Foreign Earned Income Exclusion Changes by Steve Smith

A recent change in the tax law may have a major impact on taxpayers who use Form 2555 or Form 2555-EZ to exclude their foreign earned income (FEI) from taxation.

While employees of the US Government (to include local national employees) ***cannot*** exclude their wages from US taxation, there are a lot of taxpayers in the military community who can and do take the FEI exclusion. It can be taken by those who are self-employed (*e.g.*, FCC providers) and those who work on the German economy, as well as by those who work for:

- overseas campuses of US universities,
- credit unions or the Community Bank,
- the Red Cross and the USO.

The exclusion can also be taken by:

- technical experts,
- independent contractors,
- referees, dance instructors, church organists, and others who receive "non-employee compensation" reported on Form 1099-MISC.

In past tax years, the FEI exclusion was simple. You reported your excludable income on line 7 of Form 1040 and subtracted it out on line 21, and that was the end of the story.

The "Tax Increase Prevention and Reconciliation Act of 2005" changed the rules for taxpayers who take the FEI exclusion. The Act increases the rate of income tax on non-excluded income (*i.e.*, income on which you do pay tax) by adding the excluded income back in to establish the tax rate on the non-excluded income.

Since this change takes effect in tax years beginning after 2005, we are only now beginning to see the impact of this change in our tax assistance centers. Long story short, if your only source of income is excludable (*e.g.*, if you are single and your only source of income is your University of Maryland salary), the FEI exclusion should work as it has in the past, and you should notice no major increase in your tax bill. But if your return also includes taxable income (either yours or your spouse's), the rate of tax you pay on that income will likely be higher this year.

This means that many taxpayers overseas may experience a nasty surprise when they calculate their tax obligations for 2006. Many who were used to getting refunds in the past will wind up having to pay tax this year. Depending on how much FEI they earned, and how much tax they had withheld, they could wind up owing thousands of dollars in tax.

The sooner taxpayers who have FEI calculate their taxes, the sooner they will know whether they will be adversely impacted by this change in the law. If they owe tax for 2006, they needed to pay it by 17 April 2007 to avoid interest and late payment penalties. [Just because the overseas filing deadline is 15 June does not mean they can wait until then to pay.]

Since this change to the law was new in 2006, the IRS is not assessing under-withholding penalties on returns with FEI for tax year 2006. The IRS will probably start assessing those penalties on 2007 returns. Taxpayers with FEI would be well-advised to adjust their withholdings on Form W-4 to ensure they are paying in at least 90% of what they will owe in tax in 2007.

Taxpayers who are adversely impacted by this change in the tax law may wish to make an appointment with a legal assistance attorney to explore options for minimizing the increase in their tax bill.

For more information, contact the Kaiserslautern Tax Assistance Center at DSN 483-7688 or 0631-411-7688.

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Mr. Jim Wiley receives a LRMC commander's coin and certificate for conducting an emergency SRP for deploying medical personnel. CPT Marvin McBurrows, CPT Ryan Krohn, and SSG Everett Wilson were also recognized.

NEWS FLASH...

The 21st TSC Office of the Staff Judge Advocate bids farewell to CPT Carl Hill, CPT Jocelyn Stewart, SSG Jeremy Arnold, SGT Teira Arnold, SGT Jeri Cobb, and SGT Sigfredo Mendez, and welcomes our new Labor Law Attorney, Douglas Chicka, our new Fiscal Law & Ethics Attorney, Jeannine Smith, and our new SJA Administrative Assistant, Leigh Anne Newcomer .