How U.S. Expats Can Exclude More Than $100,000 From Taxes

By Chuck Bolotin | 11/21/15 - 08:27 AM EST

Few people are not interested in legally reducing their taxes.

By living in a foreign country and meeting some other criteria, you could exclude up to $108,000 of earned income from your 2015 U.S. tax return. That can certainly be an advantage of being an expat.

The website Best Places In The World To Retire has collected more than 6,500 answers from expats to frequently asked questions about living abroad. These include cost of living, safety and healthcare.

Several expats said that they were using the Foreign Earned Income Exclusion to reduce their tax liability to Uncle Sam, and that the ability to do so was a contributing factor in their decision to move.

Alfonso Galindo, a businessman in Mexico who was born and raised in California, said that he knew individuals who were "fifty-fifty about moving to Mexico." He added that when they learned that "they could exclude over $100,000 in taxable earned income from their U.S. returns through the Foreign Earned Income Exclusion, they thought about how much more money that would put in their pocket, and when they combined that with the lower cost of living in Mexico even without the exclusion, that made all the difference."

How does this work?

David McKeegan, co-founder of Greenback Expat Tax Services and now living in Bali, and and tax attorney Don Nelson of TaxMeLess.com in California, considered a fictional expat named George. Both experts stressed that they were providing only general information and examples. There can be complicating circumstances. Everyone's tax situation is different, and before using the Foreign Earned Tax Exclusion, they strongly recommend obtaining the counsel of a qualified professional.

McKeegan said that the Exclusion might have been developed "to encourage Americans like George to do business overseas, because that helps spread American ideas and American values."

McKeegan said that many expats can exclude their entire income using this one exclusion.

Nelson said that the initial condition that George had to meet to qualify for the Exclusion was that he could not be on U.S. soil while he does the work." Nelson further clarified that "the determining factor is where George is located when he does the work, not where his customers are located when they receive the benefit of George's work, or even if George gets paid by a U.S. corporation."

"George could work for an existing U.S. corporation, but work from where he lives in Thailand over the phone for customers located in the U.S., and qualify," Nelson said. "George could even form a U.S. corporation because his customers feel more comfortable working with one, and still qualify. I know a lot of IT professionals who do this."

Expats who want to take advantage of the Exclusion must pass a Physical Presence Test or the Bona Fide Residence Test. Most expats use the Physical Presence Test, as it's the "most straight-forward" way to qualify, McKeegan said.

He added that the Physical Presence Test would require George to be present in a foreign country for 330 of any 365-day period.

Nelson explained that George could live abroad for a year and then return. However, under the Bonafide Residency Test, "George would have to demonstrate that he was moving abroad as a full-time resident, and that he would be there for a while," he said.

Nelson also emphasized that George could only apply the Earned Income Exclusion to earned income, as opposed to such areas as rent, dividends, interest and capital gains, and that, in certain circumstances, George could prorate his exclusion. According to Nelson, George could still take his other deductions and exemptions.

"George would still also receive his standard deduction and his dependent's exemption, at least for himself," he said.

McKeegan pointed out that qualifying for the Earned Income Exclusion did not, by itself, exclude payroll taxes, but there were ways to eliminate these as well. "If George qualifies for the Foreign Earned Income Exclusion, makes $100,000 and has a Nevada LLC, he will still get a bill for $15,300 for his Social Security and self-employment taxes," he said. "However, in many circumstances, George could set up a corporation overseas and then would not be responsible for paying self-employment tax."

Nelson told us that, assuming George's spouse is also employed, many expats like George effectively doubled the value of the Exclusion because their spouse could also qualify independently. "Lots of married expats do exactly this while both working for the same company, or different companies," Nelson said.

In addition to the Exclusion, both McKeegan and Nelson told us that savvy expat taxpayers considered state income taxes. In one category are states that have zero personal income tax.

For these states, how or if the Exclusion is applied is not an issue. In another category are states with an income tax that allows the Exclusion to be applied. In a third category, however, are a few states that do not.

McKeegan said that, "California is known as one of the worst states." He said that if George has a California driver's license or even a library card, and even if George qualifies for the Foreign Earned Income Exclusion he will still be required to potentially pay taxes in California."

McKeegan said that the solution is "before George moves overseas he could become a resident in a zero tax state." He said, "I know a bunch of would-be digital nomads who originally were in California and moved to Austin because Texas is a zero personal income tax state. Only after they established residency in Texas did they move overseas. Then they don't have to worry about state taxes, at all."

Just because George may qualify for Exclusion for U.S. income taxes doesn't mean that he automatically pays zero taxes in his expat home. That's a topic for another article.