

Legislative Proposals for Tax Reform Concerning U.S. Citizens Residing Abroad

This document includes four proposals for tax reform for Americans residing overseas.

- A. Section 911 modification: Foreign Earned Income Exclusion
- B. Include Foreign Earned Pensions under Section 911
- C. Foreign Retirement Savings Accounts/ Pension Accounts
- D. Functional Currency for Bona Fide Foreign Residents

A. Foreign Earned Income Exclusion (Section 911 of the Tax Code)

Situation Today:

In 2009, the Foreign Earned Income Exclusion (FEIE) is set at \$91,400. The FEIE has been indexed to inflation only since 2006 with the passage of TIPRA. If the first cap on FEIE of \$35,000 set in 1962 had been indexed to inflation, it would amount to \$253,553 in 2008.

Clearly the FEIE does not match economic reality, not only because it was not indexed to inflation for such a long time but also because the decline of the dollar over the past 47 years has significantly reduced its protection value. For instance the USD was worth 4 DM in 1962 but only 1.43 DM (euro equivalent) in 2007. In other words, the foreign currency equivalent of the FEIE today is in real terms less than it was in 1962; when inflation is taken into account, the FEIE protection is only a fraction of what it was in 1962.

The original unlimited FEIE allowed Americans to live and work abroad without the additional economic burden of double taxation. Due to perceived abuses and tax evasion by a few very wealthy individuals, the 1962 cap was set at a level which would limit this abuse but still allow middle class Americans to work and compete overseas in the world economy. This intent is no longer met by the current limit. Only about 20% of Americans who file form 2555 are fully protected by the FEIE. Furthermore, the stacking measure introduced in TIPRA in 2006 significantly increased taxes of middle class Americans overseas with incomes up to \$250,000. Simple cost of living allowances for purchasing parity, foreign taxes, housing and English speaking schools for children can balloon an \$80,000 to \$90,000 a year U.S. household income into over \$250,000 of taxable income, with no change in standard of living for the family.

Because of the diminished competitiveness arising from this artificial impediment, America's trade deficit has been soaring for decades, but not until the recent economic crisis have the consequences of continued inaction been obvious outside of tax and policy circles. Due to the insufficient protection from the current level of the FEIE in Section 911, American citizens overseas are significantly more expensive to employ than foreigners. The result is a declining number of Americans working overseas for American and multinational corporations. This ill-considered tax policy therefore prevents U.S. citizens from gaining the necessary international experience required to compete in today's world markets and to form future leaders for the global economy. Consequently US companies become dependent on foreign citizens to fill positions requiring international experience, for positions located both in the US and abroad.

Proposal:

In order to align with U.S. economic interests and to restore the original intent of Section 911 of the Tax Code, reinstate the original unlimited Foreign Earned Income Exclusion (FEIE). Thus private citizens

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abroad would be subject only to one tax jurisdiction for earned income, that of their country of residence, just as citizens who reside in the U.S. are subject only to the U.S. tax jurisdiction. Even U.S. government employees abroad are subject only to one tax jurisdiction. Furthermore, U.S. government employees overseas receive housing, cost of living, home leave transportation and education allowances which are not subject to any taxation.

Cost:

The tax revenue impact of introducing an unlimited FEIE would be less than the rounding error in the U.S. budget. This measure should be considered within the context of President Obama's tax reform proposal to reduce taxes on middle class Americans and to strengthen the U.S. economy.

Other Impacts:

- **Increase in exports = increase in domestic jobs/ economy = increase in tax revenue:** Exports are already an important source of employment in the U.S. According to the Department of Commerce, in 2006 (latest data available) total jobs linked to manufactured exports (manufacturing employment and non-manufacturing employment) numbered 5.98 million, or 5.1% of the private sector employment. The 2.58 million manufacturing employment jobs accounted for 20% of industry employment.¹⁾ Increased presence of American citizens working overseas would support a national effort to boost American exports and export-related jobs and to simultaneously lower the trade deficit that now exceeds \$700 billion a year. Prior to the establishment of the limited FEIE, the U.S. never recorded a trade deficit. OECD nations currently have on average over 3 times more nationals abroad per capita than the U.S.²⁾ It is estimated that \$1 billion of exports creates about 10,000 jobs at home in the U.S.³⁾ Just increasing exports by \$10 billion would lead to 100,000 new domestic jobs and new tax revenues of some \$18 billion over 10 years, based on the historical relationship of taxes representing 18% of GDP. Lowering the U.S. trade deficit also reduces U.S. indebtedness and vulnerability to the rest of the world. Americans encouraged to work in strategic positions overseas **do have a positive impact on export development.**
- **Significant simplification for the IRS and the overseas taxpayer:** An unlimited FEIE limit would greatly simplify tax filing, therefore increasing taxpayer compliance more efficiently than through costly international audits.
- **Increase compliance among Americans overseas:** Due to greater protection from double taxation and simplification in filing, more Americans overseas would be willing to comply with their obligation to file U.S. tax returns.

B. Include Foreign Earned Pensions under Section 911

Situation Today:

Many Americans abroad with lower income levels may be fully protected from double taxation by section 911 throughout their working career only to fall into a double taxation situation once they reach retirement. US citizens retiring abroad can only use foreign tax credits to offset their U.S. tax liability on foreign-source pensions. Foreign taxes paid on U.S. pensions cannot be used as credits to offset their U.S. tax liability on U.S. source pensions. The problem is accentuated as the myriad of possible foreign taxes are not each and every one recognized as creditable foreign taxes by the U.S. tax code. Furthermore, many Americans resident abroad contribute to a foreign pension fund which is not recognized in the U.S. and thus their own contributions as well as their employer's contributions to the fund are taxable. At retirement these same people are then taxed on the pension payouts creating a double taxation situation.



Proposal:

Since a foreign earned pension is in fact deferred income, treat foreign earned pensions for non-residents as foreign earned income and allow these pension payments to be covered by the section 911 Foreign Earned Income Exclusion.

Cost:

As foreign source pension income is already largely protected from U.S. taxation by foreign tax credits, the cost to the U.S. government of stopping this double tax situation would be the amount of U.S. tax revenue collected from Americans retired and living in countries where income tax rates are lower than those applicable in the United States or where foreign taxes are not creditable due to technicalities (e.g. wealth tax, high VAT).

C. Allow Foreign Retirement Savings Accounts/ Pension Accounts

Reminder of terms:

Defined Contribution Plans

Traditional IRA: Contributions, capital gains, interest and dividends are tax free. Payouts at retirement are taxed as income.

Roth IRA: Contributions are taxed when earned. Capital gains, interest, dividends and payouts are tax free.

Defined Benefit Plan

Pension: Employee contribution not taxed when earned (within set limits) and employer contribution is not taxed if funds meet "pension fund" eligibility requirements with the IRS, including "non discrimination" requirements. Pension payout at retirement is taxed as income.

Situation Today:

Although the current tax code has limited impact on Americans who spend a year or two living and working abroad, such residents represent only a small fraction of citizens overseas. The Overseas Vote Foundation 2008 Post Election Survey ⁴⁾ found that fully 72% of U.S. voters living abroad were overseas for a long-term or indefinite period and that 40% had already been living abroad for 10 years or more. The number one reason for living abroad was marriage (29%), the second was employment (22%).

Today these American individuals and families are exposed to a double tax burden on retirement savings which is not protected by Section 911. Currency fluctuations can create fictitious capital gains or losses, irrespective of the real gain/ loss in local currency. Furthermore, under current law, tax filers who earn less than the Section 911 limit (\$91,400 in 2009), are not allowed to contribute to a U.S. IRA account because they have no taxable U.S. income. Persons who can contribute to a U.S. IRA (either because they forgo the section 911 exclusion, or because they have income above the Section 911 limit or have some U.S. earned income) often find that their U.S. IRA account is taxable by their country of residence.

Secondly, any foreign IRA type account these people may have will be fully taxed by the U.S. as these legitimate foreign retirement tax shelters are not recognized by the U.S. Effectively, American citizens living abroad are left without the benefit of a legitimate retirement tax shelter, a benefit enjoyed by all U.S. residents.

Thirdly, the employee and employer contributions to the foreign earned pensions of Americans citizens living abroad are taxable by the U.S. because they are not officially recognized by the IRS as pensions, even though they might meet all technical requirements for pensions were they based in the U.S. Today obtaining recognition by the IRS that a foreign pension is a valid pension for U.S. tax purposes requires a

private ruling of the competent authority costing up to \$25,000. Again, this is unfair treatment when compared to the situation of U.S. residents.

Proposal:

US Based Defined Contribution Plans:

For all U.S. based defined contribution plans which currently require U.S. taxable earned income at least equal to the amount of deposits, allow tax payers to also count income excluded under section 911 in order to qualify for contributions to these accounts.

Foreign Based Defined Contribution Plans:

Allow bona fide foreign residents to designate a foreign bank account as an IRA equivalent to be managed according to the limitations for a U.S. based IRA account (Roth or Traditional.) This account must be identified and reported to the U.S. Treasury and the IRS. All contributions and withdrawals must be reported annually as proof of compliance with IRA restrictions/ requirements.

Foreign Defined Benefit Plans:

Adapt current definitions of eligible "pension funds" to allow foreign pension funds to meet IRS requirements without the need of a "private ruling."

Cost:

The vast majority of the people who would take advantage of the defined contribution retirement plans would be at the lower end of the pay scale with lower average tax rates. Many of these individuals do not even owe taxes on earned income to the United States due to the foreign earned income exclusion. In this case, the only lost revenue to Treasury would be the taxes on capital gains, interest and dividends on the investments held in designated foreign IRA equivalent accounts for people whose non-excluded income surpassed the amount of the standard deduction and exclusion.

Other Impacts:

- Encourage Americans to move overseas to work for a few years as benefits available in the United States would also be available to overseas residents.

D. Functional Currency for Bona Fide Foreign Residents

Situation Today:

Based on current tax law, for Americans living abroad, currency fluctuations create U.S. dollar capital gains or losses even on daily transactions as well as on movements of short and long term investments done in local currencies. The exchange rate on the purchase date and the exchange rate on the sale date determine the capital gain for the U.S. Treasury.

Proposal:

Allow Bona fide foreign residents the option to choose a foreign currency as their functional currency and calculate all capital gains/ loss transactions in that currency before converting to U.S. dollars. The current average annual exchange rate with the U.S. dollar is then used to convert any gains/ losses into dollar amounts from the foreign currency. Since the use of a functional currency is allowed for foreign subsidiaries of U.S. corporations, it is only reasonable that a similar logic be applied to U.S. citizens abroad.

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Cost:

The cost would be negligible. Due to the high frequency of transactions in question, the overall impact for the IRS would be null (gains cancelling losses.) However, the impact for individuals would be significant due to the lower frequency of major transactions. (For example: selling a house, shifting retirement savings from stocks to bonds when nearing retirement, selling assets due to catastrophic family event)

Other Impacts:

- Great simplification in calculation of gains, losses and taxes due
- Taxes based on economic reality, rather than arbitrary foreign exchange movements
- Increased compliance

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Notes:

1) U.S. Department of Commerce, EMPLOYMENT RELATED TO MANUFACTURED EXPORTS, 2006 (http://ita.doc.gov/td/industry/otea/jobs/Reports/2006/jobs_by_state.html and TOTAL JOBS SUPPORTED BY MANUFACTURED EXPORTS, 2006 data -

http://ita.doc.gov/td/industry/otea/jobs/Reports/2006/jobs_by_industry_mfg_totals.html

2) The Organization for Economic Cooperation and Development. Data was provided by the statistical department of the OECD for the year 2000.

3) PriceWaterhouseCoopers, ECONOMIC ANALYSIS OF THE FOREIGN EARNED INCOME EXCLUSION, November 7, 2005. Based on the U.S. Department of Commerce analysis of 2001 data where 640.2 billion of manufactured goods supported 7.5 million jobs or 11,542 domestic jobs per \$1 billion of exports, (Source: U.S. Dept. of Commerce, *Export-Related Jobs, 2001* and U.S. Department of Commerce, *U.S. Foreign Trade Highlights*. Both reports are available at: <http://www.ita.doc.gov/TD/Industry/OTEA/>), PriceWaterhouseCoopers adapted the number of export-related jobs for changes in labor productivity and wages and estimated that each billion dollar of manufactured exports supported 9,531 domestic jobs in 2004, p. 18.

4) Overseas Vote Foundation, 2008 Post Election Overseas and Military Voter Survey – www.overseasvotefoundation.org.

