

International Tax Structures

for Americans Living Abroad

Foreign Earned Income Exclusion Structure #6

Offshore Consultant Foreign Salary & Cost Segregation

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.

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.



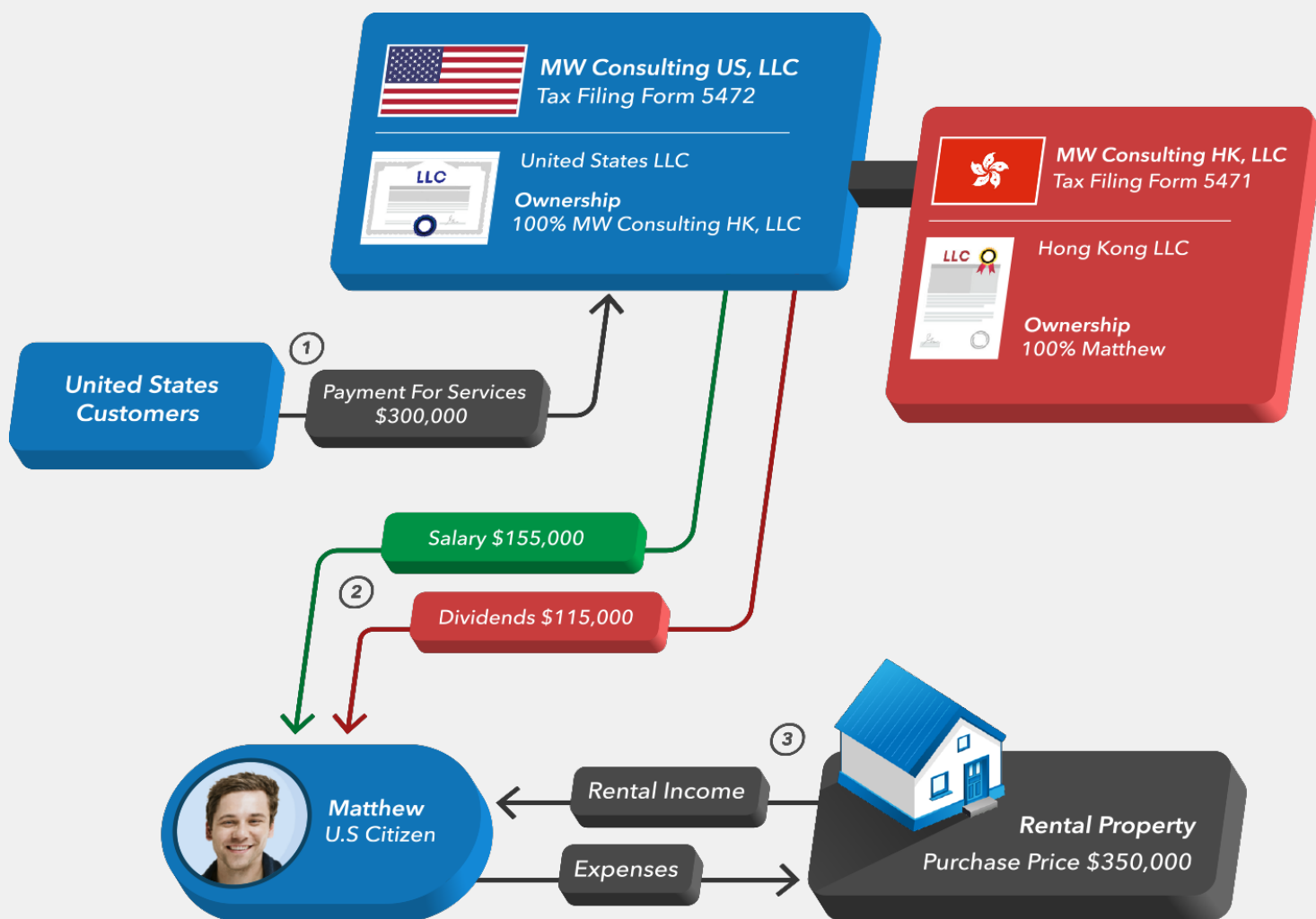
Prepared By
PACIFICOTAX

The International Tax Structures included in this publication are hypothetical structures. Read the attached Disclaimer and read our [Terms](#) to learn more.

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.



Offshore Consultant Foreign Salary & Cost Segregation

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.

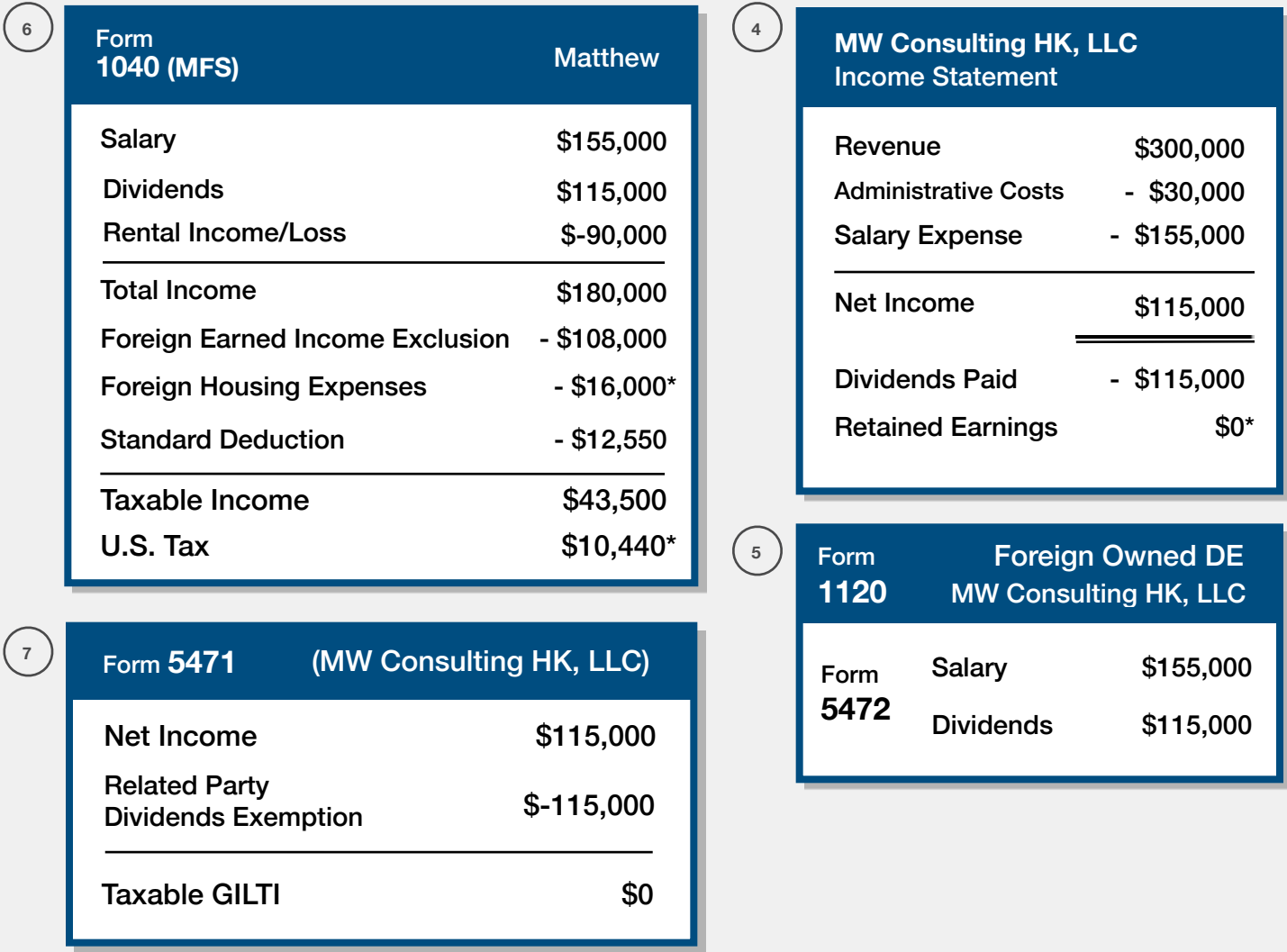
Monetary Transactions & Accounting

1. 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.
2. During the year, MW Consulting US, LLC compensates Matthew \$155,000 of salary, and the remaining Net Income as dividends of \$115,000.
3. The accelerated depreciation, in addition to initial year purchase costs, and preparing the property for rental use, totaled \$90,000.
4. 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.

U.S. Tax Filing Compliance

5. **Pro Forma Form 1120, with Form 5472 (MW Consulting US, LLC).** Foreign Owned Disregarded Entities must generally file [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.
6. **Form 1040 (MFS Matthew).** On his individual Married Filing Separate tax return, Matthew reports total income of \$180,000 (\$155,000 of salary, \$115,000 of Dividends, and a Rental Loss of \$-90,000. He elects to claim the Foreign Earned Income Exclusion on [Form 2555, Foreign Earned Income](#), for a maximum exclusion of \$108,000. 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 \$12,550, his taxable income is reduced to \$43,500.
7. **Form 5471 (MW Consulting HK, LLC).** He must also file [Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations](#) in relation to his ownership of MW Consulting HK, LLC to satisfy the reporting requirements of Internal Revenue Code §6038. As a result of all retained earnings being paid to Matthew as related party dividends, the taxable portion of Global Intangible Low-Taxed Income (GILTI) is \$0 per Internal Revenue Code §951A.

Summarized Tax Returns and Financial Statements



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.



Compliance Warning. A Foreign-Owned United LLC classified as a Disregarded Entity for Federal Tax Purposes comes with compliance risks to be aware of, including:

- Failure to file the proper Form 5472 disclosure results in a penalty of \$25,000.
- Based on the activity and nature of the business, a U.S. Trade or Business could be established, resulting in negative tax implications.
- Federal banking laws identifying a U.S. person as the beneficial owner could result in improper tax reporting and other compliance issues if foreign operations exist.
- Economic substance issues may also arise, resulting in compliance issues with the IRS.



Compliance Warning. A Cost Segregation Study may be open to interpretation based on its determination of asset separation. This could increase audit risk in some circumstances.

Effective Tax Rate

Gross Income from All Sources	\$300,000
Gross Expenses from All Sources	\$50,000*
Total Net Income	\$250,000
Federal Income Tax	\$10,440
Effective Tax Rate (Married Filing Jointly)	4.18%

* This \$50,000 total is a combination of \$30,000 of Administrative Expenses for MW Consulting HK, LLC, and Out of Pocket Rental Expenses, which were assumed to \$20,000. The Cost Segregation Deduction of \$70,000 is a tax deduciton, and not an out-of-pocket expense.

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>

DISCLAIMER

The International Tax Structures included in this publication are hypothetical structures and set of circumstances and tax rates that do not apply to any particular taxpayer and for any purpose. The information included in this tax structure is non-transferable or reusable, as each taxpayer's situation is factually unique.

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