Chapter 6: Special Taxpayers

Clergy B308
The Wingo Test B309
Self-Employed or Employee B309
The "Dual-Status" Minister B310
Self-Employed Ministers B337
Tax Reporting Summary for Self-Employed and Dual-Status Ministers . B339
Missionaries B340
Ministers Who Have Taken a Vow of Poverty B342
Retired Ministers B342
International Taxpayers B344
Tax Status of Taxpayers B344
IRS-Issued Taxpayer Identification Numbers B353
Foreign Earned Income Exclusion B356
International Education Issues B361
Foreign Tax Credit/Deduction B364
Tax Treaties B365
Social Security Totalization Agreements B372
Disclosure of Foreign Assets and Ownership Interests B374
Military Personnel B382

6

Please note. Corrections were made to this workbook through January of 2020. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

Kelly Golish, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. She was previously a manager at Crowder, CPAs in Danville, IL and worked for both public and private accounting firms in Decatur, IL, Cleveland, OH, and San Jose, CA. Kelly earned a Masters in Accounting with an emphasis in Taxation and a Bachelors in Accounting at the University of Notre Dame.

Other chapter contributors and reviewers are listed at the front of this volume.

About the Author

Marc C. Lovell, JD, LLM, MS, has headed a private tax law practice since 2001 with principal practice areas in federal, state, local and international taxation and tax litigation. He served as Assistant Director, Tax Education and Outreach of the University of Illinois Tax School program from 2011 to 2016. In addition to his private practice, Marc headed a team of 10 law librarians at the Department of Justice Main Library in Washington DC until April, 2019 when he was appointed by the Federal Reserve Board as the Assistant Law Librarian at the Federal Reserve Board Law Library in Washington, DC, where he heads the legal and legislative history research team and administers the Law Library. Marc obtained his JD and LLM from Wayne State University Law School in Detroit, Michigan, and his MS in Library and Information Science from the University of Illinois.

Other chapter contributors and reviewers are listed at the front of this volume.

CLERGY

Clergy members are subject to several specific tax provisions under the Code, some of which are covered in this chapter. To take advantage of these special provisions, a clergy member must be a "duly ordained, commissioned, or licensed minister of a church or a member of a religious order..."[1] The Tax Court has interpreted the term "minister" broadly and has held as follows.

- A cantor of the Jewish faith was a "duly ordained, commissioned or licensed minister" given the systematic manner in which the cantor was called to his ministry and his ecclesiastical duties.[2]
- A licentiate of the Cumberland Presbyterian Church, who held a status that was less than that of a fully ordained minister, was nonetheless held to be a licensed minister because he conducted worship services and was viewed by the congregation as a spiritual leader who preached, performed funerals, visited the sick, and ministered to the needy as part of his church duties.[3]
- An ordained minister, who acted as president of an exempt charitable corporation that furnishes financial advice to churches and who taught chapel management and stewardship programs, was found to **not** be acting in the capacity of a minister because the corporation did not have an affiliation with a church or religious organization.[4]
- An ordained minister employed to perform services as a director of pastoral care at a public hospital was deemed to be performing ministerial duties.[5]
- A "minister of music" (choir and music director) and a "minister of education" (Sunday school director) did **not** qualify as ministers because they were not ordained, commissioned, or licensed as ministers.[6]

Note. The term "minister" is not specifically defined in the Code but refers to individuals holding various titles within various religions. The main concern with these rules is to prevent a self-appointed minister from obtaining the benefit of the special provisions without being a bona fide religious minister. The terms "minister" and "clergy member" used in this chapter are used to denote all licensed, ordained, or commissioned spiritual leaders of various religions covered by these tax rules. Similarly, the term "churches" is used to refer to all houses of worship of various religions as applicable.

1. Treas. Reg. §1.1402(c)-5(a).
2. *Salkov v. Comm'r,* 46 TC 190 (1966); *Silverman v. Comm'r,* 57 TC 727 (1972).
3. *Knight v. Comm'r,* 92 TC 199 (1989).
4. Rev. Rul. 78-172, 1978-1 CB 35.
5. Ltr. Rul. 8519004 (Jan. 28, 1985).
6. Rev. Rul. 59-270, 1959-2 CB 44.

THE *WINGO* TEST

Qualified ministers are eligible for special tax provisions, such as nontaxable housing allowances, exemption from federal income tax withholding, and treatment as self-employed for social security tax purposes.[7] In *Wingo v. Comm'r*,[8] the Tax Court provided a 5-factor test that is used to identify a qualified minister. A **qualified minister** is one who:[9]

1. Performs sacerdotal (priestly) functions;
2. Conducts worship services;

> **Note.** Whether services performed by a minister constitute the conduct of religious worship or the performance of sacerdotal functions depends on the tenets and practices of the religious body constituting the church or church denomination.[10]

3. Provides services in the control, conduct, and maintenance of the religious organization;
4. Is considered a spiritual leader; and
5. Is ordained, licensed, or commissioned.

An individual **must satisfy all five factors** to be considered a **qualified minister.**

Example 1. Aaron is the executive director of a local Jewish temple. He has worked there for 30 years. He has always remained in an administrative position, but he has gradually become more involved with religious tasks. However, he has never officiated a ceremony. He is not an ordained rabbi or a commissioned cantor but is a fellow of a national synagogue administrators' association. Aaron does not satisfy any of the five factors outlined by the Tax Court. He is not a minister for tax purposes.[11]

Example 2. Carl, an ordained pastor, is the youth pastor at Main Street Church. Carl develops and establishes all of the youth programs and events for the children of the families attending the church. Michael, the head pastor, conducts services and officiates at baptisms, weddings, and funeral ceremonies. Although Carl is ordained, considered a spiritual leader in the congregation, and performs youth services that control or maintain the church, he is not a qualified minister for tax purposes because he does not perform sacerdotal functions. If Carl begins to conduct baptisms, weddings, funerals, or other such ceremonies, he may be considered a qualified minister for income tax purposes.

SELF-EMPLOYED OR EMPLOYEE

Determining whether the minister is categorized as either self-employed or as an employee is essential because this governs how the minister is taxed. In common law, a worker is classified as either self-employed or as an employee. An employer-employee relationship generally exists when the person or organization for which services are performed has the right to control and direct the worker in how the services are performed.[12] The common-law test is known as the **right-to-control test.** The IRS has developed a 20-factor guide it uses to determine whether a sufficient degree of control exists to establish an employer-employee relationship. The 20 factors focus on the degree of control that the firm has over the worker.[13]

7. *Clergy Tax Rules Extend Beyond Churches.* Schloemer, Paul. (Jul. 1, 2009). The Tax Adviser. [www.thetaxadviser.com/issues/2009/jul/clergytaxrulesextendbeyondchurches.html] Accessed on Mar. 12, 2019.
8. *Wingo v. Comm'r,* 89 TC 922 (1987).
9. Ibid.
10. Treas. Reg. §1.1402(c)-5(b)(2)(i).
11. This example is based on *Haimowitz v. Comm'r*, TC Memo 1997-40 (Jan. 23, 1997).
12. Rev. Rul. 87-41, 1987-1 CB 296.
13. See Rev. Rul. 87-41, 1987-1 CB 296.

The right-to-control test that applies to all taxpayers to determine employee or independent contractor status also applies to **clergy members.** The application of this test takes into account the nature of the clergy member's work and the aspects of control and oversight of the clergy member.[14]

> **Note.** For additional details and guidance on the definition of "employee" and the right-to-control test, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Individual Taxpayer Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

If it is unclear whether the minister should be categorized as an employee or as a self-employed taxpayer, the minister or the organization can obtain an IRS determination letter resolving the issue.[15] A request is made by filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.* The request can cover the determination of the status of a minister or an entire class of ministers or religious workers. Further details in connection with filing a Form SS-8 and the procedure used to obtain an IRS determination of employment status can be found in the Form SS-8 instructions.

THE "DUAL-STATUS" MINISTER

Ministers who are employed by a church receive **"dual-status"** tax treatment. For income tax reporting purposes, they are considered employees. However, for social security and Medicare purposes, ministers are treated as self-employed taxpayers and must pay self-employment (SE) tax on their earnings (unless they are exempt).[16]

Moreover, ministers are exempt from **income tax withholding** and **FICA tax withholding** on compensation received for services **in the exercise of the ministry.**[17] Ministers who have not taken a vow of poverty are deemed to be engaged in carrying on a trade or business with respect to the services they provide in the exercise of their ministry. Therefore, ministers who have **not** taken a vow of poverty **are subject** to SE tax.[18]

The exemption from federal income tax withholding, FICA withholding, and the application of SE tax exists **only** on income received for services in the exercise of the ministry or as required by the minister's order.[19] A minister applies for the exemption from SE tax on qualifying income using Form 4361, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners.* This form is discussed later in this chapter. Compensation for services unrelated to the exercise of the ministry is subject to income tax withholding and FICA taxation.[20]

> **Note**. Special tax rules apply to ministers who have taken a vow of poverty. This is discussed later in this chapter.

---

14. *Ministers Audit Technique Guide.* Apr. 2009. IRS. [www.irs.gov/pub/irs-utl/ministers.pdf] Accessed on Dec. 14, 2018.
15. See Instructions for Form SS-8.
16. IRC §1402(a)(8); *Topic Number 417 - Earnings for Clergy.* Feb. 22, 2019. IRS [www.irs.gov/taxtopics/tc417.html] Accessed on Mar. 5, 2019.
17. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*
18. Social Security Act §211(c); Treas. Reg. §1.1402(c)-5(a)(2).
19. IRC §§1402(e)(1) and 3121(b)(8)(A).
20. Treas. Regs. §§31.3401(a)(9)-1(c) and 31.3121(b)(8)-1(c)(3).

Example 3. Stephanie is the pastor at White Lake Ministry. The board of directors at White Lake Ministry interviewed and hired Stephanie as their pastor as soon as she was officially ordained. The board establishes her pay and housing allowance each year. She conducts weekly services and officiates at weddings and funerals. Each week she meets with the board and provides reports about ongoing issues with church members and her progress on the church's missionary functions and community outreach programs that she heads.

Stephanie is considered a common-law employee of White Lake Ministry. However, her pay is not subject to income tax withholding or FICA taxes. Stephanie is treated as if she were self-employed; therefore, she should make estimated income tax payments. Absent any exemption, **she is also liable for payment of SE taxes.**

Example 4. Use the same facts as **Example 3.** While employed by White Lake Ministry as pastor, Stephanie decides to take a part-time job as a youth counselor at a local children's hospital, where she earned $9,000 in 2018. She works at the hospital three nights per week. Her work for the hospital is not part of her services in the exercise of the ministry she performs for White Lake. When the hospital pays Stephanie, it must withhold income and FICA taxes.

Form W-2 Reporting

Wages that an organization pays to a minister who has not taken a vow of poverty are reported on Form W-2, *Wage and Tax Statement.*[21] Box 1 shows gross income, and boxes 3 and 5 for social security and Medicare wages, respectively, are left blank. This is the case because, as mentioned earlier, a clergy member who is an employee for federal income tax purposes is considered a self-employed person for FICA tax purposes. The organization does not withhold FICA taxes, therefore boxes 4 and 6, which show social security tax and Medicare tax withholding, respectively, are also left blank. Any parsonage and/or utilities allowance (discussed later in the chapter) can be entered in box 14 ("other"), although this is not required.[22]

Example 5. Use the same facts as **Example 4.** Stephanie receives the following Forms W-2 from White Lake Ministry and the hospital that report her compensation for the 2018 tax year.

a Employee's social security number: 456-78-1234	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file	Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN): 38-3333333	1 Wages, tips, other compensation: 22500.00	2 Federal income tax withheld:	
c Employer's name, address, and ZIP code: White Lake Ministry, 476 Davista Drive, White Lake, MI 48386	3 Social security wages:	4 Social security tax withheld:	
	5 Medicare wages and tips:	6 Medicare tax withheld:	
	7 Social security tips:	8 Allocated tips:	
d Control number:	9 Verification code:	10 Dependent care benefits:	
e Employee's first name and initial: Stephanie K. Last name: Behrens Suff.: 78910 Duck Lake Road North, White Lake, MI 48386	11 Nonqualified plans:	12a See instructions for box 12 Code:	
	13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code:	
	14 Other:	12c Code:	
f Employee's address and ZIP code:		12d Code:	

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
MI	38-3333333	22500.00				

Form **W-2** Wage and Tax Statement 2018 — Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

21. See Instructions for Form W-2.

22. Ibid.

Practitioner Planning Tip

Tax practitioners should verify that the housing allowance is not included in box 1 of Form W-2.

	a Employee's social security number 456-78-1234	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN) 38-4444444		1 Wages, tips, other compensation 9000.00	2 Federal income tax withheld 2216.00
c Employer's name, address, and ZIP code Mead Hospital 106 Teggerdine Road White Lake, MI 48386		3 Social security wages 9000.00	4 Social security tax withheld 558.00
		5 Medicare wages and tips 9000.00	6 Medicare tax withheld 130.50
		7 Social security tips	8 Allocated tips
d Control number		9 Verification code	10 Dependent care benefits
e Employee's first name and initial Last name Suff. Stephanie K. Behrens 78910 Duck Lake Road North White Lake, MI 48386		11 Nonqualified plans	12a See instructions for box 12 Code
		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code
		14 Other	12c Code
f Employee's address and ZIP code			12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
MI	38-4444444	9000.00	392.00			

Form **W-2** Wage and Tax Statement 2018 Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Optional Income Tax Withholding

As mentioned earlier, ministers are exempt from income tax withholding on their wage payments; however, they may need to make estimated tax payments to avoid penalties. Generally, a taxpayer must make estimated tax payments if they expect to owe $1,000 or more in taxes (including SE tax) when they file their return.[23]

Ministers may voluntarily request that the organization withhold income tax. The church withholds federal income tax only if **both** the clergy member and the church agree.[24] If both parties agree to the withholding, the withheld amount is based on the clergy member's Form W-4, *Employee's Withholding Allowance Certificate*.[25] A clergy member can request withholding sufficient to cover both the anticipated income taxes as well as the anticipated SE taxes.[26]

The signed Form W-4 serves as the agreement between the minister and the organization for voluntary tax withholding. Either the church or the minister can terminate the agreement at any time with signed written notice. The termination becomes effective for the first payment after the next "status determination date" that occurs at least 30 days after the date on which the notice is provided to the other party. The status determination dates are January 1, May 1, July 1, and October 1 of each year. However, the minister and the organization can agree on an alternate date if desired.[27]

Self-Employment Tax

SE status applies to clergy with respect to the performance of services:

- By a duly ordained, commissioned, or licensed minister of a church in the exercise of their ministry;
- By a member of a religious order in the exercise of duties required by the order who has not taken a vow of poverty; or
- By a person in the exercise of the profession of a Christian Science practitioner who has not taken a vow of poverty.[28]

Accordingly, qualified ministers are deemed to be engaged in a self-employed trade or business **only** with respect to services performed in the exercise of the ministry.[29] Therefore, they are subject to SE tax on net earnings on these sources of income.[30] Self-employment tax is calculated on Schedule SE, *Self-Employment Tax*.[31]

> **Example 6.** Use the same facts as **Example 3** and **Example 5.** Stephanie's reported W-2 income from White Lake Ministry is subject to SE tax. Her SE tax on the White Lake Ministry income is calculated on the following Schedule SE.

---

23. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.
24. IRC §3402(p).
25. Instructions for Form W-4.
26. IRC §3402(p).
27. Treas. Reg. §31.3402(p)-1(b)(2).
28. IRC §§1402(a)(8),1402(c)(4), and1402(c)(5).
29. Treas. Reg. §1.1402(c)-5(a)(2).
30. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.
31. See Instructions for Schedule SE.

For Example 6

SCHEDULE SE (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

▶ Go to *www.irs.gov/ScheduleSE* for instructions and the latest information.
▶ Attach to Form 1040 or Form 1040NR.

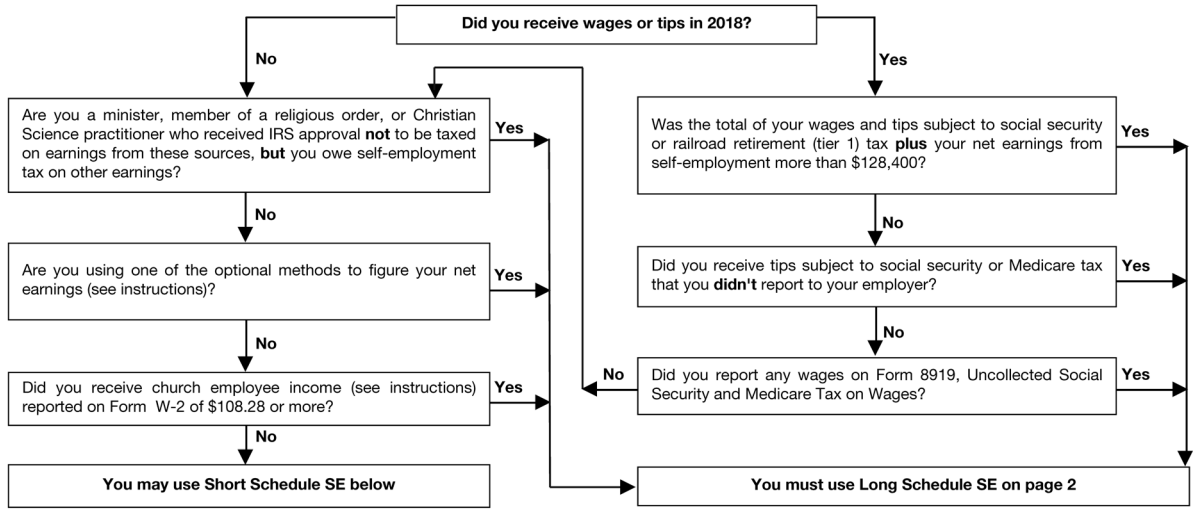
OMB No. 1545-0074
2018
Attachment Sequence No. 17

Name of person with **self-employment** income (as shown on Form 1040 or Form 1040NR)	Social security number of person with **self-employment** income ▶
Stephanie K. Behrens	456-78-1234

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note: Use this flowchart **only if** you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.



Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a		
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH	1b	( )	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2	22,500	
3	Combine lines 1a, 1b, and 2	3	22,500	
4	Multiply line 3 by 92.35% (0.9235). If less than $400, you don't owe self-employment tax; **don't** file this schedule unless you have an amount on line 1b ▶	4	20,779	
	Note: If line 4 is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.			
5	**Self-employment tax.** If the amount on line 4 is: • $128,400 or less, multiply line 4 by 15.3% (0.153). Enter the result here and on **Schedule 4 (Form 1040), line 57,** or **Form 1040NR, line 55** • More than $128,400, multiply line 4 by 2.9% (0.029). Then, add $15,921.60 to the result. Enter the total here and on **Schedule 4 (Form 1040), line 57,** or **Form 1040NR, line 55**	5	3,179	
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (0.50). Enter the result here and on **Schedule 1 (Form 1040), line 27,** or **Form 1040NR, line 27**	6	1,590	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2018**

If a clergy member or religious worker performs other services for a nonreligious organization or the services are not pursuant to an assignment by a religious superior, that work is not "in the exercise of a ministry." Therefore, it is not part of the SE income under these rules.[32]

Practitioner Planning Tip

Forms W-2 are frequently incorrect. It is a good idea to get information from the church about the minister's compensation package to ensure that the income is reported correctly on the return. If necessary, request a corrected Form W-2.

Special Rules on Items Excludable from Gross Income. The dual-status minister can exclude the following items their employer provides from gross income.[33]

- The value of meals provided in connection with ministerial services for the **convenience of the employer**
- The parsonage allowance or rental allowance
- The fair rental value (FRV) of lodging provided for the convenience of the employer in connection with ministerial services

Even though these items are excluded from gross income for income tax purposes, they **are included for the purposes of calculating SE tax.**[34]

Opting Out of SE Tax

There are two methods available to opt out of SE taxes for religious-based reasons. Religious or conscientious objection grounds are required for an exemption under either of these methods.[35]

1. A minister who is categorized as a self-employed taxpayer may apply for an exemption from SE tax by filing Form 4361.
2. A member of a recognized religious group may apply for an exemption from SE tax and FICA tax by filing Form 4029, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits.*

Self-Employed Minister Opting Out (Form 4361).[36] Form 4361 must be filed by the due date (including extensions) of the tax return for the **second year** in which the clergy member has SE income of $400 or more, with **any** part of that income coming from ministerial services.

The applicant must show that the applicable ordaining, commissioning, or licensing body or religious order is both of the following.

- Tax-exempt under IRC §501(a) as a religious organization described in IRC §501(c)(3)
- A church or similar entity described in IRC §170(b)(1)(A)(i)

32. Treas. Reg. §1.1402(c)-5(c)(2).
33. IRC §1402(a)(8); Treas. Reg. §1.1402(a)-11(a).
34. Treas. Reg. §1.1402(a)-11(a).
35. Instructions for Form 4361; Instructions for Form 4029.
36. Instructions for Form 4361.

Practitioner Planning Tip

Before making the **irrevocable** election to opt out of SE tax, practitioners should discuss the consequences with their clients.

The application is based on a religious or conscientious opposition to the acceptance of public insurance that makes payments for death, disability, old age, retirement, or medical care. Before the IRS approves the application, it must verify that the applicant is aware of the grounds for the exemption and wants to obtain the exemption on that basis. Accordingly, upon receiving the completed Form 4361, the IRS forwards a certification letter to the applicant. The certification letter consists of a statement outlining these religious or conscientious objections. The applicant must certify, by signing the letter under penalty of perjury, that they read the statement and that they are seeking an exemption on these grounds. To prevent a delay in the effective date of the exemption, the signed statement must be returned to the IRS no later than 90 days after the IRS mailed the statement to the applicant. If the applicant forwards the certification letter to the IRS after the 90-day deadline, the application may still be approved but will not be effective until the date the IRS receives the signed copy.

In addition, Form 4361 requires the applicant to inform their ordaining, commissioning, or licensing body that they are seeking an exemption from SE tax on religious or conscientious grounds.

Upon IRS approval, the SE exemption is **irrevocable** and is effective for all tax years in which SE income is $400 or more, with any of that income coming from ministerial services.[37]

Note. The SE tax exemption is effective for ministerial SE income. **The exemption has no effect on other sources of nonministerial income,** on which the applicant continues to be subject to SE tax.[38] The applicant may receive future social security benefits with respect to contributions that were made on nonministerial sources of income.

Example 7. Corey is a self-employed carpenter and ordained minister. He was ordained on December 1, 2015, and the local church hired him as an employee to help with weekly services and officiate at weddings, funerals, and other ceremonies. During 2015, he took time away from his carpentry work in order to complete his ministerial course of study. The church paid Corey a $50 fee for conducting a wedding on December 28, 2015, the same date the church hired him. Corey applies for exemption from SE tax for religious reasons.

Corey has the following income for the most recent tax years.

Tax Year	2014	2015	2016	2017	2018
Carpenter income	$22,000	$350	$24,000	$20,000	$16,000
Ministerial income	0	50	1,600	11,000	18,000
Total income	$22,000	$400	$25,600	$31,000	$34,000

37. Treas. Reg. §1.1402(e)-4A.

38. Instructions for Form 4361.

To obtain the exemption, Corey must file by the due date of his tax return for the second tax year in which he has $400 or more of SE income, with any amount of that income coming from ministerial services. Because 2016 is the second year in which Corey has at least $400 of SE income that includes some ministerial income, the normal due date for filing his Form 4361 is April 18, 2017, the due date for his 2016 tax return. If Corey filed an extension for his 2016 return, his 2016 return and the Form 4361 are due October 16, 2017.

If approved, the exemption is effective for the 2015 tax year and all subsequent years. However, the exemption only applies to Corey's ministerial income. His income from his carpentry business remains subject to SE tax.

Example 8. Use the same facts as **Example 7,** except Corey does not officiate at the December 28, 2015 wedding and consequently does not receive the $50 of additional SE income. The second year in which Corey has at least $400 of SE income with some portion of that income derived from ministerial services is therefore 2017. Corey has until April 17, 2018 (or October 15, 2018, if he files an extension) to file his Form 4361.

Example 9. Use the same facts as **Example 7.** Corey conscientiously objects to the acceptance of public insurance that makes payments in connection with death, disability, old age, retirement, or medical care. In 2015, Corey did not pay any SE tax. However, in 2016, Corey paid the following amounts of SE tax on his income.

Type of Income (2016)	Income Amount	Amount of SE Tax Paid
Carpentry	$24,000	$3,391
Ministry	1,600	226

Corey applies for exemption from SE tax. He issues a letter to his ordaining body informing them that he is seeking exemption from SE tax on conscientious-objection grounds. He subsequently completes the following Form 4361 and files the original and two copies of it with the IRS[39] on April 1, 2017.

Form **4361**
(Rev. January 2011)
Department of the Treasury
Internal Revenue Service

Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners

OMB No. 1545-0074

File Original and Two Copies

File original and two copies and attach supporting documents. This exemption is granted only if the IRS returns a copy to you marked "approved."

Please type or print

1 Name of taxpayer applying for exemption (as shown on Form 1040)
Corey C. Cook

Social security number
555-55-5555

Number and street (including apt. no.)
140 Mansfield Ave.

Telephone number (optional)

City or town, state, and ZIP code
Burlington, VT 05401

2 Check **one** box: ☐ Christian Science practitioner ☒ Ordained minister, priest, rabbi ☐ Member of religious order not under a vow of poverty ☐ Commissioned or licensed minister (see line 6)

3 Date ordained, licensed, etc. (Attach supporting document. See instructions.)
12/01/2015

4 Legal name of ordaining, licensing, or commissioning body or religious order
The United Methodist Church, New England Conference

Number, street, and room or suite no.
276 Essex Street

Employer identification number
38-5555555

City or town, state, and ZIP code
Lawrence, MA 01842-0449

5 Enter the first 2 years after the date shown on line 3 that you had net self-employment earnings of $400 or more, any of which came from services as a minister, priest, rabbi, etc.; member of a religious order; or Christian Science practitioner ▶	2015	2016

[39] In accordance with the Form 4361 Instructions, the original Form 4361 and two copies are filed with the Department of the Treasury, Internal Revenue Service Center, Philadelphia, PA 19255-0733.

Refund of SE Tax. After the IRS approves a Form 4361, a minister can file a refund claim for overpaid SE tax using Form 1040X, *Amended U.S. Individual Income Tax Return,* before the end of the applicable limitations period. The limitations period is generally three years from the date the original return was filed or two years from the date the tax was paid, whichever is later. A return filed, or tax paid, before the due date is considered to have been filed or paid on the due date. In addition, if a claim is filed after the 3-year period but within two years of the date the tax was paid, the amount refundable will not exceed the tax paid within the two years immediately before the claim is filed.[40]

> **Example 10.** Use the same facts as **Example 9.** If Corey's application for exemption from the payment of SE tax is approved, his exemption is effective for 2015, 2016, and subsequent years. Corey files a Form 1040X for the 2016 tax year. He obtains a refund of the $226 of SE tax that he paid on his ministerial income. Because the carpentry income is not ministerial, the carpentry income is not exempt from SE tax. Accordingly, Corey cannot obtain a refund of the SE tax of $3,391 that he paid on his 2016 carpentry income.

Form 1040 Disclosure of the Exemption.[41] A minister whose Form 4361 is approved by the IRS and who has no other income subject to SE tax does not file a Schedule SE. The minister indicates to the IRS that an SE exemption exists on line 57 of Schedule 4, *Other Taxes,* in the following manner.

SCHEDULE 4 (Form 1040)
Department of the Treasury
Internal Revenue Service

Other Taxes

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. 04

Name(s) shown on Form 1040 | Your social security number

Other Taxes	57	Self-employment tax. Attach Schedule SE . **EXEMPT - Form 4361** .	57	
	58	Unreported social security and Medicare tax from: Form **a** ☐ 4137 **b** ☐ 8919	58	
	59	Additional tax on IRAs, other qualified retirement plans, and other tax-favored accounts. Attach Form 5329 if required	59	
	60a	Household employment taxes. Attach Schedule H	60a	
	b	Repayment of first-time homebuyer credit from Form 5405. Attach Form 5405 if required	60b	
	61	Health care: individual responsibility (see instructions)	61	
	62	Taxes from: **a** ☐ Form 8959 **b** ☐ Form 8960 **c** ☐ Instructions; enter code(s)	62	
	63	Section 965 net tax liability installment from Form 965-A 63		
	64	Add the amounts in the far right column. These are your **total other taxes.** Enter here and on Form 1040, line 14	64	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71481R **Schedule 4 (Form 1040) 2018**

A minister with $400 or more of net earnings from another trade or business subject to SE tax must complete section B of Schedule SE.

Member of Recognized Religious Sect Opting Out (Form 4029). Employers that are members of **recognized religious sects** that are opposed to public or private insurance may apply for an exemption from the payment of FICA taxes under IRC §3127 using Form 4029.

To be eligible for the exemption, a recognized religious sect must:[42]

- Be conscientiously opposed to accepting benefits from any public or private insurance that makes payments for death, disability, old age, retirement, or medical care;
- Make some provision for the support and care of its dependent members in a manner that appears reasonable to the Secretary of Health, Education, and Welfare; and
- Exist continuously since December 31, 1950.

40. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*

41. Ibid.

42. Treas. Reg. §1.1402(h)-1(e)(2).

The employer exemption gives the employer the ability to avoid its FICA obligations for employees — but **only** for those employees who are also similarly approved for a "religious sect" exemption.[43] The election to waive social security benefits applies to all wages and SE income earned before and during the exemption period and is irrevocable.[44]

An employee who similarly conscientiously objects to any public or private insurance benefits and who is a member of a recognized religious sect (as defined previously) and follows its teachings can also apply for a religious sect exemption. In order to obtain the religious sect exemption, the employee must waive all rights to receive social security and Medicare benefits.[45]

Under FICA, the employee and employer each pay half of the social security and Medicare taxes. For both the employee and employer to be exempt from their respective share of FICA tax obligations, each needs to obtain approval for a Form 4029 exemption.[46]

Employers and employees who meet the requirements listed earlier each apply for this exemption by filing Form 4029. This application is filed in triplicate with the Social Security Administration (SSA) and may be **filed at any time.** Although the form is filed with the SSA, the IRS returns a copy to the applicant with a notice indicating whether the exemption is approved. If approved, the exemption is effective on the first day of the first quarter after the quarter in which the Form 4029 is filed.[47]

The exemption applies on an ongoing basis to all tax years in which the applicant continues to meet the exemption requirements. The exemption automatically ends when the applicant no longer meets the requirements.[48] If this happens, the exemption ends on the last day of the calendar quarter before the quarter in which the applicant fails to meet the requirements.[49] A clergy member loses the exemption if the individual or the sect fails to meet the eligibility requirements. The member must notify the IRS within 60 days if they are no longer a member of the religious group or no longer follow the established teachings of the group.[50]

The religious organization completes part II of the Form 4029 and the individual applicant completes part I.[51] The individual submits the Form 4029 exemption application to apply for an exemption from SE tax.

Tax Reporting with a Form 4029 Exemption. The following rules apply for the religious sect exemption.[52]

- If both the employer and employee have obtained approval for the exemption, the employer should not withhold any FICA tax on compensation paid to the exempt employee.
- If the employer is exempt but the employee is not, the employer must withhold the employee's share of FICA taxes and pay the employer's share.

Exempt employers with exempt employees **should not report** the exempt wages on Form 941, *Employer's Quarterly Federal Tax Return*; Form 944, *Employer's Annual Federal Tax Return*; or Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*.[53]

---

43. IRC §3127(a).
44. Instructions for Form 4029.
45. Ibid.
46. See IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*
47. Instructions for Form 4029.
48. Ibid.
49. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*
50. Ibid.
51. Instructions for Form 4029.
52. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*
53. Instructions for Form 4029.

Example 11. The Old Order Furniture Workshop (Workshop) is an Amish business that obtained a religious sect exemption from FICA taxation. John Lapp owns the shop. The Workshop employs Amos, an exempt employee. John hired Amos in October 2018 to assist with some furniture production projects that needed to be completed before the end of the year. Accordingly, Amos worked for the last quarter of 2018.

For the 2018 tax year, the shop paid Amos $12,000. Because both the Workshop and Amos have obtained religious sect exemptions, the shop only withholds federal income tax and does not withhold or pay any social security or Medicare taxes. Amos' Form W-2 for 2018 and the Workshop's Form 941 for the last quarter of the year follow.

	a Employee's social security number: 987-65-4321	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file — Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN): 37-2222222		1 Wages, tips, other compensation: 12000.00	2 Federal income tax withheld: 1200.00
c Employer's name, address, and ZIP code: The Old Order Furniture Workshop 339 E. Main Street Ephrata, PA 17522		3 Social security wages	4 Social security tax withheld
		5 Medicare wages and tips	6 Medicare tax withheld
		7 Social security tips	8 Allocated tips
d Control number		9 Verification code	10 Dependent care benefits
e Employee's first name and initial: Amos — Last name: Troyer — Suff.		11 Nonqualified plans	12a See instructions for box 12 Code
84 Ridge Avenue Ephrata, PA 17522		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code
		14 Other: Form 4029	12c Code
			12d Code
f Employee's address and ZIP code			

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
PA	37-2222222	12000.00	400.00			

Form **W-2** Wage and Tax Statement 2018 — Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

For Example 11

Form **941 for 2018: Employer's QUARTERLY Federal Tax Return**
(Rev. January 2018) Department of the Treasury — Internal Revenue Service

950117
OMB No. 1545-0029

Employer identification number (EIN): 37-2222222

Name *(not your trade name)*: John Lapp

Trade name *(if any)*: The Old Order Furniture Workshop

Address: 339 E. Main Street
Number Street Suite or room number

Ephrata | PA | 17522
City State ZIP code

Foreign country name | Foreign province/county | Foreign postal code

Report for this Quarter of 2018 (Check one.)

- ☐ 1: January, February, March
- ☐ 2: April, May, June
- ☐ 3: July, August, September
- ☒ 4: October, November, December

Go to *www.irs.gov/Form941* for instructions and the latest information.

Read the separate instructions before you complete Form 941. Type or print within the boxes.

Part 1: Answer these questions for this quarter.

1	Number of employees who received wages, tips, or other compensation for the pay period including: *Mar. 12* (Quarter 1), *June 12* (Quarter 2), *Sept. 12* (Quarter 3), or *Dec. 12* (Quarter 4)	1	1
2	Wages, tips, and other compensation	2	12,000 . 00
3	Federal income tax withheld from wages, tips, and other compensation	3	1,200 . 00
4	If no wages, tips, and other compensation are subject to social security or Medicare tax		☒ Check and go to line 6.

		Column 1		Column 2
5a	Taxable social security wages	.	× 0.124 =	.
5b	Taxable social security tips	.	× 0.124 =	.
5c	Taxable Medicare wages & tips	.	× 0.029 =	.
5d	Taxable wages & tips subject to Additional Medicare Tax withholding	.	× 0.009 =	.

Form 4029

5e	Add Column 2 from lines 5a, 5b, 5c, and 5d	5e	.
5f	Section 3121(q) Notice and Demand—Tax due on unreported tips (see instructions)	5f	.
6	Total taxes before adjustments. Add lines 3, 5e, and 5f	6	1,200 . 00
7	Current quarter's adjustment for fractions of cents	7	.
8	Current quarter's adjustment for sick pay	8	.
9	Current quarter's adjustments for tips and group-term life insurance	9	.
10	Total taxes after adjustments. Combine lines 6 through 9	10	1,200 . 00
11	Qualified small business payroll tax credit for increasing research activities. Attach Form 8974	11	.
12	Total taxes after adjustments and credits. Subtract line 11 from line 10	12	1,200 . 00
13	Total deposits for this quarter, including overpayment applied from a prior quarter and overpayments applied from Form 941-X, 941-X (PR), 944-X, or 944-X (SP) filed in the current quarter	13	.
14	Balance due. If line 12 is more than line 13, enter the difference and see instructions	14	1,200 . 00
15	Overpayment. If line 13 is more than line 12, enter the difference . Check one: ☐ Apply to next return. ☐ Send a refund.		

▶ You MUST complete both pages of Form 941 and SIGN it. Next ▶

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher. Cat. No. 17001Z Form **941** (Rev. 1-2018)

Parsonages, Parsonage Allowances, and Housing Allowances

If a church or other religious organization, as employer, provides a minister with a parsonage in which to live, the minister is entitled to exclude the FRV of the home from gross income for income tax purposes only.[54] The excludable amount includes the cost of furnishings and appurtenances such as a garage.[55] It also includes utilities costs but not food or domestic service staff.[56]

The FRV is determined by examining the facts and circumstances related to the parsonage.[57] Appropriate valuation methods must base the FRV on an arm's-length transaction. The courts have permitted the following techniques for calculating FRV.

1. Expert testimony can be used to compare similar properties. Trustworthy real estate agents can provide rental values for a residence after analyzing characteristics such as dimensions, condition, and location.
2. The comparable sales method[58] requires a determination of the fair market value of the property (available from real estate sales records) and the rate of return on investment that a lessor in an arm's-length transaction would require (a subjective measure) for a comparable property. The FRV is calculated by multiplying the fair market value by the required rate of return.

There is also an income exclusion for ministers receiving a housing or parsonage **allowance.**[59] A minister can exclude from income the amount of a parsonage allowance paid by an employing church or religious organization.

Both the FRV exclusion and the parsonage allowance exclusion **require** that the employer provide the minister with the home or parsonage allowance as compensation for services that are ordinarily the duties of a minister, which include any of the following.[60]

- Performance of sacerdotal functions
- Conduct of religious worship
- Administration and maintenance of religious organizations and agencies
- Performance of teaching and administrative duties at a seminary

Note. A traveling evangelist may exclude certain amounts received from various churches as housing allowances by having the churches designate in advance a portion of the honorariums as a housing allowance. The minister can exclude amounts to the extent they are used to maintain the minister's residence.[61]

Note. If a minister purchases a house and rents it out to a third party while traveling, the portion of the housing allowance allocated to the fraction of the year the residence was rented is **not excludable** from the minister's income.[62]

54. IRC §107(1); IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.
55. IRC §107(2).
56. Treas. Reg. §1.107-1.
57. *Tax Planning for Servants of God.* McNair, Frances; Milam, Edward; and Seifert, Deborah. Oct. 1, 2004. Journal of Accountancy. [www.journalofaccountancy.com/issues/2004/oct/taxplanningforservantsofgod.html] Accessed on Mar. 12, 2019.
58. *R.B. Dresser v. Comm'r*, TC Memo 1956-54 (Mar. 7, 1956); *G. Deukmejian v. Comm'r*, TC Memo 1981-24 (Jan. 26, 1981); *A. Imbesi v. Comm'r*, TC Memo 1981-484 (Sep. 2, 1981); *Estate of D.V. Murphy v. Comm'r*, TC Memo 1981-489 (Sep. 9, 1981); *Estate of W.A. Frieders v. Comm'r*, TC Memo 1980-184 (May 27, 1980), *aff'd* 687 F.2d 224 (Aug. 30, 1982); *W.W. Butschky v. U.S.*, DC Md., 82-1 USTC (Sep. 28, 1981); *A.M. Slater v. Comm'r*, TC Memo 1959-125 (Jun. 16, 1959); *Estate of T.L. Kaplin v. Comm'r*, 748 F.2d 1109 (Nov. 26, 1984), *rev'g* and *rem'g* TC Memo 1982-440 (Aug. 2, 1982); *A.M. Glick v. Comm'r*, TC Memo 1997-65 (Feb. 4, 1997).
59. IRC §107(2).
60. Treas. Reg. §1.107-1(a).
61. Rev. Rul. 64-326, 1964-2 CB 37.
62. Rev. Rul. 72-588, 1972-2 CB 77.

Caution. Because housing allowances are components of a minister's compensation, churches must ensure that the compensation paid to clergy is reasonable.[63] Unreasonable compensation may jeopardize the tax-exempt status for a religious organization.[64]

Limits on Exclusion From Gross Income. A minister who owns a home is generally entitled to an income exclusion equal to the **lesser** of the following amounts.[65]

- The FRV of a home (including utilities costs)
- The amount of the parsonage allowance specifically designated as such by the employer
- The amount of the housing allowance that is **actually used** to pay qualifying housing costs

Qualifying housing costs include living expenses such as the following.[66]

- Rent or mortgage payment
- Property taxes (if not included in mortgage payments)
- Home insurance premiums (if not included in mortgage payments)
- Repairs and maintenance
- Landscaping (lawn service, plants, trees, fencing, fertilizer, lawn mower, etc.)
- Pest control
- Utilities costs (electricity, gas, garbage collection, water, Internet service, telephone, cable television, etc.)
- Furnishings (furniture, rugs, curtains, dishes, appliances, household equipment, pictures, etc.)
- Remodeling expenses[67]
- Home improvements
- Cleaning supplies
- Homeowner's association fees

Note. Even though a minister may exclude from gross income that portion of a parsonage allowance used to pay mortgage interest and property taxes, the minister may still claim mortgage interest and property taxes as itemized deductions.[68] For tax years beginning after December 31, 2017, and before January 1, 2026 (Tax Cuts and Jobs Act (TCJA) period), the deduction for state and local real property taxes, personal property taxes, and state and local income taxes (or general sales taxes) is limited to $10,000 ($5,000 if married filing separately).[69]

63. *Tax Planning for Servants of God.* McNair, Frances; Milam, Edward; and Seifert, Deborah. Oct. 1, 2004. Journal of Accountancy. [www.journalofaccountancy.com/issues/2004/oct/taxplanningforservantsofgod.html] Accessed on Mar. 12, 2019.

64. IRS Pub. 4221-PC, *Compliance Guide for 501(c)(3) Public Charities.*

65. IRS Pub. 1828, *Tax Guide for Churches and Religious Organizations.*

66. See, e.g., *Richard and Elizabeth Warren v. Comm'r,* 114 TC 343 (2000).

67. Ltr. Rul. 8350005 (Aug. 19, 1983).

68. IRC §265(a)(6).

69. IRC §164(b).

Items that **do not qualify for exclusion** include:

- The repayment of loans secured by the home for uses other than providing the home,[70] and
- Expenses for food or servants.[71]

SE Tax Treatment. Even though the value of a parsonage or rental allowance is excluded from the clergy member's gross income for income tax purposes, the amount is still subject to SE tax.[72]

Designation Requirement. To qualify as an excludable parsonage allowance, the amount must be officially designated as such by the church or other employing organization before it makes any payment. The amount may be designated in an employment contract or any written instrument of official action, such as in a resolution or minutes of a church meeting or item within the organization's budget.[73]

> **Note**. Although the IRS does not provide an upper limit on the amount that may be designated to the minister as a parsonage allowance, IRS guidance states that the allowance must be reasonable with regard to other compensation the minister receives in order for the parsonage allowance to be excludable.[74]

Excess Parsonage Allowance. If the amount of the parsonage allowance paid to the minister exceeds the excludable amount, the minister includes the excess in their gross income and it is subject to income tax and SE tax. This amount is entered on Form 1040, line 1, and "excess allowance" is entered on the dotted line next to line 1.[75]

Example 12. Reverend Lucas is a pastor at Hilltop Family Church. The church held a directors' meeting in late 2017 and, by resolution, designated $12,000 as the 2018 parsonage allowance for Reverend Lucas. In order to help offset increasing utilities costs, the directors of the church also passed a resolution to designate an additional $1,200 for the year as a utilities allowance for Reverend Lucas.

During 2018, the church controller paid Reverend Lucas additional amounts of $4,800 to offset utility costs and property taxes that were higher than originally anticipated at the directors' meeting. The church's administrative board, the controller, or other church administrative body did not designate these additional amounts as an additional parsonage allowance. The church paid Reverend Lucas a total of $18,000 for the year ($12,000 parsonage allowance + $1,200 utilities allowance + additional amounts of $4,800).

Reverend Lucas provided his tax return preparer, Bernard, with the following list of household expenses for 2018.

Mortgage interest	$ 7,000
Property taxes	3,300
Utilities	800
Home insurance	1,200
Painting the living room	240
New kitchen stove	560
Flowers for front of house	100
Babysitter for children	1,400
Cleaning supplies, light bulbs	300
Groceries	4,500
Rental of neighbor's garage	600
Total household expenses	$20,000

70. *R.E. Rasmussen v. Comm'r,* TC Memo 1994-311 (Jul. 6, 1994).

71. Treas. Reg. §1.107-1(c).

72. *Minister Audit Technique Guide.* Apr. 2009. IRS. [www.irs.gov/pub/irs-utl/ministers.pdf] Accessed on Dec. 14, 2018.

73. Treas. Reg. §1.107-1(b).

74. Rev. Rul. 78-448, 1978-2 CB 105.

75. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*

Reverend Lucas told Bernard that Hilltop Family Church indicated that the FRV of the house is $1,400 per month, or $16,800 per year. Bernard must determine the amount of parsonage allowance that Reverend Lucas can exclude for the year. Because the excludable amount for housing expenses includes utilities costs, the amount called "parsonage allowance" and "utilities allowance" by the church may be added together as the "parsonage allowance" for tax purposes despite the fact that the church designates these items separately.

Bernard reviews Reverend Lucas's list of household expenses. All the costs directly related to the home qualify, including the costs of renovation or remodeling and the cost of appurtenances, such as the garage, which Reverend Lucas rented. However, the cost of domestic servants, such as the babysitter, and the cost of groceries do not qualify. Therefore, after reducing the list of household expenses by the costs of the babysitter and groceries, Bernard determines that Reverend Lucas's actual qualifying housing expenses are $14,100 ($20,000 total – $4,500 groceries – $1,400 babysitter).

Bernard researched excludable parsonage allowances and discovered that Reverend Lucas can exclude from income the **lesser** of the following items.

Item	Calculation	Result
FRV of the home (including utilities costs)	FRV of $16,800 + utilities costs of $800	$17,600
The amount of parsonage allowance designated by Hilltop Family Church	$12,000 parsonage allowance + $1,200 utilities allowance	13,200
The amount that Reverend Lucas actually spent on qualifying housing costs for the year.	$20,000 – $4,500 groceries – $1,400 babysitter costs	14,100

The amount of parsonage allowance that Reverend Lucas may exclude is limited to the $13,200 that the church actually designated as a parsonage allowance (including the designated utilities allowance). The $4,800 difference between the $18,000 that he was paid and the $13,200 that was designated must be included in Reverend Lucas's gross income for the year. This $4,800 excess parsonage allowance is included in income and is subject to income tax and SE tax.

Note. Tax software frequently includes the parsonage allowance amount on line 1 of Form 1040 automatically. Some churches may include an excess parsonage allowance amount on Form W-2, in box 1. If so, care must be taken to ensure that the excess parsonage amount is reported only once.

Practitioner Planning Tip

Practitioners may wish to advise their ministerial clients to ensure that the housing allowance the minister requests from the church will not be less than what the minister will actually spend on their housing.

Use of Parsonage Allowance for Second Home. The *Driscoll*[76] case addressed the ability of a minister to exclude the portion of the parsonage allowance that was used for a second home. Mr. Driscoll, who headed his own ministry, sought to exclude amounts that were designated as a parsonage allowance for his second home in addition to the parsonage allowance for his primary residence.

IRC §107 allows the exclusion of a parsonage allowance for amounts spent on a "home." The Tax Court held in favor of Mr. Driscoll, stating that the term "home" was intended to differentiate between an amount spent on residential property (which is excludable) from an amount expended on a farm or business (which a minister cannot exclude). According to this reasoning, "home" was not meant to limit a parsonage allowance to only one residence. However, the U.S. Court of Appeals for the 11th Circuit disagreed with the Tax Court and Mr. Driscoll, interpreting "home" to mean that **a minister can deduct a parsonage allowance on only one home.**

Constitutional Challenge to Parsonage Allowances. *Freedom From Religion Foundation v. U.S.*[77] represented a constitutional challenge to the parsonage allowance for ministers. The Freedom From Religion Foundation (FFRF) sought declaratory judgment that the parsonage allowance violates the Establishment Clause of the First Amendment by providing preferential tax benefits to ministers while denying similar tax benefits to FFRF directors who promote nonbelief, rather than religion. One such director was formerly a church minister who claimed a parsonage allowance exclusion before becoming an FFRF official.

The 7th Circuit Court of Appeals determined that the FFRF directors lacked standing to bring a lawsuit. The directors were not personally denied a parsonage allowance because they never asked for it. Therefore, they failed to show injury.

FFRF co-presidents filed amended tax returns claiming a housing allowance for 2012. The IRS denied the allowance. Accordingly, FFRF established standing to file another lawsuit.[78] The U.S. District Court ruled that IRC §107(2), which excludes a parsonage allowance from gross income, is unconstitutional. However, on March 15, 2019, the appeals court ruled that §107(2) is constitutional and reversed the District Court's decision.[79]

---

76. *Driscoll v. Comm'r*, 135 TC No. 27 (Dec. 14, 2010), *rev'd* and *rem'd Comm'r v. Driscoll*, 669 F.3d 1309 (11th Cir. 2012).

77. *Freedom From Religion Foundation, Inc. et al. v. U.S.*, No. 3:11-cv-00626-bbc (W.D. Wis. Aug. 29, 2012); *rev'd Freedom From Religious Foundation, Inc. et al. v. Lew,* 773 F.3d. 815 (7th Cir. 2014).

78. *Gaylor v. Mnuchin,* No. 16-cv-215-bbc (W.D. Wisc. Dec. 13, 2017).

79. *Gaylor et al. v. Mnuchin et al.,* Nos. 18-1277 & 18-1280 (7th Cir. 2019).

The *Deason* Rule

> **Note.** The *Deason* rule is only applicable for ministers who receive a tax-exempt parsonage or housing allowance **and who itemize unreimbursed employment expenses.**[80] For tax years during the TCJA period, miscellaneous itemized deductions are not allowed.[81] Accordingly, the *Deason* rule is not applicable during the TCJA period.

Under IRC §265(a)(1), an otherwise deductible business or employment expense that is allocable to a tax-exempt source of income is not deductible. This Code section was the basis for the Tax Court's decision in *Deason v. Comm'r.*[82] In the *Deason* case, the Tax Court disallowed the portion of a minister's unreimbursed automobile expense that was allocable to his tax-exempt parsonage allowance. The most recent IRS Minister Audit Techniques Guide states:[83]

> *A minister may deduct ordinary and necessary business expenses. However, if a minister's compensation includes a parsonage or housing allowance which is exempt from income under IRC §107, the prorated portion of the expenses allocable to the tax exempt income is not deductible, per IRC §265, Deason v. Commissioner...*

> **Note.** To review the *Deason* rule calculations for years outside the TCJA period, see pages 229–231 of the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 5: Special Taxpayers. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

If the minister is reimbursed for expenses only under an **accountable plan** (explained later) for the year, the *Deason* rule is irrelevant.

Employee Expenses and Reimbursements

Generally, expense reimbursements paid to an employee-minister are included in the minister's gross income. Such payments are treated as paid under a **"nonaccountable plan"** and are therefore included as wages. The reimbursement amounts are thus subject to income tax withholding and payroll taxes.[84] Prior to the TCJA period, amounts included in an employee's wages reported on Form W-2 were not considered reimbursements, and the employee-minister receiving such payments could claim unreimbursed employee expenses as a miscellaneous itemized deduction on Schedule A.[85] However, during the TCJA period, miscellaneous itemized deductions are not allowed.[86]

Accountable Expense Reimbursement Plans. A church or other employer organization can establish an **accountable plan** through which a minister's employment expenses are administered. Amounts paid to an employee-minister through an accountable plan **are not reported to the minister as wages** and therefore are not shown on Form W-2 or included on Form 941. Moreover, no income tax withholding or payroll taxes apply to these reimbursement amounts.[87]

---

80. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers* (2017).
81. IRC §67(g).
82. *Deason v. Comm'r,* 41 TC 465 (1964).
83. *Minister Audit Techniques Guide.* Apr. 2009. IRS. [www.irs.gov/pub/irs-utl/ministers.pdf] Accessed on Nov. 7, 2018.
84. Treas. Reg. §1.62-2(c)(5).
85. Treas. Reg. §1.62-2(c)(5) prior to amendment by the TCJA.
86. IRC §67(g).
87. Treas. Reg. §1.62-2(c)(4).

A plan to reimburse a minister for expenses must meet three requirements in order to be an accountable plan.[88]

1. The expenses reimbursed must have a business connection.
2. The reimbursement amounts paid to the minister must be substantiated.
3. The minister must return amounts paid that exceed actual expenses.

> **Note.** For further guidance on the accountable plan requirements, see Treas. Reg. §1.62-2.

An accountable plan may make advances and allowances to the minister in addition to reimbursements.[89] For travel, meals, and lodging expenses, a minister must provide evidence of the dollar amount of the expense, the time and place the expense was incurred, and the business purpose of the expense.[90] All excess advances and allowances must be returned to the church.[91]

> **Note.** For more information about accountable plans, see pages B60–B64 in the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues and the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

Tax Reporting for the Dual-Status Minister

Tax return preparation and tax reporting for dual-status ministers reflect the "hybrid" tax treatment they receive under the Code.

Example 13. Pastor Brad is single and employed by Tremont Street Church as head pastor. Under the right-to-control test, Brad is classified as a common-law employee based on the degree of control the church has over the performance of his duties. In addition to his wages, the church designates and pays Brad a housing allowance and a separate utilities allowance. Pastor Brad owns his own home near the church. The church also provides Brad with a social security allowance of $200 per month ($2,400 for the year) to assist Brad with the payment of his SE tax.

Throughout 2018, Pastor Brad had travel, meals, and other employment expenses for which the church reimbursed him under the church's accountable plan. However, he had some out-of-town travel expenses attributable to a conference he attended for which the church reimbursed him outside of the accountable plan. This was done because these expenses were not reimbursable under the terms of the plan.

The church paid Pastor Brad the following amounts for the 2018 tax year.

Pastor wages	$41,000
Social security allowance	2,400
Parsonage allowance designated and paid	5,500
Utilities allowance designated and paid	500
Expenses reimbursed under accountable plan	2,000
Nonaccountable expense reimbursement	1,500

88. Treas. Reg. §1.62-2(c).
89. Treas. Reg. §1.62-2(d)(1).
90. Treas. Reg. §1.62-2(e); IRC §274(d).
91. Treas. Reg. §1.62-2(f).

Pastor Brad is subject to SE tax because he has not made an election to opt out of SE tax. He paid the following homeowner expenses and estimated taxes for 2018.

Deductible mortgage interest	$ 5,200
Residential property taxes paid	3,200
Estimated taxes paid for 2012	10,000

He pays no state income tax. The standard deduction provides a greater benefit to Brad than itemizing on Schedule A.

Although Pastor Brad is a common-law employee, the church does not withhold income tax, social security tax, or Medicare tax. Instead, he is treated as a self-employed taxpayer and pays his own income tax through estimated payments. He also pays his own social security tax and Medicare tax.

Brad furnishes his tax return preparer, Clarissa, with all of the relevant details and information.

The $44,900 reported on Brad's Form W-2, box 1, consists of the following.

Wages from the church	$41,000
Social security allowance	2,400
Nonaccountable expense reimbursement	1,500
Compensation	$44,900

Although the reimbursements Brad received under the church's accountable plan are excluded from gross income, he must include the amount of the reimbursement for the travel that was made outside of the accountable plan (and therefore treated as a nonaccountable plan reimbursement). The social security allowance that the church pays Brad is also part of his taxable compensation and must be included in his gross income.

Brad's income for SE tax purposes includes the following amounts.

Compensation	$44,900
Parsonage allowance	5,500
Utilities allowance	500
Subtotal	$50,900
Less: unreimbursed travel expenses	(1,500)
Income for SE tax purposes	$49,400

For income tax purposes, the parsonage allowance and utilities allowance are excluded.

The TCJA eliminates the deduction for unreimbursed expenses in excess of 2% of adjusted gross income (AGI). Therefore, Brad cannot deduct any of the $1,500 of unreimbursed travel expenses for income tax purposes.

Clarissa knows that the excludable parsonage allowance includes the amount for home utilities. However, she must check to ensure that Brad's exclusion is not limited. Brad provides her with the following amounts in connection with his residential expenses for 2018.

FRV	$ 7,200
Actual utilities costs	950
Actual housing costs (excluding utilities)	10,000

Clarissa determines that the amount of parsonage allowance and utilities allowance that Brad can exclude is the lesser of the following.

- The FRV plus actual utility costs, or **$8,150** ($7,200 + $950)
- The parsonage allowance designated to Brad, or **$6,000** ($5,500 parsonage allowance + $500 utilities allowance)
- The amount Brad actually spent on housing and utilities, which is **$10,950** ($10,000 housing costs + $950 utilities)

Clarissa concludes that Brad can exclude the $6,000 that the church designated and paid to Brad for a parsonage and utilities allowance.

Clarissa prepares Brad's 2018 tax return. The following pages show the relevant forms and schedules of Brad's 2018 tax return.

Form **1040** Department of the Treasury—Internal Revenue Service (99) **U.S. Individual Income Tax Return** **2018** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing status: [X] Single [ ] Married filing jointly [ ] Married filing separately [ ] Head of household [ ] Qualifying widow(er)

Your first name and initial	Last name	Your social security number
Brad	Morrissey	7 7 7 7 7 7 7 7 7

Your standard deduction: [ ] Someone can claim you as a dependent [ ] You were born before January 2, 1954 [ ] You are blind

If joint return, spouse's first name and initial	Last name	Spouse's social security number

Spouse standard deduction: [ ] Someone can claim your spouse as a dependent [ ] Spouse was born before January 2, 1954 [ ] Spouse is blind [ ] Spouse itemizes on a separate return or you were dual-status alien

[X] Full-year health care coverage or exempt (see inst.)

Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	Presidential Election Campaign (see inst.) [ ] You [ ] Spouse
786 Boylston Street		
City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6.		If more than four dependents, see inst. and ✓ here ▶ [ ]
Portsmouth, NH 03803		

Dependents (see instructions): (1) First name Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit	Credit for other dependents
			[ ]	[ ]
			[ ]	[ ]
			[ ]	[ ]
			[ ]	[ ]

Sign Here Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Preparer's name	Preparer's signature	PTIN	Firm's EIN	Check if:
Firm's name ▶		Phone no.		[ ] 3rd Party Designee [ ] Self-employed
Firm's address ▶				

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2018)

For Example 13

Form 1040 (2018) Page 2

Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was withheld.	1	Wages, salaries, tips, etc. Attach Form(s) W-2		1	44,900
	2a	Tax-exempt interest 2a	b Taxable interest	2b	
	3a	Qualified dividends 3a	b Ordinary dividends	3b	
	4a	IRAs, pensions, and annuities 4a	b Taxable amount	4b	
	5a	Social security benefits 5a	b Taxable amount	5b	
	6	Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22		6	44,900
	7	Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6		7	41,410
Standard Deduction for— • Single or married filing separately, $12,000 • Married filing jointly or Qualifying widow(er), $24,000 • Head of household, $18,000 • If you checked any box under Standard deduction, see instructions.	8	**Standard deduction or itemized deductions** (from Schedule A)		8	12,000
	9	Qualified business income deduction (see instructions)		9	
	10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-		10	29,410
	11	**a** Tax (see inst.) 3,341 (check if any from: 1 ☐ Form(s) 8814 2 ☐ Form 4972 3 ☐) **b Add** any amount from Schedule 2 and check here ▶ ☐		11	3,341
	12	**a** Child tax credit/credit for other dependents **b Add** any amount from Schedule 3 and check here ▶ ☐		12	
	13	Subtract line 12 from line 11. If zero or less, enter -0-		13	3,341
	14	Other taxes. Attach Schedule 4		14	6,980
	15	Total tax. Add lines 13 and 14		15	10,321
	16	Federal income tax withheld from Forms W-2 and 1099		16	
	17	Refundable credits: **a** EIC (see inst.) **b** Sch. 8812 **c** Form 8863 **Add** any amount from Schedule 5 10,000		17	10,000
	18	Add lines 16 and 17. These are your total payments		18	10,000
Refund	19	If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you **overpaid**		19	
	20a	Amount of line 19 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		20a	
Direct deposit? See instructions.	▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings			
	▶ d	Account number			
	21	Amount of line 19 you want **applied to your 2019 estimated tax** ▶ 21			
Amount You Owe	22	**Amount you owe.** Subtract line 18 from line 15. For details on how to pay, see instructions ▶		22	321
	23	Estimated tax penalty (see instructions) ▶ 23			

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2018)

6

For Example 13

SCHEDULE 1 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. 01

Name(s) shown on Form 1040: **Brad Morrissey**

Your social security number: **777-77-7777**

Additional Income	1–9b	Reserved			1–9b	
	10	Taxable refunds, credits, or offsets of state and local income taxes			10	
	11	Alimony received			11	
	12	Business income or (loss). Attach Schedule C or C-EZ			12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13	
	14	Other gains or (losses). Attach Form 4797			14	
	15a	Reserved			15b	
	16a	Reserved			16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17	
	18	Farm income or (loss). Attach Schedule F			18	
	19	Unemployment compensation			19	
	20a	Reserved			20b	
	21	Other income. List type and amount ▶			21	
	22	Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and include on Form 1040, line 6. Otherwise, go to line 23			22	
Adjustments to Income	23	Educator expenses	23			
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24			
	25	Health savings account deduction. Attach Form 8889	25			
	26	Moving expenses for members of the Armed Forces. Attach Form 3903	26			
	27	Deductible part of self-employment tax. Attach Schedule SE	27	3,490		
	28	Self-employed SEP, SIMPLE, and qualified plans	28			
	29	Self-employed health insurance deduction	29			
	30	Penalty on early withdrawal of savings	30			
	31a	Alimony paid **b** Recipient's SSN ▶	31a			
	32	IRA deduction	32			
	33	Student loan interest deduction	33			
	34	Reserved	34			
	35	Reserved	35			
	36	Add lines 23 through 35			36	3,490

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2018**

For Example 13

SCHEDULE 4 (Form 1040)
Department of the Treasury
Internal Revenue Service

Other Taxes

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. 04

Name(s) shown on Form 1040: **Brad Morrissey**
Your social security number: **777-77-7777**

Other Taxes	57	Self-employment tax. Attach Schedule SE	57	6,980
	58	Unreported social security and Medicare tax from: Form **a** ☐ 4137 **b** ☐ 8919	58	
	59	Additional tax on IRAs, other qualified retirement plans, and other tax-favored accounts. Attach Form 5329 if required	59	
	60a	Household employment taxes. Attach Schedule H	60a	
	b	Repayment of first-time homebuyer credit from Form 5405. Attach Form 5405 if required	60b	
	61	Health care: individual responsibility (see instructions)	61	
	62	Taxes from: **a** ☐ Form 8959 **b** ☐ Form 8960 **c** ☐ Instructions; enter code(s)	62	
	63	Section 965 net tax liability installment from Form 965-A (63)		
	64	Add the amounts in the far right column. These are your **total other taxes.** Enter here and on Form 1040, line 14	64	6,980

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71481R **Schedule 4 (Form 1040) 2018**

6

SCHEDULE 5 (Form 1040)
Department of the Treasury
Internal Revenue Service

Other Payments and Refundable Credits

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. 05

Name(s) shown on Form 1040: **Brad Morrissey**
Your social security number: **777-77-7777**

Other Payments and Refundable Credits	65	Reserved	65	
	66	2018 estimated tax payments and amount applied from 2017 return	66	10,000
	67a	Reserved	67a	
	b	Reserved	67b	
	68–69	Reserved	68–69	
	70	Net premium tax credit. Attach Form 8962	70	
	71	Amount paid with request for extension to file (see instructions)	71	
	72	Excess social security and tier 1 RRTA tax withheld	72	
	73	Credit for federal tax on fuels. Attach Form 4136	73	
	74	Credits from Form: **a** ☐ 2439 **b** ☒ Reserved **c** ☐ 8885 **d** ☐	74	
	75	Add the amounts in the far right column. These are your total **other payments and refundable credits.** Enter here and include on Form 1040, line 17	75	10,000

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71482C **Schedule 5 (Form 1040) 2018**

For Example 13

SCHEDULE SE (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

▶ Go to *www.irs.gov/ScheduleSE* for instructions and the latest information.
▶ Attach to Form 1040 or Form 1040NR.

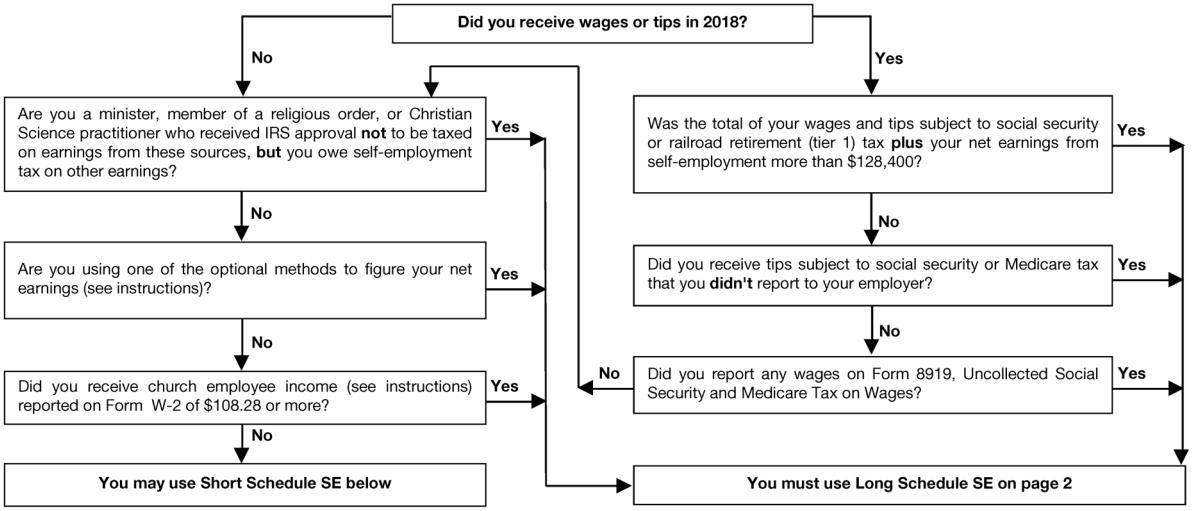
OMB No. 1545-0074
2018
Attachment Sequence No. 17

Name of person with **self-employment** income (as shown on Form 1040 or Form 1040NR)	Social security number of person with **self-employment** income ▶
Brad Morrissey	777-77-7777

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note: Use this flowchart **only if** you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.



Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a		
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH	1b	( )	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2	49,400	
3	Combine lines 1a, 1b, and 2	3	49,400	
4	Multiply line 3 by 92.35% (0.9235). If less than $400, you don't owe self-employment tax; **don't** file this schedule unless you have an amount on line 1b ▶	4	45,621	
	Note: If line 4 is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.			
5	**Self-employment tax.** If the amount on line 4 is: • $128,400 or less, multiply line 4 by 15.3% (0.153). Enter the result here and on **Schedule 4 (Form 1040), line 57,** or **Form 1040NR, line 55** • More than $128,400, multiply line 4 by 2.9% (0.029). Then, add $15,921.60 to the result. Enter the total here and on **Schedule 4 (Form 1040), line 57,** or **Form 1040NR, line 55**	5	6,980	
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (0.50). Enter the result here and on **Schedule 1 (Form 1040), line 27,** or **Form 1040NR, line 27**	6	3,490	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2018**

Retirement Contributions

Retirement plans for ministers may include the following.

1. Individual retirement arrangements (IRAs)
2. Self-employed retirement plans
3. IRC §403(b) plans
4. Defined benefit plans established by the religious organization

IRAs. Ministers may be eligible to make contributions to a traditional or a Roth IRA, subject to the same modified AGI restrictions that apply to other taxpayers. The deductibility of traditional IRA contributions may be limited if the clergy member is covered by a qualified plan through the church, such as a §403(b) plan.

Although IRA contributions made by a minister may be tax deductible, the amount of the contribution does not reduce SE earnings.[92]

> **Note.** Tax practitioners may want to verify that the Form W-2 of dual-status ministers properly includes any contributions to the minister's IRAs that were paid directly by the church into the IRA.

Self-Employed Retirement Plans. Clergy who are self-employed for income tax purposes may set up their own retirement plans[93] under the same provisions that apply to self-employed taxpayers in other professions. The following are types of retirement plans available for self-employed taxpayers.[94]

1. Simplified employee pension (SEP)
2. IRC §401(k) plan
3. Savings incentive match plan for employees (SIMPLE)
4. Profit-sharing and money purchase plans
5. Defined benefit plans

> **Note.** Retirement plans for self-employed people were formerly referred to as "Keogh plans" after the law that first allowed unincorporated businesses to sponsor retirement plans. Because the law no longer distinguishes between corporate and other plan sponsors, the term is seldom used.[95]

> **Note.** For more information about self-employed retirement plans, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Retirement Plans for Small Businesses.

92. Rev. Rul. 78-6, 1978-1 CB 273.
93. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*
94. *Retirement Plans for Self-Employed People.* Nov. 9, 2018. IRS. [www.irs.gov/retirement-plans/retirement-plans-for-self-employed-people] Accessed on May 16, 2019.
95. Ibid.

IRC §403(b) Plans. A 403(b) plan is a retirement plan offered by a public school or 501(c)(3) tax-exempt organization for its employees. An employee can only obtain a 403(b) annuity or custodial account under an employer's 403(b) plan. These annuities and custodial accounts are funded by employee elective deferrals made under salary reduction agreements, employer contributions, or a combination of both.[96]

Employer contributions to an annuity plan for a minister are **excluded** from the minister's SE earnings and are therefore exempt from SE tax to the extent that the amount is excludable from gross income under IRC §403(b). This exclusion applies even if the minister agrees to a salary reduction in exchange for part of the annuity contribution.[97]

Defined Benefit Plans Established by Religious Organizations. A church or an association of churches may establish defined benefit plans for their employees. Contributions by the **employer** to these plans for the benefit of dual-status ministers are exempt from income tax and SE taxes.[98]

> **Note.** As discussed later in the chapter, the governing body may designate retirement benefit payments as housing allowances for retired ministers. Thus, some or all of the retirement benefits may be excluded from the minister's taxable income under the same rules applicable to housing allowances received while the ministers were working.

Health Insurance Arrangements

Under the Affordable Care Act, employers (including churches) with at least 50 full-time employees must provide affordable health insurance coverage or they may be subject to an employer shared-responsibility payment.[99]

> **Note.** For more information about employer shared responsibility payments, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

Traditional Group Health Insurance Policy. Some churches provide their employees with a traditional group health insurance policy. However, traditional group health insurance policies are often hard for small churches to afford.

Qualified Small Employer Health Reimbursement Arrangement (QSEHRA). Qualified small employers may be eligible to establish a specific type of health reimbursement arrangement (HRA) focused typically on employers with under 50 full-time employees.[100] As an HRA, a QSEHRA is a plan funded exclusively by the employer that reimburses an employee for qualified medical costs including the cost of insurance.[101] Reimbursements from a QSEHRA for an eligible employee's medical expenses are not includable in the employee's gross income if the employee has coverage that provides minimum essential coverage as defined in IRC §5000A(f). For this purpose, the term **medical expenses** means expenses for medical care, as defined in IRC §213(d), including premiums for health insurance coverage.[102] Employees receive reimbursement for qualified medical expenses up to a maximum dollar amount for a given period, specified in the terms of the HRA.[103]

---

96. IRS Pub. 4483, *403(b) Tax-Sheltered Annuities for Sponsors.*

97. Rev. Rul. 68-395, 1968-2 CB 375.

98. IRC §§401(a), 401(c), and 414(e)(5).

99. *Employer Shared Responsibility Provisions.* Jul. 26, 2018. IRS. [www.irs.gov/affordable-care-act/employers/employer-shared-responsibility-provisions] Accessed on Mar. 15, 2019.

100. IRC §9831(d)(3)(B).

101. IRS Notice 2002-45, 2002-28 IRB 93.

102. IRS Notice 2017-67, 2017-47 IRB 517.

103. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*

To qualify as a QSEHRA, the arrangement must meet the following requirements.

- Be funded solely by an eligible small employer (generally an employer with under 50 full-time employees) that does not offer a group health plan to any of its employees[104]
- Provide for payment or reimbursement of qualified medical care expenses incurred by the employee (or employee's family members) after the employee provides proof of coverage to the employer[105]
- For 2019, not pay or reimburse more than $5,150 of expenses for a single employee, or more than $10,450 for an employee with family coverage for the year (These dollar amounts are prorated for eligible employees covered by the HRA for less than one year and are subject to future cost-of-living inflation adjustments.)[106]

Note. For more information on QSEHRAs, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

Note. For information about the SHOP exchange, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

SELF-EMPLOYED MINISTERS[107]

Ministers who are categorized as **self-employed independent contractors** under the right-to-control test may have various sources and types of SE income that are subject to SE tax. A minister's SE income may include the following.

- Fees and payments made to the clergy member for ministerial services
- Offerings for the performance of marriages, baptisms, funerals, and masses **(but not such payments made to a church or religious organization)**
- Payments received from churches or other parties for speaking engagements[108]
- Royalties from the sale of books or the writing of articles

Amounts that are **not** included in net earnings from self-employment include the following.

- Offerings that others made to the church
- Amounts contributed by the church to a retirement annuity plan set up for the minister, including salary reduction contributions that are not included in gross income
- Pension payments or retirement allowances for past ministerial services
- FRV or parsonage allowance provided to a retired minister

Self-employed ministers may deduct all ordinary and necessary business expenses related to their ministerial services on Schedule C. This includes expenses incurred while working as other than a common-law employee.

---

104. IRC §9831(d)(3)(B).
105. IRC §9831(d)(2)(B).
106. Ibid; Rev. Proc. 2018-57, 2018-49 IRB 827.
107. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.
108. *Minister Audit Technique Guide.* Apr. 2009. IRS. [www.irs.gov/pub/irs-utl/ministers.pdf] Accessed on Dec. 7, 2018.

Example 14. Reverend Norma, an ordained minister, works out of her home. Throughout the year, she receives fees from people who hire her to officiate weddings and conduct funerals. Because Norma is also educated and licensed in social work, she maintains her own marriage counseling practice. She also earns fee income from freelance writing, which includes a regular monthly article she writes for a magazine published by a large local church. She receives Forms 1099-MISC, *Miscellaneous Income,* from parties who pay her over $600 during the year.

Norma is a single, self-employed taxpayer. She reports her income and her business expenses on Schedule C. Her business expenses include travel, lodging, advertising, and depreciation on business assets. As a self-employed taxpayer, she also files Form 8829, *Expenses for Business Use of Your Home,* to claim her qualified home office expenses.

If the IRS approves an SE tax exemption for a self-employed minister, the SE exemption applies on income from any activity in the exercise of a ministry.[109]

Example 15. Use the same facts as **Example 14.** Although Norma's income from writing church magazine articles and from officiating weddings and conducting funerals constitutes work "in the exercise of a ministry," it can be argued that her marriage counseling practice and perhaps other freelance writing projects are activities that do not fall into this category. Therefore, these other activities are not exempt from SE tax.

Qualified Business Income Deduction[110]

During the TCJA period, a self-employed minister who files as a sole proprietor may be eligible for a qualified business income deduction (QBID) on qualified business income (QBI) from a qualified trade or business. The QBID equals up to 20% of QBI, subject to limitations, including an income threshold for 2019 of $321,400 for married couples filing jointly, $160,725 for married persons filing separately, and $160,700 for all other taxpayers.[111] A qualified trade or business includes any trade or business under IRC §162, not including the trade or business of performing services as an employee or a specified service trade or business. Generally, a taxpayer must be engaged in the trade or business on a continuous and regular basis and the primary purpose for engaging in the activity must be for income or profit.[112] Ministerial work is not considered a specified service trade or business.[113]

Note. For additional information on the QBID, including limitations and calculation details, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues, as well as the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update.

109. Ibid.

110. IRC §199A and Treas. Reg. §1.199A-1.

111. Rev. Proc. 2018-57, 2018-49 IRB 827.

112. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987).

113. Treas. Reg. §1.199A-5(b)(1).

Example 16. Use the same facts as **Example 14** and **Example 15.** Norma reports the following income and deductions on her 2018 Schedules C.

Income		
Marriage counseling practice	$30,000	
Officiating fees (baptisms and weddings)	25,000	
Freelance writing income	6,500	
Total income	$61,500	$61,500
Deductions		
Travel	$ 2,300	
Lodging	575	
Advertising	1,500	
Depreciation	7,500	
Home office expenses	6,025	
Total deductions	$17,900	(17,900)
Less: ½ of SE tax		(3,080)
Net qualified business income		$40,520

Norma has no other income, so her taxable income is below the QBID threshold. Therefore, her QBID is not limited. Norma is entitled to a QBID of $8,104 ($40,520 × 20%).

TAX REPORTING SUMMARY FOR SELF-EMPLOYED AND DUAL-STATUS MINISTERS

The following table summarizes the differences in reporting for dual-status and self-employed clergy members.

	Dual-Status Minister	Self-Employed Clergy Member
Church or organization reporting of payments	Form W-2 with nothing in boxes 3,4,5, or 6 due to the application of SE tax on the minister Nothing in box 2 for income tax withholding unless the minister has agreed to voluntary tax withholding by the employer	Form 1099-MISC (for payments received over $600)
Clergy member earnings	Form 1040 with Form W-2 Must pay SE tax on net earnings if not exempt from SE tax	Form 1040 with Schedule C Must pay SE tax on net earnings if not exempt from SE tax
Clergy member expenses	Total amount allowed against income subject to SE tax	Any ordinary, reasonable, and necessary expense incurred in connection with the trade or business of ministry work Reported on Schedule C and deducted against SE income
Tax	Estimated tax payments made unless employer withholds tax due to voluntary election by minister[114]	Estimated tax payments if necessary

[114] IRC §3402(p)(3).

MISSIONARIES

A missionary who meets the qualifications of a clergy member (defined previously) may receive dual-status tax treatment or be considered self-employed, depending on the facts and circumstances.[115] As mentioned previously, dual-status tax treatment exempts a clergy member from **income tax** withholding and **FICA tax** withholding on compensation received for services **in the exercise of the ministry;** however, they must pay SE tax on their earnings (unless exempt).[116]

A missionary who does **not** meet the qualifications of a clergy member treats income tax and social security tax withholding in the same manner as other employees.[117]

International Missions

Practitioner Planning Tip

Given the complexity of this area, it may be prudent for practitioners not well-versed in international taxation to refer the engagement to someone with more experience.

Missionaries who perform their missions work outside the United States must be aware of international tax issues.

Totalization Agreements. The United States enters into **totalization agreements** with certain foreign countries to coordinate social security coverage and taxation of workers employed in those countries. Totalization agreements eliminate dual coverage and dual taxes for the same work. The agreements determine whether a U.S. citizen or resident alien is subject to the social security taxes of a foreign country or whether an alien is subject to U.S. social security/Medicare tax. The following countries have totalization agreements with the United States.[118]

Australia	France	Luxembourg	Spain
Austria	Germany	Netherlands	Sweden
Belgium	Greece	Norway	Switzerland
Canada	Hungary	Poland	United Kingdom
Czech Republic	Ireland	Portugal	
Denmark	Italy	Slovak Republic	
Finland	Japan	South Korea	

Note. Information on specific totalization agreements can be found at **uofi.tax/19stx1** [www.ssa.gov/international/totalization_agreements.html].

115. *Robert and Betty Shelley v. Comm'r,* TC Memo 1994-432 (Aug. 25, 1994); *Michael and Barbara Weber v. Comm'r,* 103 TC 378 (Aug. 25, 1994).

116. IRC §1402(a)(8); *Topic Number 417 — Earnings for Clergy.* Feb. 22, 2019. IRS. [www.irs.gov/taxtopics/tc417.html] Accessed on Feb. 22, 2019; IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers;* Rev. Rul. 55-471, 1955-2 CB 615.

117. IRS Ann. 62-40, 1962-17 IRB 13.

118. IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad; Totalization Agreements.* Feb. 26, 2019. IRS. [www.irs.gov/individuals/international-taxpayers/totalization-agreements] Accessed on Mar. 8, 2019.

U.S. Certificate of Coverage. Generally, employees are only subject to social security taxes in the country where they are working. Missionaries who work temporarily in a foreign country and would otherwise be subject to U.S. social security generally remain covered only by U.S. social security.[119] Employers request **certificates of coverage** from the Social Security Administration that serve as proof that the employee and employer are exempt from social security taxes in a foreign country.[120]

> **Note.** Employers can request a certificate of coverage at **opts.ssa.gov.**

Foreign Resident.[121] A person permanently working in a foreign country that is covered by a social security agreement with the United States which states that pay is exempt from U.S. social security tax should obtain a statement from the authorized official or agency of the foreign country verifying that the missionary's pay is subject to social security coverage in the foreign country.

The IRS implements a bona fide residence test to establish whether a U.S. citizen or U.S. resident alien is considered a resident of a foreign country. Generally, living in a foreign country uninterrupted for an entire year is not sufficient to establish residency. The IRS evaluates factors such as the length of stay, nature of work, and intent to establish residency.

> **Note.** For more information on the bona-fide residence test, see IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Missionaries who meet the bona-fide residence test may qualify for a foreign earned income exclusion (FEIE).

> **Note.** The FEIE is covered in the International Taxpayers section of this chapter.

Additionally, qualifying foreign missionaries may claim an exclusion or deduction from gross income for housing amounts in a foreign country. The housing exclusion is available for the amount considered paid by the employer whereas the housing deduction applies to amounts paid with SE earnings. **Housing amounts** are defined as the total housing expenses for the year less a base housing amount. The base housing amount is 16% of the FEIE amount (computed on a daily basis) multiplied by the number of days in the qualifying period that falls within the taxpayer's tax year.

> **Note.** For more information on the housing exclusion or deduction, see IRS Pub. 54.

---

119. Ibid.

120. *Online Certificate of Coverage Service.* Social Security Administration. [www.ssa.gov/international/CoC_link.html] Accessed on Feb. 26, 2019.

121. IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

MINISTERS WHO HAVE TAKEN A VOW OF POVERTY

A religious order member who takes a vow of poverty is automatically exempt from SE and FICA taxes in connection with services performed in the exercise of any duties required by the order.[122] As long as an ecclesiastical superior directs or requires the services, those duties fall within this exemption regardless of their nature or extent.[123] If a member performs services outside those required by the order or directed by a superior, the member's earnings are subject to either SE taxes (if the earnings are from self-employment) or FICA taxes (if the earnings are from a common-law employee situation). The member may be entitled to a charitable deduction for the wages turned over to the order.[124]

> **Note.** Religious order members who have not taken a vow of poverty are subject to SE tax on remuneration for services performed in the exercise of a ministry. The member may file Form 4361 to obtain an exemption from the SE tax, as discussed earlier.[125]

A member's earnings from the performance of duties required by the order are considered to be earnings of the order, not the member.[126]

Special Election Available to Religious Orders[127]

An order may elect to have its members who have taken a vow of poverty covered by FICA in order to participate in the social security program. An order makes this election by filing Form SS-16, *Certificate of Election of Coverage Under the Federal Insurance Contributions Act.* This election provides social security and Medicare participation for members of a religious order who:

- Are under a vow of poverty,
- Perform services usually required of an active member of the order, and
- Are not considered retired due to age or total disability.

> **Note.** Further details on the procedure and requirements for this election are found in Treas. Reg. §31.3121(r)-1.

RETIRED MINISTERS

Several special tax rules continue to apply to a minister after retirement, particularly in connection with the receipt of a post-retirement parsonage allowance and the calculation of SE tax on retirement income.

Post-Retirement Parsonage Allowance

A retired minister may continue to exclude from gross income either the FRV (plus utilities costs) of a residence furnished to the retired minister or a rental allowance a church pays as part of compensation for past duties as a minister.[128] These exclusions are subject to the same limitations and rules as those applicable to working ministers.

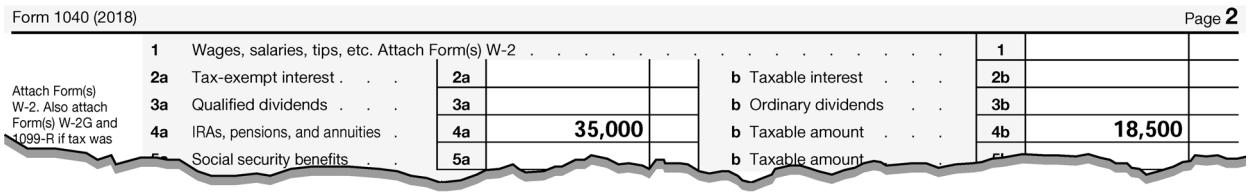
---

122. IRC §§1402(e) and 3121(b)(8)(A).
123. Treas. Regs. §§31.3121(b)(8)-1(d) and 31.3401(a)(9)-1(d).
124. IRS Pub. 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*
125. Ibid.
126. Ibid.
127. Treas. Reg. §31.3121(r)-1.
128. Rev. Rul. 63-156, 1963-2 CB 79.

In addition, a retired minister may exclude from income that portion of a pension payment designated as a rental allowance by the religious denomination's national governing body that has complete control over the pension fund.[129] The gross pension is included on Form 1040, line 4a, while the taxable portion after the reduction for the housing allowance is shown on line 4b.[130]

Example 17. Pastor Sue retired from Holy Trinity Church in 2015. Her annual pension from the church is $35,000, which includes a $21,000 housing allowance. The FRV of her house plus actual utility costs is $24,000. During 2018, Sue spent $16,500 for housing and utilities. Sue can exclude the lesser of those three amounts, or $16,500.

Sue's taxable pension amount is $18,500 ($35,000 – $16,500). Her tax preparer enters this information on line 4 as follows.



Form 1040 (2018) Page 2

Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was	1	Wages, salaries, tips, etc. Attach Form(s) W-2					1	
	2a	Tax-exempt interest	2a		b	Taxable interest	2b	
	3a	Qualified dividends	3a		b	Ordinary dividends	3b	
	4a	IRAs, pensions, and annuities	4a	35,000	b	Taxable amount	4b	18,500
		Social security benefits	5a		b	Taxable amount		

A rental allowance is not excludable from income if paid to the minister's surviving spouse.[131]

Pension Payments and SE Tax Liability

Pension payments from a church plan or retirement allowance payments made to a retired minister are not part of earnings for SE tax purposes and are therefore exempt from SE tax.[132]

Gifts to a Retiring Clergy Member[133]

The IRS has ruled in a number of cases[134] that gifts to retiring clergy members are excludable from gross income. In order to be considered **nontaxable,** the following conditions must be met.

- The payments were not made in accordance with any enforceable agreement, established plan, or past practice.
- The clergy member did not perform, and is not planning on performing, any further services for the congregation.
- The clergy member and the congregation have a closer personal relationship than would normally exist in a lay employment relationship.
- All available evidence indicates that the amount paid was determined based on the financial position of the congregation and the needs of the clergy member, who previously was adequately compensated for services.

129. Rev. Rul. 75-22, 1975-1 CB 49.

130. Instructions for Form 1040.

131. Rev. Rul. 72-249, 1972-1 CB 36.

132. IRC §1402(a)(8).

133. Rev. Rul. 55-422, 1955-1 CB 14.

134. *Schall v. Comm'r,* 174 F.2d 893 (5th Cir. 1949); *Mutch v. Comm'r,* 209 F.2d 390 (3rd Cir. 1954); *Kavanagh v. Hershman,* 210 F.2d 654 (6th Cir. 1954); *Abernethy v. Comm'r,* 211 F.2d 651 (D.C. Cir. 1954).

In *Hershman v. Kavanagh,*[135] a rabbi served his congregation for almost 40 years. The congregation adopted a resolution in 1937 that it would pay the rabbi an annual pension of $5,000 upon his retirement. When the rabbi retired in 1946, the congregation approved an increase in the amount to $7,500. Because the $5,000 was a fixed legal obligation on the part of the congregation, it was taxable as a pension. However, the extra $2,500 was a gift for past services and was nontaxable.

In *Schall v. Comm'r*,[136] Dr. Schall worked as a pastor for the church for 18 years, receiving about $6,000 per year. When he retired in 1939 for health reasons, the congregation accepted his resignation and gave him a gift of $2,000 annually for past services. Dr. Schall did not ask for this gift, nor was there any such provision existing prior to Dr. Schall's retirement. The $2,000 was nontaxable.

INTERNATIONAL TAXPAYERS

TAX STATUS OF TAXPAYERS

Generally, the Code taxes U.S. individual taxpayers depending on which of the following four categories they fall into.

1. U.S. citizen
2. Resident alien (RA)
3. Nonresident alien (NRA)
4. Dual status alien (DSA)

Each of these categories is explored in this section. This is followed by a discussion of the expatriation tax provisions applicable to U.S. citizens who have relinquished their citizenship and long-term residents who have ended their residency (i.e., expatriated).

U.S. Citizen

The Code does not define **U.S. citizen,** but Treas. Reg. §1.1-1(c) indicates that every person born or naturalized in the United States and subject to its jurisdiction is a citizen. U.S. citizens who also maintain citizenship with another country are taxed as U.S. citizens.[137]

> **Note.** The laws regarding U.S. citizenship, including who is considered a U.S. citizen at birth, are found at 8 USC §§1401–1459, while 8 USC §§1481–1489 provides the laws regarding loss of citizenship.

U.S. citizens are generally required to pay U.S. tax on worldwide income, regardless of whether that income is earned or received from sources within or outside the United States and regardless of whether the citizen resides in the United States.[138]

---

135. *Hershman v. Kavanagh, Jr.,* 120 F.Supp. 956, (E. Dist. MI 1953).
136. *Schall v. Comm'r,* 174 F.2d 893 (5th Cir. 1949).
137. *Atef. A. Gamal-Eldin v. Comm'r*, TC Memo 1988-150 (n.2) (Apr. 12, 1988).
138. Treas. Reg. §1.1-1(a); IRC §61.

Resident Alien[139]

An **alien** is a person who is not a citizen of the United States.[140] When an alien has taxable income, it is necessary to determine the location of that person's residence. An alien is considered to be an RA, taxed on worldwide income[141] and generally subject to the same tax rules as a U.S. citizen, if the alien makes an election or meets certain tests, which are described as follows.[142]

- The first-year election
- The substantial presence test
- The green card test

First-Year Election.[143] The first-year election is used by an alien who takes up residence in the United States too late in the tax year to meet the substantial presence test (described later) and who does not otherwise qualify as a U.S. resident. Under such circumstances, this individual may elect to be treated as a resident for the part of the tax year for which the election is made (the election period).

An alien qualifies for this election if the alien:

- Did not qualify as a resident for the tax year immediately preceding the election year,
- Will meet the substantial presence test for the tax year immediately after the election year,
- Is present in the United States for at least 31 consecutive days within the election year, and
- Is present in the United States for at least 75% of the number of days within the period beginning with the first day of the 31-day presence in the United States and ending with the last day of the election year.

The alien can count up to five days of absence from the United States as present in the United States during the election period.[144]

> **Example 18.** Juan Carlos is a citizen of Chile. He came to the United States for the first time in 2018. He arrived in Chicago on November 1, 2018. He stayed in Chicago until December 5, 2018, when he returned to Chile for a 14-day visit. He returned to Chicago on December 19, 2018, and remained in Chicago for the rest of the year.
>
> During 2019, Juan satisfied the substantial presence test and was a resident of the United States.
>
> Juan may make the first-year election for 2018. He was not a resident in 2017 and he met the substantial presence test in 2019. He was present in the United States for more than 31 consecutive days between November 1, 2018, and December 5, 2018. Additionally, he was present in the United States for at least 75% of the days following (and including) the first day of his 31-day period (i.e., 48 total days of U.S. presence in the 61-day period from November 1 through December 31 equals 78.69%) in 2018.

This election, made on the alien's tax return for the election year, cannot be made until the alien has met the **substantial presence test** for the calendar year immediately following the election year.[145] After this election is made, it is revocable only with the IRS's consent.[146]

---

139. IRS Pub. 519, *U.S. Tax Guide for Aliens*.
140. 8 USC §1101(a)(3).
141. Treas. Reg. §1.1-1(a); IRC §61.
142. IRC §7701(b); Treas. Reg. §301.7701(b)-1.
143. IRC §7701(b)(4).
144. IRC §7701(b)(4)(A)(iv)(ii).
145. IRC §7701(b)(4)(E).
146. IRC §7701(b)(4)(F).

Practitioner Planning Tip

When an alien makes the first-year election, all of the alien's worldwide income during the residency period will be subject to U.S. tax. Depending on the individual alien's tax circumstances, this may actually provide a lower overall tax.

Note. For additional details about this election, including the procedure for making the election, the necessary details to provide in the election statement, and applicable start dates for U.S. residency for the alien's first year of U.S. residence, see Treas. Reg. §301.7701(b)-4.

Substantial Presence Test. Under the substantial presence test, a taxpayer is considered to be a U.S. resident subject to U.S. federal tax rules if that individual is present in the United States on at least 183 days (using special counting rules) during the 3-year period that includes the current year.[147] The term **current year** for this purpose is the year for which residency status is being determined.[148]

Caution. Some NRA taxpayers are considered exempt from the substantial presence test. For more information, see the section "Foreign Students Studying in the United States" later in this chapter.

Special Counting Rules. To calculate the number of days present in the United States, the following counting rules apply.[149]

- Each actual day present in the United States during the current year is counted as a full day.
- Each actual day present in the United States during the year immediately preceding the current year is counted as one-third of a day.
- Each actual day present in the United States during the second preceding year is counted as one-sixth of a day.

Under these rules, an individual is considered present for a day in the United States when they are physically present in the United States for any time during the day.[150]

If the individual is not physically present in the United States during the current year for more than 30 days, the individual is not considered to have substantial presence in the United States. The substantial presence test is not applied to that individual (even if the number of days attributable to the first and second preceding years under the counting rules is more than 183 days).[151]

147. Treas. Reg. §301.7701(b)-1(c).
148. Treas. Reg. §301.7701(b)-1(c)(3).
149. Treas. Reg. §301.7701(b)-1(c)(1).
150. Treas. Reg. §301.7701(b)-1(c)(2)(i).
151. Treas. Reg. §301.7701(b)-1(c)(4).

The following days do not count as days of presence in the United States.[152]

- Days present in the United States as an exempt individual (as defined in Treas. Reg. §301.7701(b)-3(b))
- Days that an individual is prevented from leaving the United States because of a medical condition that arose while the individual was present in the United States
- Days in transit between two points outside the United States
- Days on which a regular commuter residing in Canada or Mexico commutes to and from employment in the United States

Note. For additional information regarding the substantial presence test, including examples and how the rules apply to aliens who may be residents of U.S. possessions and territories, see Treas. Reg. §§301.7701(b)-1(c) and (d).

Example 19. Danielle is a French citizen. She spends 60 actual days in the United States in 2017 and spends 120 actual days in the United States in 2018. In 2019, she remains in France for the first two months of the year and arrives in the United States on March 1. She remains in the United States until July 31, when she returns to France. Therefore, she has been in the United States for 153 days in 2019. Danielle does not have a green card. She must determine if she is a resident for U.S. tax purposes in 2019.

Under the substantial presence test, Danielle's time in the United States in the 3-year period (2017, 2018, and 2019) is relevant. The calculation for determining residency is as follows.

Calendar Year	Counted Days	Multiplier	Substantial Presence Days
2017	60	1/6	10
2018	120	1/3	40
2019	153	1	153
Total			203

Danielle has a total of 203 substantial presence days during the 3-year period that includes the 2019 tax year. In order to become a resident for U.S. tax purposes, she needs to have at least 183 substantial presence days. She meets this requirement. Therefore, Danielle's presence in the United States for 2017, 2018, and 2019 has been substantial enough to trigger residency in the United States for 2019 tax purposes.

Danielle is not considered a U.S. resident for 2017 or 2018. Even though Danielle reached her 183rd counted day on July 11, 2019, her starting day for U.S. residency in 2019 is March 1, 2019, the first day of presence in the United States within the year.

Closer Connection Exception. An alien that meets the substantial presence test may be considered a nonresident if the alien meets the requirements of the "closer connection exception." To meet the requirements of this exception, the alien must meet the following criteria during the current year.[153]

- Has been present in the United States for less than 183 days
- Maintains a tax home in a foreign country
- Must not have a closer connection to more than two foreign countries in which the alien maintains a tax home

152. Treas. Reg. §301.7701(b)-3.

153. Treas. Reg. §301.7701(b)-2(a).

A closer connection to a foreign country exists if the alien or the IRS establishes that the alien has maintained more significant contacts with the foreign country than with the United States. A facts-and-circumstances analysis is used to make this determination. The factors considered include the location of the alien's:

- Permanent home;
- Family;
- Personal belongings (such as cars, furnishings, and clothing);
- Social, political, cultural, or religious organizations;
- Business activities; and
- Voting activity, etc.

The alien claims the closer connection exception by completing Form 8840, *Closer Connection Exception Statement for Aliens,* and attaching it to Form 1040NR, *U.S. Nonresident Alien Income Tax Return,* or Form 1040NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents.* If the alien has taken affirmative steps to become a permanent U.S. resident, the alien may not claim the closer connection exception.

> **Note.** For additional details regarding the requirements of the closer connection exception, including other factors considered, the definition of permanent home, and related special rules, see Treas. Reg. §301.7701(b)-2. For additional details about completing and filing Form 8840, see the instructions to Form 8840 and Treas. Reg. §301.7701(b)-8.

Green Card Test.[154] An alien is considered a U.S. resident for the entire year if the alien is a lawful permanent resident in accordance with immigration law at any time during the year. Such resident status is considered continuous until lawful permanent resident status is administratively or judicially determined to have been abandoned, or until rescinded.

> **Note.** For further details on the green card test, including what constitutes administrative or judicial determination of abandonment or rescission, see Treas. Reg. §301.7701(b)-1(b)(2) and the 2011 *University of Illinois Federal Tax Workbook,* Chapter 9: International Taxation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Nonresident Alien[155]

An NRA is **generally** subject to U.S. tax **only** on the following U.S. source income.

- Income effectively connected with the conduct of a U.S. trade or business (commonly referred to as "effectively connected income" or ECI)[156]
- Fixed, determinable, annual, or periodical (FDAP) income (as defined by IRC §§871(a))

While ECI arises from a "U.S. trade or business," this term is not specifically defined in the Code or regulations. However, IRC §864(b) and Treas. Regs. §§1.864-2 and 1.864-4 provide some guidance. For example, the performance of personal services within the United States during the year constitutes a trade or business within the United States.[157]

---

154. Treas. Reg. §301.7701(b)-1(b).

155. IRS Pub. 519, *U.S. Tax Guide for Aliens*.

156. IRC §864(c).

157. Treas. Reg. §1.864-4(c)(6)(ii).

Once it is determined that the alien has a trade or business, it must subsequently be determined whether the alien's income is effectively connected to the trade or business in the United States. ECI may be either sourced in the United States or be from a foreign source, and different tax rules apply to each of these categories.

> **Note.** To determine whether trade or business income arises from a U.S. or foreign source, sourcing rules are applied. These rules are found in IRC §§861, 862, 863, and 865 and the underlying regulations.

U.S.-sourced income is categorized as either FDAP income or non-FDAP income.[158]

Income falling into the FDAP category is ECI if the income is derived from business assets (under the asset-use test) or if the activities of a trade or business were material in realizing the income (under the business-activities test). Because this income is ECI, it is taxed using the same tax brackets and tax rates that apply to U.S. citizens.[159] Income that fails to meet either the asset-use or business-activity test is not ECI and is taxed at a flat 30% rate (unless a lower tax treaty rate applies).[160]

> **Note.** For details about the asset-use and business-activity tests, see Treas. Reg. §1.864-4.

Income falling into the non-FDAP category is generally considered to be ECI regardless of any actual connection to a trade or business.[161]

> **Note.** For additional guidance regarding the tax rules applicable to NRAs, see IRS Pub. 519, *U.S. Tax Guide for Aliens,* and IRS Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities.*

Tax Elections for Aliens Married to U.S. Citizens or Residents. There are two tax elections important for aliens who are married to U.S. citizens.

First, if two taxpayers are married at the end of the tax year and one spouse is a U.S. citizen or resident while the other spouse is an NRA, the spouses may elect to treat the NRA spouse as a U.S. resident.[162] The NRA spouse relinquishes the right to claim they are a nonresident of the United States under a tax treaty.[163] This election is effective for the tax year in which it is made and all subsequent tax years until the election is either suspended or terminated. Moreover, in the year in which the election is made, the spouses must file a joint return, but they may file either jointly or separately in subsequent years.[164]

Second, if an NRA is married to a U.S. citizen or resident and becomes a U.S. resident by the end of the tax year, the spouses may elect to treat the former NRA spouse as a U.S. resident for U.S. tax purposes for the entire tax year.[165]

> **Note.** For additional details on each of these elections, see IRC §§6013(g) and (h) and the underlying regulations.

---

158. IRC §§871(a), 864(c)(2), 864(c)(3); Treas. Reg §1.864-4.
159. IRC §871(b).
160. IRC §871(a).
161. IRC §864(c)(3).
162. IRC §6013(g).
163. Treas. Reg. §1.6013-6(a)(2)(v).
164. Treas. Reg. §1.6013-6(c), Example 1.
165. IRC §6013(h)(1).

Practitioner Planning Tip

If an election is made to treat an NRA spouse as a U.S. resident for the full tax year, then all the NRA spouse's worldwide income will be included on the U.S. tax return. Absent the election, the U.S. citizen/resident spouse will be required to use the married filing separately filing status (or head of household if the spouse otherwise meets the requirements for that filing status). If the NRA spouse does not have significant income, making the election and filing jointly may produce the lowest overall U.S. tax. If the U.S. citizen/resident spouse does not have significant income, then the couple may have a lower overall tax burden without making the election to treat the NRA spouse as a U.S. resident.

Nonresident Tax Withholding. A foreign individual or entity (such as a foreign partnership, trust, or estate) is generally subject to U.S. tax on U.S.-source income received during the tax year.[166] Tax withholding ensures that this tax is collected and paid, because the tax must be withheld directly from the payment to the foreign person or corporation by a withholding agent.[167] The withholding agent is generally the person or entity that has control of the payment to be made to the foreign individual or entity, and the duty to withhold is placed on the withholding agent, who is liable for the tax required to be withheld.[168]

Generally, the types of U.S.-source income subject to withholding include payments that constitute FDAP income and income for which a source cannot be determined at the time of payment.[169] FDAP income is broadly defined and generally includes the following.[170]

- Interest
- Dividends
- Rental income
- Wages and salaries
- Income from annuities and life insurance contracts
- Royalties

Note. For additional information on the types of income that constitute FDAP income, see IRS Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities.*

166. IRC §1441(a); Treas. Reg. §1.1441-5.

167. Treas. Reg. §1.1441-7; Temp. Treas. Reg. §1.1441-7T.

168. Ibid.

169. IRC §1441(b); Treas. Reg. §1.1441-2(a).

170. *Fixed, Determinable, Annual, Periodical (FDAP) Income*. Nov. 29, 2018. IRS. [www.irs.gov/individuals/international-taxpayers/fixed-determinable-annual-periodical-fdap-income] Accessed on Apr. 10, 2019.

As mentioned earlier, FDAP income may be treated as "effectively connected with a U.S. trade or business" if the FDAP income meets either an asset-use or business-activity test.[171] In addition, all of a foreign person's U.S.-source income that is **not** FDAP income is treated as ECI, regardless of whether the income is derived from the NRA's U.S. trade or business, under the "force of attraction" principle.[172] If the income is treated as ECI, business expenses may be claimed against it to arrive at a net amount that is taxable. ECI is not generally subject to nonresident tax withholding. Deductions may not be claimed against non-ECI, which is generally subject to nonresident tax withholding.[173]

> **Note.** A foreign person generally must furnish the withholding agent with Form W-8ECI, *Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States*, to establish that the income is ECI not subject to U.S. tax withholding.

The Code requires a flat withholding tax rate of 30%[174] on payments made to foreign individuals and entities, unless there is an express provision allowing a reduced rate.[175] Under certain circumstances, the Code provides for a 14% rate on qualified scholarship income or other amounts paid by a tax-exempt organization, foreign government, international organization, or U.S. government as a scholarship or fellowship for study, training, or research in the United States.[176] A tax treaty may also provide for a reduced rate of tax withholding. A withholding agent may apply a reduced rate of withholding if sufficient documentation is provided to the withholding agent that may be relied upon to verify the payee's entitlement to the reduced rate.[177]

> **Note.** Typically, a beneficial owner of the payment is required to provide identifying information and details regarding any claim of a reduced withholding rate. This can be accomplished by furnishing the withholding agent with a form such as Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals),* or Form 8233, *Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual.*

> **Note.** The nonresident tax withholding on payments to NRAs and foreign entities discussed in this section is referred to as "chapter 3 withholding," because chapter 3 of subtitle A of the Code includes the relevant rules (found in IRC §§1441–1446 and 1461–1464) for this withholding. For additional information, see these Code sections and the underlying regulations. Additional information may also be found in IRS Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities,* and at **uofi.tax/19stx2** [www.irs.gov/individuals/international-taxpayers/tax-withholding-types].
>
> Other rules for tax withholding on payments made to foreign entities are found in chapter 4 of subtitle A of the Code. Chapter 4 withholding includes the relevant rules about tax withholding on payments made to foreign financial institutions and other entities. These withholding rules were introduced as part of the Foreign Account Tax Compliance Act (FATCA), which was enacted in March 2010. For more information on chapter 4 withholding, see IRS Pub. 515 and **uofi.tax/19stx3** [www.thetaxadviser.com/issues/2013/oct/tpp-oct2013-story-01.html].

---

171. IRC §864(c)(2); Treas. Reg. §1.864-4.

172. IRC §864(c)(3); Treas. Reg. §1.864-4(b); *Effectively Connected Income*. Mar. 27, 2015. IRS. [www.irs.gov/pub/int_practice_units/USBCUP_14_2_01.pdf] Accessed on Apr. 10, 2019.

173. *Fixed, Determinable, Annual, Periodical (FDAP) Income*. Nov. 29, 2018. IRS. [www.irs.gov/individuals/international-taxpayers/fixed-determinable-annual-periodical-fdap-income] Accessed on Apr. 10, 2019.

174. IRC §1441(a).

175. Treas. Reg. §1.1441-1(b)(1).

176. IRC §1441(b).

177. IRS Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*.

Dual Status Alien[178]

During a tax year in which an individual arrives in or departs from the United States, that individual may be both a resident and nonresident alien for parts of the tax year. Such individuals are referred to as "dual status aliens." For the resident part of the tax year, the dual status alien's income is computed as a resident alien. The dual status alien's income tax liability is computed under applicable nonresident rules for the nonresident portion of the year.[179]

> **Note.** For additional information regarding dual status aliens, including determination of start and termination dates for periods of residency and nonresidency, see Treas. Reg. §301.7701(b)-4 and **uofi.tax/19stx4** [www.irs.gov/individuals/international-taxpayers/taxation-of-dual-status-aliens]. For compliance rules applicable to the departure of an alien from the United States, including acquisition of a certificate of compliance from the IRS, see IRC §6851(d) and Treas. Reg. §1.6851-2.

Expatriation Tax Rules

IRC §§877 and 877A apply to taxpayers relinquishing U.S. citizenship or terminating U.S. residency to avoid U.S. tax liability. Under these **expatriation** rules, the individual is subject to U.S. tax on U.S.-source income and gains for 10 years following expatriation, using the same tax brackets and tax rates that apply to U.S. citizens.[180] Expatriates are also subject to the alternative minimum tax (AMT).[181]

> **Note.** IRC §877 was enacted as part of the Foreign Investors Tax Act of 1966 (PL 89-809) to discourage relinquishment of U.S. citizenship or long-term residency for tax avoidance purposes. Substantial amendments were made to the original rules in 2004 (American Jobs Creation Act, PL 108-357) and in 2008 (Heroes Earnings Assistance and Relief Tax Act, PL 110-245). While IRC §877A has largely superseded §877 in this area, §877A refers to language that was used in the original §877 provisions.

An **expatriate** is a taxpayer who has relinquished U.S. citizenship or long-term residence.[182] The rules regarding such relinquishment are found in IRC §§877A(g)(4) and 7701(a)(50)(A).

A **covered expatriate** is defined as a U.S. citizen or long-term resident expatriate that meets one of the following three tests.[183]

1. The expatriate has an average annual net income tax liability for the five preceding years ending before the date of the loss of U.S. citizenship or lawful permanent residency that exceeds $168,000 for 2019.[184] This test is referred to as the "tax liability test."
2. The expatriate has a net worth of $2 million or more on the date of expatriation. This test is referred to as the "net worth test."
3. The expatriate fails to certify that they have complied with all U.S. tax requirements for the 5-year period preceding the expatriation date or fails to provide evidence of such compliance requested by the IRS.

> **Note.** For details about the exceptions to the tax liability and net worth tests, see IRC §877A(g)(1)(B).

178. IRS Pub. 519, *U.S. Tax Guide for Aliens*.

179. Treas. Reg. §1.871-13.

180. IRC §§877(a) and (b).

181. IRC §877(b).

182. IRC §§877(a) and (e)(2).

183. IRC §877(a)(2).

184. This amount is established by IRC §877 and is subject to an annual inflation adjustment. For the 2019 amount, see Rev. Proc. 2018-57, 2018-49 IRB 827.

A **long-term resident** is generally a foreign citizen who was a lawful permanent U.S. resident for at least eight of the 15 tax years ending with the year the individual ceases lawful permanent U.S. residence.[185]

Special mark-to-market tax rules apply to covered expatriates.[186] Under these rules, a one-time tax is imposed on the net unrealized appreciation in the taxpayer's property. For purposes of determining the amount of tax, the covered expatriate is treated as having sold the property for fair market value on the day before the expatriation date. The resulting gain is taken into account in the year of the deemed sale. Losses are also taken into account. The tax does not apply on the amount of gain up to an exempted amount ($725,000 for 2019).[187]

> **Note.** For additional information on the expatriate tax rules, see IRC §877A and **uofi.tax/19stx5** [www.irs.gov/individuals/international-taxpayers/expatriation-tax].

IRS-ISSUED TAXPAYER IDENTIFICATION NUMBERS[188]

The Protecting Americans from Tax Hikes (PATH) Act of 2015,[189] signed into law December 18, 2015, made broad changes to the requirements for the issuance of individual taxpayer identification numbers (ITINs).[190]

Generally, the Social Security Administration only issues a social security number (SSN) to a U.S. citizen or an alien who has been granted lawful permanent residency status or, in some cases, who has entered the United States for permitted employment.[191] An IRS-issued ITIN must be issued to a resident or NRA who is otherwise unable to obtain an SSN. In the absence of an SSN, an ITIN is generally required to file a U.S. tax return or for an individual who is claimed as a dependent.[192]

> **Note.** Because the Tax Cuts and Jobs Act of 2017 (TCJA) suspends personal exemptions from 2018 through 2025,[193] taxpayers who would otherwise be required to renew ITINs solely for the purpose of claiming such exemptions will not need to do so.

Form W-7, *Application for IRS Individual Taxpayer Identification Number,* is used to obtain an ITIN by those individuals who are ineligible to obtain an SSN. Form W-7 (and all supporting documentation) may be submitted with the original tax return for which the ITIN is needed if the taxpayer lives in the United States.[194] Alternatively, such taxpayers may also furnish Form W-7 and supporting documentation to the IRS by mail, in person to an IRS employee, or to a certified acceptance agent (CAA).[195]

---

185. IRS Pub. 519, *U.S. Tax Guide for Aliens*; IRC §7701(b)(6).

186. IRC §877A(a).

187. IRC §877A(a)(3); Rev. Proc. 2018-57, 2018-49 IRB 827.

188. *Taxpayer Identification Numbers (TIN)*. May 2, 2018. IRS. [www.irs.gov/individuals/international-taxpayers/taxpayer-identification-numbers-tin] Accessed on Feb. 28, 2019; Instructions for Form W-7; IRS Pub. 1915, *Understanding Your IRS Individual Taxpayer Identification Number*.

189. PL 114-113.

190. PL 114-113, §203.

191. Treas. Reg. §§301.6109-1(d)(4) and (g).

192. Treas. Reg. §301.6109-1(d)(3).

193. PL 115-97, §11041.

194. IRC §6109(i)(1).

195. IRC §6109(i)(1)(A).

Taxpayers living outside the United States must submit Form W-7 and supporting documentation by mail to the IRS or in person to an IRS employee, a CAA, or a designated individual at a United States diplomatic mission or consular post.[196]

> **Note.** Not all IRS Tax Centers have employees authorized to review and accept ITIN applications. To determine if a particular tax center provides this service, see **uofi.tax/19stx6** [www.irs.gov/uac/tac-locations-where-in-person-document-verification-is-provided].

The required supporting documentation must generally include information sufficient to establish the taxpayer's identity and connection to a foreign country. ITIN applications by or on behalf of persons to be claimed as dependents must also include documentation that establishes U.S. residency unless the applicant is from Canada, Mexico, or is a dependent of a person in the U.S. military who is stationed overseas. Supporting documentation must be in the form of **original documents or certified copies** of the originals that have been certified by the agency that issued the original.

> **Note.** The requirement that original documents or issuer-certified copies be furnished with a Form W-7 does not apply to military spouses and dependent children, NRAs applying for ITINs so they may claim treaty benefits, and participants under the Student Exchange Visitors Program.[197]
>
> See the instructions to Form W-7 for additional details on the requirements for certified copies. While typical documentation to establish identity and foreign status includes a passport, foreign driver's license, birth certificate, or national identification card, the instructions to Form W-7 list 13 acceptable types of documents that may be used to establish identity and/or foreign status.

Certified Acceptance Agents[198]

A CAA is a party who enters into a written agreement with the IRS to act as an authorized IRS agent for the purpose of assisting individuals who do not qualify for SSNs to obtain ITINs. There are CAAs located both within and outside the United States.

Parties that may qualify to be CAAs include individuals, financial institutions, and educational institutions that qualify under IRC §501(c)(3) rules.

> **Note.** For further information on CAAs and what is required to obtain CAA status, including the application process and training, see **uofi.tax/19stx7** [www.irs.gov/individuals/new-itin-acceptance-agent-program-changes] and the Acceptance Agents' Guide for Individual Taxpayer Identification Number, which can be found at www.irs.gov/pub/irs-pdf/p4520.pdf. For a list of existing CAAs, see **uofi.tax/19stx8** [www.irs.gov/individuals/international-taxpayers/acceptance-agent-program].

196. IRC §6109(i)(1)(B).

197. IRS Fact Sheet FS-2012-11 (Nov. 29, 2012).

198. Treas. Reg. §301.6109-1(d)(3)(iv).

ITIN Expiration and Renewal

The PATH Act introduced expiration dates for certain ITINs.[199] An ITIN issued after 2012 does not require renewal unless that ITIN has not been used on a U.S. federal tax return at least once in the last three consecutive tax years. Use of the ITIN on a tax return within the past three consecutive years as either a filer or as a dependent ensures that the ITIN will remain in effect.[200] If not so used, the ITIN expires on the day after the due date for the tax return for the third year.[201]

The expiration date of an ITIN issued before 2013 is based on the ITIN's issue date. This expiration schedule is as follows.[202]

- ITINs issued before 2008 expired December 31, 2016 (these are ITINs with middle digits of 78 or 79).
- ITINs issued in 2008 expired December 31, 2017 (these are ITINs with middle digits of 70, 71, 72, or 80).
- ITINs issued in 2009 or 2010 expired December 31, 2018 (these are ITINs with middle digits of 73, 74, 75, 76, 77, 81, or 82).
- ITINs issued in 2011 or 2012 will expire on December 31, 2019.

Note. While the expiration schedule is based on the ITIN issue date, the IRS is administering the program by providing the middle digits of ITINs because many ITIN holders may not know or recall the issue date of their ITINs.[203] The IRS announces middle digits for expiring ITINs throughout the expiration and renewal process.

Renewal Process.[204] Taxpayers with expiring ITINs who may be required to file a 2019 tax return should receive either a CP-48 Notice or IRS Letter 5821 by mail from the IRS. An ITIN must be renewed prior to filing a tax return. However, individuals with expired or expiring ITINs do not need to wait until receiving an expiration notification from the IRS to renew their ITIN. After the ITIN is renewed, the taxpayer should receive a CP-565 Notice, *Confirmation of Your Individual Taxpayer Identification Number.*

Taxpayers with an ITIN with middle digits of 73, 74, 75, 76, 77, 81, or 82 and all previously expired ITINs may renew ITINs for their entire family (which includes the taxpayer, spouse, and dependents) simultaneously under the family renewal option. This option exists even if family members have one or more ITINs that do not have middle digits that would identify them for expiration. All family members who have an ITIN may submit their respective Forms W-7 at the same time.

When a return is filed with an expired ITIN, the IRS processes the return but disallows certain credits or exemptions and does not issue a refund. The IRS sends the taxpayer a notice explaining the refund delay and advises the taxpayer that their ITIN must be renewed. After the ITIN is renewed, the IRS reprocesses the tax return, allowing previously disallowed credits or exemptions. Any refund due plus interest is issued to the taxpayer.

---

199. PL 114-113, §203(a)(i)(3).

200. IRC §6109(i)(3)(A).

201. Ibid.

202. IRS Notice 2016-48, 2016-33 IRB 235; *Individual Taxpayer Identification Number.* Oct. 3, 2018. IRS. [www.irs.gov/individuals/individual-taxpayer-identification-number] Accessed on Jan. 12, 2019.

203. See IRS Notice 2016-48, 2016-33 IRB 235.

204. *ITIN Expiration Frequently Asked Questions*. Jan. 31, 2019. IRS. [www.irs.gov/individuals/itin-expiration-faqs] Accessed on Apr. 10, 2019; *Understanding your CP-48 Notice.* Oct. 31, 2018. [www.irs.gov/individuals/understanding-your-cp48-notice] Accessed Apr. 26, 2019; IRS Notice 2016-48, 2016-33 IRB 235.

Note. After the IRS processes a return with an expired ITIN, the taxpayer may owe interest and penalties if there is a tax liability shown on the return because of the disallowed credits or exemptions.

Observation. Extending the return to provide additional time for the taxpayer to renew their ITIN may be a better option than filing a return with an expired ITIN.

Note. For additional information on the ITIN expiration and renewal program, see IRS Notice 2016-48 at **uofi.tax/19stx9** [www.irs.gov/pub/irs-drop/n-16-48.pdf] and the IRS web page regarding ITINs at **uofi.tax/19stx45** [www.irs.gov/individuals/individual-taxpayer-identification-number]. For renewal information, including the address to which Form W-7 may be sent, see **uofi.tax/19stx46** [www.irs.gov/credits-deductions/individuals/how-do-i-renew-my-itin].

FOREIGN EARNED INCOME EXCLUSION[205]

The foreign earned income exclusion (FEIE) allows a U.S. citizen or RA to elect to exclude a limited amount of employment income earned outside the United States.[206] To qualify, the U.S. citizen or RA must:

- Have received employment income in a foreign country,
- Meet either the bona fide residency test or the physical presence test, and
- Have a tax home in the foreign country.

Note. See Treas. Reg. §§1.911-3(a), (b), and (c) for the definitions of "foreign earned income" and "earned income" and the types of income that do not qualify for the FEIE. Special rules apply in order for self-employment (SE) income to qualify for the FEIE.[207]

Bona Fide Residency

The taxpayer meets the bona fide residency test if the taxpayer is a U.S. citizen who is a bona fide resident of a foreign country for an uninterrupted period that includes an entire tax year, or is an RA who is:[208]

- A citizen or national of a country with which the United States has a tax treaty, and
- A bona fide resident of a foreign country for an uninterrupted period that includes an entire tax year.

Observation. Bona fide residence, domicile, and tax home have different meanings. For a review of how these terms are defined and used in these tests, see IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad,* and Treas. Reg. §1.911-2. For a discussion of bona fide residency that includes key court cases, see **uofi.tax/19stx10** [www.forbes.com/sites/anthonynitti/2019/02/21/top-tax-court-cases-of-2018-where-is-your-tax-home/?ss=taxes#3c6a4a134b86].

---

205. IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

206. IRC §§911(a)(1), (b) and (d).

207. Treas. Reg. §1.911-3(b)(2).

208. *Foreign Earned Income Exclusion-Bona Fide Residence Test.* Jan. 30, 2019. IRS. [www.irs.gov/individuals/international-taxpayers/foreign-earned-income-exclusion-bona-fide-residence-test] Accessed on Apr. 5, 2019.

The taxpayer does **not** automatically satisfy the bona fide residence test by living in a foreign country for an entire tax year or longer. A facts-and-circumstances analysis is required. Whether the taxpayer satisfies the bona fide residence test may depend upon the taxpayer's intention regarding the length and nature of the stay in the foreign country. A foreign stay for a definite, temporary purpose followed by an immediate return to the United States does not satisfy the bona fide residence test. However, an indefinite, extended stay during which the taxpayer makes the foreign country home may satisfy the bona fide residence test. If a foreign country's tax authority deems the taxpayer exempt from the foreign country's income tax law because the taxpayer has claimed nonresident status in the foreign country, the taxpayer is not considered a bona fide resident of that foreign country for U.S. tax purposes.[209]

Note. It is possible for the taxpayer to have a bona fide foreign residence while maintaining a U.S. domicile. For additional information, see IRS Pub. 54.

Note. For a recent case in which the Tax Court applied a facts-and-circumstances analysis in determining whether a taxpayer (who was a helicopter pilot in Iraq) met the bona fide residence test, see *J.A. Linde v. Comm'r.*[210] For a summary of this case, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 4: Rulings and Cases.

Generally, foreign earned income does not include pay received as a military or civilian employee of the U.S. government or any of its agencies.[211] However, the Bipartisan Budget Act of 2018[212] changed the tax home requirement for certain taxpayers providing military support. Effective for the 2018 tax year and subsequent years, contractors or employees of contractors providing **support** to the U.S. Armed Forces in designated combat zones may now claim the FEIE even if their tax home is in the United States.[213]

Practitioner Planning Tip

As stated earlier, RAs can claim the foreign earned income exclusion. However, it is recommended that the RA use the physical presence test rather than the bona fide residence test. With the bona fide residence claim, the IRS may contend that an RA has a closer connection with a foreign country and that the RA is in fact a resident of that foreign country for tax purposes.[214] This could lead to a conclusion that the RA abandoned their U.S. residency.[215]

209. IRC §911(d)(5).

210. *J.A. Linde v. Comm'r,* TC Memo 2017-180 (Sep. 18, 2017).

211. *Foreign Earned Income Exclusion*. May 30, 2018. IRS. [www.irs.gov/individuals/international-taxpayers/foreign-earned-income-exclusion] Accessed on Apr. 15, 2019.

212. PL 115-123.

213. IRC §911(d)(3).

214. IRC §911(d)(5).

215. IRC §7701(b)(6)(B).

Physical Presence Test

A U.S. citizen or RA meets the physical presence test if they are physically present in a foreign country for an aggregate of at least 330 days during any consecutive 12-month period. The 12-month period need not be the calendar year, and the 330 days need not be continuous.[216] Moreover, the 12-month period may begin before or after arrival in a foreign country and may end before or after departure.

> **Note.** For further details on the physical presence test, including days that do not count toward the 330-day requirement and the counting rules for taxpayers traveling between two foreign points, see Treas. Reg. §1.911-2(d).

Amount of Excludable Income

The FEIE may only be used to exclude income earned from services performed in the course of employment or qualifying SE income.[217] Several types of income do not qualify, such as pension, annuity, or social security income[218] and amounts paid to an employee of the U.S. government or government agency.[219]

> **Note.** For a definition of what income qualifies for the FEIE and guidance on the types of income that do not qualify, see Treas. Reg. §1.911-3.

Generally, the amount excludable from gross income is the lesser of:[220]

- The amount of qualifying income, or
- The maximum allowable FEIE amount for the year.

The maximum amount allowable is subject to an inflation adjustment annually.[221] The maximum is $105,900 for the 2019 tax year[222] ($103,900 for the 2018 tax year[223]).

Taxpayers who do not qualify for the FEIE for the entire year must prorate the maximum allowable amount for the year based on the number of qualifying days for the taxpayer during the year relative to the number of overall days in the tax year.[224]

> **Note.** For additional details on how to make the FEIE claim, including the use of Form 2555, *Foreign Earned Income*, and detailed examples, see the 2011 *University of Illinois Federal Tax Workbook*, Chapter 9: International Taxation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

---

216. Treas. Reg. §1.911-2(d).
217. Treas. Reg. §1.911-3.
218. Treas. Reg. §1.911-3(c)(2).
219. Treas. Reg. §1.911-3(c)(3).
220. IRC §911(b)(2).
221. IRC §911(b)(2)(D)(ii).
222. Rev. Proc. 2018-57, 2018-49 IRB 827.
223. Rev. Proc. 2018-18, 2018-10 IRB 392.
224. Treas. Reg. §§1.911-3(d)(2) and (3).

Practitioner Planning Tip

When deciding whether to elect the FEIE, tax practitioners need to consider the interplay between the FEIE and the foreign tax credit (FTC) (discussed later in this chapter). A taxpayer claiming the FEIE can also claim an FTC but only for those foreign taxes relating to income that was **not** excluded using the FEIE.[225]

For example, if a taxpayer pays $90,000 of foreign income tax on $300,000 of foreign earned income (FEI) and claims a $100,000 FEIE, then the taxpayer can only claim a credit for $60,000 of the foreign taxes. This is because $30,000 of the foreign taxes are not creditable because they are allocable to the $100,000 FEIE (($100,000 FEIE ÷ $300,000 FEI) × $90,000 foreign income taxes). In addition to losing a portion of creditable foreign taxes, the taxpayer determines their tax liability by taking the excess of tax computed on taxable income with the FEIE added back over the tax on the FEIE alone.[226] This tax calculation results in the taxpayer only getting a benefit from the FEIE at their lowest tax rates.

Consequently, U.S. taxpayers with higher income who live and work in "high tax" countries (e.g., many European countries that have relatively high tax rates) may derive little or no tax benefit from claiming the FEIE. A "high-tax" country is one whose income tax is higher than the U.S. federal income tax on the same income. In our example, if the taxpayer files jointly and has no other income/deductions, their 2019 federal income tax before the FTC but after the FEIE is approximately $40,800. However, the FTC then reduces this tax to zero and there is **$19,200** excess FTC ($60,000 previously determined – $40,800 currently utilized) available for carryback or carryover.

Alternatively, if the taxpayer forgoes the FEIE, then their 2019 federal income tax before FTC is approximately $54,500. Again, this federal tax liability is reduced to zero by the FTC but this time there is a **$35,500** excess FTC ($90,000 total foreign income tax – $54,500 currently utilized) available for carryback or carryover. This is a simplistic example but one designed to illustrate that it is advantageous for U.S. taxpayers in high-tax countries not to elect the FEIE when no current tax benefit ensues and a higher excess FTC results.

Practitioners may want to run multiple computations for U.S. taxpayers in high-tax countries to determine whether a better tax result may be gained by **not** electing the FEIE.

However, if the taxpayer resides in a lower-tax country (e.g., Saudi Arabia or the United Arab Emirates), then electing the FEIE should generally result in a lower U.S. tax.

225. IRC §911(d)(6).

226. IRC §911(f).

Foreign Housing Expenses.[227] Generally, a U.S. citizen or RA who qualifies for the FEIE may also **elect** to exclude certain foreign housing costs using the foreign housing exclusion (FHE). The FHE is in addition to the FEIE in the same tax year.

The amount excludable for foreign housing is subject to both floor and ceiling amounts that are based on the maximum excludable FEIE amount for the year.[228] The FHE floor and ceiling amounts are calculated by multiplying the maximum FEIE amount for the year by 16% and 30%, respectively. Only expenses in excess of the floor amount may be excluded, and expenses may only be excluded to the extent they do not exceed the ceiling amount. Therefore, the maximum excludable FHE amount for the year is the FEIE maximum amount for the year multiplied by 14% (30% –16%). The following table provides the maximum FHE amounts for 2018 and 2019.

Tax Year	Maximum FEIE Amount (A)	FHE Floor (FEIE Maximum × 16%) (B)	FHE Ceiling (FEIE Maximum × 30%) (C)	Maximum FHE Deduction for the Year (C) – (B)
2018	$103,900	$16,624	$31,170	$14,546
2019	105,900	16,944	31,770	14,826

The ceiling amount may be adjusted by the IRS for specific foreign locations with higher housing costs. These higher ceiling amounts are indicated in the instructions to Form 2555 each year. The IRS identified several locations with higher ceiling amounts for 2018.[229]

A taxpayer may only take into account foreign housing costs attributable to the number of days that the taxpayer qualified for the FEIE during the year. Accordingly, the floor, ceiling, and maximum limits in the preceding table are based on a qualifying 365-day year. For those taxpayers with partial qualifying years, a per-day FHE calculation is required.

Moreover, foreign housing costs in excess of the taxpayer's foreign earned income amount may not be claimed.[230] Taxpayers claiming both the FEIE and FHE must compute their FHE first and reduce their foreign earned income by this FHE amount before computing their FEIE.[231] In addition, the taxpayer must deduct the full amount of FHE to which they are entitled, because a partial claim is not permitted.[232]

> **Example 20.** Gretchen, a mechanical engineer, is a U.S. citizen who lives in an apartment in Nuremburg, Germany, where she works for an employer designing engine parts for construction equipment. Gretchen lived in Nuremberg for the entire 2019 tax year. Nuremberg is a city for which the maximum FHE deduction for 2019 is $14,826 (see preceding table) because it is not a city in which the IRS provides for higher ceiling amounts. For 2019, Gretchen's salary is $110,000 and her qualified foreign housing expenses are $20,000.
>
> Gretchen can exclude foreign housing expenses from her 2019 income up to the maximum allowable amount of $14,826. However, in Gretchen's case, the FHE floor limits her housing exclusion to $3,056 ($20,000 foreign housing expenses − $16,944 FHE floor).
>
> Moreover, Gretchen's foreign earned income of $110,000 must be reduced by her allowable FHE exclusion to arrive at adjusted foreign earned income of $106,944 ($110,000 – $3,056). Consequently, Gretchen may also claim a $105,900 FEIE (which is the lesser of the $105,900 maximum FEIE allowable for 2019 and her adjusted foreign earned income of $106,944).

---

227. IRC §911(c).

228. IRC §§911(c)(1) and (2).

229. IRS Notice 2019-24, 2019-14 IRB 932.

230. Treas. Reg. §1.911-3(d)(1).

231. See Form 2555, *Foreign Earned Income*, and associated instructions.

232. Ibid.

The taxpayer may deduct only qualified housing expenses paid or incurred in the year for foreign housing for the taxpayer and a spouse or dependents who live with the taxpayer.[233] The expenses must be reasonable, and not lavish or extravagant.[234] Qualifying expenses include the following.[235]

- Rent and/or fair rental value of employer-provided housing
- Utilities, excluding telephone charges
- Real and personal property insurance
- Furniture and accessory rentals
- Residential parking costs

Expenses incurred for domestic labor or for the purchase of property or the cost of improvements that increase the value of the property or prolong the property's life do not qualify.

Foreign Housing Deduction. A housing deduction is also available for foreign housing expenses that are not employer-provided amounts. The amount of the housing deduction cannot exceed the taxpayer's foreign earned income that is not excluded under IRC §911.[236]

> **Note.** For additional details regarding the FHE, including its integration with the FEIE and how to claim it, see the 2011 *University of Illinois Federal Tax Workbook*, Chapter 9: International Taxation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

INTERNATIONAL EDUCATION ISSUES

There are specific tax rules for international students, which are explored in this section. Such students include the following.

- U.S. citizens or RAs studying or teaching abroad
- Foreign instructors or students who are working and/or studying in the United States

U.S. Citizens or Resident Aliens Studying Abroad

The American opportunity credit (AOC) and lifetime learning credit (LLC) are allowed against federal income tax for qualified education and related expenses paid during the tax year.[237]

Tuition paid to an overseas educational institution qualifies for the AOC and LLC if it is paid to an eligible educational institution.[238] An **eligible educational institution** is a college, university, vocational school, or other post-secondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.[239] Approximately 400 foreign schools participate in U.S. Department of Education student aid programs.[240]

---

233. Treas. Reg. §1.911-4(a).
234. Treas. Reg. §1.911-4(b)(4).
235. Treas. Reg. §1.911-4(b); IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.
236. IRC §911(c)(4).
237. IRC §25A.
238. IRC §25A(f)(1).
239. Treas. Reg. §1.25A-2(b).
240. *iLibrary — Federal School Code List.* 2019-2020. U.S. Dept. of Education. [ifap.ed.gov/ifap/fedSchoolCodeList.jsp] Accessed on May 28, 2019.

Note. The U.S. Department of Education maintains a list of eligible educational institutions, which may be accessed at **uofi.tax/19stx11** [ifap.ed.gov/ifap/fedSchoolCodeList.jsp]. To claim an education benefit, the student generally must receive Form 1098-T, *Tuition Statement,* from the educational institution. If the student does not receive the form, they must request it from the educational institution and cooperate with the institution's efforts to gather information for preparation of this form. If despite these efforts the student does not receive Form 1098-T, then the student must be able to demonstrate that they (or a dependent) were enrolled at an eligible educational institution and can substantiate the payment of qualified tuition and related expenses.[241]

Note. The Bipartisan Budget Act of 2018 extended the above-the-line tuition deduction to tax years beginning before January 1, 2018. Absent legislation that extends this deduction past 2017, it is not available for calendar year 2018 or subsequent tax years.[242]

Earned Income and Housing Expenses. A U.S. citizen or RA who is abroad for educational purposes and who has earned income in the foreign country may claim the FEIE for the earned income. They may also claim the FHE in connection with eligible housing costs, if all requirements for these exclusions are otherwise met.[243] However, these exclusions must then be added back to determine modified adjusted gross income for calculating an allowable education tax credit.[244]

Note. It is prudent to always check any tax treaty between the United States and the foreign country in which the student attended school to determine if there are any specific treaty provisions affecting students.

A student with earned income in a foreign jurisdiction or who may be considered a resident of the foreign country for the duration of their school attendance may need to file a tax return with the tax authority of that foreign country.

Foreign Students Studying in the United States[245]

Generally, an NRA meeting the substantial presence test is subject to U.S. taxation as a resident alien.[246] However, the following individuals are considered exempt from the substantial presence test.[247]

- Teachers or trainees temporarily present in the United States with a J or Q visa (under the "teacher or trainee exception"[248])
- Students temporarily in the United States with an F, J, M, or Q visa (under the "student" exception)[249]

241. Instructions for Form 8863.

242. PL 115-123.

243. IRC §911.

244. IRS Pub. 970, *Tax Benefits for Education*.

245. IRS Pub. 4011, *Foreign Student and Scholar Resource Guide.*

246. IRC §7701(b).

247. Treas. Reg. §§301.7701(b)-3(b)(3) and (4).

248. IRC §7701(b)(5)(C).

249. IRC §7701(b)(5)(D).

Under these exceptions, days present in the United States do not count under the substantial presence test.[250] Family members of individuals exempt under the above exceptions are also considered exempt.[251] Continual adherence to the terms of a visa is necessary to ensure that exempt status is not lost.[252]

Teachers and trainees lose exempt status once they have been exempt for any two calendar years during the last six calendar years (or for any four calendar years during the last six calendar years if the teacher or trainee received compensation by a foreign employer).[253]

The student exception ends after five years unless the IRS is satisfied that the student meets the requirements for a student under immigration law and does not intend on becoming a permanent U.S. resident. Relevant factors in this inquiry include whether the student has continued to maintain a closer connection with another country or has taken steps to change their status under immigration law. Generally, once the duration of an exception is over, the teacher/trainee or student's continued presence in the United States will result in meeting the substantial presence test. Consequently, they are then classified for tax purposes as a U.S. resident.[254]

> **Note.** To qualify for either exception, the individual must file Form 8843, *Statement for Exempt Individuals and Individuals With a Medical Condition*.

During the period they are exempt, F, J, M, and Q visa holders are taxed as NRAs. For most **scholarships or fellowships**, an F, J, M, or Q visa holder is considered to be engaged in a trade or business within the United States.[255] A flat withholding tax rate of 14% applies to scholarship or fellowship payments made to these visa holders.[256]

Any **wage income** earned by the F, J, M, and Q visa holder is considered to be FDAP income (i.e., not derived from a U.S. trade or business) and is subject to a flat 30% tax rate.[257] Wage income earned by these visa holders is exempt from FICA taxation.[258] However, compensation for labor or personal services performed in the United States is not treated as U.S. source income if the following conditions are met.[259]

1. Such services are performed by an NRA temporarily in the United States for 90 days or less.
2. The total amount of compensation is $3,000 or less.
3. The NRA is employed by or under contract with either an NRA, foreign partnership, or foreign corporation not engaged in a trade or business in the United States, **or** a U.S. citizen or resident, or a U.S. partnership or corporation if the services are performed in a foreign office of such an employer.

The NRA notifies the payroll office (or other relevant payor) of their NRA status using Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*.[260]

---

250. IRC §7701(b)(3)(D).
251. Treas. Reg. §§301.7701(b)-3(b)(3) and (4).
252. Treas. Reg. §301.7701(b)-3SS(b)(6).
253. IRC §7701(b)(5)(E)(i).
254. Treas. Reg. §301.7701(b)-3(b)(7).
255. IRC §871(c).
256. IRC §1441(a).
257. IRC §871(a).
258. IRC §3121(b)(19).
259. IRC §861(a)(3).
260. IRS Pub. 519, *U.S. Tax Guide for Aliens*.

Claiming education credits such as the **AOC or the LLC is generally limited to U.S. citizens and RAs.** However, an NRA student with an IRC §6013(g) or (h) **election to be treated as a U.S. resident** for tax purposes may claim these credits.[261] An education credit may be claimed for an NRA dependent who is a resident of either Canada or Mexico.[262]

> **Note.** Additional information about foreign students and scholars may be found at **uofi.tax/19stx12** [www.irs.gov/individuals/international-taxpayers/foreign-students-and-scholars].

FOREIGN TAX CREDIT/DEDUCTION

A taxpayer with U.S. tax liability may claim either a foreign tax credit (FTC) or foreign tax deduction (FTD) against federal tax liability for foreign taxes paid or accrued to a foreign country.[263]

For the foreign tax paid or accrued to qualify for the FTC, the amount paid to the foreign country must be levied as a tax that has the predominant character of the U.S. income tax.[264] The FTC is subject to two limitations.

1. The taxpayer may not claim an FTC that exceeds the taxpayer's total U.S. tax liability.[265]
2. Separate FTC limitations apply to seven categories of income, including general category income (GCI) and passive category income (PCI).[266]

GCI generally constitutes income that does not fall under any of the other six categories, and includes items of income such as wages, salaries, and overseas allowances of employees. GCI also includes foreign SE income and gains from the sale of depreciable business assets or inventory.

PCI includes interest, dividends, rental income, and foreign currency exchange gains or losses received by the taxpayer.

> **Note.** GCI and PCI are the two categories of income affecting most U.S. persons living and working outside the United States. For details regarding these and the other five categories, see the instructions to Form 1116 and the additional information available from the IRS at **uofi.tax/19stx13** [www.irs.gov/forms-pubs/about-form-1116].

> **Note.** For additional information on the FTC and FTD, see IRS Pub. 514, *Foreign Tax Credit for Individuals,* and the instructions to Form 1116.

A taxpayer claims the FTC by using Form 1116, *Foreign Tax Credit.* Claiming the FTD requires the taxpayer to itemize deductions, using Schedule A, *Itemized Deductions.* The FTD is reported on Schedule A, line 6 (other taxes) and is **not** subject to the $10,000 state and local tax limit.[267]

---

261. IRC §25A(g)(7).
262. Treas. Reg. §1.25A-2(a).
263. IRC §§901 and 164.
264. Treas. Reg. §1.901-2(a). See also *Topic Number 856 — Foreign Tax Credit.* Jan. 20, 2019. IRS. [www.irs.gov/taxtopics/tc856] Accessed on Apr. 9, 2019.
265. IRC §904(a).
266. IRC §904(d).
267. IRC §164(b)(6).

Practitioner Planning Tip

It may be prudent for the practitioner to run dual calculations for the taxpayer comparing the tax savings using the FTC and FTD to determine which is most effective at reducing U.S. tax liability.

When the taxpayer claims the FTC, foreign taxes that exceed the FTC limitation for a particular year are first carried back to the immediately preceding tax year to the extent that they are not more than the FTC limitation in that preceding tax year. Any remaining excess FTC is carried forward for up to 10 years.[268]

Taxpayers subject to AMT who elect to claim FTC against their regular tax are entitled to claim an alternative minimum tax foreign tax credit (AMT-FTC) to reduce their AMT liability.[269] The AMT-FTC is applied against gross AMT. The resulting tentative minimum tax is compared to regular tax to calculate any AMT liability. An unused AMT-FTC may be carried forward or back to reduce AMT liability under the same rules as those for regular tax FTC.[270]

The FTC is limited to the portion of the taxpayer's tax liability that is proportionate to the part of taxable income that comes from foreign sources.[271] However, taxpayers with no more than $300 ($600 for MFJ filers) of foreign taxes related to passive income may elect to use a simplified FTC that bypasses this limitation for both regular tax and AMT.[272]

Note. For additional details regarding the FTC, see IRS Pub. 514.

TAX TREATIES[273]

Taxpayers who are subject to U.S. tax rules and who are also taxed on income in a foreign jurisdiction may face taxation by the foreign tax authority and the U.S. on the same income. Preventing this double taxation is a primary reason for the existence of tax treaties between the U.S. and many other countries.

Residents of foreign countries may either be exempt from U.S. income taxation or be entitled to a reduced tax rate, tax credit, or other treaty benefit.

268. IRC §904(c) and Treas. Reg. §1.904-2.

269. See Instructions for Form 6251.

270. IRC §904(c); Instructions for Form 6251.

271. IRC §904(a).

272. IRC §904(j)(2)(B); Instructions for Form 6251.

273. *Tax Treaties*. Dec. 12, 2018. IRS. [www.irs.gov/individuals/international-taxpayers/tax-treaties] Accessed on Feb. 25, 2019.

Practitioners with international tax clients subject to U.S. tax rules should always consult any relevant tax treaties that may exist between the United States and the foreign country in which the client may be a resident. This will allow a determination of whether that client is entitled to claim any treaty benefits in the United States.

Note. Tax treaties in which the United States is a party, like all U.S. treaties, are not legislated. The U.S. Constitution vests treaty power in the executive branch and the senate.[274] The president can form and negotiate a treaty, and subsequently two-thirds of the senate must concur. After senate approval, the president can ratify the treaty, which makes it binding. For additional information on the treaty process, see **uofi.tax/19stx14** [www.senate.gov/artandhistory/history/common/briefing/Treaties.htm].

General Types of Treaty Provisions

This section explains some of the general types of provisions found in typical tax treaties. However, practitioners should be aware that **each tax treaty is unique** and that the provisions and the issues addressed by the countries that are parties to the agreement vary widely. The practitioner should **always** review the actual tax treaty, as well as accompanying protocols and technical explanations to the treaty, that is applicable to the client's situation. (See the discussion under the "Pensions, Annuities, Social Security" section later in this chapter.)

Note. A list of current tax treaty agreements in effect between the United States and other countries, with links to the actual treaties, is available at **uofi.tax/19stx15** [www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z]. Tax treaty tables that summarize treaty benefits may be found at **uofi.tax/19stx16** [www.irs.gov/individuals/international-taxpayers/tax-treaty-tables].

Note. This section uses provisions from the United States–Canada Income Tax Convention (USCITC) as examples of typical provisions. This treaty, including accompanying protocols and technical explanations, may be found at **uofi.tax/19stx17** [www.irs.gov/businesses/international-businesses/canada-tax-treaty-documents]. In addition, IRS Pub. 597, *Information on the United States–Canada Income Tax Treaty,* discusses treaty provisions that most often apply to U.S. citizens or residents who may be liable for Canadian tax.

Treaty provisions are generally applied on a "mirror image" basis unless the terms of the provision expressly state otherwise.[275] Accordingly, the tax treatment under a specific provision for a U.S. resident receiving Canadian-sourced income is similar to the tax treatment for a Canadian resident receiving the same type of U.S.-source income. Moreover, when a dollar amount threshold is expressed, it is construed as being in either U.S. dollars or Canadian dollars depending upon the currency in which the income is received (e.g., article XV of the USCITC).

Note. The Organization for Economic Co-operation and Development published a model tax treaty that may serve as a basis for tax treaties entered into between nations. For additional information, see **uofi.tax/19stx18** [www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm].

274. U.S. Constitution, Article II, section 2.

275. For example, see the *United States – Canada Income Tax Convention,* Article I.

Definitions. The practitioner should review the definition section found in a tax treaty. Practitioners should not assume that the same term will be defined in the same way in each tax treaty. To the contrary, some terms are unique to the treaty agreements between countries and frequently the terms and their respective definitions are the result of substantial negotiation between the countries forming the agreement (frequently referred to as "contracting states").

Determination of Residence. Treaties typically define **resident** for treaty purposes. For example, under the USCITC, (in which the "contracting states" are the United States and Canada), a resident of the contracting state means any person who, under the laws of that state, is liable to taxation by that state "…by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature…"[276]

In the event that the taxpayer is considered a resident of both countries under this test, a tax treaty typically provides tie-breaker rules for a final determination. A hierarchy of factors is typically considered on a step-by-step basis in order to determine which contracting state is the taxpayer's residence.

For example, under the USCITC, the taxpayer is deemed a resident of the contracting state "in which the taxpayer has a permanent home available to him." However, if the taxpayer has a permanent home available in both (or neither) of the contracting states, then the taxpayer's "center of vital interests" (closer personal and economic ties) are determinative. If the taxpayer's center of vital interests cannot be determined, the taxpayer is then deemed to be a resident in the contracting state in which they have a habitual abode. If the taxpayer has a habitual abode in both (or neither) of the contracting states, citizenship is the factor that determines residency. As a final step, if the taxpayer is a citizen of both (or neither) of the contracting states, then the competent authorities of the contracting states settle the issue of the taxpayer's residence by mutual agreement.

The term "competent authority" is generally defined as the head of a country's taxing authority (or duly designated representative for treaty purposes). The Secretary of the Treasury (or delegate) and the Minister of National Revenue (or authorized representative) are the competent authorities mentioned in article III of the USCITC. Within its large business and international division, the IRS has an office of competent authority to address international issues, including those arising from the various treaties in effect between the United States and other countries. The office of competent authority has two primary offices: namely, a treaty assistance and interpretation team (TAIT) and the advance pricing and mutual agreement program (APMA). Together, these offices handle competent authority issues concerning the United States' bilateral tax treaties.

> **Note.** For additional information regarding the office of competent authority, the TAIT, and the APMA, see **uofi.tax/19stx19** [www.irs.gov/individuals/international-taxpayers/competent-authority-assistance].

Permanent Establishment. The definition of permanent establishment is important within a tax treaty because businesses frequently seek to establish a presence for business operations in another country in a manner that does not create the permanent establishment necessary to trigger corporate tax liability in that country.

The term **permanent establishment** is defined in the USCITC as a "fixed place of business through which the business of a resident of a Contracting State is wholly or partly carried on."[277] The definition further provides that a permanent establishment especially includes a place of management, office, branch, factory, workshop, mine, an oil or gas well, or a quarry or place of extraction of natural resources. A building site is considered a permanent establishment under the definition in the USCITC only if the building site lasts more than 12 months. Several exceptions to what constitutes a permanent establishment are also provided in article V. Such exceptions include the use of facilities solely for the following purposes.

- Storage or display
- To maintain an inventory for processing by another person
- The purchase of goods, collection of information, or advertising

276. United States–Canada Income Tax Convention, Article IV.

277. United States–Canada Income Tax Convention, Article V.

Moreover, under the USCITC, a person acting in one country on behalf of a resident of the other country who habitually exercises authority in the first country to conclude contracts in the name of the resident will be deemed a permanent establishment. This is the case **unless** the person concluding contracts is a broker, commission agent, or other independent agent acting in the ordinary course of their business.

Employment Income. Under the terms of a typical tax treaty, employment income is generally taxed either by the country of the taxpayer's residency or by the country in which the employment services are rendered, with the contracting countries agreeing that they will not both tax the same income, thus eliminating double taxation.[278]

Sometimes the contracting countries include thresholds or revenue-sharing formulas that determine how much income each country taxes. For example, under article XV of the USCITC, a U.S. resident is exempt from Canadian taxation on employment income earned in Canada if the amount is not more than $10,000 in Canadian currency. If the amount is more than this $10,000 threshold, the amount is exempt from Canadian taxation only if both of the following are true.

- The U.S. resident is present in Canada for no more than 183 days during any 12-month period that begins or ends in the tax year for which the taxation of the employment income is being determined.
- The income is not paid by, or on behalf of, a Canadian resident and is not paid by a permanent establishment in Canada.

An identical rule applies to Canadian residents working in the United States except that the income threshold is $10,000 in U.S. currency.

> **Note.** In the USCITC, employment is referred to as "dependent personal services," and SE income is referred to as "independent personal services."[279]

Moreover, the USCITC provides that a U.S. resident receiving employment income for work regularly done in more than one country on a ship, aircraft, motor vehicle, or train operated by a U.S. resident is exempt from Canadian tax.[280] Likewise, employment income of Canadian residents on a ship, aircraft, motor vehicle, or train operated by a Canadian resident is similarly exempted from U.S. federal income tax.[281]

Self-Employment Income.[282] Tax treaties generally have a provision that reflects the agreement between the contracting states on how SE income of a taxpayer is taxed, particularly when taxpayers provide cross-border SE services. Under the USCITC, SE income is generally considered business profit and may be taxed in the country of the taxpayer's residency unless the taxpayer has a permanent establishment in the other country. If a permanent establishment exists in the other country, business profits attributable to that permanent establishment are taxed in the country in which the permanent establishment exists.

If the taxpayer engages in SE activity in both the U.S. and Canada with a permanent establishment in each country, business profits are attributed to each country based on the profits that each permanent establishment might be expected to make if it were a distinct and separate person engaged in the same or similar business activity. Only profits derived from the permanent establishment's assets, risks assumed, or activities performed are considered attributable to that permanent establishment.

---

278. Article XXIV of the United States–Canada Income Tax Convention contains the specific provisions for the elimination of double taxation.

279. *Glossary of Tax Terms*. OECD. [www.oecd.org/ctp/glossaryoftaxterms.htm] Accessed on Feb. 25, 2019.

280. United States–Canada Income Tax Convention, Article XV.

281. Ibid.

282. United States–Canada Income Tax Convention, Article XIV; IRS Pub. 597, *Information on the United States–Canada Income Tax Treaty*.

Pensions, Annuities, Social Security.[283] The taxation of various forms of retirement income is usually included in tax treaties. Important issues addressed include how various types of retirement income are defined and whether the contracting states have agreed to tax that income either in the country from which the income is sourced or in the country in which the recipient is a resident.

Under the USCITC, the definition of pension includes any payment under a superannuation, pension, or retirement plan, armed forces retirement pay, and amounts paid under an accident, sickness, or disability plan.[284] The third protocol of March 17, 1995, amended language in the original treaty to clarify that individual retirement arrangements (IRAs) and Canadian Registered Retirement Savings Plans and Registered Retirement Income Funds and payments from other retirement arrangements (whether qualified or not under U.S. tax rules) also fall under the definition of pension (e.g., IRC §§457 and 414(d) arrangements).[285] A social security benefit is not considered pension income.[286]

Under article XVIII of the USCITC, a pension or annuity arising in one of the contracting countries (the source country) that is paid to a resident in the other country may be taxed by the country of the taxpayer's residency (residency country). However, the amount that may be included in income by the residency country may not be more than the amount that would be included in income in the source country if the taxpayer were to file a source country return.[287] Pension income may also be taxed by the source country, with a 15% limit on the tax rate.

Observation. Canada may tax a U.S. resident on pension income sourced in Canada, but the rate of tax is limited to 15%. The United States may also tax this pension income but cannot require the taxpayer to include in income an amount greater than the taxable amount that would be included in Canada if the recipient were a Canadian resident. Under the "elimination of double taxation" rules of the tax treaty (discussed later in this section), the United States would provide the U.S. resident with a foreign tax credit attributable to the 15% tax paid to Canada.

283. United States–Canada Income Tax Convention, Article XVIII.

284. United States–Canada Income Tax Convention, Article XVIII, para. 3.

285. United States–Canada Income Tax Convention, Third Protocol, Article 9.

286. IRS Pub. 597, *Information on the United States-Canada Income Tax Treaty.*

287. United States–Canada Income Tax Convention, First Protocol, Article 9.

Practitioner Planning Tip

As indicated earlier, each tax treaty is unique and provisions concerning the treatment of a specific class of income can vary widely. Many countries have an equivalent of the U.S. social security retirement benefit, including major trading partners of the United States like Canada, Germany, and the United Kingdom. The following table compares the tax treatment of "state" sponsored retirement benefits from these countries received by a U.S. citizen or permanent resident ("green card" holder).

Country	Tax Treaty Article	Tax Treatment
Canada	XVIII, Para. 5	For U.S. citizens or green card holders **resident in the United States,** Canadian social security retirement benefits are taxable **only** in the United States and are treated as U.S. social security benefits for U.S. tax purposes.[288] For U.S. citizens or green card holders **resident in Canada,** Canadian social security retirement benefits are taxable **only** in Canada.[289]
Germany	19, Para. 2	For U.S. citizens or green card holders **resident in the United States,** German social security retirement benefits are taxable in the United States and are treated as U.S. social security benefits for U.S. tax purposes.[290] For U.S. citizens or green card holders **resident in Germany,** German social security retirement benefits are taxable **only** in Germany.[291]
United Kingdom	17, Para. 3	"... payments made by a Contracting State under the provisions of the social security or similar legislation of that State to a resident of the other Contracting State shall be taxable only in that other State."[292]

As shown in the table, Canadian and German social security retirement benefits received by a U.S. citizen or green card holder are treated similarly for U.S. tax purposes.

By contrast, the United Kingdom's equivalent of U.S. social security retirement benefits received by a U.S. citizen or green card holder is taxable in the U.S. but is not treated as a U.S. social security benefit for this purpose.

---

288. *Frequently Asked Questions (FAQs) About International Individual Tax Matters*. Mar. 18, 2019. IRS. [www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-about-international-individual-tax-matters#TopFAQs] Accessed on May 16, 2019.

289. Ibid.

290. IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits*.

291. Ibid.

292. United States–United Kingdom Tax Convention, Article 17.

Dividends, Interest, and Gains. Common tax treaty provisions address the taxation of various forms of investment income and types of gains received. The characterization of these forms of income and whether they are taxed by the source country or the country of the taxpayer's residency are among the common issues addressed by such provisions.

Under the USCITC, articles X and XI, respectively, address the taxation of dividend and interest income. Generally, under the USCITC, Canadian-sourced dividends received by a U.S. resident are subject to a maximum 15% Canadian tax rate,[293] while Canadian-sourced interest income received by a U.S. resident is exempt from Canadian tax.[294]

> **Observation.** If the U.S. resident receives dividends or interest from a business activity that the U.S. resident carries on in Canada through a permanent establishment, these rules do not apply. Other relevant rules, such as those for business profits, apply instead.[295]

Gains are taxed according to article XIII of the USCITC. Gains received by a U.S. resident from the sale of Canadian real estate are taxable in Canada. Similarly, Canadian residents are subject to tax in the United States on gains from the sale of U.S. real estate.[296] The sale of personal property in Canada by a U.S. resident is exempt from Canadian taxation unless the personal property is attributable to a permanent establishment in Canada.

> **Note.** The gains provisions included in the USCITC are complex. Article XIII and protocol amendments should be consulted to determine how these detailed rules may affect a particular taxpayer, including those taxpayers that move across the U.S.-Canada border.

Elimination of Double Taxation. Tax treaties frequently contain provisions that indicate how each of the contracting countries will prevent a taxpayer's income from being subject to double taxation. One common mechanism used is for a country to allow the taxpayer to claim a tax credit for taxes paid to the other country. Because every country has its own tax laws, it is frequently necessary to clarify which foreign taxes qualify for a U.S. tax credit (and which U.S. taxes qualify for a similar tax credit in the foreign country).

The USCITC, article XXIV, aims to eliminate double taxation through the reciprocal use of tax credits. Thus, each country allows a credit against its income tax for the income tax paid to the other country on income from sources in that other country.[297]

> **Note.** Article XXIV contains several provisions regarding reciprocal foreign tax credits on various types of income mentioned in other provisions, including those with a 15% reduced tax rate.

Mutual Agreement and Information Exchange.[298] Tax treaties between countries commonly include specific provisions indicating the competent authorities of each country who can address specific cases in which taxpayers are taxed in a manner that may not be consistent with the provisions of the treaty. Also common are specific provisions that allow for information sharing by the competent authorities of the contracting states for purposes of carrying out the treaty's provisions and resolving taxpayer cases.

---

293. IRS Pub. 597, *Information on the United States-Canada Income Tax Treaty*.

294. Ibid.

295. United States–Canada Income Tax Convention, Article X.

296. United States–Canada Income Tax Convention, Article XIII.

297. IRS Pub. 597, *Information on the United States-Canada Income Tax Treaty*.

298. United States–Canada Income Tax Convention, Articles XXVI and XXVII.

Under the mutual agreement section of the USCITC, a taxpayer who considers that they are not being taxed in accordance with the treaty can request in writing that the competent authority in their country of residence resolve the issue. When necessary, the competent authority will work to resolve the case with the other country's competent authority. In general, the mutual agreement provision requires the competent authorities of the United States and Canada to:

- Work together to resolve differences regarding interpretation of treaty provisions,
- Agree to the same characterization of particular forms of income,
- Agree to definitions of treaty terms,
- Agree to the elimination of double taxation with respect to partnerships or distributions from trusts or estates,
- Agree on updated amounts to reflect economic developments, and
- Consult each other regarding double taxation issues that may be outside the scope of the treaty.

Furthermore, the USCITC mandates that the competent authorities exchange information necessary for carrying out the treaty's provisions. Any information received is given the same level of confidentiality that other tax information is provided under the laws of that country.

> **Note.** The USCITC contains many other provisions not mentioned in this section including income from real property, taxation of royalties, students, exempt organizations, and other income.

Artists and Athletes.[299] Tax treaties may include provisions for specific types of taxpayers. For example, the USCITC contains a special provision allowing a U.S.-resident musician, theater or motion picture actor, or other entertainer or athlete, to earn up to $15,000 in Canadian currency without incurring Canadian tax. Moreover, the same type of Canadian-resident artist or athlete can earn up to $15,000 in U.S. currency without incurring U.S. tax liability. If the $15,000 earnings threshold is exceeded, then either article XV or XIV of the USCITC prevail (i.e., for employment or SE). In addition, the $15,000 rule does not apply to athletes in league sports with regularly scheduled games in both countries. Income of these athletes is treated as earnings from employment subject to USCITC article XV.

SOCIAL SECURITY TOTALIZATION AGREEMENTS[300]

The United States has entered into agreements with several other countries to coordinate social security tax for U.S. workers in those countries and for individuals from those countries who work in the United States. Such agreements are referred to as totalization agreements. Prevention of dual social security tax on compensation or SE income is a primary focus of such agreements for U.S. taxpayers working overseas and foreign taxpayers working in the United States. Additionally, these agreements aim to provide benefit protection for workers who divide their careers between the United States and a foreign country.

> **Note.** Totalization agreements are not treaties but, instead, are congressional-executive agreements.

Totalization agreements are negotiated between the United States and other countries, and the terms of each totalization agreement may differ. Typically, a totalization agreement provides that an individual's compensation is subject to social security tax in the country in which the work is performed. However, if the work assignment in the foreign country is only temporary and the compensation would be subject to the social security tax of both countries, the worker generally remains covered **only** by their home country's social security system.[301]

299. United States–Canada Income Tax Convention, Article XVI; Treasury Department Technical Explanation of the USCITC.

300. *International Social Security Agreements*. Jan. 11, 2010. Congressional Research Service. [www.everycrsreport.com/files/20100111_R41009_1f2ed22b59fb81bd731776a20eb8d97458de0d09.pdf] Accessed on Feb. 26, 2019.

301. IRS Pub. 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

The Code provides some guidance in connection with SE income when a totalization agreement is in effect. For example, the Code states that a U.S. individual's SE income is exempt from SE tax to the extent that the taxpayer's SE income is **exclusively** subject to a foreign country's social security system.[302]

> **Note.** For a list of existing totalization agreements, see **uofi.tax/19stx20** [www.ssa.gov/international/agreement_descriptions.html].

If an exemption from U.S. social security is required by a U.S. taxpayer whose wages or SE income is subject to a foreign country's social security system, IRS guidance is available regarding the procedures to use.[303] Generally, a certificate of coverage for the foreign country's social security system is required to be furnished to the U.S. employer. Procedures exist for circumstances under which such a certificate cannot be obtained.

> **Observation.** For taxpayers with foreign work assignments, it is essential that the practitioner be aware of the terms of any applicable totalization agreement in order to prevent an inequitable result for the taxpayer. Specific steps may be necessary to ensure dual social security taxation does not result.

Example 21. Robert, a U.S. citizen and resident, is a consultant in the railroad business. His consulting activity is primarily in Canada, and he works as an independent contractor for RR Services, Inc. (RR), a Canadian company, as an equipment advisor and purchaser for railway companies.

Robert is taxed as an independent contractor in the United States, where he reports his SE income and expenses on Schedule C. RR treated Robert as an employee and withheld Canadian income tax and payroll tax. The payroll tax payments include amounts covered under Canada's equivalent to the U.S. social security system.

The IRS sent Robert a deficiency notice for SE tax on his income for the tax year. Under the terms of the totalization agreement between Canada and the United States, a self-employed person otherwise subject to SE taxes in both countries is considered to be subject to SE taxes only in the country in which the taxpayer resides.[304] Unfortunately, this totalization agreement rule was not properly applied to Robert's income by RR and the Canada Revenue Agency (CRA).

Robert has been unsuccessful in recovering the payroll tax payments made to the CRA, which were remitted by RR through payroll withholding. However, this does not affect his U.S. SE tax liability. Robert was double-taxed on his SE income, paying U.S. and Canadian social security taxes on his income for the year.

> **Note.** The facts in the above example are based on *R.L. Rusten v. Comm'r.*[305] Dual social security taxation could have been avoided if Robert had obtained a certificate of coverage from the Social Security Administration (SSA) and presented it to RR's payroll office. The SSA certificate of coverage would have been the authority that RR required to avert withholding Canada social security taxes from Robert's compensation.

---

302. IRC §1401(c).

303. *Totalization Agreements*. Apr. 2, 2018. IRS. [www.irs.gov/government-entities/federal-state-local-governments/totalization-agreements-2] Accessed on Feb. 26, 2019.

304. *Totalization Agreement with Canada*. Jan. 2004. Social Security Administration. [www.ssa.gov/international/Agreement_Pamphlets/canada.html] Accessed on Feb. 26, 2019.

305. *R.L. Rusten v. Comm'r*, TC Summ. Op. 2008-16 (Feb. 19, 2008).

DISCLOSURE OF FOREIGN ASSETS AND OWNERSHIP INTERESTS

The Treasury Department, through the IRS and the Financial Crimes Enforcement Network (FinCEN), has increasingly directed substantial resources and attention to the disclosure of certain foreign assets and ownership interests by taxpayers. Tax practitioners must become familiar with the most recent compliance guidance and rules. There are substantial penalties for failure to comply.

Tax practitioners need to be aware of three specific filing requirements.

1. FinCEN Form 114, *Report of Foreign Bank and Financial Accounts*
2. Form 8938, *Statement of Specified Foreign Financial Assets*
3. Various international information returns

FinCEN Form 114[306]

A U.S. person who has a financial interest in, or signature authority over, one or more foreign financial accounts must file a FinCEN Form 114, *Report of Foreign Bank and Financial Accounts,* (formerly referred to as the "FBAR" form or Form TD-F 90-22.1) if the aggregate value of the foreign financial account or accounts **exceeds** $10,000 at any time during the year.

Practitioner Planning Tip

Practitioners are encouraged to ask probing questions and document the responses in this area because penalties for noncompliance are severe.

The term **U.S. person** includes U.S. citizens and residents and also includes entities established under U.S. law. Accordingly, U.S. domestic trusts, estates, corporations, partnerships, and limited liability companies are subject to this filing requirement.

Generally, a U.S. person has a financial interest in a foreign financial account if they own the account, even if the account is held for the benefit of another person. A U.S. person also has a financial interest in an account if the account is owned by another person who acts as the U.S. person's agent or nominee with respect to the account. A U.S. person meeting a 50% control test over a partnership or corporation that owns a foreign financial account generally has the entity's account ownership attributed to them.

Note. For additional details about the special rules applicable to entities, including trusts and estates, see 31 CFR §1010.350(e) and the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

306. 31 CFR §1010.350; *BSA Electronic Filing Requirements For Report of Foreign Bank and Financial Accounts (FinCEN Form 114)*. Jan. 2017. Financial Crimes Enforcement Network. [www.fincen.gov/sites/default/files/shared/FBAR%20Line%20Item%20Filing%20Instructions.pdf] Accessed on Feb. 26, 2019.

A U.S. person has signature authority over an account if the U.S. person (either alone or in conjunction with others) has the ability to control the disposition of money, funds, or other assets held in the account by direct communication (in writing or otherwise) to the person with whom the financial account is maintained. Several exceptions from the disclosure requirement exist for certain individuals that have signature authority over a foreign financial account.

> **Note.** For details on the exceptions to disclosure for U.S. persons having signature authority, see **uofi.tax/19stx21** [www.fincen.gov/sites/default/files/shared/FBAR%20Line%20Item%20Filing%20Instructions.pdf].
>
> More information can also be found in the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues, and the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Foreign Asset Disclosure. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

A foreign financial account is generally a reportable account located outside the geographic bounds of the United States. Foreign financial accounts include the following.

- Bank accounts (including checking and savings accounts)
- Securities accounts
- An insurance or annuity policy with a cash value
- An account with a financial institution that accepts deposits

Not all foreign financial accounts are reportable. For example, an account with a military banking facility operated by a U.S. financial institution, but located in a foreign country, is not reportable.

> **Note.** For further guidance regarding reportable accounts, see FinCEN Final Rule RIN 1506-AB08 at **uofi.tax/19stx22** [www.irs.gov/pub/irs-tege/2011-4048.pdf]. For additional details about what constitutes the geographic bounds of the United States for purposes of these rules, see **uofi.tax/19stx23** [www.fincen.gov/sites/default/files/shared/FBAR%20Line%20Item%20Filing%20Instructions.pdf].

The FinCEN filing requirement is triggered if the aggregate value of the foreign financial account(s) exceeds $10,000 at any time during the calendar year. Periodic statements may be relied on to determine the maximum value of an account as long as the statements fairly reflect the maximum account value during the year. There are simplified reporting rules for U.S. persons having a financial interest in 25 or more accounts or signature authority over 25 or more accounts. The filing deadline is April 15 for the previous calendar year. However, there is an automatic extension to October 15 for the previous calendar year, which need not be specifically requested.[307] Generally, the maximum civil penalty is $10,000 per violation of these compliance rules (and a criminal penalty of up to $250,000, five years imprisonment, or both).[308] Both civil and criminal penalties may be imposed for the same violation.

> **Note.** For additional details about the reliance on periodic statements to determine the maximum value of accounts during the year, simplified reporting rules, special rules that apply to jointly owned accounts, and details regarding civil and criminal penalties, see **uofi.tax/19stx24** [www.fincen.gov/sites/default/files/shared/FBAR%20Line%20Item%20Filing%20Instructions.pdf].
>
> Additional information is also provided in the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Foreign Asset Disclosure. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

---

307. *BSA Electronic Filing Requirements For Report of Foreign Bank and Financial Accounts (FinCEN Form 114).* Jan. 2017. Financial Crimes Enforcement Network. [www.fincen.gov/sites/default/files/shared/FBAR%20Line%20Item%20Filing%20Instructions.pdf] Accessed on May 1, 2019.

308. 31 USC §§5322(a) & (b) or 18 USC §1001.

Note. FinCEN Final Rule RIN 1506-AB08[309] provides substantial guidance regarding the FinCEN filing requirement. These rules include simplified reporting for those taxpayers with 25 or more qualifying accounts. While the Financial Crimes Enforcement Network has proposed new rules that would, among other changes, eliminate the simplified reporting rules, these proposed changes have not yet been finalized. To review the proposed changes, see **uofi.tax/19stx25** [www.fincen.gov/sites/default/files/shared/FBAR_NPRM030116.pdf].

FinCEN Form 114 is not filed with the taxpayer's return. It is completed and filed online at **uofi.tax/19stx26** [bsaefiling.fincen.treas.gov/main.html]. Practitioners filing these forms on behalf of clients must register as an "institution" using this website. This may be done at **uofi.tax/19stx27** [bsaefiling.fincen.treas.gov/Enroll_Now.html].

Amounts shown on FinCEN Form 114 must be in U.S. dollars. Under the filing rules for this form, the U.S. Treasury Department Bureau of the Fiscal Service foreign currency exchange rates for December 31 of the year must be used to convert the currency of the foreign account to U.S. dollars. These exchange rates are found at **uofi.tax/19stx28** [fiscal.treasury.gov/reports-statements/treasury-reporting-rates-exchange].

Form 8938[310]

FATCA[311] requires a **specified person** with an interest in **specified foreign financial assets** (SFFAs) that exceed certain value thresholds to report those assets to the IRS on Form 8938, *Statement of Specified Foreign Financial Assets*. A specified person may be either a **specified individual** or a **specified domestic entity.**

An SFFA includes the following.[312]

- Any account maintained at a foreign financial institution
- A foreign financial account held for investment purposes but not held with a foreign financial institution (such as a non-U.S. stock or other security or an interest in a foreign entity)
- Financial instruments or contracts with a non-U.S. counterparty or issuer (In addition, an interest in a pension plan or deferred compensation plan associated with a foreign employer may also constitute an SFFA.)

Note. For additional guidance on what constitutes an SFFA, including examples, exceptions, and how to determine if the asset is "held for investment purposes," see Treas. Reg. §1.6038D-3.

A **specified individual** includes an individual who is either a U.S. citizen or RA for any part of the tax year. An NRA with an IRC §6013(g) or (h) election in effect and NRAs who are bona fide residents of Puerto Rico or certain other U.S. possessions are also specified individuals.[313]

Note. For the definition of specified individual, see Treas. Reg. §1.6038D-1(a)(2). IRC §§6013(g) and (h) concern elections to treat a nonresident alien spouse as a U.S. resident for tax purposes. For additional information on each of these elections, see Treas. Reg. §§1.6013-6 and 1.6013-7.

309. 76 Fed. Reg. 10234 (Feb. 24, 2011).

310. IRC §6038D; Treas. Reg. §1.6038D-1(a).

311. Part of The Hiring Incentives to Restore Employment (HIRE) Act of 2010, PL 111–147 (Mar. 18, 2010).

312. Treas. Reg. §1.6038D-3.

313. Treas. Reg. §1.6038D-1(a)(2).

A specified domestic entity is a domestic corporation, partnership, or trust formed or availed of for purposes of directly or indirectly holding SFFAs. Whether an entity falls under this definition is determined annually.[314]

> **Note.** For additional details on what constitutes a specified domestic entity, see Treas. Reg. §1.6038D-6.

A requirement to file a U.S. tax return for the tax year is a prerequisite to a disclosure requirement by a specified person.[315] Therefore, a taxpayer who has SFFAs exceeding the reporting threshold is not required to file Form 8938 if they are not required to file a tax return for the year.[316] Those required to file a return who meet all other criteria triggering a disclosure requirement must file Form 8938 even if the reported SFFAs have no impact on tax liability.[317]

> **Note.** Taxpayers who must disclose SFFAs under these rules comply with the disclosure requirement by filing Form 8938. This form and its instructions are found at **uofi.tax/19stx29** [www.irs.gov/pub/irs-pdf/f8938.pdf] and **uofi.tax/19stx30** [www.irs.gov/pub/irs-pdf/i8938.pdf], respectively.
>
> Specified individuals who disclose all SFFAs on certain other international information returns (i.e., Forms 3520, 5471, 8621, and 8865, which are discussed later) do not need to report the same SFFAs on Form 8938. See the instructions to Form 8938 for additional details.
>
> The filing requirements for Form 8938 are different than those for FinCEN Form 114. For a comparison of these requirements, see **uofi.tax/19stx31** [www.irs.gov/businesses/comparison-of-form-8938-and-fbar-requirements].

The Form 8938 reporting thresholds are determined by the taxpayer's filing status and residency. The following table summarizes these thresholds.[318]

Form 8938 Reporting Thresholds for Aggregate Value of All SFFAs

Filing Status	Living in the United States	Living Abroad
Single and MFS	More than $50,000 on the last day of the tax year or more than $75,000 at any time during the year [a]	More than $200,000 on the last day of the tax year or more than $300,000 at any time during the year
MFJ	More than $100,000 on the last day of the tax year or more than $150,000 at any time during the year	More than $400,000 on the last day of the tax year or more than $600,000 at any time during the year

[a] This threshold also applies to specified domestic entities. See TD 9752, 2016-10 IRB 385.

314. Treas. Reg. §1.6038D-6.

315. Treas. Reg. §1.6038D-2(a)(7).

316. Instructions for Form 8938.

317. Ibid.

318. Treas. Reg. §1.6038D-2(a).

Generally, the maximum value attained by the SFFA during the year must be reported. Amounts shown on Form 8938 must be in U.S. dollars. For SFFAs not denominated in U.S. dollars, it is necessary to convert the maximum value of the asset attained during the year from foreign currency to U.S. dollars.[319] Regulations require use of the U.S. Treasury Department Bureau of the Fiscal Service foreign currency exchange rates for December 31 of the year to convert the currency of the foreign account to U.S. dollars.[320] These exchange rates are found at **uofi.tax/19stx32** [fiscal.treasury.gov/reports-statements/treasury-reporting-rates-exchange].

> **Note.** Valuation for some types of SFFAs, such as pension accounts, trust assets, or deferred compensation plans, may be difficult. The IRS has provided some guidance on how to value such assets in Treas. Reg. §1.6038D-5.

Taxpayers with a filing requirement who fail to file a Form 8938 or who do not file a complete and correct Form 8938 are subject to a $10,000 penalty. Continued failure to file within 90 days of receiving an IRS notice may subject the taxpayer to an additional $10,000 penalty for each 30-day period (or partial period) after the expiration of the 90 days (up to a maximum penalty of $50,000).[321]

> **Note.** For further details on the Form 8938 filing requirement, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Foreign Information Returns

Several foreign information returns must be filed for taxpayers with various ownership interests or transactions with a foreign person or entity. The types of interests and transactions covered by these forms vary widely and the regulations are generally complex. Following is a list of some of these forms and the filing requirements for each, along with a reference to the applicable Code sections, which should always be consulted along with the underlying regulations to determine actual taxpayer compliance requirements.

> **Note.** Each foreign information return has very specific sets of rules as well as definitions that frequently are not consistent across all of these returns. The rules and definitions associated with the particular form being prepared for the taxpayer should be carefully studied.

Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*

Purpose of Form:	Disclose certain transactions with foreign corporations
Who Must File:	U.S. citizen or resident, or a domestic corporation, trust, or estate
Due Date:	Filer's tax return due date
Penalties:	10% of the FMV of the property transferred, up to a maximum of $100,000. 40% IRC §6662(j) penalty may also apply.
Additional Resources:	IRC §6038B and regulations
	uofi.tax/19stx33 [www.irs.gov/pub/irs-pdf/i926.pdf]
	uofi.tax/19stx34 [www.irs.gov/individuals/international-taxpayers/form-926-filing-requirement-for-us-transferors-of-property-to-a-foreign-corporation]

319. Treas. Reg. §1.6038D-5(c).

320. Ibid.

321. Instructions for Form 8938.

Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*

Purpose of Form: Disclose reportable events with foreign trusts

Who Must File: Responsible party

Due Date: Filer's tax return due date

Penalties: Greater of $10,000, or 35% of the trust's asset value

Additional Resources: IRC §6048 and regulations

uofi.tax/19stx35 [www.irs.gov/pub/irs-pdf/i3520.pdf]

Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*

Purpose of Form: Disclose foreign trust ownership interest and trust activities

Who Must File: Owner of foreign trust or U.S. agent

Due Date: 15th day of the third month after the end of the foreign trust's tax year

Penalties: **Greater** of $10,000, or 5% of the gross value of trust assets treated as owned by the U.S. owner

Additional Resources: IRC §6048(b) and regulations

uofi.tax/19stx36 [www.irs.gov/pub/irs-pdf/i3520a.pdf]

Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*

Purpose of Form: Provide financial reporting and disclose certain transactions and/or ownership interests

Who Must File: U.S. persons who are officers, directors, or shareholders in certain foreign corporations

Due Date: Filer's tax return due date (including extensions)

Penalties: $10,000, with additional penalties possible

Additional Resources: IRC §6038 and regulations

uofi.tax/19stx37 [apps.irs.gov/app/picklist/list/formsPublications.html?value=5471&criteria=formNumber]

Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

Purpose of Form: Disclose reportable transactions

Who Must File: Reporting corporation

Due Date: Filer's tax return due date (including extensions)

Penalties: $25,000, with additional penalties possible

Additional Resources: IRC §§6038A, 6038C, and underlying regulations

uofi.tax/19stx38 [www.irs.gov/pub/irs-pdf/i5472.pdf]

Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*

Purpose of Form:	Disclose control of or transactions with foreign partnerships
Who Must File:	U.S. persons with interests in, or transacting with foreign partnerships
Due Date:	Filer's tax return due date (including extensions)
Penalties:	$10,000, with additional penalties possible
Additional Resources:	IRC §§6038, 6038B, 6046A, and underlying regulations
	uofi.tax/19stx39 [www.irs.gov/pub/irs-pdf/i8865.pdf]

Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*

Purpose of Form:	Disclose interests in passive foreign investment companies (PFICs)
Who Must File:	U.S. persons with PFIC interests including a citizen or resident of the United States, a domestic partnership, a domestic corporation, and certain estates and trusts
Due Date:	Filer's tax return due date (including extensions)
Penalties:	Suspension of limitations period for return
Additional Resources:	IRC §§1291–1298 and regulations
	uofi.tax/19stx40 [www.irs.gov/pub/irs-pdf/i8621.pdf]

Compliance for Undisclosed Foreign Assets

Beginning in 2009, the IRS offered an offshore voluntary disclosure program (OVDP). This program was provided primarily for taxpayers who willfully evaded taxes or compliance requirements by failing to report income from offshore assets or disclose their offshore assets. The OVDP was extended and broadened in 2011, 2012, and 2014 due to its success. Taxpayers opting for the OVDP were required to file amended or past-due tax returns, international information returns, FinCEN Forms 114, and in some cases, pay a penalty; otherwise, they risked greater penalties and even criminal ramifications.[322]

Since the OVDP's inception, it has been used by more than 56,000 taxpayers who have paid a total of $11.1 billion in taxes, interest, and penalties.[323] However, after a peak in 2011, when approximately 18,000 taxpayers used the program, its use steadily declined, with only approximately 600 taxpayers using the OVDP in 2017.[324] The major advantage of the OVDP was an assurance that no criminal liability would be imposed on the taxpayer if they complied with all terms of the program.

---

322. *IRS to end offshore voluntary disclosure program; Taxpayers with undisclosed foreign assets urged to come forward now.* Mar. 9, 2019. [www.irs.gov/newsroom/irs-to-end-offshore-voluntary-disclosure-program-taxpayers-with-undisclosed-foreign-assets-urged-to-come-forward-now]. Accessed on Apr. 26, 2019.

323. *IRS: Offshore Voluntary Compliance Program to end Sept. 28.* Nov. 5, 2018. [www.irs.gov/newsroom/irs-offshore-voluntary-compliance-program-to-end-sept-28] Accessed on Jan. 14, 2019.

324. Ibid.

The IRS terminated the OVDP effective September 28, 2018.

> **Note.** For further information on the OVDP and the IRS termination announcement, see **uofi.tax/19stx41** [www.irs.gov/newsroom/irs-offshore-voluntary-compliance-program-to-end-sept-28].
>
> Additional information is provided in the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: IRS Update. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Streamlined Procedures.[325] The IRS initiated two new streamlined procedures as part of its reshaping of the OVDP program. Qualifying taxpayers who have failed to disclose foreign financial assets and report and pay income tax on income from those assets can use these procedures. Taxpayers who qualify include U.S. citizens, lawful permanent U.S. residents, and certain taxpayers meeting the substantial presence test. These two procedures are as follows.

1. Streamlined foreign offshore procedures (SFOP) for U.S. taxpayers residing **outside** the United States
2. Streamlined domestic offshore procedures (SDOP) for U.S. taxpayers residing **in** the United States

Both programs are available only to individual taxpayers and their estates. In addition, taxpayers must certify that their failure to file any required FinCEN Forms 114 and report and pay income tax on income from a foreign financial asset was not a result of willful conduct.

The SFOP may be used by taxpayers who meet a nonresidency requirement. The streamlined procedures typically involve the taxpayer filing the past six years of FinCEN Forms 114 and the past three years of tax returns if not previously filed (or amended returns reflecting the additional foreign income and tax liability). Both procedures require that the FinCEN Forms 114 be **filed online** using the FinCEN web portal designated for this purpose. By contrast, tax returns and all required international information returns are **filed on paper** to a specific IRS office that administers the streamlined procedures. The taxpayer also must pay a penalty and submit it with the returns, along with any tax and interest owed.

Returns submitted under the streamlined procedures are not subject to automatic IRS examination, but may be selected for audit under existing audit selection processes. The IRS may match information received from financial institutions and other sources against the return to verify accuracy. Civil and criminal penalties may be imposed at the discretion of the IRS. After use of one of the streamlined procedures, the taxpayer is expected to remain in compliance in subsequent years.

> **Note.** For additional information regarding the streamlined procedures, see **uofi.tax/19stx42** [www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures]. Specific instructions for the SFOP and SDOP, respectively, are found at **uofi.tax/19stx43** [www.irs.gov/individuals/international-taxpayers/u-s-taxpayers-residing-outside-the-united-states] and **uofi.tax/19stx44** [www.irs.gov/individuals/international-taxpayers/u-s-taxpayers-residing-in-the-united-states].

---

325. *Streamlined Filing Compliance Procedures.* Jul. 26, 2018. IRS. [www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures] Accessed on Jan. 14, 2019; *U.S. Taxpayers Residing in the United States*. Apr. 11, 2018. IRS. [www.irs.gov/individuals/international-taxpayers/u-s-taxpayers-residing-in-the-united-states] Accessed on Feb. 28, 2019; *U.S. Taxpayers Residing Outside the United States*. Apr. 11, 2018. IRS. [www.irs.gov/individuals/international-taxpayers/u-s-taxpayers-residing-outside-the-united-states] Accessed on Feb. 28, 2019.

MILITARY PERSONNEL[326]

While military pay is generally taxed as compensation,[327] other allowances and benefits may or may not be includable in income.[328]

Combat Pay

Pay earned by a service member while on duty in a combat zone[329] or qualified hazardous duty area[330] may be excluded from income. Those service members below the grade of commissioned officer can fully exclude such pay for each month or partial month of active duty in the combat zone or qualified hazardous duty area.[331] The excludable amount for commissioned officers, however, is limited to the maximum listed amount.[332] This amount is the sum of: [333]

- The highest rate of basic monthly pay at the highest pay grade for any enlisted member, and
- Any amount of hostile fire or imminent danger pay that the officer is entitled to for the month.

A commissioned warrant officer is not considered a commissioned officer under this rule.[334]

> **Note.** For additional details regarding the combat pay exclusion, including how a combat zone is designated and when service outside such a zone may still qualify as combat zone service, see IRS Pub. 3, *Armed Forces' Tax Guide.* This publication also provides a current list of combat zones.

> **Note.** Egypt's Sinai Peninsula was added as a combat zone for the period beginning June 9, 2015, and ending December 31, 2025, by the TCJA.[335] This may provide an opportunity to amend a service member's returns for affected prior tax years to reduce tax liability.

Qualified Military Benefits

Military personnel receive several benefits or allowances in connection with housing or living expenses that may be excludable from gross income.[336] As a general rule, excludable benefits or payments include the following.

- Basic allowances for housing or subsistence
- Overseas housing allowance
- Dislocation allowance
- Move-in housing
- Allowances for moving or storage of household or personal items
- Temporary lodging allowance

---

326. IRS Pub. 3, *Armed Forces' Tax Guide.*
327. IRC §61(a).
328. IRC §134.
329. IRC §112.
330. PL 104-117, §1(a).
331. IRC §112(a); Treas. Reg. §§1.112-1(a)(1)(i) and (b)(3).
332. IRC §112(b).
333. IRC §112(c)(5).
334. IRC §112(c)(1); Treas. Reg. §1.112-1(a)(3).
335. PL 115-97, §11026.
336. IRC §134.

Note. For a comprehensive list of excludable military payments or allowances in connection with moving, travel, living costs, death, in-kind benefits, and other payments, see IRS Pub. 3, *Armed Forces' Tax Guide.*

Expenses for Reservists

Members of a reserve component may deduct unreimbursed travel expenses attributable to their reserve duties if the reserve component member travels more than 100 miles from their home for duty. For purposes of this rule, a reserve component includes the following.

- The Air National Guard
- The Army National Guard
- The Army, Navy, Air Force, Marine Corps, or Coast Guard Reserve
- The Public Health Service Ready Reserve Corps

The reservist may deduct such expenses up to the federal rate. To deduct such expenses, the reserve component member must complete Form 2106, *Employee Business Expenses,* to compute the deductible amount up to the federal rate maximum. The deductible amount is shown on Schedule 1 (Form 1040), line 24, as an adjustment to income.

Note. For additional information on the applicable federal rate, see IRS Pub. 463, *Travel, Gift, and Car Expenses,* chapter 6.