



The Section 911 Mirage

Why the Foreign Earned Income Exclusion and the Foreign Housing Exclusion should not be viewed as tax expenditures

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Introduction

The Foreign Earned Income Exclusion (FEIE) and the Foreign Housing Exclusion (FHE), Section 911 of the Internal Revenue Code of 1986, as amended (“the Code”), provide U.S. taxpayers residing overseas with the right to exclude from their U.S. taxable income:

- a) income earned overseas (wages and salaries) up to an amount of \$97,600 in 2013,¹ and
- b) housing expenses capped at 30% of the FEIE, but with more than 400 exceptions for high cost cities.² The standard exclusion is currently \$29,280 and the exceptions range up to \$114,300 for Hong Kong and \$117,100 for Tokyo.

The Joint Committee on Taxation (JCT) has estimated that the FEIE reduces 2013 tax receipts by \$4.8 billion and the FHE reduces receipts by \$1 billion.³ These estimates are probably correct

¹Introduced in 1926, the FEIE initially allowed all foreign earned income to be excluded. In 1962 an annual ceiling of \$35,000 (\$20,000 for the first 3 years) was established. The amount was reduced and increased at various times. Under the Tax Reform Act of 1976, the FEIE was radically reduced and the rules were changed, resulting in the return to the United States of tens of thousands of Americans working overseas as they were no longer competitive and could not survive abroad; following widespread complaints, hearings and GAO and President’s Export Council reports, the FEIE was restored. In 2006, as a revenue raising measure, the Tax Increase Prevention and Reconciliation Act (TIPRA) made several changes. TIPRA introduced the “stacking” provisions that mean that income in excess of the exclusion is taxed at the rate it would have been taxed had there been no exclusion, the housing exclusion was limited, and the FEIE was set at \$80,000 and indexed to inflation for the first time.

² As determined by the Department of the Treasury’s evaluation of the housing costs in specific cities overseas; Notice 2013-31, 2013-21 IRB 1099. The current list of exceptions can be found at: <http://www.irs.gov/pub/irs-pdf/i2555.pdf>

³ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, Report JCS-1-13, 30, <https://www.jct.gov/publications.html?func=startdown&id=4503>. See also Congressional Budget Office,

given the assumptions used by the JCT. However, the converse argument - that elimination of the FEIE and FHE would increase tax receipts by equivalent amounts - is false, despite its frequent assertion.

Why the FEIE and FHE should not be viewed as tax expenditures

Eliminating the FEIE and the FHE would definitely not generate additional revenue in the amounts estimated above. While It might generate in the near future additional revenues in the hundreds of millions, but not in billions, it could very well lead to a loss of revenue over time. The FEIE and FHE should consequently not be thought of as tax expenditures.

This somewhat counterintuitive conclusion may surprise many, but it rests on a considered analysis of the demographics of the overseas American population, the only taxpayers affected by the FEIE and FHE.

As Americans are required to pay taxes in their country of residence, the Code currently provides them with two provisions to mitigate the impact of double taxation:

- the FEIE and FHE ; and
- the Foreign Tax Credit (FTC) under Section 901, which provides a credit against U.S. tax liability for taxes paid abroad on foreign source income.

Many of the countries that are members of the Organisation for Economic Co-operation and Development (OECD), including Canada, Mexico, Japan and the Western European countries, among others, have income tax rates that are higher than those of the United States.⁴ It is estimated that 80% to 90% of Americans abroad reside in OECD member countries.⁵

If the FEIE is eliminated as recommended by some groups⁶, it must be expected that all Americans residing in OECD countries will apply the FTC to the fullest extent possible. As a result, those Americans living in high tax jurisdictions will continue to file returns showing no tax due. Therefore, there would be no increase in tax revenues from the majority of overseas Americans.

Options for Reducing the Deficit: 2014 to 2023, November 2013, p. 130, Revenue Option 12
http://www.cbo.gov/sites/default/files/cbofiles/attachments/44715-OptionsForReducingDeficit-2_1.pdf

⁴ See Carolina Torres, Kirsti Mellbye and Bert Brys, *Trends in Personal Income Tax and Employee Social Security Contribution Schedules*, OECD Taxation Working Papers No. 12,. <http://dx.doi.org/10.1787/5k95qw9633vf-en>.

⁵ This estimate is based on 2006 IRS statistics (latest available) on filings of Form 2555, which lists number of filings, amount of foreign earned income, and FEIE by country. See <http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Foreign-Earned-Income-Foreign-Tax-Credit#2>

⁶ Most recently, Committee for a Responsible Federal Budget, *The Tax Break-down: Foreign Earned Income Exclusion*, October 24, 2013, <http://crfb.org/blogs/tax-break-down-foreign-earned-income-exclusion>

The American taxpayers most seriously affected by the elimination of the FEIE and FHE would be those living and working in countries with income tax rates significantly lower than in the U.S., such as Hong Kong or Singapore, or with no income taxes at all, such as the Gulf countries.⁷ These countries are also among those with the highest cost of living, as indicated by the additional housing exclusion levels allowed under Section 911. The FEIE is essential for Americans resident in these countries. For them, the elimination of the FEIE and FHE would lead directly to an increase in their U.S. tax bill, as they would not generate enough FTCs, if any, to offset their U.S. tax liability. Some might stay, but many can be expected to leave for countries with lower costs of living and higher taxes, thereby qualifying for the FTC on their entire taxable income. If oil field engineers, for instance, must leave the Gulf because of cancellation of the FEIE, they may find employment in Rio or Calgary, rather than Houston. Others may return to the United States to join the ranks of the unemployed. Thus, there would likely be little, if any, gain for the U.S. Treasury from this population. Furthermore, the negative impact of the departure of Americans on U.S. export markets would likely worsen the U.S. trade balance, lead to job loss in the United States and consequently decrease overall U.S. tax revenues.

The number of American wage earners living in tax havens, such as Monaco or the Cayman Islands, is insignificant. High net worth individuals living in those countries are essentially not affected by FEIE. Thus, a change in policy regarding the FEIE would not seriously affect U.S. tax receipts from this group.

One sub-group of Americans resident abroad should be considered in particular, namely those employed by U.S. corporations and posted overseas. Typically, their employer pays their U.S. taxes under tax equalization plans as part of their so-called “expat package.” Elimination of the FEIE would raise the cost of their employment significantly, giving American employers a major incentive to replace them with local staff and other nationalities not subject to non-resident taxation. This would reinforce the trend (which started many years ago) towards elimination of the American presence in the overseas staff of major U.S. corporations, clearly an undesirable development as highlighted by the U.S. Chamber of Commerce⁸ at a time of increasing global

⁷ The Gulf countries raise government revenues by the sale of petroleum and high consumption taxes.

⁸ http://waysandmeans.house.gov/uploadedfiles/u.s._chamber_of_commerce_wg_comment.pdf “As with corporations, the United States has long taxed the foreign-earned income of its citizens residing abroad, resulting in double taxation and disincentivizing the hiring of U.S. citizens. Studies have shown that U.S. expatriates employed as managers in foreign affiliates of American worldwide companies are a powerful driver of U.S. exports, so this practice significantly undermines the global competitiveness of U.S. exporters. No other country taxes its citizens working abroad, and the any transition to a territorial tax system should take this into consideration and end this damaging practice.”

competition.⁹ Why offer these jobs on a silver platter to their German, British, Canadian or Australian counterparts, particularly at a time when the United States suffers from high unemployment? Why reduce the presence of Americans abroad who represent the United States, restricting the possibilities for Americans to acquire international experience that is increasingly important in the global economy?

The JCT estimate

For the reasons outlined above, repealing Section 911 will bring little, if any, additional revenue to the Treasury and may well lead to a loss in revenue over time. This conclusion is obviously quite different from the JCT estimated tax expenditure of \$5.8 billion. Why? Simply, because the JCT estimate is based, in this case as in all other cases for tax expenditure analysis, on the explicitly stated assumption that a change in the law would result in no change in the economic behavior of taxpayers.¹⁰ But in the real world, changes in tax law lead to immediate and predictable changes in taxpayer behavior. Eliminating Section 911 will force overseas Americans to change their tax filing practice or personal circumstances, as outlined above. This will not be a question of choice, but of necessity.

In assuming no change in taxpayer behavior, the JCT is assuming that overseas Americans will not utilize the FTC. But in fact the FTC can be expected to replace the FEIE in many overseas filings, and no professional tax advisor would advise a taxpayer not to take the FTC if the FEIE was abolished. Likewise, U.S. persons living in low-tax jurisdictions can be expected to react to the elimination of the FEIE and FHE in ways that may ultimately lead to a reduction in U.S. tax revenues. The sharp cutback in the FEIE under the Tax Reform Act of 1976 forced tens of thousands of Americans working abroad to return to the United States. This movement and the resulting loss of market share captured by U.S. exporters suggest that other significant non-tax costs would be incurred as a direct result of the elimination of the FEIE.¹¹

⁹ The number of Americans employed overseas by U.S. multinational companies has been steadily declining. The current number is hard to estimate as the Department of Commerce stopped collecting and publishing the data on Americans employed overseas by U.S. multinationals in 1999. At that time, only 20,000 Americans were reported engaged overseas by American companies, down from 40,000 twenty years earlier.

¹⁰ Joint Committee of Taxation, *A Reconsideration of Tax Expenditure Analysis*, Report JCX-37-08, 14, <https://www.jct.gov/publications.html?func=startdown&id=1196>.

¹¹ GAO report of 1978, "Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas". ID-78-13; B-137762. February 21, 1978. 98 pp. + 5 appendices (22 pp.); President's Export Council report of 1979. THE PRESIDENT'S EXPORT COUNCIL SUBCOMMITTEE ON EXPORT EXPANSION: "Task Force to Study the Tax Treatment of Americans Working Overseas", December 10, 1979. <http://americansabroad.org/issues/taxation/historical-documents/>

Although most Americans living in high tax rate countries pay little, if any U.S. tax, and might therefore be expected not to care about the elimination of the FEIE, such a move would impose other costs on them. Completion of Form 2555 for the FEIE is relatively straight-forward, while Form 1116 for the FTC is extremely complicated. Most taxpayers with FTCs require expensive professional assistance to file their U.S. tax returns. Obliging a taxpayer to pay several thousand dollars for tax return preparation when no taxes are owed to the United States and the taxpayer receives no services from the U.S. government is fundamentally unjust and economically inefficient. While the Constitution attributes to the Congress the power to levy taxes, it is an unstated assumption that this power should, indeed must be wielded in a fair and equitable manner and in an economically efficient way.

Residence Based Taxation: the way forward

The above analysis examines trees, and not the forest. It sets forth a series of logical inconsistencies and contortions stemming from the uniquely American practice of taxing persons irrespective of their domicile. The simple, straightforward solution to the complexity and unfairness of citizenship-based taxation that the FEIE is meant to mitigate is the adoption of residence-based taxation. Several scholars have outlined proposals in this regard;¹² and American Citizens Abroad has advanced similar arguments in a paper entitled “RBT—Residence-Based Taxation: A Necessary and Urgent Tax Reform.”¹³ Moving to residence-based taxation would align U.S. tax law with universal practice in the rest of the world, enhance the competitiveness of American companies in the global economy, increase exports, create jobs in the U.S., and enable the IRS to direct administrative resources to more compelling pursuits such as control of fraud and implementation of healthcare legislation.

GAO report of 1981, “American Employment Abroad Discouraged by U.S. tax laws,” dated February 27, 1981, ID-81-29. <http://www.gao.gov/assets/140/132160.pdf>

¹²Cynthia Blum and Paula N. Singer, *A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals*, 41 *Vanderbilt Journal of Transnational Law*. 705, 716–18 (2008); Paula N. Singer, *A Common Sense Solution for Taxing U.S. Citizens and Immigrants Abroad*, *Tax Notes International*, November 17, 2008; Paula N. Singer, *Tax Reform for Americans Overseas*, *Tax Notes International*, May 25, 2009; Bernard Schneider, *The End of Taxation Without End: A New Tax Regime for U.S. Expatriates*, 32 *Virginia Tax Review* 1 (2012), <http://ssrn.com/abstract=2186076>; Patrick Martin and Reuven Avi-Yonah, *Tax Simplification: The Need for Consistent Tax Treatment of All Individuals (Citizens, Lawful Permanent Residents and Non-Citizens Regardless of Immigration Status) Residing Overseas, Including the Repeal of U.S. Citizenship Based Taxation*, September 2013, <http://www.procopio.com/userfiles/file/assets/files1/tax-simplification-2658.pdf>

¹³ American Citizens Abroad, *RBT—Residence-Based Taxation: A Necessary and Urgent Tax Reform*, March 2013, <http://americansabroad.org/files/6513/6370/3681/finalsubrbtmarch2013.pdf> See also: ACA submission to the Joint Senate Finance Committee and House Ways and Means website, July 2013, http://americansabroad.org/files/7913/7467/5734/July_2013_ACA_submission_to_taxreform_website_-_July_2013_copy.pdf

Conclusions

We conclude with four recommendations to Congress:

- ❖ Maintain the FEIE as long as citizenship-based taxation of non-residents continues.
- ❖ Raise the FEIE ceiling to at least US\$250,000 to exclude all but the wealthiest expatriates from the U.S. tax net and continue to adjust the FEIE for inflation, or better still, eliminate the ceiling on earned income altogether.
- ❖ Eliminate the separate FHE by merging it into the higher-ceiling FEIE.
- ❖ Move toward residence based taxation within the framework of general tax reform and eliminate the FEIE and FHE when residence based taxation is implemented.

American Citizens Abroad, Inc. (ACA) is a non-profit, non-partisan, volunteer organization whose mission is to represent the interests of Americans living overseas. The association draws on more than three decades of rich experience and knowledge of laws affecting Americans overseas. ACA is reorganizing as a US tax-exempt organization operating under section 501(c)(4) of the Internal Revenue Code with a Washington D.C. office. Alongside it is American Citizens Abroad Global Foundation, a publicly-supported charity under section 501(c)(3).

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