

# Financial Services

## Offshore Insurance Alert

Bermuda

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### IRS Issues Guidance on Adjustments to the Housing Limitation for Specific Locations November, 2006

Alert Number: 06-05

The Internal Revenue Service recently issued Notice 2006-87 which provides cost of living adjustments which may increase the deduction limitation for housing costs incurred by U.S. expatriates residing in specific geographic areas. The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") changed the calculation of the deduction for housing costs incurred for U.S. expatriates living abroad. TIPRA limited the deduction for housing expenses (termed 'housing cost amount') to a maximum \$11,536. The deduction was calculated as follows: the excess of qualified housing expenses over \$13,184 (16% of the foreign earned income exclusion of amount of \$82,400) but limited to \$24,720 (30% of the foreign earned income exclusion of \$82,400). See Offshore Insurance Alert 06-04 dated May 15, 2006. TIPRA provided that the IRS would review jurisdictions whose cost of living was higher than the U.S. and adjust the housing cost amount accordingly. TIPRA was effective for tax years beginning on or after January 1, 2006.

Within Notice 2006-87, the IRS identified a number of areas with high housing costs as compared to the U.S. The list was compiled using data from the U.S. Department of State based upon its annual Living Quarters Allowance. Because of the large disparity in the cost of living, the maximum limitation that would otherwise apply, i.e. 30% of the person's foreign earned income exclusion (30% x \$82,400 = \$24,720), was increased to account for higher costs associated with particular locations. Instead of a maximum housing deduction limitation of \$11,356, a US expatriate, depending upon their location, may be entitled to a larger deduction. The Notice is effective for tax years beginning on or after January 1, 2006.

The Notice could prove to be controversial due to the per diem allowances for particular countries. For example, according to the Notice, the daily per diem established for Bermuda is \$71.78 or \$26,200 per year. As a result, U.S. expatriates living in Bermuda who are entitled to deduct their housing cost increased their housing deduction by \$1,480 for a maximum deduction of \$13,016. By comparison, the daily per diem established for Hong Kong is \$313.15 or \$114,300 per year. Thus, individuals living in Hong Kong now can deduct a maximum amount of \$101,116 for housing costs incurred for residing abroad.

Given the disparity between the per diems for Bermuda and Hong Kong, there may be an argument that the per diem rates for countries listed in the U.S. State Department table require revision because the adjustments for housing costs do not accurately reflect the realities of costs in the identified areas. However, due to the fact that the IRS relied upon a table from the Office of Allowances of the U.S. Department of State and that the table is updated annually by administrative pronouncement, it is unclear if there will be a significant revision of the data and if so when such a revision would take effect.

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The Notice does provide that taxpayers are invited to provide comments to the Service with respect to the method used in computing the limitations provided for in the Notice where the costs differ significantly from the costs used in the Notice. Comments may be submitted in writing to CC:PA:LPD:PR (Notice 2006-87), Room 5203, Internal Revenue Service, PO Box 7604, Washington, D.C. 20044. The Service will also accept comments via email at the following email address: [Notice.comments@irs.counsel.treas.gov](mailto:Notice.comments@irs.counsel.treas.gov). The Notice number should be included on the Subject Line.

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

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