

# The Post-TIPRA Foreign Earned Income and Housing Exclusions for Individuals

---

Howard Godfrey, Ph.D., CPA

Professor of Accounting  
University of North Carolina—Charlotte  
Charlotte, NC

Neil A.J. Sullivan, CPA

Member  
International Tax Compliance Group, LLC  
New York, NY

---

**The Tax Increase Prevention and Reconciliation Act of 2005 will have a significant effect on the foreign earned income and housing exclusions under Sec. 911. This article explains the exclusions' benefits and requirements.**

A U.S. citizen or resident working abroad may exclude a limited amount of foreign earned income under Sec. 911. In addition, such individual may exclude an employer-provided "housing cost amount" under Sec. 911(a) or deduct nonemployer-provided housing costs under Sec. 911(c)(4). The foreign tax credit (FTC) also provides relief from double taxation when an expatriate's foreign earned income is subject to taxation by both the U.S. and a foreign country. However, the Sec. 911 foreign earned income exclusion and the housing cost exclusion/deduction go further, and provide relief from U.S. taxation even when there is little or no foreign income tax. This article explains the benefits of the elections under Sec. 911, and the requirements.<sup>1</sup>

## TIPRA Changes

.....

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), Section 515(a), indexes the earned income exclusion amount (limit) for inflation starting in 2006 (instead of 2008, as provided under prior law). This raises the exclusion amount from \$80,000 to \$82,400 for 2006.

The pre-TIPRA housing cost amount threshold<sup>2</sup> was 16% of the grade GS-14, step 1, U.S. government employee amount (i.e., 16% of \$77,793). TIPRA Section 515(b)(1) set the 2006 threshold at 16% of the exclusion amount under Sec. 911(b)(2)(D). The housing cost amount in excess of this threshold is eligible for exclusion or deduction, subject to a new overall 30%-of-exclusion-amount limit, computed on a daily basis.

Finally, due to the TIPRA "stacking procedure," income not excluded under Sec. 911 is taxed (under the regular and alternative minimum tax (AMT)) at higher rates. The tax rates applicable to the nonexcluded income are those that would have applied had the individual not elected the Sec. 911 exclusion.

These changes are expected to raise over \$2 billion in income taxes over the next 10 years.<sup>3</sup> The TIPRA will have the most dramatic effect on expatriates working in low-tax countries in which the benefit of the housing exclusion/deduction has been shielding foreign earned income from U.S. income tax, especially when local housing costs are high.

<sup>1</sup> This article addresses issues related to filing U.S. income tax returns, not foreign income tax returns.

<sup>2</sup> Regs. Sec. 1.911-4(c) refers to this threshold as the "base housing amount."

<sup>3</sup> Joint Comm. on Tax'n, *Estimated Revenue Effects of the Conference Agreement for the Tax Increase Prevention and Reconciliation Act of 2005* (JCX-18-06, 5/9/06).



## Qualified Individual

Sec. 911 benefits may be elected by a "qualified individual." (Exhibit 1 on p. 718 contains definitions of key terms and procedures.) A qualified individual must have a tax home in a foreign country, according to Sec. 911(d)(1). Under Sec. 911(d)(3), an individual's tax home has the same meaning as under Sec. 162(a)(2) (relating to traveling expenses while away from home). An individual's tax home is his or her regular place of employment or business, or is generally where he or she lives, if there is no regular place of business.

Regs. Sec. 1.911-2(b) provides that an individual does not have a tax home in a foreign country for any period for which his or her abode is in the U.S.; however, temporary travel to the U.S. does not necessarily affect the tax home determination. Ownership of a home in the U.S., whether or not used by an individual's spouse and dependents, does not prevent the individual from having a tax home in a foreign country.

In addition to meeting the tax home test, a qualified individual must meet either a "bona fide resident test" or a "physical presence test" described in Sec. 911(d)(1). A U.S. citizen can meet the first test by being a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year. Regs. Sec. 1.911-2(c) provides that the principles of Sec. 871 are generally used to determine residency. Special rules exist for U.S. resident aliens eligible under a nondiscrimination treaty provision.<sup>4</sup>

A U.S. citizen or resident can meet the second test by being present in a foreign country or countries for at least 330 full days in any period of 12 consecutive months. Regs. Sec. 1.911-2(d)(2) indicates that a full day is a continuous period of 24 hours beginning with midnight and ending with the following midnight. Generally, the date of

arrival in and the date of departure from a country do not enter into this computation. The 12-month period may cover two calendar years.

**Example 1:** A person who arrives in a foreign country on Dec. 1, 2006 may qualify for the exclusion for 30 days in 2006, if the residence test or 330-day presence test will be met. (The procedure for filing a U.S. tax return under these circumstances is explained later in this article.)

Income received in a foreign country from the U.S. government or its agencies does not qualify for the foreign earned income exclusion. However, Regs. Sec. 1.911-2(e) provides that time spent in a foreign country while an employee of the U.S. counts toward satisfaction of the residence or presence requirement for a qualified individual. In addition, voting by absentee ballot in a U.S. election does not jeopardize status as a foreign resident.

Sec. 911(d)(5) limits an individual's ability to exclude foreign earned income on a U.S. tax return, while claiming exemption from foreign income taxes on that income. An individual is not considered a bona fide resident of a foreign country if he or she (1) submits a statement to the authorities of that country that he or she is not a resident of that country; and (2) is not held subject as a resident of that country to its income tax by its authorities. This limit applies to the bona fide residence test, but not the physical presence test.

An individual may be required to leave a foreign country before meeting the presence or the residence test. However, under Sec. 911(d)(4), he or she may be a qualified individual even though he or she leaves because of war, civil unrest or similar adverse conditions that preclude the normal conduct of business in that country. Regs. Sec. 1.911-2(f) provides that the individual is treated as qualified for the days present or resident in the country if the

## EXECUTIVE SUMMARY

■ The TIPRA raised the foreign income exclusion and housing cost threshold amount, and taxes nonexcluded income at a higher rate.

■ A U.S. citizen or resident working abroad may exclude a limited amount of foreign earned income and deduct housing costs under Sec. 911.

■ Separate elections are required to exclude foreign earned income and housing costs.

<sup>4</sup> See TIPRA Section 515; Conf. Rep't No. 109-455, 109th Cong., 2d Sess. (2006) (hereinafter, "TIPRA Conference Report"), n. 553. A U.S. resident alien who is a citizen of a country with which the U.S. has

a tax treaty may qualify for the Sec. 911 exclusion under the bona fide residence test via application of a treaty nondiscrimination provision.

For more information about this article, contact Dr. Godfrey at [hgodfrey@email.uncc.edu](mailto:hgodfrey@email.uncc.edu).



**Exhibit 1: Key Sec. 911 terms and limits**

1. **Qualified individual.** One who qualifies for Sec. 911 benefits. The individual must have a tax home in a foreign country (Sec. 911(d)(1)) and meet one of two additional tests:

- Period of residence.* A citizen of the U.S. is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year (Sec. 911(d)(1)(A)).
- Period of presence.* A citizen or resident of the U.S. is present in a foreign country or countries during at least 330 full days during any period of 12 consecutive months (Sec. 911(d)(1)(B)).

2. **Sec. 911 benefits.**

- Sec. 911(a)(1) earned income exclusion.* Exclusion of income earned in foreign country; limited to the exclusion amount (see #3 below).
- Sec. 911(a)(2) foreign housing exclusion.* Exclusion of a limited amount of foreign income from an employer which is used for housing costs (see #7 below).
- Sec. 911(c)(4) foreign housing deduction.* Deduction of a limited amount of foreign housing expenses that are paid from funds not provided by an employer (see #7 below).

3. **Exclusion amount.** This amount is \$82,400 for 2006 and is adjusted annually for inflation. It is applied on a daily basis (see #6 below) (Sec. 911(b)(2)(D)).

4. **Overall limit on Sec. 911 benefits.** The total of the amounts excluded (foreign income and housing costs) and the amount deducted for housing costs for the tax year shall not exceed the individual's foreign earned income for such year (Sec. 911(d)(7)).

5. **Foreign earned income.** The amount received by an individual from sources within a foreign country or countries that constitute earned income attributable to services performed by such individual during the period of residence or presence (see #1 above) (Sec. 911(b)(1)(A)).

6. **Sec. 911(a)(1) daily exclusion limit.** The exclusion is limited to the amount of foreign earned income computed on a daily basis at an annual rate equal to the exclusion amount for the tax year. The 2006 daily exclusion limit is \$225.75 for each day of the individual's foreign residence or presence ( $\$82,400/365$ ) (Sec. 911(b)(2)(A)).

7. **Housing cost exclusion or deduction.** The housing cost that may be excluded or deducted is the total actual amount of foreign housing costs, limited as explained in #8 and #9 below (Sec. 911(c)(1)).

8. **"Housing cost amount" limit.** This is 30% of the exclusion amount (\$82,400 for 2006) (computed on a daily basis), multiplied by the number of days of foreign residence or presence in the tax year. This limit is \$24,720 for 2006 ( $\$82,400 \times 0.3$ ) (assuming foreign residence or presence on all days in the year) (Sec. 911(c)(2)).

9. **Housing cost threshold.** Housing costs up to 16% of the exclusion amount are not eligible to be included in the computation of the housing cost amount. This threshold is \$13,184 for 2006 ( $\$82,400 \times 0.16$ ). Thus, the maximum amount of 2006 housing costs considered, \$24,720 (see #8 above), is reduced by \$13,184, leaving a maximum housing cost amount of \$11,536 for 2006 (Sec. 911(c)(1)).

10. **Final limits on Sec. 911(a)(1) earned income exclusion and deduction.** Because the total amounts excluded or deducted under Sec. 911 may not exceed foreign income, the Sec. 911(a)(1) earned income exclusion is limited to the lesser of the:

- Excess of (1) foreign earned income over (2) foreign housing costs excluded; or
- Sec. 911(a)(1) daily exclusion limit described in #6 above, multiplied by the number of days the residence or presence test is met (Regs. Sec. 1.911-3(d)).

The housing cost deduction under Sec. 911(c)(4) (for an individual whose housing cost amount is at least partially attributable to amounts "not provided by an employer") is limited to the excess of foreign earned income over the combined exclusion for (1) foreign earned income under Sec. 911(a)(1) and (2) foreign housing costs for employer-provided amounts under Sec. 911(a)(2).



individual establishes that he or she could reasonably have been expected to have met the bona fide residence or physical presence test, but for the adverse conditions.

### Foreign Earned Income

Sec. 911(b)(1) defines an individual's "foreign earned income" as the amount received from sources within a foreign country or countries that constitute earned income attributable to services performed during the period of bona fide residency or physical presence. Regs. Sec. 1.911-2(h) states that a foreign country includes any territory under sovereignty of a government other than the U.S. In *Arnett*,<sup>5</sup> the Tax Court held there is no Sec. 911 exclusion for income earned in Antarctica, because it is not a sovereign foreign country. Foreign-source income is foreign income, even if paid from a U.S. bank account.

**Example 2:** A, a U.S. citizen, works for an employer for 240 days in 2006. He works 24 of those days in the U.S. and the remainder in Canada. Thus, 10% of A's compensation is U.S.-source income, not eligible for the exclusion.

Under Regs. Sec. 1.911-3(e), foreign income is deemed earned in the tax year in which the services are performed. Sec. 911(b)(1)(B)(iv) provides that no exclusion may be claimed for foreign earned income received after the end of the year following the year in which earned.

Sec. 911(d)(2)(A) states that "earned income" includes wages, salaries or professional fees and other compensation for personal services. Regs. Sec. 1.911-3(b) requires compensation received in a form other than cash to be reported at fair market value.

Earned income does not include payments from a corporation that represent a distribution of earnings or profits, rather than a reasonable allowance as compensation for personal ser-

vices. Regs. Sec. 1.911-3(c) states that foreign earned income does not include the value of meals and lodging excluded under Sec. 119, or income received from the U.S. or one of its agencies. Sec. 911(b)(1)(B) provides that foreign earned income does not include amounts received from a pension or annuity. Likewise, it does not include (1) payments by an employer to a nonexempt trust under Sec. 402(b) or for a nonqualified annuity under Sec. 403(c); or (2) amounts received by an individual from those trusts or annuities.

Both personal services and capital may be material income-producing factors in a trade or business, under Sec. 911(d)(2)(B). Up to 30% of an individual's share of net profits may be reported as earned income in accordance with the regulations.

Exhibit 2 below shows the types of income that may be earned or unearned, depending on the circumstances.

### Husband and Wife

When both spouses are qualified individuals, each may elect to exclude foreign earned income and exclude or deduct housing costs, according to Regs. Sec. 1.911-5(a)(1). Sec. 911(b)(2) provides that the exclusion of income is computed as if community property

law does not apply when a husband or wife performs services and receives community income. Regs. Sec. 1.911-5(b) states that the amount of excludible foreign income for each spouse is determined separately, based on the income attributable to each's services.

The Sec. 911(a) exclusion and the housing expense deduction under Sec. 911(c)(4) are not allowed, and an individual is not treated as a bona fide resident of (or as present in) a foreign country on any day he or she is present in any restricted country in violation of U.S. travel restrictions, under Sec. 911(d)(8).

### Limit on Earned Income Exclusion

The earned income exclusion is limited under Sec. 911(b)(2) to the exclusion amount, which is \$82,400 for 2006. The exclusion is prorated on a daily basis. For 2006, this amount is \$225.75 per day (\$82,400/365).

**Example 3:** B, an individual, is present in a foreign country for 330 days starting on July 4, 2006. Under Regs. Sec. 1.911-3(d)(2), B qualifies for an earned income exclusion of the lesser of (1) foreign earned income<sup>6</sup> or (2) \$40,860.75 (181 × \$225.75).

In 2006 and beyond, the exclusion is adjusted for inflation based on the

Exhibit 2: Types of income		
Earned income	Unearned income	Variable income
Salaries	Dividends	Business profits
Wages	Interest	Rents
Commissions	Capital gain	Royalties
Professional fees	Gambling winnings	Scholarships and fellowships
Bonuses	Alimony	
Tips	Pensions	
Employer allowances	Social Security benefits	

<sup>5</sup> *Dave Arnett*, 126 TC 89 (2006).

<sup>6</sup> Foreign earned income is first reduced by any exclusion or deduction claimed for housing costs under Regs. Sec. 1.911-3(d)(2)(i).



procedure in Sec. 1(f)(3), as modified by Sec. 911(b)(2)(D)(ii). According to the Conference Report for P.L. 109-222, the inflation-adjusted 2006 limit is \$82,400. A taxpayer using a fiscal year applies the exclusion for the calendar year in which the fiscal year begins.

The total exclusion for earned income and housing costs, and any deduction for housing costs, is limited to the amount of foreign earned income, according to Regs. Sec. 1.911-1(a). Thus, an individual with both foreign earned income and foreign investment income cannot shield any of the investment income, because it does not qualify for the Sec. 911 exclusion or housing cost deduction.

**Housing Costs**

**Exclusion of Foreign Housing Costs**

An individual with foreign earned income may claim an exclusion for foreign housing expenses computed under Sec. 911(c)(1) to the extent of the "housing cost amount."

Housing expenses used to compute this amount are subject to an overall limit of (1) 30% of the daily earned income exclusion amount, multiplied by (2) the number of days in such tax year in which the individual satisfies the bona fide residence or physical presence test.

The housing cost amount is limited to the excess of:

1. The individual's housing expenses for the tax year (limited as described above); over
2. A threshold amount of 16% of the Sec. 911(b)(2)(D) daily earned income exclusion amount, multiplied by the number of days in the tax year that the bona fide residency or physical presence test is met.

The maximum foreign housing cost exclusion in 2006 for an individual who is a foreign bona fide resident or physically present in a foreign country

on all days in the tax year, is \$11,536  $(\$82,400 \times 0.3) - (\$82,400 \times 0.16)$ .<sup>7</sup>

Sec. 911(c)(2)(B) authorizes Treasury to issue regulations or other guidance providing for an adjustment to the 30% limit to allow for geographic differences in housing costs versus U.S. housing costs. In Notice 2006-87,<sup>8</sup> the IRS provided adjusted limits on housing expenses for many high-cost areas. For example, the limit is \$114,300 for Hong Kong, rather than the basic limit of \$24,720.

**Foreign Housing Expenses**

Sec. 911(c)(3) provides that "housing expenses" include reasonable expenses paid by, or on behalf of, an individual (and for a spouse and dependents, if living with him or her) in a foreign country. Housing costs such as rent, utilities and insurance are included, as well as lease costs, furniture rental, residential parking and household repairs. The value of employer-provided housing is also included, unless the benefit is excluded under Sec. 119 as lodging furnished for the employer's convenience. Housing expenses are not reasonable to the extent they are lavish or extravagant under the circumstances.

According to Sec. 911(c)(3)(A), housing costs do not include interest and taxes of the kind deductible under Sec. 163 or 164, nor any amount allowable as a deduction under Sec. 216(a) for a cooperative housing corporation.

Under Sec. 911(c)(3)(B), housing costs are generally considered only if they relate to the abode that bears the closest relationship to the individual's tax home. However, housing costs for a second home may be considered when an individual maintains a separate abode outside the U.S. for a spouse and dependents, and they do not reside with him or her because of living conditions that are dangerous, unhealthful or otherwise adverse.

If spouses live together and file joint returns, they may compute the housing

cost amount jointly or separately. On separate returns, the housing cost amount must be computed separately for each spouse. Regs. Sec. 1.911-5(a)(3) provides that spouses maintaining separate residences may claim separate housing cost exclusions or deductions if they have different tax homes that are not within a reasonable commuting distance of each other and neither spouse's residence is within reasonable commuting distance of the other spouse's tax home.

*Example 4:* G, an employee, does not fully use the earned income exclusion amount in 2005, and in 2006 receives \$5,000 additional income attributable to services performed in 2005.<sup>9</sup>

Foreign earned income (2005)	\$90,000
Less: housing exclusion (Sec. 911(a)(2))	<u>15,000</u>
Balance available for Sec. 911(a)(1) exclusion	75,000
Less: exclusion amount (Sec. 911(a)(1))	<u>80,000</u>
Unused Sec. 911(a)(1) exclusion amount (2005)	<u>\$5,000</u>

G may exclude \$5,000 income received in 2006, because it would have been excluded in 2005 had it been received in that year.

**Deduction of Foreign Housing Costs**

Under Sec. 911(c)(4), an individual is allowed a deduction in arriving at adjusted gross income (AGI) for any part of the housing cost amount that is not an "employer provided amount." Under Regs. Sec. 1.911-4(d)(2), an employer-provided amount is any amount paid or incurred on behalf of an individual by his or her employer that is foreign earned income included in gross income for the tax year without regard to Sec. 911.

If an individual earns employee compensation and self-employment (SE) income, the housing cost amount is allocated to employer-provided amounts (the exclusion) under Regs. Sec. 1.911-4(d)(3) using the fraction: employer-

<sup>7</sup> See the TIPRA Conference Report., note 4 supra, at n. 556.

<sup>8</sup> Notice 2006-87, IRB 2006-43, 766.

<sup>9</sup> Examples 2 and 3 in Regs. Sec. 1.911-4(f) illustrate the housing cost exclusion for

tax years 1982 and 1983. In Example 4 in this article, the exclusion amount has been updated, and the numbers have been changed, to 2005 and 2006.



provided amounts divided by total foreign earned income. The remainder of the housing cost amount is allocated to SE income and used to compute the housing deduction. The deduction is limited to the excess of (1) foreign earned income<sup>10</sup> over (2) the sum of the foreign earned income and housing cost amount exclusions.<sup>11</sup>

Sec. 911(c)(4) provides that any amount not allowed as a deduction because of this limit is treated as a deduction in arriving at AGI in the succeeding year, to the extent that the limit is not reached in that year. The excess deduction can only be used in the succeeding year.

#### Limits on Sec. 911 Benefits

Sec. 911(d)(7) provides that the total amount excluded under Sec. 911(a) and deducted under Sec. 911(c)(4)(A) is limited to the individual's foreign earned income for the tax year.

An individual is prohibited from obtaining double benefits. Sec. 911(d)(6) provides that no deduction, exclusion from gross income or credit is allowed to the extent the deduction, exclusion or credit is "properly allocable to or chargeable against amounts excluded under subsection (a)." This includes the credit or deduction for taxes paid or accrued to a foreign country or a U.S. possession, applicable to income excluded under Sec. 911.

Regs. Sec. 1.911-6(a) provides that deductions, exclusions or credits not definitely related to any class of gross income are not allocable to excluded amounts. Thus, such items are deductible to the extent otherwise allowed by the Code. Deductions not limited under Sec. 911(d)(6) include (1) personal and family medical expenses, (2) IRA contributions,<sup>12</sup> (3) real estate taxes and mortgage interest on a personal residence, (4) charitable contributions, (5) alimony payments and (6) personal exemptions. In addition, the Sec. 119 housing exclusion may be claimed, even though the full Sec. 911 exclusion is also claimed.

## An individual may meet the presence or residence test if he or she is required to leave the country.

#### Stacking of Income

The TIPRA Conference Report<sup>13</sup> describes the tax computations required by Sec. 911(f), which was added by TIPRA Section 515(c). An individual is required to compute tax on any income in excess of the Sec. 911 exclusion amount, by applying to that income the tax rates that would have applied had the individual not elected the Sec. 911 exclusion. This approach is used in computing both the regular tax and the AMT.

**Example 4:** C, an individual, has \$80,000 of foreign earned income excluded under Sec. 911 and \$20,000 in other income (after deductions). C will be subject to tax on the \$20,000 at the rate(s) applicable to income in the \$80,000-\$100,000 range.

#### Procedure

##### Election on Tax Return

Separate elections are required to exclude (1) foreign earned income under Sec. 911(a)(1) and (2) housing costs under Sec. 911(a)(2). Regs. Sec. 1.911-7(a)(1) provides that the elections may be made on Form 2555, Foreign Earned Income, or on a comparable form.

Generally, these elections can only be made on a timely filed income tax return (including extensions) or on an amended return. No election is required to deduct foreign housing costs, but information specified in the regulations must be provided.

An individual has two filing options if the foreign residency or presence requirement has not been met at the time the U.S. income tax return is due. The return may be filed without claiming Sec. 911 benefits; they may be claimed later on an amended return. Alternatively, an extension may be obtained using Form 2350, Application for Extension of Time to File U.S. Income Tax Return, so that the benefits can be claimed on the original return filed after the foreign residency or presence requirement is met.

##### Effect of Election and Revocation

Sec. 911(e) provides that an election to exclude income under Sec. 911(a) applies to the tax year for which made and to all subsequent tax years, unless revoked. A taxpayer may revoke an election for any tax year after the tax year for which it was made. A taxpayer who revokes an election may not make another before the sixth tax year after the tax year in which the revocation was made, unless IRS consent is received.

##### Choosing Between Exclusion and Credit

In *Jones*,<sup>14</sup> a pilot for International Air Service Co. in California, frequently flew to Japan and spent 165 nights there during the tax year. He paid Japanese income taxes of \$24,293, in addition to U.S. income tax. He also excluded \$80,886 of foreign income under Sec. 911 (foreign earned income and hous-

<sup>10</sup> This is the total amount of foreign earned income, as defined in Regs. Sec. 1.911-3. This does not refer to foreign earned income as defined in Sec. 911(a), which is the amount allowed as an exclusion.

<sup>11</sup> See Regs. Sec. 1.911-4(e).

<sup>12</sup> However, careful attention should be given to the deduction limit in Sec. 219(b).

<sup>13</sup> See note 4, *supra*.

<sup>14</sup> *George H. Jones*, TC Memo 1989-616.



ing exclusions). He claimed an FTC for Japanese taxes of \$2,923 (the amount remaining after subtracting the Japanese income taxes applicable to the \$80,886 exclusion). The Tax Court found that he failed to qualify for the Sec. 911 exclusion, because he failed to meet the presence test (330 days) and the alternative bona fide residency test. He was allowed to increase his FTC, because none of his foreign income was excludible. (Exhibit 3 below illustrates the importance of filing a tax return correctly.)

**Strategy**

1. Income taxes will increase for many expatriates, due to the following

changes retroactive to Jan. 1, 2006: the new (i) limits on the housing cost amount and (ii) stacking procedure for computing tax on income not excluded.

2. Analyze adequacy of 2006 year-to-date Federal income tax withholdings (employees) and estimated income tax payments (self-employed), and recommend additional amounts to be withheld by Dec. 31, 2006 or paid by Jan. 15, 2007, to avoid or minimize underpayment penalties and interest.

3. Evaluate budget provisions for company tax equalization costs and consider adequacy of accruals.

4. Sec. 911 benefits are not available for

foreign employees of the U.S. or its agencies, but are available if the employer has a contract with the U.S. or the individual is self-employed.

5. If an individual has a temporary assignment in a foreign country, the Sec. 911 exclusion is not available, but travel costs may be deductible under Sec. 162.

6. The foreign housing exclusion is available whether or not an individual receives a housing allowance. It is beneficial when foreign earned income exceeds \$82,400 for 2006.

7. When a married couple needs to maintain two foreign homes, the housing cost exclusion is available for both homes. On a joint return, it can be advisable for one spouse to report the combined housing costs (i.e., only one base housing amount is subtracted in computing the housing exclusion).<sup>15</sup>

8. Under Regs. Sec. 1.911-6, business and many personal deductions are disallowed to the extent related to income excluded under Sec. 911. This requires care in allocating deductions between excluded and included income.

9. Reimbursement of actual employee expenses under an accountable plan does not affect the computation of foreign earned income or the Sec. 911 exclusion.

10. The Sec. 911 exclusion applies to income of self-employed individuals for regular income tax purposes, but SE income may be subject to SE tax.

11. When the taxpayer's income does not qualify for the foreign earned income exclusion (or exceeds it), consider claiming a deduction or credit for the foreign taxes paid on the nonexcluded income.

12. Check treaty provisions that may affect a taxpayer's right to claim the Sec. 911 exclusion or deduction.

13. Be alert to Treasury's actions to exercise its "discretion to provide relief in jurisdictions where this [housing] exclusion is unreasonable."<sup>16</sup> See Notice 2006-87 for specific relief. **TTA**

**Exhibit 3: FTC pitfall—failure to carefully plan tax reporting**

*P* received \$4.225 million over a four-year period from a corporation located in Israel that was owned by *P* and other members of his family. An \$80,000 exclusion of foreign earned income would have been of very limited benefit, given the amount of income he received. If he could demonstrate that these payments were foreign-source income, such as (1) dividends received from a foreign corporation or (2) payments for personal services performed in a foreign country, *P* would qualify for the FTC.

*P* reported this income on Form 1116, Foreign Tax Credit (Individual, Estate, or Trust), in the "General Limitation" Income category, which includes compensation for services. *P* did not identify the income as being in the passive category, which applies to dividends and interest. Later, he sought to characterize this income as foreign-source dividend income and claim an FTC for income taxes paid to the Israeli government.

*P* did not qualify for the credit based on classifying the payments as compensation, because the services he provided were as a U.S. resident during the relevant period; thus, none of the income was foreign-source income. In support of his claim that the payments were dividends, *P* argued that they were not compensation, because he provided no services to the foreign business. However, the Tax Court cited *P*'s lack of "clean hands," which precluded his arguing substance-over-form for post-transactional tax planning.

The Tax Court found that *P* did not qualify for the FTC, because in other reports the payments had been characterized as compensation for services. The corporation deducted the payments as compensation expense. In addition, the payments were not made to stockholders in proportion to stock ownership.

*P* should have been allowed a deduction for the foreign income taxes under Sec. 164, but the court denied this claim because he did not raise this issue until near the end of the trial. However, *P* was allowed to deduct foreign income taxes in his Tax Court Rule 55 Computations (*Jacob Pinson*, TC Memo 2000-208, supplemented at TC Memo 2000-393).

<sup>15</sup> See Regs. Sec. 1.911-5(a)(3)(ii). This procedure is available when the second home is maintained due to adverse living conditions.

<sup>16</sup> According to Prystay and Herman, "Tax Hike Hits Home for Americans

Abroad," *Wall Street Journal Online* (7/19/06), p. D1, "[a]verage annual rents for expat executives in Moscow range from \$60,000 to \$180,000, well above the \$11,536 cap."