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For U.S. citizens working abroad

AN ALTERNATE ROUTE TO TAX EQUITY

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Can you make a blanket longer by cutting a piece off one end and sewing it on the other?

Discriminatory treatment of U.S. citizens working abroad hurts the American economy far more than it hurts the citizens who are the immediate target. What might be an equitable and simple solution to the problems created for such citizens by the 1976 Tax Reform Act?

First, a brief history.

Prior to 1942, a U.S. citizen who was a nonresident for more than six months of the taxable year did not have to pay any U.S. income tax on his "earned income" from outside the U.S. This was like what other countries did and still do.

From 1942 until 1963, the U.S. required a U.S. citizen to be a bona fide foreign resident in order to exclude income earned abroad when calculating his U.S. tax. In 1951, the law was eased to provide that the citizen who was out of the U.S. for 17 out of 18 months could also get an exclusion, but in 1953 a $20,000 per year limit was put on that exclusion.

The big exception to these Section 911 rules was income received from the U.S. government itself, or any of its agencies or instrumentalities. That income was fully subject to U.S. tax. But the *government worker* had something that partially compensated for this tax disadvantage—he received a tax-free cost-of-living allowance. Tax exemption of that allowance was conferred by Section 912 of the U.S. Federal Internal Revenue Code.

After 1962, the rules changed. A limit was put on the amount of foreign income that a bona fide foreign resident could exclude from the U.S. tax. That limit was $20,000 per year for the first three years of bona fide foreign residence, and then $35,000 per year (the $35,000 was dropped to $25,000 in 1964). However, the $20,000 per year exclusion if the taxpayer qualified under the 17-out-of-18 months rule remained.

Before 1962, of course, the bona fide foreign resident paid no U.S. income tax on allowances and other fringe benefits. After 1962, to the extent that his income, including fringes, exceeded the dollar limits, it was subject to tax. The exclusion of the government employee's cost-of-living allowance was not disturbed, however.

Thus, prior to the 1976 Tax Reform Act, the pattern had been one of a gradually narrowing area of tax exemption for employees of the private sector. Government employees abroad, on the other hand, had seen cost-of-living allowances rising with inflation, so that the area of their tax exemption, small though it was, was broadening rather than contracting.

The 1976 Tax Reform Act

The 76 TRA cut the excludible amount to $15,000 (except for employees of nonprofit organizations), and changed the meaning of the $15,000. The old exclusions had come off the top of the individual's income, thus saving tax at his highest brackets. Now, the $15,000 comes off the bottom (i.e., the tax is calculated on the total income, including the $15,000, and then the tax on $15,000 is deducted).

The law was also changed to provide that the foreign taxes attributable to the $15,000 cannot be claimed as a foreign tax credit. The value of the $15,000 exclusion was thus further reduced.

Example: Assume a single individual with $50,000 of foreign salary income. Ignore deductions and the personal exemption, since these are close to being constants and complicate the example. Assume the foreign country imposes a flat 18 percent tax.

	Pre-1976	**1976 TRA**
U.S. tax on $30,000 ($50,000-$20,000 exclusion)	*$9,390*	
U.S. tax on $50,000		*$19,290*
Less: U.S. tax on $15,000		*3,512*
U.S. tax on $35,000		*15,778*
Foreign tax credit	*9,000*	*6,300*
Net U.S. tax payable	*390*	*9,478*

Thus, what looks like a 25 percent reduction in an exclusion turns out to be better than a 25-fold increase in the size of the tax check someone has to write to the U.S. government. Recognizing the reduced utility of the exclusion—and also recognizing that taxpayers taking advantage of the exclusion may forfeit deductibility of some of their relocation expenses—the new law allows a taxpayer to elect not to take the $15,000 exclusion. Once foregone, however, the exclusion can only be used in a future year after obtaining IRS permission.

In addition, while the bill was not enacted into law until September, 1976, the provisions relating to the foreign income exclusion were made effective for the entire year 1976. (The patent inequity of making such a change retroactive led this year to legislation making the change effective for 1977 and later years.)

However, the government worker's tax-free cost-of-living allowance was not touched.

Who Pays the Bill?

Almost all U.S. companies employing U.S. citizens abroad have some policy whereby the employer shares or absorbs the extra tax paid as a result of the foreign assignment. Under most of these policies, the employee is expected to absorb the estimated U.S. tax that he would pay on his base salary—the manner of computing this estimated tax varying from company to company. The employer then reimburses him for the excess of his actual taxes over this hypothetical figure.

Since the 1976 TRA contained no corresponding increase in the taxation of U.S. taxpayers generally, application of any of these "tax equalization" policies will result in no increase in what the employee's tax would have been "if—," but will result in an increase in the tax actually due. Ergo, it will result in an increase in the amount the employer will pay to the employee. This payment is itself taxable to the employee. Thus, an algebraic formula must be used to compute the tax on the tax, so as to fully "gross-up" the tax reimbursement. (Before calculating this gross-up, the cost is estimated to range from $3,000 to $6,000 per overseas employee. When tax reimbursement, the "gross-up," is reflected, total cost per employee probably doubles.)

What kind of corporate decisions will be influenced by such cost factors? One decision is whether to use someone from Canada, France, or almost anywhere else in lieu of a U.S. citizen. For it will be that much cheaper to use that someone else, all other things being equal.

The 76 TRA change did not create this discriminatory bias, incidentally, for it was grafted onto the international business scene in 1962. But the 76 TRA exacerbates it. If Congress is communicating a message to the multinational, that message is to discriminate against U.S. citizens.

Who pays the bill? The employer writes the check to the employee to reimburse him for the increased tax. Either that cost increase is passed on to customers in the form of higher produce or service prices, or corporate profits drop. If corporate profits drop, then one result is that less income tax is due to the foreign country and the U.S. A second result is that less money is available for internal investment or for distribution to stockholders. Corporations are only conduits, even multinationals—they cannot consume even a toasted cheese sandwich. And the employee, who *can* consume a toasted cheese sandwich, is not the one who normally pays the bill.

More significant, however, is the fact that if employment opportunities abroad are curtailed for U.S. citizens, then some of those employees will re-enter the U.S. labor market. Thus, the long-run effect on increasing the tax burden on U.S. citizens working abroad may well be to swell the labor market in the U.S., thus contributing to the unemployment that, with inflation, is one of our key national problems. The unemployed person may not be the

U.S. citizen no longer employed abroad, but rather the person he displaces. So, indeed, who pays?

A Recommendation

With tax rates now high in many foreign countries, the foreign tax exclusion is not as significant a factor as it was one, two, or three decades ago, when foreign taxes were lower. What is needed in the U.S. tax law today, therefore, is a realistic appreciation of the cost differences faced by the U.S. citizen abroad as compared to the U.S. citizen living and working in the States.

The differences cover housing problems, enormous moving expenses, costs of educating children adequately, trips back to the U.S. to maintain family ties, and cost-of-living differentials. Obviously, there are differences within the continental U.S. as to many of these items as well, but the magnitude of the difference between, for instance, housing costs in Iran and housing costs anywhere in the U.S. far eclipses any difference in housing costs between one part of the U.S. and another.

The tax law can be simplified, made more equitable, and its administration eased by treating all U.S. citizens working outside the United States in the same manner. As a first step, therefore, the separate rules now applicable to government employees and to all other U.S. citizens employed abroad should be eliminated.

Under this recommendation, the Section 911 exclusion would be dropped and Section 912 expanded. For U.S. citizens employed abroad for more than six months:

1. Housing allowances to the extent used would be taxable only to the extent of the rental value of comparable housing in an average U.S. city. At one point, Congress considered a comparison to housing costs in Washington, D.C.

2. Services or reimbursements provided by the employer, for what would commonly be provided by the government in the U.S., such as English language schooling, would be excluded from income.

3. Moving expense limitations applicable in the U.S. would be liberalized when the change of employment was from the U.S. to a foreign country, from one country to another, or from a foreign country to the U.S.

4. Reimbursement of travel costs would not be taxable when the travel was clearly not for personal enjoyment (e.g., return to the U.S. to attend the funeral of a parent). In addition, home leave geared to allowing the family to keep their U.S. ties and traditions would not be taxable.

5. The "away from home" tax-free travel expense reimbursement rules would be expanded to cover situations where—because of local living conditions or the indefinite nature of the assignment—the employee does not relocate his family to the foreign post and thus duplicates his living expenses.

How would these recommendations impact the taxpayer illustrated earlier in the article? He was single, earning $50,000 (including allowances) in a country imposing a flat 18 percent income tax. Assume now that his $50,000 included $6,000 for the excess cost of foreign housing and $1,500 for annual leave transportation to maintain U.S. ties.

	76 TRA	As Proposed
U.S. tax on $35,000 ($50,000-$15,000 per table 1)	*$15,778*	
U.S. tax on $42,500 ($50,000-$7,500)		*$15,540*
Foreign tax credit	*6,300*	*9,000*
Net U.S. tax payable	*9,478*	*6,540*

A family man, receiving allowances for English language schooling and increased allowances in other categories, would fare even better. However, the rationale of this proposal is not that it saves money for a specific taxpayer. Rather, it is that it treats all U.S. citizens abroad under a single set of rules which attempts to balance equitably the burdens of taxation and the costs of residing abroad.

Some of our thoughts parallel some of the thoughts of the House Ways and Means Committee Task Force on Foreign Source Income (Rep. Dan Rostenkowski [D-Illinois], Chairman). Our major difference with the task force is with its willingness to perpetuate a two-class system, treating non-military government employees differently from the employees of all other organizations. Clearly, the time has come to simplify and rationalize the taxation of U.S. citizens working abroad, and it would seem that a reasonable approach is to allow a tax exclusion for the reimbursement of those types of items which are in excess of what most employees would incur if working in the U.S.

Enactment of such legislation as part of a Carter tax reform package would be a tangible gesture toward recognizing that the future growth and prosperity of the U.S.—as well as its influence in world economic affairs—require, as a minimum, a policy that does not discourage U.S. citizens or organizations from operating outside the country. In the world we envision in the years and decades ahead, the interests of both the U.S. and of almost all other countries will be best served by American policies that encourage involvement abroad by U.S. citizens and businesses.