

International Tax Structures

for Americans Living Abroad

Foreign Earned Income Exclusion Structure #3

Married Filing Jointly Consultants Corporate Subsidiary (Isle of Man)

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.

Summary of the the Foreign Earned Income Exclusion (\$911)

The Foreign Earned Income Exclusion (FEIE) allows U.S. citizens or resident aliens living and working abroad to exclude a certain amount of foreign-earned income from U.S. federal income tax. To qualify, you must have a tax home in a foreign country and meet either the bona fide residence test or the physical presence test.

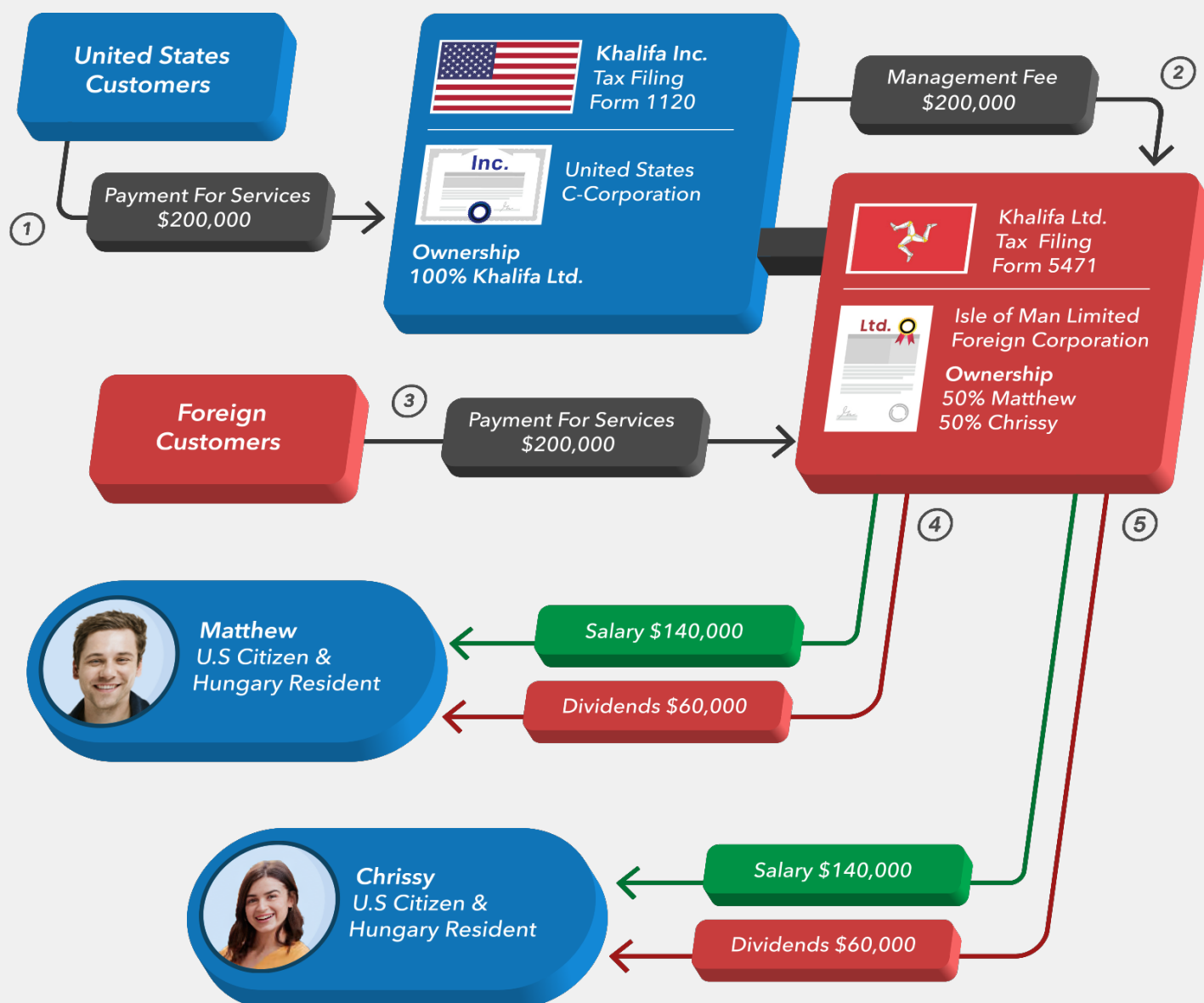


Prepared By
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Structure Background

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.



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

Both Matthew and his wife Chrissy operate each business together from their resident country in Hungary. Each spouse was a resident of Hungary for the entire year qualifying them for the Foreign Earned Income Exclusion under the bonafide residence test per Internal Revenue Code §911. While traveling and living abroad, they each incur a significant amount of housing expenses also partially excludable per Treasury Regulation §1.911-7.

Monetary Transactions & Accounting

1. 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,
2. Khalifa, Inc. pays a Management Fee to Khalifa Ltd. of \$200,000 for the same year to provide services to customers.
3. The total payments to Khalifa, Ltd., from foreign customers for services were \$200,000 for the entire year.
4. During the year, Khalifa, Ltd. compensates Chrissy \$140,000 of salary, and dividends totaling \$60,000.
5. During the year, Khalifa, Ltd. compensates Matthew \$140,000 of salary, and dividends totaling \$60,000.
6. 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.

U.S. Tax Filing Compliance

7. **Form 1120 (Khalifa, Inc.).** At the conclusion of the year, the U.S. corporation receives revenue of \$200,000, and pays a management fee for services also of \$200,000, resulting is \$0 of Net Income.
 - **Form 5472 (Khalifa Ltd.)** Attached to the U.S. Corporate tax return should include a Foreign Owned disclosures is required on [Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business](#) to report certain reportable transactions per Internal Revenue Code §6038, which in this case included the \$200,000 Management Fee paid to its foreign parent corporation.
8. **Form 1040 (MFJ Chrissy and Matthew).** On their individual Married Filing Joint tax return, each spouse report a total income of \$400,000 (\$280,000 of salary, \$60,000 of Dividends. They elect to claim the Foreign Earned Income Exclusion on [Form 2555, Foreign Earned Income](#), for a maximum exclusion of \$216,000. Additionally, their foreign housing costs are partially deductible, resulting in a foreign housing exclusion of \$16,000 (*total foreign housing expenses of \$32,000 were paid during the year). After also claiming the Standard Deduction of \$24,000, their taxable income is reduced to \$144,000.
 - **Form 5471 (Khalifa Ltd.).** Attached to their personal income tax return, Matthew and Chrissy are required to file [Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations](#) in relation to their ownership of the foreign corporation, to satisfy the reporting requirements of Internal Revenue Code §6038. On this Controlled Foreign Corporation Disclosure, all financial information is required to be reported: The Isle of Man corporation earned a total of \$400,000 for the year (\$200,000 from foreign customers and \$200,000 from management fees from its U.S. subsidiary). Salaries are then paid to each spouse respectively of \$140,000 each (\$280,000 in total), resulting in a Net Income of \$120,000. All earnings are paid out as dividends, resulting in a \$60,000 dividend payment to each spouse. As a result of all retained earnings being paid to Matthew and Chrissy as related party dividends, there is no taxable Global Intangible Low-Taxed Income (GILTI) per Internal Revenue Code §951A.

Summarized Tax Returns and Financial Statements

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Khalifa Ltd. Income Statement

Revenue	\$200,000
Management Fee	\$200,000
Salary Expense	- \$280,000
Net Income	\$120,000
Dividends Paid	- \$120,000
Retained Earnings	\$0

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Form 1040 (MFJ)

Matthew & Chrissy

Wages	\$280,000
Dividends	\$120,000
Total Income	\$400,000
Foreign Earned Income Exclusion	- \$216,000
Foreign Housing Expenses	- \$16,000*
Standard Deduction	- \$24,000
Taxable Income	\$144,000
U.S. Tax	\$34,560*

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Form 1120

Khalifa Inc.

Revenue	\$200,000
Management Expense	- \$200,000
Net Income	\$0

Form 5472

(Khalifa Ltd.)

Foreign Owned Corporation

Management Fee	\$200,000
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Form 5471

Khalifa Ltd.

Net Income	\$120,000
Related Party Dividends Exemption	\$-120,000
Taxable GILTI	\$0

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.

Effective Tax Rate

Gross Income from All Sources	\$400,000
Gross Expenses from All Sources	\$0
Total Net Income	\$400,000
Federal Income Tax	\$34,560
Effective Tax Rate (Married Filing Jointly)	8.64%

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*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.



Compliance Warning. The deductible portion of the Management Fee paid to a foreign related party is subject to interpretation. Transfer Pricing rules, and other factors, should be considered when making this determination. A Base Erosion and Anti-Abuse Tax (BEAT) could apply if the IRS determines the Management Fee paid to a foreign related party is too high.

About 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.



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

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