



ARTHURANDERSEN

Human Capital

U.S. taxation of Americans abroad

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Introduction

This booklet is designed to help expatriates (i.e., U.S. citizens and residents employed abroad) understand the unique U.S. tax provisions that apply to them. The rules discussed do not apply to expatriates employed in Puerto Rico or U.S. possessions or those employed by the U.S. government or an agency thereof.

This booklet provides a brief summary of the rules of special interest to expatriates as of August 1, 2000. However, it should not be considered a substitute for professional tax advice. Guidance should be obtained prior to departure from, and again before return to, the United States with respect to U.S. and foreign tax planning and other relevant issues relating to an international assignment. Arthur Andersen has tax personnel in all major cities in 78 countries that are qualified to provide tax advice to expatriates. For assistance, please contact any of the offices listed in the back of this booklet.

Executive summary

Taxation of U.S. expatriates

Who qualifies for expatriate exclusions?

- U.S. citizen who:
 - Is either:
 - A bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire tax year, or
 - Physically present in foreign countries for 330 full days in any 12 consecutive-month period.
 - Has a tax home outside the U.S. during the above-mentioned time periods.
 - U.S. resident who is:
 - Physically present in foreign countries for 330 full days in any 12 consecutive-month period.
 - Has a tax home outside the U.S. during the 330 days of presence in foreign countries.
 - A separate exclusion is available for earned income of each qualifying spouse.
-

What is excluded?

- Foreign earned income.
 - Limited to a maximum amount of:
 - \$76,000 in 2000
 - \$78,000 in 2001
 - \$80,000 in 2002Beginning in 2008, the exclusion will be indexed for inflation.
 - In years when the qualifying period includes only a part of the year, the exclusion is prorated on a daily basis.
 - Housing-cost amount.
 - Housing-cost amounts in excess of 16% of the salary of a U.S. government employee at pay grade GS-14, Step 1 (\$10,171 for 2000).
-

Denial of double benefits.

Deductions and credits attributable to excluded income are disallowed.

How election to claim exclusions is made.

The election to exclude income is made by filing Form 2555 with a timely filed return or amended return, or with a late return that is filed within one year of the *original* due date. Later dates may be applicable if, after taking into account the exclusion, no tax is owed or, if tax is owed, the taxpayer makes the election before IRS raises the issue.

Once an election is made, it is binding for future years until revoked.

The election can be made to exclude:

- Foreign earned income or
 - Housing-cost amount or
 - Both.
-

Who should elect?

Generally, expatriates in countries with an effective tax rate lower than that of the United States will benefit from the exclusion. Analysis is necessary for expatriates in high-tax countries to determine whether a greater benefit will result from not electing the exclusion and thereby obtaining the full benefit of the foreign tax credit and deductions attributable to foreign earned income.

Income tax provisions affecting U.S. expatriates

Exclusions from income

Foreign earned income exclusion

Housing exclusion or deduction

Separate exclusion for husband and wife

Qualifying for the exclusions

Electing the exclusions

Maximizing the exclusion in the year of transfer

Qualified second households

Moving expense reimbursements

Employees living in camps

Denial of double benefits

Quantifying the benefits of the exclusions

The United States taxes every U.S. citizen on his or her worldwide income regardless of residence or the source of the income. Accordingly, a U.S. citizen who moves abroad continues to be subject to U.S. income tax on worldwide income while at the same time becoming subject to income tax in the country where residing. However, certain exclusions and credits are available under the Internal Revenue Code to alleviate the potential double tax burden that could otherwise arise. These include the foreign earned income exclusion and the foreign tax credit.

Exclusions from income

An individual qualifying under either the bona fide residence test or the physical presence test (discussed later in this chapter) may elect to exclude two separate items from gross income:

- A foreign earned income exclusion of a fixed dollar amount.
- A housing exclusion for excess housing costs.

The two exclusions are elective and an individual may elect either or both. Once an election has been made, it remains in effect for the year elected and all future years unless revoked. The election may be revoked once without the prior consent of the Internal Revenue Service (IRS). Once revoked, a new election cannot be made within the next five years unless the IRS grants permission. The election remains in effect continuously. For example, if the election is made and the expatriate returns to the United States and later moves abroad, the election continues in effect.

Foreign earned income exclusion

The exclusion allows a qualifying taxpayer to claim an exclusion of "foreign earned income" up to the following maximum amounts for each calendar year:

Maximum exclusion allowed

Year	Amount
2000	\$76,000
2001	\$78,000
2002 and thereafter	\$80,000

Beginning in 2008 the exclusion amount will be indexed for inflation.

The exclusion is taken “off the top” so that income at the highest marginal income tax rates is eliminated first. Only foreign earned income is eligible for the exclusion. Earned income is income received for the performance of personal services. It can be in the form of cash or benefits in kind and includes such items as salaries, wages, bonuses, commissions, foreign incentive and cost-of-living allowances, tax reimbursements, housing, home leave, company cars, and education allowances. Earned income does not include items such as interest, dividends, amounts received from pensions, annuities, nonexempt employee trusts, and amounts paid by the U.S. government or agencies to its employees.

Self-employed individuals who have businesses in which both capital and personal services are material income-producing factors may treat as earned income a reasonable portion of income from the business. That portion may not exceed 30 percent of the income derived from the conduct of the business.

To be considered foreign, earned income must be received as compensation for services performed in a foreign country. It is the place where personal services are performed that determines whether the income is foreign — not the place where actual payment for the service is made. If compensation for services performed abroad is received in (or from an employer in) the United States, that compensation is treated as foreign source. On the other hand, if an individual performs some services in the United States, the compensation received for these services is treated as U.S.-source income not eligible for exclusion. When it is not possible to determine accurately what portion of an expatriate’s compensation is for U.S. services, total compensation is allocated between U.S. and foreign sources on the basis of business days.

Example: Clare qualifies as a bona fide resident of France from January 1, 2001 through March 31, 2002. Clare’s compensation for services rendered in 2001 is \$80,000. During 2002, Clare works a total of 240 days — 20 days in the United States and 220 days in Europe. The maximum amount of income considered to be from foreign sources is:

$$\begin{array}{r}
 220 \text{ foreign} \\
 \text{business days} \\
 \hline
 240 \text{ total} \\
 \text{business days}
 \end{array}
 \times
 \begin{array}{r}
 \$80,000 \\
 \text{compensation}
 \end{array}
 =
 \begin{array}{r}
 \$73,333 \\
 \text{foreign} \\
 \text{earned} \\
 \text{income}
 \end{array}$$

To be considered foreign earned income eligible for the exclusion, income must be received no later than the year after the services are performed. Therefore, a bonus received in 2001 for 2000 services is eligible for the exclusion although the same bonus received in 2002 is not. Also, in determining the amount of the exclusion, and for that purpose only, income is attributed to the year in which the services are performed. Accordingly, if an individual receives a bonus in 2001 that is attributable to 2000 services, he or she must look to the maximum 2000 exclusion to determine if the bonus is excludable. If the earned income excluded in 2000 was less than the maximum \$76,000 exclusion for

2000, the bonus can be excluded in 2001 to the extent of the unused 2000 exclusion amount.

Example: Grant is a bona fide resident of Australia from January 1, 2000 to December 31, 2001. He has no U.S. business days in 2000 or 2001. In 2000, he receives compensation of \$55,000 for 2000 services, and in 2001 he receives compensation of \$65,000 for 2001 services, plus a bonus of \$15,000 for 2000 services. In 2002, after he has terminated his foreign assignment, he receives a bonus of \$10,000 for 2001 services and a bonus of \$5,000 for 2000 services. As noted above, the maximum foreign earned income exclusion is \$76,000 for 2000 and \$78,000 for 2001.

The \$10,000 bonus received in 2001 for 2000 services is excludable from Grant's 2001 income because he has \$21,000 (\$76,000 – \$55,000) of unused 2000 exclusion. Of the \$15,000 bonus received in 2002 for 2001 services, only \$13,000 (\$78,000 – \$65,000) is excludable from Grant's income for 2002 because Grant only has \$13,000 of unused exclusion for 2001. The \$5,000 bonus received in 2002 for the 2000 services may not be excluded even though Grant still has \$11,000 of unused 2000 exclusion because it was received more than one year after the year in which the services were performed.

Housing exclusion or deduction

In addition to the foreign earned income exclusion, expatriates also may elect to claim an exclusion for the "housing-cost amount," which is the actual foreign housing expenses for the calendar year in excess of a base amount, discussed later. This exclusion is separate from the foreign earned income exclusion and requires a separate election.

Housing expenses include rent, utilities (except telephone), insurance, residential parking and repairs, but not mortgage interest and real estate taxes, which are deductible as itemized deductions. Housing expenses must be reasonable and are not deductible to the extent they are lavish or extravagant under the circumstances. Housing costs do not include the cost of buying a house, principal payments on a mortgage, depreciation, purchased furniture, domestic labor or pay TV.

The base amount is equal to 16 percent of the salary of a U.S. government employee at grade level GS-14, Step 1. This amount is \$10,171 for 2000 and is adjusted annually as federal pay levels change. If an individual qualifies under the bona fide residence or physical presence test for only a portion of the year, the base amount is prorated on a daily basis. In 2000 the daily amount of the base housing amount is \$27.79.

Example: Helen qualifies for the housing exclusion during her period of foreign residence in 2000 in China, from January 1 through May 31. She incurs \$20,000 in housing expenses in China during this period, all of which qualify for this exclusion. Her base amount is \$4,196 (151 x \$27.79), and her housing exclusion is \$15,804 (\$20,000 – \$4,196).

Housing expenses are excluded to the extent they relate to "employer-provided amounts." All amounts paid in cash or in kind, including salary, bonus and all allowances, are considered employer-provided amounts. The housing exclusion is limited to foreign earned income.

A housing deduction is allowed for excess housing expenses that are not attributable to employer-provided amounts. Because of the all-inclusive definition of employer-provided amounts, only individuals with self-employment income can claim the housing deduction as opposed to the exclusion. Employees, therefore, would treat excess housing expenses as an exclusion. Individuals with both employee wages and self-employment income must apportion their housing expenses between the housing exclusion and the housing deduction. The housing deduction is limited, however, to foreign earned income minus amounts excluded under the foreign earned income exclusion for the year. Any amount in excess of this limitation may be carried forward to the next tax year.

The housing exclusion is applied before the foreign earned income exclusion in reducing income.

Example: Jerry is a bona fide resident of Mexico for the entire calendar year 2000. During the year, he receives foreign earned income of \$100,000. He incurs \$44,500 in housing expenses. He has no other income. His adjusted gross income is computed as follows:

Compensation	\$ 100,000
Housing exclusion (\$44,500 – \$10,171)	(34,329)
Foreign earned income after housing exclusion	65,671
Foreign earned income exclusion (limited to foreign earned income)	(65,671)
Adjusted gross income	\$ —
Unused 2000 exclusion (\$76,000 – \$65,671)	\$ 10,329

The unused portion of the foreign earned income exclusion can be used to exclude payments received in 2001 but attributable to 2000 services, such as bonuses and tax reimbursements.

Separate exclusion for husband and wife

Each taxpayer is entitled to a separate foreign earned income exclusion. The determination of the amount of the exclusion is made separately for each spouse, even if the couple files a joint income tax return. For example, if each spouse has \$100,000 of foreign earned income in 2001, they would each be entitled to the \$78,000 exclusion available in 2001, for a total exclusion of \$156,000 on their 2001 joint return.

Community property laws are disregarded in computing the exclusions. For exclusion purposes, income is attributable to the person who actually earns it.

Spouses residing together and filing a joint return may calculate the amount of their housing cost either jointly or separately. If each spouse elects to separately exclude or deduct portions of their housing cost, the spouses may allocate their total housing expenses between each other

in any manner they wish. However, each spouse claiming the exclusion or deduction would have to reduce his or her exclusion or deduction by the entire base amount applicable. Alternatively, if housing costs are allocated entirely to one spouse, the housing expenses would be reduced by only one base housing amount.

If both spouses are qualifying individuals and are filing separate returns or are residing apart, each must separately calculate the base housing amount applicable to the exclusion or deduction.

Qualifying for the exclusions

To claim the exclusions, an individual must be “qualified.” A qualified individual must maintain a tax home in a foreign country and meet either the bona fide residence test or the physical presence test.

Bona fide residence test. To qualify under this test, an individual generally must be a U.S. citizen who has established a bona fide residence in a foreign country or countries for an uninterrupted period that includes an entire calendar year. U.S. residents who are not citizens may be able to qualify under this test if they are citizens of a country with an income tax treaty with the U.S.

If a person goes to a foreign country to work for a period of time, sets up permanent quarters for himself or herself and his or her family and otherwise becomes established in the local community, then that person becomes a bona fide resident immediately upon so doing. An intention to return to the United States at some future time does not preclude an expatriate from being a bona fide foreign resident. A nonresident, on the other hand, is a transient who goes to a foreign country for a definite purpose that can be accomplished promptly.

Once bona fide residence has been established, temporary visits to the United States or elsewhere on vacation or business trips do not interrupt the period of residence. Abandonment of a foreign residence simultaneously with a trip to the United States, followed by a transfer to another foreign post, may terminate a period of bona fide foreign residence. Abandonment of one foreign residence followed by the immediate taking up of another does not interrupt the period of bona fide foreign residence. The individual's tax home must be in a foreign country during the bona fide residence period.

An individual is not considered a bona fide resident of a foreign country if he or she:

- Makes a statement to the authorities of that country that he or she is not a resident thereof, and
- Has earned income from sources within the country which is not subject to income tax as a resident of that country.

Physical presence test. The other test for qualifying to exclude foreign earned income requires that a U.S. citizen or resident be physically present in one or more foreign countries for at least 330 days (approximately 11 months) during any period of 12 consecutive months. The individual's tax home must be in a foreign country during this 330-day period.

The rule is simple but very exacting. A qualifying day means a period of 24 consecutive hours beginning at midnight and ending the following midnight. In computing the minimum of 330 full days of presence in foreign countries, all separate periods of presence during the period of 12 consecutive months are to be totaled. If an individual travels from one foreign country to another over a route a portion of which is not within any country, and if the travel not within any country is less than 24 hours, the individual is deemed to be within a foreign country during the period of travel.

A person in transit between two foreign countries can stop off in the United States for less than 24 hours and still have the travel day counted as a foreign day. Intent to stay or return or the nature and purpose of the stay abroad are irrelevant. Time spent in a foreign country in the employ of the U.S. government counts toward satisfaction of the 330-full-days requirement, even though the amounts paid by the U.S. government are not excludable.

Any period of 12 consecutive months during which an individual satisfies the 330-full-days requirement, even though the period constitutes a part of a longer period of presence in a foreign country or countries, is permitted.

Because the physical presence rule is so precise, a careful record of dates and times of travel, with appropriate documentary support, is required.

Tax home. "Tax home" generally refers to the location of an expatriate's principal place of business or employment regardless of where the family residence is located. Accordingly, an employee's tax home is where he or she earns the major source of income.

Other rules. The requirement that either the bona fide residence or physical presence test be met to qualify for the exclusions may be waived if the Secretary of the Treasury determines that expatriates generally had to flee a foreign country due to civil unrest, war or other adverse conditions, and the expatriate can establish that, but for this fact, he or she would have satisfied the applicable test.

An individual traveling to certain restricted countries is not treated as having left the U.S. for purposes of determining the foreign earned income and housing exclusions or deduction. The individual is not treated as being present in a foreign country for days in a restricted country. There is no exclusion for income attributable to days in a

restricted country and there is no housing exclusion or deduction for expenses attributable to living in such a foreign country. Currently, restricted countries are Cuba, Libya, and Iraq.

Electing the exclusions

Taxpayers may elect the exclusions on a timely filed original or amended return, or on a late return filed no more than one year after the original due date. In addition, an election may be made on a later return if, after taking into account the exclusion, no tax is owed or, if tax is owed, the taxpayer makes the election before IRS discovers the taxpayer failed to timely elect the exclusion. The exclusions are elected by filing with the income tax return a Form 2555, Foreign Earned Income, claiming the foreign earned income and/or the housing exclusion.

Taxpayers may revoke an election for any year, including the first year the election was made. A revocation is effective for that year and all subsequent years. Once an election is revoked, an individual may not re-elect within the next five years without IRS approval. The circumstances IRS will consider include: a period of U.S. residence, a move between foreign countries with differing tax rates, changes in foreign tax laws and a change of employer.

Maximizing the exclusion in the year of transfer

In a year of transfer to or from a foreign country when a taxpayer meets either the bona fide residence or physical presence test for only a portion of the year, the amount of the foreign earned income exclusion is prorated on a daily basis, with the decimal rounded to the nearest two digits.

Example: Jay is a bona fide resident of Hungary from January 1, 2000 through March 31, 2001. Prorating his foreign earned income exclusion for 2001 on the basis of his residence would result in an exclusion of \$19,233, determined as follows:

$$\frac{90 \text{ qualifying days}}{365 \text{ total days}} \times \$78,000 \text{ foreign earned income exclusion amount} = \$19,233$$

Expatriates can maximize the foreign earned income exclusion in both the year of arrival abroad and the year of departure by using the physical presence test and including days spent in the United States during the qualifying period as qualifying days. Frequently this test produces a higher available exclusion than the bona fide residence test. Income is still sourced based on where services are performed. Therefore, this approach will increase the tax benefit only if the individual has foreign earned income that is not otherwise excludable.

Example: Emily's first full day of foreign assignment is April 1, 2000. Without any interruptions in physical presence, her 330th full day will be completed February 24, 2001. Counting back from February 24, 2001 for 12 consecutive months establishes February 26, 2000 as the first full day of the 12-month period. By using the physical presence test, the maximum exclusion for 2000 will be that portion of the \$76,000 that the number of days in 2000 within the 12-month period (February 26 to December 31, inclusive) bears to the total number of days in 2000. The number of qualifying days is 310, and the total days in 2000 are 366. The maximum excludable amount accordingly is \$64,372 $(310/366) \times \$76,000$. Note that, under the bona fide-residence test, the period of exclusion begins April 1, 2000, and the maximum excludable amount for the period from April 1 to December 31, 2000 is only \$57,104 $(275/366) \times \$76,000$.

The bona fide residence test can be used for the second year abroad, assuming all requirements are met, even though the physical presence test is used for the first year. In the above example, the second year will be calendar year 2001 despite the fact that a portion of 2001 is used in assembling 12 consecutive months to exclude some compensation earned in 2000 under the physical presence test.

When an individual terminates a period of bona fide foreign residence, he or she should calculate whether the physical presence or the bona fide residence test will result in the larger exclusion and choose the more favorable one. In the year of return to the United States, by counting forward, the qualifying physical presence period can end up to 35 days after physical presence ceases. This may result in a higher available exclusion for the year.

Qualified second households

When an expatriate is employed in a foreign location that has adverse, unhealthy or dangerous living conditions, two separate households (outside the United States) may be maintained, one at the work location and one elsewhere, for spouse and children. Under these circumstances, the costs incurred for both households may be combined in computing the housing-cost amount.

Moving expense reimbursements

Certain moving expense reimbursements, such as temporary living, pre-move/house-hunting, and real estate expenses, are includable in income and are not deductible. For these moving expense reimbursements, special rules apply for determining the amount that may be excluded in the year of the move. As discussed earlier, only income attributable to the current year may be excluded by using the current-year foreign earned income exclusion amount.

Moving expense reimbursements are treated as entirely attributable to the year of the move if the taxpayer qualifies for the exclusion for at least 120 days during that year. Consequently, the following table shows the latest possible dates in the year by which expatriates may move to a

foreign county, and the earliest dates they may return to the United States, and still have the reimbursement attributed entirely to the year of the move:

	Move to foreign country	Move to United States ^a
Bona fide residence	September 2	May 1
Physical presence	October 7 ^b	March 27 ^c

^a Assuming not a leap year.

^b Assuming no U.S. days for the 330 days after the move.

^c Assuming no U.S. days for the 330 days prior to the move.

If the taxpayer does not meet the 120-day test, a portion of the reimbursement is attributable to the year of the move and a portion to the succeeding year (for foreign moves) or the preceding year (for certain U.S. moves).

Example: Larry moves to a foreign country October 31, 2000. His qualifying days begin on November 1, 2000. He received a taxable moving expense reimbursement of \$10,000 in 2000; the \$10,000 must be reported as income in his 2000 return, but only \$1,667 is treated as attributable to services performed in 2000 and, therefore, eligible for the 2000 foreign earned income exclusion:

$$\frac{61 \text{ qualifying days}}{366 \text{ total days}} \times \$10,000 \text{ moving reimbursement} = \$1,667$$

The balance of the moving reimbursement (\$8,333) is attributable to services performed in 2001. The balance, however, can be excluded only if in 2001 Larry does not entirely use the full amount of the 2001 foreign earned income exclusion. In this case, he may amend his 2000 return and exclude the \$8,333 balance to the extent of the unused portion of his 2001 exclusion.

Lacking evidence to the contrary, moving-expense reimbursements are treated as attributable to future services to be performed at the new place of work. Therefore, reimbursements for moves to a foreign country are presumed to be foreign-source income, and moves to the United States are presumed to be U.S.-source income, which is not eligible for the foreign earned income exclusion. However, if there is evidence to the contrary, the reimbursement for the move to the United States is deemed to be foreign-source income and therefore is eligible for the exclusion.

Evidence to the contrary includes a written agreement between the employee and the employer or a written company policy concerning moving expenses entered into prior to the foreign assignment that states the employer will reimburse the employee for the move back to the United States. This agreement or policy must be an intended inducement to the foreign assignment.

Although the agreement or policy must indicate that the employer will reimburse the employee's moving expenses regardless of whether the employee continues to work for the employer in the United States, either document may include restrictions governing payment of the reimbursement. However, any terms or conditions must be specified and fulfilled prior to the employee's return move to the United States. This affords some relief to the employer, who can stipulate payment will not be made if the employee resigns or fails to successfully complete the foreign assignment. In no case will an oral agreement or an oral statement of policy be considered acceptable as evidence to the contrary.

Employees living in camps

Employees living in camps outside the United States are allowed the same foreign earned income exclusion as other taxpayers living and working in foreign countries.

In addition, the value of meals and lodging provided by employers in camps may be excluded from the employee's compensation provided three conditions are met:

- The lodging is furnished by the employer for its convenience because the place at which the services are to be performed is in a remote area without satisfactory housing.
- The camp is located as closely as practicable to the vicinity where the services are rendered.
- The camp is in a common area that normally accommodates 10 or more employees and that is not available to the general public.

Denial of double benefits

The law denies double benefits to taxpayers by disallowing deductions, exclusions or credits allocable to or properly chargeable against excluded income. Items properly allocable to excluded earned income include the foreign tax credit, business interest expense and employee business expenses. Other deductible nonbusiness expenses (medical, contributions, interest, etc.) and personal exemptions are not subject to this disallowance. The intent of Congress in disallowing these items is, in effect, to prevent taxpayers from excluding income twice.

- Deductions subject to disallowance — Deductions related to the realization of earned income, such as employee business expenses, are not allowed to the extent they are properly allocable to excluded income, as follows:

$$\begin{array}{r}
 \text{Excluded foreign} \\
 \text{earned income} \\
 \hline
 \text{Total foreign} \\
 \text{earned income}
 \end{array}
 \times
 \begin{array}{l}
 \text{Deductions} \\
 \text{related} \\
 \text{to foreign} \\
 \text{earned income}
 \end{array}
 =
 \begin{array}{l}
 \text{Disallowed} \\
 \text{deductions}
 \end{array}$$

Therefore, if an expatriate has \$100,000 of foreign earned income during the year and excludes \$76,000, 76 percent of the deductions related to foreign earned income are disallowed.

- Foreign tax credit disallowance — A portion of the foreign income taxes paid or accrued during the tax year properly allocable to excluded income is not available as a foreign tax credit (or as a deduction). This disallowed portion is generally determined as follows:

$$\begin{array}{r} \text{Excluded foreign} \\ \text{earned income} \\ \text{less disallowed} \\ \text{deductions} \\ \hline \text{Total foreign} \\ \text{earned income} \\ \text{less allocable} \\ \text{deductions} \end{array} \quad \times \quad \begin{array}{l} \text{Foreign taxes} \\ \text{paid or accrued} \end{array} = \begin{array}{l} \text{Disallowed} \\ \text{foreign} \\ \text{income taxes} \end{array}$$

However, if the foreign taxes are imposed not only on foreign earned income but also on other income (such as U.S.-source earned income or passive income) and the taxes paid on this other income cannot be segregated from the taxes paid on foreign earned income, the formula to be used is:

$$\begin{array}{r} \text{Excluded foreign} \\ \text{earned income} \\ \text{less disallowed} \\ \text{deductions} \\ \hline \text{Total income taxed} \\ \text{by foreign country} \\ \text{less allocable} \\ \text{deductions} \end{array} \quad \times \quad \begin{array}{l} \text{Total foreign} \\ \text{taxes paid} \\ \text{or accrued} \end{array} = \begin{array}{l} \text{Disallowed} \\ \text{foreign} \\ \text{income taxes} \end{array}$$

Example: Tyler moves overseas January 1 and has \$100,000 of foreign earned income and deductible employee business expenses of \$18,000. He elects the foreign earned income exclusion of \$76,000 and a housing-cost amount exclusion of \$20,000. Under the allocation formula, \$17,280 of these expenses is disallowed ($\$96,000/\$100,000$) x \$18,000 and \$720 is deductible. Assuming \$20,000 of foreign taxes are paid for the year, the computation of the foreign tax disallowance is \$19,200:

$$\frac{\$ 96,000 - \$17,280}{\$100,000 - \$18,000} \times \$20,000 = \$19,200$$

Thus, \$800 of the \$20,000 total foreign taxes can be used in the current year or, if not fully used currently, for carryover to prior or future years. The possible tax benefit of the disallowed foreign taxes (\$19,200) is lost forever.

Quantifying the benefits of the exclusions

An individual should not elect the foreign earned income and housing exclusions without carefully evaluating the benefits to be derived. As just discussed, by electing either exclusion, the expatriate gives up the right to claim as a foreign tax credit taxes paid or accrued that are properly allocable to the excluded income. Therefore, the higher the effective foreign tax rate, the lower the benefit of claiming the exclusions. If the foreign tax on foreign-source earned income is higher than the U.S. tax on the same income, thereby creating excess foreign tax credits, it may be more beneficial not to claim the exclusions. Excess foreign tax credits may be carried back two years and forward five years to offset the U.S. tax on foreign-source taxable income in those years. However, to be able to use these excess credits, the expatriate must have or generate low-taxed foreign-source earned income in those years.

The impact of the alternative minimum tax (AMT) discussed on page 27 and illustrated in the following example must be considered. Foreign tax credits are only allowed to offset 90 percent of the AMT.

Example: Benjamin, a married expatriate with no children, is located in a high tax country, and pays \$100,000 of foreign income tax in 2000. His compensation is \$200,000. Housing costs are \$40,000. As shown in the table on page 13, if Benjamin elects both exclusions, his regular taxable income after exemptions is \$81,221 and his AMT income is \$49,171. The foreign tax available as a credit is disallowed to the extent of $(\$105,829/200,000) \times \$100,000$, or \$52,915. The remaining \$47,085 is available as a credit. If he does not elect either exclusion, his regular taxable income and AMT income are \$187,050 and \$167,500 respectively; the foreign taxes available as a credit for either tax are \$100,000. Although the tax is higher without the exclusions, the foreign tax credit available for carryover is significantly higher than when the exclusions are claimed. If Benjamin believes the unused \$19,569 (regular tax) or \$25,226 (AMT) of additional foreign tax credit may be used as a carryback or carry-forward, he should not elect the exclusions. The carryover may be used to offset U.S. tax on foreign-source income received in a later year and subject to no or low foreign tax.

Evaluating the exclusions — example

2000

	With exclusions		Without exclusions	
	Regular tax	Alternative minimum tax	Regular tax	Alternative minimum tax
Compensation	\$200,000	\$200,000	\$200,000	\$200,000
Housing exclusion:				
Housing expenses	\$40,000			
Base amount	(10,171)	(29,829)		(29,829)
Foreign earned income exclusion	(76,000)	(76,000)		
Personal exemptions	(5,600)		(5,600)	
Standard deduction	(7,350)		(7,350)	
Regular taxable income	\$ 81,221		\$187,050	
Regular tax				
Tax before credits	\$ 17,041		\$ 50,387	
Foreign tax credit	(17,041)		(50,387)	
Total regular U.S. tax(A)	\$ —		\$ —	
Alternative minimum tax				
AMT exemption		(45,000)		(32,500)
AMT income		\$ 49,171		\$167,500
AMT @ 26%		\$ 12,784		\$ 43,550
Foreign tax credit (90% limitation)		(11,506)		(39,195)
AMT (B)		\$ 1,278		\$ 4,355
Tax payable (higher of A or B)		\$1,278		\$4,355
Excess foreign tax credit	\$ 30,044¹	\$ 35,579²	\$ 49,613³	\$ 60,805⁴
Additional foreign tax credit carryover without exclusions:				
Regular tax		\$ 19,569		
Alternative minimum tax		\$ 25,226		

¹ \$100,000 – \$52,915 – \$17,041

² \$100,000 – \$52,915 – \$11,506

³ \$100,000 – \$50,387

⁴ \$100,000 – \$39,195

The foregoing example reflects, for simplicity, only foreign-source compensation income. Where there is also U.S.-source income or any unearned income, the effective tax rate on that income, which is not available for the exclusions, may be significantly higher where the exclusions are not claimed. This result occurs because the exclusions come “off the top” and therefore have the effect of placing the remaining taxable income in lower tax brackets. The effect of this and the AMT means that each expatriate located in a country having a tax rate equal to or higher than the U.S. rates should make a detailed computation to determine the position that is best in his or her circumstances. Careful consideration is required, however, since it is not possible to elect the exclusion and then revoke it on a regular basis. As noted in the first chapter, once an election is made, it can be revoked later. However, once revoked, a new election cannot be made within the next five years without approval from IRS.

Filing tax returns and other administrative requirements

Who must file

When to file

Where to file and pay

Interest and penalties

Withholding of income tax

Estimated tax payments

Other filing requirements

Exchange rates

Nonresident alien spouse

Who must file

U.S. citizens and resident aliens, wherever located, are subject to U.S. income tax on their worldwide income regardless of where the income is earned, paid or received. Every U.S. citizen or resident alien must file an annual U.S. income tax return even though an individual's exemptions, exclusions and deductions are sufficiently large to prevent any final tax liability. For example, an individual who earns \$76,000 of foreign earned income is required to file a U.S. Individual Income Tax Return even though all the income is excluded under the rules discussed earlier.

Exceptions to this general rule are provided if gross income *before* exemptions and exclusions is below minimum statutory requirements.

When to file

Normally, calendar-year taxpayers must file income tax returns with IRS by April 15 of the following year. An extension of two months, to June 15, is granted automatically if the taxpayer's tax home is outside the United States and Puerto Rico on April 15. (Note that this automatic two-month extension does not apply if the taxpayer is only traveling outside the United States.) No extension request is required, but the taxpayer should attach a statement to the return stating that he or she was residing outside the United States on April 15.

A taxpayer who does not reside outside the United States on April 15 may file Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. Calendar-year taxpayers must file this form by April 15, and it automatically extends the time for filing the U.S. tax return by four months, to August 15, assuming certain conditions are met.

In addition, a taxpayer may request an *additional* extension of time to file by completing Form 2688, Application for Extension of Time to File U.S. Individual Income Tax Return. If the extension is timely filed and states reasonable cause why the time for filing the return must be

extended, it will be granted for an additional period, not to exceed six months from the original due date (i.e., until October 15 for calendar-year taxpayers). Individuals with a tax home outside the United States may request an additional two-month extension, if necessary (until December 15 for a calendar-year taxpayer).

Since the first return of a U.S. citizen or resident while abroad may be due before he or she has completed either of the two alternative requirements — bona fide residence or physical presence — for the foreign earned income exclusions, the expatriate may need to apply for an extension of time (in addition to the automatic extension) for filing the first return until the requirements for excluding income are met. This application should be made on Form 2350, Application for Extension of Time to File U.S. Income Tax Return, and filed with the IRS Center, Philadelphia, Pennsylvania 19255. The extension normally is granted for a period ending 30 days after the date on which the qualifying period ends.

Example: Kathy moves to India on July 1, 2001. Under the bona fide resident test, she will qualify for the foreign earned income exclusion in the period January 1, 2002 through December 31, 2002, retroactively applicable from July 1, 2001. She would be granted an extension of time to file the 2001 income tax return until January 30, 2003.

For taxpayers who do not meet the 120 day rule (previously discussed on page 8) and must allocate their moving expense reimbursements over a two-year period, the extension is granted until after the end of the second year. If a return is filed before completion of the period necessary to qualify for the exclusion, the return must be filed without taking into consideration the two exclusions. If the taxpayer subsequently qualifies for the exclusions for that year, an amended return can be filed to claim a refund for the excess tax paid. It usually is preferable to request an extension to avoid an unnecessary tax payment.

Where to file and pay

U.S. taxpayers who elect to exclude foreign earned income are required to file their tax returns with the IRS Center, Philadelphia, Pennsylvania 19255. Timely filings also may be made with offices IRS maintains in consulates outside the United States. Tax returns mailed by the due date are considered timely filed. The only permitted means of proving that the return was mailed prior to the due date are a U.S. or foreign Government Postal Service postmark or, under certain circumstances, documentation of a designated private delivery service. Tax payments must be made in U.S. currency or drawn upon U.S.-dollar bank accounts.

Interest and penalties

An extension of time for filing a return (including an automatic extension) does not extend the time for payment of tax. Accordingly, to avoid an interest charge, the tax due must be paid on or before the

original April 15 due date. Interest is payable on any unpaid tax from the original due date of the return until the tax is finally paid.

A penalty of 5 percent of the tax due with the return is imposed for failure to file an income tax return by the due date, with an additional 5 percent for each month that failure continues, unless the failure is due to reasonable cause and not willful neglect. The penalty may not exceed 25 percent of the tax due. If the return is filed on a timely basis, failure to pay the tax due with the return gives rise to a penalty of up to one-half of 1 percent of the unpaid tax for each month that failure continues unless the failure is due to reasonable cause and not willful neglect. The one-half-of-1 percent underpayment penalty does not apply if the tax return is automatically extended due to a foreign tax-home residence on April 15 and the tax due is paid by June 15. If an extension is required, a reasonable estimate of the tax that will be due with the return must be reported on the extension request. If the balance is not paid with the extension, interest will be due on the unpaid amount. In addition, a penalty of one half of 1 percent of the unpaid tax per month will be assessed.

Withholding of income tax

Generally, every U.S. employer paying wages is required to deduct and withhold U.S. income taxes. Certain exceptions to this requirement apply to U.S. expatriates.

Foreign withholding. Compensation paid for services performed by a U.S. expatriate in a foreign country is not subject to U.S. withholding if the employer is required by the law of the foreign country to withhold foreign income tax.

Earned income exclusions. Compensation paid for services performed outside the United States by an expatriate is not subject to withholding if it is reasonable to believe that at the time payment is made the amount paid will be excluded. A pro rata portion of the exclusion is applied to each payment, and withholding is made on any excess.

For the exclusion to be taken into consideration, the employer must reasonably believe that the employee will meet the bona fide residence or physical presence requirements. This is accomplished by written representations made by the employee to the employer.

Foreign tax credit. Additional withholding allowances may be claimed for estimated foreign tax credits. The allowances for foreign tax credits are in addition to any other withholding allowances, such as personal exemptions, and are allowable only for foreign tax credits attributable to salary or wage income. Disallowed foreign tax credits attributable to excluded income do not qualify as foreign tax credits for this purpose.

The additional withholding allowances for foreign tax credits can be claimed on Form W-4, Employee's Withholding Allowance Certificate.

No prior-year liability. A taxpayer who had no income tax liability for the prior year and expects to have none in the current year may claim (on Form W-4) full exemption from U.S. income tax withholding.

Estimated tax payments

An expatriate employee may be required to file a U.S. Estimated Tax Voucher, Form 1040-ES. The mere withholding of income taxes or the exemption from withholding does not exempt the individual from making estimated tax payments. Although a complete discussion of estimated tax requirements is beyond the scope of this booklet, events that may trigger the necessity of making estimated tax payments include:

- The receipt of a large bonus from which tax is withheld at the flat 28 percent rate, and the income ultimately will be taxed at a higher rate.
- The receipt of investment income such as dividends or interest. This type of income is not generally subject to withholding or eligible for the foreign earned income exclusion. Also, if the income is U.S. source, the U.S. tax on the income cannot be offset by foreign tax credits.
- An exemption from U.S. withholding due to foreign withholding requirements. The taxpayer still may incur a U.S. tax liability if he or she receives U.S.-source income or if the foreign income tax liability is lower than the U.S. income tax liability.

Estimated tax underpayment penalty — "safe harbor" based on prior-year's tax

Year	Portion of prior-year's tax required*
2000	108.6%
2001	110%
2002	112%
2003 and after	110%

* Assumes prior-year adjusted gross income exceeds \$150,000.

An underpayment penalty based on the current statutory interest rate is imposed in the case of any taxpayer who has not paid at least 90 percent of the U.S. tax liability through quarterly estimated payments and/or withholding. However, there are several ways to avoid the penalty, the most common being the ratable payment of estimated tax for the current year based on the prior year's tax. Individuals who pay at least 100 percent of the prior year's tax can avoid the underpayment penalty, except for high-income individuals, who must pay at least the following percentage of their prior year's tax:

A person is a high-income individual if his or her prior-year adjusted gross income exceeds \$150,000 (\$75,000 if married filing separately).

If the amount of tax that will not be covered by withholding reasonably can be expected to be less than \$1,000, no estimated tax need be paid. An employee having earnings subject to withholding may wish to have his employer withhold more than the minimum amount of withholding tax to eliminate the need for an estimated-tax payment.

Ordinarily, calendar-year taxpayers must make their first estimated-tax payment by April 15 of the tax year.

The following example illustrates the *normal* due dates and amounts of estimated-tax payments:

2001 tax payments required to avoid underpayment penalty	\$5,000
Less estimated 2001 withholding	(3,000)
Estimated tax required for 2001	\$2,000
Payments of estimated tax —	
April 16, 2001*	\$ 500
June 15, 2001	500
September 16, 2001**	500
January 15, 2002	500
	\$2,000
* April 15 is a Sunday	
** September 15 is a Sunday	

Other filing requirements

Information returns are required to be filed at the time a person applies for or renews a U.S. passport. Information is requested with respect to the taxpayer's Social Security number and foreign country of residence. This requirement is an attempt to increase taxpayer compliance in filing U.S. income tax returns.

Any person having an interest in a foreign bank account or other foreign financial account during the year is required to report that interest by filing Form 90-22.1 by June 30 of the following year. This filing requirement does not apply if the maximum aggregate value of all accounts during the year does not exceed \$10,000. The required form should be filed with the Department of the Treasury, P.O. Box 32621, Detroit, Michigan 48232.

U.S. citizens and residents receiving large gifts or bequests from a nonresident alien or foreign estate, corporation or partnership are required to report the transactions on Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." This form is attached to the income tax return for the year the gift is made. The form must also be filed with the IRS Center in Philadelphia. There are also separate, complex reporting requirements if a U.S. resident or citizen has certain transactions with respect to a foreign trust or has an ownership interest in a foreign corporation or partnership. A detailed discussion of these requirements is outside the scope of this publication.

Exchange rates

In preparing a U.S. tax return, taxable income must be stated in U.S. dollars. All items of income, deduction and credit originating in foreign currencies must be translated into U.S. dollars on the basis of prevailing rates of exchange. The rate most nearly reflecting the value of the foreign currency — the official rate, the open-market rate or any other appropriate rate — should be used. The translation technically should be made at the rate of exchange as of the date of receipt or payment even though not actually converted into or from U.S. currency at that time. As a practical matter, however, the average rate of exchange for the tax year may be used if there is only a minor fluctuation in rates during the year.

Nonresident alien spouse

Generally, a resident must pay U.S. income tax on worldwide income and, if married, the couple may file a joint income tax return. A nonresident alien may be subject to U.S. tax only on income from U.S. sources or income that is effectively connected with a U.S. business.

An expatriate may not file a joint return with a spouse who is a nonresident alien at any time during the tax year. However, an election may be made by an expatriate and his or her nonresident alien spouse to treat the alien spouse as a resident. This election is permitted on the condition that the worldwide income of the nonresident alien spouse for the entire year be included in the U.S. return. If the election is made, it is binding for all subsequent years until death, separation or revocation or if IRS determines adequate books and records have not been kept. If one spouse is a nonresident alien at the beginning of the year but a resident alien married to a citizen or resident alien at the end of the tax year, a separate election may be made for that year to treat the nonresident spouse as a resident for the entire year. Nonresident aliens who make an election to be treated as residents are eligible for the foreign earned income and housing exclusions.

For a more detailed discussion of the tax treatment of foreign nationals, refer to the Arthur Andersen publication *U.S. Taxation of Foreign Nationals*, available from any of our offices.

Social security taxes

Social security totalization agreements

U.S. citizens and resident aliens working outside the United States are not, as a general rule, subject to U.S. social security (FICA) tax unless they are performing services for a U.S. employer. When they are subject to FICA tax, FICA contributions continue to be withheld from compensation, including overseas allowances and tax reimbursements, even if some or all of the compensation is excluded for U.S. income tax purposes.

Employees performing services for a foreign corporation are not subject to FICA. However, U.S. citizens employed by a foreign corporation that is a subsidiary of a U.S. corporation may be covered by FICA if the U.S. parent corporation has entered into an agreement with the U.S. Treasury providing for coverage. All U.S. citizens and residents in the employ of the foreign subsidiary to which the agreement applies must be included in the agreement. The U.S. corporation must pay both the employer's and the employee's share of FICA. There is no requirement that the U.S. citizen or resident employed by the foreign subsidiary for whose benefit the payment is made reimburse the U.S. corporation for his or her share of the contribution.

Social security totalization agreements

A U.S. citizen working abroad may be subject to both U.S. and foreign social security taxes. The United States has entered into "totalization" agreements with a number of foreign countries providing for limited coordination of the U.S. social security system with the systems of the other countries.

Totalization agreements generally have two principal purposes: first, relief from double social security taxation and, second, reduction of minimum requirements to receive payment of benefits from each country. A totalization agreement may exempt the U.S. citizen from social security tax of one of the countries.

To establish exemption from compulsory coverage under a social security totalization agreement, an employer must apply for a certificate of coverage from the country with which the employee will remain covered. If requested, this certificate is presented to the appropriate officials of the country in which the employee seeks exemption to prove there is coverage under the social security system of the other country.

Totalization agreements also provide for a coordination of social security benefits. If an individual has accumulated periods of coverage under the social security systems of both the United States and the other country and if the period of coverage in either country is not long enough to entitle the employee to social security benefits, a "totalized" benefit may be obtained from either country. For this purpose, service in both countries is aggregated for testing service requirements, though the benefit from each country is calculated based on wage credits in that country. If the individual qualifies for benefits under the local law of one of the countries, he or she is not required to elect a totalized benefit in both countries. The individual would be entitled to the benefit from the former country and still could elect to receive a totalized benefit from the latter country.

At present, the United States has entered into social security totalization agreements with Austria, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. Additional agreements are under negotiation.

Foreign tax credit

Deduction versus credit

Foreign taxes paid or accrued

Disallowance of foreign taxes attributable to excluded income

Foreign tax credit limitation

Foreign-source income

Carryback and carryover of unused credits

U.S. citizens and residents may claim a foreign tax credit on their U.S. tax returns for income taxes paid to a foreign country. The purpose of the foreign tax credit is to avoid double taxation of income, once in the United States and once in the foreign country where income is earned. Accordingly, the foreign tax credit operates to limit the total tax on foreign-source income to the higher of the tax imposed by the foreign country or by the United States. Also, it prevents the taxpayer from using foreign taxes to offset U.S. tax on U.S.-source income. This is accomplished by a special limitation of the credit to the amount of U.S. tax on foreign-source income for the year. This limitation is discussed more fully on the following pages. Moreover, a portion of the foreign tax paid is disallowed to the extent it is attributable to the foreign earned income or housing exclusions discussed on pages 1-3.

Only foreign *income* taxes qualify for the credit. Foreign property, valued-added or similar taxes are not considered creditable income taxes. If foreign countries impose social security taxes that are in effect income taxes, these may be claimed as a foreign tax credit except for those imposed by countries with which the United States has a totalization agreement (as discussed on page 21-22).

Deduction versus credit

A taxpayer may either deduct foreign taxes incurred (as an itemized deduction) or elect to claim them as a credit. As a general rule, a credit is more beneficial in that it will result in a dollar-for-dollar reduction in tax. The election to claim a credit is an annual election, and it may be made at any time that the statute of limitations is open. If the election is made, it applies to all foreign taxes paid or accrued during the year.

Foreign taxes paid or accrued

Taxpayers may elect to claim the foreign tax credit either as taxes are paid or as they are accrued. If the paid basis is used, the foreign tax credit for the year is the total amount of foreign taxes actually paid during the year even though the taxes may relate to income taxable in a

different year. If the accrual method is elected, the taxpayer claims a foreign tax credit for his or her total foreign tax liability for the year even though the foreign tax is paid in a different year.

Example: Barbara, a U.S. taxpayer employed in a foreign country, has \$9,000 of foreign income taxes withheld during 2000. In March 2001, her 2000 foreign income tax return for calendar year 2000 is prepared and shows a tax of \$12,000. At this time, she pays the foreign government the \$3,000 balance due. During 2000, Barbara has \$10,500 of foreign income taxes withheld. When her 2001 foreign income tax return for calendar year 2001 is prepared in March 2002, it indicates a total tax of \$14,000 and the \$3,500 balance due is paid at this time. The following table compares the foreign tax credit claimed under the paid and the accrued methods.

	Foreign tax credit					
	Paid method			Accrued method		
	2000	2001	2002	2000	2001	2002
2000 tax withheld	\$9,000	\$ -	\$ -	\$ 9,000	\$ -	\$ -
2000 tax paid in 2001	-	3,000	-	3,000	-	-
2001 tax withheld	-	10,500	-	-	10,500	-
2001 tax paid in 2002	-	-	3,500	-	3,500	-
	\$9,000	\$13,500	\$3,500	\$12,000	\$14,000	\$ -

Once the accrued method is elected, it applies to all foreign income taxes. The election is binding for all future years, and it may not be revoked. Therefore, taxpayers must carefully consider this decision.

The accrued method permits a taxpayer to accelerate the time that the foreign tax credit may be claimed. This may be beneficial if the taxpayer is residing in a country that does not require payment of tax until the year after the liability arises. There is less benefit in those countries requiring withholding or estimated tax payments. Many taxpayers use the paid basis because it usually is easier to quantify the available credit. The accrual method should be elected in an original tax return. The IRS does not permit taxpayers to change from the cash method to the accrual method once a tax return has been filed for a particular year.

If the foreign tax actually paid for a year differs from the taxes accrued and claimed as a foreign tax credit for that year, IRS must be notified and the tax redetermined. Similarly, if a foreign country redetermines a taxpayer's foreign tax, the taxpayer should notify IRS by filing a Form 1040X, Amended U.S. Individual Income Tax Return, adjusting the available foreign tax credit claimed for the year. A special 10-year statute of limitations applies to filing claims for refund of federal tax due to adjustments to foreign tax credits. There is no statute of limitations with respect to adjustments to a taxpayer's foreign tax liability that would result in an increase in U.S. tax liability for an earlier year. Therefore, an amended tax return adjusting the earlier foreign tax credit must be filed regardless of when the foreign adjustment occurs.

Foreign taxes are converted into U.S. dollars using the exchange rate on the date the foreign tax is paid. If the taxpayer uses the accrued method, the exchange rate used for accrued but unpaid taxes is the average exchange rate for the tax year to which the taxes relate. This rule does not apply to foreign income tax paid two years after the close of the tax year to which the taxes relate, to taxes paid in a year prior to which they relate, or to tax payments denominated in an inflationary currency. Foreign taxes to which this rule does not apply, are translated into U.S. dollars using the exchange rate as of the time the taxes are paid. If use of the exchange rate in effect when the tax is paid results in a difference in U.S. tax liability that exceeds either \$10,000 or 2 percent of the foreign tax (in U.S. dollars), the taxpayer should amend the tax return (as discussed on page 24). Any lesser difference may be reflected on the current-year tax return. If the different exchange rate results in no change in the foreign tax credit used, the taxpayer need only adjust the foreign tax credit carryforward.

Disallowance of foreign taxes attributable to excluded income

A foreign tax credit or deduction is not allowable for foreign taxes attributable to excluded income. The formula used to compute the disallowance is:

$$\frac{\text{Excluded foreign earned income less disallowed deductions}}{\text{Total foreign earned income less allocable deductions}} \times \text{Foreign taxes paid or accrued} = \text{Disallowed foreign taxes}$$

If the foreign taxes are imposed not only on foreign earned income but also on other income, such as U.S. or foreign-source income, dividends, interest, etc., that income also may be included in the denominator of the formula as further discussed below and on page 11.

The disallowed foreign taxes are not available as a deduction or as a credit carryover to other years.

Foreign tax credit limitation

When a taxpayer elects to claim foreign taxes as a credit, a computation must be made to determine the maximum amount of foreign tax that can be taken as a credit against the U.S. tax liability.

The foreign tax credit for the year is limited to the *lesser* of:

- The actual foreign income taxes paid or accrued during the year to all foreign countries (less any disallowed foreign taxes attributable to excluded income) plus carryovers or
- The amount of U.S. tax on foreign-source taxable income for the year.

To determine the maximum amount of foreign taxes that can be credited for the year, the following limitation formula is used:

$$\frac{\text{Foreign-source taxable income before exemptions}}{\text{Total taxable income before exemptions}} \times \text{U.S. tax} = \text{U.S. tax on foreign-source taxable income}$$

This formula must be applied separately to various categories of foreign-source income, including passive income, shipping income, financial-services income, dividends from 10 percent to 50 percent owned foreign subsidiaries and “all other” foreign income. The separate foreign tax credit limitation formula for each category of foreign income prevents a taxpayer from using excess foreign tax credits generated by one type of income (e.g., salary) against U.S. taxes on foreign-source income of another type (e.g., passive income such as interest, dividends or capital gains). The two categories most applicable to expatriates are: (1) passive income and (2) “all other” income.

Foreign-source income

To determine the numerator of the limitation formula for each income category, it is necessary to compute foreign-source taxable income. In making this computation, except where otherwise indicated, it is irrelevant whether the income actually was subject to foreign taxation. Foreign-source income includes the following items:

- Compensation for services performed outside the United States.
- Dividends received from foreign corporations not engaged in a U.S. business.
- Interest income received from a foreign payor.
- Rent and royalties generated by property located outside the United States.
- Capital gains and losses from the sale or exchange of real property located outside the United States.
- Certain capital gains from the sale or exchange of personal property (including corporate stock) by an expatriate. If the expatriate’s tax home is outside the United States and if an income tax of at least 10 percent of the gain is actually paid to a foreign country, the gain is foreign source regardless of where title passes. Where either of the two conditions is not met, all gains are U.S. source regardless of where title passes.

Adjustments and deductions that are allocable or apportionable to foreign-source income must be subtracted from foreign-source gross income to arrive at foreign-source taxable income. For example, qualified unreimbursed moving expenses incurred in a move to a foreign country generally are allocable directly to foreign-source income. In theory, the employee incurs these expenses in anticipation of future services to be rendered in a foreign country. When a taxpayer rents his or her home in the United States, rental expenses are directly

allocable to U.S.-source rental income. Deductions that are not directly allocable to either U.S.- or foreign-source income are apportioned ratably between U.S.- and foreign-source income. Items that are ratably apportioned include the standard deduction, and most, but not all, itemized deductions. Any foreign losses from a particular income category are first allocated proportionately to other foreign income categories and then, if all foreign income is offset, to any U.S. income. Any U.S. losses reduce proportionately the categories of foreign-source income. The effect of these rules is to further limit foreign tax credits that may be claimed.

Example: Ron is a U.S. expatriate, married with no children and residing in Chile. He earns \$120,000 annually and works a total of 240 days, 20 in the United States and the remainder in South America. He incurs annual housing expenses in Chile of \$19,500. His annual foreign-source dividend income and interest income are \$3,000 and \$6,000, respectively. His home in the United States is rented out, and he receives \$8,000 of rental income and incurs \$14,000 of rental expenses. Ron does not itemize deductions. His foreign tax credit limitations for 2000 are computed in the accompanying chart on page 28.

Many taxpayers are subject to the alternative minimum tax (AMT). The AMT is imposed on taxpayers with significantly reduced regular-tax liability because they have made use of certain “tax preferences,” i.e., certain exclusions, deductions or credits. The foreign earned income and housing exclusions are not considered tax preference items for AMT purposes. The AMT is computed as 26 percent of AMT income up to \$175,000, and 28 percent of AMT income over \$175,000. Foreign tax credits can be used to offset the AMT. However, there is a separate calculation of the foreign tax credit limitation for AMT purposes. Further, the AMT foreign tax credit can only offset up to 90 percent of a taxpayer’s AMT liability. As a result, many expatriates who would otherwise have no U.S. regular tax due to the exclusions and foreign tax credit do have some AMT liability. (For examples of the AMT calculation, see page 13.)

Carryback and carryover of unused credits

The amount of any regular tax or AMT foreign tax credit that exceeds the limitations for any year may be carried back to the two prior tax years and thereafter carried forward for five years and used to offset a taxpayer’s regular tax or AMT as the case may be. The amount carried back or forward to any year is treated as additional foreign income taxes paid or accrued in the year to which carried. Unused foreign tax credits must first be carried back to the earliest taxable year (the second prior year) and then forward in chronological order. Having been subject to disallowance attributable to foreign earned income excluded in the year from which carried, foreign tax credits carried to another year are not again subject to disallowance in the year to which carried.

Sourcing of income — example

2000				
	Total	U.S. source	Foreign source	
			Passive	All other
Income				
Compensation	\$120,000	\$10,000 ¹		\$110,000
Dividends	3,000		\$3,000	
Interest	6,000		6,000	
Gross rental income	8,000	8,000	–	–
Gross income	137,000	18,000	9,000	110,000
Deductions and exclusions				
Housing exclusion (\$19,500 – \$10,171)	(9,329)	–	–	(9,329)
Foreign earned income exclusion	(76,000)	–	–	(76,000)
Rental deductions ²	(14,000)	(14,000)	–	–
Standard deduction ratably allocated	(7,350)	(966) ³	(483) ⁴	(5,901) ⁵
Taxable income before personal exemptions	\$ 30,321	\$ 3,034	\$8,517	\$ 18,770
Taxable income after personal exemptions	\$ 24,721			
U.S. tax on net taxable income	\$ 3,708			

Foreign tax credit limitation for 2000

Passive income:

$$\frac{\$8,517 \text{ Foreign-source taxable income}}{\$30,321 \text{ Total taxable income}} \times \$3,708 \text{ U.S. tax} = \$1,042$$

All other income:

$$\frac{\$18,770 \text{ Foreign-source taxable income}}{\$30,321 \text{ Total taxable income}} \times \$3,708 \text{ U.S. tax} = \$2,295$$

¹ $\frac{20 \text{ U.S. business days}}{240 \text{ Total business days}} \times \$120,000 = \$10,000$

² Taxpayer actively participates in the rental activity.

³ $\frac{\$18,000 \text{ U.S. gross income}}{\$137,000 \text{ Total gross income}} \times \$7,350 = \$966$

⁴ $\frac{\$9,000 \text{ Foreign-source passive gross income}}{\$137,000 \text{ Total gross income}} \times \$7,350 = \$483$

⁵ $\frac{\$110,000 \text{ Other foreign-source gross income}}{\$137,000 \text{ Total gross income}} \times \$7,350 = \$5,901$

Foreign country taxation of U.S. expatriates

Short-term business trips

Long-term foreign assignment

Method of tax assessment

Most countries impose income taxes on individuals either working or deriving income within their borders. Therefore, most expatriates will be subject to local country taxation on income earned within that country. In some instances, they will be taxed as residents, in other instances as nonresidents. With a thorough knowledge of the local country tax system, and careful planning, the expatriate's compensation package may be structured to reduce local country taxes.

Short-term business trips

For business trips of up to six months, most foreign countries impose income tax on earnings generated in that country. However, the tax can sometimes be limited either by unilateral exemption or by income tax treaties. An income tax treaty is an agreement between two countries to minimize double taxation of residents of one treaty country doing business in the other. Treaties provide that:

- Only one treaty country will impose taxes or
- The taxes imposed will be at a limited rate or credited against the taxes imposed by the other.

Either provision avoids double taxation. For example, most U.S. income tax treaties include a provision that exempts a U.S. citizen's income from taxation by the foreign country provided he or she spends less than 183 days in that country during the year and the compensation is not paid or borne by an employer in the foreign country. This provision generally eliminates a double tax burden for expatriates on short-term business trips of up to six months. The United States has income tax treaties with over 55 countries.

Long-term foreign assignment

Most foreign countries assess a tax on income earned in those countries during business trips of longer than six months and on worldwide income earned by residents. Generally, the imposition of tax on residents is not limited by income tax treaties, except in the cases of certain teachers, students and trainees.

A number of countries, in an attempt to attract foreign investment or to encourage the establishment of regional headquarters, grant special concessions to expatriates. These concessions take a variety of forms. Some countries tax only a certain percentage of the expatriate's earned income, provided certain requirements are met. For example, Belgium allows qualifying expatriates exclusions for certain allowances and reimbursements up to a specified maximum. In addition, earned income attributable to travel days outside Belgium may be excluded from taxable income. Several countries do not tax income having its source outside the country, provided the foreign-source income is not remitted into the country. Other countries tax only income remitted to the country regardless of its source. These concessions may or may not be limited to the first few years of residence in the country, and they generally apply regardless of whether there is a tax treaty. In some cases, the individual must choose between the benefits of the concessions and the benefits of the applicable treaty.

In addition to special rules for foreign residents, every country has detailed rules applying to all taxpayers, specifying which elements of an employee's compensation are taxable as income. Certain compensation items that are taxable under U.S. law are not taxable under foreign law, and vice versa. Every country also has detailed rules concerning investment income. Many countries impose no tax on capital gains; others impose no tax, or a limited tax, on dividend and interest income.

Rules relating to tax deductions also may differ from U.S. rules. Some countries allow deductions for local social security taxes, life insurance premiums and commuting expenses. These items generally are not deductible for U.S. income tax purposes. On the other hand, many countries do not allow deductions for home mortgage interest and real estate taxes. A charitable contribution deduction is allowed under most countries' income tax laws, but only for contributions to local charities. With limited exceptions, U.S. law allows a deduction only for contributions to U.S. charities.

Some items of income and fringe benefits that are taxable in the United States may be tax free in other countries. Employers frequently structure compensation packages to include these fringe benefits to achieve significant local tax savings. Deferred compensation is often used to reduce the overall host country and U.S. tax burden. An analysis of the interaction of foreign and U.S. tax law must be made to determine if deferred-compensation plans are beneficial. As discussed earlier, if income is received later than the year following the year it is earned, it is not eligible for the U.S. foreign earned income exclusion.

Any techniques for compensating expatriates should be implemented only after consultation with tax and exchange-control specialists in the host country.

Method of tax assessment

The U.S. self-assessment income tax system is somewhat unique. In many countries, the tax return is simply a listing of income, withholdings and deductions without any computation of the balance of tax payable. The local tax administration computes the tax due on the basis of information provided in the return, and sends the taxpayer a bill.

Often several months elapse between the filing of the foreign tax return and receipt of the assessment. Accordingly, the precise amount of the income tax for a given year may not be known at the time the U.S. return is filed. This can pose a problem when the accrued method for claiming the foreign tax credit on the U.S. return is used, as discussed on page 24.

In some countries, the tax year does not coincide with the calendar year. The United Kingdom's tax year, for example, runs from April 6 through the following April 5, and Australia's runs from July 1 through the following June 30. When claiming the foreign tax credit on the accrued method for one of these (or similar) countries, the foreign tax credit generally is determined by reference to the liability for the foreign tax year that ends within the U.S. tax year. When computing the foreign tax credit disallowance for these countries, as discussed on page 25, foreign taxes are deemed to accrue ratably as income is earned.

Other considerations

Sale or rental of principal residence

State taxation

Several tax-related considerations unique to expatriates should be addressed before or during an expatriate assignment. Problems can be resolved best by appropriate planning prior to a person's departure from the United States and by consultation with competent tax advisers.

Sale or rental of principal residence

One of the most important decisions an expatriate will make when accepting a foreign assignment is whether to sell his or her home. Due to increasing real estate values and fluctuating interest rates on home mortgages, some expatriates decide to retain their homes during their assignments.

Certain tax rules apply if an expatriate decides to sell a principal residence. Individuals may exclude up to \$250,000 of gain (\$500,000 if married filing jointly) on the sale of a principal residence where the home has been used as a principal residence for at least two of the five years preceding the sale. This is a permanent exclusion, not just a deferral or rollover of gain until a later time. Moreover, there is no reinvestment requirement. The exclusion may be claimed only once every two years. If, because of health reasons, a job relocation or other unforeseen circumstances, the taxpayer fails to meet the two-years-out-of-five ownership and use requirements or has a second sale of a residence within a two-year period, an exclusion may still be available, but only for a portion of the gain.

Example: In January 2001, Mary Ann, who is single, sells her home for \$400,000 at a gain of \$230,000, which is fully excluded. She immediately buys a condo for \$225,000. (Note that with the exclusion of up to \$250,000, Mary Ann pays no tax on the \$230,000 gain.) Six months later her employer transfers her to another city and she sells the condo. Although Mary Ann did not own and use the condo as a residence for two years, she will have a pro rata portion of the exclusion available to her. Because she had used the condo as a principal residence for six months, or one fourth of the required two-year period, she can exclude her gain up to \$62,500 (25 percent of \$250,000).

If an expatriate decides to retain and rent the residence, the rental income must be included in the U.S. income tax return but certain deductions against this income are allowed. Frequently, these deductions create a net rental loss because deductions are allowed for such items as depreciation, repairs and maintenance, insurance and management fees as well as mortgage interest and real estate taxes. The rental losses may be disallowed to some extent under the “passive loss” rules.

Depreciation may be claimed on the rented residence. The depreciable basis of the property is the lower of the fair market value on the date the property is converted to rental property or the adjusted cost basis of the property. The adjusted depreciable cost basis of the property is original cost, less the cost of the land, which cannot be depreciated, plus any capital improvements. Basis also must be reduced by any depreciation allowed or allowable in prior years. If the expatriate realized a gain on the sale of a principal residence in a prior year and deferred the recognition of the gain by reinvesting the sales proceeds in a new house that is to be depreciated, the depreciable basis in the new house must be reduced by the amount of the deferred gain. When the house is sold, any gain relating to depreciation claimed after May 6, 1997, cannot be offset by the capital gain exclusion discussed on page 32. If an expatriate rents his or her home and later sells the home at a gain, the portion of the gain attributable to depreciation will be subject to tax at a 25 percent rate.

State taxation

Some expatriates may continue to be liable for state income taxes even though they are residing abroad. Depending on the state, if an individual retains a permanent home in that state, he or she may continue to be subject to state taxation.

To prevent state taxation of income earned after leaving the state, the taxpayer must be able to support the contention that residence has been terminated in the state. Some states issue questionnaires on which the taxpayer is required to affirm that he or she has terminated residence and inform the state of the actions taken to terminate residence. Actions pointing to a termination of residence include closing bank accounts and brokerage accounts; resigning from church, social and business club memberships; closing all safety deposit boxes and department store charge accounts; allowing driver’s licenses to expire; and abstaining from voting in any state elections.

Note that termination of state residence may subject dependent children to more rigorous acceptance standards and more costly nonresident tuition rates at state colleges and universities.

Income tax reimbursement

Tax protection and tax equalization

Expatriates are subject to a total income tax burden that generally is either higher or lower than what they would have been subject to had they not left the United States. Although base salary and bonus may remain the same, the total income tax liability generally is different. For example, income taxes increase dramatically when the expatriate is stationed in a country that has a higher income tax rate than the United States and receives assignment-related allowances. Many companies have adopted tax-reimbursement policies under which the expatriate is reimbursed for increased income tax costs arising from the foreign assignment. The policies usually cover only income and social security taxes and specifically exclude other taxes such as value-added taxes.

Tax protection and tax equalization

Generally, one of two basic types of tax-reimbursement policies is used — tax protection or tax equalization. Under both types, the employee is not held responsible for any taxes in excess of the amount of the “hypothetical tax,” which represents the tax the expatriate would have paid had he or she remained in the United States. The hypothetical tax is computed on the expatriate’s regular “stay at home” compensation and other income and losses if the employee is to be reimbursed for the increase in tax on personal income. Either actual or hypothetical itemized deductions (frequently set at a certain percentage of income) are allowed, along with the expatriate’s exemptions. The hypothetical tax liability also may include a hypothetical state income tax liability.

Under a *tax-protection policy*, the company reimburses the employee for all actual taxes paid, both U.S. and foreign, in excess of the hypothetical tax liability amount. Therefore, the employee is protected from an overall tax burden higher than what would have been incurred had the employee remained in the United States. Generally, the expatriate files the U.S. and foreign tax returns and pays all the taxes. If the sum of the foreign and U.S. tax liabilities is higher than the hypothetical tax, the company reimburses the expatriate for the difference. If the actual tax liability is less than the hypothetical liability, the expatriate realizes a windfall.

Under a *tax-equalization policy*, the expatriate is assured that he or she will pay neither more nor less tax on foreign assignment than what would have been paid had the employee remained in the United States. A hypothetical tax computation is made in the same manner as under a tax-protection plan. However, under tax equalization, the hypothetical tax generally is retained by the employer and the employee's pay is reduced. The company assumes and pays all actual foreign and U.S. tax liabilities directly. A yearend tax settlement is generally made to adjust the amount retained by the employer to the final hypothetical tax liability. Because the employee's compensation is reduced by the amount of the hypothetical tax, the amount withheld by the employer is not included in income and is not subject to U.S. or foreign tax. This results in a tax deferral to the company and possibly an actual reduction in total tax cost.

The following examples demonstrate the difference between tax protection and tax equalization.

Example: In 2000, a U.S. citizen, married with two children, has a compensation package and hypothetical tax calculation as follows:

Compensation	
Base salary	\$ 90,000
Cost-of-living allowance	18,000
Housing allowance	30,000
	\$138,000

Hypothetical tax calculation	
Base salary	\$ 90,000
Outside income	3,600
Standard deduction	(7,350)
Personal exemptions	(11,200)
Taxable income	\$ 75,050
U.S. hypothetical tax	\$ 15,314
State hypothetical tax (3.5%)	2,688
Total hypothetical tax	\$ 18,002

This individual's tax-reimbursement, in a low-tax and a high-tax country, under the tax-protection and the tax-equalization methods, is:

	Tax protection	Tax equalization
Low-tax country		
Actual U.S. and foreign tax	\$ 3,000	\$ 3,000
Hypothetical tax	(18,002)	(18,002)
Due to employer	\$ -*	\$15,002
* Employee receives windfall of \$15,002		
High-tax country		
Actual U.S. and foreign tax	\$45,000	\$45,000
Hypothetical tax	(18,002)	(18,002)
Due to employee	\$26,998	\$26,998

In a high-tax country, there is no difference in the result between a tax-protection program or a tax-equalization program. However, in a low-tax country, under a tax-protection program, the expatriate realizes a windfall.

Both programs, however, ensure that the expatriate does not bear an excess tax burden as a result of the foreign assignment.

When the expatriate completes the foreign assignment and returns to the United States, the final tax-reimbursement payment normally is “grossed up” so that the employee receives not only the final tax reimbursement but also the tax on the final tax reimbursement itself.

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