

# AARO'S 2006 U.S. TAX UPDATE

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AARO members may call me for quick answers to short questions. You may also write, e-mail or fax, but please include your phone number as I will not have time for written responses. My e-mail is: [n.reuter@libertysurf.fr](mailto:n.reuter@libertysurf.fr)

You may contact AARO (The Association of Americans Resident Overseas) in Paris, France at 33 (0)1 47 20 24 15 or at [aaro@aaro.org](mailto:aaro@aaro.org)

**Please consult your tax advisor:** This article is only a brief alert to a limited number of issues, and it is much too short to cover all the exceptions.

## WHAT'S NEW FOR 2006

**The telephone tax refund** is a one-time credit designed to refund U.S. Federal excise tax previously collected on long distance or bundled service from March 1, 2003 to July 31, 2006. Bundled service is a single plan that does not differentiate between local and long distance. Anyone who paid the excise tax during this period, regardless of the amount, is entitled to a credit which varies based on the number of exemptions claimed on their 2006 return as follows: \$30 for one exemption, \$40 for two exemptions, \$50 for three exemptions, and \$60 for four exemptions or more. You claim it by entering the correct amount on Line 71 of Form 1040, Line 42 of Form 1040A, or Line 9 of 1040EZ. If you don't owe any tax, it will be refunded to you. If you don't have to file a return, you can claim it on Form 1040EZ-T.

Many overseas Americans will not have paid the excise tax during the above period, and consequently are not entitled to the refund. It may be useful, however, to jog your memory. For example, when I was in the U.S. for Christmas 2004, I had to make one long distance call using my credit card. So I'm going for it!

**Electronic deposit of refunds to two or three accounts:** A direct deposit of an income tax refund can now be split between more than one account. They all have to be your own accounts, or your spouse's accounts if you are filing jointly, although some financial institutions will not allow a joint refund to be deposited to an individual account. Check the box on Line 74a of Form 1040 and fill-out Form 8888 instead of Form 1040 Lines 74b to 74d. (Check box on Line 45a of Form 1040A and fill-out Form 8888 instead of Lines 45b to 45d.) If the direct deposit is rejected, a check will be sent instead.

**Eureka!:** This year, for the first time, those who file electronically can program automatic electronic debits of all four 2007 estimated income tax payments. See Pages 4 and 5 for more on electronic filing and paying from overseas.

**Tax on Children's income:** If you have set up accounts for your children under age 18 and any child receives over \$1 700 of investment income, you have to figure his/her tax rate on Form 8615. Previously the age ceiling was under 14. The new age ceiling also applies to the election to report a child's investment income on a parent's return using Form 8814.

**The standard mileage rate** for business use of your car in 2006 is 44.5 cents a mile; 18 cents for medical expenses and moving expenses; and 14 cents for volunteer charitable work (32 cents if Katrina related) but only if in connection with a U.S. charitable organization.

**Changes to the foreign earned income exclusion:** Beginning with 2006, the foreign earned income exclusion will be adjusted for inflation. The maximum 2006 amount is \$82 400.

The excluded amount must be added back, however, in order to calculate the tax on non-excluded income, thereby pushing non-excluded income into the higher tax brackets. This is done by using the worksheet on page 37 of the Form 1040 instructions. Unfortunately, the mechanics of the calculation are intentionally conceived so that non-excluded income does not get the benefit of the lower brackets. This will affect different taxpayers in different situations as follows:

You will continue to be non taxable if you have zero taxable income, i.e., adding back the exclusion will not make you taxable if you had no tax before adding it back.

Consequently, a single person with \$87 000 of overseas salary and \$3 000 of investment income will not be taxed as per the following calculation: \$87 000 minus the exclusion of \$82 400 leaves \$4 600. This plus investment income of \$3 000 equals \$7 600 of non-excluded income. However, a single person with no dependents is also entitled to a standard deduction of \$5 150 and a personal exemption of \$3 300, for a total of \$8 450 in deductions. So taxable income becomes zero and the taxpayer has zero tax.

Now let's take a single individual with \$200 000 of overseas salary, no investment income and no housing exclusion. All examples assume taxpayer(s) is (are) using the standard deduction. In this example, the taxpayer would have had \$24 894 of U.S. income tax were it not for the legislative change, and will have \$32 392 of tax after the change.

But this doesn't necessarily mean that he/she will pay U.S. income tax. **If the taxpayer pays sufficient foreign tax, the U.S. tax can be off-set by the foreign tax credit. So it is more important than ever to keep records of foreign taxes paid.** IRS auditors want copies of foreign tax returns, proof of filing, foreign tax bills, copies of checks, proof of mailing, copies of bank statements, etc. If taxes are paid by withholding, keep all relevant pay statements, bank statements, and anything else which indicates withholding and/or how it was calculated.

If in a particular year you pay more foreign tax than you need to off-set U.S. tax for that year, the excess can be carried over for 10 years beginning with taxes paid in 1999. If you haven't paid enough foreign tax in a particular year to off-set all the U.S. tax, you can use those excess amounts carried over from the past. So keep all foreign and U.S. records for 10 years, and if you haven't kept good records to date, you may find it extremely interesting to reconstruct records back to 1999.

An OECD employee with no income other than OECD salary will have all the U.S. tax reimbursed by the organization. If the employee's income consists partly of OECD salary and

partly of investment income, tax will be allocated between OECD and non OECD income for purposes of calculating the reimbursement, and non-reimbursed taxes will increase. The UN and its affiliated international organizations also have reimbursement plans.

Now let's assume that the single taxpayer's \$200 000 consists of half salary and half investment income. The preliminary U.S. tax calculation will be the same, i.e., \$32 392. However, the foreign tax credit calculation could change depending on whether or not the taxpayer is entitled to a foreign tax credit on investment income.

As concerns foreign investment income, one is entitled to a foreign tax credit on foreign investment income if one has paid foreign income taxes on investment income.

As concerns U.S. investment income, it depends on the income tax treaty between the U.S. and your country of residence. To my knowledge, rents and capital gains from U.S. real estate and income from natural resources or from an unincorporated business located in the U.S. will always be taxable only in the U.S. The new legislation will simply push this income into the higher brackets with no off-set for foreign tax credits. Long term capital gains, however, will continue to be taxed at a maximum 15% rate if otherwise entitled.

As for U.S. interest, dividends and securities capital gain, most treaties give your country of residence the right to tax. We still have to report this income on our U.S. income tax returns, but can take a tax credit for the foreign taxes paid. So most Americans living overseas should have tax credits to off-set part or all of the U.S. tax on U.S. source income from liquidity.

Under the French treaty, however, the United States retains the exclusive right to tax U.S. interest, dividends and securities capital gain paid to U.S. citizens in France. Consequently, Americans in France will find that the new legislation has simply pushed U.S. income into the higher brackets with no off-set for foreign tax credits. Long term capital gains and qualified dividends, however, will continue to be taxed at a maximum 15% rate if otherwise entitled.

In summary, the foreign tax credit is extremely complicated and it hasn't changed. But its importance has been multiplied considerably. Also, please be aware that the alternative minimum tax is affected by the new legislation, but is beyond the scope of this article.

Let's look at some quick examples of the increase in U.S. tax without regard to the foreign tax credit. The first example is a couple, both of whom earn exactly \$82 400 of overseas salary, and both of whom are excluding all their work income. If they have \$20 000 of interest income, the old rules give rise to \$310 of tax and the new rules to \$868. If they have \$40 000 of interest income, the old rules produce \$2 710 of tax and the new rules \$6 468. If they have \$100 000 of interest income, the old rules result in \$13 890 of tax and the new rules \$26 241.

A single person with \$82 400 overseas salary and \$16 000 interest: \$755 of tax under the old rules and \$2 114 under the new. With \$28 500 of interest: \$2 630 of tax under the old and \$5 607 under the new. With \$100 000 of interest: \$19 966 under the old and \$26 584 under the new. And with \$200 000 of interest: \$50 093 under the old and \$59 874 under the new.

**Changes to the foreign housing exclusion:** The method of calculation has changed and the amount has been severely limited in some cases. For 2006, the first \$13 184 of foreign housing expenses are disallowed and the maximum taken into account is generally limited to \$24 720. This results in a maximum housing exclusion of only \$11 536 (24 720 minus

13 184 = 11 536). However, Congress delegated authority to the IRS to make special allowances for high cost areas. This was done in IRS Notice 2006-87 last fall. Consequently, the maximum taken into account for London is \$72 100, for Paris is \$79 300, Rome \$53 500, Milan \$79 800, Brussels \$45 600, Geneva \$70 300, Berlin \$48 200, and so forth.

You should be able to find Notice 2006-87 on the IRS web site at [www.irs.gov](http://www.irs.gov) by using the search engine on the home page, or by sending me an e-mail at [n.reuter@libertysurf.fr](mailto:n.reuter@libertysurf.fr)

Notice 2006-87, however, leaves some things to be desired and some open questions. For example, what if you live just outside the city limits of one of the high cost designated cities? My understanding is that the IRS did not have a fixed idea of legal city limits under local law when the Notice was drafted, and that they were aware it was an issue but did not know how to resolve it, so they left it open. Consequently, I will be explaining this to clients who live in adjacent suburbs but work in the high cost designated city, and suggesting they take the higher amounts if they don't mind living with a little uncertainty.

Since this article first went to print, Notice 2006-87 has been updated by Notice 2007-25 containing modifications and additions including a special allowance for the city of Zurich.

## **DIVERSE**

Have you ever wondered if you're entitled to any of the **credits for environmentally sound homes, cars, etc.**? The Residential Energy Credit is for the most part limited to expenses concerning a main home located in the U.S. However, expenses for qualified solar water heating equipment and qualified solar electric energy generating equipment are allowed for a second home in the U.S. See Form 5695. As for the environmentally clean motor vehicles, they have to be used primarily in the U.S. in order to get the credit. See Form 8910.

Certain captains may be able to take a charitable deduction for reasonable and necessary expenses of **bowhead** whale hunting activities. See Publication 526. Whaling expenses include acquiring and maintaining whaling boats, harpoons, knives and other weapons, supplying food for the crew, storing and distributing the catch (if any), and talking about the one that got away over a business lunch. Rev. Proc. 2006-50.

## **ELECTRONIC FILING & PAYING**

If you prepare your own return and want to file electronically, you have two options: try the Free File option on the IRS Web site (see below) or purchase tax software that will enable you to do your return on your computer and send it electronically to the IRS. If you purchase software, it must be able to handle foreign addresses. Also, if you want to take the Child and Dependent Care Credit, your nanny must have a U.S. Taxpayer Identification Number (TIN). And if you are filing Head of Household because you have a nonresident alien qualifying child, that child must have a TIN. These last two obstacles are programmed into the IRS electronic system, and the most expensive software is helpless against them, although neither the nanny nor the child need a TIN if you file a paper return. There are other obstacles, but electronic filing from overseas works quite well in most cases.

Electronic paying also continues to work quite well. When you e-file a return with a balance due, you can quickly program a debit from your U.S. checking account. You have to enter only the bank routing number and the account number. So it is reasonably safe since this

information already appears on the bottom of every one of your checks. And this year, for the first time, you can program four automatic Federal estimated tax debits for 2007.

Even if you cannot or do not wish to e-file, you can still program electronic debits by registering separately with EFTPS (the Electronic Federal Tax Payment System). You can do so via their web site at [www.eftps.gov](http://www.eftps.gov) and then go to the same site to program payments. It works very well but the registration process is slow because they have to send two access codes by snail mail to your IRS address of record.

You can also pay by **credit card** through the following two companies who charge a fee:

Official Payments Corporation  
Tel: 800-272-9829  
Customer Service: 877-754-4413  
[www.officialpayments.com](http://www.officialpayments.com)

Link2Gov Corporation  
Tel: 888-729-1040  
Customer Service: 888-658-5465  
[www.PAY1040.com](http://www.PAY1040.com)

From some countries, including France and the Czech Republic, substitute 880 for 800, 881 for 888, and 882 for 877.

### **SUGGESTION**

If you wish to do your own return, I suggest you choose software from one of the software developers that you will find by clicking on “**2007 Free File**” on the IRS home page at [www.irs.gov](http://www.irs.gov). If your income is low enough and you otherwise qualify, you may even be able to file electronically from the developer’s web site for free. If you don’t qualify for free filing, most of the developers will allow you to download software for a very modest price. The software may allow you to file and pay electronically from your computer, and if you cannot file electronically for one reason or another, it will allow you to do a paper return. The most popular, Turbo Tax, will not let you file electronically with a foreign address. Last year an AARO member related to me his experience with Tax Act which he found quite satisfactory and which enabled him to use the foreign earned income exclusion and file electronically from overseas. In order to download he had to call the company because of his foreign address, but this was not a significant obstacle.

### **WHERE TO FILE AND PAY**

If living overseas or claiming the Foreign Earned Income or Housing Exclusions, send paper returns to: Internal Revenue Service Center, Austin, TX 73301-0215 U.S.A.  
Nonresident aliens should file at the above address this year.

Checks should be written to “United States Treasury”. Be sure to write your U.S. Social Security Number and the phrase “2006 FORM 1040” on the front of your check.  
If you are a nonresident alien, you should write “2006 FORM 1040NR”.

### **WHERE TO FILE AND PAY 2007 ESTIMATED TAX PAYMENTS**

When living overseas, please send your check with 2007 payment voucher Form 1040-ES to: Internal Revenue Service, P.O. Box 660406, Dallas, TX 75266-0406 U.S.A.  
Nonresident aliens should file at the above address this year.

Checks should be written to “United States Treasury”. Be sure to write your U.S. Social Security Number and the phrase “2007 FORM 1040-ES” on the front of your check. If you are a nonresident alien you should write “2007 FORM 1040-ES(NR)”.

### WHEN TO FILE AND PAY

If you live and work (or are retired) overseas, the date for avoiding interest on a 2006 balance due is April 17, 2007. On the other hand, U.S. citizens have an automatic two month extension to June 15th before penalties for late filing and late paying begin to run. Nonresident aliens also get the automatic two month extension, but see below for an exception. Don’t forget that payments sent from overseas are considered paid on the date *received* by the IRS. Returns, however, are considered filed on the date sent.

If you are not ready to file your return by April 17th and you think you will have a balance due, you can make a payment with Form 4868. This will also give you an extension until October 15th for filing. If, however, you don’t pay enough to cover all the tax due, the late paying penalty will run from June 15th. Be sure to mark box 8 or 9. Make your check to “United States Treasury” and write your Social Security Number and the phrase “2006 FORM 4868” on the front. File Form 4868 at Internal Revenue Service, P.O. Box 660575, Dallas, TX 75266-0575 USA if with payment, or the address for filing your return if not. **You can also get an extension if you pay the balance due by credit card: See above.**

April 17th is also the date for the first 2007 estimated income tax payment. One can take care of the 2006 balance due and the first 2007 estimated payment in one fell swoop by making an overpayment with Form 4868 before April 17th. When you file your income tax return, request that the overpayment be credited to 2007 estimated payments by writing the amount of the overpayment on Line 75 of Form 1040.

If you are a nonresident alien with U.S. wage withholding, penalties and interest begin running from April 17th even if you are living overseas. And, of course, April 17th is also the date for penalties and interest if you are living in the United States.

### HOW TO GET TAX INFORMATION

You may call the IRS at 215-516-2000 (fax: 215-516-2555) where there are employees with international training. The regular IRS number is 800-829-1040 (from some countries including France and the Czech Republic substitute 880 for 800).

You can send e-mails with international and domestic tax questions by going to:

<http://www.irs.gov/help/page/0,,id=133197,00.html>

The only IRS offices outside the U.S. are Paris, London, and Frankfurt:

Paris: (walk in service 9 to noon) Tel: 33-1-4312-2555 E-mail: <a href="mailto:irs.paris@irs.gov">irs.paris@irs.gov</a> Fax: 33-1-4312-4752 Web: <a href="http://www.amb-usa.fr">www.amb-usa.fr</a> (Moving to the other corner of place de la Concorde, 2 avenue Gabriel, on April 1, 2007)	CONSULAT AMERICAIN - IRS 2 rue Saint Florentin, 4th Floor 75001 PARIS, FRANCE
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London: (walk in Tu/Wed/Thur 9 to noon, 1 to 4) Tel: 44-207-894-0477 (9 to noon) Fax: 44-207-495-4224 Web: <a href="http://www.usembassy.org.uk">www.usembassy.org.uk</a>	United States Embassy - IRS 24 Grosvenor Square London W1A 1AE, England
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Frankfurt: (No walk in)  
Phone: 49-69-7535-3834  
E-mail: IRSFrankfurtMailbox@irs.gov

U.S. Consular General Frankfurt – IRS  
Giessener Str. 30, 60435 Frankfurt (Main), Germany  
Web: <http://frankfurt.usconsulate.gov>

Short of talking to an expert, the best source of information is the free IRS publications. And the quickest place to get them is the IRS web site at [www.irs.gov](http://www.irs.gov). Go to the link “More Forms and Publications” on the left side of the home page. On the Forms and Publications web page you will also find links to previous year IRS forms, instructions and publications, and to a web site that will direct you to State forms and instructions.

To find tax treaties click on the “Businesses” button at the top left of the IRS home page, then on “International Businesses” at the top left, then on “Tax Treaties” in the middle of the page, then on “tax treaties” in the only paragraph on that page.

You can also write for forms, instructions and publications by mail at:  
IRS National Distribution Center, P.O. Box 8903, Bloomington, IL 61702-8903 U.S.A.

### **2006 AVERAGE EXCHANGE RATES from [www.oanda.com](http://www.oanda.com)**

There is no official IRS exchange rate. One U.S. dollar equals:

1.32851 Australian dollars	3.09139 Argentine Pesos
2.17995 Brazilian Real	1.56637 Bulgarian Lev
1.13461 Canadian dollars	539.39322 Chilean Pesos
7.98189 Chinese Renminbi	5.84293 Croatian Kuna
<b>22.62525 Czech Koruna</b>	0.45944 Cyprus Pounds
5.94473 Danish Krone	5.81779 Egyptian Pounds
12.47357 Estonian Kroon	<b>0.79703 EUROS</b>
7.76895 Hong Kong Dollars	210.83024 Hungarian Florint
70.10221 Icelandic Krona	45.31880 Indian Rupee
9183.77255 Indonesian Rupiah	4.46685 Israel New Shekel
65.75956 Jamaican Dollars	116.33664 Japanese Yen
0.71329 Jordanian Dinar	72.61840 Kenyan Shilling
0.55657 Latvian Lats	1542.60085 Lebanese Pounds
2.75200 Lithuanian Litas	10.91549 Mexican Pesos
8.90841 Moroccan Dirham	1.54282 New Zealand Dollars
6.41557 Norwegian Kronor	60.24505 Pakistan Rupee
51.40865 Philippine Pesos	3.10768 Polish Zloty
2.81809 Romanian new Lei	27.18950 Russian Ruble
3.75035 Saudi Riyal	69.35731 Serbian Dinar
1.58942 Singapore Dollars	29.70829 Slovak Koruna
191.09301 Slovenian Tolar	6.78812 South African Rand
969.90155 South Korean Won	7.37864 Swedish Krona
<b>1.25364 Swiss Franc</b>	32.55646 Taiwanese Dollars
37.98621 Thai Baht	6.28591 Trinidad/Tobago Dollars
1.34242 Tunisian Dinar	1.44367 Turkish New Lira
<b>0.54354 UK Pound Sterling</b>	5.22046 Ukrainian Hryvnia
24.93117 Uruguayan Pesos	2149.03540 Venezuelan Bolivar

**Next page: For address to file Form 4868, see page 6, WHEN TO FILE AND PAY.**



**It's Convenient,  
Safe, and Secure**

IRS e-file is the IRS's electronic filing program. You can get an automatic extension of time to file your tax return by filing Form 4868 electronically. You will receive an electronic acknowledgment once you complete the transaction. Keep it with your records. Do not send in Form 4868 if you file electronically.

Complete Form 4868 to use as a worksheet. If you think you may owe tax when you file your return, you will need to estimate your total tax liability and subtract how much you have already paid (lines 4, 5, and 6 below).

For more information about e-filing the Form 4868, go to [www.irs.gov](http://www.irs.gov).

If you think you may owe tax and wish to make a payment, you can pay by electronic funds withdrawal using option 1 or you can pay by credit card using option 2. See 1 and 2 on this page for details.

**1  E-file Using Your Personal Computer or Through a Tax Professional**

Refer to your tax software package or tax preparer for ways to file electronically. Be sure to have a copy of your 2005 tax return—you will be asked to provide information from the return for taxpayer verification. If you wish to make a payment, you can pay by electronic funds withdrawal (see page 4) or send your payment to the address shown in the middle column under *Where To File a Paper Form 4868* on page 4.

**2  E-file and Pay by Credit Card**

You can get an extension if you pay part or all of your estimate of income tax due by using a credit card (American Express® Card, Discover® Card, MasterCard® card, or Visa® card). Your payment must be at least \$1. You can pay by phone or over the Internet through one of the service providers listed below.

Each service provider will charge a convenience fee based on the amount of the tax payment you are making. Fees may vary between service providers. You will be told what the fee is during the transaction and will have the option to continue or cancel the transaction. You can also obtain the convenience fee by calling the providers' toll-free automated customer service numbers or visiting their websites. Do not add the convenience fee to your tax payment.

**Official Payments Corporation**  
1-800-2PAY-TAX<sup>sm</sup>  
(1-800-272-9829)  
1-877-754-4413 (Customer Service)  
[www.officialpayments.com](http://www.officialpayments.com)

**Link2Gov Corporation**  
1-888-PAY-1040<sup>sm</sup>  
(1-888-729-1040)  
1-888-658-5465 (Customer Service)  
[www.PAY1040.com](http://www.PAY1040.com)

**Confirmation number.** You will receive a confirmation number when you pay by credit card. Enter the confirmation number below and keep for your records.

Enter confirmation number here ► .....

** File a Paper Form 4868**

If you wish to file on paper instead of electronically, fill in the Form 4868 below and mail it to the address shown on page 4. If you are a fiscal year taxpayer, you must file a paper Form 4868.

▼ DETACH HERE ▼

For calendar year 2006, or other tax year beginning \_\_\_\_\_, 2006, ending \_\_\_\_\_, 200 .

Part I Identification			Part II Individual Income Tax	
1 Your name(s) (see instructions)			4 Estimate of total tax liability for 2006 . . . \$	_____
Address (see instructions)			5 Total 2006 payments . . . . .	_____
City, town, or post office			6 <b>Balance due.</b> Subtract line 5 from line 4 (see instructions) . . . . .	_____
State			7 Amount you are paying (see instructions) . . . . .	► _____
ZIP code			8 Check here if you are "out of the country" and a U.S. citizen or resident (see instructions) . . . . .	► <input type="checkbox"/>
2 Your social security number	3 Spouse's social security number		9 Check here if you file Form 1040NR or 1040NR-EZ and did not receive wages as an employee subject to U.S. income tax withholding . . . . .	► <input type="checkbox"/>