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USA Foreign Earned Income Exclusion

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The USA Federal income tax regime is based upon the concept of taxing its citizens and residents on their world wide income regardless of their physical presence within the USA. Residents include, among others, those who hold USA permanent resident status commonly referred to as "green card" holders.

There are certain exceptions to this general principle one of which is the exclusion for certain non-USA sourced earned income.

Earned income arises from our personal labors. Thus, for example, rental income sourcing in the ownership of residential or commercial property outside of the USA is not earned income.

An individual who works and resides outside of the USA may be eligible to exclude up to $80,000 of non-USA sourced earned income from their otherwise taxable income.[i] This income must be sourced in personal efforts actually delivered while the individual's tax residency is outside of the USA.

In addition to having a tax home outside of the USA to qualify for this exclusion, the individual must either:

1. Be a *bona fide* resident of a country other than the USA;

   or

2. Meet a physical presence test.

An individual's tax home is the location of their principal place of business. However, an individual whose principal place of abode is within the USA does not meet this test even where their principal place of business is outside of the

USA. For example, a person who resides in New York City as a sales representative of Britt (a Costa Rican coffee producer) and has a vacation home on Costa Rica's Pacific coast does not qualify for the exclusion of foreign sourced income. On the other hand, the USA citizen who represents Britt in England, resides in London and has a vacation home on Cape Cod may qualify for the exclusion of earned income.

In order to meet the *bona fide* resident requirement, an individual must be a *bona fide* resident of a country or countries other than the USA for the entire tax year. *Bona fide* residency is the intent to truly live in a particular location. All of the facts and circumstances will be considered. Thus, an individual's intent as to duration and purpose, among other factors, impact this determination. While certainly probative, the individual's actual legal status under the laws of the country of residency is **not** controlling. Other indicia of an intent to reside in a particular location include all of the typical issues of day to day life such as where minor children live, the location of one's office or other business facility, the location of primary financial relationships, the maintenance of more than one house, and so on.

As an alternative to the bona fide residence test, an individual can qualify for the exclusion if they are physically present in the foreign country for at least 330 days out of a consecutive 12 month period. However, the individual must reduce the maximum US$80,000 exclusion proportionately for the days during their tax year (typically, the calendar year) that they are physically present in the USA. For example, a USA individual is physically present in Costa Rica for 330 days from 1 August 2005 through 26 June 2006. This individual may exclude up to US$33,534 foreign sourced earned income from their 2005 USA taxable income (153 days in Costa Rica during 2005 divided by 365 days in the year times the $80,000 maximum exclusion).

If there is income tax on the excluded foreign sourced earned income assessed by the source country, it may not be used as a credit against USA income tax to the extent the individual elects to exclude it from income. Thus, a USA taxpayer must elect whether to utilize the foreign tax credit or the exclusion of foreign sourced earned income.

There appears to be some confusion among taxpayers. Some believe that 183 days in the foreign country provides for the ability to qualify for the exclusion of up to US$80,000 of foreign sourced income. This is not true.

There is, however, a test in the USA tax regime which does consider 183 days. A non-USA citizen without USA permanent residency status (for example, without a "green card") under the USA immigration laws can, nonetheless, be viewed as a USA resident for income tax purposes. A non-USA citizen will be viewed as a USA resident for income tax purposes if they are physically present in the USA for at least 31 days during the calendar year and 183 days cumulatively during the current and two preceding calendar years. While this is certainly a trap for the unwary non-USA citizen, it has no applicability to a USA citizen's status.

[i] The $80,000 is indexed to certain inflation indices. Thus, it will change from year to year.