Economic Policy Consulting Services

ECONOMIC ANALYSIS OF THE FOREIGN EARNED INCOME EXCLUSION

prepared for

The Section 911 Coalition

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Price Waterhouse LLP

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Table of Contents

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EXECUTIVE SUMMARY

Present law

The United States is the only major industrial country that does not completely exempt the foreign earned income of its citizens working abroad.[1] Instead, under the provisions of Section 911 of the Internal Revenue Code, a U.S. citizen or resident alien whose tax home is outside the United States and who meets a foreign residence or foreign presence test, may exclude from gross income up to $70,000 per year of foreign earned income plus a housing cost amount. 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.

Prior law

The foreign earned income exclusion originally was enacted in 1926 to help promote U.S. exports. From 1926 to 1952, the exclusion was unlimited, corresponding to the present day practice of other major industrial countries. From 1953 to 1977, the exclusion was limited to $20,000 per year; however, for Americans working abroad more than three years, the exclusion was increased to $35,000 from 1962-1964 and subsequently reduced to $25,000 from 1965 to 1977.

In 1978, the Foreign Earned Income Act replaced the Section 911 exclusion with Section 913, a series of deductions for certain excess costs of living abroad.

The Economic Recovery Tax Act of 1981 restored Section 911 and increased the exclusion to $75,000 in 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 compared to foreign nationals, reduced U.S. exports, rendered the United States less competitive abroad, and due to the complexity, the new rules required many Americans employed abroad to use professional tax preparers.

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 through 1987. The Tax Reform Act of 1986 reduced the exclusion to $70,000, the amount in present law.

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[1] In addition to the United States, the following countries tax on the basis of citizenship rather than residence: Bulgaria, Republic of Gabon, Honduras, Indonesia, Jamaica, Kenya, Korea, Philippines, Senegal and Zambia (limited form).

Effect of inflation

As the exclusion is not adjusted for inflation, the real value of the exclusion has dropped substantially. As illustrated in Figure E.1, in 1995 dollars, the exclusion has dropped by 39 percent from its level in 1953 when the exclusion was first limited, and by 43 percent from its level in 1982 when the exclusion reached its highest level after the 1981 Act. The dollar amount of the foreign earned income exclusion currently is lower, in constant dollars, than it has been in all but five of the last 43 years (1973-1977).[1] If the $70,000 exclusion had been adjusted for inflation since its enactment in 1987, the exclusion would be $94,000 as of 1995, rising to over $111,000 in the year 2000.

Unlike the $70,000 section 911 exclusion, many other dollar amounts in the Internal Revenue Code are indexed so that real tax burdens do not increase as a result of inflation, including: the income tax tables (sec. 1); the earned income credit (sec. 32); the standard deduction (sec. 63); the overall limit on itemized deductions (sec. 68); the personal exemption (sec. 151); and the contribution limits to qualified pension plans (sec. 415).

Utilization of Section 911

Tax returns claiming the Section 911 exclusion increased from 154,000 in 1983 to 220,000 in 1991 (the last year for which IRS data is available). The average amount of foreign earned income reported on these tax returns increased by 38 percent, from $45,000 in 1983 to $62,000 in 1991. The average exclusion per return did not increase as rapidly as foreign earned income; consequently, the excluded portion of foreign earned income dropped from 87 percent in 1983 to 78 percent in 1991. If Section 911 is not adjusted for inflation, the excluded portion of foreign earned income will likely continue to decline.

Effect of Section 911 on Employment of Americans Abroad

To determine the increase in compensation, absent Section 911, necessary to provide the same after-tax level of income to Americans working abroad, Price Waterhouse's Assignment Cost Projection System (ACPS) was used.

Profiles were developed for 105 representative taxpayers (seven income levels in 15 countries) using data tabulated from IRS Form 2555 ("Foreign Earned Income") filed for tax year 1987. The data were adjusted to 1993 levels, and the ACPS was used to calculate the tax "gross-up" for each of the 105 representative taxpayers under 1993 law, with and without Section 911. The difference in tax gross-up represents the increase in compensation that would be required to maintain taxpayers' after-tax income.

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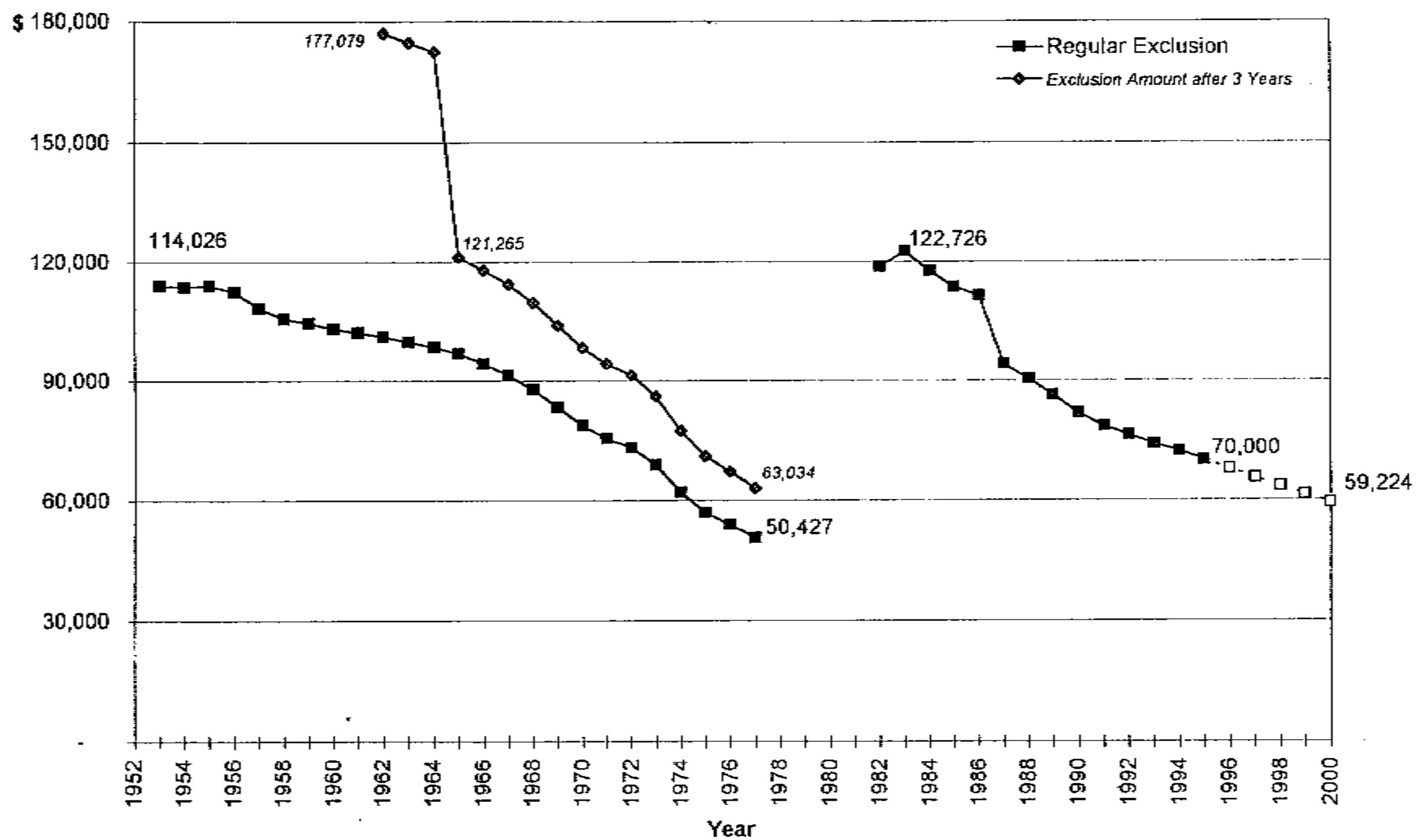
[1] In four of these years (1978-1981) the foreign earned income exclusion was replaced by a series of deduction for excess foreign living costs.

Figure E.1. Section 911 Exclusion Amount 1953 - 2000 (in 1995 Dollars)



CPI projections for 1995 - 2000 are based on CBO forecasts. (Annual Increase of 3.1% for 1995 and 3.4% for 1996-2000)

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Weighting the results to be representative of all taxpayers utilizing the foreign earned income exclusion, the ACPS simulations show that compensation levels would need to increase by an average of 7.19 percent to preserve after-tax income absent Section 911. Contrary to conventional wisdom, this analysis shows that Section 911 provides benefits in most major industrial countries despite relatively high tax rates. For example, absent Section 911, required compensation would increase by an average of 8.6 percent in Australia, 8.0 percent in Japan, 4.5 percent in France, 3.3 percent in Canada, and 3.1 percent in Germany.

The ACPS simulations also show that the tax incentive arising from Section 911 represents a larger share of the compensation of low income than of high income Americans working abroad. For example, absent Section 911, to protect the income of expatriates, average compensation would need to increase by 12.7 percent in the bottom seventh of the income distribution compared to 6.8 percent in the top seventh of the income distribution.

To estimate the effect of repealing Section 911 on employment of Americans abroad and U.S. exports, a model developed by Prof. John Mutti was used. The model was developed while Prof. Mutti was employed in the Office of Tax Analysis of the U.S. Treasury Department. Prof. Mutti's econometric model simultaneously estimates the market for U.S. exports and the market for Americans working abroad. These markets are interrelated because U.S. exports are influenced by the number of Americans working abroad while the demand for U.S. nationals to work abroad itself depends upon U.S. exports.

The results of the Mutti model are summarized in Table E.1, below. A 7.19 percent increase in required compensation (due to repeal of Section 911) would, according to the Mutti model, result in a 2.83 percent decrease in Americans working abroad -- a loss of 6,800 jobs for Americans in 1993.

Table E.1.--Estimated Effects of Section 911 Repeal

[Dollar amounts in billions]

Item	1993 level	Change absent Section 911	
		Percent	Amount
Compensation required to maintain after-tax income	NA	7.19%	NA
Number of Americans working abroad[1]	240,700	-2.83%	-6,800
U.S. merchandise exports	$456.9	-1.89%	-$8.7
Domestic employment associated with U.S. exports[2]	7,553,000	-1.89%	-143,000

[1] Returns filed by taxpayers claiming the benefit of Section 911. Projected from 1991 levels using average annual growth rate over the 1983-1991 period. The number of Americans working abroad may be greater where a spouse working abroad is included in a joint return.

[2] The most recent U.S. Department of Commerce estimate of U.S. employment supported by U.S. goods exports is 16,532 for 1992.

Elimination of Section 911 would cause the number of Americans working abroad to decline because (1) companies that compensate U.S. nationals for the tax costs of international assignments would be more reluctant to transfer Americans abroad, and (2) U.S. nationals who do not work for companies that cover tax costs would be less likely to accept international positions. Conversely, an increase in the section 911 exclusion would cause the number of Americans working abroad to increase.

Effect of Section 911 on U.S. Exports

According to the Mutti model, U.S. exports would decline by 1.89 percent absent Section 911, causing an $8.7 billion drop in exports at 1993 levels. The most recent U.S. Commerce Department study estimates that each $1 billion of merchandise exports supports 16,532 jobs. Therefore, an $8.7 billion reduction in U.S. exports would affect approximately 143,000 jobs in the United States. In summary, at 1993 levels, repeal of Section 911 is estimated to result in a loss of 6,800 Americans jobs overseas and an $8.7 billion drop in U.S. exports supporting an additional 143,000 jobs in the United States.

Survey Analyses

According to a recent survey by Profs. Charles Pearson and James Riedel of the Johns Hopkins School of Advanced International Studies, U.S. companies that employ Americans abroad project that repeal of Section 911 would cause an even greater loss in U.S. jobs abroad than predicted by the Mutti model.[2] 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. The Pearson-Riedel survey also found that 77 percent of respondents believe that the nationality of foreign workers has an effect on sourcing decisions, of which two-thirds indicated that there is a "large tendency" for Americans working abroad to purchase from U.S. suppliers. The Pearson-Riedel findings are generally consistent with a 1978 General Accounting Office survey which found that over 80 percent of respondents believed that the reductions in Section 911 contained in the 1976 Act would have resulted in at least a 5 percent reduction in U.S. exports.[3]

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[2] Charles Pearson and James Riedel, *The Importance of Section 911 for U.S. International Competitiveness*, August 1995.

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

Fairness, Efficiency, and Simplicity

Over the nearly 70 years that the foreign earned income exclusion has been part of U.S. law, it has been modified numerous times, including both increases and decreases in the dollar amount of the exclusion as well as a complete restructuring of Section 911 enacted in 1978 and repealed in 1981. Although Section 911 has not been changed since the exclusion was reduced from $80,000 to $70,000 in 1986, some have proposed to repeal the exclusion while others have proposed to raise the $70,000 limitation. The continuing controversy reflects basic disagreements regarding the tax policy rationale for the foreign earned income exclusion.

The traditional standards for evaluating income tax provisions are fairness, economic efficiency, and simplicity.

The *fairness* standard, as it applies to individuals, generally is interpreted to mean that taxpayers with equal "ability to pay" should pay the same amount of income tax ("horizontal" equity), while taxpayers with greater ability to pay should pay a larger amount of income tax ("vertical" equity). The concept of "ability to pay" is inherently subjective, but it has generally been recognized that costs of earning income reduce ability to pay and should be deducted.

When Americans are assigned abroad, their compensation typically is determined by adding to base pay those allowances for additional costs of living abroad such as housing, education, home leave travel, taxes, and cost of living adjustments (COLAs). Consequently, an employee on international assignment typically will have a significantly higher level of gross compensation than a U.S.-based employee with the same company with the same base pay.[4] To the extent that international assignment allowances reflect the additional costs of maintaining the same standard of living abroad, individuals assigned abroad have the same ability to pay tax notwithstanding higher gross income than their domestic counterparts.

Fairness requires equal taxation of families with equal ability to pay; consequently, individuals on international assignment should not be taxed on that part of their compensation which reasonably reflects the added costs of working abroad. One of the purposes of the Section 911 exclusion is to place overseas workers in a more equitable position as compared to domestic workers. Absent Section 911, Americans working abroad would pay much higher taxes than U.S. workers with the same base pay. The foreign earned income exclusion also makes some adjustment for the fact that Americans working abroad do not receive the same level of benefits from the U.S. government as domestic residents.

The *Economic efficiency* standard dictates that the tax law not interfere with the efficient allocation of resources. Absent Section 911, Americans working abroad generally would pay

[4] International assignment allowances averaged 32 percent of foreign salaries and wages (net of allowances) on full-year joint tax returns filed for tax year 1987. Allowances were much higher in some countries, averaging over 87 percent in Japan and Indonesia.

much higher taxes than U.S. workers with the same base pay, and employers often would bear a large share of these added tax costs. Consequently, absent Section 911, the tax law would frequently discourage U.S. companies from hiring Americans in overseas positions, causing foreign nationals to be hired even where Americans would, but for taxes, be preferred.

The Section 911 exclusion does not provide a precisely tailored exclusion for the excess costs of working abroad. It does, however, have an enormous advantage from the standpoint of *simplicity*. The current structure of the Section 911 exclusion was specifically enacted by Congress in 1981 in reaction to the unmanageable complexity of the rules enacted in 1978.

In summary, both the standards of equity and economic efficiency justify exclusion of the portion of foreign earned income attributable to the additional costs of living abroad. Such a system was enacted in 1978 but was found to be overly complex. The fixed dollar exclusion adopted in 1981 as a replacement for the 1978 law is an approximate method for meeting the equity and efficiency standards without undue complexity.

Competitiveness, Protection of the U.S. Tax Base, and Harmonization

In addition to fairness, simplicity, and efficiency, three additional tax policy standards are often used to evaluate U.S. tax provisions that affect international income: competitiveness, protection of the U.S. tax base, and harmonization.

The standard of international *competitiveness* requires that U.S. capital and labor employed in foreign markets bear the same tax burden as foreign capital and labor in those markets. For Americans working abroad, the competitiveness standard would be achieved if the United States excluded *all* foreign earned income without the $70,000 limitation in present law. In this way, Americans working abroad would be subject *only* to foreign income taxes on their foreign earned income in exactly the same manner as foreign workers are taxed. In re-enacting the Section 911 exclusion in 1981, Congress was primarily concerned about maintaining U.S. competitiveness:[5]

> "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 the employees becomes a cost to the

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

> 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."

While recognizing the need to maintain U.S. competitiveness, policymakers have also sought to prevent U.S. source income from escaping the income tax net. The Section 911 exclusion is consistent with the goal of *protecting the U.S. tax base*, because it applies only to income that is earned abroad for activities that are performed abroad by individuals that are not residents of the United States.

Another standard of international taxation is *harmonization* of U.S. tax rules with international norms. As no other major industrial country taxes the foreign earned income of their citizens, harmonization of U.S. law would require an *unlimited* exclusion of foreign earned income, as was in effect from 1926 through 1952.

In summary, an unlimited foreign earned income exclusion would be consistent with the international tax policy standards of competitiveness, preservation of the U.S. tax base, and harmonization. Thus it would be appropriate to lift the $70,000 cap on the foreign earned income exclusion to better achieve these tax policy objectives.

Tax expenditure estimate

One of the reasons that the foreign earned income exclusion has received criticism in the past is that it is shown in the "tax expenditure" list published in the annual Budget. While the tax expenditure list is a useful tool for budget analysis, the revenue loss shown for Section 911 may be seriously misleading for public policy purposes.

First, the tax expenditure estimate does not take into account offsetting revenue losses which would occur if Section 911 were repealed; in particular, the deductibility of certain expenses which currently are disallowed as a result of the exclusion and the reduction in corporate income tax revenues that would occur due to higher compensation costs absent Section 911. For 1987, the Treasury Department estimated that, as a result of these offsetting factors, the revenue that could be raised by repealing Section 911 would be about 20 percent less than the tax expenditure estimate.

Second, tax expenditures are measured relative to a "normal" tax baseline, which is a conception of how the income tax system would look absent tax preferences. The explanation in the Budget states that the normal tax baseline allows deductions for expenses incurred in earning income.

Excess foreign living costs for Americans on international assignments are expenses incurred in earning income and, under Budget principles, should be deductible for purposes of the "normal" tax baseline. Consequently, only the excess of the Section 911 exclusion over the additional costs of living abroad would appear to fit the definition of a tax expenditure. The Budget substantially overstates the tax expenditure attributable to Section 911 because it treats the entire foreign earned income exclusion as a tax preference rather than only the excess of the exclusion over the additional costs of living abroad.

I. OVERVIEW

The United States is the only major industrial country that does not completely exempt the foreign earned income of its citizens working abroad. Instead, under the provisions of Section 911 of the Internal Revenue Code, the United States permits a limited exclusion for $70,000 per annum of foreign earned income plus certain foreign housing costs. 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.

Although Section 911 has not been changed since the exclusion was reduced from $80,000 to $70,000 in 1986, proposals have been made to modify the exclusion. Some have introduced bills to repeal the exclusion, while others have sponsored legislation to increase the exclusion.[1]

While the economic effects of Section 911 received considerable attention as part of the debate surrounding the Foreign Earned Income Act of 1978, little analysis has been done over the last 15 years. The purpose of this report is to assess the economic effects of Section 911 using more recent data.

The following section of the report (Chapter II), describes the present and prior rules applicable to the taxation of Americans working abroad. Chapter II also reviews the types of compensation arrangements commonly used by multinational companies in connection with international assignments. In addition, the Chapter summarizes the most recent available data regarding taxpayers' utilization of the foreign earned income exclusion.

Chapter III uses data from the Internal Revenue Service and Price Waterhouse's Assignment Cost Projection System (ACPS) to estimate the increase in compensation of Americans working abroad that would be necessitated by repeal of Section 911. This projected increase in required compensation is used in conjunction with an econometric model of U.S. exports and expatriate employment developed by Prof. John Mutti to estimate the effect of Section 911 repeal on employment of Americans abroad and U.S. exports. The results of the econometric model are then compared with a recent survey, conducted by Profs. Charles Pearson and James Riedel, of U.S. companies that employ Americans overseas.

The last Chapter assesses the tax policy issues raised by the foreign earned income exclusion. Section 911 is evaluated according to the traditional tax policy objectives of fairness, simplicity, and economic efficiency as well as three criteria that are particularly important for assessing international tax provisions, i.e., international competitiveness, preservation of the U.S. tax base, and compatibility with international tax norms. Chapter IV concludes with a discussion of the estimated revenue cost of Section 911 which is included in the "tax expenditure" list published in the annual federal budget.

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[1] On January 4, 1995, Rep. Bill Archer introduced H.R. 57 which would increase the exclusion to $100,000 and index this amount annually for inflation. On July 6, 1995, House Minority Leader Richard Gephardt announced a comprehensive tax reform proposal which would, *inter alia*, repeal section 911.

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.[2] 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 $70,000 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 (*i.e.*, housing costs over $9,060 in 1994). Housing costs must be provided by an employer to qualify for the exclusion and included in the taxpayer's gross income; otherwise, a deduction is allowed for these costs. 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 "foreign earned." 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 $70,000 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

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[2] In addition to the United States, the following countries tax on the basis of citizenship rather than residence: Bulgaria, Republic of Gabon, Honduras, Indonesia, Jamaica, Kenya, Korea, Philippines, Senegal and Zambia (limited form).

nonresidence to 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. Therefore, a taxpayer, for example, who was abroad from July 1, 1994 through August 31, 1995 and spent 11 days in the U.S. from July 1 through December 31, 1994, could only claim an exclusion for 173 out of 184 days in 1984, resulting in an exclusion of $33,178 for 1994 (*i.e.*, 173/365 times $70,000).

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 which 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 costs 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, as follows:

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

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

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 the foreign source income (see discussion that follows regarding source of income and expense allocation rules). Therefore, the amount of the FTC in a given year is the lesser of: (1) foreign taxes paid or accrued; or (2) the amount computed under the FTC limitation formula:

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

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

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

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 two years and utilized against any unused FTC limitation existing in either of those years. Any taxes remaining after the "carryback" may be carried forward for a period of five years.

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.

There are currently nine "baskets" which the FTC formula limitation must be separately applied to, including: general limitation income; passive income; high withholding tax interest; financial services income; non-controlled Section 902 dividends; shipping income; dividends from a DISC; distributions from a FSC; and taxable income attributable to foreign trade income.

Individual taxpayers typically have to contend only with the separate baskets for general limitation income, passive income and high withholding tax interest. General limitation income typically includes wages, assignment allowances and other remuneration paid by an employer. Passive income generally includes, but is not limited to, interest, dividends, rents, royalties. High withholding tax interest includes interest which is subject to foreign withholding tax of 5 percent or more.

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, the location of the property or the place of sale have no 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 nonbusiness, nonincome-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 1995.

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

Years	Limitation 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-present	$70,000

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

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.[3] In 1953, the exclusion was first limited to a set dollar amount of $20,000.[4] 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.

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.

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[3] In 1928, section 213(b)(14) was redesignated as section 116(a).

[4] In 1954, section 116(a) was redesignated as section 911(a).

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.[5]

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 permanently reduced the exclusion to \$70,000.

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
- 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 partaking in 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,

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

residential parking, and insurance. In certain situations an employer may pay mortgage interest and taxes where an assignee purchases a home.[6] 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 "difficult" locations, such as in certain Middle Eastern countries.

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.[7] 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.[8]

Under a tax equalization or tax protection policy, an 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.

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

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

7 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

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

and the foreign tax credit. The most recent report, issued in the Fall of 1994, is based on an analysis of tax returns for income earned in 1991.

The Treasury report indicates that about 220,000 taxpayers claimed the foreign earned income exclusion on timely filed returns for 1991. The total section 911 exclusion increased at an annual rate of 13.7 percent per year over the 1987-1991 period, from $6.4 billion to $10.7 billion, as compared to foreign earned income which increased by 14.0 percent per year over the period (See Table II.3).

Over the 1987-1991 period, the exclusion declined from 78.9 percent to 78.1 percent of foreign earned income. The Section 911 exclusion protects a smaller share of foreign earned income over time because the $70,000 limitation, established in the Tax Reform Act of 1986, has not been adjusted for inflation.

Section 911 provides for a housing exclusion and deduction as well as the $70,000 foreign earned income exclusion. The housing exclusion and deduction, which are based on the actual cost of housing, have increased much more rapidly over the 1987-1991 period than the foreign earned income exclusion (21.0 and 26.9 percent per year, versus 12.9 percent per year).

Table II.3.—Comparison of Section 911 Returns: 1983, 1987 and 1991

[Money amounts in thousands]

Item	1983 a/	1987	1991	Average annual percent change		
				1983-87	1987-91	1983-91
Returns with Sec. 911	154,429	171,191	220,165	2.6%	6.5%	4.5%
Foreign earned income	$7,185,955	$8,147,355	$13,748,634	3.2%	14.0%	8.4%
Sec. 911 exclusion	$6,021,819	$6,427,167	$10,743,696	1.6%	13.7%	7.5%
Foreign earned income	$5;707,052	$5,959,271	$9,697,339	1.1%	12.9%	6.9%
Housing exclusion	$314,767	$467,896	$1,002,847	10.4%	21.0%	15.6%
Housing deduction	$13,385	$16,791	$43,510	5.8%	26.9%	15.9%
Avg. foreign earned income per return	$45.1	$47.6	$62.4	1.4%	7.0%	4.2%
Avg. sec. 911 exclusion per return	$39.0	$37.5	$48.8	-1.0%	6.8%	2.8%
Exclusion as percent of foreign earned income	83.8%	78.9%	78.1%	-1.5%	-0.2%	-0.9%

a/ Note that the Statistics of Income data include all returns filed in 1983, including returns for prior years filed in 1983.

Sources: U.S. Dept. of the Treasury, "Foreign Income and Taxes Reported on U.S. Individual Tax Returns, 1983: An Overview," SOI Bulletin, Summer 1987, p. 72.

U.S. Dept. of the Treasury, "Individual Foreign Earned Income and Foreign Tax Credit, 1987, SOI Bulletin, Winter 1992-93, pp. 18-19.

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

Price Waterhouse LLP calculations.

III. ECONOMIC EFFECTS OF SECTION 911

This Chapter analyzes the economic effects of the Section 911 exclusion. In Part A, the increase in average compensation necessary to maintain the after-tax income of U.S. nationals working abroad absent Section 911 is estimated. In Part B, this estimate is combined with an econometric model of the expatriate labor market, developed by Prof. Mutti,[9] to determine the reduction in Americans working abroad that would occur absent Section 911. In Part C, the Mutti model is used to estimate the change in U.S. exports and associated U.S. employment that would occur if Section 911 were repealed. In the last part of this Chapter, the results of this analysis are compared with a recent survey, conducted by Profs. Pearson and Riedel,[10] of companies that employ Americans overseas.

A. Effect of Section 911 on Compensation Costs

Background

Under Section 911, qualified U.S. expatriates may exclude up to $70,000 per year of foreign earned income plus a housing 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.

Absent Section 911, all foreign earned income and housing allowances would be fully taxable and, as a consequence, nonexcluded income (*e.g.*, investment income) could be taxed in higher income tax brackets. Taxpayers would be eligible to credit foreign taxes paid (if any) with respect to otherwise excluded income, subject to the foreign tax credit limitation. Also, certain expenses allocable to otherwise excluded income would become deductible for U.S. income tax purposes.

To estimate the increase in expatriate compensation necessary to provide the same after-tax level of income absent Section 911, it is necessary to take into account taxpayer specific factors (*e.g.*, marital status) as well as U.S. and foreign income tax rules. To make these complex tax calculations, Price Waterhouse's Assignment Cost Projection System ("ACPS") was utilized.

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[9] 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.

[10] Charles Pearson and James Riedel, *The Importance of Section 911 for U.S. International Competitiveness*, August 1995.

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 taxes.

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 over 50 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
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 costs
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 project, profiles were developed for representative taxpayers at seven income levels in 15 countries.

The starting point for the development of these profiles was a tabulation of 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, including Price Waterhouse's International Assignment Tax Services, to complete the taxpayer profiles used in the ACPS analysis. The methodology used for determining these inputs is described in Appendix A.

IRS data

At the request of Price Waterhouse, the IRS Statistics of Income Division tabulated four items from the 1987 Form 2555 for each of seven income classes in each of 15 countries.[11] The four tabulated items are:

1. Total foreign source wages, salaries, bonuses, commissions, *etc.*;

2. Allowances, reimbursements, *etc.* including cost of living and overseas differential, family allowance, education allowance, home leave allowance, and temporary quarters;

3. Total foreign earned income (wages and other income for personal services performed abroad, plus noncash employer benefits, plus allowances, less meals and lodging furnished by the employer); and

4. Net exclusion (housing exclusion plus foreign earned income exclusion less deductions allocable to excluded income).

The 15 countries for which detailed data were provided by the IRS are shown in Table III.1. According to the IRS data, these countries were the source of the largest amount of foreign earned income in 1987, accounting for two-thirds of the foreign wage and salary income reported on Form 2555.

For all countries, the IRS also provided Price Waterhouse with tabulations by income class of numerous items from Form 1040 (U.S. Individual Income Tax Return) and Form 2555 returns of all joint filers living abroad during the entire 1987 tax year.

Using IRS data for 15 countries and 7 income classes, a total of 105 (15 times 7) tax profiles were developed for representative taxpayers electing the Section 911 exclusion. As discussed below, the effect of Section 911 repeal on these taxpayers was then determined using the Assignment Cost Projection System.

[11] The 1987 data was the most recent available data at the time this study was initiated in 1994.

Table III.1.--All 1987 Returns with Form 2555
[Ranked by salary and wages]

Country	Returns	Salary, wages	Percent	
			Returns	Salary, wages
United Kingdom	15,829	709,106	9.2%	12.1%
Saudi Arabia	13,407	649,669	7.8%	11.1%
West Germany	18,149	458,028	10.6%	7.8%
Canada	12,912	436,151	7.5%	7.5%
Japan	10,196	395,644	6.0%	6.8%
France	5,392	195,404	3.1%	3.3%
Switzerland	4,343	183,094	2.5%	3.1%
Hong Kong	3,221	161,338	1.9%	2.8%
Australia	3,748	116,342	2.2%	2.0%
Indonesia	3,062	114,817	1.8%	2.0%
Brazil	3,140	100,964	1.8%	1.7%
South Korea	2,887	97,604	1.7%	1.7%
Israel	5,077	96,336	3.0%	1.6%
Italy	2,679	84,138	1.6%	1.4%
Belgium	1,687	83,688	1.0%	1.4%
Subtotal	105,729	3,882,323	61.8%	66.4%
Other countries	65,462	1,964,589	38.2%	33.6%
Total	171,191	5,846,912	100.0%	100.0%

Source: Internal Revenue Service, *SOI Bulletin*, Winter 1992-93, p. 86.

ACPS simulations

For each of 105 representative taxpayers, the ACPS model was used to determine the tax gross-up under present law as well as the hypothetical tax gross-up assuming repeal of Section 911, requiring a total of 210 ACPS runs.[12] The ACPS model was run using 1993 law and was based on 1987 IRS data adjusted to 1993 levels using the Consumer Price Index (see Appendix A for details). The difference in the tax gross-up, with and without Section 911, represents the increase in compensation that would be required to maintain the taxpayer's after-tax income.

The percentage compensation increases (absent Section 911) for the 105 representative taxpayers were weighted to be representative of all taxpayers that file returns claiming the Section 911 exclusion. 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.

Results of ACPS simulations

The results of the ACPS simulations are summarized in Table III.2, which reflects the required increase in compensation, pursuant to repeal of Section 911, as a percent of compensation levels under present law (*i.e.,* base pay plus allowances plus tax gross-up).

In 1993, it is estimated that compensation levels would need to increase by an average of 7.19 percent, if the Section 911 exclusion were repealed, to maintain the same after-tax level of income for U.S. expatriate employees.

The required compensation increases vary across countries, and generally are higher in low-tax foreign jurisdictions such as Saudi Arabia (19.7 percent) and Hong Kong (11.7 percent), and are lower in high-tax jurisdictions such as Italy (1.4 percent) and Israel (1.8 percent).

This analysis also shows that, contrary to conventional wisdom, *Section 911 provides benefits in most major industrial countries* despite their relatively high levels of individual income tax. For example, absent Section 911, required compensation would increase by an average of 8.6 percent in Australia, 8.0 percent in Japan, 5.4 percent in Switzerland, 4.5 percent in France, 3.3 percent in Canada, and 3.1 percent in Germany.

It is often supposed that Section 911 only provides an incentive to locate Americans in low-tax countries 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

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[12] The tax gross-up is the additional compensation required to compensate an employee assigned abroad for the additional tax liability attributable to the assignment. The tax gross-up takes account of the fact that the gross-up is itself subject to U.S. income tax.

Table III.2 --Effect of Section 911 on Required Compensation, 1993

[Increase in compensation required absent Section 911 to maintain after-tax income as a percent of present law compensation]

Country	Base wages (1987 amounts inflated to 1993 dollars)							
	$12,720	$25,440	$38,160	$50,880	$63,600	$89,040	$152,640	All Income
Australia	15.02%	2.67%	1.98%	7.61%	12.92%	11.38%	8.29%	8.58%
Belgium	17.27%	4.40%	1.40%	3.49%	2.95%	1.90%	0.55%	2.14%
Brazil	21.10%	11.77%	10.82%	4.30%	4.06%	4.55%	7.24%	6.22%
Canada	11.45%	2.93%	2.16%	2.42%	2.23%	1.23%	5.08%	3.32%
France	17.49%	9.19%	8.51%	8.45%	6.24%	3.10%	2.11%	4.54%
Germany	16.29%	4.70%	2.83%	2.51%	1.91%	1.58%	1.33%	3.07%
Hong Kong	20.91%	14.17%	9.85%	12.08%	14.21%	12.47%	10.34%	11.65%
Indonesia	4.94%	2.61%	1.95%	6.82%	6.19%	4.51%	5.23%	5.45%
Israel	5.41%	3.99%	1.13%	2.12%	1.44%	1.23%	0.59%	1.80%
Italy	6.16%	2.81%	2.07%	1.68%	1.40%	1.41%	0.43%	1.40%
Japan	7.55%	2.85%	8.11%	11.67%	11.25%	8.37%	4.94%	7.96%
Saudi	20.82%	15.99%	21.90%	23.55%	22.68%	20.57%	17.51%	19.71%
South Korea	20.22%	11.02%	6.32%	8.55%	7.27%	7.33%	3.11%	6.83%
Switzerland	21.24%	13.97%	8.98%	5.02%	5.28%	4.25%	5.07%	5.35%
UK	5.54%	2.51%	2.82%	1.92%	1.32%	1.26%	2.84%	2.17%
All Countries	12.66%	6.16%	8.32%	8.92%	7.07%	6.38%	6.77%	7.19%

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 modelling 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.2 also show that the *tax incentive arising from Section 911 represents a larger share of the compensation of low and middle income Americans working abroad* than of high-income expatriates. For example, absent Section 911, to protect the income of expatriates in the bottom and middle seventh of the income distribution, compensation would on average need to increase by 12.7 and 8.9 percent, respectively, compared to 6.8 percent for expatriates in the top seventh of the income distribution (see Table III.2). Thus, the Section 911 exclusion is progressive -- providing relatively greater benefits to lower and middle income expatriate workers.[13] The progressive nature of the Section 911 exclusion primarily is attributable to fixed dollar nature of the exclusion. The exclusion provides no benefit for foreign earned income in excess of the $70,000 exclusion.

B. Employment of Americans 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 some 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.

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[13] Where employers use tax equalization packages, the employer, rather than the employee, retains the tax savings from Section 911.

To estimate the effects of Section 911 repeal, a model of the expatriate labor market developed by Prof. John Mutti was used. Prof. Mutti developed this model when he was employed in the Office of Tax Analysis of the U.S. Treasury Department in 1978. The paper was first released as an Office of Tax Analysis research paper and subsequently published in the Southern Economic Journal.[14] The Mutti model is described below.

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, but 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 repealing 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. expatriate employees; (2) the supply of U.S. employees abroad; and (3) the demand for U.S. exports. The demand for U.S. nationals abroad is modeled as depending on the value of 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 and 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.[15] 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.

Results of Mutti model

The estimated coefficients from the Mutti model imply that a 1.00 percent increase in required wages will result in a 0.39 percent reduction in Americans employed abroad (i.e., the "elasticity" of American employment abroad with respect to wages is -0.39).

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[14] 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.

[15] 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.

As described above, repeal of Section 911 would cause the average level of required expatriate compensation to increase by 7.19 percent. According to the Mutti model, this implies that Americans employed abroad would fall by 2.83 percent (7.19 percent times elasticity of -0.39).

According to the IRS, the number of returns claiming Section 911 benefits in tax year 1991 amounted to 220,165, an increase of 4.53 percent per annum from the 1983 level of 154,429 (see Table II.3). Assuming that the number of individuals claiming Section 911 benefits continued to grow at the 1983-1991 rate, the number of individuals claiming the exclusion would have reached about 241,000 in 1993. A 2.83 percent reduction in Americans employed abroad, as a result of repeal of Section 911, would imply a loss of 6,800 American jobs in 1993 (see Table III.3).

Table III.3.--Estimated Effect of Section 911 Repeal on U.S. Expatriate Employment, 1993

Average required increase in expatriate compensation absent Section 911	7.19%
Elasticity of U.S. expatriate employment with respect to wages	-0.39
Estimated percentage change in Americans employed abroad absent Section 911	-2.83%
Section 911 claimants, 1991	220,165
Average annual growth rate of Section 911 claimants, 1983-1991	4.53%
Estimated number of Section 911 claimants, 1993	240,600
Estimated reduction in Americans employed abroad absent Section 911, 1993	-6,800

C. U.S. Exports and Associated Employment

U.S. exports

The estimated coefficients from the Mutti model imply that a 1.00 percent increase in average wages required by expatriate U.S. workers will result in a 0.26 percent reduction in U.S. exports.[16]

As described above, repeal of Section 911 would cause the average level of required expatriate compensation to increase by 7.19 percent. According to the Mutti model, this implies that U.S. exports would fall by 1.89 percent (7.19 percent times -0.26).

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[16] It should be noted that Professor Mutti interprets his results as providing an upper-bound projection of the responsiveness of Americans living abroad to changes in after-tax wages. As discussed in Section III.D., however, a recent survey by Professors Charles Pearson and James Riedel finds that the sensitivity of U.S. expatriate employment to taxes is greater than that found by Mutti.

According to the Commerce Department, U.S. merchandise exports (excluding military exports) totalled $456.9 billion in 1993. A 1.89 percent reduction in merchandise exports, as a result of repeal of Section 911, would imply a loss of $8.7 billion in exports in 1993 (see Table III.4).

Prof. Mutti offered several explanations for the relationship between 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 purchases of U.S. goods by foreigners by, in effect, setting an example. Also, Americans living abroad also may be directly engaged in marketing U.S. made goods, in which case the connection between Americans living abroad and U.S. exports is quite direct.

Employment associated with U.S. exports

According to the most recent U.S. Commerce Department study, each $1 billion of U.S. merchandise exports supports 16,532 domestic jobs.[17] Consequently, a decline in U.S. exports of $8.7 billion, from repeal of Section 911, would affect about 143,000 U.S. jobs (see Table III.4).

Table III.4.--Estimated Effect of Section 911 Repeal on U.S. Exports and Associated Employment, 1993

Average required increase in expatriate compensation absent Section 911	7.19%
Cross-elasticity of U.S. exports with respect to U.S. expatriate wages	-0.26
Estimated percentage change in U.S. exports absent Section 911	-1.89%
U.S. merchandise exports, 1993 (billions)	$456.9
Estimated reduction in U.S. exports absent Section 911, 1993 (billions)	-$8.7
Domestic employment per $1 billion in U.S. goods exports, 1992[a]	16,532
Domestic employment affected by Section 911 repeal	-143,000

[a] The most recent U.S. Department of Commerce estimate of U.S. employment supported by U.S. exports is for 1992. The Commerce Department estimates that each $1 billion of U.S. *services* exports supports 23,029 jobs. The effect of section 911 on services exports is not included in this study.

[17] U.S. Dept. of Commerce, *U.S. Jobs Supported by Goods and Services Exports, 1983-1992*, May 1995.

D. Pearson-Riedel Survey

To better understand the relationship between Americans working abroad, U.S. exports, and the foreign earned income exclusion, the Section 911 Coalition recently commissioned a survey by Profs. Charles Pearson and James Riedel at the Johns Hopkins University School of Advanced International Studies.[18]

The Pearson-Riedel survey covers 148 employers who collectively employ 12,682 U.S. nationals abroad and have 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 even more than the 7.19 percent estimate based on the Assignment Cost Projection System simulations.

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 an even greater reduction in Americans working abroad than the 2.8 percent estimate based on the Assignment Cost Projection System simulations and the Mutti model. Given that survey respondents anticipate a large increase in compensation costs absent Section 911, it is not surprising that employment of U.S. nationals is expected to fall sharply.

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 believe that employee nationality has an effect on sourcing decisions. Of this 85 percent, 60 percent believe 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. Pearson and Riedel's findings are consistent with a 1978 General Accounting Office (GAO) survey of 183 U.S. firms

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

employing Americans abroad. The GAO found that "Over 80 percent of the firms surveyed were of the opinion that the tax changes [reduction of the foreign earned income exclusion in the 1976 Act] would result in at least a 5 percent reduction of U.S. exports."[19]

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 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.

Small business. The Pearson-Riedel sample included both small companies (500 employees or less) and large companies. Pearson and Riedel found that among small businesses, U.S. expatriates accounted for 32 percent of total overseas employment while the corresponding percentage for large businesses was 3 percent. This suggests that repeal of Section 911 could have over **ten times** the impact, relative to total overseas compensation costs, on small businesses as compared to large businesses. The greater dependence of small business on the foreign earned income exclusion is an important finding from the survey.

[19] 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, former IRS Commissioner Fred Goldberg outlined five tax policy objectives for taxation of international income[20]

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. The Chapter 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.[21]

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.

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[20] 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.

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

The Section 911 exclusion has in the past been criticized as violating both the principles of horizontal and vertical equity.[22] 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 inequity 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.

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. International assignment allowances are substantial. As shown in Table IV.1, for full-year joint tax returns filed for 1987, allowances averaged 32 percent of foreign wage and salaries (net of allowances). Allowances vary substantially by country, however, from 6 percent of base pay in Canada to over 87 percent in Indonesia and Japan.

Under U.S. 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 a result, the assignee's standard of living remains the same as his U.S. counterpart with the same base salary.

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.

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[22] 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).

Table IV.1.—Allowances as a Percent of Foreign Wages and Salaries, 1987

[Joint returns, full year abroad]

Country	Foreign Wages and Salaries							
From:	0	12,151	22,701	34,101	47,101	59,151	80,801	All incomes
To:	12,150	22,700	34,100	47,100	59,150	80,800	and over	
Australia	0.0%	0.0%	0.0%	41.1%	109.4%	75.7%	30.7%	39.5%
Belgium	20.4%	NA	20.4%	121.2%	118.0%	46.3%	34.7%	59.6%
Brazil	0.0%	15.2%	9.8%	29.8%	40.5%	57.6%	25.2%	31.5%
Canada	0.0%	0.0%	7.6%	8.0%	1.5%	8.8%	5.4%	5.5%
France	NA	26.0%	21.3%	40.9%	41.8%	40.3%	20.4%	32.6%
West Germany	0.0%	4.8%	4.0%	16.0%	29.6%	14.3%	21.9%	14.6%
Hong Kong	0.0%	0.0%	31.1%	23.0%	144.5%	97.3%	27.0%	46.3%
Indonesia	0.0%	37.0%	0.0%	132.8%	122.0%	65.4%	83.2%	87.2%
Israel	NA	0.0%	NA	0.0%	NA	19.0%	25.3%	9.7%
Italy	0.0%	NA	13.3%	16.5%	34.4%	68.2%	40.5%	39.1%
Japan	0.4%	0.0%	43.5%	73.2%	154.3%	121.7%	76.5%	87.0%
South Korea	0.0%	0.0%	0.0%	16.2%	36.2%	60.5%	29.9%	32.8%
Saudi Arabia	NA	35.9%	39.9%	24.1%	18.6%	8.8%	1.7%	10.4%
Switzerland	0.0%	0.0%	0.0%	71.7%	25.9%	29.5%	16.6%	22.6%
United Kingdom	33.3%	5.8%	11.2%	46.7%	62.4%	54.4%	37.2%	43.7%
Subtotal	4.2%	7.9%	17.1%	39.3%	50.6%	40.5%	25.2%	32.1%
All countries	4.9%	7.0%	21.2%	39.4%	48.7%	40.1%	24.8%	31.9%

Source: IRS, Statistics of Income Division, special tabulation of 1987 Form 2555, full-year joint returns.
Price Waterhouse calculations.

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.[25]

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 a 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, it can be argued that 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 costs, was abandoned after only three years. A General Accounting Office review of the 1978 law concluded[26]

> "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.

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

[26] General Accounting Office, 1981, p. 16.

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.[27] 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 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. Based on the Assignment Cost Projection System, it is estimated that 29 percent of Americans working abroad on international assignments in 1993 received allowances in excess of $70,000 per year. Thus, 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.

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

Conclusion

Repeal of the Section 911 exclusion would not achieve economic efficiency in the allocation of resources because there typically 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, in a rough fashion, 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. Originally enacted in 1926, the foreign earned income exclusion was designed to[28]

> "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."

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.[29]

In re-enacting the Section 911 exclusion in 1981, Congress was primarily concerned about maintaining U.S. competitiveness:[30]

> "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.

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

[29] General Accounting Office, 1981, op cit., p. 17.

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

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 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 $70,000 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[31]

> "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."

Based on the apparent anti-competitive effects of the reduction in the foreign earned income exclusion in 1978, the GAO recommended[32]

> "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.

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[31] General Accounting Office, 1981, op cit., p. 28.

[32] Ibid.

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 four 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 over half of the profits of U.S. multinational corporations. 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. A recent example is the Treasury Department's participation in the development of a new set 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 $70,000 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."[33]

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.[34] 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."[35]

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

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

[34] 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).

[35] U.S. Budget, FY 1996, op cit., p. 51.

by federal government employees working abroad).[36] 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 September 1, 1995 by the Joint Committee on Taxation. The estimate is reproduced in Table IV.2, below:

Table IV.2.--Tax Expenditure Estimate, 1994-2000
[Fiscal years, billions of dollars]

Item	1996	1997	1998	1999	2000	1996-2000
Exclusion of income earned abroad by U.S. citizens	1.6	1.7	1.8	1.9	1.9	8.9

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1996-2000*, JCS-21-95, September 1, 1995, p. 12.

The tax expenditure estimate of the foreign earned income exclusion increased from $1.6 billion in fiscal year 1996 to $1.9 billion in fiscal year 2000. 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 20 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, however, may be seriously misleading for public policy purposes for two reasons:

First, the tax expenditure estimate depends crucially on the definition of the "normal" tax baseline which 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 judgement."[37] The explanation in the Budget states that the normal tax baseline used for measuring tax expenditures explicitly includes the standard deduction, personal exemption, and

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

[37] Ibid. p. 51.

"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, ostensibly should be treated as part of the normal tax baseline. Only that portion of the foreign earned income exclusion that is larger than necessary to compensate for the excess cost of living abroad would appear to 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 is accepted, the revenue effect of repealing section 911 would be expected to 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) which 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.[38]

[38] 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 to the ACPS model were determined as follows:

1. **Base salary**. The base salary septiles, which are the same for each country, were chosen to fall within the ranges used by the SOI Division of the IRS in providing Form 2555 information for each country. The SOI Division of the IRS broke-down the Form 2555 information into the following septiles:

   (i) X < \$12,000
   (ii) \$12,000 < X < \$22,700
   (iii) \$22,700 < X < \$34,100
   (iv) \$34,100 < X < \$47,100
   (v) \$47,100 < X < \$59,150
   (vi) \$59,150 < X < \$80,800
   (vii) X > \$80,800

   Accordingly, the following 1987 base salaries were used as a starting point:

   (i) \$10,000
   (ii) \$20,000
   (iii) \$30,000
   (iv) \$40,000
   (v) \$50,000
   (vi) \$70,000
   (vii) \$130,000

   The base salaries were increased by 27.2% to account for inflation over the period 1987-1993. The 27.2% is based on the CPI for this period. After adjustment for inflation, the following base salaries were used:

   (i) \$12,720
   (ii) \$25,440
   (iii) \$38,160
   (iv) \$50,880
   (v) \$63,600
   (vi) \$89,040
   (vii) \$152,640

2. **Country of assignment**. The following countries were used in the sample:

    1. Australia
    2. Belgium
    3. Brazil
    4. Canada
    5. France
    6. Hong Kong
    7. Israel
    8. Italy
    9. Indonesia
    10. Japan
    11. South Korea
    12. Saudi Arabia
    13. Switzerland
    14. United Kingdom
    15. West Germany

3. **Length of assignment**. The assignment dates of July 1, 1993 through June 30, 1996 were used for each simulation as this represents a typical assignment length for an expatriate employee.

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. The 1993 yearly average exchange rates were used, the latest available yearly averages, consistent with the assignment start dates and wages which were inflation adjusted from 1987 to 1993. The average exchange rates were computed from the 1993 quarterly averages provided in International Financial Statistics.

5. **Gross-up method.** Taxes can be reimbursed by the employer and included in the assignee's expatriate compensation under one of three methods: one-year rollover method, current year gross-up, or the loan bonus method. The method used in each foreign country was determined based on the standard method allowed in that country. For example, Japan and the United Kingdom only allow the current-year gross-up method to be used; whereas, all the other countries in our sample 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 Forms 2555, the itemized deductions and standard deductions as a percent of wages and salaries (*i.e.*, from Form 1040, line 1) were computed to be as follows:

Septile	Salaries & Wages (S&W)	Itemized deductions Total	Itemized deductions Percent of S&W	Standard deduction Total	Standard deduction Percent of S&W
1	195,091,942	10,972,042	5.62%	26,808,425	13.74%
2	223,715,849	9,116,406	4.07%	23,587,890	10.54%
3	327,243,494	9,301,231	2.84%	20,437,219	6.25%
4	560,861,089	16,502,569	2.94%	20,097,838	3.58%
5	742,985,579	23,948,030	3.22%	19,571,731	2.63%
6	925,925,048	36,626,904	3.96%	16,902,784	1.83%
7	1,503,382,715	82,599,028	5.50%	15,582,992	1.04%

For septiles 1 through 4, the standard deduction as a percentage of wages and salaries was greater than the itemized deduction as a percentage of wages and salaries, therefore, the standard deduction was used for these septiles. For septiles 5 through 7, the itemized deductions as a percentage of wages and salaries per the Form 2555 was greater than the standard deduction, therefore, the itemized deductions were computed using this methodology for septiles 5 through 7. This is consistent with the manner in which the ACPS system computes itemized deductions which is based on base salary and gross wages including assignment allowances.

8. **Hardship premium**. Out of the sample of countries, hardship premiums are only given for Indonesia and Saudi Arabia. The premium is x% of base salary. For Indonesia and Saudi Arabia, the percentages are 15% and 20%, respectively. The percentages were taken from the State Department pamphlet entitled "U.S. Department of Living Costs Abroad, Quarters Allowances, and Hardship Differentials--January 1994 ("State Department Indices").

9. **International service premium ("ISP")**. The ISP was determined to be one-month's base salary for each assignee, as this is the typically ISP given to an expatriate.

10. **Education allowance**. Allowances for education were determined based on information obtained in Price Waterhouse's annual survey of companies with expatriate employees.

11. **Cost-of-living allowance ("COLA")**. The COLA allowance was computed based on information provided in the State Department Indices.

12. **Employer paid housing costs**. Were determined based on the State Department Indices with inputs of family size, location and base salary.

13. **Transportation and moving costs:**

    a. **Storage.** A nominal amount of $500 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 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 \$151.00.

14. **Estimated outside income.** This was determined based on the aggregate information provided by the SOI Division of the IRS. The amount was arrived at by taking salaries per line 1, Form 1040, less foreign earned income on line 17, Form 2555, less business income on Form 2555, less partnership income on Form 2555. The net result per septile was then divided by the number of returns per septile to arrive at the "other income" per septile.

15. **Filing status/family size.** Married filing joint filing status was used because the comparative IRS data was based on individuals filing married filing joint returns. Family size of four was used as this represents the typical family size of expatriate employees.

16. **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.

17. **Family home leave.** The cost of three round-trip tickets (*i.e.*, for spouse and children).

Once all the allowances were determined, the total was compared to the actual 1987 Form 2555 allowances per septile, per country provided by the SOI Division of the IRS. Each allowance was either scaled-up or scaled-down based on the difference.

APPENDIX B. WEIGHTING OF ACPS RESULTS

Table III.2 shows the percentage increase in compensation required in 1993 to maintain the after-tax income of 105 representative U.S. expatriate taxpayers in the event that Section 911 were repealed.

These results were weighted to be representative of all taxpayers filing returns that claim the Section 911 exclusion. The weighted average percentage increase in required compensation absent Section 911 (P) was derived as follows:

$$P = \sum_{i=1}^{7} \sum_{c=1}^{15} P_{i,c} \times [\ w_{i,c} / \sum_{i=1}^{7} \sum_{c=1}^{15} w_{i,c}\ ]$$

where:

P_{ic} = Increase in tax gross-up required if Section 911 were repealed, as a percent of wages and allowances, for representative taxpayer within income class i and assigned to country c.

w_{ic} = Aggregate wages, salaries, and allowances reported on 1987 Form 2555 for taxpayers within income class i and assigned to country c.

The weighted average percentage increase in required compensation absent Section 911 for country "c" (P_c) was derived as follows:

$$P_c = \sum_{i=1}^{7} P_{i,c} \times [\ w_{i,c} / \sum_{i=1}^{7} w_{i,c}\ ]$$

The weighted average percentage increase in required compensation absent Section 911 for income class "i" (P_i) was derived as follows:

$$P_i = \sum_{c=1}^{15} P_{i,c} \times [\ w_{i,c} / \sum_{c=1}^{15} w_{i,c}\ ]$$