Alleviating Double Taxation on Foreign Income at the State Level

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As the fiscal lives of an increasing number of U.S. residents' cross international borders, tax planning for these individuals is full of complications. In this article, Mary Beth Lougen, EA, USTCP discusses tax strategies and tips to alleviate double taxation on foreign income at the state level, using tax relief provisions offered by the states to offset taxation by a foreign jurisdiction.

For those of U.S. who work in the arena of international taxation our idea of a great client is one who lives in Texas, Washington or any of the seven states that do not impose income tax on their residents. On a good day figuring out how to prepare the federal tax returns for people whose fiscal lives cross international borders can be vexing and time consuming. But throw an extra taxing jurisdiction into the mix and there are now another set of regulations to consider. What may have been the best outcome when considering only the implications at the federal level may no longer be the case.

Let's start with the basic concept of double taxation. Double taxation occurs when the same income is subject to tax by more than one taxing jurisdiction or in the hands of more than one taxpayer. The example most people in the tax industry are familiar with is the taxation of dividends- company earnings are taxed at the corporate level, and again in the hands of the shareholder when they are distributed. Another common example is taxation of wages earned in one place when the employee lives in another, as is the case with many people who work for the government in our nation's capital. These individuals may live in Virginia, Maryland or the District of Columbia but commute across the boundaries to work in another jurisdiction. To simplify things, many states have reciprocal agreements with neighboring states that allow the employee to pay tax only to their state of residence, not the state where they earn their wages, thus eliminating double taxation. Virginia, Maryland and the District of Columbia have a reciprocal agreement which allows the employer to withhold taxes for the state of residence rather than the state of employment. The employee simply completes an exemption form for the employer, the employer withholds taxes for the state of residence and the taxpayer only need file a state return where they live. Double taxation at the federal level is not quite as easy to remedy. Choices must be made whether the best overall outcome for the client is to exclude foreign earned income (Form 2555), take a credit for taxes paid to a foreign jurisdiction (Form 1116) or whether a treaty provision (Form 8833) will provide something even better. In most cases double taxation can be eliminated on the federal level (not the case with the new Net Investment Income Tax but that is a different article); and the most challenging part of your day is deciding which option lets your client pay the least amount of overall taxes when all jurisdictions are netted. This is not the case with the U.S. states- the inconsistent treatment of foreign income and foreign taxes paid across the 43 states that have income taxes and the District of Columbia-makes every tax return a new adventure.

The easiest states to work with are the ones that provide no relief from the double taxation of foreign income. It isn't a great outcome for the client, but it is usually pretty straight forward. These states are Alabama, New Jersey and Pennsylvania (2014 forward). California does not allow a remedy for double taxation from foreign income unless the client meets the conditions to be considered a nonresident under the safe harbor rules. There are several possibilities offered by the rest of the states to offset taxation by a foreign jurisdiction. These include allowing your client to be treated as a nonresident of their state of domicile while they are outside of the state, exclusions of foreign income under I.R.C. § 911 or a tax treaty, and deductions or credit for taxes paid to the foreign country. You will need to look at each state's regulations to see which provision or combination of provisions is allowed for your client's situation, and further which combination of remedies provide the best overall outcome when all the taxing jurisdictions are considered. Below is a broad description for each type of relief-keep in mind each state will likely put its own spin on who may qualify to use it, as well as which of the following are allowed under that state's tax laws.

Safe Harbor Provisions

Safe harbor provisions offered by some states allow their domiciliaries to be treated as nonresidents of the state for income tax purposes when they are on foreign assignments for certain periods of time. Typically, 15 to 18 months outside the state will trigger the safe harbor rules. Be sure to read the regulations carefully to make sure your client meets the qualifications to be treated as a nonresident during their absence from the state.

California allows a domiciled taxpayer to be taxed as a nonresident of the state if they are outside of California for an uninterrupted period of at least 546 days under an employment related contract, unless they have intangible income of greater than $200,000, or the principal reason for their absence is tax avoidance.[1] The employment related contract can be in another country or another state. The taxpayer is also allowed to have up to 45 days of presence in the state each tax year before they no longer can claim the safe harbor. A person can start filing as a nonresident on the presumption that their out-of-state assignment will last the required 18 months; but if for some reason their foreign employment terminates early and the 546-day requirement will not be met, any tax years for which the taxpayer treated themselves as a nonresident must be refiled as a resident and all taxes owed for that period must be paid.
Persons who do not meet safe harbor's strict guidelines would then look to their facts and circumstances to determine whether they are residents or nonresidents under California tax law.

Maine on the other hand has two safe harbor exceptions to the residency rules.[2] One exception is based on the location of a taxpayer's permanent abode and time spent in Maine; the other relates to time spent in a foreign country. Under the foreign safe harbor rules, if a Maine domiciliary is present in a foreign country for at least 450 days in any 548 consecutive day period, does not maintain a permanent place of abode where their spouse and children are present for more than 90 days, is not present in Maine for more than 90 days during that period and during the first and last year of the 548 period they have not spent more than the proportional number of the allowed 90 days of presence in Maine, the taxpayer can be treated as a nonresident for state tax purposes.
By comparison California and Maine have very similar rules in some areas such as time spent outside the state, allowing presumptive filing as a nonresident and the requirement that the taxpayer amend prior returns to resident status if the rules are not met at the end of the safe harbor period. However, the two are very different in other key aspects. For example, California is very specific about the reason for the absence, while Maine does not specify that it must be for employment. Additionally, the two differ with regards to the allocation of the days of presence in the state during the safe harbor period. It is apparent that under the same circumstances, while a taxpayer in California may not be able to claim the safe harbor, a taxpayer in Maine may have qualified.

Most clients that accept foreign assignments can meet the safe harbor rules if their families go with them. In cases where the spouse and child remained in state while the taxpayer is abroad, they are generally precluded from being able to file as safe harbor nonresidents.

Safe harbor states include California, Connecticut, Delaware, Idaho, Maine, Missouri, New York, Oklahoma, Oregon and West Virginia.

Foreign Earned Income Exclusion

Under I.R.C. §911 a person who is working outside the U.S. may exclude from their taxable income up to $99,200 of foreign earned income for 2014. In order to qualify, the individual's tax home must be in a foreign country and the individual must either be physically outside the U.S. for 330 days in any 12 month period or have bona fide residence in a foreign country. If the taxpayer maintains an abode in the U.S., their tax home is considered to remain in the U.S. and they will not qualify to use the foreign earned income exclusion on their federal or state tax returns.

Many states allow the foreign earned income exclusion; others will make you add back the excluded income before calculating the state taxable income. If no exclusion is allowed, the state may provide a safe harbor, a credit for taxes paid to a foreign country or a deduction of foreign taxes paid as part of the state itemized deductions to provide relief from double taxation. You will have to check each state's coordination rules to see if you can take the credit or deduction when you have used the I.R.C. § 911 exclusion on the federal return when it is disallowed for state filing.

The exclusion is usually the best course for clients working in a foreign country that does not impose an income tax, or has rates lower than the U.S., such as
Saudi Arabia. These lucky taxpayers can end up with tax free wages on all levels if the state of domicile also allows the exclusion. Even if your client falls into this group don't automatically assume that the § 911 exclusion is the best way to go. Consider clients that have children under the age of 17 who would otherwise qualify for the child tax credit. If there is a way to eliminate or reduce the federal tax liability to below the allowable credit amount using other deductions and credits, the balance of the child tax credit will be pushed down to the additional child tax credit and become refundable. Conversely, if all the earned income is removed from Form 1040 then no refundable credit for the children will be allowed. I have also found with couples both of whom work outside the U.S. that sometimes excluding just one of the incomes results in a better overall outcome. To make this even more interesting, some states like New York[3] have their own version of the child tax credit which can be impacted by whether or not the credit appears on the federal return. For example, the New York Empire State Child Credit starts at $100 per child over the age of four if no child tax credit is claimed on Form 1040; and maxes out at one third of the federal credit. This strategy will need to be balanced against the extent a state liability is created by not excluding the income on the federal return.
For example, married taxpayers domiciled in N.Y. with two children in elementary school, both currently working in the United Arab Emirates earning a combined $60,000 USD annually (husband earns $40,000, wife earns $20,000) will pay no tax to the UAE, and none to the U.S. or New York State if they use Form 2555 to elect the I.R.C. §911 exclusion. No taxes owed; no refund being received— many consider this the perfect solution. But there is the potential for the taxpayer to receive $2,660 in refunds due to the child tax credit between the 1040 and NY returns- $2,000 additional child tax credit on the federal return and $660 for the Empire State Child Credit. Look for ways to eliminate or reduce the federal or state tax liabilities by taking above the line or itemized deductions, utilize other nonrefundable credits such as for childcare or higher education, or it could even be as simple as only excluding only one spouse's income. In the case of the family in this example, if you exclude only the husband's wages, they will receive the full benefit of the child tax credits and a refund of $2,660 between the federal and state returns.

Be mindful of the federal rules surrounding revoking this election. Using the foreign tax credit subsequent to using Form 2555 will result in preclusion from excluding income again for 6 years, so you need to have an eye to the future when working this strategy.

Most young families could really use the extra monies to help cover additional expenses for their families or even to cover the costs involved in having a cross border tax professional prepare their tax returns while they are abroad. Besides, this type of strategy is one of the reasons why our clients pay U.S. instead of doing it themselves.

Credit for Taxes Paid to Another Country

The foreign tax credit is a dollar-for-dollar reduction of taxes for each dollar of income tax paid to a foreign taxing jurisdiction. On the federal side any excess credits are carried back one year and then forward 10. Using the foreign tax credit to reduce U.S. taxes on foreign wages will still allow the taxpayer to receive the Additional Child Tax Credit, which can result in a very nice refund for your client.

A great deal of variance exists in the state regulations surrounding foreign tax credits so you will have to read the rules carefully when considering this method of alleviating double taxation. Some states will allow a credit for taxes paid to any foreign country; others allow a credit only for Canada and/or its provinces, and a couple even narrow the credit to just foreign jurisdictions that are analogous with a U.S. state such as a Canadian province or Mexican state. Minnesota allows a credit for taxes paid to a Canadian province, but a subtraction from income for taxes paid to a subnational level of all other foreign countries. Others do not offer the credit at all.

A common limitation of the credit is that the amount of the credit on the state return cannot exceed the amount of foreign taxes paid, less the credit taken on the federal return on Form 1116. But, this is not always the case. For example, Louisiana gives you 10 percent of the credit taken on the federal return or you can take a deduction from income for the taxes paid to the foreign country; Michigan will give you a credit for Canadian provincial taxes paid but you must have filed a Canadian tax return and taken the foreign tax credit on Form 1040; and Delaware will not give you a credit but will instead allow you to deduct foreign taxes paid as part of the state itemized deductions, even if you did not deduct them or itemize on the federal return. The variances in the application of this credit are vast and you will need to exercise due diligence in your research to make sure you have executed the credit correctly. Keep in mind that states will generally offer a credit for taxes paid to other states, but depending on how the regulations are written, a foreign country may or may not fall within the definition of "other state". To discern this often means a trip into the state tax regulations.

Foreign Tax Deduction

Deductions of foreign taxes from taxable income are often the least effective way to deal with double taxation, but sometimes it is all you have available to you, even on the federal level. Again, there is little consistency between states on the deduction of foreign income taxes. Many states do not have itemized deductions, therefore no foreign tax deduction. Some states begin their computation with federal taxable income so if the foreign taxes were included on federal schedule A, they are inherently deducted on the state return. Idaho doesn't have a foreign tax credit but will allow an itemized deduction for the amount that would have
been allowed on the federal return had the credit not been taken. Maryland will allow foreign taxes as an itemized deduction, but you must have itemized on your federal return.

Tax Treaties

The United States has tax treaties with a number of foreign countries that allow certain income to be taxed at a reduced rate or exempted from taxation all together by either the country of residence or the country of source. Most of the taxpayer-friendly provisions of the tax treaties do not apply to citizens of the U.S. thanks to a provision called the “savings clause” which essentially states that the U.S. has the right to tax its citizens as if no treaty existed. However, in the paragraph following the savings clause is a list of exceptions to the rule. These exceptions allow U.S. citizens to take advantage of specific sections of the tax treaty and can be used as an advantage in both federal and state tax preparation. Not all states honor the tax treaty, so you may have to do a bit of searching to discern whether this is a possibility for your client.

I work on the United States- Canada Tax Treaty on a regular basis and we often use Article XVIII(5) which exempts benefits received under the social security legislation of Canada or the U.S. from U.S. taxation if the recipient resides in Canada. Another provision that can really move the numbers on U.S. and state returns is found in the new Fifth Protocol to the treaty in Article XVIII(8-13) which allows a U.S. citizen to reduce his or her taxable income by the amount of contributions into certain Canadian retirement plans. For obvious reasons this can be quite a tax saver if taxable income is reduced by thousands of dollars. Generally this is not needed on the federal level as Canada’s tax rates tend to be higher than the U.S.’s in most instances, but can be very handy in situations where you need to reduce state taxable income.

Conclusion

A reference table has been provided at the end of this article to point you in the right direction for dealing with each state and what they allow in regard to foreign income taxes paid by your client. This should only be used as a starting point; you will need to ascertain all the fine points for executing a strategy for your client by researching the state regulations as they pertain to your clients situation.

Nothing is easy. You will have to do research. If it is easy you have probably missed something.

With the added layer of complexity when a state with income taxation enters the picture for our clients who live and/or work outside the U.S. you have to do a bit of extra work to make sure you are doing the best for your client. This of course has to be weighed against the additional cost to the client for your time to drill down every possible scenario. But if you take nothing more from this article you should at minimum decide between excluding foreign earned income and taking the foreign tax credit on the federal return only after looking at the state rules for foreign income and taxes, and the refundable credits potentially available federally and on the state level. All too often I see where the client or the previous preparer took the easy way out and just excluded all foreign earned income on the federal return under the assumption that as long as they gave the client a zero balance 1040 they had done their job, and the accompanying state return just came out however it came out based on the federal exclusion. This is a definite disservice to your clients and although the returns may have been technically correct, the net cost to the client was quite large in some instances when considering the lost refunds. Enjoy the challenge of international taxation and the hunt for strategies to reduce overall taxation whenever you have the opportunity to go the extra mile for a client. What a great feeling of accomplishment when you can make a big difference for your clients- whether they realize it or not.

[1] California Tax Publication 1031.

[2] Maine Revenue Services Guidance to Residency "Safe Harbors."

[3] N.Y. State Dept. of Taxation and Finance, Form IT-213, Instructions for Form IT-213, Claim for Empi