[COMMITTEE PRINT]

DESCRIPTION OF PROPOSALS RELATING TO THE TAXATION OF AMERICANS WORKING OVERSEAS LISTED FOR A HEARING BY THE COMMITTEE ON WAYS AND MEANS ON FEBRUARY 23 AND 24, 1978

PREPARED FOR THE USE OF THE

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BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet has been prepared by the staff of the Joint Committee on Taxation for the use of the Ways and Means Committee in its public hearing on the tax treatment of income earned by Americans working abroad. The hearings are scheduled for February 23 and 24, 1978.

The pamphlet includes a discussion of present law and background information, and the various proposals, regarding (1) the tax treatment of income earned abroad in private employment (sec. 911 of the Code), and (2) the tax treatment of allowances paid to U.S. Government employees serving outside the continental United States (sec. 912).

I. TAXATION OF INCOME EARNED ABROAD BY U.S. CITIZENS IN PRIVATE EMPLOYMENT (SEC. 911)

A. Present Law and Background

Law prior to the Tax Reform Act of 1976

U.S. citizens are generally taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1977, U.S. citizens (other than employees of the U.S. Government) who were working abroad could exclude up to $20,000 of income earned during a period in which they were present in a foreign country for 17 out of 18 months or during a period in which they were bona fide residents of a foreign country (sec. 911). In the case of individuals who had been bona fide residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. Further income tax savings could be obtained where foreign taxes were paid on the excluded income because those taxes could be credited against the U.S. tax on any foreign income above the $20,000 (or $25,000) limits.

Under prior law individuals claiming the standard deduction were not entitled to claim the foreign tax credit.

Under certain circumstances, an employee (whether working in the United States or overseas) is entitled to exclude from gross income the value of lodging furnished in kind by his employer (sec. 119). The value of employer-provided lodging is excludable from the employee's gross income if three tests are met: (1) the lodging is furnished on the business premises of the employer, (2) the lodging is furnished for the convenience of the employer, and (3) the employee is required to accept the lodging as a condition of his employment. For employees working abroad, this exclusion for employer-provided housing under section 119 is available in addition to the earned income exclusion allowed under section 911.

There were 140,000 individuals who claimed the earned income exclusion in 1975. The largest concentration of individuals using the earned income exclusion in 1975 resided in Canada, the United Kingdom, West Germany, Iran, Australia, Japan, Saudi Arabia, Brazil, France, and Switzerland. The revenue loss attributable to the excluded income (under law in effect prior to the Tax Reform Act of 1976) has been estimated at $498 million for calendar year 1977.

Tax Reform Act of 1976

House bill.—The Tax Reform Act of 1976, as reported by the Ways and Means Committee and as passed by the House, would have generally phased out the earned income exclusion over a 4-year period beginning in 1976. The House bill provided an exception for overseas employees of U.S. charities; for them the exclusion would have been permanently retained at $20,000. The House-passed bill also provided that during the phaseout period engineering or construction workers

employed on a project to build or construct a permanent facility outside the United States for unrelated parties were to be entitled to the full $20,000 or $25,000 exclusion. Individuals entitled to an exclusion under the House bill, either during the phaseout period or permanently would not have been allowed a foreign tax credit with respect to foreign taxes paid on amounts that were excludable from gross income.

The House bill provided a new deduction of up to $1,200 for elementary or secondary school tuition paid for a dependent who was a full-time student during the period the taxpayer was employed abroad. An exclusion from gross income was also provided by the bill for amounts which would otherwise be includible in gross income as compensation and which are provided in the form of municipal-type services furnished to employees by an employer in a foreign country. Finally, the House bill provided that individuals would be allowed to claim the foreign tax credit even though they claim the standard deduction.

Senate bill.—The Senate bill retained the $20,000 exclusion for all employees but made several changes in the manner of computing the exclusion which were designed to eliminate certain unintended results of prior law. These modifications in the manner of computing the exclusion were contained in the 1976 Act as finally enacted and are described below (*Conference report*).

The Senate bill also provided an exclusion for housing furnished in kind to the employee by the employer or reimbursed by the employer. The exclusion was limited to the amount by which the State Department allowance in that particular geographic locale exceeded the cost of comparable housing in Washington, D.C. The exclusion under section 911 was to be reduced on a dollar-for-dollar basis to the extent of any housing exclusion allowed.

Conference report.—As finally enacted, the Tax Reform Act of 1976 would generally reduce the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act would retain a $20,000 exclusion for employees of charitable organizations. In addition, the Act would make three modifications in the computation of the exclusion.

First, the Act provides that any individual entitled to the earned income exclusion is not to be allowed a foreign tax credit with respect to foreign taxes allocable to the excluded income.

Second, the Act provides that any additional income derived by individuals beyond the income eligible for the earned income exclusion is subject to U.S. tax at the higher rate brackets which would apply if no exclusion were allowed.

Third, the Act makes ineligible for the exclusion any income earned abroad which is received outside the country in which earned if one of the purposes of receiving such income outside of the country is to avoid tax in that country.

In addition to the changes made in the computation of the exclusion, the Act provides an election for an individual not to have the earned income exclusion apply. The election is binding for all subsequent years and may be revoked only with the consent of the Internal Revenue Service.

Finally, the Act provides that individuals taking the standard deduction are to be allowed the foreign tax credit.

Under the 1976 Act as originally enacted, the changes in the taxation of Americans working abroad would have become effective for taxable years beginning in 1976. The changes made by the 1976 Act would reduce the total revenue expenditure of the earned income exclusion to an estimated $180 million a year (from an estimated $498 million a year under pre-1976 Act law).

Tax Reduction and Simplification Act of 1977

The 1977 Act delayed for one year the effective date of the changes made by the 1976 Act in the taxation of individuals working abroad (i.e., the changes to the earned income exclusion and the change allowing the foreign tax credit to individuals claiming the standard deduction) so that the changes would not apply until 1977.

Tax Treatment Extension Act (H.R. 9251)

The Tax Treatment Extension Act passed the House on October 25, 1977, and is presently under consideration in the Senate.

House bill.—The House bill would delay the January 1, 1977, effective date of the 1976 Act (as amended by the 1977 Act) for an additional year (until January 1, 1978) to allow Congress more time for consideration of the various proposals which have been made to modify the substance of the earned income exclusion so that it more effectively takes into account the extraordinary costs of living which exist in certain parts of the world. However, the provision permitting individuals who claim the standard deduction to claim the foreign tax credit would become effective for taxpayers who are not entitled to the earned income exclusion.

Senate action.—The Senate Finance Committee considered H.R. 9251 on February 10, 1978, and ordered the bill reported with two amendments. First, the Finance Committee amendment would extend the pre-1976 Act law for two additional years (until 1979) rather than the one-year extension contained in the House bill. Second, under the Finance Committee bill, the 1976 Act provisions would not take effect in 1979 but instead would be replaced by deductions for the excess costs of living overseas. This new system of deductions for excess foreign living costs is described in more detail below under Proposals.

B. Proposals

Recommendations of the Task Force on Foreign Source Income

On January 5, 1976, following House action on the Tax Reform Act of 1976, Chairman Ullman appointed Mr. Rostenkowski and nine other members of the Ways and Means Committee to a special task force to study five areas involving the taxation of foreign source income. One area studied by the task force was the tax treatment of Americans working abroad. The task force met weekly from February 11, 1976, until June 30, 1976, and made tentative recommendations prior to the enactment of the 1976 Act. The task force report, containing its final recommendations, was issued on March 8, 1977.

While the task force felt that the 1976 Act changes dealt substantially with certain problems that arose under pre-1976 Act law, it nevertheless felt that a reexamination of the section 911 exclusion would be appropriate. In particular, the task force recommended:

(1) *Repeal of exclusion of income earned abroad in most situations.*—The $15,000 earned income exclusion would be phased out in most instances.

(2) *Education expenses and municipal-type services.*—In lieu of the general earned income exclusion, a deduction would be provided for certain educational expenses provided in kind or reimbursed by the employer, and an exclusion would be provided for the value of employer-supplied municipal-type services.

(3) *Employees of U.S. charities and engineering or construction workers.*—The exclusion provided in present law for overseas employees of U.S. charities would be retained. The exclusion would also be retained with respect to U.S. construction and engineering workers employed on a project to build or construct a permanent facility outside the United States for unrelated parties.

(4) *Excess living costs.*—In conjunction with an examination of the exclusion for overseas allowances provided employees of the U.S. Government, there should be an examination of the appropriateness of extending to private employees any exclusions from tax for excess living costs which are provided for government employees.

Senate Finance Committee Proposal (Senator Ribicoff)

H.R. 9251 (the Tax Treatment Extension Act) was amended by the Senate Finance Committee to include a set of proposals by Senator Ribicoff (generally, as included in his bill S. 2115) which would substantially revise the treatment of income earned abroad. The amendment would substitute for the flat exclusion provided in present law a system of deductions which is designed to take into account the costs of working overseas which exceed those generally incurred by individuals working in the United States. These deductions would be available beginning in 1979; pre-1976 Act law would apply for 1977 and 1978.

The special itemized deductions for excess foreign living costs would be provided in three areas: cost of living, housing, and education. The deductions would be adjustments to gross income and thus would be allowed in addition to the standard deduction. The deductions would generally be allowed only to the extent that the employer pays directly or provides reimbursement for the employee's excess cost-of-living, housing, and education expenses. In addition, employees would be required to file with their returns an employer certification attesting to the fact that the reimbursements are in addition to normal compensation.

Cost of living.—The cost-of-living deduction would be limited to amounts set forth in tables prepared by the IRS showing the excess of the cost of living (excluding housing and education) in the particular foreign place over the average cost of living in the U.S. for families of various sizes with an income of $22,000, which will be adjusted for inflation.

Housing.—The excess housing costs deduction would be limited to the excess of the amount expended on housing in the foreign place over an amount representing the housing cost the individual typically would have incurred if he were working in the U.S. For this purpose, typical U.S. housing costs are considered to be an amount equal to

one-sixth of the individual's base salary (earned income less excess housing, cost of living, and educational costs).

Educational expenses.—The deduction for reimbursed educational expenses would cover the cost of tuition, fees, books, and local transportation for elementary and secondary education of dependent children at local American-type schools. Reimbursed expenses for room and board would be allowed in situations where no local American-type schools are available.

Charitable employees and employees furnished lodging.—The principal exception to these rules involves employees of charitable organizations, employees who reside in camps because of their employment, and employees who would qualify under section 119 for exclusion of employer-supplied housing (the special deductions are available only if an election is made not to claim the sec. 119 exclusion). These employees are required to deduct, in lieu of their actual reimbursed excess foreign living costs, an amount equal to the average deductions claimed for cost of living, housing, and education by all other taxpayers in that foreign place for the previous year (the educational deduction is limited to the amount actually expended). Appropriate average deduction tables would be issued by the IRS.

Self-employed and employees of foreign corporations (other than CFCs).—Special rules are also provided for self-employed individuals and employees of foreign businesses (other than U.S. controlled foreign businesses). Because employer reimbursements are either not possible or not meaningful in these situations, the deductions are not limited to employer reimbursements but rather to the average amount deducted by employees of U.S. companies for the foreign place for the previous year.

Other proposals

There have been bills introduced by members of the Ways and Means Committee which would repeal the changes made by the 1976 Act and reinstate the $20,000 (or $25,000) exclusion of pre-1976 Act law. There have also been bills introduced by members of the committee which would repeal entirely the earned income exclusion.

II. TAXATION OF ALLOWANCES PAID TO U.S. GOVERNMENT EMPLOYEES SERVING OUTSIDE THE CONTINENTAL UNITED STATES (SEC. 912)

A. Present law and background

Section 912 excludes from gross income certain statutory allowances paid to civilian employees of the United States Government who work in foreign countries and, in certain instances, in Hawaii and Alaska and in the territories and possessions of the United States.

In October 1975, the House Ways and Means Committee tentatively decided to provide for the phaseout of section 912 as part of the legislation ultimately enacted as the Tax Reform Act of 1976. Before reporting the legislation out of committee, however, it was decided not to take action at that time so that an interagency committee composed of representatives of the various departments of the Executive branch could complete a study which they were then preparing. The interagency study was released in June 1977.

The major categories of allowances are described in the following paragraphs. As indicated, some of these allowances would, in the absence of section 912, be excluded from income, in whole or in part, under other provisions of the tax laws. Others are amounts for which the employee may be entitled to a deduction in computing taxable income.

(a) *Cost-of-living allowances (post allowance).*—Using Washington, D.C. as a reference, cost-of-living allowances are provided to all U.S. Government civilians employed abroad. Moreover, permanently assigned U.S. Government civilians employed in Alaska, Hawaii, Puerto Rico, the Virgin Islands, and Guam are entitled to a cost-of-living allowance based on living costs and conditions, also using Washington, D.C. as a reference; this allowance is not to exceed 25 percent of the rate of basic pay involved. These allowances would be taxable if section 912 were repealed.

(b) *Housing allowances.*—In many cases, the Government provides housing to the employee and his family at no cost. In other instances, living quarters allowances are made to reimburse the employee for the rent (including utilities), paid by the employee. In certain cases, employees may also be provided with basic household furnishings and equipment for use on a loan basis in personally owned or leased residences. If section 912 were repealed, the fair rental value of the lodging and furniture provided, or the amount of the living quarters allowance, would be taxable income to the employee.

The housing allowance not only compensates for excess housing costs overseas, but reimburses the employee for the entire cost of housing overseas. Thus, this allowance includes an element of incremental compensation at least to the extent it reimburses the employee for typical U.S. housing costs. In addition, double allowances are in effect provided for the additional cost of housing overseas because, despite

the fact that housing costs are fully reimbursed, the cost-of-living allowance is paid with respect to the employee's total spendable income (compensation less taxes and savings) without any reduction for typical U.S. housing costs.

(c) *Educational allowance.*—This allowance is intended to reimburse the employee for the additional tuition and education-related travel expenses of living abroad. This allowance would be includible in taxable income if section 912 were repealed.

(d) *Home leave and rest and recuperation travel allowances.*—The travel allowances are provided as reimbursement for the roundtrip travel costs of employees and dependents to the United States for home leave or to a designated favorable location for rest and recuperation.

(e) *Post differential allowance.*—This allowance is intended to offset the hardship of serving in particularly dangerous or potentially unhealthy areas of the world. This allowance is not subject to the exclusion of section 912, and therefore it is presently subject to taxation.

(f) *Other allowances.*—Other tax-exempt allowances and benefits paid or provided to U.S. Government employees working overseas include medical benefits, official residence expenses, representation allowances, relocation allowances and benefits, separate maintenance and family visitation allowances, evacuation travel, emergency visitation travel, preparation and transportation of remains, and special commissaries, eating, and recreation facilities.

It is estimated that 100,000 U.S. citizen employees of the Government benefit under section 912. This total includes approximately 40,000 people employed in foreign countries (not including Peace Corps volunteers), an estimated 20,000 in territories and possessions, and 40,000 in Alaska and Hawaii. The benefits and allowances, other than salary, provided to civilian employees of the Government in 1975 amounted to roughly $343 million, of which $256 million was for employees in foreign countries, $47 million for employees in possessions, and $40 million for employees in Alaska and Hawaii. The revenue cost of the exclusion provided in section 912 for 1975 was estimated at $100 million, of which $77 million was for employees overseas, $12 million for employees in U.S. territories, and $11 million for employees in Alaska and Hawaii.

B. Proposals

Ways and Means Task Force Recommendations

The Ways and Means Task Force on Foreign Source Income recommended that the present system of a blanket exclusion for the statutory allowances and benefits provided to civilian employees of the United States Government serving overseas be replaced with a system which treats private and public overseas employees in the same circumstances more nearly the same. Such a system would provide for the taxation of that part of the overseas allowance which constitutes an economic benefit to the employee but would allow an exclusion or a deduction for that part of the allowance which represents a business cost or which reflects the peculiar nature of being an overseas employee of the United States Government. More specifically, this would provide for the following modifications:

(1) *Repeal of special exclusion for allowances.*—The exclusion from gross income under section 912 of certain statutory allowances and ben-

efits provided to civilian employees of the Government who work in foreign countries, Alaska and Hawaii, and the territories and possessions of the United States, would be phased out over a 4-year period. The task force also agreed that if its recommendation is adopted by the committee, the committee should communicate that decision to the appropriate committees of the Congress so that they could review the compensation levels of the employees stationed abroad of the departments under their jurisdiction.

(2) *Modification and clarification of the tax treatment of certain expenses and allowances.*—The Internal Revenue Code provisions which would otherwise govern the tax treatment of the allowances and expenses of civilian employees of the Government would be modified and clarified in certain respects as described below:

(a) In recognition of the extraordinary costs involved when travel from the foreign post is required for reasons other than personal enjoyment, deductions would be allowed (where the costs are reimbursed or provided in kind) for costs incurred to visit immediate family members in the case of serious illness, injury, or death, or to prepare and transport, or to accompany, the remains of employees and family members who may die abroad, or for other similar expenses.

(b) In situations where adverse conditions at the employee's post compel the family to live elsewhere, a deduction would be allowed (where the expenses are reimbursed or provided in kind) for the employee's additional costs involved in maintaining his abode separate from that of the family.

(c) In recognition of the fact that the employee normally intends to remain overseas only for the duration of his assignment, moving expense deductions (to the extent the costs are reimbursed or provided in kind) would be allowed for costs incurred by a retiring Government employee in moving from an overseas duty station to a permanent home in the United States.

(d) Since international moving often requires that temporary living accommodations be obtained for a longer time than ordinarily required in domestic moving, the limitation on deductible temporary living expenses and other indirect moving costs would be expanded to cover those incurred in the 30-day period preceding and the 60-day period following the move (instead of only 30 days after the move). Also, the dollar limits on such expenses ($1,500 for premoving and house-hunting expenses and $3,000 for overall indirect moving expenses) would be increased to 1½ times the domestic allowances.

(e) Overseas Government employees would be allowed a deduction of up to $2,000 per year per child for reimbursed private school tuition costs. In addition, municipal-type services, including schools, provided by the Government in kind to its overseas civilian employees would be excluded from income.

(f) A deduction would be allowed with respect to that portion of the overseas housing costs (to the extent reimbursed or provided in kind) which exceeds a base amount the employee might be expected to incur if stationed in Washington, D.C.

(3) *Comparable treatment for private employees.*—The application of the provisions under which individuals receive deductions or exclusions would be reviewed to provide assurance that overseas employees—public and private—are provided more comparable treatment.

Inter-Agency Committee of the Executive Branch

In response to OMB and GAO reports recommending changes to the overseas allowances and benefits system for civilian employees of the Government working overseas, the Secretary of State formed an Inter-Agency Allowances and Benefits Committee in 1975 to review the allowances and benefits system. The committee's final report was issued in June 1977.

The committee recommended against the repeal of the section 912 exclusion for overseas allowances and benefits. If the exclusion is repealed, however, the committee recommended three possible alternatives:

Alternative 1.—Legislate new Internal Revenue Code provisions which would permit "income" earned from overseas allowances and benefits to be offset by the expenses required by service abroad. Such legislation would specify those benefits which Congress considers to include elements of "income" in excess of expenses, and guidelines would be provided for their taxation. The Congress should also specify those allowances and benefits which are fully offset by expenses and, therefore, are tax free.

Alternative 2.—Adopt and implement a system of "tax equalization" which would compensate employees for their added tax liability on their allowances and benefits. Under this method, which is the most frequently used in the private sector, the Government would pay its overseas employees the difference between their tax liability and the hypothetically computed tax liability of domestically assigned employees. The new tax equalization provisions could be implemented by augmenting the existing system of allowances to provide for a tax equalization allowance.

Alternative 3.—Provide the necessary relief by increasing the overseas allowances and benefits to levels high enough to offset the added tax liability incident to the employee's service abroad. In some cases this relief might be accomplished administratively by revising existing regulations. But it would still require a willingness by the Congress to augment the appropriations of the Federal agencies having employees serving abroad.

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