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TAXATION

IMPORTANT INCOME TAX CHANGES FOR AMERICANS WORKING ABROAD

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The omnibus Tax Reform Act of 1976[1] brought about important limitations in the time-honored methods of computing the taxable income of United States citizens employed in foreign countries. These changes have stirred controversy and criticism to the point that they have been assailed as contributing to unfavorable trade balances for the United States. Prior to its amendment in the Tax Reform Act of 1976, Int. Rev. Code of 1954 (hereinafter *Code)*, Section 911 provided exemptions from certain types of gross income of U.S. citizens who earned income for services rendered in foreign countries, other than for services rendered to the United States or any agency of the United States. *Code* Section 911 permitted United States citizens who were bona-fide residents[2] of a foreign country to exclude from gross income (for U.S. tax purposes) up to $25,000 of earned income attributable to services rendered outside the United States.

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[1]Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520.

[2]I.R.C. §911(c)(6) sets forth a negative test for residency. It provides that if the United States citizen has made a representation to the foreign country's taxing authorities that such citizen was not a resident of the foreign country in which the income was earned, and as a result the foreign country determined he is not taxable in that country regarding that income, he shall be conclusively presumed *not* to be a resident of that foreign country. *See also* Treas. Reg. §1.911-2(a)(3) (1963). Treas. Reg. §1.911-2(a)(2) (1963) refers to the factual tests set forth in Treas. Reg. §§1.871-2, 3, and 4 for determining residence, in general.

Code Sections 911(a)(1) and (a)(2) distinguished between two classifications of United States citizens: those who were bona fide residents of foreign countries for an uninterrupted period which encompasses an entire taxable year,[3] and those who, during any period of 18 consecutive months, are present in a foreign country at least 510 full days.[4] For individuals coming within the first classification, *Code* Section 911(a) provided an exclusion for earned income during that period computed on a daily basis at an annual rate of $20,000.[5] Persons who were bona fide residents of one or more foreign countries for an uninterrupted period of three years or more, were provided an exemption at a $25,000 annual rate for income earned after the three year period.[6] For United States citizens in the second category who were present in a foreign country for at least 17 months during any 18 consecutive month period, the exemption was computed on a daily basis at an annual rate of $20,000.[7]

Under the Tax Reform Act of 1976, the annual rates have been reduced to $15,000 both for United States citizens who are described in *Code* Section 911(a)(1) and 911(a)(2), with no greater amount for persons who have been residents in foreign countries for extended periods. This reduction in the annual exclusion is effective for taxable years beginning after December 31, 1975.

A special provision, added by the 1976 Act, places the annual rate at $20,000 for persons performing services for a charitable organization organized in the United States and exempt from United States tax under *Code* Section 501(c)(3).[8]

EARNED INCOME

The annual exclusion under *Code* Section 911(a) is limited to "earned income attributable to services performed" from sources outside the united States. Earned income is defined in *Code* Section 911(b) to be wages, salaries, professional fees and other amounts received for

[3]I.R.C. §911(a)(1).

[4]I.R.C. §911(a)(2).

[5]I.R.C. §911(c)(1)(A).

[6]I.R.C. §911(c)(1)(B).

[7]I.R.C. §911(c)(1)(A).

[8]I.R.C. §911(c)(1)(B).

services actually rendered. The statute contains caveats excluding from the definition of "earned income" amounts found to be "disguised dividends." For taxpayers engaged in a business where both capital and services are material income producing factors, *Code* Section 911(b) calls for an allocation wherein not more than 30 percent of the income is deemed a reasonable allowance for personal services rendered.

ELECTIVE PROVISION

The exemption is no longer mandatory. New *Code* Section 911(e) permits taxpayers, to whom the exemption would apply, to elect to be excluded from its application. The principal reason for making such an election would be to retain the foreign tax credit (or deductions) attributable to the income which would otherwise be exempt under *Code* Section 911.

FOREIGN TAXES

The Tax Reform Act amended *Code* Section 911(a) to deny a United States citizen any deduction or credit for foreign taxes paid or accrued to a foreign country to the extent that the deduction or credit is attributable to amounts excluded from United States gross income under *Code* Section 911. Thus, for example, if a United States citizen earned $100,000 for personal services rendered in country X of which he has been a bona fide resident for several years and paid $10,000 in income tax, he would be denied a foreign tax credit (or deduction) of $1,500. [$15,000 x $10,000 ÷ $100,000 = $1,500]

UNITED STATES TAX COMPUTATION

One of the most important changes in *Code* Section 911 is the addition of *Code* Section 911(d). That section requires the United States citizen, who avails himself of the *Code* Section 911 exclusion, to pay tax on any taxable income in excess of the excluded portion at the higher incremented rates applicable if the excluded portion had been subject to tax. Under the old law, any taxable income in excess of the excluded portion was subject to tax rates as if the taxpayer had no other income.

The new law requires a computation of "net taxable income"[9] wherein all income from all sources is determined. The "net excluded earned income"[10] is subtracted from "net taxable income." The tax is determined for the "net excluded earned income" portion and that amount is subtracted from the tax computed on the net taxable income. The effect of this computation is to tax the non-excluded portion at higher progressive rates, as illustrated by the following example:

EARNED INCOME FROM FOREIGN SOURCES		$ 50,000.00
OTHER EARNED INCOME		+ 10,000.00
GROSS INCOME		$ 60,000.00
ALLOWANCE DEDUCTION AND EXEMPTIONS		20,000.00
DEDUCTIONS NOT ALLOWABLE UNDER *CODE* SECTION 911(a)		1,000.00
		TAX
GROSS INCOME	$ 60,000.00	
ALL DEDUCTIONS	11,000.00	
NET TAXABLE INCOME	$ 49,000.00	16,560.00
TAX ON NON-EXCLUDED PORTION		$ 2,766.00
TOTAL TAX		$ 13,794.00

Under the old law the tax on the non-excluded portion would have been computed on a taxable income of $35,000 and would have been $9,920.

PLACE OF PAYMENT

The new law further provides in *Code* Section 911(c)(8) that no amounts will be excluded under *Code* Section 911 when the taxpayer received payment for services rendered in a foreign country and: (1) received the payment in a place outside of that where the services were performed; and (2) one of the purposes for receipt outside that country was to avoid any taxes it imposes on the payments. Congress explained the provision:

> The tax avoidance purpose does not have to be the only purpose for receiving the money outside of the country in which earned,

[9]"Net taxable income" is defined in I.R.C. §911(d)(2)(A) as the sum of the "net excluded earned income" and the taxable income in excess of the exclusion.

[10]"Net excluded earned income" is defined in I.R.C. §911(d)(2)(B) as the amount excluded (as determined under I.R.C. §911(c)) less the deductions disallowed under I.R.C. §911(a) attributable to the earned income excluded.

nor does it have to be the principal reason for receiving the money outside of that country. It is the Committee's intention that the fact that the country in which the income is earned does not tax amounts received outside of the country be viewed as a strong indication of a tax avoidance purpose.[11]

SUMMARY

The 1976 Tax Reform Act substantially reduced the United States tax benefits previously enjoyed by United States citizens working overseas. We have seen a reduction in the exclusion to $15,000. A denial of the foreign tax credit (or deduction) for foreign taxes paid attributable to the excluded income, and a change in the manner of computing tax on non-excluded income also subjects that income to higher tax rates. Moreover, the provision is now elective.

The retroactive effect of the amendments has been criticized. The proposed Tax Reduction and Simplification Act of 1977[12] contains a provision to change the effective date of the *Code* Section 911 amendments to taxable years beginning after December 31, 1976. The reason stated for the change is that many taxpayers were caught by surprise by the changes in 1976 which caused particular hardships for that year.[13]

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[11]S. Rep. No. 94-938, 94th Cong., 2d Sess. (1976).

[12]H.R. 3477, 95th Cong., 1st Sess. (1977).

[13]S. Rep. No. 95-66, 95th Cong. 1st Sess. 84 (1977).