

SMITH CARMICHAEL ASSOCIÉS

Re: Foreign Earned Income and Housing Exclusion

U.S. citizens and resident aliens are generally taxed on their worldwide income regardless of where the income is earned or received. A U.S. citizen who earns income in a foreign country may also be taxed on that income by a foreign host country, thus leading to double taxation. However, a number of tax provisions provide relief from this inequity, including the foreign tax credit and deduction, the foreign earned income exclusion, and the foreign housing cost exclusion. Based on a review of your prior year's tax information, we feel it would be beneficial for you to meet with us to discuss tax planning regarding your foreign source income.

As an alternative, qualifying individuals may elect to exclude from gross income up to \$91,500 (in 2010, an increase of \$100 from 2009) of foreign earned income, as well as certain employer-provided housing costs. Individuals with self-employment income are also entitled to deduct certain non-employer-provided housing costs. In order to qualify for these exclusions and deductions, an individual's tax home must be in a foreign country and he must meet either a residence or physical presence test. A determination of whether a taxpayer qualifies is based on all the facts and circumstances including:

- ☐ The taxpayer's intention,
- ☐ The length of stay in a foreign country,
- ☐ The nature and duration of employment,
- ☐ The establishment of a home in the foreign country, and
- ☐ The nature, extent and reasons for temporary absences from the foreign home.

To substantiate eligibility for the foreign earned income and housing exclusion, a taxpayer must have adequate documentation. The IRS plans to improve compliance on international issues and expects to increase the use of foreign information documents and data sharing with other federal agencies. For instance, travel dates may be verified with U.S. passport information.

Taxpayers may not elect to take both the foreign-earned income and housing exclusions and the foreign tax credit. Also, if a taxpayer claims the foreign earned income exclusion, the taxpayer will not qualify for the earned income credit for that year. The choice between the foreign earned income and housing exclusions and the foreign tax credit depends on which option more effectively reduces taxes. If the taxpayer's foreign earned income is subject to a higher foreign income tax than his U.S. income, it is more advantageous to claim the foreign tax credit.

In selecting the more appropriate option, a taxpayer must also consider factors, such as length and certainty of stay in a foreign country. If a taxpayer working in a high tax country revokes the election, he may not take the election for five years without permission from the IRS and, therefore, would be at a disadvantage if he were transferred to a low tax country. In addition, a "stacking rule" has been added to ensure that U.S. citizens living abroad are subject to the same U.S. tax rates as individuals living and working in the United States. Thus, income that is excluded from gross income is included for determining the applicable tax rate.