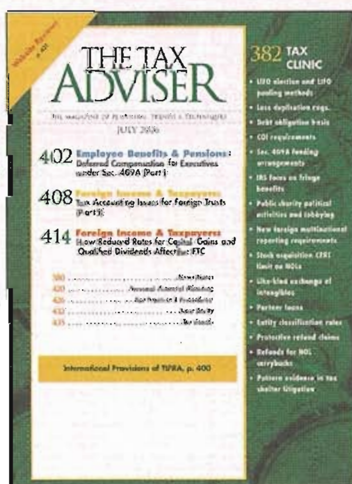
CHANGES TO INCOME AND HOUSING EXCLUSIONS

New Rules for Individuals Working Abroad

In general, U.S. citizens are subject to federal income tax on all their income, wherever earned. U.S. citizens or residents living abroad have been allowed to exclude certain foreign earned income and housing costs from taxable income, regardless of whether any foreign tax is paid on these amounts, under IRC section 911. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) made significant changes to some of these rules; CPAs need to become familiar with these modifications.



FOREIGN EARNED INCOME

Qualified individuals. To qualify for the earned income exclusion, an individual must have a tax home (that is, "the general area of a main place of business, employment or post of duty" regardless of the location of the family home) in a foreign country and must be (1) 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 (2) a U.S. citizen or resident present in a foreign country for at least 330 full days in any 12-consecutive-month period.

Determination of income. Foreign earned income is received from sources within a foreign country attributable to services performed during a period of bona fide residency or physical presence. It includes wages, salaries, professional fees and other compensation for personal services; noncash compensation must be reported at fair market value. It does *not* include interest or payments that represent a distribution of earnings and profits.

Limit on exclusion. Previously, the most an individual could exclude from income was $80,000. The TIPRA indexes this amount for inflation; thus, for 2006, the maximum exclusion is $82,400.

HOUSING COSTS

Individuals can exclude from income certain foreign housing costs paid or incurred on their behalf. Previously, the amount excludable was the excess of housing expense over a base housing cost amount (a percentage of the salary level of certain government employees). Now, the base housing cost is 16% (computed daily) of the maximum foreign earned income exclusion (the $80,000 inflation-adjusted amount previously discussed), multiplied by the number of days the taxpayer meets the bona fide residence or presence test. In addition, the exclusion now is capped at a maximum of 30% of the foreign earned income exclusion (minus the 16% base housing cost amount).

Housing expenses. Included in this amount are the reasonable costs paid for the taxpayer's housing (and that of spouse and dependents, if living with the taxpayer). The amount can include rent, utilities, insurance, furniture rental, residential parking and household repairs.

STACKING

The TIPRA also introduced a "stacking" concept. If an individual uses the foreign earned income or housing exclusion, any income in excess of the amount excluded is taxed (under the regular and alternative minimum tax) using the rates that would have been applied had the exclusion not been elected. This will result in larger tax bills for some individuals abroad.

For more information on the section 911 changes, see "The Post-TIPRA Foreign Earned Income and Housing Exclusions for Individuals" by Howard Godfrey and Neil A.J. Sullivan in the December 2006 issue of *The Tax Adviser*.

—*Lesli S. Laffie, editor*
The Tax Adviser

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