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 U.S. person to consider prior to accepting an assignment outside the U.S. This article is not designed to teach you the technical competence required to perform self compliance; however it will certainly arm you with the knowledge to determine if your U.S. tax preparer knows all that they should know to provide you with technically competent professional services.

The Foreign Housing Exclusion (HE) or Deduction (HD):

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 $102,100 for 2017 ($101,300 for 2016, $100,800 for 2015, $99,200 for 2014, $97,600 for 2013, $95,100 for 2012, $92,900 for 2011 and $91,500 for 2010), there is an opportunity to augment this basic earned income exclusion 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 housing expenses are clear and well established and include: Rent, Fair Market Value (FMV) of employer provided housing, foreign real-estate or occupancy taxes, 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 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. Housing costs for the convenience of the employer on the employer premises, such as in a mancamp are not considered taxable compensation. These type of arrangements may also include a safety or security 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 (or deductible) representing the amount that needs to be exceeded before any qualified housing costs are excluded or deducted, effective January 1, 2016, has risen from $44.28 per day or $16,208 for a full 366 days to $44.76 per day or $16,336 for a full 365 days, representing 16% of the amount of the FEIE or $102,100 for 2017 ($101,300 for 2016).
2) further TIPRA has placed an overall effective cap on the total qualified housing costs eligible for consideration for either the HE or HD, at 30% of the FEIE of $102,100 for 2017 ($101,300 for 2016) or for 2017 $83.92 per day or $30,630 for a full 365 days (30% * $102,100). For 2016-$83.04 per day or $30,390 for a full 366 days (30% * $101,300). 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 $30,630 less the deductible base housing amount of $16,336, which equals $14,294 or $39.16 per day for a full 365 days.

Further to the ratification of TIPRA, the IRS continues to issue Notice(s) for 2016- IRS Notice 2016-21, issued March 7, 2016, (for 2015- IRS Notice 2015-33, issued April 14, 2015)- which allows for certain cities (of 52 countries worldwide) with very high housing costs a higher overall exclusion cap, effectively overriding the 30% limitation on the FEIE or $30,630 cap. Until the 2017 IRS Notice is issued assumingly in April 2017 for the 2016 tax year we will continue to apply the 2016 Notice to 2016 tax year. When the 2017 Notice is issued we may elect to apply the 2017 Notice adjustments to 2016 tax year, in lieu of the adjusted 2016 Notice adjustments (Notice 2016-21), if the 2017 Notice limitations are higher. Please consult us on a list of these cities and amounts separately.

Other Interesting Form 2555- FEIE, HE and HD, Form 1116- FTC and General Facts:

- These exclusions- FEIE, HE and HD are elective, and should not be used when they trigger income inclusion. This would occur 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 2017 is $44.76 per day based upon 366 days (2016- $44.28 per day based upon 366 days). So, if in 2017 the taxpayer were abroad a full 365 calendar tax year the taxpayer would first need to deduct $16,336 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 FTC, their U.S. tax liability should be NIL...