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UNITED STATES GENERAL ACCOUNTING OFFICE  
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STATEMENT OF  
FRANK C. CONAHAN  
DIRECTOR, INTERNATIONAL DIVISION  
U.S. GENERAL ACCOUNTING OFFICE



BEFORE THE  
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT  
SENATE FINANCE COMMITTEE

ON

[ U.S. TAXATION OF AMERICAN CITIZENS  
EMPLOYED ABROAD ]

Mr. Chairman and members of the Subcommittee:

We are pleased to be here today to discuss with you the taxation of American citizens employed abroad. Our remarks are based on our report, "American Employment Abroad Discouraged by U.S. Income Tax Laws," issued February 27, 1981. Much of the data for our review was obtained in interviews at the corporate headquarters of 63 major U.S. companies with substantial foreign operations, and questionnaires completed by 41 of these companies. Because the questionnaires were completed only by large firms, the data should not be regarded as representative of all Americans employed abroad; however, they do indicate the magnitude of the problem for a relatively large group.

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[The Foreign Earned Income Act of 1978 (FEIA) was intended to create greater equity between people working abroad and at home and to provide an incentive to Americans working in foreign hardship areas. Foreign earned income of employees of the companies we surveyed includes allowances received as compensation for unusual or higher overseas living costs. Equity under FEIA was to be achieved through a series of deductions from income for these excess foreign living costs--that is, the general cost of living, housing, education, and home leave.] An additional \$5,000 deduction was established for workers in hardship areas. For employees in camps in hardship areas, an alternative \$20,000 exclusion was to be allowed in lieu of deductions for hardship and excess cost of living expenses.

sol. [The FEIA falls far short of meeting the objective of relieving Americans working abroad from taxation on compensation reflecting excess costs of living overseas. The deductions for housing and the general cost of living are substantially smaller than the allowances employees receive as compensation for the added costs of working abroad. Furthermore, the FEIA does not even recognize certain excess foreign living costs, e.g., the tax on reimbursements for the added taxes incurred by working abroad. The end result is that taxable income and, hence, tax liability, often far exceed what an individual would have incurred had he remained in the United States.]

[Most major U.S. firms reimburse expatriate employees for the additional tax burdens resulting from their overseas assignments. The reimbursements are generally designed to ensure that the

employee's personal tax burden does not exceed the home-country tax on his base salary.

It is significantly more expensive for companies to reimburse American employees than to reimburse third country nationals (TCNs). Since most countries do not tax foreign-source income, companies need to reimburse TCNs only to the extent that the host-country tax exceeds the hypothetical home-country tax on base salary. In contrast, a firm must reimburse Americans to the extent that their actual worldwide tax liability, including home-country tax on total compensation, exceeds the hypothetical U.S. tax on base salary. The difference between the tax reimbursement payments provided to Americans and those made to TCNs contributes significantly to the relative costliness of employing Americans.

The U.S. firms we surveyed reported that this cost differential was a major reason why they have decreased their employment of Americans overseas, both absolutely and relative to TCNs.

In addition to the tax burden of the FEIA, tax return preparation is highly complex and requires costly professional assistance.

The question of Americans working abroad is part of the continuing conflict among the tax policy objectives of raising revenue, achieving tax equity, simplifying tax returns, and other special aims of public policy, such as promoting U.S. exports and competitiveness abroad. In considering the question of whether, and to what extent, Americans working abroad should be taxed, the Congress must decide what priority should be assigned to each of the conflicting policy objectives.

When evaluating the alternatives to the FEIA, we believe that the [Congress should consider that the:

- Present U.S. tax provisions are widely regarded as discouraging employment of U.S. citizens abroad.
- Present tax provisions have reportedly made Americans relatively more expensive than competing third-country nationals, thereby reducing their opportunities for employment abroad by major U.S. companies.
- Americans retained abroad by major companies are generally reimbursed for their higher taxes, adding to the companies' operating costs and making them less competitive.]

Our observations are explained in greater detail in the following pages.

#### HOUSING DEDUCTIONS

[ Firms generally provide a housing allowance equal to actual housing expenses less a hypothetical amount that the individual would normally incur for housing had he remained in the United States.] Under the Act, it was intended that housing deductions should approximately equal the average housing allowance provided employees by their employers; i.e., an individual would include as a deduction from income the housing expenses to the extent that they exceeded the hypothetical amount the individual would have paid for housing in the United States. [The method of computing this hypothetical U.S. housing cost, however, can cause it to be highly inflated.]

[Subtracting the inflated hypothetical cost from the actual housing expense generally left a relatively small housing deduction; consequently, a substantial part of housing allowances remained taxable.] The average housing allowance included in taxable income for taxpayers covered by our survey was \$10,400

for married individuals and \$7,200 for single individuals.

Details are shown in table 1.

Table 1 1979

Country	Married individual			Unmarried individual		
	Average Housing Allowance	Housing Deduction	Excess Allowance Taxable	Average Housing Allowance	Housing Deduction	Excess Allowance Taxable
Brazil	\$14,457	\$ 4,428	\$10,029	\$10,761	\$ 3,351	\$ 7,400
Hong Kong	30,280	19,896	10,384	18,037	9,493	8,544
Japan	24,748	11,337	13,411	13,716	5,216	8,500
Saudi Arabia	23,608	14,323	9,285	21,480	14,481	6,999
United Kingdom	14,238	4,055	10,183	9,471	3,198	6,273
Venezuela	15,067	5,914	9,153	10,257	4,747	5,510

COST OF LIVING DEDUCTION

There are wide variances between the cost of living allowances provided by U.S. firms and the related deductions specified by the Internal Revenue Service (IRS). The variances result from differences in methods and criteria used by the Government and private parties to determine appropriate amounts. The FEIA specifies certain criteria that Treasury must use in deriving its tables, which tend to reduce the amounts allowable as deductions. It specifies that (1) the metropolitan area which has the highest cost of living in the continental United States (excluding Alaska) is to be the point of comparison and (2) the deduction is to be based on the reasonable daily living expenses of a person with a GS-14, step 1, salary and is not to be variable by income.

In contrast, many large U.S. companies use either a national composite or their corporate headquarters' city as their base of comparison rather than Boston, the highest cost U.S. city. In addition, the firms apply the allowance indices to a range of incomes that exceed by far the salary of a GS-14, step 1, specified in the law.

As a result of the variances in allowances and deductions, the taxpayers in our survey were being taxed on a significant part of their cost of living allowances--47 percent for married individuals and 40 percent for single individuals. Details are shown in table 2.

Table 2 1979

Country	Married individual			Unmarried individual		
	Average Cost of Living Allowance	Deduction	Excess Allowance Taxable	Average Cost of Living Allowance	Deduction	Excess Allowance Taxable
Brazil	\$ 5,036	\$ 1,216	\$ 3,820	\$ 2,005	\$ 500	\$ 1,505
Hong Kong	5,529	775	4,754	3,704	500	3,204
Japan	17,161	9,702	7,459	10,121	7,125	2,996
Saudi Arabia	8,937	6,299	2,638	5,983	4,650	1,333
United Kingdom	9,393	4,851	4,542	6,325	3,264	3,061
Venezuela	7,021	5,449	1,572	4,641	3,480	1,161

TAX REIMBURSEMENT ALLOWANCES

Tax reimbursements are generally designed to compensate employees for taxes related to working overseas to the extent that total taxes--both U.S. and foreign--exceed taxes the employee would have paid on his salary had he remained in the United States. If the FEIA reduced inflated foreign income by all the excess costs of foreign employment, then the overseas American's taxable income would be the same as if he had remained in the United States and no tax reimbursement benefits for higher U.S. taxes would be necessary. In practice, however, FEIA does not reduce the inflated foreign income sufficiently to make that possible. In addition, the payment of tax reimbursements raises taxable income even more as taxes are assessed on tax reimbursements.

Almost 95 percent of the firms we surveyed indicated that they provided tax reimbursements to all or most of their American

employees working overseas in 1979. The reimbursement, of course, varied according to salary level, host country, compensation package, and family status, etc., but often represented 40 percent or more of the taxpayer's base salary, as shown in table 3.

Table 3

Country	<u>Average Tax Reimbursement Allowance - 1979</u>			
	<u>Married individual</u>		<u>Unmarried individual</u>	
	<u>Amount</u>	<u>Percent of base salary</u>	<u>Amount</u>	<u>Percent of base salary</u>
Brazil	\$22,724	49.3	\$14,488	44.9
Hong Kong	18,775	39.2	11,739	39.7
Japan	29,131	64.7	14,557	52.9
Saudi Arabia	18,889	39.6	10,558	34.3
United Kingdom	19,734	41.1	13,841	46.8
Venezuela	18,413	40.4	12,486	39.5

COMPARISON OF ALLOWANCES AND TAX DEDUCTIONS FOR EXCESS FOREIGN LIVING COSTS

The inadequacy of the FEIA deductions, combined with the lack of a deduction for tax reimbursements, places many taxpayers in the position of paying taxes on a major share of allowances designed to compensate for excess living costs overseas. For the taxpayers covered by our survey, only one group (married taxpayers in Saudi Arabia) was able to claim FEIA deductions that averaged more than half of the related allowances plus tax reimbursements, as shown in table 4.

Table 4

Country	1979			1979		
	Married individual			Unmarried individual		
	Average Total Allowances (note a)	Deductions (note b)	Excess Allowance Taxable	Average Total Allowances (note a)	Deductions (note b)	Excess Allowance Taxable
Brazil	\$62,343	\$16,526	\$45,817	\$32,125	\$ 7,216	\$24,909
Hong Kong	70,433	31,498	38,935	37,324	11,398	25,926
Japan	82,264	29,408	52,856	43,663	15,408	28,255
Saudi Arabia	58,836	30,304	28,532	36,334	17,120	19,214
United Kingdom	55,648	17,896	37,752	32,710	8,250	24,460
Venezuela	54,913	21,213	33,700	31,761	10,225	21,536

a/Allowances include not only schooling, home leave transportation, housing and cost of living allowances, but also the tax reimbursement and moving and other allowances. Any hardship allowance is not included.

b/In addition to the schooling, home leave transportation, housing, and cost of living deductions, any moving expense deduction was included to afford a better comparison with the total allowance figure which did include moving expenses. (The FEIA does provide a deduction for moving expenses.) Any hardship deduction is not included.

#### COMPLEXITY OF THE LAW

We found a general consensus that the FEIA is unreasonably complex. As a consequence, U.S. firms incur high costs to have employee returns prepared inhouse or by outside accountants.)

Most individuals we interviewed in the six countries complained of the law's complexity. For those taxpayers who prepare their returns themselves, according to tax professionals, the risk of incorrect preparation is great. The various deductions and the way in which they are calculated are difficult for the average taxpayer to understand, and the effort required is much greater than would be required of a taxpayer in the United States. In addition, the recordkeeping required by the law is burdensome. A tax professional estimated that a tax return with supporting schedules could run to 25 pages.



The complexities of the FEIA force many taxpayers to seek expensive professional tax assistance. More than 60 percent of the domestic firms responding to our questionnaire either prepared their employees' returns inhouse or had them prepared by a third party the firm selected and paid for. The estimates for inhouse cost averaged almost \$700 and for preparation by a third party more than \$1,100.

INCOME TAXES ENCOURAGE U.S. FIRMS  
TO REPLACE AMERICANS OVERSEAS

The United States is alone among the major industrial powers in taxing foreign-source earned income on a citizenship basis. Nationals of other countries can usually avoid such taxation by taking measures to sever residency ties with their home countries. This difference has significantly altered the relative cost of employing Americans abroad compared with TCNs. Most major U.S. firms reimburse employees for the amount their worldwide tax liability exceeds the home-country tax on base salary. The surveyed firms reported that the difference in reimbursement payments received by Americans and TCNs has contributed significantly to a shift toward hiring TCNs at the expense of Americans.

The reimbursements to American employees of the companies surveyed in six countries ranged from a low of 10.0 percent of total compensation to a high of 21.9 percent, as shown in table 5. In contrast, the tax reimbursement payments to TCNs are generally insignificant relative to their total compensation, except in Japan and Brazil where tax reimbursements are primarily due to host-country taxes.

Table 5

Reimbursement Payments as percent  
of Total Compensation

<u>Country</u>	<u>Unmarried</u>		<u>Married</u>	
	<u>American</u>	<u>TCN</u>	<u>American</u>	<u>TCN</u>
	(percent)			
Brazil	20.1	14.6	16.4	16.6
Hong Kong	17.7	0.9	13.3	1.9
Japan	21.9	10.9	16.8	18.6
Saudi Arabia	10.0	0	13.1	0
United Kingdom	17.8	2.1	14.3	6.9
Venezuela	11.4	0	11.9	5.5

As stated above, the U.S. firms we surveyed reported that, because of the relative costliness of Americans, they have decreased their employment of Americans in overseas positions, both absolutely and relative to TCNs. They reported that the U.S. taxation of foreign-earned income has contributed significantly to this decreasing trend.

As shown in table 6, the Americans' share of our respondents' expatriate employment declined significantly between 1976 and 1980.

Table 6

Changes in relative employment of Americans overseas

<u>Industry (selected companies)</u>	<u>American share of expatriate workforce (percent)</u>	
	<u>1976</u>	<u>1980</u>
Construction and architect/engineering	65.1	44.7
Aerospace	74.8	62.1
Resource extraction	52.1	34.6
Manufacturing	60.0	56.0

This completes my statement, Mr. Chairman. We will be pleased to respond to any questions you may have.