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Making Section 911 Universal is Good Economic Policy and Good Tax Policy

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Introduction

America is one of the few nations to tax citizens who live and work abroad. Indeed, no other industrialized nation imposes a second layer of tax on its expatriates. Senator Jim DeMint (R-SC) has introduced legislation, the Working American Competitiveness Act (S. 3496), to eliminate the worldwide reach of the IRS. By creating a territorial system for labor income, the DeMint legislation will put American workers and U.S.-based multinationals on a level playing field with competitors from other nations. This is a welcome move, particularly since American expatriates were just hit with a tax hike.

A Step in the Wrong Direction

The *Tax Increase Prevention and Reconciliation Act of 2005*, signed into law on May 17, generally is a pro-growth legislation, but it has significantly increased the tax obligations of American citizens who live and work overseas. A last-minute amendment attached to the bill has curtailed—and for some expatriates, effectively eliminated—**Section 911** benefits, which allow U.S. workers abroad to protect a portion of their overseas compensation from being hit by a second layer of taxation by the Internal Revenue Service. (Overseas Americans must pay all applicable taxes to the government of the country where they live and work, just as foreigners who live and work in the U.S. pay tax to the IRS). The amendment retroactively increases the total allowable foreign-earned-income exclusions from \$80,000¹ to 82,400. But this limit now includes housing benefits (which were previously separate from income exclusions)², and also requires expatriates to stack their residual income on top of the excluded amount before

¹ When the Section 911 exclusion was first introduced in 1926, no limitations existed on the amount of foreign income that could be exempted from taxation. In 1952, the Congress limited the benefits to \$20,000, and the Tax Reform act of 1976 pushed the cap back to \$15,000 but this change never took effect. In 1982, President Reagan pushed up the income exclusions cap to first \$75,000 then, a year later to its current level of \$80,000 (and scheduled a further increase to \$95,000 for 1986). Various deficit reduction measures prevented further increases; in fact, in 1987, allowable income was capped at \$70,000. The Tax Relief Act of 1997 gradually increased the cap back to \$80,000 over a decade and then tied the benefits to inflation. For details on the history of Section 911, see [Price Waterhouse Coopers, 2005, 7-9].

² The combination of income and housing benefits under the same cap effectively eliminates the impact of exclusion on some expatriates, regardless of their income. The housing exclusions must not exceed “reasonable” amounts set at \$11,536 per year. In densely populated countries with high housing costs, this amount is completely inadequate. One analyst points out that in Hong Kong, rents for a typical house can run \$100,000 per year [Hilken, 2005].

determining the rate at which they ought to pay taxes. Both these changes will lead to significant tax increases for many overseas Americans.

Senator Chuck Grassley (R, Iowa), who slipped the last minute amendment into the Act, maintains that this move will help pay for the tax breaks introduced by the same Act, and make the US tax system fairer by closing the tax gap between U.S. residents and expatriates [Grassley, 2006]. Senator Grassley is wrong on both counts. First, the potential tax revenue gains from the recent changes are modest, especially compared to the associated losses in exports and employment. The new limitations are expected to generate \$200 million every year in additional taxes from Americans who live and work abroad [Wozniak, 2006].³ At the same time, one study estimates that the near-elimination of the housing allowance will reduce U.S. exports by \$2.5 billion, or add 25,000 more people into the pool of unemployed [Price Waterhouse Coopers, 2005]. Second, while this amendment indeed makes the tax treatment of expatriates and U.S. residents more similar, it would tax the expatriates at even higher rates compared to their competitors from other nations (no other developed nation taxes the employment income of its citizens that live and work abroad), while forcing expatriates to pay for public services they will not get to enjoy.⁴ In return, the increased tax burden threatens the livelihood of expatriates because it makes hiring U.S. citizens more expensive compared to potential employees from countries with no home-tax requirements. Given these serious problems expatriates are now facing, it is not clear how the new changes make the U.S. tax system “fairer.”

Curtailing Section 911 is bad economic policy and bad tax policy. Double-taxing U.S. citizens who live and work overseas is bad economic policy because it hurts U.S. employment abroad, and consequently stifles U.S. exports and employment here at home, without generating tax revenues large enough to justify these losses. By increasing the costs on U.S. companies that hire expatriates, double-taxing also hurts U.S.’s overall competitiveness around the world. Limiting Section 911 benefits is bad tax policy because it makes the U.S. tax system unfair and complicated, and renders compliance too costly, and sometimes, impossible [Mitchell, 2005].

Making Section 911 Universal to Cover All Levels of Foreign-Source Income is Good Economic Policy

The U.S. is the only developed country that requires its citizens who live and work overseas file tax returns and pay taxes on foreign-source labor income.⁵ Citizenship-based taxing is a poor proposition for the economic well-being of the U.S. and its citizens. This is because the

³ The Joint Committee on Taxation puts the total “expenditures” associated with Section 911 to \$3.5 billion to \$4.5 billion annually—or less than three tenths of a percent of the cost of all the tax incentives offered in the current code [Joint Committee On Taxation, 2006].

⁴ This is even true for services typically provided by the state and local governments, for example, basic and higher education, roads and highways, health, public welfare and crime prevention. In 2004, states and local government received 23% of their general revenues from the Federal Government, and the rest by taxing their own resources. Even including user charges and utility revenues, the intergovernmental transfers from the Federal government reached 17% of total revenues raised by the state and local governments. Expatriates receive none of these benefits. For details, see Government Finance Statistics collected by the U.S. Bureau of Census, available at <http://ftp2.census.gov/govs/estimate/04slsstab1a.xls>.

⁵ Other countries with similar tax rules include Bulgaria, Gabon, Honduras, Indonesia, Jamaica, Kenya, South Korea, The Philippines, Senegal, Zambia, Eritrea, North Korea, the Philippines, and Vietnam [Mitchell, 2005]

additional tax burden makes it harder for companies to hire U.S. citizens, especially in countries where income tax rates are lower taxes than the U.S. (Singapore, Russia, United Arab Emirates, among others) [Reinhardt, et al., 2004; Rankin, 2004]. This is inefficient in itself because “high taxes are a poor reason for turning down jobs.”⁶

Table 1: Summary of Findings on the impact of Section 911 modifications on US employment abroad, US employment home, Exports and Competitiveness				
Section 911 Scenario	Source and Method	Full Double-Taxation (Repeal Section 911)	Restrict Housing Exclusion	No Double-Taxation (Make Section 911 Universal)
Change in costs to overseas employers (or compensation)	PwC Study (simulations)	Costs up 4.38%, higher (10-18%) in low-tax jurisdictions	Costs up 1.3%, higher (5%) in low-tax jurisdictions	Costs down 7.8%
	JHU-Pearson & Riedel Survey	Costs up by 5%-25%		
	GAO Survey*	Half the respondents predicted 5%+ costs increases		
Change in American employment abroad	PwC Study (simulations)	Employment of Americans overseas down 1.7% (5500 employees)	Down 0.5% (1700 employees)	Up 3% (9700 employees)
	JHU-Pearson & Riedel Survey	Half the respondents who predicted a fall in US expat employment expected a more than 5% decline		
	GAO Survey*	16% of US expats expected to return home as a direct result of reductions in FEI exclusions. 40% of the overseas employers expected to cut back on US workers.		
Percentage change in U.S. exports, 2004	PwC Study (simulations)	Exports down 1.14% (\$8.1 billion)	Exports down 0.35% (\$2.5 billion)	Exports up 2% (\$14.4 billion)
U.S. employment affected by change in U.S. manufactured exports, 2004	PwC Study (simulations)	Employment down by 77,000	Employment down by 24,000	Employment up by 137,000
US competitiveness Abroad	JHU-Pearson & Riedel Survey	80% of respondents expected an impact on U.S. companies' ability to secure projects and compete abroad-two thirds of these companies predicted moderate to major impact on their businesses.		

* The GAO survey inquired about the impact of reductions in FEI exclusions as proposed in 1976-cut back from \$20,000 to \$15,000 annually.

Table 1 summarizes the findings of three studies that estimate the impact of various modifications to Section 911 benefits. According to a study commissioned by the U.S Chamber of Commerce and conducted in 2005 by Price Waterhouse Coopers (PwC), making Section 911 benefits universal to cover all levels of foreign-source labor income could have increased total employment among U.S. citizens by 147,000 in 2004. Almost 10,000 more expatriates would have been employed abroad, and the consequent increase in the demand for U.S. goods overseas

⁶ Op.cit. [Reinhardt, et al., 2004]

would have increased U.S. exports by 2 percent (or 14.4 billion), creating an additional 137,000 jobs for Americans here at home [Price Waterhouse Coopers, 2005].⁷ While universalized Section 911 benefits are likely to cut costs associated with hiring U.S. citizens by about eight percent, removing housing benefits could increase costs by up to 5 percent and repealing Section 911 could make U.S. citizen-employees up to 18 percent costlier than local or non-U.S. alternatives.

While these results are expected to materialize only within a year, the long-term impact of Section 911 on growth and prosperity is much larger. In fact, studies that focus on the longer-term find even bigger costs associated with reducing Section 911 protection or repealing the provision completely. A survey of 148 international businesses (with collectively 12,000 U.S. expatriate employees and a worldwide labor force of 3.5 million) conducted by Johns Hopkins University researchers finds that 70 percent of the respondents expect higher than five percent increase in compensation costs if Section 911 is repealed—and half this group expects more than 25 percent increase, which would cut U.S. employment abroad by half [Pearson and Ried, 1995]. A larger group of respondents agrees that losing Section 911 protection would reduce companies' abilities to secure and complete projects—that is, a loss in the competitiveness of U.S. companies. An earlier survey of 183 firms with overseas U.S. employees conducted by the U.S. General Accounting Office (now, the Government Accountability Office) finds that a 25 percent cut on the foreign earned income allowances would increase companies' compensation costs by five percent and would force at least forty percent of these companies to cut back U.S. employees [General Accounting Office, 1978].

It is important to note that these survey findings are from 1995 and 1978 respectively. Competition is now fiercer and the added pressure of cutting costs in today's global economy means that the reaction to the current limitations on Section 911 and the consequent impact on U.S. growth and prosperity could be even more dramatic.

Making Section 911 Universal is Good Tax Policy

Universalizing Section 911 to cover all levels of foreign-sourced labor income is good tax policy because it would eliminate double-taxation, level the playing ground for U.S. expatriates, make the tax code fairer and simpler, and reduce compliance problems.

Because taxation in the U.S. is based on citizenship, not on territory, Americans who work and live overseas are subject to onerous forms of double-taxation. Some have argued that the foreign tax credit, which allows Americans to reduce their U.S. tax liability by the amount paid to foreign governments, puts expatriates on the same ground as the U.S. citizens who live in the U.S., and the Section 911 exemptions give a "better deal" to the expatriates. But this argument assumes that Americans abroad should be taxed as if they lived in the U.S. when the more appropriate benchmark is how they are treated compared to other residents of their respective foreign domiciles. In fact, expatriates who file income taxes face significant obligations—in 2001, on average, each expatriate who filed income taxes paid \$11,000 in taxes – putting them on an unequal footing with citizens of other developed nations, none of whom are double-taxed

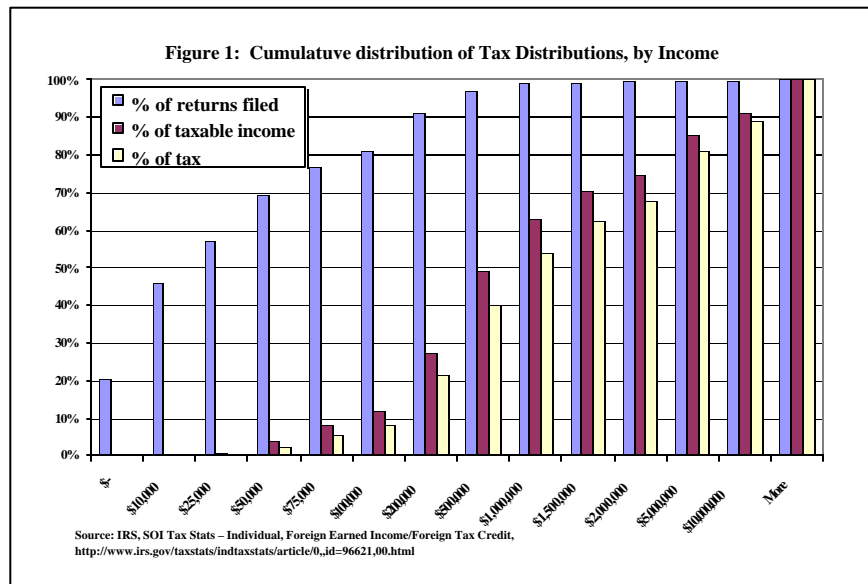
⁷ In estimating the number of jobs created, the study uses elasticities calculated by Mutti in a 1980 article that appeared in the *Southern Economic Journal* [Mutti, 1980].

by their countries of citizenship. The situation is particularly bad for those employees who live in low-tax jurisdictions, because these expatriates are particularly expensive to hire compared to local or foreign employees with no home-tax requirements. An American living and working in a high-tax jurisdiction like France, by contrast, must deal with the headache of a complicated system, but at least is unlikely to face an additional tax liability to the IRS.

Limitations on Section 911 benefits also do not take into consideration indirect forms of taxation on the expatriates' income. For example, in Hong Kong, annual housing costs typically go above \$100,000 (with the current legislation, housing benefits expatriates could claim are capped at \$11,536 per year). Analysts predict that recent changes are likely to double the U.S. tax obligations of Hong Kong residents, while these expatriates will continue to shoulder high taxes on the local housing market (the taxes on land sales constitute 40 percent of Hong Kong's revenues) [Wozniak, 2006].

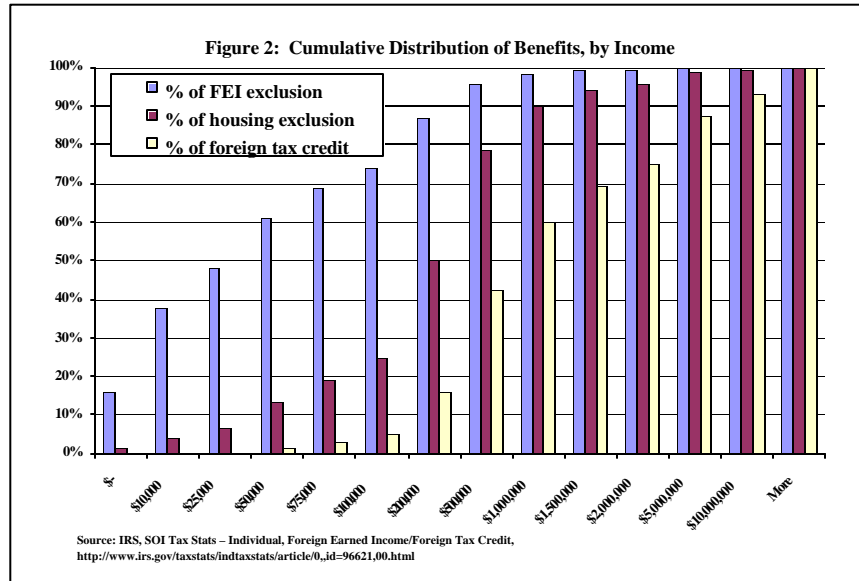
While expatriates continue to bear the costs of the U.S. government, they get little back in return. In 2004, intergovernmental transfers from the federal government financed one in every four dollars spent by state and local governments. U.S. expatriates did not receive any services in return for at least a quarter of their tax payments because they did not send their kids to public schools, drive on local roads, or benefit in any way from hospitals, public welfare, policing and other public services offered by state and local governments.⁸ In fact, they had to pay additional taxes on, for example, schooling benefits they received from their employers. This type of double-taxation hardly gets attention from the opponents of Section 911.

A recent *Wall Street Journal* editorial also points out that the recent limitations on Section 911 benefits are likely to make the tax system less progressive by shifting the larger proportion of tax burden on middle level earners [Wall Street Journal, 2006]. Assuming the goal is to have a pro-growth tax system that treats everyone equally, progressivity is not necessarily desirable. But the way to reduce the adverse impact of progressivity is to lower tax rates on those who contribute most to the economy, not to raise taxes on those with more modest incomes. The recent tax hike on expatriates moves tax policy in the wrong direction. In 2001, expatriates with an adjusted income level of \$200,000



⁸ In 2004, total intergovernmental transfers from federal to state and local governments) constituted 24% of all federal government revenues and equaled fifty six percent of the individual income taxes collected by the federal government.

or less filed almost 91 percent of all returns, accounted for 27 percent of taxable income reported on these forms, and paid 22 percent of all taxes (Figure 1). The same group claimed 87 percent of all foreign earned income exclusions, half the housing benefits, and only five percent of the foreign earned income credits (Figure 2). This suggests that expatriates with relatively low incomes tend to live in low-tax jurisdictions with high housing costs. Thus, recent limitations on



Section 911 are likely to put a bigger squeeze on lower-income expatriates.

Rules governing foreign-earned-income exclusions are also very complicated with numerous inconsistencies that occasionally give U.S. citizens no options other than non-compliance. For instance, five pages of regulations deal with the definition of foreign-earned income, and another four pages, with the application

of foreign residence and qualifying day tests. One must decipher six more pages to understand the allocation of deductions to exempt income and limitations on deductibility. In addition, mastering extensive case law is required in order to deal with income from the sale of services, self-produced art works and property [Ault, 2003]. A recent webcast held by IRS officials conceded that U.S. expatriates do not understand their tax obligations and often fail to file taxes. And when they file, expatriates bear large compliance costs, yet often fail to correctly claim their benefits [Smartpros, 2006].

In some cases, the rules and regulations of their domicile country make non-compliance the only option. In countries with currency controls, for example, expatriates cannot pay taxes because they cannot obtain U.S. dollars with which they could pay their taxes [Mitchell, 2005]. As a result of such complexities associated with Section 911 limitations, the majority of expatriates willingly or unwillingly fail to comply with the tax code. Senator Grassley has argued that the recent limitations will only affect a handful—the latest count of tax-filing expatriates is 306,393—but he ignores the remaining four million American expatriates, many of whom have been turned into criminals by the current tax code.

Conclusion

Current limitations on Section 911 are bad policy. Double-taxation hurts the American economy and employment, both domestic and overseas. Adding insult to injury, it also is unfair and complicated. Congress should make Section 911 universal so that there is no double-taxation of foreign earned income, just as Senator DeMint has proposed. Lawmakers also should remove all caps and limitations that are currently attached to this benefit. The forgone revenues associated with unlimited Section 911 benefits would be dwarfed by gains to employment, exports and the overall economy, and improvements in the tax code.

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