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Uncle Sam Wants You (To Pay Tax): It Pays to Plan Ahead

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This article is the second in a bimonthly series, which addresses U.S. tax considerations for U.S. expatriates. The following explores how U.S. citizens living abroad can avoid common tax traps by using certain strategies involving property, the timing of tax payments and foreign tax credits.

I. Introduction

In March, we wrote the first article in a series regarding tax considerations for U.S. taxpayers living abroad.[1] We discussed a handful of common problems that we, as practitioners, see frequently arising for U.S. expats. Seasoned members of the tax bar can attest that the issues we highlighted were not due to recent amendments to the Internal Revenue Code. After all, the foreign earned income exclusion (i.e. section 911) was first provided as part of the Revenue Act of 1926.[2] The controlled foreign corporation rules were added in 1962,[3] the passive foreign investment company rules were added in 1986,[4] and even the net investment income tax (the so-called "Obamacare" tax) was added over five years ago in 2010.[5] Given that some of these laws have been around for decades, surely someone with a pocket protector and thick-framed glasses has thought of a way around them?

In this second part of the series we will review potential opportunities for U.S. citizens living abroad to escape these tax pitfalls. After all, the Second Circuit Court of Appeals noted, "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[6] Of course, there is no single solution that covers every situation. However, certain themes are common: holding property in a tax-efficient manner; timing tax payments properly; maximizing foreign tax credits; monitoring compliance; and, most importantly, being mindful that there may be U.S. tax consequences for any financial decision Americans make, whether at home or abroad.

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II. (Not) Holding Title to a Principal Residence

Many Americans abroad are aware that gain on the sale of a principal residence is included in the gross income of a U.S. taxpayer, regardless of the location of that residence, if the gain exceeds $250,000.[7] Yet many other nations exempt or defer principal residence gain, including Australia, Denmark, France, Germany, Iceland, Luxembourg, the Netherlands, New Zealand, Spain, Sweden, and the U.K.[8] It is crucial that U.S. taxpayers living abroad take tax advice before purchasing (or selling) their principal residence. This is especially true because the U.S. treatment of jointly-owned real property differs for U.S. federal income tax, gift tax, and estate tax purposes.

For Americans married to a non-U.S. person, it may be beneficial from a tax perspective to have the non-U.S. spouse or partner own as much of the family home as they are comfortable with. This would require the couple to use more flexible forms of ownership (such as a tenancy in common) so that they can alter their share in the property over time.

Yet, many Americans abroad own property as joint tenants with right of survivorship. This is often the default form of ownership for many couples, and for good reason. It allows the family home to pass to a surviving joint tenant automatically in the event of an untimely passing, thereby avoiding probate. The non-tax reasons for property ownership should be carefully considered. However, where appropriate, severing a joint tenancy and taking ownership as tenants in common may save the American owner a significant amount of tax.

For example, consider a U.S.-U.K. couple that owns their home in London. If the property is owned jointly with right of survivorship, the U.S. spouse will likely be responsible for 50 percent of the gain on sale. The British spouse will pay a nil rate of tax on the gains from the sale of the property, whereas the American will be on the hook for any gain in excess of the $250,000 principle residence exclusion. Although that does not produce any tax for the non-U.S. spouse, the American spouse will have U.S. income tax exposure on a sale.

With the maximum rate of tax on gains from the sale of a principal residence at 23.8%,[9] U.S. taxpayers are often shocked at the amount of U.S. tax they will owe when they sell their home. A knee-jerk reaction may be to transfer some or all of the property out of the American's name. Often, the property is re-titled in solely the non-American's name, non-tax consequences be damned. However, such a transfer may be a taxable gift for U.S. federal gift tax purposes. Although a U.S. citizen is able to transfer up to $5.43 million during life or on death without triggering U.S. federal gift or estate tax,[10] there may be more tax-efficient alternatives than the use of the exemption for a "sideways" transfer (i.e. at the same generational level) to a spouse.

The couple might consider a long-term plan to have the American take advantage of the annual gift tax allowance to gift a portion of his or her interest in the principal residence. In addition to the $5.43 million lifetime exemption, an American can transfer up to $147,000 per year to a non-U.S. citizen spouse without triggering tax or using up the lifetime exemption.[11] Over time, and assuming that the gifting outpaces the growth in value of the property, the U.S. citizen spouse can reduce his or her share of the property—thereby reducing the potential tax exposure on the capital gains.

This analysis does not even take into account the fact that the gain will be determined in U.S. dollars, regardless of the location of the property. A taxpayer must determine the purchase price in U.S. dollars and the sale price in U.S. dollars. Depending on the movement in the non-U.S. currency, there may be a U.S. dollar gain even where the value in the local jurisdiction has remained the same.

III. Paying the Piper

The advice for American taxpayers abroad is not just to pay their tax, they must also be sure they pay their tax at the right time. Differences in tax years and filing deadlines may result in a mismatch between the U.S. and the local jurisdiction. While an unaware taxpayer may fall victim of this mismatch, a well-advised U.S. taxpayer can use differences to his or her advantage.

If they qualify, the section 911 exclusion we discussed in Part One is useful for many Americans living abroad to eliminate U.S. tax. However for taxpayers earning wages in excess of the earned income exclusion under section 911 ($100,800 for 2015[12]), or for taxpayers with investment income, the foreign tax credit provided by section 901, et seq. may be more useful.

The foreign tax credit is complicated but its essence can be easily explained: on any item of income, a U.S. person should pay the higher of the local tax or the applicable U.S. federal income tax. In practice, this means providing a credit against U.S. tax for foreign tax paid during the tax year. Yet (perhaps unsurprisingly), determining how much foreign tax a U.S. taxpayer paid in the tax year is not always straightforward.

First, it is necessary to know which dates fall within the U.S. tax year. For most individuals the U.S. tax year is the calendar year.[13] Many foreign jurisdictions' tax year for individuals also follow the calendar year. However, notable exceptions exist for: Australia (June 30 year end), Hong Kong (March 31), India (March 31), and the U.K. (April 5).[14]

Second, it is necessary to know the amount of foreign tax paid during the applicable time period (e.g. calendar year). Here, accounting jargon threatens to mystify matters further. While most individual U.S. taxpayers operate on a cash method of accounting, section 905(a) allows for a deviation from a taxpayer's normal method of accounting with respect to foreign taxes.[15] If a taxpayer elects under section 905(a), she may claim a foreign tax credit for taxes accrued during the tax year rather than taxes paid. The taxes are deemed to accrue when they meet the "all events" test, generally the final day of the foreign jurisdiction's tax year.[16]

For cash accounting taxpayers, determining the amount of foreign tax paid should be straightforward. Wage withholding by employers or intermediaries is widely used abroad (often called "pay-as-you-earn" or PAYE); thus a sum of figures from pay stubs is easily computed. Non-earned income reporting sometimes follows the self-reporting method we have in the U.S. In the U.K., for example, capital gains tax is self-assessed and may be paid as late as January 31 for the prior year ending April 5.[17] Thus, a cash accounting taxpayer can simply add any withholding tax paid and any self-assessed amounts paid.

An example may be illustrative to demonstrate how electing an accrual method for foreign taxes paid applies in practice. Suppose Jane has a piece of real property in the U.K. she would like to sell. She expects to make a handsome gain, which will be subject to capital gains tax in the U.K. and the U.S. If Jane sells her property on April 1, 2015, the sale occurs during the 2014-2015 U.K. tax year and the 2015 U.S. tax year. If Jane has elected the accrual method for foreign taxes paid, she may offset her U.S. capital gains tax with a credit for her U.K. capital gains tax in the same year. If Jane is on the cash basis for foreign taxes paid, she can only claim a foreign tax credit in the U.S. once she has actually paid the U.K. capital gains tax. It may be more tax-efficient for Jane to pay her U.K. tax by December 31, 2015.

If Jane delays just one week to sell her property, until April 8, 2015, things look quite different. Jane has now sold her property during the 2015-2016 U.K. tax year, though the transaction still occurs during the 2015 U.S. tax year. Jane's U.K. capital gains tax will not be creditable until 2016, if she elected to accrue

	U.K.		U.S.		
Date of Sale	Tax Year Ends	Tax Due	Tax Creditable as of "All Events"	Tax Creditable as of Paid Date	Tax Due
April 1, 2015	April 5, 2015	January 31, 2016	April 5, 2015	On or before January 31, 2016	April 15, 2016
April 8, 2015	April 5, 2016	January 31, 2017	April 5, 2016	On or before January 31, 2017	April 15, 2016

foreign taxes under section 905(a). If Jane is on the cash method but does not pay her U.K. capital gains tax until it is due in January 2017, the gap between the U.S. and the U.K. widens even further. Thus, Jane may be required to pay 20% capital gains tax and 3.8% net investment income tax ("NIIT") on the gain in the U.S. initially, then amend her 2015 return to claim a refund due to the foreign tax credit. In the meantime, Jane has loaned the U.S. government her money on an interest-free basis. The table above illustrates the example.

On the other hand, this foreign tax credit mismatch might be advantageous. As we noted in Part One, the 3.8 % NIIT cannot be reduced by foreign tax credits.[18] Thus, Jane may seek to spread out her worldwide tax liabilities, despite the administrative costs, if she has difficulty accessing the cash to pay tax due. This could take the form of waiting until April 8, 2015 to sell her property and electing section 905(a). Jane will pay NIIT and capital gains tax to the U.S. in April 2016; her 28% U.K. capital gains tax becomes creditable for U.S. purposes as of April 2016 but is not due until the end of January 2017. The usefulness of this strategy may depend on Jane's other U.K.-source passive income in 2016 and she will still pay a hefty 31.8% in tax to the U.S. and the U.K. However, she may be able to split her payments up to be more manageable.

As foreign tax credits can be carried back one year and forward 10 years,[19] there should be a reduced risk of losing out on a creditable tax over the long-term. Yet because of the limitations on the foreign tax credit carried to other years, a U.S. taxpayer must carefully consider their options.[20] As individuals may encounter liquidity issues in the short-term, taxpayers should work with competent tax professionals to tailor their strategy to their needs.

IV. Use of Excess Foreign Tax Credits

A taxpayer that can navigate the timing issues may find himself accruing unused ("excess") foreign tax credits if the local tax exceeds the tax due in the U.S. Moreover, he may also find that these tax credits are a bit like airline miles: easy to accrue, difficult to use. And because foreign tax credits can be rolled forward for 10 years, many Americans abroad will build up large pools of the credits.

Using foreign tax credits is further complicated by the fact that the credits are separated into two "baskets" of income: the passive income basket and the general limitation basket.[21] Credits in one basket cannot be used to offset a tax in another basket.

The stockpile of credits can be alleviated by finding situations in which there will not be a tax in the local jurisdiction but tax would be triggered in the U.S. For example, the U.K. has historically had a more generous annual pension contribution limitation. The maximum contribution in the U.S. generally stands at $18,000.[22] By funding a U.K. pension (or a pension in another jurisdiction), such as a Self-Invested Personal Pension ("SIPP") up to the maximum allowed in the U.K., a U.S. taxpayer may be able to utilize excess foreign tax credits to frank the difference between the limitation in the U.S. and the U.K.

The benefit of using the tax credits in the pension situation will depend, in part, on where the individual intends to retire and how he intends to utilize the pension going forward. This is because the cost basis for U.S. purposes will differ from the cost basis in the U.K. If the individual will retire to the U.S. (or elsewhere outside of the U.K.), he may be able to take advantage of the higher U.S. basis.

V. Conclusion: Be Mindful That American Citizenship Complicates Matters

The strategies we outline above demonstrate that there are ways for U.S. taxpayers abroad to avoid the pitfalls common for U.S. taxpayers abroad. Yet, none of these strategies should be considered in a vacuum: the most important "strategy" for taxpayers is to take a business-like approach to their personal taxes. Finding a U.S.-qualified tax preparer abroad is easier than ever: the IRS maintains a website searchable by location.[23] Once a taxpayer finds a preparer to trust, the preparer may be able to refer the taxpayer to a U.S. qualified tax attorney, if needed.

It is worth noting in this context that for some individuals, relinquishment of U.S. citizenship and citizenship-based taxation, is an option. However, a more detailed discussion of the process and pitfalls of renouncing U.S. citizenship (or, indeed, relinquishing a green card) will follow in Part Four of our series on U.S. tax matters.

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Notes

[1] Chris McLemore and Erin Fraser, *Uncle Sam Wants You (To Pay Tax): Income Tax Pitfalls for Americans Living Abroad*, Tax Planning International Review, Mar. 2015.

[2] Revenue Act of 1926, Pub. L. No. 69-20, § 213(b)(14), 44 Stat. 9, 26 (1926).

[3] Revenue Act of 1962, Pub. L. No. 87-834, § 12, 76 Stat. 960, 1006 (1962).

[4] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1235, 100 Stat. 2085, 2566 (1986).

[5] Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1402, 124 Stat. 1029, 1061 (2010).

[6] Helvering v. Gregory, 69 F.2d 806, 807 (2nd Cir. 1934).

[7] *See* IRC § 121(a), (b)(1)-(2).

[8] *See* OECD, Taxation of Capital Gains of Individuals: Policy Considerations and Approaches, Nov. 24, 2006, at 111, *available at* http://www.oecd-ilibrary.org/taxation/taxation-of-capital-gains-of-individuals_9789264029507-en.

[9] This rate is a combination of the highest marginal rate for capital gains (20%), *see* IRC § 1(h)(1)(D), and the NIIT rate (3.8%), *see* IRC § 1411(a)(1). *See also* IRS, *Questions and Answers on the Net Investment Income Tax* (Nov. 13, 2014), http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

[10] *See* IRC § 2010(c) (providing a unified transfer tax exemption of $5,000,000 to be indexed for inflation). *See also* Rev. Proc. 2014-61, 2014-47 I.R.B. 860, at § 3.33 (setting the 2015 exclusion amount to $5,430,000).

[11] This figure is adjusted for inflation. The $147,000 limit is for 2015. *See* IRC § § 2053(a), 2523(i)(2) (setting the exclusion at $100,000 per year). *See also* Rev. Proc. 2014-61, 2014-47 I.R.B. 860, at § 3.35(2) (setting the 2015 exclusion amount to $147,000).

[12] Rev. Proc. 2014-61, 2014-47 I.R.B. 860, at § 3.32. *See also* IRC § 911(b)(2)(D).

[13] *See* IRC § 441(b) (defining "taxable year"). *See generally* Treas. Reg. 1.441-1 (explaining and expounding on accounting year provisions). *See also* Anthony P. Polito, 574-3rd T.M., *Accounting Periods*, at III.I. Clever individual taxpayers filing a U.S. return for the first time could select a tax year of their choosing, however, the long-term benefit would likely not outweigh the administrative costs to maintain fiscal books and records.

[14] Ernst & Young, *Worldwide Personal Tax Guide* (2014-2015), *available at* http://www.ey.com/GL/en/Services/Tax/Global-tax-guide-archive. Additional exceptions exist for: Botswana (June 30), Ethiopia (July 7), Lesotho (March 31), Malawi (June 30), Myanmar (March 31), Namibia (February 28), New Zealand (March 31), Pakistan (June 30), South Africa (February 28), Sri Lanka (March 31), Swaziland (June 30), and Uganda (June 30). *Id.*

[15] *See* IRC § 905(a), Treas. Reg. 1.905-1(a). Certain limitations are imposed on this rule, *see* IRC § 905(c).

[16] Treas. Reg. 1.461-4(g)(6)(iii)(B) (providing that "economic performance occurs when the requirements of the all events test" are met). *See also* Treas. Reg. 1.461-1(c)(1)(ii) (describing the all events test for accrual taxpayers).

[17] *See* Taxes Management Act 1970 § § 8, 12.

[18] *See* McLemore and Fraser, *supra* note 1, at 7. *See also* Treas. Reg. 1.1411-1(e).

[19] *See* IRC § 904(c). Note, the credit must be carried back before being carried forward. Treas. Reg. 1.904-2(b)(1).

[20] *See* Treas. Reg. 1.904-2(c)(1), (2).

[21] The number of baskets was mercifully reduced from nine to two by Congress in 2004. *See* IRC § 904(d). *See also* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 417.

[22] *See IRS*, *IRS Announces 2015 Pension Plan Limitations*, Oct. 23, 2014, http://www.irs.gov/uac/Newsroom/IRS-Announces-2015-Pension-Plan-Limitations-1. The allowed contribution amount depends on the type of savings plan, the filing status of the taxpayer, and the taxpayer's gross income.

[23] *See IRS.gov, Directory of Federal Tax Return Preparers with Credentials and Select Qualifications*, http://irs.treasury.gov/rpo/rpo.jsf.

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