

HOUSING AND FOREIGN EARNED INCOME: U.S. EXCLUSIONS

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A recent US Tax Court decision, *Nancy McDonald v. Commissioner* (tc Memo 2015-169), is a cautionary tale for every US citizen who lives in Canada and earns income from Canadian sources. Although a US citizen is generally taxed on his or her worldwide income, certain foreign earned income may be excluded from gross income for US tax purposes if the individual's tax home is in Canada and he or she is either (1) a bona fide Canadian resident or (2) physically present in Canada for 330 full days during any consecutive 12-month period. For calendar 2015, the foreign earned income exclusion allows up to US\$100,800 of foreign earned income to be excluded from a US citizen's income tax return.

Ms. McDonald met all the substantive conditions, but she did not adhere to the mechanics set out in Treasury regulation section 1.911-7(a)(2) for making a proper election to exclude foreign earned income on IRS form 2555 ("Foreign Earned Income"). In upholding the regulation's validity, the US Tax Court noted that the opening words of Code section 911(a)—"[a]t the election of a qualified individual"—made it clear that the taxpayer must also affirmatively elect to exclude foreign earned income from gross income.

A taxpayer can validly elect on form 2555 in several different ways. In the court's view, the regulation's timing requirements were "generous" because they provided multiple alternative methods for making the election: the form can be attached to (1) a US tax return filed by its original due date (including extensions); (2) a US tax return amending a timely filed return (the amended return generally must be filed by the later of three years after the original return's filing-due date and two years after the tax is paid); or (3) a US tax return filed within one year from its original due date. Even if all of those deadlines have passed, a taxpayer can still elect if (1) no federal income tax is owed after taking into account the exclusion, or (2) the IRS has not yet discovered the failure and the phrase "Filed pursuant to section 1.911-7(a)(2)(i)(d)" appears at the top of the first page of the us income tax return. An election remains in effect for later tax years unless it is revoked by the taxpayer.

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In addition to the foreign earned income exclusion, in certain circumstances a US citizen living in Canada may also claim an exclusion from gross income for certain housing expenses. The housing exclusion applies only to expenses that are considered to have been paid with employer-provided amounts and is adjusted depending upon cost-of-living guidelines prescribed by the IRS for various cities around the world. (For example, the annual limit for housing expenses in 2014 in Toronto was US\$52,000; in London, Ontario, the limit was US\$30,000.)

Housing expenses include reasonable expenses paid or incurred for housing outside the United States for all members of the taxpayer's household. Housing expenses include rent; the fair rental value of housing provided in kind by an employer; repairs; utilities (other than telephone charges); real and personal property insurance; non-deductible occupancy taxes; non-refundable fees for securing a leasehold; rental of furniture and accessories; and residential parking.

A US citizen living in Canada should ensure that he or she does not lose the ability to take advantage of these valuable income exclusions and should adhere to the required election mechanics that the IRS has outlined.