[COMMITTEE PRINT]

TAXATION OF AMERICANS WORKING ABROAD

(Sections 911 and 912 of the Code)

PREPARED FOR THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

MAY 15, 1978

U.S. GOVERNMENT PRINTING OFFICE
26-518 WASHINGTON: 1978 JCS-24-78

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I. INTRODUCTION

This pamphlet is prepared for the use of the Committee on Ways and Means in its consideration of proposals to modify the tax treatment of Americans working abroad. The pamphlet covers both the exclusion provided for income earned abroad by citizens in private employment (sec. 911) and also the exclusion provided for overseas allowances paid to Government employees (sec. 912).

The Tax Reform Act of 1976 made several changes in the section 911 exclusion for individuals working abroad in private employment. Under present law, those changes are to be effective on January 1, 1977. The 1976 Act changes substantially increase the tax burden on many of these taxpayers, and a number of proposals have been made to modify these provisions to lessen this impact and to deal with the problems of extraordinary housing and other costs which exist in certain parts of the world. Because of these concerns, the House on October 25, 1977, passed H.R. 9251 which delays the effective date of the 1976 Act provisions until 1978 to allow Congress sufficient time for consideration of these proposals for substantive changes. On May 11, 1978, the Senate passed H.R. 9251 with an amendment which would replace the exclusion with a new system of deductions for excess foreign living costs, to be effective in 1978.

Although proposals to revise the section 912 exclusion for overseas allowances of civilian employees of the U.S. Government were also considered by the Ways and Means Committee during its markup to the 1976 Act, it was decided that no action should be taken until an interagency committee of the Executive branch completed a study which it was then preparing. That study was completed and released in June, 1977. The Ways and Means Task Force on Foreign Source Income studied the section 912 exclusion and recommended that certain modifications be made to the treatment of these allowances.

On February 23 and 24, 1978, the Ways and Means Committee continued its inquiry into the taxation of Americans working abroad by holding two days of hearings on the exclusions provided in sections 911 and 912.

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

A. Present Law and Legislative History

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) limit.

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. (The exclusion for employer-provided housing was not modified by the Tax Reform Act of 1976.)

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. 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 phase-out 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 (under *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 generally reduces the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act retains a $20,000 exclusion for employees of charitable organizations. In addition, the Act makes 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 these 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 cost 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 (H.R. 9251) passed the House on October 25, 1977, and passed the Senate, with amendment, on May 11, 1978. A conference to resolve the differences between the House and Senate bills has not yet been scheduled.

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). 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 passed H.R. 9251 on May 11, 1978, with an amendment relating to the tax treatment of income earned abroad by U.S. citizens after 1977. Under the Senate bill, the 1976 Act provision would not take effect in 1978, 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 section D, Alternative Proposals.

B. Background

Beneficiaries of the Exclusion

The earned income exclusion clearly results in a U.S. income tax saving for individuals involved in those cases where the excluded income of the U.S. citizen is not taxed at all by any foreign country or is taxed at a lower foreign rate than that otherwise imposed by the United States. In those situations where the foreign income tax rate is higher than that of the United States, the changes made by the Tax Reform Act of 1976 (as explained above) eliminated any income tax benefit derived by the taxpayer.

There were 140,000 individuals who claimed the earned income exclusion in 1975, the most recent year for which statistics are available. The largest concentration of individuals using the earned income exclusion in that year resided in Canada, the United Kingdom, West Germany, Iran, Australia, Japan, Saudi Arabia, Brazil, France, and Switzerland.

Estimated Tax Effect of the Exclusion

The estimated revenue effect from the foreign earned income exclusion for calendar year 1977, under prior law and under the provisions of the 1976 Act, are set forth in Tables 1 and 2.[1] As Table 1 indicates,

[1] Based on U.S. Treasury Department, *Taxation of Americans Working Overseas: Revenue Aspects of Recent Legislative Changes and Proposals* (1978), and additional information supplied by the Office of Tax Analysis.

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the 1976 Act increased U.S. tax liabilities for taxpayers with adjusted gross incomes of $20,000 and under by relatively little, but increased liabilities more substantially in the upper income ranges. The special allowances received by taxpayers overseas from their employers are included in the reported income figures to the extent that these allowances are reported on individuals' returns.[2] Accordingly, some employees may be included in a higher income class than would have been the case had they remained in the U.S.

Table 2 shows that, although the 1976 Act would have significantly decreased the benefits of the exclusion for taxpayers working in Mideast and African OPEC countries, the effects would have been greater in Western Europe. Taken together, these areas account for more than half the total decrease in revenue effect for the section 911 exclusion which would have resulted under the 1976 Act.

TABLE 1.—REVENUE REDUCTION FROM THE SECTION 911 EXCLUSION BY INCOME CLASS [1]

[Revenue effect in millions]

	1975 Law	1976 Act	Difference
Income class:			
Under $10,000	17	17	0
$10,000 to $20,000	64	51	13
$20,000 to $30,000	93	42	51
$30,000 to $40,000	95	27	68
$40,000 to $50,000	76	18	58
Over $50,000	154	27	127
Total	498	180	318

[1] Estimates are based on 1975 data projected to 1977 levels. Income classes are defined as reported income plus exclusion based on 1975 tax practice. Tax liabilities based on 1977 rates.

Details may not add to totals because of rounding.

[2] See, *e.g.*, *James H. McDonald*, 66 T.C. 223 (1976) and *Philip H. Stephens*, T.C. Mem. 1976-13, which require such inclusion. Increased capability of the Internal Revenue Service to audit taxpayers abroad and increased taxpayer awareness of the includability of the value of such benefits have increased the amount of such allowances actually included in gross income.

TABLE 2.—REVENUE REDUCTION FROM THE SECTION 911 EXCLUSION BY REGION [2]

[Revenue effect in millions]

	1975 Law	1976 Act	Difference
Region:			
Canada	6	2	4
Latin America	70	23	47
Western Europe	171	54	117
Mideast and African OPEC	107	35	72
Japan	26	9	17
Oceania	20	12	8
Other Mideast and Africa	25	13	12
Other Asia	61	24	37
All other	11	6	5
Total	498	180	318

[2] See note to Table 1.

Details may not add to totals because of rounding.

GAO Report

In a recently released report, the General Accounting Office (GAO) estimated the macroeconomic effects of the 1976 Act on a "worst case" basis.[3] GAO estimated that the 1976 Act changes would result in the loss of 3,000 jobs annually in 1978, rising to 15,000 in 1982. However, GAO pointed out that the U.S. economy generates 30,000 jobs a week. GAO also estimated that the U.S. gross national product would be decreased annually by $160 million in 1978 and by $430 million in 1982. On the other hand, the GAO also found that the 1976 Act amendments would improve the U.S. balance of payments by more

[3] U.S. General Accounting Office, *Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas* (1978). GAO estimates are expressed in 1972 dollars. The GAO show the maximum theoretical negative effect of the changes. The study assumes that: (1) all Americans excluding foreign earned income sell U.S. exports; (2) all employees are taxed at the maximum marginal rate on earned income (50 percent); (3) all increases in taxes resulting from reduction in the exclusion are offset by increases in salary sufficient to offset completely the increased tax liability; and (4) the cost of the extra salary is entirely passed forward to customers in the form of a price increase.

than $300 million a year, on the assumption that reimbursements to employees for the increased taxes due to the 1976 Act changes are not subject to foreign tax (the assumption GAO considered more realistic). If the reimbursements were subject to foreign tax at a 50-percent rate, it was estimated that the 1976 Act changes would not have a substantial effect on the balance of payments. The GAO report cautioned, however, that these estimates do not take into account fluctuating currency exchange rates or changes in macroeconomic policy, which it states could reduce most or all of the effects described.

The GAO also conducted a survey of taxpayers working abroad and their employers. The survey responses indicated substantial concern that, if the 1976 Act were allowed to come into effect, the cost of employing Americans overseas would be increased and consequently U.S. companies would lose some foreign business, there would be a withdrawal of Americans from jobs abroad, there would be a decrease in U.S. exports, and some U.S. companies would close down their foreign operations. The survey indicated that the greatest impact of the 1976 Act changes would be experienced by companies which rely heavily on American employees (in particular, those in the building/construction and service industries operating in a country for a limited period of time on a contract/project basis) and those operating in high-cost/low-tax foreign countries.

CRS Report

The Congressional Research Service recently released a report [1] which analyzed five alternative policies for the taxation of foreign earned income against criteria of neutrality, equity, and achievement of economic goals. The five analyzed were pre-1976 Act law, the 1976 Act changes, the Senate bill (described under section D, Alternative Proposals), the Administration proposal (described under section C, below) and the elimination of special tax treatment for Americans working overseas.

The study defined a neutral tax regime as one which provided neither an incentive nor a discouragement to work abroad. The report assessed the equity of the proposals on the basis of whether similarly situated taxpayers would be treated the same and the effect of the proposals on the progressivity of the tax system. The report reached the following conclusions:

1. Both the 1976 Act and prior law are not neutral because the flat exclusions provided by them are unrelated to the additional costs of working abroad.

2. The various proposals for deduction of excess foreign living costs, such as the Senate bill and the Administration proposal, are not neutral. The study takes the position that neutrality requires:

(i) that compensation for excess foreign living costs be taxed at the effective tax rate which would apply to the taxpayer's income if the taxpayer received no reimbursements for excess foreign living costs,

(ii) that a general excess foreign cost-of-living adjustment be provided rather than separate adjustments for housing costs, education, and the like, and

[1] Congressional Research Service, U.S. Library of Congress, *U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis* (1978).

(iii) that the cost of living adjustment be based on actual salary and with respect to the highest living cost locale in the United States rather than the U.S. average.

3. In many situations, eliminating special treatment for taxpayers working abroad comes closest to neutrality. In some high-cost foreign countries, the 1976 Act provisions come closest to neutrality.

4. Deductions for foreign living costs in excess of the U.S. average would be unfair to taxpayers in the United States who also have above-average living costs because taxpayers in the United States are not allowed similar deductions where their local cost of living is higher than the U.S. average.

5. Special benefits for taxpayers working abroad would tend to reduce the progressivity of the income tax because those taxpayers, as a group, have disproportionately high incomes.

6. Although the study recognized that departures from principles of neutrality and equity might be justified by economic considerations, it concluded, based partly on the GAO report's findings, that special treatment of taxpayers working abroad did not result in significant economic advantages to the United States.

C. Administration Proposal

Summary of Proposal

The Administration proposal would replace the flat exclusion under present law with deductions for excess foreign housing and education costs. (There would be no general excess cost-of-living deduction.) A deduction would be allowed for the travel costs of one trip to the United States every two years. The full value of housing would be excluded for employees in camps. Special rules are provided for foreign moving expenses and for deferral, while abroad, of gain from selling a home.

Explanation of Proposal

1. Replacement of earned income exclusion with foreign living cost deduction

The Administration proposal would replace the earned income exclusion with a new system of deductions for certain expenses incurred for housing, education and home-leave travel. The deductions would be available if the taxpayer is out of the country for at least 11 months during the year (in contrast to 17 out of 18 months under present law). In addition, qualification for the deductions would be extended to resident aliens. The amounts deductible under the new section would, however, be limited to the amount of earned income from foreign sources.

The foreign living cost deductions under the Administration proposal would be as follows:

(*a*) *Housing:* A deduction would be allowed for the excess of the actual expense incurred for reasonable housing (including rent and utilities) over 20-percent of earned income reduced by actual housing costs and the allowable deductions for education and home-leave travel. This 20 percent figure is based on the premise that a typical American living overseas would spend approximately one-sixth ($16\frac{2}{3}$ percent) of his income on housing if he lived in the United States. The mathematical equivalent of $16\frac{2}{3}$ percent of the taxpayer's earned income minus his education and home-leave allowances and his *excess* housing costs is 20 percent of the taxpayer's earned income minus the allowable deductions for education and home-leave and minus the *total* cost of the employee's housing.

(*b*) *Education:* A deduction would be allowed for tuition, books and room and board up to $4,000 per year for each dependent child in kindergarten through grade 12, plus actual economy travel for two round trips per year between the school and the foreign place where the taxpayer is resident or present. The transportation deduction, but *not* the deduction for tuition, would also be available for transportation of students at colleges, technical schools, or other post-secondary schools.

(*c*) *Home-leave travel:* A deduction would be allowed for one economy round-trip fare every 2 years for each member of the taxpayer's family between a foreign post and the taxpayer's residence in the United States. If the taxpayer maintains no residence in the United States, the deduction would be allowed for transportation between the foreign post and the taxpayer's place of residence before he went abroad.

2. Reports to Treasury and Congress

The Treasury Department would be required to present to Congress every 2 years a detailed description of the revenue costs and economic effects of the new foreign living cost deductions.

3. Changes in exclusion for employer-furnished meals or lodging (sec. 119 of the Code)

The Administration proposal would broaden the conditions under which housing and meals furnished by the employer overseas can be excluded from income (under section 119). Housing and meals which are furnished in a camp or barracks or similar compound would be excludable from income if they are furnished in the general vicinity of the business premises of the employer or the place where the employee's services are rendered and are furnished because adequate alternative meals and lodging in that vicinity are not available.

4. Changes in deduction for moving expenses (sec. 217 of the Code)

The Administration proposal would also increase the period during which the cost of temporary living arrangements is deductible from (under sec. 217) 30 days to 60 days, and to raise the ceiling on those temporary living costs from $1,500 to $5,000 for international moves. No part of the moving expenses would be disallowed as attributable to excluded income.

5. Changes in nonrecognition of gain on sale or exchange of residence (sec. 1034 of the Code)

The Administration proposal would also suspend the running of the 18- or 24-month period for reinvestment of the proceeds realized on the sale of a principal residence to avoid recognition of gain (under sec. 1034). The suspension would apply only to persons working overseas who qualify for the new foreign living cost deductions, or the exclusion of certain allowances of government employees. The suspension would continue only while the taxpayer is overseas and would be for a maximum of 4 years.

D. Alternative 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 ten other members of the Ways and Means Committee to a special task force headed by Mr. Rostenkowski 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 deal substantially with certain problems that arose under pre-1976 Act law, it nevertheless felt that a reexamination of the foreign earned income 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.

Members' Proposals

Mr. Archer

Mr. Archer would amend the exclusions for foreign earned income and for the value of meals and lodging provided by the employer to provide either a general exclusion or itemized deductions from income for Americans working abroad.

Mr. Crane, Mr. Jones, and Mr. Holland

Summary of Proposals

Mr. Crane, Mr. Jones, and Mr. Holland introduced bills (H.R. 11057, 11065, and 11459, respectively) which would restore the flat exclusion to its level prior to the 1976 Act. In addition, deductions would be allowed for excess foreign cost-of-living, housing and education costs. A deduction would be allowed for travel costs of one trip to the United States every year and, if the taxpayer is at a hardship post, for rest and recreation travel paid by his employer. The full value of housing would be excluded for employees in camps. Special rules are provided for foreign moving expenses and for deferral of gain from selling a home.

Explanation of Proposals

1. *Restoration of exclusion.*—The earned income exclusion under section 911 would be retained and the dollar limitations would be restored to their levels prior to the enactment of the 1976 Act (i.e., $20,000 annually in general and $25,000 annually for persons who are *bona fide* foreign residents for 3 years or more). In addition, the dollar limitations would automatically be increased in the future to compensate for inflation.

2. *Foreign living cost deductions.*—In addition to the earned income exclusion, taxpayers whose principal place of work is outside the United States would receive the following deductions, whether or not they also qualify for the exclusion under section 911:

a. *Cost-of-living.*—An amount determined by multiplying the cost-of-living differential (as set forth in an IRS table) for the taxpayer's foreign country by his earned income.

b. *Housing.*—An amount equal to the excess of the reasonable cost of housing (including utilities, taxes, and insurance), over the base housing amount. The base housing amount would equal 16⅔ percent of the taxpayer's "base compensation" in any plan of deferred compensation in which he participates (or could participate but for age or service requirements). If he does not participate in such a plan, the deduction equals the excess of actual housing costs over 10 percent of the taxpayer's earned income minus actual housing costs and the other deductions allowed under the bills. The taxpayer may deduct the full cost of his foreign housing if he must maintain two households because of adverse living conditions at his place of work or for the convenience of his employer.

c. *Educational expenses.*—The reasonable cost of education through secondary school for dependents. The cost of nonlocal travel and room and board are deductible if there is no adequate United States-type school within a reasonable commuting distance.

d. *Home leave.*—The cost of one round-trip fare every year for each member of the taxpayer's family between his principal place of work and a place in the United States approved by his employer (if any).

e. *Hardship post travel.*—Travel costs for the taxpayer's family from a hardship post to any place in the world approved by the employer, to the extent that the costs are reimbursed by the employer and are attributable to the taxpayer's employment in an area with adverse living conditions or which is remote or isolated.

3. *Moving expenses.*—The bills would also modify the deduction for moving expenses to increase the period during which the cost of tem-

porary living arrangements is deductible from 30 days to 90 days, and raise the ceiling on those temporary living costs from $1,500 to $4,500 for international moves. Moving expenses will include the cost of storing goods while abroad.

4. *Meals and lodging furnished by employer.*—The bills would expand the scope of the exclusion (under section 119) for meals and lodging provided by the employer in both foreign and domestic situations. The exclusion would extend to meals and lodging provided by a third party "pursuant to" the employment and would cover the taxpayer's spouse and dependents as well. Also, employees abroad could exclude the value of "camp style" meals and lodging even if the general requirements of section 119 are not met.

5. *Sale or exchange of residence.*—The bills would also suspend the running of the 18- or 24-month period for reinvestment of proceeds realized on the sale of a principal residence for up to 4 years while the taxpayer is working abroad.

Mr. Pickle

Mr. Pickle would repeal the changes made by the 1976 Act to the exclusion for foreign earned income.

Mr. Waggonner

Mr Waggonner would amend the exclusions for foreign earned income and the value of meals and lodging provided by the employer to provide a $20,000 flat exclusion and a series of itemized deductions similar to those set forth in bills introduced by Mr. Crane, Mr. Jones, and Mr. Holland. (See description above.)

Senate Bill

Summary of Proposal

H.R. 9251 (the Tax Treatment Extension Act) was amended by the Senate to include a set of proposals by Senator Ribicoff (generally, as included in his bill S. 2115). The amendment would substitute for the flat exclusion provided in present law a system of deductions 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 1978; pre-1976 Act law would apply for 1977.

Explanation of the Proposal

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.

E. Comparison of Provisions and Tax Effects of Various Proposals

Table 3 summarizes the principal features of the 1976 Act and various proposals regarding the tax treatment of income earned abroad by individuals and certain associated living costs.

Tables 4 and 5 compare the estimated tax expenditures for calendar year 1977 under the 1976 Act and various proposals. Tables 4 and 5 also show the tax expenditure for total exemption of foreign earned income for individuals.

TABLE 3.—PRINCIPAL FEATURES OF 1976 ACT AND VARIOUS ALTERNATIVE PROPOSALS REGARDING INCOME EARNED ABROAD

Provision	1976 Act	Administration	Crane, Jones, Holland	Pickle (1975 Law)	Senate
Flat exclusion	$15,000 "off the bottom".	No	Pre- '76 Act levels, to be increased annually for inflation, "off the top".	$20,000 ($25,000 if abroad 3 years) "off the top".	No.
Deductions for:					
Cost-of-living	No	No	Proportional to income.	No	Based on $22,000 income to extent reimbursed.
Education	No	Up to $4000 plus travel.	Actual	No	Reimbursed expenses limited by IRS table.
Housing	No	Excess of cost over ⅙ of income.	Excess of cost over no more than ⅙ of income.	No	Excess of cost over ⅙ of income to extent reimbursed.
Home leave	No	One economy class trip every 2 yrs.	One trip every year	No	No.
Rest and recreation	No	No	Any travel approved and paid by employer and attributable to hardship post.	No	No.

Groups to Receive Special Treatment.	Charities	No	No	No	Charities and employees in camps or in employer-provided housing.
Employer-Provided Housing Exclusion (§ 119) Expanded.	No	To cover foreign camps.	To cover foreign camps and to expand domestic exlusion.	No	No, but treated specially.
Moving Expenses (§ 217):					
Partially disallowed	Yes	No	No	Yes	No.
Temporary living expense limits.	30 days/$1,500	60 days/$5,000	90 days/$4,500	30 days/$1,500	30 days/$1,500.
Storage included	No	No	Yes	No	No.
Suspense of Period to Reinvest Proceeds from Sale of Home (§ 1034).	No	4 years	4 years	No	No.

TABLE 4.—ESTIMATED REVENUE REDUCTION FROM FOREIGN INCOME EXCLUSION/DEDUCTIONS, BY INCOME CLASS [1]

[Revenue effect in millions]

Proposal	Income class						
	Under $10,000	$10,000 $20,000	$20,000 $30,000	$30,000 $40,000	$40,000 $50,000	Over $50,000	Total
1976 Act	17	51	42	27	18	27	180
Administration	16	40	59	56	36	48	254
Senate	17	46	71	66	44	67	310
Pickle (1975 law)	17	64	93	95	76	154	498
Crane, Jones, Holland	18	68	112	115	99	239	650
Exempt foreign earned income	18	68	113	117	101	264	[2] 679

[1] Estimates are based on 1975 data projected to 1977 levels. Income classes are defined as reported income plus exclusion based on 1975 tax practice. Tax liabilities based on 1977 rates.

Details may not add to totals because of rounding.

[2] Assumes all other income of individuals with foreign earned income is from foreign sources; would be $656 million if such income were from U.S. sources.

TABLE 5.—ESTIMATED REVENUE REDUCTION FROM FOREIGN INCOME EXCLUSION/DEDUCTIONS, BY REGION [1]

[Revenue effect in millions]

Proposal	Region									
	Canada	Latin America	Western Europe	Mideast and Africa OPEC	Japan	Oceania	Other Mideast and Africa	Other Asia	All other	Total
1976 Act	2	23	54	35	9	12	13	24	6	180
Administration	1	40	75	72	15	8	11	30	3	254
Senate	1	40	89	110	20	6	12	25	5	310
Pickle (1975 law)	6	70	171	107	26	20	25	61	11	498
Crane, Jones, Holland	9	92	211	161	36	23	30	75	13	650
Exempt foreign earned income	11	98	224	162	36	24	32	78	14	[2] 679

[1] See note 1 to Table 4.

[2] See note 2 to Table 4.

Details may not add to totals because of rounding.

F. Issues

In General

Proponents of an exclusion for income earned abroad or deductions for excess foreign living costs argue that without the tax incentive provided by the exclusion or deductions, it would become difficult to recruit U.S. individuals to work abroad because of the substantial cost-of-living differentials between U.S. and foreign localities. They also argue that some expenses are borne by those working abroad to obtain services normally provided by State or local governmental agencies in the United States. One important example of this is schooling costs.

Moreover, it is argued that the elimination of the exclusion would have an adverse impact on U.S. companies operating overseas by increasing their cost of labor. This, it is argued, will ultimately cause U.S.-made goods and services to be less competitive in overseas markets than foreign-made goods and foreign services.

Opponents of an exclusion or deductions argue that they provide an unwarranted tax advantage to those U.S. citizens who live and work abroad compared with those who live and work in the United States. The CRS study argues that most alternative proposals are nonneutral because they would provide an incentive for Americans to work abroad rather than in the U.S. Critics of the CRS study argue that the tax treatment of Americans working abroad should be compared not to Americans in the U.S. but to foreign nationals of other developed countries working abroad, who in many instances pay little or no tax.

Specific Aspects

1. Flat exclusion

A flat exclusion has the virtue of simplicity. Many of the issues relating to special deductions (discussed below) would be eliminated by the use only of a flat exclusion. Moreover, a taxpayer living abroad in a construction camp and not accompanied by his family may have few, if any, excess foreign living costs. An exclusion from income would provide a tax incentive for that a taxpayer to work abroad; deductions for excess foreign living costs would not.

Opponents of a flat exclusion argue that relief based on a flat exclusion is arbitrary and unfair. The amount excluded would be the same regardless of whether the individual's living expenses abroad are higher than, the same as, or lower than comparable costs in the United States. It is argued that equitable treatment of individuals working abroad requires that relief be more closely related to the actual increased expenses which the individual must incur while working abroad.

If the Committee decides to adopt a flat exclusion, it will be necessary to determine the amount and consider whether the amount should be excluded from the highest marginal brackets of the taxpayer ("off the top"), as was the case prior to passage of the 1976 Act, or from the lowest brackets ("off the bottom"), as the 1976 Act provides. A deduction "off the top" simplifies the necessary computations. It also provides a greater incentive for taxpayers with high incomes because the excluded income would have been taxed at higher marginal rates. In the 1976 Act, Congress changed the exclusion so that it was taken "off the bottom" because Congress believed it would be more equitable for taxpayers earning the same amount of excludable foreign income to save the same amount in taxes. A simpler way to achieve this result could be to convert the provision to a credit against tax rather than an exclusion from income. If the deduction were "off the top," a taxpayer with income in excess of the exclusion could save more in taxes than a taxpayer with the same amount of foreign earned income but no additional income.

Some proposals provide for an automatic increase in the amount of the exclusion to compensate for inflation. Indexation automatically preserves the value of the exclusion against inflation. Opponents of indexation argue that it would increase complexity and reduce the opportunity for periodic review of the appropriateness of the amount of the exclusion.

If a flat exclusion is to be allowed, the Committee should consider whether the exclusion is to be in addition to, or in place of, deductions for certain additional foreign living costs. The Committee may also want to consider whether the eligibility standards for the exclusion and the deductions should be the same or different.

Those who propose that both a flat exclusion and special deductions be provided argue that both are necessary in order to compensate fully U.S. employees working abroad for the hardships they must endure and to encourage U.S. companies to employ U.S. citizens abroad. The presence of citizens working abroad is said to encourage the purchase of U.S., instead of foreign, goods and to improve the U.S. economy.

Opponents believe that the provision of both an exclusion and deductions creates duplicate relief or double benefits to deal with the same problem. Such combined relief is said to be unnecessary to encourage U.S. citizens to work abroad and is opposed because it treats employment overseas more favorably than employment in the United States.

2. Deductible allowances

Several proposals provide for deduction of the excess costs of living abroad for some or all of the following specific areas:

a. *Cost of living.*—Proponents of a cost-of-living deduction argue that it is necessary to offset increased living costs abroad which are incurred for the purpose of obtaining employment abroad. These increased costs, it is argued, do not provide any additional personal benefits or luxuries to Americans working abroad, but are generally incurred in an attempt to attain a standard of living abroad comparable to one which may be attained for substantially less cost in the U.S. In certain areas of the world, such as Tokyo, the obtainable standard of living may be less attractive for those accustomed to American-style living even though the costs are substantially higher.

However, opponents of a deduction for a cost-of-living allowance point out that the cost of living varies considerably within the U.S., but no special allowances are made for persons who must live in high-cost areas to obtain employment. Moreover, with the exception of a few foreign areas, living costs abroad are generally comparable to those found in certain areas of the U.S. The CRS argues that, if a cost-of-living deduction is provided, it should not be measured with reference to the average cost of living in the United States or the cost of living in Washington, D.C., but with reference to the cost of living in places such as Anchorage, Honolulu, and New York where American residents incur high living costs without any special tax deductions.

Table 6 compares cost-of-living indexes for foreign areas compiled by the State Department, the United Nations, Union Bank of Switzerland, Business International, and Organization Resources Counselors. All exclude the cost of housing, and the State Department, Business International, and Organization Resources Counselors indexes also exclude the cost of education. Table 6 also shows the cost-of-living index (excluding housing) for major U.S. cities compiled by the Bureau of Labor Statistics.

TABLE 6.—RELATIVE COSTS OF LIVING IN CERTAIN FOREIGN AND DOMESTIC CITIES [1]

[Washington, D.C.=100]

	Foreign [2]					United States	
	State Department [3]	United Nations [4]	Union Bank of Switzerland [5]	Business International [6]	Organization Resources Counselors [7]		Bureau of Labor Statistics [8]
Tokyo	165	148	147	138	209	Anchorage	126
Brussels	160	—	109	102	170	Honolulu	121
Geneva	158	147	120	126	206	New York-Northeastern N.J.	119
Dusseldorf (*Frankfurt*)	152 (*150*)	— (—)	102 (—)	107 (*106*)	184 (*184*)	Boston	113
Paris	142	129	109	111	138	Milawaukee	102
Caracas	139	103	98	85	128	San Francisco-Oakland	102
Riyadh	137	—	—	—	156	Philadelphia	100
Djakarta	126	114	—	—	152	Baltimore	98
Canberra (*Sydney*)	121 (—)	— (*97*)	— (*94*)	— (*99*)	122 (*122*)	Los Angeles-Long Beach	97
Hong Kong	120	—	104	100	136	Detroit	96
Tehran	118	98	87	98	136	Chicago-Northwestern Ind.	94
Tel Aviv	114	—	112	—	80	Cleveland	94
Rio de Janeiro	111	94	78	74	118	Denver	94
Singapore	111	96	84	89	132	Kansas City	94

Madrid	109	98	73	79	141	San Diego	93
Rome	108	95	—	69	118	St. Louis	92
London	102	92	75	85	126	Seattle-Everett	91
Ottawa (*Montreal*)	102 (—)	— (*92*)	— (*108*)	— (—)	106 (—)	Indianapolis	90
Manila	88	93	70	70	110	Houston	86
Mexico City	78	75	94	90	80	Dallas	85
						Southern non-metropolitan	79

Note: A dash indicates that information is not compiled for that city.

[1] Figures in each column show costs of living (excluding housing) relative to Washington, D.C. at the time the index was compiled. The figures are not intended to show changes in the cost of living in each city over time resulting from fluctuating exchange rates and inflation.

[2] These cities are in countries having the greatest numbers of Americans claiming exclusions in 1975.

[3] U.S. Dept. of State, Indexes of Living Costs Abroad and Quarters Allowances (April 1977), as supplemented through March 20, 1978. Educational costs are excluded.

[4] U.N. Monthly Bulletin of Statistics (August 1977), adjusted to Washington, D.C.=100.

[5] Union Bank of Switzerland, Prices and Earnings around the Globe 25 (1976). Goods and services, excluding rent, adjusted by comparing indexes for New York, Chicago, Los Angeles and San Francisco with indexes for those cities compiled by Bureau of Labor Statistics for Autumn, 1976, as reported in U.S. Dept. of Labor, Bureau of Labor Statistics News, Apr. 27, 1977. See note 7 for method of calculating BLS indexes.

[6] Business International's 1976 Survey of Executive Living Costs. Educational costs are excluded.

[7] Organization Resources Counselors, Inc., estimates becoming effective from December 15, 1977 through April 30, 1978. Educational costs are excluded.

[8] U.S. Dept. of Labor, Bureau of Labor Statistics News, Apr. 26, 1978. Based on Table 3 by subtracting "Total Housing" from "Total Budget" for a family of four with a budget of $25,202, adjusted to Washington, D.C.=100. The cities are those in Labor's indexes which have the largest populations, except for Anchorage, which is included because it represents the extreme of cities in Labor's index, and Southern non-metropolitan, for places with populations of 2,500 to 50,000, which is the lowest figure.

Many opponents of a cost-of-living deduction, including the Administration, point to the administrative complexity of compiling a suitable index. There is no single accepted method of computation. Also, it is difficult to keep the tables current in the light of fluctuating inflation and currency exchange rates. The variance among the indexes for each foreign city in Table 6 illustrates the problems involved. One problem with cost-of-living tables is that they may be a source of continuing dispute with taxpayers in the affected areas. On the other hand, proponents argue that a cost-of-living deduction, even if not totally accurate, is nevertheless accurate than no deduction at all.

b. *Housing.*—Proponents of the housing deduction single out housing costs for special treatment because those costs are often determinable by taxpayers involved. Most of the difficulties in establishing an excess housing cost allowance arise from an attempt to determine what the *excess* cost of housing is over what the employee would have spent in the U.S. for housing. (The latter amount is generally recognized to be a nondeductible personal expense.) Proposals generally make the assumption, based on statistics compiled by the Department of Labor, that an average taxpayer would have spent one-sixth of his income (not including special allowances for excess costs of living abroad) on housing. It may be argued that, because of this arbitrary assumption, a housing deduction fails in its purpose to provide equity between similarly situated taxpayers. That is, the amount of the deduction may bear little relation to the actual excess housing costs incurred by the taxpayer. Proponents of the special housing deduction argue that, even if it is not a perfect measurement of excess housing costs, it is a closer approximation than a flat exclusion.

Some proposals calculate base income by reference to the taxpayer's "base compensation" as defined in any qualified deferred compensation plan in which he participates or could participate but for minimum age or service requirements. The definition of "base compensation" varies among plans and may exclude, for example, bonuses and overtime pay. Because bonuses and overtime may be excluded, the plan definition may substantially reduce the employee's economic base income and correspondingly increase his excess housing cost deduction. Proponents of the plan definition respond that most overseas bonuses are not paid to the employer's labor force remaining in the U.S. However, it is apparently the practice in a number of industries to award substantial bonuses to domestic employees as well as foreign employees. Another problem with the plan definition approach is that similarly situated employees of different employers in the same foreign place earning the same compensation will have different housing deductions depending upon their compensation bases for pension purposes.

c. *Education.*—Proponents of an education deduction point out that elementary and secondary education for dependent children is generally available without cost in the U.S. as a local government service but that adequate English-language schools are frequently unavailable abroad. Accordingly, Americans working abroad may be required to spend substantial amounts to send their children to private schools on site or to boarding schools in other locations. However, the employee generally will not obtain any advantage over what would have been available in the U.S. Opponents point out that family education expenses are personal in nature. Taxpayers in the U.S. who send their children to private schools receive no special tax benefits (although proposals for tuition tax credits are now pending in Congress).

Advocates of limitations on the maximum deductible amount for education argue that limitations are necessary to prevent abuse, such as deductions for the cost of luxurious boarding schools in Western Europe. Opponents argue that the variation among localities of reasonable education expenses is so great that no flat limitation could fairly take into account all possible personal circumstances.

d. *Home leave.*—Proponents of a home-leave deduction argue that the travel costs are incurred solely to enable the employee to go between his job site and his permanent "home" in the U.S. and therefore are business-related expenses for which a deduction should be allowed. It is also argued that deductibility of home-leave expenses is necessary if employers are to continue to attract U.S. citizens to foreign employment.

Opponents argue that home-leave trips to and from the U.S. are inherently personal in nature and should not be deductible. A number of court cases have held that if an employee chooses a nontemporary job and home which are remote from each other, that is a personal decision, and the resulting costs are not deductible. Moreover, a simular problem exists for an employee who is transferred by his employer to a location within the U.S. for an extended period, but no special tax relief is provided in that situation.

The Administration argues that one home leave round trip every second year in economy class travel is sufficient. Other proposals would permit one trip every year in any class of travel, in part because such frequency is necessary to permit travel home during personal emergencies. The Administration, on the other hand, points out the increased revenue loss ($25 million annually) which would result from allowance of one trip per year.

e. *Rest and recreation.*—Proponents of a deduction for rest and recreation argue that it should be viewed as a business expense, and that it is a necessary incentive in any case. Opponents point out the personal nature of the expenditures. They argue that deductibility of the costs in effect allows the employer to give his employee tax-free vacation pay. They also point out the substantial administrative difficulty in determining the circumstances in which a deduction for rest and recreation costs should be allowed.

f. *Allowances as adjustments to gross income or itemized deductions.*—Proponents of treating the above deductible allowances as adjustments to gross income argue that the costs are closely related to business expenses and, like moving expense deductions, should be allowed regardless of whether or not the taxpayer itemizes deductions. Opponents argue that the zero bracket amount is generous and should provide adequate relief if the amount of the deductible allowances is small. If the amount is large, the taxpayer will itemize deductions. Treatment of the allowances for excess foreign living costs as itemized deductions rather than as adjustments to gross income would permit a more generous system of allowances for the same revenue cost.

3. Groups to receive special treatment

With respect to U.S. service companies, in particular engineering and construction firms, it is argued that the removal of the exclusion would substantially increase the costs of operations abroad, thus preventing these companies from effectively competing with foreign companies. This would have a negative impact on the U.S. economy because U.S. firms in this field are more likely to design foreign projects with specifications calling for U.S.-made parts and equipment. Opponents of special treatment of employees of particular industries argue that it is not fair to provide different tax treatment for similarly situated taxpayers in the same foreign place merely because they are employed in different industries.

With respect to overseas employees of U.S. charities, it is argued that the removal of the exclusion would result in U.S. charities having to reimburse these employees for the U.S. tax imposed, making it more expensive for the U.S. charities to retain their employees overseas. Particularly for organizations (such as CARE) whose overseas payrolls constitute a large portion of their budgets, the additional costs needed to reimburse employees for U.S. taxes could cause a substantial curtailment of their overseas operations. However, this additional tax cost is also incurred by charities when they hire employees in the United States, who generally receive no special treatment.

4. Expansion of exclusion for employer-provided housing (sec. 119)

Present law permits employees (whether abroad or in the U.S.) to exclude from gross income the value of certain housing provided to them by their employers as a condition of employment if the housing is located on the business premises. Some employees are provided housing in a construction camp which is not on the business premises but otherwise meets the requirements for exclusion. Many proposals would expand the exclusion of present law to include housing in foreign camps. Some proposals also have the effect of expanding the domestic exclusion.

Those in favor of the expanded exclusion argue that foreign geography, the requirements of local law, and other circumstances often prevent employers from providing housing to their employees on the job site. It is said that the excludability of the value of employer-provided housing should not be lost merely because one of the technical requirements for the exclusion cannot be met completely. Special treatment is said to be especially important because of the substandard quality of most camp housing abroad.

On the other hand, expansion of the exclusion would add complexity. In addition, in some instances, construction camps may provide housing at least as attractive as what is available locally on the open market in the same area. In these instances, opponents argue that employees living in camps should not receive special treatment over employees in the same country who are not in camps. Under many proposals, employees would get a deduction for excess housing costs even if there were no exclusion for the value of camp housing.

5. Moving expense deduction (sec. 217)

Under present law, certain employees who move to accept new mployment may deduct specified moving expenses from gross income, whether or not they itemize. Among these is the cost of temporary living accommodations in the new location for up to 30 days in an amount up to $1,500. Many proposals would increase the time and dollar limitations for employees moving to, from, or between foreign countries. Some proposals would also permit a deduction in these cases for the cost of storing household goods, which is not permitted under present law.

It is said that it is more difficult and costly to execute a foreign move and that limitations set with domestic moves in mind are inappropriate. In particular, the cost of storing furniture is frequently incurred in foreign moves but is relatively rare in the case of domestic moves.

6. Nonrecognition of gain from sale of house (sec. 1034)

In general, a taxpayer need not recognize gain on the sale of his house if he reinvests the proceeds in a new house within 18 months of the sale. The Administration proposal and some other proposals would suspend the running of this 18-month period for up to 4 years while the taxpayer is working abroad. A similar suspension is provided under present law for members of the U.S. Armed Forces on active duty for more than 90 days or for an indefinite period.

The reasons advanced for this change are similar to those for expanding allowable moving expense deductions.

7. Treatment of foreign taxes

No proposal deals specifically with this question. However, some individuals working abroad argue that they are discriminated against because they are not allowed to deduct the high foreign value-added or sales taxes they pay, while U.S. residents can deduct State or local income, sales, and property taxes. (The President's 1978 Tax Program includes a proposal to eliminate the deduction for State and local sales taxes.) Moreover, Federal excise and use taxes (taxes on tires, communications, alcohol, and tobacco, etc.), which on some purchases are comparable to foreign value-added taxes, are not deductible in the United States. In addition, foreign local income taxes are allowed as a credit against U.S. tax, while State and local income taxes paid in the United States are only deductible by those who itemize. Further, the IRS has ruled that some foreign taxes equivalent to our social security taxes qualify for the foriegn tax credit and thus offset Federal income taxes, while no credit or deduction against the Federal income tax is provided for social security or other Federal employment taxes. Taking into account all these factors it is difficult to determine whether individuals working abroad are generally better off or worse off than those working in the United States from a tax standpoint. The results vary depending on a variety of circumstances including the extent to which a foreign country relies on value-added or sales taxes rather than income taxes, and the extent to which creditable foreign local income taxes are imposed.

Opponents of providing a deduction for foreign value-added taxes argue that it would present substantial administrative difficulties to determine the amount of such foreign taxes the individual had paid.

It should be noted, however, that if there is to be a cost-of-living deduction, tables promulgated may be structured to take value-added taxes into account or to eliminate them from consideration. In fact, most cost-of-living tables include the effect of foreign value-added or sales taxes in their indexes for foreign countries.

8. Treatment of resident aliens

By its terms, the foreign earned income exclusion is available only to U.S. citizens. However, resident aliens are also entitled to the exclusion if they otherwise meet the requirements and are from a country which has a tax treaty with the U.S. requiring nondiscrimination. Many proposals would expand the exclusion to apply to all resident aliens.

This expansion in the applicability of the exclusion would provide more equal treatment among resident aliens, who are generally subject to the same tax rules as are U.S. citizens.

On the other hand, it is questioned whether an exclusion for the excess cost of living abroad should be afforded to individuals who are citizens of foreign countries and presumably have greater ties abroad than U.S. citizens. Moreover, allowance of the exclusion only to resident aliens who are from countries which have tax treaties with the U.S containing nondiscrimination clauses is an incentive, albeit a small one, for foreign countries to agree to nondiscrimination clauses in treaties with the U.S.

Nonresident aliens who apply for resident immigration status generally must pay U.S. income taxes on their worldwide income as though they were residents. This is a considerable disincentive for a residence application by an alien who has no real intention to reside in the U.S. However, if an exclusion or deduction were made available to all resident aliens, the disincentive would be reduced.

9. Foreign tax credit

Prior to the 1976 Act, foreign taxes paid on excluded foreign earned income could be credited against U.S. tax liability on other foreign income. Opponents of that treatment argued successfully in 1976 that it produced an unwarranted double benefit. Excluded foreign earned income was not subject to double taxation because the U.S. did not tax it, but foreign taxes paid on the excluded income could be used to reduce U.S. tax on other foreign income even though double taxation on the other income was avoided through the allowance of a credit for foreign taxes paid on it. Opponents of the 1976 Act amendment argue that it adds complexity and significantly reduces the incentive for Americans to work abroad.

10. Simplification and administrative aspects

As noted above, a flat exclusion would have the virtue of simplicity, although equity may make different relief more desirable. A series of deductions for specific excess foreign living expenses could add complexity to returns. In particular, the Treasury Department has noted the administrative problems in developing suitable cost-of-living indexes.

On the other hand, many provisions relating to the exclusion of foreign earned income under the 1976 Act are complex, including the method for calculating the exclusion "off the bottom" and the disallowance of foreign tax credits allocable to the excluded income.

G. Revenue Effect of Various Proposals

Table 7 sets forth the revenue effect as compared with the 1976 Act of various proposals for fiscal years 1978 through 1983. It is assumed that each proposal is effective for taxable years beginning after December 31, 1977.

TABLE 7.—REVENUE EFFECT OF VARIOUS PROPOSALS RELATING TO TAX TREATMENT OF INCOME EARNED ABROAD, FISCAL YEARS 1978–83

[Dollar amounts in millions]

Proposal	1978	1979	1980	1981	1982	1983
Administration	12	87	95	103	109	117
Senate	21	153	167	181	182	197
Pickle (1975 law)	51	374	405	441	444	480
Crane, Jones, Holland	76	553	597	646	648	697

III. ALLOWANCES PAID TO U.S. GOVERNMENT EMPLOYEES SERVING ABROAD (SEC. 912)

A. Present Law

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.[1]

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 allowance (post allowance)*.—Using Washington, D.C., as a reference, cost-of-living allowances are provided to eligible 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 in whole or in part for the cost of rent, electricity, gas, fuel, and water, and any taxes required to be paid by the employee. In certain cases, officers and employees may also be provided with basic household furnishings and equipment for use on a loan basis in leased residences. If section 912 were repealed, the fair rental value of the lodging and furniture provided, cr the amount of the living quarters allowance, would be taxable income to the employee.

(c) *Official residence expenses*.—This allowance is primarily intended to reimburse the principal officer and other eligible senior officers for the cost of maintaining and repairing the residence and additional servants necessary to operate an official residence. Other expenses incident to the maintenance of the official residence are paid

[1] The Acts providing these allowances are: (1) title IX of the Foreign Service Act of 1946, as amended (22 U.S.C., sec. 1131 and following); (2) section 4 of the Central Intelligence Agency Act of 1949, as amended (50 U.S.C., sec. 403(e)); (3) title II of the Overseas Differentials and Allowances Act; (4) subsections (e) and (f) of the first section of the Administrative Expenses Act of 1946, as amended, and section 22 of such Act; (5) 5 U.S.C., sec. 5941, and (6) sections 5 and 6 of the Peace Corps Act.

from operating funds of the State Department. Also, certain senior officers are supplied with residences which are for official use. If section 912 were repealed, the rental value of the official residence and the value of the housekeeping services would continue to be excluded from the officer's income, provided that the officer is required to live in the residence as a condition of his employment. While the official residence allowance would ordinarily be includible in the officer's income because it is a cash payment, the underlying expenses would probably be deductible as business expenses.

(d) *Representation allowances.*—These allowances are made in order to provide for the proper representation of the United States by officers or employees of the Government. An example of this would be an allowance for the entertainment expenses incurred by a Foreign Service officer. If section 912 were repealed, the allowance would be taxable income to the employee. The employee would, however, be entitled to an offsetting deduction for all amounts actually spent for the proper representation of the United States.

(e) *Relocation allowances and benefits.*—These allowances are intended to provide reimbursement for expenses incurred in transporting the employee and his family to and from his post of duty; transporting the employee and his family's effects to successive posts, including packing and storing; the importing of one motor vehicle each four years, if authorized; temporary living expenses incurred while arranging for personal quarters at an overseas post; and for other miscellaneous expenses incurred in traveling from an old to a new duty station. Although the amount of the allowances, or their value if furnished in kind, would be taxable income to the employee if section 912 were repealed, an offsetting moving expense deduction would be allowed with respect to most of the expenses actually incurred, including, *inter alia*, all expenses incurred for transporting household goods and personal effects, for traveling (including meals and lodging) to the new residence, and for meals and lodging (subject to a $1,500 limit) for a 30-day period while occupying temporary quarters at the new post.

(f) *Medical benefits.*—Certain medical expenses are reimbursed and certain medical services are provided to employees and dependents. If section 912 were repealed, these benefits would generally be excludible under other provisions of the tax law and, if not, would generally be deductible to the extent they exceeded 3 percent of the employee's adjusted gross income.

(g) *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 is repealed.

(h) *Home-leave and rest and recuperation travel allowances.*—The travel allowances are provided as reimbursement for the round-trip travel costs of employees and dependents to the United States for home leave or to a designated favorable location for rest and recuperation. Certain Government employees are required to return to the United States on home leave (the time is not chargeable to annual leave) every few years in order to reacclimate themselves to the American way of life. The rest and recuperation allowance is available to employees stationed at posts with difficult conditions. Except for the travel expense of employees on mandatory home leave, reimbursement for home-leave and rest and recuperation travel expenses would be taxable if section 912 were repealed. Where, however, an employee such as a Foreign Service officer is required to take home leave, the courts have differed as to whether his home leave expenses incurred for transportation, meals, and lodging are deductible business expenses.

(i) *Separate maintenance and family visitation allowances.*—The separate maintenance allowance is provided to reimburse the employee for the cost of housing his dependents and certain other expenses when adverse conditions at the employee's post compel the dependents to live at another place. The family visitation allowance reimburses the employee for travel expenses incurred by the employee in visiting his family at the separate location (limited to two trips a year) only when separation is due to hostile action at the post. These allowances would, in the absence of section 912, be taxable income to the employee and no deduction would be allowed for the expenses incurred.

(j) *Evacuation travel.*—This allowance is provided as reimbursement for the costs of transporting the employee, his family, and their furniture and other possessions from a post at which there is imminent danger to life and property. Since the allowances are not intended to be compensatory in nature, but are only authorized under extreme emergency conditions and are solely intended to offset the direct added expenses incurred as the result of the evacuation, the allowances would not be includible in income if section 912 were repealed. (Cf. Rev. Rul. 63–258, 1963–2 Cum. Bull. 22.) Moreover, even if such allowances were not excludible on that basis, in most instances the expenses involved would be deductible expenses.

(k) *Emergency visitation travel.*—This allowance is provided to cover expenses incurred by the employee or his dependents to visit immediate family members in the event of serious illness, injury, or death. It is not clear whether the allowance would be taxable in the event of the repeal of section 912.

(l) *Preparation and transportation of remains.*—This allowance is provided to pay the expenses of preparing, transporting, or accompanying the remains of employees and family members who may die abroad. The first $5,000 paid by reason of the death of the employee would be excludible as an employee death benefit if section 912 did not apply. (However, the President's 1978 Tax Program contains a proposal to repeal the $5,000 exclusion.) It is not clear whether payments in excess of that amount or payments made in the event of the death of a dependent would be taxable.

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

(n) *Other allowances.*—Other allowances and benefits provided Government employees serving overseas such as special commissaries, eating and recreation facilities might be excludible even if section 912 were repealed.

B. Background

Legislative History

The exclusion was added to the tax law in 1943, during World War II, when it was felt that relief was essential to Government personnel stationed in foreign countries. During this time, Government personnel stationed in foreign countries were faced with runaway inflation in these foreign countries. Having U.S. personnel in these overseas posts was viewed as a crucial part of the nation's war effort, and the Department of State indicated that it neither had the funds nor the authority to compensate its personnel for the extra tax burden resulting from the taxation of various allowances.

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 task force composed of representatives of the various departments of the Executive branch could complete a study which it was then preparing. The study, titled *Report of the Inter-Agency Committee on Overseas Allowances and Benefits for U.S. Employees*, was released in June 1977.

B. Economic Background

The cost-of-living and housing allowances represent in dollar terms the largest part of the aggregate amounts paid by the Government in allowances which are now exempt from tax, but which would, if section 912 were repealed, be includible in income and would not be offset by deductions allowed for the underlying expenses.

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 is estimated at $100 million, of which $77 million is for employees overseas, $12 million for employees in U.S. territories, and $11 million for employees in Alaska and Hawaii.

C. Administration Proposal

The Administration has not proposed any changes in the tax treatment of allowances paid to Government employees. Instead, under the Administration's proposal, Government agencies furnishing allowances excludable by their employees under section 912 would be required to submit annual reports to the Treasury Department itemizing those allowances. The Treasury Department would also be required to present to Congress every 2 years a detailed description of the revenue costs and economic effects of the exclusions under section 912.

D. Alternative 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 benefits 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.

E. Issues

The Administration suggests that no action be taken with respect to allowances of Government employees at this time in order to permit further study. Proponents for changing the treatment argue that there is at least as much information available concerning Government employees' allowances as there is information relating to compensation of Americans in private employment working abroad. Moreover, they argue that the consideration of the tax treatment of private employees working abroad provides an opportunity to make similar the treatment of Government and private employees.

One justification given for the exclusion of overseas allowances is that they are not actually income to the recipient but merely reimbursement for business-related expenses which would not otherwise be incurred (i.e., the expenses for which the employee is being provided allowances should be viewed as deductible employee business expenses). However, if the section 912 exclusion for allowances paid to Government employees were repealed, some of the allowances would be excluded from the employee's income in any event, and deductions would be allowable for any legitimate business expenses as well as various other expenses, such as moving expenses. (The possible exceptions set forth in the alternatives presented above would, in any event, appear to cover most real business-related expenses.)

It is argued that the allowances to which section 912 pertains cover increased living expenses, thereby enabling overseas employees to live at the same standard as they enjoyed in the United States. It is suggested that to tax these allowances only results in subjecting these employees to a lower standard of living. However, certain allowances not only compensate the employee for increased costs, but also reimburse him for the entire cost involved. One example of this is the living quarters allowance which is intended to provide for completely free housing, not just reimbursement for the housing costs in excess of those which would have been incurred at a post in the United States. In addition, a recent GAO study [2] points out that, until recently at least, overlapping allowances were in effect provided for the additional costs of housing overseas. Despite the fact that housing costs were for many fully reimbursed, the cost-of-living allowance was paid with respect to the employee's total spendable income (compensation less taxes and savings), without reduction for the amounts that would have been spent for housing in the United States. It is understood, however, that this overlap is being eliminated as the result of an Inter-Agency Committee recommendation.

While in some cases the cost of living and additional travel and educational expenses make total living costs for a U.S. employee working abroad higher than those of many U.S. citizens working in the United States, the cost of living also varies greatly from area to area within the United States, as is shown by Table 6. Cost-of-living allowances are also paid to Government employees stationed in

[2] Comptroller General of the United States. "Fundamental Changes Needed to Achieve a Uniform Government-wide Overseas Benefit and Allowances System for U.S. Employees." Sept. 9, 1974 (GAO report No. B180403).

Hawaii, in amounts up to 17.5 percent of their base salary, even though the cost of living in Honolulu is only 2 percent above the New York/New Jersey level. Moreover, the cost of living in the United States is significantly higher than in many areas abroad as is also shown by Table 6. In light of these wide variations, both within and without the United States, it is argued that the tax laws cannot, in practice, be fairly adjusted to take into account cost of living variations.

It has been suggested that because of the presence of the various allowances, the regular compensation of foreign service personnel is lower than it otherwise would have been. It would appear that there is some validity to this point, and if the various allowances are not generally to remain tax-exempt, the change in this status could be made gradually over a period of years in order to give the other committees of Congress an opportunity to make appropriate adjustments in foreign service compensation and allowances. Should the tax-exempt status of many of these allowances be removed over a period of years, this change in treatment might be noted in a communication from the Ways and Means Committee to the Committee on International Relations and any other relevant committees with the suggestion that they might want to review the compensation levels of the foreign employees of departments under their jurisdiction.

Opponents of change point out that if compensation and allowances are adjusted upward, there may be no net revenue gain from taxing allowances but there would be an increase in administrative complexity.

It is argued that morale would be severely impaired and Government agencies would find it difficult to recruit and retain competent people to serve at overseas posts if the various allowances were made taxable. However, the recruitment and retention of personnel for Federal agencies with respect to their overseas duty posts in practice have not presented significant problems. The GAO study indicates that there is virtually no problem in filling any overseas vacancy. For example, in 1972, the State Department had 11,000 applicants for 70 vacant posts. The GAO study indicates that, according to State Department officials, the only place they have a problem recruiting clerical staff is for positions in Washington, D.C.

The GAO study points out that inconsistencies exist in the rules under which allowances are granted by the various Federal agencies. For example, some agencies will reimburse employees for travel expenses for rest and recuperation, while others will not. The section 912 exclusion tends to magnify these inconsistencies, since the exemption only benefits those employees who incur expenses which are reimbursable by the particular Federal agency employing them. In addition, some agencies, such as the Treasury and Agriculture Departments, pay allowances to their employees which are similar to those provided by other agencies but are not exempt under present law. It should be noted, however, that the Inter-Agency Committee has recommended that the allowances provided by the various agencies be made more uniform, and thus in the future these inconsistencies should be substantially reduced.

In the event that Congress reduces the exclusion provided under section 912, a case can be made that it should also clarify and, in certain instances, modify the rules governing the taxation of certain expenses and allowances. The Internal Revenue Service apparently takes a restrictive view as to the types of payments which are expenses of the employer (and not personal expenses of the employee) and thus are entitled to be excluded from income by the employee. The Service's position is contrary to some court cases won by employees, and repeal of the exclusion could force Government employees into litigation to ascertain the tax treatment of certain allowances. Therefore, it might be advisable for Congress to state explicitly which allowances would not be subject to tax as payments made for the convenience of the employer rather than personal expenses of the employee.