1981–82 MISCELLANEOUS TAX BILLS, IV

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 408

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 WITH RESPECT TO THE INCOME TAX TREATMENT OF EARNED INCOME OF CITIZENS OR RESIDENTS OF THE UNITED STATES EARNED ABROAD, AND FOR OTHER PURPOSES

S. 436

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO INCREASE THE COMPETITIVENESS OF AMERICAN FIRMS OPERATING ABROAD AND TO HELP INCREASE MARKETS FOR UNITED STATES EXPORTS

S. 598

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO EXEMPT FROM TAXATION THE EARNED INCOME OF INDIVIDUALS WORKING OUTSIDE THE UNITED STATES

S. 867

A BILL TO AMEND THE INTERNAL REVENUE CODE WITH RESPECT TO THE TAX TREATMENT OF AMERICANS ABROAD

APRIL 24, 1981

Printed for the use of the Committee on Finance

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CONTENTS

ADMINISTRATION WITNESSES

	Page
Baldrige, Hon. Malcolm, Secretary of Commerce	49
Brock, Hon. William E., U.S. Trade Representative	60
Chapoton, Hon, John E., Assistant Secretary for Tax Policy, U.S. Treasury	70
Conahan, Hon. Frank C., Director, International Division, U.S. General Accounting Office	89

PUBLIC WITNESSES

American Citizens Abroad, Robert T. Angarola	194
Angarola, Robert T., representing American Citizens Abroad	148
Arthur Anderson & Co., Melchoir S. Morrione	230
Arthur Young & Co., Robert H. Castles, director of expatriate services	214
Asia-Pacific Council of American Chambers of Commerce, George Liesenberg	309
Association of American Chambers of Commerce in Latin America, Buenos Aires, Argentina, Alexandria Perry Jr., president	283
Baer, Stephan, director of international compensation, Research Counselors, Inc	92
Brown, Ben Jarratt, vice president operations, United States and Overseas Tax Fairness Committee	145
Castles, Robert H., director of expatriate services, Arthur Young & Co	206
Chase Econometrics, Robert R. Shriner, Ph. D	91
DuBos, Thomas, National Foreign Trade Council	143
Emergency Committee for American Trade, Donald R. Niemi	146
Ernst & Winney, Michael A. Henning, partner-in-charge, International Tax Services	277
Hammer, Richard M., national director of international tax services, Price, Waterhouse & Co	224
Henning, Michael A., partner-in-charge, International Tax Services, Ernst & Winney	228
Jepsen, Hon. Roger W., a U.S. Senator from Iowa	55
Kraft, Steven E., Tax Committee of the American Chambers of Commerce in Europe and the Mediterranean	281
Liesenberg, George, Asia-Pacific Council of American Chambers of Commerce.	285
Morrione, Melchoir S., Arthur Anderson & Co	204
National Foreign Trade Council, Thomas DuBos	143
Niemi, Donald R., representing, Emergency Committee for American Trade	146
Perry, Alexander Jr., president, Association of American Chambers of Commerce in Latin America, Buenos Aires, Argentina	283
Price, Waterhouse & Co., Richard M. Hammer, director of international tax services	254
Research Counselors, Inc., Stephan Baer, director of international compensation	92
Shriner, Robert R., Ph. D., Chase Econometrics	91
Tax Committee of the American Chambers of Commerce in Europe and the Mediterranean, Steven E. Kraft	281
United States and Overseas Tax Fairness Committee, Ben Jarratt Brown, vice president operations	160

COMMUNICATIONS

Air Transport Association of America	330

Page
American Constituency Overseas 336
American Chamber of Commerce (United Kingdom), Connie Borken-Hagen, special project coordinator 399
Association of Americans Resident Overseas 326
Barratt, George, vice president, finance, Computer Sciences Corp 333
Bechtel Civil & Minerals, Inc., Richard P. Godwin, director and president 384
Borken-Hagen Connie, special project coordinator, American Chamber of Commerce (United Kingdom) 399
Computer Sciences Corp., George Barratt, vice president, finance 333
Conklin, Roger D., president, Cook Electric International 402
Cook Electric International, Roger D. Conklin, president 402
Coudert Brothers, John D. Maiers 400
Council of American Chambers of Commerce-Europe and Mediterranean 288
Crawley, Winston, vice president for planning, foreign mission board, Southern Baptist Convention 357
Deloitte Haskins & Sells, Warren K. Wentworth, partner 360
Frenzel, Hon. Bill, a U.S. Representative from Minnesota 317
Long, Joseph M., Longs Drug Stores 324
Godwin, Richard P., director and president, Bechtel Civil & Minerals, Inc 383
Machinery and Allied Products Institute, Charles W. Stewart, president 340
Maiers, John D., Coudert Brothers 400
Mathias, Hon. Charles McC. Jr., a U.S. Senator from Maryland 320
Nordhauser, Susan and Janet Richmond 416
NRECA, Robert D. Partridge, executive vice president and general manager 352
Partridge, Robert D., executive vice president and general manager, NRECA 353
R. J. Reynolds, Inc., C. Jackson Sink, director, domestic tax administration 412
Sink, C. Jackson, director, domestic tax administration, R. J. Reynolds Industries, Inc 412
Southern Baptist Convention, Winston Crawley, vice president for planning, foreign mission board 357
Stewart, Charles W., president, Machinery and Allied Products Institute 340
Wentworth, Warren K., partner, Deloitte Haskins & Sells 359

ADDITIONAL INFORMATION

Committee press release 1
Text of bills S. 408, S. 436, S. 598 and S. 867 3
Description of bills S. 408, S. 436, S. 598 and S. 867 34
Opening statement of Senator Robert J. Dole 43
Prepared statement of Senator John H. Chafee 44
Prepared statement of Hon. Malcolm Baldrige, Secretary of Commerce 47
Prepared statement of Senator Roger W. Jepsen, from Iowa 58
Prepared statement of Ambassador William E. Brock, U.S. Trade Representative 66
Prepared statement of Hon. John E. Chapoton, Assistant Secretary, U.S. Treasury 68

1981-82 MISCELLANEOUS TAX BILLS IV

FRIDAY, APRIL 24, 1981

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Senator Packwood (chairman) presiding.

Present: Senators Packwood, Dole, and Chafee.

[The press release announcing this hearing, the bills S. 408, S. 436, S. 598, and S. 867 and Joint Committee Print describing the above bills follow:]

[Press Release No. 81-120]

PRESS RELEASE, APRIL 7, 1981—COMMITTEE ON FINANCE, U.S. SENATE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON MISCELLANEOUS TAX BILLS

Senator Bob Packwood, Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on April 24, 1981.

The hearing will begin at 9:30 a.m. on April 24, 1981, in Room 2221 of the Dirksen Senate Office Building.

The following legislative proposals will be considered at the hearing:

S. 408—Introduced by Senator Chafee. Would provide an annual exclusion for foreign earned income of $50,000 plus one-half of the next $50,000 of foreign earned income. Housing costs in excess of $5,800 per year would also be excluded from income tax.

S. 436—Introduced by Senator Bentsen. Would provide an annual exclusion of up to $75,000 for foreign earned income in 1981, increasing $5,500 each year to $95,000 in 1985. A housing deduction would be provided for expenses in excess of $5,500 and housing furnished to an individual in a camp would be nontaxable.

S. 598—Introduced by Senator Jepsen. Would exempt all foreign earned income of certain individuals from taxation.

S. 867—Introduced by Senator Moynihan. Would exempt 80 percent of all foreign earned income of certain individuals from taxation.

Senator Packwood noted that on June 26, 1980, the Subcommittee received testimony on legislative proposals to modify the treatment of foreign earned income under section 911 and section 913 of the Internal Revenue Code of 1954, and was provided with strong evidence of the difficulties of Americans living and working abroad and of the impact of current law on the export position of the United States. In addition, Senator Packwood noted that on August 21, 1980, the Committee on Finance approved a modified version of an amendment proposed in Committee by Senator Chafee concerning the tax treatment of foreign earned income.

In view of the favorable testimony on the general issue received last year, Senator Packwood suggested that it would be helpful for the Subcommittee to receive testimony that addresses the following specific issues:

(1) The impact of current law on the ability of U.S. nationals to compete in overseas markets with foreign nationals.

(2) The impact of current law on total U.S. exports and on U.S. employment generated by exports.

(3) Factors the Subcommittee should consider in designing an exclusion for foreign income, including the level of the exclusion, ease of administering the exclusion, the effect of limiting the exclusion to individuals engaged only in certain business activities or employed only in certain countries, and the effect of limiting the exclusion only to earned income.

Requests to Testify.—Witnesses who desire to testify at the hearing on April 24, 1981 must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than noon on April 17, 1981. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, they may file a written statement for the record in lieu of the personal appearance. In such case a witness should notify the Committee of his inability to appear as soon as possible.

Consolidated testimony.—Senator Packwood urges all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Subcommittee. This procedure will enable the Subcommittee to receive a wider expression of views than it might otherwise obtain. Senator Packwood urges very strongly that all witnesses exert a maximum effort to consolidate and coordinate their statements.

Legislative Reorganization Act.—Senator Packwood stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed not later than noon on the last business day before the witness is scheduled to appear.

(2) All witnesses must include with their written statements a summary of the principal points included in the statement.

(3) The written statement must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by noon on Thurday, April 23, 1981.

(4) Witnesses should not read their written statements to the Subcommittee, but ought instead to confine their oral presentations to a summary of the points included in the statement.

(5) Not more than five minutes will be allowed for the oral summary.

Written statements.—Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record on the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, not later than Friday, May 8, 1981.

II

97TH CONGRESS
1ST SESSION

S. 408

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of earned income of citizens or residents of the United States earned abroad, and for other purposes.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 5 (legislative day, JANUARY 5), 1981

Mr. CHAFEE (for himself, Mr. TSONGAS, Mr. MATHIAS, Mr. ROTH, Mr. MATSUNAGA, Mr. COCHRAN, Mr. LUGAR, Mr. BOSCHWITZ, Mr. SCHMITT, Mr. GRASSLEY, Mr. BOREN, and Mr. SIMPSON) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of earned income of citizens or residents of the United States earned abroad, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

★(Star Print)

1 **SECTION 1. PARTIAL EXCLUSION FOR EARNED INCOME FROM**
2 **SOURCES WITHOUT THE UNITED STATES AND**
3 **FOR FOREIGN HOUSING COSTS.**
4 (a) IN GENERAL.—Section 911 of the Internal Revenue
5 Code of 1954 (relating to income earned by individuals in
6 certain camps) is amended to read as follows:
7 **"SEC. 911. EARNED INCOME FROM SOURCES WITHOUT THE**
8 **UNITED STATES; FOREIGN HOUSING COSTS.**
9 "(a) EARNED INCOME EXCLUSION.—In the case of an
10 individual who is—
11 "(1) a citizen of the United States and who estab-
12 lishes to the satisfaction of the Secretary that he has
13 been a bona fide resident of a foreign country or coun-
14 tries for an uninterrupted period which includes an
15 entire taxable year, or
16 "(2) a citizen or resident of the United States and
17 who, during any period of 12 consecutive months, is
18 present in a foreign country or countries during at
19 least 330 full days in such period,
20 at the election of such individual (made at such time and in
21 such manner as the Secretary prescribes by regulation), there
22 shall be excluded from the gross income of such individual,
23 and exempt from taxation under this subtitle, amounts re-
24 ceived by such individual from sources within a foreign coun-
25 try or countries (except amounts paid by the United States or
26 any agency thereof) which constitute earned income attribut-

1 able to services performed by such individual during the
2 period described in paragraph (1) or (2), whichever is appro-
3 priate.

4 "(b) DEFINITION OF EARNED INCOME.—For purposes
5 of this section, the term 'earned income' means wages, sala-
6 ries, or professional fees, and other amounts received as com-
7 pensation for personal services actually rendered, but does
8 not include that part of the compensation derived by the tax-
9 payer for personal services rendered by him to a corporation
10 which represents a distribution of earnings or profits rather
11 than a reasonable allowance as compensation for the personal
12 services actually rendered. In the case of a taxpayer engaged
13 in a trade or business in which both personal services and
14 capital are material income-producing factors, under regula-
15 tions prescribed by the Secretary, a reasonable allowance as
16 compensation for the personal services rendered by the tax-
17 payer, not in excess of 30 percent of his share of the net
18 profits of such trade or business, shall be considered as
19 earned income.

20 "(c) SPECIAL RULES.—

21 "(1) LIMITATIONS ON AMOUNT OF EXCLU-
22 SION.—The amount excluded from the gross income of
23 an individual under subsection (a) for any taxable year
24 shall not exceed an amount which shall be computed

1 on a daily basis at an annual rate of compensation
2 equal to the sum of—
3 "(A) $50,000, plus
4 "(B) 50 percent of the lesser of—
5 "(i) the amount of compensation re-
6 ceived by such individual in such taxable
7 year which exceeds $50,000, or
8 "(ii) $50,000,
9 for each day of the taxable year during which such in-
10 dividual is present in a foreign country.
11 "(2) ATTRIBUTION TO YEAR IN WHICH SERVICES
12 ARE PERFORMED.—For purposes of applying para-
13 graph (1), amounts received shall be considered re-
14 ceived in the taxable year in which the services to
15 which the amounts are attributable are performed.
16 "(3) TREATMENT OF COMMUNITY INCOME.—In
17 applying paragraph (1) with respect to amounts re-
18 ceived from services performed by a husband or wife
19 which are community income under community prop-
20 erty laws applicable to such income, the aggregate
21 amount excludable under subsection (a) from the gross
22 income of such husband and wife shall equal the
23 amount which would be excludable if such amounts did
24 not constitute such community income.

1 "(4) REQUIREMENT AS TO TIME OF RECEIPT.—
2 No amount received after the close of the taxable year
3 following the taxable year in which the services to
4 which the amounts are attributable are performed may
5 be excluded under subsection (a).
6 "(5) CERTAIN AMOUNTS NOT EXCLUDABLE.—No
7 amount—
8 "(A) received as a pension or annuity, or
9 "(B) included in gross income by reason of
10 section 402(b) (relating to taxability of beneficiary
11 of nonexempt trust), section 403(c) (relating to
12 taxability of beneficiary under a nonqualified an-
13 nuity), or section 403(d) (relating to taxability of
14 beneficiary under certain forfeitable contracts pur-
15 chased by exempt organizations),
16 may be excluded under subsection (a).
17 "(6) TEST OF BONA FIDE RESIDENCE.—A state-
18 ment by an individual who has earned income from
19 sources within a foreign country to the authorities of
20 that country that he is not a resident of that country, if
21 he is held not subject as a resident of that country to
22 the income tax of that country by its authorities with
23 respect to such earnings shall be conclusive evidence
24 with respect to such earnings that he is not a bona fide
25 resident of that country for purposes of subsection (a).

1 "(7) FOREIGN TAXES PAID ON EXCLUDED
2 INCOME NOT CREDITABLE OR DEDUCTIBLE.—An indi-
3 vidual shall not be allowed as a deduction or as a
4 credit against the tax imposed by this chapter any
5 credit or deduction for the amount of taxes paid or ac-
6 crued to a foreign country or possession of the United
7 States, to the extent that such deduction or credit is
8 properly allocable to or chargeable against amounts ex-
9 cluded from gross income under this subsection, other
10 than the deduction allowed by section 217 (relating to
11 moving expenses).
12 "(d) HOUSING COST EXCLUSION.—
13 "(1) IN GENERAL.—In the case of an individual
14 described in subsection (a), at the election of such indi-
15 vidual (made at such time and in such manner as the
16 Secretary prescribes by regulation), there shall be ex-
17 cluded from the gross income of such individual, and
18 exempt from taxation under this subtitle, in addition to
19 any amounts excluded and exempt under subsection
20 (a), an amount equal to the housing cost amount.
21 "(2) HOUSING COST AMOUNT.—For purposes of
22 this subsection, the housing cost amount is the amount
23 by which an individual's housing expenses for the tax-
24 able year exceed 16 percent of the salary of an em-
25 ployee of the United States who is compensated at a

1 rate equal to the annual rate paid for step 1 of grade
2 GS-14.
3 "(3) HOUSING EXPENSES.—The term 'housing
4 expenses' means the reasonable expenses paid or in-
5 curred during the taxable year by or on behalf of an
6 individual for housing for the individual (and, if they
7 reside with him, for his spouse and dependents) in a
8 foreign country. The term—
9 "(A) includes expenses attributable to the
10 housing (such as utilities and insurance), but
11 "(B) does not include interest and taxes of
12 the kind deductible under section 163 or 164 or
13 any amount allowable as a deduction under sec-
14 tion 216(a).
15 Housing expenses shall not be treated as reasonable to
16 the extent such expenses are lavish or extravagant
17 under the circumstances.
18 "(4) SECOND FOREIGN HOUSEHOLD.—If an indi-
19 vidual described in subsection (a) maintains a separate
20 household outside the United States for his spouse and
21 dependents and they do not reside with him because of
22 living conditions which are dangerous, unhealthful, or
23 otherwise adverse, then the words 'if they reside with
24 him' in paragraph (3) shall be disregarded.".
25 (b) CLERICAL AMENDMENTS.—

1 (1) The table of sections for subpart B of part III
2 of subchapter N of chapter 1 of such Code is amended
3 by striking out the item relating to section 911 and in-
4 serting in lieu thereof the following:

"Sec. 911. Earned income from sources without the United States; foreign housing costs.".

5 (2) Sections 43(c)(1)(B), 1302(b)(2)(A)(i), 1304-
6 (b)(1), 1402(a)(8), 6012(c), and 6091(b)(1)(B)(iii) are
7 each amended by striking out "relating to income
8 earned by employees in certain camps" and inserting
9 in lieu thereof "relating to earned income from sources
10 without the United States and foreign housing costs".

11 **SEC. 2. EMPLOYEES LIVING IN CAMPS.**

12 Section 119 of the Internal Revenue Code of 1954 is
13 amended by adding the following new subsection:

14 "(c) EMPLOYEES LIVING IN CAMPS.—In the case of an
15 individual who is furnished lodging in a camp by or on behalf
16 of his employer, such camp shall be considered to be part of
17 the business premises of the employer. For purposes of this
18 section a camp constitutes lodging which is—

19 "(1) provided by or on behalf of the employer be-
20 cause the place at which such individual renders serv-
21 ices is in an area where satisfactory housing is not
22 available on the open market,

1 "(2) located, as near as practicable, in the vicinity
2 of the place at which such individual renders services,
3 and
4 "(3) furnished in a common area (or enclave)
5 which is not available to the public.".
6 **SEC. 3. REPEAL OF DEDUCTION FOR CERTAIN EXPENSES OF**
7 **LIVING ABROAD.**
8 (a) IN GENERAL.—Section 913 of the Internal Revenue
9 Code of 1954 (relating to deduction for certain expenses of
10 living abroad) is hereby repealed.
11 (b) CONFORMING AMENDMENTS.—
12 (1) The table of sections for subpart B of part III
13 of subchapter N of chapter 1 of such Code is amended
14 by striking out the item relating to section 913.
15 (2) Section 62 of such Code (relating to definition
16 of adjusted gross income) is amended by striking out
17 paragraph (14).
18 **SEC. 4. EFFECTIVE DATE.**
19 The amendments made by this Act shall apply with re-
20 spect to taxable years beginning after December 31, 1980.

II

97TH CONGRESS
1ST SESSION

S. 436

To amend the Internal Revenue Code of 1954 to increase the competitiveness of American firms operating abroad and to help increase markets for United States exports.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 6 (legislative day, JANUARY 5), 1981

Mr. BENTSEN introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to increase the competitiveness of American firms operating abroad and to help increase markets for United States exports.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. EXCLUSION FROM GROSS INCOME.**
4 Section 911 of the Internal Revenue Code of 1954 (re-
5 lating to income earned by individuals in certain camps) is
6 amended to read as follows:

1 "SEC. 911. PARTIAL EXCLUSION FROM GROSS INCOME FOR
2 INCOME EARNED ABROAD.

3 "(a) GENERAL RULE.—The following items shall, at
4 the election of the taxpayer, not be included in gross income
5 and shall be exempt from taxation under this subtitle:

6 "(1) BONA FIDE RESIDENT OF FOREIGN COUN-
7 TRY.—In the case of an individual citizen of the
8 United States who establishes to the satisfaction of the
9 Secretary that he has been a bona fide resident of a
10 foreign country or countries for an uninterrupted period
11 which includes an entire taxable year, amounts which
12 constitute earned income attributable to services per-
13 formed during such uninterrupted period, except
14 amounts paid by the United States or any agency
15 thereof. The amount excluded under this paragraph for
16 any taxable year shall be computed by applying the
17 special rules contained in subsection (c).

18 "(2) PRESENCE IN FOREIGN COUNTRY FOR 11
19 MONTHS.—In the case of an individual citizen or resi-
20 dent of the United States who during any period of 12
21 consecutive months is present in a foreign country or
22 countries at least 330 full days in such period, amounts
23 which constitute earned income attributable to services
24 performed during such 12-month period except
25 amounts paid by the United States or any agency
26 thereof. The amount excluded under this paragraph for

1 any taxable year shall be computed by applying the
2 special rules contained in subsection (c).
3 An individual who elects the exclusion provided by this sub-
4 section shall not be allowed as a deduction from his gross
5 income or as a credit against the tax imposed by this chapter
6 any credit for the amount of taxes paid or accrued to a for-
7 eign country or possession of the United States, to the extent
8 that such deduction or credit is properly allocable to or
9 chargeable against amounts excluded from gross income,
10 other than deductions allowed by section 217 (relating to
11 moving expenses).
12 "(b) DEFINITION OF EARNED INCOME.—For purposes
13 of this section, the term 'earned income' means wages, sala-
14 ries, or professional fees, and other amounts received as com-
15 pensation for personal services actually rendered, but does
16 not include that part of the compensation derived by the tax-
17 payer for personal services rendered by him to a corporation
18 which represents a distribution of earnings or profits rather
19 than a reasonable allowance as compensation for the personal
20 services actually rendered. In the case of a taxpayer engaged
21 in trade or business in which both personal services and capi-
22 tal are material income-producing factors, under regulations
23 prescribed by the Secretary, a reasonable allowance as com-
24 pensation for the personal services rendered by the taxpayer,

1 not in excess of 30 percent of his share of the net profits of
2 such trade or business, shall be considered as earned income.
3 "(c) SPECIAL RULES.—For purposes of computing the
4 amount excludable under subsection (a), the following rules
5 shall apply:
6 "(1) LIMITATION ON AMOUNT OF EXCLUSION.—
7 "(A) EXCLUDABLE AMOUNT.—The amount
8 excluded from the gross income of an individual
9 under subsection (a) for any taxable year shall not
10 exceed an amount which shall be computed on a
11 daily basis at an annual rate of an amount equal
12 to the excludable amount for a period during
13 which he qualifies.
14 "(B) DETERMINATION OF EXCLUDABLE
15 AMOUNT.—The excludable amount shall be—
16 "(i) for 1981, $75,000;
17 "(ii) for 1982, $80,000;
18 "(iii) for 1983, $85,000;
19 "(iv) for 1984, $90,000;
20 "(v) for 1985 and years thereafter,
21 $95,000.
22 "(2) ATTRIBUTION TO YEAR IN WHICH SERVICES
23 ARE PERFORMED.—For purposes of applying para-
24 graph (1), amounts received shall be considered re-

1 ceived in taxable year in which the services to which
2 the amounts are attributable are performed.
3 "(3) TREATMENT OF COMMUNITY INCOME.—In
4 applying paragraph (1) with respect to amounts re-
5 ceived from services performed by a husband or wife
6 which are community income under community prop-
7 erty laws applicable to such income, the aggregate
8 amount excludable under subsection (a) from the gross
9 income of such husband and wife shall equal the
10 amount which would be excludable if such amounts did
11 not constitute such community income.
12 "(4) REQUIREMENT AS TO TIME OF RECEIPT.—
13 No amount received after the close of the taxable year
14 following the taxable year in which the services to
15 which the amounts are attributable are performed may
16 be excluded under subsection (a).
17 "(5) CERTAIN AMOUNTS NOT EXCLUDABLE.—No
18 amount—
19 "(A) received as a pension or annuity, or
20 "(B) included in gross income by reason of
21 section 402(b) (relating to taxability of beneficiary
22 of nonexempt trust), section 403(c) (relating to
23 taxability of beneficiary under a nonqualifed annu-
24 ity), or section 403(d) (relating to taxability of

1 beneficiary under certain forfeitable contracts pur-
2 chased by exempt organizations),
3 may be excluded under subsection (a).
4 "(6) TEST OF BONA FIDE RESIDENCE.—A state-
5 ment by an individual who has earned income from
6 sources within a foreign country to the authorities of
7 that country that he is not a resident of that country, if
8 he is held not subject as a resident of that country to
9 the income tax of that country by its authorities with
10 respect to such earnings, shall be conclusive evidence
11 with respect to such earnings that he is not a bona fide
12 resident of that country for purposes of subsection
13 (a)(1).
14 "(d) CROSS REFERENCES.—
15 "(1) For administrative and penal provisions relat-
16 ing to the exclusion provided for in this section, see
17 sections 6001, 6011, 6012(c), and the other provisions
18 of subtitle F.
19 "(2) For elections as to treatment of income sub-
20 ject to foreign community property laws, see section
21 981.".
22 **SEC. 2. EMPLOYEES LIVING IN CAMPS.**
23 Section 119 of the Internal Revenue Code of 1954 is
24 amended by adding the following new subsection:

1 "(c) EMPLOYEES LIVING IN CAMPS.—In the case of an
2 individual who is furnished lodging in a camp, such camp
3 shall be considered to be part of the business premises of the
4 employer. For purposes of this section a camp constitutes
5 lodging which is—
6 "(1) provided by or on behalf of the employer be-
7 cause the place at which such individual renders serv-
8 ices is in an area where satisfactory housing is not
9 available on the open market,
10 "(2) located as near as practicable, in the vicinity
11 of the place at which such individual renders services,
12 and
13 "(3) furnished in a common area (or enclave)
14 which is not available to the public.".
15 **SEC. 3. DEDUCTION FOR CERTAIN HOUSING EXPENSES.**
16 Section 913 of the Internal Revenue Code of 1954 is
17 amended to read as follows:
18 **"SEC. 913. DEDUCTION FOR CERTAIN HOUSING EXPENSES OF**
19 **LIVING ABROAD.**
20 "(a) ALLOWANCE OF DEDUCTION.—In the case of an
21 individual who is—
22 "(1) BONA FIDE RESIDENT OF FOREIGN COUN-
23 TRY.—A citizen of the United States and who estab-
24 lishes to the satisfaction of the Secretary that he has
25 been a bona fide resident of a foreign country or coun-

1 tries for an uninterrupted period which includes an
2 entire taxable year, or
3 "(2) PRESENCE IN FOREIGN COUNTRY FOR 11
4 MONTHS.—A citizen or resident of the United States
5 and who during any period of 12 consecutive months is
6 present in a foreign country or countries during at
7 least 330 full days in such period.
8 there shall be allowed as a deduction for such taxable year or
9 for any taxable year which contains part of such period, the
10 qualified housing expenses set forth in subsection (b).
11 "(b) QUALIFIED HOUSING EXPENSES.—
12 "(1) IN GENERAL.—For purposes of this section,
13 the term 'qualified housing expenses' means the excess
14 of—
15 "(A) the individual's housing expenses, over
16 "(B) the individual's base housing amount.
17 "(2) HOUSING EXPENSES.—
18 "(A) IN GENERAL.—For purposes of para-
19 graph (1), the term 'housing expenses' means the
20 reasonable expenses paid or incurred during the
21 taxable year by or on behalf of the individual for
22 housing for the individual (and, if they reside with
23 him, fo his spouse and dependents) in a foreign
24 country. Such term—

1 "(i) except as provided in clause (ii), in-
2 cludes expenses attributable to the housing
3 (such as security, utilities, and insurance),
4 and

5 "(ii) does not include interest and taxes
6 of the kind deductible under section 163 and
7 164 or any amount allowable as a deduction
8 under section 216(a).

9 "(B) PORTION WHICH IS LAVISH OR EX-
10 TRAVAGANT NOT ALLOWED.—For purposes of
11 subparagraph (A), housing expenses shall not be
12 treated as reasonable to the extent such expenses
13 are lavish or extravagant under the circum-
14 stances.

15 "(3) BASE HOUSING AMOUNT.—For purposes of
16 paragraph (1) $5,500 shall be the 'base housing
17 amount.'—

18 "(4) PERIODS TAKEN INTO ACCOUNT.—

19 "(A) IN GENERAL.—The expenses taken
20 into account under this subsection shall be only
21 those which are attributable to housing during pe-
22 riods for which—

23 "(i) the individual's tax home is in a
24 foreign country, and

1 "(ii) the value of the individual's hous-
2 ing is not excluded under section 119.
3 "(B) DETERMINATION OF BASE HOUSING
4 AMOUNT.—The base housing amount shall be de-
5 termined for the periods referred to in subpara-
6 graph (A).
7 "(5) ONLY ONE HOUSE PER PERIOD.—If, but for
8 this paragraph, housing expenses for any individual
9 would be taken into account under paragraph (2) of
10 subsection (b) with respect to more than one abode for
11 any period, only housing expenses with respect to that
12 abode which bears the closest relationship to the indi-
13 vidual's tax home shall be taken into account under
14 such paragraph (2) for such period.
15 "(c) REGULATIONS.—The Secretary shall prescribe
16 such regulations as may be necessary or appropriate to carry
17 out the purposes of this section, including regulations provid-
18 ing rules—
19 "(1) for cases where a husband and wife each
20 have earned income from sources outside the United
21 States, and
22 "(2) for married individuals filing separate re-
23 turns.".

1 **SEC. 4. EFFECTIVE DATE.**

2 The amendments made by this Act shall apply with re-

3 spect to taxable years beginning after December 31, 1981.

II

97TH CONGRESS
1ST SESSION

S. 598

To amend the Internal Revenue Code of 1954 to exempt from taxation the earned income of individuals working outside the United States.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 27 (legislative day, FEBRUARY 16), 1981

Mr. JEPSEN introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to exempt from taxation the earned income of individuals working outside the United States.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. EXCLUSION OF EARNED INCOME FROM SOURCES**
4 **OUTSIDE THE UNITED STATES.**
5 (a) GENERAL RULE.—The section heading and subsec-
6 tion (a) of section 911 of the Internal Revenue Code of 1954
7 (relating to income earned by individuals in certain camps) is
8 amended to read as follows:

1 "SEC. 911. EARNED INCOME FROM SOURCES OUTSIDE THE
2 UNITED STATES.

3 "(a) GENERAL RULE.—The following items shall not
4 be included in gross income and shall be exempt from tax-
5 ation under this subtitle:

6 "(1) BONA FIDE RESIDENT OF FOREIGN COUN-
7 TRY.—In the case of an individual citizen of the
8 United States who establishes to the satisfaction of the
9 Secretary that he has been a bona fide resident of a
10 foreign country or countries for an uninterrupted period
11 which includes an entire taxable year, amounts re-
12 ceived from sources without the United States (except
13 amounts paid by the United States or any agency
14 thereof) which constitute earned income attributable to
15 services performed during such uninterrupted period.
16 The amount excluded under this paragraph for any
17 taxable year shall be computed by applying the special
18 rules contained in subsection (c).

19 "(2) PRESENCE IN FOREIGN COUNTRY FOR 17
20 MONTHS.—In the case of an individual citizen or resi-
21 dent of the United States who during any period of 18
22 consecutive months is present in a foreign country or
23 countries during at least 510 full days in such period,
24 amounts received from sources without the United
25 States (except amounts paid by the United States or
26 any agency thereof) which constitute earned income at-

1 tributable to services performed during such 18-month
2 period. The amount excluded under this paragraph for
3 any taxable year shall be computed by applying the
4 special rules contained in subsection (c).
5 An individual shall not be allowed as a deduction from his
6 gross income any deduction, or as a credit against the tax
7 imposed by this chapter any credit for the amount of taxes
8 paid or accrued to a foreign country or possession of the
9 United States, to the extent that such deduction or credit is
10 properly allocable to or chargeable against amounts excluded
11 from gross income under this subsection, other than the
12 deduction allowed by section 217 (relating to moving
13 expenses).".
14 (b) ELIMINATION OF LIMITATION ON AMOUNT OF EX-
15 CLUSION.—Subsection (c) of section 911 of such Code (relat-
16 ing to limitations and special rules) is amended—
17 "(1) by striking out paragraphs (1), (2), (3), and
18 (7), and
19 (2) by redesignating paragraphs (4), (5), and (6) as
20 paragraphs (1), (2), and (3), respectively.
21 (c) REPEAL OF SECTION 913.—Section 913 of such
22 Code (relating to deduction for certain expenses of living
23 abroad) is hereby repealed.
24 (d) TECHNICAL AND CONFORMING AMENDMENTS.—

1 (1) The table of sections for subpart B of part
2 III of subchapter N of chapter 1 of such Code is
3 amended—
4 (A) by striking out the item relating to section
5 911 and inserting in lieu thereof the following:

"Sec. 911. Earned income from sources outside the United States.",

6 and
7 (B) by striking out the item relating to sec-
8 tion 913.
9 (2) Sections 43(c)(1)(C), 1302(b)(2)(A)(i),
10 1304(b)(1), 1402(a)(8), 6012(c), and 6091(b)(1)(B)(iii) of
11 such Code are each amended by striking out "relating
12 to income earned by employees in certain camps" and
13 inserting in lieu thereof "relating to earned income
14 from sources outside the United States".
15 (3) Subsection (k) of section 1034 of such Code
16 (relating to an individual whose tax home is outside the
17 United States) is amended—
18 (A) by striking out "(as defined in section
19 913(j)(1)(B)", and
20 (B) by adding at the end thereof the follow-
21 ing new sentence: "For purposes of the preceding
22 sentence, the term 'tax home' means, with respect
23 to any individual, such individual's home for pur-
24 poses of section 162(a)(2) (relating to travel ex-

1 penses while away from home); except that an in-
2 dividual shall not be treated as having a tax home
3 in a foreign country for any period for which his
4 abode is within the United States.".
5 (4) Subsection (a) of section 3401 of such Code
6 (defining wages) is amended by striking out paragraph
7 (18) which was added by section 207(a) of the Foreign
8 Earned Income Act of 1978.
9 (5) Clause (iii) of section 6091(b)(1)(B) of such
10 Code is amended by striking out "section 913 (relating
11 to deduction for certain expenses of living abroad)".
12 SEC. 2. EFFECTIVE DATE.
13 The amendments made by section 1 of this Act shall
14 apply to taxable years beginning after December 31, 1981.

II

97TH CONGRESS
1ST SESSION

S. 867

To amend the Internal Revenue Code with respect to the tax treatment of Americans abroad.

IN THE SENATE OF THE UNITED STATES

APRIL 2 (legislative day, FEBRUARY 16), 1981

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code with respect to the tax treatment of Americans abroad.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE.**
4 This Act may be cited as the "Expatriates' Tax Act of
5 1981".

1 SEC. 2. PARTIAL EXCLUSION FOR INCOME FROM SOURCES
2 OUTSIDE THE UNITED STATES.
3 (a) IN GENERAL.—Section 911 of the Internal Revenue
4 Code of 1954 (relating to income earned by individuals in
5 certain camps) is amended to read as follows—
6 "SEC. 911. INCOME FROM SOURCES OUTSIDE THE UNITED
7 STATES.
8 "(a) GENERAL RULE.—There shall be excluded from
9 taxation under this subtitle 80 percent of the income that a
10 United States citizen—
11 "(1) receives from sources within a foreign coun-
12 try or countries,
13 "(2) during the portion of the taxable year that he
14 meets the eligibility requirements of subsection (b).
15 "(b) ELIGIBILITY.—A United States citizen is eligible
16 for the exclusion if—
17 "(1) he establishes to the satisfaction of the Sec-
18 retary that he is a bona fide resident of a foreign coun-
19 try, or
20 "(2) during any period of 12 consecutive months,
21 he is outside the United States, its possessions and ter-
22 ritories for at least 330 full days.
23 "(3) LIMITED WAIVER.—If, in the opinion of the
24 Secretary—
25 "(i) a United States citizen is forced by war,
26 civil unrest or similar conditions to return to the

1 United States before he has met the requirements
2 of this subsection, and
3 "(ii) the citizen could reasonably have been
4 expected to have met those requirements,
5 then he shall be eligible for the exclusion for the period
6 during which he was abroad.
7 "(c) EXCLUSION DOES NOT APPLY TO UNITED
8 STATES GOVERNMENT EMPLOYEES.—This section does not
9 apply to income that is paid by the United States or any
10 agency thereof to military or civilian officers or employees of
11 the United States, or for service as a Peace Corps volunteer
12 or volunteer leader.
13 "(d) DEDUCTIONS AND CREDITS DISALLOWED.—No
14 deduction or credit against tax shall be allowed to the extent
15 that it is properly allocable to income that has been excluded
16 from tax under this section.
17 "(e) EXCLUSION OPTIONAL.—A United States citizen
18 may elect to ignore the exclusion and to pay tax in any year
19 as if there were no exclusion. The election shall be made in
20 such manner as the Secretary may prescribe by regulation."
21 (b) CONFORMING AMENDMENTS.—
22 (1) Section 7701(a) of the Internal Revenue Code
23 (relating to definitions) is amended by adding a new
24 paragraph at the end:

1 "(38) EARNED INCOME.—The term 'earned
2 income' means wages, salaries or professional fees, and
3 other amounts received as compensation for personal
4 services actually rendered, but does not include that
5 part of the compensation which represents a distribu-
6 tion of earnings or profits rather than a reasonable al-
7 lowance as compensation for the personal services ac-
8 tually rendered. In the case of a taxpayer engaged in a
9 trade or business in which both personal services and
10 capital are material income-producing factors, under
11 regulations prescribed by the Secretary, a reasonable
12 allowance as compensation for the personal services
13 rendered by the taxpayer, not in excess of 30 percent
14 of his share of the net profits of such trade or business,
15 shall be considered as earned income."
16 (2) Sections 37(e)(9)(B), 63(e)(2), 105(h)(3)(B)(v),
17 879(a)(1), 1303(c)(2), 1304(c)(3), and 1348(b)(1)(A) are
18 amended by striking out "section 911(b)" and inserting
19 in lieu thereof "section 7701(a)(38)".
20 (c) CLERICAL AMENDMENTS.—
21 (1) The table of sections for subpart B of part III
22 of subchapter N of chapter I of such Code is amended
23 by striking out the item relating to section 911 and in-
24 serting in lieu thereof the following:

"Sec. 911. Income from sources outside the United States."

1 (2) Section 43(c)(1)(C)(i) is amended by striking
2 out "relating to income earned by individuals in certain
3 camps outside the United States" and inserting in lieu
4 thereof "relating to income from sources outside the
5 United States".
6 (3) Sections 1302(b)(2)(A)(i), 1304(b)(1),
7 1402(a)(8), 6012(c), and 6091(b)(1)(B)(iii) are each
8 amended by striking out "relating to income earned by
9 employees in certain camps" and inserting in lieu
10 thereof "relating to income from outside the United
11 States".

12 **SEC. 3. REPEAL OF DEDUCTION FOR CERTAIN EXPENSES OF**
13 **LIVING ABROAD.**

14 (a) IN GENERAL.—Section 913 of such Code (relating
15 to deduction for certain expenses of living abroad) is hereby
16 repealed.
17 (b) CLERICAL AMENDMENTS.—
18 (1) The table of sections for subpart B of part III
19 of subchapter N of chapter 1 is amended by striking
20 out the item relating to section 913.
21 (2) Section 43(c)(1) is amended by striking out ",
22 913," as it appears in the title, by inserting "or" after
23 the comma at the end of subparagraph (i), and by strik-
24 ing out subparagraph (ii).

1 (3) Section 6091(b)(1)(B)(iii) is amended by strik-
2 ing out "section 913 (relating to deduction for certain
3 expenses of living abroad),".

4 **SEC. 4. EFFECTIVE DATE.**

5 The amendments made by this Act shall apply with re-
6 spect to taxable years beginning after December 31, 1980.

DESCRIPTION OF BILLS (S. 408, S. 436, S. 598, AND S. 867)

RELATING TO

TAX TREATMENT OF FOREIGN EARNED INCOME

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

APRIL 22, 1981

INTRODUCTION

This pamphlet provides a description of four Senate bills (S. 408, S. 436, S. 598, and S. 867) which are scheduled for a public hearing on April 24, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management. The bills relate to the tax treatment of foreign earned income of individuals.

The first part of the pamphlet is a summary. This is followed by a description of the bills, including a discussion of present law, issues involved, an explanation of the provisions of the bills, effective dates, and estimated revenue effects.

I. SUMMARY

Under the Foreign Earned Income Act of 1978, Americans working abroad generally are eligible for deductions intended to reflect the excess costs of living abroad. Employees in camps in hardship areas may in the alternative elect to exclude $20,000 from income. Prior to the 1978 Act, Americans working abroad generally could exclude $20,000 (or, in some cases, $25,000) from foreign earned income.

Under S. 408 (Senators Chafee, Mathias, Roth, Matsunaga, Cochran, Lugar, Boschwitz, Schmitt, Grassley, Boren, Simpson, and Tsongas), present law would be replaced with an annual exclusion of the first $50,000 of foreign earned income plus 50 percent of the next $50,000 of foreign earned income (total of $75,000 exclusion on the first $100,000 of foreign earned income) and a deduction for excess foreign housing costs. S. 436 (Senator Bentsen) would replace present law with an exclusion in 1981 of $75,000 of foreign earned income (the exclusion would increase to $80,000 in 1982, $85,000 in 1983, $90,000 in 1984, and $95,000 in 1985 and years thereafter) and a deduction for excess foreign housing costs. S. 598 (Senator Jepsen) would exclude foreign earned income entirely. S. 867 (Senator Moynihan) would replace present law with an optional exclusion of 80% of all foreign source income (i.e., both earned and investment income).

II. DESCRIPTION OF THE BILLS

A. Present Law and Background

Law prior to the Foreign Earned Income Act of 1978

United States citizens and residents are generally taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1978, U.S. citizens working abroad could exclude up to $20,000 of earned income a year if they were present in a foreign country for 17 out of 18 months or they were *bona fide* residents of a foreign country for a period which included an entire taxable year (Code sec. 911).[1] In the case of individuals who had been *bona fide* residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. In addition, under the law prior to 1978, foreign taxes paid on the excluded income were creditable against the U.S. tax on any foreign income above the $20,000 (or $25,000) limit.

The Tax Reform Act of 1976 would generally have reduced the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act would have retained a $20,000 exclusion for employees of domestic charitable organizations. In addition, the Act would have made certain modifications in the computation of the exclusion.

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. However, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under the Tax Reform Act of 1976.

Foreign Earned Income Act of 1978

The Foreign Earned Income Act of 1978 generally replaces the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. The basic eligibility requirements for the deduction are generally the same as for the prior earned income exclusion.

The new excess living cost deduction (new Code sec. 913) consists of separate elements for the general cost of living, housing, education, and home leave costs. The cost-of-living element of the deduction

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[1] This eligibility requirement was modified by Public Law 96-608 so that the minimum time periods could be waived for Americans working abroad who could reasonably have been expected to meet the eligibility requirements, but who left the foreign country under conditions of war, civil unrest, or similar conditions which precluded the normal conduct of business.

is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a Federal employee at grade level GS–14, step 1, regardless of the taxpayer's actual income. The housing element is the excess of the taxpayer's reasonable housing expenses over his base housing amount (generally one-sixth of his net earned income). The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable cost of coach airfare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

In addition, taxpayers living and working in certain hardship areas are allowed a special $5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. For this purpose, hardship areas are generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees is 15 percent or more of their base pay.

As an exception to these new rules, the Act permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion (under Code sec. 911) in lieu of the new excess living cost and hardship area deductions. No foreign tax credit would be allowed for foreign taxes attributable to the excluded amount. For taxpayers electing the exclusion, the camp would be treated as the employer's business premises so that the exclusion for employer-provided meals and lodging can also be claimed (provided the other requirements of Code sec. 119 are satisfied).

The 1978 Act liberalized the deduction for moving expenses for foreign job-related moves, increasing the dollar limitations applicable to temporary living expenses. The Act also extended up to four years while the taxpayer is working abroad the 18- or 24-month period for reinvestment of proceeds realized on the sale of a principal residence.

Exclusion for Charitable Employees

In P.L. 96–595 Congress allowed a $20,000 annual exclusion to employees of charitable organizations who perform charitable services in less developed countries. The charitable organization must be an organization that meets the requirements of Code section 501(c)(3) and which is not a private foundation (within the meaning of Code section 509(a)).

1980 Senate Finance Committee bill

The Tax Reduction Act of 1980, reported by the Senate Finance Committee on September 15, 1980 [2] (but not considered by the full Senate), would have granted a $50,000 exclusion (increased to $65,000 after two years of *bona fide* residence in a foreign country) to U.S. citizens or residents who were present in a foreign country for at least 330

[2] Secs. 121–122 of the Finance Committee amendment to H.R. 5829 (S. Rept. 96–94).

days out of any 12-month period. Only income from services performed in a developing country or services performed in charitable, extractive, or export-related activities would have been eligible for the exclusion. The exclusion was elective and was in lieu of the present system of the excess living costs deduction.

Under the bill, qualified individuals would have also been allowed to exclude an amount of foreign earned income equal to the excess of their foreign housing costs over a base housing cost (approximately $5,555 in 1980). As under present law, no deduction or credit would have been allowed for taxes or other amounts attributable to the excluded income.

GAO Report

On February 27, 1981, the General Accounting Office released a report [3] on Americans working abroad. The report concluded that U.S. taxes were an important factor in reducing the number of Americans employed overseas because (a) the employees were subject to U.S. tax on the reimbursement of their excess costs of living overseas, (b) these taxes were reimbursed by the employers, thus increasing the cost of the U.S. employee, and (c) the complexity of the new law made compliance difficult and expensive.

The report stated that the United States is the only major industrial country which taxes foreign-source income on a citizenship basis. It concluded that 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.

B. Issues

The issue is whether U.S. tax laws have caused a decline in the number of Americans working abroad, which in turn has caused a decline in U.S. exports and in U.S. employment generated by these exports. If so, should the U.S. tax laws be modified to afford more generous relief to Americans working abroad? Should this relief apply only to foreign earned income or to all foreign income? Should any relief that is given be targeted to those Americans working abroad that are in a position to have a positive affect on U.S. exports?

A related issue, if only part of the individual's foreign earned income is to be excluded, is the extent to which the relief should be limited to the specific circumstances of the taxpayer or should be in the form of a flat dollar or formula amount.

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[3] Report to the Congress by the Comptroller General of the United States, "American Employment Abroad Discouraged by U.S. Income Tax Laws" (U.S. General Accounting Office, I.D.-81-29; Feb. 27, 1981).

C. Explanation of Provisions

1. S. 408 (Sens. Chafee, Mathias, Roth, Matsunaga, Cochran, Lugar, Boschwitz, Schmitt, Grassley, Boren, Simpson, and Tsongas): Partial exclusion for foreign earned income of individuals

Explanation of the bill

The bill would modify the eligibility standards of present law and would replace the present system of deductions for excess living costs with an exclusion, subject to a cap, of foreign earned income. The *bnoa fide* residence test would remain in its present form. However, an individual would also be eligible for the special provisions if he were present in a foreign country or countries for 330 days in any period of 12 consecutive months (rather than 510 days in any period of 18 consecutive months as under present law). Individuals meeting these requirements generally could elect to exclude foreign earned income attributable to the period of foreign residence or presence at an annual rate of $50,000 plus 50 percent of the next $50,000 (total of $75,000 on the first $100,000 of foreign earned income).

In addition to the exclusion described above, an individual would be allowed to elect to exclude a portion of his housing expenses. The exclusion is equal to the excess of the taxpayer's "housing expenses" over a base housing amount. The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year by or on behalf of the individual for housing for the individual (and, if they reside with him, for his spouse and dependents) in a foreign country. The term includes expenses attributable to the housing, such as utilities and insurance, but does not include interest and taxes, which are separately deductible. If the taxpayer maintains a second household outside the United States for his spouse and dependents who do not reside with him because of adverse living conditions, then the housing expenses of the second household are also eligible for the exclusion. Housing expenses are not treated as reasonable to the extent they are lavish or extravagant under the circumstances.

The base housing amount is 16 percent of the salary of an employee of the United States whose salary grade is step 1 of grade GS-14. Currently, this salary is $34,713, so the current base housing amount would be $5,554.

As under present law, amounts paid by the United States or its agencies could not be excluded. The rules now in effect relating to the computation of the exclusion and the disallowance of a credit or deduction for foreign taxes or expenses allocable to the excluded income would be retained.

The present deduction for excess foreign living costs (Code sec. 913) would be repealed. Thus, if a taxpayer chooses not to elect the

above exclusions, he would be fully taxed on his foreign source income, subject, however, to a full foreign tax credit. The bill would also retain the rule of present law that a hardship area camp is treated as the business premises of the employer, permitting (if other conditions are met) the exclusion from income of the value of meals and lodging.

Effective date

The bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1981	1982	1983	1984	1985
Calendar	523	565	610	659	712
Fiscal	288	546	590	637	689

2. S. 436 (Mr. Bentsen): Partial exclusion for foreign earned income of individuals

Explanation of the bill

The bill would modify the eligibility standards of present law. The *bona fide* residence test would remain in its present form. However, an individual would also be eligible for the special provisions if he were present in a foreign country or countries for 330 days in any period of 12 consecutive months (rather than 510 days in any period of 18 consecutive months as under present law).

Individuals meeting the eligibility requirements could elect to exclude foreign earned income attributable to the period of residence or presence at an annual rate of $80,000 for 1982, $85,000 for 1983, $90,000 for 1984, and $95,000 for 1985 and years thereafter. As under present law, amounts paid by the United States or its agencies could not be excluded. The rules, now in effect relating to the computation of the exclusion, and disallowing a credit or reduction for foreign taxes or expenses allocable to the excluded income, would be retained.

In addition, individuals qualifying for the exclusion would be entitled to a deduction for qualified housing expenses. These are the excess of the individual's housing expenses over a base housing amount of $5,500. The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year by or on behalf of the individual for housing for the individual (and, if they reside with him, for his spouse and dependents) in a foreign country. The term includes expenses attributable to the housing (such as security, utilities, and insurance), but does not include interest and taxes, which are separately deductible. Housing expenses are not treated as reasonable to the extent they are lavish or extravagant under the circumstances.

The present deduction for excess foreign living costs (Code sec. 913) would be repealed. Thus, if a taxpayer chooses not to elect the exclusion, his foreign source income would incur full U.S. taxation subject, however, to a full foreign tax credit. However, the deduction for qualified housing expenses is allowed regardless of whether the taxpayer elects the exclusion or not. Also, the bill would retain the rule of present law that a hardship area camp is treated as the business premises of the employer, permitting (if other conditions are met) the exclusion from income of the value of meals and lodging.

Effective date

The bill would apply to taxable years beginning after December 31, 1981.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1982	1983	1984	1985	1986
Calendar	586	639	694	754	814
Fiscal	322	615	670	727	787

3. S. 598 (Senator Jepsen): Exemption for foreign earned income of individuals

Explanation of the bill

The bill would retain the eligibility standards of present law (the *bona fide* residence and presence tests). Individuals meeting these requirements could exclude the entire amount (except amounts paid by the United States or any of its agencies) of their foreign earned income attributable to services performed during the period of foreign residence or presence. Taxes or expenses allocable to the excluded amounts would not be allowed as a credit or deduction. The deduction for excess foreign living costs of present law (Code sec. 913) would be repealed.

Effective date

The bill would apply to taxable years beginning after December 31, 1981.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1982	1983	1984	1985	1986
Calendar	610	659	712	769	831
Fiscal	336	637	689	743	803

4. S. 867 (Senator Moynihan): Partial exclusion for foreign income of individuals

The bill provides that if a U.S. citizen is a *bona fide* resident of a foreign country (for any period of time, not just a taxable year) or is outside the United States for 330 days during any 12 consecutive month period, he could exclude 80 percent of all his foreign source income (both earned and investment income) during the period he met these qualification requirements. As under present law, amounts paid by the United States or any of its agencies would not be excluded and no deduction or credit would be allowed to the extent allocable to excluded income.

The bill would repeal the present system of deductions for excess foreign living costs (sec. 913). It also would allow the taxpayer to elect not to exclude his foreign source income. Thus, if a taxpayer chooses not to elect the 80-percent exclusion of his foreign source income, that income would incur full U.S. taxation subject, however, to a full foreign tax credit.

Effective date

The bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1981	1982	1983	1984	1985
Calendar	498	539	582	629	681
Fiscal	274	520	563	608	658

Senator PACKWOOD. The hearing will come to order. This is a hearing on the general subject of the taxation of income of Americans earned who are working overseas.

We have some opening statements, but I have asked the committee members to defer them so that Secretary of Commerce, Malcolm Baldrige might testify. He has a deadline to meet.

I would also like to thank Roger Jepsen, who would have been the first witness, for saying that he is happy to yield to the Secretary. So, Mr. Secretary, we are ready to take you now and we appreciate you accommodating your schedule to us.

Senator DOLE. Mr. Chairman, could I just put a statement on the record? I have another hearing in line down the hall.

Senator PACKWOOD. Yes.

Senator DOLE. I appreciate your calling these hearings and I know of your deep interest and Senator Chafee's and others on the committee. I hope that we can address this problem in the right way this year, and I thank you very much. I have a very nice statement which I will just put there.

Senator PACKWOOD. Thank you very much, Senator Dole.

[Statements of Senators Dole and Chafee follow:]

STATEMENT OF SENATOR DOLE BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

THE TAX ON AMERICANS OVERSEAS

Mr. Chairman: I believe this hearing will serve to focus attention on a vital issue: The extent to which our tax treatment of U.S. citizens working overseas undermines efforts to improve our export position.

The United States is the only major industrial country that taxes the earned income of its citizens working abroad. Those citizens are also subject to foreign income taxes and must accommodate themselves to higher living cost overseas. This policy can impair the competitive position of American companies with respect to their overseas operations. It hinders our ability to maintain highly qualified Americans in key positions overseas, and often results in fewer job opportunities abroad for Americans. That means more pressure on the domestic job market. In addition, our tax treatment of expatriates means American companies face higher costs when they seek to compensate for the inequity. That means they are more likely to be outbid on contracts by foreign competitors. This is an unwarranted and unjustifiable restriction on the ability of American companies to compete overseas.

Mr. Chairman, Congress intended to alleviate this tax burden on our expatriates when it passed the Foreign Earned Income Act of 1978. That Act allowed Americans working overseas to deduct reimbursements that reflect the higher costs of living abroad. Unfortunately, the evidence seems clear that the deductions allowed are significantly less than the actual reimbursement required to cover reasonable expenses. The result is a higher tax burden for U.S. citizens who work overseas.

Senator Chafee has performed a valuable service in keeping this issue before the public, and the proposals by Senator Bentsen, Senator Jepsen, and Senator Moynihan to deal with this issue are proof of the bipartisan concern over the impact of our tax policy on the competitive position of U.S. companies that have sizable overseas operations. Last year the Finance Committee approved a modified version of the Chafee proposal to reduce the tax burden on our expatriates, and that is proof, I believe, of the concern of this Committee with the issue. I understand that the Administration is likely to recommend a lower tax burden on Americans overseas when it submits its second round of proposals to the Congress. I would like to take this opportunity to thank Ambassador Brock for his considerable efforts to focus attention on this and other policy changes that can improve our ability to export American goods and services.

Mr. Chairman, it seems to this Senator that the revenue cost of each of these proposals is modest compared to the potential benefits that can be realized. We should not forget that the high quality of work done by Americans overseas contributes greatly to the way we are viewed by the world and improving our balance of payments. We must encourage a greater number of highly-skilled American workers

to contribute to the world economy by working abroad. That is ample reason to support more equitable tax treatment for our expatriates.

Mr. Chairman, I appreciate the fact that you have scheduled this hearing in a timely fashion. I look forward to hearing the testimony from Senator Jepsen, from Ambassador Brock and Secretary Baldrige and from Assistant Secretary Chapoton and the many other witnesses who are concerned over this matter. I hope this forum will help bring out the pros and cons of the different approaches that have been suggested.

A STATEMENT BY

SENATOR JOHN H. CHAFEE (R-R.I.)

TO THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

ON THE

TAXATION OF AMERICANS ABROAD

REMOVING EXPORT DISINCENTIVES

APRIL 24, 1981

MR. CHAIRMAN. I want to thank you for granting my request for this hearing and permitting the Subcommittee an entire morning to consider the tax issues affecting Americans who live and work overseas.

For two years, since it became evident that the Foreign Earned Income Act of 1978 created more problems than it solved, I have been promoting legislation to simplify and reduce the taxes on Americans abroad. This is extremely important, not just in the interest of good tax policy, but in the interest of an effective U.S. export policy.

I am particularly pleased today that we have an opportunity to discuss the Section 911/913 problem with three distinguished Administration officials.

Ambassador Bill Brock, the United States Trade Representative, is President Reagan's spokesman for trade policy. As Chairman of the White House Trade Policy Committee, he has been the individual most responsible for bringing this issue into focus on placing it on the Administration's agenda for discussion and action.

Secretary Mac Baldrige, who made a special effort to be here today, manages all our federal export promotion programs at the Department of Commerce, and as a former businessman is intimately familiar with the Section 911/913 trade disincentive.

Assistant Secretary John Chapaton is the Treasury's tax policy export and, from previous conversations, I know he is fully aware of and sympathetic to the difficulties of Americans trying to compete abroad.

In addition, we will hear from the General Accounting Office which completed a significant study in February of this year called, "American Employment Abroad Discouraged by U.S. Income Tax Laws." This report supplemented by the views and studies of our other witnesses will leave the Senate with little doubt about the immediate need to change our overseas tax laws.

We have four bills on the agenda today, sponsored by Republicans and Democrats. While they are different, each seeks the same result: changing the tax laws which put Americans abroad at a competitive disadvantage with their foreign counterparts. This effort was enthusiastically endorsed in both the Republican and Democratic platforms in 1980.

The arena of world trade is a very sophisticated place today. U.S. industry is challenged by aggressive foreign competitors at every turn, and we are fooling ourselves to think we can stay in contention with one arm tied behind the back. The testimony at this hearing will show that, indeed, our tax laws are forcing American workers out of their overseas jobs and creating a new generation of foreign management in the overseas operations of U.S.

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firms. And, conversely, we are losing the opportunity to educate a generation of U.S. business people the mechanics of foreign trade. Since raising the overseas tax burden in 1976, this has had a bad impact on U.S. exports, and it will only get worse in the future.

This development also has significance for our role as the world's premiere free trader. With several basic U.S. industries threatened by foreign competition, with an ever-escalating bill for foreign oil, and with foreign imports outstripping U.S. exports consistently over the past five years, there is increasing pressure in this country for protectionist import quotas to preserve U.S. jobs. Nothing could be more detrimental to the health of our economy. New jobs will never be created by narrowing our markets and withdrawing into a protectionist shell.

We must, instead, promote an aggressive U.S. export program. It has been estimated that $1 billion of increased exports will create 40,000 new jobs here at home. Opportunities for workers in this country rest heavily on our ability to sell the products of American ingenuity and technology in the world market. Today, one American in every 9 can attribute his or her job to exports by U.S. companies.

It is urgent, therefore, that we begin eliminating export disincentives from our laws. We have been talking about it and studying it for a number of years, but Congress has failed so far to enact any meaningful legislation in this regard.

Now, with the support of President Reagan, we have a real chance to take on issues such as the taxation of Americans working

abroad, the Foreign Corrupt Practices Act, and the export trading company restrictions which have been hampering U.S. export efforts.

This morning, for the first time, we have an opportunity to discuss the most prominent of these issues -- the taxation of overseas Americans -- with key Administration officials and, hopefully, come to an understanding about what must be done by Congress to eliminate a major U.S. export impediment.

We welcome all the witnesses who have come to assist the Finance Committee in this task.

Senator PACKWOOD. Mr. Secretary, good to have you with us.

Mr. BALDRIGE. Thank you, Mr. Chairman.

[The prepared statement of Hon. Malcolm Baldrige follows:]

STATEMENT OF HON. MALCOLM BALDRIGE BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Mr. Chairman and members of the committee, I am pleased to be here to discuss with you how to increase our exports by removing tax disincentives for Americans working abroad.

THE PROBLEM

The costs to U.S. firms of employing American workers overseas have risen dramatically in recent years, in large part because companies often provide "tax equalization" programs to these employees. In some instances, rising tax costs have forced U.S. employers to reduce the number of their American workers, or to replace them with foreign nationals. American workers responsible for purchasing goods or services for their companies are more likely to specify American-made products in fulfilling job requirements abroad than would their foreign counterparts. If a U.S. firm chooses to replace its American employees abroad with nationals of other countries, the valuable follow-on of U.S. exports is often lost. This trend has serious consequences for export growth.

A June 1980, report by Chase Econometrics found that the 1978 changes in the U.S. tax code have led to a 5 percent drop in exports, and a reduction in overall tax receipts far greater than the increased taxes paid by overseas workers.

The U.S. government is not receiving significant revenue from taxing U.S. expatriate foreign source income. However, the U.S. is losing U.S. employment both at home and abroad which is reducing U.S. tax revenues from the business being lost. Further, to employ foreign nationals rather than U.S. expatriates abroad will tend to hasten and intensify foreign competition with U.S. companies as U.S. technology and know-how are spread more widely and rapidly throughout the world.

THE PRESENT SYSTEM

The issue of how we can remove the present tax disincentives for Americans working abroad was discussed intensively for more than two years prior to the enactment of the Foreign Earned Income Act of 1978 (Act). That Act provided special deductions to reduce the additional U.S. tax cost incurred by expatriate Americans and their overseas employers on pay allowances and other offsetting compensation which do not represent increases in their real income. However, tax benefits provided by the Act are extremely complicated, difficult to use, and do not provide meaningful relief.

INADEQUACIES OF THE PRESENT SYSTEM

The increased costs of living overseas, when not fully compensated by the employer, are a signficant deterrent to overseas service. Americans with families often

must make personal sacrifices to accept assignments in even the most attractive locations, Americans living in countries with tax rates comparable to those of the United States are returning home because of the additional tax cost they encounter. Since tax reimbursement is itself deemed by the United States to be taxable income, firms compensating their employees for the tax cost of working overseas find that "a forty thousand per year executive can wind up paying taxes on $95,000 of gross income."

Many U.S. firms provide for certain allowances such as extra housing and living costs for their American employees abroad. Some companies also reimburse the employee for taxes, U.S. and foreign, which exceed those the employee would have paid had he not gone abroad. Both the allowances and the tax equalization payments result in added U.S. taxable income. Therefore, to keep the employee economically in the same position after taxes as he would have been had he not gone abroad, the allowances and tax equalization payments must be "grossed-up" or basically doubled.

The present system involves a heavy burden of recordkeeping and tax preparation, which itself constitutes an additional cost to the American and his overseas employer. U.S. firms abroad incur fees from their independent public accountants for preparation of U.S. and foreign tax returns of the expatriates and computation of the tax equalization payments. For lower income expatriates the fees average about $1,000 per year. For senior executives with complex situations the fees can be $3,000 or more. In addition, there are internal corporate administrative costs involved in monitoring the tax equalization program.

PRESENT WAYS OF DEALING WITH THE PROBLEM

Let me refer to some U.S. companies with which I am familiar, Mr. Chairman. This reimbursement and taxation situation for expatriates results in Bendix incurring costs of about 2½ to 3 times the base compensation of the expatriates.

In a major contract recently awarded to a Bendix affiliate by the U.S. Government for services to be performed in the Middle East, Bendix was asked to bid on the basis of staffing with 100% U.S. personnel as compared with only U.S. personnel in those positions considered critical. The bid which included all U.S. personnel was 183 percent of the bid which included U.S. personnel in only the critical positions involving 21 percent of the total staffing requirements. Needless to say, Bendix was awarded the contract on the bid which included only 21 percent U.S. personnel. About 1,860 positions were filled with foreign nationals and not U.S. expatriates.

Bendix and its U.S. affiliates (excluding foreign affiliates) have several thousand employees working abroad. To minimize the costs of conducting foreign business, Bendix had taken specific steps to employ foreign personnel rather than U.S. expatriates.

A subsidiary involved in geophysical services has opened an office in London to recruit English speaking foreign nationals for employment in Sudan and Nigeria.

The Bechtel Group has had similar experiences. In connection with a hydroelectric powerhouse project in Egypt, the portion of their proposal relating to on-site construction management required 23 engineers. They could only include seven American engineers, due to the high tax cost involved. The remaining 16 engineers had to come from other countries. This $155 million-four year engineering and construction management job was lost to a Swedish consortium due, to a large extent, to the fact that the on-site personnel mix so weakened their proposed technical team, they were no longer considered to be an American firm bidding against foreign firms, but rather were themselves a foreign firm.

Bechtel is at the present time designing and building the Riyadh International Airport in Saudi Arabia. This is a $3.5 billion project which was opened to tendering by firms from all parts of the world. On that particular project of the 30 contractors besides Bechtel working on the project not one is a U.S. firm and this is with a plant designed and being managed by Bechtel. No U.S. firm won a bid in competition with foreign firms in the international market.

As a result of these problems, more and more firms are turning to employing foreign nationals. A joint-venture company in which Bendix is a partner has established recruiting offices both in London and Manila to recruit employees from Europe, Australia and the Philippines for a government contract to be performed in the Middle East.

One company indicated that its expatriates, with an annual average base pay of $50,000 were costing the company $150,000. In the opinion of that company management, nothing short of a major restructuring of the taxation of expatriate foreign source income was going to solve the company's expatriate cost problems.

Another result of employing less U.S. expatriates to do the work of U.S. companies in foreign countries is to more rapidly spread the U.S. know-how and technol-

ogy to foreign nationals and hasten and intensify foreign competition with U.S. companies. Obviously, this will further reduce U.S. business activity and employment over time.

Under these conditions, we believe the most sound tax policy for the U.S. government would be to exempt generous portions of the earnings of expatriates. To prevent artificial tax avoidance, reasonable tests of bona fide foreign residence could be established.

The cost of employing an American engineer on an overseas project in Jordan is approximately 47 percent greater than the cost of employing a British expatriate on the same project. Seventy-five percent of this cost differential is due to the more favorable UK tax policy for expatriates. A contractor using 100 percent British mid-level personnel rather than Americans on a project funded by the World Bank in Jordan computed that he would experience a cost savings of 2.8 percent—an amount exceeding his expected profit. Margins of this size are often the difference between an award and a loss contract.

U.S. government taxation of expatriates income earned abroad has some perverse results. First, the grossing-up of payments to the expatriate results in added taxable income for both U.S. and foreign tax purposes in many cases. The foreign government collects a higher tax on the higher income. For U.S. tax purposes, the higher foreign taxes are a credit against the U.S. tax liability of the expatriate and the U.S. collects little or no added tax. In total, U.S. government revenue from expatriate taxes is small. However, as less U.S. expatriates are employed abroad, total U.S. business activity is reduced and tax revenues are lost from both lower employment and lost business income.

SOLVING THE PROBLEM

The United States is unique in taxing the foreign earned income of its nonresident citizens. A comparison of the U.S. system with the tax system of Canada, France, Germany, Japan and Britain reveals the United States to be alone in taxing on the basis of citizens rather than residence. To place Americans working abroad and their U.S. employers on an equal footing with their foreign counterparts requires a liberalization and simplification of current law as applied to Americans working overseas.

To place Americans working abroad and their U.S. employers on an equal footing with their foreign counterpart requires amendment to the complex and costly provisions of Internal Revenue Code Sections 911 and 913. They should be replaced with a major restructuring of the exclusion from U.S. taxable income of expatriate income earned abroad. To prevent artificial abuse and tax avoidance, reasonable tests of foreign residency would have to be provided. In concept, if an American is employed abroad in a legitimate business activity, his foreign source earned income should not be paralyzed by excessive U.S. taxes. To continue to do so will further reduce U.S. employment abroad and continue to provide a significant disincentive to our national export effort.

STATEMENT OF HON. MALCOLM BALDRIGE, SECRETARY OF COMMERCE

Mr. BALDRIGE. The costs to U.S. firms of employing American workers overseas have risen dramatically in recent years, mostly because companies have to provide tax equalization programs to those employees. In many instances, rising tax costs have forced U.S. employers to reduce the number of American workers or replace them with foreign nationals.

American workers responsible for purchasing goods or services are more likely to buy American products than foreign nationals. I think that is obvious. This trend has serious consequences for export growth.

A June 1980 report by Chase Econometrics found that the 1978 changes in the U.S. tax codes had led to a 5-percent drop in exports and reduction in overall tax receipts far greater than the increased taxes paid by overseas workers.

The U.S. Government is not receiving significant tax revenues from taxing U.S expatriate foreign source income. However, the

United States is losing U.S. employment, both at home and abroad, which is reducing tax revenues from the business being lost.

Further, to employ foreign nationals rather than U.S. expatriates abroad, will tend to hasten and intensify foreign competition with U.S. companies as U.S. technology and know-how are spread more widely and rapidly throughout the world. This is a particular problem in the industries in which we are leading worldwide now—technology and know-how transfer.

Senator PACKWOOD. Senator Jepsen, do you want to sit up here until your time for testimony comes and then you go down there and come back up afterward?

Excuse me, Mr. Secretary.

Mr. BALDRIGE. Yes, Senator.

Americans living in countries with tax rates comparable to those in the United States are returning home because of the additional tax costs they encounter.

Since tax reimbursement is in itself deemed by the United States to be taxable income, firms compensating their employees for the tax costs of working overseas find that a $40,000 per year executive can wind up paying taxes on $95,000 worth of income.

Another not completely understood additional cost are legal and accounting fees. The present taxation system has been a boon for both the accounting and the legal profession. Many companies I know of, with reasonably highly paid people working abroad for them, have to pay $3,000 for accounting just to figure out the complicated provisions of this present act, so that the employee will not have to bear the costs.

Let me refer specifically because I think that brings the problem home, if I may, Mr. Chairman, to some U.S. companies and name some names and give some specific examples.

The reimbursement and taxation situation for expatriates in the Bendix Corporation results in their incurring costs they estimate are 2½ to 3 times the base compensation of the expatriates.

In a major contract recently awarded to a Bendix affiliate, by the U.S. Government for services to be performed in the Middle East, Bendix was asked to bid on the basis of staffing with 100-percent U.S. personnel as compared with only U.S. personnel in those positions considered critical. The bid which included all U.S. personnel was 183 percent of the bid which included U.S. personnel in only the critical positions involved 21 percent of the total staffing requirement. Needless to say, Bendix was awarded the contract on the bid which included only 21-percent U.S. personnel. This meant a loss of 1,860 jobs that were filled with foreign nationals and not U.S. expatriates. That is the kind of a trend I am talking about, when the top professional jobs go to Americans. If the rest of the jobs don't, that expertise is rapidly transferred to our competitors.

Bendix and its U.S. affiliates have several thousand employees working abroad. To minimize the cost of conducting foreign business, Bendix has taken specific steps to employ foreign personnel rather than U.S. expatriates.

For example, a subsidiary involved in geophysical services, an area in which the United States is ahead, has opened an office in London to recruit English-speaking foreign nationals for employment in Sudan and Nigeria.

The Bechtel group has had similar experiences. In connection with the hydroelectric project in Egypt, the portion of their proposal relating to onsite construction management, required 23 engineers. They could only include seven American engineers due to the high tax cost involved. The remaining 16 engineers had to come from other countries and learn at our expense as a result. This $155 million, 4-year engineering and construction management job was lost to a Swedish consortium, due, to a large extent, to the fact that the onsite personnel mix so weakened the proposed technical team on the Bechtel side, because their American constituents were in the minority, that they were no longer considered to be an American firm bidding against foreign firms.

Yet, they had to include only the 7 Americans out of 23 engineers, because the cost difference would have been 1 to 1½ percent approximately on this job and that is enough to win or lose a contract.

Bechtel is, at the present time, designing and building the Riyahd International Airport in Saudi Arabia. This is a $3.5 billion project which was opened at tendering by firms from all parts of the world. On that particular project, of the 30 contractors besides Bechtel working on the project, not one is a U.S. firm and this is with a plant designed and being managed by Bechtel.

No U.S. firm won a bid in competition with the foreign firms and a rough rule of thumb is that half of the purchases on a job like that—you can argue whether it is 35 to 55 percent, somewhere around half of the purchases—are usually U.S.-made goods. That is what we are losing when we have a situation like that.

As a result of these problems, more and more firms are turning to employing foreign nationals. The joint venture companies, of which Bendix is a partner, have established recruiting offices in London and Manila to recruit employees from Europe, Australia, and the Philippines for a government contract to be performed in the Middle East. That is a practical effect of this law.

One company indicates that its expatriates, with an annual base pay of $50,000, were costing the company $150,000. In the opinion of that company, nothing short of a major restructuring of the taxation of expatriate foreign source income is going to solve the company's expatriate cost problems.

Another result that we have touched on before, but is so important, of employing less U.S. expatriates to do the work of U.S. companies in foreign countries, is to more rapidly spread the U.S. know-how and technology to foreign nationals and hasten and intensify foreign competition with U.S. companies.

This will further reduce U.S. business activity and employment in the future as a ripple effect of our technology spread goes on. They are going to school on us because of the way these tax laws are written.

Under these conditions, we believe the most sound tax policy for the U.S. Government would be to exempt generous, and I mean very generous, portions of the earnings of expatriates. To prevent artificial tax avoidance, reasonable tests of bona fide foreign residence could be established.

The cost of employing an American engineer in an overseas project in Jordan is approximately half again as much as employing a British expatriate on the same job.

U.S. Government taxation of expatriates' income here and abroad also has some perverse results which I am not sure are completely understood. First, in many cases the grossing up of payments to the expatriate results in added taxable income for both U.S. and foreign tax purposes. The foreign government, therefore, collects a higher tax on a higher income. For U.S. tax purposes, the higher foreign taxes are a credit against the U.S. tax liability of the expatriate and the United States collects little or no additional tax.

The total U.S. Government revenue from expatriate taxes is small. However, as less U.S. expatriates are employed abroad, total U.S. business activities are reduced and tax revenues are lost from both employment and lost business income. Literally, gentlemen, we feel that the United States is worrying about pennies in this situation and losing dollars because of this tax law.

To solve the problem, we have to realize that the United States is unique in taxing the foreign-earned income of its nonresident citizens. A comparison of the U.S. system with the tax system of Canada, France, Germany, Japan, and Britain, reveals the United States to be alone in taxing on the basis of citizenship rather than residency.

To place Americans working abroad and their U.S. employers on an equal footing with their foreign counterparts requires a strong liberalization and simplification of the current laws applied to Americans working overseas.

To place Americans working abroad and their U.S. employers on an equal footing requires amendment to the complex and costly provisions of 911 and 913. They should be replaced with a major restructuring of the exclusion from U.S. taxable income of expatriate income earned abroad.

If an American is employed abroad in a legitimate business activity, his foreign source earned income should not be penalized by excessive U.S. taxes. To continue to do so will further inhibit U.S. employment abroad and continue to provide a significant disincentive to our national export effort.

Thank you very much, Mr. Chairman.

Senator PACKWOOD. Mr. Secretary, thank you. Senator Chafee?

Senator CHAFEE. Thank you for scheduling these hearings. This is a matter that, as you know, has been of deep concern to me and I appreciate your tax subcommittee taking up this matter quickly. Mr. Baldrige what is your time schedule?

Mr. BALDRIGE. If I leave here by 10:15 I am all right.

Senator CHAFEE. Oh, well that is easy. Let me ask you this, you're preaching to the choir, in effect, here in this committee in that last year, as you perhaps you know, we brought out a repeal of 911 in the tax bill that the Senate Finance Committee brought out.

Therefore, the questions I am asking you are to bolster and I'll ask the others, too, the other witnesses, are to bolster our arguments on the floor because this bill will not be greeted with unani-

mous approval on the Senate floor. There are some long foes to it, although they are not many.

Now, here is my question. Why should an American engineer going to Nigeria, have his taxes paid by the Federal Government? Why by the employer? Why is there this escalation? Why isn't he perfectly prepared to go for $50,000? Is the problem that you can't get somebody to go for $50,000, an American, to go for $50,000 which is taxed at the standard U.S. rates?

Mr. BALDRIGE. That is the problem, Senator. You have the problem of just changing your whole style of living. If you have a family, you have those inevitable problems—if you have children, you have schooling problems.

There is, I think, no desire on the part of the average, or the potential employee to go to some faraway place and be able to not save as much money as he was making at home. He just doesn't want to do it; too many problems involved.

Senator CHAFEE. Now, in your testimony you mentioned reasonable residency. In the bill last year we had 11 out of 12 months.

Since then there has been a problem which has come up from some oil drillers, oil companies that are doing drilling actually off Nigeria and there they have the situation where their people go on—oh, let's say a month on and a month off. They are on rigs off Nigeria for a month and then they might be back in the United States for a month or say they are back for 2 weeks, they fly them in and out.

Now, this legislation would not take care of those people. Do you have any thoughts on the residency requirement and should we stretch it to cover these people or are these people just like those who are working on the rigs in northern Alaska for example?

Mr. BALDRIGE. Well, I believe we should stretch it, Senator. I think that in the desire to cover up every potential loophole, we can get this bill so complicated it is going to miss some very important exceptions.

The essential thrust of my testimony is to say we are losing business abroad. We are losing the future business that we don't even know about now and to try and be so clever in constructing a bill so that every possible loophole is covered, I think we can be far too clever. That is what has happened to us in the past and it has hurt us.

Other countries that we are competing with don't tax foreign earned income at all. Any kind of a barrier we put on this is adding to the lack of competitiveness of the United States. Anything we do except be directly competitive with our foreign competitors is that way. I think we should be loose on that area.

Senator CHAFEE. Well, I must say that in opening up this residency problem, I think we are getting into an area that those who have submitted legislation have never wrestled with because we have always felt we wanted to cover the person who was, indeed, working abroad, either on a long-term basis or on a contract in Saudi Arabia. The 11 out of 12 months, we have never run into any problem because we have not really looked for problems, particularly as in connection with this oil drilling situation.

Can I say, from the testimony you are giving, that you are speaking for the administration? Is the administration in support of this legislation?

Mr. BALDRIGE. Well, it depends how you describe the legislation, Senator. The administration does support the idea of changing 911 and 913 so that the tax problems are ameliorated on foreign earned income abroad.

The administration does not have a position yet on whether there should be a cap or some of the details of it. I could say that we do support the thrust of what you are trying to do, but we are not prepared to support any particular bill today.

Senator CHAFEE. In other words, you talk a reasonable test of residency and you talk about some income, so the administration hasn't agreed on a position; whether it is to exempt the first 50 or the first 75?

Mr. BALDRIGE. No.

Senator CHAFEE. Do you think the administration would go for a complete exemption of all foreign earned income? Senator Jepsen's bill fits that.

Mr. BALDRIGE. I think there would be some—oh, what's the right word, Senator—some lengthy discussion about it. There would be some who would advocate and some who would not. I think that is probably the most honest answer to your question.

Senator CHAFEE. How are we going to know? You know we get into the markup of these bills that the Treasury Department would submit.

Oh, OK, I'm sorry. Thank you, Mr. Chairman.

Senator PACKWOOD. We are going to operate on a time limit on questions. We'll move to Senator Jepsen.

Senator JEPSEN. Thank you, Mr. Chairman. Just one brief question. We'll try to get at where the administration stands and not pushing things to the wall, but get a general—

Speaking for the administration, do you have any reservations about a total exclusion if adequate residency tests can be formulated?

Mr. BALDRIGE. I want to make sure I understand your question, Senator. Speaking from the administration's stand.

Senator JEPSEN. Well, as Mr. Secretary, in your capacity. Do you have any reservations about total exclusion if adequate residency tests can be formulated?

Mr. BALDRIGE. I happen not to personally, but I think the administration has not decided that. As a matter of fact, I think there would be a real problem in perhaps total exclusion of earned income from abroad because there are some specific problems and I understand full well you have the author, the movie star problem and so forth.

Senator JEPSEN. I am going to address that, but if you're correct—strong feeling that we just can't do this any way you look at the hodgepodge we have in this thing and if you try to answer everything that I think you have eluded, it is going to be very difficult to alleviate the real problem.

The real problem is that we have 2 percent for every 2-percent decline in personnel, we lose 1-percent export and we have gone from 70 to 40. Seventy percent of all the people working overseas

were Americans a few years back. It is down to 40 now, that means we have lost a big hunk of exports and transfer that back down the line to mainstream and I know I'm talking with prior answers to the American employment here and this is a lot more serious thing than most people realize.

Mr. BALDRIGE. Well, I agree 100 percent, Senator, and I cannot stress enough the fact that where we are exporting—sending our companies abroad on engineering and manufacturing projects—we are the world's leaders. Because we have to cut back on the number of foreign personnel, we are training our competitors to take that leadership away from us in the near future.

There are problems here that we haven't even seen yet because of this bill.

Senator JEPSEN. Thank you, sir.

Senator PACKWOOD. Thank you, Senator Jepsen. John do you have any more questions at the moment?

Senator CHAFEE. No; I do not, Mr. Chairman. I have to go, temporarily, to the next Judiciary Committee to introduce a judge law statement.

Senator PACKWOOD. Thank you. Roger, why don't we take your testimony now, if you want to go down to the witness table and then come back here and then we will take Ambassador Brock.

Thank you, again, Mr. Secretary for accommodating your schedule.

Senator Jepsen.

STATEMENT OF HON. ROGER W. JEPSEN OF IOWA

Senator JEPSEN. Mr. Chairman, I want to personally thank you and the other members of the Subcommittee on Taxation and Debt Management for inviting me to participate in today's hearing. The gesture means a great deal.

The subject of foreign earned income taxation is of great importance to Iowa; 20 percent of the State's work force is directly employed in export related activities. I welcome this opportunity to hear these excellent witnesses and I am confident their testimony will lead to important reforms in present law.

We are fortunate to have persons today representing a variety of backgrounds and considerable experience in this subject area. From what I can tell they are going to cover the broad issues pretty thoroughly.

I will restrict my remarks to two often heard justifications against total exclusion of foreign earned income.

The first is the movie star argument. Defenders of the legal status quo contend the liberalization of sections 911 and 913 would bring a windfall for wealthy entertainers and independent businessmen and women. The source of this argument is legitimate.

In the early 1950's, many Hollywood stars set up residence in Mexico and went overseas for the unique purpose of sheltering their substantial incomes from the Internal Revenue Service.

That legitimacy ended, however, when the loophole was closed by the 1953 amendments. However, the contention that total exclusion would resurrect this shelter is a straw man's argument.

To begin with, few traditional tax shelters remain. The modest havens of the past have become the exclusive hotels of the present.

For example, effective tax rates in France, England, Spain, Italy, and Mexico are all higher than the American ones.

On pure economic grounds, it doesn't pay to live abroad. Most Americans overseas are taxed at confiscatory rates. They are better off staying home; too many of them do.

Two, no active entertainer or businessman can afford to fulfill the 17 or 18 months' residency requirement if the intention is merely avoiding American taxes. You don't make a lot of money doing rock concerts in Saudi Arabia or marketing Caterpiller tractors in Bermuda.

In a few cases where residency is feasible for tax reasons, it becomes professionally impractical. And that is not an opinion, that's a fact.

Three, it is insulting to punish American companies and their employees for the added domestic employment and production their international activity inevitably creates. Americans working overseas provide a critical service and they do so at great sacrifice. Close friends, familiar language, life-long customs, and tolerable climate are left behind when they relocate abroad. These people should not be punished, but that is exactly what the current law does.

Finally, perhaps commonsense speaks most strongly against the movie star argument. Where do all the foreign movie stars, entertainers, and sports celebrities choose to live? I'll tell you where, right here in the good old United States of America.

If there were any substance to the wealthy tax avoider argument, how come all the foreign movie stars aren't living in Saudi Arabia or Hong Kong? The movie star argument is a myth. By taxing our foreign nationals we do not create equity, we aggravate inequity. The repeal of the 911 limitations will do only one thing: Permit companies to market more aggressively abroad and produce employment at home. That's not a maybe, that's a promise.

The other issue I want to look at today, is the question of citizenship responsibility. I have heard several of my colleagues in the Senate suggest that one of the duties of American citizenship is the payment of taxes regardless of domicile.

It is argued that since all Americans benefit from citizenship, all should share equally in the cost of those benefits. Well, three observations seriously question the validity of that analysis.

To begin with, there is the weight of precedent. Although it is often unfortunate to sight the behavior of others as a reason for the support of the given policy, the fact that every leading industrial nation in the world today exempts foreign earned income from domestic taxation, should give the Congress pause to reconsider the current law.

Sweden, for example, the leading free socialist nation in the Western World, excludes their foreign nationals from any income tax whatsoever. We can't accuse that government of lacking in concern for social equity. It would appear that the issue is not one of citizenship responsibility, but economics, pure and simple.

Elected officials could do better to think more about lost jobs, lost production and lost growth in their home States and less about the abstract social equity concerns.

Next, we tend to forget that Americans overseas benefit very little from citizenship except in the unlikely instances of political unrest. In fact, if we judge from recent kidnaping and murder, citizenship appears to have less and less tangible value.

Our Government is increasingly helpless in the fact of international terrorism. The taxation of earned income adds insult to injury.

Lastly, Mr. Chairman, commonsense speaks loudly against the idea.

Certainly the American living in Seoul, South Korea, benefits from the presence of our Armed Forces in that nation. But if we tax him or her, fairness dictates that we levy a tax on all South Koreans and similarly on the Japanese, German, Brazilian, Israeli, and other populations who share in the enormous windfall of a strong American military force all around the world.

We don't tax those peoples. We should not tax our own nationals either. The analysis, if admittedly esoteric, is, nevertheless, sound.

Citizenship responsibility means contributing to America's welfare. When Government taxes our foreign nationals, it does the exact opposite. It destroys incentive.

The argument looks good on paper, Mr. Chairman, but in practice, it is contradictory.

To conclude, the growing participation of newly industrialized countries (NIC's) and lesser developed countries (LDC's), in international trade threaten American jobs. If the U.S. Government continues to shackle free enterprise and forbid by law, equal competition with other nations in international markets, only one person loses: the American worker. Next to that fact the emptiness of the movie star and citizenship argument, is only more forcefully underlined.

No one denies that sections 911 and 913, as they now stand, are having an adverse impact on the American economy. Differences arise only on how to best solve that problem.

Total exclusion would involve a static revenue loss only $100 million higher than the alternative proposals. Objections can be raised, then, only about equity and responsibility, but these arguments are weak. Little speaks against total exclusion. Millions of unemployed workers here at home speak for it.

We can't afford to toss around recriminations about helping rich movie stars when those statements contradict evidence. We can't afford to talk about citizenship responsibility when that responsibility means lost jobs and lost production in the United States.

We have to talk, Mr. Chairman, about the bottom line; American competitiveness in international markets. We have to talk about total exclusion, half-way measures just won't do the trick.

I thank you very kindly.

Senator PACKWOOD. Roger, I agree with you. I was on this committee when we passed the laws that have led to this maze. In attempting to make equity, we passed these exceptions and loopholes and our tax law makes a pretzel look simple, by comparison.

It doesn't work and does not achieve the end that we want to achieve. I hope from the administration and elsewhere, there is no serious objection to our trying to undo the mistake that we made. The facts are almost 100 percent on one side.

I have not heard any valid arguments, any longer, for continuing the law the way it is. You and I are at exactly the same wavelength. I hope we are successful.

I have no questions. Why don't you come back up here and join us.

Senator JEPSEN. Thank you, Mr. Chairman.

[The prepared statement of Senator Jepsen follows:]

TESTIMONY OF SENATOR ROGER W. JEPSEN ON FOREIGN-EARNED INCOME TAXATION

Mr. Chairman: I want to personally thank you and the other members of the Subcommittee on Taxation and Debt Management for inviting me to participate in today's hearing. The gesture means a great deal. The subject of foreign-earned income taxation is of great importance to Iowa; 20 percent of the State's work force is directly employed in export-related activities. I welcome this opportunity to hear these excellent witnesses and I am confident their testimony will lead to important reforms in present law.

We are fortunate to have persons here today representing a variety of backgrounds with considerable experience in this subject area. They will cover the broader issues thoroughly. I will restrict my remarks to two often-heard justifications against total exclusion of foreign-earned income.

The first is the "movie star" argument. Defenders of the legal *status quo* contend that the liberalization of sections 911 and 913 would bring a windfall for wealthy entertainers and independent businessmen and women. The source of this argument is legitimate. In the early 1950's, many Hollywood stars set up residences in Mexico and overseas for the unique purpose of sheltering their substantial incomes from the Internal Revenue Service. That legitimacy ended when the loophole was closed by the 1953 amendments. However, the contention that total exclusion would resurrect this shelter is a straw man's argument.

To begin with, few of the traditional tax shelters remain. The havens of the past have become the hotels of the present. For example, effective tax rates in France, England, Spain, Italy and Mexico are all higher than American ones. On purely economic grounds, it doesn't pay to live abroad. Most Americans overseas are taxed at confiscatory rates. They'd be better off staying home.

Two, no active entertainer or businessman can afford to fulfill the 17 of 18 months residency requirement if the intention is merely avoiding American taxes. You don't make a lot of money doing rock concerts in Saudi Arabia or marketing caterpillar tractors in Bermuda. In the few cases where residency is feasible for tax reasons, it becomes professionally impractical. That is not opinion; that is fact.

Three, it is counterproductive to punish American companies and their employees for the added domestic employment and production their international activity inevitably creates. Americans working overseas provide a critical service, and they do so at great sacrifice. Close friends, familiar language, lifelong customs, and tolerable climate are left behind when they relocate abroad. These people should not be punished, but that's exactly what current law does.

Finally, perhaps common sense speaks most strongly against the moviestar argument. Where do all the foreign moviestars, entertainers and sports celebrities choose to live? I'll tell you where. Right here in the United States.

The moviestar argument is a myth. By taxing our foreign nationals, we do not create equity: We aggravate inequity. The repeal of 911 limitations will do only one thing: Permit companies to market more aggressively abroad and produce employment at home. That's not a maybe—that's a promise.

The other issue I want to look at today is the question of citizenship responsibility. I have heard several of my colleagues in the Senate suggest that one of the duties of American citizenship is the payment of taxes regardless of place of domicile. It is argued that since all Americans benefit from citizenship all should share equally in the cost of those benefits. Three observations seriously question the validity of that analysis.

To begin with, there is the weight of precedent. Although it is often unfortunate to cite the behavior of others as a reason for the support of a given policy, the fact that every leading industrial nation in the world today exempts foreign-earned income from domestic taxation should give the Congress pause to reconsider current law. Sweden, for example, the leading free socialist nation in the western world, excludes their foreign nationals from any income tax whatsoever. We can't accuse

that government of lacking in concern for social equity! It would appear that the issue is not one of citizenship responsibility, but economics, pure and simple. Elected officials could do better to think more about lost jobs, lost production, and lost growth in their home States and less about abstract "social equity" concerns.

Next, we tend to forget that Americans overseas benefit very little from citizenship except in the unlikely instances of political unrest. In fact, if we judge from recent kidnappings and murders, citizenship appears to have less and less tangible value. Our Government is increasingly helpless in the fact of international terrorism. The taxation of earned income adds insult to injury.

Lastly—even if we grant the possiblity of the equity case which common sense rejects—practical logic speaks against the issue. Certainly, the American living in Seoul, South Korea benefits from the presence of our armed forces in that nation. But, if we tax him or her, fairness dictates that we levy a tax on all South Koreans and similarly on the Japanese, German, Brazilian, Israeli and other populations who share in the enormous windfall of a strong American military force all around the world. We don't tax those peoples. We shouldn't tax our own nationals either. Citizenship responsibility means contributing to America's welfare. When Government taxes our foreign nationals, it does the exact opposite. It destroys incentive. Citizenship responsibility argument looks good on paper. In practice, however, it is contradictory.

To conclude, the growing participation of newly-industrialized countries (NICs) and lesser-developed countries (LDCs) in international trade threatens American jobs. If the United States Government continues to shackle free enterprise and forbid by law equal competition with other nations in international markets, only one person loses: The American worker. Next to that fact, the emptiness of the "moviestar" and "citizenship" argument, is only more forcefully underlined.

Nobody denies that sections 911 and 913 as they now stand are having an adverse impact on the American economy. Differences arise only on how to best solve the problem. Total exclusion would involve a static revenue loss of $100 million dollars higher than alternative proposals.

Objections can be raised, then, only about equity and responsibility, but these issues are not strong arguments. Little speaks against total exclusion: millions of unemployed workers here at home speak for it. We can't afford to toss around recriminations about helping rich moviestars when those statements contradict evidence. We can't afford to talk about citizenship responsibility when that responsibility means lost jobs and lost production in the United States. We have to talk about the bottom line: American competitiveness in international markets. We have to talk about total exclusion. Halfway measures just won't do the trick.

In 1981, 25 percent of Iowa's 3,500 manufacturers intend to export a share of their products. This international activity will provide 30,000 jobs for Iowans. Projections for agricultural, industrial and service exports are about $6.3-billion dollars. This ranks Iowa second of all 50 states in per capita exports.

The aggregate numbers listed above are impressive, but it is their translation at the margin which brings home the point most strongly. Each $100-thousand dollar increase in exports means 2 new jobs for Iowans, $28-thousand dollars additional state and local taxes. The importance of international trade to Iowa's economy cannot be overstated.

If there is one issue no one disagrees on, it is what most threatens the United States' position worldwide. Whether you ask a construction company, a labor union, the Treasury Department or a Senate colleague on the other side of the aisle, the answer is the same. The biggest current problem is the taxation of foreign-earned income. That is why this hearing is so important. If we are to begin to regain our international prominence, we must act expeditiously on section 911.

Every sector of Iowa's economy is feeling the adverse impact of present law. The Iowa Development Commission's (IDC) international division can afford to staff only one overseas office. This restriction severely limits its flexibility and coverage. The Third World, where the greatest growth in international trade is expected over the next decade, is virtually ignored. IDC just doesn't have the resources to exploit these potential markets. In other words, present law effects far more than the current situation; it locks us into a disastrous future course as well. If we don't get our foot in the door now, these new markets will be lost to Americans forever.

Construction firms in Iowa have seen a 10 percent share of Mideast contracts fall to less than 1 percent since FEIA became law. In conversations with these companies, I have learned that when they do win a foreign contract, it is usually at the sacrifice of American employees. The result is that European equipment and replacement parts are purchased to carry out the projects; European engineers simply are not familiar with American machinery. That means lost production and lost

jobs in Iowa. It is these secondary effects which underline the real tragedy of present law.

In conclusion, I want to emphasize that this is not a partisan issue. For every time I've said "Iowa", another senator could fill in the name of his or her own state. The actors would be different, but the problem is universal. Foreign-earned income restrictions hurt all Americans. The matter is a pressing one. We cannot afford to hesitate.

Senator PACKWOOD. Next, we will take Ambassador Brock. Good morning, Bill. Mr. Brock is a former member of this Committee when he was in the Senate. I am delighted to have him in the position he is in because it brings him back to us frequently. I am glad to have you here again.

STATEMENT OF AMBASSADOR BROCK, U.S. TRADE REPRESENTATIVE

Mr. BROCK. I am glad to be back before this committee. I am glad to back on this subject, because this is one I feel strongly about and appreciate the comments that have been made today. I will try to summarize briefly, my testimony and I will be delighted to respond to any question you have, Mr. Chairman.

The administration supports the principal of removing tax disincentives for Americans working abroad in order to improve our export performance. We, therefore, support a liberalization and simplication of current laws which apply to Americans working overseas.

Our current taxation practice is the result of changes in our tax laws in 1976 and 1978 and the court decisions in 1976 that established that employee benefits, such as housing and educational assets, are fully subject to U.S. income taxes.

The intent of the foreign earned income act of 1978 was to create tax comparability between Americans employed abroad and at home and to benefit the U.S. economy by encouraging Americans to work in hardship areas.

Comparability was to be achieved by taxing foreign and domestic source earned income on an equal basis and the establishment of a series of deductions for excess cost of living, housing, school expenses, and home leave transportation. The Foreign Earned Income Act has failed to achieve its comparability objective.

I have mentioned in my testimony statement a study of the Comptroller General which states that American employment abroad is discouraged by current law and recommended changes.

The Foreign Earned Income Act has also not achieved its objective of benefiting the United States economy. In this regard, I mention the report of the President's Export Council, studies done by our Office, the Department of Commerce, extensive testimony before Finance and Ways and Means Committees in the last Congress, and other studies, which indicate, not only the complexity, but the counterproductive nature of the current law, in so much as the law is so complicated that Americans overseas are unable to prepare their own tax returns. The U.S. firms have to pay the entire cost of hiring accountants to compute the tax returns of their employees.

It is difficult to measure precisely, the effects of our current tax practice on the economic circumstance domestically. Many surveys

and studies have been made excepting the difficulty in measuring precisely the impact.

The results are extremely interesting. A Treasury study postulates that a 10-percent decline in Americans overseas can expect to produce a 5-percent drop in U.S. exports.

I might say, parenthetically, that I read the Treasury Department's testimony, before this committee, last year, in which the then leadership of the Treasury Department used that study to argue that no changes should be made in tax laws affecting U.S. workers overseas. How they could read their own data in that fashion, I don't know. It was a ridiculous excercise. It was a good piece of work and I would commend it to the committee's attention. I am sure you have seen it.

As the Senator from Iowa mentioned, while the total number of expatriates from other countries employed abroad grew by 359 percent between 1976 and 1980, the number of U.S. expatriates working abroad dropped by 39 percent in 1 year—from 1979 to 1980.

As you also mentioned, Senator, the survey found that the percentage of U.S. expatriates to total expatriates abroad, declined from 73 percent in 1976 to 37 percent in 1980.

If we were to apply the Treasury postulate to the survey results mentioned just now, we would conclude that the decline in American presence abroad between 1979 and 1980 will result in a potential 19 percent less exports than would otherwise be achieved. That is just unbelievable and unacceptable.

The Chase econometric study postulates that the drop in U.S. income, due to a 5-percent drop in exports, could raise domestic employment by 80,000 people. That is a 5-percent drop; if we take the 19-percent reduction in exports from the Chase study, we would be talking as much as 304,000 additional lost jobs.

I believe that the revenue impact on the U.S. Treasury, of changing our current practice, can only be measured by its dynamic impact and not by simply looking at static effect.

In the 1978 study, Treasury calculated an estimated gain of $500 million in income tax collections if pre-1976 law were repealed and Americans abroad were to be taxed on an equal basis with Americans at home.

This estimate was based on the assumption that neither U.S. citizens employed nor U.S. employers would act differently because of this change in our tax method. That is an utterly ridiculous premise. It assumes that there is no human nature factor; that we don't respond to the laws that affect our income.

Obviously, in reality, both U.S. employers and U.S. employees overseas have acted differently. Many U.S. employees have returned to the United States, resulting in lower personal income tax payments and receipts to the U.S. Government.

In order to induce American workers to remain overseas, some employers have paid extra amounts to neutralize the additional tax impact on their employees. These additional costs must either be passed on to potential customers in form of higher prices, which in turn make American goods less competitive or be absorbed by U.S. firms reducing their profitability and thereby, reducing their own corporate income tax payments.

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The Treasury revenue estimate did not, at that time, consider the loss in U.S. corporate tax payments resulting from lost U.S. exports.

Again, in my written statement, I have gone into some additional reference in the Chase study which found that even at the State and local tax level, there was a reduction in State and local tax receipts by another $800 million. We are not talking just about the Federal tax receipts. This tax policy has a real negative effect throughout the Nation's economy.

The United States is the only major industrial country that presently taxes foreign source income on the basis of citizenship. Other countries tax on the basis of residency.

Our major export competitors, Canada, West Germany, Japan, the United Kingdom, France and Italy do not tax the foreign earned income of their citizens. The effects of our current tax practices are to provide an incentive to U.S. companies to replace their American employees abroad with foreign nationals, and to make U.S. exports less competitive. Both results encourage the displacement of U.S. exports by the exports of other countries.

Our current tax practice is bad trade policy and bad tax policy. Available information strongly indicates: (1) That our present tax practice is a major export disincentive that causes the substantial loss of U.S. exports; (2) that our tax practice is counterproductive, discouraging American employment abroad; (3) that our tax practice is overly complex; and (4) that rather than increasing U.S. revenue collections, our present tax practice has substantially reduced U.S. revenue collection.

Our unrealistic current practice of taxing foreign earned income must be replaced with a system that does not provide U.S. companies with either an incentive or a disincentive to employ American workers abroad.

This can only be accomplished by neutralizing the impact of tax cost in employment decisions. Americans abroad must be taxed on a coequal basis with their foreign counterparts. This will not result in a bonanza to Americans employed abroad. Rather, it will permit American companies to set salary levels and make employment decisions based upon market forces as direct competitors, rather than on tax considerations as is presently the case.

Foreign earned income of U.S. citizens residing overseas, for 17 out of 18 months, must be exempted from U.S. taxation if we are to remain export competitive.

Improved export performance is essential to reviving our economy and strengthening our influence abroad. Government imposed distortions to international trade, such as our current method of taxing foreign earned income, must be removed in order to improve our export performance.

Thank you very much, Mr. Chairman.

Senator PACKWOOD. Mr. Ambassador, I noticed in page 1 of your statement, you said the administration supports the principal of removing tax disincentives and we therefore support a liberalization and simplification of the current law. Secretary Chapoton's statement says the same thing, although his statement says that therefore the administration wants to attach it to the second tax bill.

Of course, the first tax bill is the administration's Roth-Kemp proposals and depreciation. I can't tell yet, whether that format is going to be the format that a tax bill finally takes, but I would hope the administration would not fight us too hard if that format doesn't hold and other things are added to that first bill, I know many of us would like to add this to the first tax bill.

Mr. BROCK. I appreciate your comments.

Senator PACKWOOD. Senator Chafee.

Senator CHAFEE. Thank you, Senator Packwood. Ambassador Brock, first I would like to pay tribute to you. I think you have been really the leader in the administration circles to try and get a change in this taxation of Americans abroad. I think we all owe a deep debt of gratitude for the way you have hung in there and also Mr. Baldrige, Secretary Baldrige, likewise. I certainly didn't want this opportunity to go by without paying tribute to your persistent efforts in this area.

Mr. BROCK. Thank you very much. There are many of us who care about this issue, Senator. I appreciate your remarks.

Senator CHAFEE. Now, I noticed in the last page of your testimony, you talk 17 out of 18 months. Frankly, none of the legislation is that tough. All of that legislation, except I think Senator Jepsen's, does not have a residency requirement. The rest of us, Senator Bentsen, mine and I haven't reviewed all the others, but I suspect that they all deal with 11 out of 12 months. I think is 330 days.

How did you happen to take this 17 out of 18 months, which is the current law and would you resist going lower and indeed, do you have any thoughts on whether we should go to some form of prorating funds income if you are abroad, say 10 percent of the time or 50 percent? Then 50 percent of one's income, total earned income for the year, would be exempt. Do you have any proposals on the lines of thoughts?

Mr. BROCK. My testimony refers to the fairly stringent requirement of 17 out of 18, only in so much as a reference to the current law. It was not meant to be taken as a suggestion that the current residency requirements be necessarily retained.

Having said that, I would add that there is some concern that abuses not be created in amending these tax laws. In trying to eliminate what is obviously a counterproductive law now, we have to be careful that we don't create another law that is written with such latitude that abuses occur; and which leads the Congress to again react and perhaps swing the pendulum back too far the other way.

I want to be sure that this law is written to do precisely what it is intended to do, and that is to make us export competitive, allowing Americans abroad, corporate Americans and private Americans, to be taxed on a competitive basis. Such a tax policy must allow employment decisions overseas to be based on market judgment, not on tax judgment.

Senator CHAFEE. You wouldn't object to the 11 out of 12, though?

Mr. BROCK. No, Senator Chafee, there would be no objection to that change. I would only add that when new residency requirements or safeguards are incorporated in the legislation that efforts be made to avoid any potential for abuse.

Senator CHAFEE. Frankly, I don't think we'd go beyond that. I think we'd just say, beyond 330 days, and let it go at that. I do worry about complete exemption, no requirement, because you could have situation where you could put your men abroad for a month and pay his whole year's salary in that time.

Mr. BROCK. I agree, Senator. You don't want to get into that kind of abuse.

Senator CHAFEE. I think that would be the potential backlash that you mentioned.

Could you briefly touch on the so-called pull-through effect which you mention in page 3 of your testimony. The fact that more Americans abroad means more U.S. exports. I think that is the key. It is not only jobs we are talking about, we are talking the export.

Mr. BROCK. That's right. The studies that have been done which include Treasury, GAO, Chase, without exception, all have made this point.

The results vary somewhat in terms of numbers, but they don't vary at all in terms of the basic principal that Americans working overseas do offer an export promotion opportunity for us. The purpose of sending a U.S. engineer to build a hospital in the Middle East, is that he will call upon American suppliers to provide the basic ingredients to build that hospital.

If he is not allowed to work there by the disincentives presently imposed, then a foreign national is hired, let's say from India, or from Korea, or from France, who would tend to buy his own domestic products, because those are the products with which they are most familiar. The whole premise of placing Americans overseas is to sell American goods and services. That is the reason they are there and it is demonstrable that we have become less competitive as we have reduced the presence of Americans overseas.

Let me just point out, for you, that while we did have an increase in exports, our share of the world market has declined. That's ridiculous. We still are the most price and quality competitive country in the whole world and for us not to be increasing our share, says that something is creating a barrier other than the performance of American workers.

Senator CHAFEE. Thank you, Mr. Chairman.

Senator JEPSEN. Thank you, Mr. Chairman. For the record, I know Senator Chafee's omission was not intentional but on account of misinformation. I do in fact have a residency requirement in my bill and it is very specifically spelled out. It is simply 17 or 18 months or 510 days.

No apology necessary. I just want to get the record straight.

Mr. Ambassador, speaking for the administration, do you have any reservations about total exclusion if adequate residency tests can be formulated?

Mr. BROCK. Well, speaking for the administration, there are some reservations among some in the administration. We have carefully avoided the basic decision to change tax policy in the fundamental sense that is suggested by the question; that is, by changing to a tax based upon residency rather than citizenship.

I have tried to qualify my statement today to suggest the importance of substantial liberalization without making that fundamental break tax policy.

Senator JEPSEN. Mr. Ambassador, personally, do you have any reservations about total exclusion if adequacy residency tests be formulated?

Mr. BROCK. No, I do not; as long as there are adequate safeguards which you and other Senators have mentioned. If the qualification in your question can be sufficiently circumscribed, with adequate protection, safeguards, residency requirements and the like, I would see no objection or reservations.

Senator JEPSEN. Later this morning we are going to hear detailed testimony on the complexity of current law. Costs for overseas returns are projected at $750 for in-house preparation and well over $1,000 for public accounting. That's average.

Considering the strong stand taken by the President against unnecessary paperwork and that an average overseas return this year, will be about 25 pages, do you favor elimination or merely modification of section 913 provisions.

Mr. BROCK. The answer to your question depends upon how much section 911 is liberalized, or how much earned income is excluded from taxation and how. If the exclusion is substantial, it would make great sense to eliminate the complicated system of deductions under section 913. I think we are back to the same subject we were just discussing, are we not? Basically, I am urging as much liberalization as is possible in the effort to improve exports, but I do not believe it is within my purview, nor should it be, to address the more detailed questions of tax policy per se.

I think that is for Treasury to consider. My basic instinct would be to state that we feel very strongly about the need for substantial liberalization. I am confident that it is the administration's position while a decision has not been reached regarding elimination of all earned income, we do support liberal exemption from taxation for U.S. citizens working overseas, and simplification of such tax laws.

Senator JEPSEN. I can appreciate that and I thank you for your answer and please know that is not in any way an attempt to embarrass either the administration or you, Mr. Ambassador.

I am concerned and I am committed all the way forward if there is any exclusion because you get rid of a cancer by taking part of it and hoping the other will follow suit and go away.

One last question, do you share the view that emerging Third World markets will be permanently lost if Congress does not act soon in this area, or if not permanently lost, will be very adversely affected?

Mr. BROCK. There is not a moment's doubt in my mind that the present law is impeding our ability to be competitive in what has to be the most productive emerging new market that there is, namely, the Third World. We are doing a lot of business, but should do a great deal more if we allowed our people to be competitive.

Senator JEPSEN. Thank you, Mr. Ambassador.

Senator PACKWOOD. Senator Chafee, any other questions?

Senator CHAFEE. No, thank you, Mr. Chairman. Thank you.

Senator PACKWOOD. Thank you for your comments. Bill, thank you for coming up. I appreciate it.

Mr. BROCK. Thank you, Mr. Chairman. It is nice to be back.

[The prepared statement of Ambassador Brock follows:]

TESTIMONY OF WILLIAM E. BROCK, U.S. TRADE REPRESENTATIVE

I am pleased to appear before this Committee today to testify on the subject of liberalization of our current method of taxing foreign earned income (Sections 911 and 913 of the Internal Revenue Code). A number of bills have been introduced in both the Senate and the House of Representatives on this subject. Those introduced in the Senate and presently under consideration by this Committee include S. 408, S. 394, S. 436, S. 867, S. 598, and S. 969.

The Administration supports the principle of removing tax disincentives for Americans working abroad in order to improve our export performance. We therefore support a liberalization and simplification of current law as applied to Americans working overseas.

Our current taxation practice is the result of changes in our tax laws in 1976 and 1978, and of court decisions in 1976 that established that employee benefits, such as housing and educational allowances, are fully subject to U.S. income taxes. The intent of the Foreign Earned Income Act of 1978 (FEIA) was to create tax comparability between Americans employed abroad and at home, and to benefit the U.S. economy by encouraging Americans to work in hardship areas. Comparability was to be achieved through taxing foreign and domestic source earned income on equal basis, and the establishment of a series of deductions for excess cost of living, housing, school expenses, and home leave transportation.

The Foreign Earned Income Act has failed to achieve its comparability objective. The Comptroller General reported to the Congress on February 27, 1981 that American employment abroad is discouraged by present U.S. income tax law and recommended that Congress consider changing current law to place 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. The Comptroller General reported that FEIA does not provide comparability between Americans working overseas and at home, and concluded that failure to meet this objective often results in a tax liability for Americans living abroad far in excess of what would be incurred in the United States under similar living conditions. Foreign living cost deductions were also found to be excessively complex; most Americans overseas are unable to prepare their own tax returns and U.S. firms incur high costs to have returns prepared by accountants.

The Foreign Earned Income Act has also not achieved its objective of benefiting the U.S. economy. Considerable evidence has been compiled since 1978, showing that if an American company wishes to maintain its American employees abroad, it must absorb substantial costs resulting from reimbursement of their higher taxes, making the company less price competitive and in many cases resulting in lost U.S. export sales. If, on the other hand, a company chooses to replace its American employees abroad with third country nationals who do not pay home country taxes in order to remain competitive, the United States loses exports attributable to the presence of Americans abroad, the so-called pull through effect. As a consequence, U.S. firms are decreasing the employment of Americans in overseas positions because of their relative costliness. These findings are supported by information contained in a December 1980 Report by President Carter's Export Council, a review prepared by the U.S. Trade Representative's Office and the Department of Commerce on export incentives and disincentives that was submitted to Congress in September 1980, extensive testimony before both the Senate Finance and House Ways and Means Committees during the last Congress, and other sources.

While no hard data is available to precisely measure the effects of our current tax practice on the U.S. economy, several surveys and studies have been made. These studies employ statistical sampling techniques and econometric analysis, which, as we all know, are never fully accurate.

Nevertheless, the results of these surverys are extremely interesting. A 1978 study done by the Treasury Department postulates that a 10 percent decline in Americans oveseas can be expected to produce a 5 percent drop in U.S. exports. According to a survey of 306 U.S. companies done by Organization Resources Counselors (ORC) in July 1980, while the total number of expatriates from other countries employed abroad grew by phenomenal 359 percent between 1976 and 1980, the number of U.S. expatriates dropped by about 39 percent between 1979 and 1980. This survey also found that the percentage of U.S. expatriates to total expatriates declined from 73 percent in 1976 to 37 percent in 1980. If we were to apply the

Treasury postulation to the ORC survey results, we would conclude that the decline in American presence abroad between 1979 and 1980 will result in a whopping 19 percent loss in U.S. exports.

Yet another study done by Chase Econometric Associates in June 1980 postulates that the drop in U.S. income due to a 5 percent drop in exports will raise domestic unemployment by 80,000. If we were to apply the Chase postulation to the 19 percent reduction in exports, it would result in a staggering addition to the domestic unemployment level of 304,000 people.

We believe that the revenue impact on the U.S. Treasury of changing our current tax practice can only be measured by its dynamic economic effects and not by simply looking at static effects. In a 1978 study, Treasury calculated an estimated gain of about $500 million in income tax collections if pre-1976 law were repealed and Americans abroad were to be taxed on an equal basis with Americans at home. This estimate was based on the assumption that neither U.S. citizens employed abroad nor U.S. employers would act differently because of this change in our tax method. However, in reality, both have acted differently. Many U.S. employees have returned to the United States, resulting in lower personal income tax payments. In order to induce American workers to remain overseas, some employers have paid extra amounts to neutralize the additonal tax impact on their employees. These additional costs must either be passed on to the potential customer in the form of higher prices, making American goods less competitive, or be absorbed by U.S. firms, reducing their profitability, thereby reducing their corporate income tax payments. The Treasury estimate also did not consider the loss in U.S. corporate tax payments resulting from lost U.S. exports.

Chase Econometrics has done a very interesting study of these aspects of the revenue impact of our current tax practice; the results are impressive. Chase found that a 5 percent reduction in real exports results in a $6 billion loss in personal and corporate income tax receipts, many times the value of estimated tax collections under existing Sections 911 and 913. In addition, Chase found that reduced domestic income from lost exports reduces state and local corporate and personal income tax collections by another $800 million per year.

The United States is the only major industrial country that presently taxes foreign source income on the basis of citizenship. Other countries tax on the basis of residency. Our major export competitors, including Canada, West Germany, Japan, the United Kingdom, France, and Italy do not tax the foreign earned income of their citizens. The effects of our current tax practice are to provide an incentive to U.S. companies to replace their American employees abroad with foreign nationals, and to make U.S. exports less price competitive. Both results encourage the displacement of U.S. exports by the exports of other countries.

Our current tax practice is bad trade policy and bad tax policy. Available information strongly indicates: (a) that our tax practice is a major export disincentive that causes a substantial loss in U.S. exports, (b) that our tax practice is counterproductive, discouraging American employment abroad, (c) that out tax practice is overly complex, (d) that rather than increasing U.S. revenue collections, our tax practice has substantially reduced U.S. revenue collections.

Our unrealistic current practice of taxing foreign earned income must be replaced with a system that does not provide U.S. companies with either an incentive or a disincentive to employ American workers abroad. This can only be accomplished by neutralizing the impact of tax costs in employment decisions. Americans abroad must be taxed on a coequal basis with their foreign counterparts. This will not result in a bonanza to Americans employed abroad. Rather, it will permit American companies to set salary levels and make employment decisions based on market forces, as do our competitors, rather than on tax considerations, as is presently the case.

Foreign earned income of U.S. citizens residing overseas for 17 out of 18 months must be exempted from U.S. taxation if we are to remain export competitive. Improved export performance is essential to reviving our economy and strengthening American influence abroad. Government imposed distortions to international trade, such as our current method of taxing foreign earned income, must be removed in order to improve our export performance.

Senator PACKWOOD. Next, we will take Secretary Chapoton, the Assistant Secretary for Treasury for Tax Policy. Good morning, Buck.

Mr. CHAPOTON. Good morning, Mr. Chairman.

With the Chair's permission, I will just go through my entire statement. It is rather brief. I will then be happy to answer any questions.

[The prepared statement of Hon. John E. Chapoton follows:]

TESTIMONY OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. Chairman and Members of the Committee: I am pleased to appear today to discuss with you the taxation of Americans overseas.

The Administration supports liberalization and simplification of present law. We intend to address this urgent problem in the second tax bill which will be proposed as soon as the legislative action on the President's first set of proposals is completed. Our first priority must be the economic recovery program. We are not, therefore, prepared to present a specific proposal regarding the taxation of Americans abroad at this time. In addition, we would like to give more careful attention to the specifics of our proposal. This issue has been under review continually for several years. We want to resolve it in a way that will be satisfactory on a lasting basis.

This issue is viewed by many as a trade issue, but it is also an important tax policy matter. Some of the questions which must be addressed go to the very heart of the approach in present law to the taxation of income obtained abroad. These tax matters transcend the concerns of trade policy; they should be resolved only after careful study of the issues and of the basic tax policy implications of the alternatives. While we strongly support removing any tax penalty to working abroad which may result from our taxing the additional compensation needed to cover high foreign living costs, we do not support a general tax exemption for overseas employment at this time.

The changes enacted in the Foreign Earned Income Act of 1978 were intended to provide tax relief for the high costs and hardship conditions often incurred by Americans working in foreign countries. Those rules have proved to be unacceptably complex, and often inadequate.

Most Americans overseas are subject to a foreign income tax liability high enough that, after claiming the foreign tax credit, they owe little or no U.S. tax. Yet, under present law, they must keep extensive records and make complex calculations in determining their tentative (pre-credit) U.S. liability. This is the case, for example in Canada, Japan, and much of Western Europe. For Americans working in such locations, the special deductions mean more work and expense and no benefit. We need a simpler system.

In the Middle East, however, there is frequently no foreign income tax liability, and living costs, especially for housing, are exceptionally high. There the problem with present law is that the deductions may not adequately cover the expenses they were intended to offset. Where that happens, the added U.S. tax cost is a disincentive to employing Americans in those locations. And since the Middle East is a source of large contracts to service industries, this can cost us valuable exports. In addition to simplifying the rules, we need to provide more generous relief.

A number of witnesses who will be appearing before the Subcommittee are primarily concerned with trade, and for them the preferred solution is complete exemption of foreign earned income. I understand their perspective. The United States is virtually unique in taxing nonresident citizens on their foreign income. Many countries tax residents or domiciliaries on their worldwide income, but they do not tax income derived outside the country—whether from employment, investments or business—by nonresidents. Perhaps we should review our system. But such a fundamental change should not be embarked upon without considering all its ramifications, such as its implications for our longstanding foreign tax credit system.

Exempting all or most income earned by Americans working abroad would amount to a partial elimination of citizenship basis taxation. It would provide a large tax incentive to work in low-tax foreign countries. In some cases, the increased attractiveness of such foreign employment would increase exports. But in some cases it would simply allow persons who can arrange to receive very high incomes while working abroad in tax havens to avoid tax. In still other cases complete exemption would amount to a government bonus to temporary foreign employment, unrelated to any specific national objective. The incentive would apply equally in all situations.

The Treasury Department is preparing a report on the operation of the Foreign Earned Income Act of 1978, and one of the things we are looking at is the occupation of Americans employed abroad. We do not have complete data yet, but we do

have some preliminary data on the occupation and location of taxpayers filing during 1980.

The largest single occupational group was construction, engineering, petroleum exploration and extraction and other mining, which accounted for nearly 22 percent of the total returns. The second largest category was teaching and religion, accounting for 18 percent of the total. This category is understated, since the date for employees of charitable organizations in developing countries to file their 1979 returns was not until April 1981.

Business managers accounted for about 16 percent of the returns; accounting, law and finance about 7 percent; research and journalism, 7 percent; sales and public relations, 5 percent; clerical office workers, 5 percent; health services, 2 percent; art and entertainment, 2 percent; and all others, including unidentified, 15 percent. Leaving aside the "other and unidentified" category, if we take as a rough approximation that everyone in the construction, management, and sales groups influences exports, that accounts for 43 percent of the returns. And assuming that teachers, preachers, office workers, lawyers, entertainers, and doctors do not influence exports, they account for 41 percent of the returns. Realistically, there is some overlap. Not all oil rig operators or public relations specialists influence exports and some lawyers and accountants do. But these figures give us a first glimpse at least at the occupational distribution of Americans working overseas. At a later date we will have information on the numbers employed by U.S. companies, foreign affiliates of U.S. companies, foreign companies, those who are self employed and the like.

The largest area of foreign residence is the Middle East, which accounts for nearly 23 percent of the returns tabulated, with 60 percent of those—i.e., 14 percent of the total—in Saudi Arabia. Thus, Saudi Arabia alone accounted for a higher proportion of 1979 returns than the entire Middle East and Northern African oil producing countries together constituted of the 1975 returns.

We cannot now cross-tabulate the figures by occupation with those by area. But it seems very likely that there is a large overlap between the 20-25 percent of the returns reporting an occupation in the construction or mining category and the 20-25 percent of returns originating in the Middle East. These groups, we believe, are the most sensitive to the potential tax penalty on overseas living allowances under present law.

As a general matter we can and should remove the disincentive to Americans to work overseas, whatever their occupation. Toward that end, we would strongly support eliminating any U.S. tax on the additional compensation which represents amounts needed to cover added living costs abroad. If an employee who would earn $40,000 in the United States must be paid $80,000 to work in a foreign country because of the high cost of living, that added $40,000 should be free of U.S. tax.

There are various ways to reach this objective. One possible approach would be to exempt a single flat percentage of the foreign earned income of all Americans working abroad who qualify for foreign earned income tax relief. The percentage would be set at a level to cover foreign living costs in excess of U.S. levels in the highest cost foreign countries. The importance of simplicity dictates that those Americans in high cost areas be protected, even though this will result in some Americans in low cost areas receiving a higher benefit than necessary to exempt their added costs. Or, since foreign housing costs vary so widely and can be so high, it might be preferable to set the flat percentage exemption to cover added foreign living costs *other* than housing, and to provide, in addition, a separate deduction for excess housing costs.

One of the attractive features of a percentage exemption is that it would automatically increase with inflation. Although it may be desirable to establish a ceiling on the exempt amount, that would reduce the indexing feature. Similar questions arise in the calculation of the housing base. It could be a flat amount, which would soon become obsolete, or a percentage based upon foreign compensation. What is required is a mechanism which is at once responsive to the problem of high housing costs and relatively simple.

Other approaches might also be acceptable. Surely we can devise an approach which will remove any disincentive to foreign employment compared to employment in the United States. While U.S. companies would still have to compensate their employees for high overseas living costs, there would be no U.S. tax on those allowances and, consequently, no grossing up of a tax reimbursement which is itself taxable. Such an approach should be much more satisfactory to U.S. employers than present law. We look forward to working with the Committee on this issue so that we may move quickly once the tax bill is enacted.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY

Mr. CHAPOTON. I am pleased to appear before the subcommittee, today, to discuss the taxation of Americans overseas. The administration supports liberalization and simplification of present law. We intend to address this urgent problem in the second tax bill, which will be proposed as soon as the legislative action on the President's first set of proposals is completed.

Our first priority must, of course, be the President's economic recovery program. We are not, therefore, prepared to present a specific proposal regarding the taxation of Americans abroad, at this time.

In addition, we would like to give more careful attention to the specifics of our proposal.

This issue has been under review continually for several years. We want to resolve it in a way that will be satisfactory on a lasting basis.

This issue is viewed by many as a trade issue, but it is also an important tax policy matter. Some of the questions which must be addressed go to the very heart of the approach in present law to the taxation of income obtained abroad. These tax matters transcend the concerns of trade policy. They should be resolved only after careful study of the issues and of the basic tax policy implications of the alternatives.

While we strongly support removing any tax penalty to working abroad which may result from our taxing the additional compensation needed to cover high foreign living costs, we do not support a general tax exemption for overseas employment at this time.

The changes enacted in the Foreign Earned Income Act of 1978 were intended to provide tax relief for the high costs and hardship conditions often incurred by Americans working in foreign countries. Those rules have proved to be unacceptably complex and often inadequate.

Most Americans overseas are subject to a foreign income tax liability high enough that, after claiming the foreign tax credit, they owe little or no U.S. tax. Yet, under present law, they must keep extensive records and make complex calculations in determining their tentative precredit U.S. tax liability. This is the case, for example, in Canada, Japan, and much of western Europe. For Americans working in such locations, the special deductions mean work and expense and no benefit. We need a simpler system.

In the Middle East, however, there is frequently no foreign income tax liability. Living costs, especially for housing, are exceptionally high. There the problems with present law is that the deductions may not adequately cover the expenses they were intended to offset. Where that happens the added U.S. tax cost is a disincentive to employing Americans in those locations. Since the Middle East is the source of large contracts to service industries, this can cost us valuable exports. In addition to simplifying the rules, we need to provide more generous relief.

A number of witnesses who will be appearing before the subcommittee today are primarily concerned with trade and for them the preferred solution is complete exemption of foreign earned income.

I understand their perspective. The United States is virtually unique in taxing nonresident citizens on their foreign income. Many countries tax residents or domiciliaries on their worldwide income, but they do not tax income derived outside the country, whether from employment, investments, or business, by nonresidents. That is, for nonresidents they have a territorial system.

Perhaps we should review our system. But such a fundamental change should not be embarked upon without considering all of its ramifications, such as its implications for our long-standing foreign tax credit system.

Exempting all or most income earned by Americans working abroad would amount to a partial elimination of citizenship basis of taxation. It would provide a large tax incentive to work in low tax foreign countries.

In some cases, the increased attractiveness of such foreign employment would increase exports. But, in some cases, it would simply allow persons who can arrange to receive very high incomes while working abroad in tax havens to avoid tax. In still other cases, complete exemption would amount to a Government bonus to temporary foreign employment unrelated to any specific national objective. The incentive would apply equally in all situations.

The Treasury Department is preparing a report on the operation of the Foreign Earned Income Act of 1978, and one of the things we are looking at is the occupation of Americans employed abroad. We do not have complete data yet, but we do have some preliminary data on the occupation and location of taxpayers filing during 1980.

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Business managers accounted for about 16 percent of the returns; accounting, law, and finance about 7 percent; research and journalism, 7 percent; sales and public relation, 5 percent; clerical workers, 5 percent; health services, 2 percent; art and entertainment, only 2 percent; and others and unidentified, 15 percent.

Leaving aside the "others and unidentified" category, if we take as a rough approximation that everyone in the construction, management, and sales groups influence exports, that accounts for 43 percent of the returns. And assuming that teachers, preachers, office workers, lawyers, entertainers, and doctors do not influence exports, they account for 41 percent of the return.

Realistically, there is a lot of overlap. Not all oil rig operators or public relations specialists influence exports, and some lawyers and accountants, of course, do.

These figures give us a glimpse, a first glimpse at least, at the occupational distribution of Americans working overseas. At a later date we will have information on the numbers employed by U.S. companies, foreign affiliates of U.S. companies, foreign companies, and those who are self-employed and the like.

The largest area of foreign residence is the Middle East, which accounts for nearly 23 percent of the returns tabulated, with 60

percent of those, that is 14 percent of the total in Saudi Arabia. Saudi Arabia, alone, accounted for a higher proportion of 1979 returns than all the Middle Eastern and northern African oil producing countries, together, constituted of the 1975 returns.

We cannot now cross-tabulate the figures for occupation with those by area. But it seems very likely that there is a large overlap between the 20 to 25 percent of the returns reporting an occupation in the construction or mining category and the 20 to 25 percent of returns originating in the Middle East. These groups, we believe, are the most sensitive to the potential tax penalty on overseas living allowances under present law.

As a general matter, we can and should remove the disincentives to Americans who work overseas, whatever their occupation. Toward that end, we would strongly support eliminating any U.S. tax on the additional compensation which represents amounts needed to cover living costs abroad.

If an employee who would earn $40,000 in the United States must be paid $80,000 to work in a foreign country because of the high cost of living, that added $40,000 should be free of U.S. tax.

There are various ways to reach this objective. One possible approach would be to exempt a single, flat percentage of the foreign earned income of all Americans working abroad who qualify for foreign earned income tax relief. The percentage would have to be set at a level high enough to cover foreign living costs in excess of U.S. levels in the highest cost foreign country. The importance of simplicity dictates that those Americans in high cost areas be protected, even though this will result in some Americans in low cost areas receiving a higher benefit than necessary to exempt their added costs.

Since foreign housing costs vary so widely and can be so high, it might be preferable to set the flat percentage exemption to cover added foreign living costs *other* than housing, and to provide, in addition, a separate deduction for excess housing.

One of the attractive features of a percentage exemption is that it would automatically increase with inflation. Although it may be desirable to establish a ceiling on the exempt amount, that would reduce the indexing feature.

Similar questions might arise in the calculation of the housing base. It could be a flat amount, which would soon become obsolete, or a percentage based upon foreign compensation. What is required is a mechanism which, at once, is responsive to the problem of high housing costs and relatively simple. Other approaches might also be acceptable.

Surely we can devise an approach which will remove any disincentive to foreign employment compared to employment in the United States. While U.S. companies would still have to compensate their employees for high overseas living costs, there would be no U.S. tax on those allowances and consequently, no grossing up of a tax reimbursement which is itself taxable.

Such an approach would be much more satisfactory to U.S. employers than present law.

Mr. Chairman, we look forward to working with the subcommittee on this issue so that we may move quickly once the tax bill is enacted.

Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you, Mr. Secretary. Senator Chafee.

Senator CHAFEE. Well, Mr. Secretary, administrations come and administrations go, but the Department of the Treasury remains the same. Nothing much has changed.

What you said here, is exactly what your precedessor said and I suppose his predecessor before. We have great difficulty with the Treasury Department, which always looks at immediate revenue returns and it seems to me when you say this issue is viewed by many as a trade issue, but is also an important tax policy, but I think the trade factor just cannot be overlooked. That's where you get revenue from also.

To say that we are disappointed, at least I am disappointed in your testimony, would be an understatement. It is really not much help. You pointed out that this is a matter that we have to study. I don't know how many studies we need on this.

You, perhaps, have seen the GAO study which is very strong on this and various outside studies, and I would hope that the Treasury Department would be supportive of what we are trying to do here.

To say that we have to wait until the first tax bill passes, then you will come forward with something, isn't very helpful.

Now, let me ask you a question. You talked about those where there's tax credit for Americans earning abroad. What about, are there some countries which do not have a tax credit, a tax treaty with the United States and thus the taxes that they apply on Americans abroad are not a credit against U.S. income taxes.

Mr. CHAPOTON. No, sir. Our credit system allows a credit for taxes.

Senator CHAFEE. In other words, if lets say, Nigeria doesn't have a tax treaty with the United States; if they tax U.S. citizens working abroad, that would be a credit against U.S. income tax?

Mr. CHAPOTON. Yes, sir.

Senator CHAFEE. Even if there isn't a tax treaty?

Mr. CHAPOTON. Yes, that's right, without regard to a tax treaty. The only question that sometimes arises is whether the tax is, indeed, creditable. That is, is the tax on income? That type of question.

Senator CHAFEE. You'll have to go through that one again.

Mr. CHAPOTON. Well, this is mainly a problem for businesses, but there are questions involved as to whether a tax qualifies as a creditable tax under the Internal Revenue Code, whether, if there is no treaty, it would not be a creditable tax.

Senator CHAFEE. Put it this way. Do we have citizens that are working abroad that have taxes levied on them by a foreign government based on their income and those taxes subsequently cannot be used as a credit against the U.S. income tax?

Maybe you could answer this for the record. This specific question came up last evening when I was home and dealing with Nigeria. I just couldn't feel it was so, but perhaps, you could let me know.

Mr. CHAPOTON. There are certainly taxes on citizens abroad that are not creditable. For example, the value added tax is a good example.

Senator CHAFEE. I see.

Mr. CHAPOTON. We do have in the law the requirement that the foreign tax must be a tax on income for it to be creditable.

Senator CHAFEE. Now, Mr. Secretary, one of the points we made here, we're making, as you noticed in our legislation, first of all, most of the bills before us are not complete exemptions of all income. They are $50,000, my bill is $50,000—50 percent of the next $50,000. Senator Bentsen's, I believe, is $75,000, maybe something above that.

There is a residency requirement on all of them, so I just think the fears that you raise are not valid fears.

Mr. CHAPOTON. Senator Chafee, if I could respond to that, we are agreeing that there is a significant problem here and that the tax law has to be changed to address that problem. The question that we are raising is how you do it. We are not making a specific proposal at this time, but there is no question that you have to exclude a significant amount of income of Americans working abroad.

Senator CHAFEE. But, again, you come forward on the last forward on the last page; some of your suggestions go back to the complexities that dog the problem right now. Certain credit for the higher costs of living abroad, this percentage would be set a level to cover foreign living costs in excess of U.S. levels in the highest cost foreign countries.

Those are the very problems that are harshly responsible for us pressing forward with this legislation, today.

Mr. CHAPOTON. Senator, let me explain. Maybe that is not clear in my testimony. If you went that route, and we are not now proposing that route, you would look at the data and pick a percentage—40, 50 percent—and exclude that percentage of the income of all Americans working abroad. You would not try to target it to specific countries. You would not try to look at specific allowances paid to specific employees. The rule would simply be that if you work abroad, *x* percent of your earned income is excluded.

Because the housing problem seems so severe, in the Middle East particularly, maybe any allowance, maybe a $50,000 cap or a percentage allowance is not enough. Maybe you need to make sure that you have covered housing independently of that because added housing costs might eat up most of whatever the exemption.

Senator CHAFEE. My time is up, Mr. Chairman. I'll get back to you.

Senator PACKWOOD. Senator Jepsen.

Senator JEPSEN. Mr. Secretary, in 1978 the Treasury projected a revenue gain of $500 million with the passage of the Foreign Earned Income Act of 1978.

Ambassador Brock has indicated that the figure was optimistic. I was wondering, could you be more precise? When the numbers are eventually tabulated, do you expect to see a negative tax effect or a net revenue loss?

Mr. CHAPOTON. I'm not trying to be evasive. It is very difficult to go back after the fact and see what specific revenues come from specific areas. We can look at the Americans abroad, and we are looking at the returns of Americans abroad, and see how much

income tax they would pay given any specific change in the law, the static revenue effect of doing that. We cannot say what the specific changes in 1978 resulted in or did not result in.

In other words, we can look at the data and say, if you take that income and change the law applicable to that income what the revenue impact is.

Senator JEPSEN. How does the Treasury view the Chase Econometric study?

Mr. CHAPOTON. I think we have some problems with it.

Senator JEPSEN. Why?

Mr. CHAPOTON. Well, it is based on some assumptions that we are not sure are correct. I prefer not to be more specific.

Senator JEPSEN. Once the President's tax bill is passed, I am trying to examine where the bill comes from and we all want the same end result.

Mr. CHAPOTON. Yes, sir.

Senator JEPSEN. Once the President's tax bill is passed, would you feel any differently about total exclusion or looking at total exclusion to solve the problem?

Mr. CHAPOTON. I think it is quite appropriate that we study the possibility of going to a territorial system of taxation which is what most of our trading partners do on earned income and unearned income, alike. That would require a fundamental review of our system. I think that is appropriate.

Senator JEPSEN. It think I understand the uniformative feeling about the tax bill he has packaged and so we get into these very, very important things that are not advocated one way or another. There are other things like marriage tax, Federal estate tax which has not been altered in about 50 years, which is driving the small business and family farm right out of existence and the backbone of our country. Those are all equally important and I know the administration is concerned about it, but I think generally from the reading I get is that's the second time around.

Mr. CHAPOTON. Yes, sir.

Senator JEPSEN. Is that what you feel the administration's view would be on this also?

Mr. CHAPOTON. Yes, sir, it is. We view this as very important, and we view those two other matters, I might add, as quite important also. We are insisting that, or are hopeful that, they will be in the second bill, after the economic program has passed.

Senator JEPSEN. Thank you, Mr. Chairman.

Senator PACKWOOD. Senator Dole.

Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Mr. Secretary, on page 2 of your statement, in the middle, you say the added U.S. cost is a disincentive to employing Americans in these locations. Since the Middle East is a source of large contracts to service industries, this can cost us valuable exports. Are you in doubt that it costs us valuable exports?

Mr. CHAPOTON. No, sir, I am not in doubt. In those countries the additional tax cost definitely is counterproductive and unquestionably costs some exports. It is very difficult to measure how much.

Senator CHAFEE. So you can use a strong word—this does cost us valuable exports.

Mr. CHAPOTON. You're right, I could use that strong word.

Senator CHAFEE. The point I am trying to make, Mr. Secretary, is in coming at this problem, although you are a member of the Department of Treasury, don't you look at it, isn't there an inclination or something inside you that says let's look at it in a broader way than strictly the static revenue situation?

Mr. CHAPOTON. Absolutely. That's why we are proposing or supporting a very large liberalization. To repeat my testimony, we would support a change which totally removes any tax penalty on Americans working abroad, any additional tax above what they would have paid in the United States.

Senator CHAFEE. Oh, tax penalty. In other words, that results from being abroad.

Mr. CHAPOTON. Correct.

Senator CHAFEE. But; we have had testimony here, that Americans aren't going to go abroad. Let's say somebody is making $50,000 in Palo Alto, and they have a chance to go to Nigeria or Saudi Arabia for $50,000. But, under your proposal, let's say the costs of living would be another $50,000. You would exempt the original $50,000 and tax the first $50,000 since that is what they are being paid, an engineer. That's what they received at home; that's what they get in Saudi Arabia. Is that your approach?

Mr. CHAPOTON. That is what that proposal would say, yes, if that proposal were made.

Senator CHAFEE. But, the problem is, he is not going to go to Saudi Arabia for $50,000. He'd be separated from his family. He'd be living under a difficult situation. He's not going to do it and so, therefore, to get him to go, the company has to pay him $75,000. He is willing to do it for the extra. Again, that would be taxable under your proposal.

Mr. CHAPOTON. No, sir. No, I'm sorry that I misquoted. What we would try to study, and we have looked at the Ernst & Whinney study, is all additional compensation, costs of living and incentive compensation, that U.S. companies are required to pay employees working abroad. All that additional compensation would be exempt. In the ideal situation, in your example, it would leave him taxable on $50,000, the same amount on which he is taxable if he stays in the United States.

Senator CHAFEE. I thought, oh, you mentioned unearned income. It seems to me, the mere mention of unearned income throws a whole new problem into this that none of us have ever suggested in the legislation of the Senate, here.

Mr. CHAPOTON. I agree with that, but that is what our trading partners do. They exempt the foreign income of nonresidents. They do not tax foreign income of nonresidents.

Senator CHAFEE. Well, I held hearings last year in June, I guess it was, in which we had many of the same witnesses that I notice here on this list. But, I don't think a single one of those witnesses, proposed anything to do with unearned income. Therefore, in the approach, at least, that those members on this committee that are deeply involved in this have taken, they have set aside unearned income.

Let that be taxed at U.S. rates and I think by even considering that, you are adding an additional problem, a new dimension to

this that we are not prepared to deal with. That truly would cost you, us, Treasury, a lot of revenue. I don't even see why you get into it.

Mr. CHAPOTON. Well, there is investment, there is unearned income in other words, on U.S. stocks and securities which is what most people think about. There is also unearned income on investment made abroad by U.S. citizens. Sometimes those investments affect exports as well.

Senator CHAFEE. Well, all I am saying is when you add that into the equation, you are adding all kinds of revenue losses that we never dealt with. You are adding inequities, possible inequities, that we didn't want to deal with and as I say, to the best of knowledge, every piece of legislation dealing with 911 and 913 is strictly earned income.

Mr. CHAPOTON. I think that is correct.

Senator CHAFEE. What are your thoughts on residency?

Mr. CHAPOTON. I think I share the thoughts that have been expressed here that there should be a meaningful residency requirement. Perhaps 17 or 18 months might be too long.

Senator CHAFEE. How about 11 out of 12?

Mr. CHAPOTON. That might be acceptable; that sounds rather reasonable. I don't want to endorse that, because we don't have a position on it, but that might well be reasonable.

Senator CHAFEE. No one will accuse of having had a position here this morning.

Well, Mr. Secretary, we appreciate your coming up and look forward to when the Department arrives at its conclusions. I tell you that I think the train is going to have left the station by the time the Treasury Department makes up its mind.

Thank you.

Mr. CHAPOTON. Sure.

Senator DOLE. I don't want to repeat if this has already been asked, but are we discussing the first tax bill or the second?

Senator CHAFEE. We did discuss that earlier and we are talking about the second package.

Senator DOLE. This year?

Senator CHAFEE. Yes, sir.

Senator DOLE. Is that in process?

Senator CHAFEE. The second package is in process.

Senator DOLE. Is that the everything package?

Senator CHAFEE. That is the "everything on the second bill" package.

Senator DOLE. Well, there is some skepticism here, I might add. I am mystified whether, indeed, like waiting for a taxi, most of us are going to take the first one.

Senator PACKWOOD. I didn't hear any comment on that one. I thought the analogy was the train. I have no other questions. I might say, Mr. Secretary, you are patient and long-suffering.

I know you have to come up here when we have good ideas and on occasion when we have bad ones and represent the administration's position.

I agree with what Senator Chafee said about the Treasury. Indeed, there does seem to be endemic consistency to it, for better

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or for worse. I do not envy your position because I know what you have to do in terms of representing the administration.

Thank you very much for giving us your time.

Mr. CHAPOTON. Thank you, Mr. Chairman.

Senator PACKWOOD. Next, we will take Mr. Frank Conahan, the Director of the International Division of the General Accounting Office. I might say I have an 11 o'clock appointment and have to leave. Senator Chafee will preside for the remainder of the hearings. I simply want to say what I said earlier. I think we made a mistake in the passage of these tax limitations earlier and that we should undo it at the earliest possible moment. John.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Chairman, I have a statement that I would like to submit it at this time and I will not read it, but I will submit it for the record and ask that it go in the first part of this session prior to Mr. Baldrige. Mr. Conahan.

[The prepared statement of Hon. Frank Conahan follows:]

UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

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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.

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.

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: Average Allowance	Married Individual: Housing Deduction	Married Individual: Excess Allowance Taxable	Unmarried Individual: Average Allowance	Unmarried Individual: Housing Deduction	Unmarried Individual: Excess Allowance Taxable
Brazil	$14,457	$ 4,428	$10,029	$10,761	$ 3,3[illegible]	$ 7,400
Hong Kong	30,280	19,896	10,348	18,037	9,49[illegible]	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

	Married individual			Unmarried individual		
	Average Cost of Living		Excess	Average Cost of Living		Excess
Country	Allowance	Deduction	Allowance Taxable	Allowance	Deduction	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

Average Tax Reimbursement Allowance - 1979

Country	Married individual		Unmarried individual	
	Amount	Percent of base salary	Amount	Percent of base salary
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

1979

Country	Married individual			Unmarried individual		
	Average Total		Excess	Average Total		Excess
	Allowances (note a)	Deductions (note b)	Allowance Taxable	Allowances (note a)	Deductions (note b)	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

Country	Unmarried American	Unmarried TCN	Married American	Married TCN
	(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

Industry (selected companies)	American share of expatriate workforce (percent) 1976	1980
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.

STATEMENT OF HON. FRANK C. CONAHAN, DIRECTOR, INTERNATIONAL DIVISION, GENERAL ACCOUNTING OFFICE

Mr. CONAHAN. Thank you, Senator Chafee. We are pleased to be here today to discuss our recent report on the taxation of American citizens overseas.

The report was issued in February of this year. It has been referred to a number of times today. I believe that the committee is generally familiar with the message of our report. So, perhaps I might just take one or two moments today, and summarize it for these hearings.

The Foreign Earned Income Act of 1978 was intended to create greater equity between people working abroad and at home and provide an incentive to Americans working in foreign hardship areas.

Our report discloses that the Foreign Earned Income Act falls far short of meeting the objective of relieving Americans working abroad from taxation on compensation reflecting the excess costs of living overseas.

The deductions for housing and the general cost of living are substantially smaller than the allowances the employees receive as compensation for these added costs of working abroad.

Furthermore, the FEIA does not recognize certain excess foreign living costs. For example, the tax on reimbursements for the added taxes incurred by working abroad.

The end result is that taxable income and hence the tax liability, as has been said earlier today, often far exceeds what an individual would have incurred had he remained in the United States.

Most major U.S. firms that we interviewed reimbursed expatriate employees for the additional tax burdens resulting from their overseas assignments. The reimbursements—

Senator CHAFEE. Now, Mr. Conahan, and I would like to say this for the subsequent, we have something like 18 witnesses to go here and I have to go to a meeting—luncheon at 12:30, so we have really got to consolidate these statements and perhaps you could highlight your statement.

I want to commend you and the GAO for that study which I have read and it certainly is, well, it's like most things, if we agree with it, we think it is outstanding. I thought that was an excellent report.

Why don't you go ahead, Mr. Conahan? Maybe you could summarize or abbreviate.

Mr. CONAHAN. Yes, sir. Three declarations and then our conclusion.

We believe that when evaluating the alternatives to the present tax provisions, the Congress should keep in mind three points as disclosed by our report.

One, present U.S. tax provisions do discourage employment of U.S. citizens abroad.

Senator CHAFEE. That's a conclusion?

Mr. CONAHAN. That's a conclusion.

Second, present tax provisions have made Americans relatively more expensive than competing third country nationals, thereby reducing their opportunities for employment abroad by major U.S. companies.

Third, Americans retained abroad by major companies are generally reimbursed for their higher taxes, adding to the company's operating costs and making them less competitive.

Our report made a final conclusion that the Congress should consider placing Americans working abroad on an income tax basis comparable with that of citizens of competitor countries, who are generally not taxed on their foreign earned income.

Now, insofar as the GAO position on the bills that are presently before the Congress, we said that two of these complete exclusion or 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 would be relatively simple to administer.

We think that the——

Senator CHAFEE. So, is it total exemption?

Mr. CONAHAN. Either, sir. We think that either, depending upon the levels at which exclusions are set, would accomplish the objectives that we see.

Senator CHAFEE. And, you only addressed earned income?

Mr. CONAHAN. Yes, sir.

Senator CHAFEE. I must say, I'd like to say this for the other witnesses that come up, you might be prepared to touch, if anybody is going to suggest unearned income, please give me your reasons, because I will assume we are always talking earned income.

Go ahead.

Mr. CONAHAN. I would be pleased to take any further questions.

Senator CHAFEE. What about the proposal that Mr. Chapoton made, which was basically that you would tax the person on the income he would have earned at home and anything beyond that is tax free?

Mr. CONAHAN. I think that one has to explore the purposes for which allowances are made. As I understand the situation, allowances are made for two purposes. One, as an incentive to have someone move to a location outside of the United States.

Second, to cover excessive or excess costs associated with living in that foreign area.

Certainly, in the case of the latter, there should not be a penalty. He would concede that.

In the case of the former, I suppose that it's a matter of national policy. It's a thing that does not really lend itself to good analysis in the manner in which GAO would do it. I think it is a policy decision that simply has to be made by the Congress, sir.

Senator CHAFEE. Also, it seems to me there is a point, if somebody is making $50,000 in Palo Alto, presumably they are saving some of it, or using it for purposes they deem important. If they are living in Saudi Arabia and getting $50,000, plus $50,000 for cost of living, that the items that they might go out and buy with their first $50,000, oh, recreation or whatever it is, would itself, be far more expensive. Thus, the individual isn't really equal what he would have at home. Do you see? Do follow that?

Mr. CONAHAN. Well, I think that one of the difficulties discussed in our report goes essentially to that point and that is the implementation of the current legislation. The current legislation does not take into account Palo Alto versus Boston, for example, and

the index does not result in relieving the additional tax burden to these people.

Senator CHAFEE. Well, thank you very much. Were you one of the major ones working on the report, this study?

Mr. CONAHAN. No, sir. We have people here who worked on it directly.

Senator CHAFEE. I want to pay tribute to GAO for that report. It is a very thoughtful and thorough job. Thank you.

Now, we'll have some panels. Let's start with the first one on the list. We are going to have to move rather rapidly.

Mr. Shriner from Chase Econometrics and Mr. Stephen Baer.

Dr. Shriner, you were here a year ago. Will you not make a presentation for Chase? Why don't you proceed?

STATEMENT OF DR. ROBERT R. SHRINER, CHASE ECONOMETRICS

Dr. SHRINER. Yes, I will try to summarize very briefly.

What we have tried to do in the second phase of analysis, building on the work we did before, is to get additional details regarding impacts on individuals overseas and, in turn, the impacts on the companies who employ them. To do this we conducted a survey of companies—U.S. companies—outside the United States, and got responses from 250 organizations in 30 different countries. Our object was to look at the differences in impact by type of firm, by region of the world, and by the levels of income and taxation in the countries where Americans work overseas.

The principal findings were as follows. First of all, the number of Americans returning home since 1976, is substantial. This is essentially the same thing GAO found. Compared with the level in 1976, for example, before the tax changes, the 1979 employment of Americans in Latin America was down by 15 percent and in the Asia-Pacific region, by 14 percent.

One of the most interesting things was that some 10 percent of the U.S. firms that responded to the survey indicate that they now employ no Americans at all in those areas. Though a number of other factors have some effect on the decline, we believe the magnitude of the reduction in after-tax income of American workers is so large that the relative impact of other factors pales in comparison. For example, as a result of the tax changes the average reduction in after-tax income of American workers in the firms we surveyed was $7,650 in 1979. If you hit them with a $7,650 reduction in income, that is certainly going to cause them to change their behavior, largely to come back home.

Looking at the impact on companies, the cost incurred by companies to maintain workers overseas rose sharply as a result of the new tax. For those having tax equalization programs, an average of $12,100 per U.S. worker was required in 1979 for increased tax equalization payments over the 1976 levels. Translating that into cost of products and services sold, it represented on the average a 3-percent increase. There is a lot of variation by country and by industry, but the overall average was 3 percent. We also determined that, to a very considerable degree, companies are not able to pass that cost along to the customer because of competition or, in some cases, because of price controls.

The types of firms most affected are those in areas such as finance, professional services, and construction, especially in low income, low tax countries where market competition is keenest.

One of the things that we had been challenged on before, and that the Mutti study has been challenged on before, is the two-to-one ratio. That is for every 2 percent reduction in the number of workers, there is a 1 percent reduction in exports. We tried to get corroboration or refutation with regard to that issue by asking firms what the impact of a 20 percent decline in the number of their U.S. employees would be on the volume of their organization's U.S. exports in that location. Interestingly, although there was wide variation in individual responses, the average for the entire group of firms in the study was that a 20 percent decline in employment would produce a 13 percent decline in exports. That comes out to an elasticity of 0.65 which compares very well with Mutti's results of 0.5. There is not very much difference between those two measures of impact, which reinforces the results in our earlier study.

What are the implications in our view? The industrial distribution of impacts, as indicated by the survey, suggest that the workers most affected are those in such areas as finance, professional services and construction which have high value added because of the specialized skills involved, rather than areas in which unskilled foreign labor competes with unskilled U.S. workers. Thus, the taxation of U.S. workers overseas is not a means of protecting jobs in the United States from foreign competition. Instead, it interferes with the ability of U.S. workers to be competitive in foreign markets and contributes to unemployment at home.

There is also serious cause for concern in the fact that the impact of the added tax burden is especially severe in countries that are emerging markets, particularly the newly industrialized countries of Latin America and the Asia-Pacific region among others. We think the U.S. loss of market share in these areas now, while these markets are expanding rapidly, will be virtually be impossible to recover later.

Thank you.

Senator CHAFEE. Well, thank you. That is kind of gloomy to say U.S. loss of market share in these areas now, while these markets are rapidly expanding, will be virtually impossible to recover later.

What we have to do is hustle and see if we can't prevent that from happening. Thank you, Doctor. Mr. Baer.

Mr. BAER. Thank you, Senator.

STATEMENT OF MR. STEPHAN BAER, DIRECTOR, INTERNATIONAL COMPENSATION, ORGANIZATION RESEARCH COUNSELORS, INC.

Mr. BAER. I am going to be brief and just summarize this because I am probably the only witness here that hasn't taken a strong position one way or the other.

Our view is to provide the committee with information and help it make its decision.

Just a quick word about Organization Resources Counselors. We are an employee relations consulting firm. A major part of our

business is in providing international cost of living services to U.S. multinationals abroad.

The information in the body of this statement has been summarized from one of ORC's surveys of personnel practices and compensation for expatriate employees. The survey is completed by responsible officials of corporating ORC multinational client companies and to the best of knowledge, reflects an accurate accounting of each company's practices.

ORC has been conducting such surveys since 1948, initially at 2-year intervals but more recently on an annual basis.

The data summarized are for the years 1972, 1976, 1979, and 1980. It was provided by 192 companies in the first year, 257 in the second, and slightly over 300 in the last two.

The increase in sample size from 192 to 306 is basically reflective, not of international trade but rather of our company's ability to generate new business.

The U.S. Federal tax regulations obtaining with reference to U.S. citizens employed offshore, but one of many factors affecting the level and geographic distribution of that employment.

Decisionmakers must also recognize that changes in markets, availability of natural resources, relative costs of production of which I might say, tax incidence is one, and the vigor with which other nationalities compete for our business, can also affect the locational distribution and level of U.S. expatriates abroad.

In the 8 years from 1972 to 1980, as the tables below demonstrate, there have been dramatic shifts in both the numbers of Americans employed offshore and their distribution by nationality. By that, I mean where they are.

Levels have substantially diminished and I stress the word substantially. The locational distribution has shifted, by and large, from the European theater to the Middle Eastern theater. It is a popular contention and it has been positive by other witnesses here, that a high level of American presence abroad is positively related to high levels of domestic employment, increases in the U.S. share of international trade, potential increases in U.S. tax revenue, increased opportunities for new business and the like.

Should this be true, and I think there is some more than preliminary evidence suggest that it is, then reductions in such presence as we have seen in the last 8 years would certainly have some kind of adverse effect on the U.S. economy.

Let me give some summary results, in the interest of time. As a percent of all expatriates employed by U.S. multinational corporations abroad, U.S. expatriates comprised about 84 percent of that total in 1972, diminished to 73 percent in 1976; 66 percent in 1979; and currently is 37 percent in 1980.

If I recall in Ambassador Brock's testimony, he was using a figure of 40 percent in 1980, which is very close. In terms of host locations, by that I mean where Americans are currently, for U.S. expatriates employed by U.S. corporations abroad in 1972, 50 percent were in Europe. Only 2 percent were in the Middle East; 47 percent in other areas of the world.

By 1980 that distribution had taken a dramatic shift to 25 percent in Europe, 40 percent in the Middle East, and 35 percent in all other areas of the world.

Of the great increase of the American presence in the Middle East, the bulk of it is concentrated in Saudi Arabia, and I think for a lot of obvious reasons.

In 1972 U.S. exports——

Senator CHAFEE. Could I just ask you a question?

Mr. BAER. Certainly.

Senator CHAFEE. Let's take the work location of chart 2, table 2. The survey years of 1972-76, let's compare 1972 and 1980. You say in 1972, 50 percent of the expatriates were in Europe and in 1980, 25 percent. Now, was there a decline in actual numbers in Europe in that time?

Mr. BAER. I don't have those figures with me, but I can supply for them the record if you want.

Senator CHAFEE. No, but it seems to me that statistics are not very meaningful if the total force has grown and thus, the numbers in Europe remain constant, then obviously the percentage in Europe would decline.

The reason I bring is, that there is a theory, anyway, that since the European countries levy their own income tax, that the taxation of Americans abroad is less significant in Europe than it would be in the Middle East. Since they have to pay the European taxes anyway, regardless of whether this legislation passes or not and they get a tax credit for it and thus this legislation, as for Americans in Europe, is not that significant?

Mr. BAER. Indeed.

Senator CHAFEE. OK, go ahead.

Mr. BAER. Just one last point on the summary and that is that in terms of the number of U.S. expatriates, the survey was completed by more than 300 U.S. corporations and indicated in 1979 those companies employed slightly over 36,000 Americans offshore, but in 1980, that number had decreased to 22,580, which is a very dramatic decline.

Senator CHAFEE. Well, that is a significant figure. Now, what table do you have that on? Is that in your testimony?

Mr. BAER. I hope so.

Senator CHAFEE. Maybe, it is, Table 1. Is that it?

Mr. BAER. Yes, Table 1, I believe is it.

Senator CHAFEE. Is that it?

Mr. BAER. Yes, Table 1, line 2, Senator. In 1979 there were 36,756 U.S. expatriates, from 305 companies off-shore and that number with only more company, was 22,580. I might add that I can supply the committee with the names of the companies. There is tremendous overlap between the 2 years. It is not a mere image sample, however.

Senator CHAFEE. I must say that figure is so startling.

Mr. BAER. It is. It is startling.

Senator CHAFEE. I would find that because look at the prior year, the prior couple of years, in 1976 it was 28,000 so you had a rather dramatic jump in 2 or 3 years from 1976 to 1979 and then down again in 1980.

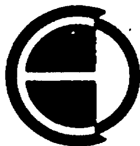
No, don't bother with the names of the companies. That would overwhelm us.

Mr. BAER. I cannot give them to you now.

Senator CHAFEE. Thank you very much.

Mr. BAER. Thank you, Senator.

[The prepared statements of the preceding panel follow:]



CHASE ECONOMETRICS

STATEMENT BY

ROBERT D. SHRINER, PH.D.
DIRECTOR OF WASHINGTON OPERATIONS
CHASE ECONOMETRICS

TO

THE SENATE FINANCE COMMITTEE
WASHINGTON, D.C.

APRIL 24, 1981

April 1981

TAXATION OF U.S. WORKERS OVERSEAS: SURVEY OF U.S. FIRMS IN 30 COUNTRIES

SUMMARY

In April 1980 Chase Econometrics began a study of the impact of higher taxation of U.S. workers overseas, including a review of existing data and prior research. The initial results, published last year, concluded that a decline in U.S. overseas employment on the order of ten percent or more could be attributed to tax changes and that U.S. exports decline on the order of one percent or more for every two percent decline in number of U.S. workers abroad. Therefore, we concluded that U.S. exports would fall short of the level they otherwise would have reached in 1980 by at least five percent and quite possibly by much more. Using that conservative estimate of export impact, we then estimated the impact on the U.S. economy for the year 1980 and concluded that the negative impact on the U.S. economy exceeded many times over the small benefits the Treasury hoped to gain from these taxes.

Since that initial report, we have completed a second phase of research involving an extensive survey of U.S. firms operating overseas. Over 250 responses were received, from U.S. firms in 30 different countries, showing differences in impact by type of firm, by region of the world, and by country levels of income and taxation. The results add further body and substance to our earlier analysis.

MAJOR FINDINGS

The number of Americans returning home since 1976 is substantial -- compared with the level in 1976, before these tax changes, 1979 employment of Americans in Latin America was down 15 percent and in the Asia-Pacific region by 14 percent. Many U.S. firms operating overseas -- 10 percent of those responding -- indicated that they now employ no Americans at all. Though other factors may have some effect on this decline, the magnitude of the reduction in after-tax income of American workers is so large -- on average $7650 for 1979 -- that the relative impact of other factors pales in comparison.

The cost incurred by companies to maintain workers overseas rose sharply. For those having tax equalization programs, an average of $12,100 per U.S. worker was required in increased tax equalization payments over 1976 levels. Companies report that product costs increased an average of about 3 percent as a result of the increased taxes. For the present, they are largely absorbing this increase rather than passing it along to customers due to price controls and/or competition in their market areas. Firms most affected are those in areas such as finance, professional services, and construction, especially in low income, low-tax countries where market competition is keenest.

Although there are wide differences by industry and country, on average firms estimate that a 20 percent decline in U.S. overseas employment results in a sales decline of 13 percent.

MAJOR CONCLUSIONS

The exact impact of the tax on U.S. exports is impossible to estimate with precision, but we can readily determine the approximate magnitude, and it is large. Numerous studies (including this one) conclude that U.S. overseas employment has fallen ten percent or more because of the tax. The preponderance of evidence also indicates that, on average, the level of U.S. exports is reduced by one percent or more for every two percent reduction in the number of U.S. workers overseas. These two facts together indicate that the minimum impact of the tax is a level of U.S. exports five percent lower than would otherwise have been achieved in the absence of the tax, and the magnitude of the impact could potentially be much higher.

The industrial distribution of impacts, as indicated by the survey, suggests that the workers most affected are those in such areas as finance, professional services, and construction which have high value added because of the specialized skills involved rather than reas in which unskilled foreign labor competes with unskilled U.S. workers. Thus, the taxation of U.S. workers overseas is not a means of protecting jobs in the U.S. from foreign competition; instead, it interferes with the ability of U.S. workers to be competitive in foreign markets and contribute to unemployment at home.

There is also serious cause for concern in the fact that the impact of the added tax burden is especially severe in countries which are "emerging markets" -- the newly industrializing countries of Latin America and the Asia-Pacific region, among

others. The U.S. loss of market share in these areas now, while these markets are rapidly expanding, will be virtually impossible to recover later.

The implications for Treasury receipts from the tax are also clear. Treasury estimates based on the number of tax returns filed overseas in 1977 will significantly over-estimate potential tax revenues. Because of the reduction in number of workers overseas, especially among those expected to pay the greatest share of additional taxes, the actual revenue from the tax will be at least 10 percent (and more likely 15-25 percent) below the amount estimated by Treasury. When the impact on U.S. exports and reduced U.S. domestic income is taken into account, the net revenue to the Treasury from the tax becomes negative. As shown in our earlier analysis, the net revenue loss after accounting for domestic impacts is on the order of ten times greater than the direct revenue Treasury hopes to gain from taxing overseas workers.

I. INTRODUCTION

The U.S. is virtually alone among the developed countries in taxing the income of its citizens living overseas. Moreover, in the past five years decisions by Congress and the courts have greatly increased the tax burden on Americans working abroad.

- In 1976, the Tax Court ruled that allowances for education, housing, and travel were taxable unless they were expressly for the convenience of the employer. Previously, many Americans working overseas treated these allowances as non-taxable.
- The Tax Reform Act of 1976 substantially increased the tax liabilities of Americans overseas. Though its provisions on overseas income were never implemented, the threat of implementation placed a cloud over Americans abroad.
- The 1978 Foreign Earned Income Act allowed some specific deductions for allowances, but these were not as liberal as the exclusions many taxpayers took before the Tax Court decision. The net effect was to increase taxes on Americans overseas above the pre-1976 levels. For most taxpayers, these changes were effective beginning in tax year 1979.

These tax changes impose a substantial additional burden on overseas workers, who find their after-tax income declining, and on companies, which find that the cost of maintaining workers overseas increases. The immediate results of this additional burden are twofold: first, there is a significant reduction in the number of American workers overseas; second, the cost of goods and services sold by American firms overseas increases. As a result, U.S. exports are reduced in two ways:

- The decline of American presence overseas results in fewer American goods being ordered by foreign buyers.
- The increase in product costs results in a decline in the competitiveness of U.S. goods and a subsequent decline in sales.

The magnitude of the tax impact on exports and employment is difficult to determine conclusively because other factors are also involved. Data are limited in this area, the linkages are complex, and thus it is difficult to isolate the effects of taxes only. For example, during the period 1976-1980 in which these added taxes have taken effect, exchange rates generally changed in directions favorable to U.S. exports, offsetting the unfavorable effects of increased taxes. Also at work are changes in the level of political unrest, differences in living standards and internal tax rates, and changing personal attitudes toward life in the various countries in which Americans reside. Nevertheless, it is essential that a systematic effort be made to obtain the best estimate the existing information will support.

In April 1980 Chase Econometrics began a study of this problem for the U.S. & Overseas Tax Fairness Committee. In our initial report, issued in July 1980, we reviewed the existing data and prior research, looking closely at the evidence -- both anecdotal and numerical -- on each step in the chain. Our study concluded that a decline in U.S. overseas employment on the order of ten percent or more could be attributed to recent changes in taxes on U.S. workers overseas. We also noted evidence strongly indicating that U.S. exports decline on the order of one percent or more for every two percent decline in number of U.S. workers abroad. Therefore, we concluded that U.S. exports will fall short of the level they otherwise would have reached by <u>at least</u> five percent and quite possibly by much more. Using that conservative estimate of export impact, we then estimated the impact on the U.S. economy for the year 1980. Our analysis showed that the negative impact on the U.S. economy exceeded many times over the small benefits the Treasury hoped to gain from these taxes.

Since that initial report, we have completed a second phase of research involving an extensive survey of U.S. firms operating overseas. Over 250 responses were received, from U.S. firms in 30 different countries. This report describes the results of this second phase.

While our study was nearing completion, the General Accounting Office recently published the results of a study which it had conducted. Their methodology was somewhat different and the number of firms they contacted was smaller; but their results are consistent with ours. Our study can therefore be viewed as extending and confirming the GAO's findings.

Our study was designed to provide additional information about differences in impact by type of firm, by region of the world, and by level of income and taxation of the country in which respondents operated. The details of our analysis are discussed in later chapters; however, the following are the principal findings:

- The impact of the tax varies widely from country to country and among different kinds of firms in the same country. Firms most affected are those in areas such as finance, professional services, and construction in which specialized skills are involved.

- Compared with the level in 1976, before these tax changes, 1979 employment of Americans in Latin America was down 15 percent and in the Asia-Pacific region by 14 percent. Many U.S. firms operating overseas -- 10 percent of those responding -- indicated that they now employ no Americans at all. This could likely have a major impact on the U.S. share of markets in these fast-growing areas for many years.

- The tax change caused an average decline of $7650 in the 1979 after-tax incomes of U.S. overseas workers employed by firms not offering tax equalization plans. Even in countries with high income taxes, where the effects should be smallest, the decline averaged $4900.

- The cost incurred by companies to maintain workers overseas rose sharply. For those having tax equalization programs, an average of $12,100 per U.S. worker was required in increased tax equalization payments over 1976 levels.

- Product costs increased an average of 2.91 percent as a result of the increased taxes. Companies report that, for the present, they are largely absorbing this increase rather than passing it along to customers due to price controls and/or competition in their market areas.

- While companies report that the nominal value of their U.S. exports increased in 1979 over 1976, 24 firms reported an average of $10 million each in lost business

due to the tax. When the value of exports is adjusted for price increases, a high percentage of firms show no growth or actual declines.

- Although there are wide differences by industry and country, on averaga firms estimate that a 20 percent decline in U.S. overseas employment results in a sales decline of 13 percent. This result is very similar to estimates made previously by other studies.

- The fact that companies are absorbing the added costs due to the tax indicates that there may be an additional delayed effect. If companies continue to absorb the added costs, profits will decline and overseas operations will become less attractive. If they pass on the added costs, their products will not meet foreign price competition.

Chapter II, which follows, describes the survey methodology. Chapter III discusses the impact of the tax on workers and firms. Chapter IV discusses the impact on exports, and Chapter V gives conclusions, followed by statistical tables. In accordance with Chase Econometrics' policy of providing objective and nonpartisan analysis, this report offers no recommendations.

II. METHODOLOGY

The objective of this survey was to collect more detailed information on the impact of recent tax changes on U.S. workers and firms operating overseas. A direct survey of individual workers overseas was considered but was determined to be impractical, because of the limited resources available and the difficulties of obtaining a representative mailing list of overseas workers and recent returnees. We also considered a survey of corporation headquarters in the U.S. However, a survey of U.S. firms overseas potentially provides a better representation of the diverse types of firms and circumstances than a survey of the headquarters of large U.S. multinationals. Therefore, a questionnaire was designed to collect information directly from U.S. firms overseas. Copies of the questionnaire were sent by telex to American Chambers of Commerce throughout the world, who distributed copies to their member companies. In most cases, responses were sent back directly from individual firms by telex. In a few cases -- for example, Brazil -- responses were collected and tabulated by the local Chamber and then the tabulation was telexed back to the U.S. for analysis. Over 250 responses were received, from firms in 30 different countries and a wide range of industries. Tables 1 through 3 show the number of responses by country, region, and type of firm.

Responses from individual countries were grouped by region, level of taxation, and income levels, in order to analyze the varying effects of the tax laws under different situations. Results are presented for Latin America, Asia-Pacific, Europe, and Africa. In a few countries, there are enough responses to make country-level inferences; but in most countries the number of responses is too small to draw detailed conclusions on a country by country basis.

The level of income taxation of foreign countries is important to this analysis because workers overseas receive a credit against U.S. tax for foreign income taxes paid. The impact of a U.S. tax increase is likely to be greatest on workers in countries in which the tax structure is much lower than in the U.S., because workers in these countries will have less foreign tax to credit against the U.S. tax increase. Using data on foreign tax rates obtained from the Price Waterhouse Information Guide, "Individual Taxes in 80 Countries", sample taxes for

various countries were computed by averaging the taxes on a $40,000 income paid by workers in three possible family situations -- single, married, and married with two children. Countries were then grouped on the basis of their average tax relative to the U.S. tax for similar income levels. The middle tax category included countries whose tax levels range from 10 percent below to 10 percent above the U.S. tax; the high and the low tax levels fall on either side.

Income levels of countries are also important; and the groupings used here are based on per capita Gross Domestic Product from the United Nation's Statistical Yearbook and the IMF's International Financial Statistics. The income categories are defined as low income, with per capita GDP below $1,400; middle income, with per capita GDP from $1,400 to $3,500; and high income with per capita GDP greater than $3,500.

The level of response varied greatly from country to country. The greatest response came from low income countries (103) and low tax countries (163). Africa, with only three firms responding, was poorly represented in the sample. The region from which the greatest number of responses came was Latin America, where 111 firms replied. Europe and the Asia-Pacific region each had about 70 responses. The United Kingdom alone accounted for over 50 responses -- nearly 20 percent of the total. The heavy weight of the UK responses tends to skew some results at the aggregate level but does not change the results for Europe significantly.

Survey responses were aggregated by country, by industry, by region and by tax and income levels in order to analyze the varying effects of the tax laws under differing foreign situations. Detailed breakdown of responses are provided in tables at the rear of this report.

Several factors limit the conclusions which we can draw from the survey:

- The survey did not cover organizations which halted operations as a result of the tax.

- While we distributed the questionnaire to all U.S. Chambers overseas, it is possible that respondents are not statistically representative of American Business

overseas. However, the diversity of response suggests that a good cross-section of firms has been obtained.

- The response to some individual questions was very low, due in part to difficulty in compiling the data. This makes it difficult to analyze the pattern of differences among categories for those questions. In some cases, respondents have provided their best estimate in lieu of precise data, introducing possible inaccuracies; however, the diversity of responses does not suggest a significant bias in response. The number of responses to individual questions is noted in the presentation of results.

Despite these limitations, this study represents a major systematic effort to determine the impact of the tax on U.S. firms overseas. The large number of overall responses received and the wide range of countries from which the responses have come add weight to the conclusions, which are consistent with our earlier research.

III. IMPACT ON WORKERS AND FIRMS

1. EFFECTS OF TAX ON WORKER INCOME

The immediate effect of the change in tax has been a large decline in the after-tax income of U.S. workers overseas. Among firms in our survey, the average decline per worker in 1979 was $7,650. However, there was considerable variability depending on the taxation level of the country of residence. Because U.S. workers receive a credit for foreign taxes paid, the tax has a larger impact in low-tax countries (where the worker cannot offset the impact of increased U.S. tax) than in high-tax countries (where the worker might have an excess foreign tax credit to offset increased U.S. taxes). The average income loss was $13,300 in low-tax countries and $4,900 in high-tax countries, according to the survey.

2. EFFECTS OF TAX ON FIRMS

The change in tax has had several adverse effects on American firms operating overseas, which are shown in survey results. These impacts include greatly increased equalization costs, a decline in both the demand and supply of Americans overseas, and increased product costs.

Many companies operating overseas provide full or partial tax equalization to their workers, so that workers pay roughly the same amount of tax while overseas as they would pay if in the U.S. The 136 companies which provided information on these costs in response to our survey paid an average of $12,100 per worker in 1979 in additional tax equalization payments to employees due to the recent changes in U.S. tax laws. The largest increase in equalization costs occurred in medium-tax countries, and the increase was higher in low-tax countries than in high-tax countries. The largest increases for specific industry groups were in wholesale trade and finance.

The cost of tax equalization raises the costs of products and services sold by firms operating overseas. The greatest percentage increases in costs were reported by firms in services, transportation, and construction; the lowest increases -- still more than 1 percent -- were reported by firms in manufacturing and in wholesale trade. The average increase in cost of product

attributed to the change in tax and associated equalization payments to workers was 2.91 percent.

The pattern of responses among high-, low-, and medium-tax countries showed wide variations in the impact on product cost. The greatest cost increase -- 3.13 percent -- is reported from firms in low-tax countries. Firms in high-tax countries reported smaller cost increases -- 2.55 percent -- while firms in medium-tax countries reported a still smaller cost increase -- 1.10 percent.

For over 80 percent of firms responding to the survey, these added costs must be fully absorbed by the firm rather than passed on in higher product price.* Price controls and competitive pressures were both cited by several respondents as reasons for not passing on the added costs. This means that profits suffer and it becomes less attractive for American businesses to operate and market overseas.

As a result of income loss due to the tax changes, Americans are less willing to work overseas without equalization. As a result of increased equalization costs, firms become less willing to employ Americans. The combined result of these effects is that fewer Americans will be employed outside the U.S. We asked firms how many Americans were employed by them during each of the years 1976-79. Changes in the number of Americans employed in this period are indicative of the impact of the tax. There are many factors, such as terrorist activity, the attractiveness of a particular country, or the availability of third country nationals, which affect the number of Americans overseas; but, since these factors have not changed significantly during this period while U.S. tax policy has changed dramatically, the impact of the tax is clearly a major factor.

Over the period 1976-79, there was a general decline in employment in low-income countries. In low-income, low-tax countries the number of American workers decreased by one-third. Moreover the decline was not limited to countries

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*Of remaining firms responding, 8 percent report that they were able to pass on all the increased costs and 12 percent were forced to absorb a portion of the expense.

typically thought of as hardship areas but extended to countries like Australia, Belgium, Japan, and Spain. The largest percentage declines in number of workers were in construction, transportation, and "other" industries.

The overall number of U.S. workers overseas in the firms we surveyed increased 1 percent over the period 1976-1979, but this increase was almost entirely due to 3 countries -- Indonesia, Venezuela, and Great Britain -- where petroleum exploration created special conditions.

IV. IMPACT ON U.S. EXPORTS

Many factors in addition to taxes affect exports. For example, during the 1976-79 period exchange rates generally changed in a way that would make American exports more competitive and thus increase real exports, offsetting the negative effects of the change in taxes and product costs. The price level, income and productive capacity of individual countries also influence the level of U.S. exports and, in the absence of very detailed data, tend to mask effects of changes in any single variable. It is thus difficult to isolate the impact of the tax change alone. However, the results of the survey shed light on the question through a number of different avenues:

- U.S. exports of respondents over the period 1976-79.
- amount of business lost due to the tax.
- impact on exports due to replacement of American staff by third country nationals.

Each of these is discussed further below.

1. IMPACT ON TOTAL U.S. EXPORTS

Firms in the survey reported that their U.S. exports increased an average of 69 percent over the period (1976-79), (32 percent in real terms). The smallest increase, 45 percent, occurred in low-tax countries. In the last year (1978-79) exports for all respondent countries increased 19 percent (5 percent in real terms) while low-tax countries showed a real decline in exports in the same period.

Although the nominal value of exports has increased, their share in the expanding volume of world trade has declined when the effects of inflation are taken into account. For example, in Table 15, the change in value of exports to high tax countries between 1978 and 1979 is up 22 percent in current dollars; but when an adjustment for price changes is made, an actual decline of 8 percent is revealed. Among industry groups, finance, wholesale trade, and manufacturing, did the worst while petroleum did the best.

80-61? O—81——°

2. BUSINESS LOST DUE TO THE TAX

Several firms reported that they had already lost business as a result of the increases in the tax. Twenty-four respondents reported a total of over $250 million in business lost in 1979, an average of over $10 million per firm. Most of this they attributed to the decreased American presence overseas and less to cost increases, because most companies absorbed increased costs. However, as noted earlier, such cost increases can not be absorbed over an extended period. About 88 percent of the lost business was reported by the manufacturing sector. Services, retail and wholesale trade, transportation, and finance also reported losses.

3. THIRD COUNTRY NATIONALS AND U.S. EXPORTS

Rising equalization costs and the increasing reluctance of Americans to work abroad have forced U.S. firms to employ an increasing number of third country nationals (TCN's) for their overseas operations. These workers are not taxed by their home countries and thus do not require additional equalization payments to maintain their income level. For example, a construction company operating in Korea commented that in its industry "TCN's are just as good as Americans and 35 percent to 40 percent cheaper." Among U.S. firms responding to the survey, 10 percent indicated they employed no Americans in the country surveyed.

Most firms responding to the questionnaire see a direct link between employment of third country nationals and U.S. exports sold or bought for use by the company, though many found it difficult to quantify the effect.

- A manager for a manufacturing company in Venezuela stated that "it is obvious that a British engineer who has worked for 20 years in Britain and Europe will be inclined to recommend familiar equipment."

- An architectural and engineering consulting firm responded that "although a relatively small number of employees are required, the construction value for which we have supervision responsibility runs into hundreds of millions of dollars. It follows logically that specifications of materials, supplies and equipment will

be greatly influenced by the nationalities of the professional employees assigned to the projects."

- A conservative estimate of the lost sales by one firm was one million dollars annually as clients have been attracted to European and Japanese products.

- Another firm suggested that its foreign office may be shut down entirely due to its declining profitability. Although their operations will continue from the U.S. they estimate future sales will decrease by at least 25 percent.

- A supplier of international contractors replied that "when U.S. contractors and firms started employing local or third country technicians, engineers, managers etc. we felt a tremendous shift in purchases away from U.S. sources toward German, French and English suppliers." They added that in the Middle East three major competitors emerged as a result of increased European management in the area.

The firms that responded quantitatively to the question linking U.S. exports to the nationality of their employees indicated that a 20 percent replacement of Americans by TCN's would on average reduce their U.S. exports by 13 percent. That implies an elasticity of 0.65, which is similar to an earlier estimate of 0.5 made by John Mutti* for Treasury's Office of Tax Analysis.

*Mutti, John, The American Presence Abroad and U.S. Exports. Office of Tax Analysis Paper No. 33, U.S. Treasury Department, October 1978.

V. CONCLUSIONS

The picture that emerges from the survey results adds further body and substance to our earlier analysis. The number of Americans returning home since 1976 is substantial -- for the emerging economic regions of Latin America and Asia-Pacific, survey results indicate a 15 percent decline in American employment. Though other factors may have some effect on this decline, the magnitude of the reduction in after-tax income of American workers is so large -- on average $7650 for 1979 -- that the relative impact of other factors pales in comparison. The additional tax burden on U.S. workers overseas, along with the associated higher costs of tax equalization by U.S. firms for their American workers, are clearly the major factors at work in reducing U.S. employment overseas.

The survey results also lend additional support to the conclusions reached by Mutti and others regarding the magnitude of the impact of reduced employment of American workers abroad on the level of U.S. exports. Mutti found an elasticity of exports with respect to employment of 0.5; the average of responses to our survey, when translated into an elasticity, was 0.65 -- very similar to Mutti's finding.

The industrial distribution of impacts, as indicated by the survey, suggests that the workers most affected are those in such areas as finance, professional services, and construction which have high value added because of the specialized skills involved, rather than areas in which unskilled foreign labor competes with unskilled U.S. workers. Thus, the taxation of U.S. workers overseas is not a means of protecting jobs in the U.S. from foreign competition; instead, it interferes with the ability of U.S. workers to be competitive in foreign markets and contributes to unemployment at home.

There is also serious cause for concern in the fact that the impact of the added tax burden is especially severe in countries which are "emerging markets" -- the newly industrializing countries of Latin America and the Asia-Pacific region, among others. The U.S. loss of market share in these areas now, while these markets are rapidly expanding, will be virtually impossible to recover later.

The overall impact of the tax on U.S. exports can only be estimated with rough precision. However, the evidence is clearly sufficient to show that the impact is large. Numerous studies (including this one) conclude that U.S. overseas employment has fallen ten percent or more because of the tax. The preponderance of evidence also indicates that, on average, the level of U.S. exports is reduced by one percent or more for every two percent reduction in the number of U.S. workers overseas. These two facts together indicate that the minimum impact of the tax is a level of U.S. exports five percent lower than would otherwise have been achieved in the absence of the tax, and the magnitude of the impact could potentially be much higher.

The implications for Treasury receipts from the tax are also clear. Treasury estimates based on the number of tax returns filed overseas in 1977 will significantly over-estimate potential tax revenues. Because of the reduction in number of workers overseas, especially among those expected to pay the greatest share of additional taxes, the actual revenue from the tax will be at least 10 percent (and more likely 15-25 percent) below the amount estimated by Treasury. When the impact on U.S. exports and reduced U.S. domestic income is taken into account, the net revenue to the Treasury from the tax becomes negative. As shown in our earlier analysis, the net revenue loss after accounting for domestic impacts is on the order of ten times greater than the direct revenue Treasury hopes to gain from taxing overseas workers.

* * *

The tables which follow provide additional data gained in our survey of U.S. firms operating abroad.

EXHIBITS AND TABLES

EXHIBIT I Survey Questionnaire

TABLE 1 Number of Responses By Country By Per Capita Income And Level Of Taxation

TABLE 2 Number of Responses By Geographic Area

TABLE 3 Number of Responses By Type Of Business Activity

TABLE 4 Average Change In After Tax Income In 1979 As A Result Of Changes From Pre-1976 Tax Provisions (U.S. Dollars)

TABLE 5 Change In Cost Of Product In 1979 As A Result Of Changes From Pre-1976 Tax Provisions By Type Of Business Activity

TABLE 6 Change In Cost Of Product In 1979 As A Result Of Changes From Pre-1976 Tax Provisions By Level Of Taxation

TABLE 7 Increased Equalization Cost In 1979 As A Result Of Changes From Pre-1976 Tax Provisions By Level Of Taxation (U.S. Dollars)

TABLE 8 Increased Equalization Cost In 1979 As A Result Of Changes From Pre-1976 Tax Provisions By Type Of Business Activity (U.S. Dollars)

TABLE 9 Number Of American Employees, 1976-1979 By Level Of Taxation

TABLE 10 Number Of American Employees, 1976-1979 By Region

TABLE 11 Number Of American Employees, 1976-1979 By Level Of Per Capita Income In Host Country

TABLE 12 Number Of American Employees, 1976-1979 By Type Of Business Activity

EXHIBITS AND TABLES
(cont'd)

TABLE 13 Number Of American Employees, 1976-1979 By Per Capita Income & Level Of Taxation Of Host Country

TABLE 14 Value Of Exports Bought Or Sold, 1976-1979 By Per Capita Income & Level Of Taxation Of Host Country (Millions Of Dollars)

TABLE 15 Value Of Exports Bought Or Sold, 1976-1979 By Level Of Taxation Of Host Country (Millions Of Dollars)

TABLE 16 Value Of Exports Bought Or Sold, 1978-1979 By Level Of Taxation Of Host Country (Millions Of Dollars)

TABLE 17 Value Of Exports Bought Or Sold, 1976-1979 By Level Of Per Capita Income Of Host Country (Millions Of U.S. Dollars)

TABLE 18 Value Of Exports Bought Or Sold, 1976-1979 By Type Of Business Activity (Millions Of U.S. Dollars)

TABLE 19 Lost Business Due To Increased Taxes On U.S. Workers Overseas (Millions Of Dollars)

TABLE 20 Expected Change In Exports Due To Hypothetical 20% Replacement Of U.S. Workers Overseas

TABLE 21 Number Of Firms Responding That They Employed No Americans

EXHIBIT 1

Survey Questionnaire

1. What is primary activity of your firm in this country (e.g. construction, accounting, manufacturing, banking etc.)?

2. How many Americans did firm employ locally each year--1976 through 1979?

3. In what capacities did they serve (e.g. sales, engineering, management etc.)?

4. What was value of imports from U.S. sold or purchased by your firm locally in 1976, 1977, 1978 and 1979?

5. For following questions, please estimate as best you can, amount involved for each year, 1976 through 1979.

A. If your employer has tax equalization plan for American employees, what was total additional cost to your firm for these employees in country as result of changes from pre-1976 tax provisions?

B. If you did not tax equalize, what was average change in after-tax income (in U.S. dollars) for your firm's American employees locally as result of these tax changes.

C. What percentage of tax equalization costs to your company locally were

I. Absorbed by your company as decreased profits? and/or

II. Passed on to your customers in higher prices in each year, 1976-79?

D. What percent increase in costs of your products sold locally stemmed from additional costs of these tax changes in each year, 1976-1979?

6. Please estimate dollar value of any lost sales (U.S. exports) attributable to:

A. Higher unit costs discussed in previous questions, and/or

B. Any reduction that may have occurred in number of Americans employed locally by your firm.

7. Does employment of third country nationals, instead of Americans, in overseas operations result in lower level of exports from U.S. operations? If so, please estimate percentage change in your sales or purchase of U.S. products locally that would result from a 20 percent replacement of your American employees by TCNs.

8. Any additional comments welcome.

TABLE 1

NUMBER OF RESPONSES BY COUNTRY
BY PER CAPITA INCOME AND LEVEL OF TAXATION

	LOW TAX	MIDDLE TAX	HIGH TAX	
LOW INCOME	Brazil 24 Guatemala 5 Panama 11 Uruguay 4	Costa Rica 5 Dominican Republic 1 Taiwan 4	Chile 3 Columbia 9 Ecuador 2 Indonesia 2 Korea 10 Mexico 6 Morocco 1 Peru 4 Phillipines 8 Thailand 4	103
MIDDLE INCOME	Argentina 13 Hong Kong 13 Spain 5	Singapore 7	Italy 10 Portugal 1 South Africa 2	75
HIGH INCOME	Japan 10 Switzerland 3 United Kingdom 51		Australia 12 Belgium 3	79
	163	17	77	257*

*16 responses could not be classified by country

TABLE 2

NUMBER OF RESPONSES BY GEOGRAPHIC AREA
AND TYPE OF BUSINESS ACTIVITY

Europe		Latin America		Asia Pacific		Africa	
Belgium	3	Argentina	13	Australia	12	Morocco	1
Italy	10	Brazil	24	Hong Kong	13	South Africa	2
Portugal	1	Chile	3	Indonesia	2	Total	3
Spain	5	Columbia	9	Japan	10		
Switzerland	3	Costa Rica	5	Korea	10		
United Kingdom	51	Dominican Republic	1	Phillipines	8		
		Ecuador	2	Singapore	7		
Total	73	Guatemala	5	Taiwan	4		
		Mexico	6	Thailand	4		
		Panama	11	Total	70		
		Peru	4				
		Uruguay	4				
		Venezuela	24				
		Total	111				

TABLE 3

Number Of Responses By Type
Of Business Activity

Mining	2
Construction	8
Manufacturing	81
Transportation	10
Wholesale Trade	52
Finance	43
Services	28
Petroleum	15
Other, Unclassifiable	34
Total	273

TABLE 4

AVERAGE CHANGE IN AFTER TAX INCOME IN 1979
AS A RESULT OF CHANGES FROM PRE-1976 TAX PROVISIONS
U.S. DOLLARS

LOW-TAX COUNTRIES (20)	$13,323
Venezuela (5)	32,549
United Kingdom (8)	12,375
Hong Kong (1)	8,000
Guatemala (3)	5,400
Panama (1)	5,000
Uruguay (1)	2,800
Argentina (1)	2,000
HIGH-TAX COUNTRIES (15)	$ 4,872
Korea (1)	10,000
Italy (3)	6,667
Australia (3)	6,000
Phillipines (2)	5,110
Colombia (4)	4,500
Thailand (1)	1,500
Morocco (1)	1,150
UNKNOWN (1)	$ 2,500
TOTAL (36)	7,642

TABLE 5

CHANGE IN COST OF PRODUCT IN 1979
AS A RESULT OF CHANGES FROM PRE-1976 TAX PROVISIONS
BY TYPE OF BUSINESS ACTIVITY

	PERCENT CHANGE
SERVICES (4)	7.00%
TRANSPORTATION (2)	6.00%
CONSTRUCTION (3)	5.57%
MINING (1)	5.00%
FINANCE (2)	2.00%
MANUFACTURING (14)	1.45%
WHOLESALE TRADE (6)	1.17%
TOTAL (32)	2.91%

TABLE 6

CHANGE IN COST OF PRODUCT IN 1979
AS A RESULT OF CHANGES FROM PRE-1976 TAX PROVISIONS
BY LEVEL OF TAXATION

	PERCENT CHANGE
LOW-TAX COUNTRIES (14)	3.13%
MEDIUM-TAX COUNTRIES (3)	1.10%
HIGH-TAX COUNTRIES (8)	2.55%
ALL RESPONSES (32)	2.91%

(INCLUDING RESPONSES WITH NO DETERMINABLE COUNTRY)

TABLE 7

INCREASED EQUALIZATION COST IN 1979
AS A RESULT OF CHANGES FROM PRE-1976 TAX PROVISIONS
BY LEVEL OF TAXATION
(U.S. DOLLARS)

	TOTAL	NO. OF U.S. EMPLOYEES	PER EMPLOYEE
LOW-TAX COUNTRIES (66)	8,217,922	640	12,840
Switzerland (2)	600,000	17	35,294
Uruguay (1)	32,000	1	32,000
Argentina (9)	548,637	34	16,136
Panama (4)	100,685	7	14,384
Guatemala (1)	14,000	1	14,000
United Kingdom (20)	5,679,000	437	12,995
Venezuela (13)	651,000	59	11,034
Spain (1)	10,600	1	10,600
Japan (6)	126,500	13	9,731
Hong Kong (9)	455,500	70	6,507
MIDDLE-TAX COUNTRIES (8)	577,000	30	19,133
Singapore (3)	316,000	11	28,767
Costa Rica (2)	106,000	4	26,500
Taiwan (2)	115,000	5	23,000
HIGH-TAX COUNTRIES (29)	1,178,200	138	8,538
Thailand (2)	150,000	6	25,000
Belgium (1)	40,000	2	20,000
Dominican Republic (1)	40,000	10	4,000
Eucador (1)	15,000	1	15,000
Italy (3)	85,000	6	14,167
Phillipines (3)	413,000	3	13,000
Portugal (1)	13,000	1	13,000
Australia (6)	155,000	12	12,917
South Africa (1)	10,000	1	10,000
Colombia (5)	307,000	34	9,029
Korea (5)	345,900	68	5,087
Peru (1)	16,000	4	4,000
UNKNOWN (9)	637,697	70	9,110
·azil (24)	76,000	*	*
TOTAL (136)	10,686,819		
(excluding Brazil)	10,610,819	878	12,085

*The Brazilian response was aggregated by the Brazilian American Chamber of Commerce and we were unable to disaggregate the data. The Chamber indicated that all firms had not responded to the equalization question. Therefore, we do not know how many employees the equalization cost represents and could not compute a cost per employee.

TABLE 8

INCREASED EQUALIZATION COST IN 1979
AS A RESULT OF CHANGES FROM PRE-1976 TAX PROVISIONS
BY TYPE OF BUSINESS ACTIVITY
(U.S. DOLLARS)

	TOTAL	NO. OF U.S. EMPLOYEES	PER EMPLOYEES
Wholesale Trade (27)	1,515,185	72	21,044
Petroleum (8)	2,728,200	134	20,360
Manufacturing (35)	1,942,437	176	11,037
Finance (21)	849,497	91	9,335
Construction (7)	732,000	112	6,536
Transportation (6)	1,415,000	29	4,879
Other, Unclassifiable	59,000	13	4,538
Services (7)	23,000	8	2,875
TOTAL* (112)	10,610,819	878	12,085

*excluding Brazil

TABLE 9

NUMBER OF AMERICAN EMPLOYEES, 1976-1979
BY LEVEL OF TAXATION

	1976	1979	CHANGE	PERCENT
Low-Tax Countries (116)	768	860	92	12%
Middle-Tax Countries (12)	155	114	-41	-26%
High-Tax Countries (53)	434	382	-52	-12%
Unknown (9)	82	97	15	18%
TOTAL (190)	1439	1453	14	1%

TABLE 10

NUMBER OF AMERICAN EMPLOYEES, 1976-1979
BY REGION

	1976	1977	1978	1979	1976-1979	PERCENT CHANGE 1976-1979
Europe (45)	466	519	546	595	129	28%
United Kingdom (30)	416	470	498	551	135	32%
Switzerland (1)	14	11	17	16	2	14%
Italy (7)	8	10	8	8	0	0%
Portugal (1)	1	1	1	1	0	0%
Spain (3)	7	6	6	5	-2	-29%
Belgium (3)	20	21	16	14	-6	-30%
Latin America (84)	382	385	359	325	-57	-15%
Guatemala (1)	0	1	1	1	1	NA
Argentina (9)	9	14	23	24	15	167%
Uruguay (2)	14	17	15	19	5	36%
Venezuela (21)	53	77	77	69	16	30%
Mexico (6)	23	26	29	28	5	22%
Columbia (2)	11	8	9	11	0	0%
Costa Rica (3)	14	14	12	13	-1	-7%
Panama (11)	26	23	21	21	-5	-19%
Dominican Republic (1)	15	14	11	10	-5	-33%
Brazil (24)	196	173	146	118	-78	-40%
Peru (4)	21	18	15	11	-10	-48%
Asia Pacific (51)	507	418	379	435	-72	-14%
Hong Kong (7)	18	20	22	25	7	39%
Indonesia (2)	106	101	92	120	14	13%
Singapore (6)	15	15	11	14	-1	-7%
Australia (11)	81	70	67	68	-13	-16%
Phillipines (5)	56	36	33	46	-10	-18%
Thailand (4)	10	9	8	8	-2	-20%
Japan (7)	15	14	14	11	-4	-27%
Korea (7)	95	57	42	66	-29	-31%
Taiwan (2)	111	96	90	77	-34	-31%
Africa (1)	2	2	1	1	-1	-50%
South Africa 91)	2	2	1	1	-1	-50%
Unknown (9)	82	95	102	97	15	18%
TOTAL (190)	1439	1419	1387	1453	14	1%

TABLE 11

NUMBER OF AMERICAN EMPLOYEES, 1976-79
BY LEVEL OF PER CAPITA INCOME
IN HOST COUNTRY

	1976	1979	CHANGE	PERCENT CHANGE
LOW-INCOME COUNTRIES (74)	698	549	-149	-21%
MEDIUM-INCOME COUNTRIES (55)	113	147	34	30%
HIGH-INCOME COUNTRIES (52)	546	660	114	21%

TABLE 12

NUMBER OF AMERICAN EMPLOYEES, 1976-79
BY TYPE OF BUSINESS ACTIVITY

		1976	1979	CHANGE	PERCENT CHANGE
PETROLEUM	(10)	103	176	73	71%
SERVICES	(17)	390	375	15	40%
MINING	(1)	70	90	20	29%
MANUFACTURING	(55)	249	271	22	9%
FINANCE	(30)	166	169	3	2%
WHOLESALE TRADE	(33)	85	84	-1	-1%
CONSTRUCTION	(7)	129	112	-17	-13%
OTHER, UNCLASSIFIABLE	(34)	229	164	-65	-28%
TRANSPORTATION	(3)	18	12	-6	-33%
TOTAL	(190)	1439	1453	14	1%

TABLE 13

NUMBER OF AMERICAN EMPLOYEES, 1976-79
BY PER CAPITA INCOME & LEVEL OF TAXATION
OF HOST COUNTRY

	1976	1979	Change	Percent Change
Low Income Low Tax (38)	236	159	-77	-33%
Low Income Medium Tax (6)	140	100	-40	-29%
Low Income High Tax (30)	322	290	-32	-10%
Medium Income Low Tax (40)	87	123	36	41%
Medium Income Medium Tax (6)	15	14	-1	-7%
Medium Income High Tax (9)	11	10	-1	-9%
High Income Low Tax (9)	445	478	33	30%
High Income Medium Tax (0)	-	-	-	-
High Income High Tax (14)	101	82	-19	-19%

TABLE 14

VALUE OF EXPORTS BOUGHT OR SOLD, 1976-79
BY PER CAPITA INCOME & LEVEL OF TAXATION
OF HOST COUNTRY
(Millions of Dollars)

	1976	1979	Change	Percent Change
Low Income Low Tax (37)	177.1	182.26	5.16	2.9%
Low Income Medium Tax (7)	51.78	87.34	35.56	65.5%
Low Income High Tax (26)	1183.53	2225.4	1041.87	88.0%
Medium Income Low Tax (34)	243.34	470.9	227.56	93.5%
Medium Income Medium Tax (4)	27.19	53.63	26.44	97.2%
Medium Income High Tax (8)	61.75	85.94	24.19	39.2%
High Income Low Tax (16)	357.55	473.86	116.31	32.5%
High Income Medium Tax (0)	-	-	-	-
High Income High Tax (8)	70.18	94.18	24.0	34.2%

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TABLE 15

VALUE OF EXPORTS BOUGHT OR SOLD, 1976-79
BY LEVEL OF TAXATION
OF HOST COUNTRY
(Millions of Dollars)

	1976	1979	CHANGE	PERCENT CHANGE Ajusted	PERCENT CHANGE Adj. for Inflation
LOW-TAX COUNTRIES (87)	777.99	1127.02	349.03	45%	14%
Argentina (7)	44.66	118.86	74.20	166%	110%
Spain (4)	2.27	6.03	3.76	166%	110%
Uruguay (3)	.41	.91	.50	122%	76%
Hong Kong (6)	8.78	18.94	10.16	116%	69%
Venezuela (17)	187.63	327.07	139.44	74%	38%
Panama (8)	27.69	40.65	12.96	47%	16%
Switzerland (3)	139.40	194.31	54.91	39%	10%
Japan (5)	33.38	45.78	12.40	37%	8%
United Kingdom (8)	184.77	233.77	49.00	27%	0%
Brazil (24)	147.00	140.00	-7.00	-5%	-25%
Guatemala (2)	2.00	.70	-1.30	-65%	-72%
MEDIUM-TAX COUNTRIES (11)	78.97	140.97	62.00	79%	41%
Singapore (4)	27.19	53.63	26.44	97%	56%
Taiwan (2)	30.34	56.53	26.19	86%	47%
Costa Rica (5)	21.44	30.81	9.37	44%	14%
HIGH-TAX COUNTRIES (42)	1315.46	2405.52	1090.04	83%	44%
Colombia (4)	6.38	17.52	11.14	175%	117%
Phillipines (3)	.22	.52	.30	136%	86%
Belgium (1)	2.80	6.56	3.76	134%	85%
Mexico (6)	16.35	32.89	16.54	101%	59%
Korea (5)	1135.12	2146.62	1011.50	89%	49%
Italy (6)	46.23	76.91	30.68	66%	31%
Indonesia (2)	6.55	9.90	3.35	51%	19%
Australia (7)	67.38	87.62	20.24	30%	3%
Thailand (2)	.77	.97	.20	26%	0%
Ecuador (1)	2.50	2.50	.00	0%	-21%
Portugal (1)	1.00	1.00	.00	0%	-21%
Peru (3)	15.64	14.48	-1.16	-7%	-27%
South Africa (1)	14.52	8.03	-6.49	-45%	-56%
UNKNOWN (9)	44.71	70.90	26.19	59%	25%
TOTAL (149)	2217.13	3744.41	1527.28	69%	33%

TABLE 16

VALUE OF EXPORTS BOUGHT OR SOLD, 1978-79
BY LEVEL OF TAXATION
OF HOST COUNTRY
(Millions of Dollars)

	1978	1979	CHANGE	PERCENT CHANGE	
				Adjusted	Adj. for Inflation
LOW-TAX COUNTRIES (80)	1007.64	1128.47	120.83	12%	-1%
Spain (4)	4.16	6.03	1.87	45%	28%
Argentina (7)	84.86	118.86	34.00	40%	24%
Hong Kong (6)	14.10	18.94	4.84	34%	18%
Switzerland (3)	152.02	194.31	42.29	28%	13%
Japan (5)	36.40	45.78	9.38	26%	11%
Panama (8)	36.67	40.65	3.98	11%	-2%
Brazil (24)	127.00	140.00	13.00	10%	-2%
United Kingdom (9)	213.02	234.47	21.45	10%	-2%
Uruguay (3)	.88	.91	.03	3%	-8%
Venezuela (18)	336.28	327.82	-8.46	-2%	-14%
Guatemala (2)	2.25	.70	-1.55	-699%	-73%
MEDIUM-TAX COUNTRIES (14)	133.80	175.37	41.57	31%	16%
Singapore (7)	51.62	88.03	36.41	71%	51%
Taiwan (2)	49.80	56.53	6.73	14%	14%
Costa Rica (5)	32.38	30.81	-1.57	-5%	-16%
HIGH-TAX COUNTRIES (46)	1987.95	2421.21	433.26	22%	-8%
Chile (2)	2.41	11.09	8.68	360%	308%
Peru (3)	8.51	14.48	5.97	70%	51%
Phillipines (4)	.66	1.12	.46	70%	50%
Mexico (6)	25.21	32.89	7.68	30%	16%
Korea (6)	1744.17	2150.62	406.45	23%	9%
Belgium (1)	5.60	6.56	.96	17%	4%
Indonesia (2)	8.60	9.90	1.30	15%	2%
Australia (7)	79.84	87.62	7.78	10%	-3%
Thailand (2)	.92	.97	.05	5%	-8%
Ecuador (1)	2.50	2.50	0.00	0%	-12%
Portugal (1)	1.00	1.00	0.00	0%	-11%
Italy (6)	78.27	76.91	-1.36	-2%	-13%
Columbia (4)	19.10	17.52	-1.58	-8%	-19%
South Africa (1)	11.16	8.03	-3.13	-28%	-36%
UNKNOWN (9)	60.23	70.90	10.67	18%	4%
TOTAL (149)	3189.62	3795.95	606.33	19%	5%

TABLE 17

VALUE OF EXPORTS BOUGHT OR SOLD, 1976-79
BY LEVEL OF PER CAPITA INCOME
OF HOST COUNTRY
MILLIONS OF U.S. DOLLARS

	1976	1979	CHANGE	PERCENT CHANGE
LOW-INCOME COUNTRIES (70)	1412.41	2495.00	1082.59	77%
MEDIUM-INCOME COUNTRIES (46)	332.28	610.47	278.19	84%
HIGH-INCOME COUNTRIES (24)	427.74	568.04	140.30	33%
UNKNOWN (9)	44.71	70.90	26.19	59%
TOTAL (149)	2217.14	3744.41	1527.27	69%

TABLE 18

VALUE OF EXPORTS BOUGHT OR SOLD, 1976-79
BY TYPE OF BUSINESS ACTIVITY
MILLIONS OF U.S. DOLLARS

	1976	1979	CHANGE	PERCENT CHANGE
PETROLEUM (9)	17.96	45.40	27.44	153%
MINING (1)	.30	.80	.50	167%
TRANSPORTATION (1)	35.00	80.80	45.80	131%
SERVICES (8)	2.93	6.70	3.77	129%
CONSTRUCTION (3)	1110.23	2110.50	1000.28	90%
MANUFACTURING (49)	457.47	734.84	277.37	61%
WHOLESALE TRADE (40)	415.65	574.37	158.72	38%
FINANCE (5)	9.01	11.03	2.02	22%
OTHER, UNCLASSIFIABLE (33)	168.60	179.98	11.38	7%
TOTAL (149)	2217.14	3744.41	1527.27	69%

TABLE 19

LOST BUSINESS DUE TO INCREASED TAXES
ON U.S. WORKERS OVERSEAS
(MILLIONS OF DOLLARS)

	Lost Business Due To Increased Cost		Lost Business Due To Fewer U.S. Employees	
	AMOUNT	NUMBER OF COMPANIES	AMOUNT	NUMBER OF COMPANIES
1976	0	0	2.2	2
1977	0	0	3.25	2
1978	2	1	3.3	2
1979	2.9	6	249.1	18

TABLE 20

EXPECTED CHANGE IN EXPORTS
DUE TO HYPOTHETICAL 20% REPLACEMENT
OF U.S. WORKERS OVERSEAS

	AVERAGE PERCENT DECLINE
TRANSPORTATION (3)	30%
FINANCE (6)	22%
OTHER, UNCLASSIFIBLE (3)	17%
WHOLESALE TRADE (21)	15%
MANUFACTURING (31)	12%
PETROLEUM (9)	9%
SERVICES (6)	6%
CONSTRUCTION (2)	5%
MINING (2)	0%
TOTAL (75)	13%

TABLE 21

NUMBER OF FIRMS RESPONDING
THAT THEY EMPLOYED NO AMERICANS

	No Americans	Employed Americans	Total Responses	Percent with No Americans
Belgium	1	3	4	25%
Italy	15	10	25	60%
Phillipines	1	8	9	11%
Spain	1	5	6	17%
United Kingdom	11	52	63	17%
TOTAL	29	78	107	27%
for all responses	29	274	303	10%

TESTIMONY PRESENTED BEFORE

THE SENATE FINANCE COMMITTEE

April 24, 1981

Stephen Van Dyke Baer, Director

Of International Compensation

Research And Development

Organization Resources Counselors, Inc.

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The Changing Pattern Of US

Expatriates Abroad. - A

Summary of Results From

ORC's Periodic Surveys of

Personnel Practices And Compensation

For Expatriate Employees

Summary of Findings

- As a percent of all expatriates employed by U.S. multinational corporations, U.S. expatriates comprised 84 percent of the total in 1972, 73 percent in 1976 66 percent in 1979 and 37 percent in 1980.

- In terms of host locations for U.S. expatriates employed by U.S. multinational corporations abroad in 1972, 50 percent were in Europe, 2 percent in the Middle East and 47 percent in other areas of the world.

- By 1980 that distribution had shifted to 25 percent in Europe, 40 percent in the Middle East and 35 percent in all other areas.

- Of the substantial increase in the American presence in the Middle East, the great bulk has been concentrated in Saudi Arabia. In 1972 U.S. expatriates in Saudia Arabia accounted for 67 percent of the total expatriate work force. But in 1980 U.S. expatriates accounted for only 24 percent of that expatriate work force.

- Non-American expatriates employed in Saudia Arabia as a percent of total has grown from 33 percent in 1972 to 76 percent in 1980.

- In terms of the number of U.S. expatriates, the survey, completed by more than 300 U.S. corporations indicated that in 1979 those companies employed 36,756 Americans offshore. In 1980 that number had decreased to 22,580, a net reduction of 14,176 representing, a 39 percent decline.

April 24, 1981

TEXT OF STATEMENT

Organization Resources Counselors, Inc. (ORC) wishes to thank the Senate Finance Committee for its invitation to provide background information that the Committee might wish to use in carrying out its deliberations with regard to reconsideration of U.S. Tax Policy as it may affect U.S. citizens working abroad.

The information provided in the body of this statement has been summarized from ORC's Survey of Personnel Practices and Compensation for Expatriate Employees. The survey is completed by responsible officials of cooperating ORC multinational client corporations and to the best of our knowledge reflects an accurate accounting of each company's practices.

ORC has been conducting such surveys since 1948, initially at two year intervals but more recently on an annual basis. The data summarized are those for the years 1972, 1976, 1979, 1980 which were provided by 192, 257, 305, 306 companies in those respective years.

The increase in sample size since 1972 is a consequence of ORC's market growth in the provision of International Services. Today in excess of 800 U.S. firms use ORC as a source of

place-to-place cost of living indexes and housing measures; counsel on a broad spectrum of employee relations issues and for the conduct and coordination of seminars and meeting groups.

The U.S. Federal Tax Regulations obtaining with reference to U.S. citizens employed offshore are but one of many factors affecting the level and geographic distribution of that employment.

Decision makers must also recognize that changes in markets, availability of natural resources, relative costs of production, the vigor with which and public policy under which non-U.S. firms compete in the market place may also affect the level and locational distribution of the U.S. expatriate population.

In undertaking its deliberations the Committee would seem well advised to consider issues such as the tax revenue impact, employment effects and balance of payments effects which might be associated with tax policy options.

In the eight years from 1972 to 1980 as the tables below demonstrate, there have been dramatic shifts in both the numbers of Americans employed offshore and their offshore employment locations. Levels have substantially diminished and the locational distribution has shifted emphatically to the Middle East from Europe.

It is a popular contention that a high level of American presence abroad are positively related to high levels of domestic employment, increases in the U.S. share of international trade, potential increases in U.S. tax revenue, increased opportunities for new business and the like. Should this be true it would seem logical that reductions in such presence would have an adverse effect on the U.S. economy.

It is not within the purview of this statement to support or refute this contention, rather its intent is only to provide the Committee with information ORC has assembled on the current and historical levels and locational distribution of employees of U.S. corporations working offshore.

TABLE I

Summary of U.S. Multinational Expatriate Employment Statistics n)

ITEM	SURVEY YEAR			
	1972	1976	1979	1980
Companies Participating	192	257	305	306
U.S. Expatriates	NA	28,679	36,756	22,580
Other Expatriates	NA	10,597	19,240	38,091
Total Expatriates	NA	39,276	55,996	60,681
U.S. expatriates as a percent of total	84.0	73.0	65.6	37.2
Expatriates of Other Nationalities as a percent of total	16.0	27.0	34.4	62.8

n) Survey of Personnel Practices and Compensation for Expatriates - selected years. ORC, Inc. 1211 Avenue of the Americas, New York, New York 10036

TABLE II

Work Locations of U.S. Expatriates

LOCATIONS	SURVEY YEAR		
	1972	1976	1980
Europe	50%	23%	25%
Middle East	2	23	40
Other Areas	48	54	35

TABLE III

Saudi Arabia			
	Percent Distribution of All Expatriates Present		
ITEM	SURVEY YEAR		
	1922	1976	1980
U.S. Expatriates	67%	44%	24%
All Other	33	56	76

TABLE IV

Work Locations for Expatriates other than Americans
1980

LOCATION	PERCENT
Saudi Arabia	64
Other Middle East	3
Europe	7
All Other	26

TABLE V

Country of Origin of Non-American
Expatriates in the Middle East
1980

COUNTRY OF ORIGIN	PERCENT OF TOTAL
UK	30
Philippines	21
Pakistan	11
Thailand	10
India	9
Canada	2
Other Countries	17

80-612 O—81——10

Notes to Tables

The sample universe of companies is drawn each year from the ORC, Inc. International Services client base. Of the 800 plus companies contacted in 1979 and 1980 more than 300 cooperated in each year.

No attempt was made to ratio estimate or "weight" the sample returns to the sample universe primarily because no employment control totals were available. ORC is willing to supply the Committee with a list of cooperating companies and a copy of the 1979 and 1980 survey collection documents, if it so requests. It will not however be possible to disclose the individual company data reports since ORC believes that to do so would constitute a breach of client confidentiality.

SVB/glg

Senator CHAFEE. Thank you, Doctor. I appreciate your testimony. This is helpful and we have this from Mr. Baer too.

All right, now a panel of Mr. Gore, Mr. Brown, Mr. Niemi, Mr. Angarola, and Dr. Crawley.

Now, gentlemen, again, I will have to—much of this is indeed, repetitive, so please summarize your statements to the greatest extent possible.

Why don't we take it in the order here. Mr. Gore. Now, are we missing somebody?

Mr. DUBOS. Mr. Chairman, there has been a substitution. We notified the committee within 48 hours. I am representing Mr. Gore. My name is Thomas DuBos.

Senator CHAFEE. All right, now, Mr. DuBos. Now is Mr. Brown here?

Mr. DUBOS. He is, yes.

Senator CHAFEE. Mr. Niemi.

Mr. NIEMI. Right here, sir.

Senator CHAFEE. Mr. Angarola and I guess Dr. Crawley is missing. OK, gentlemen, Mr. DuBos.

STATEMENT OF THOMAS DuBOS, THE NATIONAL FOREIGN TRADE COUNCIL

Mr. DUBOS. Thank you, Mr. Chairman, I am a representing the National Foreign Trade Council. I am member of their tax committee. The National Foreign Trade Council is a nonprofit organization consisting of a cross-section of 600 U.S. companies with highly diversified interests engaged in all aspects of international trade and investment.

I am pleased to appear, today, on the four bills before this subcommittee. The NFTC is delighted with the interest shown to liberalize the existing rules set forth in sections 911 and 913 of the Internal Revenue Code relating to the taxation of foreign earned income of Americans overseas.

All of these bills, Mr. Chairman, represent a substantial improvement over the existing law. A full statement has been submitted for the committee. Our remarks, orally, will be very brief.

The National Foreign Trade Council endorses Senate Bill 598, introduced by Senator Jepsen, as being the most effective in eliminating the competitive disadvantage imposed on U.S. businesses by the present tax laws.

All of the other bills before this subcommittee, would continue the costly pyramiding and the costly and complex compliance burden.

Senator CHAFEE. What would you want for residency? Mr. Jepsen's bill, as I understand, is 17 out of the 18 months. Are you willing to go with that?

Mr. DUBOS. We could go with that Senator. We think the 11 out of 12 is a better test.

Senator CHAFEE. All right.

Mr. DUBOS. Many U.S. companies have been forced to replace U.S. citizens abroad with foreign nationals. This causes a transfer of technology and know-how to these foreign nationals, which leads to a reduction in U.S. exports.

Prior studies have been cited, this morning, the Chase Econometrics, the President's Export Council report of last December and the GAO report, which was mentioned this morning.

The Foreign Earned Income Act of 1978 has failed to meet the objectives which was intended by Congress. The equity that was sought, has not been achieved. The simplification which was the general goal, has not been achieved. Liberalization of the rules for taxation of U.S. citizens working abroad is essential to enhance the competitiveness of U.S. international business and to create more export-related jobs at home and improve our balance of payments.

Thank you, Mr. Chairman.

Senator CHAFEE. What do you say about Mr. Chapoton's proposal that you would, indeed, exempt all income, earned income, beyond what would be the person's salary at home?

Mr. DuBos. I think, Senator, since the relationship of this thrust is to improve exports, there is no need for the threshold. That is why we favor Senator Jepsen's bill.

Senator CHAFEE. Well, Mr. Chapoton does represent the Treasury and obviously the support of the Treasury is always a help in getting this legislation passed.

Mr. DuBos. Indeed, it is.

Senator CHAFEE. What would it do to employment of Americans abroad. The American would go abroad, he wouldn't be any worse off. He'd be just as well off, financially, presumably. Would he or wouldn't he?

Mr. DuBos. It is presumable, I think, Senator. All of the conditions, when you take living in areas of hardship, the Middle East, certain hardship areas, the money is just not going to compensate the individual for living and his services abroad.

Senator CHAFEE. Well, then Mr. Chapoton says they would be willing to recognize that. The additional bonus for going abroad would be tax free, as well as the cost of living. Let's take a man at $50,000 and so they say we will pay you $75,000 and in addition we will pay all the costs of living. Now, the person is getting an extra $25,000 and the $25,000 under Mr. Chapoton's example would be tax free.

Mr. DuBos. Yes, sir.

Senator CHAFEE. What about that?

Mr. DuBos. Well, we are delighted with the Treasury's change in thinking. I think, however, it continues to impose some of the compliance complexities which we will hear from another panel dealing with the public accounting firms.

We feel that now is the time to include the export related position and go all the way.

Senator CHAFEE. Also, I suppose, one of the answers would be that it increased the cost of the companies sending them and reduces their competitiveness.

Mr. DuBos. Exactly.

Senator CHAFEE. All right, Mr. Brown. Thank you, Mr. DuBos.

Mr. DuBos. Thank you, sir.

STATEMENT OF BEN JARRATT BROWN, U.S. AND OVERSEAS TAX FAIRNESS COMMITTEE

Mr. BROWN. Mr. Chairman, I am Ben Jarratt Brown. I am with the U.S. and Overseas Tax Fairness Committee. The views I express, today, also reflect those of the American constituency overseas and the Association for the Advancement of International Education.

For the first time in memory, the TFC, a fountain of statistics on this subject, will be extremely brief and nonstatistical in its comments. I will truncate my remarks even further, at this point.

I would like to say for the record, that the problem, quite simply put, is this: Current U.S. tax practices mean fewer Americans overseas. Fewer Americans overseas mean less business for American firms and fewer jobs at home. Less business for American firms means lower business revenues and therefore, lower tax revenue on corporate payroll and profit accounts.

The points are obvious and you have seen many data, and today will see more that back the points. I do not propose to get any further into data, but I think a point should be made that has not yet been made.

Without minimizing the importance of the data being presented today, I want to point out that there are many intangible benefits to an American presence overseas. If they could somehow be measured and statistically tabulated, as is the current custom, the benefits would far exceed any quantifiable values we are discussing today.

The more Americans we have overseas establishing commercial, cultural, and social bonds, the less the likelihood of misunderstandings and the greater the prospect of international security. We know that to be a fact, but we can't prove it with numbers.

I am reminded, however, that the Federalists Papers, the foundation of thought and wisdom and reason, upon which our still wonderful Nation rests, do not rely on data and statistical methodology, but on the sheer power of human reason guided by the weight of human experience. That, in the final analysis, is what is needed now.

We applaud the new directions set out by the President and under debate in the Senate and the House to restore our Nation's economic vitality. What we propose is in that spirit. It is our view, that for many reasons, Americans must be able to work overseas. They must, at least, have the same tax standing as citizens from competing nations.

We believe that any new tax remedy must be: (1) simple, (2) complete, (3) lasting, that is, not subject to attrition by inflation, and (4) absolutely effective.

It should not invite a new round of restrictive regulation writing at the Treasury Department. It should announce to all business, large and small, here at home and to our friends abroad, that we mean to come alive again in the global market.

There is an old axiom that you don't tax the farmer until the crops are harvested. In this case, we are trying to tax the farmer before the crops are even planted.

The ideal solution is complete elimination of U.S. taxes on income abroad with perhaps, a nonceiling safeguard against slight risks of abuse.

That requires no fundamental change in the historic tax policy. That solution will yield a boundless harvest in business, in jobs and in tax revenues.

Senator CHAFEE. Are you talking earned income?

Mr. BROWN. I am talking earned income, yes, sir. Thank you.

Senator CHAFEE. So, you'd be for the total exemption. Is that right?

Mr. BROWN. Yes, sir, it is.

Senator CHAFEE. What about residency?

Mr. BROWN. We would go for, I think, an 11 out of 12 months, which would be an adequate test.

Senator CHAFEE. Is anybody suggesting a lower residency than 11 out of 12?

Mr. BROWN. Not that I am aware of. I don't think it is realistic.

Senator CHAFEE. What about the workers on the oil rigs? They wouldn't thus be covered.

Mr. BROWN. That is a special case and frankly, we don't deal with that.

Senator CHAFEE. All right, Mr. Niemi.

STATEMENT OF DONALD R. NIEMI, ISSUES ANALYSIS MANAGER, CATERPILLAR TRACTOR CO., REPRESENTING THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. NIEMI. Mr. Chairman, I am Don Niemi representing the Emergency Committee for American Trade or ECAT, in support of legislation to reduce or eliminate the U.S. income tax burden on income earned overseas by American citizens.

ECAT is an organization of the leaders of 63 large U.S. business firms with extensive overseas business interests. Its member companies had 1980 worldwide sales of close to $600 billion and employed over 5 million people.

I am also issues analysis manager for Caterpillar Tractor Company and will draw on Caterpillar's experience with respect to this issue.

ECAT member companies are concerned about the way current tax treatment of income earned overseas by American citizens hurts U.S. exports.

There are two reasons for concern. One is the high cost of sending Americans abroad, which can lead to contract losses by making U.S. bids uncompetitive.

Caterpillar's tax equalization program cost about $12 million in 1979, most of that attributable to U.S. taxation of overseas earned income. Tax equalization payments cost 80 percent of the average Caterpillar foreign service employee's base salary in 1979 compared with 15 percent of base salary back in 1972.

Senator CHAFEE. Now, Mr. Niemi, I think, be sure and highlight this because I am going to have to cut you off in exactly 5 minutes.

Mr. NIEMI. I plan to, sir.

The other reason for concern is the impact on a broad range of U.S. exports when Americans abroad are replaced by citizens of other countries. We are pleased, therefore, to note the congressional

interest in this problem. Any of the four bills under consideration, today, would represent an improvement over the current law and we in ECAT welcome these bills and express our appreciation for them.

Which is the best bill? I'd like to address that question in the context of factors we believe the subcommittee should consider.

Point No. 1 is that we need to take into account the tax policies of countries with which we compete. With some limited qualifications, other industrial countries exclude foreign personal income from taxation. We think the closer we come to doing the same, the better, and S. 598 provides for total exclusion.

S. 408 and S. 436 establish an exclusion that we thought, until quite recently, would be adequate. In November of 1978, the average Caterpillar foreign service employee had a base salary in the mid to upper thirties. By January of 1981 that average base salary had risen, because of inflation, to over $50,000. The average total cost per employee, taking in foreign service incentive premium and make-whole payments is now approximately three times that amount, or $150,000.

Senator CHAFEE. Well, now explain that, will you? What are you saying that in order to get the person to go overseas that is what the incentive payment is you are describing or in addition to that you have so-called make-whole payments? Is that right?

Mr. NIEMI. Well, there is a person's base salary and then he gets an incentive payment to induce him to go overseas and then there are cost-of-living payments, housing allowances, educational allowances, et cetera. If you add all of those up, the base salary, plus incentives, plus make-whole allowances, it all comes to about a three times base salary, or about $150,000 right now for the average worker.

Senator CHAFEE. Well, what would you do? Let's say you have the same person and now you're saying if his salary was $50,000 at home, it would cost you $150,000 to put him abroad.

Mr. NIEMI. Right.

Senator CHAFEE. Now, let's say that his salary is $50,000 at home and the first $50,000 was tax exempt. Now, what would you have to pay him?

Mr. NIEMI. The first $50,000 is tax exempt. Well, there would be an incentive premium. You would be paying all of his various allowances. Those would be taxable income.

Senator CHAFEE. Well, the housing wouldn't be under the bill I had. The housing, the first $5,000 or something, would be taxable. Any housing above that would be nontaxable.

Mr. NIEMI. Right. But, we are talking about our average employee, today, Senator. Looking at what has happened with inflation in the last several years and anticipating the possibility of that increasing even more, we see that within a few years we'd be back in a difficult situation.

Senator CHAFEE. Here's my worry. Going to an unlimited amount, is the problem that some lawyer, smart lawyer or accountant, would come up with a system whereby we would have a flagrant example that would bring down the whole system like it has been brought down in the past. We just want to avoid that.

I feel that, I am very nervous about going to an unlimited amount.

Mr. NIEMI. Well, we recognize this danger. Of course, that is how we got a ceiling in the first place back in the 1960's. There may have to be some kind of restrictions to correct abuse situations.

Senator CHAFEE. You are not suggesting anything on unearned income?

Mr. NIEMI. No.

Senator CHAFEE. All right. Well, thank you, Mr. Niemi. Mr. Angarola.

Mr. ANGAROLA. Thank you, Senator Chafee.

STATEMENT OF MR. ROBERT T. ANGAROLA, AMERICAN CITIZENS ABROAD

Mr. ANGAROLA. I represent American Citizens Abroad, a nonprofit group which we believe represents the typical American living overseas. These are people such as school teachers, pensioners, small businessmen.

I think the various panelists and previous speakers have addressed the economic impact of driving Americans back home quite eloquently.

I would like to spend a little time on the idealogical and political costs that these moves have caused and the negative impact it has had.

Our tradition, as exemplified by tax policy before 1962, was to encourage Americans to live overseas. We encouraged direct competition with other ideologies in the foreign marketplace, the ideological marketplace.

By forcing these people back home and out of foreign countries, we are losing that battle. I think the movie star syndrome of the picture of the affluent American living on the shores of the Mediterannean has led to the unfortunate consequences we face today.

Our typical member is a school teacher struggling to survive in a very expensive European city teaching American or, perhaps more importantly, foreign students, or the small businessman trying to develop markets in West Africa.

We have to recognize that our tax policy affects these people much more dramatically and directly than it does the few people who actively avoided the just payment of taxes.

Senator CHAFEE. Didn't we take care of the school teacher last year in that legislation?

Mr. ANGAROLA. The statistics that we have are anecdotal. We don't have vast resources to research this directly. We have indications that people in developing countries in particular, are very severely affected by the tax policies.

The concept we would support in changing the policy, would be to go toward the residency based taxation, as every other country does. That, of course, would exempt earned income and "unearned" income. We are talking about pensions and annuities.

We would oppose any cap on the amount of income which would be exempted. Any cap would discourage the positioning of senior managers and entrepreneurs abroad, the people who hire Ameri-

can workers and order American goods. These are the very people we want to encourage to live overseas.

Any such cap would also make administration of the tax law much more complex. We would support a mechanism such as that described by Mr. Brown, which would allow scrutiny of obvious abuses by the IRS. Perhaps, put a limit of $200,000, $500,000 on people who exempt that much income, allow the IRS to look at those people more closely and to take action if it is warranted.

We would also oppose any legislation that differentiates among U.S. citizens on the basis of country of residence or function or profession.

We believe that the test of benefit to the United States should not rest only on exports, but that we should look at the ideological benefits that accrue from having Americans in foreign countries.

We believe that tax relief is necessary soon. This will result in benefits, not only to America, in terms of increased exports, but also in terms of sending the American message across the world.

Thank you.

Senator CHAFEE. Well, I think you are opening a whole new area here, that I think we'd have considerable trouble with, Mr. Angarola.

You're suggesting that the Americans, retirees, that go to Mexico, be exempted. They would be included.

Mr. ANGAROLA. They would be included.

Senator CHAFEE. I think that we have enough troubles selling this legislation. One of the fine arrows in our quiver is the increase in exports. We are talking strictly earned income as we understand it and to get into retirees, I think, would bog us down.

Mr. ANGAROLA. I would like to say that we support what Mr. Chapoton has said. That, in fact, perhaps now is the time for the Treasury Department to go back and look at the concept of residency base income taxation and to await their study.

In the meantime, we firmly support and totally concur with the analysis provided regarding exports. We would certainly support what has been said by the other panelists here.

Senator CHAFEE. Well, I want to echo that the views that have been expressed here and Mr. Brown, particularly, I think that you have the value of having Americans abroad, the sort of intangible value, is very precious.

Where do the people in our State Department come from that are linguistic experts? In many instances they are children of Americans who have lived abroad for many years, be they missionaries, or be they business persons.

For us to drastically reduce the numbers of Americans living abroad, raising their children abroad, I think it is harmful to our Nation for a host of other reasons than exports.

[The prepared statements of the preceding panel follow:]

SUMMARY

1. S.408, S.436, S.598 and S.867 would liberalize the existing rules relating to the taxation of foreign earned income of Americans overseas and would represent a substantial improvement over existing law.

2. The National Foreign Trade Council endorses S.598 which would eliminate the costly pyramiding as well as the costly and complex compliance burden. It would also bring U.S. law into line with international practice.

3. Many U.S. companies have been forced to replace U.S. citizens abroad with foreign nationals. This has caused a transfer of technology and know-how from U.S. citizens to foreign nationals and a reduction of U.S. exports.

4. The Foreign Earned Income Act of 1978 has failed to meet the objectives intended by Congress. It does not lead to equity between Americans working overseas and those working at home. Taxable income and tax liability of U.S. expatriates are frequently far in excess of what would have been incurred had the employee remained in the U.S.

5. Liberalization of the rules for taxation of expatriates is essential to enhance the competitiveness of U.S. international business and to create more export related jobs at home and improve our balance of payments.

April 22, 1981

My name is Thomas J. DuBos, and I am a member of the Tax Committee of the National Foreign Trade Council, a non-profit organization whose membership comprises a broad cross-section of over 600 U.S. companies with highly diversified interests engaged in all aspects of international trade and investment. The Council is pleased to submit comments on S.408 (Senator Chafee) S.436 (Senator Bentsen), S.598 (Senator Jepsen) and S.867 (Senator Moynihan). All of these bills would substantially liberalize the existing rules set forth in Sections 911 and 913 of the Internal Revenue Code relating to the taxation of foreign earned income of Americans overseas, and would, therefore, represent a substantial improvement over existing law. The Council believes that S.598 (Senator Jepsen) would be most effective in eliminating the competitive disadvantage imposed on U.S. business by the present tax laws. S.598 would exempt from taxation the earned income of citizens working outside the United States who meet the bona fide foreign residence or physical presence tests. That bill would eliminate the

costly pyramiding of tax discussed below as well as the costly and complex compliance burden currently imposed on U.S. expatriates. Other major industrial nations do not tax the foreign earned income of their citizens. S.598 would bring U.S. law into line with international practice. U.S. citizens would continue to pay income tax to the foreign country where they are employed, the same as citizens of other countries.

The U.S. first taxed foreign income to correct what was considered to be an abuse of the tax system by a few highly paid individuals. Through a succession of revenue acts, culminating in the Foreign Earned Income Act of 1978 (FEIA), the U.S. tax burden on citizens abroad became more burdensome and complex. Most U.S. corporations in order to attract U.S. citizens to work abroad, have found it essential to institute a tax equalization program which reimburses overseas employees for taxes attributable to their foreign employments. That tax reimbursement, as well as other allowances related to the foreign assignment, is included in the U.S. taxable income of the employee, thereby increasing his U.S. tax liability. Since that additional liability is reimbursed to the employee

by many firms under their tax equalization program, such firms are finding it prohibitive to keep U.S. expatriates abroad. To remain competitive, they have been forced to replace U.S. nationals with foreign citizens not subject to home country taxation. In addition, many U.S. contractors bidding on foreign projects have been losing bids to foreign based competitors because of the higher cost of using U.S. employees on foreign projects, largely attributable to the additional tax cost.

The President's Export Council, in its report "The Export Imperative", December 1980, points out that the replacement of U.S. citizens by foreigners abroad has resulted in a sharp loss of American business abroad. This loss of business to foreign competition reduces the number of U.S. jobs and increases our balance of payments deficit.

The Chase Econometrics study "Economic Impact of Changing Taxation of U.S. Workers Overseas" (published June 1980), reiterates and quantifies this conclusion. Some 80,000 jobs would be lost in 1980, and a drop of $12 billion in export dollars would be a likely result if U.S. exports diminish by 5%. The 5% reduction is not arbitrary. The Chase study states on page 27:

"The presence of Americans overseas helps generate export business. In response to GAO's 1977 survey, 88% of overseas affiliates of U.S. companies estimated that U.S. exports would decline by at least 5% if the 1976 legislation were implemented. In addition, a 1978 study by Treasury's Office of Tax Analysis projected that a decline of 10% in the number of overseas workers would result in a 5% decline in real exports. Many overseas Americans are involved in work which involves substantial procurements or the potential for large amounts of follow-on work. They also tend to be employed in highly skilled positions, thus involving the export of high value-added services rather than lower value-added commodities and products. The reduction in exports due to the tax changes is difficult to quantify with precision, but responses from hard-hit firms are indicative of the type of effects which have occurred and as a result of the Tax court decision and the 1978 legislation: ..."

Important new support is found for substantially liberalizing the Sections 911 and 913 provisions in the Report to the Congress by the Comptroller General of the United States entitled "American Employment Abroad Discouraged by U.S. Income Tax Laws" dated February 27, 1981. The Council endorses the findings and conclusions of that report. In particular, we endorse the conclusions of pages 15 and 16, which state:

> "The FEIA of 1978 falls far short of meeting the equity objective of the law as intended by the Congress. It does not, for the most part, lead to equity between Americans working overseas and those working at home. However, the firms we surveyed reimburse most of their employees for these extra taxes. The mechanics of the law are such that various deductions fail to fully relieve Americans of taxation on certain income reflecting excess costs of living overseas, most notably allowances associated with housing and the general cost of living. Furthermore, the FEIA does not even consider certain income reflecting other excess foreign living costs. The tax reimbursement

is by far the most significant item of additional income. It is given by a firm to compensate an employee for excess taxes, both U.S. and foreign, that are incurred as a result of overseas employment. This tax reimbursement may often amount to more than 30 percent of an individual's base salary.

The end result of the FEIA's failure to meet its equity objective is a taxable income and, hence, tax liability, often far in excess of what an individual would have incurred had he remained in the United States. Employees of large corporations generally receive tax reimbursements from their employers, but this in turn is taxed, adding to taxable income and tax liability.

Not all firms provide tax reimbursements, however. Employees of such firms, as well as self-employed individuals, must reevaluate their decisions to continue working overseas.

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. Consequently, many firms provide expensive tax preparation services to such employees. Employees of firms that do not provide such services and self-employed individuals must incur substantial added costs."

We believe that a liberalization of the rules for taxation of expatriates is essential to enhance the competitiveness of U.S. international business and every effort should be made to improve the foreign business of American firms in order to create more export-related jobs at home and improve our balance of payments. When American firms replace U.S. citizens abroad with foreign nationals as they have been forced to do because of U.S. tax laws, those U.S. firms are exporting U.S. technology and know-how when they train the foreign replacements. They are also replacing a potential purchaser of U.S. goods and services with a potential purchaser of foreign goods and services. Putting our technology and purchasing power in the hands of foreign nationals has adversely affected U.S. technological advancement. When exports are reduced there are fewer sales to support costly Research and Development, and there are fewer trained

Americans on which technological and know-how advancement is built. The Council strongly objects to provisions such as those contained in H.R. 5829, reported by the Senate Finance Committee in 1980. That bill limited the liberalized benefits of H.R. 5829 to individuals working in developing countries and individuals performing export related or charitable services. Those restrictions would be discriminatory, unnecessary, and would interfere with the optimum utilization of personnel in the multinational enterprise. They would severely retard the objectives of encouraging exports and improving our competitive position in the international marketplace. In addition, many problems would arise in determining whether a particular job qualified for liberalized benefits, and a substantial amount of time of both government and industry employees would be spent on regulations and particular situations with little revenue impact.

We recommend that the Congress act at the earliest possible time to liberalize Sections 911 and 913 to eliminate the disadvantage currently faced by American business.

U.S. & OVERSEAS TAX FAIRNESS COMMITTEE, INC.
STATEMENT FOR THE RECORD
THE UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

April 24, 1981

JOBS AT HOME, JOBS ABROAD MORE BUSINESS, MORE REVENUES

SUMMARY

This statement documents in full detail and with extensive data and citations the following points:

1. Current U.S. tax practices mean fewer Americans overseas.

2. Fewer Americans overseas mean less business for American firms and fewer jobs at home.

3. Less business for American firms means lower business revenues and, therefore, lower tax revenues on corporate payroll and profit accounts.

This statement points out that no other nation taxes incomes earned by its citizens at work in foreign countries; and it makes the case that Americans can only be competitive and maintain their share of international markets if they are placed on the same tax footing as those with whom they must compete overseas.

The Tax Fairness Committee calls for total exclusion of income earned by Americans overseas from U.S. taxes with no ceiling or cap but with an adequate non-ceiling, non-cap provision to avoid the few instances were some abuses might otherwise be possible.

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MORE BUSINESS, MORE
REVENUES

Mr. Chairman and Members of the Committee:

This statement is submitted on behalf of the U.S. & Overseas Tax Fairness Committee, Inc. Among our members are more than sixty of the larger U.S. companies that export U.S. goods and services.

Our constituency, though, goes well beyond that.

Through our work with other groups with like interests, we can speak with authority to the concerns of most Americans whose prosperity and security depend on our nation's commerce with other nations.

That's a large constituency: Few Americans think of their jobs as tied to sales to foreign countries. But we know, by the most conservative estimates, that at least 10 million American jobs in this country and abroad are tied indirectly to exports.

That constituency is threatened.

It's threatened by national policies that discourage and often penalize trade abroad. It's threatened by national policies that make us less able to compete overseas. It's threatened by national policies that limit our presence in foreign markets.

The blunt truth is that we've created a vast, uncoordinated mixture of competing, often contradictory and self-cancelling objectives and policies -- notably tax policies -- laws and regulations that are clogging our vital arteries of trade with other nations. American exports today are subject to controls and restraints imposed by at least five federal departments and over eighty different agencies.

In contrast, our trading partners among the industrial nations have moved into the global markets with no such inhibitions, or at least very few.

We've lost, or are rapidly losing, our competitive edge overseas.

We can look to current U.S. tax practices for much of the blame.

Our purpose today is to make one basic point. And the point is this: No policy has proved to be more of a disincentive to exports -- more destructive of our nation's export interests -- than the policy of taxing Americans at work overseas.

We need to change that policy.

And let us stress this fact at the outset: The changes we'll propose, though they call for the virtual elimination of taxes on overseas Americans, will generate -- not cost -- revenues for our national treasuries.

We're proposing changes that will produce new tax revenues. There will be no real net revenue loss or cost.

As matters now stand, the practice of taxing Americans at work overseas is strangling us in overseas markets. The result is a highly potent disincentive that is:

- Cutting into our nation's economic growth and efficiency.
- Adding to our nation's unemployment.
- Reducing our nation's tax revenues and increasing taxpayer expenses.
- Producing greater imbalances in our national budget and in both our trade and payments accounts.
- Devaluing our currency and destabilizing the world monetary system.
- And, undermining our international prestige and influence.

The fact is, when you add taxes you add to our costs. If you impose taxes on our exports that other nations do not impose on theirs, our costs will tend to be greater. If our costs are greater we will not be competitive in the sale of goods and services of like quality or calibre.

This point we stress: Any tax that hikes the price of our goods and services above the price of the goods and services offered by other nations is effectively a tariff. If other nations do not import what we offer for export because of the tax premium we add to our price, we're talking about a tariff pure and simple. The fact that it originates in our own tax policies does not alter the effect on us.

How many other nations apply a tariff against the sale of their own goods and services? None.

We can't compete with that kind of burden.

Consider:

- Because we've failed to remain competitive in recent years, our share of world markets, which stood at close to 24% at the start of the decade, now stands at less than 14% and is dropping fast.

- Because we've not done enough to make markets for our exports -- because our policies have actually discouraged it -- we've accumulated trade deficits in excess of $150 billion since 1976.

Think about it: If our export policy -- aided by realistic tax practices -- had been to do whatever had to be done to keep our share of overseas markets:

- We'd have a much healthier, more efficient and productive economy.

- Unemployment would probably be about half what it is today.

- Our dollars would buy more both at home and abroad because our dollar would be stronger and inflation would be weaker.

- We'd be taking more tax revenues into our treasury and we'd be taking less out of our treasury for welfare and other expenses.

Gentlemen, what we're saying is that this country must increase its exports. We have no choice. Our country needs the business and our people need the jobs.

The question is, "How do we do it?"

We will focus on part of the answer -- on what we of the Tax Fairness Committee propose.

Our position is this:

Our national policy must be to encourage a very substantial increase in the presence of Americans in foreign markets.

Current U.S. tax laws run directly counter to such a policy. The unvarnished facts are these:

- Only Americans are taxed on incomes earned abroad.

- No other nation taxes the incomes earned by its citizens employed in foreign markets.

From those two facts flow a series of consequences that boil down to this:

- Fewer Americans in overseas markets.

- Fewer American exports.

In case after case what we've found is this: Because of the tax premium on Americans it often costs twice as much or more to employ an American overseas as it does to employ anyone else.

For example, Gilbert/Commonwealth International found in an actual case that it would have to pay an American in middle management $62,500 for that person to take home 27,480. If the firm hired a West German the firm would only have to pay $36,700 for the person to take home $29,244 (after payment of taxes to the host country only).

Since Americans cost more to employ overseas than anyone else, the overseas employment of Americans adds to the costs of doing business overseas.

Consider:

- An unmarried American working in Saudi Arabia at a base salary of $30,000 can face U.S. taxes of $35,444.

- A married American with two children and a base salary of $40,000 in Hong Kong can face a U.S. tax bite of $31,238.

Under current U.S. tax law, Americans are taxed not only on their base salaries but also on a host of cost differential allowances. As a result of tax revisions in 1978 they are not now taxed on all such allowances. But they are taxed on enough of the so-called "keep whole" allowances that the tax bite on imputed earnings may exceed actual earnings or real income.

Those added tax costs apply only to Americans. An employer does not have to take those tax costs into account in offering the same job at the same base salary to anyone other than an American.

No one else is subject to them or anything like them.

If the employer wanted to hire 100 Americans on single status on a base salary of $30,000 for a project in Saudi Arabia, his added costs of doing business, due solely to the costs of providing tax equalization for those Americans, would be more than $3.5 million. That's $3.5 million in business costs that favor the competition which does not incur such costs.

There are limits to the costs even a large corporation can absorb and remain profitably in business. And there are limits to the costs that a customer will allow a corporation to pass along.

Any company that goes beyond those limits is not competitive.

American companies that employ Americans overseas more and more generally are forced to exceed the limits. They can't pay the taxes on their American employees and remain competitive.

So the trend is not to employ Americans overseas. The trend is to employ anyone except Americans. In fact, the trend is to get rid of Americans already on overseas payrolls and to send them home.

Surprisingly, we're often asked: "Why does that matter? What does the employment of Americans overseas have to do with exports?"

Any American who's been in business should know the answer: Trade is people doing business with people. You certainly don't build a market by staying at home. You don't meet people who might be interested in what you have to offer by staying at home. You don't make contacts, get visibility or establish credibility and earn confidence and trust by staying at home.

You can't create a foreign market for American goods and services by proxy.

Sheikh Nasser Muhammad Ashemimry, who is chairman of the Saudi Arabian Marketing Corporation, in a recent talk to a group of American businessmen summed it up this way:

> "We can attract experts from England, France, Italy, Germany, Korea, Japan, and so on, for much less because their countries' tax laws encourage their citizens to work abroad. They know that their citizens will return and spend the bulk of their money in their motherland. Since the United States' foreign tax laws no longer encourage

> the American citizen to work abroad, America is suffering the additional loss of having a people—to-people contact, which is the basis of most freindships between countries." [Our emphasis added.]

That speaks for itself!

Any policy that keeps Americans at home -- that limits our presence in foreign markets -- is foolish. And yet that's the effect of our current tax policies. How severe is the problem? Very! And in limited time and space we can only give you some indication of the consequences and their severity.

Over the past four years, we've presented volumes of case histories, data and various reports before various committees of both the House and the Senate.

We've presented many specific cases or single anecdotes. Taken collectively, they tell a devastating story. We will present a few recent cases as we go along to aid your insight into the kinds of things that are happening -- how and why.

We have good data at this point on the overall impacts. One source is based on the findings of a Chase Econometrics study:

- The employment of Americans overseas during a recent twelve month period was reduced by about 10%.

- The effect was about a 5% reduction in the potential level or trajectory of exports from the U.S.

- That resulted in a loss to the federal treasury of about $6 billion in tax revenues and an added loss in state and local revenues of $700 million on corporate profits and $100 million on personal earnings.

- The immediate impact was a loss of 80,000 in the domestic economy as a result the 5% downturn in the export trajectory. That added another $200 million in taxpayer expenses for unemployment and related costs.

Chase proves the obvious: American exports follow American people into foreign markets. The link is inescapable. You keep your place in the market only if you're there to claim it. Americans overseas, whatever their occupations, directly or indirectly, create a demand and pave the way in foreign markets for goods and services produced in the U.S.

They direct business back to the U.S. domestic economy.

It's fair to ask, as some have, whether or not the Chase findings might be overstated.

Clearly, as with all assessments of this sort, an allowance must be made for some margin of statistical error, plus or minus. For the sake of discussion let's say that Chase overstates its findings by as much as 500%. Even then the business and attributable tax revenue losses still far exceed all revenues Treasury may hope to collect by keeping current tax practices in place. That holds true even if you use the Treasury Department's own demonstrably highly inflated static tax cost estimates.

But there's no way the Chase study is off by 500% either plus or minus. If there is marginal error -- and it would be just that, marginal -- the margin is more apt to err towards understatement than towards overstatement. That becomes clear when you take a close look at how the estimates were generated.

Let's look first at the estimated 10% drop in the overseas employment of Americans:

- The Chase surveys look at actual reductions in the employment of Americans overseas. They document what's happening in fact -- not what might happen given this tax policy or that.

- Chase found that current U.S. tax policies have forced U.S. engineering and construction firms to reduce the overseas employment of all Americans overseas by U.S. firms by 9% to 11%, with strong evidence that the trend is continuing especially in the manpower intensive high growth service sectors. Roughly 75% of all new positions overseas are going to other than Americans.

- Chase arrives at the median estimate of 10% reduction in the employment of Americans overseas as well within the safe range.

Turning to the Chase estimate of a 5% loss in exports, the fact is that Chase exercises. similar restraint:

- Through the network of overseas American Chambers of Commerce, Chase has collected data from almost two hundred respondents to date. The data support a conclusion that each 1% reduction in the employment of Americans overseas results in a 1% loss in U.S. exports. That's an elasticity of 1.0.

- But Chase also had access to an earlier Treasury Department study. That study had nothing like the volume of the Chase data to back it. Nevertheless, it arrived at the conclusion that each 1% reduction in the American presence overseas results in a loss of 1/2% in U.S. exports. That's an elasticity of 0.5.

- Chase, further, drew on other studies and the results of its own surveys -- all of which pointed to an elasticity of 0.5 as exceptionally safe.

• Chase had ample data in fact to warrant the use of its higher 1.0 elasticity estimate. But to err on the side of caution, it used the Treasury Department's own elasticity estimate which of course was substantially lower.

• Chase gives the result in a progress report to us:

> "If we apply the lower elasticity of 0.5 to the existing decline in employment, the implied reduction in exports is 5%. If we were to take the higher elasticity and the 1980 expected decline in employment [of Americans overseas], we would obtain an estimated reduction in exports of 10% or higher."

• The Chase estimate of a 5% drop in U.S. exports in relation to a 10% drop in U.S. overseas employment has solid foundation.

How does all of this square with recent estimates from the various federal sources that, even though our trade deficits are continuing to grow, our exports have increased in the past three years.

The answer is that it squares perfectly.

Chase does not say that exports have decreased in absolute terms by 5%. Nor does it say that the overseas employment of Americans has dropped in absolute terms by 10%.

What Chase does say is this: The comparative level or trajectory has changed from what it would otherwise have been.

The distinction is considerable: If the momentum of exports and of overseas employment of U.S. citizens increase in absolute terms for other reasons (the result on an undervalued dollar, for example), then the losses in potential exports and overseas employment become correspondingly greater.

Obviously, a given percentage of a larger number is a larger number.

Unhappily, the current estimates of increased exports are more imagined than real.

The source of the estimate has been verified as the monthly "Summary of U.S. Export and Merchandise Trade." That source does, indeed, suggest an annual increase in the range of 25% -- in something.

That "something" is the unadjusted raw dollar value or price of exports in inflated, not constant, dollars and with no accounting made for exchange rate fluctuations and other variables.

Moreover, as noted in the explanation of the statistics, certain changes were made in January 1978 in what was included in the tabulations -- the export of nonmonetary gold for example -- which would cause an artificial, purely accounting surge in the data.

In no way would that reflect real change in exports.

All the data really show is an upward change in the prices of exports. The upward change in prices combined with the accounting change in 1978 in fact mask general flattening in real merchandise exports on a unit or on a market share basis until the past eighteen months when there appears to have been some increase in exports in unit volume combined with a continued decline in market share.

That increase is the product of a devalued dollar overseas and the correspondingly highly inflationary pressures at home.

Generally accepted weighted Commerce Department data show that the prices of U.S. exports rose 6.8% from 1977 to 1978, 15.3% from 1978 to 1979, and 17.6% through 1980.

Part of that increase in prices is attributable to increases in taxes -- including taxes on foreign earned income. Apply those price inflation rates to the raw data in the "Summary of U.S. Export and Merchandise Trade," and the result is that the "25% increase" virtually evaporates.

If, despite all of this, we were to accept the interpretation of the tables as originally offered we would then have to conclude that the way to wipe out the massive deficits in our trade accounts is simply to raise the prices of our merchandise for export by imposing more taxes.

Perhaps it was simply by inadvertance, but completely overlooked are data only several columns removed and on the same pages that show a virtually unbroken string of monthly defiicts in the U.S. trade accounts since 1976.

They total approximately $100 billion -- which does not include another $50 billion since those tables were prepared.

One other point needs to be made about the basis of the Chase findings. Chase did not limit its sources. It examined all known Americans overseas on U.S. export performance.

Sources included:

• The General Accounting Office • The Treasury Department • The Commerce Department • The U.S. Chamber of Commerce • The Overseas American Chambers of Commerce (almost 200 responses to date) • The American Consulting Engineers Council • The National Association of Manufacturers • The Center for Strategic and International Studies at Georgetown University • McGraw-Hill, and • Others.

Those estimates were used with complete confidence in the highly regarded Chase model of the domestic economy for purposes of assessing both the business and the tax revenue impacts -- and for determining the first year impacts on domestic employment.

As you may know, the Chase model has been in use for more than ten years. It's widely used by U.S. businesses and by many agencies of government to help in planning and policy making.

Boiled down, what Chase finds is this:

> "The increased cost of employing U.S. workers overseas and the reduction in the number of U.S. workers overseas reduces the competitiveness of U.S. goods and services abroad and results in a substantial drop in U.S. exports . . . The return of American workers from overseas will increase the domestic labor force but will not increase the number of domestic jobs. Therefore, unemployment increases."

It's worth noting that the Georgetown Center for Strategic and International Studies independently reaches similar conclusions.

Georgetown looks at what would happen if U.S. exports were increased by $15 billion. Georgetown estimates that the result would be an increase in:

- U.S. consumption by $20 billion per year,
- Employment by 1 million jobs,
- U.S. output by about $37 billion per year,
- Private investment by $4 billion per year,
- Federal tax revenues by $9.5 billion per year,
- State and local tax revenues by about $2.7 billion per year.

Georgetown, of course, is looking at a <u>hypothetical</u> export <u>increase</u>. Chase is looking at a roughly corresponding <u>actual decrease</u> in export trajectory.

Georgetown and Chase approach from opposite directions. But they meet with estimates that are very much in line, though the Chase estimates are universally somewhat lower.

There appears to be one key variance: Georgetown estimates that one million jobs are at stake. Chase estimates that 80,000 jobs are at stake.

The variance, however, is more apparent than real: Georgetown's estimate projects the ultimate impact. Chase, on the other hand, limits its estimate to the known immediate impact. Allowing for substantial temporary elasticity Chase does not attempt to estimate the ultimate impact on jobs as the losses in exports work their way through the economy.

It is significant, we believe, that two organizations, operating completely independently, and approaching the problem from opposite directions, have arrived at results that come as close as they do.

Two additional studies reinforce the findings of Chase and Georgetown. They are:

- A report by the Organization Resources Counselors, Inc. entitled, "The Diminishing Number of U.S. Expatriates Abroad."

- A report by the General Accounting Office dated February 27, 1981, entitled "American Employment Abroad Discouraged By U.S. Income Tax Laws."

Both confirm that our nation's tax practices are, indeed, producing a diminished presence of Americans overseas at roughly the rate of a 10% loss per year. That suggests a total loss in the trajectory of American overseas employment of about 40% since 1976.

The GAO report makes the following conclusions:

> "To adequately promote and service U.S. products and operations in foreign countries, U.S. companies employ a large force of U.S. citizens abroad. GAO surveyed a group of major U.S. companies which reported that U.S. tax provisions established by the Foreign Earned Income Act of 1978 are a major disincentive to employment of U.S. citizens overseas.
>
> GAO found that the Act does not fully meet its goal of relieving taxes on income reflecting excessive costs of living abroad for the employees of these companies. Further, tax returns are difficult and expensive to prepare under the Act's complex rules.
>
> Most of the companies surveyed reimburse U.S. employees abroad for excessive taxes, making them more costly than citizens of competing countries, who generally are not taxed by their home countries. The greater costs have led these companies to favor third-country nationals.

> GAO urges that Congress consider placing Americans working abroad on an income tax basis comparable to that of citizens of competitor countries."

Is any of this a surprise?

For more than four years, we've been collecting data, some in the form of anecdotes that point to exactly the kinds of conclusions inevitably reached by Chase, Georgetown, GAO, ORC and others.

We've had no doubts about the impacts of the improvident U.S. tax practice.

- We knew that that tax policy was forcing American workers to return home in substantial numbers.

- We knew that we were losing substantial business revenues overseas as a result.

- We knew the tax policy was misdirected with the result that it was not producing a real net gain in tax revenues for our nation's treasuries but producing large losses in potential tax revenues.

There are no surprises.

The current U.S. practice of taxing Americans overseas is costing our nation dearly and is gaining our nation nothing.

Up to this point we've discussed what economists and data specialists like to call the "macroeconomic" picture.

We'd like to put a bit more life into that picture. We'd like to show you a bit of the "micro" side. What follows are some actual cases that should give you some insights into the kinds of things that are happening.

If you have any doubt that Americans are currently being forced out of jobs overseas, consider these cases:

- One of the Tax Fairness Committee's engineering and construction company members reported on March 27, 1980 that it now employs 103 Americans overseas, down from 2200 in .1977.

- Teleconsult reports to us that, on a small job in Jordan, "We have had to replace all but 2 of the 14 American engineers with foreign engineers."

- Berger International reports that on a project in Nigeria it has been forced to cut its staff of 35 Americans in 1977 to 2 in 1980. The company further reports that 40% of its overseas staff was American before 1976 as compared to 17% at present.

Tax Fairness Committee
April 24, 1981
Page 13

• The editor of Near East Business Magazine reported that by late 1977 more than a thousand of the 3,800 Americans who were working in the United Arab Emirates at the beginning of the year had packed up and left because of recent changes in U.S. tax laws. Today only a few hundred remain.

• Reports another Tax Fairness Committee member firm: "Our manpower commitments are increasingly being met by supplying personnel from our affiliates in U.K., Italy, France, and Spain. In a major contract in Saudi Arabia, 95% of the 300 expatriate supervisors, including top level, are supplied by our U.K. affiliate. This work force mix has obvious ramifications as far as purchasing policies are concerned."

• And another member firm advises us that "we currently have 3 positions on a highway construction management project in Kuwait which we have been unable to fill with Americans because of the potential tax liabilities. Over the past several months we have filled 6 key positions with Englishmen and Europeans because of our inability to recruit American staff."

• Abdullah Dabbogh, a Saudi diplomat, pointed out late in 1980 in New York that, "Americans are still being priced out of competition in overseas markets." He notes that in 1976, 65% of employees in U.S. firms operating in Saudi Arabia were Americans. He says the figure is now down to 35%.

• Jennifer D. Milre, M.A. recently completed a study of the impacts of current U.S. tax practices on the presence of Americans in England. Yet the study found that there has been a 20% decline in Americans at work in England since 1975. England is a high tax country where the impact of U.S. taxes would not be as great as expected.

• Harza Engineering Company makes this report: "We estimate that this year alone we will pay out nearly $1,000,000 to keep a few key U.S. overseas employees "whole." This is necessary because of taxes they must pay to cover high cost-of-living 'allowances.' If the situation does not improve, we expect foreign clients to turn to Germans, Japanese, Canadians, etc. who can provide the management and technology without the costs."

• Enserch Corporation, a natural resources development company, makes the following report:

> "In November, 1979, we were renegotiating a service contract with Aramco in Saudi Arabia. At Aramco's request (because of a generally higher level of American expertise in a number of areas of the petroleum business) we were asked to use U.S. personnel, including welding inspectors, welders, civil and mechanical engineers and an accountant. When we presented the Aramco negotiator's figures showing the cost to the project of

> U.S. labor, they requested that we return with cost projections for non-U.S. citizens. Today, there are 62 contract personnel on that job -- 60 United Kingdom nationals, one Pakistani, and one Saudi. The cost of using Americans was $10,000 to $12,000 per year higher for each employee, in large measure because of the present tax treatment of U.S. citizens. Thus there was a cost differential involved of more than $600,000 just on this project. Jobs which would have gone to 62 Americans were lost to foreign competitors."

Those are just some examples among the volumes of cases we can site that show that Americans are not being employed as they once were overseas.

Even in the teeth of evidence of that sort, we're still confronted with claims that there are instances where the employment of Americans overseas has actually increased.

Let's look more closely at that kind of claim:

- Aramco notes in a survey completed in February 1980 that, "In 1970, 50% of Aramco's expatriate (non-Saudi) workforce of 1,725 employees was American." In contrast, because of U.S. tax practices, Aramco's report continues, "Americans are now only 23% of the 16,500 expatriate workforce and number some 3,800 rather than the 8,200 as would have been the case if U.S. expatriates had remained at the 50% level."

That's cold comfort by any standard. What it really shows is that we've not kept pace with a rapidly expanding market. The share of Aramco jobs held by Americans today is less than half what it was in 1970. That means that our exposure and influence have been cut by half in a growth market that's virtually exploded.

Yes, you'll find instances where more Americans are at work on projects overseas than in prior years. You'll even find some Americans at work today in foreign places where there was no work at all for anybody a few years ago.

But those variances do not hide the underlying truth: The share of the international job market held by Americans is down. Way down.

And that is having another effect that has been given too little attention. Americans are not being employed as they once were in our own country to staff the international operations in the home offices of American companies.

Why?

The answer should be obvious:

- If an American firm cannot staff its overseas operations with Americans and remain competitive it will not staff its overseas operations with Americans.

• If Americans have no direct experience overseas -- if they do not know those markets firsthand -- they will not be qualified to deal in international operations even from company home offices.

• American companies will have to look elsewhere for the experience and skills needed to operate in international markets. They will have to bring in citizens from other countries who have the qualifications.

There's nothing hypothetical in this. It is happening right now. We're seeing a lot of it already.

And it's going to continue to happen -- and to happen more frequently -- until this country decides that it's in its own best inerests to see to it that American firms can afford to employ Americans in their operations overseas.

But does all of this really mean that U.S. firms are losing business overseas?

It does. Again, we can give example after example.

Look, for instance, at what's been happening just to U.S. engineering and construction firms that are attempting to compete overseas:

• That industry's share of the Middle East market has dropped from over 10% to less than 1.5% since 1976 (down from first to twelfth place in market share since 1976).

• Worldwide, the same industry has dropped from first place in contract awards among the competing industrial nations to eighth place as of the end of 1980 for a 4.3% share of the worldwide construction as compared with 16% in 1976.

It's true, of course, that you can measure market shares of engineering and construction contract awards in two basic ways:

• You can look at the number of contracts awarded to American firms out of the total.

• You can look at the dollar value of the contracts awarded to American firms out of the total.

If you win a few big dollar contracts, you may have a higher market share on a dollar basis and a lower share on a numbers basis.

American firms are losing by either measure. In fact, they're tending to lose more heavily on "big ticket," big dollar awards.

McGraw-Hill recently made a survey that makes the point. McGraw-Hill looked at 14 Middle East countries between May 1978 and June 1979 and found that:

- Out of a total of 220 contracts awarded during that period only seven (7) went to American firms -- about 3% of the total on a numbers basis.

- Out of the total dollar value of those contracts -- $21.8 billion -- only $346 million went to American firms -- about 1.6% on a dollar basis.

Going a bit deeper, a survey by Arab News spotted another closely related and very disturbing trend. Arab News looked at contracts awarded by the U.S. Army Corps of Engineers, on projects the Corps manages for the Saudi Arabian government, for the period from July 1976 through September 1979. It found that:

- American engineering and construction firms only managed to win $333 million out of the $1.2 billion awarded by the Corps.

Moreover:

- Out of the $333 million attributed to American companies, $206 million actually went to a U.S.-Korean joint-venture in which the Koreans provided the bulk of the project staffing. (In addition, Korean firms won about half of the contracts, or $598 million out of the $1.2 billion awarded by the Corps during the period.)

Gentlemen, you should know that because of the tax problem, American engineering and construction firms are not even competitive on overseas construction projects funded by various agencies of the U.S. government with U.S. taxpayer's dollars!

The problem does not stop with the Corps of Engineers:

- Each year the U.S. spends about $5 billion in U.S. taxpayer funds for various foreign assistance programs. Many of those funds are channeled into The World Bank. American engineering and construction companies have not been able to win a major project awarded by The World Bank in the past two years.

- Looking a bit further we find that, although U.S. tax payers pay 23% of the total subscriptions to The World Bank, our share of World Bank procurements in goods and services was only 20.5% last year.

Over and over again the pattern is clear. American engineering and construction firms, though still competitive and even superior in technical resources, are losing out overseas because of price.

One more piece of evidence: A recent survey of engineering and construction firms found that, though judged technically best qualified on the short lists, the firms were disqualified on the basis of costs attributable to U.S. tax policies. For 1978, a sampling of major losses to U.S. firms included documented contract losses of $4.157 billion for one, $4.076 billion for another, and $1.4 billion for a third.

We can take some comfort, of course, in the fact that American firms are not completely out of overseas markets. But most of the American firms still operating overseas are in trouble.

For example:

- Berger International reports that it is in trouble in Nigeria (which has a $5 billion surplus position with the U.S.) on a sewage infrastructure project for Abuja, a new city for 3 million people with 5 new satellites of 100,000 to 200,000 people because of its inability to staff with Americans -- and faces diversion of equipment sales from the U.S. to the U.K. valued at $36 million for the first phase (or approximately 5% of the total amount).

Now, we've shown that the U.S. tax treatment of Americans overseas has been knocking them out of competition and forcing them to return home. We've shown that American business overseas is losing business as a result.

Let's look at what that means at home:

- A member of the Tax Fairness Committee performed an analysis of a loss of 25 contracts in one year with a total value of $1.3 billion and found that:
  - The losses cost 598 potential U.S. engineering and construction supervisors jobs overseas;
  - The losses cost conservatively 1800 jobs in the U.S. for engineering support;
  - The losses cost $637.594 million worth of goods and services that were to have been purchased in the U.S. or about 13,000 jobs associated with those lost export sales by conservative estimate.

Why is it so difficult to convince people who've never worked overseas that it's important to have Americans overseas where they can direct business back to our economy?

A few more examples:

- Tippetts-Abbett-McCarthy-Stratton (TAMS) notes that its only product is professional services" and that "75% of our revenues are generated from overseas contracts." TAMS says that "30% of our professional staff is stationed overseas and 60% of our home office manpower concerns projects overseas."

- One American firm estimates that its $230 million construction project near Riyadh generated 600,000 man-hours of work in the U.S. Much of that can be attributed to $90 million worth of U.S.-made equipment and materials that would not otherwise have gone into that project.

• An analysis by Arab News found that $18,000 worth of American products exported to the Middle East support one American job at home. An American construction firm in the Middle East employing 10 Americans and purchasing $1.4 million in U.S. equipment generates some 77 American domestic jobs."

The cases we've cited are principally in the field of engineering and construction. That industry is particularly hard-hit by current U.S. tax practices because it must be able to provide substantial numbers of skilled technical people on large projects overseas. It is manpower intensive.

But the impacts are felt in all sectors.

For example, the Asia Pacific Council of American Chambers of Commerce, which represents some 4500 Americans working throughout Asia, reports that:

> "In terms of trade with the U.S., East Asia is the fastest growing region in the world and its imports are roughly equivalent of those of Western Europe. While other industrial nations have enjoyed an increasing share of growth in this market, that of the U.S. has been declining."

The report goes on to note that the area is of vital importance to the U.S. domestic economy and observes that, "U.S. exports to our region provide direct employment for over a million Americans and indirect employment for a million more."

Americans are being forced to leave that area and return home. They're being forced to abandon parts of the rapidly growing market to the competition. And that will mean job losses at home.

A recent analysis by Arthur Andersen & Company looks at the same problem from a slightly different perspective. In a report prepared in June 1980 the firm notes that:

> "From 1965 through 1978, sales of the 50 largest foreign industrial companies increased 595% (from $68.4 billion in 1965 to $475.6 billion in 1978). The corresponding increase for the 50 largest U.S. companies was only 317% (from $147.2 billion in 1965 to $613.4 billion in 1978). Stated another way, in 1965 total sales of the foreign companies were 46% of the sales of their U.S. counterparts; by 1978, foreign companies' sales had increased to 78% of U.S. companies' sales.

The Arthur Andersen firm notes that, "The only other major country that showed a decline in competitive position was the United Kingdom."

Although it currently appears that the highest growth potential in the international markets is in the services sector, demand for quality manufactured goods will also continue to grow.

At present we export:

- 63% of our office machinery production,
- 43% of our construction machinery production,
- 35% of our aircraft production,
- 32% of turbine and generator production,
- 26% of our computer production,
- 24% of our pump and compressor production,
- 18% of our farm machinery production.

Any policies that adversely impact our presence in overseas markets will not only cut into exports in areas where we continue to be strong, as in the exports of office machinery, but will also be felt where there is substantial potential for growth, as in the export of farm machinery.

We think it's worth noting here that because of the high costs of keeping Americans overseas -- costs greatly exacerbated by the way the U.S. government taxes them -- many of the medium to smaller businesses in the U.S. simply can't afford to venture into overseas markets.

Estimates are that about 250 major U.S. firms account for about 85% of all the manufactured goods exported by the U.S. The balance of about 15% is accounted for by about 25,000 smaller American companies. In contrast, small business accounts for about 40% of the exports from Japan. An estimated 300,000 U.S. small businesses produce goods or services that could readily be exported.

If it were not so costly to employ Americans overseas to represent American goods and services more small businesses would take the plunge.

The blame for the declining U.S. share of world markets cannot be placed entirely on the U.S. policy of taxing the foreign earnings of Americans. But just as clearly that policy cannot be held blameless.

It is a major cause.

Gentlemen, what all of this says is this:

- The U.S. is not sufficiently competitive in exports.
- Our tax codes are partly to blame.
- We're losing our share of overseas markets as a result.
- Someone's picking up the share we're losing.
- Someone is unemployed in Madison because we lost sales that gave the job to someone who's happily at work in Osaka.

We need to have more Americans -- not less -- in foreign markets. We can't meet that need if we continue to operate under current tax practices. What we're calling for, of course, is effectively the elimination of U.S. taxes on incomes earned by Americans overseas.

It is the only practical remedy. It is the only realistic solution.

Yet, there are still people who have problems with that proposition. Among their basic arguments are these:

- Such a change would cost too much in tax revenues.

- The current tax policies haven't been in force long enough to measure their impacts -- to know whether they're adverse or not.

Let's look at each a little more closely:

The people at Treasury have said that our proposal would cost anywhere from $495 million to as much as $700 million in lost tax revenues.

That is not the case.

Let's go back to 1976 for a minute. At that time, the people at the Treasury Department testified in support of a proposal to greatly reduce or eliminate the amount of income Americans working overseas could exclude from U.S. taxes. The apparent aim was to end suspected abuses of the exclusion provisions, principally by movie stars and the like. Treasury said at that time that the change would only add about $48 million in taxes spread among all Americans other than U.S. government employees living overseas.

The idea was that the total sums were negligible, that most Americans would hardly miss their share of the sums involved, and that those who were living high on the hog overseas by taking undue advantage of the exclusion would be brought up short.

An appealing notion. The proposal became law.

Today we're hearing a completely different story: Treasury now says that it would cost much too much in tax revenues to revert to the practice of effectively exempting typical Americans working overseas from U.S. taxes. Somehow what was a modest little tax bite that most Americans overseas would hardly even notice has become a hugh revenue source the national treasuries can hardly survive without.

Somehow the overseas Americans' $48 million loss became the Treasury's $495 million to $700 million gain! The people at Treasury have said that the 1976 estimates were apparently made on the basis of incomplete data. We're inclined to agree. But we don't think the current estimates have much going for them either. We've looked at explanations of the methods used to estimate the tax or revenue effects of any proposals we might make. They are static.

• And replaced it with a $15,000 exclusion off-the-bottom (which resulted in an actual maximum tax benefit of less than $3005).

The fact is that by 1976, the $20,000 exclusion off-the-top was already woefully inadequate. Its effect had virtually been wiped out by rampant inflation overseas.

In that light, the effect of the 1976 action cannot be overstated. The action had a deep psychological effect. And because it was seen as a major shift in traditional export policies, it caused considerable changes in corporate overseas marketing strategies and commitments.

Despite the fact that implementation of the law was twice delayed, the fact cannot be ignored that it was the law: All business and personal decisions had to be made on the assumption that the 1976 action would sooner or later take force.

It has had a profound effect as all of our material shows.

At least as profound was the impact of two Tax Court Rulings in 1976. Those rulings, for the first time as a matter of actual tax practice, made all employer "keep whole" contributions to the employee taxable as income to the employee.

The practice took force from the date of the rulings in 1976. The rulings remained fully in force until the provisions of I.R.C. Section 913 provided some relief late in 1978. For the interim period every American overseas had to proceed in his or her personal planning on the basis of the court rulings as did any U.S. company hiring Americans for overseas assignments.

Even then relief was clouded. In the case of the new Section 911, Treasury took another eighteen months to write regulations -- which when finally released proved highly restrictive. They virtually wiped out the effects of the relief in 1978. And, of course, a similar cloud hung over the new Section 913 even longer.

What we've had since 1976 is sheer chaos.

The impacts of the 1976 and 1978 actions were immediate, real and sustained. They set in motion momentum which continues -- the forced return of Americans from overseas markets.

"Where do we go from here? What will work?"

We suggest that of all the trade disincentives currently in operation, none can be reversed as readily or produce more immediate positive results than the current U.S. practice of taxing the incomes earned by Americans abroad.

Finally, we'd like to make the point that this country's trade policies must also take into account the many non-trade benefits of an American presence overseas -- benefits that are, or should be, obvious.

It takes little imagination to realize the potential damage to our future influence in the Middle East that stems from the fact that, due almost entirely to U.S. tax policies, the percentage of Americans on the faculty at the University of Petroleum and Minerals in Dhahran, Saudi Arabia, has dropped from 89% in the early 1970's to less than 15% today. That's where many of the future leaders in the Middle East are now in training. Think what that shift will cost our nation -- its vital interests, influence and security -- in the years ahead.

It is symptomatic of a process that is in full flood around the world.

And, of course, you'd still have to cope with all of the strange problems that crop up the minute you try to tax solely on the basis of citizenship -- the minute you try to give extraterritorial effect to your domestic tax codes.

Another category of equally bizarre problems arises from exchange rate variances. And still another category arises from a host of instances where the host country tax laws run directly counter to our own tax laws. You have to break one to comply with the other.

Our current tax practices wholly ignore the value to the U.S. in the international market place of American dedication, drive, energy and resourcefulness -- things we take for granted here at home and that are built into our culture and work ethic.

Our current tax practices wholly ignore our greatest asset -- the people we can and should be sending overseas in greater numbers. In most parts of the world Americans are especially liked for a very basic reason: Americans will not hesitate to roll up their sleeves and sweat alongside the people in whose country they're working in order to get the job done. That sets us apart -- and makes us especially welcome.

Anyone with experience knows that it's those qualities that give us a substantial advantage in overseas markets -- an enormous appeal -- if we can afford to keep Americans in the international marketplace. And that, of course, goes to the issue.

Americans must have incentives to work overseas. They must at least be on the same tax footing as the citizens from the competing industrial nations. And we're showing you today that the incentives we need will cost the government nothing. It will net the government billions of dollars in added <u>real</u> tax revenues.

If there is any concern that special tax consideration for overseas Americans may still be perceived as somehow unequitable, we ask you to reflect on the current policies and ask:

- "What's fair to Americans about an American tax law that encourages the employment of anyone except Americans."

- "What's fair to Americans about an American tax law that denies Americans payrolls and puts them on the welfare rolls?"

We thank you for your interest and hope with your help we'll start to move back toward our proper share of overseas markets this year.

Prepared by:
U.S. & Overseas Tax Fairness Committee
Ben Jarratt Brown
Vice President Operations

SUMMARY OF STATEMENT OF DONALD NIEMI ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE

April 24, 1981

1. The Emergency Committee for American Trade believes that the current tax treatment of American citizens working overseas is far too costly and is detrimental to U.S. exports.

2. ECAT welcomes S.408, S.436, S.598, and S.867 as significant improvements over present system.

3. On the whole, other countries do not tax the incomes of their citizens working abroad.

4. For one representative ECAT member company -- the Caterpillar Tractor Co. -- the average base salary for its overseas employees in January, 1981, was about $50,000. Average total cost per overseas employee -- including the foreign service incentive premium and "make whole" payments -- was approximately three times that amount, or $150,000.00. These costs have increased by one-third in the past two years.

5. ECAT believes that Congress should fashion a law under which the vast majority of Americans working abroad are not liable for U.S. income tax on their overseas earnings. Otherwise, American companies won't be able to afford to have Americans working overseas and will replace them with foreign nationals to the detriment of U.S. exports.

6. ECAT recommends that the tax treatment of Americans working abroad should be stable and simple and should place the United States in a competitive position with the tax practices of other countries.

7. The income exemption levels of S.408 and S.436 are inadequate. The $75,000 exemption level, for example, covers one-half of the $150,000 it costs a typical ECAT company to maintain an American employee overseas.

8. S.598 which exempts an American worker's income overseas from U.S. tax clearly matches the tax policies of competitive countries, establishes a stable policy, and provides for administrative simplicity.

STATEMENT OF DONALD NIEMI

ON BEHALF OF THE

EMERGENCY COMMITTEE FOR AMERICAN TRADE

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

APRIL 24, 1981

Mr. Chairman and members of the Committee, I am Donald Niemi, representing the Emergency Committee for American Trade (ECAT) in support of legislation to reduce or eliminate the U.S. income tax burden on income earned overseas by American citizens. ECAT is an organization of the leaders of 63 large U.S. business firms with extensive overseas business interests. Its member companies had 1980 worldwide sales of close to $600 billion and employed over five million people. ECAT's purpose is to advocate and support expansionary international trade and investment policies.

I am also Issues Analysis Manager for Caterpillar Tractor Co. -- a member company of ECAT -- and will draw on Caterpillar's experience with respect to the issue before this Committee.

ECAT member companies are concerned about the negative impact on U.S. exports of current tax treatment of income earned overseas by American citizens.

There are two reasons for such concern. One is the high cost of sending Americans abroad. These high costs can lead to contract losses since they make U.S. bids uncompetitive.

The other reason for concern is the impact on a broad range of U.S. exports when Americans abroad are replaced by citizens of other countries,

who are more familiar with products and services from their own home countries -- and therefore are less likely to specify or order U.S. products.

Exporters need to send Americans abroad -- to stay in touch with customers' changing needs, seek new business opportunities, provide key services, and understand how goods and services we export must be adapted to local conditions.

Most ECAT companies provide a tax equalization program for American employees working outside the United States. Without such a program, most American employees would be reluctant to accept foreign assignments.

The cost to Caterpillar of our tax equalization program in 1979 was $12 million, most of which was attributable to U.S. taxation of overseas earned income. Tax equalization payments cost 80 percent of the average Caterpillar Foreign Service Employee's base salary in 1979, compared with 15 percent of base salary in 1972.

That's a cost from which competitor companies based in other countries are largely exempt because other countries do not tax their non-resident citizens on foreign earned income. In an increasingly competitive world, there is a particular need for the U.S. Government to examine costs that affect only U.S. companies.

We're pleased to note the congressional interest in this problem and the several constructive proposals advanced for dealing with it. Any of the

four bills under consideraton today -- S. 408, S. 436, S. 598, S. 867 -- would represent an improvement over the current law. We in ECAT welcome these bills and express our appreciation for them.

Which is the best of these bills? I'd like to address that question in the context of factors we believe the subcommittee should consider.

Point number one is that we need to take into account the tax policies of countries with which we compete. With some limited qualifications, other industrial countries exclude foreign personal income from taxation. The closer we can come to doing the same, the better.

When Congress in 1963 first established a ceiling on the amount of overseas earned income that could be excluded from U.S. taxation, the limit was set high enough so that most Americans abroad paid little or no U.S. income tax. The average base salary of Caterpillar's U.S. Foreign Service Employees in January 1968, for example, was $17,750. In those days, the purchasing power of the dollar around the world was still strong, and "make whole" payments for such items as housing and cost of living differentials were relatively modest. To place Americans abroad back on a competitive footing with citizens of other countries, we believe that Congress should fashion a law under which the vast majority of Americans working abroad do not pay U.S. income taxes on their overseas earnings.

That can be done in any of several ways. One way is to exclude all overseas earned income, as in S. 598. Another approach is to establish

an exclusion ceiling high enough that the total income and allowances of most Americans abroad would fall below the ceiling.

Still another approach is a combination of an exclusion plus a housing allowance deduction that would result in most Americans not paying U.S. income taxes on overseas earned income. That's the basic approach of S. 408 and S. 436.

Both bills establish an exclusion that appeared to be adequate not long ago. In November 1978, the average Caterpillar Foreign Service Employee had a base salary in the mid-to-upper-thirties. By January 1981, however, the average base salary had risen, because of inflation, to over $50,000. Average total cost per employee -- including the foreign service incentive premium and "make whole" payments -- is now approximately three times that amount, or $150,000. These numbers may sound high, but they are the costs we face today. The exclusion levels in S. 408 and S. 436 are thus not adequate to deal with our 1981 costs.

Both of these bills have a fair and workable housing allowance exemption. Housing is one of the more expensive cost items for many Americans working abroad. In 1979, the cost to Caterpillar for Foreign Service Employee housing allowances averaged 33 percent of base salary. I should note that Caterpillar's compensation system requires the employee to pay a fair share of housing expenses. The 33 percent housing allowance payment is in addition to the employee's fair share. Housing allowances in 1979 ranged from 3 percent to 51 percent of base salary, depending on overseas location.

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Point two is the need for a stable policy in this area — a bill that would put this issue to bed for at least the rest of this decade. That means some way should be found to deal with the impact of possible continued inflation or major fluctuations in the foreign exchange value of the dollar. If inflation averages 7 percent over the next 10 years, for example, 1991 costs and prices will be approximately double their current levels.

S. 598 deals with this problem very effectively. S. 436 and S. 408 both allow for expansion of the exclusion. But as I noted, inflation has already made the exclusion levels in these two bills inadequate for the average Caterpillar Foreign Service Employee. We believe our experience is similar to that of other ECAT member companies. Whatever higher level of exclusion is established today is very likely to be inadequate for tomorrow, as witnessed by our own corporate experience. S. 867, while less generous in some respects, would permit the exclusion of 80 percent of any level of income.

Our third point is the need for simplicity in new legislation.

The 1978 law began with reasonably clear concepts, but has turned into an administrative morass. Caterpillar has a full-time staff of five tax accountants who work year round on the returns of some 340 U.S. Foreign Service Employees.

The average Caterpillar Foreign Service Employee's tax return is about 25 pages in length. Even a simple return with no income other than

wages and no itemized deductions -- corresponding to a two-page U.S. return -- requires 17 pages if filed by an expatriate. Not surprisingly, such returns are expensive to prepare. We estimate that the average cost per return is $750.

Let me cite an example of the kinds of problems that have arisen under the 1978 law.

The housing deduction is the most complex deduction and -- as presently defined -- is also one of the most inadequate. It provides a deduction for the excess cost of housing over a base housing amount. That base housing amount is supposed to represent the employee's fair share of housing costs, or what he would pay were he living in the United States and earning the same base salary. The base housing amount is calculated as 20 percent of foreign earned income minus other deductions and actual housing costs.

While the housing deduction alone is complicated, there are other complications. Overseas employees of U.S. firms typically receive other "make whole" type payments. Examples are non-deductible moving expense reimbursements, income tax reimbursements, and education allowances. Such reimbursement amounts increase the employee's tax liability, thereby resulting in a higher tax reimbursement, which further increases tax liability.

That's one of the reasons our $50,000 per year employees have to report $150,000 a year incomes. With such artificially inflated incomes, Foreign Service Employee returns are selected more often for audit.

Audits are time consuming ordeals for both the preparer and the IRS, adding to costs for both sides.

We urge the Congress to strive for a simple and clear law. Last year, the Senate Finance Committee developed a bill that sought to categorize Americans employed abroad, limiting the exclusion of earned income to individuals engaged in certain kinds of business activities. We hope this subcommittee will avoid drawing such distinctions, which are extraordinarily difficult to apply in the varied and constantly changing world of international trade. If the current law is complex, it's a model of simplicity compared to last year's proposal.

There is one technical point on which we'd like to offer a suggestion. In defining income that may be excluded, several of the bills refer to "amounts received from sources within a foreign country." That wording -- which is also contained in the present law -- creates problems. For example, tax reimbursement payments for Foreign Service Employees may be made by the parent company in the United States directly to the Internal Revenue Service. That payment is regarded as additional taxable income by the IRS. It is clearly income attributable to foreign employment, but is not technically from a source within a foreign country. We urge the committee to use the language of S. 436, which permits exclusion of amounts that constitute earned income attributable to services performed during an uninterrupted period of foreign residence.

Where do we come out with respect to the four bills before the Committee? All four bills represent an improvement over current law. S. 598 most

clearly achieves the three goals I mentioned earlier, i.e., matching the tax policies of competitor countries, establishing a policy that we can expect to remain stable for a number of years, and simplicity. We recognize that S. 598 will need amendment to prevent abuses such as cases of people who earn very high incomes and establish foreign residences solely as device for avoidance of U.S. taxes.

The most important objective for the member companies of ECAT is to see a good bill passed by Congress on a timely basis. We welcome the attention of this subcomittee to this important issue and thank you for the opportunity to present our views.

STATEMENT OF ROBERT T. ANGAROLA*

ON BEHALF OF

AMERICAN CITIZENS ABROAD

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

UNITED STATES SENATE

April 24, 1981

Taxation of Americans Overseas

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* Attorney, Hyman & Phelps, 1101 Connecticut Avenue, N.W., Suite 1201, Washington, D.C. 20036, (202) 223-5600.

Mr. Chairman, Members of the Committee:

Thank you for allowing me to testify on the important issue of tax relief for Americans living overseas. I represent American Citizens Abroad, a non-profit, non-partisan, voluntary association whose purpose is to promote the interests of Americans living outside of the United States, ensure that their rights are observed and protected, and provide a vehicle for Americans overseas to communicate more directly with policy and opinion makers in the United States. We are represented in over 50 countries throughout the world and our membership includes individuals from many professions and walks of life.

Most other panel members will focus on the hardship current United States tax policy has caused American firms and individuals doing business overseas and the negative impact it has had on our export performance. American Citizens Abroad agrees with their conclusions and fully supports their efforts to have §§ 911 and 913 amended to bring the United States into conformity with the tax practices of our major competitor nations. I however would like to speak principally on the effect our tax policy has had on the typical American living overseas.

Prior to 1962 the U.S. government did not tax foreign-earned income. This was due primarily to a recognition of the benefits derived from having Americans overseas who would not only bolster our commercial standing in the world but also

transmit our social and economic ideology to other peoples. We correctly believed that the most effective means of convincing people that the American way of life and the American form of government were the best models to follow was to have our citizens live and work in foreign lands. By doing this, we could show, first-hand, the superiority of our economic system and, perhaps more important, could help transfer to other societies our concept of freedom and worth of the individual.

Because of a few isolated instances of wealthy overseas Americans taking advantage of existing loopholes in the tax law and actively avoiding their responsibilities as citizens, in 1962 our tax policy changed. The actions of these individuals gave Americans living in the United States an impression that every American abroad owned limousines, wore mink coats, and resided in mansions on the shores of the Mediterranean. This stereotype is of course far from reality. The small businessman trying to establish a market in a West African country, the construction engineer working in the Mid-East desert, or the low-salaried teacher struggling to survive in an expensive European city bear little resemblance to this image of affluence. It must be kept in mind that our current tax policies affect many more people, and affect them more seriously, than the few who precipitated the 1962 change in law.

As the other panel members have demonstrated, our tax policy has made it more and more difficult for Americans to

live abroad. Top corporate positions overseas, even in American companies, are being filled by non-Americans; teaching positions are being filled by non-Americans, even in schools with predominantly American students; influential positions in foreign corporations are now being filled by non-Americans. In addition to the impact this has had on exports, it has driven out of foreign countries the very people we need to transfer our ideals to citizens of other nations. We are a country built upon the tradition of the "Yankee Trader," the entrepreneurial capitalist who through his own efforts makes a better life for himself, his family, and his society. This is the capitalist system at its best, a system we have attempted at great expense to have other nations adopt. Our present tax policy is thwarting this effort. It can be argued that by driving Americans from the international marketplace we are doing the Kremlin's work since the people of other countries cannot directly compare our two systems. As Congressman Bill Alexander has stated recently on the floor of the Congress:

> The American entrepreneur abroad does more to build respect and admiration for the free enterprise system than all the tanks and airplanes we could ever deploy. The thoughtful and dedicated overseas American does more to bring about a better understanding of our political ideas and institutions than all of the propaganda expenditure we might be tempted to use as a substitute. The economic development of the rest of the world, and the creation of markets for American products, are fostered more by dedicated American entrepreneurs than by all of our bilateral and multilateral assistance programs combined.

Capitalism will produce a better life for the underdeveloped nations than communism if allowed to compete equally.

No other country in the world taxes its nationals who live away from home. Our tax policy has therefore not allowed our citizens to compete equally in the international marketplace. We lose not only economically, but also ideologically, politically and culturally. The overseas American is the best vehicle possible for demonstrating that our way of life is an efficient and productive one. Americans working in developing countries prove by their actions and successes that our system is effective.

For these reasons, American Citizens Abroad urges Congress to enact legislation replacing existing rules for taxing Americans overseas with a single exemption based upon residency outside of the United States.

Such legislation would place Americans resident abroad in the same position as nationals of every other industrialized country. It would be a boon to exports from the United States, and to the rendering of services abroad by U.S.-controlled businesses. This approach would also strengthen the position of Americans overseas who are promoting and protecting the many interests of the United States in social, political, cultural and ideological spheres. The revenue cost of this straightforward approach is comparable to the cost of more complex measures proposed now and in the past. In fact, a recent study questions whether tax relief along these lines

would result in a revenue loss. More probably it would engender greater revenues for the Treasury due to increased exports and creation of jobs in the United States.[1]

American Citizens Abroad supports the concepts found in H.R. 2014, the "Tax Treatment of Americans Abroad Act," which applies the principle of residence taxation to Americans abroad. Every major competitor nation applies this principle to citizens living outside its borders. We should do the same. This approach would exempt all foreign-source earned income, as well as pension and annuity income attributable to work performed while abroad. This latter income, unfairly called "unearned" income, includes pensions, interest and dividends upon which tax has often already been paid. The retired American abroad or the widow or widower play vital roles in projecting American values and defending by example the efficacy of the American way of life.

1/ "Economic Impact of Changing Taxation of U.S. Workers Overseas," Chase Econometric Associates, Inc., June 1980. The Treasury Department estimates that it would lose about $500 million in tax revenues if taxes on overseas Americans were eliminated. A February 1981 GAO study found that since the 1976 tax policy change, the percentage of Americans employed abroad has been reduced from 20 to 50 percent in some important export industries. A Treasury Department study estimated that a 10 percent reduction in American presence abroad resulted in a 5 percent reduction in exports. The Chase report assumed only a 5 percent export reduction and concluded that the Treasury would lose $6 billion in tax revenues on corporate profits alone -- 12 times the revenue gained by taxing earned income.

In the interest of equity and simplicity, American Citizens Abroad opposes any cap on the amount of income which would be excluded. In order for the United States to be competitive internationally and to increase its exports, we must encourage senior managers and entrepreneurs to live and work overseas. These are the people that hire American workers and order American goods. In addition, the marginal revenue increase from taxing these individuals would be small. We support efforts aimed at preventing a reoccurrence of the few abuses which led to the 1962 tax policy change but we believe this can be accomplished without prejudice to the millions of Americans who legitimately reside abroad.

American Citizens Abroad is extremely concerned over possible enactment of a more complex proposal (such as the bill reported by the Senate Finance Committee last year which tied benefits to Americans abroad to an "export related" test) which would discriminate against many who are serving in vital roles that are not uniquely related to just one aspect of the American national interest. We are opposed, therefore, to any proposal that differentiates among U.S. citizens on the basis of country of residency or physical presence, or on the basis of function or profession.

American Citizens Abroad is committed to working with members of Congress and the Executive Branch to develop appropriate rules for taxing Americans overseas. These rules should be fair to all taxpayers. They should give Americans

overseas an equal chance to compete for employment abroad, and to allow exports to grow. This change in tax policy will result in increased employment at home to meet the demands of newly developed markets. This Committee can formulate these rules and American Citizens Abroad stands ready to assist in any way possible.

Thank you.

Summary

- United States tax policy has placed the members of American Citizens Abroad at a severe competitive disadvantage when compared to nationals of other countries.

- Prior to 1962 there was no tax on foreign-earned income in recognition of the benefits derived from having Americans overseas who would not only bolster our commercial standing in the world but also transmit our social and economic ideology to other peoples.

- Americans working abroad show first-hand the superiority of our economic system and help transfer to other societies our concept of freedom and worth of the individual.

- The excesses of a few individuals who actively avoided taxes led to the 1962 change in our tax policy and gave Americans living in the United States the wrong impression that all Americans abroad lived lives of great affluence.

- The typical American, as reflected in the membership of American Citizens Abroad, is the small businessman trying to establish a market in a West African country, the construction engineer working in the Mid-East desert, or the low-salaried teacher working in an American school struggling to survive in an expensive European city.

- These typical Americans are by far the vast majority of U.S. citizens living abroad and are more seriously affected by our current tax policies than the few who precipitated the 1962 change in law.

- We are a country built upon the tradition of the entrepreneurial capitalist who through his own efforts makes a better life for himself, his family and his society.

- By driving these people out of the international marketplace, we are affecting our national security and doing the Kremlin's work by not allowing people of other countries to compare directly our two systems.

- American Citizens Abroad asks that U.S. citizens be taxed in the same manner as every other industrialized country taxes its nationals, i.e. on the basis of residency.

- This taxation principle would expand exports from the United States and increase the provision of services abroad by U.S.-controlled businesses as well as strengthen the position of Americans overseas who are promoting and protecting the many interests of the United States in social, political, cultural and ideological spheres.

- American Citizens Abroad supports H.R. 2014, "The Tax Treatment of Americans Abroad Act," which exempts all foreign-source earned income as well as pension and annuity income attributable to work performed while abroad.

- American Citizens Abroad opposes any cap on the amount of income which would be exempted since this would discourage the positioning of senior managers and entrepreneurs abroad who hire American workers and order American goods.

- American Citizens Abroad supports efforts aimed at preventing a reoccurrence of the abuses which led to the 1962 tax policy change.

- American Citizens Abroad opposes any legislation which differentiates among U.S. citizens on the basis of country of residence or physical presence, or on the basis of function or profession -- the test of benefit to the United States should not rest only on exports.

- American Citizens Abroad is committed to working with the Congress and Executive Branch to develop equitable rules of taxation which will allow Americans an equal chance to compete for markets abroad and permit exports to grow.

- Tax relief is needed as soon as possible.

Senator CHAFEE. Well, thank you very much, gentlemen. The next panel will be Mr. Morrione, Mr. Castles, Mr. Hammer, and Mr. Henning. Mr. Morrione.

STATEMENT OF MR. MELCHIOR S. MORRIONE, ARTHUR ANDERSEN & CO.

Mr. MORRIONE. My name is Melchior Morrione. I am a tax partner in the New York office of Arthur Andersen & Co. and I am responsible for coordinating the firm's expatriate tax practice.

We believe the major tax policy issue is the declining competitive position of U.S. companies in world markets. The economic balance among nations has decidely shifted. An analysis of data in our written statement demonstrates that the U.S. multinational company no longer dominates the international marketplace. The competitiveness of the U.S. company has been significantly weakened and as a result, multinationals of other companies have moved in to exploit the opportunities available.

As a result, the cost of products and services has assumed a more important role in international trade. The advantage of superior quality and technolgy is no longer held by the U.S. multinational and as a result cost is the greatest factor in international competition.

The increased cost incurred to reimburse U.S. expatriate employee for additional U.S. taxes has seriously impaired the competitive position of the U.S. multinational. Most of our foreign competitors do not tax the foreign earnings of their nationals residing abroad, as you have heard.

Senator CHAFEE. Well, could you, that is a question that is always raised and we have had a lot of testimony here that our foreign competitors do not tax. I think you say most of our foreign competitors do not tax. Who has done some research on this? Can we say unequivocally that a citizen of the United Kingdom serving abroad is not taxed, a citizen of France, a citizen of West Germany, a citizen of Canada?

Mr. MORRIONE. I looked into that question for the following four countries, the United Kingdom, West Germany, France and Japan. Once the national establishes residence abroad (generally, a period beyond a year) he is not taxed in his home country on any income earned in the other country. He is only taxed in his home country on income sourced there. Normally, such an expatriate takes his family and is on assignment for a 2- or 3-year period.

In other words, foreign earnings both earned and unearned are not taxed, in the four countries you mentioned.

Senator CHAFEE. Now, take the Canadian situation. I have been challenged on this and I just want to know the answer. If a Canadian goes abroad, goes to Saudi Arabia, does not take his family, leaves his family in Montreal, stays 11 out of 12 months, 330 days in Saudi Arabia, what is his tax situation?

Mr. MORRIONE. I think the question is whether he has changed his residence. Is he really residing abroad? I didn't look at Canada specifically but in the other four countries, if he does not take his family, the question would arise has he really changed his residence? Is he no longer a resident of his country of citizenship?

If he does, in fact, take his family and establishes residence in another country, those four countries which tax on the basis of residence consider him a nonresident.

Senator CHAFEE. I would guess that the Canadian rule would be similar to the other four countries. Any time you get talking residency, you get into a tangle. All right, go ahead.

Mr. MORRIONE. Specifically, the recognition of this increased cost which relates to the U.S. taxation has caused many U.S. multinationals to conclude that the additional burden of maintaining U.S. expatriates overseas is just no longer cost-justified. In essence, we are pricing ourselves right out of the market.

The changes in taxation made in 1976 and 1978 did nothing more than aggravate the problem. They increased the cost of maintaining Americans overseas. They unduly complicated the law and they imposed burdensome recordkeeping and substantiation requirements on both the employees and the employers.

The fundamental objectives of U.S. tax policy, in this area, we believe should be first to make the tax cost of maintaining U.S. citizens abroad no greater than that of nationals of other developed countries competing in the same international marketplace and second, to eliminate the disincentive that presently exists, caused by the higher tax cost of maintaining U.S. employees abroad which has led to their replacement by nationals of other countries.

We recommend that the complex rules adopted in 1978 be replaced by a simple system that provides complete exclusion from U.S. taxation of the earnings of Americans working abroad. This would achieve total comparability with the tax rules of other countries.

Senator CHAFEE. No limitation?

Mr. MORRIONE. No limitation. If however, Congress decides that as a matter of policy, a major potential for abuse requires some limitation in such favorable treatment, then we believe a basic alternative would be to limit the amount the exclusion.

Senator CHAFEE. You are an accountant. Do you see a potentiality for abuse with the residency requirement of 330 days?

Mr. MORRIONE. With the residency requirement? It's possible.

Senator CHAFEE. In that great, big office of yours, you ought to be able to think up some

Mr. MORRIONE. Very probably.

Senator CHAFEE. Ingenious, not evasion, avoidance.

Mr. MORRIONE. One could probably come up with a series of facts that would make it look like one were abusing the privilege. It is always, indeed, possible.

Senator CHAFEE. OK, please continue.

Mr. MORRIONE. We, then, believe, that if there should be a limit, a limited exclusion from the bills under consideration, would best be provided by S. 436, Senator Bentsen's bill which is simple, practical, workable. The reason we find it preferable, at this time to the other bills under consideration, is: first, the amount of the exclusion is somewhat realistic in terms of today's compensation levels; second, the acknowledgment of an annual $5,000 increment deals with preserving the value of this exclusion; third, the deduction for housing costs is realistic; and fourth, the benefit is elective. We suggest that if any limited flat exclusion should be adopted on

an elective basis, so that expatriates on assignment in high tax rate countries need not become at all involved with the exclusion because it would provide them no benefit. They would simply utilize the foreign tax credit to eliminate double taxation.

Finally, because of the uncertainties created by changes in this area of tax law over the last few years, we urge that simplicity be the fundamental objective.

We need a system of taxation simple enough to be understood by the persons being taxed. We urge quick action on expatriate taxation by this Congress effective for the calendar year 1981.

Thank you.

Senator CHAFEE. Thank you very much. I think there is some reluctance in this Congress, certainly I have it, to deal with indexing which in effect, is in that bill you discussed.

All right, fine, thank you. Mr. Castle?

STATEMENT OF MR. ROBERT H. CASTLES, NATIONAL DIRECTOR OF EXPATRIATE SERVICES, ARTHUR YOUNG & CO.

Mr. CASTLES. Thank you, Senator Chafee. My name is Robert H. Castles. I am a tax partner of Arthur Young & Co. and serve as firm director of expatriate services.

Arthur Young & Co. is a large international accounting firm and we presently provide a full range of expatriate services to over 100 American companies and several foreign corporations.

We will prepare approximately 10,000 1980 U.S. tax returns.

I am pleased with the opportunity to present our views to your subcommittee.

I am going to limit my comments to areas where our experience shows changes are desirable or essential in designing incentive and simplified legislation. Repeat, incentive and simplified.

By simplified, I mean, simplified in terms of preparing returns and recognition of the fact that we are dealing with cash basis taxpayers.

I also fervently hope that your committee will permit me not to expand this book that we publish annually to provide simplified rules for expatriates. It requires about 40 pages in dealing only with the expatriate rules and another 50 pages of filled-in forms to show how to do a return for both the campsite provision and section 913 deduction situations.

In addition to hoping that you will assist us in simplifying the rules, I hope that the rules will come at an early and timely date in recognition of the fact that the returns that we and other members of the panel prepare go all over the world. Communication is not easy in many areas.

On my specific presentation, I am going to limit my comments to three areas. The level of the exclusion, ease of administration and simplicity and a peculiarity which I think is important, the disallowance of the foreign tax credit provision.

In terms of level, we believe that the level should be sufficient to exclude allowances, including tax reimbursements, or all items which are known as overbase items.

We also believe it should provide an incentive based on salary or other compensation. We think the final design of the bill should be

such that it will assist the vast majority of Americans but avoid abuse situations.

We think all of the bills presented are a pleasant change from the law presently in effect. We have not selected a particular bill and are not recommending a level of exclusion.

We simply point out that if the exclusion level eliminates the overbase or allowance items, company cost for U.S. tax reimbursements would be reduced to zero and would be no impediment to increased exports.

The only remaining issue would be incentive. How much further incentive is needed to get Americans to take particular jobs? Again, we are not offering specific comments on the level of the exclusion.

We favor an exclusion in preference to an exclusion and a combination of deductions or incentives for matters of simplicity.

Finally, the exclusion selected and decided upon by the committee and Congress should be adjusted for inflation in some fashion.

Concerning ease of administration and complexity, we believe that you should limit the alternatives. We don't believe that it would be desirable to adopt a combination approach, as I mentioned before, or to adopt a new approach and yet retain sections 911 and 913 on an elective basis.

As our book points out, where an expatriate qualifies for the campsite exclusion, a return must be completed under both sections to decide which alternative provides the lowest tax.

Senator CHAFEE. Well, would you—now you say, we do not think it would be wise either to adopt a new combination approach such as exclusion of income and excess housing. You wouldn't deal with the housing matter. You would what, just do it solely on total income?

Mr. CASTLES. That would be our inclination.

Senator CHAFEE. Now, I am curious about that because it seems to me that the housing can get extremely expensive. If you had a system whereby the person would be taxed for the first $5,000 of housing and anything beyond that, it's a better system than the one you proposed. Unless you, of course, go to unlimited. But you are not proposing unlimited, are you?

Mr. CASTLES. No.

Senator CHAFEE. Well, could you give me your rationale for not dealing with the housing? It can't be that complicated, if that is the only one you deal with.

Mr. CASTLES. We think it is a question of adopting a very simplified position. Our preference is for the decision to be made at the exclusion level, but the elimination of housing is clearly not a detriment.

Senator CHAFEE. OK.

Mr. CASTLES. Finally, on simplification, the 11 out of 12 months, we believe, is workable as a physical presence requirement. We would also make the residency test any 12 month period, rather than a period including a calendar year.

Senator CHAFEE. Oh, yes. I agree with that. How would you do your return though, if you do your returns on a calendar year?

Mr. CASTLES. At the present time, you get an extension until you meet the qualifying test. The reduced period would reduce the

number of extensions that will be required. There still might be a chance of an extension for a brief period of time. At the present time, the extension could go from a year to 17 months.

It would reduce the number of extensions and the compliance responsibilities for the Government as well as ourselves.

Senator CHAFEE. All right.

Mr. CASTLES. Finally, I would like to turn to the disallowance provision. Most of the bills include a provision which disallows the foreign tax credit attributable to excluded income.

This adds an additional limitation to the provisions already existing for foreign tax credits. We believe careful drafting of the provisions is very important or we might be in a position where we will have won the battle and lost the war and end up back in this room in 2 years.

We believe the present overall foreign tax provision operates well. It provides carrybacks and carryovers. To supplement it with a special annual provision can produce very undesirable results.

We have designed a computer program which calculates the effects of U.S. taxes and the taxes of 30 foreign countries. We ran all bills through the computer program and we were surprised to find, in high tax countries or countries where the level of taxation is comparable to the United States, that the disallowance provision could either nullify the new exclusion or increase the tax reimbursement costs under all of the bills.

We know it is a complicated question. We have prepared an article on this particular subject which is in the process of being printed right now. We would be pleased to provide the committee and their staff with copies of the article so that they can appreciate the potential difficulties.

[Material provided follows:]

ARTHUR YOUNG

ARTHUR YOUNG & COMPANY
277 PARK AVENUE
NEW YORK, NEW YORK 10172

May 6, 1981

The Honorable Robert Packwood
Chairman
Subcommittee on Taxation and
Debt Management
Committee on Finance
United States Senate
Washington, D.C. 20510

Subject: Material Requested at April 24, 1981 Hearing on Foreign Earned Income

Dear Chairman Packwood:

During my testimony before your subcommittee on April 24, 1981, I mentioned and was requested to provide a copy of an article two of my partners and I wrote for the magazine "Innovations in International Compensation", published by Organization Resources Counselors, Inc. Enclosed are five reprints of the requested article.

The article further explains the last point in my testimony of April 24 before your subcommittee. It deals with the unexpected impact of the annual foreign tax credit disallowance provision included in legislation being considered to ease the U.S. tax burden for Americans overseas. At worst, the disallowance provision could nullify an increased exclusion or even cause U.S. taxes to increase in countries where foreign tax rates equal or exceed U.S. tax rates. At best, it will be difficult to predict the results of the new legislation.

Upon my return to New York after testifying before your hearing, I discussed this problem further with several of my partners. We have developed eight new examples of the effects of disallowing the foreign tax credit and enclose them as an exhibit with this letter.

ARTHUR YOUNG

May 6, 1981
The Honorable Robert Packwood
Page 2

In conclusion, we believe that the general foreign tax credit limitation which has been in the law for many years provides a flexible but adequate limitation and accordingly urge you to reconsider the need for an additional annual foreign tax credit limitation. While the additional limitation was included in the aborted 1976 Act and is included with the 1978 Campsite exclusion provision, we believe it is an unnecessary complication and can be expected to provide distorted results in many cases of general application.

We also enclose for your reference copies of our 1980 edition of Taxation of Expatriates. We hope that your efforts to ease the taxation of Americans overseas will make it possible for us to reduce the size of the enclosed booklet in the future.

We would be happy to meet with you or your staff at your convenience to clarify any aspects of our testimony regarding the proposed legislation.

Very truly yours,

Robert H. Castles

Robert H. Castles

Enclosures

cc: Senator John H. Chafee
Robert E. Lighthizer, Esq. (Chief Counsel)

RHC/mm

Pending Expatriate Tax Legislation: Better Than Section 913? Or Worse?

by Michael J. Bishko
Robert H. Castles
Robert B. Klein
Partners, Arthur Young & Company

Proposed expatriate tax legislation is in the wind in Washington again. Most of the proposals would replace the existing law governing expatriates (in effect only since 1978) with new rules providing for the exclusion of substantial amounts of foreign earned income. The new exclusion generally would be in excess of the deductions available under Section 913 of the Internal Revenue Code.

Background

Even before the recent publication of the GAO report, "American Employment Abroad Discouraged by U.S. Income Tax Laws",* there was evidence in Washington of reasonable prospects for tax incentive legislation which would benefit U.S. expatriates and their employers. There were reports, Congressional testimony and proposed legislation all designed to promote American competitiveness through reductions in employees' U.S. income taxes and therefore in employers' tax reimbursement costs.

The GAO report added the icing to the cake by criticizing the 1978 U.S. tax legislation in terms of equity and complexity, and by calling for a "complete exclusion or limited but generous exclusion" to place Americans abroad on a comparable income tax basis with competitor country employees and to achieve ease of administration.

Despite widespread agreement on the objective of new tax legislation, it is not clear that the proposals advanced will accomplish the desired result in all cases. This article identifies one potential problem — namely, the foreign tax credit disallowance or "scaledown" — and demonstrates the critical importance of understanding the *overall* ramifications of proposed legislation to the success or failure of Congressional objectives.

Foreign Tax Credit Disallowance

The foreign tax credit has been an important vehicle in avoiding double taxation of foreign earned income. Normal operation of the foreign tax credit over a period of years will usually achieve its goal despite differences in foreign tax years, concepts of foreign taxation and timing of foreign tax payments.

Most of the legislative proposals would provide a substantially increased foreign earned income exclusion *at the expense of* disallowing foreign tax credits attributable to excluded income. This is quite acceptable in a no-tax country and may not be detrimental in a low-tax country. But in a higher-tax country, it is possible — depending upon how the disallowance is calculated — for the disallowance to distort the results and even cause more in tax benefits to be lost than will be gained with the higher exclusion. Should this happen, the employer's tax reimbursement costs will actually increase in comparison to existing law (Section 913).

Impact of Credit Disallowance

In order to isolate this phenomenon, we utilized our in-house computer program, AY-EXPATRIATE, to calculate the total tax reimbursement cost in a selected foreign country under two different legislative proposals, using salary and allowances provided by ORC. For each proposal we considered at least three alternatives for treatment of the foreign tax credit:

- No foreign tax credits disallowed.
- Foreign tax credits disallowed with respect to earned income exclusion *only*.
- Foreign tax credits disallowed with respect to earned income exclusion *and* excess housing deduction.

The Table on page 8 shows the results of these calculations and compares them to the results under existing Section 913.

Analysis of Results

The table shows that the total tax reimbursement cost under present law — which Congress consciously enacted without providing for any foreign tax credit disallowance — is $34,417.

However, in two cases, alternatives (3) and (5), which reflect substantial disallowances of foreign tax credits, the total reimbursement costs are $53,831 and $51,277, respectively — significantly higher than under Section 913. It should be noted that while the disallowance does not have any impact in the indicated single year (in both cases the net U.S. tax is zero), it reduces the excess foreign tax credits available for carryforward to future years where they would otherwise be utilized to offset U.S. taxes on the final tax reimbursement and gross-up.

The results under alternatives (1) and (4), where foreign tax credits are not disallowed at all, are that total tax reimbursement costs are identical to those under Section 913. This will be the case when the effective foreign tax rate over the course of an assignment is higher than the U.S. tax rate, which is not surprising.

An interesting result is that in alternative (2), the total tax reimbursement cost is the same as under Section 913 — $34,417 — indicating that while foreign taxes are disallowed only with respect to the basic $60,000 exclusion, enough credits are still available in this case to be utilized in the future to offset the final tax reimbursement and gross-up.

Lastly, alternative (6) results in a total tax reimbursement cost of $30,939, which is a slight reduction from the cost under Section 913. This result indicates that if tax reimbursements received after termination of foreign residency are eligible for the 80% exclusion, total reimbursement costs may actually decrease.

The table portrays the extent to which taxes and reimbursement costs will be impacted by the mechanics of the foreign tax credit disallowance rule under the stated assumptions. Different fact patterns and assumptions will obviously produce different results.

For example, the adverse effect of the disallowance rule will be increased or decreased depending upon whether tax reimbursements and gross-ups received after the expatriate returns to the U.S. are eligible for exclusion under a new law and also whether these reimbursements are taxed in the country of prior assignment.

However, it is important that expatriates and their employers be aware now that the proposed legislation, much of which has been promoted by multinationals in an attempt to reduce their tax reimbursement costs, may in fact have the opposite effect in some situations.

Conclusion

As a result of our review of this subject, including numerous computer calculations for a variety of foreign assignments, the following general conclusions can be drawn concerning proposed legislation which couples a generous exclusion with a foreign tax credit disallowance:

- Reimbursement costs in low-tax countries will decrease.
- In higher tax countries, reimbursement costs for the total assignment may increase even though the exclusion eliminates most or all of foreign earnings from taxation. The foreign taxes, which otherwise would be available as carryforwards to offset U.S. taxes on final reimbursements and tax gross-ups, will not be available to do so if they are disallowed.
- The mechanics of calculating the disallowance under new legislation should receive the direct and immediate attention of all interested parties.
- We are entering an environment in which planning for reducing foreign taxes will take on far greater importance in minimizing the cost of maintaining expatriates overseas.
- Companies considering a change from tax protection to tax equalization — and, for that matter, companies already using tax equalization — may encounter resistance from expatriates who perceive that new legislation will (or should) result in a "tax windfall" for them. In no-tax and low-tax countries, many expatriates will have an actual tax cost much lower than their "theoretical" tax. However, as we have seen, this may not be the case in higher tax countries.

It seems to us that great care must be exercised by both Congress and the multinational business community in designing expatriate tax legislation. Clearly, it is important that Congressional proponents of new legislation be made aware of the potential consequences of their proposals — such as the adverse effects of the foreign tax credits disallowance — so that meaningful legislation is the eventual outcome.

The essential point to be borne in mind is that the objectives which have such widespread acceptance today — namely, achieving tax parity with overseas employees of competitor countries, and simplifying administration of the U.S. tax law — will not be accomplished in all cases unless an increased foreign earned income exclusion is coupled with reasonable foreign tax credit provisions.

□□□

COMPARISON OF U.S. TAXABLE INCOME, U.S. TAX AND TAX REMIBURSEMENT COSTS UNDER SECTION 913 AND PROPOSED LEGISLATION

	Section 913	PROPOSED LEGISLATION					
		$60,000 exclusion plus excess housing			80% exclusion		
		(1)	(2)	(3)	(4)	(5)	(6)
Base Salary	$65,000						
Retained hypothetical tax	(17,057)						
COLA	5,000						
Housing	24,000						
U.S. housing charge	(9,750)						
Education	7,000						
Home leave	9,000						
	83,193	$83,193	$83,193	$83,193	$83,193	$83,193	$83,193
Section 913 deductions	(32,321)						
Exclusion:							
$60,000		(60,000)	(60,000)	(60,000)			
Excess housing		(18,448)	(18,448)	(18,448)			
80% of earned income					(66,554)	(66,554)	(66,554)
Exemptions	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)
U.S. taxable income (1 year)	$46,872	$ 745	$ 745	$ 745	$12,639	$12,639	$12,639
Foreign tax (1 year)	$24,729	$24,729	$24,729	$24,729	$24,729	$24,729	$24,729
Creditable foreign tax*	$24,729	$24,729	$ 6,894	$ 1,410	$24,729	$ 4,946	$ 4,946
U.S. tax	$13,245	$ -0-	$ -0-	$ -0-	$ 1,559	$ 1,559	$ 1,559
Foreign tax credit	(13,245)	-0-	-0-	-0-	(1,559)	(1,559)	(1,559)
Net U.S. tax (1 year)	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-
Excess foreign tax credit (1 year)	$11,484	$24,729	$ 6,894	$ 1,410	$23,170	$ 3,387	$ 3,387
Total tax reimbursement cost** (2-year tour of duty):							
Total reimbursement payments	$68,531	$68,531	$68,531	$87,945	$68,531	$85,391	$65,053
Less: Retained hypothetical tax	(34,114)	(34,114)	(34,114)	(34,114)	(34,114)	(34,114)	(34,114)
Net cost to employer	$34,417	$34,417	$34,417	$53,831	$34,417	$51,277	$30,939

*After reduction for disallowed foreign taxes attributable to excluded income (where applicable).

**Assumes excess taxes reimbursed in following year and expatriate taxable in foreign country only during period of residency.

(1) No foreign tax credit disallowance.
(2) Foreign tax credits disallowed with respect to $60,000 exclusion only.
(3) Foreign tax credits disallowed with respect to $60,000 exclusion and excess housing.
(4) No foreign tax credit disallowance.
(5) Foreign tax credits disallowed with respect to 80% exclusion, but 80% exclusion does not apply to final reimbursement.
(6) Foreign tax credits disallowed with respect to 80% exclusion; 80% exclusion applies to final tax reimbursement.

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ADDITIONAL EXAMPLES

IMPACT OF THE PROPOSED PROVISIONS

DISALLOWING FOREIGN TAX CREDITS ALLOCABLE TO

EXCLUDED EARNED INCOME

SUBMITTED BY

ROBERT H. CASTLES

DIRECTOR OF EXPATRIATE SERVICES

ARTHUR YOUNG & COMPANY

MAY 6, 1981

ARTHUR YOUNG

Introduction

For simplicity, the examples hereafter assume the following facts:

No work days are spent in the U.S. which would result in U.S. source income.

Investment income or losses, deductions, exemptions and the zero bracket amount net to zero.

Foreign earned income exclusion of $75,000.

Married taxpayers filing joint returns.

While foreign tax facts are assumed to demonstrate dramatic results, it should be noted that the results are possible although the magnitude may be lower in all countries where foreign tax obligations and employee tax reimbursements for any year are not settled entirely during the year.

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Example 1

Expatriate receives a reimbursement of excess income taxes paid by him in prior years following completion of an overseas assignment and upon return to the U.S. It is not taxable in the foreign country for one of many possible reasons, such as residency, territorial tax system, nature of payment, etc.

	1981	1982
Base salary	$40,000	$40,000
Allowances	40,000	-
Reimbursement of excess income taxes		30,000
Earned income exclusion	(75,000)	-
U.S. taxable income	$ 5,000	$70,000
Gross U.S. tax	$ 224	$24,678
Less foreign tax credit (*)	(224)	(1,963)
Net U.S. tax	$ -	$22,715
(*) Gross 1981 foreign income tax	$35,000	
Less disallowance $75,000÷$80,000 X $35,000	(32,813)	
Available foreign tax credit	2,187	
Less general foreign tax credit limit for 1981	(224)	
Foreign tax credit carryover to 1982		$ 1,963
Total income taxes paid for both years (foreign of $35,000 plus U.S. of $22,715)		$57,715

Comment

Foreign taxes are higher than U.S. taxes but will be largely disallowed as allocable to the earned income exclusion. A small carryover remains to offset U.S. taxes in the subsequent year in which the tax reimbursement is received. The amount would be entirely disallowed where the exclusion exceeds current income or when transfer to or from the U.S. occurs in the middle of the tax year. If the tax reimbursement could be received in 1981 without increasing foreign income taxes, the U.S. tax could be eliminated as will be shown in Example 2.

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Example 2

Facts are the same as Example 1, except that the excess income tax reimbursement is received in December 1981 but subsequent to termination of the assignment.

	1981	1982
Base salary and allowances	$80,000	$40,000
Bonus or other items	30,000	-
Earned income exclusion	(75,000)	-
U.S. taxable income	$35,000	$40,000
Gross U.S. tax	$ 8,088	$10,226
Less foreign tax credit (*)	8,088	-
Net U.S. tax	$ -	$10,226
(*) Gross foreign income tax	$35,000	
Less disallowance $75,000÷$110,000 X $35,000	(23,864)	
Available foreign tax credit	11,136	
Less general foreign tax credit limit	(8,088)	
Foreign tax credit carryback/carryover	$ 3,048	
Total income taxes paid for both years (foreign of $35,000 plus U.S. of $10,226)		$45,226

Comment

Payment of the $30,000 tax reimbursement in 1981 rather than 1982 will reduce current U.S. taxes by $12,479 and generate a foreign tax credit carryback/carryover of $3,048 which could reduce U.S. taxes by a total of $15,527 compared to the result shown in Example 1.

Example 3

Same facts as Example 1 except the expatriate is a Third Country National (TCN). Many foreign countries will not tax earned income attributable to a prior foreign assignment or the TCN can arrange to receive the payment after he leaves the assignment country but before he arrives in his new assignment country or home country. Americans who are taxed based on citizenship do not have the same flexibility.

ARTHUR YOUNG

Example 4

To minimize double taxation during their prior assignments, taxpayers elected to use the accrual method of determining their foreign tax credit. At the beginning of 1981, taxpayers moved to France where taxes are paid for the first year of residence in the next year. At the beginning of 1982, taxpayers moved to Bahrain where there are no foreign income taxes.

	1981	1982
Base salary and allowances	$75,000	$75,000
Foreign tax reimbursement	-	34,000
Earned income exclusion	(75,000)	(75,000)
U.S. taxable income	$ -	$34,000
Gross U.S. tax	$ -	$ 7,718
Less available foreign tax credit (*)	-	-
Net U.S. tax before gross-up	$ -	$ 7,718
(*) Gross foreign tax accrued	$34,000	N/A
Less disallowance	(34,000)	N/A
Available foreign tax credit	$ -	N/A
General foreign tax credit limit	$ -	$ 7,718
Total income taxes paid in both years (foreign of $34,000 plus U.S. of $7,718)		$41,718

Comment

Where foreign taxes for a year are paid in the following year, an expatriate on the accrual basis for foreign tax credit purposes (but not for income recognition purposes) could have the entire foreign tax credit disallowed in 1981 and be subject to U.S. tax on a reimbursement of the entire 1981 foreign tax made by his employer in 1982. The same treatment could apply to reimbursements received in any year after return to the U.S. The converse will be the case for a cash basis taxpayer with identical facts as shown in Example 5.

ARTHUR YOUNG

Example 5

Facts are the same as Example 4, except that taxpayers use the cash method of determining their foreign tax credit.

	1981	1982
Gross U.S. tax	$ -	$ 7,718
Less allocable foreign tax credit (*)	-	(7,718)
Net U.S. tax	$ -	$ -
(*) Gross foreign tax paid	N/A	$34,000
Less disallowance ($75,000 ÷ $109,000 X $34,000)	N/A	23,394
Available foreign tax credit	N/A	10,606
Less foreign tax credit used in 1982	N/A	(7,718)
Foreign tax credit available for carryback/carryover	N/A	$ 2,888
Total income taxes payable in both years (all foreign)		$34,000

Comment:

An expatriate on the cash basis for foreign tax credit purposes will have no disallowance of foreign tax credit, would pay no U.S. tax on the foreign tax reimbursement and generate a foreign tax credit carryback/carryover which could be utilized in other years in sharp contrast to Example 4.

ARTHUR YOUNG

Example 6

Expatriate works at a foreign location where a substantial amount of income is exempt from foreign taxation for one or more of the following reasons: specific exemption, exemption for a limited period, special housing provision, exclusion for income earned outside the country, etc. It is assumed that the foreign country excludes from income the same amount as the U.S. and the foreign tax rate significantly exceeds the U.S. tax rate.

	1981	
	Foreign Tax	U.S. Tax
Base salary and allowances	$100,000	$100,000
Earned income exclusions	(75,000)	(75,000)
Taxable income	$ 25,000	$ 25,000
Income taxes	$ 10,000	$ 4,633
Less foreign tax credit disallowance ($75,000 ÷ $100,000 X $10,000)	(7,500)	
Available foreign tax credit	$ 2,500	$ (2,500)
Net U.S. tax payable		$ 2,133

Comment:

The expatriate would be subject to U.S. taxes after paying substantially higher foreign taxes on the same income.

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ARTHUR YOUNG

Example 7

Multinational employer assigns an American for five years to a foreign country where the income tax rates significantly exceed the U.S. rates. To minimize the foreign tax cost of the assignment, the employer arranges for the expatriate to borrow the amount of his foreign taxes from a U.S. bank. The employer agrees to pay the employee a bonus at the end of his assignment equal to the amount of his outstanding loan at the end of the assignment (including interest which is ignored in this example). The future deferred bonus will be subject to forfeitability provisions in certain cases. Such bonuses will not be subject to tax under the law of many foreign countries, under certain treaty provisions or will be subject to tax at reduced rates.

	Each year	Entire Assignment	Year After Assignment
Base salary and allowances	$75,000	$375,000	$ 50,000
Earned income exclusion	(75,000)	(375,000)	-
Deferred compensation/bonus	-	-	250,000
U.S. taxable income	$ -	$ -	$300,000
Foreign tax paid	$50,000	$250,000	$ -
Less disallowance	(50,000)	(250,000)	-
Available foreign tax credit	$ -	$ -	$ -

U.S. tax on termination of assignment

Using disallowance rule (before gross-up)	$139,678
Without disallowance rule but using general foreign tax limit	
Gross U.S. tax	$139,678
Less foreign tax credit (excess credit of $22,822 per year X 5)	114,110
Net U.S. tax (applicable to salary after return)	$ 25,568

Comment:

A multinational company could only use an American in such countries at a cost substantially in excess of the U.S. cost. Such countries include Australia, Denmark, Egypt, Sweden, New Zealand, etc.

ARTHUR YOUNG

Example 8

Expatriate is assigned to a high tax rate country. A standard practice is to pay the expatriate a transfer bonus prior to taking up residence in the foreign country to minimize foreign taxes. Assume the employee is paid the bonus in 1981 and works in the foreign country in 1982.

	1981	1982
Base salary and allowances	$40,000	$75,000
Transfer bonus	40,000	-
Earned income exclusion	-	(75,000)
U.S. taxable income	$80,000	$ -
Gross U.S. income tax	$29,678	$ -
Less foreign tax credit (*)	-	-
Net U.S. income tax	$29,678	$ -
(*) Gross foreign income tax		$45,000
Less disallowance ($75,000 ÷ $75,000 X $45,000)		(45,000)
Available foreign tax credit		$ -

Comment:

Under current rules, foreign taxes in excess of the general foreign tax credit limit in 1982 (assuming the entire compensation is subject to U.S. taxes) could be carried back to eliminate the entire U.S. income tax applicable to the transfer bonus and thereby minimize the cost of transferring an American to an overseas assignment.

Senator CHAFEE. Well, I would appreciate that because I must confess I don't understand the point here. If you have the election provision, which all of the legislation provides, wouldn't that take care of it? In other words, you could elect to take the foreign tax credit or you could elect to take the exemption. Is that what you are talking about here?

Mr. CASTLES. If you mean the election provisions of other part provisions, yes, but if we went back to 913 it wouldn't improve the position of Americans overseas.

Senator CHAFEE. Now, wait a minute. As I understand the election provision, you could either go with taking the foreign tax credit.

Mr. CASTLES. The foreign tax credit is intended to reduce double taxation.

Senator CHAFEE. Yes, 913 would be out and the taxpayer then, could either take all his returns using the foreign tax credit. Let's say he is in England. Using the foreign tax credit or he could proceed under this legislation to have the exempt amounts.

Mr. CASTLES. I raised the same questions when I saw the results; I couldn't believe the answer.

Senator CHAFEE. All right, why don't you send us that, will you, because I see this is getting a little complicated.

Mr. CASTLES. Thank you very much.

Senator CHAFEE. It must be a good point we don't understand. Thank you, Mr. Castles. Mr. Hammer.

STATEMENT OF RICHARD M. HAMMER, NATIONAL DIRECTOR OF INTERNATIONAL TAX SERVICES, PRICE, WATERHOUSE & CO.

Mr. HAMMER. Thank you, Senator. I am Richard M. Hammer, national director of International Tax Services at Price, Waterhouse & Co. With me here today, on my right, is Peter J. Hart, formerly our national director of tax policy here in the District of Columbia and Mr. Hart did testify before the hearing last year of this subcommittee.

Both Peter and I have extensive experience in providing tax services and advice to U.S. citizens resident outside the United States.

Senator CHAFEE. Are the returns as complicated as people say they are?

Mr. HAMMER. Absolutely, twice as complicated, Senator. Our clients, to give you a measure, our clients include many multinational corporations all over the globe and this year, as Arthur Young so stated, we are preparing for 1980 over 10,000 expatriate and alien tax returns. The volume of paper is probably twice, three times what it was 5 years ago.

Our firm favors the repeal of the concept of section 913 and the restatement of an earned income exclusion concept. We do believe that the concept in your colleague's bill, Senator Jepsen, which allows a complete exclusion for all foreign earned income should be given very, very serious consideration as a basis with which to start to address this problem.

From an aspect of simplicity, again reducing that volume of paper on tax returns, a full exclusion for earned income, and

earned income only, outside the United States is clearly the simplest and most efficient way of dealing with the problem.

Your proposal, and that of your colleague, Senator Bentsen, while limiting the exclusion to meaningful amounts—certainly more than what was the case prior to 1978—would be big steps, positive steps toward alleviating the existing problems created by the section 913 concept.

We quite understand the political problem involved in attempting to get through Congress a complete exclusion. We understand that it may not be acceptable. Therefore, I think your bill and colleague Senator Bentsen's bill, the principals in those bills form a good basis again upon which to build a reasonable approach to taxing U.S. citizens abroad.

We tend to like Senator Bentsen's bill a little bit more, sir, because of the higher exclusion level. Your bill and his bill also contain excess housing expense exclusion or deduction, and we think that, together with a meaningful amount of earned income exclusion is absolutely necessary to achieve satisfactory legislation where the exclusion in full, 100 percent, is not feasible.

Senator CHAFEE. Do you see the complexities, Mr. Hammer, that Mr. Castles sees in the housing situation?

Mr. HAMMER. No, sir. I really don't. I think the housing situation now is atrocious the way it works under section 913 and there, there are so many complexities and unintended results which yield no benefit.

I prefer the flat amount approach, and we have written to the joint committee staff on this about 2 years ago, to do something about the housing situation, to simplify it and also make it responsive to the problem of creating the relief which the current system does not.

In Senator Bentsen's bill it is a $75,000 figure. Yours, I believe, is $50,000 going up to $75,000 over a period of time. This is simple to apply. Anything in excess of that becomes taxable income.

The housing the same way. With a $5,500 or $5,800 floor, to the extent the individual pays more for housing costs and reimbursed for it, that is excludable. I don't see the complexity.

Senator CHAFEE. Also, the housing costs that taxed for, could be added to your wages if they are both below the limit then of course you wouldn't pay any tax.

Mr. HAMMER. The difficulty with flat exclusion, if it's say $75,000 and you're in Saudi Arabia or any other place where the housing might cost you $50,000, that you'd eat up the exclusion if you didn't provide a separate item for the housing aspect of it. This is the reason I favor it.

Senator CHAFEE. Well, I agree with that too. Of course, I suppose Mr. Castles' answer would be that he was for the total exclusion, so that therefore, it would be taken care of. Is that it?

Mr. HAMMER. The unlimited exclusion would be my objective also.

Senator CHAFEE. Well, unlimited exclusion.

Mr. HAMMER. I am in favor of that too, basically as I indicated at the outset, it would take care of it, but I understand the political problems of achieving that.

Senator CHAFEE. Setting aside the political problem, do you see potential abuses? For instance, in your testimony, or I guess it was in Mr. Castles' testimony, he mentioned how we got into this problem of movie actors. I don't know how the movie actors did it because if in the old days you would have to stay abroad that whole time, we would have the same situation under an unlimited exclusion now wouldn't we? Whose testimony mentioned the movie actor?

Mr. CASTLES. It was mine.

Senator CHAFEE. Well, now if you have an unlimited exclusion and you have a residency requirement of say 11 out of 12 months or 17 out of 18, and the movie actors managed to do it in the old days under those conditions, why wouldn't we have a repeat?

Mr. CASTLES. We would.

Mr. HAMMER. Senator Chafee, I think that that problem can be dealt with and I am sure the abuse potential is there, but if you go to a test of residence which doesn't just take into account a number of months physically present in a foreign country, but actually have a list of criteria which establish residence, such as moving your family, entering into the community, a type of test that has been applied by the courts and not a simple month count test.

You may well deal with that abuse potential because the person is really going to have to go to Switzerland and live there, in the true sense of residing there and give up the ties, the basic ties to the United States. Whereas if you say 11 out of 12 months, that's a different question. You are talking physical presence.

I think that the best approach to the whole thing is to perhaps, put a cap on physical presence. But, an unlimited exclusion for true bonafide residence and make it a real test of bonafide residence. There is a lot of precedence in the courts that deal with that question.

Senator CHAFEE. Well, now this a new suggestion you're making.

Mr. HAMMER. It may well be.

Senator CHAFEE. What worries me, we are all trying to get rid of complexities and we just don't want to get this bogged down to an argument about family, family residence. Let's say the man goes abroad on January 1 to Nigeria and because of school and so forth, his family doesn't come until June. Then they make the move.

Mr. HAMMER. But that man has become a resident and you have a question about.

Senator CHAFEE. But has he been a resident for 11 out of 12 months?

Mr. HAMMER. That is the complexity with using a number of months test. To establish residence just by being there 11 out of 12 months, you inject the artificiality in it which you do not if you go for a true residence type of concept.

You can still retain 11 out of 12 months test for the itinerent worker or for the person who is going over for a limited period of time. The construction workers, importantly, and give them a meaningful cap on the physical presence test with an unlimited exclusion on the bona fide resident.

Again, I understand the problems of attempting to get a full exclusion 100 percent through.

Senator CHAFEE. Yes, there certainly have been lots of litigation about the residence. You get into that squabble because obviously the Treasury Department would take the view they don't want to give the person the exemption, then the burden is to prove your residence.

Mr. HAMMER. That's right.

Senator CHAFEE. Where do you vote? You have given up your voting rights. You've sold your home.

Mr. HAMMER. I think they can vote today. I think a foreign resident can still vote in the States.

Senator CHAFEE. Yes, but I mean have you taken yourself off the voting lists at home and just vote as an expatriate rather than a resident of the state.

Well, its an ingenious idea. Does that complete your testimony?

Mr. HAMMER. I was going to say a lot of other things, but I took up a lot of time saying things I wasn't, so I'll just close.

Senator CHAFEE. Well, I'll give you one more minute.

Mr. HAMMER. I'll just close on the point that I have already made. The point of the complexities of 913 which are totally inadequate to deal with the problem and that as accountants we all do a lot of expatriate tax work and nobody is better positioned than we are to see the increase in costs to employers, administrative costs and compensation costs, and cost of fees for getting tax returns prepared for their expatriate employees who just can't handle it themselves.

This to me is one of the key problems in the whole area. We have just made it too complex for corporations to deal with, injecting the additional cost element in the equation and that has probably been one of the reasons why we have become less of a force in the marketplace overseas.

Senator CHAFEE. Of the exclusions that are present in there or the 913, what is the one that is most sought after, would you say? I have people talk to me about the importance of the education expense. That seems to be incredibly complicated.

Mr. HAMMER. I think the housing is the worst, frankly. The education allowance is important because Americans going overseas with their kids have to pay to send them to a school.

There are complications and what is an adequate type U.S. school, whether the school is located in the vicinity of the taxpayers tax home or someplace else, there are several complications.

I think in the majority of the cases there is a complete reimbursement and exclusion for most of those costs. It is really the housing, the one we focused on before, in connection with your bill that has the housing allowance where the scheme is just not working.

It is complex as hell and it is not getting the intended benefit. That is really the problem, I think, that we have faced most often in our practice. I think many, many tax returns that we have prepared over the 2 years or so since the 1978 scheme went into effect, have had either zero housing deduction or very minimal housing deduction because of the calculation which is based on earned income artificially inflated by other factors that are not actually compensatory in nature.

That is where the scheme falls down. Now, there are problems also in the education and home leave and definitional problems which the regulations attempt to address, but I think it is the housing where it really fails.

Senator CHAFEE. Under our proposition, whether it is $75,000 or whatever it is, home leave could be in it.

Mr. HAMMER. Home leave would be part of the $75,000. Education would be part of the $75,000. I think that is fine.

Senator CHAFEE. What do you think your clients would think of that?

Mr. HAMMER. I think they would like it very much. I think it would really simplify things and in the housing, you would inject some complexity if you singled it out for special treatment, as I think you really have to for the reasons enumerated.

There you would have the definitional problem of defining what is housing expenses, but that has already been done by a regulation for the 913 scheme, reasonably I believe. There are a couple of inequities in it, but it is basically a reasonable definition.

Senator CHAFEE. OK, thank you. Mr. Henning.

Mr. HAMMER. Thank you, Senator.

STATEMENT OF MICHAEL A. HENNING, PARTNER-IN-CHARGE, INTERNATIONAL TAX SERVICES, ERNST & WHINNEY

Mr. HENNING. My name is Michael A. Henning. I am a partner-in-charge of international tax services for Ernst & Whinney.

For the past 16 years I have advised U.S. citizens abroad on their U.S. tax problems. Each year Ernst & Whinney, which has over 300 offices in 70 countries, prepares U.S. tax returns for Americans abroad.

This is done either by our U.S. tax experts located in the foreign countries or by U.S. tax experts traveling to the foreign countries.

In addressing the issue on the U.S. tax treatment of income earned abroad by Americans, we believe the problem is more of an employer problem than an employee problem.

We say this because almost all U.S. multinational corporations have what is called the tax equalization policy for their employees. Under this policy a U.S. citizen who works abroad neither gains nor loses from a tax aspect.

The employee pays an amount equal to the U.S. tax he would have paid had he remained back in the United States. To the extent that this amount, the hypothetical U.S. tax, is exceeded by his actual U.S. and foreign income taxes, the U.S. employer makes the employee hold.

In other words, the employer reimburses the employee for this excess. However, this excess is most likely passed on by those employers to overseas customers just like any other cost would have to be recaptured from the customer.

Therefore, to whatever extent there is a U.S. tax cost involved in employing U.S. citizens abroad, it is a cost to the employer.

Recently, we sent to each Senator on the committee, a copy of the study done by our firm, Ernst & Whinney, entitled "Tax and Total Costs of U.S. Citizens Abroad" and we submit it here as part of our testimony, today.

[The study was made part of the committee files:]

Mr. HENNING. This study shows the costs to U.S. employers of having U.S. citizens abroad in 60 countries. It shows both the tax and general foreign living allowances needed to station U.S. citizens abroad.

The overall cost to U.S. employers varies from country to country and generally people look at it as a ratio of the foreign allowances and tax costs to base pay with the highest ones, base pay, to total being 3 to 1, for example, in Nigeria and Saudi Arabia.

The costs in our study do not include the company's administrative costs in tax equalizing their employees' compensation.

These costs include the fees of firms such as ours, for preparing U.S. employees' tax returns. And, in our opinion, probably what is a greater burden, the indirect costs of the international personnel departments in administering these tax equalization programs.

It has been our experience that the international personnel departments spend more time in dealing with the U.S. tax problems of their employees than any other single item.

It is very fair to say that these U.S. tax and administrative costs, are costs which companys which compete with us overseas as has been mentioned before, do not incur because they do not in general tax their citizens stationed abroad.

Turning to the proposals before us, our firm favors the provisions similar to that of S. 598 which Senator Jepsen has proposed.

It provides that all foreign earned income be exempt from U.S. tax. That was the situation that existed before 1963 when the then section 911 was amended to prevent abuses which had arisen after World War II when many countries were in a developing stage.

We believe that the potential for abuses of the then section 911 which was present in those days, no longer exists. This is true in part because the U.S. tax rates on earned income have been significantly reduced. We now have maximum tax on earned income and at the same time foreign tax rates and living costs have been increased significantly, especially in what might be labeled desirable overseas locations.

We talked before about abuses. To monitor the provisions and avoid future abuses, we recommend that Congress require the U.S. Treasury to report periodically on how this new provision is actually working.

This has happened recently with the Domestic International Sales Corporation legislation and in the Possessions Corporation which is similarly monitored and I think it could be done here as well.

Senator CHAFEE. I see, OK, fine. Thank you very much. I appreciate it, gentlemen.

[The prepared statements of the preceding panel follows:]

STATEMENT OF MELCHIOR MORRIONE

OF

ARTHUR ANDERSEN & CO.

ON

TAXATION OF U.S. CITIZENS WORKING ABROAD

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

HEARINGS ON SENATE BILLS 408, 436, 598 AND 867

APRIL 24, 1981

TAXATION OF U.S. CITIZENS WORKING ABROAD

SUMMARY OF COMMENTS

1. We are pleased that Congress is refocusing its attention on this important tax policy area involving the taxation of Americans working abroad.

2. We believe the major tax policy issue involved in taxing Americans working abroad is the declining competitive position of United States companies in world markets. Analyses of data included in our statement indicate that American companies have lost a significant part of the dominant position they occupied 15 to 20 years ago.

3. A major factor that bears on a U.S. company's competitive position in relation to foreign companies is the cost of products and services being marketed in other countries. The cost of maintaining U.S. citizens in foreign locations is often a significant element which must be recovered in sale prices for goods and services.

4. Changes made in 1976 and 1978 in our rules for taxing expatriates have aggravated the problem, particularly since most of our foreign competitors do not tax foreign earnings of their citizens. We clearly are at a competitive disadvantage with these companies.

5. The fundamental objective of U.S. tax policy should be to make the tax cost of maintaining U.S. citizens working abroad no greater than that of citizens of other developed countries in comparable positions. The disincentive that presently exists caused by the higher tax cost of U.S. employees, which has led to their replacement by nationals of other countries, should be eliminated.

6. In lieu of the complex rules adopted in 1978, we recommend the adoption of a simple system that would provide complete exclusion from U.S. taxation for earnings of Americans working abroad. If Congress decides as a matter of policy that there is a major abuse potential, we favor a liberalized limited exclusion approach. Of the Bills under consideration, we believe S. 436 introduced by Senator Bentsen provides the best solution.

7. We recommend that any limited exclusion should be made elective to provide simplicity and fairness for individuals employed in high tax rate jurisdictions.

My name is Melchior Morrione and I am a tax partner in the New York office of Arthur Andersen & Co. I am responsible for coordinating the Firm's practice in assisting Americans working abroad on their tax affairs. Arthur Andersen is an international firm of accountants with offices throughout the world. While we have clients, both foreign and domestic, that would be affected by the proposals before this subcommittee, this statement is not made on their behalf and the views expressed are those of the Firm itself.

In the course of our practice in this area, we have had first-hand experience in working with a large number of Americans employed abroad as well as with their corporate and other business employers. We have observed and are quite concerned with the impact that the changes enacted in 1976 and 1978 affecting the taxation of these citizens have had on the competitive position of American companies operating in many parts of the world. We are particularly pleased that legislation has been introduced and is being considered by your subcommittee that would attempt to correct the problems created by present U.S. rules for taxing Americans working abroad.

I. DECLINING POSITION OF THE U.S MULTINATIONAL IN THE GLOBAL ECONOMY

Shortly after World War II, U.S. business embarked on an international expansion program under which it became the dominant force in international trade. The expansion of business vistas toward foreign markets progressed from exporting commodities and manufactured products to investment in local manufacturing and distribution facilities to better serve distant markets. Advanced technology together with high-quality workmanship and business acumen made the U.S. enterprise the major competitor in the international marketplace.

During the past two decades, the economic balance among industrial nations has decidedly shifted. This movement has been caused by many factors including government fiscal policies, upheaval in the international monetary system, and national politics. Unfortunately, the United States government, by a number of its actions, has impaired the effectiveness of American business in world markets.

Over the last few years, changes in U.S. Government attitudes and tax policies have weakened the competitiveness of American companies in world markets, and multinationals based in other countries have quickly moved in to exploit the opportunities available. The downward trend in the competitive position of U.S. companies in relation to foreign companies is demonstrated by analyses of the largest industrial companies in the world.

The following table shows that, in 1963, 67 U.S. corporations were among the 100 largest companies in the world,

ranked by sales. In 1979, the number of U.S. companies in the top 100 had dropped to 47.

Distribution of the World's 100 Largest Industrial Companies

(Ranked by Sales)

	Number of Companies		
	1963	1971	1979
U.S.-based companies	67	58	47
Foreign-based companies	33	42	53
Total companies	100	100	100

Source: "The World's Multinationals: A Global Challenge," Conference Board Bulletin 84 (1981)

A comparable analysis of the 500 largest industrial corporations shows a similar trend.

Distribution of the World's 500 Largest Industrial Corporations

(Ranked by Sales)

	Number of Companies		
	1963	1971	1979
U.S.-based companies	300	280	219
Foreign-based companies	200	220	281
Total companies	500	500	500

Source: Conference Board Bulletin 84, ibid.

From 1963 through 1979, sales of the 100 largest foreign industrial companies increased nearly 1000% (from $82.3 billion in 1963 to $876.6 billion in 1979). The corresponding increase for the 100 largest U.S. companies was about 600% (from $159.5 billion in 1963 to $963.7 billion in 1979). Stated another way, in 1963 total sales of the foreign companies were 52% of the sales of their U.S. counterparts; by 1979, foreign companies' sales had increased to 91% of the U.S. companies' sales.

This data shows that the relative position of U.S. companies in international markets has declined substantially during the years surveyed. The competition faced by U.S.

companies in overseas markets is of substantial economic strength; it seems clear that the large companies outside the United States are growing faster than their U.S. counterparts.

The success of non-U.S. multinational companies in penetrating international markets is not accidental. Through excellent research and development and product design efforts, major technological advances, and the backing of their governments in many ways, they have concentrated on the development of export markets which has led to significant contributions to their national economies.

In recent years, there has been a shift in the focus of non-U.S. multinationals from foreign markets to the U.S. market. We have seen major acquisitions of U.S. companies by non-U.S. multinationals not unlike the way U.S. multinationals invested in other countries decades ago. U.S. companies are already experiencing increased competition from the non-U.S. multinational company for the local U.S. market.

While initially the dominant market position held by U.S. multinationals resulted from providing superior products, this advantage no longer exists. In today's world, product cost has assumed increased significance in international trade.

Other governments assist their companies in penetrating export markets by a number of direct export incentives. These include long term credits, low interest financing, elimination of tax (usually VAT) on exported goods and services, and favorable taxation income from foreign operations controlled by domestic companies. The combination of these policies has permitted non-U.S. multinationals to offer their products at attractive prices in world markets, and this has enhanced their competitive position in relation to U.S.-based companies.

With the cost of products becoming increasingly important, the U.S. taxation of Americans working abroad becomes a more critical factor for American companies that compete in world markets. The tax changes made in 1976 and in 1978 have placed American companies at a distinct competitive disadvantage because of the cost of employing U.S. citizens in countries where they wish to do business.

Other policy issues are at stake in this area. Because of the increased cost of maintaining U.S. citizens abroad, U.S. based multinationals have been forced to replace Americans with nationals of other countries whose tax burdens are considerably less than ours. Once foreign nationals reach management levels in foreign entities controlled by U.S. companies, they can exert considerable influence upon decisions affecting the purchase of goods and services. Quite logically, they prefer services and products with which they are familiar, and these are usually not of U.S. origin. This factor alone can be significant in lessening the demand for U.S. products, and thus directly affect the export market for U.S. manufactured goods and services.

The global economy is now more homogeneous. National economies are much more interdependent. Large industrial companies can and do operate on a truly multinational scale in response to the needs of a global economy. It will be difficult for U.S. multinational companies to recapture their former role. They have lost so much ground in the past that they are a decreasingly important factor in the international competitive arena. Restoring balance will take concerted efforts fostered by a supportive government policy. Fundamentally, we need a reduction in disincentives to international expansion. We should adopt policies that reduce the cost of maintaining expatriates overseas and create an incentive for Americans to accept assignments abroad.

A fundamental objective should be to make the tax cost of maintaining a U.S. citizen working abroad no greater than that of citizens of other developed countries in comparable positions. Almost uniformly, major competing countries do not tax the overseas earnings of their citizens working abroad.

II. COST OF MAINTAINING EXPATRIATES AT OVERSEAS LOCATIONS

A number of Americans working abroad are self-employed in their own businesses and professions, and they must bear directly the cost of taxation. However, the majority of working U.S. expatriates are employed by U.S. multinational companies. For this reason, the U.S. taxation of Americans working abroad is a matter of considerable corporate and business interest.

Because of prevailing compensation programs that reimburse the U.S. employee for any increased tax burden suffered as a result of accepting a foreign assignment, the extra tax cost incident to an expatriate assignment is borne primarily by the U.S. employer. This excess cost must eventually be passed on to customers in pricing U.S. products or services in overseas markets.

In considering the competitiveness of U.S. companies operating abroad, it must also be recognized that most multinational companies of whatever country provide their expatriate employees additional benefits while on foreign assignment to compensate them for duplicate or higher costs incurred during such assignments. Many also pay premiums based on the location of certain assignments, in order to create a direct incentive to attract employees to accept them. In the case of non-U.S. multinational companies, this premium is often the absence of income tax in the expatriate's home country. In the case of a U.S. multinational employer, however, this opportunity is not available, since U.S. expatriates are subject to tax on their worldwide income.

A typical U.S. expatriate compensation package, in addition to the usual elements of housing, educational

allowances, home leave and incentive premiums, all of which are usually taxable in the U.S. as well as abroad, will include a reimbursement for additional income taxes that will be incurred by the employee. A major objective has generally been to achieve tax neutrality in the expatriate compensation package, so that the employee has neither a benefit nor a detriment as a result of a foreign assignment. The combination of base salary, a series of allowances and tax equalization reimbursements has simply increased the cost to an employer of maintaining a U.S. employee in many parts of the world.

The tax equalization reimbursement is a singular cost, which must be grossed-up in order to achieve its objective; that is, because the reimbursement is taxable, the tax on it must also be reimbursed. The recognition and evaluation of this added cost to U.S. multinational enterprises has had a significant impact on their activities. It has caused many of them to reexamine the cost of maintaining U.S. employees abroad and to reduce significantly the number so employed by replacing them with local national or third-country national employees. Further, U.S.-based companies have lost opportunities for work because their competitors are not required to factor this increased cost into prices quoted for their goods and services.

There is little question that the U.S. multinational incurs a much higher cost maintaining U.S. employees abroad than is the case for his non-U.S. competitor. The burden and the adverse consequences of this fall on the U.S. company and ultimately on the U.S. economy. We believe that efforts by the U.S. Government to eliminate or correct perceived abuses in expatriate taxation and to achieve alleged equity goals have resulted in overkill. As indicated earlier, the U.S. position in the international marketplace is deteriorating. Unless positive action is taken to reestablish a foundation for U.S. multinational companies to resume a leadership role in world markets, the U.S. economy may be subject to increased penetration and control by foreign multinationals.

III. THE FOREIGN EARNED INCOME ACT OF 1978

The Foreign Earned Income Act of 1978 (1978 Act) introduced a novel system of deductions designed to compensate an expatriate for extraordinary costs incurred while on foreign assignment. This system of deductions replaced the old earned income exclusion for most taxpayers. Although this system appeared more precise than the former exclusion, it has resulted generally in a much higher tax for expatriates.

Incentive for Foreign Employment

In developing the 1978 legislation, Congress showed some concern about the need for an incentive to encourage Americans to accept employment abroad, but this does not appear to have been a major factor. Subsequent to enactment of the 1978

Act, considerable support has developed for adopting tax policies that would create such an incentive. For reasons beyond tax equity or neutrality for the employees who are directly affected, Congress should establish a system for taxing such employees that would encourage employers and their employees to develop a stronger U.S. presence abroad. This should enhance opportunities for expanding export markets and, in the final analysis, contribute to the U.S. economy both domestic jobs and foreign source funds to improve our balance of payments.

Complexities of Current Law

The series of special deductions included in the 1978 legislation was premised on the types of extraordinary costs normally incurred by U.S. expatriates. Although this system appeared more precise than the former flat dollar exclusion, and therefore was expected to be more equitable, it generally resulted in a much smaller overall tax benefit than the actual expenses incurred by or on behalf of the taxpayer for these costs. In addition, the 1978 Act imposed a series of burdensome recordkeeping and substantiation requirements on both expatriate taxpayers and their employers. This has resulted in additional fees for professional services and will cause greater problems for the Internal Revenue Service in auditing expatriate returns.

From our experience in working with many expatriate taxpayers, we have found that they have great difficulty in understanding how the law works and appreciating the need for increased documentation, which far exceeds requirements for citizens employed in the United States.

There is little question that an increased burden and undue complications are imposed on expatriates in filing their annual U.S. tax returns. While tax simplification has often been a significant consideration in the development of our tax laws, the 1978 system for expatriate taxation has been complicated far beyond expectations. It is little wonder that American citizens abroad are confused by the tax laws they must deal with. While the normal individual taxpayer in the U.S. has difficulty in understanding and completing his annual Federal tax return, the requirements placed upon American citizens abroad go far beyond the form itself. The end result does not seem to justify the complications that have been created.

IV. COMPETITIVE POSITION OF U.S. COMPANIES -- THE DOMINANT TAX POLICY ISSUE

In testimony before Senate Finance Committee hearings on the "Taxation of Americans Working Abroad" in May of 1978, Comptroller General Elmer Staats, after summarizing the results of a survey conducted by the General Accounting Office, referred to the seriousness of the deteriorating U.S. economic position, and the relatively few policy instruments available for promoting U.S. exports and commercial competitiveness abroad. He stated:

80-612 O—81——16

"Our concern is based upon a fundamental belief that, to maintain and build upon the competitive position of the United States, it is essential for a large force of U.S. citizens to be maintained abroad to promote and service U.S. products and operations."

A Task Force of the Subcommittee on Export Expansion of the President's Export Council submitted a report to the President on December 5, 1979. In referring to the U.S. system for taxing Americans working abroad, the Chairman of the Export Council stated:

"The Foreign Earned Income Act of 1978 has done little to alleviate the problems of differences in tax treatment between American citizens working overseas and their counterparts from competing industrial nations. The result has been that third-country nationals, who generally do not have the burden of paying taxes in their home countries on their foreign earned income, are employed instead of American citizens. This has brought about a sharp loss in the U.S. share of overseas business volume in vital economic sectors, largely because third-party nationals tend to specify equipment manufactured in their home country, whereas American citizens would specify and order U.S. equipment with which they are most familiar."

The title of the February 27, 1981 report of the General Accounting Office, "American Employment Abroad Discouraged by U.S. Income Tax Laws" aptly summarized the findings of this recent survey of major U.S. companies.

The report concludes as follows:

"Taxation 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.

"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, because

- Present U.S. tax provisions are widely regarded as discouraging employment of U.S. citizens abroad.

- o Present tax provisions have reportedly made Americans relatively more expensive than competing third-country nationals, thereby reducing their share of employment abroad by major U.S. companies.

- o Americans retained abroad by major companies are generally reimbursed for their higher taxes, adding to the companies' operating costs and making them less competitive."

V. BILLS UNDER CONSIDERATION

The fundamental objective of U.S. tax policy should be to make the tax cost of maintaining U.S. citizens working abroad no greater than that of citizens of other developed countries in comparable positions. The disincentive that presently exists caused by the higher tax cost of U.S. employees, which has led to their replacement by nationals of other countries, should be eliminated.

The four Bills being considered by this Committee all work toward these objectives. To achieve total comparability with the tax rules of other countries, the complete exclusion of foreign earned income as suggested in S 598, introduced by Senator Jepsen, would seem the appropriate solution. If Congress believes, however, that complete exclusion would create opportunities for tax avoidance or abuse, and that some limitation on this favorable tax treatment is required, the basic alternative is to place a limitation on the amount of the exclusion. Such a limitation would be achieved by S 408, introduced by Senator Chafee, S 436 introduced by Senator Bentsen, or the somewhat novel approach suggested in S 867, introduced by Senator Moynihan. The first two of these Bills provide a fixed dollar exclusion plus a simplified excess housing cost allowance. Senator Moynihan's approach would exempt 80% of all foreign source income regardless of the total amount of such income.

S 436 introduced by Senator Bentsen provides a practical and workable solution to the problem. It provides a flat $75,000 exclusion, together with a deduction for housing costs in excess of $5,500. This approach is simple and the amount of the exclusion is realistic in terms of today's compensation levels. Moreover, the Bill increases the exclusion by $5,000 per year to a maximum of $95,000 in the year 1985. This annual increment deals realistically with preserving the value of this benefit.

S 408, Senator Chafee's Bill, is very similar, although it provides for a lower exclusion and does not contain annual increments after 1981. This Bill provides that the first $50,000 in earnings and one-half of the next $50,000 in earnings shall be excluded from taxation. Senator Chafee's Bill also contains a deduction for housing costs in excess of $5,785.

S 867, Senator Moynihan's Bill, instead of providing a flat dollar exclusion, creates an exclusion for 80% of all foreign source income. This is the only Bill under consideration which deals with all foreign source income and not just foreign earned income. Since most of the developed nations of the world tax their citizens on the basis of residence, this aspect of S 867 would place U.S. expatriates on an equal footing with nationals of those countries from that particular viewpoint. However, it is not clear that the taxation of unearned foreign source income has created a significant competitive disadvantage. The creation of a percentage exclusion deals responsively with the preservation of this incentive in the future at a value equivalent to that at the time enacted. On the other hand, 20% of all income earned by U.S. citizens working abroad will be subject to taxation. For employees at lower compensation levels, this Bill will impose a tax where none of the other bills under consideration would. As a result, in situations where the host country imposes no income tax, the U.S. employer would still be at a competitive disadvantage with competing multinationals.

Making the Exclusion Elective

We believe it is important that the exlusion be elective. Such a provision is presently contained in S 436, Senator Bentsen's Bill, and S 867, Senator Moynihan's Bill.

Each of the Bills under consideration provides for a reduction in the amount of foreign taxes which may be claimed as deductions or credits by the U.S. taxpayer, to the extent attributable to excluded income.

The foreign tax credit serves to unilaterally eliminate from double taxation income subject to tax in both the United States and in foreign jurisdictions. When all factors are equal (that is, the nature of taxable income and the definition of deductible expense are essentially equivalent in the two taxing jurisdictions) the foreign tax credit works effectively to eliminate double taxation.

When the overall effective foreign tax rate is greater than the effective U.S. rate, no tax is paid to the United States on such income. However, any foreign taxes in excess of the U.S. rate may be carried over for possible use in other years against other foreign source income. In situations in which the host country's overall effective tax rate on the expatriate's income is equal to or higher than the effective U.S. rate, a U.S. multinational company employer is not at any disadvantage, vis-a-vis the multinationals of other countries, since expatriates of whatever nationality are subject to tax at the same local rates.

In fact, it is only when the host country's effective tax rate is lower than that of the United States that U.S. multinationals are at a competitive disadvantage. This is because U.S. citizens must continue to bear the burden of U.S.

taxation at an overall effective rate greater than that which prevails in the host country, and the U.S. multinational employer must reimburse the employee for this cost. In so doing the U.S. company tries to factor this additional business expense into the price of its goods or services.

Therefore, with respect to expatriates on assignments to countries whose effective tax rate is lower than that of the United States, the legislation under consideration will achieve the objective. However, with respect to expatriates on assignment to countries whose overall effective tax rate exceeds that of the United States, then the legislation under consideration provides no benefit. In such case, the operation for the foreign tax credit mechanism is sufficient to provide relief from double taxation.

Senator Bentsen's Bill, S 436, and Senator Moynihan's Bill, S 867, make the exclusion elective on an annual basis. Senator Chafee's Bill, S 408, contains no such election. The existence of an election would indeed simplify the system of taxing U.S. expatriates and would eliminate any unintended disadvantage to those on assignment to countries whose overall effective rates are greater than that of the United States. It is therefore recommended that an exclusion be made elective.

Other Considerations

A key factor in providing legislation in this area should be simplicity. There is ample evidence to indicate that the system of deductions created by the 1978 Act not only did not provide adequate relief but was far too complicated to be readily understood by the typical expatriate. Moreover, in the bill approved by the Senate Finance Committee last year (HR 5829) which was modeled on Senator Chafee's bill (S.2283), a series of complicated conditions was introduced that would have restricted the benefits of the bill to certain sectors of the international economy.

This bill would have provided an opportunity to elect an exclusion of $50,000, increasing to $65,000 after an employee has been abroad for two years, as an alternative to Section 913. However, the exclusion would only have been available to persons employed in certain qualified activities in developed countries or performing any services in undeveloped countries. Qualified activities in developed countries would include mining and petroleum exploration and development, export related services, or certain charitable activities.

While well intentioned and objectively defined, this targeted approach was far too complicated. With multinational companies engaged in various businesses in different parts of the world, it is not unusual for an employee to be transferred from one division to another in different countries, or between divisions in the same country engaged in different business

activities. One geographical location or type of activity would qualify for the increased exclusion, while others would not. The average expatriate taxpayer would have great difficulty understanding the logic of such an arrangement.

We urge that in providing appropriate tax treatment for expatriates, simplicity be a fundamental objective. We need a system of taxation simple enough to be understood by the persons being taxed. This would be far more effective than one which is overly precise and difficult to comprehend.

VI. CONCLUSION

In providing professional tax services to many U.S. multinational companies as well as a significant portion of the U.S. expatriate community, our Firm has developed a genuine concern about the economic impact of our rules for taxing Americans who are working abroad. We see an increased awareness by multinational companies of the high cost of maintaining U.S. citizens overseas. We see significant reductions in the number of U.S. expatriates located abroad. These actions are being taken because the extra U.S. tax cost that must be incurred on behalf of an American expatriate seems no longer justified.

The expatriate tax legislation enacted in 1978 should be reconsidered in light of the eroding competitive position of U.S. companies in international markets.

To achieve equality with non-U.S. multinational competitors insofar as the tax burden on employees abroad is concerned, complete exemption from U.S. taxes for income earned abroad by U.S. citizens should be adopted. This in essence is Senator Jepsen's proposal embodied in S. 598.

We realize that an unlimited exclusion, which for some time was U.S. tax policy, was reduced to a flat dollar amount to avoid certain abuses that had occurred. It Congress decides that the potential for such abuse remains a significant factor, proposals that would place limitations on the exclusion would seem appropriate. As noted above, Senate Bills 408, 436, and 867 all provide limitations on the exclusion. Of these three proposals, S. 436 appears the most practical and workable approach to this problem. It starts with a flat $75,000 exclusion plus a simple housing cost allowance, and increases the exclusion allowance by $5,000 per year until a level of $95,000 has been reached in 1985. In our view, the level of these proposed allowances is realistic in terms of today's compensation levels and would achieve a great deal of parity with non-U.S. employees employed by competitor country employers.

As noted above, however, we recommend that any limited exclusion be elective to provide simplicity and fairness for U.S. citizens employed in high tax rate foreign jurisdictions.

Because of the problems and uncertainties created by existing law over the last few years, and the concern of many Americans now working abroad about future U.S. tax policy, we urge quick action on expatriate taxation by this Congress, effective for the calendar year 1981.

We appreciate the chance to submit our views on this important area of tax policy and urge favorable action by this Congress on proposals that would make American business more competitive in world markets.

ARTHUR YOUNG

STATEMENT OF ROBERT H. CASTLES

DIRECTOR OF EXPATRIATE SERVICES

ARTHUR YOUNG & COMPANY

ON

TAXATION OF AMERICANS WORKING OVERSEAS

BEFORE THE

FINANCE TAXATION SUBCOMMITTEE

OF THE

SENATE FINANCE COMMITTEE

HEARINGS ON BILLS S408, S436, S598 AND S867

APRIL 24, 1981

ARTHUR YOUNG

Summary of
Statement of
Robert H. Castles
Director of Expatriate Services
Arthur Young & Company, New York, New York
on the Taxation of Americans Working Overseas
Before the Finance Taxation Subcommittee

April 24, 1981

- Lowering U.S. taxation of Americans overseas will benefit U.S. industry without raising international trade questions which might result from other economic proposals.

- Congress in 1926 considered and rejected a proposal to base an exclusion from U.S. taxation on export related activities. Use of a broad exclusion was considered to be more feasible and sensible.

- An earned income exclusion large enough to exempt overseas allowances (including tax reimbursements) and some portion of salary and other compensation should be enacted. This exclusion should also apply to amounts received related to the foreign assignment after return to the U.S. and should be adjusted in some fashion in subsequent years for inflation.

- The physical presence test should be reduced to 11 out of 12 months and the bona fide residence test should be based on any 12 month period.

- The foreign tax credit limitation now in the law is adequate. An additional scaledown of foreign taxes relating to excluded income is unnecessary. Furthermore, it could nullify or increase taxes of Americans overseas even with the increased exclusion contemplated by current proposals. At best, it will be impossible to predict the benefits of current proposals where a foreign tax credit scaledown limitation is provided in addition to the regular foreign tax credit limitation.

ARTHUR YOUNG

Statement of
Robert H. Castles
Director of Expatriate Services
Arthur Young & Company, New York, New York
on the Taxation of Americans Working Overseas
Before the Finance Taxation Subcommittee

April 24, 1981

To: Chairman Packwood and Members of the Committee:

My name is Robert H. Castles. I am a tax partner of Arthur Young & Company and serve as firm Director of Expatriate Services. Arthur Young & Company is a large International Accounting Firm and has become a leader in providing expatriate services to multinational companies. We presently provide a full range of expatriate tax services to approximately 100 U.S. corporations and to several foreign companies. We will prepare 1980 U.S. tax returns for approximately ten thousand American expatriates.

I am pleased to have the opportunity to present these comments to your subcommittee.

Introduction

The past few decades have seen increasing problems for certain segments of U.S. industry in meeting overseas competition. Many U.S. industries have lost their leadership positions in world commerce. American companies have turned to our government in many areas for assistance in reversing this trend. While difficult international trade questions are raised by some of the proposed solutions, lowering the U.S. taxation of Americans overseas should not be questioned by other nations. We strongly

believe that it is in the interest of the U.S. to grant this relief.

These comments will be limited to areas where our experience indicates that changes in existing law are desirable or essential. Before dealing with specific areas, I think it would be worthwhile to review some of the history of prior law dealing with the taxation of Americans overseas.

History of U.S. Taxation of Americans Overseas

The question of whether to provide tax relief to overseas Americans as an export incentive is not new. It was debated, and such incentives were adopted, by the sixty-ninth Congress in 1926. It is informative to briefly review the history of the law from 1926 to date. It shows that some of the proposals before Congress today were either previously considered or actually once part of the law.

In enacting the 1926 law, Congress considered and rejected in conference a proposal to exclude from U.S. taxation income relating to export activities and chose instead to base the exclusion on earned income from foreign sources. A reading of the testimony before Congress at that time indicates that administrative and definitional problems resulting from relating the exclusion to export activities were recognized by Congress.

In response to reports of abuse by persons absenting themselves from the U.S. for more than six months simply for tax purposes, the period of required bona fide residence in a foreign country was raised from six months to one year by The Revenue Act of 1942.

To encourage individuals with technical knowledge (who would not otherwise qualify as bona fide residents of a foreign country) to go abroad in order to complete specific projects, a 17 out of 18 month physical presence alternative to bona fide residence was added in 1951.

At this point, U.S. taxation of earned income of Americans overseas was probably comparable with taxation of foreign expatriates by their home countries.

Both the House Ways and Means Committee and the Senate Finance Committee concluded in 1953 that the 17 out of 18 month physical presence alternative had "been subject to a great deal of abuse. Some individuals with large earnings have seized upon the provision as an inducement to go abroad to perform services, which were customarily performed at home, for the primary purpose of avoiding Federal income taxes." A key concern was the fact that movies were being filmed outside the U.S. and that the actors were therefore avoiding taxes on their earnings. This problem was solved by reducing the unlimited exclusion of earned income from foreign sources pursuant to the 17 out of 18 month alternative to a maximum exclusion of $20,000.

A ceiling on the earned income exclusion for bona fide residents was added in 1962 to encourage investment in the U.S. rather than investment overseas as well as for perceived reasons of equity.

Recommendations

Our comments and recommendations will be limited to factors to be considered in designing a new exclusion for foreign earned income.

Level of the Exclusion

An earned income exclusion sufficient to exempt overseas allowances (including tax reimbursements) and some portion or all of the salary and other incentive compensation paid to Americans should be enacted. Presumably the exclusion should work effectively for the vast majority of American employees and be established at a level to eliminate abuse situations. An exclusion would clearly be preferable to the existing package of deductions to minimize complexity in achieving this result. Furthermore, the exclusion should also apply to amounts received after return to the U.S. which are clearly related to the foreign assignment.

If the subcommittee desires to adopt a mechanism to insure equity between Americans working at home and overseas, consideration might be given to limiting taxation of compensation to base salary and other incentive compensation amounts.

A major objective of either of the foregoing approaches is eliminating the taxation of allowances which are necessitated by unusual or high overseas living costs.

To keep the exclusion current, it should be adjusted in some manner for inflation in subsequent years. It is noted that Senator Moynihan's proposal of a percentage exclusion would automatically provide such an adjustment.

ARTHUR YOUNG

Ease of Administering the Exclusion

Reducing the complexity of U.S. taxation of Americans overseas should be a key Congressional objective.

This objective could be accomplished in a general way by limiting the number of alternative provisions which could apply to such Americans. We do not think it would be wise either to adopt a new combination approach (such as exclusion of income and excess housing) or retain one or more of the provisions of existing law on an elective basis.

Another way you reduce complexity would be to simplify eligibility requirements for excluding foreign earned income. We believe the 17 out of 18 month physical presence period should be reduced to 11 out of 12 months and the 12 month bona fide residence period should cover any consecutive 12 month period. Such provisions would be consistent with the rules of many foreign countries. In addition, this provisions would also reduce the number of return extensions required by Americans overseas.

Finally, we believe that the exclusion should be based on compensation rather than a function of specific items of income or expenses.

The Effect of Limiting Exclusion to Individuals Only In Certain Business Activities or Employed Only In Certain Countries

Such a provision would result in further complications in the law and require new definitions. We believe that the decision made by Congress in 1926 to define the exclusion broadly

was sensible and that the exclusion should not be predicated upon export related activities or work in certain countries. Furthermore, we point out that the final regulations interpreting the 1978 Foreign Earned Income Tax Act which were promulgated in November 1980 differed significantly from many of the regulations initially proposed by the Internal Revenue Service. Application of the final regulations to individual taxpayers will require the filing of many amended returns for 1978 and 1979. A repetition of such a scenario for contemplated legislation would continue to complicate matters for Americans overseas and their employers.

Disallowance of Foreign Tax Credit

The proposals reflect a provision which disallows foreign tax credits allocable to excluded foreign earned income. In all the years that the foreign earned income exclusion was in effect, there was never a reduction of creditable foreign taxes except for the regular limitation on foreign tax credits provided in the Internal Revenue Code. In addition to limiting the allowable foreign tax credit based on the effective U.S. tax rate, these foreign tax credit rules provide for carrybacks and carryovers. Such provisions are essential where foreign rules provide different tax years, different concepts of taxation and different timing of tax payments. As such, they serve to avoid double taxation over the term of an assignment.

ARTHUR YOUNG

While disallowance provisions were introduced with the 1976 Act and with the camp exclusion in the 1978 Act, these provisions have had limited application. Furthermore, camp situations have been generally limited to low tax foreign countries. Where the tax rates of foreign countries equal or exceed U.S. tax rates, the foreign tax credit disallowance provision could nullify or increase the taxes of Americans overseas even with the increased exclusion contemplated by current proposals.

For example, the scaledown could completely eliminate foreign tax credits in one year where the exclusion eliminates or drastically reduces U.S. taxes. After the American returns home, he could have high income from a U.S. assignment but still receive a reimbursement of items attributable to his foreign assignment. These items could be subject to no or low foreign taxes when received and a high U.S. tax.

At best, it will be impossible to predict the benefits of current proposals where a foreign tax credit scaledown limitation is provided annually in addition to the regular foreign tax credit limitation. We believe that the abuse situations contemplated by the disallowance provision are limited and the current flexible foreign tax credit provisions are adequate to deal with them.

ARTHUR YOUNG

Conclusion

In conclusion, we should remember that the original reason for easing the tax burden of Americans overseas was to improve or at least make our foreign trade position competitive with that of other countries. We seem to have lost sight of this objective over the years and should now attempt to correct a problem which is critically important to the economy of our country.

80-612 O—81——17

SUMMARY OF PRINCIPAL POINTS

STATEMENT OF RICHARD M. HAMMER

PRICE WATERHOUSE & CO.

HEARINGS ON FOREIGN EARNED INCOME

1. We favor the repeal of Section 913 and the reinstatement of an earned income exclusion. We believe the legislation proposed by Senator Jepsen (S. 598), which would allow a complete exclusion for all foreign earned income, should be given serious consideration. A full exclusion of income earned outside the U.S. is clearly the simplest and most efficient method of dealing with taxation of Americans working overseas.

2. The proposals of Senators Chafee (S. 408) and Bentsen (S. 436), while limiting the exclusion, would provide positive steps toward remedying the existing problems created by Section 913. In the event a complete exclusion for earned income is not acceptable, we believe these two bills should receive favorable consideration. The exclusion proposed in S. 436 comes the closest to our suggestion for total exclusion.

3. Senator Chafee's proposal would provide a further exclusion for excess housing expense, and Senator Bentsen's proposal would provide a deduction for excess housing expense in addition to an exclusion for earned income. These are the key elements to satisfactory legislation if total exclusion is not feasible.

4. In our opinion, Section 913 of the Internal Revenue Code, which introduced into the Code in 1978 a deduction for five categories of overseas living expenses, is just not working. Some of the reasons for this conclusion follow:

   <u>Housing Expenses</u>

   The computation of the housing expense deduction is based not on comparable U.S. housing costs but on a percentage of the overseas individual's artificially inflated earned income. In a majority of the cases with which we are familiar, this rule completely eliminates any housing expense deduction. Compounding the inequities are the extensive record keeping

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requirements and computations necessary to determine whether any housing expenses are actually deductible.

Schooling Expenses

This element of the deduction was intended to represent reasonable expenses for the education of the taxpayer's dependents at elementary and secondary levels. In fact, the determination of this component has proved, in many cases, to be almost as elusive as the housing expense component.

Home Leave Transportation

The home leave deduction has proved to be much more confusing, and much less equitable, than originally intended, similar in complexity to the other Section 913 components. The narrow technical requirements of the home leave transportation component operate unfairly to deny many taxpayers a deduction for valid home leave costs.

Cost-of-Living Differential

Although the simplest element of the deduction from a computational standpoint, the COL differential is, in many cases, an inaccurate measure of actual living cost differentials.

5. The additional complexities introduced by the Foreign Earned Income Act of 1978 have dramatically increased the direct, as well as the hidden indirect, administrative costs to corporate employers of sending employees abroad. We understand from our foreign offices that IRS examinations of tax returns of Americans abroad continue to increase dramatically. This is not surprising considering the numerous new audit areas introduced by Section 913. The use of an earned income exclusion significantly reduces these problems, not only for the employer and the individual taxpayer, but for the government as well.

6. There are certain countries of residence where the proposals for replacing the current system of deductions with a flat exclusion plus a housing deduction could result in a higher U.S. tax liability relating to a foreign assignment. This problem could be eliminated by providing that foreign taxes attributable to excluded income could be carried forward and applied to foreign earned income to which the exclusion did not apply following repatriation to the U.S. A separate limitation, similar to that provided in I.R.C. Section 904(d), could be used to prevent abuse.

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STATEMENT OF

RICHARD M. HAMMER, PARTNER

PRICE WATERHOUSE & CO.

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARING ON TAXATION OF FOREIGN EARNED INCOME

April 24, 1981

My name is Richard M. Hammer. I am the National Director of International Tax Services for Price Waterhouse & Co. I am accompanied by Peter J. Hart, formerly National Director of Tax Policy for Price Waterhouse & Co. Both Mr. Hart and I have had extensive experience in providing tax advice to Americans resident outside the U.S.

We are appearing before this Committee as representatives of Price Waterhouse & Co., a group of international accounting firms having offices in ninety countries. Our clients include many multinational corporations employing U.S. citizens in all parts of the world. As part of our client services, we prepare tax returns for U.S. citizens working abroad. For 1980 we are pre-

paring more than 10,000 U.S. expatriate and alien tax returns on a worldwide basis. We also assist employers in planning compensation arrangements for their employees and work with employer and employee alike in making determinations of excess tax reimbursements. In addition to our U.S.-based staff, we employ over sixty U.S. tax professionals (most of whom are Americans) in overseas offices for this purpose.

This statement is submitted in our capacity as concerned professionals engaged in an international tax and accounting practice. We are not representing the interests of any specific company, organization, or individual.

NEED FOR CONGRESSIONAL ACTION

The formulation of equitable tax policy often results in complex and confusing tax legislation. Nowhere is this more apparent than in the taxation of U.S. citizens abroad, especially following the passage of the Foreign Earned Income Act of 1978. This legislation replaced the longstanding earned income exclusion with a special deduction for excess foreign living expenses which, although theoretically feasible, has resulted in a myriad of compliance problems for individual taxpayers, has sharply escalated administrative costs for their corporate employers, and in many instances does not achieve the desired equitable treatment.

The United States is the only major nation that continues to impose an individual income tax on all its citizens regardless of where they live and work. By allowing a foreign tax credit, the U.S. effectively yields to the foreign host country the primary right to tax an individual on the basis of residency.

To the extent the host country tax rate exceeds the effective U.S. rate, an income exclusion approach to taxing Americans abroad without a foreign tax credit would accomplish the same net tax result as exists under current law without many of the compliance complications and administrative costs which have resulted. Should the effective U.S. tax rate exceed the local rate and the income exclusion approach be readopted, the individual's net U.S. tax burden would be reduced; however, any projected revenue loss should be significantly offset by a substantial reduction in corporate tax deductions resulting from reduced payments for employee tax reimbursements. The net cost to the Treasury would be further reduced by a decrease in cost to the IRS of administering and enforcing the present system, enacted by the Foreign Earned Income Act of 1978.

OUR POSITION ON LEGISLATIVE PROPOSALS

We favor the repeal of Section 913 and the reinstatement of an earned income exclusion. We believe the legislation proposed by Senator Jepsen (S. 598), which would allow a complete exclusion for all foreign earned income, should be given serious consideration. A full exclusion of income earned outside the U.S. is clearly the simplest and most efficient method of dealing with taxation of Americans working overseas. This method would be consistent with the concept of imposing a tax on the basis of residency, which is followed by most major countries, thereby placing U.S. employees in overseas locations on a closer income tax parity with Nationals of other countries.

We recognize that a full exclusion approach could be considered by many as an invitation for abuse and perhaps even an incentive for Americans to move overseas. Such concerns, we believe, are unfounded except in unusual instances. Accordingly,

we urge this Committee to seriously consider the enactment of a full earned income exclusion as proposed by Senator Jepsen.

The proposals of Senators Chafee (S. 408) and Bentsen (S. 436), while limiting the exclusion, would provide positive steps toward remedying the existing problems created by Section 913. In the event a complete exclusion for earned income is not acceptable, we believe these two bills should receive favorable consideration. The exclusion proposed in S. 436 comes the closest to our suggestion for total exclusion.

Senator Chafee's proposal would provide a further exclusion for excess housing expense, and Senator Bentsen's proposal would provide a deduction for excess housing expense in addition to an exclusion for earned income. These are the key elements to satisfactory legislation if total exclusion is not feasible.

INADEQUACIES OF THE PRESENT TAX SYSTEM

A special deduction for certain foreign living expenses, and a limited exclusion of income earned in a camp, were introduced by the Foreign Earned Income Act of 1978 in an effort to achieve greater tax parity among U.S. taxpayers. The flat income exclusion which existed prior to 1978 was perceived as an arbitrary mechanism insufficient for some and too generous for others. Unfortunately, the replacement system that emerged from the 95th Congress has, based on our experience, fallen well short of its intended purpose of producing tax equity. In addition, the extensive compliance burdens and resulting administrative costs have caused many corporate employers to reassess their ability to compete effectively and profitably outside the United States, particularly with regard to employing U.S. citizens stationed

abroad. These conclusions are supported by the recent Comptroller General's Report to Congress titled American Employment Abroad Discouraged By U.S. Income Tax Laws, dated February 27, 1981.

In our opinion, Section 913 of the Internal Revenue Code, which introduced into the Code in 1978 a deduction for five categories of overseas living expenses, is just not working. Some of the reasons for this conclusion are presented below:

Housing Expenses

As in the U.S., the largest single expense, other than taxes, incurred by an individual overseas is normally for housing. In view of the extraordinarily high housing costs in many foreign locations, this component of the Section 913 deduction was intended to provide a deduction for housing expenses incurred in excess of comparable housing costs in the United States. The computation of the housing expense deduction, however, is based not on comparable U.S. housing costs but on a percentage of the overseas individual's artificially inflated earned income. Such "income" elements as excess tax reimbursements and nondeductible moving expense reimbursements which are non-compensatory in nature, are required to be included in the base housing limitation computation, thus severely limiting the deduction. Other allowances, such as for cost-of-living, further accentuate the problem to the extent that a full offsetting deduction is not allowed under Section 913. In a majority of the cases with which we are familiar, this rule completely eliminates any housing expense deduction.

Another obvious inequity in the housing expense area is an effective denial of a housing expense deduction to individuals

who choose to purchase a home abroad rather than to rent. This situation most often affects taxpayers with large families. In addition, allowing a housing expense deduction for the cost of furniture rental but not for depreciation on purchased furniture clearly (by Regulation) discriminates against the individual who chooses to purchase furniture overseas.

Compounding the inequities are the extensive record keeping requirements and computations necessary to determine whether any housing expenses are actually deductible. For example, all of the following steps are typically required just to compute this one element of the Section 913 deduction:

1. Amounts paid during the taxable year for rent, utilities, insurance, repairs and other housing costs must be determined. If a payment is attributed to a prior or subsequent taxable year, a proration between years is necessary.

2. In order to determine total housing expense, each separate payment noted in step 1 must be translated into U.S. dollars at the exchange rate in effect on the date of payment. This step alone may require more than fifty translations.

3. Total "housing income" must be determined. This is total income earned (including allowances and expense reimbursements) while living abroad reduced by allocable deductions.

4. Housing income must be reduced by other Section 913 deductions (schooling expenses, cost-of-living differential, home leave travel expenses and hardship

area allowance) as well as the total housing expenses determined in step 2.

5. The amount determined in step 4 is multiplied by 20 percent. The result is known as the "base housing amount."

6. Total housing expenses (determined in step 2) in excess of the base housing amount (determined in step 5) constitute the deductible housing expenses.

<u>In many cases the resulting deduction is zero</u>.

These steps are further complicated if housing income includes any earned income attributable to services performed in other than the current taxable year. In such cases, comparative hypothetical computations are necessary to determine what the proper housing expense deduction would have been had the income been received in the year of service. A special adjustment to income is then required if prior year housing deductions exceed the hypothetically determined amount.

Verification and substantiation problems have multiplied under Section 913, especially in the housing expense area. In France, for example, cancelled checks are not returned to the payor, thus making it virtually impossible to provide an examining agent with adequate support for rent, utilities and other housing expenses normally paid by check. This is typical of the practical problems we have encountered since the enactment of Section 913.

Numerous interpretational problems also arise in the housing expense area. Determination of the appropriate amount of expenses actually qualifying for the deduction is still the subject of much debate, even though three tax years involving housing expense deductions have now elapsed.

We believe that if an excess housing expense concept is to be retained it must be simplified. One possible approach would be the use of a table similar to that used in determining the cost-of-living (COL) differential. As with the COL table, the reference point should be the highest cost U.S. city; however, unlike the COL table, the housing deduction table should reflect different levels of earned income. Tables could be developed for each city or area of the world, which would provide the actual housing component of the Section 913 deduction based on the taxpayer's income level. Income for this purpose should include only base salary (i.e., true earned income) not increased by elements over which the taxpayer has no economic control such as excess tax reimbursements and nondeductible expense reimbursements.

Another approach toward simplification is found in the bills introduced by Senator Chafee (S. 408) and Senator Bentsen (S. 436). Senator Chafee's bill would provide an exclusion from gross income for housing expense in excess of 16% of a Step 1 grade G.S. 14 U.S. employee's annual salary. Senator Bentsen's bill would allow a deduction to annual housing expense amounts in excess of $5,500.

Schooling Expenses

Recognizing the additional expenses that an overseas taxpayer incurs for the education of his children, the Foreign Earned Income Act of 1978 includes a schooling expense component in the

Section 913 deduction. This element of the deduction was intended to represent reasonable expenses for the education of the taxpayer's dependents at elementary and secondary levels. In fact, the determination of this component has proved, in many cases, to be almost as elusive as the housing expense component.

For example, schooling expenses are limited to the cost of tuition, fees, books, local transportation, and other required expenses, but such costs may not exceed similar costs charged by an adequate U.S.-type school available within a reasonable commuting distance. The determination of such things as an adequate U.S.-type school, or reasonable commuting distance and other required expenses are subjective even with Treasury guidance in the form of regulations. In practice, a significant amount of time and effort is spent on such determinations, in computing as well as defending the deduction, particularly when the return is examined by the IRS.

Home Leave Transportation

The Section 913 deduction also includes an annual home leave element which consists of the reasonable cost of coach fare transportation for the taxpayer, his spouse, and his dependents to and from his tax home outside the U.S. to his most recent place of residence in the U.S. (or nearest port of entry in the continental U.S., other than Alaska). The home leave deduction has proved to be much more confusing, and much less equitable, than originally intended, similar in complexity to the other Section 913 components.

Determining the lowest coach or economy fare available at the date and time of travel can be particularly difficult, not to mention frustrating, considering the widely fluctuating fares in

the present competitive airfare environment. This determination is normally made when the tax return is prepared which could be more than a year after the home leave trip occurred.

The narrow technical requirements of the home leave transportation component operate unfairly to deny many taxpayers a deduction for valid home leave costs. A number of U.S. citizens working outside the U.S., who consider their home to be other than the U.S. due to a long absence from the U.S. or marriage to a nonresident alien, receive no deduction for their home leave travel. For example, a U.S. citizen living in Venezuela spends his annual home leave with his wife's family in Mexico. In order to claim a home leave deduction he is required to travel through Miami (the nearest U.S. port of entry) enroute to Mexico. No doubt this result was not anticipated when the legislation was introduced but it typifies the kinds of problems encountered by Americans abroad under the present tax system.

Cost-of-Living Differential

A deduction in recognition of general excessive costs of living (i.e., costs other than housing, schooling and home leave) in specific foreign locations is provided in the cost-of-living differential component of the Section 913 deduction. Although the simplest element of the deduction from a computational standpoint, the COL differential is, in many cases, an inaccurate measure of actual living cost differentials.

For example, the COL differential for a family of four in the United Kingdom in 1978 was $300. In 1979, the same family of four was entitled to a COL differential of $4,500. Such wide fluctuations in a country, as reasonably stable economically as was the United Kingdom in 1978 and 1979, implies the existence of

serious problems in reliance upon the COL table. This result probably has its origin in the fact that tables are published once a year, reflecting information available at only one point in time during that year.

ADMINISTRATIVE COSTS

The additional complexities introduced by the Foreign Earned Income Act of 1978 have dramatically increased the direct, as well as the hidden indirect, administrative costs to corporate employers of sending employees abroad. With the desire not to interfere in an employee's personal tax affairs, many corporations have turned to independent firms, such as ours, to prepare tax returns and tax reimbursement calculations for their overseas employees. The extent and need for these services have increased greatly as a direct response to the compliance requirements of Section 913.

Based on a review of 1979 annual proxy statements filed with the Securities and Exchange Commission, professional fees for expatriate tax services have been disclosed to be significant by many registrants. The additional costs to an employer of maintaining an adequate record-keeping system to report in detail amounts paid on behalf of the employee for housing, home leave and schooling are difficult to assess but can be assumed to be substantial.

With the loss of the earned income exclusion, the overseas taxpayer who is not protected by a corporate tax reimbursement plan, or entitled to company provided tax preparation services, is faced with the prospect of either preparing his own return or incurring a substantial sum to have it prepared for him. Con-

sidering the complexities introduced by Section 913, he often has little choice but to seek professional assistance.

Greater complexity in the tax return obviously increases the probability of error as well as the possible need for a detailed IRS examination. We understand from our foreign offices that IRS examinations of tax returns of Americans abroad continue to increase dramatically. This is not surprising considering the numerous new audit areas introduced by Section 913. The use of an earned income exclusion significantly reduces these problems, not only for the employer and the individual taxpayer, but for the government as well.

COMMENTS ON PROPOSALS

General Suggestions

As stated previously, we support the full earned income approach proposed by Senator Jepsen in S. 598. We believe that such a change would signficantly simplify the taxation of overseas Americans leading to lower employer costs and, logically, increased American business presence abroad. In addition, such an approach positions U.S. citizens abroad in an equivalent tax position with their foreign counterparts, thus providing less of an impediment to U.S. business competitiveness.

The modified exclusion approach proposed by Senators Chafee and Bentsen would remove much of the complexity inherent in the present system without changing the fundamental principle of individual taxation based on citizenship. Income now protected from double taxation in small part by the Section 913 deduction and in large part by the foreign tax credit would, instead, be protected by an earned income exclusion. Accordingly, we support

the proposals of Senators Chafee and Bentsen in the event Senator Jepsen's proposal is not considered a viable alternative to the Section 913 approach.

We also support the proposals of Senators Chafee and Bentsen that would grant a housing expense exclusion or deduction in addition to an earned income exclusion; however, in the interest of simplification and equity we would suggest that such deduction be determined either by reference to housing deduction tables as outlined previously, or the excess over a stipulated amount.

There are certain countries of residence where the proposals for replacing the current system of deductions with a flat exclusion plus a housing deduction could result in a higher U.S. tax liability relating to a foreign assignment. This problem could be eliminated by providing that foreign taxes attributable to excluded income could be carried forward and applied to foreign earned income to which the exclusion did not apply following repatriation to the U.S. A separate limitation, similar to that provided in I.R.C. Section 904(d), could be used to prevent abuse.

Some of the other areas that require Congressional action if an earned income exclusion is reinstated are:

1. Stipulating that net income rather than gross income of self-employed persons and partners is to be used for exclusion purposes; and

2. Determining nondeductible moving expenses related to excluded income.

If the exclusion is not reinstated, the following items require attention:

1. Allowance of a deduction for "Excess Tax Reimbursement". A deduction of this nature would eliminate the problem of tax spiral illustrated in Appendix I attached hereto.

2. Clarification beyond question that retirement allowances attributable to foreign service rendered prior to December 31, 1962 is, and has been since 1963, fully excludible in accordance with the relevant grandfather clause contained in the Revenue Act of 1962 (see Appendix II).

Technical Suggestions

The computation of foreign taxes allocated to excluded earned income should be clearly stated in the legislation. Without legislative guidance any one of a number of methods could be used to compute the disallowed foreign taxes. For example, under the Tax Reform Act of 1976 the following formula was prescribed:

$$\text{Foreign taxes} \times \frac{\text{U.S. tax on net excluded earned income plus zero bracket amount}}{\text{Numerator plus the Section 904 limitation}}$$

The final regulations under new Section 911, however, prescribe the following different formula:

$$\text{Foreign taxes} \times \frac{\text{Excluded earned income subject to country X tax}}{\text{Income subject to country X tax}}$$

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Other formulas could be used as could a specific identification of foreign tax to excluded income. Legislative guidance is clearly needed.

Indexing the Exclusion

We believe that readopting an exclusion to taxing earned income of U.S. citizens working outside the U.S. would move decisively in the direction of tax simplification compared to the existing special deduction approach. In addition, we believe that in the interest of tax equity, the blanket earned income exclusion should be indexed for inflation. The Consumer Price Index or the GNP deflator could be used for this purpose. In the alternative, the IRS could prepare an index for each foreign area based on a standard level of compensation such as the base salary of a GS-14. The exclusion would be calculated as an amount equal to the base salary, multiplied by the index which would be the percentage by which costs in the foreign area exceed U.S.-based costs. This latter suggestion is made on page 87 of the Comptroller General's Report to Congress on the Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas, dated February 21, 1978.

Washington, D.C.
April 24, 1981

APPENDIX I

EXAMPLE OF TAX SPIRALING (TAX ON TAX) RELATED SOLELY TO TAXATION OF EXCESS TAX REIMBURSEMENT

	Year			
	I	II	III	IV
Base salary	$40,000	$40,000	$40,000	$40,000
Hypothetical tax	(10,000)	(10,000)	(10,000)	(10,000)
	30,000	30,000	30,000	30,000
Allowances	20,000	20,000	20,000	20,000
Tax reimbursement	-	11,500	17,000	19,700
Section 913 deduction	(5,000)	(5,000)	(5,000)	(5,000)
	45,000	56,500	62,000	64,700
Exemptions	(2,000)	(2,000)	(2,000)	(2,000)
Taxable income	43,000	54,500	60,000	62,700
U.S. tax (rounded)	11,500	17,000	19,700	21,000

Assumptions:

1. All income, allowances and deductions remain constant in all years.
2. No foreign taxes are paid.
3. Taxpayer is married with no children and has not itemized deductions in excess of $3,400.
4. 1979 tax rates are used for all years.
5. Tax reimbursement is paid in the year subsequent to the applicable tax return year.

Observation:

This spiraling of tax will accelerate even more if foreign tax reimbursements are also received.

APPENDIX II

UNINTENDED EFFECT OF THE FOREIGN EARNED INCOME TAX OF 1978 ON TAXATION OF EARNED INCOME ATTRIBUTABLE TO SERVICES PERFORMED PRIOR TO JANUARY 1, 1963

Background

Prior to the Revenue Act of 1962, Section 911 of the Internal Revenue Code provided that amounts received from sources without the United States which constitute earned income attributable to services performed by a U.S. citizen who was a bona fide resident of a foreign country were not included in gross income and were exempt from taxation. Earned income for this purpose included deferred compensation paid after retirement as a retirement allowance.

Amendments to Section 911

The Revenue Act of 1962 placed a first time limit on the exclusion of income earned by a foreign resident. This Act contained an exception to the limitation (Section 11(c)(1)(B)--an effective date provision) for deferred compensation attributable to foreign services performed on or prior to December 31, 1962, provided the recipient had a right to such amounts on March 12, 1962. This Act also provided an exception (Section 11(c)(2)--an effective date provision) to amendments to Section 72(f), relating to special rules for computing employee's contributions in connection with annuities. Employer contributions after December 31, 1962 were no longer considered part of employee's contributions by reason of the application of Section 911, unless services were performed before January 1, 1963.

Subsequent amendments to Section 911, prior to the Tax Reform Act of 1976, clearly did not affect the "grandfather clauses" of the Revenue Act of 1962. The postponement of the application of provisions of the Tax Reform Act of 1976 retained the status quo through December 31, 1977.

The Foreign Earned Income Act of 1978 changed Section 911(a) from an exclusion for earned income from sources without the U.S. to an exclusion for foreign source income earned by individuals in certain camps for taxable years beginning after December 31, 1977. The Act did not mention the March 12, 1962 grandfather clause. Section 209(c) of this Act did provide for a one time election of the application of prior law (the never previously implemented Tax Reform Act of 1976) for calendar year 1978.

One of the changes embodied in the Tax Reform Act of 1976 affected the computation of tax on nonexcluded income. The effect of this change was to tax an individual's other income at the higher rate brackets which would have applied if the excluded income were not so excluded (i.e., the exclusion was "off the bottom").

Among the changes made by the Foreign Earned Income Act of 1978 was a rule that excluded income is not taken into account in computing the tax on the taxpayer's other income (i.e., the exclusion is "off the top"). In recognition of this change, the recently enacted Technical Corrections Act of 1979 provided for the use of tax tables by taxpayers electing the exclusion effective for taxable years beginning after December 31, 1977. This provision is not applicable for any taxable year for which an individual elects to be taxed under the Tax Reform Act of 1976.

Analysis of the Effect of Subsequent Legislation

It does not appear that Congress deliberately intended to terminate the March 12, 1962 grandfather clause and subject to tax the previously excluded income of a dwindling number of taxpayers who relied on that provision for over fifteen years. It also does not appear that Congress intended to increase the tax for 1978 on the other income of such individuals by taking the exclusion "off the bottom" for such years.

These assumptions are based on the premise that the Revenue Act of 1962 permanently excluded from taxable income deferred compensation attributable to pre-1963 services to which an employee had a right on March 12, 1962. Subsequent legislation in 1964, which modified (but did not repeal) Section 911, made no reference to the grandfather clause, and, in fact, no reference was needed, as these amendments affected only post-1962 earnings.

The Tax Reform Act of 1976 likewise only amended Section 911, however it made no reference to the grandfather clause. (Again, these changes affected only post-1962 income.) The House bill relating to the 1976 Act, entitled "Tax Reform Act of 1975", differed from the subsequent Senate bill in that it phased out the Section 911 exclusion entirely, replacing it with a deduction for certain educational expenses together with an exclusion for the value of certain employer-supplied services. The House bill would have repealed Section 911 effective for taxable years after December 31, 1978, but its effective date provisions contained a savings clause for the March 12, 1962 grandfather rule.

The Foreign Earned Income Act of 1978 is the most recent and significant change to Section 911. This Act also did not include a savings clause for the March 12, 1962 grandfather rule.

Although the Act revised the basic nature of Section 911, its provisions were nonetheless amendments to rather than a repeal of Section 911. Accordingly, based on the manner in which previous amendments were handled, a specific savings clause should not have been required. Any revision to Section 911, no matter how extensive, would apply only to post-1962 Section 911, leaving pre-1962 Section 911 intact.

The continued applicability of the March 12, 1962 grandfather rule to 1978 and future years can be further supported by Section 72(f). The Revenue Act of 1962 codified the March 12, 1962 grandfather rule as applied to annuities governed by Section 72, and this section was not changed by the 1978 legislation.

Present Status

Notwithstanding the foregoing analysis, the Treasury Department and the Internal Rvenue Service are of the view that the effect of the 1978 legislation was to terminate the March 12, 1962 grandfather clause, albeit inadvertently. For years subsequent to 1978, the exclusion granted by the grandfather clause would be totally eliminated. For 1978 returns, the exclusion would be available, but the tax on non-excluded income would be increased by considering the exclusion "off the bottom", under the one time election under the provisions of the Tax Reform Act of 1976.

It is difficult to know how many other individuals have been adversely affected by the inadvertent elimination of this provision. While the revenue impact of a restoration of this provision would be negligible overall, failure to restore the provision can represent a sizeable tax burden on individual

retire - who, for the most part, are trying to live on fixed incomes in a period of unprecedented inflation.

Recommended Action

The present Section 911 should be amended to clearly indicate that the exclusion for deferred compensation attributable to foreign services performed on or prior to December 31, 1962, provided the recipient had a right to such amounts on March 12, 1962, is applicable for all taxable years beginning after December 31, 1977. In addition, any subsequent amendment(s) to Section 911 should clearly retain this exclusion.

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202/862-6000

TESTIMONY BEFORE THE
SENATE FINANCE TAXATION SUBCOMMITTEE HEARING ON
THE TAX TREATMENT OF INCOME EARNED BY AMERICANS ABROAD
APRIL 24, 1981

MICHAEL A. HENNING
ERNST & WHINNEY

My name is Michael A. Henning. I am the Partner in Charge of International Tax Services for Ernst & Whinney. For the past 16 years I have advised U.S. citizens abroad on their U.S. tax problems. Each year Ernst & Whinney, which has over 300 offices in 70 countries, prepares tax returns for Americans abroad. This is done by our U.S. tax experts located overseas or U.S. tax experts that travel to foreign countries. These countries include Brazil, the United Kingdom, Nigeria, Saudi Arabia and most recently, China. We employ about 50 U.S. citizens abroad in our overseas offices who assist on audits and tax services for our clients.

In addressing the issue of the U.S. Tax Treatment of Income Earned by Americans Abroad we believe the problem is more of an employer problem than an employee problem. We say this because almost all U.S. multinational corporations have what is called a "tax equalization" policy for their employees. Under this policy a U.S. citizen who works abroad neither gains nor loses, from a tax aspect. The employee pays an amount equal to the U.S. tax that he would have paid had he remained in the United States.

To the extent that this amount, the hypothetical U.S. tax, is exceeded by his actual U.S. and foreign income taxes, the U.S. employer makes the employee whole. In other words, the employer reimburses the employee for this excess. The excess is most likely passed on by those employers to overseas customers just as with any other cost that has to be recaptured from the customer. Therefore, to whatever extent there is a U.S. tax cost involved in employing U.S. citizens abroad, it is a cost to the employer.

Recently, we sent to each Senator on the Committee a copy of a study done by our firm, Ernst & Whinney, entitled Tax and Total Cost of U.S. Citizens Abroad. We hereby submit it as part of our testimony today. This study shows the costs to U.S. employers of having U.S. citizens abroad in 60 countries. It shows both the tax cost and the general foreign living allowances needed to station U.S. citizens abroad. The overall cost to U.S. employers varies greatly from country to country. The ratio of total foreign allowances and tax costs to base pay can in some instances be over 3 to 1, for example, in Nigeria and Saudi Arabia. The costs shown in our study do not include the companies' administrative costs in tax equalizing their employees' compensation. These costs include the fees of firms such as ours for preparing employees' U.S. tax returns and, probably what is a greater burden, the indirect costs of international personnel departments

in administering tax equalization programs. It has been our experience that international personnel departments spend more time in dealing with the U.S. tax problems of their employees abroad than on any other single item.

It is, we believe, fair to say that these U.S. tax and administrative expenses are costs which companies in nations which compete with us do not have to incur because they do not tax their citizens stationed abroad. We compete with these nations for contracts all over the world but particularly in the Middle East and perhaps, in the future, in China. These contracts run into the billions of dollars. Our competing countries include Canada, West Germany, Italy, Japan, and the United Kingdom, none of which impose a tax burden on their overseas citizens.

Turning to the proposals that we have before us, our firm favors the provision similar to that in S. 598 that Senator Jepsen has proposed. It provides that all foreign earned income be exempt from U.S. tax. That is the situation that existed before 1963. The then Sec. 911 was amended to prevent abuses which had arisen after World War II when many countries were in a developing stage. We believe that the potential for abuses of the then Sec. 911 which was present in those days no longer exists. This is

because U.S. tax rates on earned income have been reduced considerably and, at the same time, foreign tax rates and living costs have increased significantly, especially in desirable overseas locations. To monitor the provision and thus avoid future abuses, we further recommend that Congress require the U.S. Treasury to report periodically on how the provision is actually working. Domestic International Sales Corporations and Possessions Corporations are similarly monitored and this could easily be done here as well.

Thank you. I would be pleased to answer any questions the Committee may have.

Senator CHAFEE. Last panel, Mr. Kraft, Mr. Perry, and Mr. Liesenberg. Thank you for coming, Mr. Kraft. Welcome gentlemen. I recognize some familiar faces here. Mr. Kraft, why don't you proceed?

STATEMENT OF STEVEN E. KRAFT, TAX COMMITTEE OF THE AMERICAN CHAMBERS OF COMMERCE IN EUROPE AND THE MEDITERRANEAN

Mr. KRAFT. Thank you, Mr. Chairman. I am grateful for the opportunity to testify here today. My name is Steven Kraft. I am a self-employed, certified public accountant and tax consultant with an office in Zurich. I have lived there for over 9 years and prepared thousands of tax returns for clients.

I am here today in my capacity as chairman of the Tax Committee of the Council on the American Chambers of Commerce, Europe and Mediterranean (EUROMED).

Before saying anything further, I would like to express the gratitude of Americans in Europe and the Mediterranean for the work of the Senate Finance Committee. Your committee preserved the section 911 benefits from extinction at the time of the 1976 act. It is this committee that basically prevented the 1976 act from going into effect and that helped us, as much as possible, given the atmosphere on the floor of the Senate with regard to the 1978 act.

We are also appreciative of the several bills introduced by the members of this committee. We recognize that all these bills are intended to help us, and although they take different approaches, we view them not as isolated proposals by individual members but as a collective effort to arrive at the right result, regardless of the route taken or the sponsor whose name happens to appear on the bill.

Our belief is that the day has finally arrived to write legislation that will establish the tax policy to be followed in this area for the foreseeable future.

As a matter of fact, one of our principal goals is to lay this matter to rest, once and for all.

I would like to state my organization's position and then make five specific points with regard to suggestions for the design of any proposal.

Senator CHAFEE. All in 5 minutes? You are a long-distance commuter, I believe.

Mr. KRAFT. That is correct.

Senator CHAFEE. But, we are going to have to keep you to the same rules as the others although we are grateful to you for making this long trip. I guess Mr. Perry has had a pretty long trip, too.

Mr. PERRY. I have.

Senator CHAFEE. All right, go ahead, Mr. Kraft.

Mr. KRAFT. We appreciate that, Mr. Chafee. We, on the EUROMED Council, which is comprised of over 15,000 members in 13 countries, recommend that the income of Americans who have established the center of their economic activity abroad should be exempt from U.S. taxation.

Senator CHAFEE. All income?

Mr. KRAFT. That is correct.

Senator CHAFEE. Unearned as well.
Mr. KRAFT. That is correct.
Senator CHAFEE. Pension?
Mr. KRAFT. That is correct. Pension earned with respect to earnings overseas should be exempted as is the practice in virtually every other country in the world, limited only by safeguards to prevent U.S. citizens from abusing the exemption by taking up temporary residence abroad.

We think that this is the only fair and wise course of action, if the export of U.S. goods and services is to be supported and promoted.

This position is elaborated in the written materials submitted by us. The specific points which I would like briefly to mention are, first, if the exclusion from income is not total, then consider please a percentage exclusion such as 80 or 90 percent rather than a flat exclusion which would unavoidably be outdated shortly after enactment.

The reason for not having 100-percent exclusion is probably political in nature, so as to be able to say that Americans abroad pay some U.S. tax. This is penny-wise and pound-foolish. However, I would like to point out that the mentioned percentage exclusion rule operates as a reverse minimum tax which in fact would be the concept that you would be adopting.

Second, do not differentiate among Americans abroad on the basis of geography or relation to exports. The former test is arbitrary and discriminatory and it will justifiably anger those who are adversely affected. The latter test is almost certainly illegal under GATT.

Third, if the exclusion is a partial exclusion, do not attack the nonexcluded income. Do not stack the nonexcluded income on top of the excluded income for purposes of computing the tax.

Also, do not disallow foreign tax credit allocable to the excluded income. These mechanisms were used in the tax reform act of 1976. They are merely means of taking away on one hand that which is given with the other.

The persons who would be most benefited by such provisions would be individuals like myself, who prepare these tax returns for Americans overseas and advise them on how to cope with the new law.

Fourth, the problems of abuses arising due to actors and actresses qualifying for the exclusion with regard to production of films abroad should be nonexistent. Experience shows that the producer of the film who is paying the bills will want the production of work wrapped up, if possible, in less than 11 months.

Thus, an 11- to 12-month presence test should, perhaps, suffice. If there is disagreement, other solutions can be devised. This point is discussed in our written statement.

Fifth, and finally, whatever approach is taken, pension income accrued while working abroad should be viewed as earned income for this purpose. This is as much sweat-of-the-brow income as wages or salary and should be treated as favorably.

Thank you, Mr. Chairman.

Senator CHAFEE. Mr. Kraft, I appreciate that statement. I have a summary here. Thank you. Well, Mr. Kraft, let me just say that as

far as the pensions and then dividing up as to what pension is attributable having lived abroad or worked abroad, it seems to place an incredible complexity in this.

Mr. KRAFT. Mr. Chairman, this is presently done today in determining the foreign tax credit allowed to an individual. It must be determined as to what portion of his pension had been earned while overseas.

Senator CHAFEE. I see. OK, fine. Well, thank you. Mr. Perry?

STATEMENT OF ALEXANDER PERRY, JR., PRESIDENT, ASSOCIATION OF AMERICAN CHAMBERS OF COMMERCE IN LATIN AMERICA, BUENOS AIRES, ARGENTINA

Mr. PERRY. I am Alexander Perry, Jr., from Argentina, a businessman with over 36 years experience in Latin America. I come before you, today, on behalf of the Association of American Chambers of Commerce in Latin America, a business organization which represents more than 35,000 U.S. citizens resident in the area.

I might mention that up in room 5110, we have 160 to 170 delegates from our own annual general meeting, as well as representatives from Europe and Asia who are here to see these proceedings today, because they feel that they are of such vital interest.

Statement of our problem—in 1963, the United States of America became the only major industrial nation in the world to tax the foreign earned income of its citizens living abroad.

This provision of the tax law discourages Americans from going overseas to promote U.S. technology and U.S. products in foreign markets.

The negative effect on our economy is unmistakably clear. Therefore, it appears unreasonable to adhere to an antiquated concept. Decisive action is required now to change our concept of taxation of foreign earned income from nationality to territoriality in order to put the United States back on track with the rest of the world.

The present law—the Foreign Earned Income Act of 1978. In 1978 the law changed the entire concept from exclusion of income to allowable deductions for excess foreign living costs. This law, however, is extremely complicated. It not only burdens the oversea taxpayer with additional recordkeeping requirements, but also significantly increases the tax payable on reimbursements received for excess living costs. As a result there are a variety of tax equalization plans that are paid to overseas employees for the excessive cost of maintaining a U.S. lifestyle in a foreign country.

The deductions which the law allows are generally substantially less than the actual costs incurred and reimbursements received. This results in significantly increased taxable income which is taxed at an incrementally higher rate.

Then, because the tax liability is more than had been paid in the United States, his employer must reimburse the difference.

We have complicated tax returns under the present law. In addition to this unfairness of the 1978 act, the law is so complicated that the overseas employees must use tax specialists to prepare the returns either from corporate staffs or professional accounting firms.

In either case, the cost of this service is significant, averaging $700 to $1,200. Also, there are thousands of Americans living

abroad who do not work for multinational firms and who can ill afford the cost of this type of service.

Track one and track two.—A reform in the tax law which places Americans on a comparable basis with citizens of other countries fundamentally coincides with the administration's track one tax program.

Track one basically advocates the supply side economic theory, as pointed out in the GAO report. By removing the disincentives for Americans to work abroad, more U.S. technicians and executives will be inclined to go overseas. Placing these U.S. citizens in key overseas positions will improve the U.S. competitive position and increase demand for U.S. products from foreign sources.

This yields the same results as the administration supply side, track one legislation. Therefore, since both track one and the reform in the taxation of Americans abroad, accomplishes the same economic goal, they should be given equal importance for legislative action.

Track one should be opened to include such a reform amendment.

Residency test. The present law requires that for 17 out of 18 months the taxpayer must be physically present in a foreign country in order to be eligible for excess foreign living cost deductions.

On many occasions, especially in the case of engineers and technicians, this qualifying period is excessive. Many major construction projects require the services of specialists for limited periods of time, but not for 17 months.

These specialities are often critical to the project and provide excellent opportunities for promoting U.S. products. Therefore, this qualifying period should be reduced from 17 out of 18 months to 11 out of 12 months, so more U.S. citizens will be inclined to participate in such projects.

Recommendations. In order to simplify the administration of taxation of Americans abroad and to place them on a comparable basis with citizens of other countries, the present laws should be replaced with one which either excludes all foreign earned income or excludes a substantial amount of such income.

We recommend an exclusion of $100,000 per year for the first 2 years of foreign residence and an unlimited exclusion thereafter.

The logic of this approach is that after residing abroad for 2 years, a taxpayer has clearly established that he is a foreign resident and is making his contribution to U.S. economy from his expatriate position and is not abroad for the sole purpose of avoiding U.S. taxes.

Whatever law is adopted, it should avoid complicated formulas and judgmental factors which require legal definitions in order to determine if the provisions of the law apply or not. Also the law should apply to all expatriates, not just a select few living in certain countries or hardship areas or working in certain industries.

We will support a reasonable bill which provides for exclusion of foreign earned income and is simple to apply and administer. I thank you.

Senator CHAFEE. Well, thank you, Mr. Perry. I want to pay tribute for your long work in this area. Are you suggesting in here not to deal with the housing deductions, exemption?

Mr. PERRY. We are suggesting that the housing exemption be included in earned income because this varies so.

Senator CHAFEE. You don't have a special item for housing, even though you recommend a $100,000 exclusion.

Mr. PERRY. Which you could have in Argentina.

Senator CHAFEE. Let's just say, the best we could do was or we did $100,000 exemption, would you then say go with that and nothing special for housing? What would you do about housing? Suppose the company paid $30,000 for somebody's house.

Mr. PERRY. In this case, the company would have to make some special arrangement with the man involved. But, $100,000 protects your committee to a certain extent against movie actors, and I think that is one of your preoccupations, for citizens going abroad for a 6-month period or a shorter period and then using that as a writeoff.

Senator CHAFEE. No, what I am raising is the problem of the housing. Let's say you are paying the person abroad $80,000 but, in Saudi Arabia the company has to pay the fellow $30,000 to get a house or provides a house that costs the company $30,000. There is $110,000 total. Would you say he is subject to $10,000 tax then?

Mr. PERRY. With the limitation of $100,000, he would be subject to it. Would you consider moving that up to $150,000?

Senator CHAFEE. Well, don't try and bid me right now.

Mr. PERRY. No, I am not.

Senator CHAFEE. We went a long way to get to the $100,000 for the illustration. The point I am making is that because—I take it you would not have the housing exemption that I dealt with, that two of the bills deal with, because of the complexity problem?

Mr. PERRY. Because of the complexity of the problems, yes.

Senator CHAFEE. Well, thank you, Mr. Perry. Mr. Liesenberg, last witness and we appreciate your coming here. Did Mr. Hughes want to testify?

Mr. HUGHES. No, I am just here to answer questions, sir, if any come our way.

Senator CHAFEE. All right fine. Mr. Liesenberg.

STATEMENT OF GEORGE LIESENBERG, ASIA-PACIFIC COUNCIL OF AMERICAN CHAMBERS OF COMMERCE

Mr. LIESENBERG. Mr. Chairman, my name is George Liesenberg. I live and work in Singapore. I have traveled 12,000 miles to speak as chairman of the tax committee on behalf of the Asian-Pacific Council Chambers of Commerce, APCAC.

Senator CHAFEE. Well, you're our long-distance traveler I guess. You outdid Mr. Perry and Mr. Kraft.

Mr. LIESENBERG. I tried to convince them we should split the time based on travel but——

Senator CHAFEE. Didn't you come last year?

Mr. LIESENBERG. Yes, I was here last year, Senator.

Senator CHAFEE. All right, because you came so far, you get 6 minutes.

Mr. LIESENBERG. Thank you. APCAC represent U.S. business interests of 4,500 members companies in 12 Asian-Pacific countries.

The U.S. policy on taxing the earned income of citizens working overseas is one of the most critical problems facing the U.S. business community in Asia.

This policy adversely affects our ability to compete. This additional cost of operations has resulted in many firms replacing their U.S. expatriates with third country nationals.

My written statement cites, as one example, a company in Singapore where the third country national expatriates population has increased from 19 to over 50 percent. These are the engineers, the supervisors who decide which pumps will be used in the oilfield, whose pipes and casings will be put in the ground, which equipment will be used to clear the drill sites.

The effect on the U.S. economy of this problem, we feel, is sufficiently documented in the Chase econometric study and the report of the President's Export Council.

The Foreign Earned Income Act of 1978, while well intended by Congress, has done nothing but increase this problem.

Attached to my written statement, are the results of a survey conducted by APCAC. This survey shows the percentage increase in U.S. taxes before the foreign tax credit as compared to the previous law.

It shows an increase in Taiwan of 77 percent; Singapore, 42; Malaysia, 39; and Hong Kong, 24. The only country with a decrease is Japan.

Even after considering the foreign tax credit, the current law has resulted in a substantial increase in tax in most of the countries in Asia.

The fact that in practice the Foreign Earned Income Act has not resulted in what was intended, I think is well documented by the GAO report.

We feel with the current trade deficits, the continuing balance of payment problem and the need to create export related jobs, APCAC feels that it is imperative that the U.S. tax law be restructured to place the American businessmen overseas in an equal position with his competitors.

APCAC feels the necessary changes should not be targeted to any one area or certain business activities.

The investor overseas is making a valuable contribution to the balance of payment problem through dividends, royalties, et cetera, as is the service industry overseas.

A targeted bill would be a tremendous problem to administer. Anyone that doubts that, I recommend they read the House Committee reports from 1926 when this question was first discussed.

To conclude, to achieve equalization with our competitors, the Asian-Pacific Council of American Chambers of Commerce strongly endorses the complete exclusion from taxation of foreign earned income, as outlined in Senator Jepsen's bill, S. 598.

We feel that this should be done at the earliest opportunity in the first taxi. Thank you.

Senator CHAFEE. Thank you, very much. Gentlemen, I would like to ask you, Mr. Kraft took one position, Mr. Perry what do you say about pensions?

Mr. PERRY. I think pensions, if you can consider the earned income of a man working abroad for a period of time and exempt that from taxation, I think that is a very fair approach to the problem.

Senator CHAFEE. If there is some way of allocating it, what portion of his pension?

Mr. PERRY. What portion of it was developed from working abroad?

Senator CHAFEE. Mr. Kraft, would you say that's a readily available statistic?

Mr. KRAFT. Well, it must be, again, Mr. Chairman, currently in determining the foreign tax credit which as we know avoids double taxation, it must be determined source of income, including pension income and so it must be available. One must be able to determine the related part of the pension that deals with overseas service.

Senator CHAFEE. I see. All right, well thank you very much, gentlemen. I know you have all come a long way and we appreciate it.

Mr. KRAFT. Thank you.

Mr. PERRY. Thank you.

Mr. LIESENBERGY. Thank you.

Senator CHAFEE. That concludes this hearing.

[Hearing adjourned at 12:29 p.m.]

[The prepared statements of the preceding panel follow:]

Kraft

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S U M M A R Y

OF THE TESTIMONY OF THE
COUNCIL OF AMERICAN CHAMBERS OF COMMERCE,
EUROPE AND MEDITERRANEAN (EUROMED),
BEFORE THE
SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,

APRIL 24, 1981

* *

1) The income of Americans who have established the center of their economic activity abroad should be exempt from US taxation - as in virtually every other country in the world - limited only by safeguards to prevent US citizens from abusing the exemption by taking up temporary residence abroad.

2) The US system of taxing foreign earned income stands as a self-inflicted trade barrier, both in underlying policy and in implementation.

3) The present law with deductions, exclusions and credits is too complicated to administer or comply with.

4) The foreign tax credit is supposed to equalize tax liability, but it fails because high foreign indirect taxes are not creditable, because credits are lost on any foreign income taxes in excess of US income tax rates, and because other countries use different rules of income recognition and deduction of allowances for the calculation of taxable income.

5) Americans living abroad are not in a position to use most government services, yet we pay direct and indirect taxes to our country of residence and use the services and protection of the host country, so there is little justification for taxing us at all.

6) Americans living in Europe should not be excluded. US trade with the EEC in 1979 amounted to 1/5 of all US foreign trade, and 1/3 of US direct investment abroad was in the 9 EEC countries at the end of 1979. In 1979 the US exported $42.39 billion to the EEC while we imported $33.23 billion. In 1980 25% of Americans working abroad were in Europe, often based in administrative headquarters servicing Africa, the Middle East and Eastern Europe.

7) A two-step concept of residence abroad, as was embodied in the pre-1976 law, would encourage Americans to work abroad, even for a short period, and at the same time would discourage extremely high earners from moving abroad for a short stay to avoid US tax. Only bona fide residents abroad, defined as those living abroad for more than 3 consecutive years, would be eligible for a full exemption. Temporary residents outside the US, in order to be competitive in the world market, would have a ceiling on exemptions, but a ceiling that would effectively exempt virtually all US workers.

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STATEMENT OF THE
COUNCIL OF AMERICAN CHAMBERS OF COMMERCE,
EUROPE AND MEDITERRANEAN (EUROMED),
BEFORE THE
SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
APRIL 24, 1981,

IN SUPPORT OF
BILLS TO AMEND THE
INTERNAL REVENUE CODE OF 1954
TO EXEMPT FROM TAXATION
THE INCOME OF AMERICANS
RESIDING OUTSIDE THE UNITED STATES

* *

Mr. Chairman and distinguished members of the Committee: The Council of American Chambers of Commerce - Europe and Mediterranean (EuroMed) - representing American business interests in the region with over 15,000 constituent entities in 13 countries, very much appreciates this opportunity to submit testimony with respect to taxation of Americans living abroad. We thank you for your interest in the issue, and commend you for your apparent understanding of our sense of urgency, because further delay in reducing the crippling tax burdens imposed by the Foreign Earned Income Act of 1978 is sending those Americans who can come home, back to the US to seek employment and leaving America uncompetitive in the world market.

There is basic injustice in taxing US citizens living outside the country who have moved the center of their economic interest abroad and who do not benefit from the full range of US government services. There is considerable political and economic value to the United States in having Americans working abroad. The present US tax laws are incompatible with international practice. And there is an administrative advantage in having a simple tax law. Thus, EuroMed recommends:

RECOMMENDATION

The income of Americans who have established the center of their economic activity abroad should be exempt from US taxation - as in virtually every other country in the world - limited only by safeguards to prevent US citizens from abusing the exemption by taking up temporary residence abroad.

Arguments

Equity in taxation arises from applying consistent principles of tax jurisdiction to taxpayers in similar circumstances. A US citizen who puts down his or her roots in a foreign country is not in the same position as a US citizen in the US Because Americans living abroad are not in a position to use most government services, yet do pay direct and indirect taxes to their country of residence and use the services and protection of the host country, there is little justification for taxing them at all.

As early as 1925 Congress recognized that US citizens abroad were at a competitive disadvantage with non-Americans whose governments do not impose income tax on the foreign source income of their nonresident citizens. Thus, in 1926 all foreign source earned income was excluded from US taxation.

In 1953 and 1962 limitations were placed on the amount excludable, and by 1978, the Foreign Earned Income Act all but eliminated it.

The foreign tax credit is supposed to equalize tax liability for similarly situated individuals. While it is designed to eliminate double taxation, it fails because high foreign indirect taxes are not creditable, because credits are lost on any foreign income taxes in excess of US income tax rates, and because other countries use different rules of income recognition and deduction of allowances for the calculation of taxable income.

The US system of taxing foreign earned income stands as a self-inflicted trade barrier, both in underlying policy and in implementation. America's tax on citizenship is so high it has made it almost prohibitively expensive for American business people to work abroad, yet removing this trade disincentive now can create jobs at home and abroad through increased trade, and can make a significant contribution to restoring the economic vitality of the US by putting American business on an equal footing with its competitors.

The present law with deductions, exclusions and credits is too complicated to administer or comply with. It demands simplification and consistency.

Americans residing abroad should be placed on an income tax basis comparable to that of citizens of other countries, and EUROMED supports any legislation that moves toward the effective elimination of US tax on the incomes of Americans living abroad.

Legislative History

After imposition of the US income tax in the 1920's, the income earned by Americans working in foreign countries was virtually exempt from US taxes as a matter of public policy and by specific acts of Congress. The purpose was to encourage foreign trade.

In the early 1950's some revisions were made to foil abuse by highly paid movie stars. These revisions tightened foreign residency tests and placed a ceiling on the amount of foreign earned income that could be excluded. The income and allowances of most Americans working abroad was below $20,000, so they were not affected, and were not meant to be, but by the mid-1970's, the effects of inflation had overtaken this exclusion.

The 1976 Tax Reform Act represented a drastic policy shift. It reduced the exclusion, whereas Congress shouldhavesignificantly increased it to reflect inflation. Instead of encouraging Americans to work abroad, it discouraged such employment.

At the same time Tax Court rulings made so-called "keep whole" contributions paid by employers to offset extraordinary overseas living costs taxable to the employees at full overseas value.

The amendments never went into general effect because the Foreign Earned Income Act of 1978 replaced the Section 911 earned income exclusion for the years beginning after December 31, 1977, with the new system of itemized deductions for the excess cost of working overseas. Section 911 now provides a $20,000 exclusion for Americans living in so-called "camps" in remote hardship areas. Section 913 provides deductions for certain allowances for extraordinary foreign living expenses under strict qualifications.

While foreign income taxes paid to the country of residence may be credited against US taxes due, neither the credit nor the special deductions fully compensate Americans living abroad for the many indirect taxes paid to foreign governments. Thus, Americans abroad pay higher taxes than similarly situated residents of the United States.

Economic and Political Benefit to the USA *

Americans who work abroad increase our exports and thus improve our balance of payments, and at the same time stimulate our domestic economy. Jobs are created by the increased trade. It is sound economic policy, consistent with supply-side economics, to encourage more Americans to work abroad. Yet US tax policy is a major factor in reducing the number of Americans who work abroad. Many companies are replacing Americans with foreigners who are taxed only by the host country because it is too expensive to employ Americans.

Americans in Europe

Americans living in Europe should not be excluded from consideration. US trade with the European Economic Community in 1979 amounted to almost one-fifth of total US foreign trade. More than one-fifth of all US exports of agricultural commodities went to the Community, and one-third

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*EUROMED refers the Committee to the following reports:

GAO Report to The Congress, February 27, 1981.

The President's Export Council, Subcommittee on Export Expansion, Report of the Task Force to Study the Tax Treatment of Americans Working Overseas, December 5, 1979.

of all US direct investment abroad was spread among the nine EEC countries at the end of 1979. In 1979 the US exported $42.39 billion to the EEC while we imported $33.23 billion. (Department of Commerce: Survey of Current Business, June 1980) US Agricultural exports were $7.67 billion. (Department of Agriculture: FATUS, January-February 1980)

In 1980 25% of Americans working abroad were in Europe. Many of those Americans were based in administrative headquarters in London, Brussels, Paris, Milan, Frankfurt, Athens and so forth, to service the Middle East, Africa and Eastern Europe. These business people travel north and south, not changing more than two or three time zones, as a health and safety precaution and for greater effeciency in business. Europe becomes, then, a commuter suburb for a very large proportion of senior American administrators and professional people, as well as marketing and servicing staff officially residing there.

Tax Harmonization

International tax harmonization is not an objective by itself, but exists mainly to facilitate trade. Other nations generally observe principles of territorial jurisdiction, but the US government réaches out for world-wide income with only a limited foreign tax credit mechanism to help curtail some of the double taxation that inevitably results. The practical consequence is that Americans are able to serve abroad only if they or their employers are willing to pay for the resulting excess tax costs.

Justice

There is basic injustice in taxing Americans beyond the territorial jurisdiction of the US. Americans abroad make little use of US government services or protections. Medicare and Medicaid are unavailable. American public education is not available. Americans abroad are not protected under pollution control laws or any US health or safety legislation. There are generally fewer personal freedoms compared with those enjoyed by residents of the US. In short, the benefits of American citizenship - the Constitution and the laws made thereunder - stop at the territorial limits of the USA. The obligations of citizenship, taxation, now follow the passport, and that system is unjust.

Simplification

Tax simplification is an announced goal of tax policy makers. The Section 911 exclusion that was in effect for so many years was easy to understand and administer, even though the amount excluded had fallen way below inflation. The 1978 FEIA imposed a system so complex it is impossible for Americans abroad to fill out the tax forms without professional help. The cost of that professional help is itself an added tax on Americans living abroad. Exclusion would reduce costs of administration and increase compliance.

THE ABUSE QUESTION

In the past, questions of abuse of tax exemptions were raised again and again. While we believe the incidence of abuse is enormously exaggerated, we have addressed ourselves to the issue and submit that a two step concept of residence abroad, as was embodied in the pre-1976 law, would encourage Americans to work abroad, even for a short period, and at the same time would discourage extremely high-earners in, for example, the entertainment industry, from moving abroad for a short stay to avoid US tax. Only bona fide residents abroad, defined as those living abroad for more than three

consecutive years, would be eligible for a full exemption. Temporary residents outside the US, in order to be competitive in the world market, would have a ceiling on exemptions, but a ceiling that would effectively exempt virtually all US workers.

Qualifications -- Foreign Residence

Americans now qualify for the special overseas deductions in two ways:-

* Bona fide residence in a foreign country/ies for one full calendar year; or
* Physical presence in a foreign country/ies for 510 days out of 18 months.

Before 1976 bona fide residents of foreign countries could exclude $25,000 per year from their taxable income.

Americans were deemed bona fide residents after living three consecutive years in a foreign country or countries. When instituted, this exemption covered the salaries of all but a very few highly paid individuals.

Temporary residents spending up through three consecutive years abroad could exclude a lesser, but still substantial amount.

The two-step concept established in 1962 to foil abuse can be re-instituted now to:-

* encourage Americans to work abroad even temporarily while
* preventing possible abuse by extremely highly paid individuals.

How to Stimulate Trade Yet Prevent Abuse

A bona fide resident abroad should be exempt from US taxation on his or her income except to the extent non-resident aliens are taxed by the US government. Why? That American has shifted his or her center of economic activity abroad.

* Define "bona fide resident" as one who has lived abroad more than three consecutive years.

Temporary residents, qualifying after one year in a foreign country or countries should have all or nearly all of their earned income exempt. Why? America should encourage its people to work abroad comeptitively.

* Define "temporary resident" as one who has lived abroad at least 11 out of 12 consecutive months, and through three consecutive years.

EUROMED RECOMMENDATIONS

Americans who reside abroad more than three consecutive years, and who are thus deemed to have shifted the center of their economic activities abroad should be exempt from taxation on their incomes except to the extent non-resident aliens are taxed.

Temporary residents of a foreign country or countries should enjoy a substantial -- total in most cases -- earned income exclusion to promote the American presence abroad, yet prevent abuse.

EUROMED supports any legislation that moves toward the effective elimination of US tax on the incomes of Americans abroad.

EUROMED appreciates the opportunity to share our views and concern with the members of this Committee. We are committed to reducing the excessive tax burdens on our American members because that will mean more jobs for Americans

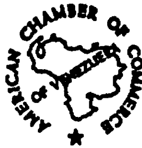
We would be pleased to provide the Committee with any further information which you might find useful.

Respectfully submitted,

Council of American Chambers of Commerce - Europe and Mediterranean

Steven Kraft, Chairperson,
Tax Committee

Affiliated with:
Chamber of Commerce of the United States;
Association of American Chambers
of Commerce in Latin America



AMERICAN CHAMBER OF COMMERCE
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April 24, 1981

The Honorable Bob Packwood
Chairman
Subcommittee on Taxation and
Debt Management
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Dear Senator Packwood:

On behalf of the American Chamber of Commerce of Venezuela, we submit the following statement for inclusion in the record of your subcommittee hearings on legislative proposals to modify the treatment of foreign earned income under section 911 and section 913 of the Internal Revenue Code of 1954.

We thank you for this opportunity to express our views to you and your subcommittee.

Very truly yours,

Thomas L. Hughes
Director and Past President

INTRODUCTION

Who We Are

I am Thomas L. Hughes, past president of the Venezuelan American Chamber of Commerce and Industry located in Caracas and I have lived in Venezuela for over 24 years. I am a senior partner of Travieso, Evans, Hughes, Arria and Rangel, an international law firm located in Caracas, Venezuela. Our Chamber is a binational organization with over 1,400 individuals and 500 corporate members. The majority are branches or affiliates of U.S. companies. In addition, many of the Venezuelan corporate members employ U.S. citizens in managerial or technical positions.

Our organization is associated with the Council of the Americas, the Chamber of Commerce of the United States, and the Association of American Chambers of Commerce in Latin America (AACCLA), the latter organization representing over 17,000 companies and businessmen involved in over $28 billion worth of U.S. investment in the region and over $40 billion in total U.S.-Latin American trade yearly.

We appreciate very much this opportunity to submit this written testimony with respect to proposals

relating to taxation of Americans abroad. The following legislation has been introduced in the U.S. Senate:

S. 408 -- Introduced by Senator John H. Chafee, (R. - R.I.): (Sens. Mathias, Roth, Matsunaga, Cochran, Lugar, Boschwitz, Schmitt, Grassley, Boren, Simpson, and Tsongas): Partial exclusion for foreign earned income of individuals

It would provide an annual exclusion for foreign earned income of $50,000 plus one-half of the next $50,000 of foreign earned income. Housing costs in excess of $5,800 per year would also be excluded from income tax.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1981	1982	1983	1984	1985
Calendar	523	565	610	659	712
Fiscal	288	546	590	637	689

S. 436 -- Introduced by Senator Lloyd Bentsen, (D.- TX): Partial exclusion for foreign earned income of individuals

It would provide an annual exclusion of up to $75,000 for foreign earned income in 1981, increasing $5,000 each year to $95,000 in 1985. A housing deduction would be provided for expenses in excess of $5,000 and housing furnished to an individual in a camp would be nontaxable.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1982	1983	1984	1985	1986
Calendar	586	639	694	754	814
Fiscal	322	615	670	727	787

S. 598 -- Introduced by Senator Roger W. Jepsen, (R. - IA): Exemption for foreign earned income of individuals.

It would exempt all foreign earned income of certain individuals from taxation.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1982	1983	1984	1985	1986
Calendar	610	659	712	769	831
Fiscal	336	637	689	743	803

S. 867 -- Introduced by Senator Daniel P. Moynihan (D.-NY): Partial exclusion for foreign income of individuals.

It would exempt 80 percent of all foreign earned income of certain individuals from taxation.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1981	1982	1983	1984	1985
Calendar	498	539	582	629	681
Fiscal	274	520	563	608	658

We find these legislative proposals responsive to the needs to place U.S. taxpayers abroad on a competitive basis with citizens of other industrial nations to keep Americans abroad and in a position to promote American trade in an effort to eliminate the huge trade deficit of the last few years.

Issues

The major issue is whether the provisions for the taxation of Americans working abroad should be modified to afford more generous relief.

The two related issues are:

a. Total exemption:

Whether a system of total exemption from U.S. taxes for all foreign income earned abroad by U.S. citizens should be adopted. This system should be consistent with a concept of taxing U.S. residents abroad on the basis of residency or source income, a method followed by most industrialized countries.

b. Exclusions:

If only part of the individual's foreign earned income is to be excluded, should the relief be tailored to the specific circumstances of the taxpayer, or should it be in the form of a flat dollar or formula amount.

Statement of the Problem

In 1963, the United States of America became the only major industrial nation in the world to tax the foreign earned income of its citizens living abroad. At that time the U.S.

held a dominant competitive position in world trade and relied very little on foreign imports.

Today, even though U.S. business is faced with enormous pressure from foreign entities and is more and more dependent on imports of raw materials to keep its industries going, the U.S. continues to impose taxes on income earned by citizens residing abroad.

This section of the tax law discourages Americans from going overseas to promote U.S. technology and U.S. products in foreign markets. It also makes Americans considerably relatively more expensive because the citizens of the other industrial nations are not burdened with taxation by their home countries.

In the industrial world today, only the U.S. taxes the earned income of its citizens living abroad.

The negative effect on our economy is unmistakably clear. Therefore, it appears unreasonable to adhere to an antiquated concept that may or may not have served a useful purpose in the past, a concept which clearly diminishes the dissemination abroad of our "Yankee ingenuity", reduces our foreign markets, and adversely affects our competitive position.

Decisive action is required now to change our concept of taxation of foreign-earned income from nationality to territoriality in order to put the U.S. back on track with the rest of the world.

80-612 O—81——20

The GAO Report to Congress

In February 1981 the GAO delivered to Congrees its report titled "American Employment Abroad Discouraged by U.S. Income Tax Laws". This report clearly pointed out the following:

- The Foreign Earned Income Act of 1978 (the present law) is a major disincentive to employment of U.S. citizens abroad.
- The present law does not relieve the overseas employees from taxes on income which is a reimbursement of excessive foreign living costs.
- Companies generally reimburse overseas employees for this additional tax burden. This makes Americans more costly than citizens of competing countries who are not taxed by their home countries.
- The complexity of the new tax law makes it necessary for the employers to arrange to have the overseas employees' return prepared either by the corporation or by outside professionals. In either case, this adds another cost for hiring a U.S. citizen to work overseas.
- The present law falls short of its goal of providing equity to Americans abroad and is contrary to its goal of simplifying the preparation of U.S. tax return.

The report recommends that Congress consider placing Americans working abroad on an income tax basis comparable with that of citizens of competing countries who generally are not taxed by their home countries because:

- Present U.S. tax provisions generally discourage the employment of U.S. Citizens abroad.
- Present tax provisions have made Americans relatively more expensive than competing third country nationals, thereby reducing their share of 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.

The report also mentioned that either a complete exclusion or a limited, but generous, exclusion of foreign earned income for qualifying taxpayers would accomplish the above goal, and, at the same time, be relatively simple to administer.

Present Law: The Foreign Earned Income Act of 1978 (FEIA)

Prior to 1963, Americans abroad were not taxed on foreign earned income. From 1963 to 1977, they were allowed to exclude $25,000 annually. In the beginning, this amount was adequate to exempt most Americans abroad from taxation. However, by 1977, inflation rendered this amount inadequate and most businessmen would up being taxed on a portion of their salaries, as well as their foreign living allowances.

In 1978 the FEIA changed the entire concept from exclusion of income to allowable deductions for excess foreign living costs. This law, however, is extremely complicated. It not only burdens the overseas taxpayers with additional record keeping requirements, it also significantly increases the tax payable on reimbursements received for excess living costs. Such reimbursements are not income which the taxpayer puts in his pocket. They are merely amounts paid to compensate the overseas employee for the excessive cost of maintaining a U.S. lifestyle in a foreign country.

The deductions which the law allows are generally substantially less than the actual costs incurred and reimbursements received. This results in significantly increased taxable income which is taxed at incrementally higher rates. Then, because the tax liability is more than would have been paid in the United States, the employer must reimburse the difference. The Catch 22 then takes effect because the tax equalization reimbursement becomes taxable income in the year reimbursed and increases the taxpayer's equalized income in that year. For most taxpayers, this means that taxable income increases each year by double the amount of the previous year's tax reimbursement. In other words, a tax reimbursement of $10,000 in 1981 results in additional taxable income of $80,000 on 1984.

Clearly the taxpayer obtains no advantage from these payments because they are merely a reimbursement of the additional tax liability he has incurred by living overseas.

Under a tax equalization program, the taxpayer still pays just as much as he would have paid i he had remained in the U.S. In addition to this unfairness of the FEIA, the law is so complicated that the overseas employee is virtually incapable of preparing his own tax return. This means that the employer must provide a tax specialist to prepare the return, either from the Corporate staff or from a professional accounting firm. In either case, the cost of this service is significant (according to the GAO report it averages from $700 to $1.100). It is unfair to impose a tax law on the public which is so complicated that an average taxpayer must have professional help to prepare his return. Also, there are thousands of Americans living abroad who do not work for multinational firms who can ill afford the cost of this service.

TRACK 1 and TRACK 2

A reform in the tax law which places Americans on a comparable basis with citizens of other countries fundamentally coincides with the Administration's TRACK 1 tax program. TRACK 1 basically advocates the "Supply Side" economic theory. As pointed out in the GAO report, by removing the disincentives for Americans to work abroad, more U.S. technicians and executives will be inclined to go overseas. Placing these U.S. citizens in key overseas positions will improve the U.S. competitive

position and increase demand for U.S. products from foreign sources. This yields the same results as the Administration's "Supply Side" TRACK 1 legislation. Therefore, since both TRACK 1 and a reform in the taxation of Americans abroad accomplish the same economic goal, they should be given equal importance for legislative action. TRACK 1 should be opened to include such a reform amendment.

Indirect Taxation

Americans abroad are not only subjected to U.S. income taxes, they are also required to pay income taxes in their host countries. In addition, other host country taxes (indirect taxes) often add to an overseas American's living costs, either directly or indirectly. For example, if the import duties on an item are prohibitive, it usually means that an inferior quality locally manufactured product will cost substantially more in the host country than a superior product would cost in the U.S.

Residency Test

The present law requires that for 17 out of 18 months a taxpayer must be physically present in a foreign country in order to be eligible for excess foreign living cost deductions. On many occasions, especially in the case of engineers and technicians, this qualifying period is excessive. Many major construction projects require the services of specialists for

limited periods of time, but not for 17 months. These specialists are often critical to the project and provide excellent opportunities for promoting U.S. products. Therefore, this qualifying period should be reduced from 17 out of 18 months to 11 out of 12 months, so more U.S. citizens will be inclined to participate in such projects.

Recommendations

In order to simplify the administration of taxation of Americans abroad and to place them on a comparable basis with citizens of other countries, the present law should be replaced with one which either excludes all foreign earned income or excludes a substantial amount of such income. We recommend an exclusion of $100,000 per year for the first two years of foreign residence and an unlimited exclusion thereafter. The logic of this approach is that after residing abroad for two years, a taxpayer has clearly established that he is a foreign resident and is making his contribution to the U.S. economy from his expatriate position and is not abroad for the sole purpose of avoiding U.S. taxes.

Whatever law is adopted, it whould avoid complicated formulas and judgemental factors which require legal definitions in order to determine if the provisions of the law apply or not. Also, the law should apply to all expatriates, not just a select few living in certain countries or hardship areas or working in certain industries.

We will support any reasonable bill which provides for a generous exclusion of foreign earned income and is simple to apply and administer.

APCAC

THE ASIA-PACIFIC COUNCIL OF AMERICAN CHAMBERS OF COMMERCE

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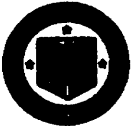
STATEMENT OF
GEORGE LIESENBERG
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE
APRIL 24, 1981



APCAC REPRESENTS THE OPINION OF AMERICAN BUSINESSMEN LOCATED IN THE ASIA-PACIFIC REGION

STATEMENT OF
GEORGE LIESENBERG
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE
APRIL 24, 1981

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is George Liesenberg and I am a partner with the accounting firm of Arthur Young & Company based in Singapore. I have traveled 12,000 miles to Washington to speak on behalf of the Asian Pacific Council of American Chambers of Commerce (APCAC). APCAC represents U.S. business interests in 12 Asian-Pacific countries from Japan to Australia.

APCAC strongly believes that the taxation of the earned income of Americans working overseas adversely affects the ability of U.S. companies and small businessmen to compete in the international market place. This tax policy, which has resulted in an ever increasing tax cost of maintaining American personnel overseas, is one of the most critical problems faced by American business interests in our area. The point was documented in our testimony to the Joint Economic Committee during their East Asia study trip in January 1980 and our testimony before this subcommittee on June 26, 1980. It is highlighted in the President's Export Council report issued on December 5, 1979, titled Task Force to Study the Tax Treatment of Americans Working Overseas and in the Report to Congress titled American Employment Abroad Discouraged by U.S. Income Tax Laws issued on February 27, 1981 by the United States General Accounting Office.

The United States is the only major country in the world which effectively taxes its citizens on income earned while working overseas.

This has substantially increased the cost of maintaining an American employee overseas and has forced many U.S. companies to replace their American employees with third country expatriates who do not have the burden of a home country tax. The significance of this increased cost is well documented in the GAO report cited above in its comparison of the difference in tax reimbursements as a percent of the additional costs of American compared to selected TCN's.

From a personal standpoint, the small businessman operating overseas is faced with even a worse problem than his American friends working for multi-national corporations. The employee of a multi-national in most cases is reimbursed for his additional tax burden by his company. The small businessman, on the other hand, suffers both in his business in which he is carrying a greater cost burden than his foreign counterpart, but personally as well since he cannot pass on the additional costs to his clients or customers. This has led to a substantial reduction in the number of small American businessmen overseas.

There has clearly been a relative reduction in Americans working overseas. In some cases, there has been an absolute decrease and in other cases, while there has been an increase in the absolute number, it has been at a rate lower than that of nationals from other countries. An example of the trend is a company in Singapore operating in the oil and gas exploration field with approximately 150 expatriates. The percentage of third country nationals in this expatriate population has increased since 1975 from 19% to over 50%. This is typical of many companies operating in the Asia-Pacific region. These are the engineers, supervisors, etc. who decide which pump will be used at the drill site, whose casing will be put in the ground, which equipment will be used to clear the drill site, etc.

The reduction of Americans overseas has had a negative impact on U.S. exports. Not only are we losing business because of the high cost of American employees, their replacement by other nationals has resulted in the purchasing of supplies and equipment from the home country of the non-American managers. As documentation for this adverse impact, I refer you to the Chase Econometric Study.

The Foreign Earned Income Act of 1978, has dramatically increased the U.S. tax cost of Americans working in most countries of the Asian region. Attached is a summary of the results of a survey conducted by APCAC (Appendix A). This survey compares the 1978 U.S. tax liability of a number of individuals in each country in the region with what they would have paid in the U.S. on their basic salary (excluding the allowances necessary to offset the higher costs of working abroad) and with what their 1978 tax would have been under the old $20,000/$25,000 rules. The percentage increase in U.S. taxes (before the foreign tax credit) in Taiwan was 77%, Singapore - 42%, Malaysia - 39% and Hong Kong - 24%. The only country showing a decrease in tax under the Foreign Earned Income Act is Japan. Even after considering the foreign tax credit, the current law resulted in a substantial increase in tax in most of the countries.

One of the intents of Congress in passing the FEIA was to provide tax relief for the excess costs of working and living overseas. This was done through a series of deductions for certain excess foreign living costs. In practice however, these deductions are substantially less than the actual related costs. For example:

Housing Deduction - Most Americans working overseas are being taxed on a substantial amount of their housing costs. For example, according to the GAO study cited above, a married American working in Japan is permitted a housing deduction of approximately 45% of actual costs. The comparable percentage in Hong Kong is 66%. This problem is especially acute in Asia because of the high housing costs in most of the business centers.

Cost of Living Differential

The cost of living tables issued for both 1978 and 1979 do not reflect the actual differences in the cost of living between Boston (which we understand was the reference point) and the overseas locations in the Asian-Pacific region. This is shown by the attached comparison of the IRS cost of living differences with these computed by the Organization Resources Counselors, Inc., (ORC) at the GS-14, Step 1 level with three dependents. For example, in 1979, these tables show a cost of living differential of $4,500 in the case of Indonesia, while the IRS provides no cost of living differential. While a small portion of the variance reflects the difference in the cost of living between Boston and Washington, it demonstrates that the IRS tables are unreasonably low.

Other Allowances

There are many other costs required for an American working in Asia which are not reflected in the excess living cost deductions. The largest of these is typically the tax reimbursement which reflects the excess of total taxes over the amount of tax on an employee would incur had he remained in the U.S. This reimbursement is of course income in the year of receipt which in turn increases the tax reimbursement in the subsequent period. This results in a never ending pyramiding affect.

In short, the Section 913 deductions are substantially less than the allowances required to support a American working overseas. Thus, we feel it is fair to say that the current law has not achieved what Congress intended.

Im summary, the ability of U.S. firms to compete in overseas markets is substantially reduced by the current Sections 911/913 of the Internal Revenue Code. With the current trade deficit, negative balance of payments, and need to create export related jobs, it is imperative that the U.S. tax law be restructured to place the American

businessmen working overseas in an equal position with his competition - it is vital to encourage the presense of U.S. citizens overseas:

(1) to promote the sale of U.S. goods and services, and
(2) to continue the valuable contribution to our balance of payments being made by U.S. business investors abroad through dividends, royalties, etc.

Accordingly, to achieve equalization with our competitors, APCAC strongly endorses the complete exclusion of foreign earned income from taxation for all Americans working overseas.

APPENDIX A

A P C A C - U. S. T A X S T U D Y

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	TAX "AS IF" EMPLOYED IN U.S.	TAX (BEFORE FOREIGN TAX CREDIT) ON PRE-1976 RULES	ACTUAL 1978 TAX (BEFORE FOREIGN TAX CREDIT)	TAX (AFTER FOREIGN TAX CREDIT) ON PRE-1976 RULES	ACTUAL 1978 TAX (AFTER FOREIGN TAX CREDIT)	FOREIGN TAX PAID OR ACCRUED	TOTAL TAX
Hong Kong	15,617	22,683	26,850	11,467	14,167	10,317	24,484
Indonesia	8,533	21,296	24,318	3,106	3,819	18,264	22,083
Japan	10,350	40,526	29,280	13,615	5,042	27,410	32,452
Malaysia	6,187	17,526	21,718	3,257	4,512	23,230	27,742
Philippines	5,652	13,116	16,423	6,431	7,554	5,035	12,589
Singapore	6,620	12,270	14,881	2,423	3,443	13,538	16,981
Taiwan	8,687	10,215	13,934	3,966	7,021	8,134	15,155

TABLE I

COST OF LIVING ALLOWANCE DIFFERENTIALS

COUNTRIES	ORC	IRS
Hong Kong	5,964	800
Indonesia	4,500	None
Japan	14,388	11,200
Korea	4,692	4,500
Malaysia	3,996	1,500
Philippines	528	None
Singapore	4,692	2,300
Taiwan	5,496	800
Thailand	828	None

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT BY THE HONORABLE BILL FRENZEL

BEFORE THE

SENATE FINANCE COMMITTEE, SUBCOMMITTEE ON TAXATION

AND DEBT MANAGEMENT

ON SECTION 911 REVISIONS

APRIL 2[illegible], 1981

Mr. Chairman, I first want to commend you and your fine Committee for holding these hearings. I believe Section 911 and 913 of the Tax Code represent a critically important aspect of the country's economic future.

In 1978, this Congress recognized, in what has come to be known as the Ribbicoff amendments, that it had made a dreadful mistake in reducing the foreign exemption in 1976. Even by 1978, only two years later, it was apparent that we had shot ourselves in our collective foot in the 1976 Act.

In our excessive zeal for tax reform, we forgot about, or perhaps we never knew about, competitiveness abroad. Our own mistakes were compounded by some grotesque Treasury rules that imputed high income for expenses of living in miserable circumstances abroad.

Those 1978 amendments took care of some of the very worst Treasury rulings and helped to compensate Americans abroad for extraordinary living expenses. But they carried with them an awful price in administrative complexity and cost, and they did not address the central problem.

The real problem is, of course, that the U.S. is the only major trading country to tax the earned income of its citizens who are working outside of its borders. Thus, for U.S. companies, U.S. nationals are far more expensive than are foreign nationals.

Therefore, the goods and services of U.S. companies abroad are not competitively priced unless the U.S. companies hire foreign nationals. The problems are extreme

for services, such as construction, which have a high American supervisory labor cost component. But Section 911 also poses cost difficulties for any U.S. firms who want to have Americans selling American exports in foreign countries.

The 1976 changes have caused Americans abroad to be brought home in droves. These Americans have been replaced by foreign nationals. These foreign nationals are undoubtedly good people, but experience proves that they do not order American products instinctively as an American would, and they do not instinctively place American interests first.

In short, since 1976, a number of us in Congress (a number which is now thankfully growing) have warned that U.S. export business was being lost because of the unwise tax policy in Sections 911 and 913 of the Internal Revenue Code. We warned about continuing trade deficits, and the effect on unemployment here at home.

Finally, we are able to describe those warnings in more definite terms because of a recently completed study by Chase Econometrics. The Chase study reinforces the generally accepted belief that the tax which the United States places on its citizens abroad is forcing many American exporters to replace their U.S. employees with foreign nationals whose income is not subject to tax by their native country. These individuals are likely to purchase products from their home country, as opposed to purchasing American made products.

The study determined that the current tax treatment of Americans abroad has resulted in a drop of at least 5% in exports in 1980. Chase estimates that this decline will raise domestic unemployment by at least 80,000, and reduce Federal tax receipts by more than $6 billion. This is many times the estimated $585 million a total exemption of foreign earned income would cost the Treasury.

The evidence is in. It is absolutely necessary, in order for the U.S. to maintain (and improve) its trading position, that we tax our overseas citizens on the same basis as our major trading partners tax their expatriot citizens.

Fortunately, many of my colleagues in both the House and the Senate have come to recognize this need, and have introduced legislation to try to bring about some improvement in the foreign earned income laws. Unfortunately, many of these bills, while well intended, do not go far enough.

Mr. Chairman, this Committee has before it several bills which would vastly improve the tax treatment of overseas Americans. However, only one of these bills addresses the entire problem, and provides a comprehensive solution.

Two of the bills before this Committee provide for an increase in the income exclusion amount, up to a $75,000 limit. This $75,000 limit would take care of about 85% of all U.S. workers abroad, and would provide virtually all construction workers and middle management employees with a total exemption from U.S. taxation. Unfortunately, the upper level employees, those individuals who make the decisions that most affect a company's overseas operations, and those individuals who have the most imput into executive decisions, would still have a potentially large tax liability.

The only way that we can start to put Americans abroad on an equal footing with our major trading partners is to provide them with equal tax treatment, a total exclusion of all foreign earned income from U.S. taxation. This is accomplished in Senator Jepsen's bill, S. 598, and in the bill I introduced, H.R. 913.

In conclusion, I would again like to commend this Committee for its courage and initiative in holding these hearings, and I would like to again urge the Members of the Committee to support legislation which provides for a total exclusion of all overseas earned income from taxation. Only then will the Yankee Traders again be able to go abroad and compete fairly.

STATEMENT

BY

SENATOR CHARLES McC. MATHIAS, JR.

on the

Taxation of Americans Living Overseas

before the

Subcommitee on Taxation and Debt Management

April 24, 1981

Mr. Chairman. I would like to congratulate you for scheduling these hearings and taking the initiative in this important area. The importance of exports to our economy can not be overstated.

If we are ever going to get our country moving again, we have got to increase our exports.

Exports now contribute more to our Gross National Product than private corporate investment does. One of every eight jobs in this country is involved in exports. One dollar of every three of U.S. corporate profits comes from international activities. And one of every three acres of farmland produces for export.

Yet, despite the critical importance of exports to our economic well-being, the United States still lags far behind its major trading partners in international trade. The United States share of Free World exports has steadily decreased--from 18.2 percent in 1960 to 12.1 percent in 1980. In Germany, France, Italy, and the United Kingdom, exports account for more than 50 percent of all goods produced, while in the United States they account for only 14 percent.

Much of the blame for our poor export performance can be pinned on the maze of disincentives to trade which have built up over the years. Over the past four years, we have steadily tightened the screws on our overseas sales force--increasing the rate of taxation and making the whole system more complicated. The result is clear and calamitous--in the Middle East it now costs an American company $62,500 for an American worker to take home $27,500. In the long run, we all pay the price for that kind

of unenlightened tax policy. Without American technicians overseas, we lose contracts, and that translates into jobs lost back home. If we don't encourage these Americans to remain abroad as good-will ambassadors, as a dedicated sales force, and as a foot in the door for other export opportunities, our balance of payments will grow increasingly out of whack and in the red.

Last year, I introduced a bill to reduce the tax on Americans living abroad in all countries. This year, I have joined Senator Chafee as a cosponsor of his bill, S. 408, which would exempt from U.S. tax the first $50,000 of income plus half of the next $50,000 up to a total of $75,000. The bill would also reduce the residency requirement from the present 17 out of 18 months, to 11 of 12 months.

If enacted, this bill would put American companies and American workers on an equal footing with their foreign competitors. It would give them a chance to bring back home some of the $60 billion dollars a year we are spending for foreign oil.

Our tax policy is costing the United States over $6 billion in lost trade, while the U.S. Treasury is gaining only $300 million in tax revenues. It doesn't take a Ph.D. in economics to figure out that this tax policy is short-sighted and misguided. The same impulse that prompted the much-ballyhooed crusade against the three-martini lunch led to our current policy. Its creators thought only in terms of rich movie stars living overseas in the lap of luxury on the Riviera. We've got to refocus our attention on the real world--on the hardworking men and women who are doing

a tremendous, but increasingly difficult, job on behalf of all their fellow Americans. Rather than the Riviera, they will more likely be found in the desert heat or tropical monsoons of the less glamorous corners of the globe. Unless we make it possible to continue their important work, we'll all be in trouble.

My point is simple. If export promotion is to become a top national priority--which it must--we need a team effort, with the federal government removing this and other self-imposed barriers and substituting creative incentives to exports. Like Churchill in another context, businesspeople have asked us to give them the tools; they will finish the job.

Mr. Chairman, again I thank you for holding these hearings and I urge you to lend your support to Senator Chafee's bill.

Longs Drug Stores

General Offices: 141 North Civic Drive, P.O. Box 5222, Walnut Creek, California 94596, (415) 937-1170

April 24, 1981

The Honorable Steven D. Symms, Chairman
Sub-Committee on Estate & Gift Taxation
United States Senate Finance Committee
452 Russell Building
Washington, D.C. 20510

RE: INHERITANCE AND GIFT TAX HEARING - MAY 1, 1981

Dear Senator Symms:

I would like to request that this letter be made a part of the record of the Sub-Committee hearing on May 1, 1981, of the Sub-Committee on Estate and Gift Taxation of the United States Senate Finance Committee.

The high estate and gift tax rates now in existence have a very deleterious effect on the make up of the U.S. economy. There are many people in positions like myself who started out with no capital and worked hard all their lives and built up a going organization only to see it either (1) being confiscated through inheritance taxes, or (2) merge with a large corporation which has a large stock base, or (3) put into a foundation.

To me none of these help the American economy and I would like for you to consider permitting the deduction of a contribution of stock to an ESOP as a deductible item for tax purposes.

Donating stock to an ESOP would be sharing it with the employees that helped build the business and gives them a rightful portion which they deserve. When a business starts out it doesn't know what the end result will be; and, in many cases like that of myself, the stock was practically worthless and now has become worth many millions of dollars. All of this is due to the hard work of our entire organization and, by sharing this increase in the value of the corporation with the employees, would be a just and honorable thing to do.

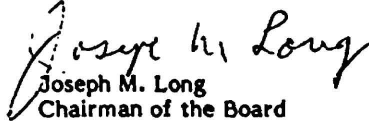
If the employees knew that they were involved in building a "nest egg" for themselves, they would be motivated to work harder because there is something of great value at the end of the trail.

I urge your Sub-Committee to either lower or repeal inheritance taxes and gift taxes or at least make contributions to an ESOP deductible from an individual's estate.

Our economy has gotten into a situation which is largely due to forced mergers which ruins small, independently run businesses. It has been too easy for successful small businessmen to go the route of the merger all to the detriment of the nation as a whole. Please give this your careful consideration.

Very truly yours,

LONGS DRUG STORES, INC.



Joseph M. Long
Chairman of the Board

JML/lml
Attachment
cc: Mr. Robert E. Lighthizer
United States Senate Committee on Finance
Room 222, Dirksen Office Building
Washington, D.C. 20510

The Association of Americans Resident Overseas

49, rue Pierre Charron — 75008 Paris, France — Tél.: [illegible] 256-1022

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STATEMENT

before the Senate Committee on Finance
Subcommittee on Taxation and Debt Management

Presented by: John R. Raedel
April 24, 1981

Mr. Chairman and Members of the Subcommittee:

We thank you for giving us the opportunity to express the views of your overseas constituents on the matter of taxation of Americans resident overseas. Most of the members of our organization, located in 39 foreign countries around the world, are not affiliated with any other lobbying group and therefore especially appreciate this chance to be heard. All AARO funds are obtained by dues and contributions from individual U.S. citizens.

The membership of AARO includes some of the most influential Americans overseas, those who are ignored by other lobbying efforts: i.e., Americans employed by foreign companies; American wives of foreigners, many of whose husbands are governmental or industrial personalities of considerable influence; and retired Americans, many of whom have spent their careers serving U.S. interests and who continue to do so in retirement. These civic-minded Americans are proud of their citizenship, and vote in elections for President, Senators, and Congressmen. Year in, year out, they have complied with the extremely burdensome complexity of their U.S. tax obligations, and since 1976 have also lived in profound uncertainty as to both present and future U.S. tax laws applicable to them. Now is the time to come to grips with this problem and put unnecessary complexity, uncertainty, and unfairness behind us once and for all.

Life overseas is not a prolonged vacation trip. The problems of adaptation to a foreign culture are numerous and demand many sacrifices on the part of the Americans there. Value added taxes and inflation are not necessarily compensated for by higher salaries. Generally the purchase of a home is so expensive compared to the cost in the U.S. that overseas Americans either

forego entirely the American dream of owning one's own home or settle for a lot less than what they could have had in the U.S. Rarely are mortgage interest and real property taxes deductible on foreign income tax returns in more than token amounts. Many Americans, having lived and worked overseas for long years, find that they do not have a home to return to in the U.S.

These are the Americans overseas who are, for the most part, not protected in any way by U.S. companies in connection with exchange rate fluctuations, foreign tax burdens, costs of living, housing, etc. overseas. By the fact of their solid integration into foreign communities, including their knowledge of a foreign language, these Americans make significant contributions to American goals by expressing in their daily words and deeds American culture and American conscience. Yes, they facilitate U. S. exports as well, because they can make meaningful and convincing comparisons between U.S. and foreign goods and services. But what value can be placed on the subtle political and social influences exercised by individual Americans overseas, when believers in philosophies alien to ours vigorously promote their own.

America is well served by its residents overseas. But since 1976 these Americans have had to suffer through extremely complicated and burdensome changes in U.S. tax laws affecting them. You may not realize it, but the I.R.S. has to publish a special booklet for Americans resident overseas, in addition to and thicker than the Federal Income Tax Forms received each year by U.S. residents. This booklet, called "Overseas Filers of Form 1040 - Supplemental Package", attempts to cover the vastly complex U.S. tax laws on American citizens overseas. It is easy to see from it why taxpayers are forced to seek professional assistance costing frequently upwards of $1,000 for what would have been a simple return for a U.S. resident: a professionally-prepared tax return for an overseas taxpayer is usually from 15 to 30 pages long. Since income taxes overseas are frequently very high, the U.S. tax is often nil -- but to get to that result, costly professional assistance is usually a necessity.

A major concern to both AARO and the Congress is that of strengthening the U.S. economy including competition in overseas markets. We agree with other lobbying groups in their conclusion concerning the negative impact on the U.S. economy of the unique U.S. system of taxing on the basis of citizenship. Recently this has been explained in the General Accounting Office Report dated February 27, 1981. Some of you may recall that in 1977 the U.S. Treasury

itself, in "Blueprints for Basic Tax Reform", recommended taxation of worldwide income by all countries on the basis of residence alone as the long term objective of the U.S.

AARO PROPOSAL

AARO proposes that the United States adopt the basic principle of taxation by the country of residence, supplemented by taxation at source for U.S. source income, with the proviso that overseas taxpayers may elect to be treated as U.S. residents for tax purposes. In other words, we recommend that the Congress legislate taxation of non-resident U.S. citizens in the same way as non-resident aliens, with one reservation: those citizens, all in moderate to low income brackets, for whom U.S. withholding taxes on non-residents would be unfairly high, should be permitted to elect taxation as though they were resident in the U.S. This system would be simple and easy to administer, and fair to all.

Basically, this would mean that foreign source income, both earned and unearned, would not be taxed at all by the United States. Earned income from U.S. sources (from a trade or business, or from work in the U.S.) would, under existing tax treaties, normally be taxed only in the U.S. Unearned income from U.S. sources (dividends, royalties, and non-bank interest) would be subject to U.S. withholding tax; capital gains from U.S. investments (except real estate) would not be taxed by the U.S. at all. In addition, under the AARO proposal, anyone who would pay less tax as a U.S. resident than he would through U.S. withholding could elect to be taxed as a U.S. resident.

What are the practical consequences of this position? First of all, simplicity. Existing structures for withholding tax on non-resident aliens would apply to U.S. citizens abroad. Tax treaties would also apply without any changes required. Tax returns, for those not electing to be treated as U.S. residents, could become largely limited to questions dealing with whether residence overseas was bona fide. Because of the election provision, no one would be worse off than he currently is under U.S. tax law. (The foreign tax credit provisions are and would remain available for U.S. residents.)

In addition to putting U.S. citizens on a tax basis similar to that of other major exporting countries, this proposal would give Americans overseas the same tax incentives as are granted to non-resident aliens to invest their savings in the U.S. Under current law, there is a tax incentive for Americans who are

taxed overseas to invest their savings overseas, rather than in the United States, which seems to us flatly contrary to U.S. policy to encourage investment in the U.S., particularly by its own citizens. You may be surprised to learn that even Americans who have lived overseas many years still prefer to and actively do invest their savings in U.S. securities, businesses, real estate, and other investments. They do not understand why U.S. tax law discriminates against them for doing so.

CONCLUSION

AARO and Congress share the same basic goals of a strong America at home and abroad, in the political, economic, military, cultural, educational, and social spheres. In working toward these goals we ask no special privileges, we expect to pay our fair share of taxes, but we ask to be treated fairly. We are tired, and we hope the Congress is tired as well, of the ever-increasing complexity and the year-to-year changes in our tax obligations. The AARO proposal for taxation on the basis of residence will restore tax equity to Americans overseas, put the United States on the same footing as other major exporting countries, and vastly simplify tax administration overseas for the Treasury.

Statement of
Air Transport Association of America
Before the Subcommittee on Finance Taxation
of the U.S. Senate Committee on Finance
on Income Earned from Sources Outside the United States
April 24, 1981

The Air Transport Association, which represents virtually all of the scheduled airlines of the United States, requests that this statement be included in the Subcommittee hearing record regarding the taxation of income earned abroad by citizens in private industry.

By virtue of the international carriers having routes to other nations, they must employ individuals in foreign locations. These individuals, who service the needs of our passengers and shippers and who promote travel to the United States on U.S. airlines, can be either U.S. nationals or foreign nationals. At the present time the U.S. airlines employ about 1,000 U.S. citizens working abroad as bona fide residents of a foreign country. This is not a question of exporting jobs, but rather a question of employing people.

In addition to these standard roles, several airlines have management contracts to assist in the operation of a foreign airline. These positions have traditionally been filled by dedicated Americans willing to live abroad. The U.S. airline manufacturers have been exceedingly aided by U.S. nationals in the maintenance and purchasing functions of these airlines. The commitment to U.S. standards of quality help insure the safety of U.S. nationals being transported via foreign carriers.

It is essential for the U.S. airlines as well as their employers to continue to secure highly competent technical, professional and management people to serve overseas. This is becoming increasingly more difficult in light of competition of foreign nations who do not tax such income and the upward pressure of worldwide inflation.

The airlines share the widespread concern that tax provisions contained in the Foreign Earned Income Act (Public Law 95-615, Title II, November 8, 1978),

are proving a disincentive to employment of U.S. citizens abroad; and, therefore, adversely affecting exports. The results of a recent General Accounting Office survey of a group of major U.S. companies having substantial operations abroad confirms that U.S. taxes are an important factor in reducing the number of Americans employed overseas. A summary of the GAO survey was included in a Comptroller General's Report to the Congress (ID-81-29) and reported:

- Tax laws do not fully relieve the companies' employees from taxes on income reflecting the excessive costs of living and working abroad.
- Companies generally reimburse overseas employees for their additional tax burden, making Americans more costly than citizens of competing countries, who generally are not taxed by their home countries.
- Complexity of the new tax laws makes compliance difficult and expensive.

The GAO survey confirms that changes made by the Foreign Earned Income Act of 1978 have created administrative and economic hardships for both the U.S. nationals employed overseas and the U.S. companies that hire them. Prompt relief is needed. The airlines believe these hardships can be completely eliminated by repealing Sections 911 and 913 of the Internal Revenue Code of 1954. U.S. nationals living abroad would be exempt from U.S. income tax and subject only to the tax of the foreign country of residence.

S. 598 under consideration by the Subcommittee would repeal Sections 911 and 913 and bring relief to the greatest number of U.S. nationals employed abroad. S. 436, also under consideration, would not repeal Sections 911 and 913, but would greatly lessen the hardships being encountered by increasing the amount excluded from income to $75,000 in 1981. Additionally, under provisions of this

measure, the excluded income amount would increase $5,000 each year until 1985 when it would reach a maximum of $95,000. Enactment of either measure would bring needed relief.

Thank you for the opportunity to provide this statement for the record. We hope our comments will be of assistance in your deliberations.

Statement of
George Barratt,
Vice President, Finance,
Computer Sciences Corporation, El Segundo, California
Before the Taxation Subcommittee,
Committee on Finance of the United States Senate,
April 24, 1981.

My name is George Barratt, I am the Vice President, Finance of Computer Sciences Corporation (CSC), the world's largest independent data processing services company. CSC is a New York Stock Exchange-listed firm, generating approximately 600 million dollars in annual revenue through the efforts of 15,000 employees working throughout the United States and in 26 foreign countries.

Approximately 17% of CSC's existing business comes from international operations. We are working to increase our international activities, and believe that the world market offers enormous growth opportunities for the high-technology services offered by CSC and by other U.S. companies in our industry.

Unfortunately, the foreign source income provisions embodied in Sections 911 and 913 of the Internal Revenue Code constitute a major export disincentive for companies, like CSC, which must employ expatriate American workers to do business overseas. Foreign firms, employing citizens of countries that tax the foreign source income of their nationals lightly or not at all, are given a significant cost advantage.

This situation works a particular hardship on CSC and all other American high-technology service companies which must, by the nature of their activities, send a large number of professional employees abroad to perform the work required on contracts for international customers.

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The export of American high-technology professional services can have an important, positive impact upon the entire U.S. economy. To cite just one example: CSC was selected to design and develop a nation-wide data processing and communications system for the government of a developing Mideast country. Including the purchase of American-made computer and communications equipment, this one contract will recycle at least $200 million back into our economy.

CSC's primary competitors on this procurement were foreign firms employing foreign nationals. Their bid prices did not reflect the high costs, borne by CSC, associated with compensating American employees for excessive foreign source income taxation. Likewise, our foreign competitors did not share the burden of having to budget approximately $1000 per expatriate employee per year just to prepare the complicated income tax returns required of Americans who seek to utilize the present provisions of Sections 911 and 913.

The need to step up exports of American professional services, particularly those services which have a significant "multiplier effect" on other exports, was clearly noted several years ago in a report of the Commerce, Consumer and Monetary Affairs Subcommittee of the House Government Operations Committee (page 3, House Report No. 95-955, March 14, 1978).

In view of the importance of enhancing the international competitive posture of American business, we urge the Congress to enact a major reduction in the tax burden on Americans who earn their living overseas. We further urge a major simplification of the laws governing the taxation of U.S. expatriates to eliminate the kind of highly complex and very restrictive rules under which the present Sections 911 and 913 are administered.

We express our enthusiastic support for the efforts of Senators Bentsen, Chafee, Jepsen and Moynihan to attain those goals through the legislative process. We most strongly endorse the approach embodied in S 598 because of its effectiveness in liberalizing the tax treatment of U.S. expatriate workers, as well as the simplicity of administration envisioned by that bill's provisions.

If the sweeping reduction of federal taxes on foreign earned income envisioned under S 598 are felt to be too drastic a step at this time, we believe that the approach taken in S 436 would represent an equitable and workable compromise.

Combined with realistic provisions relating to excessive housing costs overseas, the earned income exclusion embodied in S 436 would help address the need for tax relief for the vast majority of American workers involved in export-related foreign employment. These provisions would still maintain a reasonable tax burden on the handful of wealthy expatriates who choose to reside abroad for reasons of lifestyle.

We respectfully appreciate this opportunity to make known our views on the subject of foreign source income taxation, and would be pleased to provide any additional information which would assist in the evaluation of this critical economic issue.

2152 DuPONT DR., SUITE 106 • IRVINE, CA 92715 • 714/752-8954

April 24, 1981

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
2227 Dirksen Senate Office Bldg
Washington, D.C. 20510

Subject: Testimony for Finance Subcommittee on Taxation & Debt Management hearings

Gentlemen:

Senator Packwood has urged all who hold common views on the subject of these hearings to consolidate their testimony in order to avoid repetition. Senators, our very presence is a redudancy.

Five long years ago those of us favoring tax exclusion for Americans overseas told the Congress what would happen as a result of the 1976 Tax Reform Act. Three years ago we told had happened and today, we are back to square one telling you again what will happen if Congress does not act to provide tax relief for the American community abroad. Only this time we have a five year track record which has seen America's share of major markets abroad dwindell from 20 - 30% to 5 - 10%. Indeed, in Saudi Arabia we have dropped from a position of 37% of the Saudi market to now less than 5%. Those opposing such relief have lost all their arguements save one. They persist in the inane notion that tax equality is the goal, the Holy Grail of our democracy. And I say to you - rubbish! If there were true tax equality in this country there would be a flat rate paid by everyone with no deductions, shelters, loop-holes and the sort. If our tax policy is voluntary, it is also discriminatory and in no other sector is that policy more discriminatory than as applied to the U.S. citizen abroad.

The goal then of tax policy, is and always has been to create opportunity and advantage for the economy and the people. Home ownership is made desirable because of favorable tax policy to home owners while renters are disadvantaged. Moreover, substantial tax revenues are lost due to mortgage interest and property

tax deduction. Yet, were it not for these tax inequities, the home building and mortgage banking business would be severely limited - if not crippled. Besides, property ownership in this country is nearly constitutional in its character and import. The tax policy toward Americans overseas should reflect the same interest in this nation's export development as that tax policy which has made home ownership, home building, home financing and associated services possible and the very envy of the world.

I have been directly involved in international manpower support services for 30 years. In that time I have supplied American and TCN manpower to all major U.S. contractors overseas, many of America's largest operating companies and both U.S. and foreign government agencies. I have seen the shocking retreat of America's sales force from their overseas posts and the markets left behind that have been devoured happily and greedily by the Koreans, Japanese, British, Filipinos, Germans, French, et al. Amongst my company's activities is the publishing of a newsletter which is widely circulated amongst U.S. companies and their overseas employees. Two of our regular advertisers are firms in Pakistan and the Philippines offering labor from those countries to U.S. employers. If Congress places American labor on an equal tax footing with the rest of the world I'm going to lose those advertisers and I will be glad to do so because I know that 4 million of my fellow Americans will have new job opportunities at home, countless thousands more will work overseas and best of all, America's business will regain it's position of preeminence in the international marketplace. Also, the cultural, social and political advantages of a substantial American community abroad cannot be overstated. They influence by example and instruct by service. They recommend, specify and purchase American products. These Yankee traders are America's sales force abroad.

It is redundant to tell you over and over that Congress erred grievously in 1976 and again in 1978. The statistics entered into the testimony of this day by my colleagues speak eloquently enough for all but the most stubborn and stupid not to understand the problem and solution. You have before you a plethora of

legislation drawn to eliminate or alleviate the problem. If you choose to offer total exclusion with appropriate restrictions to avoid abuse you will eliminate for all time the necessity of more such hearings as these. If you elect to provide limited or targeted exclusion you invite us to return in the future because inflation and other unforeseen economic factors will surely invalidate such limitations.

Before closing, permit me to leave you with some numbers of my own. Of more than 1,300 employees of the Israel Airbase construction U.S. joint venture, Air Base Constructors, less than 400 are U.S. Citizens. The balance are TCN's. Yet, it is the American taxpayer who is paying for that work and it is being administered by the U.S. Corp of Engineers. That U.S. contractor has told me that if Americans were on an equal tax footing with TCN's the numbers of Americans hired would increase by 35 - 40%.

The Ralph M. Parsons Company has reduced it's American staff overseas by 1,000 since 1976.

Santa Fe Engineers & Constructors have reduced their U.S. Staff within the past 3 years by a factor of some 60%.

Both Boeing and Pan American service companies have advised that they have been forced by foreign competition to staff their overseas programs with TCN's and all because they cannot afford to pay the taxes for their American employees in order to attract Americans to work abroad and remain competitive against foreign companies.

As you can see, the problem is not limited to construction contractors and that is a very significant point. The measure you fashion must include all those who serve abroad - the private business man, the lawyer, the contractor and all those who employ or are employed overseas must be set free to bring home the jobs and trade America so desparately needs.

GEORGE E. FISCHER & ASSOCIATES

. . . was founded in 1975. Mr. Fischer has authored in excess of two million words on the subject of international operations and has acted as a consultant to foreign governments, U.S. government agencies and private concerns throughout the world. He has testified before the United State Senate, the U.S. House of Representatives, negotiated at the diplomatic level, traveled to foreign jobsites on five continents, and as a manpower supplier, has been associated with every major company involved in foreign work in the past thirty years. His writings have included reports on projects in nearly every country of the world, political essays, a highly praised series of articles on the energy crisis, the history of Islam, the Middle East, taxation and many more. He was the youngest founder member of The Beavers, America's largest fraternity of engineering construction executives and named 1969 Man of the Year by America's *Builders Yearbook*. In January 1977, Mr. Fischer founded "The Committee for the Abolition of U.S. Individual Income Taxes Abroad" (CAUSIITA) and later its successor organization, "The American Constituency Overseas," which has been influential in improving the tax treatment of Americans overseas.

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MACHINERY and ALLIED PRODUCTS INSTITUTE

1200 EIGHTEENTH STREET, N.W. WASHINGTON, D.C. 20036 202-331-8430

April 27, 1981

The Honorable Bob Packwood
Chairman
Subcommittee on Taxation and
Debt Management
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

<u>Federal Income Taxation of U.S. Workers Abroad</u>

<u>Introduction</u>

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to comment to the Subcommittee on Taxation and Debt Management concerning proposals to correct inequities in existing tax law that directly affect U.S. workers in foreign service and indirectly impede U.S. international trade, including domestic exports.

<u>MAPI's Concern</u>

As the subcommittee may know, MAPI is the national organization of companies engaged in the manufacture of capital goods and allied products. Nearly all of the Institute's member companies have substantial foreign operations, including export trade, in addition to their domestic sales. In the past, such companies relied to a very considerable extent on the use of U.S. nationals in their work forces at foreign locations to manage,

MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION, COMMUNICATION AND COMMERCE) IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES

engineer, construct, sell, and otherwise conduct corporate affairs. Because of misdirected U.S. tax policies, the use of U.S. nationals abroad is now greatly diminished. Not only have such policies adversely affected these individuals, but the burden necessarily has been passed to and borne by the employer. As a result, our member companies find that the cost of maintaining U.S. personnel in foreign service is virtually prohibitive. Inasmuch as such personnel are indispensable in certain positions, the effect of current tax policy is to make these firms less competitive vis-a-vis foreign producers in the same markets, with adverse effects for U.S. exports and other undesirable consequences.

Our position, summarized below, was first formulated in 1975 when we intervened with only partial success to try to avert a total repeal of the foreign earned income exclusion as it then existed under Internal Revenue Code Section 911. At that time, we explained that the exclusion should not be reduced or targeted, and, in fact, should be increased to reflect inflation since the early 1960s when it was enacted. We continued to espouse this position in the wake of the egregious policy errors involving Section 911 in the Tax Reform Act of 1976, which were suspended and generally did not take effect. Also, we adhered to this view in 1978, and advised Congress without noteworthy success that the Ribicoff "compromise"--eventually enacted as the Foreign Earned Income Act of 1978 and still applicable--was both inadequate and unworkable.

Current Position,
in Brief

In view of the more constructive attitudes now in evidence regarding this subject, we believe that more can be accomplished. In-

stead of our earlier recommendation that there be an across-the-board exclusion set to reflect inflation since the early 1960s, we urge Congress to reexamine the question of a total exclusion as recommended in Senator Jepsen's bill, S. 598, in order to put all American workers on the same basis as foreign nationals.

If there still is some lingering concern about "movie moguls" who produce their films and source their income in tax havens, then denial of the exclusion may be necessary for persons whose activities abroad demonstrably have as their principal purpose the avoidance of U.S. taxes. Alternatively, some cap could be considered for the exclusion, in which case the subcommittee might favor the Bentsen approach in S. 436 or an indexed exclusion beginning at a minimum of $75,000 "off the top" in 1981. It should be recognized, however, that a cap at such levels would discriminate without justification against higher salaried individuals in foreign service and, therefore, would be less desirable than a "principal purpose" test. For a residency requirement, we favor bona fide residence for an entire taxable year or physical presence for 11 out of 12 months, as in S. 436, with authority in the Treasury Secretary to waive the requirement in cases of civil disorder.

If a total exclusion is put aside in favor of a limited one, we concur in also having the excess housing cost deduction of the Bentsen bill/1 as well as the provision for nontaxability of housing furnished in camps, although such provisions are complicating elements that we normally would rather avoid. On the subject of complications, we never supported Code Section 913 because of its intolerable complexity and

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1/ The House companion bill of S. 436 is H.R. 911 of Congressmen Archer and Pickle.

niggardly "allowances." Therefore, we enthusiastically urge its repeal. Regarding the foreign tax credit, we note that all 11 currently pending variants of tax change in this area state that foreign taxes on excluded amounts should be neither creditable nor deductible, and we take no exception to this provision. Finally, we request prompt action by Congress on reform of Code Sections 911 and 913, and suggest that it be taken up as soon as possible with an effective date retroactive to January 1, 1981.

Our further remarks are in response to specific issues raised by the subcommittee in its Press Release No. 81-120 of April 7, 1981, announcing hearings on the subject at hand.

Specific Issues

The subcommittee inquires about (1) the impact of current law on the ability of U.S. nationals to compete abroad with foreign nationals; (2) the impact of current law on total U.S. exports and employment; and (3) other factors to consider in setting matters straight.

Competitiveness

It stands to reason that current policy has an adverse impact on the ability of U.S. nationals to compete abroad. The public record already contains testimony from corporations and their representatives, including MAPI, stating that the U.S. tax law causes the employment of an American in foreign service to be significantly more expensive than the use of a foreign national of equivalent standing and ability. The reason for this is that the United States, with its system of asserting taxing jurisdiction over the worldwide income of all its citizens, is the only major trading nation to tax its citizens on income earned

outside the country. In the absence of compelling circumstances, no rational employer overseas would pay more than the market rate for an employee from stateside just to help him pay his U.S. federal income taxes.

Of course, U.S.-based employers occasionally encounter compelling circumstances that cause them to pay seemingly exorbitant amounts to maintain U.S. workers abroad./1 In the usual instance, an American can afford to take a foreign position only if the employer will gross up his pay with various allowances plus an amount for tax equalization. Whereas the U.S. national may thus be more competitive for reasons related to his skills, familiarity with the enterprise, or other reasons, the costs borne by the employer leave it less competitive. For example, in testimony given to the House Committee on Ways and Means earlier this month, one witness stated that an employer wanting to hire 100 Americans--as compared to third-country nationals--on "single" status at a base salary of $30,000 for a project in Saudi Arabia would incur added tax equalization costs of $3.5 million, an amount that foreign competitors would not incur. Comments to us by our member companies generally support this contention.

Studies of this subject by Chase Econometrics, Organization Resources Counselors Inc., and others point to the declining presence of Americans in foreign markets and generally link the retrenchment to the punitive U.S. tax policies that have been in place since 1976. Of course, there are other causes as well, including U.S. antiboycott and

1/ For example, some positions require a working knowledge of the company, of key personnel, of management techniques, or of the various U.S. laws with extraterritorial application, etc.

foreign corrupt practices laws; the projection of other U.S. socio-economic and "human rights" values into foreign trade policies; difficulties with Eximbank funding and competitiveness; etc. However, U.S. taxation appears to have priced the U.S. expatriate out of the foreign job market more directly and more effectively than the other factors. In its recent study of this matter, the General Accounting Office (GAO) spoke directly to the competitiveness consideration in its conclusion, in part as follows:/1

> 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, because
>
> --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 share of 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.

1/ "American Employment Abroad Discouraged by U.S. Income Tax Laws," GAO Report No. ID-81-29, February 27, 1981.

> A number of optional means of taxing Americans abroad have been proposed to the Congress. Two of these--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. [Emphasis added.]

As already mentioned, U.S. tax law requires more tax-based cost input for American labor abroad than for labor from any other source. Also, this country is imposing taxation of a kind that is generally not imposed by other trading nations. Taking all other factors as constant for purposes of evaluating the tax consideration, it is obvious that we are hurting ourselves and conferring trade advantage on others. This has been described aptly as "unilateral economic disarmament," and it amounts to U.S. subsidization of foreign industrial growth to the extent that U.S.-based firms are dependent upon Americans abroad and consequently are less competitive.

Exports

In a June 1980 report, Chase Econometrics stated, in essence, that the increased cost of employing U.S. workers overseas and the reduction in the number of such workers had resulted in an overall drop in real U.S. exports by 5 percent./1 Similarly, a December 1979 report by the President's Export Council provided evidence to the effect that (1) Americans have lost overseas jobs, (2) U.S. companies have lost

1/ "Economic Impact of Changing Taxation of U.S. Workers Overseas," Chase Econometrics, June 1980.

business in selected markets, and (3) the replacement of Americans by foreign nationals can lead to reduced exports./1 Although Chase Econometrics used an econometric model in its study and the Export Council relied on case studies, both arrived at approximately the same conclusion. Our member companies report the same findings to us, and we believe that any contentions to the contrary are questionable.

Clearly, one cannot easily quantify the extent to which U.S. exports depend on Americans abroad, and any attempt to do so must rest on certain assumptions. For example, some U.S. exports occur without a foreign presence of any kind. Also, some U.S. exports exist because of sales and service activity of third-country nationals employed abroad by the exporter. Further, some Americans in foreign service are engaged in activities that are linked to foreign manufacturing, sales, or service facilities with no connection whatsoever to U.S. exports. In other words, there is no "necessary" connection between a particular American abroad and U.S. exports. On the other hand, it is difficult to imagine vigorous U.S. export activity without Americans in key posts abroad to direct customers to domestic contractors and subcontractors and to provide continuing service and support.

In our opinion, there can be no reasonable doubt that the number of Americans resident abroad has a statistically significant relationship to the value of U.S. exports./2 Furthermore, U.S. export activity obviously has desirable effects in providing domestic employment and in reducing the U.S. trade deficit. We also are persuaded that

1/ "Report of the Task Force To Study the Tax Treatment of Americans Working Overseas," President's Export Council, December 1979.
2/ See, e.g., "The American Presence Abroad and U.S. Exports," by Professor John Mutti, U.S. Department of the Treasury, October 1978.

U.S. taxes which are higher than, and otherwise out of phase with, those of other countries can--and do--have a negative effect on the American presence abroad. As set forth earlier, either the U.S. national becomes less competitive because of the added tax burden, or his employer becomes less competitive as he tries to rationalize and absorb the extra cost. One arrives both intuitively and empirically at the same conclusions, and we believe that persons who demur when presented with these propositions have very difficult presumptions to overcome.

As to the precise effects of current policy, we think it is irrelevant whether someone's econometric model cranks out an estimated export loss of 3, 5, or 7 percent or a domestic job loss of 60,000, 80,000, or 100,000. Inasmuch as losses are attributable to current policy and changes should be made, we urge Congress to wind up the seemingly interminable debate and take action.

<u>Factors</u>

The subcommittee requests information on factors to consider in designing an exclusion for foreign income, including the level of the exclusion; the ease of administering the exclusion; the effect of limiting the exclusion to individuals engaged only in certain business activities or employed only in certain countries; and the effect of limiting the exclusion only to earned income.

<u>The level</u>.--Clearly, the level of the exclusion must be set at a reasonably high level if there is not to be a total exclusion. We support a total exclusion if only because international tax harmonization points in that direction. Also, we frankly are not very concerned about movie barons who use the Sahara Desert instead of the

Mojave Desert to film their productions because other tax climates are more salutary. Taxes affect decisions in the market place just as do other costs, and we would prefer to do without artificial impediments to resource allocation. As already noted, the exclusion could be withheld where it is demonstrated that income has been sourced abroad for the principal purpose of tax avoidance. To place a ceiling on the exclusion is to "target" it to lower- and middle-income expatriates and to leave some measure of added tax burden taxation in place for senior management, senior engineers, and others.

In our opinion, punitive U.S. taxation is no more in order for "key" employees abroad than for the rank and file. Also, if U.S. taxation is to be "neutral" in decisions, it should be conformed to that of our trading partners, which suggests the desirability of a general exclusion. We repeat that a tax on U.S. workers abroad beyond a stated period of residency is a discriminatory tax that punishes foreign service by U.S. nationals vis-a-vis third-country nationals. Also, an exclusion with a cap discriminates without any justification against higher income individuals abroad. Discriminatory taxes in this context are improper without reference to income level, as recognized by Senator Jepsen. We might add that a cap on an exclusion requires periodic congressional attention if it is not indexed or increased annually in increments by the original enactment.

If there is to be a ceiling, the subcommittee should consider either the Bentsen approach or an indexed exclusion that would increase in line with inflation from a starting point that is as high as the Congress will accept. The excluded amount should come "off the top" rather than "off the bottom." Additionally, we would favor an excess

80-612 O—81——23

housing allowance deduction such as Senator Bentsen has proposed to complement the exclusion in view of the very high housing costs encountered in some foreign countries. The housing deduction should be kept as simple as possible, and the subcommittee also should give thought to a higher general exclusion as an alternative to the deduction.

Administration.--Ease of administration should be a high priority objective of Congress in this area of the tax law. Currently, Code Sections 911 and 913 are a briar patch of provisions so poorly conceived and designed that they require inordinate agency time to administer. Moreover, most affected taxpayers do not understand them, and need certified public accountants to complete their returns. Moving to a general exclusion should resolve this shortcoming of current policy.

Targeting.--Generally, we oppose provisions to target the exclusion, as indicated earlier. Although there would be some variations from country to country in the benefit to be derived from a general exclusion, the recommended approach delivers rough justice in all cases by keeping U.S. taxes out of the picture. In exchange, there would be simplicity of administration which could not be had if targeting refinements were added. In that connection, we take no position at this time on the proposal to continue restricting the foreign earned income exclusion to "earned income," as opposed to treating investment income on the same basis.

Concluding Comment

In analyzing proposals to amend Code Sections 911 and 913, we hope that Congress will recognize the extravagance of current policy and not be distracted by specious assertions of revenue loss based on static econometric models. Even the "conservative" estimates we have seen of

domestic export and employment sacrifice attributable to the existing tax law suggest that significant revenues are being foregone for failure to amend the law. The subcommittee now has before it several measures designed to bring down this existing, unwittingly self-imposed, barrier to U.S. international trade, including exports. In our opinion, the question of "revenue loss" associated with the pending bills--as compared to current policy--is a red herring, and the only matter for resolution is the extent to which the barrier will be dismantled.

MAPI appreciates having this opportunity to comment to the subcommittee on a subject of continuing concern.

Respectfully,

Charles Stewart

President

NRECA NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036/202-857-9500

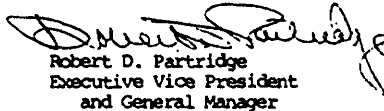
April 20, 1981

Honorable Robert Packwood
Chairman, Subcommittee on Taxation
and Debt Management
Senate Finance Committee
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

We appreciate the opportunity to submit a statement setting forth NRECA's views on tax treatment for Americans working abroad for your hearing on this matter scheduled April 24, 1981. We are requesting the inclusion of the enclosed statement in the hearing record.

Sincerely,



Robert D. Partridge
Executive Vice President
and General Manager

RDP:mk
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STATEMENT OF ROBERT D. PARTRIDGE
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Before

The Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate

April 24, 1981

Mr. Chairman and members of the Subcommittee, I am pleased to submit this statement in support of bills to liberalize the tax treatment of income earned by Americans working abroad.

For the record, I am Robert D. Partridge, Executive Vice President and General Manager of the National Rural Electric Cooperative Association (NRECA). NRECA is the national service organization representing more than 1,000 rural electric systems in 46 states. These systems, mostly all cooperatives, serve more than 25 million consumers in 2,600 of the 3,100 counties in the United States. Members of NRECA provide electricity to about 75 percent of the land area of this nation.

NRECA has been providing assistance to Lesser Developed Countries of the world since 1962 when we completed an agreement with the Agency for International Development. We have now provided formal assistance in 43 countries of the world, carrying out more than 300 assignments to assist countries in planning or implementing rural electrification programs and have assisted in making 1.8 million electric connections, reaching 12 million rural poor.

In January, NRECA concluded its 39th annual meeting in San Francisco. During the course of this meeting, the 11,700 delegates passed the continuing resolution below in support of foreign aid programs with special attention to cooperative rural electrification projects.

MANAGEMENT SERVICES INTERNATIONAL PROGRAM. We urge Congress and the administration to give increased support to foreign aid programs which provide for sharing United States cooperative expertise with developing countries for the purpose of improving food production, rural development and nutrition, population planning and health, and education and human resources. We especially recommend the fostering of cooperative rural electrification projects as one of the most respected and effective programs for enhancing human dignity and improving job and education opportunities, income and living conditions in those countries. We commend those systems which have participated in the international program by permitting members of their staff to serve overseas, or have provided training for rural electric specialists from the developing countries.

The majority of NRECA's overseas activities during the first fifteen years was financed by the Agency for International Development, but NRECA has carried out several assignments financed by the countries themselves and the international development banks.

At the present time, several of NRECA's overseas activities are financed by the World Bank. To obtain these contracts that are funded by the international banks, it was necessary to compete against consultants from many other countries of the world. Most of these countries do not tax the income of their citizens who are employed overseas. When this is coupled together with their normally lower salaries as compared to U. S. consultants, the consultants from other countries are given a major advantage in competing with U. S. firms.

Added to this competitive disadvantage is the uncertainty at play when U. S. firms try to recruit specialists for overseas assignments. Many prospects have heard rumors of the benefits of working overseas which trace back to the more liberal exemptions that applied for many years. Now, when a job opportunity is presented in 1981, the exemption no longer exists as an incentive, and it is difficult to recruit qualified advisors.

In actual practice, when these persons are recruited and placed in overseas assignment, if they receive housing allowances or salary differentials for hardship posts, they are required to pay additional income taxes on these allowances and are placed in higher income brackets which seriously detracts from any increases in pay received for the overseas assignment. This is a further disenchantment to overseas employment to the new recruit.

NRECA's recruting problems are even more difficult than most other U. S. consultants or contractors because our work is done primarily in the remote rural areas where, many times, living conditions are not the best.

Hence, U. S. firms are faced with very real difficulties in trying to recruit the top-flight people that are needed when there is no real incentive for overseas assignments, and, in many cases, there is a disincentive.

When NRECA does obtain a consulting project overseas, it designs and recommends U. S. standards developed by the Rural Electrification Administration. This results in millions of dollars of U. S. manufactured goods being purchased for the project. If the advisory contract is awarded to the British or French, they recommend their own countries' products.

Hence, we would urge the Chairman and members of this subcommittee to favorably report legislation to provide relief to Americans employed abroad from taxes on earnings from overseas assignments. We believe this is necessary so that U. S. firms can compete with firms from other developed countries in carrying out consulting assistance in the developing world.

Statement for Senate Finance Subcommittee
on Taxation and Debt Management
Hearing on Miscellaneous Tax Bills
April 24, 1981

Submitted by the Foreign Mission Board
Southern Baptist Convention

SUMMARY POINTS

I. Identification of the Foreign Mission Board of the Southern Baptist Convention

A. 13 million constituents
B. 3,000 overseas missionaries
C. Involved in 94 countries

II. Scope of Overseas Involvement

A. Medical ministries
B. Sanitation/public health
C. Schools
D. Community development
E. Agriculture centers
F. Church development

III. Tax Exemption Status: Historical/Contemporary

IV. Support of Proposed Legislation Along Lines of S. 408 or S. 436

V. Support of Worldwide Exclusion, Rather Than Distinction Between Lesser Developed and More Developed Countries

Statement for Senate Finance Subcommittee on Taxation and Debt Management
Hearing on Miscellaneous Tax Bills, April 24, 1981

Submitted by Winston Crawley, Vice President for Planning
Foreign Mission Board, Southern Baptist Convention

The Foreign Mission Board of the Southern Baptist Convention is the international service agency for more than 13 million members of Southern Baptist churches. At present the Foreign Mission Board maintains more than 3,000 missionaries in 94 countries and territories around the world. Those missionaries serve also as facilitators for several thousand other persons annually who participate overseas in a variety of special projects on a shorter-range basis.

Southern Baptist missionaries are engaged in a wide variety of benevolent programs, including sanitation and public health, medical ministries (20 hospitals and over 100 clinics and dispensaries), schools (561 schools at various academic levels), literacy courses, community development centers, children's homes, agricultural centers, etc. Major efforts are focused on combating world hunger. Vigorous response is made to natural disasters and to the needs of refugees.

Across the years, missionaries have served with a level of financial support considerably lower than the usual salary level for comparable employment in the United States. As Americans residing overseas in connection with their work, they have had an exemption of income up to $20,000 annually from United States income tax. Because of that tax exclusion, the Foreign Mission Board (like other charitable and religious organizations) has not had to divert additional amounts of money from its programs of work to enable employees who are on a minimal support level to carry an income tax burden.

A few months ago action was taken by the Congress and signed by the President to continue the $20,000 annual exclusion of income from taxation for employees of the religious and charitable organizations, as defined in Section 501(c)(3) of the Internal Revenue Code. However, that exclusion was limited to persons located in lesser developed countries.

Although the recent action does provide a great deal of relief for religious and charitable organizations, thereby enabling them to devote much larger amounts of money to their programs of work, additional legislation along the lines of S. 408 or S. 436 is highly desirable.

A number of representatives of the Southern Baptist Foreign Mission Board are located in countries to which the current $20,000 exclusion does not apply. Assistance which the board must provide to enable the missionaries to meet that tax burden (as a matter of equity with missionaries in other locations) reduces the amount available for the board's worldwide programs for human welfare.

Furthermore, with rapid inflation worldwide and with reduced exchange rates for the American dollar in many lands, the $20,000 exclusion is rapidly proving to be unrealistic, even for persons on the limited support that is provided for missionaries. In some countries, $20,000 has less than half the purchasing power it would have in the United States.

We strongly support legislation which would increase the exclusion to a figure more appropriate to the world economy at present and in the years ahead. We also strongly support the applying of the exclusion worldwide, without the current distinction between lesser developed and more developed countries. Therefore, we urge the Finance Committee and Senate to take favorable action on legislation (such as S. 408 or S. 436) to accomplish those purposes.

SUMMARY

Statement of Warren K. Wentworth,
Partner, Deloitte Haskins & Sells
on Proposals to Modify Taxation
of Americans Working Abroad

April 24, 1981

- Legislation should remove tax cost impediment of doing business overseas
- Legislation should simplify the reporting requirements of American taxpayers working overseas
- Legislation should provide additional relief with respect to --

  .. housing

  .. the use of foreign tax credits

  .. waiver in case of war or civil unrest

  .. liberal physical presence test

  .. early effective date

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Senator Robert Packwood, Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate
2227 Dirksen Senate Office Building
Washington, D.C.

April 21, 1981

Dear Senator Packwood:

Comments On Legislative
Proposals To Modify Taxation
Of Americans Working Abroad

As an international firm of accountants heavily involved in advising expatriate Americans and their employers on U.S. taxation of its citizens working overseas, including the preparation of a substantial number of tax returns for such expatriates, we appreciate this opportunity to express our views on how to modify the treatment of foreign earned income under section 911 and section 913 of the Internal Revenue Code of 1954.

The thrust of the current legislation should be three-fold.

First, the legislation should encourage business overseas.

The legislation should put American companies on a competitive par with foreign companies. The overriding purpose is to allow American companies to successfully compete in foreign markets so that American-made goods and technology will flow abroad to the benefit of the American economy.

This flow of American goods abroad takes place when American companies are awarded foreign contracts requiring American goods and services, but the flow also results from the fact that Americans employed abroad, even by foreign companies, will order goods and services from third party American companies. You can't win a race without entering it, and you can't sell American goods overseas unless you have Americans living and

working around the world who are competing on behalf of America in world markets. The American tax system stands in the way of this process. Most foreign countries do not impose this impediment. They do not tax their citizens working abroad. Foreign countries have recognized the economic value of having their own people in foreign lands developing foreign markets. The United States is one of the few remaining industrialized countries that imposes a tax on the necessary living allowances granted overseas workers. American companies are penalized and forced to further compensate their overseas workers by paying a U.S. tax on these allowances. In turn these "tax protection" payments are subject to U.S. tax, creating an escalating tax burden to American business. Legislation is urgently needed to remove this burden.

Recent studies have shown, and the experience of our clients has demonstrated that the U.S. tax cost of maintaining an employee overseas has limited the ability of U.S. companies to compete overseas with foreign companies and as a result U.S. exports have suffered. The number of U.S. nationals employed overseas has declined significantly in recent months and a major factor has been the U.S. tax imposed on the cost of maintaining U.S. workers overseas. Appendix I to this letter traces the legislative history of expatriate taxation and shows the need for further action in this area. We believe that the testimony received by the subcommittee in June of 1980 provided strong evidence that further action was necessary and we have seen no improvement in the competitive situation since that date.

The $20,000 exclusion of the early 1950's was a simple system that worked. We urge a return to this system with an appropriate increase in the exclusion to absorb the inflation that has occurred throughout the world, plus the decline in the value of the dollar. Based on U.S. inflation since the early 1950's, a minimum exclusion should be at least $60,000. Such an amount is set forth in the proposed legislation, adjusted for increased living costs abroad.

Second, the legislative remedy should simplify the self-assessment system as it applies to American taxpayers overseas.

The present system partially reduces the U.S. tax on overseas allowances imposed on American business but at the same time involves a very cumbersome, time consuming and complex set of deductions and allowances that requires expertise beyond the usual knowledge of most taxpayers, resulting in an additional cost to American business who must provide tax assistance to overseas workers, and to the U.S. government which incurs extra costs of collecting the tax.

It should be pointed out that American workers in certain Western Europe and Far East countries pay very little U.S. tax because of the present section 913 deductions and crediting of foreign taxes against U.S. income taxes. However, to prove this result takes a great deal of record keeping on the part of the American worker and his employer, and the creation of complex accounting systems to provide the necessary information for expenses which most Americans do not have to account for. A more simple system is needed which comes to the same answer but relieves the American worker of the record keeping and compilation requirements. A system based on a reasonable exclusion of earned income accomplishes the simplicity that we should be seeking.

Third, the legislation should provide for certain corollary items --

Housing -- a stated exclusion from gross income does not adequately deal with the disparity in world-wide housing costs. Workers in Japan, Hong Kong, Saudi Arabia and the U.K. face unusually high housing costs while workers in Spain and Italy incur more moderate expenses. It seems sensible, therefore, to deal with the housing exclusion that is responsive to varied cost situations. An exclusion should be allowed for housing costs in excess of a percentage of base pay or some outside benchmark. Such an exclusion would automatically decrease the benefit available to certain highly compensated individuals. Many multinational companies use a percentage of base pay to determine the portion of housing costs to be bourne by the employee. A percentage of fifteen or sixteen percent is common. However, an outside benchmark as contained in some of the proposals would simplify this provision.

Foreign tax credit or deduction -- we wish to point out that all of the bills being considered at this time contain a provision which excludes a deduction or credit for foreign taxes on excluded income. This provision may need further study because it is possible in some cases for a taxpayer to pay more taxes under the proposed exclusion basis than under section 913. This may happen under the proposed legislation, because a taxpayer may lose foreign tax credits or deductions that may have been available under present law.

Waiver in case of war or unrest -- we suggest that paragraph (j) (4) section 913 be retained that allows a waiver of the bona fide resident or physical presence tests in case of war, civil unrest or similar adverse conditions which prevent the normal conduct of business in a foreign country.

Physical presence test -- we urge the subcommittee to adopt a less stringent physical presence test, such as 330 days out of 12 consecutive months. The current test is 510 days out of eighteen months. It is becoming increasingly common for U.S. companies to send workers with special knowledge or skills overseas for periods of less than 510 days and for a time period which does not encompass an entire taxable year. In these cases where the eligibility tests cannot be met no relief is provided and all allowances, except for perhaps moving costs, become taxable, imposing a substantial hardship on American business.

Effective date -- we urge that the proposed legislation become effective January 1, 1981 so as to immediately remove the current tax barrier to overseas employment. If this legislation can be passed in the near future, an effective date of January 1, 1981 will give American business the ability to immediately compete in foreign markets. An early passage date will also allow taxpayers and employers time to react to the new rules before the due date for filing 1981 tax returns.

I wish to thank you for the opportunity to make this statement.

Sincerely,

DELOITTE HASKINS & SELLS

Warren K. Wentworth
Partner

Appendix I

Deloitte Haskins & Sells

LEGISLATIVE HISTORY OF EXPATRIATE TAXATION

Congress has been dealing with the complicated issues of taxation of U.S. expatriates for more than fifty years, beginning in the 1920s as the United States grew in its role as a major exporting country after the disruptions of world trade caused by World War I. From the beginning, Congress recognized the competitive disadvantages that U.S. firms encountered in the world marketplace as compared with foreign firms, whose nationals were often exempt from domestic taxation when employed outside their home countries. In answer to this problem and in support of the public policy of encouraging foreign trade, legislation was enacted in 1926 that virtually exempted from U.S. taxation the income earned by Americans working abroad.

. 1926 to 1976

When the "foreign earned income exclusion" was first introduced, it was very broad and enabled U.S. companies to compete on nearly equal terms for foreign business. It appeared to be accomplishing the stated purpose of increasing the trade of U.S. firms that especially suffered in overseas competition

through individual taxation policies. It was not long, however, before the exclusion came under criticism, and pressure was exerted to modify the provision.

In 1932, Congress avoided efforts to modify the exclusion substantially and, instead, acted to close an area of abuse by amending the law so that income paid by the United States or any agency thereof was not eligible for the exclusion. For about ten years, there were no further serious attempts to change the foreign earned income exclusion. In 1942, however, there was a strong move by the House Ways and Means Committee to repeal the provision because of certain additional abuses.

Again, the action taken by Congress, led by the Senate Finance Committee, resulted in an effort to remedy abuses rather than repeal the entire section. Under the changes brought about by the Revenue Act of 1942, the exemption of foreign earned income was applicable only when the U.S. citizen became a bona fide resident of a foreign country for an entire taxable year, instead of the previous more liberal qualification requirement. Although this change did result in some unintended hardships, these were certainly less onerous than complete repeal of the exemption.

During the early 1950s, additional revisions were made in the taxation of overseas Americans. These changes were

80-612 O—81——24

brought about principally because of concern about abuses by certain individuals, such as actors and actresses, who received large amounts of compensation and could avoid U.S. income tax simply by working abroad. The most important change by Congress was to impose a maximum limit of $20,000 on the exclusion. It is important to note that Congress felt that all of the income and allowances of most individuals would continue to be excluded by falling under the $20,000 ceiling.

Between 1953 and the mid-1970s, the exclusion and the foreign residency tests were subjected to additional technical adjustments. Substantially, however, the operation of the provisions remained intact. The value of the exclusion, unfortunately, was significantly reduced. While the basic $20,000 exclusion remained constant, the effects of inflation caused salaries, benefits, and living costs abroad to rise above that amount for most people. The original intent of Congress to exclude the entire earned income from performing services abroad was, for most individuals, no longer being served by existing legislation.

. Tax Reform Act of 1976

Considerable debate accompanied the 1976 legislative changes in section 911, IRC. Although many Members of Congress were concerned that the competitive position of U.S. firms

operating abroad should not be harmed, overzealous attention was directed at ensuring that Americans overseas were not gaining preferential tax treatment. It was feared that, by combining the $20,000 or $25,000 exclusion of income earned abroad with the allowance of full foreign tax credits attributable to all income, taxpayers who paid taxes to foreign governments received an unintended benefit.

Acting on these concerns, section 911, IRC, was amended both to reduce the maximum exclusion to $15,000 for most taxpayers and to provide for the disallowance of foreign taxes applicable to the excluded income as a deduction or for U.S. foreign tax credit purposes. Compounding the problem, it was decided that the non—excluded income was to be taxed by the United States at the higher marginal rates applicable if no income had been excluded.

After the effects of the 1976 Act changes were analyzed, it soon became clear that the end result was a disaster. The benefit of the exclusion, even before considering the loss of foreign tax credits, was reduced to a maximum of only about $3,000 per person. For some taxpayers abroad, it was more beneficial to simply elect not to use the section 911, IRC, exclusion at all, rather than suffer the loss of foreign tax credits that could exceed the exclusion benefit.

. Foreign Earned Income Act of 1978

Congress quickly realized that the 1976 legislative changes would lead to unacceptable hardships for U.S. taxpayers abroad and could severely restrict export marketing opportunities beneficial to the American economy. After twice postponing the effective date of the section 911, IRC, changes, a comprehensive revision of the U.S. tax treatment of Americans working aborad was passed to replace the law in the form that had generally existed since the 1926 legislation. The Foreign Earned Income Act of 1978, however, was not adequate to deal with the substantial problems of inequitable taxation of U.S. expatriates and maintenance of a favorable U.S. competitive position abroad.

CURRENT TAXATION OF EXPATRIATES

A U.S. citizen or resident accepting employment abroad is usually faced with a higher cost of living than in the United States. To compensate for that higher cost of living the employer must generally offer higher income and allowances. The extra amount is primarily meant to cover the additional costs incurred as a result of living aborad. In this sense, the extra amount is not compensatory at all, but merely permits the U.S. citizen to maintain roughly the same standard of living he would enjoy in the United States on the lower income. Under U.S. tax law, however, all income

generally is taxable unless specifically exempted. Consequently, reimbursement of the excess costs of living abroad is seen as taxable income even though it represents no real economic gain to the employee. As the employee's taxable income increases, so does the U.S. tax liability. Section 913, IRC, was written to mitigate the increase in tax liability of U.S. citizens working abroad that is caused by this artificial increase in taxable income. It is structured to allow deductions for the excess costs of working abroad and thereby reduce the expatriate U.S. citizen's taxable income to what it would be had he or she not been working overseas. In short, the purpose of section 913, IRC, is to eliminate the difference in tax liability between U.S. citizens working at home and those working abroad whose real economic income is equal.

In concept, the law seems to represent a logical approach to achieving the goal of providing tax equity among U.S. taxpayers. The relief provided to U.S. overseas employees shold increase to cover the rising costs associated with their assignments. If all such costs were properly identified, the deduction of these items from taxable income would remove much of the inequitable taxation of these individuals.

Even though all of the higher costs of maintaining Americans in overseas locations were not identified and dealt with in

the 1978 legislation (such as the pyramiding effects of tax equalization payments), substantial progress toward a tax equity goal was accomplished.

The Foreign Earned Income Act of 1978 also made significant changes in the provisions that allow certain individuals to exclude some of their foreign earned income from U.S. taxation. Under these rules, qualifying individuals residing in camps located in hardship areas abroad may claim an exclusion of up to $20,000 annually of foreign earned income instead of using the section 913, IRC, provision for deduction of certain expenses of living abroad. The section 911 "camp exclusion," even under the final regulations, remains extremely complex as to when it does and does not apply. Of course, even ignoring the uncertainty of application, an exclusion of $20,000 established in the 1950s is hardly adequate now.

If the section 913, IRC, deduction provisions are to accomplish the intended purpose of providing tax equity for U.S. taxpayers abroad to any useful degree, the needless complexity and restrictiveness of the regulations under that section must be reduced. Some examples of these problem areas follow.

. Source of Deduction

In computing the foreign tax credit limitation under section 904, IRC, the regulations require that the deduction allowed by section 913, IRC, be wholly allocable to income from sources without the United States. Therefore, even though some of the income used for the payment of foreign expenses may have either a U.S. or a foreign source under long-standing IRS interpretations, the regulations require that the deduction arising from the expenses and from the foreign assignment can have a foreign source only. The effect of this inconsistency is potentially to disallow foreign tax credits merely as a result of claiming the benefits of section 913, IRC. This clearly goes beyond statutory provision.

. Housing Expense Deduction

Two factors significantly restrict the housing expense deduction from accomplishing its intended purpose of placing the expatriate family housing costs on a level approximating what a family might pay for housing in the United States. First, the regulations determine that certain costs will automatically be disqualified from housing expenses, even without the tests of reasonableness or lavishness being applied. The result is to prevent taxpayers abroad from claiming a deduction for certain expenditures that were comprehended in the statute. Second, the base housing amount, which reduces the amount of housing expenses that can be claimed as a deduction and is supposed to approximate what

a family in the United States would pay for comparable housing, is often overstated because the base salary is artificially inflated by tax equalization payments.

The result of the operation of the two factors is the understatement of a fair housing expense deduction for many expatriate taxpayers who must rent their homes abroad. In some foreign locations, such as Saudi Arabia, where even modest housing can cost $60,000 or more a year in basic rent, the burden of an unrealistic housing expense deduction is severe and must be alleviated.

. Home Leave Expenses

The regulations require that, for full deduction of transportation costs, the taxpayer must visit the present or most recent principal residence location in the United States, even if that residence is no longer relevant to the taxpayer and his family.

This element of the section 913, IRC, deduction is, thus, severely restricted and rendered less effective.

. Spouses Employed Abroad

In a greater number of U.S. families than ever before, both spouses are working, and often both will expect to continue their careers even if an overseas transfer of one is contemplated. Under prior law, each spouse was allowed a separate earned income exclusion, and in many cases the wife's

income fell within the exclusion's maximum limitation. In the past, therefore, there was an added incentive for working families to accept overseas assignments.

However, under the current provisions of section 913, IRC, the wife's income is subject to the very high incremental rates on the joint return and is often taxed at the 50 percent maximum rate for earned income. In addition, the earnings by the spouse actually reduce the housing deduction to which the family is entitled by the application of the base housing amount provision. By taxing the income at 50 percent and reducing the housing deduction by approximately $20 for each of $100 that the spouse earns, there is little, if any, incentive for a working couple to go overseas.

NEED FOR LEGISLATIVE REFORM

In the past few years there have been a number of government and private research studies on the effects of expatriate taxation policies on U.S. export trade capabilities and our operating competitive position abroad. With virtual unanimity, these studies (as recent as the last several months) have found persuasive evidence that our comparatively severe taxation of U.S. citizens and residents abroad inhibits our country's export trade and has resulted in loss of thousands of jobs abroad and in the United States because of our increasing inability to compete on various overseas projects. This is

especially true for those in sectors, such as construction, that are labor intensive and that base contract awards on relatively narrow profit margins. A review of some of the persuasive findings and other considerations follows.

. Export Trade

As early as the 1920s, it was evident to many that America's export of goods and services was significantly dependent on the presence of U.S. personnel in foreign locations. Certainly now, as the United States has lost the overwhelming industrial and technological superiority once held, and as we find ourselves in the fifth consecutive year of trade deficits and declining competitive position, we must not ignore the fact that it is vital to encourage the presence of Americans abroad.

A Government Accounting Office report suggested that the United States could be losing up to $7 billion worth of exports a year solely as a result of our tax policies governing expatriate taxpayers, warning that the projections might well prove conservative. This loss, as well as worsening our balance of trade position, can be translated into loss of several hundreds of thousands of jobs a year for Americans.

As a specific example of this export drop, it has been reported that in the huge export market of Saudi Arabia,

where five years ago the United States was the leading exporter, we have now slipped to third or fourth position. Senator Chafee recently summarized the export problem as follows: "What we gain from increasing exports is very simple --- more jobs for Americans here, and more tax revenue. For every one-billion dollar increase in exports, over 40,000 new jobs are created here, which in turn create $1 billion in increased corporate and individual tax revenues."

. Foreign Contract Competition

The margin of profit in many foreign contracts is not sufficient to permit a U.S. firm to assume the additional costs of the U.S. tax burden on expatriates. Of course, the foreign customer, with the option of choosing contractors from France, Germany, or Japan for the project, is also not willing to absorb these extra costs of using U.S. personnel. Therefore, the U.S. engineering/construction industry is forced into the position of replacing U.S. personnel with local or third-country nationals in an attempt to remain competitive. Unfortunately, many of the U.S. personnel who leave are in positions where they are directly involved either in purchasing decisions or in the design stage of contract work where purchasing specifications are decided upon. The loss of individual employment abroad is compounded by reduction in purchases of U.S. products and, ultimately, loss of jobs in the United States.

A private engineering, planning and research firm recently reported that American engineers and contractors have been able to sign up only approximately 10.3 percent of the more than $90 billion worth of Middle Eastern design and construction projects, even though the United States has about 40 percent of the worldwide engineering and construction capacity. Unless we are able to reduce the tax burden placed on U.S. employees of U.S. companies abroad engaged in competitive bidding with foreign companies, American companies will continue to fail to win contracts and the United States will not be able to benefit fully from the increased economic activity in the Middle East, the Eastern European and Asian markets, and the other developing countries.

. Comparative Trade Policies

In a report last year to the Speaker of the U.S. House of Representatives and the Chairman of the Senate Committee on Foreign Relations, former President Carter discussed some of the various concepts of income tax jurisdiction. He observed that the United States is virtually unique in taxing income on the basis of residence, source, and citizenship. As a result of the U.S. jurisdictional policies and the absence of substantial relief provisions for our expatriate workers, America is the only major trading nation that taxes the income of its citizens while resident outside the home country.

This difference in taxation policy means that it costs more to maintain an American expatriate employee overseas than a local or third-country national employee. For the American employee to receive the same net pay as a competing foreign national, his gross pay package must be higher. Assuming the employer has the option to hire equally qualified persons, one of whom will cost more, he may hire a foreign national on the basis of cost. Usually, the company that does not hire Americans has far lower costs to recover and can be more competitive.

The President's Export Council, Subcommittee on Export Expansion, in its Report of the Task Force To Study the Tax Treatment of Americans Working Overseas (December 5, 1979), illustrated the effects of the anomaly of U.S. taxation of the earned income of its expatriates abroad with the following examples:

.. "Recruiting firms in France, Germany, Italy and the United Kingdom report they are swamped with requests for qualified citizens of their respective countries to replace Americans who are being forced home by U.S. tax policies.

.. "Several leading U.S. contractors in the Middle East have reduced their American staff by more than half and adopted hiring policies overseas that specifically exclude Americans on future work.

.. "The University of Petroleum and Minerals in Saudi Arabia says Americans now make up less than 30 percent of its teaching staff compared to more than 80 percent several years ago."

Senator Chafee reported in 1980 that a U.S. expatriate employee in Saudi Arabia earning a salary of $40,000 a year costs his employer $140,000 a year, including housing allowances and tax costs. A large U.S. company, with regional headquarters in Hong Kong, recently reported that non-executive salary costs were more than $40,000 a year higher for American expatriate employees there than for third-country nationals. Primarily because of U.S. tax costs, this company can hire three non-U.S. expatriates in Hong Kong for the cost of two American employees.

. Small Businesses

The United States is in obvious need of increased export sales for balance-of-trade considerations and for job creation here in the United States. A fertile source of such export sales and jobs can be the small businesses all over the country that currently serve only the domestic market. However, the additional costs of overseas operations can be a significant disincentive for entering the foreign markets. The U.S. tax rules for expatriates make the commencement of foreign operations by these smaller companies even more

difficult, because often the local workers do not possess the U.S. know-how and familiarity with the smaller companies' operations.

. Taxpayer Compliance Complexities

Because of a substantial degree of needless complexity in applying the section 913, IRC, provisions taxpayer compliance with the law is quite difficult. It has been observed in recent months that even the tax professionals engaged by the taxpayers to assist them in preparing their U.S. income tax returns while they are abroad have had difficulty in dealing with the uncertainties surrounding compliance. As a result, the costs to the employees, and often to their employers, of compliance have risen at the same time that the relief provided has, in many cases, decreased. Effective taxpayer compliance and understanding of taxation provisions can best be encouraged by the drafting of clear and comprehensive legislation that places the U.S. expatriate on a competitive footing with third-country nationals.

. Training Considerations

An often overlooked but very important additional benefit of American employees working abroad is the valuable personal experience gained in handling international business situations. The personal relationships developed and local knowledge acquired cannot be duplicated in any other way.

Future business managers need this kind of experience if they are to guide U.S. business in competitive international commerce.

. <u>Cost Reduction for American Business Operating Abroad</u>
The inordinately high tax burden on Americans working overseas is borne, for the most party, by employers. This results in extremely high employment costs for U.S. businesses sending Americans abroad, putting them at a competitive disadvantage as compared to businesses form competing nations. As pointed out by the President's Export Council Report of December 5, 1979, even if the existing tax provisions were to operate in the least restrictive way possible it remains clear that U.S. citizens and residents overseas would <u>not</u> be in a competitive position with nationals from other countries in terms of taxes.

Therefore, we think it is appropriate to provide a reasonable earned income exclusion, in addition to certain deductions for excess living costs, such as housing, to further reduce the higher costs now being borne by U.S. businesses.

Many of our trading partners abroad, particularly other members of the General Agreement on Tariffs and Trade, have criticized U.S. tax policies for promoting exports. Those countries do not tax the income earned by their nationals residing abroad. They thereby enhance the competitive posi-

tion of their companies and increase their chances of expanding foreign contracts. Yet, we fail to utilize this same measure to promote exports, even though those who are critical of some of our policies could not disapprove.

We believe, therefore, that the earned income exclusion should be set at a level high enough to exclude the employment earnings of <u>most</u> U.S. citizens and residents employed abroad. The amount of the exclusion should be adjusted from time to time as inflationary pressures cause salaries to increase.

The exclusion should be allowed to both working spouses, as under prior law, in order to avoid a disincentive for working couples to go abroad.

. <u>Incentives for Overseas Employment</u>
The amount of the earned income exclusion should be set at an amount high enough not only to eliminate additional taxes on Americans working abroad (and resulting higher employment costs), but also to result in a reduction in the individual employee's personal tax burden. This would provide an incentive for Americans to accept overseas assignments.

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. Other Considerations

We strongly urge the subcommittee to be sensitive to the effects upon expatriates and their employers of the timing any significant changes. Twice in recent years (in 1977 and 1978) taxpayers were faced with approaching filing deadlines while the rules affecting their tax returns were still in the making. Partial relief in the form of the extended deadlines came only at the eleventh hour, and that was too late to alleviate the administrative burden.

We emphasize that this situation resulted in extremely high costs -- needlessly -- for the preparation of income tax returns.

The legislation should be clear and complete enough so that legislatively mandated regulations would not be required. This would help to prevent recurrence of the difficulties such as those caused by the temporary regulations under section 913, IRC.

(Record)

SUMMARY OF STATEMENT OF RICHARD P. GODWIN
ON TAX TREATMENT OF AMERICANS EMPLOYED ABROAD
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

April 24, 1981

1. The international marketplace is highly competitive, and it is vitally important that the 1978 Foreign Earned Income Act be substantially revised to help keep U.S. business competitive. With high U.S. unemployment, it is critical to this nation to change tax policies that inhibit the ability of U.S. companies operating abroad to employ Americans on overseas projects.

2. The Foreign Earned Income Act of 1978 should be judged by its impact on jobs, both abroad and here at home, exports that can be created thereby and the effect of these actions in creating a favorable balance of payments.

3. Experience of U.S. construction firms operating in the Middle East shows that even after the changes made by the '78 Act, U.S. tax laws still penalize companies that employ Americans abroad. Most other countries do not tax the overseas earned income of their citizens. The U.S. does. It is, therefore, not surprising that Bechtel experience since 1978 shows a decline in the number of Americans employed abroad, and a decline in the percentage of Americans hired for overseas locations as compared to nationals from other countries.

4. On foreign construction projects, principally with respect to cost-plus contracts, foreign private and government clients do not consider high U.S. taxes on Americans employed on such projects to be a legitimate cost. Such clients are increasingly insistent that any extra workers employed be nationals of other countries with low or no taxes on foreign earned income.

5. The declining competitiveness of Americans in overseas job markets adversely affects U.S. employment; adversely affects the ability of U.S. firms to obtain foreign contracts; lessens reliance on American technological standards and knowledge; and adversely impacts the U.S. balance of trade and payments and revenues.

STATEMENT OF RICHARD P. GODWIN
DIRECTOR OF BECHTEL GROUP, INC.
DIRECTOR AND PRESIDENT OF BECHTEL CIVIL & MINERALS, INC.
SUBMITTED TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

April 24, 1981

Mr. Chairman and Members of the Committee:

My name is Richard P. Godwin, and I welcome the opportunity to submit this statement on the taxation of Americans employed abroad. I am a Director of Bechtel Group, Inc., headquartered in San Francisco, and of its three principal operating companies, Bechtel Power Corporation, Bechtel Petroleum, Inc. and Bechtel Civil & Minerals, Inc., and a member of their Executive Committees. I am also President and Chief Operating Officer of Bechtel Civil & Minerals, Inc. Bechtel Group, Inc. and its subsidiaries are international engineering and construction firms conducting their activities in every corner of the world. My company has joined with Caterpillar Tractor Company, The M.W. Kellogg Company, and Dresser Industries, Inc. to form an ad hoc working group to analyze the Foreign Earned Income Act of 1978 and its impact on the operations of our companies.

We are strongly in favor of the goals of the President's tax program. Economic revitalization is highly important to this nation, and I commend this Committee and Congress for moving swiftly to consider the President's recommendations. Substantial change in the current taxation of Americans employed overseas is consistent with the goals of the President's proposals. With unemployment continuing to run over seven percent, it is of vital importance to this nation to change its tax policies that inhibit the ability of U.S. companies operating abroad to employ Americans on overseas projects. The international marketplace is highly competitive, and we have concluded that the 1978 Foreign Earned Income Act must be substantially revised to allow U.S. business to again become competitive.

My basic arguments can be summarized as follows:

1. The Foreign Earned Income Act of 1978 should be judged by its impact on jobs, both abroad and here at home, exports that can be created thereby and the effect of these actions in creating a favorable balance of payments.

2. Experience of U.S. construction firms operating in low tax countries, such as in the Middle East, shows that even after the changes made by the '78 Act, U.S. tax laws continue to penalize companies that want to employ Americans abroad. Most other countries do not tax the overseas earned income of their citizens. The U.S. does. It is, therefore, not surprising that our experience since the passage of the 1978 Act shows a decline in the number of Americans employed abroad, and a decline in the percentage of Americans hired for overseas locations as compared to nationals from other countries.

3. The declining competitiveness of Americans in overseas job markets adversely affects U.S. employment; adversely affects the ability of U.S. firms to obtain foreign contracts; lessens reliance on American technological standards and knowledge; and adversely impacts the U.S. balance of trade and payments and revenues.

Taxation of overseas earned income was not a significant issue prior to the early 1970s. Overseas earned income was excluded from U.S. taxation until 1963, when Congress placed a $20,000 ceiling on the amount of income that could be excluded from taxation. That ceiling was high enough, however, that the vast majority of Americans employed abroad during the 1960s were still able to exclude all of their earned income, and Americans were highly successful in competing for international employment.

By the early 1970s, the combination of inflation and the declining value of the U.S. dollar in foreign exchange markets resulted in greatly increased dollar amounts of taxable income. The $20,000 ceiling should have been raised periodically over the years to keep Americans competitive. Unfortunately, just the reverse was done with the enactment of the Tax Reform Act of 1976, which lowered the ceiling and made Americans far less competitive for jobs abroad. Although the 1976 Act was never implemented, American work overseas suffered a severe setback due to the confusion that was caused by it.

Enactment of the Foreign Earned Income Act of 1978 improved the tax treatment of U.S. citizens and residents working abroad over the drastic provisions of the 1976 Act. However, the 1978 Act has turned out to be highly complex and costly to our employees. While "tax equity" was one of the goals of the 1978 Act, the actual result of the legislation has been that an American working overseas must pay much higher U.S. income taxes than an American living in the United States and earning the same base salary.

As a result, the 1978 Act still inhibits employment of Americans abroad. The Act still does not respond adequately to the competition Americans face from companies based in other countries whose method of taxing their overseas citizens is so different from ours.

This Committee is now exploring various methods of revitalizing the industrial base of our country by changing the ways in which capital employed in that base is to be recovered. I submit that it is therefore timely and appropriate to consider ways in which to expand our export markets. Unless the employment of Americans abroad is permitted to increase in areas of the world in which we are presently not competitive, sales of U.S. goods and services in these areas will not increase to their full potential.

I will develop these arguments by describing our experience in the international marketplace since passage of the Foreign Earned Income Act of 1978.

Costs of Employing Americans Abroad

Bechtel is involved currently in 130 major projects in 20 different countries around the world. The competition for such international engineering and construction projects is increasingly intense. There are many disadvantages imposed by U.S. law and practice on U.S. trade -- the lack of a clearly defined U.S. export policy, conflicting considerations in various boycott laws, problems in export-import practice, antitrust policy -- and not the least of which is the noncompetitive tax treatment afforded Americans employed overseas. This impacts adversely on each of the companies I am speaking for, but allow me to use the Bechtel example to show this tax impact.

Bechtel simply must keep its employee costs in line with competitors from other nations -- most of whom do not tax their nationals at all when working in certain foreign countries. But the company must daily deal with the fact that it costs substantially more to employ an American on one of its overseas projects than a qualified national from the U.K., Canada, Australia, etc. By substantially, I mean in the range of 35 percent or more.

I do not mean to infer that complete exclusion from taxation of income earned overseas would place a U.S. national's employment cost on a parity with the cost incurred in employing a national from another country. Complete parity cannot be achieved due to the higher compensation level enjoyed by our citizens, our higher standard of living as compared to those of other countries, etc. But the elimination of U.S. tax on foreign income would significantly reduce the "cost" gap that presently exists between our nationals and those of other countries.

For example, under present law, to station the average married U.S. citizen with two school aged children in Saudi Arabia costs about $107,000 per year, whereas the costs associated with stationing a similar U.K. citizen are approximately $67,000. The American, therefore, costs over 1-1/2 times as much as the citizen from the U.K. If complete income tax exclusion were adopted (similar to that allowed a U.K. citizen), the cost to maintain this U.S. family would decrease nearly 25 percent to about $80,000 per year. This $27,000 differential cost applicable to such an employee would become available as a direct reduction of cost passed on to our client, which could well become the difference as to whether a contract was obtained in the first instance.

Effect on Foreign Competition on Jobs for Americans

That additional tax cost in employing an American abroad is one part of what makes us less competitive internationally. We cannot ignore or hide that cost -- it is too large a difference. If we include that differential as a non-reimbursed cost, our profit margin goes down and at some point the project cannot be successfully bid, or even bid at all. In the alternative, if we try to pass that added cost along to the client, in many cases a foreign government or one of its agencies, we will probably be ordered to use fewer Americans in the mix of workers on that foreign project. Since many of our contracts are on a "cost-plus" basis, the clients are increasingly insistent that any extra workers employed be nationals of other countries with low or no taxes on foreign earned income.

For example, in a recent proposal for a refinery in Saudi Arabia that would require approximately 350 foreign workers over a three-year span, Kellogg estimated that filling these jobs would entail a U.S. tax cost of $21,000,000. Kellogg will probably employ U.K. nationals for these 350 positions or otherwise lose the work. For much the same reasons, Kellogg employed 100 Dutch nationals on a project in Oman. This work could have gone to Americans had we had a more favorable tax treatment.

A recent Bechtel experience in connection with a hydroelectric powerhouse project in Egypt clearly illustrates this point. The portion of our proposal relating to on-site construction management required 23 engineers. We could only include seven American engineers, due to the high tax cost involved. The remaining 16 engineers would have to come from other countries. This $155 million-four year engineering and construction management job was lost to a Swedish consortium due, to a large extent, to the fact that the on-site personnel mix so weakened our proposed technical team, we were no longer considered to be an American firm bidding against foreign firms, but rather were ourselves a foreign firm.

Furthermore, due to the U.S. "tax cost difference," one client recently required Bechtel to limit the number of U.S. personnel to 20 percent of the expatriate work force. Normally 50 to 60 percent of the available jobs would have been filled with Americans. In this instance, the differential was filled by U.K. nationals.

In earlier Congressional testimony on Section 911 -- from 1975-1980 -- various witnesses pointed out that, because of the added tax costs, Americans would return home either voluntarily or involuntarily, and that the positions formerly held by such returnees, as well as new overseas jobs, would be filled by nationals from other countries. These earlier predictions have been borne out by recent experience.

Recruitment of Americans for Overseas Work

Recruiting of U.S. personnel for overseas positions has become extremely difficult. The converse has been true in the case of personnel from other countries.

As an example, just last year Bechtel placed an ad in a Perth, Australian newspaper for technical services personnel to work in Saudi Arabia. This resulted in receipt of 40 applicants, 30 percent of which (12) were considered to be good candidates. This response far surpassed the results we can obtain in the U.S., where our experience during 1979, for example, produced only a four percent return of good candidates.

One basic reason for this difference has been that no monetary incentive for overseas service in low tax countries exists for our U.S. nationals under our current tax policies. This differs from the other major industrialized countries of the world which have no tax on the earned income of its citizens employed in other countries. It should not be surprising that persons from

foreign countries are eager to accept an assignment in a low or no tax host country (even one having a different culture and language from that of their home country) when their net take-home pay approaches that of their gross compensation.

Current Reduction of Americans Abroad

Some have said that the overall employment of Americans abroad is on the increase. That is not the Bechtel experience. Since the passage of the Tax Reform Act of 1976, the absolute number of Americans working abroad has decreased by about 5.5 percent while nationals of third countries has increased about 6.4 percent. Previously some 20 to 30 percent of the employees in the Bechtel office in London were American. That percentage is now down to six to eight percent.

Kellogg likewise has advised me that in the past year alone, the total number of Americans employed abroad by Kellogg has decreased to 688 persons, a drop of 13 percent, while the third country nationals has increased to 332 positions, a 20 percent increase.

The recent release by the General Accounting Office* also reported that an adverse change in Americans working overseas is taking place. The General Accounting Office found that current law does not fully relieve taxes on income which reflects excessive living costs abroad for U.S. employees. They further noted the difficulty and expense in complying with the complex rules of the 1978 Foreign Earned Income Act. GAO recommended that Congress give serious consideration to placing Americans working abroad on an income tax foundation comparable to that of countries with whom we are in direct competition for foreign work.

In the final analysis, the critical question is not only whether our expatriate population is increasing, but whether the percentage of Americans employed abroad is increasing.

International Trade and Competitiveness

From our experience, it appears clear that the level of U.S. tax on Americans employed abroad has a definite impact on the overseas operations of U.S. engineering and construction firms and firms supplying equipment and services associated with overseas projects. The U.S. firm is no longer "invincible" in the world marketplace. It is still true that U.S. expertise in the engineering and construction industry is highly prized, especially in developing areas of the world such as the Middle East. In like manner, U.S. technology in the petroleum sector and other services has always been considered preeminent. However, foreign clients are no longer willing to pay a high premium for that "uniquely" American expertise. The American "flavor" can now be obtained with fewer Americans than ever before. Either our clients specify fewer Americans, or we are forced to employ fewer Americans in order

* Report to the Congress by the Comptroller General of the United States, "American Employment Abroad Discouraged by U.S. Income Tax Laws," February 27, 1981.

to stay competitive with the companies headquartered in countries such as France, the U.K., West Germany, Italy, South Korea and Japan. Simply put, in a cost-plus contract, foreign private and government clients do not consider high U.S. taxes on Americans employed on that project to be an acceptable cost. On a non-cost-plus contract, companies must factor into any project bid the high compensation necessary to keep U.S. workers on that proposed project. Such compensation must, of course, reflect the U.S. tax consequences that will result by accepting employment overseas.

There is a dramatic "pull" effect on goods and services -- and therefore jobs -- from the United States on construction projects in foreign locations. The "ripple" or "feedback" effect is highly important. For example, in a typical foreign construction project in a developing country, about 50 percent of the non-manual job hours is expended "on site," and the rest of expended in permanent offices in the U.S. or elsewhere. If, due to the higher tax costs on Americans overseas, American business is not competitive and the bid is lost, an enormous amount of support work in the U.S. is never done. Supplies of goods never leave our shores; work and jobs directly related to those goods are lost; tax revenues on that work never reach the U.S. Treasury. There is, in short, a tie-in between American jobs abroad and our domestic employment picture.

There are some "key" long range concerns we should not forget. The developing countries still highly value American technology and managerial know-how for the individual programs costing billions of dollars (mega-projects). This may continue throughout the decade of the 80's. However, there are many firms in Europe, Japan, and Korea which can now perform well at reduced cost on the jobs in the $100 million to, say, $300 million range. It is principally in this "bread and butter" area of project size -- $100 to $300 million -- that we are losing out because of the cost of keeping Americans overseas. If this trend continues, the upper limit to that range will keep on rising as contractors from other countries gain additional experience.

We find ourselves in the position of training engineers and supervisors from other countries who are serving as contractors on Bechtel's mega-projects. With the skills thus obtained, they in turn are bidding, in competition with us, to do work as prime contractors on the "smaller" jobs, thus depriving the U.S. of a chance to supply plant and equipment, initially and for future expansion, follow-on spare parts, etc., which would be so positive to our balance of payments and reduction of U.S. unemployment rates. This is what we speak of as the "ripple" effect of employing American engineers overseas.

When Americans are involved on a project from start to finish, there is a natural tendency for them to use U.S. goods and services with which they are more familiar. An American consultant brought in when a project is in the initial concept stage is more likely than a European or Japanese consultant to think in terms of U.S. products, ranging from electrical equipment to hospital beds.

Further, there is great value to the long-term competitiveness of this country's export sector in having Americans serving abroad in sales, financing, training, and services and other product support functions. Personal contact with day-to-day challenges of selling and using U.S. made products in a wide range of situations around the world helps keep American individuals and companies alert to changing needs, and aware of what our competitors are doing. Finding a better way to meet today's challenges contributes to more competitive products and methods tomorrow. Our tax laws, unfortunately, penalize through higher costs those who seek to provide international business experience for their American employees.

Conclusion

I would urge this Committee to seriously consider removing entirely U.S. tax on income earned by Americans employed abroad. Of course, there should be provisions or limitations to prevent the "abuse" case. There have recently been introduced a number of bills that either remove taxation entirely or provide a significant exemption. First priority should be given to bills, such as S. 598 (Jepsen, R-IA), that would remove taxation on overseas income. If that approach is not feasible, there are other alternatives. If the general exclusion approach is followed, we would urge as large a general exclusion as possible with, additionally, a more appropriate housing deduction than that under present law. One very good approach is S. 436 (Bentsen, D-TX). Since it seems difficult and time consuming to be continually "revisiting" those code provisions, you may wish to consider further "indexing" these amounts.

I believe these suggestions are consistent with the recommendations of the recent report of the General Accounting Office which I referred to earlier. Only with such changes in U.S. tax law as are recommended above will American construction, engineering and supply firms become more competitive in the international marketplace, with the resulting benefits, both directly and indirectly, going to U.S. citizens, business, and local, state and the national government as well.

This material is being submitted by Connie Borken-Hagen, 75 Brook Street, London W1Y 2EB, on behalf of her client, the American Chamber of Commerce (United Kingdom), 75 Brook Street, London W1Y 2EB. Since the American Chamber of Commerce (UK) is a foreign organization, Connie Borken-Hagen is registered with the Department of Justice under the provisions of 22 U.S.C. §611, *et seq.*, as an agent of such foreign principal. Copies of this material are being filed with the Department of Justice and copies of Connie Borken-Hagen's registration statement are available for public inspection at the Department of Justice. Registration does not indicate approval of this material by the United States Government.

COUNCIL OF AMERICAN CHAMBERS OF COMMERCE – EUROPE AND MEDITERRANEAN

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S U M M A R Y

OF THE TESTIMONY OF THE
COUNCIL OF AMERICAN CHAMBERS OF COMMERCE,
EUROPE AND MEDITERRANEAN (EUROMED),
BEFORE THE
SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,

APRIL 24, 1981

* *

1) The income of Americans who have established the center of their economic activity abroad should be exempt from US taxation - as in virtually every other country in the world - limited only by safeguards to prevent US citizens from abusing the exemption by taking up temporary residence abroad.

2) The US system of taxing foreign earned income stands as a self-inflicted trade barrier, both in underlying policy and in implementation.

3) The present law with deductions, exclusions and credits is too complicated to administer or comply with.

4) The foreign tax credit is supposed to equalize tax liability, but it fails because high foreign indirect taxes are not creditable, because credits are lost on any foreign income taxes in excess of US income tax rates, and because other countries use different rules of income recognition and deduction of allowances for the calculation of taxable income.

5) Americans living abroad are not in a position to use most government services, yet we pay direct and indirect taxes to our country of residence and use the services and protection of the host country, so there is little justification for taxing us at all.

6) Americans living in Europe should not be excluded. US trade with the EEC in 1979 amounted to 1/5 of all US foreign trade, and 1/3 of US direct investment abroad was in the 9 EEC countries at the end of 1979. In 1979 the US exported $42.39 billion to the EEC while we imported $33.23 billion. In 1980 25% of Americans working abroad were in Europe, often based in administrative headquarters servicing Africa, the Middle East and Eastern Europe.

7) A two-step concept of residence abroad, as was embodied in the pre-1976 law, would encourage Americans to work abroad, even for a short period, and at the same time would discourage extremely high earners from moving abroad for a short stay to avoid US tax. Only bona fide residents abroad, defined as those living abroad for more than 3 consecutive years, would be eligible for a full exemption. Temporary residents outside the US, in order to be competitive in the world market, would have a ceiling on exemptions, but a ceiling that would effectively exempt virtually all US workers.

* *

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STATEMENT OF THE
COUNCIL OF AMERICAN CHAMBERS OF COMMERCE,
EUROPE AND MEDITERRANEAN (EUROMED),
BEFORE THE
SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
APRIL 24, 1981,

IN SUPPORT OF
BILLS TO AMEND THE
INTERNAL REVENUE CODE OF 1954
TO EXEMPT FROM TAXATION
THE INCOME OF AMERICANS
RESIDING OUTSIDE THE UNITED STATES

* *

Mr. Chairman and distinguished members of the Committee: The Council of American Chambers of Commerce - Europe and Mediterranean (EuroMed) - representing American business interests in the region with over 15,000 constituent entities in 13 countries, very much appreciates this opportunity to submit testimony with respect to taxation of Americans living abroad. We thank you for your interest in the issue, and commend you for your apparent understanding of our sense of urgency, because further delay in reducing the crippling tax burdens imposed by the Foreign Earned Income Act of 1978 is sending those Americans who can come home, back to the US to seek employment and leaving America uncompetitive in the world market.

There is basic injustice in taxing US citizens living outside the country who have moved the center of their economic interest abroad and who do not benefit from the full range of US government services. There is considerable political and economic value to the United States in having Americans working abroad. The present US tax laws are incompatible with international practice. And there is an administrative advantage in having a simple tax law. Thus, EuroMed recommends:

RECOMMENDATION

The income of Americans who have established the center of their economic activity abroad should be exempt from US taxation - as in virtually every other country in the world - limited only by safeguards to prevent US citizens from abusing the exemption by taking up temporary residence abroad.

Arguments

Equity in taxation arises from applying consistent principles of tax jurisdiction to taxpayers in similar circumstances. A US citizen who puts down his or her roots in a foreign country is not in the same position as a US citizen in the US Because Americans living abroad are not in a position to use most government services, yet do pay direct and indirect taxes to their country of residence and use the services and protection of the host country, there is little justification for taxing them at all.

As early as 1925 Congress recognized that US citizens abroad were at a competitive disadvantage with non-Americans whose governments do not impose income tax on the foreign source income of their nonresident citizens. Thus, in 1926 all foreign source earned income was excluded from US taxation.

In 1953 and 1962 limitations were placed on the amount excludable, and by 1978, the Foreign Earned Income Act all but eliminated it.

The foreign tax credit is supposed to equalize tax liability for similarly situated individuals. While it is designed to eliminate double taxation, it fails because high foreign indirect taxes are not creditable, because credits are lost on any foreign income taxes in excess of US income tax rates, and because other countries use different rules of income recognition and deduction of allowances for the calculation of taxable income.

The US system of taxing foreign earned income stands as a self-inflicted trade barrier, both in underlying policy and in implementation. America's tax on citizenship is so high it has made it almost prohibitively expensive for American business people to work abroad, yet removing this trade disincentive now can create jobs at home and abroad through increased trade, and can make a significant contribution to restoring the economic vitality of the US by putting American business on an equal footing with its competitors.

The present law with deductions, exclusions and credits is too complicated to administer or comply with. It demands simplification and consistency.

Americans residing abroad should be placed on an income tax basis comparable to that of citizens of other countries, and EUROMED supports any legislation that moves toward the effective elimination of US tax on the incomes of Americans living abroad.

Legislative History

After imposition of the US income tax in the 1920's, the income earned by Americans working in foreign countries was virtually exempt from US taxes as a matter of public policy and by specific acts of Congress. The purpose was to encourage foreign trade.

In the early 1950's some revisions were made to foil abuse by highly paid movie stars. These revisions tightened foreign residency tests and placed a ceiling on the amount of foreign earned income that could be excluded. The income and allowances of most Americans working abroad was below $20,000, so they were not affected, and were not meant to be, but by the mid-1970's, the effects of inflation had overtaken this exclusion.

The 1976 Tax Reform Act represented a drastic policy shift. It reduced the exclusion, whereas Congress shouldhavesignificantly increased it to reflect inflation. Instead of encouraging Americans to work abroad, it discouraged such employment.

At the same time Tax Court rulings made so-called "keep whole" contributions paid by employers to offset extraordinary overseas living costs taxable to the employees at full overseas value.

The amendments never went into general effect becau.. [illegible] eign Earned Income Act of 1978 replaced the Section 911 earned income exclusion for the years beginning after December 31, 1977, with the new system of itemized deductions for the excess cost of working overseas. Section 911 now provides a $20,000 exclusion for Americans living in so-called "camps" in remote hardship areas. Section 913 provides deductions for certain allowances for extraordinary foreign living expenses under strict qualifications.

While foreign income taxes paid to the country of residence may be credited against US taxes due, neither the credit nor the special deductions fully compensate Americans living abroad for the many indirect taxes paid to foreign governments. Thus, Americans abroad pay higher taxes than similarly situated residents of the United States.

Economic and Political Benefit to the USA *

Americans who work abroad increase our exports and thus improve our balance of payments, and at the same time stimulate our domestic economy. Jobs are created by the increased trade. It is sound economic policy, consistent with supply-side economics, to encourage more Americans to work abroad. Yet US tax policy is a major factor in reducing the number of Americans who work abroad. Many companies are replacing Americans with foreigners who are taxed only by the host country because it is too-expensive to employ Americans.

Americans in Europe

Americans living in Europe should not be excluded from consideration. US trade with the European Economic Community in 1979 amounted to almost one-fifth of total US foreign trade. More than one-fifth of all US exports of agricultural commodities went to the Community, and one-third

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*EUROMED refers the Committee to the following reports:

GAO Report to The Congress, February 27, 1981.

The President's Export Council, Subcommittee on Export Expansion, Report of the Task Force to Study the Tax Treatment of Americans Working Overseas, December 5, 1979.

of all US direct investment abroad was spread among the nine EEC countries at the end of 1979. In 1979 the US exported $42.39 billion to the EEC while we imported $33.23 billion. (Department of Commerce: Survey of Current Business, June 1980) US Agricultural exports were $7.67 billion. (Department of Agriculture: FATUS, January-February 1980)

In 1980 25% of Americans working abroad were in Europe. Many of those Americans were based in administrative headquarters in London, Brussels, Paris, Milan, Frankfurt, Athens and so forth, to service the Middle East, Africa and Eastern Europe. These business people travel north and south, not changing more than two or three time zones, as a health and safety precaution and for greater effeciency in business. Europe becomes, then, a commuter suburb for a very large proportion of senior American administrators and professional people, as well as marketing and servicing staff officially residing there.

Tax Harmonization

International tax harmonization is not an objective by itself, but exists mainly to facilitate trade. Other nations generally observe principles of territorial jurisdiction, but the US government reaches out for world-wide income with only a limited foreign tax credit mechanism to help curtail some of the double taxation that inevitably results. The practical consequence is that Americans are able to serve abroad only if they or their employers are willing to pay for the resulting excess tax costs.

Justice

There is basic injustice in taxing Americans beyond the territorial jurisdiction of the US. Americans abroad make little use of US government services or protections. Medicare and Medicaid are unavailable. American public education is not available. Americans abroad are not protected under pollution control laws or any US health or safety legislation. There are generally fewer personal freedoms compared with those enjoyed by residents of the US. In short, the benefits of American citizenship - the Constitution and the laws made thereunder - stop at the territorial limits of the USA. The obligations of citizenship, taxation, now follow the passport, and that system is unjust.

Simplification

Tax simplification is an announced goal of tax policy makers. The Section 911 exclusion that was in effect for so many years was easy to understand and administer, even though the amount excluded had fallen way below inflation. The 1978 FEIA imposed a system so complex it is impossible for Americans abroad to fill out the tax forms without professional help. The cost of that professional help is itself an added tax on Americans living abroad. Exclusion would reduce costs of administration and increase compliance.

THE ABUSE QUESTION

In the past, questions of abuse of tax exemptions were raised again and again. While we believe the incidence of abuse is enormously exaggerated, we have addressed ourselves to the issue and submit that a two step concept of residence abroad, as was embodied in the pre-1976 law, would encourage Americans to work abroad, even for a short period, and at the same time would discourage extremely high-earners in, for exam[illegible] entertainment industry, from moving abroad for a short stay to avoid US tax. Only bona fide residents abroad, defined as those living abroad for more than three

consecutive years, would be eligible for a full exemption. Temporary residents outside the US, in order to be competitive in the world market, would have a ceiling on exemptions, but a ceiling that would effectively exempt virtually all US workers.

Qualifications -- Foreign Residence

Americans now qualify for the special overseas deductions in two ways:-

* Bona fide residence in a foreign country/ies for one full calendar year; or
* Physical presence in a foreign country/ies for 510 days out of 18 months.

Before 1976 bona fide residents of foreign countries could exclude $25,000 per year from their taxable income.

Americans were deemed bona fide residents after living three consecutive years in a foreign country or countries. When instituted, this exemption covered the salaries of all but a very few highly paid individuals.

Temporary residents spending up through three consecutive years abroad could exclude a lesser, but still substantial amount.

The two-step concept established in 1962 to foil abuse can be re-instituted now to:-

* encourage Americans to work abroad even temporarily while
* preventing possible abuse by extremely highly paid individuals.

How to Stimulate Trade Yet Prevent Abuse

A bona fide resident abroad should be exempt from US taxation on his or her income except to the extent non-resident aliens are taxed by the US government. Why? That American has shifted his or her center of economic activity abroad.

* Define "bona fide resident" as one who has lived abroad more than three consecutive years.

Temporary residents, qualifying after one year in a foreign country or countries should have all or nearly all of their earned income exempt. Why? America should encourage its people to work abroad comeptitively.

* Define "temporary resident" as one who has lived abroad at least 11 out of 12 consecutive months, and through three consecutive years.

EUROMED RECOMMENDATIONS

Americans who reside abroad more than three consecutive years, and who are thus deemed to have shifted the center of their economic activities abroad should be exempt from taxation on their incomes except to the extent non-resident aliens are taxed.

Temporary residents of a foreign country or countries should enjoy a substantial -- total in most cases -- earned income exclusion to promote the American presence abroad, yet prevent abuse.

EUROMED supports any legislation that moves toward the effective elimination of US tax on the incomes of Americans abroad.

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EUROMED appreciates the opportunity to share our views and concern with the members of this Committee. We are committed to reducing the excessive tax burdens on our American members because that will mean more jobs for Americans

We would be pleased to provide the Committee with any further information which you might find useful.

Respectfully submitted,

Council of American Chambers of Commerce - Europe and Mediterranean

AMERICAN CHAMBER OF COMMERCE (UNITED KINGDOM)
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INCORPORATED WITH LIMITED LIABILITY IN THE DISTRICT OF COLUMBIA U.S.A.

May 14, 1981.

Mr Robert E. Lighthizer
Chief Counsel
Senate Finance Committee
2227 Dirksen
WASHINGTON D.C. 20510
USA

Dear Mr Lighthizer,

Re: Taxation of Americans Abroad

It is urgent we find a suitable long-term solution this year to the problem of taxation of Americans abroad, and in that regard I would like to call your attention to our proposal, detailed in the enclosed pamphlet and testimony, which, I submit, can secure the necessary votes for passage and satisfy all parties involved. Briefly, we propose:

* For the first three years of foreign residence, the Archer-Bentsen bills, would grant a $75,000 exclusion, rising to $95,000 plus an exemption for excess housing costs above $5,500 per year. It would cover most rotating technical personnel, yet foil possible abuse by very high earners who may go abroad to avoid US taxes.

* After three consecutive years of foreign residence, the Frenzel-Jepsen bills, would exclude all foreign earned income from US taxation. Senior management and professional personnel and entrepreneurs who must remain abroad longer periods of time to learn the territory will thus be encouraged to "sell America".

There is precedent in pre-1976 law for this two-step approach, and after three years abroad, Americans would be competitive with businesspeople from other countries - Sweden, Germany, Britain, etc. - who are not taxed by their governments.

Let me emphasize, however, that we support the simplest solution - H.R.913/S.598 - or any workable solution which will effectively eliminate US taxation of Americans living abroad and at the same time not be subject to abuse.

I plan to be in Washington this month and I will telephone for an appointment to discuss this approach and to work out a draft to be presented at mark-up.

Sincerely,

Connie Borken-Hagen

CONNIE BORKEN-HAGEN
SPECIAL PROJECT COORDINATOR

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May 7, 1981

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Subcommittee on Taxation and Debt Management Hearing on Miscellaneous Tax Bills, April 24, 1981

Dear Mr. Lighthizer:

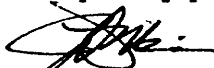
In reference to your mailgram dated April 21, 1981 concerning the above-captioned hearing, I am submitting herewith five copies of the following, as my written statement for printing in the record:

(1) An article entitled, "The Foreign Earned Income Exclusion: Reinventing the Wheel," which appears in the Spring 1981 issue of The Tax Lawyer.

(2) A summary of the Tax Lawyer article, as published in The Washington Star on May 5, 1981.

Thank you for this opportunity to place in the legislative record my views on this important subject.

Very truly yours,



John D. Maiers

enclosure

THE WASHINGTON STAR Tuesday, May 5, 1981

Comment

JOHN D. MAIERS

U.S. Workers Abroad Lose Ground on Taxes

The United States is the only major industrialized country which taxes on the basis of citizenship. An American citizen, wherever he resides, is taxed on this worldwide income.

Taxation on the basis of citizenship creates a discrepancy of tax burden between foreign-based American taxpayers and third-country nationals whose home governments do not tax them.

This discrepancy increased dramatically in 1976, in part because the Tax Reform Act of 1976 severely curtailed use of the foreign earned income exclusion. Under prior law, Americans working abroad had been able to exclude from annual gross income up to $20,000 of foreign earned income, and up to $25,000 if they were foreign residents for three years.

Also in 1976, the U.S. Tax Court ruled that overseas taxpayers must include in gross income the excess allowances provided by an employer, even though such allowances were only intended to put the taxpayer in the same economic position he would have been in had he remained in the United States.

New System Complex

With the enactment of the Foreign Earned Income Act of 1978, Congress completely abolished the foreign earned income exclusion for most overseas taxpayers. Congress replaced the exclusion with a complex new system of excess foreign living cost deductions, to relieve the harsh consequences of the 1976 Tax Court rulings and to counterbalance some of the tax effects of repealing the foreign earned income exclusion.

Last year the Carter administration and the Senate Finance Committee endorsed separate proposals to reinstate the foreign earned income exclusion. House Ways and Means Committee Chairman Rostenkowski recently put induced taxes for Americans abroad on his recommended tax-cut agenda. Tax relief for overseas taxpayers is reportedly among the tax law changes which the Reagan administration will seek.

Since 1976 American businessmen have complained loudly about the adverse foreign trade consequences of taxing Americans who reside outside the United States. Any incremental tax burden on Americans abroad is borne initially by the taxpayer, but all or part of the burden is ultimately shifted to his employer, usually an American company, whose production costs and product prices then rise. A heavier tax burden on Americans abroad encourages their replacement with nationals of other countries. The recall and replacement of Americans abroad who are strategically placed to influence the purchasing decisions of their companies, in turn, leads to a diversion of future purchases away from American goods.

The additional costs of hiring Americans to work overseas have other collateral effects: (1) drain of labor skills to foreign nationals who replace and then compete against Americans, (2) decrease of foreign operations of U.S. companies overseas, (3) slow-down of inward technology transfer to the United States, and (4) snowballing decline of U.S. exports.

The secretary of commerce, the U.S. trade representative, the President's Export Council and, most recently, the comptroller general each report an increasing tendency to replace Americans overseas with foreign nationals, because federal tax laws make it more expensive for American firms to employ Americans than to employ foreigners. The comptroller general recommended 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."

At the bottom of the controversy concerning the economic impact of taxation of Americans abroad is the responsiveness of U.S. exports to changes in the tax burden of Americans abroad. A recent Chase Econometrics study projects an overall drop in U.S. real exports of about five per cent ($6-7 billion per year), due to changes in the tax treatment of Americans abroad since 1975. The Department of the Treasury disputes the Chase Econometrics export assumptions and refers to other findings that repeal of special tax treatment for Americans abroad would cause the value of U.S. exports to decline by only 2 per cent, which, still amounts to about $2 billion annually. Whatever the actual magnitude of the export effect, the economic multipliers involved are extremely large for *any* incremental tax change affecting Americans abroad, particulary when compared with the amount of tax revenue collected from American expatriates.

Tax Losses Assessed

The Joint Committee on Taxation and the Treasury have estimated that complete exemption of foreign earned income would cause a tax revenue loss of $508 million in 1981, rising to almost $790 million in 1985. Even these estimates overstate the amount of actual revenue loss, because Treasury practice is not to take into account any secondary revenue effects or any new economic activity resulting from proposed tax changes. For example, Treasury estimates do not include the favorable impact of exemption on the corporate profits taxes of American employers, who heretofore have had to pay overseas tax equalization allowances for which deductions are claimed.

Whatever the full tax consequences of the Foreign Earned Income Act of 1978, it is clear that the real economic position of Americans working abroad has declined considerably in recent years. High inflation in most foreign countries, the devaluation of the dollar, and the limited availability of housing and other facilities overseas to accommodate increasing numbers of third-country nationals, have all combined to make expatriate employment less inviting to Americans than ever before. It is therefore ironic that the tax burden on Americans abroad has increased.

As the United States emerges at home from the post-Vietnam syndrome, it is vital for us to create again a tax environment overseas in which Americans can reestablish themselves alongside their foreign counterparts.

The present system of taxing Americans abroad should make the Reagan administration see red. The current system of excess foreign living costs deductions is a prime example of over-regulation, misplaced priorities, and complex tax laws which makes no long-term economic sense. The Foreign Earned Income Act of 1978 achieves neither tax equity nor traditional foreign trade objectives. The United States instead needs a basic tax policy which encourages the assignment of Americans abroad and recognizes that overseas citizens are valuable trade and strategic assets, just as was recognized in 1926 when Congress first enacted the foreign earned income exclusion.

The author is an attorney with the international law firm of Coudert Brothers, and is a former Foreign Service officer. This is based on his article in the spring issue of The Tax Lawyer, published by the Section of Taxation, American Bar Association.

STATEMENT OF ROGER D. CONKLIN, PRESIDENT, COOK ELECTRIC INTERNATIONAL, A DIVISION OF NORTHERN TELECOM, MIAMI, FLORIDA

INTRODUCTION

Cook Electric International's business is exporting U.S. made telephone equipment, principally to foreign government-owned national telecommunications systems.

I personally spend over half my working time abroad with our foreign customers. I was an expatriate for 11 years and am keenly aware of the effects of the Tax Reform Act of 1976 and the Foreign Earned Income Act of 1978, both from the point of view of an exporter as well as from the vantage point of the U.S. citizen abroad. I have studied the GAO report to Congress American Employment Abroad Discouraged by U.S. Income Tax Laws dated February 27, 1981, and am in complete agreement with the GAO conclusions.

CITIZENS ABROAD NOT EMPLOYED BY U.S. FIRMS

My statement concerns principally the situation of the tens of thousands of overseas U.S. citizens not employed by U.S. firms, but whose presence abroad is just as important to our exports as those who are. Some are self employed. Others work for foreign companies or foreign governments, or teach in foreign schools, colleges and universities. The knowledge they impart, the decisions they make, and the recommendations they provide, are decisive in determining the source of imports. They are as important to our exports as employees of U.S. companies abroad.

U.S. CITIZENS EMPLOYED ABROAD BY FOREIGN GOVERNMENTS, COMPANIES AND ORGANIZATIONS

It is not unusual for key staff, and sometimes line, positions in foreign companies and organization in developing countries to be filled by specialists from developed countries. These specialists make policy decisions and recommendations which influence where imports will come from for many years. I was formerly deputy general manager of the Peruvian Telephone Company, served as a consultant to various Brazilian telephone companies and was managing director of a Brazilian owned firm distributing U.S. made imports. Some decisions and recommendations I made 15 years ago are still resulting in millions of dollars of imports annually from the U.S.

Foreign governments and foreign government organizations frequently offer tax free salaries, subsidized housing, diplomat-like duty free import privileges and the like to make the low salaries they offer expatriate specialists attractive. This is a common way to attract university professors who not only enhance the quality of education but impart a knowledge of foreign cultures and technology which have a tremendous influence on the directions taken in those countries.

Because of our current tax laws Americans, once very common in these foreign positions, have all but disapeared. Among the reasons is that taxes forgiven by foreign governments as an incentive to accept low salaries abroad become obligations to the I.R.S. Since expatriate citizens of other countries have no home country tax obligations, they now dominate this influential job market. In several countries where American consultants used to be employed by foreign telecommunications administrations, other nationalities have entered to fill this vacuum. They are influencing the changing of standards from those recommended previously by American consultants to those used in the countries of origin of their replacements. This is causing my company to lose business in our traditional markets.

The 1976 and 1978 tax legislation has decimated this expeditionary force of Americans employed by foreign firms, organizations and governments. A few have stayed on by renouncing their U.S. citizenship and becoming citizens of their country of residence.

AMERICANS ABROAD WHO DON'T PAY U.S. TAXES

Nations used to recognize their territorial waters as extending 3 miles from their coastlines; roughly the distance a cannon ball could reach when fired from shore. No nation on the earth screamed any louder or took more direct retaliatory action, than the U.S. when Peru, Ecuador and Chile first proclaimed that their territorial jurisdiction over fishing rights extended to 300 miles, and began siezing U.S. fishing vessels within this limit. The United States, however, stands alone among the nations of the world in asserting tax jurisdiction beyond it's national boundaries.

The I.R.S. has no more power to collect taxes from U.S. citizens resident in foreign countries who have no assets in the United States than nations in the last century had to control the waters beyond the three mile range of their cannons. By law no non-resident U.S. citizen is exempt from taxation; not those with dual nationality, not those born on U.S. soil to foreign parents just passing through, nor even those stranded behind the iron curtain. There are an estimated 2 million U.S. citizens living abroad, filing about 150,000 tax returns. This means that either the average American family abroad consists of some 13 members, a most unlikely possibility, or that a substantial number simply don't obey U.S. tax laws.

Many U.S. citizens abroad do not, in fact, file tax returns. Some either do not know, or else do not believe, that they are violating the law by not doing so. I've met quite a few living abroad in this category. Others with no assets in this country simply choose to take the chance and ignore the law, knowing full well the I.R.S. is unable to do anything about it. No foreign court would recognize that the United States has any authority to collect taxes or sieze property for non-payment in a foreign country , and it is doubtful that any nation would honor an extradition request based on a law which implies that the United States has jurisdiction of any kind within the soverign borders of that naion. Unjust laws breed disrespect and defiance. Some Americans resident abroad who used to file tax returns under the pre-1976 law no longer do so.

U.S. TAX LAWS REQUIRE SOME U.S. CITIZENS ABROAD TO VIOLATE FOREIGN LAWS

Perhaps the most objectionable aspect of the laws enacted by the United States imposing taxes on foreign source income of non-resident citizens is the requirement that taxes on foreign currency income be paid in U.S. dollars, and that tax payments be remitted outside of the country where the citizens resides. One or both of these two conditions cannot be met by thousands of non-resident U.S. citizens, except by violating the currency control laws of the countries where they live.

The typical expatriate employee of a U.S. firm is paid in dollars, whereas non-resident citizens not employed by U.S. firms are almost always paid in the currency of their country of residence. Some countries have laws which require that local firms pay their employees in the currency of that country and which in varying degrees control, restrict or prohibit the conversion of that currency into another currency, or the sending or carrying out of either local or foreign currency to another country. In some countries the mere posession of dollars or the owning of assets outside that country by *any* residents, including U.S. citizens, is a crime.

BLOCKED CURRENCY

Reproduced below is the "Blocked Currency" section from page 40 of the I.R.S. publication 776 (1-81 revision) Overseas Filers of Form 1040 - Supplemental Package:

Blocked Income

You must report your foreign income in terms of U.S. dollars and, with one exception (see *Fulbright grants*), you must pay taxes due on it in U.S. dollars.

If, because of restrictions in a foreign country, your income is not readily convertible into U.S. dollars or into other money or property readily convertible into U.S. dollars, your income is "blocked" or "deferrable" income. There are two ways to report this income:

1) Pay your federal income tax with U.S. dollars that you have in the United States or in some other country, or
2) Defer the reporting of the income until it becomes unblocked.

If you choose to defer the reporting of the income, you must file with your tax return, an information return on Form 1040 labeled "Report of Deferrable Foreign Income, pursuant to Rev. Rul. 74-351." You must declare on the information return that the deferrable income will be included in taxable income in the year that it ceases to be deferrable. You also state that you waive any right to claim that the deferrable income was includible in income for any earlier year.

All amounts reported on the information return must be reported in the foreign currency involved. If you have blocked income from more than one foreign country, include a separate information return for each country.

Income becomes unblocked and reportable for tax purposes when it becomes convertible, or when it is converted, into dollars or into other money or property that is convertible into U.S. currency. Also, if you use blocked income for your personal expenditures, or dispose of it by gift, bequest, or devise, you treat it as unblocked and reportable.

If you have received blocked income on which you have not paid the tax, you should check to see whether that income is still blocked. If it is not, you should take immediate steps to pay the tax on it, file a declaration or amended declaration of estimated tax, and report the income on your tax return for the year in which the income became unblocked.

Fulbright grants. The one exception to the rule that federal income tax must be paid in U.S. dollars applies to the tax on Fulbright grants, provided at least 70% of the grant or compensation is paid in nonconvertible foreign currency. To the extent the recipients of such funds are paid in nonconvertible currency of the foreign country in which they are working, special arrangements have been made that allow them to pay the federal income tax due on this income in the currency of the foreign countries involved. Details of these arrangements may be found in Publication 520, *Tax Information for U.S. Scholars*, or obtained from the U.S. Educational Foundations or Commissions in foreign countries.

According to this I.R.S. information, the tax on non-convertible blocked currency can be deferred until it becomes unblocked. Several years of income could become unblocked and taxable all at once, resulting in a considerably higher marginal tax rate. The obvious intent is to make it extremely unattractive for a taxpayer to defer taxes on blocked income. Whether this is just is highly debatable. Theoretically it is workable, as long as the tax doesn't have to be paid until the income can actually be converted into dollars.

There is a "Catch 22" provision in this requirement which would require something akin to alchemy in order to be workable. This is the requirement, underlined above, which says that using blocked currency income for "personal expenditures", meaning food, clothing, transportation, rent, medical expenses, children's schooling, etc., automatically makes it "unblocked" and immediately reportable and the tax payable in dollars. Taxes on blocked income cease to be deferable the moment it is used for personal expenditures. This is absurd and unreasonable since compliance requires U.S. citizens to pay taxes in dollars which can only be obtained by illegal means.

PAYING TAXES WITH DOLLARS BOUGHT ON THE BLACK MARKET

In those countries where governments do not permit residents to change local currency into dollars to pay taxes to the U.S., the U.S. citizen has two choices: Ignore his U.S. tax obligation in violation of U.S. law, or obtain dollars on the black market and smuggle them out of the country in violation of the laws of that country.

I was in Kingston, Jamiaca several months ago when The Gleaner carried a news report on the arrest and conviction of a U.S. citizen for "a breach of the Exchange Control Act". He was caught attempting to smuggle $4075 out of the country. His dollars were confiscated and he was fined $21,317.34. When I was in Rio de Janeiro, Brazil in January of this year, Jornal do Brasil reported the arrest of two Uruguayans and one Brazilian by federal police for illegal trafficking in foreign currency. They were apprehended with a few thousand U.S. dollars in their posession which they were attempting to illegally take with them out of Brazil into Uruguay. A U.S. citizen acquaintance of mine, resident for many years in Peru where he operated his own business, was apprehended a few years ago in the act of exchanging local currency for dollars with a tourist. His home and all his posessions and assets in that country were confiscated, his resident visa was cancelled and he was deported. In quite a few countries currency law violations are subject to penalties similar to those imposed for drug law violations. Yet violation of foreign currency laws is the only way thousands of non-resident Americans can comply with U.S. tax laws.

THE I.R.S. ASSISTS U.S. CITIZENS IN VIOLATING FOREIGN LAWS

What is the I.R.S. attitude towards the problems faced by Americans who have no legal way to obtain dollars to pay non-deferable taxes as required by U.S. law? Four years of exchanging correspondence with the I.R.S., mostly with the director of international operations, has revealed the following:

1. The I.R.S. is most reluctant to provide information on how Americans who only have blocked currency income used for personal expenditures can obtain dollars to pay U.S. taxes, other than the "Catch 22" information contained in publication 776. Whether or not overseas citizens have to breach foreign laws in order to comply with U.S. law does not concern the I.R.S. Their job is to collect taxes. They only suggest you "be careful".

2. When pressed for meaningful answers, the I.R.S. responded to my quiries reluctantly and evasively, and then only after long delays of up to 6 months or more. Follow-up letters were generally ignored and some questions were never answered. It was only through the personal intervention of a member of the White House staff that some responses were finally received.

3. The director of international operations admitted that the present law is a problem to thousands of U.S. citizens in blocked currency countries, and advised that a project was underway to develop proposed Treasury regulations allowing payment of U.S. taxes in foreign currency. Some seven months after providing this information, he advised that this project had no schedule. It obviously has a very low priority.

4. In some countries where it is illegal for U.S. citizens to obtain dollars and remit them to the I.R.S., it may be possible, if there is an I.R.S. representative located at a U.S. embassy or consulate, to have him exchange local currency for dollars sent into that country to operate the diplomatic mission, within the four walls of the embassy or consulate where there is little probability that the illegal exchange will be observed by foreign government authorities.

5. When the illegal currency exchanges described above have been consumated, the I.R.S. representatives arrange for tax payments to be illegally smuggled out and sent to the I.R.S. in the U.S., via diplomatic pouch. Any withholding taxes imposed by the laws of those countries on remittances sent abroad are not withheld nor are they paid by the I.R.S. to those governments. The violations of currency exchange and remittance laws go undetected and foreign remittance taxes are evaded through the direct intervention of the I.R.S.

6. In countries where these exchange and remittance operations are consumated, no authorizations have been granted to the U.S. by those governments for such activities. The director of international operations advised me they would discontinue such a practice if the government of a country were to question this activity. In fact, "when the heat is on", it may temporarily be suspended. The Brazil Herald reported on January 31, 1980 that the I.R.S. representatives at the consulate in Sao Paulo were no longer accepting Brazilian cruzeiros in payment of U.S. taxes, and quoted the regional I.R.S. director as stating "It has always been the policy of the I.R.S. to only accept U.S. dollars for tax payments". I was advised by the director of international operations that the Sao Paulo office had, as reported above, temporarily suspended the acceptance of cruzeiros "pending the resolution of administrative problems", but that the exchange operation had been subsequently resumed.

7. The I.R.S. refuses to include any information in it's publications concerning exchanging blocked currency for dollars at U.S. diplomatic missions for what seems to me to be the rather obvious reason of not wanting to pubically reveal the fact that it engages in these covert activities. This information is instead disseminated by word of mouth. I feel that the only reason I received this information from the I.R.S. in writing, in bits and pieces over some four years, was due to unusual persistence, dissatisfaction with evasive answers, and the personal assistance of a member of the White House staff who believed a citizen has a right to receive honest answers.

I believe the I.R.S. engages in these illegal exchange and remittance activities because the monkey in on their back to collect taxes in conformance with the legislation enacted by Congress. Does the end justify the means when foreign laws have to be violated? Absolutely not. But the problem will not be solved by barring the I.R.S. from collecting taxes they are mandated by law to collect. The solution is to change the law so U.S. citizens abroad are not obligated to compliance in violation of foreign laws.

UNINFORCEABLE TAX LAWS

Some U.S. citizens abroad are dual citizens of another county for reasons of parentage, marriage or birth. Some were born abroad of a U.S. parent or in the United States of a foreign mother who happened to be here when birth took place. Some of them have never lived here after that event. Although they can't speak a word of English and have never been in the U.S. except to be born, they are as much a U.S. citizen as any of the rest of us. Some born here would prefer not to be U.S. citizens, but they live in a country like Mexico where becoming a naturalized citizen is a privilege granted only to a select few by special order of the president of the republic.

All persons with U.S. citizenships have a common obligation to pay taxes. There is no exemption for dual nationals, no exemption for those who happen to be U.S. citizens just because they were born here when their mother was in Miami while a flight from Barbados to Bermuda was refueling, or for any other reason.

According to the State Department, there are some 700 U.S. citizens still living in Cuba. I.R.S. publication 776 indicates that none of Cuba, except Havana, is a hardship area. This means all the income of citizens living outside Havana, both earned and unearned and including Cuban government pensions, is taxable. How many of these 700 U.S. citizens are sending dollars to the I.R.S. to pay U.S. taxes? Probably none. I wonder what action the I.R.S. has taken to collect back taxes from the hundred or so U.S. citizens whose returned to the U.S. about a year and a half ago? They should all have been indicted for tax evasion for having not paid taxes in dollars on their Cuban peso income in past years.

TAXING FOREIGN SOURCE UNEARNED INCOME OF NON-RESIDENT CITIZENS

I have not examined all of the proposed legislation, but what I have seen would limit exemptions to foreign earned income. Americans permanently resident abroad have the same needs to invest their savings in order to survive after retirement as do Americans at home. Not exempting unearned income causes some unnecessary and undue hardships, for example:

1. Blocked currency unearned income can't be converted to dollars to pay taxes.

2. U.S. Social Security benefits are tax free, but foreign Social Security benefits are fully taxed as unearned income by the I.R.S.

3. The first $400 of domestic dividends and interest income to a couple is now tax free, but all foreign dividends and interest are fully taxed.

4. Residents of the U.S. can invest in state and municipal bonds and enjoy tax free unearned income. Residents abroad can only invest in the kinds of investments defined as tax free by the laws of their country of residence in order to not be taxed by that country. U.S. tax free bond interest doesn't qualify for exemption from foreign taxes, and foreign investment income of all kinds is fully taxed by the U.S. as unearned income. This precludes the overseas resident from being able to avail himself of the tax free unearned income available to citizens at home.

TAXATION UNREASONABLY COMPLICATED

The GAO Report to Congress American Employment Abroad Discouraged by U.S. Income Tax Laws dated February 27, 1981 concludes that the tax instructions are so complicated that the average overseas taxpayer is now incapable of preparing his own return. He must, according to the GAO, seek the help of a qualified U.S. accounting firm for whose services he can expect to pay from $700 to $1200. The 1981 edition of I.R.S. publication 776, Supplemental Package for Overseas Filers of Form 1040, contains 92 pages of complex instructions and special forms applicable only to U.S. citizens overseas. This situation raises the following questions:

1. How is a retired American missionary living on Brazilian social security in the Amazon River city of Manaus ever going to find, let alone afford, a "qualified U.S. accounting firm" to prepare his tax return?

2. How can the U.S. citizen living to Mexico City who was born to a Mexican mother temporarily in the U.S. but who has himself never lived here after being born, and who understands no English, be expected to understand publication 776 and file a U.S. tax return?

3. Why are deductions for schooling expenses limited to schools taught in English? It isn't in the law, but is in the regulations. Grauduation from a school taught in English is not a requirement for admission to U.S. colleges and universities. This is blatent discrimination against Puerto Ricans whose offical language is Spanish. As U.S. citizens, Puerto Ricans should certainly have the same right to deductions if their children attend Spanish speaking schools which would qualify them for high school graduation if they transferred to Puerto Rico, and prepare them to enter a Puerto Rican university.

RECOMMENDATIONS

The GAO Report to Congress was restricted to considering the problems of U.S. companies and their expatriate employees. It did not address the problems of the tens of thousands of U.S. citizens abroad not working for U.S. firms but who have the same tax obligations, plus a multitude of additional complications, not faced by employees of U.S. companies. Even though the GAO report only considered one segement of the U.S. citizen population living abroad affected by the current tax law, as well as any new legislation which may result from these hearings, it does, in my opinion, correctly diagnose the overall problem and point to a satisfactory and correct solution which is summarized on the front cover of the GAO report. It states:

> "GAO urges that congress consider placing Americans working abroad on an income tax basis comparable to that of citizens of competitor countries".

The "comparable basis" is described on page 36 of the GAO report, as follows:

> "Canada, the Federal Republic of Germany, France, Japan and the United Kingdom, the major U.S. trade competitors, generally assert tax jurisdiction over (1) the worldwide income of residents and (2) income of non-residents which originates within their respective borders. They do not impose income tax on foreign source income of non-resident citizens".

This list of countries could well have included Italy, France, South Korea, Sweden, Brazil and many more whose share of the export market is increasing while the U.S. share is decreasing, and whose tax policies are substantially identical to the 5 countries listed in the GAO report. None of them tax the foreign source income of any kind, either earned or unearned, of their non-resident citizens. This is what the United States must do if we are to place Americans on an income tax basis comparable to that of other countries. There is no other viable way to make overseas Americans competitive.

SUMMARY

American overseas are in deep trouble taxwise. Because this is the case our nation has a serious export disadvantage. The provisions of the Tax Reform Act of 1976 were so damaging that it's effective date was delayed until the Foreign Earned Income Act of 1978 replaced it. The FEIA failed to solve the competitive problem of either individual Americans or firms employing expatriate Americans. It did not eliminate taxes on excessive living costs as it's backers expected, and it is so complex that hardly anybody can complete their tax return without the kind of professional help which is totally unavailable and too expensive for tens of thousands of overseas Americans.

In short, the situation could hardly be worse. The time has come to quit being swayed by the propaganda of those false prophets who wax eloquent describing Americans abroad as swathed in mink at the gambling tables of Monte Carlo, and to start recognizing overseas citizens not only as one of the most valuable resources any nation can have, but also as human beings who deserve to be treated in a humane manner. This valuable resource has been seriously depleted and brutally decimated by the 1976 and 1978 legislation. Competitor nations who encourage their citizens to go abroad are puzzled by the way we apply taxes punitively to our own non-resident citizens. The attempt in 1976 to make taxation of Americans equitable with Americans at home was in error. It instead accentuated their incquity with expatriates from other countries. It hurt our competitive position in the export market. Any attempt receive substantial tax revenue from overseas citizens while simultaneously attempting making them competitive with other nationalities is doomed to failure because the two objectives

are mutually exclusive. The aspects of our tax laws which ignore the realities of foreign laws and obligate Americans in some countries to violate those laws are downright inhumane. Trying to fine-tune the present hopelessly complicated law with it's hardship exclusions, deductions for home leave, housing, schooling, cost of living, etc. can never accomplish the objective of making Americans competitive, and would only lead to more hearings and new legislative proposals 2 or 3 years from now.

STATEMENT OF R. J. REYNOLDS INDUSTRIES, INC.
TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE
APRIL 30, 1981

This statement sets forth the views of R. J. Reynolds Industries, Inc., (Reynolds), in connection with your consideration of S.436, which bill would alleviate the tax burden of United States citizens living and working abroad (expatriates).

Reynolds, with combined 1980 sales and revenues of $10.4 billion, 114,141 stockholders, 83,417 employees, doing business in more than 140 countries and territories outside the U. S., considers ability to thrive and compete internationally directly related to placement of competent U. S. employees in our operations abroad. These U. S. employees consistently experience greater tax burdens than employees of other nations, and Reynolds pays the difference between its employees' tax burdens as expatriates and their tax burdens as U. S. based employees. This increased cost reduces our competitiveness with foreign companies because the United States is alone among major industrial countries in taxing foreign-source earned income on a citizenship basis.

Reynolds' subsidiaries include three with very substantial foreign operations employing over 200 U. S. citizens in 50 countries:

(1) Sea-Land Service, Inc., an ocean common carrier, serves more than 122 ports in over 45 countries operating U. S. Flag vessels in the United States foreign commerce and serves the major coastal ranges of the United States. Sea-Land is the world leader in its field and is the largest U. S. Flag carrier in the American Merchant Marine.

Sea-Land's success is due in large part to American technology and particularly to the know-how and skills of key American personnel stationed in overseas posts. The specialized nature and advanced technology of the containership industry require that key managerial personnel be skilled in Sea-Land's systems and methods.

(2) Del Monte Corporation, a major processor and distributor of fruits and vegetables, utilizes 48 domestic and 23 foreign plants in distributing more than 250 varieties of canned, fresh, frozen, and snack foods around the world.

(3) R. J. Reynolds Tobacco International, Inc., an international affiliate of R. J. Reynolds Tobacco Company, supervises manufacturing by foreign subsidiaries and licensees and oversees marketing and distribution of U. S. produced tobacco products in more than 140 countries and territories outside the United States. This requires maintaining a cadre of highly experienced manufacturing, marketing, financial, and other management personnel.

In order to attract and retain competent, qualified employees it is Reynolds' policy to equalize income and living conditions of its employees whether they are located in the U. S. or abroad. To ensure that equality of compensation between our domestic and foreign service employees is maintained, Reynolds incurs additional cost with respect to expatriates by reimbursing them for certain additional costs of living attributable to overseas assignments as well as for income and social taxes imposed on their salaries and allowances by most foreign countries. These reimbursements of costs and taxes are then included in employees'

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compensation subject to tax under U. S. and most foreign country tax laws, mitigated somewhat by the U. S. foreign tax credit permitted on the expatriates' U. S. income tax returns. Reynolds further reimburses its expatriates for the additional U. S. income tax arising from including the initial reimbursements as compensation. This reimbursement then becomes income subject to tax in the U. S. and most foreign countries resulting in a pyramiding of tax assessed on tax.

Examples comparing the tax costs of U. S. expatriates under the tax law prior to 1976, the "Tax Reform Act of 1976" and the "Foreign Earned Income Act of 1978" generally show the tax costs of the latter to be less than under the "Tax Reform Act of 1976" but greater than they would have been prior to 1976.

The effect of Reynolds' equalization policy under present tax law is that of increasing the cost of placing an expatriate employee overseas from two to three times the cost of the same employee within the United States. The expatriate employee, however, has received no net economic benefit by virtue of this overseas assignment.

The tax laws of the United States do not encourage U. S. companies to deploy Americans overseas to explore and establish new ventures in foreign countries - ventures which could open up new employment opportunities in the United States as well as provide vital overseas training and career development opportunities for U. S. citizens. Employers from other countries, not hampered by home country restrictive taxation of their expatriates employees, are more able to use headquarters personnel to search out and develop new opportunities in international trade.

We urge the Committee to assist the worldwide competitiveness of the American economy to retain a strong and competitive position in world market places by adopting legislation which will result in a lower and more equitable tax burden on those Americans working in foreign countries. We support S.436 as a minimum to accomplish this result. We realize that there could be problems of administration and enforcement if all U. S. citizens not resident in the United States were freed from U. S. taxation of all their foreign earned income as proposed by S.598. Nevertheless, we suggest that these problems might be substantially alleviated by formulating a statutory standard which would ensure that the U. S. citizen's residence abroad is attributalbe to a bona fide business purpose of the individual or his employer.

Reynolds appreciates the opportunity to present this statement to the Committee in its consideration of changes to Sections 911 and 913 of the Internal Revenue Code.

Statement submitted by:
C. Jackson Sink
Director of Domestic Tax Administration

PROPOSED CHANGES IN TAXATION OF U.S. CITIZENS WORKING ABROAD

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PROPOSED CHANGES IN TAXATION OF U.S. CITIZENS WORKING ABROAD

This paper is designed to evaluate the tax effects of four legislative proposals on firms employing Americans working abroad and to provide input for the future resolution of this controversial area. This paper compares the tax and total cost to the employer under the current law and under each of the proposals. The proposals are designed to provide tax relief to American expatriates. However, this paper shows that in some cases the expatriate will actually pay more U.S. taxes under the proposals than he would under the current law.

PROPOSED CHANGES IN TAXATION OF U.S. CITIZENS WORKING ABROAD

Statement of Purpose

This paper is designed to evaluate the tax effects of various legislative proposals on firms employing Americans working abroad and to provide input for the future resolution of this controversial area.

Legislative History

Since the 1920's, Congress has been dealing with the complex issues of expatriate taxation. Before 1925, United States citizens resident abroad were subject to U.S. income tax on foreign source earned income. In 1925 Congress, in an attempt to increase foreign trade, recommended that foreign source earned income be excluded from U.S. gross income. This recommendation, part of the Revenue Act of 1926, virtually exempted foreign source earned income from U.S. taxation.[1]

The exemption led to abuses. As a result, in 1932, efforts were made to repeal the exclusion altogether. As a compromise, the law was amended to close an area of abuse. After the amendment, income paid by the U.S. or any agency thereof was not eligible for the exclusion.[2] This resulted in a situation which some felt was more equitable, because U.S. government employees were already exempt from tax in the foreign country of residence.

No further serious attempts were made to change the foreign earned income exclusion until 1942. The House Ways and Means Committee moved to repeal the exclusion of foreign income because of abuses by individuals who left the United States for more than six months simply for tax-evasion purposes. The Senate Committee

proposed a compromise which would allow income earned abroad to be excluded only if the U.S. citizen was a bona fide foreign resident for the entire taxable year. This proposal, which provided that mere physical absence from the U.S. would no longer be sufficient, became part of the Revenue Act of 1942.[3]

The Revenue Act of 1951 changed the "entire taxable year" requirement to "an uninterrupted period which includes an entire year." Also, the 1951 Act added the "physical presence" rule in order to extend the exclusion to a U.S. citizen who is present in a foriegn country for 510 days out of an 18-month period.[4]

In 1953 Congress imposed a $20,000 per year ceiling on the amount of foreign earned income eligible for exclusion. This change was made to prevent abuses by certain highly paid individuals, such as actors and actresses, who could avoid U.S. income tax simply by working abroad.[5] The income and allowances of most Americans working abroad was below the $20,000 limit, so they were not affected. Congress did not intend for them to be.[6]

During the 1960's, additional technical adjustments were made in foreign residency tests and in the amounts that could be excluded. By the mid-1970's, the effects of inflation, including rising living costs and rising salaries and benefits for expatriates, had overtaken the amount of foreign earned income that could be excluded from U.S. taxes.[7] Some people felt that the ceiling on foreign earned income should be raised.

On the other hand, there were some Congressmen who felt that Americans overseas had preferential tax treatment over those working in the U.S. In 1976 Congress reduced the exclusion to $15,000 and changed the manner in which it was computed so that its maximum practical effect was about $3,000. As stated by the President's Export Council:

> The philosophy behind these provisions was directly contrary to the principles which had guided the United States' tax treatment of overseas Americans for more than 50 years. Instead of encouraging Americans to work overseas, the 1976 amendments discouraged such employment.[8]

The new lower limit generated so much opposition that enactment of the new law was postponed. After postponing the effective date of the tax code revisions, the revisions were replaced with the current law, the Foreign Earned Income Act of 1978 (FEIA). In general, the current law has no exclusions, but instead allows deductions for certain expenses of living abroad including deductions for cost-of-living differential, housing expenses, schooling expenses, home leave travel expenses, and hardship area deductions.[9] In some cases the deductions result in less U.S. tax for citizens working abroad than the old $20,000 exclusion. However, extensive record keeping is required and this has made the current law very unpopular. In special circumstances, an exclusion is still allowed. Under Section 911 of the FEIA, qualifying individuals residing in camps located in hardship areas abroad may claim an exclusion of up to $20,000 annually for foreign earned income instead of using the Section 913 deduction for certain expenses of living abroad.[10] Both Sections 911 and 913 are very complex.

Worldwide Taxation of Expatriates

The two major concepts of income tax jurisdiction are source basis taxation and residence basis taxation. Most countries use a combination of both, taxing residents or domiciliaries on their worldwide income and taxing nonresidents and nondomiciliaries only on income derived from sources in that country. The U.S. is the only major industrialized country which taxes on the basis of citizenship. The U.S. also taxes on the basis of source and residence.[11] The result of this is that U.S. firms are at a competitive disadvantage when paying U.S. citizens to work abroad. For example, a U.S. citizen working in the United Kingdom must pay U.K. taxes and U.S. taxes (although he will be allowed some foreign tax credits for the U.K. taxes paid). On the other hand, a German citizen working in the United Kingdom pays only U.K. taxes. Germany does not tax nonresidents on their foreign source income. Nor does any other industrialized country

besides the U.S. Consequently, a U.S. firm must compensate a U.S citizen not only for the higher costs of living abroad but also for the additional U.S. taxes the citizen must pay.[12]

Senate Bills 2283, 2321, 2418, and 3251

Senators Chafee, Jepsen, Bentsen and Moynihan have each proposed bills to amend the taxation of Americans working abroad.

Senator Chafee, in S. 2283, proposes a partial exclusion for foreign earned income of individuals. The bill would retain the eligibility standards of present law. Under the current law, an individual can qualify for the Section 911 exclusion or the Section 913 deduction by meeting either the bona fide residence requirement or the physical presence test. A U.S citizen who establishes that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year or a citizen or resident of the U.S. who is present in a foreign country or countries during at least 510 full days of any period of 18 consecutive months qualifies under the current law and Senator Chafee's proposal.[13]

Senator Chafee would allow an individual meeting these requirements to exclude foreign earned income at an annual rate of $50,000. When an individual has been a bona fide resident of a foreign country or countries for three years, the annual rate of exclusion would increase to $65,000. As under current law, amounts paid by the U.S. or any of its agencies would not be excluded. The rules presently in effect relating to the computation of the exclusions, and disallowing a credit or deduction for foreign taxes or expenses allocable to the excluded income, would be retained.[14]

Chafee's proposal would allow an additional exclusion for housing. The exclusion is equal to the greater of (1) the amount by which an employee's housing allowances exceeds 20% of his earned income for the taxable year, or (2) the amount by which his

housing expenses exceed 20% of his earned income for the taxable year. In both cases, earned income is determined without regard to any housing allowance received.[15]

The Section 913 deduction for excess foreign living costs would be repealed.[16]

Senator Jepsen's proposal, S. 2321, would allow an individual meeting the current eligibility requirements described earlier to exclude the entire amount of his foreign earned income attributable to services performed during the period he is abroad. Amounts paid by the U.S. or any of its agencies would not qualify for the exclusion. Furthermore, taxes or expenses allocable to the excluded amounts would not be allowed as a credit or deduction. The Section 913 deduction would be repealed.[17]

Senator Bentsen (S. 2418) proposes a partial exclusion for foreign earned income of an individual. Senator Bentsen's bill would modify the eligibility standards of present law. The bona fide residence test would remain unchanged. However, the presence test would be made more lenient. The individual would be eligible for the special provisions if he were present in a foreign country or countries for 330 days in a period of 12 consecutive months (rather than 510 days in any period of 18 consecutive months).[18]

An employee who meets Senator Bentsen's proposed eligibilty requirements would be allowed to exclude foreign earned income attributable to the period abroad at an annual rate of $60,000. As under present law and the other two proposals, amounts paid by the U.S. or any of its agencies could not be excluded. Also, the current rules relating to the computation of the exclusion, and disallowing a credit or deduction for foreign taxes or expenses allocable to the excluded income, would be retained.[19]

In addition,an individual who qualifies for the exclusion would be entitled to a deduction for qualified housing expenses. The deduction equals the individual's housing expenses which exceed his base housing amount. This base housing amount is computed at an annual rate of 16% of the salary of an employee of the U.S. whose salary grade is step 1 of grade GS-14. (Currently, this salary is $34,713; the base housing amount would be $5,554.)[20]

Except for deduction for certain housing expenses, Senator Bentsen would repeal the present Section 913 deduction for excess foreign living costs.[21]

Senator Moynihan, in S. 3251, proposes a flat 80% exclusion of foreign earned income for Americans working abroad. The eligibility requirements under the bill are the same as those proposed by Senator Bentsen. Senator Moynihan would also repeal the Section 913 deduction. Furthermore, no credit or deduction for foreign taxes will be allowed to the extent that the foreign taxes are allocable to the excluded income.[22]

Effect of the Proposals

The purpose of this paper is to evaluate the effects the proposals would have on a U.S. citizen working abroad. Foreign taxes remain the same. Each proposal has some effect on U.S. taxes paid.

This paper compares the amount of 1979 taxes which would be paid by a hypothetical employee to the United States under the current law and under each of the four legislative proposals. Four countries have been selected for the analysis in order to illustrate how different foreign tax laws affect an employee's U.S. tax liability.

There is no precise count of Americans living overseas. However, by all available measures, Canada has the largest population of American citizens (about 15-20% of the total). The United Kingdom, a moderate-tax country, accounts for about 7-8% of the total, according to State Department and tax return data. Japan, a high-tax country combined with a high cost of living, is another relatively large center of U.S. expatriates.[23] For these reasons, these three countries were chosen for the study. Kuwait, which has no individual income taxation, was also chosen for comparative purposes.

When a multinational company has a number of employees working abroad, it will often develop a compenstaion package to equalize the employees. Under a program of tax

equalization, the employee is in the same financial position working in a foreign country as he would have been if he had remained in the U.S. He is no better or worse off. Therefore, higher or lower costs of living abroad or higher or lower total tax liabilities do not influence an employee's decision concerning a foreign work assignment.

The data used in this study were derived form actual industry compensation packages. The foreign compensation packages and corresponding foreign taxes can be found in a 60-country study by Ernst & Whinney.[24] The amount of the foreign taxes paid by the employee greatly affects his U.S. tax liability. The foreign taxes payable under the various alternatives were computed by the Ernst & Whinney offices in each of the foreign countries.

Compensation packages at three different salary levels are given. In each situation, the hypothetical employee is a U.S. citizen and is married with two children. In addition to his base salary, it is assumed that the employee has received the typical foreign allowances for 1979 contained in an overseas compensation package such as overseas premium, cost of living, housing, home leave, and educational allowances. Furthermore, it is assumed that the employee is covered under a tax equalization policy that provides for his overseas compensation to be reduced by a hypothetical U.S. tax and for reimbursement of all foreign and U.S. income taxes paid on his overseas compensation. Finally, it is assumed that the individual is in the first year of his foreign assignment and has not yet paid any reimbursable foreign or U.S. taxes. Therefore, the tax cost to the employer is before gross-up to reimburse the tax that will be imposed on foreign and U.S. tax reimbursements. The amount of the gross-up will generally be at least equal to the original tax reimbursements based on the U.S. maximum rate of tax of 50% on personal service income. For example, it costs a U.S. employer an additional $1.00 to reimburse $1.00 of tax at a 50% tax rate, or a total tax cost of $2.00. The gross-up will be greater

for expatriates working in foreign countries where the effective tax rate is greater than the U.S. 50% maximum tax rate.[25]

Table I on page 12 shows the amount of tax which the U.S. would collect from the employee under the current law, the Foreign Earned Income Act of 1978. It also illustrates the total cost to the employer to employ the expatriate working in four different countries at three salary levels.

Table II on page 13 shows the amount of tax the U.S. would collect if Senator Chafee's proposal were adopted. Also given is the total cost to the employer under Chafee's bill.

Table III on page 14 shows that the U.S. will collect no tax under Senator Jepsen's proposal to exclude all foreign earned income from U.S. tax. It can be seen, however, that the total cost to the employer is still high due to foreign allowances and foreign taxes (including foreign taxes on the tax reimbursements).

Tables IV and V show the amount of taxes collected by the U.S. under Senator Bentsen's proposal and Senator Moynihan's proposals respectively. The total cost to the employer under these two bills is also shown.

Finally, Tables VI, VII and VIII summarize the results of the first five tables. At each different salary level, these tables provide a ready comparision of the total cost to the employer under the current law and each of the proposals.

When analyzing these tables, it is important to keep in mind that the employee is in his first year of foreign employment. He will probably receive his reimbursement for foreign and U.S taxes paid sometime during the second year. These reimbursements will constitute taxable income. Therefore, he will have as taxable income in the second year his base salary, foreign allowances, and foreign and U.S. tax reimbursements. As a result, his second year tax will be higher than his first year tax, and his second year reimbursement (paid during the third year) will also be higher than that of the first year.

Therefore, every year his total taxes get higher, simply because his tax reimbursements increase.

Conclusions

There are basically two objectives that U.S. tax laws can try to achieve in taxing U.S. citizens working abroad: (1) to place such individuals in the same position as other employees working in the same country earning the same salary, or (2) to place such individuals in the same tax position as other employees working in the U.S. and earning the same salary.

These objectives are not entirely compatible and cannot be met with the same laws. Congress must first decide which objective is more important and then choose the tax law which best meets the objective.

If the first objective is selected, that is, to place U.S. citizens working abroad in the same tax position as their foreign counterparts, then all U.S. tax on foreign earned income should be eliminated. This is what is done in every industrialized country except the United States and is what has been proposed by Senator Jepsen. In high-tax countries such as Japan, the elimination of U.S. tax on foreign source income would not result in any loss in U.S. tax revenue because current law does not provide any U.S. tax anyway. This is because U.S. tax is usually eliminated by foreign tax credits. Moreover, the second objective, to place U.S. citizens working abroad in the same tax position as U.S. employees earning the same salary, is also met as far as is possible. Foreign taxes in such countries are already far higher than U.S. taxes so it seems unfair to add additional U.S. tax burdens. The advantage of complete exclusion of foreign earned income over current tax law is that an exclusion is far simpler to calculate and does not require extensive record keeping.

In low-tax countries or no-tax countries, such as Kuwait, the decision is more complex. Again, the decision depends on which objective is considered paramount. If it is more important to compete with non-U.S. employees working in the same country, then a complete exclusion of foreign income from U.S. taxation as proposed by Senator Jepsen is the solution. However, if this is done, then employees working abroad will pay less tax than their U.S. counterparts and the second objective cannot be met.

A possible compromise position is to allow an exclusion of some portion of the total compensation earned by American citizens working abroad as proposed by Senators Bentsen, Chafee, or Moynihan. If this course is selected, then U.S. citizens working in high-tax countries such as Japan may have U.S. taxes to pay in addition to already high foreign tax burdens. One solution here might be to make the exclusion amount high. Certainly, $20,000 is not sufficient. Even amounts of $50,000 or $60,000 may be too low in today's environment and in view of the amounts which must be paid to offset the high cost of living in countries such as Japan. Too low an exclusion makes it difficult for U.S. employees to compete with their foreign counterparts.

However, simply allowing the expatriate to exclude a large amount of his foreign-earned income will not necessarily result in a lower U.S. tax liability than under current law. As under current law, Senators Chafee, Bentsen, and Moynihan all propose that foreign taxes allocable to excluded income not be available for the foreign tax credit. Very high exclusions result in lower foreign tax credits. In some situations, an expatriate will pay more U.S. taxes under S. 2283, S. 2418, or S. 3251 than he would under the current rules. This situation will usually be the case in high-tax countries. (More U.S. citizens reside in high-tax foreign countries than in low-tax or no-tax countries, so this situation will occur frequently.) Therefore, if Congress decides to adopt a proposal allowing a large exclusion of foreign-earned income with the intention of providing tax relief to expatriates, the manner in which the foreign tax credit is computed must also be

changed. As an alternative to the present computation, a foreign tax credit could be allowed for all foreign taxes paid. The foreign tax credit would be limited to the U.S. taxes on the foreign-earned income.

All four proposals provide an improvement over current law in at least one respect. Under each of the four proposals made by Senators Chafee, Jepsen, Bentsen and Moynihan, the U.S. tax of expatriates is very easy to calculate. Current law is exceedingly complex to compute. In addition, taxpayers are required to keep an unreasonable amount of detailed records. The flat exclusion allowed by each of the proposals relieves the taxpayer of the unnecessary record-keeping burden throughout the year and the problems of interpretation and difficult calculations at tax preparation time.

80-612 O—81——28

TABLE I

U.S. TAX UNDER CURRENT LAW

	Base Salary (A)	Foreign Allowances (B)	Total (C)	Foreign Tax (D)	U.S. Tax (E)	Hypo-thetical U.S. Tax (F)	Tax Cost to Employer (G)	Gross-Up (H)	Total Cost to Employer (I)
CANADA	30,000	3,300	33,300	7,400	-0-	(4,500)	2,900	7,400	43,600
	40,000	3,300	43,300	10,700	-0-	(7,400)	3,300	10,700	57,300
	60,000	3,700	63,700	17,300	-0-	(14,700)	2,600	17,300	83,600
JAPAN	30,000	59,000	89,000	16,600	-0-	(4,500)	12,100	24,900	126,000
	40,000	66,700	106,700	18,100	-0-	(7,400)	10,700	27,100	144,500
	60,000	82,000	142,000	46,500	-0-	(14,700)	31,800	69,700	243,500
KUWAIT	30,000	39,600	69,600	-0-	4,800	(4,500)	300	4,800	74,700
	40,000	54,500	94,500	-0-	9,400	(7,400)	2,000	9,400	105,900
	60,000	71,400	131,400	-0-	20,500	(14,700)	5,800	20,500	157,700
UNITED KINGDOM	30,000	28,700	58,700	7,900	-0-	(4,500)	3,400	7,900	70,000
	40,000	32,700	72,700	10,200	-0-	(7,400)	2,800	10,200	85,700
	60,000	40,600	100,600	15,100	4,400	(14,700)	4,800	19,500	124,900

TABLE II

U.S. TAX UNDER SENATOR CHAFEE'S PROPOSAL

	Base Salary (A)	Foreign Allowances (B)	Total (C)	Foreign Tax (D)	U.S. Tax (E)	Hypothetical U.S. Tax (F)	Tax Cost to Employer (G)	Gross-Up (H)	Total Cost to Employer (I)
CANADA	30,000	3,300	33,300	7,400	-0-	(4,500)	2,900	7,400	43,600
	40,000	3,300	43,300	10,700	-0-	(7,400)	3,300	10,700	57,300
	60,000	3,700	63,700	17,300	-0-	(14,700)	2,600	17,300	83,600
JAPAN	30,000	59,000	89,000	16,600	1,600	(4,500)	13,700	26,500	129,200
	40,000	66,700	106,700	18,100	4,400	(7,400)	15,100	31,500	153,300
	60,000	82,000	142,000	46,500	2,100	(14,700)	33,900	71,800	247,700
KUWAIT	30,000	39,600	69,600	-0-	1,300	(4,500)	(3,200)	1,300	67,700
	40,000	54,500	94,500	-0-	7,400	(7,400)	-0-	7,400	101,900
	60,000	71,400	131,400	-0-	21,000	(14,700)	6,300	21,000	158,700
UNITED KINGDOM	30,000	28,700	58,700	7,900	-0-	(4,500)	3,400	7,900	70,000
	40,000	32,700	72,700	10,200	600	(7,400)	3,400	10,800	86,900
	60,000	40,600	100,600	15,100	3,500	(14,700)	3,900	18,600	123,100

TABLE III

U.S. TAX UNDER SENATOR JEPSEN'S PROPOSAL

	Base Salary (A)	Foreign Allowances (B)	Total (C)	Foreign Tax (D)	U.S. Tax (E)	Hypo-thetical U.S. Tax (F)	Tax Cost to Employer (G)	Gross-Up (H)	Total Cost to Employer (I)
CANADA	30,000	3,300	33,300	7,400	-0-	(4,500)	2,900	7,400	43,600
	40,000	3,300	43,300	10,700	-0-	(7,400)	3,300	10,700	57,300
	60,000	3,700	63,700	17,300	-0-	(14,700)	2,600	17,300	83,600
JAPAN	30,000	59,000	89,000	16,600	-0-	(4,500)	12,100	24,900	126,000
	40,000	66,700	106,700	18,100	-0-	(7,400)	10,700	27,100	144,500
	60,000	82,000	142,000	46,500	-0-	(14,700)	31,800	69,700	243,500
KUWAIT	30,000	39,600	69,600	-0-	-0-	(4,500)	(4,500)	-0-	65,100
	40,000	54,500	94,500	-0-	-0-	(7,400)	(7,400)	-0-	87,100
	60,000	71,400	131,400	-0-	-0-	(14,700)	(14,700)	-0-	116,700
UNITED KINGDOM	30,000	28,700	58,700	7,900	-0-	(4,500)	3,400	7,900	70,000
	40,000	32,700	72,700	10,200	-0-	(7,400)	2,800	10,200	85,700
	60,000	40,600	100,600	15,100	-0-	(14,700)	400	15,100	116,100

TABLE IV

U.S. TAX UNDER SENATOR BENTSEN'S PROPOSAL

	Base Salary (A)	Foreign Allowances (B)	Total (C)	Foreign Tax (D)	U.S. Tax (E)	Hypothetical U.S. Tax (F)	Tax Cost to Employer (G)	Gross-Up (H)	Total Cost to Employer (I)
CANADA	30,000	3,300	33,300	7,400	-0-	(4,500)	2,900	7,400	43,600
	40,000	3,300	43,300	10,700	-0-	(7,400)	3,300	10,700	57,300
	60,000	3,700	63,700	17,300	-0-	(14,700)	2,600	17,300	83,600
JAPAN	30,000	59,000	89,000	16,600	-0-	(4,500)	12,100	24,900	126,000
	40,000	66,700	106,700	18,100	700	(7,400)	11,400	27,800	145,900
	60,000	82,000	142,000	46,500	-0-	(14,700)	31,800	69,700	243,500
KUWAIT	30,000	39,600	69,600	-0-	-0-	(4,500)	(4,500)	-0-	65,100
	40,000	54,500	94,500	-0-	2,700	(7,400)	(4,700)	2,700	92,500
	60,000	71,400	131,400	-0-	11,900	(14,700)	(2,800)	11,900	140,500
UNITED KINGDOM	30,000	28,700	58,700	7,900	-0-	(4,500)	3,400	7,900	70,000
	40,000	32,700	72,700	10,200	-0-	(7,400)	2,800	10,200	85,700
	60,000	40,600	100,600	15,100	1,500	(14,700)	1,900	16,600	119,100

TABLE V

U.S. TAX UNDER SENATOR MOYNIHAN'S PROPOSAL

	Base Salary (A)	Foreign Allowances (B)	Total (C)	Foreign Tax (D)	U.S. Tax (E)	Hypothetical U.S. Tax (F)	Tax Cost to Employer (G)	Gross-Up (H)	Total Cost to Employer (I)
CANADA	30,000	3,300	33,300	7,400	-0-	(4,500)	2,900	7,400	43,600
	40,000	3,300	43,300	10,700	-0-	(7,400)	3,300	10,700	57,300
	60,000	3,700	63,700	17,300	-0-	(14,700)	2,600	17,300	83,600
JAPAN	30,000	59,000	89,000	16,600	700	(4,500)	12,800	25,600	127,400
	40,000	66,700	106,700	18,100	1,200	(7,400)	11,900	28,300	146,900
	60,000	82,000	142,000	46,500	300	(14,700)	32,100	70,000	244,100
KUWAIT	30,000	39,600	69,600	-0-	900	(4,500)	(3,600)	900	66,900
	40,000	54,500	94,500	-0-	1,700	(7,400)	(5,700)	1,700	90,500
	60,000	71,400	131,400	-0-	3,000	(14,700)	(11,700)	3,000	122,700
UNITED KINGDOM	30,000	28,700	58,700	7,900	200	(4,500)	3,600	8,100	70,400
	40,000	32,700	72,700	10,200	400	(7,400)	3,200	10,600	86,500
	60,000	40,600	100,600	15,100	800	(14,700)	1,200	15,900	117,700

TABLE VI

TOTAL COST TO EMPLOYER OF EMPLOYEE EARNING $30,000 PLUS ALLOWANCES

	United States	Canada	Japan	Kuwait	United Kingdom
Current law	30,000	43,600	126,000	74,700	70,000
Chafee	30,000	43,600	129,200	67,700	70,000
Jepsen	30,000	43,600	126,000	65,100	70,000
Bentsen	30,000	43,600	126,000	65,100	70,000
Moynihan	30,000	43,600	127,400	66,900	70,400

TABLE VII

TOTAL COST TO EMPLOYER OF EMPLOYEE EARNING $40,000 PLUS ALLOWANCES

	United States	Canada	Japan	Kuwait	United Kingdom
Current law	40,000	57,300	144,500	105,900	85,700
Chafee	40,000	57,300	153,300	101,900	86,900
Jepsen	40,000	57,300	144,500	87,100	85,700
Bentsen	40,000	57,300	145,900	92,500	85,700
Moynihan	40,000	57,300	146,900	90,500	86,500

TABLE VIII

TOTAL COST TO EMPLOYER OF EMPLOYEE EARNING $60,000 PLUS ALLOWANCES

	United States	Canada	Japan	Kuwait	United Kingdom
Current law	60,000	83,600	243,500	157,700	124,900
Chafee	60,000	83,600	247,700	158,700	123,100
Jepsen	60,000	83,600	243,500	116,700	116,100
Bentsen	60,000	83,600	243,500	140,500	119,100
Moynihan	60,000	83,600	244,100	122,700	117,700

APPENDIX A

Explanatory Notes for Tables I - V[26]

(A) Base Salary: This is the amount of compensation the employee would have received for performing a comparable job in the U.S.

(B) Foreign Allowances: These are the amounts given to the employee to cover the excess costs of living in a foreign country. The allowances include cost of living, housing, education and home leave. Also, the expatriate is given an overseas premium as an incentive to transfer overseas.

(C) Total: This is the total of base pay and foreign allowances.

(D) Foreign Tax: This is the actual foreign income tax the employee would have paid on his total compensation reduced by the hypothetical U.S. tax.

(E) U.S. Tax: This is the U.S. tax the employee would have paid on his total compensation less the hypothetical U.S. tax.

(F) Hypothetical U.S. Tax: This is an amount that is equivalent to the tax the employee would have paid had he remained in the U.S.

(G) Tax Cost to Employer: This is the total of the foreign and U.S. taxes the employee is required to pay less the hypothetical U.S. tax. This tax cost is before gross-up for the foreign and/or U.S. tax that would be imposed on the tax reimbursements.

(H) Gross-Up: This is the additional cost to the employer to reimburse the employee for the tax imposed on the tax reimbursements.

(I) Total Cost to Employer: This amount represents the annual cost to the employer of an American working in a foreign country. It is the sum of the base salary, foreign allowances, tax cost to employer, and gross-up.

NOTES

1. Hoff, *Citizens and Resident Aliens Employed Abroad* 13-3rd Tax Management Portfolio (Bureau of National Affairs), p. A-5 (Hereafter referred to as Hoff.)

2. Letter from Deloitte Haskins & Sells to Subcommittee on Taxation and Debt Management of the Senate Finance Committee, July 30, 1980, p. 3. (Hereafter referred as Deloitte Haskins & Sells.)

3. Hoff, p A-6.

4. Hoff, p. A-6.

5. Deloitte Haskins & Sells, p. 4.

6. President's Export Council, *Report of the Task Force to Study the Tax Treatment of Americans Working Overseas* (Washington, D. C.: U.S. Government Printing Office, 1979), p. 45. (Hereafter referred to as *Report of the Task Force.*)

7. *Report of the Task Force*, p. 45.

8. *Report of the Task Force*, p. 45.

9. IRC, §913(b).

10. IRC, §911(c).

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12. *Report on Equitable Tax Treatment*, pp. 28-32.

13. S.2283, 96th Cong., 2nd Sess. §1 (1980).

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16. S.2283, 96th Cong., 2nd Sess. §2 (1980).

17. S.2321, 96th Cong., 2nd Sess. §1 (1980).

18. S.2418, 96th Cong., 2nd Sess. §1 (1980).

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22. S.3251, 96th Cong., 2nd Sess. §2 & 3 (1980).

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24. Ernst & Whinney International Series, *Tax and Total Cost of U.S. Citizens Abroad*, E&W No. 48597. (Hereafter referred to as *Tax and Total Cost*.)

25. *Tax and Total Cost*, p. 1.

26. *Tax and Total Cost*, p. 3.

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THE NEW YORK CLEARING HOUSE ASSOCIATION

STATEMENT IN SUPPORT OF LIBERALIZING THE FEDERAL INCOME TAX TREATMENT OF INCOME EARNED ABROAD BY AMERICAN EMPLOYEES

Presented in Connection with Hearings Before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee

The New York Clearing House Association is an association of twelve major New York City commercial banks which carry on substantial international business from offices throughout the world. We recognize the importance of foreign commerce to the American economy and the importance of American citizens working abroad in strengthening the position of American business in international trade.

American commercial banks have long played a key role in American and foreign financial markets and in facilitating the growth of foreign commerce. American banks have employed a significant number of American citizens in the banks' foreign offices because of the need for employees who understand American banking business and regulation. To compensate employees for the generally higher cost of living and working abroad, American banks normally pay correspondingly higher salaries, or provide compensating allowances, to employees who are assigned to foreign offices. However, because American citizens are

subject to Federal income tax on their worldwide incomes, if an employer is to fill the gap between domestic and foreign living expenses, he must pay his employee supplemental compensation in an amount which will make the employee whole after subtracting the employee's Federal and foreign income tax liabilities on the supplemental compensation.

For example, suppose that housing in a foreign country will cost an employee $15,000 more than comparable housing in the United States, that an employee assigned to that country has sufficient personal service taxable income to benefit from the 50% maximum tax (which in the case of a married employee requires only $60,000 of total personal service taxable income, taking into account all supplemental compensation received from the employer), and that the employer has agreed to make up the difference. To do so, the employer must pay the employee <u>twice</u> the additional cost (<u>i</u>.<u>e</u>., $30,000) in order to provide the employee with $15,000 after Federal and foreign income taxes. If the employee will incur other excess foreign living costs, the employer will have to increase the amount it pays the employee as supplemental compensation by <u>twice</u> the amount of those additional costs.

Although Section 913 of the Internal Revenue Code, which was added to the Code by the Foreign Earned Income Act of 1978, allows some American employees who work abroad to claim limited deductions for certain excess foreign living costs, and although foreign earned income is not subject to

Federal income tax withholding to the extent that the employer reasonably believes that the employee will be entitled to a corresponding deduction under Section 913, those provisions do not eliminate the need for the employer to pay an employee assigned abroad supplemental compensation in order to reimburse the employee fully for all excess foreign living costs.

The additional cost to an employer of supporting an American employee in a foreign office can be substantial, and American commercial banks often have large numbers of American employees working in their foreign offices. The additional cost is significant for American banks and puts them at a competitive disadvantage in relation to foreign banks inasmuch as all other important industrialized countries do not tax nonresident citizens on income derived outside the country.

Employees also incur a financial and emotional cost in keeping required records and in making the complex calculations necessary to compute their tentative Federal income tax liabilities and their foreign tax credits.

To improve the competitive position of American banks in international banking and to reduce the burdens imposed on American employees who work abroad, The New York Clearing House supports the liberalization of the Federal income taxation of foreign earned income. Specifically, we urge that legislation be enacted to:

(1) Reduce the income tax burden imposed on Americans who work abroad;

(2) Simplify the present record keeping and return requirements; and

(3) Simplify the process of auditing Federal income tax returns.

In addition, we ask that such legislation apply to all American citizens working abroad, not solely to persons employed in particular industries or countries, and that the application of the new rules be subject to an annual election by the taxpayer in order to allow for the varying circumstances of Americans who work in different foreign countries.

THE NEW YORK CLEARING HOUSE ASSOCIATION

The Bank of New York

The Chase Manhattan Bank, N.A.

Citibank, N.A.

Chemical Bank

Morgan Guaranty Trust Company of New York

Manufacturers Hanover Trust Company

Irving Trust Company

Bankers Trust Company

Marine Midland Bank, N.A.

United States Trust Company of New York

National Bank of North America

European American Bank & Trust Company