for working in a foreign country, otherwise known as foreign earned income. The taxpayer must also meet one of two tests: the bona fide residence test or the physical presence test.

3. **The Exclusion Amount;** The foreign earned income exclusion is adjusted annually for inflation. For 2012, the maximum exclusion is up to $95,100 per qualifying person. See IRS Foreign Earned Income Exclusion for more detailed information.

4. **Claiming the Exclusion:** The foreign earned income exclusion and the foreign housing exclusion or deductions are claimed using Form 2555, Foreign Earned Income, which should be attached to the taxpayer's Form 1040. A shorter Form 2555-EZ, Foreign Earned Income Exclusion, is available to certain taxpayers claiming only the foreign income exclusion.

5. **Taking Other Credits or Deductions:** Once the foreign earned income exclusion is chosen, a foreign tax credit or deduction for taxes cannot be claimed on the excluded income. If a foreign tax credit or tax deduction is taken on

Tax Home

Your tax home is the general area of your main place of business, employment, or post of duty, regardless of where you maintain your family home. Your tax home is the place where you are permanently or indefinitely engaged to work as an employee or self-employed individual. Having a "tax home" in a given location does not necessarily mean that the given location is your residence or domicile for tax purposes.

If you do not have a regular or main place of business because of the nature of your work, your tax home may be the place where you regularly live. If you have neither a regular or main place of business nor a place where you regularly live, you are considered an itinerant and your tax home is wherever you work.

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100 ARW/JA
APO AE 09459
DSN 314-238-2028
COMM (0)1638-54-2028
E-mail: 100ARW.JAV3@mildenhall.af.mil

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