[JOINT COMMITTEE PRINT]

DESCRIPTION OF BILLS (S. 408, S. 436, S. 598, AND S. 867)

RELATING TO

TAX TREATMENT OF FOREIGN EARNED INCOME

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON APRIL 24, 1981

PREPARED FOR THE USE OF THE

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INTRODUCTION

This pamphlet provides a description of four Senate bills (S. 408, S. 436, S. 598, and S. 867) which are scheduled for a public hearing on April 24, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management. The bills relate to the tax treatment of foreign earned income of individuals.

The first part of the pamphlet is a summary. This is followed by a description of the bills, including a discussion of present law, issues involved, an explanation of the provisions of the bills, effective dates, and estimated revenue effects.

I. SUMMARY

Under the Foreign Earned Income Act of 1978, Americans working abroad generally are eligible for deductions intended to reflect the excess costs of living abroad. Employees in camps in hardship areas may in the alternative elect to exclude $20,000 from income. Prior to the 1978 Act, Americans working abroad generally could exclude $20,000 (or, in some cases, $25,000) from foreign earned income.

Under S. 408 (Senators Chafee, Mathias, Roth, Matsunaga, Cochran, Lugar, Boschwitz, Schmitt, Grassley, Boren, Simpson, and Tsongas), present law would be replaced with an annual exclusion of the first $50,000 of foreign earned income plus 50 percent of the next $50,000 of foreign earned income (total of $75,000 exclusion on the first $100,000 of foreign earned income) and a deduction for excess foreign housing costs. S. 436 (Senator Bentsen) would replace present law with an exclusion in 1981 of $75,000 of foreign earned income (the exclusion would increase to $80,000 in 1982, $85,000 in 1983, $90,000 in 1984, and $95,000 in 1985 and years thereafter) and a deduction for excess foreign housing costs. S. 598 (Senator Jepsen) would exclude foreign earned income entirely. S. 867 (Senator Moynihan) would replace present law with an optional exclusion of 80% of all foreign source income (i.e., both earned and investment income).

II. DESCRIPTION OF THE BILLS

A. Present Law and Background

Law prior to the Foreign Earned Income Act of 1978

United States citizens and residents 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 1978, U.S. citizens working abroad could exclude up to $20,000 of earned income a year if they were present in a foreign country for 17 out of 18 months or they were *bona fide* residents of a foreign country for a period which included an entire taxable year (Code sec. 911).[1] 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. In addition, under the law prior to 1978, foreign taxes paid on the excluded income were creditable against the U.S. tax on any foreign income above the $20,000 (or $25,000) limit.

The Tax Reform Act of 1976 would generally have reduced the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act would have retained a $20,000 exclusion for employees of domestic charitable organizations. In addition, the Act would have made certain modifications in the computation of the exclusion.

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. However, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under the Tax Reform Act of 1976.

Foreign Earned Income Act of 1978

The Foreign Earned Income Act of 1978 generally replaces the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. The basic eligibility requirements for the deduction are generally the same as for the prior earned income exclusion.

The new excess living cost deduction (new Code sec. 913) consists of separate elements for the general cost of living, housing, education, and home leave costs. The cost-of-living element of the deduction

[1] This eligibility requirement was modified by Public Law 96–608 so that the minimum time periods could be waived for Americans working abroad who could reasonably have been expected to meet the eligibility requirements, but who left the foreign country under conditions of war, civil unrest, or similar conditions which precluded the normal conduct of business.

is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a Federal employee at grade level GS–14, step 1, regardless of the taxpayer's actual income. The housing element is the excess of the taxpayer's reasonable housing expenses over his base housing amount (generally one-sixth of his net earned income). The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable cost of coach airfare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

In addition, taxpayers living and working in certain hardship areas are allowed a special $5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. For this purpose, hardship areas are generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees is 15 percent or more of their base pay.

As an exception to these new rules, the Act permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion (under Code sec. 911) in lieu of the new excess living cost and hardship area deductions. No foreign tax credit would be allowed for foreign taxes attributable to the excluded amount. For taxpayers electing the exclusion, the camp would be treated as the employer's business premises so that the exclusion for employer-provided meals and lodging can also be claimed (provided the other requirements of Code sec. 119 are satisfied).

The 1978 Act liberalized the deduction for moving expenses for foreign job-related moves, increasing the dollar limitations applicable to temporary living expenses. The Act also extended up to four years while the taxpayer is working abroad the 18- or 24-month period for reinvestment of proceeds realized on the sale of a principal residence.

Exclusion for Charitable Employees

In P.L. 96–595 Congress allowed a $20,000 annual exclusion to employees of charitable organizations who perform charitable services in less developed countries. The charitable organization must be an organization that meets the requirements of Code section 501(c)(3) and which is not a private foundation (within the meaning of Code section 509(a)).

1980 Senate Finance Committee bill

The Tax Reduction Act of 1980, reported by the Senate Finance Committee on September 15, 1980 [2] (but not considered by the full Senate), would have granted a $50,000 exclusion (increased to $65,000 after two years of *bona fide* residence in a foreign country) to U.S. citizens or residents who were present in a foreign country for at least 330

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[2] Secs. 121–122 of the Finance Committee amendment to H.R. 5829 (S. Rept. 96–94).

days out of any 12-month period. Only income from services performed in a developing country or services performed in charitable, extractive, or export-related activities would have been eligible for the exclusion. The exclusion was elective and was in lieu of the present system of the excess living costs deduction.

Under the bill, qualified individuals would have also been allowed to exclude an amount of foreign earned income equal to the excess of their foreign housing costs over a base housing cost (approximately $5,555 in 1980). As under present law, no deduction or credit would have been allowed for taxes or other amounts attributable to the excluded income.

GAO Report

On February 27, 1981, the General Accounting Office released a report [3] on Americans working abroad. The report concluded that U.S. taxes were an important factor in reducing the number of Americans employed overseas because (a) the employees were subject to U.S. tax on the reimbursement of their excess costs of living overseas, (b) these taxes were reimbursed by the employers, thus increasing the cost of the U.S. employee, and (c) the complexity of the new law made compliance difficult and expensive.

The report stated that the United States is the only major industrial country which taxes foreign-source income on a citizenship basis. It concluded that Congress should consider placing Americans working abroad on an income tax basis comparable with that of citizens of competitor countries who generally are not taxed on their foreign earned income.

B. Issues

The issue is whether U.S. tax laws have caused a decline in the number of Americans working abroad, which in turn has caused a decline in U.S. exports and in U.S. employment generated by these exports. If so, should the U.S. tax laws be modified to afford more generous relief to Americans working abroad? Should this relief apply only to foreign earned income or to all foreign income? Should any relief that is given be targeted to those Americans working abroad that are in a position to have a positive affect on U.S. exports?

A related issue, if only part of the individual's foreign earned income is to be excluded, is the extent to which the relief should be limited to the specific circumstances of the taxpayer or should be in the form of a flat dollar or formula amount.

[3] Report to the Congress by the Comptroller General of the United States, "American Employment Abroad Discouraged by U.S. Income Tax Laws" (U.S. General Accounting Office, I.D.–81–29; Feb. 27, 1981).

C. Explanation of Provisions

1. S. 408 (Sens. Chafee, Mathias, Roth, Matsunaga, Cochran, Lugar, Boschwitz, Schmitt, Grassley, Boren, Simpson, and Tsongas): Partial exclusion for foreign earned income of individuals

Explanation of the bill

The bill would modify the eligibility standards of present law and would replace the present system of deductions for excess living costs with an exclusion, subject to a cap, of foreign earned income. The *bnoa fide* residence test would remain in its present form. However, an individual would also be eligible for the special provisions if he were present in a foreign country or countries for 330 days in any period of 12 consecutive months (rather than 510 days in any period of 18 consecutive months as under present law). Individuals meeting these requirements generally could elect to exclude foreign earned income attributable to the period of foreign residence or presence at an annual rate of $50,000 plus 50 percent of the next $50,000 (total of $75,000 on the first $100,000 of foreign earned income).

In addition to the exclusion described above, an individual would be allowed to elect to exclude a portion of his housing expenses. The exclusion is equal to the excess of the taxpayer's "housing expenses" over a base housing amount. The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year by or on behalf of the individual for housing for the individual (and, if they reside with him, for his spouse and dependents) in a foreign country. The term includes expenses attributable to the housing, such as utilities and insurance, but does not include interest and taxes, which are separately deductible. If the taxpayer maintains a second household outside the United States for his spouse and dependents who do not reside with him because of adverse living conditions, then the housing expenses of the second household are also eligible for the exclusion. Housing expenses are not treated as reasonable to the extent they are lavish or extravagant under the circumstances.

The base housing amount is 16 percent of the salary of an employee of the United States whose salary grade is step 1 of grade GS-14. Currently, this salary is $34,713, so the current base housing amount would be $5,554.

As under present law, amounts paid by the United States or its agencies could not be excluded. The rules now in effect relating to the computation of the exclusion and the disallowance of a credit or deduction for foreign taxes or expenses allocable to the excluded income would be retained.

The present deduction for excess foreign living costs (Code sec. 913) would be repealed. Thus, if a taxpayer chooses not to elect the above exclusions, he would be fully taxed on his foreign source income, subject, however, to a full foreign tax credit. The bill would also retain the rule of present law that a hardship area camp is treated as the business premises of the employer, permitting (if other conditions are met) the exclusion from income of the value of meals and lodging.

Effective date

The bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1981	1982	1983	1984	1985
Calendar	523	565	610	659	712
Fiscal	288	546	590	637	689

2. S. 436 (Mr. Bentsen): Partial exclusion for foreign earned income of individuals

Explanation of the bill

The bill would modify the eligibility standards of present law. The *bona fide* residence test would remain in its present form. However, an individual would also be eligible for the special provisions if he were present in a foreign country or countries for 330 days in any period of 12 consecutive months (rather than 510 days in any period of 18 consecutive months as under present law).

Individuals meeting the eligibility requirements could elect to exclude foreign earned income attributable to the period of residence or presence at an annual rate of $80,000 for 1982, $85,000 for 1983, $90,000 for 1984, and $95,000 for 1985 and years thereafter. As under present law, amounts paid by the United States or its agencies could not be excluded. The rules, now in effect relating to the computation of the exclusion, and disallowing a credit or reduction for foreign taxes or expenses allocable to the excluded income, would be retained.

In addition, individuals qualifying for the exclusion would be entitled to a deduction for qualified housing expenses. These are the excess of the individual's housing expenses over a base housing amount of $5,500. The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year by or on behalf of the individual for housing for the individual (and, if they reside with him, for his spouse and dependents) in a foreign country. The term includes expenses attributable to the housing (such as security, utilities, and insurance), but does not include interest and taxes, which are separately deductible. Housing expenses are not treated as reasonable to the extent they are lavish or extravagant under the circumstances.

The present deduction for excess foreign living costs (Code sec. 913) would be repealed. Thus, if a taxpayer chooses not to elect the exclusion, his foreign source income would incur full U.S. taxation subject, however, to a full foreign tax credit. However, the deduction for qualified housing expenses is allowed regardless of whether the taxpayer elects the exclusion or not. Also, the bill would retain the rule of present law that a hardship area camp is treated as the business premises of the employer, permitting (if other conditions are met) the exclusion from income of the value of meals and lodging.

Effective date

The bill would apply to taxable years beginning after December 31, 1981.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1982	1983	1984	1985	1986
Calendar	586	639	694	754	814
Fiscal	322	615	670	727	787

3. S. 598 (Senator Jepsen): Exemption for foreign earned income of individuals

Explanation of the bill

The bill would retain the eligibility standards of present law (the *bona fide* residence and presence tests). Individuals meeting these requirements could exclude the entire amount (except amounts paid by the United States or any of its agencies) of their foreign earned income attributable to services performed during the period of foreign residence or presence. Taxes or expenses allocable to the excluded amounts would not be allowed as a credit or deduction. The deduction for excess foreign living costs of present law (Code sec. 913) would be repealed.

Effective date

The bill would apply to taxable years beginning after December 31, 1981.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1982	1983	1984	1985	1986
Calendar	610	659	712	769	831
Fiscal	336	637	689	743	803

4. S. 867 (Senator Moynihan): Partial exclusion for foreign income of individuals

The bill provides that if a U.S. citizen is a *bona fide* resident of a foreign country (for any period of time, not just a taxable year) or is outside the United States for 330 days during any 12 consecutive month period, he could exclude 80 percent of all his foreign source income (both earned and investment income) during the period he met these qualification requirements. As under present law, amounts paid by the United States or any of its agencies would not be excluded and no deduction or credit would be allowed to the extent allocable to excluded income.

The bill would repeal the present system of deductions for excess foreign living costs (sec. 913). It also would allow the taxpayer to elect not to exclude his foreign source income. Thus, if a taxpayer chooses not to elect the 80-percent exclusion of his foreign source income, that income would incur full U.S. taxation subject, however, to a full foreign tax credit.

Effective date

The bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1981	1982	1983	1984	1985
Calendar	498	539	582	629	681
Fiscal	274	520	563	608	658

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