

North American Compensation and Employment Law Practice Group

Client Alert

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Changes to Section 911 Mean Higher Taxes for Some Expatriates

Over the years there have been numerous attempts to repeal or substantially revise Section 911 of the Code, the provision that provides a tax exemption for foreign earned income and housing benefits of U.S. employees who work overseas. In each case, in the face of heavy lobbying, these attempts have failed and the tax exemption has been preserved. Now, however, the tax reformers have won a battle and have put a dent into Section 911. Under The Tax Increase Prevention and Reconciliation Act of 2005 (H.R. 4297) (“TIPRA”), signed into law on May 17, 2006, Section 911 has been substantially revised. The result is a smaller tax exemption, and thus potentially higher taxes, for U.S. expats.

Background

Code Section 911 currently provides an individual who works outside of the United States with the ability to exempt from U.S. income tax up to \$80,000 (indexed for inflation beginning in 2008) of foreign earned income, plus reasonable housing cost amounts that are in excess of a “base amount”. In general, this tax exemption is available to a U.S. citizen who has been a bona fide resident of a foreign country for a taxable year, or a U.S. citizen or resident who is physically present in a foreign country or countries for at least 330 full days during a period of 12 consecutive months. For these purposes, “foreign earned income” includes compensation earned for services performed outside of the United States, other than: amounts received as a pension or annuity, amounts taxable under Code Section 402(b) (nonexempt trusts) or Section 403(c)(nonqualified annuities), amounts received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable were performed, and certain other items. Under current law, the “base amount” for purposes of excluding housing costs is defined as 16% of a grade GS-14, step 1 salary (\$77,793 in 2006). So, for 2006 the “base amount” under current law is \$12,447.

TIPRA makes four important changes to Section 911, effective for tax years beginning after December 31, 2005:

1. The maximum foreign earned income exclusion is indexed for inflation after 2005, using 2004 (instead of 2006) as the base year. As a result, the 2006 maximum exclusion is now \$82,400.
2. The “base amount” for purposes of excluding housing costs is now defined as 16% of the maximum foreign earned income exclusion (i.e., \$82,400 in 2006). Accordingly, in 2006 the “base amount” is \$13,184.
3. There is now a maximum exclusion for housing cost amounts. The maximum is now 30% of the maximum foreign earned income exclusion (i.e., \$82,400 in 2006). Accordingly, the maximum exclusion for housing costs in 2006 is \$11, 536 ($(\$82,400 \times 30\%) - \$13,184$).
4. Any income excluded under Section 911 is now included for purposes of calculating the tax rate applicable to non-excluded income. Under prior law, any income excluded under Section 911 was simply not taken into account when determining the U.S. federal income tax on non-excluded income, even though the excluded income was considered in certain situations (e.g. determining eligibility for IRA contributions and conversions). In particular, under the new law, where a taxpayer excludes income under Section 911, the taxpayer’s regular tax is equal to the excess (if any) of: (i) the regular tax that would be imposed for the tax year if the taxpayer’s taxable income were increased by the amount of the exclusions, over (ii) the tax which would be imposed for the tax year if the taxpayer’s taxable income were equal to the amount of such exclusions. A similar new rule now applies with respect to the calculation of alternative minimum tax under Section 55. According to the Conference Report, this provision is intended to subject individuals working abroad to the same tax rates applicable to individuals living and working in the United States who have the same amount of economic income.

Observations

The thrust of these changes is to reduce the amount available as a tax-exemption for U.S. citizens and residents who work outside of the United States. Since many companies tax-equalize their expatriates, the impact will be felt most by the companies that send these executives abroad, since under tax-equalization an additional U.S. income tax applicable to the expatriate usually comes out of the company’s pocket. These companies may want to consider updating their foreign assignment cost projections in order to increase the accrued liability for the future tax-equalization costs.

The impact of these changes will be most pronounced in the following situations:

- (a) Expatriates on assignment in jurisdictions where there is no income tax or a low rate of income tax (e.g., the United Arab Emirates, Hong Kong). In these jurisdictions, the expat will not have a significant foreign tax credit to reduce U.S. income tax on income not excluded under Section 911 (such as high housing cost amounts). In higher tax jurisdictions, such as Australia and France, the foreign tax credit can help in this regard.

- (b) Expatriates on assignment in jurisdictions where typical expatriate housing is relatively expensive (e.g., Japan, United Kingdom, Hong Kong) will be limited by the new maximum housing cost exclusion and will not receive a U.S. tax benefit for all of their housing costs. TIPRA does provide that on an annual basis, the IRS may issue regulations or other guidance providing for the adjustment of the 30% limit on the basis of geographic differences in housing costs relative to housing costs in the United States. It is unclear at this time whether the IRS will actually provide this relief to the higher cost locations.
- (c) Expatriates on assignment who have substantial U.S. source income as a result of (i) many or lengthy business trips to the United States, or (ii) significant investment income or other business income earned in the United States (other than capital gains or dividend income eligible for the preferential tax rates). Because U.S. expats in general will no longer be able to exclude foreign earned income and housing cost amounts for purposes of determining the tax rates on their non-excluded income, expats with substantial U.S. source income during their foreign assignment will feel the impact the most, because they will likely have to pay a higher rate of tax on such non-excluded amounts.

Please let us know if you have any questions regarding this Client Alert. This Client Alert is intended to provide general information, not legal advice, and is not a substitute for a thorough analysis of expatriate taxation.

Perhaps the only saving grace of the new legislation is the acceleration for indexing the maximum foreign earned income limitation. Instead of waiting for an increase to occur in 2008, we now have a higher limit beginning in 2006. However, this accelerated increase is small compensation for the group of U.S. expatriates who will be subject to a significant reduction in the housing cost amount exclusion and an increased tax rate on non-excluded income.

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