

Alert Regarding the Claim of the Foreign Earned Income and Housing Exclusions for U.S. Expatriates Abroad

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Housing Exclusion

As you may recall, TIPRA enacted in May 2006 changed the rules regarding the claim of the Foreign Earned Income and Housing Exclusions. The Housing Exclusion claim has been scaled back, and the housing cost limits are now customized by location. Refer to the instructions to Form 2555 to see the latest limits on housing claims available for various locations around the world. The IRS is continually updating this information, so it is worth revisiting their site to check for changes and updates.

The full text of the latest Treasury notice issued can be found at: <http://www.irs.gov/pub/irs-drop/n-08-107.pdf>

Consider Not Claiming the Exclusions:

More importantly though, we have found that there are many examples where the taxpayer is better off without claiming any exclusion tax relief at all. This is due to the onerous provision surrounding this claim, referred to as “stacking”, whereby the income that remains unexcluded from the tax return is now subject to tax at the highest graduated rates as if the exclusion was not claimed, instead of previously when the taxpayer could access lower graduated rates after the exclusion.

We have found that in the case of a high income taxpayer, such that their income is higher than the total of the exclusions available, they are possibly going to be better off making use of available foreign tax credits ALONE, rather than a combination of the exclusions and foreign tax credits. This will apply to those residing in higher tax jurisdictions. If the taxpayer resides in a no or low tax foreign location, the exclusion is still the best form of U.S. tax relief.

When you use the exclusions, some of the foreign tax credits available for use get allocated away, or “scaled back”, because you can’t double dip your relief - in other words, you can’t claim both the exclusion and the foreign tax credit on the same foreign income in your US return. If you claim the exclusion, some of your FTC’s available for claim must be removed, making them ineligible for carryforward to a future year.

There are cases where claiming the exclusion is too high a price to pay, because it removes too much FTC for future use. Under the old law, claiming s.911 relief was usually better than claiming FTC’s, since the exclusion worked to reduce the top marginal tax bracket that your unexcluded income was taxed at, but now that

advantage has been virtually erased under the new law (i.e. the “stacking” rule). The unexcluded income is now taxed at as high a tax bracket as if the exclusion was not claimed, which levels the playing field between the exclusion and the FTC form of relief. Now the FTC claim will look better in many cases, because the tax relief of the exclusion is similar, but you leave yourself with more FTC carryovers for the future.

Therefore, watch for:

- Income remaining on the return after the exclusion
- Sufficient foreign tax credits available

A few cautions:

- If you choose not to claim the exclusion and you were eligible to, this is considered to be a revocation of your election to claim the exclusion (if you have already elected to claim it in the past), and then you cannot claim it again for the next 5 years, (unless IRS gives you a ruling - such requests are not difficult to obtain, but may cost as much as \$1,500 in fees). If you plan on moving to a lower tax jurisdiction in the future, you may not want to revoke the exclusion now.
- If you are a continuing resident of your home state, you should check what form of double tax relief they allow. i.e. if they allow the exclusion but do not allow FTC, then you should consider that 911 may still be the best overall option for you, taking into account both federal and state taxes.
- The exclusion income reduction may still be better if you want to reduce the itemized deduction 3% threshold, or ensure the claim of a rental loss which is lost after AGI exceeds \$150K. In other words, it is best to completely run the return both ways to conclude which is best.

This bulletin is a summary and is not intended as tax or legal advice. You should consult with your tax advisor to obtain specific advice with respect to your fact pattern.

Based on the most recent "best practice" standards for tax advisors issued by the Treasury Department, commonly referred to as Circular 230, we wish to advise you that this bulletin has not been prepared to be used, and cannot be used, to provide assurance that penalties which may be assessed by the IRS or other taxing authority (including specifically section 6662 understatement penalties) will not be upheld.