

Foreign earned income exclusion

We have been asked whether income you will earn from services you will perform outside the U.S. can be excluded from your income for tax purposes.

If you meet certain tests, you can elect the "foreign earned income exclusion," subject to limitations. The election is made by completing Form 2555 or Form 2555 EZ and attaching it to your return for the first tax year that you want the election to be effective. To qualify for the election, you must satisfy the following requirements.

First, you must have a "tax home" in a foreign country. This means your main place of business or employment must be in a foreign country on either a permanent or indefinite basis. Your "family" home can still be in the U.S. If your foreign assignment is merely temporary, you will not qualify for the exclusion. However, lodging and meals expenses of a temporary assignment can be deductible travel expenses. It will not be considered temporary, however, if it's for more than a year.

Next, while having the above tax home, you must either meet the bona fide foreign residence test or the foreign physical presence test.

To meet the bona fide foreign residence test, you must be a bona fide resident of one or more foreign countries for an uninterrupted period fully covering at least one tax year (e.g., Jan. through Dec. if, like most individuals, you're a calendar year taxpayer). Broadly speaking, you're a bona fide resident if you have the intention to live there for the time being. You can still intend to return to live in the U.S. eventually. Also, temporary brief trips back for vacation or business will not cause you to fail this test.

For the physical presence test, you must be physically present in a foreign country for 330 full days during a period of 12 consecutive months. For this test, the months do not have to cover an entire tax year—they can run, for example, from April through March.

If you qualify under the above tests, you can exclude from income the amount of your foreign earned income, up to a maximum of \$85,700 for tax year 2007 (\$82,400 for tax year 2006). The limitation is computed on a daily basis if you do not satisfy the tests for the entire year. If both you and your spouse qualify, an exclusion is separately determined for each of you.

Income paid by the U.S. government to its employees and income received as a pension, annuity, or social security benefit is not included in foreign earned income.

Note that the foreign earned income exclusion is elective, not automatic. If you elect to take advantage of the exclusion, you cannot also claim a tax credit for taxes paid to a foreign country allocable to the excluded income. Thus, in some cases you will have to compare the tax savings of the exclusion with those of a credit.

If your employer covers all or part of your foreign housing costs you may also qualify for a foreign housing cost exclusion. (In some cases, however, this may reduce your foreign earned income exclusion.)

You are exempt from income tax withholding on wages earned outside the U.S. that you reasonably expect to be covered by the foreign earned income exclusion or the foreign housing cost exclusion. You can claim this exemption by completing IRS Form 673 and giving the form to your employer.