

CONTENTS

STATE TAXES

FEDERAL TAXES

INCOME

ADJUSTMENTS TO INCOME

IRAs

Foreign Earned Income Exclusion

TAXES AND EDUCATION

DEDUCTIONS

Medical/Dental Expenses

Real Estate Expenses

Charitable Contributions

Business Expenses

Home Leave Expenses

Moving Expenses

Representation Expenses

Other Deductible Expenses

EXEMPTIONS

REPORTING

Income of Child

Filing

TAXES FOR NON-U.S. CITIZENS

GENERAL ADVICE

RESOURCES

Chapter 7
INCOME TAXES

Every year U.S. citizens and resident aliens must prepare for the Internal Revenue Service (IRS) an accounting of income, exemptions and deductions, and taxes paid. Tax forms are available at the IRS website, <http://www.irs.gov>, by telephone at (800) 829-3676 (weekdays 7 a.m. to 10 p.m.), as part of commercial tax preparation software, at the Employee Services Center, certain IRS and state offices, banks, libraries, or post offices. Each post abroad should also have a supply.

STATE TAXES

You must prepare a similar accounting for your state of domicile if it has an income tax.

(For more information on determining domicile, see Chapter 22, "Legal Issues.") *The Foreign Service Journal* prints a summary of state

tax requirements every year, usually in February (see <http://www.afsa.org>).

The most important thing to remember is that *most states and the District of Columbia require that Foreign Service personnel continue to pay taxes while on assignment abroad.* Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not collect income tax. New Hampshire and Tennessee have no tax on personal income but do tax businesses and profits from the sale of property and bonds. States for which there is no tax liability for out-of-state income under certain conditions include California, Connecticut, Idaho, Minnesota, Missouri, New Jersey, New York, Oregon, Pennsylvania, and West Virginia. To qualify for the exemption, most require a permanent place of abode outside of the state and limit the number of days allowed in the state. (Be careful about home leave). Pennsylvania does not consider government-provided quarters as a permanent place of abode; therefore, Foreign Service personnel domiciled in Pennsylvania living in government-leased quarters overseas could be liable for income tax.

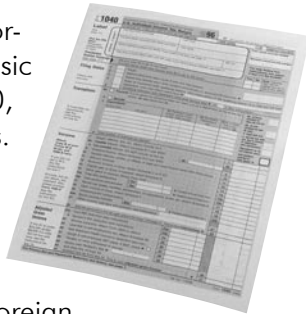


Some states consider you liable for taxes if you have been physically present in that state more than 183 days of the calendar year even if you are domiciled in another state. If you have any uncertainty about

your liability to a state jurisdiction, consult tax authorities, prior to departure if possible. If you fail to meet your state tax obligation, you face paying interest and penalties, as well as the unpaid taxes.

FEDERAL TAXES

The following discussion is organized according to the basic federal tax form, Form 1040, and its supporting schedules. The IRS offers many publications and guides online at <http://www.irs.gov>. The AFSA Tax Guide provides information specific to the Foreign Service (www.afsa.org). Various publishers produce tax information guides that try to cover the whole field in one book. These often have good indices so that you can easily find the information you need. Higher end tax preparation software includes reference materials as well.



INCOME

To prepare your tax return, you must first calculate your income. In January, employers prepare W-2 forms, which are mailed to you or posted online. These forms give totals for the amount earned in the previous year and show the federal and state taxes withheld. One copy of each set of W-2s must be sent with your tax return to the IRS and another to the state(s) to which you owe tax. An additional copy is for you to keep with your copy of your tax return.

Other income must also be reported. Banks and companies send you Form 1099 to report interest and dividends earned. Use the information on these forms to fill in Schedule B. Interest earned on money loaned to someone also must be reported. More information is given in IRS Publication 17, "Your Federal Income Tax."

Money earned from self-employment is taxed, including freelance work such as tutoring, catering, or selling your written work or artwork. Certain expenses incurred in connection with self-employment may be deducted; these are listed on Schedule C, the form used to report this kind of income. It is essential to

keep good records of expenses if you plan to deduct them. Refer to Publication 17 for the definition of hobby income and deductions.

Earning more than \$400 annually from self-employment obliges you to pay Social Security tax by using Schedule SE. Many Foreign Service spouses find self-employment attractive as a means of earning additional credit toward Social Security retirement benefits, particularly when they are serving abroad and unable to continue regular employment. Some income earned abroad, however, is exempt from Social Security tax. This area must be explored carefully.

If you sell capital assets, such as stocks, bonds, or real estate, you must pay tax on the profit.

Some losses can be deducted from your taxes. Capital gains and losses are reported on Schedule D. See the instructions for this schedule to find out whether your situation qualifies.

The capital-gains exclusion on the sale of a principal residence on or after May 7, 1997, applies to all homeowners, regardless of their age. Current tax laws allow an exclusion of up to \$500,000 for couples filing jointly and up to \$250,000 for single taxpayers on the gain from the sale of their principal residence. The Military Families Tax Relief Act of 2003 benefits Foreign Service families who would not meet the "two-year occupancy within the five years preceding the date of sale" requirement because of overseas assignments. The law states that the five-year period may be extended for up to ten years while serving on qualified official duty.

It is to your benefit to research this provision thoroughly to familiarize yourself with the intricacies of and qualifications to this exclusion. Above all, keep good records of purchase price, costs of improvements, and documents such as deeds and titles and settlement sheets.

In addition to Publication 17, other good sources of information are the following:

- Publication 523, "Selling Your Home"
- Publication 530, "Tax Information for First-Time Home Owners"
- Publication 554, "Older Americans' Tax Guide"

Rental income you receive is taxable and is reported on Schedule E. If you show a net loss on Schedule E, you are allowed up to \$25,000 of such loss against your other income, as long as your adjusted gross income does not exceed \$100,000.

Mortgage interest, property manager payments, depreciation, and other expenses can be deducted from your rental income. Depreciation must be researched carefully, as you need to begin with the right “basis.” Even if you do not claim depreciation, certain points of tax law will assume that you do, particularly if you eventually sell the property. There are ways to “catch up” if you mistakenly did not claim depreciation. Consult a tax advisor for assistance. For more information, see Publication 527, “Residential Rental Property.”

Form 1040 provides space for reporting other income, such as taxable pensions, IRA distributions, unemployment compensation (part of which could be taxable), or alimony received. The portions of Foreign Service and Civil Service annuities that exceed what the employee paid into the retirement system are taxable. Social Security benefits have been partially taxed since 1984 and need to be reported. Keep records of any Social Security benefits you receive. Child support payments are not taxable.

Separate Maintenance Allowances, like most allowances Foreign Service employees receive while serving abroad, are not taxed and need not be reported. Note, however, some allowances (primarily the Post Differential and Danger Pay) are considered extra compensation and are taxed; these will be included in the W-2 statement of income received at the end of the year. In addition, tax-exempt interest, although not taxed, must be reported, and may not be exempt on your state returns.

ADJUSTMENTS TO INCOME

The next major section of Form 1040 covers adjustments to income. In this section, you claim eligible contributions to Individual Retirement Arrangements (IRAs), alimony payments, reimbursed employee business expenses (where the reimbursement had been included in your gross income), self-employed health insurance deductions, and penalties on early withdrawal of savings.

IRAs

Individual Retirement Arrangements (IRAs) are personal savings plans that give you tax advantages for setting aside money for retirement. If you or your spouse receive taxable compensation during the year, you may set up a **traditional IRA**, which may be tax-deductible under certain circumstances. Permitted contributions and deductions are based on earnings and adjusted gross income. While contributions may be tax-deductible, distributions (which also have defined conditions and amounts) are generally taxable. For more details, see Publication 590, “Individual Retirement Arrangements (IRAs).”

Contributions to **Roth IRAs** are not tax-deductible, but qualified distributions are tax free. Again, income affects contribution limits and participation.

A self-employed family member may set up a **SEP** (Simplified Employee Pension), **SIMPLE** (savings incentive match plan for employees), or **qualified plan** (sometimes known as a Keogh or H.R. 10 plan). As of 2005, SEP contributions may be as high as 25% of self-employed compensation, with \$42,000 the maximum contribution. The same year, the limit for a non-employment-related IRA was \$4-5000 depending on age. If you would like to make larger contributions to a retirement plan and have self-employment or small business income, investigate these options. IRS Publication 560, “Retirement Plans for Small Businesses” provides extensive information.

Foreign Earned Income Exclusion

Family members may benefit from the Foreign Earned Income Exclusion while working overseas. This applies to work on the local economy or work performed as an independent contractor, even if for the U.S. Embassy. It does not apply to any interest earned or salaries paid by the U.S. Government. If you are paid by the U.S. Government under a non-personal services contract (meaning that the agency for which you work does not control your work functions, work facilities, work hours, etc.), your earnings may be excludable.

To be eligible in any instance, you must have a tax home in another country and meet either the bona fide residence test or the physical presence test (be-

ing outside the United States for 330 days out of a full 365-day year). To find out if you qualify for the foreign-earned income exclusion, obtain Form 2555, "Exemption of or Reduction from Income Earned Abroad," with instructions.

Other helpful publications include:

- Tax Topic 853, "Foreign Earned Income Exclusion – General"
- Tax Topic 854, "Foreign Earned Income Exclusion – Who Qualifies"
- Tax Topic 855, "Foreign Earned Income Exclusion – What Qualifies"
- Publication 54, "Tax Guide for U.S. Citizens and Resident Aliens Abroad"

TAXES AND EDUCATION

Publication 970, "Tax Benefits for Education," explains education credits and deductions. These include two credits: the Hope credit and the lifetime learning credit.

Other potential benefits allow you to:

- deduct student loan interest
- receive tax-free treatment of a canceled student loan
- receive tax-free student loan repayment assistance
- deduct tuition and fees for education
- establish and contribute to a Coverdell education savings account (ESA)
- participate in a qualified tuition program (QTP, also known as a 529 plan)
- take early distributions of an IRA for education expenses without paying 10% additional tax on early distributions
- cash in savings bonds for education costs without having to pay tax on the interest
- receive tax-free educational benefits from your employer or
- take a business deduction for work-related education

You generally cannot claim more than one of the above for the same educational expense.

DEDUCTIONS

At this point you have determined your adjusted gross income. You now need to consider your deductions. You can claim either a standard deduction or itemized deductions, which are figured on Schedule A (Form 1040). The standard deduction differs according to your filing status, which is explained further in the instructions accompanying Form 1040 and in Publication 17. If you are single or head of a household, look up the definition before you claim this status! There is also a phase out of Schedule 1040-A totals when adjusted gross income exceeds a certain amount.

For federal taxes, the status "married filing a separate return" is disadvantageous because the tax rates are higher. However, on most state tax returns, the lowest tax often results when spouses split their income. Each claims his/her own salary or wages, and earnings from separately owned bank accounts, stocks, rental property, etc. Jointly owned earnings from dividends, interest, and rents are divided equally. Deductions may be allocated in any way that reduces your tax. In the District of Columbia, Virginia, and Maryland the form has two parallel columns, one for each spouse. You may use whichever filing status results in the lower tax.

If your deductions total more than the standard deduction, you may itemize them on Schedule A. You must have good records to prove that the deductions you claim are valid, in case you are challenged by the IRS.

Medical/Dental Expenses

You may deduct only certain items, summarized on Schedule A and described more fully in Publication 17 and Publication 529, "Miscellaneous Deductions." Medical insurance premiums paid by you, prescription drug expenses, and other medical and dental outlays are deductible to the extent that they exceed 7.5 percent of adjusted gross income.

Transportation to source of medical care at a specified rate of reimbursement can be included. Publication 17 tells you more, as does Publication 502, "Medical and Dental Expenses."

Real Estate Expenses

You may deduct the interest portion of your home mortgage. If your house is rented while you are abroad, you can deduct the taxes and mortgage interest from the rent received, using Schedule E. For interest expense, see Publication 17. Mortgage "points" on the loan on the house you live in are deductible on Schedule 1040 the year of purchase. If paid through refinancing, they are amortized over the life of the loan.

Charitable Contributions

You may deduct charitable contributions and perhaps even the use of your car and other out-of-pocket expense for volunteer work connected with charitable purposes within certain limits (for example, only U.S.-based charities are eligible). See Publication 17 and Publication 526, "Charitable Contributions."

Business Expenses

Business travel expenses include airplane, bus, railroad, and taxi fares, auto rental expenses and mileage, baggage transfer costs, cleaning expenses, hotel expense, meals, telephone expense, and tips. Receipts provide the best substantiation for business travel expenses. For expenses such as mileage in a personal automobile, a contemporary written record usually suffices. You should keep a diary to show such expenses. A claim for meal expenses can be made in two ways. You can claim the exact costs, using a receipt for substantiation. Or, you can claim a standard amount without submitting receipts, but in this event you must have receipts for lodging and travel covering the period for which you claim the meal expenses. (Any food or entertainment expenses claimed must be reduced by 50 percent before entering on Schedule 1040A.)

Unreimbursed and documented expenses incurred during training while on temporary duty (TDY) orders for periods of less than 12 months may be deducted as employee business expenses. Use Form 2106 to file claims for lodging for you and accompanying family members, based on actual costs; meals, estimated on a reasonable basis; and books and other training expenses. The claims may be accompanied

by a statement from the Director of the Department of State's George P. Shultz National Foreign Affairs Training Center (Shultz Center) or other appropriate official to the effect that your training was a temporary assignment and that you were either not entitled to per diem or entitled to only a limited amount. It is not necessary to include this statement when filing, but is helpful in case of an audit. If you took a course at the Shultz Center between two overseas posts and the government shipped your family car directly to the next overseas post, the cost of car rental is also deductible, if not reimbursable.

You do not need to submit your substantiation to the IRS with your tax return, but you should have receipts and an expense diary along with a copy of your travel orders, in case of an audit.

Home Leave Expenses

Substantiated home leave expenses of a U.S. Foreign Service employee are deductible business expenses. However, the employee's family members' personal and living expenses are non-deductible. Business travel expenses include airplane, bus, railroad, and taxi fares, baggage transfer costs, dry cleaning, hotel, meals, telephone, tips, auto rental, and mileage.

Claim home leave expenses on Form 2106. Attach a statement explaining that you are a Foreign Service employee on mandatory home leave, giving dates. If you traveled with family members, explain how you have allocated expenses between them and yourself. Keep all receipts and records of other expenses (such as an expense diary) along with a copy of your travel orders, in case of an audit.

Moving Expenses

To be eligible for a moving expense deduction, you must be at post at least 39 weeks during the 12 month period immediately after arrival. Moving expense deductions cannot be taken if you retire or resign within those 39 weeks. However, if departure from post is unexpected and involuntary, the deductions are allowed.

Deductions are allowed (Form 3903) for any legitimate expenses not covered by government allowances, such as:

- cost of shipping effects in excess of government allowances
- shipping pets
- transit insurance for effects and cars
- unreimbursed losses incurred during shipment
- disconnecting utilities (does not include telephone)
- cost of shipping a second car, or the first car if it is foreign made and not covered by the government
- extra cost of first class air travel, if you select it in lieu of economy class
- cost of transporting a family member who may be ineligible to travel at government expense
- actual cost of lodging in excess of per diem payments for official travel

Representation Expenses

Unreimbursed entertaining (representation) expenses also can be claimed, although this is one area the IRS often questions. Read Publication 463, "Travel, Entertainment, Gift and Car Expenses."

Keep records of all official representation such as restaurant bills or home entertainment accounts to show the amount spent, time and place of function, representational purpose, and position and official relationship to those entertained. These can justify business expense deductions if certified by the post fiscal officer as performed in the interest of the government and as prescribed in the employee's job description but not reimbursed due to insufficiency of funds. On Form 2106 show the total amount claimed, any amount reimbursed by the government, and the balance as your deduction. Attach an itemized list showing date and type of expense, and relationship to Foreign Service activity.

Other Deductible Expenses

Losses of property due to theft or casualty above a certain percentage of adjusted gross income are

deductible under limited circumstances described in Publication 17.

Other deductible expenses are dues paid to professional organizations (including AFSA and AAFSW) or unions for government employees, professional publications, enrollment in classes, or correspondence courses related directly to improving your job skills (not deductible if incurred to meet the minimum requirements of your profession or to qualify you for a new profession), and transportation to official functions at the yearly specified rate per mile or the actual documented costs. Claim these on Form 2106.

On Schedule A, deduct safe deposit box rental fees and cost of tax consultants and tax preparation.

Specifically not deductible are losses due to foreign currency exchange and payments to a retirement fund. Also not permitted are direct contributions to foreign charities. However, some government employees have successfully defended contributions to foreign charities as unavoidable business expenses related to the proper conduct of business of diplomatic representation. Some have made their contributions deductible by routing them through American charitable organizations with overseas operations. But scrutiny by IRS can be expected if such expenses are deducted.

Miscellaneous deductions are subject to a floor of two percent of your adjusted gross income; you can deduct only the excess above that amount. However, the moving expense deduction and a few others are not subject to the two-percent floor.

It is very important to maintain and retain careful records of expenditures and reimbursement and to obtain post certification of expenses related to transfer or conduct of official diplomatic representation.



EXEMPTIONS

Two kinds of exemptions reduce your taxable income: personal exemptions (for yourself and your spouse) and dependent exemptions (for qualifying children or relatives). A number of tests determine whether someone is a qualifying child or relative. Since these changed in 2005, see Publication 501, "Exemptions, Standard Deductions, and Filing Information" for more information. Dependents over two years old need Social Security numbers.

You may lose part or all of your exemptions if your adjusted gross income is above a certain level.

After determining your taxable income, find your tax by looking at the tax tables that come with the instructions. Now determine if you are eligible for any of the following credits or deductions:

Child and Dependent Care Credit

Credit for expenses paid to care for a child, disabled dependent, or disabled spouse so you could work or look for work. Limits and qualifications apply. See Form 2441, "Credit for Child and Dependent Care Expenses," and Publication 503, "Child and Dependent Care Expenses."

Child Tax Credit

Credit if you have a qualifying child. See Publication 972, "Child Tax Credit."

Adoption Credit

Credit for qualifying expenses paid to adopt an eligible child. Complete Form 8839, "Qualified Adoption Expenses."

Foreign Tax Credit

Credit for foreign taxes paid. Use Form 1116, "Foreign Tax Credit," and see Publication 514, "Foreign Tax Credit for Individuals."

Credit for the Elderly and Disabled.

Credit for people over age 65 or permanently disabled below a certain income level. See Publication 524, "Credit for the Elderly and Disabled."

After subtracting the credits you might have to add other taxes, such as Social Security tax on self-employment income (Schedule SE).

REPORTING

After determining your total tax, compare it with the tax you have paid during the year. If you owe more, pay it by enclosing a check with your return or by using a credit card if you file electronically. Be sure to write your Social Security number on your check. If you owe less, the IRS will send you a refund.

The law states that you must pay your taxes as you earn your money. For this reason, taxes are withheld from salaries. If the amount being withheld is insufficient, the employee should arrange to change the amount with the appropriate personnel officer. For Foreign Service employees and families whose income is mainly or entirely from Foreign Service salaries, the tax withheld should be adequate to cover most tax liability. However, if you have additional income, such as capital gains, interest, dividends, or self-employment income, it may be necessary to file a Declaration of Estimated Tax (Form 1040 ES) to prepay the additional tax in quarterly installments, or have payroll withhold more from your pay check. *Anyone taking a lump sum retirement or annuity benefit should be especially careful about these regulations.* The rules about who must file a Declaration of Estimated Tax are spelled out in Publication 17 and should be studied carefully; the penalties for underpaying the tax are substantial. Publication 17 also describes the conditions under which you may be excused from the penalty. This is a confusing area, and it may be advisable to consult a tax professional.

Income of Child

Under certain circumstances, dependent children must file tax returns. See Publication 929, "Tax Rules for Children and Dependents" to investigate filing requirements.

Filing

Federal income tax is payable on or before April 15 each year. United States citizens and resident aliens who live abroad are given until June 15 to file their federal returns, but they must attach a statement indicating they were living and working outside the United States on April 15. They will be billed for interest from April 15 on any tax due.

If you cannot meet the April 15 deadline (or June 15, as described), you may file a Form 4868, "Application for Automatic Extension of Time to File." The automatic extension is four months, to August 15, which includes the two-month extension for overseas taxpayers. *Note that the extension of time to file does not mean extension of time to pay.* If you do not pay the estimated amount due at the time you file Form 4868, you will be assessed interest and penalty charges.

TAXES FOR NON-U.S. CITIZENS

Many Foreign Service Officers marry citizens of other countries, who may be considered resident or non-resident aliens for tax purposes. Resident aliens are generally subject to tax in the same manner as U.S. citizens. Non-resident aliens generally owe tax only on U.S.-source income. Non-residents may choose to be considered residents for tax purposes. For more information, see Publication 519, "U.S. Tax Guide for Aliens" and, if relevant, Publication 54, "Tax Guide for U.S. Citizens and Resident Aliens Abroad."

GENERAL ADVICE

Because tax calculation is complicated, you should stay informed of changes in regulations and allowances. Government publications, IRS booklets, and consultations with visiting tax specialists are ways to do this while you are overseas. You may want expert advice as to whether it is in your interest to itemize deductions or take the standard deduction. The expense of tax consultation is deductible.

If you are a do-it-yourself taxpayer, you will still need expert counsel if you have special concerns about community property income, if your spouse is a non-resident alien, if you are ordered to evacuate to a safe haven post and incur expenses not covered by the government allowances, and/or if you believe the cost of domestic help or out-of-pocket costs constitute legitimate business expenses. Consider discussing your situation with a professional before departing for post. You will then be able to call upon that person as need arises with greater confidence that you will receive sound and timely advice.

When you go overseas, leave copies of tax records in a safe, accessible place in the United States so

that you can get them easily in case of an emergency such as evacuation from post. Do not put them into storage with other household effects. Also, use an address on your return where you can be sure any notices sent by the IRS will reach you at least through several years in the future.

RESOURCES

Foreign Service Institute Transition Center (M/FSI/TC)

George P. Shultz National Foreign Affairs Training Center (SA-42)

Department of State

Washington, DC 20522-4202

Physical location: 4000 Arlington Blvd., Arlington, VA (do not send mail to this address)

Internet: <http://www.state.gov/m/fsi/tc/>

Intranet: <http://fsi.state.gov/fsi/tc/>

Directions, maps, parking and other information

<http://www.state.gov/m/fsi/tc/c16687.htm>

Overseas Briefing Center (M/FSI/TC/OBC)

Room E2126

Tel: (703) 302-7277

Fax: (703) 302-7452

E-mail: FSIOBCInfoCenter@state.gov

Related videos that can be checked out from OBC:

Tax Seminar – 1 hour 50 min. (2006)

Transition Center Training Division (M/FSI/TC/T)

Foreign Service Life Skills Training

Tel: (703) 302-7268

E-mail: FSITCTraining@state.gov

Related Transition Center Training

Tax Seminar (MQ 117)

Managing Rental Property from Overseas (MQ 853)

<http://www.state.gov/m/fsi/tc/c6950.htm>

AFSA Tax Guide

<http://www.afsa.org> (choose "Tax Guide" from the drop-down menu).

This includes issues such as state domicile and taxes, home ownership, Foreign Service-specific tax issues, and tax liability upon sale of a residence.

IRS Resources

<http://www.irs.gov>

This site contains publications, forms, frequently asked questions, and much more. Make it your first stop for tax information.

IRS Taxpayer Assistance Centers are available throughout the U.S. and in several other countries for personalized service. See the IRS website (www.irs.gov/localcontacts) for locations, hours, and contact information.

For assistance by phone, call IRS at: (800) 829-1040 or (215) 516-2000 (not toll-free).

If you have attempted to deal with an IRS problem unsuccessfully, contact your Taxpayer Advocate toll-free at (877) 777-4778, contact the Taxpayer Advocate Office in your area, or visit www.irs.gov/advocate. For more information, see Publication 1546, "How to Get Help with Unresolved Tax Problems". This publication is available in Spanish, Chinese, Korean, Russian, and Vietnamese, as well as in English.