

ECONOMIC ANALYSIS OF THE FOREIGN EARNED INCOME EXCLUSION

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EXECUTIVE SUMMARY

Section 911 is a provision of the U.S. tax Code designed to offset the competitive disadvantage U.S. taxpayers face working abroad. Repeal of Section 911 is estimated to reduce the number of Americans working abroad, causing an \$8.1 billion loss in U.S. manufactured exports that support 77,115 U.S. domestic jobs. By contrast, removing the \$80,000 cap on the foreign earned income exclusion is estimated to increase U.S. manufactured exports by \$14.4 billion supporting 137,319 U.S. domestic jobs.

A. BACKGROUND

Unlike any other major industrial country, the United States taxes citizens and resident aliens who live abroad on their worldwide income.¹ Limited relief is provided under Section 911 of the Internal Revenue Code, which permits an exclusion of certain foreign employment related income. The principal rationale for the exclusion historically has been to make the tax treatment of Americans working abroad less uncompetitive relative to foreign nationals and, thereby, to promote exports of U.S. goods and services.

Limits of the exclusion. Under Section 911, a U.S. citizen or resident alien who maintains a tax home outside the United States *and* who meets a residence test during this period may exclude from gross income up to of \$80,000 per year of foreign earned income (referred to as the "general exclusion") plus a "housing cost amount". Deductions allocated to excluded income are disallowed. Examples of deductions that may be disallowed as a result of this rule include: moving expenses, employee business expenses, state income taxes, and foreign taxes claimed as a deduction.

History of the provision. The foreign earned income exclusion has been part of the Internal Revenue Code since 1926. Originally there was no limit on the exclusion; it applied to all earned income (received for work done as opposed to passive income) derived and received from sources outside of the United States provided that certain residency requirements were met.² In 1953, the exclusion was limited to a fixed dollar amount.

Congress reinstated the provision in 1981 to promote exports. In 1978, Congress replaced the earned income exclusion with a new set of deductions under Section 913. However, the Economic Recovery Tax Act of 1981 restored the original structure of the foreign earned income exclusion in Section 911, and increased the exclusion amount from \$20,000 to \$75,000. The legislative history indicates that Congress was concerned that the rules enacted in 1978 made it more expensive to hire Americans abroad as compared to foreign citizens, reduced U.S. exports, made U.S. business less

¹ See, Hale E. Sheppard, "The Impact of Recent Events on the U.S. Foreign Earned Income Exclusion: Rocking the Boat or Capsizing the Vessel," *Tax Notes International*, April 19, 2004; and Government Accountability Office, "IRS Activities to Increase Compliance of Overseas Taxpayers," GAO/GGD-93-93, May 1993. Available at <http://archive.gao.gov/t2pbat6/149177.pdf>.

² In 1928, section 213(b)(14) was redesignated as section 116(a).

competitive abroad, and were so complex that many Americans employed abroad found it necessary to use professional tax preparers:

"The Congress was concerned with the increasing competitive pressures that American businesses faced abroad. The Congress decided that in view of the nation's continuing trade deficits, it is important to allow Americans working overseas to contribute to the effort to keep American business competitive.

As a result, some U.S. companies either cut back their foreign operations or replaced American citizens in key executive positions with foreign nationals. In many cases, these foreign nationals may purchase goods and services for their companies from their home countries, rather than from the United States, because they often are more familiar with these goods and services."³

The real value of the exclusion has dropped by over 45 percent. Since the exclusion of foreign earned income was first limited in 1953, its real value has dropped by over 45 percent. If the \$20,000 cap enacted in 1953 had been indexed for inflation, the exclusion would be over \$145,000 in 2005.

Section 911 exclusion has not kept pace with foreign earned income. Treasury Department data show that, over the 1996-2001 period, the foreign earned income exclusion declined from 66.5 percent to 58.6 percent of reported foreign earned income. Although the Section 911 exclusion was increased over this period, it has not kept pace with compensation.

Compensation arrangements. Employers typically reimburse U.S. employees for the additional costs of working overseas, such as school costs, home leave travel, certain medical services, and transportation. Under the tax Code, reimbursements and allowances for such costs are treated as income and are taxable to the employee. In some cases the employer may agree to reimburse the employee for the excess tax cost (including the tax on the tax reimbursement). Under such a tax equalization arrangement, the employer bears the full burden of the employee's additional tax liability. In other cases, the employee bears the additional tax burden. In either case, absent Section 911 relief, the tax Code discourages foreign posting of U.S. citizens.

B. ECONOMIC ANALYSIS

Overview. PricewaterhouseCoopers LLP ("PwC") used its Assignment Cost Projection System to model the effect of changes in Section 911 on assignees with tax equalization packages at four levels of compensation and working in each of 10 countries. The study also used a model developed by Professor John Mutti for the Treasury Department Office of Tax Analysis, which shows the interrelationship between U.S. exports and the number of Americans working abroad. This relationship is likely due to a number of factors, including: (1) Americans living abroad tend to purchase U.S. made goods both for personal consumption and for their businesses; (2) Americans

³ Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981*, JCS-71-81, December 20, 1981, p. 43.

living abroad increase foreign purchases of U.S. goods by setting an example for foreign nationals; and (3) Americans living abroad may be directly engaged in marketing U.S. goods in foreign markets.

Changes in Section 911 would affect exports and domestic employment. Repeal of Section 911 is estimated to cause a \$8.1 billion reduction in U.S. manufactured exports that support 77,115 U.S. domestic jobs at 2004 levels. Further limiting the housing exclusion, as proposed in the Senate version of the JOBS Act, is estimated to reduce U.S. manufactured exports by \$2.5 billion, affecting 23,676 U.S. domestic jobs. By contrast, removing the cap on the foreign earned income exclusion is estimated to increase U.S. manufactured exports by \$14.4 billion supporting 137,319 U.S. domestic jobs.

Changes in Section 911 would affect the number of Americans working abroad. Repeal of Section 911 would increase the level of compensation required to maintain the after-tax income of Americans working abroad. In some cases employers would increase compensation to retain American employees, but in other cases employers would not raise compensation levels. In either case there would likely be a reduction in Americans working abroad because: (1) Americans would be less willing to accept foreign assignments if after-tax compensation falls; (2) employers would have an incentive to substitute lower cost non-U.S. workers to the extent that the cost of employing Americans abroad increases.

Empirical evidence suggests that this was the case when Congress repealed Section 911 in 1978. To assess the effects of the 1978 Act, the General Accounting Office conducted a survey in 1980 of 33 major firms in four industries and found that:

"The major U.S. firms we surveyed reported to us that this cost differential [additional tax cost attributable to the 1978 Act] was a major reason why they have decreased their employment of Americans overseas ... Employment abroad by the firms decreased absolutely from 1979 to 1980 in three of these industries. Further, the relative number of Americans in overseas positions decreased compared with TCNs [third country nationals] from 1976 to 1980 in all of these industries."⁴

Limiting the housing exclusion could effectively eliminate it. As passed by the Senate in 2004, further limiting the housing exclusion to the excess, if any, of the cap on the general exclusion over foreign earned income, could effectively eliminate the exclusion for many overseas workers. For example, the housing exclusion of a taxpayer with \$75,000 of foreign earned income would have been limited to \$5,000 (\$80,000 less \$75,000), and the housing exclusion of a taxpayer with more than \$80,000 of foreign earned income would have been completely eliminated. This would be a burden in expensive housing markets, such as Japan, where the cost of living is more than 50 percent higher in Tokyo than it is in Washington, D.C.⁵ As another example, the cost of living is 30 percent higher in Jakarta, Indonesia, than it is in Austin, Texas, and this does not take into account the non-monetary costs of moving to countries where safety is a serious concern for families.

⁴ General Accounting Office, 1981, op cit., p. 28.

⁵ National Association of Realtors data available at <http://www.homestore.com/move/tools/SalaryCalcInt.asp?poe=homefair>.

Compensation levels would have to increase by as much as 18 percent if Section 911 were repealed. If the Section 911 exclusion were repealed, average compensation costs would need to increase by as much as 18 percent in some jurisdictions in order to maintain the same after-tax level of income for U.S. expatriate employees. All countries would require increases, but in Saudi Arabia, Hong Kong, and Switzerland average compensation would need to increase by more than 10 percent.

Section 911 is progressive. The tax incentive arising from Section 911 represents a larger share of the total compensation of middle income Americans working abroad than of high-income expatriates. Thus, Section 911 is progressive—providing relatively greater benefits to lower and middle income expatriates.⁶

Section 911 benefits U.S. taxpayers in low and high tax countries. The perception that Section 911 only provides an incentive to locate Americans in low-tax countries is false, because there are other factors that are often overlooked, such as: (1) countries with high tax rates may have generous deductions that reduce the effective tax rate; (2) international assignments often begin and end in mid year; and (3) U.S. source income may be taxed in lower brackets due to Section 911.

Eliminating the cap on the exclusion would reduce compensation costs. Eliminating the \$80,000 cap on the foreign earned income exclusion would *reduce* average compensation costs of Americans working abroad. The reduction is largest in Switzerland (14.2 percent), Hong Kong (12.6 percent), Saudi Arabia (11.6 percent), Singapore (10.5 percent), and Canada (10.1 percent).

C. OTHER STUDIES

1. Johns Hopkins University survey of international businesses

Survey shows Section 911 has even larger impacts. According to a survey of 148 international employers by Professors Pearson and Riedel of Johns Hopkins University School of Advanced International Studies, 88 percent of survey respondents reported that compensation costs would increase if Section 911 were repealed. The survey also found that 84 percent of respondents anticipated that prospective hires would be reduced. Profs. Pearson and Riedel found that 71 percent of respondents anticipated a reduction in U.S. expatriate employment levels if Section 911 were repealed, and by a greater amount than estimated by the PricewaterhouseCoopers Assignment Cost Projection System. The survey revealed that 85 percent of respondents believed that employee nationality has an effect on sourcing decisions, and 60 percent of these believed that there is a "large tendency" for U.S. expatriates to purchase from U.S. suppliers.

Reduced U.S. competitiveness. The Pearson-Riedel survey found that elimination of Section 911 would adversely affect U.S. companies' ability to secure projects and compete abroad: 81 percent of respondents indicated that elimination of Section 911 would reduce their foreign business and almost three-quarters of these (64 percent) described the impact as "moderate" or "major." By contrast, 65

⁶ The progressive nature of the section 911 exclusion primarily is attributed to the fixed dollar nature of the exclusion. The exclusion provides no benefit for foreign earned income in excess of the \$80,000 exclusion.

percent of respondents indicated that an *increase* in the Section 911 exclusion from \$70,000 to \$100,000 would increase their competitiveness abroad.

2. General Accounting Office

GAO Survey found reduction in the Section 911 exclusion would reduce exports. The findings of Profs. Pearson and Riedel are consistent with a 1978 General Accounting Office (GAO) survey of 183 U.S. firms employing Americans abroad. The GAO found that "Over 80 percent of the firms surveyed were of the opinion that the reduction of the foreign earned income exclusion in the 1976 Act would result in at least a 5 percent reduction of U.S. exports."⁷

Based on the apparent anti-competitive effects of the reduction in the foreign earned income exclusion in 1978, the GAO made the following recommendation:⁸

"We believe that the Congress should consider placing Americans working abroad on an income tax basis comparable with that of citizens of competitor countries who generally are not taxed on their foreign earned income ... complete exclusion or a limited but generous exclusion of foreign earned income for qualifying taxpayers ... would establish a basis of taxation comparable with that of competitor countries and, at the same time, be relatively simple to administer."

D. TAX POLICY ISSUES

Equity. Absent Section 911, Americans working abroad would pay much higher taxes than domestic workers with the same base pay. Section 911 offsets the various international assignment allowances and reimbursements that cause gross income of Americans working abroad to be taxed at a higher rate than their domestic counterparts. While Section 911 likely overcompensates some taxpayers and under compensates others, repeal of Section 911 would cause all Americans working abroad to pay more tax than domestic workers with equal ability to pay. In addition, the benefits of Section 911 are larger share of income for middle-income than for higher-paid Americans working abroad.

Efficiency. Repeal of the Section 911 exclusion would not achieve economic efficiency in the allocation of resources because there would be a greater tax penalty for assigning Americans to overseas positions. Absent Section 911, Americans working abroad would pay much higher taxes than U.S. workers with the same base pay, and employers typically would bear a large share of these added tax costs. In fact, strict adherence to the economic efficiency principle would in many cases require more generous tax relief than what is currently provided under present law.

Harmonization. Section 911 is a glaring example of the failure on the part of the United States to harmonize with international tax practice, as all other major industrial countries exempt the foreign earned income of their nationals. Decades ago, Americans may have possessed skills and experience in short supply abroad. Today, however, U.S. workers face substantial competition from technically

⁷ U.S. General Accounting Office, *Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas*, ID-78-13, February 21, 1978.

⁸ *Ibid.*

sophisticated foreign workers. The failure of the United States to harmonize the tax treatment of expatriate workers means that, from a tax standpoint, U.S. citizens are more expensive to employ abroad than the citizens of other nations. In summary, the principle of tax harmonization strongly argues for complete exclusion of foreign earned income, *i.e.*, elimination of the \$80,000 cap.

Treasury report concluded that tax expenditure estimates are misleading. The published tax expenditure estimates for Section 911 may be seriously misleading for public policy purposes. A 1993 Treasury Department report concludes that the published tax expenditure estimates do not take into account that, absent Section 911, taxpayers would be able to deduct the portion of certain expenses (e.g., moving expenses) that currently are disallowed because they are allocated to excluded income. The Treasury report further notes that, absent Section 911, U.S. employers of Americans working abroad would in many cases increase compensation to offset additional employee taxes. As a result, corporate profits would decline, causing a reduction in corporate income tax revenue. Taking into account these two offsetting factors, the Treasury Department estimated that the net revenue cost of the Section 911 exclusion is less than the published tax expenditure estimate.⁹

E. CONCLUSION

Section 911 is an important provision that was reinstated and strengthened by Congress in 1981 because repeal of Section 911 would, and did, result in fewer Americans working abroad, a loss of American jobs, and a decline in exports and in U.S. competitiveness. U.S. companies face more competition internationally than ever, and are hampered by the fact that U.S. tax system is so structurally different than that of its competitors. As observed by Karen Hughes, Under Secretary of State for Public Diplomacy and Public Affairs, in remarks to the 2005 Forum on the Future of Public Diplomacy, October 14, 2005:

"...Citizens are our very best natural asset and we've got a lot of people who really travel around the world all the time who, for example, have skills and expertise that parts of the world would like -- our teachers, our legal professionals, our science community, our technology community."

⁹ U.S. Dept. of the Treasury, *Taxation of Americans Working Overseas: The Operation of the Foreign Earned Income Exclusion in 1987*, January 1993, p. 2, 20-22.

I. OVERVIEW

The United States is the only major industrial country that does not completely exempt from taxation the foreign earned income of its citizens working abroad.¹⁰ Instead, under the provisions of Section 911 of the Internal Revenue Code, the United States permits a limited exclusion of \$80,000 per annum of foreign earned income plus certain foreign housing allowances. The principal rationale for the exclusion historically has been to make the tax treatment of Americans working abroad more competitive with that of foreign nationals and, thereby, to promote exports of U.S. goods and services.

Over the nearly 80 years that the foreign earned income exclusion has been part of U.S. law, it has been modified numerous times. On May 11, 2004, the Senate Committee on Finance passed S. 1637 which would have, among other things, limited the combination of the earned income exclusion and the housing allowance to \$80,000. More recently, on January 27, 2005, the Joint Committee on Taxation published a pamphlet that included a proposal to limit the housing exclusion and make other changes in the treatment of taxpayers with foreign earned income.¹¹ The continuing controversy reflects basic disagreements regarding the economic effects of and tax policy rationale for the foreign earned income exclusion.

This report analyzes the economic effect of Section 911 and proposed modifications and evaluates the exclusion from a tax policy perspective.¹² The following section describes the present and prior rules applicable to the taxation of Americans working abroad, reviews the types of compensation arrangements commonly used by multinational companies in connection with international assignments, and summarizes the most recent available data regarding taxpayers' utilization of the foreign earned income exclusion.

The third section of the report uses IRS data and the PricewaterhouseCoopers Assignment Cost Projection System ("ACPS") to estimate the change in the gross compensation of Americans working abroad that would be necessitated by possible modifications to Section 911. In conjunction with an econometric model of U.S. exports and expatriate employment developed by Prof. John Mutti, the projected change compensation cost is used to estimate the impact of modifications to Section 911 on employment of Americans abroad and U.S. exports.

The last section of the report evaluates Section 911 based on the traditional tax policy objectives of fairness, simplicity, and economic efficiency, as well as three criteria that are relevant for international tax provisions: international competitiveness, preservation of the U.S. tax base, and compatibility with international norms. This section concludes with a discussion of the estimated budgetary effect of Section 911 that is shown in the "tax expenditure" list published in the annual federal budget.

¹⁰ In addition to the United States, the only other country that appears to tax on the basis of citizenship rather than residence is Zambia (limited form).

¹¹ Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures", JCS-02-05 (January 27, 2005).

¹² This report updates an earlier report "Economic Analysis of the Foreign Earned Income Exclusion," released by Price Waterhouse in October 1995.

II. BACKGROUND

A. Tax Rules Applicable to Americans Working Abroad

1. Present law

Foreign Earned Income Exclusion

Unlike other major industrial countries, the United States taxes citizens and resident aliens who live abroad on their worldwide income.¹³ Limited relief is provided under Section 911 of the Internal Revenue Code, which permits an exclusion of certain foreign employment income.

Under Section 911, a U.S. citizen or resident alien who maintains a tax home outside the United States *and* who meets a "bona fide residence" or "physical presence" test during this period, may exclude from gross income up to \$80,000 per year of foreign earned income (referred to as the "general exclusion") plus a "housing cost amount". The foreign earned income exclusion is not treated as a tax preference item for purposes of the alternative minimum tax.

For purposes of Section 911, the "housing cost amount" is defined as the excess of reasonable housing costs over 16 percent of the salary of a U.S. civil servant at step one of the GS-14 pay scale as of January 1 of the taxable year (\$12,190 in 2005). Housing costs must be provided by an employer to qualify for the exclusion and included in the taxpayer's gross income. To the extent not provided by the employer, the housing cost amount is treated as a deduction allowable in computing adjusted gross income (sec. 911(c)(3)). The *deduction* for housing costs is limited to the excess of foreign earned income over the amount excluded under the general exclusion.

Foreign earned income includes wages, salaries, professional fees, and other remuneration or benefits received as compensation for services performed in a foreign country. The location where the services are performed determines whether the income is considered "foreign earned income". Foreign housing expenses are the reasonable expenses paid or incurred during a taxable year for housing in a foreign country. Housing expenses include apartment or housing rental expenses, the cost of temporary quarters, and expenses attributable to housing.

A U.S. citizen becomes a "bona fide" resident of a foreign country by establishing a tax home abroad for an uninterrupted period during an entire tax year (from January 1 through December 31). Temporary visits to the United States or elsewhere for vacation or business will *not* disrupt the establishment of a bona fide residence. Once bona fide residence is established, the taxpayer is eligible to claim the entire \$80,000 exclusion, without reduction for days spent in the U.S. on temporary visits, for each full tax year abroad. Individuals who make a declaration of nonresidence to

¹³ See, Hale E. Sheppard, "The Impact of Recent Events on the U.S. Foreign Earned Income Exclusion: Rocking the Boat or Capsizing the Vessel," *Tax Notes International*, April 19, 2004; and Government Accountability Office, "IRS Activities to Increase Compliance of Overseas Taxpayers," GAO/GGD-93-93, May 1993. Available at <http://archive.gao.gov/t2pbat6/149177.pdf>.

the authorities of a foreign country, with the result that they are taxed there as nonresidents, are precluded from qualifying for the exclusion under the bona fide residence test.

Alternatively, individuals may qualify under the "physical presence" test. A U.S. citizen or resident alien meets the physical presence test by being physically present and having a tax home in a foreign country (or countries) for at least 330 full days during any period of 12 consecutive months. In applying the physical presence test, any period of 12 months may be used as long as they are consecutive. In counting days physically present in a foreign country, only whole days are considered; therefore, the days of arrival in and departure from a foreign country do not count as days of presence. Under this test, a taxpayer is only able to claim the foreign earned income exclusion for each day spent abroad.

In addition to meeting either the bona fide residence or physical presence test, an individual's tax home must be in a foreign country during the bona fide residence or physical presence period. In general, a tax home is the location of one's principal place of employment. However, a tax home cannot be in a foreign country for any period during which an individual maintains an abode (*i.e.*, the place where the person is actually living) in the United States. The location of one's tax home is not affected by temporary absences from the principal place of employment. For example, business trips to the United States or the maintenance of a dwelling unit in the United States would not result in a change in tax home from the location of principal employment to the United States. Also, an individual may have a tax home separate from that of a spouse. However, an extended stay in the United States may cause a shifting of an individual's abode to the United States and result in disqualification from electing the foreign earned income exclusion.

Disallowance of double benefits

Taxpayers with both U.S. and foreign source income must allocate tax deductions between U.S. and foreign income. Deductions related to foreign income are further allocated between income that is excluded from U.S. income tax as a result of the foreign earned income exclusion and other deductions. Deductions allocated to excluded income are disallowed. Examples of deductions that may be disallowed as a result of this rule include: moving expenses, employee business expenses, state income taxes, and foreign taxes claimed as a deduction. The disallowance of deductions is based on the following formula:

$$\text{Disallowed deductions} = \frac{\text{Excluded income}}{\text{Qualifying earned income}} \times \text{Deductions related to foreign income}$$

For example, assume an individual has \$120,000 of foreign earned income, a \$90,000 exclusion under Section 911 for foreign earned income and housing allowances, and \$24,000 of moving expenses. Under the disallowance formula, \$18,000 of this individual's moving expenses would be disallowed as a deduction as they are allocable to excluded income:

$$\$18,000 = \frac{\$90,000}{\$120,000} \times \$24,000$$

Other deductions, such as medical expenses, real estate taxes, mortgage interest, alimony payments, charitable contributions, the housing cost deduction, and deductions for personal exemptions are *not* considered allocable to excluded income and, therefore, are *not* subject to disallowance.

Exclusion is disregarded in determining phase-out of many tax benefits

Many individual tax benefits provided in the Code are limited on the basis of modified adjusted gross income, a concept that adds back income excluded under Section 911. As a result of allowances and reimbursements associated with a foreign assignment, employees may lose a number of tax benefits that they otherwise would enjoy, including:

- Adoption expenses credit (Code sec. 23)
- Child tax credit (Code sec. 24)
- Hope and lifetime learning credit (Code sec. 25A)
- Elective deferrals and IRA contributions (“savers”) credit (Code sec. 25B)
- Exclusion of income from U.S. savings bonds used to pay higher education tuition and fees (Code sec. 135)
- Exclusion of adoption assistance (Code sec. 137)
- Deduction of interest on education loans (Code sec. 221)
- Deduction of qualified tuition and related expenses (Code sec. 222)
- Coverdell education savings accounts (sec. 530)
- First-time homebuyer credit for District of Columbia (Code sec. 1400C)

In addition, income excluded under Section 911 is taken into account in modified adjusted gross income for purposes of phasing in the taxation of social security benefits.

Foreign tax credits

A U.S. taxpayer residing in a foreign country is generally subject to the tax laws of that country. Because income could potentially be subject to both U.S. and foreign tax, the United States allows, subject to limitation, a credit against its tax for income taxes paid to a foreign country.

A foreign tax credit (“FTC”) may be claimed only for foreign income taxes, including, in many cases, foreign social security taxes unless there is a totalization agreement with the country imposing social security taxes. Foreign taxes withheld on interest, dividends, or other similar types of gross income are also eligible for the FTC. Other foreign taxes, such as real estate taxes and value-added taxes, may not be claimed as an FTC.

The FTC is limited to the portion of U.S. tax related to foreign source income. Therefore, the amount of the FTC in a given year is the lesser of: (1) eligible foreign taxes paid or accrued; or (2) the amount computed under the FTC limitation formula:

$$FTC \text{ limitation} = \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income before personal exemption}} \times \text{U.S. tax liability}$$

Special rules provide that foreign taxes levied on income that has been excluded from U.S. tax cannot be claimed as foreign tax credits. Such taxes are disallowed as credits based on the following formula

$$\text{Disallowed foreign taxes} = \frac{\text{Excluded foreign - earned income less allocable expenses}}{\text{Total foreign - earned income less allocable expenses}} \times \text{Foreign income taxes}$$

For example, assume the same taxpayer, as in the previous example, incurred \$30,000 of foreign income taxes attributable to his \$120,000 of foreign earned income. As a result, \$22,500 of the

$$\$22,500 = \frac{\$90,000 - \$18,000}{\$120,000 - \$24,000} \times \$30,000$$

taxpayer's foreign income taxes would be disallowed based upon the following formula:

Because the income tax rates in many foreign countries are in excess of the rates of tax in the United States, in many cases, only a portion of foreign taxes paid may be credited against U.S. tax in a particular tax year. Any resulting "excess" foreign taxes may be carried back one year and utilized against any unused FTC limitation existing in that year. Any taxes remaining after the "carryback" may be carried forward for a period of 10 years.¹⁴

Foreign income taxes claimed as credits against U.S. tax may reduce only the U.S. tax on the *same category* or item of gross income giving rise to the foreign tax. For example, foreign tax imposed on earned income may not be used to reduce U.S. income tax on passive income, such as dividends, interest or capital gains.

¹⁴ Prior to the enactment of "The American Jobs Creation Act of 2004," the FTC carryback and carryforward periods were two and five years, respectively.

Source of income and expense allocation rules

The numerator of the FTC limitation fraction is gross income from foreign sources less deductions attributable to that income. Classification of income as U.S. or foreign source can greatly affect the FTC calculation. This classification is made in accordance with the rules indicated below in Table II.1. It should be noted that the place of payment or receipt of income is generally irrelevant for purposes of determining the source of the income.

Table II.1.--Income Source Rules

Type of income	Source of income
Compensation	Where services are performed.
Dividends and interest	Generally, the place of residence or organization of the payer. However, the rules vary depending upon the type of interest/dividend and the payer's amount of income-earning activity within the United States.
Rents from the lease of tangible property	Where property is located.
Royalties from the lease of intangible property (such as patents; copyrights, secret processes and franchises).	Where property is used.
Gains from real property	Where the property is located.
Gains from personal property	Generally the residence of the seller.

Gains from sales of stock or securities by individuals qualifying for the foreign earned income exclusion may be foreign source income. Foreign source treatment applies provided an individual's tax home is in a foreign country and a foreign income tax of at least 10 percent of the gain is paid to a foreign country. Otherwise, the gain will be entirely U.S. source. Under these source rules, neither the location of the property nor the place of sale has a bearing on the source of income from the sale. It should be noted, however, that gain from the sale of real estate is sourced based on where the real estate is located.

Once foreign source gross income has been determined, the final step in calculating the numerator of the foreign tax credit limitation formula is to allocate and/or apportion deductions against such income to arrive at net foreign source taxable income. Deductions that must be allocated and/or apportioned include both adjustments in arriving at adjusted gross income, such as IRA contributions and moving expenses, and itemized deductions, such as contributions and interest.

The allocation and apportionment of deductions is generally governed by the factual relationship between the deduction to be allocated and the income to which it relates. For example, expenses related to compensation are allocated against that category of income. Such expenses may include deductions for unreimbursed business travel and entertainment expenses. However, it may be that some of the travel expenses are incurred solely in connection with business trips to the United States.

If so, these expenses would be allocated directly to U.S.-source income earned during the U.S. business trips.

If there is no direct relationship between a deductible expense and an item of gross income, the deduction is ratably apportioned among the various items of the taxpayer's gross income. Deductible expenses that are often subject to apportionment in this manner include charitable contributions, and certain taxes on non-business, non-income-producing property.

2. Prior law

Originally unlimited for bona fide residents of a foreign country, the foreign earned income exclusion has been part of the Internal Revenue Code since 1926. Table II.2 summarizes the amount of the exclusion from 1926 through 2008 and beyond.

In 1926, the foreign earned income exclusion was enacted under Section 213(b)(14). There was no limit on the exclusion; it applied to earned income derived and received from sources outside of the United States provided that certain residency requirements were met.¹⁵ In 1953, the exclusion was first limited to a set dollar amount of \$20,000.¹⁶ In 1962, the exclusion was limited for bona fide residents to \$20,000 for the first three years abroad and \$35,000 per year thereafter. In 1965, the limitation for bona fide residents was changed to \$20,000 for the first three years abroad and \$25,000 per year thereafter.

The Tax Reform Act of 1976, which was to apply retroactively to the 1976 calendar year, would have reduced the exclusion to \$15,000 (\$20,000 for employees of certain qualifying charitable organizations). Prior to taking effect, however, the effective date of the 1976 changes was delayed to January 1, 1977. In 1977, both the House and Senate approved a second extension of the effective date of the 1976 changes to January 1, 1978.

¹⁵ In 1928, section 213(b)(14) was redesignated as section 116(a).

¹⁶ In 1954, section 116(a) was redesignated as Section 911(a).

Table II.2. -- History of Foreign Earned Income Exclusion

Years	Limitations on Foreign Earned Income Exclusion
1926-1952	Unlimited
1953-1961	\$20,000
1962-1964	\$20,000 (\$35,000 after 3 years)
1965-1977 ^a	\$20,000 (\$25,000 after 3 years)
1978-1981	Deduction based on excess foreign living costs (\$15,000 election in 1978)
1982	\$75,000
1983-1986	\$80,000
1987-1997	\$70,000
1998	\$72,000
1999	\$74,000
2000	\$76,000
2001	\$78,000
2002-2007	\$80,000
2008 and beyond	\$80,000 indexed for inflation

^a The Tax Reform Act of 1976 generally reduced the exclusion to \$15,000; however, these provisions never took effect.

The Foreign Earned Income Act (FEIA) of 1978 repealed the foreign earned income exclusion under Section 911 and replaced it with a new set of deductions under Section 913. Under Section 913, U.S. citizens who were bona fide residents of a foreign country for an entire taxable year who were present in a foreign country for 17 out of 18 months were entitled to a deduction made up of 5 factors:

1. **Cost-of-living differential.** The excess of the cost-of-living in a foreign location over the highest cost-of-living in any U.S. metropolitan area.
2. **Housing expenses.** The excess of an individual's "housing expenses" (including utilities and insurance but *not* mortgage interest and taxes which were otherwise deductible) over a base housing amount. The base housing amount was equal to 20 percent of the excess of the individual's earned income over the sum of the individual's allowances, including housing expenses, cost-of-living differential, school expenses, home leave, hardship area deduction, *etc.* (*i.e.*, one-sixth of net earned income).
3. **Schooling expenses.** A deduction was available for actual costs of tuition, fees, books and local transportation where an adequate U.S.-type school was *not* available within a reasonable commuting distance of the individual's foreign home.
4. **Home leave travel expenses.** An individual could deduct the actual cost of an annual round trip for the expatriate, spouse, and each dependent from the location of the individual's foreign tax home to the principal residence in the U.S.

5. **Hardship area deduction.** An individual could deduct \$5,000 per year, computed on a daily basis, when located in a hardship area.

For 1978, taxpayers could elect the provisions of the 1976 Act (*i.e.*, a \$15,000 or \$20,000 exclusion) or the exclusion as computed under the 1978 Act.

The Economic Recovery Tax Act of 1981 restored the original structure of the foreign earned income exclusion in Section 911 and increased the amount from \$20,000 to \$75,000 per year for 1982, with scheduled increases to \$95,000 in 1986. The legislative history indicates that Congress was concerned that the rules enacted in 1978 made it more expensive to hire Americans abroad as compared to foreign citizens, reduced exports, made U.S. business less competitive abroad, and were so complex that many Americans employed abroad found it necessary to use professional tax preparers.¹⁷

Among a number of other deficit reduction measures, the Deficit Reduction Act of 1984 delayed the scheduled increases in the foreign earned income exclusion, freezing the benefit at \$80,000 (the 1983 benefit level) through 1987. The Tax Reform Act of 1986 later reduced the exclusion to \$70,000 beginning in 1987. The exclusion remained at this level through 1997 when the Taxpayer Relief Act of 1997 increased the exclusion to \$80,000 in increments of \$2,000 beginning in 1998. Furthermore, beginning in 2008, the exclusion for foreign earned income will be adjusted for inflation. Thus, for any calendar year after 2007, the exclusion amount will be equal to \$80,000 times the cost-of-living adjustment for that year. The cost-of-living adjustment will be calculated using the methodology that adjusts the income brackets in the tax rate schedules (Section 1(f)(3) of the Internal Revenue Code).¹⁸

B. Compensation Arrangements for International Assignments

When an employee goes on an international assignment, the employee typically is paid a number of allowances, in addition to base salary, to compensate for the additional costs of the assignment. A typical compensation package for a married employee with children who goes overseas would include the following:

- Base salary
- International service premium
- Education allowance

¹⁷ Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981*, JCS-71-81, December 20, 1981, p. 43.

¹⁸ The Consumer Price Index for all urban consumers (CPI-U) that is published by the Department of Labor will be used to determine the adjustment. Specifically, the cost-of-living adjustment for a calendar year will equal the CPI-U for the preceding calendar year divided by the CPI-U for calendar year 2006 (the base year). The Internal Revenue Code further specifies that, in making this calculation, the CPI-U for a calendar year is to be calculated as the average of the CPI-U as of the close of the 12-month period ending August 31 of such calendar year. Finally, the Taxpayer Relief Act of 1997 stipulates that if the adjusted exclusion amount is not a multiple of \$100, then it is to be rounded to the next lowest multiple of \$100.

- Cost-of-living allowance ("COLA")
- Employer paid housing
- Assignee and family home leave
- Employer paid moving expenses
- Excess tax reimbursement

The international service premium typically is paid to reward the employee for accepting the international assignment. Educational allowances are paid to cover the cost of schooling for the assignee's children. The COLA is paid to cover the additional cost of the purchase of day-to-day living items. The COLA is determined by comparing what it costs to purchase a market basket of goods in the foreign location versus what it would cost to purchase the same goods in the United States. Employer-provided housing generally includes amounts paid for rental of housing, furniture, and accessories, expenses attributable to housing such as repairs and utilities, residential parking, and insurance. In certain situations an employer may pay mortgage interest and taxes where an assignee purchases a home.¹⁹ Assignee and family home leave allowance typically includes round-trip airfare for the assignee and his family for one trip to the U.S. per year. Employer paid moving expenses will generally include the cost of airfare for the assignee and family, shipment of household goods, storage of household items that remain in the U.S., temporary living expenses incurred in the new location, and possibly assistance with the costs associated with selling the assignee's residence in the U.S. Some employers also provide an assignee with a lump-sum relocation allowance upon the return move to the U.S. Hardship premiums may also be provided for assignments in certain locations.

In most cases, overseas employees of major U.S. companies are also reimbursed for any additional tax burdens resulting from their assignments. In 1978, the General Accounting Office surveyed 50 U.S. companies and 160 foreign affiliates of U.S. companies in 11 countries. This survey found that 77 percent of the respondents reimburse their American employees for all or part of the additional taxes incurred as a result of living abroad.²⁰ In a 1981 survey, the General Accounting Office found that 39 out of 41 companies responding reported providing tax reimbursement payments to American employees assigned on a long-term basis. Approximately three-fourths of respondents also provided tax reimbursement payments to their third-country national employees.²¹

Under a tax protection policy, the employer agrees to reimburse an employee for an "excess tax cost" associated with undertaking a foreign assignment. In the case of a U.S. national, the employee's share of the total tax burden is computed on a "stay-at-home" basis and the employer reimburses the employee for tax costs in excess of the stay-at-home tax. Of the total compensation paid, which typically includes allowances as discussed above, only the base salary amount (and often bonus) is taken into account in computing the stay-at-home tax. Thus, the employer bears the tax cost associated with the taxable assignment benefits. Under a tax equalization policy, the employer adjust

¹⁹ To the extent these amounts are deductible, they are not eligible for the housing exclusions under Section 911.

²⁰ General Accounting Office, *Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas*, ID-78-13, February 21, 1978, p. 28-32.

²¹ General Accounting Office, *American Employment Abroad Discouraged by U.S. Income Tax Laws*, ID-81-29, February 27, 1981, pp. 18-19.

compensation up or down to take into account both increases and decreases in the employee's total tax burden as a result of undertaking a foreign assignment.

C. Utilization of Section 911 Exclusion

Under the reporting requirements originally enacted in 1978, the Treasury Department is required to report periodically on the operation and effect of the foreign earned income exclusion and the foreign tax credit. The most recent report, issued in the Spring 2004 *SOI Bulletin*, is based on an analysis of tax returns for income earned in 2001.

The Treasury report indicates that about 294,763 taxpayers claimed the foreign earned income exclusion on timely filed returns for 2001. The total Section 911 exclusion increased at an average annual rate of 2.7 percent per year over the 1996-2001 period, from \$14.0 billion to \$16.0 billion, as compared to foreign earned income which increased by 5.2 percent per year over the period (See Table II.3).

Over the 1996-2001 period, the average amount of foreign earned income per return increased from \$75,500 to \$93,000 and the average Section 911 exclusion increased from \$50,200 to \$54,600; consequently, the foreign earned income exclusion declined from 66.5 percent to 58.6 percent of reported foreign earned income over the period. Although the Section 911 exclusion was increased over this period, from \$70,000 in 1996 to \$78,000 in 2001, it has not increased at the same pace as compensation paid to employ Americans working abroad. The housing exclusion also has expanded much more slowly than the foreign earned income exclusion over the 1996-2001 period (0.4 percent versus 3.1 percent).

Table II.3. -- Comparison of Section 911 Returns: 1991, 1996, and 2001

[Money amounts in thousands]

Item	1991	1996	2001	Average annual percent change		
				1991-96	1996-2001	1991-2001
Returns with Section 911	220,165	279,758	294,763	4.9%	1.1%	3.0%
Foreign earned income	\$13,748,634	\$21,116,034	\$27,420,096	9.0%	5.4%	7.1%
<u>Section 911 exclusion</u>	\$10,743,696	\$14,046,890	\$16,081,207	5.5%	2.7%	4.1%
Foreign earned income	\$9,697,339	\$12,090,833	\$14,073,789	4.5%	3.1%	3.8%
Housing exclusion	\$1,002,847	\$1,880,610	\$1,915,344	13.4%	0.4%	6.7%
Housing deduction	\$43,510	\$75,447	\$92,074	11.6%	4.1%	7.8%
Average foreign earned income per return	\$62.4	\$75.5	\$93.0	3.9%	4.3%	4.1%
Average Section 911 exclusion per return	\$48.8	\$50.2	\$54.6	0.6%	1.7%	1.1%
Exclusion as percent of foreign earned income	78.1%	66.5%	58.6%	-3.2%	-2.5%	-2.8%

Sources: U.S. Dept. of the Treasury, "Individual Foreign Earned Income and foreign Tax Credit, 1991." SOI Bulletin, Fall 1994, p. 117.

U.S. Dept. of the Treasury, "Individual Foreign Earned Income and foreign Tax Credit, 1996." SOI Bulletin, Summer 1999, p. 136.

U.S. Dept. of the Treasury, "Individual Foreign Earned Income and foreign Tax Credit, 2001." SOI Bulletin, Summer 2004, p. 98.

PwC Calculations.

III. ECONOMIC EFFECTS OF POSSIBLE MODIFICATIONS TO SECTION 911

This section describes three possible modifications to the taxation of foreign earned income, describes the methodology for estimating the economic effects of these modifications, and summarizes the results of the economic analysis.

A. Section 911 Scenarios

The foreign earned income exclusion modifications considered in this report are: (1) repeal the foreign earned income exclusion; (2) further limit the housing allowance exclusion; and (3) remove the cap on the foreign earned income exclusion. Each of these scenarios is described below.

Repeal Foreign Earned Income Exclusion

Under Section 911, qualified Americans working abroad may exclude up to \$80,000 per year of foreign earned income plus a housing cost allowance. Foreign taxes paid with respect to excluded income may not be claimed as a foreign tax credit, and certain otherwise deductible expenses attributable to excluded income (*e.g.*, moving expenses) are treated as nondeductible.

Repeal of Section 911 would result in U.S. taxation of all foreign earned income and foreign housing allowances of Americans working abroad. One consequence of Section 911 repeal is that the taxpayer's income from sources other than foreign employment (*e.g.*, investment income) may be taxed in a higher income tax bracket. Taxpayers would be eligible to credit foreign taxes paid (if any) with respect to foreign income not eligible for exclusion, subject to the foreign tax credit limitation. In addition, expenses allocable to foreign income not eligible for exclusion would be deductible for U.S. income tax purposes.

Further Limit Housing Allowance Exclusion

The Jumpstart Our Business Strength Act (S. 1637), as passed by the Senate on May 11, 2004, included a provision (Sec. 632(c)) that effectively would have further limited the present law exclusion for foreign housing allowances. This provision, which was dropped in conference, would have limited the housing exclusion to the excess, if any, of the general exclusion cap (currently \$80,000) over foreign earned income. For example, the housing exclusion of a taxpayer with \$75,000 of foreign earned income would have been limited to \$5,000 (\$80,000 less \$75,000), and the housing exclusion of a taxpayer with more than \$80,000 of foreign earned income would have been completely eliminated.

Remove Cap on Foreign Earned Income

The third scenario considered in this report is an elimination of the cap on the exclusion of foreign earned income (currently \$80,000). Under this option the present law foreign housing cost allowance is retained. As under present law, expenses allocated to excluded foreign income would be nondeductible and foreign taxes imposed on excluded foreign income would not be creditable.

B. Methodology

1. Effect of Section 911 on Compensation Costs

Any change in the foreign-earned income exclusion would affect the U.S. tax liability of Americans working abroad. For example, repeal of Section 911 would increase the level of compensation required to maintain the after-tax income of Americans working abroad. In some cases employers would increase compensation to retain American employees, but in other cases employers would not raise compensation levels. In either case, there would likely be a reduction in Americans working abroad, because: (1) Americans would be less willing to accept foreign assignments if after-tax compensation falls; and (2) employers would have an incentive to substitute lower cost non-U.S. workers to the extent that the cost of employing Americans abroad increases.

In this study, the effect of Section 911 changes on the compensation of Americans working abroad is computed assuming the worker is tax equalized, i.e., that the worker's after-tax income (net of the allowances provided for the additional costs occasioned by the foreign assignment) is held constant by the employer. In theory, tax equalization allows the worker to enjoy the same standard of living as if employed in the United States.

To estimate the effect of possible modifications to Section 911 on the gross cost of compensating Americans working abroad, it is necessary to take into account taxpayer-specific factors (*e.g.*, marital status, number of dependents, etc.) as well as U.S. and foreign income tax rules. To make these complex tax calculations, the PricewaterhouseCoopers Assignment Cost Projection System ("ACPS") was utilized.

Assignment Cost Projection System

The Assignment Cost Projection System was developed to assist U.S. companies in budgeting for assignment costs and tax planning. The ACPS projects total assignment costs, including home- and host-country tax reimbursements.²²

The ACPS contains detailed information on the income tax systems of the United States and over fifty other countries in which a multinational may choose to locate an expatriate. The reliability of this system has been demonstrated through years of use by major multinational corporations.

The ACPS requires the following taxpayer-specific information for purposes of making projections:

1. Base salary
2. Country of assignment
3. Length of assignment
4. Average annual exchange rates
5. Gross-up method for reimbursement of foreign taxes

²² In the report, U.S. state and local income taxes are not considered in the home-country tax calculations.

6. Equalization method
7. Itemized and standard deductions
8. Hardship premium
9. International service premium
10. Education allowance
11. Cost-of-living allowance
12. Employer-paid housing allowances
13. Transportation and moving costs
14. Estimated outside income
15. Filing status and family size
16. Assignee home leave
17. Family home leave

For purposes of this report, profiles were developed for representative taxpayers at four income levels in 10 countries.

The starting point for the development of these profiles was a tabulation of the 2001 Form 2555 (Foreign Earned Income) from the Statistics of Income ("SOI") Division of the Internal Revenue Service (see below).

The IRS data was supplemented with information from a variety of sources to complete the taxpayer profiles used in the ACPS analysis. The methodology used for determining these taxpayer profiles is described in Appendix A.

IRS data

For purposes of this report, the IRS Statistics of Income Division tabulated five items from the most recently filed (2001) Form 2555 by income class in each of 10 countries. The five tabulated items are:

1. Total foreign source wages, salaries, bonuses, commissions, *etc.* [Form 2555, Line 19];
2. Allowances, reimbursements, *etc.* including cost of living and overseas differential, family allowance, education allowance, home leave allowance, and temporary quarters [Form 2555, Line 22g];
3. Annualized qualified housing expenses [Form 2555, Line 28];
4. Total foreign earned income (wages and other income for personal services performed abroad, plus non-cash employer benefits, plus allowances, less meals and lodging furnished by the employer) [Form 2555, Line 26]; and
5. Net exclusion (housing exclusion plus foreign earned income exclusion less deductions allocable to excluded income) [Form 2555, Line 43].

The 10 countries for which detailed data were provided by the IRS are shown in Table III.1., below. According to the IRS data, these countries were the source of the largest amount of foreign earned income in 2001, accounting for two-thirds of the foreign wage and salary income reported on Form 2555 (Foreign Earned Income).

The IRS also provided PricewaterhouseCoopers with tabulations by income class for all joint filers living abroad during the entire 2001 tax year, including various items from Form 1040 (U.S. Individual Income Tax Return) and Form 2555.

Using IRS data for the top 10 countries and 4 income classes, a total of 40 (10 times 4) tax profiles were developed for representative taxpayers electing the Section 911 exclusion. As discussed below, the effect of Section 911 changes on these taxpayers was determined using the Assignment Cost Projection System.

Table III.1. -- 2001 Individual Tax Returns with Form 2555

[Ranked by salary and wages]

Country	Returns	Salaries and Wages Reported on Form 2555	Percent	
			Returns	Salaries and Wages
United Kingdom	33,344	3,082,486	11.3%	18.2%
Canada	24,790	1,355,266	8.4%	8.0%
Japan	24,578	1,168,248	8.3%	6.9%
Hong Kong	12,476	1,101,230	4.2%	6.5%
Germany	23,432	730,742	7.9%	4.3%
Saudi Arabia	7,449	658,052	2.5%	3.9%
Singapore	4,624	473,203	1.6%	2.8%
Switzerland	6,370	461,805	2.2%	2.7%
France	8,975	448,932	3.0%	2.7%
China	5,103	377,886	1.7%	2.2%
<i>Subtotal</i>	151,141	9,857,850	51.3%	58.2%
Other Countries	143,622	7,082,784	48.7%	41.8%
<i>Total</i>	294,763	16,940,634	100.0%	100.0%

Source: Internal Revenue Service, SOI Bulletin, Summer 2004, p. 112-113.

ACPS simulations

Assuming tax equalization, the ACPS model was used to calculate the total assignment cost for 40 hypothetical workers (10 countries and four income classes) under present law as well as three possible modifications to Section 911. The ACPS model was run using 2004 law and was based on 2001 IRS data adjusted to 2004 levels using the Consumer Price Index (see Appendix A for details).

The percentage change in assignment costs under each possible modification to Section 911 was determined for each of the 40 representative assignees and then weighted to be representative of all taxpayers filing returns with Form 2555 (Foreign Earned Income).²³

2. Employment and Export Effects

This report relies on an econometric model developed by Prof. John Mutti to estimate the effects of possible modifications to Section 911 on the number of Americans working abroad and on the level of U.S. exports. Prof. Mutti's model was first released as a U.S. Treasury Department research paper and subsequently was published in the *Southern Economic Journal*.²⁴ The Mutti model is described below.

The Mutti Model

Prof. Mutti's econometric model simultaneously estimates the market for U.S. exports and the market for Americans working abroad. These markets are inter-related because U.S. exports depend on the number of Americans abroad, and the demand for Americans in foreign labor markets itself depends upon U.S. exports. The structure of the Mutti model allows a direct examination of the effects of modifying Section 911 on the number of Americans working abroad and the level of U.S. exports.

The Mutti model has three equations: (1) the demand for U.S. employees abroad; (2) the supply of U.S. employees abroad; and (3) the demand for U.S. exports. The demand for U.S. employees abroad is modeled as depending on U.S. exports and wage levels. The supply of Americans willing to work abroad is influenced by a measure of U.S. cultural ties to a given country (as represented by tourism) and the net-of-tax wage. The demand for U.S. goods in other countries is a function of foreign per capita income, tariffs and transportation costs, foreign production capacity, foreign R&D expenditures, and the number of U.S. expatriates in the country.

The Mutti model was estimated over a sample consisting of U.S. exports of 14 industrial goods to 26 countries in 1974, using tax data for 1975.²⁵ The industries were selected to reflect U.S. goods with both strong and weak market positions abroad. The countries include all major industrial countries and major developing countries.

The estimated coefficients from the Mutti model imply that a 1.00 percent increase in compensation costs reduces demand for Americans employed abroad by 0.39 percent.²⁶

²³ As described in Appendix B, these percentages were weighted by the aggregate amount of wages and allowances reported on Form 2555 for taxpayers within the corresponding income classes and countries.

²⁴ John H. Mutti, "The American Presence Abroad and U.S. Exports," *Southern Economic Journal*, Vol. 47, 1, (July 1980) pp. 40-50. See also, U.S. Treasury Department, OTA paper 33, (October 1978) with the same title and author.

²⁵ Service industries, where labor costs are particularly important, could not be included in Mutti's analysis because the necessary data was not available. Prof. Mutti excluded agricultural products because trade appeared to depend more on government restrictions and subsidies than on market factors.

²⁶ Prof. Mutti interprets this result as providing an upper-bound estimate of the responsiveness of Americans living abroad to changes in after tax wages. However, as discussed in section III.D., a survey by Profs. Pearson and Riedel finds that the sensitivity to taxes of Americans employed abroad is greater than that found by Prof. Mutti.

The estimated coefficients from the Mutti model also imply that a 1.00 percent increase in average compensation costs of Americans working abroad results in a 0.26 percent reduction in U.S. exports. Prof. Mutti offers several explanations for the empirical results linking Americans working abroad and U.S. exports. First, Americans living abroad tend to purchase U.S. made goods both for personal consumption and for their businesses. Second, Americans living abroad increase foreign purchases of U.S. goods by setting an example for foreign nationals. Finally, Americans living abroad may be directly engaged in marketing U.S. made goods in foreign markets.

Domestic Employment Associated with U.S. Exports

According to the U.S. Department of Commerce, exports of manufactured goods totaled \$640.2 billion in 2001 and supported 7.5 million jobs. Thus, 11,542 domestic jobs were supported per billion dollars of manufactured exports in 2001.²⁷ Adjusting for changes in labor productivity and wages, we estimate that each billion dollar of manufactured exports supported 9,531 domestic jobs in 2004. This figure is used to estimate the number of U.S. jobs that would be affected as a result of changes in U.S. manufactured exports caused by modifications of Section 911.

C. Results

1. Change in Compensation Costs

As discussed section B, above, the PricewaterhouseCoopers Assignment Cost Projection System was used to calculate the change in total compensation costs for 40 representative taxpayers under three possible modifications to Section 911. Based on 2004 law and assuming full tax equalization, Table III.2a shows the percentage change in total compensation costs for representative taxpayer under each of the three Section 911 scenarios. The corresponding dollar change in total compensation costs are shown in Table III.2b.

Repeal of Section 911

If the Section 911 exclusion were to be repealed, total compensation costs for 2004 would need to increase by an average of 4.4 percent in order to maintain the same after-tax level of income for U.S. expatriate employees. The required increase in total compensation varies across countries but is generally higher in low-tax jurisdictions such as Saudi Arabia (17.9 percent) and Hong Kong (10.5 percent). However, Section 911 provides benefits in most major industrialized countries despite their

²⁷ U.S. Dept. of Commerce, *Export-Related Jobs, 2001* and U.S. Department of Commerce, *U.S. Foreign Trade Highlights*. Both reports are available at: <http://www.ita.doc.gov/TD/Industry/OTEA/>

Table III.2a--Effect of Section 911 Modifications on Total Compensation Cost, 2004

[Percentage change in total compensation cost assuming full equalization]

Base Compensation ¹	Country										All Countries
	Canada	China	France	Germany	Hong Kong	Japan	Saudi Arabia	Singapore	Switzerland	United Kingdom	
<i>Scenario 1. Repeal Foreign Earned Income Exclusion</i>											
\$60,241	1.38%	1.01%	0.80%	1.04%	12.87%	7.52%	17.85%	10.31%	13.98%	0.91%	6.40%
\$75,095	1.29%	0.90%	0.76%	0.75%	13.00%	8.64%	18.77%	8.84%	13.50%	0.79%	6.69%
\$117,932	1.01%	0.89%	0.45%	0.71%	14.31%	7.39%	19.05%	13.43%	13.64%	0.60%	7.25%
\$246,245	3.67%	0.17%	0.18%	0.15%	7.93%	0.99%	9.97%	5.09%	7.03%	0.23%	2.06%
All income	2.47%	0.53%	0.49%	0.66%	10.53%	4.20%	17.93%	8.52%	11.02%	0.38%	4.38%
<i>Scenario 2. Further Limit Housing Allowance Exclusion</i>											
\$60,241	0.25%	0.11%	0.16%	0.16%	3.37%	0.38%	2.42%	0.50%	1.08%	0.45%	0.94%
\$75,095	0.18%	0.35%	0.25%	0.11%	5.22%	1.72%	3.34%	2.64%	2.18%	0.32%	1.69%
\$117,932	0.17%	0.39%	0.14%	0.15%	7.02%	3.02%	3.89%	4.70%	2.85%	0.25%	2.27%
\$246,245	0.66%	0.08%	0.07%	0.05%	5.16%	0.63%	3.33%	2.51%	3.01%	0.13%	1.04%
All income	0.44%	0.20%	0.13%	0.12%	5.13%	1.14%	3.32%	3.00%	2.40%	0.18%	1.35%
<i>Scenario 3. Eliminate Cap on Foreign Earned Income Exclusion</i>											
\$60,241	-2.05%	-1.96%	-2.42%	-2.17%	-2.07%	-2.12%	-3.16%	-1.88%	-2.87%	-1.63%	-2.21%
\$75,095	-3.91%	-3.30%	-3.77%	-3.84%	-4.53%	-3.65%	-7.53%	-3.41%	-6.53%	-2.56%	-4.15%
\$117,932	-5.91%	-4.74%	-5.04%	-5.21%	-9.16%	-5.08%	-14.96%	-7.08%	-12.05%	-3.89%	-7.10%
\$246,245	-16.84%	-8.79%	-8.49%	-9.34%	-19.22%	-7.82%	-31.78%	-16.59%	-24.83%	-6.58%	-10.73%
All income	-10.06%	-6.40%	-5.45%	-5.22%	-12.55%	-5.78%	-11.55%	-10.51%	-14.21%	-5.53%	-7.81%

¹ 2001 amounts inflated to 2004 dollars.

Source: PwC calculations.

Table III.2b--Effect of Section 911 Modifications on Total Compensation Cost, 2004

[Dollar change in total compensation assuming full equalization]

Base Compensation ¹	Country										Average of All Countries
	Canada	China	France	Germany	Hong Kong	Japan	Saudi Arabia	Singapore	Switzerland	United Kingdom	
<i>Scenario 1. Repeal Foreign Earned Income Exclusion</i>											
\$60,241	1,601	1,597	1,519	1,774	25,353	11,662	26,139	14,877	20,961	1,528	10,701
\$75,095	2,003	2,200	2,000	1,742	34,530	21,194	36,078	17,480	27,336	2,263	14,682
\$117,932	2,298	3,321	1,782	2,560	57,294	30,316	55,080	41,359	42,829	2,396	23,924
\$246,245	17,817	1,348	1,513	1,108	68,072	8,868	65,411	33,787	51,940	1,914	25,178
<i>Scenario 2. Further Limit Housing Allowance Exclusion</i>											
\$60,241	294	173	304	279	6,641	586	3,549	723	1,613	754	1,492
\$75,095	281	866	648	254	13,849	4,225	6,420	5,219	4,414	920	3,710
\$117,932	396	1,454	546	541	28,131	12,374	11,233	14,482	8,952	985	7,909
\$246,245	3,200	638	567	354	44,257	5,692	21,818	16,652	22,226	1,075	11,648
<i>Scenario 3. Eliminate Cap on Foreign Earned Income Exclusion</i>											
\$60,241	(2,374)	(3,093)	(4,579)	(3,694)	(4,073)	(3,292)	(4,623)	(2,708)	(4,308)	(2,747)	(3,549)
\$75,095	(6,089)	(8,068)	(9,929)	(8,949)	(12,018)	(8,959)	(14,467)	(6,735)	(13,221)	(7,332)	(9,577)
\$117,932	(13,387)	(17,701)	(19,895)	(18,666)	(36,691)	(20,842)	(43,249)	(21,792)	(37,834)	(15,445)	(24,550)
\$246,245	(81,733)	(69,590)	(72,499)	(71,416)	(164,949)	(70,291)	(208,398)	(110,051)	(183,371)	(54,402)	(108,670)

¹ 2001 amounts inflated to 2004 dollars.

Source: PwC calculations.

relatively high levels of individual income tax. For example, in the absence of Section 911, total compensation would need to increase by an average 4.2 percent in Japan and 2.5 percent in Canada.

Example.—Effect of Section 911 Modifications: Hong Kong Assignee

Present law. John was relocated from the United States to Hong Kong on July 1, 2003 for a 3-year assignment. Prior to relocation, his base compensation was \$246,245, his total taxable income was \$404,827, and his U.S. tax was \$126,195. John's average annual allowances and reimbursement for the period excluding tax equalization payments are \$341,657 (including \$154,960 in housing allowances), and his total relocation expense is \$48,830, or an average of \$16,277 over three years. On average, John receives a payment of \$95,271 per year to equalize his tax liability. On his average annual income of \$858,032 (sum of \$404,827, \$341,657, \$16,277, and \$95,271) including allowances, reimbursements, and tax equalization payments, Hong Kong levies an average of \$120,774 in tax per year. After the Section 911 exclusions for housing and \$80,000 of foreign earned income, U.S. tax averages \$100,692, so the combined Hong Kong and U.S. tax averages \$221,466 (\$120,774 plus \$100,692); however, because John receives a tax equalization payment of \$95,271, his net tax burden is the same as before he was relocated to Hong Kong (\$221,466 less \$95,271 equals \$126,195).

Absent Section 911. If the Section 911 exclusion were repealed, John's tax equalization payment would need to increase from \$95,271 to \$163,343 per year. As a result, his average annual taxable income would increase to \$926,104 (the sum of \$404,827, \$341,657, \$16,277, and \$163,343). John's average Hong Kong tax liability is \$132,768 and his average U.S. tax liability is \$156,770 on \$926,104 of income (without the benefit of the Section 911 exclusions for housing and \$80,000 of foreign earned income). Because John receives a tax equalization payment of \$163,343, his net tax burden is unaffected (\$132,768 plus \$156,770 less \$163,343 equals \$126,195). Thus, repeal of Section 911 would increase the average annual tax equalization payment by \$68,072 (excess of \$163,343 over \$95,271), an increase of 7.93 percent (\$68,072 as a percent of \$858,032) in total compensation costs (see Hong Kong results for the top income class shown in Tables III.2a and III.2b).

It is often supposed that Section 911 provides an incentive to locate Americans in low-tax countries only because, in the absence of Section 911, U.S. expatriates would still be eligible to credit foreign income taxes against U.S. tax liability. Thus, it would seem that there would be no residual U.S. tax liability on foreign earned income where foreign income tax rates are higher than in the United States. However, as demonstrated by the detailed ACPS modeling of expatriate tax costs, this perception is false. Section 911 can be beneficial in high-tax countries for a number of often overlooked reasons, including:

- Countries with very high statutory rates may, nevertheless, have generous deductions and exclusions that result in relatively low tax liability, particularly for taxpayers at modest income levels.
- International assignments often begin or end at mid-year resulting in little foreign income tax liability in the year of assignment and/or return.

- Unlike the foreign tax credit, Section 911 may cause U.S. source income of Americans working abroad to be taxed in lower U.S. income tax brackets.

The results in Table III.2a also show that the tax incentive arising from Section 911 represents a larger share of the total compensation of middle income Americans working abroad than of high-income expatriates. For example, absent Section 911, the increase in compensation required to protect the after-tax income of expatriates with incomes in the bottom fourth of the income distribution is 6.4 percent compared to 2.1 percent for expatriates in the top fourth of the income distribution. Thus, the Section 911 is progressive – providing relatively greater benefits to lower and middle income expatriates.²⁸

Further Limit Housing Allowance

Similar to repeal of the Section 911 exclusion, limiting the housing allowance exclusion to the excess of the general exclusion cap (\$80,000) over foreign earned income would increase the total compensation required to maintain the after-tax income of U.S. expatriates. Under this scenario, total compensation would need to be increased by an average of 1.4 percent in 2004. Among the 10 countries included in this analysis, the impact is largest in Hong Kong (5.1 percent), Saudi Arabia (3.3 percent), and Singapore (3.0 percent).

Eliminate Cap on Foreign Earned Income Exclusion

Eliminating the \$80,000 cap on the foreign earned income exclusion would *reduce* compensation costs of Americans working abroad in 2004 by an average of 7.8 percent in 2004. The reduction is largest in Switzerland (14.2 percent), Hong Kong (12.6 percent), Saudi Arabia (11.6 percent), Singapore (10.5 percent), and Canada (10.1 percent).

²⁸ The progressive nature of the Section 911 exclusion primarily is attributed to the fixed dollar nature of the exclusion. The exclusion provides no benefit for foreign earned income in excess of the \$80,000 exclusion.

2. Change in Employment of Americans Abroad

For each of the three modifications to Section 911, the Mutti model, discussed above, was used to estimate the change in employment of Americans working based on the change in total compensation costs estimated using the Assignment Cost Projection System. The change in the number of Americans working abroad in 2004 under each of the three scenarios is shown in Table III.3., below.

Table III.3.—Effect of Section 911 Modifications on Employment of Americans Abroad, 2004

Item	Section 911 Scenario		
	Repeal Sec. 911	Restrict housing exclusion	Remove cap on Sec. 911 exclusion
Average percentage change in total compensation (from ACPS model)	4.38%	1.35%	-7.81%
Percentage change in American employment abroad ¹	-1.71%	-0.53%	3.04%
Individuals claiming foreign earned income exclusion, 2004 ²	321,729	321,729	321,729
Estimated change in American employment abroad ³	-5,502	-1,705	9,781

¹ Based on elasticity of U.S. expatriate employment with estimated by Prof. Mutti.

² Based on 294,763 Section 911 returns in 2001 increased to 2004 at the average annual growth rate of Section 911 returns from 1991 to 2001 (3.0 percent per year). The number of Americans working abroad may be greater than shown where two Americans working abroad file a joint return.

³ Percentage change in Americans employed abroad times number of individuals claiming Section 911 in 2004.

Source: PwC calculations.

Repeal of Section 911 is estimated to reduce American employment abroad by 1.71 percent; a decrease in the number of Americans working abroad of 5,502 in 2004.

Further limiting the housing allowance exclusion would reduce the number of Americans working abroad by 0.53 percent, a loss of 1,705 American jobs in 2004.

By contrast, removing the cap on the Section 911 exclusion would increase the number of Americans working abroad by 3.04 percent, an increase of 9,781 Americans working abroad.

3. Change in U.S. Exports and Associated Employment

The impact of each of the three Section 911 scenarios on U.S. manufactured exports and associated U.S. employment in 2004 is shown in Table III.4., below.

Table III.4.—Effect of Section 911 Modifications on U.S. Exports and Associated Employment, 2004

Item	Section 911 Scenario		
	Repeal Sec. 911	Restrict housing exclusion	Remove cap on Sec. 911 exclusion
Average percentage change in total compensation (from ACPS model)	4.38%	1.35%	-7.81%
Percentage change in U.S. exports ¹	-1.14%	-0.35%	2.03%
U.S. manufactured exports, 2004 (\$billions) ²	\$709.7	\$709.7	\$709.7
Estimated change in U.S. manufactured exports, 2004 (\$billions) ³	\$-8.1	\$-2.5	\$14.4
U.S. employment affected by change in U.S. manufactured exports, 2004 ⁴	-77,115	-23,676	137,319

¹ Based on cross-elasticity of U.S. exports with respect to U.S. assignee compensation of - 0.26 as estimated by Prof. Mutti.

² Department of Commerce, International Trade Administration, *U.S. Foreign Trade Highlights*, Table 14: <http://www.ita.doc.gov/TD/Industry/OTEA/usfth/tabcon.html>.

³ Percentage change in U.S. exports times the U.S. manufactured exports in 2004.

⁴ Change in U.S. manufactured exports times 9,531 U.S. jobs per billion dollars of U.S. manufactured exports.

Source: PwC calculations.

Repeal of Section 911 is estimated to reduce U.S. manufactured exports by 1.14 percent, or about \$8.1 billion in 2004. As each \$1 billion of manufactured exports supported 9,531 domestic jobs in 2004, repealing the foreign earned income exclusion is estimated to affect 77,115 domestic jobs in the U.S.

Further limiting the housing exclusion as proposed Senate version of the JOBS Act is estimated to reduce U.S. manufactured exports by \$2.5 billion, affecting 23,676 domestic jobs in the U.S.

By contrast, removing the cap on the foreign earned income exclusion is estimated to increase U.S. manufactured exports by \$14.4 billion supporting 137,319 domestic jobs in the U.S.

D. Other Studies

1. Pearson-Riedel Survey

To better understand the relationship between Americans working abroad, U.S. exports, and the foreign earned income exclusion, Profs. Charles Pearson and James Riedel at the Johns Hopkins University School of Advanced International Studies conducted a survey of companies with U.S. employees on international assignments in 1995.²⁹ The Pearson-Riedel survey covered 148 employers who collectively employed 12,682 U.S. nationals abroad and had a total worldwide labor force, including U.S. nationals, of 3.26 million. Survey responses were received from both small and large firms representing both manufacturing and service industries.

Section 911 and compensation costs. According to Pearson and Riedel, 88 percent of survey respondents reported that compensation costs would increase if Section 911 were repealed, of which 40 percent reported that compensation costs would increase by more than 25 percent, 40 percent reported an increase of between 6 and 25 percent, and the balance reported an increase of 5 percent or less. The survey also found that 84 percent of respondents anticipated that prospective hires would be reduced. These results indicate that survey respondents believe that repeal of Section 911 would increase compensation costs more than estimated by the Assignment Cost Projection System simulations based on 2004 law (i.e., 4.38 percent).

Section 911 and U.S. expatriate employment. Profs. Pearson and Riedel found that 71 percent of survey respondents anticipated a reduction in U.S. expatriate employment levels if Section 911 were repealed, of which 31 percent reported a reduction of more than 25 percent, 19 percent reported a reduction of between 6 and 25 percent, and the balance reported a reduction of 5 percent or less. Thus, survey respondents believe that repeal of Section 911 would cause a greater reduction in Americans working abroad than estimated in this report for 2004 (i.e., 1.71 percent).

U.S. expatriates and exports. The Pearson-Riedel survey also explored the relationship between Americans working abroad and U.S. exports. The survey asked employers whether U.S. expatriate employees were more likely to source purchases from U.S. companies than foreign national employees. Among respondents for which the question is applicable, 85 percent believed that employee nationality has an effect on sourcing decisions. Of this 85 percent, 60 percent believed that there is a "large tendency" for U.S. expatriates to purchases from U.S. suppliers. While not determinative, the survey helps to explain the strong relationship between U.S. expatriate employment and U.S. exports in the Mutti model.

Section 911 and U.S. competitiveness. The Pearson-Riedel survey found that elimination of Section 911 would adversely affect U.S. companies' ability to secure projects and compete abroad: 81 percent of respondents indicated that elimination of Section 911 would reduce their foreign business and almost three-quarters of these (64 percent) described the impact as "moderate" or "major." By

²⁹ Charles Pearson and James Riedel, *The Importance of Section 911 for U.S. International Competitiveness*, A report to the Section 911 Coalition, June 1995.

contrast, 65 percent of respondents indicated that an *increase* in the Section 911 exclusion from \$70,000 to \$100,000 would increase their competitiveness abroad.

2. GAO Survey

In 1977, the General Accounting Office (GAO) conducted a survey of 367 U.S. citizens working in 11 countries and 183 U.S. firms employing American workers overseas.³⁰ The purpose of the survey was to assess the impact of the reduction in the foreign earned income exclusion in the Tax Reform Act of 1976.

While the majority of U.S. companies surveyed believed that few, if any, companies would shut down as the result of these changes, more than half of the survey respondents said that they believed that at least 5 percent of U.S. companies would close down their overseas operations. More than 80 percent of the respondents believed that the reduction in Sec. 911 contained in the Tax Reform Act of 1976 would reduce U.S. exports by at least 5 percent.

Of the companies surveyed by GAO, 77 percent reimbursed their American employees for all or part of the additional taxes incurred as a result of living and working abroad. GAO concluded that, these companies would have to absorb the cost of additional taxes resulting from a reduction in 911, pass the increased cost on to consumers, or replace American workers abroad with less costly foreign workers. They also noted that companies that did not reimburse workers for additional taxes might lose workers due to the higher tax burden imposed by the 1976 Act. 60 percent of the U.S. companies surveyed planned to reduce the number of Americans working abroad as a result of the tax change. In addition, of the 104 companies that reimbursed employees that estimated the increase in employee compensation costs resulting from the Act, 50 percent expected their costs to increase by 5 percent or more.

Of the 367 workers surveyed by GAO, 45 percent expected to return to the United States on or before the end of their present assignment due to the tax changes enacted in the Tax Reform Act of 1976. Of these, about 29 percent were planning to return even though they expected their company to reimburse them for part of the expected tax increase.

In total, GAO reported that the reduction in Sec. 911 contained in the 1976 Act would increase the tax liability of the approximately 150,000 U.S. citizens working in foreign countries by more than \$290 million. According to the survey, this would lead to a reduction in Americans working abroad, in increase in costs for U.S. companies, and a reduction in U.S. exports and U.S. competitiveness.

³⁰ U.S. General Accounting Office, *Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas*, ID-78-13, February 21, 1978.

IV. POLICY ISSUES

In 1992 testimony before the House Committee on Ways and Means, then Assistant Secretary Fred Goldberg outlined five tax policy objectives for taxation of international income³¹

1. Administrability and simplicity;
2. Economic efficiency in the allocation of resources;
3. International competitiveness;
4. Preservation of the U.S. tax base; and
5. Compatibility with appropriate international norms.

These five objectives are used to evaluate Section 911 as well as the concept of "equity" which has particular relevance to the taxation of individuals. This section concludes with a brief examination of the "tax expenditure" attributable to Section 911.

A. Equity

Measurement of equity

The most basic criterion for evaluating the equity of the individual income tax is that taxpayers with equal ability to pay should be liable for the same amount of tax. This standard is often referred to as "horizontal" equity. Another principle for evaluating equity is "vertical" equity, *i.e.*, taxpayers with greater ability to pay should be liable for more income tax than taxpayers with lesser ability to pay.³²

Assessments of horizontal and vertical equity depend crucially on the measurement of "ability to pay." The present income tax provides a number of deductions and exemptions from gross income to take account of factors that influence ability to pay. Such factors include basic living expenses (a factor accounted for by the current standard deduction and personal exemption), certain moving expenses, certain business expenses, certain costs of homeownership (property tax and interest expense), certain health care and health insurance costs, and numerous other items.

The Section 911 exclusion has in the past been criticized as violating both the principles of horizontal and vertical equity.³³ It is argued that Section 911 is horizontally inequitable because it treats Americans working abroad more favorably than equal income Americans working in the United States. It is further argued that Section 911 is vertically inequitable because Americans working abroad are, on average, more highly compensated than Americans working in the United States. These criticisms of Section 911 are misleading, however, because they fail to take into account that the higher costs of living abroad reduce ability to pay.

³¹ U.S. Department of the Treasury, "Statement of Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy), Department of the Treasury, before the Committee on Ways and Means, United States House of Representatives," July 21, 1992.

³² Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, 1973, p. 199.

³³ Jane G. Gravelle and Donald W. Kiefer, "U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis," *Congressional Research Service*, 78-91 E (April 20, 1978).

Application of equity principles to Americans working abroad

When Americans are assigned abroad, their compensation typically is determined by adding to base pay allowances for such factors as: general cost of living differential, housing costs, educational expenses, home leave, and additional tax costs. The purpose of these allowances is to compensate the employee for extra costs that arise from the international assignment. IRS data show that international assignment allowances are substantial, averaging 34 percent of foreign wages and salaries in 2001 (Table IV.1).

Under U.S. tax law, international assignment allowances generally are included in the taxpayer's gross income. Consequently, two individuals with the same base pay that work for the same company—one in the United States and the other abroad -- typically will have very different amounts of gross income. The international assignee will have much higher gross income — often twice as high as the domestic worker, despite the fact that the assignee's base pay is the same. If the allowances provided by the employer reflect the additional costs of international assignment, these two workers have the same ability to pay tax notwithstanding large differences in gross income.

As is clear from this example, the principles of horizontal and vertical equity would be served if international assignment allowances, which reasonably reflect the added costs of working abroad, were excluded from taxable income. Failure to adjust for international assignment allowances not only causes more tax to be paid out of the same base salary, but also causes unrelated income (*e.g.*, investment income) to be taxed in higher rate brackets.

In the Foreign Earned Income Act of 1978, Congress replaced the Section 911 exclusion with a new (Section 913) set of itemized deductions for certain excess foreign living costs. As noted by one commentator, "The goal was to place the overseas taxpayer in an equitable position vis-à-vis his domestic counterpart."³⁴

The system of special itemized deductions for excess foreign living costs was replaced in 1981 by a flat dollar exclusion (now \$80,000) and an excess housing cost exclusion. The change was in response to concerns about complexity as well as U.S. competitiveness.³⁵ As a result, the present

³⁴ Renee Judith Sobel, "United States Taxation of Its Citizens Abroad: Incentive or Equity," *Vanderbilt Law Review*, vol. 38:10, p. 131.

³⁵ For a discussion of the problems with Section 913, see: General Accounting Office, *American Employment Abroad Discouraged by U.S. Income Tax Laws*, ID-81-29, February 27, 1981.

Table IV.1 -- Allowances as a Percent of Foreign Wages and Salaries, 2001
[Joint returns]

Country	AGI Class								All Incomes
	From:	\$0	\$10,000	\$25,000	\$50,000	\$70,000	\$100,000	\$200,000	
	To:	\$9,999	\$24,999	\$49,999	\$69,999	\$99,999	\$199,000	and over	
Canada		0.0%	1.3%	0.1%	6.6%	7.1%	16.8%	4.7%	4.9%
China		1.7%	13.7%	4.2%	53.8%	36.5%	101.7%	70.8%	63.7%
France		6.5%	17.0%	26.5%	36.3%	21.8%	32.4%	40.6%	29.6%
Germany		0.7%	3.0%	4.7%	6.0%	21.2%	25.0%	60.1%	22.5%
Hong Kong		13.3%	26.1%	11.3%	37.1%	12.8%	44.8%	73.4%	47.2%
Japan		6.5%	1.1%	1.9%	14.4%	50.2%	78.4%	106.9%	61.4%
Saudi Arabia		9.2%	7.6%	6.6%	4.1%	11.9%	3.9%	29.7%	7.7%
Singapore		8.8%	24.0%	22.9%	45.1%	47.9%	92.9%	86.8%	72.4%
Switzerland		0.6%	3.4%	1.3%	8.0%	11.6%	36.3%	28.4%	19.3%
United Kingdom		7.1%	2.7%	11.7%	28.9%	24.0%	40.4%	57.3%	47.1%
<i>Subtotal</i>		5.4%	6.9%	6.9%	20.8%	22.7%	40.6%	57.6%	38.3%
<i>All Countries</i>		4.5%	6.3%	7.9%	18.5%	23.0%	42.3%	54.8%	33.9%

Source: IRS, Statistics of Income Division, special tabulation of 2001 Form 2555 joint returns and PwC calculations.

foreign earned income exclusion is not as precisely tailored to the circumstances of individual taxpayers as the Section 913 system in effect from 1978-1980.

Repeal of the Section 911 exclusion would not improve the horizontal or vertical equity of the tax system for two reasons. First, absent Section 911, Americans working abroad would pay much higher taxes than U.S. workers with the same base pay. Section 911 offsets the various international assignment allowances that cause gross income of Americans working abroad to be taxed at a higher rate than their domestic counterparts. While Section 911 likely overcompensates some taxpayers and undercompensates others, repeal of Section 911 would cause *all* Americans working abroad to pay more tax than domestic workers with equal ability to pay.

Second, the benefits of Section 911 are lower for higher-paid Americans working abroad (see Table III.2a, above). Consequently, repeal of Section 911 would tax a larger share of the income of expatriate workers at the bottom end of the income distribution.

Benefits principle

Another principle that is often invoked in evaluations of tax equity is the "tax benefit" principle. Under this principle, taxes should be levied according to government benefits received. Clearly, Americans living abroad do not receive the same level of benefits from the U.S. government as domestic residents. Thus, if the benefits principle were applied, Americans working abroad should be subject to lower U.S. income taxes. Consistent with the benefits principle, Senator Moynihan in 1980 proposed an 80-percent exclusion for all Americans living abroad on the grounds that they do not make the same use of federal government services as U.S. residents.³⁶

B. Administrability and Simplicity

Complexity in the tax law is itself a tax, levied in the form of additional taxpayer hours needed to comply with the law and fees paid to professional tax preparers. Complex tax laws also require additional IRS resources for taxpayer information, return processing, examination, assessment, appeals, litigation, *etc.* Complexity is very poor tax policy, indeed, as it imposes costs on taxpayers and on the budget and produces no revenue for the government.

One of the principal arguments for the current structure of the foreign earned income exclusion is its simplicity, particularly in comparison to the complex rules adopted in the FEIA of 1978. As discussed above, from the standpoint of horizontal and vertical equity, the foreign earned income exclusion should be designed to exclude all of the excess costs of foreign employment, so that U.S. taxable income would be unaffected by the country where a taxpayer works. While such a system may be desirable in theory, attempts to implement the theory were disastrous. The FEIA of 1978, which repealed Section 911 and put into place a system of exclusions for various excess foreign living

³⁶ John D. Maiers, "The Foreign Earned Income Exclusion: Reinventing the Wheel," *Tax Lawyer*, vol. 34, no. 3, 1981, p. 726.

costs, was abandoned after only three years. A General Accounting Office review of the 1978 law concluded³⁷

"Simplification has been a general goal of national tax policy during the last several years. The FEIA does not realize this goal. It is extremely difficult for an American working abroad to correctly prepare a tax return under the new law."

The structure of the current foreign earned income exclusion, while not as precisely tailored to the circumstances of individual taxpayers working abroad than prior law, is much easier to comply with and administer, particularly for low and moderate income taxpayers.

C. Economic Efficiency

Measurement of economic efficiency

One of the basic conclusions from economic theory is that absent taxes and other government interventions, competitive markets allocate resources efficiently.³⁸ An efficient tax system is one which does not alter or "distort" resource allocation from that which would occur absent taxes. This standard of economic efficiency can be used to evaluate the tax treatment of Americans working abroad.

In the case of business taxpayers with foreign operations, the application of the efficiency principle to income taxation has resulted in a policy called capital export neutrality (CEN). Under CEN, the decision of U.S. companies to invest in the United States or abroad would be unaffected by income taxes. One way to achieve CEN would be to tax the worldwide income of U.S. companies but to allow an unlimited credit for foreign income taxes. Present law deviates from CEN by, among other things, imposing a limit on the foreign tax credit to ensure that the credit does not reduce U.S. tax on U.S. source income.

Application of efficiency principle to Americans working abroad

Most Americans on international assignments for U.S. companies are covered by compensation packages that provide allowances for excess foreign living costs and an adjustment for income tax differentials (*i.e.*, tax equalization). Even though the various international assignment allowances are included in the employee's gross income, the employee's decision whether to work abroad is unaffected by the tax system because the employer compensates for any additional tax liability (and absorbs any tax savings).

From the employer's perspective, however, taxes have a major impact on the decision whether to transfer an American abroad. Taxes could be eliminated from the employer's decision by (1) excluding international assignment allowances from the employee's gross income, and (2) allowing

³⁷ General Accounting Office, 1981, p. 16.

³⁸ Certain "market failures" can cause competitive markets to produce inefficient results. A classic example of a market failure is the lack of charges for use of the environment, resulting in excessive pollution.

the employee to claim an unlimited tax credit for foreign income taxes. This would ensure that the employee would be taxable only on base pay and would eliminate the need for employer's to provide tax gross ups. The efficiency principle justifies a foreign earned income tax system more generous than the system enacted in 1978 and, in many cases, more generous than present law.

Conclusion

Repeal of the Section 911 exclusion would not achieve economic efficiency in the allocation of resources because there would be a sizable tax penalty for assigning Americans to overseas positions.

Absent Section 911, Americans working abroad would pay much higher taxes than U.S. workers with the same base pay, and employers typically would bear a large share of these added tax costs. Section 911 offsets the various international assignment allowances that cause gross income of Americans working abroad to be higher than their domestic counterparts. In fact, strict adherence to the economic efficiency principle would in many cases require more generous tax relief than what is currently provided for by the foreign earned income exclusion.

D. International Competitiveness

International competitiveness has historically been the main justification for the foreign earned income exclusion. The legislative history indicates that the foreign earned income exclusion was designed to "encourage citizens to go abroad and to place them in an equal position with citizens of other countries going abroad who are not taxed by their own countries."³⁹

The United States continues to be the only major industrial country that taxes individuals on the basis citizenship rather than residence. Other countries generally do not tax income earned abroad by nonresidents.⁴⁰

In re-enacting the Section 911 exclusion in 1981, Congress was primarily concerned about maintaining U.S. competitiveness.⁴¹

"The Congress was concerned with the increasing competitive pressures that American businesses faced abroad. The Congress decided that in view of the nation's continuing trade deficits, it is important to allow Americans working overseas to contribute to the effort to keep American business competitive.

The Congress believed that the tax burdens imposed on these individuals made it more expensive for U.S. businesses to utilize American employees abroad. In many cases, the policy of these businesses is to reimburse their employees for any extra tax expenses the employees incur because of overseas transfers. Thus, an extra tax cost to

³⁹ Senate Report no. 781, 82nd Congress, 1st Session, 1951, pp. 52-53.

⁴⁰ General Accounting Office, 1981, op cit., p. 17.

⁴¹ Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981*, JCS-71-81, December 29, 1981, p. 43.

the employees becomes a cost to the business, which cost often is passed through to customers in the form of higher prices. In intensely competitive industries, such as construction, this can lead to noncompetitive bids for work by American firms.

As a result, some U.S. companies either cut back their foreign operations or replaced American citizens in key executive positions with foreign nationals. In many cases, these foreign nationals may purchase goods and services for their companies from their home countries, rather than from the United States, because they often are more familiar with these goods and services."

Concept of international competitiveness

International competitiveness refers to the ability of U.S. companies to compete with foreign-headquartered companies in international markets. In the context of income taxation, the competitiveness principle has led to a policy called capital import neutrality (CIN). Under CIN, U.S. firms operating in a foreign market pay the same tax as foreign firms in that market. One way to achieve CIN would be to exempt foreign source income from U.S. taxation. In this way both a U.S. company operating in, for example, Germany, and a German competitor operating in Germany would be subject to the same amount of income tax (*i.e.*, the German income tax).

Application to Americans working abroad

In the case of individuals, international competitiveness could be achieved if the United States exempted *all* foreign earned income, without the \$80,000 limitation in present law. Under such a system, Americans working abroad in, for example, Germany, would pay the same amount of income tax as equally compensated German workers.

Empirical evidence

One way to assess the importance of Section 911 to U.S. competitiveness is to look at changes in U.S. expatriate employment during periods when the foreign earned income exclusion was changed. Based on revenue estimates by the Joint Committee on Taxation, the 1978 Foreign Earned Income Act represented a 23 percent reduction in the tax benefit of the foreign earned income exclusion relative to prior law. Therefore, the significant changes in the foreign earned income exclusion enacted in 1978 provide a natural experiment for measuring the effects of the exclusion on U.S. competitiveness.

To assess the effects of the 1978 Act, the General Accounting Office conducted a survey in 1980 of 33 major firms in four industries: 11 firms in construction, architecture, and engineering; 4 firms in aerospace; 7 firms in resource extraction; and 11 firms in the manufacturing sector. The GAO found that

"The major U.S. firms we surveyed reported to us that this cost differential [additional tax cost attributable to the 1978 Act] was a major reason why they have decreased their employment of Americans overseas ... Employment abroad by the firms decreased absolutely from 1979 to 1980 in three of these industries. Further, the

relative number of Americans in overseas positions decreased compared with TCNs [third country nationals] from 1976 to 1980 in all of these industries." ⁴²

Based on the apparent anti-competitive effects of the reduction in the foreign earned income exclusion in 1978, the GAO recommended ⁴³

"We believe that the Congress should consider placing Americans working abroad on an income tax basis comparable with that of citizens of competitor countries who generally are not taxed on their foreign earned income ... complete exclusion or a limited but generous exclusion of foreign earned income for qualifying taxpayers ... would establish a basis of taxation comparable with that of competitor countries and, at the same time, be relatively simple to administer."

Conclusion

In summary, the principle of international competitiveness provides a strong rationale for increasing the dollar amount of the foreign earned income exclusion or restoring the unlimited exclusion that applied from 1926 to 1952.

E. Preservation of the U.S. Tax Base

While recognizing the need to mitigate double taxation of foreign source income (by both the United States and foreign countries), tax policymakers have also sought to prevent U.S. source income from escaping the U.S. tax net. To defend the U.S. tax base, Congress has over the years imposed various limits on the foreign tax credit and subjected certain types of income that can easily be moved across national boundaries (*e.g.*, passive types of investment income) to current taxation.

Exclusion of foreign earned income of bona fide foreign residents is consistent with the principle of preserving the U.S. tax base. The Section 911 exclusion applies only to active income that is earned abroad for activities performed abroad. Such income is foreign source income. Moreover, Section 911 denies a U.S. income tax deduction for expenses that are allocable to excluded foreign income (*e.g.*, moving expenses). Further, Section 911 does not apply to investment income and other types of passive income which can readily be moved offshore. Finally, Section 911 is limited to bona fide residents of a foreign country.

In summary, the present structure of the Section 911 exclusion has been carefully designed to prevent U.S. source income from escaping U.S. taxation.

F. Compatibility with International Tax Norms

Over the last five decades, U.S. investment abroad has grown rapidly, and the United States continues to be the world's largest supplier of foreign direct investment. Foreign operations account for 24.6

⁴² General Accounting Office, 1981, *op cit.*, p. 28.

⁴³ *Ibid.*

percent of U.S. corporate income. In this environment, U.S. tax policymakers have increasingly recognized the importance of harmonizing the operation of U.S. and foreign income tax systems to remove barriers to the flow of capital and labor across national boundaries, much as the General Agreement on Tariffs and Trade (GATT) has reduced barriers to international trade in goods and services. Another example is the development of OECD guidelines regarding inter-company pricing.

Section 911, however, is a glaring example of the failure on the part of the United States to harmonize with international tax practice. As noted by the General Accounting Office, the United States is the only major industrial power that taxes its individuals on the basis of citizenship rather than residence. Lack of harmonization was, perhaps, of little importance in a world where the U.S. was technologically and economically dominant. Decades ago, Americans may have possessed skills and experience in short supply abroad. In today's global economy, however, U.S. workers face substantial competition from technically sophisticated foreign workers. The failure of the United States to harmonize the tax treatment of expatriate workers means that U.S. citizens are more expensive to employ abroad than citizens of many other industrial nations.

In summary, the principle of tax harmonization strongly argues for complete exclusion of foreign earned income, *i.e.*, elimination of the \$80,000 limitation in current U.S. law.

G. Tax Expenditure

Theory and measurement of tax expenditures

The Congressional Budget Act of 1974 requires that a list of tax expenditures be included in the federal budget. The 1974 Act defines tax expenditures as "... those revenue losses due to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax or a deferral of tax liability."⁴⁴

Measurement of tax expenditures requires comparison of present law provisions with a "baseline" tax system that is deemed free of tax concessions. The 1974 Budget Act does not specify the tax baseline which should be used for purposes of measuring tax preferences. The Treasury Department has developed a concept of a "normal" income tax structure for purposes of the annual budget.⁴⁵ A similar concept also is used by the Joint Committee on Taxation and the Congressional Budget Office. "The normal tax baseline is patterned on a comprehensive income tax ... [and] allows personal exemptions, a standard deduction, and deductions of the expenses incurred in earning income."⁴⁶

By longstanding convention, tax expenditure estimates are made on a completely static basis. Consequently, *tax expenditure* estimates can be significantly different from *revenue* estimates

⁴⁴ Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344) sec. 3(a)(3).

⁴⁵ During the Reagan Administration, the Treasury Department introduced an alternative tax expenditure baseline referred as the "reference" baseline. A number of items which are treated as tax expenditures under the normal baseline are not treated as tax preferences under the reference baseline (and thus have a zero tax expenditure).

⁴⁶ U.S. Budget, FY 1996, *op cit.*, p. 51.

prepared by the Treasury Department and the Joint Committee on Taxation which do take into account behavioral responses as well as specific transition rules in legislative proposals.

Tax expenditure estimate of foreign earned income exclusion

The normal tax baseline treats all income earned by Americans working abroad, including cost of living allowances, as properly subject to U.S. income tax with a credit for foreign income taxes paid on this income, up to the foreign tax credit limitation.

The tax expenditure for the foreign earned income exclusion is the difference in the amount of federal income tax Americans working abroad pay under present law, and the amount they would pay absent Section 911 and Section 912 (*i.e.*, the exclusion of certain allowances received by federal government employees working abroad).⁴⁷ In theory, the tax expenditure estimate should take into account the foreign tax credit that otherwise would be allowed if Section 911 were repealed.

The most recent published tax expenditure estimate of the foreign earned income exclusion was published on January 12, 2005 by the Joint Committee on Taxation. The estimate is reproduced in Table IV.2, below:

Table IV.2.--Tax Expenditure Estimate, 2005-2009

[Fiscal years, billions of dollars]

Item	2005	2006	2007	2008	2009	2005-2009
Exclusion of income earned abroad by U.S. citizens	3.6	3.8	4.0	4.2	4.4	20.1

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, JCS-1-05, January 12, 2005, p. 30.

The tax expenditure estimate increases from \$3.6 billion in fiscal year 2005 to \$4.4 billion in fiscal year 2009. The Section 911 exclusion is one of six tax preference items listed in the "international affairs" section of the tax expenditure budget and accounts for 21.6 percent of the total tax expenditure estimated in this category.

Accuracy of tax expenditure estimate

Given the magnitude of these tax expenditure estimates, it is not surprising that the foreign earned income exclusion has attracted a certain amount of controversy, and has been amended a number of times since federal tax expenditure estimates started to appear in the Budget. The published tax expenditure estimates for the foreign earned income exclusion, however, are seriously misleading for two reasons:

⁴⁷ Executive Office of the President, Office of Management and Budget, Budget of the United States Government, FY 1996, Analytical Perspectives, p. 52.

First, the tax expenditure estimate depends crucially on the definition of the "normal" tax baseline that is used to determine the extent to which any provision represents a tax concession. As noted in the Budget, the determination of the tax baseline "... is a matter of judgment."⁴⁸ The explanation in the Budget states that the normal tax baseline used for measuring tax expenditures explicitly includes the standard deduction, personal exemption, and "deductions of the expenses incurred in earning income." The excess cost of living abroad is an expense incurred in earning income and, under the principles set forth in the Budget, should be treated as part of the normal tax baseline. Only that portion, if any, of the foreign earned income exclusion that is larger than necessary to compensate for the excess cost of living abroad would fit within the Budget definition of a tax expenditure. Consequently, the tax baseline used in the Budget substantially overstates the tax expenditure attributable to the foreign earned income exclusion.

Second, even if the "normal" tax baseline used in the Budget were accepted, the revenue effect of repealing Section 911 would be significantly less than the published tax expenditure estimate. As noted in Treasury's 1993 report on the foreign earned income exclusion, the published tax expenditure estimate does not take into account that, in the absence of Section 911, a taxpayer would be able to deduct the portion of certain expenses (e.g., moving expenses) that currently are disallowed because they are allocated to excluded income. The Treasury report further notes that, absent Section 911, U.S. employers of Americans working abroad would in many cases increase compensation levels to offset the additional tax liabilities of U.S. nationals employed overseas. As a result, corporate profits would decline, causing a corresponding reduction in corporate income tax revenue. Taking into account these two offsetting factors, the Treasury Department estimates that the net revenue cost of the Section 911 exclusion is 21 percent less than the published tax expenditure estimate.⁴⁹

⁴⁸ Ibid. p. 51.

⁴⁹ U.S. Dept. of the Treasury, *Taxation of Americans Working Overseas: The Operation of the Foreign Earned Income Exclusion in 1987*, January 1993, p. 2, 20-22.

APPENDIX A. DETERMINATION OF INPUTS FOR ACPS MODEL

The inputs for the ACPS model were determined as follows:

1. **Base salary.** The base salary ranges, which are the same for each country, were aggregated from the seven Adjusted Gross Income ("AGI") classes used by the Statistics of Income ("SOI") Division of the IRS in providing information on all returns with Form 2555 filing joint returns in the tax year 2001. The SOI Division of the IRS provided the following AGI classes:

- (i) Under \$10,000
- (ii) \$10,000 to under \$25,000
- (iii) \$25,000 to under \$50,000
- (iv) \$50,000 to under \$70,000
- (v) \$70,000 to under \$100,000
- (vi) \$100,000 to under \$200,000
- (vii) \$200,000 or more

For our analysis, the seven AGI classes were collapsed into four income classes, as follows:

- (i) Under \$50,000
- (ii) \$50,000 under \$100,000
- (iii) \$100,000 under \$200,000
- (iv) \$200,000 or more

The following 2001 base salaries (representing the average salaries in each income class) were used as a starting point for the analysis in this report:

- (i) \$56,478
- (ii) \$70,404
- (iii) \$110,565
- (iv) \$230,863

The base salaries were increased by 6.7 percent to account for inflation over the period 2001-2004. After adjustment for inflation, the following 2004 base salaries were used:

- (i) \$60,241
- (ii) \$75,095
- (iii) \$117,932
- (iv) \$246,245

2. **Country of assignment.** The 10 countries with the largest number of U.S. nationals filing Section 911 tax returns in 2001 were included in this report.
 1. United Kingdom
 2. Canada
 3. Japan
 4. Hong Kong
 5. Saudi Arabia
 6. Germany
 7. Singapore
 8. China
 9. France
 10. Switzerland

3. **Length of assignment.** A three-year assignment was assumed with assignment dates of July 1, 2003 through June 30, 2006. This represents a typical assignment length for a U.S. assignee.

4. **Average annual exchange rates.** The computation of the foreign tax for each country required the conversion of the compensation elements from U.S. dollars to foreign currency. Average exchange rates for 2004 were used from the International Monetary Fund International Financial Statistics On-Line.

5. **Gross-up method.** Taxes can be reimbursed by the employer and included in the assignee's expatriate compensation under one of three methods: (i) one-year rollover method, (ii) current year gross-up method, and (iii) the loan bonus method. The method used in each country was determined based on the standard method allowed in that country. For example, Japan, the United Kingdom, and Germany only allow the current year gross-up method. All other countries allow the one-year rollover method.

6. **Equalization method.** Tax equalization was used for each calculation.

7. **Itemized/standard deductions.** Based on the information provided by the SOI Division of the IRS for married individuals filing joint returns with Form 2555, the itemized deductions and standard deductions as a percentage of the wages and salaries (i.e., from Form 1040, Line 7) were computed for 2001 returns as follows:

Range	Salaries & Wages (S&W)	Total itemized deduction	Itemized deduction: % of S&W	Total standard deduction	Standard deduction: % of S&W
(i)	\$4,983,987,000	\$164,804,000	3.31%	\$452,695,000	9.08%
(ii)	\$2,849,586,000	\$199,411,000	7.00%	\$101,163,000	3.55%
(iii)	\$4,675,027,000	\$283,065,000	6.05%	\$78,091,000	1.67%
(iv)	\$12,905,247,000	\$607,749,000	4.71%	\$70,167,000	0.54%

For each salary range, the ACPS uses the greater of the standard and itemized deductions for purposes of calculating the taxable income.

8. **Hardship premium.** For the 10 countries considered in this report, hardship premiums typically are only given for Saudi Arabia and China. The premium is a percentage of base salary. For Saudi Arabia and China, the percentages are 25% and 20%, respectively. The percentages are taken from the January 2005 State Department publication "Quarterly Report Indexes: Hardship, Differentials and Danger Pay (Table 3)."
9. **International service premium ("ISP").** The ISP was determined to be one-month's base salary for each assignee, as this is the typical ISP given to international assignees.
10. **Cost-of-living allowance ("COLA").** The COLA allowance (excluding housing and education allowances) was computed based on the "Local Index" published by the U.S. State Department ("Table 1. Indexes of Living Costs Abroad", January 2004. Available at <http://www.state.gov/m/a/als/qtrpt/2004/>).
11. **Housing allowance.** The housing allowance was estimated based on average housing qualified expenses reported on 2001 Form 2555 for each of the 10 countries and four income classes considered in this report. The 2001 dollar amounts were inflated to 2004 levels.
12. **Transportation and moving costs:**
 - a. **Storage.** A nominal amount of \$750 was included for each year while on assignment.
 - b. **Airfare.** Cost of four round-trip tickets.
 - c. **Shipment.** \$9,000 was used for assignments in Europe and North and South America. \$11,000 was used for assignments in the Middle East and Far East.
 - d. **Temporary living, start of assignment.** Computed by taking 14 days, which is the average number of days of temporary living, times the local per diem rates. Temporary living, end of assignment, was computed taking 14 days times the per diem rate for Washington, DC of \$201.00.
13. **Estimated outside income.** This was determined based on tabulations provided by the SOI Division of the IRS for married individuals filing joint returns with Form 2555. For each of the four aggregate AGI classes, the amount was calculated by taking the difference between worldwide income (i.e. total income or loss reported on Form 1040 before the foreign-earned income and housing exclusions have been taken) and the total foreign earned income reported. The result was divided into the total salaries and wages reported on Form 1040 to obtain the "outside income" ratio. The ratio was then applied to the base salaries to arrive at the average "outside income" for each income class. The outside income is assumed to be US-sourced income.

14. **Filing status/family size.** Joint return filing status was used in this analysis. A family size of four was used as this represents the typical family size of assignees.
15. **Assignee home leave.** The cost of one round-trip ticket with no restrictions. Two airfare quotes were obtained for each location, and the average was used.
16. **Family home leave.** The cost of three round-trip tickets (*i.e.*, for spouse and children).

APPENDIX B. WEIGHTING OF ACPS RESULTS

Table III.2a shows the percentage change in compensation required in 2004 under each of three modifications to Section 911 by income class and country. For each scenario, these results were weighted to be representative of all taxpayers filing returns that claim the Section 911 exclusion. The weighted average percentage change in required compensation under each of the three possible modifications to Section 911 (P) was derived as follows:

$$P = \sum_{i=1}^4 \sum_{c=1}^{10} P_{i,c} \times \left[w_{i,c} / \sum_{i=1}^4 \sum_{c=1}^{10} w_{i,c} \right]$$

where:

$P_{i,c}$ = Change in tax gross-up required if Section 911 were modified under each of three scenarios, as a percent of wages and allowances, for representative taxpayer within income class i and assigned to country c.

$w_{i,c}$ = Aggregate wages, salaries, and allowances reported on 2001 Form 2555 for taxpayers within income class i and assigned to country c.

The weighted average percentage increase in required compensation if Section 911 were modified under each of three scenarios for country "c" (P_c) was derived as follows:

$$P_c = \sum_{i=1}^4 P_{i,c} \times \left[w_{i,c} / \sum_{i=1}^4 w_{i,c} \right]$$

The weighted average percentage increase in required compensation if Section 911 were modified under each of three scenarios for income class "i" (P_i) was derived as follows:

$$P_i = \sum_{c=1}^{10} P_{i,c} \times \left[w_{i,c} / \sum_{c=1}^{10} w_{i,c} \right]$$