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FOREIGN EARNED INCOME EXCLUSION (FORM 2555)

BY KEISHA KIM

The US tax system requires all its citizens and permanent residents to file tax returns based on worldwide income, regardless of where they live.

As such, if a person lives overseas and files taxes in a foreign country, the person also needs to report the foreign income to the IRS by filing US taxes.

In an effort to mitigate the risk of double taxation, the IRS has come up with several provisions that can benefit US expats when they file their US federal tax returns. Among the provisions are **Foreign Earned Income Exclusion** and **Foreign Housing Exclusion/ Deduction.**

Through these tax benefits, expats can exclude all or a portion of their foreign earned income from being taxable in the US, thus eliminating or reducing US taxes on foreign income. This is not an automatic exclusion of all foreign earned income. There are rules on what you can exclude as foreign earned income and what you cannot exclude. To qualify for the benefit, you will need to qualify for the exclusion and file the proper tax form 2555.

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Foreign Earned Income Exclusion

Examples of Foreign Earned income are wages, salaries, professional fees, commissions, and other payments to you for services rendered by you.

Foreign earned income does not include unearned income such as passive/investment income, pension/annuity/ social security payments, payments received as a military or civilian employee of the US government or agencies, or payments for services rendered in international waters or airspace.

Generally, rental income is excluded from Foreign Earned Income; however, if a person performs personal services in producing rent, up to 30% of the net rental income can be considered earned income. Meals and lodging picked up by your employer are not considered foreign earned income.

For Tax Year 2022, the maximum exclusion amount has increased to $112,000 (up from $108,700 for 2021).

Qualifications

To claim the benefits, you must have foreign earned income, your tax home must be in a foreign country, and you must meet one of the following:

A. **Bona Fide Residence Test** – A US citizen is considered a bona fide resident of a foreign country when the person lives overseas for the entire tax year. If a person goes to a foreign country to work for an extended period and establishes permanent quarters there, the person probably has a bona fide residence in a foreign country even if the intent is to eventually move back to the States.

B. **Physical Presence Test** – A US citizen or a US resident alien who is physically present in a foreign country for at least 330 full days during any period of 12 consecutive months. One can count the days overseas for any reason as long as the tax home is in a foreign country. If a person is in transit from Country A to B outside of the US and is present in the US for less than 24 hours, then the person is not considered to be present in the US nor is the person considered to be in any foreign country during the transit.

Foreign Housing Cost Exclusion and/or Deduction

US citizens or residents working and living abroad can claim to exclude or deduct a portion or all the amounts paid for foreign housing. The foreign housing exclusion applies to housing costs considered paid for with employer-provided amounts that are taxable foreign income. Whereas the housing deduction applies only to the amounts paid for with self-employment income.

First, it must be determined if one is a qualified individual. A qualified individual is someone who is a bona fide resident or meets the physical presence test, must have a tax home in a foreign country, must have a foreign earned income, and also must make a valid election.

Second, one needs to determine if housing expenses are reasonable. Some examples of eligible housing expenses are rent, housing repairs, insurance, utilities, residential parking, and occupancy taxes. Improvement costs, cost of buying property, deductible interest and taxes, and other lavish expenses are not included.

Third, one needs to determine if the housing exclusion/deduction is properly calculated. There is a limit on housing expenses which is 30% of max foreign earned income exclusion (for 2021, $108,700 x 30% = $32,610). Also, the number of qualifying days during the tax year, and the ratio of employer-provided amounts/ total foreign earned income come into play in calculating the Housing Exclusion.

- **Foreign Housing Exclusion** – This should be computed before figuring foreign earned income exclusion. If one chooses to exclude foreign housing expenses, the individual is unable to take a foreign tax credit on the income excluded.
- **Foreign Housing Deduction** – This amount cannot exceed foreign earned income minus foreign earned income exclusion and housing exclusion.

Filing Form 2555

Use Form 2555 to compute Foreign Earned Income Exclusion and Housing Exclusion/Deduction. One cannot exclude or deduct more than the amount of foreign earned income for the year. Attach Form 2555 to Form 1040 (or Form 1040-SR) when filed.

This article is only a summary of Foreign Earned Income Exclusion and how it can be utilized in your tax situation. If you are an expat with potential taxable income in the US or if you need assistance in preparing your US tax return and analyzing your potential tax situation in the US, please contact our International Tax Principal, Evelyn Fernandez at Evelyn.Fernandez@KROSTCPAs.com.

About the Expert

Evelyn Fernandez, CPA, MST

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Evelyn is a Tax Principal at KROST. She has been in the public accounting profession for over 15 years. Her areas of expertise include tax planning and compliance for high net worth individuals, international entities and individuals, multi-state taxation, partnerships, S corporations, trusts, nonprofit organizations, and entertainment businesses.
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