



BDO Seidman, LLP
Accountants and Consultants

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Subject:

Modification of Exclusions for U.S. Citizens/Green Card Holders Living Abroad

Expatriate Tax Alert

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In the House/Senate Conference Report to the "Tax Increase Prevention and Reconciliation Act of 2005," passed by Congress on May 11, 2006, and expected to be soon signed by the President, amendments were made that have the effect of increasing the amount of U.S. tax paid by U.S. citizens/Green Card holders living abroad.

There are two exclusions currently available to U.S. citizens and residents living abroad. The first is the Foreign Earned Income (FEI) Exclusion, whereby such taxpayers may exclude up to \$80,000 (subject to limitations) of foreign earned income from their U.S. tax returns, provided certain facts and time tests are met. The second exclusion is the Housing Exclusion, which allows those taxpayers who qualify to exclude from their foreign earned income the cost of their foreign housing (e.g., rent, utilities) in excess of a certain threshold amount. The only upper limit to this second exclusion is the amount of foreign earned income.

The new legislation provides for taxable years beginning after December 31, 2005:

a) that the \$80,000 FEI Exclusion limitation is to be adjusted for inflation commencing in 2006 (instead of beginning in 2008, as previously enacted). For 2006, the inflation adjusted amount will be \$82,400;

b) a higher threshold over which housing costs are eligible for exclusion equal to 16 percent of the FEI exclusion limitation (for 2006, this amount will be $\$82,400 \times 16\% = \$13,184$);

c) an upper limit on the Housing Exclusion equal to 30 percent (or a different percent prescribed by the Treasury Department based on geographical differences in housing costs relative to housing costs in the United States) of the amount of the FEI Exclusion limitation (for 2006, this amount will be $\$82,400 \times 30\% = \$24,720$); and

d) that the total of the FEI and Housing Exclusions is to be added back to income for determining the graduated tax rates applicable to all non-excluded income (i.e., the exclusions will no longer apply to reduce the taxpayer's average tax rate on all other income).

Example: To illustrate the effect of the Act on the Housing Exclusion, assume a U.S. citizen or Green Card holder taxpayer living abroad had foreign housing costs of \$100,000 and foreign earned income in excess of that amount in 2005 and will have the same in 2006. For 2005, the taxpayer's Housing Exclusion is \$88,106 (\$100,000 less the threshold of \$11,894 for 2005). For 2006, the taxpayer's Housing Exclusion will be \$11,536 (\$24,720 minus \$13,184).

Observations: The Act increases the U.S. taxes of U.S. citizens and Green Card holders living abroad. If affected taxpayers are tax equalized by their employers, the additional cost will be borne by the employers and increase their cost of assignments. Taxpayers located in countries with low foreign tax rates and high housing costs will be most affected. Usually, if the Housing Exclusion is reduced, taxpayers can still obtain some double tax relief through foreign tax credits, but if affected taxpayers are in a low or no-tax foreign country, then the exclusions are of greater significance. The countries where taxpayers are likely to be most impacted by these changes are those in the Middle East and in Asia, due to their low or no tax environments and relatively high cost of housing.

IRS to Increase Audit Activity

In a related development, the IRS announced a new audit initiative to increase the number of audits of nonresident aliens and expatriates living abroad to 10,000 for 2006. The IRS is hiring 100 additional staff to cope with the increased number of filers claiming residency tax breaks and foreign tax credits, among other international transactions.

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For more information, please contact:

Carol-Ann Simon, Partner

125 South Market Street
San Jose, CA 95113
Tel (408) 352-1975
Fax (408) 278-0230
csimon@bdo.com

Wendy Odabashian, Director

330 Madison Avenue
New York, NY 10017
Tel (212) 885-8192
Fax (212) 697-5012
wodabashian@bdo.com

Donna Chamberlain, Director

1001 Morehead Square Drive
Charlotte, NC 28203
Tel (704) 887-4218
Fax (704) 887-4290
dchamberlain@bdo.com