The Hidden Jewel

Form 2555- Foreign Earned Income Exclusion's Other Cousin

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The goal of this article is to provide a comprehensive checklist of information for the United States (U.S.) person to consider prior to accepting an assignment outside the U.S. This article is not designed to teach you the required technical competence required to perform self compliance; however it will certainly arm you with the technical knowledge to determine if your U.S. Certified Public Accountant (CPA) tax preparer knows all that they should know to provide you with technically competent professional services.

The Foreign Housing Exclusion (HE) or Deduction (HD)/ Qualified Foreign Housing Expenses (QFHE):

In addition to the FEIE, there is a little-known hidden jewel, the Foreign Housing Exclusion (HE) for employed persons or the Foreign Housing Deduction (HD) for self-employed persons. In addition to the above FEIE of $120,000 for 2023 ($112,000 for 2022, $108,700 for 2021, $107,600 for 2020, $105,900 for 2019, $103,900 for 2018, $102,100 for 2017, $101,300 for 2016, $100,800 for 2015, $99,200 for 2014, $97,600 for 2013, and $95,100 for 2012), there is also an opportunity to augment this basic earned income exclusion (FEIE) by an overseas taxpayer's reasonable (but not lavish or extravagant) Qualified Foreign Housing Expenses. Qualified Foreign Housing expenses are typically much higher than a taxpayer's taxable employer paid housing income, allowance, or quarters.

Further 'actual' Qualified Foreign Housing Expenses should never be confused with employer paid housing income, allowances or quarters. One is an actual expense or outlay, the other simply an element of compensation.

The nice feature of the HE or HD is that the list of Qualified Foreign Housing Expenses are clear and well established and include: Rent, Fair Market Value (FMV) of employer provided housing, foreign real-estate or occupancy taxes (now more relevant with the elimination of the deduction of such expenses on Schedule A as a result of the Tax Cuts and Jobs Act of 2017 (TCJA 2017)), TV taxes, utilities (but not telephone), real or personal property insurance, "key" money or other similar nonrefundable deposits paid to secure a lease, repairs and maintenance, furniture rental, temporary living expenses and residential parking.

However, the truly astonishing feature about the HE or HD is that it does *not* matter who pays for these qualified foreign housing expenses. Regardless of whether the employee directly pays for these costs or the employer directly pays (or reimburses the employee), these costs are still includable as Qualified Foreign Housing costs for determining the HE or HD. This is due to the fact that employer directly paid or reimbursed costs may need to be included in the taxpayer's employment income, since they are considered an element of taxable compensation as they relate to personal living expenses.

However, housing costs for the 'convenience of the employer' on the employer premises such as in a man camp are not considered taxable compensation. These types of arrangements may also include a safety or security or remoteness element.

Effective January 1, 2006, as amended by IRC Sec. 515 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), this new law provides for two changes regarding the HE and HD:

1) the base housing amount (otherwise known as 'Housing Norm', which acts like a deductible) representing the amount that needs to be exceeded before any qualified housing costs are excluded or deducted, effective January 1, 2023, has risen from $49.10 per day or $17,920 for a full 365

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days for 2022 *to* $52.60 per day or $19,200 for a full 365 days for 2023, representing 16% of the amount of the FEIE or $120,000 for 2023 ($112,000 for 2022).

2) further TIPRA has placed an overall effective cap on the total Qualified Housing Expenses eligible for consideration for either the HE or HD, at 30% of the FEIE of $120,000 for 2023 ($112,000 for 2022) or for 2023 $98.63 per day or $36,000 for a full 365 days (30% * $120,000). For 2022- $92.05 per day or $33,600 for a full 365 days (30% * $112,000). This cap had not existed prior to January 1, 2006.

Therefore, the maximum excludable or deductible Qualified Housing Expenses is the difference between the cap of $36,000 less the deductible base housing amount of $19,200 which equals $16,800 or $46.03 per day for a full 365 days.

Further to the ratification of TIPRA, the IRS continues to issue IRS Notice(s) for 2022 Notice 2022-10 (issued March 7, 2022) (2021 Notice 2021-18 (issued March 1, 2021)) which allows for certain cities (of 52 countries worldwide) with very high housing costs a higher overall exclusion cap, effectively overriding the 2023 30% limitation on the FEIE or $36,000 cap. Until the 2023 IRS Notice is issued assumingly in March or April of 2023 for the 2023 tax year, we will continue to apply the 2022 Notice to 2022 tax year. When the 2023 Notice is issued, we may elect to apply the 2023 Notice adjustments to the 2022 tax year in lieu of the adjusted 2022 Notice adjustments (Notice 2022-10) if the 2023 Notice limitations are higher. Please consult us on a list of these cities and amounts separately.

<u>Other Interesting Form 2555- FEIE, HE and HD, Form 1116- FTC and General Facts:</u>

- These exclusions (and Housing Deduction) - FEIE, HE and HD are elective, and should not be used when they trigger income inclusion. This would occur, for example where Schedule C expenses outstrip income and these expenses are added back to actually create income.

- The HE and HD are both subject to a base deduction or “Housing Norm” which for 2023 is $52.60 per day based upon 365 days (2022 is $49.10 per day based upon 365 days). So, if in 2023 the taxpayer was abroad a full 365 calendar tax year days the taxpayer would first need to deduct $19,200 prior to any of the Foreign Qualified Housing Costs counting towards the HE or HD.

- Theoretically, if the taxpayer has no U.S. source income, then using the FEIE, HE, HD and/ or FTC, their U.S. tax liability should be NIL. This assumes that the taxpayer is resident in a country that has an income tax and that foreign income tax is at least as high as U.S. income tax. Otherwise, if the taxpayer uses the FEIE and HE and/ or HD and in addition requires the use of the FTC in a hybrid situation, the taxpayer will end up paying the higher of either the U.S. income tax or the foreign income tax on that unexcluded earned income requiring the FTC.

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