IRS Nationwide Tax Forum 2019

Social Security and Self-Employment Tax Obligations of U.S. Individuals Working Outside the United States

Objectives

- Describe the self-employment tax obligations of U.S. citizens and green card holders who have self-employment income from a U.S. territory.
- Specify the social security and self-employment tax obligations of U.S. individuals working abroad.
- Explain the effect of totalization agreements on social security and self-employment tax obligations of U.S. individuals working abroad.

Objectives (cont'd)

- Clarify the net investment income tax and explain rules pertaining to it.
- Note the impact of tax reform on individuals living and working in foreign countries as it relates to the foreign earned income exclusion and foreign real estate taxes.

Social Security, Medicare and Self-Employment Taxes

- Federal Insurance Contributions Act (FICA) tax:
  - Applies to wage earners (employees)
  - Consists of social security taxes (including old-age, survivors, and disability insurance) and Medicare taxes (hospital insurance tax)
- Self-Employment Contributions Act (SECA) tax:
  - Similar to FICA, provides for social security and Medicare taxes on self-employed individuals
  - Applies to individuals with net self-employment income of $400 or more

U.S. Territories Self-Employment Tax

- U.S. territories have separate, autonomous income tax systems but do not have separate systems for Social Security.
- If earnings from self-employment are $400 or more, report and pay self-employment taxes to the IRS even if not required to file a U.S. federal income tax return.
  - If not required to file a U.S. Form 1040, use Form 1040-SS or Form 1040-PR.
  - If required to file a U.S. Form 1040, attach Schedule SE.

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U.S. Territories
Net Self-Employment Income

- Self-employment income includes:
  - Gross income (including any tips) from a trade or business less allowable deductions attributed to that trade or business
  - A general partner's distributive share (whether or not distributed) of partnership income
  - Payments received by a partner for services rendered to the partnership (such as guaranteed payments)

U.S. Territories
Net Self-Employment Income (cont'd)

- Fees for services as a notary public are not subject to self-employment tax; however, all the individual's other self-employment income is subject to self-employment tax.
- Net self-employment income is generally computed the same way as it is for territory income tax purposes; however, some operating expenses may not be allowable, such as:
  - Deduction for ½ SE tax
  - Self-employed health insurance
  - Contributions to Simplified Employee Pension (SEP) plans

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U.S. Territories
Net Self-Employment Income (cont'd)

- Income:
  - Legal services $95,000
  - Notary services <u>5,000</u>

    $100,000

- Expenses:
  - Related to legal income $9,700
  - Related to notary income 300
  - Health insurance <u>7,000</u>

    $17,000

U.S. Territories
Net Self-Employment Income (cont'd)

	Territory Return	1040SS/PR
Income for legal services	$95,000	$95,000
Income for notary services	5,000	5,000
Gross business income	$100,000	$100,000
Business expenses	-17,000	-10,000
Net profit from business	**$83,000**	$90,000
Net profit from notary services		- 4,700
Net profit for U.S. SE tax purposes		**$85,300**

U.S. Territories – Other Instances Requiring Form 1040-SS/1040-PR

- Unreported tips
- Wages from an employer with no social security or Medicare taxes withheld
- Uncollected social security and Medicare tax on tips or group term life insurance
- Household employment taxes (to be paid by the person who has the household employee; attach Schedule H)
- Additional Medicare Tax

U.S. Territories
Additional Medicare Tax

- Applies to self-employment income which exceeds the threshold amount.
- If applicable, attach Form 8959, *Additional Medicare Tax*, to the Form 1040-SS, 1040-PR, or 1040.
- Additional Medicare Tax is not deductible as part of ½ self-employment tax on Form 1040.

U.S. Individuals Working Abroad FICA

- FICA taxes are payable under the Internal Revenue Code on the wages of U.S. citizens and resident aliens working abroad for:
  - An American employer,
  - A foreign person treated as an American employer under IRC § 3121(z), or
  - In certain instances, the foreign affiliate of an American employer.

U.S. Individuals Working Abroad FICA (cont’d)

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- U.S. employment taxes do not apply to payment for services performed abroad as an employee of a foreign government, including payments for services performed by ambassadors, other diplomatic and consular officers and employees, and non-diplomatic representatives.
- Payments for services performed for a United States or Puerto Rican corporation that is owned by a foreign government are subject to U.S. employment taxes.

U.S. Individuals Working Abroad SECA

Self-employed U.S. citizens and resident aliens are responsible for paying SE Tax under the Internal Revenue Code if net earnings from self-employment equal or exceed $400, regardless of:

- Where the self-employment activities occur,
- Where the individual resides during the period of self-employment, and
- Whether any self-employment income is excluded from U.S. income due to the foreign earned income exclusion.

U.S. Individuals Working Abroad Totalization Agreements

- Totalization agreements are entered into between the United States and some foreign countries to prevent the payment of social security taxes to two jurisdictions on the same wage or self-employment income.
- If the U.S. has entered into a totalization agreement with the foreign country in which the wages or net earnings from self-employment were earned, the terms of that agreement will govern whether FICA or SECA taxes must be paid to the United States.

Totalization Agreements Employee

- Either the employer or employee should obtain a certificate of coverage or similar statement from the authorized official or agency of the foreign country verifying that wages are subject to social security coverage in that country.
- If the authorities of the foreign country will not issue such a certificate or statement, obtain one from the U.S. Social Security Administration.
- A copy of the certificate or statement should be retained in the employer's files.

Totalization Agreements Self-Employed

- Request a certificate of coverage or similar statement from the appropriate agency of the foreign country.
- If unable to obtain a certificate or statement from the foreign country, request one from the U.S. Social Security Administration.
- Attach the certificate or statement to the tax return and print "Exempt, see attached statement" on the line on the tax return for self-employment tax.

Net Investment Income Tax

- The IRC § 1411 Net Investment Income Tax (NIIT) under Chapter 2A of the Internal Revenue Code is separate from the hospital insurance portion of the taxes imposed by Chapters 2 and 21 of the IRC.
- Amounts collected under the NIIT are not designated for the Medicare Trust Fund.

Net Investment Income Tax (cont'd)

"[I]n the case of an individual, estate, or trust an unearned income Medicare contribution tax is imposed. No provision is made for the transfer of the tax imposed by this provision from the General Fund of the United States Treasury to any Trust Fund."

See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11) (Mar. 24, 2011) and Joint Committee on Taxation, Description of the Social Security Tax Base (JCX-36-11) (June 21, 2011).

Net Investment Income Tax (cont'd)

- An individual who is exempt from Medicare taxes, has net investment income and has modified adjusted gross income (MAGI)* over the applicable thresholds is still subject to the NIIT.

* Section 1411(d) defines MAGI as adjusted gross income increased by the excess of the amount excluded from gross income under section 911(a)(1) over the amount of any deductions or exclusions disallowed with respect to that excluded amount.

Net Investment Income Tax(cont'd)

- Treas. Reg. § 1.1411-2 expands the IRC § 1411 statutory definition of MAGI by including increases and decreases from certain types of income attributable to Controlled Foreign Corporations and Passive Foreign Investment Companies.

Net Investment Income Tax - Not Covered by Totalization Agreements

- The NIIT is not covered by social security agreements (totalization agreements).
- A U.S. individual who is not subject to FICA under the terms of an applicable totalization agreement is still subject to NIIT.

Net Investment Income Tax No Foreign Tax Credit

Treas. Reg. § 1.1411-1(e) - *Disallowance of certain credits against the section 1411 tax*. Amounts that may be credited against only the tax imposed by chapter 1 of the Code may not be credited against the section 1411 tax imposed by chapter 2A of the Code unless specifically provided in the Code. For example, the foreign income, war profits, and excess profits taxes that are allowed as a foreign tax credit by § 27(a), § 642(a), and § 901, respectively, are not allowed as a credit against the § 1411 tax.

Net Investment Income Tax Deductibility of Foreign Taxes

Per Treas. Reg. § 1.1411-4(f)(3)(iii), foreign taxes are allowable as deductions under section 164(a)(3) in determining net investment income only if the taxpayer does not choose to take any foreign tax credits under section 901 with respect to the same taxable year. See section 275(a)(4).

Impact of Tax Reform
Foreign Earned Income Exclusion

- The Bipartisan Budget Act of 2018 changed IRC § 911(d)(3).
- For tax years beginning after 12/31/17, citizens or residents of the United States serving in an area designated by the President of the United States by Executive order as a combat zone for purposes of section 112 in support of the U.S. Armed Forces can qualify as having a tax home in a foreign country, even if they have an abode within the United States.

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Impact of Tax Reform
Foreign Earned Income Exclusion

- The Tax Cut and Jobs Act changed the method for calculating the annual maximum foreign earned income exclusion amount, in that the annual inflation adjustments under IRC § 911(d)(2) will now be computed using the chained consumer price index for all urban consumers (referred to as C-CPI-U).
- This is effective for tax years beginning after 12/31/17.

Impact of Tax Reform
Foreign Real Estate Taxes

- New IRC § 164(b)(6)(A) states that "foreign real property taxes shall not be taken into account under subsection (a)(1)."
- For tax years beginning after 12/31/17 and before 01/01/26, individuals may not deduct foreign real property taxes unless paid or accrued in carrying on a trade or business or an activity described in IRC § 212 (production or collection of income).

Objectives Met

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