

# Financial Services

## Offshore Insurance Alert

Bermuda

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### U.S. Modifies Foreign Earned Income Exclusion Driving Up the Cost of Doing Business Abroad

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President Bush is expected to sign the Tax Increase Prevention and Reconciliation Act of 2005 into law Wednesday, May 17<sup>th</sup>. Whilst commentators have focused on the demographics of the tax savings contained in the new law (e.g., the substantial benefit to wealthy Americans), U.S. persons living and working abroad are bearing a substantial portion of the cost of those savings.

U.S. persons are generally subject to U.S. taxation on their worldwide income whether derived in the United States or elsewhere. Historically, U.S. persons were able to exclude up to \$80,000 of their foreign earned income from U.S. taxation. Additionally, the amount a U.S. person paid for their foreign housing (rent, utilities, insurance etc) was also allowed as a deduction without limitation (less a base adjustment tied to a U.S. Governmental reimbursement rate for a GS 14). Finally, a U.S. person living and working abroad was subject to tax rates after taking into account the foreign earned income exclusion and housing deduction.

The new law affects these U.S. persons in three ways:

**Foreign Earned Income Exclusion Indexed for Inflation.** The new law indexes the foreign earned income exclusion for inflation (originally planned to be indexed from 2007) from 2005. The result is that in 2006, the foreign earned income exclusion rises to \$82,400.

**Housing Deduction is Limited.** The new law changes the way a U.S. person living and working abroad would compute their housing deduction. First, the new law replaces the historical floor limitation (using the U.S. governmental reimbursement rate for a GS 14 rated U.S. government employee) to a limitation based upon 16% of the foreign earned income exclusion (maximum of \$82,400 in 2006). Secondly, the new law limits the overall housing deduction to 30% of the U.S. person's foreign earned income exclusion. The maximum housing deduction for 2006 would be \$11,536 = (\$82,400 x 30%) minus (\$82,400 x 16%). The additional tax cost to the U.S. person would be the amount of the housing deduction under the prior rules, less the maximum deduction of \$11,536, times the marginal tax rate which would normally be 35%.

**Affect on Tax Brackets.** U.S. persons benefiting from the foreign earned income exclusion and housing deduction will now be subject to U.S. tax at the marginal rate the U.S. person would have been subject to tax if the foreign earned income exclusion and housing deduction had not been applied. The additional tax cost of this change to the tax brackets to the U.S. person living and working abroad maximizing the foreign earned income exclusion and housing deduction would be \$20,806 and \$16,811 for a single taxpayer or married filing jointly taxpayers, respectively.

**Ability to Adjust Limitation.** The new law gives Treasury the ability to issue guidance adjusting the 30% limitation to reflect geographic differences in housing costs relative to housing costs in the U.S.

*PricewaterhouseCoopers Commentary* – The new law will increase the U.S. tax cost of U.S. persons living and working abroad. Further, since most U.S. persons are employed based upon some type of equalization

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package, all or a portion of the cost will most likely be passed on to the foreign employers making the employment of Americans unattractive to foreign employers.

For additional information, please contact your PricewaterhouseCoopers tax advisor or Rick Irvine at 441-299-7136.

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