Filing from Abroad: Filing U.S. Tax Returns from Mexico

U.S. citizens and green card holders who reside abroad (eg. in Mexico) continue to have a filing obligation to the USA – even if they also file tax returns to the country of their residence. It is entirely possible to have a filing requirement, even if you do not owe taxes. Many are confused by these filing requirements and end up not filing for years – which can be a costly error.

If you find yourself in this situation, then you may also qualify for catch up procedures which reduce or eliminate any penalties. In any case, if you file your "catch-up" returns before the IRS notifies you of your negligence, then chances are that your penalties will be greatly reduced. Fortunately, there are legal exclusions and credits to help reduce your taxes, but you must file a return to receive them and to start the clock on the IRS's statute of limitations.

Some items to consider as a U.S. person (individual, partnership, or corporation) filing from outside the U.S.:

U.S. citizens living abroad are given **an automatic extension** to **file** their tax returns until June 15th each year. One can apply for a further extension until October 15th using Form 4868. **Payment**, however, is due on or before April 15th. You are subject to interest and penalties if you pay late.

The **foreign-earned income (FEI) exclusion** in 201 was $104,100. You must have *earned* income as an employee or through self-employment to be eligible for this *income* tax exclusion (i.e. passive income from rentals or investments usually do not qualify as earned income). You must also qualify as either a *bona fide* resident (resident visa, foreign tax obligations, and permanent residence for at least 12 calendar months (but you can still visit the USA)) or with the physical presence test (out of the U.S. for 330 days of any 365-day period) to exclude income. Note that those who are self-employed will still owe SE tax (15.3% which is a *payroll* tax, not an *income* tax).

If you reside less than 6 months in the USA and have earned income from the USA, then you will not be eligible for the **Earned Income Tax Credit**. Foreign-earned income is not eligible for this credit.

You may be able to get a **foreign tax credit** for Mexican income taxes paid – but not for taxes you paid on income you exclude on your U.S. return. You can also get a credit for foreign taxes paid on passive income – like the ISR withheld by your Mexican bank – up to the tax treaty limit. Similarly, foreign property taxes can also be deducted. IVA is a sales tax, not an income tax, so there is no foreign tax credit.

Employees and the self-employed may also be eligible to claim the **foreign-housing exclusion or deduction**. To claim this, your expenses must exceed a limit set for your location. This limit is generally higher than most actual expenses in Mexico and so you may not be eligible for it.

If you have and exclude foreign income, you may not be able to contribute to an **IRA**. There are some tax strategies, however, that may help you continue contributions.

If you have **foreign financial accounts**, such as bank accounts, securities, or investments, you should:

Report this on Schedule B, Part III (part of your 1040 tax return). You'll report any **interest** you earned on Part I of this form and any dividends on part II. **Capital gains/losses** are reported on Schedule D and on Form 8949 or if from a **passive foreign investment company, called a PFIC,** (like a mutual fund or ETF) on Form 8621. If you or your tax preparer failed to correctly

identify that you had foreign financial assets on prior years' returns or that you had interest or other income from these accounts, you are not in compliance and could face penalties for failure to disclose and report. If income from these accounts was not reported, then you could be held criminally liable for tax evasion. If this is your situation, there are programs to help you come back into compliance at reduced penalties.

If in aggregate your foreign account(s) exceeded US$10,000 at any time during the year, you (as a U.S. person, an entity like a corporation, or as a signatory on the account(s)) must report this on **Form 114** (known as the **FBAR**). The deadline for this form now has a deadline that matches that of the Form 1040: April 15th each year (in 2017 the date is April 17th). The FBAR may also now be extended for up to 6 months to October 15th (Oct 16th in 2017). Missing these deadlines may incur severe penalties (min. USD10,000). This annual disclosure form is not part of your tax return, but a separate report for the Department of Treasury. If you did not know that you were to file this form and you have failed to report, and you are not in compliance for up to the last six years – then you may be able to avoid some or all penalties. If this situation pertains to you, let's talk.

If you own more than 10% of a **foreign corporation**, are part of a **foreign partnership**, or foreign LLC, the special IRS tax forms required for those entities (such as Forms 5471 and 8865) are due with your personal tax return, including any extension. If you have signing authority on these entity accounts, then their bank account information will be reported by the entity on its FBAR and on your own FBAR. In 2017, a new one-time transition tax went into effect (also referred to as Sec. 965 tax). This tax was aimed at large corporations, but has swept up small shareholders and corporations, too. Proposed legislation may come forward to address this, but in the meantime there is a reporting issue.

If, in aggregate, your foreign financial accounts exceeded US$50,000 then you may have to file **Form 8938** with your tax return. The rules are a bit complicated, depending on the balance of your accounts, your filing status and whether you are living abroad. This form is filed with your tax return, so if you would not otherwise file a tax return, you do not need file the form.

Be aware that **FATCA** went into effect in July 2014. This is a law that requires all foreign financial institutions to report to the IRS about their accounts held by U.S. persons (individual, partnership, corporation, or tax-exempt organization) which exceed US$50,000. Mexico signed its agreement to comply with FATCA in late 2012. To help ensure clarity and avoid unnecessary withholding taxes of your U.S. accounts[1], you should send a W-9 form (if a U.S. person) to all your financial institutions. If a foreigner (non-USA person), send your U.S. financial institutions a W-8BEN claiming the rights of your country's tax treaty with the USA (you'll need the relevant treaty article number(s)). If you are a dual citizen, then you must wear your US "cap" when considering how to report to the IRS – i.e. you are responsible for any reporting and filing as any other US citizen.

The Overseas Voluntary Disclosure Program remains open to those who have not reported financial assets and the income derived from them. But there is also now a **Streamlined**

[1] Some U.S. financial institutions are withholding 30% from U.S. persons, under the mistaken presumption that a foreign address means a foreign person – or worse, a U.S. person is attempting to avoid tax responsibilities. If you find that you are being subjected to improper withholding, you must provide the W-9 and inform the institution about the law. I have the legal references you may need.

Foreign Offshore Disclosure Program which may be more suitable for you. If you are interested in these programs, let's talk.

If you own property or received money through a **foreign trust or estate**, the IRS tax return 3520A (by the trust with a U.S. citizen beneficiary) is due on March 15th, and the 3520 form, if required, is due with the personal tax return. If filed late, the penalty is 5% of the value of the property held in the trust. Fortunately, Mexican *Fideicomisos* are no longer considered foreign trusts and it is no longer necessary to file the Forms 3520 and 3520-A for them. If your real property is a commercial or rental property, and per Mexican law you choose to own it through a Mexican corporation, then each year with your U.S. income tax return you must file Form 5471. Again, severe penalties apply for failing to file.

If you are **not a U.S. citizen nor green card holder**, but file a U.S. tax return because you have/had **US source income**, you are subject to many requirements, such as:

Initially, you will need an **ITIN (Individual Tax Identification Number)** which you can apply for using a Form W-7 – normally with a tax return, but under certain exceptions you can apply without a return. As a Certified Acceptance Agent, I can help you with that process and in some cases eliminate the need for sending your original identification documents to the IRS.

You will want to make sure that financial institutions and others have a **W-8BEN** which can significantly reduce or eliminate the taxes withheld from interest, dividends, royalties, etc. based on the applicable tax treaty.

You should be receiving proper documents from U.S. financial institutions and others such as a **Form 1042-S** to ensure that you know what amounts they are reporting to the IRS.

You must file the **correct type of return**. Green card holders, while not U.S. citizens, are treated as U.S. citizens for tax purposes and file a 1040 return. They are subject to all the same requirements as U.S. citizens, such as reporting of worldwide income. Those who are foreign, living in Mexico, and not green card holders would normally file a Form 1040NR as non-resident aliens. However, if you are the spouse of a U.S. citizen then you can choose to file as a resident (even though neither of you may reside in the U.S.), but beware of the worldwide income reporting requirements you are opening yourself up to.

Other Tax Tips:

You can earn up to 14 days rental income tax-free per year.

Rental property abroad is depreciated over 40 years – not the 27.5 years when on U.S. soil.

There's no disclosure form for purchasing and holding foreign real estate. Capital gains from sales are handled the same, whether in or out of the USA, including the residential exclusion.

Filing from abroad can be complicated and is getting more so nearly every year. The U.S. government is now focusing on those with foreign assets for special disclosures and filings and enforcing old laws. Generally, this targeting is to catch the bad guys, but sometimes the good guys get caught up in the web of regulations. I'd like to talk to you about your situation and see how I can help you meet your reporting obligations and ensure you pay no more taxes and penalties than necessary.

Kimberly Morris, MBA, EA, CAA
E-mail: admin@taxesabroad.com; Direct cell (044) 415-153-5124; U.S. Vonage 601-427-2881