

TAX FREE EXPAT

*A Framework for American Expats
to Live Tax Free*

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A guidebook taking a step-by-step approach to how most American Expatriates can live offshore to remain largely free from the U.S. income tax system.



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*A Framework for American
Expats to Live Tax Free*

***By* Marcus Marcial**

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The Author

Marcus Marcial is a seasoned tax professional with experience predominantly dealing with International Taxation. Originally from Southern California, he attended Hunter College in New York City and has resided abroad for many years.



While employed at the IRS, he learned from examining and preparing tax returns for individuals residing and businesses operating offshore. After leaving the IRS, he started his own tax firm, helping various international clients with tax compliance, accounting, and consultation.



Tax Consultations

To schedule a consultation to discuss the planning, concepts, and tax law references found in this book, custom tax structure development, or consultation for tax return filing, and strategy, visit <https://pacifico.tax/schedule-consultation>

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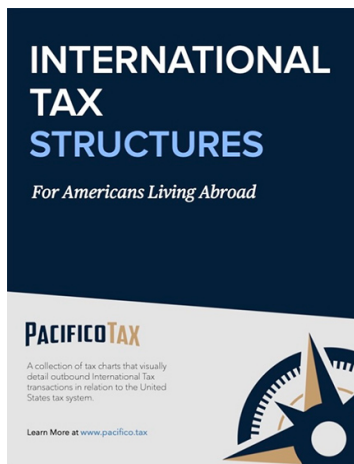
Concepts Covered in This Book

This book is developed as a primer to understanding the most basic concepts of international tax planning for Americans abroad. It is not meant to replace international tax law references, comprehensive client planning/strategy, or a singular reference for global planning. Concepts related to the U.S. International Tax system are vastly complex and a continually growing and changing field. This book does not claim to describe every situation and every legal reference in a given structure, as each real-world structure is factually unique.

Instead, this book only describes the basic understanding of the most relevant and commonly used concepts for the average international tax transaction, which include:

1. Income Sourcing Rules for U.S. Citizens/Residents
2. Foreign Earned Income Exclusion Qualification and Implementation
3. Claiming the Foreign Tax Credit
4. Introduction to Controlled Foreign Corporation Concepts

International Tax Structures



A separate book, **International Tax Structures for Americans Living Abroad**, provides a technical reference that visualizes scenarios for U.S. Citizens and Residents Conducting Business Offshore.

This book seeks to describe in more detail the forms and calculations related to international tax strategy and help taxpayers optimally reduce their tax liability as a compliance reference.

To learn more about this supplemental guidebook, visit <https://pacifico.tax/international-tax-structures>



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***“Paying yourself a Salary
from a Foreign Corporation
(you control) can
substantially reduce your
tax liability, and in some
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liability... ”***

Preface

Let's rewind years ago to when I was an International Tax Auditor working at the IRS...

At that time, when I was an auditor, the primary function of my work was examining documents to verify that taxpayers met the conditions of the Foreign Earned Income Exclusion (the bulk of cases assigned to me), as well as the Foreign Tax Credit, or Tax Treaty Exemptions for Non-Residents living in the United States.

In one particular instance, a taxpayer was receiving a salary from a Foreign Corporation and paying no U.S. tax. Usually, when a taxpayer filed a tax return earning significant income and paying no tax, it was considered questionable, and my job was to determine why and if the tax return was correct.

During the course of the examination, it was determined that he did own a valid Foreign Corporation, and payments to him were made throughout the year designated as a Salary. But I was perplexed, as shouldn't he owe some U.S. tax?

Occasionally, senior Revenue Agents would provide assistance in complex cases for which we were untrained, and I received her guidance in this situation. “No,” she explained; Social Security and Medicare taxes didn’t apply when he worked in a foreign country and was paid by a foreign entity, and income tax didn’t apply as he elected the Foreign Earned Income Exclusion. After researching the relevant laws regarding the Foreign Exclusion and Social Security/Medicare, no U.S. tax applied.

At that is the premise of this book; **Paying yourself a Salary from a Foreign Corporation (you control) can substantially reduce your tax liability, and in some cases, eliminate your U.S. liability if you fall below the exclusion threshold.**

Coincidentally, years later, I departed the IRS, started my own tax firm, and lived overseas myself, structuring my income in the way described above. And with some trial and error, I developed a template on how my clients can do the same..

Hopefully, the guidance in this book provides the tax strategies you need, so you yourself can be a Tax Free Expat.

Part I

Foreign Income Concepts

**Separating U.S. Source
Income from Foreign
Source**

Chapter 1

The American Trap of Worldwide Income

The United States operates one of the most far-reaching tax systems in the world – one that follows its citizens no matter where they live.

Often called the “American Trap of Worldwide Income,” this system means that U.S. citizens must report and potentially pay taxes on all their income, regardless of where they live, work, or invest.

Unlike most countries, which tax based on residency, the U.S. imposes citizenship-based taxation (CBT).

How Worldwide Taxation Works

Under the Internal Revenue Code, U.S. citizens are required to report all income from anywhere in the world, regardless of where they reside.

This includes:

- **Earned income:** salaries, wages, self-employment income, and bonuses.
- **Investment income:** interest, dividends, and capital gains from both U.S. and foreign sources.
- **Passive income:** rental income, royalties, pensions, and annuities.
- **Foreign government benefits:** some foreign social security or pension payments.

Example scenarios:

- A software engineer living in Singapore must report their local salary to the IRS.
- A retiree in France must report U.S. Social Security and French pension income.
- An investor in Costa Rica must disclose gains from selling property, even if the property is located entirely outside the U.S.

Regardless of whether income is already taxed overseas, U.S. citizens **must still file** a U.S. tax return annually.

Historical Origins of Citizenship- Based Taxation

The idea of taxing citizens abroad originated during the **Civil War**.

In 1864, Congress expanded the wartime income tax to cover citizens living overseas to prevent wealthy individuals from avoiding tax by leaving the country.

After the war, the tax was repealed, but the concept returned permanently with the **Revenue Act of 1913**, passed shortly after the **16th Amendment** authorized a federal income tax.

Lawmakers justified the policy by claiming that U.S. citizenship brought benefits – such as diplomatic protection – and therefore required financial obligations.

The policy was challenged but upheld in **Cook v. Tait (1924)**, where the Supreme Court ruled that the U.S. could tax its citizens abroad because the benefits of citizenship follow them worldwide.

Today, the U.S. and Eritrea are the only countries that enforce such a system. Efforts in Congress to shift to a residence-based model have so far failed.

Passport Warning – “U.S. Taxes” Section

This rule is not hidden in obscure tax code – it is printed directly inside U.S. passports. Under the section titled **“U.S. Taxes”**, the government reminds travelers that:

All U.S. citizens, including those who reside abroad, are subject to U.S. income tax for their worldwide income.

Many first-time expatriates overlook this message, assuming it only applies to people earning income in the United States. In reality, it applies universally to all citizens, no matter where they live.

Reducing the Burden – Exclusions, Credits, and Deductions

While the system is strict, Americans abroad can often reduce or eliminate their U.S. tax liability by using certain provisions:

- **Foreign Earned Income Exclusion (FEIE)** – Allows qualifying taxpayers to exclude a set amount of foreign-earned income each year (over \$120,000 per person in recent years).
- **Foreign Tax Credit (FTC)** – Offers a dollar-for-dollar credit for income taxes paid to a foreign country.
- **Foreign Housing Exclusion/Deduction** – Provides relief for housing costs incurred while living abroad.

Key point: Even if these reduce U.S. tax liability to **\$0**, the annual filing requirement remains. Citizens must file to claim these benefits.

In addition, Americans abroad may have **extra financial reporting obligations** such as:

- **FBAR (Foreign Bank Account Report)** – Required if total foreign bank account balances exceed \$10,000.
- **FATCA Form 8938** – Required if foreign financial assets exceed certain thresholds.

Both carry **severe penalties** for noncompliance, even if no tax is due.

Why It's Called a “Trap”

The “trap” is that citizenship creates a permanent tax connection to the United States, regardless of residence.

This means:

- Moving abroad does **not** sever your U.S. tax obligations.
- Working exclusively for a foreign employer does **not** exempt you.
- Holding investments solely in foreign countries does **not** shield them from reporting requirements.

Some frustrated expatriates choose to **renounce U.S. citizenship** to escape the system. However, this can trigger the **exit tax** for individuals above certain income or asset thresholds, and the process is costly and irreversible.

In Closing

The U.S. taxation of worldwide income is a rare policy rooted in Civil War history, reinforced by the 16th Amendment, and upheld by the Supreme Court.

It is stated plainly inside U.S. passports and enforced through both annual returns and global financial reporting rules.

While exclusions, credits, and deductions can often reduce U.S. tax liability to nothing, they do not eliminate the obligation to file.

For Americans abroad, understanding this system is not a matter of choice – it is an ongoing legal duty tied to citizenship itself.

Chapter 2

Understanding Offshore Sourcing Rules

Qualifications for the Foreign Earned Income Exclusion

Introduction

U.S. tax law follows a **citizenship-based taxation** system, meaning that Americans—regardless of where they reside—are taxed on their **worldwide income**. However, how income is sourced (classified as U.S. source or foreign source) plays a critical role in determining the applicability of certain tax benefits, such as the **Foreign Earned Income Exclusion (FEIE)** and the **Foreign Tax Credit (FTC)**. The Internal Revenue Service (IRS) has clear rules for sourcing various types of income, and understanding these rules is essential for Americans living offshore.

The Purpose of Income Sourcing Rules

The IRS sourcing rules determine whether income is considered U.S.-source or foreign-source. These classifications affect:

- **Eligibility for the FEIE** - Only foreign-earned income qualifies for exclusion.
- **Foreign Tax Credit limitations** - The FTC is generally available only for foreign-source income that has been taxed by a foreign country.
- **Withholding and treaty applications** - Certain types of income are subject to different withholding rates depending on the source.

The goal is to ensure the correct allocation of income between U.S. and foreign sources to prevent double taxation while maintaining compliance with U.S. tax law.

How Income Is Sourced

The IRS applies different sourcing rules depending on the type of income. In general:

- **Earned income** is sourced where the services are performed.
- **Investment income** is sourced based on the payer's location or the location of the asset.
- **Gains from property** are sourced based on the property's location.

Categories of Income and Sourcing Rules

Salary and Wages

- **Rule:** Sourced where the work is physically performed.
- If you are a U.S. citizen working for a foreign employer while living abroad, your wages are generally foreign source.
- If you perform work in both the U.S. and abroad, the income is allocated proportionally.

Self-Employment Income

- **Rule:** Also sourced where the services are performed.
- If services are rendered overseas, the income is foreign source. This is important for FEIE qualification.
- Special note: Self-employed taxpayers may still owe U.S. self-employment tax, even on foreign-source earnings.

Business Income

- **Rule:** Sourcing depends on whether income is from **personal services** or **sale of goods**:
 - Services - sourced where performed.
 - Goods - sourced where the title passes (often at the point of delivery).
- Mixed business income may require allocation between service and sales components.

Rental Income

- **Rule:** Sourced where the property is located.
- Rental income from property abroad is foreign source; rental income from U.S. real estate is U.S. source.

Royalties

- **Rule:** Sourced where the intangible property is used.
- Royalties for the use of patents, copyrights, trademarks, etc., in a foreign country are foreign source.

Interest

- **Rule:** Sourced based on the **residence of the payer.**
- Interest paid by a U.S. resident or U.S. corporation is U.S. source, even if the payee lives abroad.
- Interest from foreign residents or foreign corporations is foreign source.

Dividends

- **Rule:** Sourced based on the **location of the corporation.**
- Dividends from U.S. corporations are U.S. source; dividends from foreign corporations are generally foreign source (with certain exceptions for U.S.-connected earnings).

Capital Gains

- **Rule:** Depends on the type of property:
 - Real property - sourced where the property is located.
 - Personal property - for individuals, usually sourced to the seller's residence at the time of sale.
- Gains from the sale of stock are generally sourced to the seller's residence.

The Connection to FEIE and FTC

Foreign Earned Income Exclusion (FEIE)

- FEIE allows eligible taxpayers to exclude up to a set amount of foreign earned income each year.
- Only **earned income** from a **foreign source** qualifies.
- Correct sourcing is critical: U.S.-source wages cannot be excluded under FEIE, even if paid while living abroad.

Foreign Tax Credit (FTC)

- The FTC allows a credit against U.S. taxes for foreign taxes paid on foreign-source income.
- There are **“baskets”** (general income, passive income, etc.) that require correct classification and sourcing.
- U.S.-source income taxed by a foreign country generally does not qualify for FTC, unless a treaty overrides this rule.

Why Sourcing Rules Matter for Offshore Americans

For U.S. citizens living abroad:

- **Incorrect sourcing** can lead to overpayment of tax or denial of FEIE/FTC benefits.
- **Hybrid situations** (e.g., work performed in multiple countries, or income from both U.S. and foreign assets) require careful allocation.
- **Recordkeeping**—maintaining logs of where work was performed, where assets are located, and where income was derived—is essential.

Practical Examples

1. Remote Employee for U.S. Company Abroad

- Works full-time from Spain for a U.S. company.
- Wages are foreign source (since services are performed abroad) and potentially eligible for FEIE.

2. Consultant Traveling Between U.S. and Asia

- Works 60 days in the U.S., 300 days abroad.
- Must allocate income proportionally (60/360 to U.S. source, 300/360 to foreign source).

3. U.S. Citizen with Overseas Rental Property

- Rents out an apartment in Costa Rica.
- Rental income is foreign source and may qualify for FTC if taxed locally.

4. Royalties from Software License in Europe

- Software is used in Germany; royalties are foreign source.

5. Summary Table of Sourcing Rules

Type of Income	General Sourcing Rule	Example (Foreign Source)	Example (U.S. Source)
Salary/ Wages	Where services performed	Teaching in Spain	Teaching in Texas
Self Employment	Where services performed	Consulting in Costa Rica	Consulting in Florida
Rental Income	Location of property	Apartment in Paris	Apartment in Miami
Royalties	Where property rights are used	Patent used in France	Patent used in U.S.
Interest	Residence of payer	Loan to French person	Loan to U.S. person
Dividends	Place of incorporation of payer	French Corporation	U.S. Corporation
Capital Gains - Real	Location of property	Land in Italy	Land in Arizona
Capital Gains - Stocks	Seller's tax residence (special rules apply)	(Rare for U.S. Source)	Most U.S. citizens

In Closing

The IRS's **offshore sourcing rules** are the foundation for determining how income is taxed for Americans abroad and directly affect the ability to claim the **Foreign Earned Income Exclusion** and **Foreign Tax Credit**. Correct classification between **foreign-source** and **U.S.-source** income is not just a compliance matter—it's a strategy for optimizing tax outcomes. Americans overseas must understand these rules, track their activities, and consult professionals when navigating complex or mixed-source situations.

Part II

Offshore Foundational Strategies

Discovering a Baseline on
how to Exclude Foreign
Income

Chapter 3

The Baseline of the Foreign Earned Income Exclusion

The Foreign Earned Income Exclusion: The Cornerstone Tax Strategy for Americans Living Offshore

Introduction

For Americans living abroad, U.S. tax laws can feel like a frustrating anchor – pulling them back into the Internal Revenue Service’s reach, even if they have no ties to U.S. soil. Unlike most countries, the United States taxes its citizens on their **worldwide income**, regardless of where they live or where their income is earned.

However, one provision has long been the most powerful and widely used tool for reducing this burden: the **Foreign Earned Income Exclusion (FEIE)**. For qualifying taxpayers, the FEIE allows a substantial amount of foreign-earned income to be excluded from U.S. taxation, often resulting in little or no U.S. income tax owed.

When properly applied, the FEIE is **the single most beneficial tax strategy** for Americans abroad. It can shield well over \$100,000 of annual income from U.S. taxation and, when combined with other strategies, can legally eliminate most Americans' U.S. tax liability entirely.

A Brief History of the Foreign Earned Income Exclusion

The origins of the FEIE date back to the early 20th century, at a time when the U.S. was expanding its diplomatic, business, and military presence overseas. The key driver was **economic competitiveness**: U.S. citizens working abroad were often subject to foreign taxes and faced a competitive disadvantage compared to citizens of countries that didn't tax their citizens on worldwide income.

The **Revenue Act of 1926** included the first formal exclusion for Americans working abroad. At that time, the U.S. recognized that taxing citizens on income earned overseas, without relief, would discourage international trade and diplomacy.

Over the years, the exclusion evolved:

- **1950s-1970s** - The exclusion amount was modest but grew in recognition of rising costs of living abroad.
- **1981** - Major reforms set a fixed dollar exclusion limit and expanded qualifying rules.
- **Present Day** - Indexed annually for inflation, the FEIE amount continues to increase. For 2025, the maximum exclusion is \$126,500 per qualifying taxpayer.

The policy rationale remains the same: encourage U.S. citizens to work overseas without being double-taxed on the first portion of their foreign income.

The FEIE Today: Why It's the Core Offshore Strategy

The FEIE stands apart from other tax relief measures for Americans abroad for three main reasons:

1. **It's the largest single exclusion available.** No other provision allows such a high amount of income to be excluded from taxation outright.
2. **It directly reduces taxable income, not just the tax owed.** Unlike a deduction or credit, the FEIE removes income from the tax calculation entirely.
3. **It's relatively straightforward to qualify for** – provided you meet either the Physical Presence Test or the Bona Fide Residence Test.

While other strategies (such as the Foreign Tax Credit) can also reduce tax, the FEIE should generally be the first line of defense in an American expat's tax planning.

Qualifications for the Foreign Earned Income Exclusion

To claim the FEIE, you must meet three main requirements:

1. You Must Have Foreign Earned Income

The exclusion applies only to income earned from work (salary, wages, self-employment). It does not apply to:

- Passive investment income (dividends, interest, rents, royalties)
- Pensions or retirement distributions
- Capital gains
- U.S.-source income

Your work must be performed outside the U.S., and the compensation must be tied to services you rendered abroad.

2. Tax Home Must Be in a Foreign Country

Your **tax home** is your regular or principal place of business, employment, or post of duty – **regardless of where you maintain your family home**. If your main place of work is abroad, your tax home is abroad.

Exceptions:

- If you keep a U.S. home available for your use, the IRS may argue your tax home is still in the U.S.
- Temporary assignments (less than 1 year) generally do not shift your tax home.

3. Must Pass One of Two Residency Tests

You must qualify under either:

A. Physical Presence Test (PPT)

- You must be **physically present in a foreign country (or countries)** for at least **330 full days** in any consecutive 12-month period.
- The 12-month period can begin or end in any month – it does not have to be the calendar year.

This test is **objective** – it is purely about counting days.

B. Bona Fide Residence Test (BFR)

- You must be a **bona fide resident** of a foreign country for an **entire tax year**.
- This is **subjective** – the IRS looks at factors like:
 - Your intentions (permanent or indefinite stay).
 - Whether you've established a home and integrated into the local community.
 - Length and nature of your stay.
 - Ties to the U.S. you've maintained or severed.

The BFR test offers more flexibility than the PPT but requires stronger documentation.

Step-by-Step Action Plan to Qualify and Remain Qualified

Here is a **practical roadmap** for
Americans seeking to leverage the FEIE
year after year:

Step 1: Determine Your Primary Qualifying Method

- **If your work keeps you moving between countries** or your residency is uncertain, aim for the **Physical Presence Test** – it's the easiest to document.
- **If you are settling in one country long-term**, pursue the **Bona Fide Residence Test**.

Step 2: Establish Your Foreign Tax Home

- Sign a lease or buy property abroad.
- Secure foreign work contracts.
- Avoid maintaining an available U.S. residence.
- Open a local bank account and use it for daily expenses.

Step 3: Track Your Travel Days Meticulously

- Use travel apps or a simple spreadsheet to log **every entry and exit** from each country.
- Keep passport stamps, airline tickets, and other proof.
- Remember: For PPT, even 1 partial day in the U.S. **does not count** toward the 330-day total.

Step 4: Maintain Residency Ties Abroad

For the Bona Fide Residence Test:

- Join local clubs, obtain local IDs, and integrate into the community.
- File local tax returns if required.
- Keep documentation showing your intent to remain (e.g., work permits, visas).

Step 5: File the Proper IRS Forms Annually

- **Form 2555** - Claiming the FEIE (and possibly the Foreign Housing Exclusion/Deduction)
- **Form 1040** - U.S. tax return, even if all income is excluded
- **Form 8938 / FBAR** (FinCEN 114) - Required if you hold foreign financial accounts over certain thresholds

Step 6: Combine with Other Strategies When Necessary

If your income exceeds the FEIE limit:

- Use the **Foreign Housing Exclusion/Deduction** to shelter additional amounts.
- Apply the **Foreign Tax Credit** to offset remaining U.S. tax on income above the exclusion.

Step 7: Reassess Annually

- Life changes – your residency test or tax home may shift.
 - Each year, confirm that you still qualify under the same test, or adjust your travel/residency to maintain eligibility.
-

The Numbers: Why FEIE Dominates Offshore Tax Strategy

The FEIE allows up to **\$126,500** per qualifying individual in 2025 to be excluded from U.S. taxation. For married couples both working abroad, that means over **\$253,000** of earned income can be eliminated from the U.S. tax base.

For example:

- Single filer earns \$110,000 abroad → Entirely excluded under FEIE → **\$0** U.S. income tax.
- Married couple earns \$240,000 abroad (split evenly) → Entirely excluded → **\$0** U.S. income tax.
- Even if income exceeds the limit, pairing FEIE with the Foreign Housing Exclusion and Foreign Tax Credit can still reduce U.S. tax to zero.

Common Pitfalls to Avoid

- **Failing the day-count** under PPT – even one miscalculation can cost the exclusion.
 - **Returning to the U.S. mid-year** without meeting the full-year residency requirement under BFR.
 - **Not filing a return** – you must claim the FEIE; it's not automatic.
 - **Trying to apply FEIE to investment or U.S.-source income** – it applies only to foreign earned income.
-

Conclusion: FEIE as the First Line of Defense

The Foreign Earned Income Exclusion is not just another tax break – it is the cornerstone strategy for Americans living overseas. No other provision offers the same dollar-for-dollar reduction of taxable income, nor the ability to legally eliminate such a large portion of income from the U.S. tax system.

When structured correctly, the FEIE can:

- Eliminate U.S. tax on most, if not all, of your earned income.
- Keep compliance simple and predictable.
- Provide a clear, rules-based method to protect your income every year.

For U.S. citizens abroad, **qualifying for the FEIE should be the primary focus of offshore tax planning**. Once you've secured the exclusion, you can layer in other strategies to protect additional income – but the FEIE remains the foundation.

In short: **qualify, document, file, and repeat** – and you can live and work abroad with the confidence that the bulk of your earnings will remain beyond the reach of the IRS.

Chapter 4

Efficiencies of the Foreign Exclusion

Using the Foreign Earned Income Exclusion Efficiently: Why a Foreign Corporation Paying a Salary is Often the Best Choice for Americans Living Offshore

Introduction

For many Americans living and working abroad, the Foreign Earned Income Exclusion (FEIE) under **Internal Revenue Code §911** is the most valuable tax planning tool available. It allows qualifying taxpayers to exclude up to \$126,500 (for 2024) of earned foreign income from U.S. federal income tax, with an additional exclusion for housing costs in certain high-expense locations.

However, while many expats know about the FEIE, far fewer understand that how you earn that foreign income—and through what legal and tax structure—can make a dramatic difference in your total U.S. tax liability. The exclusion only applies to income tax. It does not automatically eliminate Social Security or Medicare tax (collectively known as “self-employment tax” for the self-employed, or “payroll taxes” for employees).

This means that even if you qualify for the FEIE, you may still be on the hook for thousands of dollars annually if your structure isn't optimized.

This summary examines the major ways an American abroad can structure their income, starting from the **least tax-efficient** method and progressing to the **most tax-efficient**—culminating in the use of a foreign corporation to pay a salary that is completely excluded from both U.S. income and payroll tax, when FEIE requirements are met.

The Foreign Earned Income Exclusion, in Brief

Before comparing structures, it's important to understand the basics of the FEIE:

1. Purpose & History

Enacted in 1926, the FEIE was designed to encourage U.S. citizens to work abroad, particularly in roles that benefit U.S. trade and diplomacy. Originally much more generous, the exclusion has been modified many times, but it remains the cornerstone tax benefit for U.S. expats.

2. Qualification Methods

To claim the FEIE, you must meet **two key tests**:

- **First, The Tax Home Test** - Your tax home must be in a foreign country.
- **Second, Either:**
 - **Physical Presence Test (PPT)** - Spend 330 full days outside the U.S. in a 12-month period, or
 - **Bona Fide Residence Test (BFR)** - Be a bona fide resident of a foreign country for an uninterrupted period that includes an entire tax year.

3. Income Limits

- **Income Exclusion** - Starting \$130,000 per qualifying individual (at the time of this publication), and increasing annually for inflation.
- **Housing Exclusion/Deduction** - Additional amount for high-cost living areas, subject to IRS limits.

4. Key Limitation

The FEIE **only excludes *income tax***. It does not exclude self-employment tax or payroll tax unless your structure eliminates those obligations.

Tax Structures from Least Efficient to Most Efficient

1. Sole Proprietor / Self-Employment (Schedule C) – *Least Efficient*

For Americans abroad working as independent contractors or running their own small business without a corporate entity, income is reported on **Schedule C** of the Form 1040.

Tax Impact:

- **Income Tax** - Potentially reduced or eliminated if you qualify for the FEIE.
- **Self-Employment Tax** - Still applies in full (15.3% on net earnings up to the Social Security wage base, then 2.9% for Medicare, plus an extra 0.9% Medicare surtax above certain thresholds).

Example:

If you earn \$100,000 as a self-employed consultant abroad and qualify for the FEIE:

- **Income Tax:** \$0 (fully excluded under FEIE).
- **Self-Employment Tax:** \$15,300 (15.3% of \$100,000).

This structure is the most common and the most inefficient, because **self-employment tax applies regardless of FEIE eligibility**. Unless you live in a country with a totalization agreement that allows you to opt out of U.S. Social Security, you are paying a tax that could be avoided through a better structure.

2. U.S. C-Corporation – *More Efficient, But Still Costly*

A C-Corporation separates the business from the owner, which removes the “self-employment tax” issue. However, if you operate a U.S.-based C-Corp while living abroad, there are other problems:

Tax Impact:

- **No Self-Employment Tax:** Your income can be taken as salary (subject to payroll taxes) or dividends (subject to dividend tax).
- **Payroll Taxes on W-2 Salary:** If you take a salary, both you and the corporation must pay Social Security and Medicare taxes—totaling 15.3% combined—up to the wage base limit.
- **Corporate Income Tax:** The C-Corp itself pays a flat **21% U.S. corporate tax** on profits not paid out as salary.
- **Double Taxation Risk:** Profits distributed as dividends are taxed again at the shareholder level.

Example:

If you earn \$100,000 in salary from a U.S. C-Corp abroad:

- FEIE may exclude the salary from income tax.
- Payroll taxes still apply (~\$7,650 employer, ~\$7,650 employee).
- If you leave earnings in the corporation, the 21% corporate tax applies.

3. U.S. S-Corporation – Similar to C-Corp, with Pass-Through Treatment

An S-Corporation allows profits to pass through to your personal return, avoiding the corporate-level tax. This can reduce total taxation compared to a C-Corp.

Tax Impact:

- **No Corporate Tax:** Profits flow through to the individual return.
- **Payroll Taxes on W-2 Salary:** Required “reasonable salary” must still have payroll taxes withheld.
- **FEIE Eligibility:** W-2 salary can be excluded from income tax under FEIE.
- **Distributions:** Additional profit distributions are not subject to self-employment tax.

Example:

If you earn \$100,000 salary from an S-Corp abroad:

- Salary excluded from income tax under FEIE.
- Payroll taxes still apply (~15.3% combined employer + employee).
- Any remaining profit distributions avoid payroll tax, but are still reported.

While better than being a sole proprietor, this structure still cannot eliminate U.S. payroll taxes on your salary.

4. Foreign Corporation Paying a Salary – *Most Efficient*

A foreign corporation owned and controlled by you (or with partners) can provide the most tax-efficient structure for an American abroad under the FEIE.

How It Works:

- The foreign corporation is incorporated in your country of residence or another jurisdiction.
- You are employed by this foreign corporation and receive a salary.
- Because the corporation is foreign, U.S. Social Security and Medicare payroll taxes generally do not apply—unless you reside in a country with a totalization agreement that requires participation in that country's social security system.

Tax Impact:

- **Income Tax:** If you qualify for the FEIE, the salary is excluded from U.S. income tax.
- **Payroll Taxes:** No U.S. Social Security or Medicare tax on salary from a foreign employer.
- **Local Tax:** You may owe income or payroll taxes to the country where you live, depending on local law.
- **Corporate Profit Retention:** Additional corporate profits (above your salary) may be subject to U.S. anti-deferral rules (like GILTI), but can be managed with proper planning.

Example:

If you earn \$100,000 salary from a foreign corporation and qualify for the FEIE:

- **U.S. Income Tax:** \$0.
- **U.S. Payroll Taxes:** \$0.
- **Net U.S. Tax Liability:** Zero, assuming no other taxable U.S. income.

IV. Step-by-Step to Implement a Foreign Corporation Structure

1. Determine FEIE Eligibility

- Confirm you meet either the Physical Presence Test or Bona Fide Residence Test.

2. Choose Incorporation Jurisdiction

- Often best to incorporate in your country of residence for local compliance.
- Consider corporate tax rates, reporting requirements, and treaties.

3. Set Up the Corporation

- Draft incorporation documents.
- Register with local authorities.
- Open a local corporate bank account.

4. Set Up the Corporation

- Clearly outline salary, duties, and benefits.

5. Process Payroll

- Pay yourself through the foreign corporation.
- Keep payroll records for proof of employment and foreign source income.

6. File U.S. Tax Forms

- **Form 2555** - Claim FEIE for salary.
- **Form 5471** - Report ownership of the foreign corporation (mandatory for U.S. owners of certain foreign corporations).
- **Other Forms** - FBAR/FinCEN 114 if accounts exceed \$10,000; Form 8938 for FATCA compliance.

7. Coordinate with Local Taxes

- Pay required local income or social security taxes, if applicable.

V. Comparative Summary Table

FEIE Efficiency: U.S. Expat Income Structures

From Least to Most Tax Efficient

Sole Proprietor / Schedule C

Income tax excluded via FEIE, but 15.3% self-employment tax applies.



U.S. C-Corporation

No self-employment tax, but payroll taxes (15.3%) + 21% corporate tax.



U.S. S-Corporation

No corporate tax, but payroll taxes (15.3%) on salary remain



Foreign Corporation

Salary excluded via FEIE, no U.S. payroll taxes, only local taxes.



VI. In Closing

While the FEIE is a powerful tool for Americans living abroad, the structure through which you earn income determines whether you also pay U.S. self-employment or payroll taxes.

- **Least Efficient:** Sole proprietorship – subject to full self-employment tax.
- **Somewhat Efficient:** U.S. C-Corp or S-Corp – avoids self-employment tax but still incurs U.S. payroll taxes.
- **Most Efficient:** Foreign corporation paying a salary – avoids both U.S. income and payroll taxes when FEIE applies.

For many Americans abroad, forming and working for a foreign corporation offers the closest thing to “tax-free” U.S. income—legally and compliantly—while meeting FEIE requirements.

With careful planning, record keeping, and compliance with both U.S. and local laws, this strategy can yield substantial long-term tax savings.

Chapter 5

Avoiding Double Taxation with Foreign Tax Credits

The Foreign Tax Credit for U.S. Citizens Living Offshore

Introduction

For U.S. citizens living outside the United States, the Foreign Tax Credit (FTC) is one of the most important tax tools available to prevent double taxation. Because the U.S. is one of the few countries that taxes its citizens on their worldwide income regardless of residency, Americans working offshore often face the possibility of paying tax both to their country of residence and to the United States.

The FTC provides a way to reduce or eliminate this double tax burden by allowing taxpayers to claim a credit against their U.S. tax liability for income taxes paid to a foreign country. However, the FTC is not a one-size-fits-all benefit—it has specific rules about sourcing, income categories (or “buckets”), and documentation requirements.

This chapter explains:

1. How the IRS determines whether income is **foreign source** or **U.S. source**.
 2. The four main FTC “buckets” and how each works.
 3. How to qualify for and claim the FTC effectively.
 4. A Foreign Tax Credit practical action plan for U.S. citizens living offshore.
-

How Income Is Sourced for the Foreign Tax Credit

Before you can determine whether foreign taxes are eligible for the FTC, you must identify whether the income is **foreign source** or **U.S. source**. The IRS applies income sourcing rules to prevent taxpayers from applying foreign tax credits to income that isn't truly foreign.

General Sourcing Principles

- **Foreign Source Income:** Income that originates from activities, property, or investments located outside the U.S. Examples include wages earned in another country, rent from foreign real estate, or dividends from a foreign corporation.
- **U.S. Source Income:** Income generated from U.S. activities or property, even if the taxpayer lives abroad. Examples include rental income from U.S. property, interest from U.S. bank accounts, or dividends from U.S. corporations.

Sourcing Rules by Income Type

The IRS applies different sourcing rules depending on the type of income:

Type of Income	Source Determination
Salary/ Wages	Where the services are performed. If you work in France, your wages are foreign source—even if paid by a U.S. employer.
Interest Income	Residence of the payer. Interest from a U.S. bank = U.S. source; interest from a foreign bank = foreign source.
Dividends	Residence of the corporation paying the dividend. U.S. corporation = U.S. source; foreign corporation = foreign source (with exceptions for certain U.S.-connected income).
Rental Income	Location of the property. Foreign property = foreign source; U.S. property = U.S. source.
Royalties	Where the property (patent, copyright, trademark) is used.
Capital Gains on Real Estate	Location of the property.
Capital Gains on Personal Property	Taxpayer's tax home, with exceptions for certain securities transactions.

These sourcing rules are crucial because the **FTC can generally only be claimed for foreign taxes paid on foreign source income**. If foreign taxes are paid on U.S. source income (for example, if a foreign country imposes tax on U.S. dividends), the FTC is usually not allowed unless a tax treaty “re-sources” the income.

The Primary Four FTC Categories (“Buckets”)

The IRS separates foreign taxes into distinct categories—often referred to informally as buckets—to prevent taxpayers from using excess credits from one type of income to offset U.S. taxes on another. Each category is calculated and limited separately.

There are four main categories for purposes of the Foreign Tax Credit, which are most commonly used, *although others exist*. The main buckets are:

Bucket #1: General Category Income

Definition: The “catch-all” bucket for most foreign-earned income not classified in another category.

Examples:

- Salary and wages from foreign employment.
- Foreign business income from active operations.
- Certain foreign pension income.

Key Points:

- The FTC limit for this category is calculated as:
- You cannot use unused credits from the general category to offset taxes in the passive category or others.

Bucket #2: Passive Category Income

Definition: Primarily investment income such as dividends, interest, rents, and royalties—unless derived from active business operations.

Examples:

- Dividends from a foreign company.
- Interest from a foreign bank account.
- Royalties from intellectual property used abroad.

Key Points:

- Designed to prevent sheltering U.S. investment income with foreign credits.
- Special rules apply to passive foreign investment companies (PFICs), where FTCs may be severely limited.

Bucket #3: Section 951A Category Income (GILTI)

Definition: Income inclusions under **Global Intangible Low-Taxed Income (GILTI)** rules for U.S. shareholders of controlled foreign corporations (CFCs).

Examples:

- A U.S. person owning at least 10% of a foreign corporation that earns low-taxed intangible income.

Key Points:

- Special computation rules apply; FTCs for GILTI are limited to 80% of foreign taxes paid.
- No carryback or carryforward of unused GILTI credits is allowed.
- Applies mostly to U.S. business owners with offshore corporate structures.

Bucket #4: Income Re-Sourced by Treaty

Definition: Certain tax treaties can “re-source” income—treating what would normally be U.S. source income as foreign source for FTC purposes.

Examples:

- U.S. citizen living in the U.K. receives U.S. pension income. A treaty might allow that pension to be treated as foreign source, permitting an FTC for U.K. tax paid on it.

Key Points:

- Treaty provisions must be carefully reviewed.
- A taxpayer invoking a treaty position must disclose it on IRS Form 8833.
- This category can be powerful but is often overlooked by taxpayers and preparers.

Limitations and Carryover Rules

The FTC is not unlimited. The foreign tax credit limitation ensures you can only claim credits up to the proportion of U.S. tax attributable to foreign source income. The equation for the foreign tax credit limit is:

$$\text{FTC Limit} = \frac{\text{Foreign Source General Category Income}}{\text{Total Worldwide Income}} \times \text{U.S. Tax Liability}$$

When there are unused credits, the Excess credits:

- **Can be carried back** 1 year.
- **Can be carried forward** up to 10 years (except GILTI-related credits).

If foreign taxes exceed the limit in one category, the excess cannot be applied to another category but may be used in future years for the same category.

Claiming the Foreign Tax Credit

To claim the FTC, taxpayers must:

1. **Have paid or accrued a foreign tax:** Must be an income tax (or a tax in lieu of income tax). VAT, sales tax, or property tax do not qualify.
2. **Prove the tax is legal and actual:** The foreign government must have the legal right to tax the income.
3. **Ensure no refund or subsidy:** If the foreign tax is refunded or subsidized by the foreign government, it may not qualify.
4. **File Form 1116:** Required for most taxpayers unless they meet the simplified foreign tax credit rules for small amounts.

FTC vs. Foreign Earned Income Exclusion (FEIE)

The FTC and FEIE cannot be used on the same income. If you exclude income under the FEIE, you cannot also claim a foreign tax credit for taxes paid on that excluded income.

Key Planning Point:

- Use the FEIE for income from low-tax or no-tax countries.
- Use the FTC for income from high-tax countries.
- In some cases, a combination strategy works best.

Common Mistakes

- **Mixing categories:** Using passive income taxes to offset general income taxes.
- **Ignoring carryover rules:** Losing valuable credits by not tracking them year to year.
- **Claiming non-qualifying taxes:** Trying to credit VAT or social security taxes.
- **Not using treaty re-sourcing:** Missing opportunities to treat U.S. source income as foreign for FTC purposes.

Action Items for U.S. Citizens Living Offshore

To maximize and properly claim the FTC, follow these steps:

1. Identify All Sources of Income

- Classify each item as U.S. source or foreign source based on IRS rules.
- Keep documentation (employment contracts, property records, bank account details).

2. Categorize the Income into FTC Buckets

- Determine whether income falls into General, Passive, Section 951A, or Treaty Re-Sourced categories.

3. Track Foreign Taxes Paid

- Keep official foreign tax payment receipts.
- Note whether taxes were withheld or paid directly.

4. Separate Documentation by Category

- Avoid mixing categories—keep a separate record of taxes paid for each.

5. Monitor Carryovers

- Track unused credits for each category.
- Keep carryback and carryforward records.

6. Review Tax Treaties

- Determine if your country of residence has a treaty with the U.S. that allows re-sourcing of income.
- File Form 8833 if using a treaty position.

7. Decide Between FTC and FEIE

- Evaluate annually whether to claim the FEIE, the FTC, or a combination strategy.

8. File Form 1116 Accurately

- One Form 1116 per category.
- Attach all required supporting documentation.

9. Decide Between FTC and FEIE

- Maintain foreign tax returns, payment confirmations, and translations if not in English.

10. Work with a Cross-Border Tax Specialist

- The FTC is highly technical, and missteps can result in lost credits or IRS penalties.

In Closing

For U.S. citizens living offshore, the Foreign Tax Credit is a vital mechanism to prevent double taxation and manage global tax exposure. Success with the FTC depends on understanding the sourcing rules, knowing which category each type of income falls into, and maintaining precise documentation. By following the outlined action plan, taxpayers can ensure they maximize their credit while staying compliant with both U.S. and foreign tax laws.

Part III

**Combining
Foreign
Income with
Other Tax
Deductions**

Going Beyond the
Exclusion

Chapter 6

Above the Foreign Exclusion Limit Deductions & Credits

Federal Tax Deductions & Credits for Americans Residing Overseas (Beyond FEIE)

Introduction

When your income exceeds the Foreign Earned Income Exclusion, there are still numerous opportunities to reduce U.S. federal tax liability. These deductions and credits can apply to various types of income and personal situations, and are especially valuable when living abroad. Below is a streamlined, category-based checklist with brief explanations.

1. Itemized Deductions

- **Medical Expenses** - Deduct qualified unreimbursed medical and dental costs exceeding 7.5% of adjusted gross income (AGI). Includes treatment, prescriptions, and certain travel for medical care.
- **State Income Tax & Sales Tax** - Deduct either state/local income taxes or general sales taxes paid, useful for those who moved abroad from a high-tax state.
- **Real Estate Taxes** - Deduct property taxes paid on real estate you own in the U.S. or abroad, subject to IRS limits.
- **Mortgage Interest & Points** - Deduct interest paid on qualified mortgages for your primary or second home, plus points paid to obtain the loan.
- **Charitable Contributions** - Deduct cash or property donations to qualified charities, even from overseas, as long as the organization meets IRS requirements.

- **Casualty & Theft Losses** - Deduct qualified losses from federally declared disasters or certain thefts, reduced by insurance reimbursements.
- **Investment Interest** - Deduct interest paid on loans used to purchase taxable investments, limited to your net investment income.

2. Retirement

- **Traditional IRA** - Contributions may be deductible depending on income and participation in employer plans; reduces taxable income now.
- **Roth IRA** - Contributions are not deductible, but qualified withdrawals in retirement are tax-free; income limits apply.
- **SIMPLE IRA** - Employer-sponsored plan allowing pre-tax contributions, often for small businesses.
- **SEP IRA** - For self-employed or business owners; allows higher contribution limits and full deduction of contributions.
- **Employer Qualified Plan** - Includes 401(k) and 403(b) plans; contributions are pre-tax and reduce current income.

- **Defined Contribution Plan** - Employer retirement plan with fixed annual contributions, fully deductible within limits.
- **Defined Benefit Plan** - Pension-style plan promising a set payout; contributions can be substantial and deductible.

3. Education

- **American Opportunity Credit** - Credit for first four years of higher education, covering tuition, fees, and course materials.
- **Lifetime Learning Credit** - Credit for tuition and fees for any post-secondary education, with no limit on years claimed.
- **Qualified Tuition Program (529 Plan)** - Earnings grow tax-free if used for qualified education expenses; no federal deduction, but state benefits may apply.
- **Education Savings Account (ESA)** - Contributions grow tax-free, with withdrawals for education expenses also tax-free.

- **U.S. Savings Bond Exclusion** - Interest on qualified bonds may be excluded if used for higher education expenses.
- **Student Loan Interest Deduction** - Deduct up to \$2,500 in interest paid annually, subject to income limits.
- **Penalty-Free IRA Distribution** - Withdraw IRA funds early without penalty for qualified education expenses.

4. Capital Gains & Losses

- **Capital Gain Exclusion (Personal Residence)** - Exclude up to \$250,000 (\$500,000 married) of gain from selling a primary home if ownership and use tests are met.
- **Loss Harvesting** - Sell investments at a loss to offset capital gains; unused losses may offset up to \$3,000 of ordinary income.
- **Installment Sales** - Spread gain from selling certain property over several years, reducing annual taxable income.

5. Children & Family

- **Change in Filing Status** - Filing as Head of Household or Married Filing Jointly can reduce tax rates and increase deductions.
- **Child Tax Credit** - Credit per qualifying child under age 17; partially refundable depending on income and filing status.
- **Dependent & Childcare Credit** - Credit for a portion of expenses for child or dependent care needed for work.
- **Gifting Assets to Children/Non-Resident Spouse** - Shift income to lower-taxed family members within IRS gifting limits.
- **Estate & Trust Planning** - Structure assets to reduce future estate taxes and provide income distribution flexibility.
- **Earned Income Credit** - Refundable credit for low-to-moderate income earners, though residency abroad may limit eligibility.

- **Child Employment Deduction** - Deduct wages paid to your child in a family business, shifting income to a lower bracket.

6. Healthcare & Savings

- **Health Savings Account (HSA)** - Tax-deductible contributions, tax-free growth, and tax-free withdrawals for qualified medical expenses; requires a high-deductible health plan.
- **Medicare Savings Account (MSA)** - Similar to an HSA but tied to Medicare-eligible individuals.
- **Premium Tax Credit** - Helps offset health insurance costs purchased through the marketplace; overseas eligibility is limited.

7. Relocation

- **Move to Lower Tax States** - Eliminates or reduces state income and/or sales tax burden; still must establish residency.

- **Puerto Rico Act 20/22 (Now Act 60)** - Special incentives for qualifying individuals and businesses relocating to Puerto Rico.

8. Real Estate Rental

- **Depreciation** - Deduct annual depreciation on rental property, or use accelerated methods like Section 179 or bonus depreciation for certain property types.
- **Cost Segregation** - Break property into components to accelerate depreciation deductions.
- **Qualified Improvement Property Bonus Depreciation** - Immediate deduction for certain improvements to nonresidential property.
- **1031 Exchange** - Defer capital gains by reinvesting in similar property within IRS timelines.
- **Opportunity Zone Investment** - Defer or reduce capital gains tax by investing in designated zones.
- **Energy-Efficient Home Credit (Section 45L)** - Credit for building qualifying energy-efficient homes.
- **Solar Investment Tax Credit** - Credit for installing solar energy systems on property.
- **Low-Income Housing Credit** - Credit for providing affordable rental housing.

- **Convert to Self-Managed Property** - May allow use of passive losses against active income.
- **Convert Personal to Rental** - Allows depreciation and expense deductions once personal use ceases.
- **Self-Rental Augusta Rule** - Rent your home to your business for up to 14 days annually tax-free.

9. Self-Employment

- **Start-Up Expenses** - Deduct up to \$5,000 in initial business expenses, with the remainder amortized.
- **83(b) Election** - For restricted stock, elect to pay tax at grant date rather than vesting, potentially reducing future tax.
- **Net Operating Loss (NOL) Carryforward** - Carry forward losses to offset future income.
- **NOL Carryback** - Amend prior returns to claim refunds using prior-year losses (if allowed for that year).
- **Passive Activity Losses** - Offset passive income with passive losses, subject to limitations.
- **Qualified Business Income (QBI) Deduction** - Deduct up to 20% of qualified business income, subject to thresholds.

- **Asset Depreciation** - Deduct the cost of business assets over time or immediately via Section 179 or bonus depreciation.
- **Intangible Asset Amortization** - Amortize the cost of intangible business assets like patents or goodwill.
- **Home Office Deduction** - Deduct a portion of home expenses if used regularly and exclusively for business.
- **Business Mileage** - Deduct mileage at the IRS standard rate for qualified business driving.
- **Moving Expenses** - Deduct certain business-related moving expenses (limited to active-duty military for personal moves).
- **State Apportionment Planning** - Allocate income to lower-tax states through proper apportionment.
- **Entity Tax Classification** - Elect S- or C-Corp status for tax planning benefits.
- **Accounting Method Changes** - Switch between cash, accrual, or hybrid methods to optimize taxes.
- **Unreimbursed Owner Expenses** - Deduct eligible expenses personally paid for business.
- **Residential Energy Credits** - Credits for installing a qualifying energy-efficient property in a residence.

- **Research & Development Credit** - Credit for qualified R&D activities and expenses.
 - **Electric Vehicle Credit** - Credit for purchasing qualifying plug-in electric vehicles.
 - **Employee Retention Credit** - Credit for keeping employees during qualified economic hardship periods.
-

Chapter 7

Domestic and Offshore Real Estate

Tax Advantages and Disadvantages Between Domestic and Offshore Real Estate

Introduction

U.S. citizens, regardless of where they live, must report and pay taxes on their worldwide income. Real estate can provide substantial tax benefits, but the tax treatment varies significantly depending on whether the property is located domestically (within the United States) or offshore (outside the United States). One of the most impactful tax strategies available for U.S.-based property is **Cost Segregation**, which allows for accelerated depreciation deductions. However, this strategy generally does not apply to foreign property, creating a sharp contrast in potential tax savings.

Domestic Real Estate: Access to Cost Segregation

What is Cost Segregation?

Cost Segregation is a tax planning technique that allows real estate investors to separate a property's components into different asset classes, accelerating depreciation deductions for certain parts of the property. Instead of depreciating the entire building over the standard 27.5 years (for residential) or 39 years (for commercial), components like flooring, cabinetry, fixtures, electrical systems, and land improvements can be depreciated over **5, 7, or 15 years.**

This results in significantly higher deductions in the early years of ownership, which reduces taxable income and improves cash flow.

Why Domestic Real Estate Qualifies

The U.S. tax code permits domestic property owners to apply Modified Accelerated Cost Recovery System (MACRS) rules, which include shorter depreciation periods for certain assets. Domestic real estate investors can:

- Use an **engineering-based cost segregation study** to identify short-life assets.
- Apply **bonus depreciation** (currently 60% in 2024, phasing out unless extended by Congress) to qualifying components, further accelerating tax benefits.
- Deduct these amounts directly against rental income, potentially offsetting other passive income as well.

Tax Benefits

1. **Front-Loaded Deductions** - Larger write-offs in the early years reduce current tax liability.
2. **Cash Flow Improvement** - Tax savings can be reinvested into new acquisitions or property improvements.
3. **Offset Passive Income** - Excess depreciation can reduce taxes on income from other rental properties.
4. **Estate Planning Benefits** - Lower taxable income can preserve wealth over time while property value continues to appreciate.

Offshore Real Estate: No Cost Segregation Advantage

Why Offshore Property Is Treated Differently

The IRS requires foreign property to be depreciated under the **Alternative Depreciation System (ADS)** rather than MACRS. Under ADS:

- **Residential rental property** is depreciated over **30 years**.
- **Nonresidential property** is depreciated over **40 years**.
- There is **no accelerated depreciation** and no bonus depreciation allowed.

This means the depreciation deduction for foreign property is spread evenly over decades, eliminating the ability to take large deductions in the early years.

Tax Disadvantages for Offshore Real Estate

1. **Slower Depreciation** - Reduces immediate tax benefits.
2. **No Bonus Depreciation** - Offshore property does not qualify for accelerated write-offs.
3. **Limited Offsetting** - Smaller annual deductions mean less ability to offset rental income or other passive income.
4. **Higher Long-Term Tax Exposure** - Since deductions are spread out, taxable income from the property may remain higher year over year.

Side-by-Side Comparison

Feature	Domestic Real Estate	Offshore Real Estate
Depreciation Method	MACRS (Accelerated)	ADS (Straight-Line)
Residential Depreciation Period	27.5 years	30 years
Commercial Depreciation Period	39 years	40 years
Cost Segregation Available	Yes	No
Bonus Depreciation	Yes (phasing out)	No
Early-Year Tax Savings	High	Low
Cash Flow Impact	Strong	Minimal

When Domestic Real Estate Makes Sense for Expats

For a U.S. citizen living overseas, investing domestically (even while living abroad) can be highly beneficial when aiming to maximize depreciation-based deductions. This is especially true for those with:

- High U.S. taxable income from other sources.
- Passive income from multiple rental properties.
- A goal of building a U.S.-based property portfolio while abroad.

Domestic property investments can be self-managed remotely or handled through property managers, allowing overseas investors to benefit from U.S. tax rules without being physically present.

Action Plan: Implementing Cost Segregation as an Overseas U.S. Citizen

Step 1: Acquire Domestic Investment Property

- Choose residential or commercial property located within the United States.
- Properties with significant improvements, specialized construction, or unique features often yield greater cost segregation benefits.

Step 2: Engage a Qualified Cost Segregation Specialist

- Hire an engineering-based firm experienced with IRS-approved cost segregation methodologies.
- Ensure they provide a detailed report that can withstand an IRS audit.

Step 3: Perform the Cost Segregation Study

- The study will break down the property into:
 - **Personal property components** (5 or 7-year depreciation)
 - **Land improvements** (15-year depreciation)
 - **Structural components** (27.5 or 39-year depreciation)
- Identify any components eligible for bonus depreciation.

Step 4: Apply Accelerated Depreciation and Bonus Depreciation

- Use Form 4562 to claim depreciation deductions.
- In early years, large deductions can significantly reduce taxable rental income.

Step 5: Coordinate with Your Tax Preparer

- Ensure your CPA understands both **domestic and foreign property depreciation rules**.
- Integrate the deductions into your overall tax plan, especially if you are also claiming the Foreign Earned Income Exclusion or Foreign Tax Credit.

Step 6: Reinvest Tax Savings

- Deploy tax savings into additional U.S. real estate acquisitions.
 - Repeating the process across multiple properties compounds the benefits.
-

Additional Considerations for Overseas Investors

1. **Property Management** - Hire a reputable U.S.-based property manager to handle tenants, maintenance, and rent collection.
 2. **Financing** - Some U.S. lenders may have stricter requirements for overseas borrowers; maintain strong U.S.-based credit and financial records.
 3. **Entity Structure** - Consider holding property in an LLC for liability protection and pass-through taxation.
 4. **State Tax Implications** - Be aware of state-level taxes and reporting requirements.
 5. **Exit Strategy** - When selling, anticipate **depreciation recapture tax**, which may partially offset earlier tax benefits, but the time value of money often makes the early deductions worthwhile.
-

In Closing

Domestic real estate offers U.S. citizens—whether living stateside or overseas—a powerful tax planning opportunity through the Cost Segregation Strategy. Accelerated depreciation under MACRS, coupled with bonus depreciation, can produce substantial early-year tax savings and cash flow benefits. Offshore real estate, while potentially attractive for diversification or personal use, lacks these accelerated depreciation benefits due to IRS rules mandating the slower ADS method.

For a U.S. citizen living abroad, the most tax-efficient approach to real estate investing often involves acquiring and holding U.S.-based properties, implementing cost segregation studies, and reinvesting the tax savings into further domestic acquisitions. By doing so, an investor can maximize cash flow, reduce current tax burdens, and strategically grow a property portfolio while living anywhere in the world.

Part IV

**Fundamentals
of Foreign
Corporation
Taxation and
Anti-Deferral**

Understanding the Basics
of U.S. Taxation of Foreign
Corporations

Chapter 8

Developing a Foreign Corporation Tax Strategy: Where to Go?

Choosing the Best Country for a Foreign Corporation: Why “It Depends”

Introduction

When it comes to forming a foreign corporation to pay yourself a salary and leverage the **Foreign Earned Income Exclusion (FEIE)**, the short answer is: **it depends**. There is no single “best” country that works for everyone. The ideal jurisdiction is influenced by a combination of practical, legal, and personal factors that vary widely between individuals. These include **language barriers, proximity to customers, banking ease, administrative burdens, anti-deferral rules, and the reputation of the jurisdiction.**

While the primary tax objective is to create a legal entity that can pay you a salary qualifying for the FEIE while avoiding unnecessary U.S. payroll taxes, other considerations—such as business operations, compliance obligations, and banking—often weigh just as heavily in the decision-making process.

Key Factors That Influence the Choice of Country

1. Language Barriers

Operating in a country where you do not speak the official language can create challenges for company formation, accounting, legal compliance, and general communication. While English-speaking jurisdictions simplify administrative tasks, you might find that non-English-speaking countries offer better local business opportunities, especially if you are targeting a regional market.

2. Proximity to Customers and Operations

If your business requires physical presence, regional networking, or in-person sales, proximity to your customer base matters. For example, a software consultant serving European clients may find it advantageous to establish in an EU country, while someone targeting Asian markets might choose Singapore or Hong Kong.

3. Banking and Financial Infrastructure

Access to reliable and internationally recognized banking is critical. Some jurisdictions have a strong banking reputation and robust online banking systems (e.g., Singapore, Hong Kong, Switzerland), while others—particularly low-tax “offshore” jurisdictions—face banking restrictions due to anti-money laundering compliance and reputational risks. Without dependable banking, even a favorable tax structure can become operationally unworkable.

4. Administrative and Compliance Burdens

Some countries require extensive annual reporting, audited financial statements, and physical office space, while others have lighter requirements. For example, **Singapore** is known for efficient corporate compliance, whereas Germany has more rigorous reporting and employment laws.

5. Avoiding Anti-Deferral & “Tax Haven” Pitfalls

The U.S. tax code has anti-deferral rules (Subpart F and GILTI) that can neutralize the tax advantages of forming in certain low- or zero-tax jurisdictions if the company earns mostly passive or easily movable income. Jurisdictions like the Cayman Islands or BVI, while popular historically, can trigger increased IRS scrutiny and may require additional structuring to remain tax efficient.

6. Cost of Formation and Ongoing Maintenance

Formation fees, local taxes, accounting costs, and legal retainers vary widely. Some countries have minimal annual fees, while others (especially those with strong economies and reputations) have higher ongoing costs.

Why There's No “One Size Fits All”

Choosing the best country is not a purely tax-driven decision. The **optimal jurisdiction balances U.S. tax benefits with operational realities**, regulatory compliance, and long-term stability. Even among expats using the FEIE, the “best” choice differs depending on whether the business is:

- **Location-based** (e.g., a retail shop in Costa Rica)
 - **Remote service-based** (e.g., online consulting, software development)
 - **Product-based** with import/export needs (where trade agreements matter)
-

Popular Jurisdictions for Foreign Corporations

While no country is universally best, several jurisdictions frequently appear on the shortlist for expats aiming to maximize FEIE through a corporate salary.

1. Singapore

- **Advantages:** Strong financial system, excellent banking, English as an official language, low corporate tax rates (17% standard with partial exemptions), strategic Asian location.
- **Drawbacks:** Physical presence requirements for directors, higher cost of living, strict regulatory environment.

2. Hong Kong

- **Advantages:** Territorial tax system (profits earned outside HK are generally not taxed), efficient banking, major international trade hub.
- **Drawbacks:** Increased scrutiny from international banks, geopolitical considerations, higher setup complexity for Americans due to compliance checks.

3. United Arab Emirates (Dubai)

- **Advantages:** No corporate tax in many free zones, English widely used, strong global connectivity, favorable business environment.
- **Drawbacks:** Certain activities may now fall under new UAE corporate tax rules; local office presence often required.

4. Panama

- **Advantages:** Territorial tax system, U.S. dollar-based economy, relatively low formation costs, favorable geographic position for the Americas.
- **Drawbacks:** Reputation as a tax haven can cause banking friction; Spanish as the primary language.

5. Belize

- **Advantages:** English-speaking, simple offshore company structures, relatively low cost.
- **Drawbacks:** Limited local banking options, reputational issues in global finance, may trigger anti-deferral scrutiny for passive income businesses.

6. Costa Rica

- **Advantages:** Stable political environment, relatively low formation costs, good for those living in Central America.
- **Drawbacks:** Spanish language requirement for most administrative tasks, slower bureaucratic processes.

7. Malta or Cyprus (for European markets)

- **Advantages:** EU access, favorable tax structures for certain foreign-owned businesses, English widely spoken.
 - **Drawbacks:** Higher compliance burdens, limited relevance for non-EU business models.
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Balancing FEIE and Corporate Structure

When using a foreign corporation to pay yourself a salary, **the goal is to ensure the salary qualifies for the FEIE** while minimizing U.S. Social Security and Medicare taxes. In many cases, this means the corporation must be set up in your country of residence (or one where you can meet substance requirements) to avoid challenges under IRS rules.

For example:

- If you live in Singapore and work there full-time, forming your corporation in Singapore may be best for both FEIE qualification and practical operations.
 - If you live in Costa Rica but serve clients in the U.S., you might choose to form locally or in a nearby country with better banking, depending on your administrative tolerance.
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Final Takeaways

- **No single “best” country exists**—your choice depends on language, location, market access, compliance tolerance, and banking needs.
 - Avoid purely “paper” corporations in tax havens without real substance, as they can invite IRS scrutiny and potentially negate FEIE benefits.
 - Many expats opt for **Singapore, Hong Kong, UAE, or Panama** for their balance of tax advantages and operational efficiency, but local incorporation in your country of residence is often the simplest for compliance.
 - Always align corporate structure with your actual living and working arrangement to support FEIE claims.
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Chapter 9

The Basics of Controlled Foreign Corporations

Controlled Foreign Corporations (CFCs) – Fundamentals and U.S. Tax Implications

1. Introduction

A Controlled Foreign Corporation (CFC) is a legal concept in U.S. tax law that applies to certain foreign corporations in which U.S. shareholders hold significant ownership. While foreign corporations are generally taxed in the country where they operate, the U.S. government imposes special rules for CFCs to prevent U.S. taxpayers from avoiding taxes by shifting income offshore.

The CFC regime exists to ensure that certain categories of income earned through foreign entities are reported and, in some cases, taxed in the U.S. immediately—even if no distributions are made to shareholders. This approach reflects the U.S. policy of taxing its citizens and residents on worldwide income, regardless of where the income is earned or retained.

2. Definition of a CFC

a. Statutory Test

Under **Internal Revenue Code (IRC) §957**, a foreign corporation is considered a **Controlled Foreign Corporation** if:

- **Ownership Threshold:** More than **50% of the total combined voting power** of all classes of stock entitled to vote, or more than **50% of the total value of the stock** of the corporation, is owned directly, indirectly, or constructively by **U.S. shareholders**; and
- **U.S. Shareholder Definition:** A **U.S. shareholder** is any U.S. person (citizen, resident, domestic corporation, partnership, trust, or estate) who owns at least **10% or more of the voting power or value** of the foreign corporation's stock.

The ownership calculation uses **constructive ownership rules (IRC §958)**, meaning shares owned by related persons or entities may be attributed to the taxpayer for determining CFC status.

3. Why CFC Rules Exist

Before the enactment of anti-deferral rules, U.S. taxpayers could establish foreign corporations in low-tax jurisdictions to accumulate passive or mobile income without paying current U.S. taxes. This practice eroded the U.S. tax base and gave offshore structures a significant advantage over domestic operations.

To counteract this, Congress enacted **Subpart F (1962)** and later expanded the regime with the **Global Intangible Low-Taxed Income (GILTI)** rules under the 2017 Tax Cuts and Jobs Act (TCJA). These provisions require certain categories of income earned by a CFC to be **currently includible** in the U.S. shareholder's taxable income, even if no cash is distributed.

4. Determining CFC Status - Key Considerations

1. **Ownership Tests:** Must evaluate both voting power and value. Even non-voting preferred stock can contribute to CFC status if it represents more than 50% of the corporation's value.
2. **Indirect Ownership:** Stock owned by entities (corporations, partnerships, trusts) is attributed proportionally to their owners.
3. **Constructive Ownership:** Stock owned by certain family members, or entities controlled by the shareholder, is treated as owned by the shareholder.
4. **Look-Through Rules:** For certain tax years, ownership through foreign partnerships or trusts is considered for determining CFC status.

5. U.S. Tax Implications for a CFC Owner

When a foreign corporation qualifies as a CFC, U.S. shareholders may face **two primary sets of tax rules**:

a. Normal Taxation on Distributions

Under general U.S. tax rules, a U.S. shareholder of a foreign corporation is not taxed until the corporation **distributes dividends**. The dividends are then taxable in the U.S., with a potential **foreign tax credit (FTC)** to avoid double taxation. However, these rules are modified significantly for CFCs.

b. Current Inclusion Rules (Anti-Deferral)

Under **Subpart F** and **GILTI**, certain earnings of the CFC must be included in the shareholder's U.S. taxable income in the **year they are earned**—even if not distributed. These rules target income that is considered highly mobile or easily shifted to low-tax jurisdictions.

6. Categories of CFC Income Subject to Immediate U.S. Tax

a. Subpart F Income (IRC §§951-965)

Subpart F targets **passive and easily moveable income**, which includes:

- **Foreign personal holding company income** (interest, dividends, rents, royalties)
- **Foreign base company sales income** (income from buying and selling goods where the goods are manufactured outside and sold for use outside the CFC's country)
- **Foreign base company services income** (services performed outside the CFC's country for related parties)
- **Certain insurance income**

These categories are taxed to the U.S. shareholder proportionally to their ownership, regardless of whether the earnings are repatriated.

b. Global Intangible Low-Taxed Income (GILTI)

GILTI is a broader category aimed at capturing the excess of a CFC's income over a deemed return on its tangible assets. Unlike Subpart F, GILTI applies to most active business income of a CFC, unless the CFC is already paying a relatively high foreign tax rate.

Key points about GILTI:

- Applies to **all U.S. shareholders** of CFCs (except certain corporations eligible for a deduction under IRC §250).
- Calculated on an **aggregate basis** across all CFCs owned by the taxpayer.
- Individuals may be taxed at their marginal rate unless they make a **§962 election** to be taxed as a corporation (potentially allowing a 50% deduction and FTCs).

7. Reporting Requirements for CFCs

U.S. shareholders of a CFC have significant compliance obligations. Failure to comply can result in **steep penalties**.

Key forms include:

- **Form 5471** - Information Return of U.S. Persons With Respect to Certain Foreign Corporations. This form discloses ownership, income, Subpart F and GILTI calculations, and other details.
- **Form 8992** - For reporting and calculating GILTI inclusions.
- **Form 1116** - For claiming the Foreign Tax Credit on CFC income already taxed abroad.

8. Interaction with the Foreign Tax Credit (FTC)

When a U.S. shareholder includes Subpart F or GILTI income, they may be entitled to claim an FTC for foreign income taxes paid by the CFC. However:

- For **individuals**, FTCs are often unavailable for GILTI unless a §962 election is made.
- FTCs are **basket-specific** (general vs. passive category), meaning credits from one category can't generally offset tax in another.
- Excess FTCs may be carried forward or backward, subject to limitations.

9. Practical Tax Planning for CFC Owners

U.S. citizens owning CFCs can manage their tax exposure through strategies such as:

- **Deferring income recognition** by carefully structuring operations to avoid Subpart F and GILTI triggers.
- **Maximizing FTC utilization** by aligning CFC operations in jurisdictions with moderate-to-high tax rates.
- **Using a U.S. corporation holding company** to benefit from the §250 GILTI deduction and indirect FTCs.
- **Considering a §962 election** for individuals to mimic corporate treatment of GILTI.
- **Reinvesting earnings locally** to avoid taxable distributions while funding growth.

10. Risks of Non-Compliance

CFC rules are **complex** and carry high penalties:

- **Form 5471 penalties** - \$10,000 per form per year, plus continuation penalties.
- **Loss of FTC eligibility** for noncompliance.
- **Increased IRS scrutiny** of foreign structures, especially in low-tax jurisdictions.

The IRS and U.S. Treasury maintain a strong enforcement focus on offshore compliance, supported by FATCA reporting from foreign banks.

11. Brief Overview of Anti-Deferral Rules

Subpart F

Subpart F prevents U.S. shareholders from deferring U.S. tax on **passive or mobile income** earned by a CFC. Even without a distribution, the shareholder must report the income in the current year. The logic is that such income could easily be shifted to a low-tax country for tax avoidance.

GILTI

GILTI expands the reach of anti-deferral by taxing most **active business income** earned by CFCs, with an exclusion for a 10% return on qualified tangible assets. This ensures that earnings from intangible-heavy businesses—often the easiest to shift offshore—are taxed currently.

Both regimes operate to **accelerate U.S. taxation** on certain CFC earnings, significantly reducing the benefits of parking income in low-tax jurisdictions.

In Closing

A Controlled Foreign Corporation is a powerful and common structure for U.S. citizens conducting international business. However, the CFC regime under U.S. tax law is **highly regulated**, aiming to prevent the deferral of U.S. taxes through offshore entities.

While CFCs can offer legitimate operational and tax planning benefits—such as reduced foreign taxes, asset protection, and access to local markets—they also come with **complex reporting obligations** and potential **current-year income inclusions** under Subpart F and GILTI.

Any U.S. person considering or currently owning a CFC must carefully weigh:

- Ownership thresholds and attribution rules
- Impact of anti-deferral rules
- Compliance burden and penalties
- Foreign tax credit interactions
- Long-term operational strategy

Engaging experienced **international tax counsel** is essential to navigating the intricacies of CFC taxation and ensuring compliance while optimizing tax outcomes.

Chapter 10

Anti-Deferral Pitfalls

Avoiding Major Pitfalls When a U.S. Citizen Owns or Operates a Foreign Corporation

For U.S. citizens venturing into international business, forming or acquiring a foreign corporation can offer legitimate tax advantages, operational flexibility, and strategic global positioning. However, it also carries a unique set of U.S. compliance requirements and potential tax traps that can lead to significant penalties, unnecessary costs, and higher audit risk if not handled properly.

The following guide addresses the most critical pitfalls to avoid.

1. Failing to File or Disclose the Proper U.S. Tax Forms

U.S. tax law requires citizens to report worldwide income and disclose ownership or control over certain foreign entities. Failure to file the correct forms can trigger severe penalties—often **far exceeding the tax owed**—and may remain enforceable for years.

Key Filing Requirements

- **Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations):** Required for U.S. shareholders (generally those owning 10% or more) of foreign corporations, with multiple “categories” of filers based on ownership and control.
- **FinCEN Form 114 (FBAR):** Required if the corporation has foreign bank accounts that a U.S. person controls or has signature authority over, and the aggregate balance exceeds \$10,000 at any point in the year.
- **Form 8938 (FATCA Reporting):** Required when certain thresholds of foreign financial assets are met.
- **Form 8992 (GILTI Inclusion):** Required for Controlled Foreign Corporation (CFC) shareholders to report and pay tax on Global Intangible Low-Taxed Income.
- **Form 926 (Transfers to Foreign Corporations):** Required when transferring property (including cash) to a foreign corporation.

Potential Penalties

- **Form 5471:** \$10,000 penalty per form, per year, plus additional \$10,000 for each 30 days late after IRS notice, up to \$50,000.
- **FBAR:** Up to \$10,000 per non-willful violation; willful violations can reach the greater of \$100,000 or 50% of the account balance.
- **Form 8938:** \$10,000 initial penalty, with further penalties for continued noncompliance.

Best Practices

- Engage a tax professional experienced in international compliance.
- Maintain a compliance calendar to track filing deadlines.
- Gather detailed information from your foreign corporation regularly to ensure accurate reporting.

2. Administrative Burden and Associated Costs of a Foreign Corporation

Owning and maintaining a foreign corporation is more than just a matter of filing U.S. forms—it involves meeting both local and U.S. requirements.

Ongoing Obligations

- **Local Corporate Governance:** Board meetings, shareholder meetings, and compliance with host country corporate laws.
- **Financial Statement Preparation:** Many jurisdictions require annual audited or certified financial statements. Even if not locally mandated, U.S. reporting often requires accurate financial statements prepared under either local GAAP or IFRS.
- **Bilingual Recordkeeping:** Where documents are in a foreign language, translations may be needed for U.S. reporting or audits.

Associated Costs

- **Professional Fees:** Accounting, legal, and compliance costs can be substantial, especially if audits are required.
- **Banking Fees:** Some countries impose higher banking costs or transaction taxes for corporate accounts.
- **Compliance Management Software:** Necessary for tracking and storing cross-border financial data securely.

Risk Mitigation

- Budget for these costs from the outset to avoid cash flow surprises.
- Choose a jurisdiction with reasonable reporting requirements relative to your operational needs.
- Work with both a local accountant and a U.S. international tax specialist to ensure financial statements meet both jurisdictions' standards.

3. Improper Reporting of a Controlled Foreign Corporation (CFC) and GILTI

If your foreign corporation meets the CFC definition—generally, more than 50% ownership by U.S. shareholders—it triggers additional, complex reporting under Subpart F and GILTI rules. Mishandling these rules can result in increased audit scrutiny, lost deductions, and penalties.

GILTI Overview

- **Global Intangible Low-Taxed Income (GILTI):** A category of income that U.S. shareholders of CFCs must report annually, even if not distributed.
- **Calculation:** Broadly, GILTI equals the CFC's income minus a 10% deemed return on certain tangible assets.
- **Tax Impact:** For individuals, GILTI is taxed at ordinary income rates unless a Section 962 election is made (allowing corporate rates and foreign tax credits).

Common Mistakes

- **Not Identifying CFC Status:** Overlooking ownership attribution rules (including family and entity attribution) can cause you to miss required filings.
- **Failing to File Form 8992:** The IRS considers this a serious omission and may assess accuracy-related penalties.
- **Not Using Available Elections:** Failure to make a Section 962 election when beneficial can lead to significantly higher tax liability.

Best Practices

- Conduct an annual CFC status review considering attribution rules.
- Model the tax impact of making a Section 962 election versus paying GILTI at individual rates.
- Keep detailed records of foreign taxes paid to maximize the foreign tax credit.

4. Poor Tax Structure Planning Leading to Overpayment

The way your foreign corporation is structured can greatly influence your U.S. tax liability. Without careful planning, you may end up paying more tax than necessary, both in the U.S. and abroad.

Common Inefficiencies

- **Using the Wrong Entity Type:** Some jurisdictions' default corporate forms lead to double taxation when paired with U.S. rules.
- **No Salary vs. Dividend Planning:** Paying yourself entirely through dividends can lead to U.S. tax without the benefit of the Foreign Earned Income Exclusion (FEIE).
- **Failing to Separate Active and Passive Income Streams:** Passive income may be fully taxable under Subpart F even if retained abroad.

Strategic Planning Tools

- **Hybrid Structures:** In some cases, a foreign entity can be treated as a disregarded entity for U.S. purposes but as a corporation locally, reducing compliance burdens.
- **Salary Optimization:** Paying a reasonable salary can qualify it for FEIE (if you meet the physical presence or bona fide residence test), while retaining profits in the corporation for reinvestment.
- **Use of Holding Companies:** Strategically placed holding companies may provide treaty benefits or protect against local withholding taxes.

Best Practices

- Consult with both U.S. and local tax advisors before forming or acquiring the corporation.
- Model the tax implications under multiple scenarios (salary-heavy vs. dividend-heavy distributions, retained earnings strategies, etc.).
- Revisit your structure annually to adjust for changes in tax laws or business strategy.

Conclusion: Proactive Compliance and Strategic Structuring Are Key

Owning or operating a foreign corporation as a U.S. citizen requires navigating a complex intersection of U.S. and foreign tax law. The most costly mistakes often stem from **non-disclosure, poor recordkeeping, mishandling of CFC rules, and inefficient structuring**. By implementing robust compliance systems, engaging qualified cross-border tax advisors, and strategically planning the corporation's structure, you can both minimize tax liability and reduce audit risk.

Action Checklist

1. **Identify All Filing Requirements:** Map out Forms 5471, 8992, 926, FBAR, and FATCA obligations from the outset.
2. **Maintain Accurate Financials:** Prepare annual financial statements in both local and U.S.-compliant formats.
3. **Monitor CFC and GILTI Exposure:** Review ownership and income composition annually; make elections where beneficial.
4. **Optimize Structure and Distributions:** Balance salary and dividend planning to maximize exclusions, credits, and deferrals.
5. **Budget for Compliance Costs:** Include professional fees, translation costs, and audit expenses in your business plan.

When managed proactively, a foreign corporation can be a valuable part of an international business strategy—but neglecting the points above can turn potential advantages into costly liabilities.

Chapter 11

Risks of Transfer Pricing

Transfer Pricing: Strategies and Risks for Americans with Foreign Corporations

What is Transfer Pricing?

Transfer pricing refers to the pricing of goods, services, intellectual property, or financing arrangements between related entities within a multinational group. These entities may be located in different countries but are under common ownership or control. Because these transactions occur internally rather than on the open market, tax authorities worldwide—including the IRS—require that prices be set at **arm's length**: the same as if the transaction occurred between unrelated parties.

For Americans living offshore who own or operate a foreign corporation, transfer pricing becomes a critical consideration when the U.S. company and the foreign company exchange goods, services, or intangible property. The rules ensure that income is appropriately allocated among jurisdictions to prevent tax base erosion and profit shifting.

Why Transfer Pricing Matters for Offshore Americans

If you own a foreign corporation, transfer pricing rules can:

- Determine **where profits are taxed**—in the foreign country, the U.S., or both.
- Impact **Foreign Earned Income Exclusion (FEIE)** and **Foreign Tax Credit (FTC)** calculations.
- Affect whether your foreign corporation's profits are subject to U.S. anti-deferral rules like **Subpart F** or **GILTI**.

A carefully planned transfer pricing policy can **legally shift taxable income** to lower-tax jurisdictions while complying with IRS rules, potentially lowering global tax liabilities.

-

Common Transfer Pricing Strategies

While the exact strategy depends on the business model, Americans with foreign corporations often consider:

1. Service Agreements

- Offshore entities provide management, administrative, or consulting services to related companies.
- Pricing is based on cost-plus or comparable market rates.
- Useful for moving some income offshore, but must be documented with invoices and service agreements.

2. Intellectual Property (IP) Licensing

- Foreign entities hold ownership of IP and license it to U.S. or other foreign affiliates.
- Royalties are paid at arm's length rates.
- Can concentrate income in a jurisdiction with lower tax rates, but IRS scrutiny is high.

3. Contract Manufacturing

- A foreign subsidiary manufactures products for a U.S. parent (or vice versa) at a cost-plus markup.
- Profits from manufacturing remain in the country where production occurs.
- Requires detailed cost tracking to justify pricing.

4. Cost-Sharing Arrangements

- Related entities share the costs of developing products or services.
 - Allocation is based on expected benefits, with formal agreements in place.
 - Popular in tech and R&D-heavy industries.
-

Risks Associated with Transfer Pricing

The IRS and foreign tax authorities closely examine transfer pricing because it directly affects taxable income allocation.

Common risks include:

1. Non-Compliance Penalties

- IRC Section 482 allows the IRS to reallocate income between related parties and assess penalties up to 40% for substantial understatements.

2. Double Taxation

- If one country increases your taxable income without the other allowing a corresponding adjustment, the same income can be taxed twice.

3. Increased Audit Risk

- Transfer pricing is a “high audit priority” for the IRS, especially for offshore structures involving low-tax jurisdictions.

4. Documentation Failures

- Inadequate or missing contemporaneous documentation can trigger automatic penalties, even if pricing was reasonable.

5. Reputational Risk

- Aggressive transfer pricing strategies can attract negative attention from regulators, media, or clients.

Best Practices to Avoid Problems

To maximize benefits while minimizing risks, Americans living offshore should:

1. Adopt Arm's Length Pricing

- Use recognized methods: Comparable Uncontrolled Price (CUP), Resale Price, Cost-Plus, Transactional Net Margin Method (TNMM), or Profit Split Method.
- Benchmark against publicly available market data.

1.2. Prepare Contemporaneous Documentation

- Maintain agreements, pricing studies, invoices, and cost allocation schedules.
- Document how prices were determined and why they are arm's length.

3. Understand Local Rules

- Many countries have their own transfer pricing documentation requirements (OECD guidelines are a global baseline).
- Failure to comply locally can impact your foreign corporation's ability to claim deductions.

4. Align with Business Substance

- Ensure that the foreign corporation has real operations—employees, assets, and decision-making authority—in its jurisdiction.
- “Paper companies” with no genuine activity are more likely to be challenged.

5. Review Annually

- Markets, exchange rates, and regulations change—annual reviews ensure ongoing compliance.
- Adjust pricing where necessary to reflect changing business realities.

Key Takeaways

- **Transfer pricing is not optional**—it's required for cross-border related-party transactions.
- Properly implemented, it can **legally reduce taxes** and align profits with real business activity.
- **The biggest risk is poor documentation**—you can have a compliant policy, but without records, the IRS can still penalize you.
- **Work with specialists**—transfer pricing is complex and often requires legal, tax, and economic expertise.

Example Scenario

Without Planning:

An American in Costa Rica owns a foreign marketing company serving a U.S. client. They arbitrarily bill the U.S. client at a low rate, leaving high profits in the U.S. company. Result: More income taxed in the U.S., and possibly triggering GILTI on retained foreign earnings.

With Transfer Pricing Strategy:

They benchmark comparable marketing services in Costa Rica, set a market-based hourly rate, and draft a service agreement. Profits are shifted offshore at arm's length, documented with invoices and cost breakdowns. Result: More income is taxed at Costa Rica's lower rate, eligible for FTC if needed, with minimal U.S. exposure.

In Closing

Understanding Transfer Pricing and the dynamics of transactions between related entities is an important skill for Americans living abroad who own Foreign Corporations. Developing and implementing a plan is key for cash flow planning and tax saving strategies.

Part V

Expatriation

Relinquishing U.S.
Citizenship

Chapter 12

An Opinion on Expatriation

The Case Against U.S. Expatriation for Tax Savings

For U.S. citizens frustrated by their worldwide tax obligations, renouncing citizenship may seem like a tempting solution. However, while the allure of escaping the reach of the Internal Revenue Service (IRS) is understandable, the long-term consequences of expatriation—both financial and personal—are profound. In many cases, the costs and risks outweigh the perceived benefits. Below is a detailed analysis of why most Americans living abroad should think twice before giving up their citizenship.

U.S. Tax Exclusions and Credits Can Substantially Reduce or Eliminate Liability

A common misconception among expatriates is that U.S. tax rules inevitably lead to double taxation. In reality, several robust mechanisms exist to prevent or significantly reduce that burden.

- **Foreign Earned Income Exclusion (FEIE)** - For 2024, the FEIE allows qualifying U.S. citizens to exclude up to \$126,500 of earned income from U.S. taxation. A married couple both working abroad could potentially exclude more than \$250,000 annually, provided they meet the Bona Fide Residence or Physical Presence test.
- **Foreign Housing Exclusion/Deduction** - In addition to the FEIE, Americans abroad can exclude or deduct certain foreign housing costs above a base threshold, particularly beneficial in high-cost cities.

- **Foreign Tax Credit (FTC)** - For taxpayers with income exceeding the FEIE limit, the FTC often eliminates most remaining U.S. tax liability by allowing dollar-for-dollar credits for foreign taxes paid. In high-tax jurisdictions, this can completely offset U.S. taxes, while in lower-tax jurisdictions, it can still reduce liability substantially.

When applied strategically, these provisions often result in either zero or very minimal U.S. tax liability for most expatriates. In practice, for Americans living in countries with moderate-to-high tax rates, it is rare to owe significant U.S. tax after exclusions and credits are applied.

U.S. Citizenship as a Global “Insurance Policy”

While the tax obligations tied to U.S. citizenship are often the most visible downside, the less tangible benefits of holding a U.S. passport are frequently undervalued. Citizenship can act as a form of **personal and financial insurance**—a safeguard that cannot be easily replicated once surrendered

- **Emergency Return Capability** - Life circumstances can change unexpectedly. Family emergencies, health crises, political instability abroad, or sudden career opportunities may necessitate a rapid return to the United States. Citizenship guarantees unrestricted entry and residency without the need for visas or immigration processing.

- **Government Assistance Abroad** - U.S. embassies and consulates can provide a range of support, including emergency evacuation during crises, assistance with lost travel documents, and legal liaison services. While assistance is not unlimited, in volatile regions the backing of a stable, powerful nation can be invaluable.
- **Freedom of Mobility** - The U.S. passport consistently ranks among the most powerful in terms of visa-free travel, opening access to countries that may be more restrictive toward other nationalities. Losing this mobility could mean reduced travel opportunities or increased visa costs and hassles.

Relinquishing citizenship means relinquishing these protections permanently—there is no guarantee of regaining them later.

U.S. Financial System Benefits Are Difficult to Replace

Banking and investing as a U.S. citizen brings advantages that many only appreciate after they are gone.

- **Access to U.S. Banking & Credit** - U.S. citizens enjoy easy access to a broad network of banks, credit unions, and digital financial services. Even with offshore residence, maintaining U.S. citizenship often makes it easier to keep domestic accounts, secure mortgages, or obtain credit.
- **Investment Opportunities** - Many U.S.-based brokerage accounts and retirement plans (e.g., IRAs, 401(k)s) are restricted or closed to non-citizens living abroad. Additionally, U.S. markets remain among the most stable and liquid in the world, providing unique investment opportunities and regulatory protections.

- **Strong Consumer Protections** - U.S. financial law, despite its complexity, offers higher levels of investor protection compared to many jurisdictions, including Securities Investor Protection Corporation (SIPC) insurance for brokerage accounts and Federal Deposit Insurance Corporation (FDIC) coverage for bank deposits.

Losing citizenship could also lead to certain financial accounts being closed due to foreign compliance requirements, further complicating wealth management.

The Potential Exit Tax

The IRS imposes an **Exit Tax** on certain expatriates deemed “covered expatriates” under Internal Revenue Code § 877A. This applies if an individual meets any of the following:

- Average annual net income tax liability over a threshold amount for the prior five years (for 2024, about \$202,000),
- Net worth of \$2 million or more, or
- Failure to certify tax compliance for the five years preceding expatriation.

For those subject to the Exit Tax, the IRS treats most worldwide assets as if they were sold the day before expatriation, triggering immediate capital gains tax on unrealized gains above an exemption amount (about \$821,000 in 2024). Retirement accounts and certain deferred compensation arrangements may also be taxed.

For high-net-worth individuals, this tax can result in substantial and immediate liabilities—potentially erasing much of the perceived benefit of future tax avoidance.

Other Relevant Factors

Beyond taxes, other considerations make expatriation an irreversible and high-stakes decision:

- **Loss of Voting Rights** - Expatriates lose the right to vote in U.S. federal elections, giving up a say in policies that can still affect them indirectly (e.g., global trade agreements, defense policies, foreign relations).
- **Inheritance and Estate Tax Complications** - U.S. estate tax rules for non-citizens are far less favorable. Without citizenship, the estate tax exemption drops dramatically (currently \$60,000 for non-resident aliens vs. over \$13 million for citizens), which can expose heirs to substantial tax liabilities on U.S.-based assets.
- **Inability to Work in the U.S. Without Immigration Sponsorship** - If future employment opportunities arise in the United States, former citizens may need to go through the same complex visa process as any other foreign national.
- **Possible Loss of Cultural & Family Ties** - Citizenship is more than a legal status; it is often intertwined with identity, heritage, and personal connections. Losing it can create emotional and social consequences not easily foreseen.

Rare Cases When Expatriation May Make Sense

While the case against expatriation is compelling for most, there are limited circumstances in which it could be beneficial:

- Individuals with substantial wealth who have permanently relocated to a jurisdiction with zero or minimal taxation, have no intent to return to the U.S., and can navigate the Exit Tax effectively.
- Dual citizens from birth who maintain stronger ties to another country and have minimal U.S. assets, obligations, or family connections.
- Situations where personal, political, or security reasons outweigh the benefits of maintaining citizenship.

Even in these cases, the decision should be made only after thorough consultation with tax, legal, and financial professionals, and with a clear understanding of the long-term implications.

In Closing

The idea of severing ties with the IRS through expatriation may seem appealing in theory, but in practice it is a severe, irreversible, and often unnecessary measure for most Americans abroad. With the combination of the **Foreign Earned Income Exclusion**, **Foreign Housing Exclusion**, and **Foreign Tax Credit**, the majority of expatriates can eliminate or drastically reduce their U.S. tax burden while still retaining the many advantages of U.S. citizenship.

Furthermore, citizenship functions as a **global safety net**, providing unique protections, mobility, and financial privileges that cannot be easily replaced once lost. The potential **Exit Tax**, coupled with estate tax disadvantages and diminished access to the U.S. financial system, can make expatriation an expensive and regrettable decision.

While there are rare scenarios where relinquishing citizenship makes strategic sense, these are exceptions—not the rule. For most, retaining U.S. citizenship remains the smarter, safer, and more flexible choice for both financial and personal security.

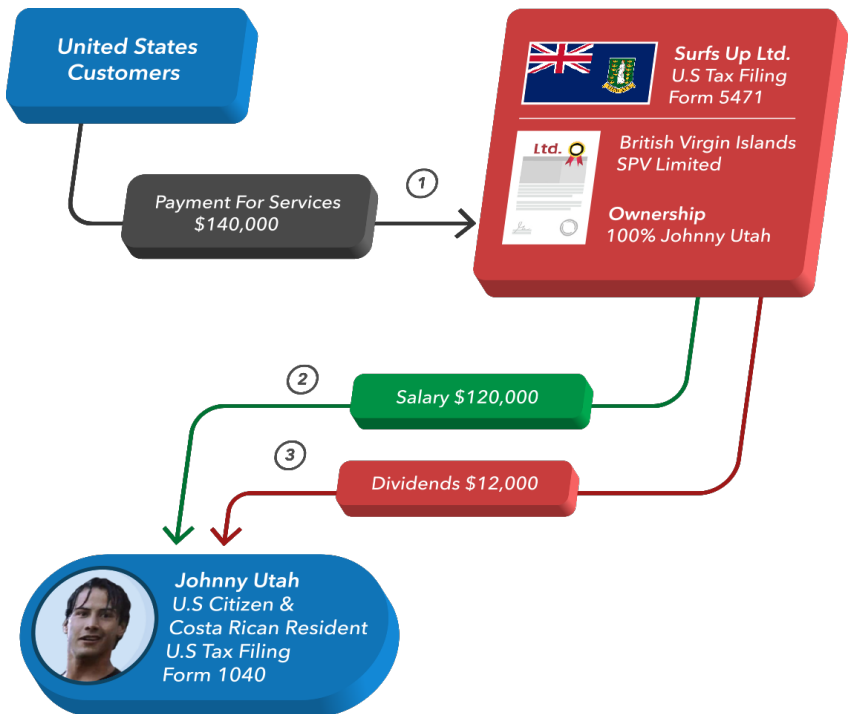
Case Study 1

Johnny Utah, the Costa Rican Surfer

Foreign Earned Income Exclusion #1

International Tax Structures for Americans Living Abroad

For further, information visit <https://pacifico.tax/international-tax-structures>



Structure Summary

A consultant working overseas earns a salary from a foreign corporation to claim the Foreign Earned Income Exclusion, in addition to receiving dividends, to reduce his U.S. tax liability to zero. This structure is a simple method of obtaining a salary from a foreign corporation to claim the Foreign Earned Income Exclusion, while also being exempt from U.S. Social Security taxes while working in a foreign country.

Monetary Transactions & Accounting

- The total payments from U.S. customers to the BVI corporation for consultation services were \$140,000 throughout the year.

- During the same calendar year, the BVI corporation compensates Johnny a \$120,000 Salary. As the performance of work is based on where the work was performed, rather than the location of the customer, all income is considered foreign-source income. Furthermore, his salary from a foreign corporation while working in a foreign country is not subject to U.S. Social Security and Medicare tax per Internal Revenue Code §3121.
- In addition to his salary, \$12,000 of dividends from retained earnings were also paid to Johnny before the end of the year.
- Surfs Up, Ltd. earned a total of \$140,000 for consultation income, paid \$120,000 of salary expenses to Johnny, had other administrative expenses of \$8,000 throughout the year, resulting in a Net Income of \$12,000.

Resulting Tax Implications

As a result of this structure and his income, the Federal personal U.S. tax liability of Johnny Utah is \$0. No state income tax is due, as he is not a resident of any U.S. state, nor has any income been sourced in any U.S. state.

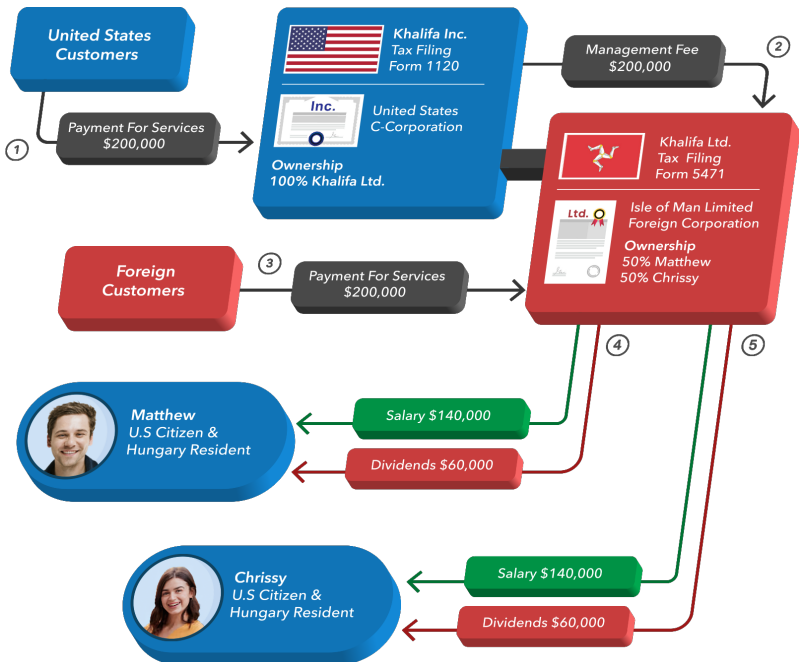
Case Study 2

Matthew & Chrissy, the Hungarian Consultants

Foreign Earned Income Exclusion #3

International Tax Structures for Americans Living Abroad

For further, information visit <https://pacifico.tax/international-tax-structures>



Structure Summary

A married couple provides consulting services overseas, and receives initial payment from U.S. clients through a C-Corporation for payment processing, which in turn compensates a foreign subsidiary for management services provided. The foreign subsidiary also received payment from foreign clients, and in turn compensates each spouse in order for them to claim the Foreign Earned Income Exclusion based on a salary originating from a foreign corporation, and avoiding Social Security taxes.

Structure Background

An Isle of Man Limited company, Khalifa, Ltd. (owned 50% by Matthew, a U.S. citizen and resident of Hungary and 50% by his wife Chrissy also U.S. citizen and resident of Hungary) is the parent company of Khalifa Inc., a U.S. Corporation. Matthew, as the manager of each business works with clients throughout the world. Khalifa, Inc. Collects payments from U.S. customers, and Khalifa, Ltd. collects payments from foreign customers, largely located in the European Union. However, Khalifa, Inc. primarily acts as a payment processor for the purposes collecting payments from U.S. customers, and pays a management fee to Khalifa Ltd., as the parent business operations are location offshore.

Khalifa Ltd. then pays a wage throughout the year, and also issues dividends for the any remaining earnings at the close of the year.

Monetary Transactions & Accounting

- The total payments to Khalifa, Inc. from U.S. customers for services were \$200,000 for the entire year. The business recognizes income under the cash basis of accounting,
- Khalifa, Inc. pays a Management Fee to Khalifa Ltd. of \$200,000 for the same year to provide services to customers.
- The total payments to Khalifa, Ltd., from foreign customers for services were \$200,000 for the entire year.
- During the year, Khalifa, Ltd. compensates Chrissy \$140,000 of salary, and dividends totaling \$60,000.
- During the year, Khalifa, Ltd. compensates Matthew \$140,000 of salary, and dividends totaling \$60,000.

- Khalifa, Ltd. earned a total of \$400,000 of gross income, paid \$280,000 of salary expenses to Matthew and Chrissy, resulting in a Net Income of \$120,000. The entire \$120,000 were also paid out as dividends, resulting in \$0 of Retained Earnings.

Resulting Tax Implications

As a result of this structure, the U.S. tax liability of Chrissy and Matthew filing jointly is \$34,560, resulting in an effective tax rate of 8.6%, based on receiving worldwide income of \$400,000.

*Note, the marginal tax rate for this year is 24% based on the “stacking rule” per Internal Revenue Code §911(f), which taxes remaining taxable income at a higher marginal tax rate when income was excluded under the Foreign Earned Income Exclusion, which would have otherwise been taxed at a lower rate.

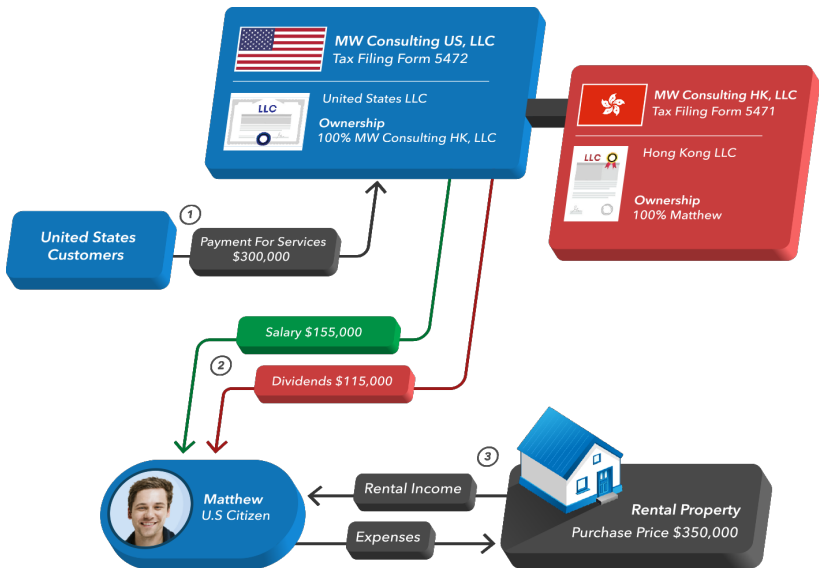
Case Study 2

Matthew, the Hong Kong Real Estate Investor

Foreign Earned Income Exclusion #6

International Tax Structures for Americans Living Abroad

For further, information visit <https://pacifico.tax/international-tax-structures>



Structure Summary

An individual claiming the Foreign Earned Income Exclusion (compensation paid via a U.S. Disregarded Entity LLC) who exceeds the exclusion limit. He then invests in U.S. rental property to defer income tax through a Cost Segregation strategy on invested real estate.

Structure Background

A Hong Kong LLC, MW Consulting HK, LLC (owned 100% by Matthew Wilson, a married U.S. citizen individual filing separately) received payment for software consulting and marketing for the year from U.S. customers. MW Consulting HK, LLC is a Controlled Foreign Corporation as defined in Internal Revenue Code §957. To process payments from customers, MW Consulting HK, LLC owns a wholly owned subsidiary MW Consulting US, LLC (a Delaware LLC). As a Single-Member LLC, MW Consulting US, LLC is disregarded for Federal tax purposes per Treasury Regulation § 301.7701-3, and conducts no business in the United States (further explanation below). The U.S. LLC pays salary and dividends to Matthew throughout the year.

Matthew remains outside the United States for more than 330 days during the year, qualifying for the Foreign Earned Income Exclusion under the physical presence test per Internal Revenue Code §911. While traveling and living abroad, they each incur a significant amount of housing expenses, which are also partially excludable per Treasury Regulation §1.911-7.

Not ‘Engaged in a U.S. Trade or Business’ in the United States

The primary purpose of the United States LLC is to easily collect payment from U.S. customers, obtain credit (primarily via credit cards), pay for expenditures, and easily conduct business from the use of the domestic banking system.

MW Consulting US, LLC also owns a virtual mailbox in the state of Delaware in order to receive U.S. mail, and as required by financial institutions. Based on the circumstances, the foreign corporation is determined not to be “conducting business” in the United States simply by owning a U.S. LLC for banking and mailing purposes per Internal Revenue Code §862 and related definitions found in §864.

Additionally, MW Consulting US, LLC, as a disregarded entity, nor the foreign parent maintains a Permanent Establishment in the United States within the meaning of Article 5 of the OECD Model Convention with respect to taxes. As a result, neither MW Consulting HK, LLC nor its U.S. subsidiary, MW Consulting US, LLC, conducts business in the United States and has no direct U.S. tax liability.

Cost Segregation

Additionally, Matthew purchased a residential U.S. real estate property for a purchase price of \$350,000, in which a Cost Segregation study was completed to claim accelerated depreciation in its first year of operation. The first year's depreciation and expenses totaled \$90,000, as analyzed.

Monetary Transactions & Accounting

- The total payments from U.S. customers for services were \$300,000 for the entire year. The business recognizes income under the cash basis of accounting.
- During the year, MW Consulting US, LLC compensates Matthew \$155,000 of salary, and the remaining Net Income as dividends of \$115,000.
- The accelerated depreciation, in addition to initial year purchase costs, and preparing the property for rental use, totaled \$90,000.

- At the conclusion of the year, MW Consulting HK, LLC has Net Income of \$115,000 (Revenue of \$300,000 less \$30,000 of Administrative Costs, less \$155,000 of salary expenses). Dividends of \$115,000 are paid to Matthew, with no remaining retained earnings.

Resulting Tax Implications

As a result of this structure, the U.S. tax liability of Matthew, filing separately, is \$10,440, reducing his effective tax rate to 5.8%.

*Note, the marginal tax rate for this year is 24% based on the “stacking rule” per Internal Revenue Code §911(f), which taxes remaining taxable income at a higher tax rate when income was excluded under the Foreign Earned Income Exclusion, which would have otherwise been taxed at a lower rate.