Impact of the Tax Reform Act of 1976 on Americans Working Abroad

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I. PRIOR LAW

The United States is almost the only country which taxes its citizens on their worldwide income regardless of whether they reside in the United States or outside.[1] Ever since 1926, however, there has been an exclusion for income earned abroad by U.S. citizens under specified circumstances. Until 1962, U.S. citizens abroad were allowed to exclude all of their foreign earned income. The Revenue Act of 1962[2] limited the amount excludable to $20,000, rising to $35,000 after a period of residence abroad of three years. In 1965 the $35,000 figure was reduced to $25,000.

Until the Tax Reform Act of 1976[3] (TRA), the "earned income exclusion" under section 911 of the Internal Revenue Code was $20,000 for an individual who satisfied one of two conditions:

> 1. He was a bona fide resident of a foreign country or countries for an uninterrupted period which included an entire taxable year; or
> 2. He was physically present in a foreign country or countries for at least 510 days during any period of 18 consecutive months.

If the bona fide residence requirement was met, the exclusion was increased to $25,000 after a 3-year period of bona fide foreign residence.

In 1971 the Burke-Hartke Bill[4] proposed the repeal of section 911 for virtually all U.S. citizens working abroad. Repeal on a phaseout basis was proposed by Congress in the Tax Reform Bill of 1974[5] and again in 1975.[6] Finally, the Tax Reform Act of 1976 reduced the exclusion to such an extent that the

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1. The other country is the Philippines.
2. Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (codified in scattered sections of 12, 26 U.S.C.).
3. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.
4. H.R. 10914, 92d Cong., 1st Sess. (1971).
5. H.R. 17488, 93d Cong., 2d Sess. (1974).
6. H.R. 10612, 94th Cong., 1st Sess. (1975).

maximum tax saving it provides to a married man filing a joint return is now $3,000, *i.e.*, the U.S. tax on the first $15,000 of taxable income. Originally, the TRA made these changes effective for taxable years beginning after December 31, 1975. The Tax Reduction and Simplification Act of 1977[6.1] postponed the effective date to taxable years beginning after December 31, 1976.

II. SUMMARY OF THE 1976 CHANGES

The following changes were made by the TRA to section 911:

1. The amount of the exclusion is reduced to $15,000 per annum regardless of length of overseas residence. Employees of charitable organizations can exclude $20,000 per annum.
2. The taxable income remaining after application of the exclusion is subject to tax at the higher graduated rates which would have been applicable if that earned income had not been excluded. This is known in some foreign tax systems as "exemption with progression," because the exemption of income from tax does not affect the progressive rates on the other income.
3. Foreign income taxes paid or accrued which are attributable to the excluded income are not creditable or deductible.
4. Foreign earned income which is received outside the country in which the employee earned it is not eligible for exclusion if one of the purposes of receiving such income outside that country is to avoid local income tax.
5. Taxpayers qualifying for the earned income exclusion can elect not to claim it. An election not to claim the exclusion for any taxable year is binding and can be changed only with the consent of the Internal Revenue Service.

These changes, which are effective for taxable years beginning after December 31, 1976, and their impact on U.S. citizens abroad and their employers are discussed in greater detail below. There were also a number of changes to other provisions which have an impact on U.S. citizens abroad. These are as follows:

1. Formerly, individuals claiming the foreign tax credit were required to itemize deductions and could not claim the standard deduction. Under the TRA, individuals who claim the foreign tax credit can also claim the standard deduction.[7]

6.1 Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 302, 91 Stat. 152.

7. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(c), 90 Stat. 1611.

2. Formerly, U.S. taxpayers could compute their foreign tax credit on either a per country basis or an overall, worldwide basis. The TRA repealed the per country method, and the overall method is thus mandatory with some consequences for carryovers of excess foreign tax credits from prior years.[8]
3. Changes in the geographic source rules affecting the sale of property will have some impact on the foreign tax credit of U.S. citizens abroad, who formerly were able to convert some U.S.-source capital gains into foreign-source capital gains by selling property, such as stocks and securities, outside the U.S. In some cases such sales will now result in U.S.-source income, and offset of excess foreign tax credit against such income will not be possible.[9]
4. Formerly, a married couple of which one spouse was a nonresident alien for any part of the year was precluded from filing a joint income tax return or computing tax liability under the maximum tax rules. Under the TRA, a nonresident alien can elect (with the spouse) to be taxed as a U.S. resident alien. In such event the married couple can file a joint U.S. tax return (which must include the worldwide income of the nonresident alien) and can limit their tax under the maximum tax rules.[10]

III. PROBLEM AREAS UNDER THE NEW SECTION 911

The changes to section 911 raise a number of problems. First and foremost, the changes amount to a virtual repeal of the exclusion, because the tax saved is at the most $3,000, and the additional tax cost for an employee in the 50 percent tax bracket could be $9,500 as shown in A and B below. Secondly, for taxpayers and their advisers there are a number of computational uncertainties which cannot be resolved from a reading of the statutes or the committee reports, and clarification will have to await the issuance of regulations by the Treasury. The most controversial of these problems may be handled by the Technical Corrections Bill of 1977.[11] Thirdly, since the election not to claim section 911 is binding, the taxpayer cannot make a decision on the election until the Treasury issues regulations on circumstances in which the Internal Revenue Service will allow a subsequent change in the election.

The main problem for the taxpayers is the additional tax cost, which will be brought home very forcefully to them when

8. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1031, 90 Stat. 1620.
9. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1034, 90 Stat. 1629.
10. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1012, 90 Stat. 1612.
11. H.R. 6719, 95th Cong., 1st Sess. (1977).

they file their 1977 returns. Since in many cases employees are being reimbursed by their employers under tax reimbursement plans,[12] U.S. employers have also become aware of the additional U.S. tax costs of doing business abroad. These problem areas are discussed in more detail below.

A. *Reduction in Exclusion*

By reducing the exclusion from $25,000 to $15,000, an expatriate's tax is increased by $10,000 at his top marginal rates if he has been abroad for more than three years and was formerly eligible for an exclusion of $25,000. Thus the TRA increases the U.S. tax of an employee in the 50 percent tax bracket by $5,000 at one stroke. For an employee who has been abroad for three years or less, the increased tax would be $5,000 at 50 percent or $2,500. Since the tax rate for a married couple filing jointly reaches the 50 percent marginal rate of tax on taxable income over $44,000, it is not too unrealistic to assume many U.S. citizens working abroad would be in this tax bracket, because in addition to their compensation they are also taxed on the allowances they receive from their employers for housing, cost-of-living, and other extra expenses of living abroad.

B. *Exemption with Progression*

In determining the tax rate applicable to nonexcluded income, the taxpayer must add back to his taxable income the $15,000 of excluded income in the tax computation. Based on section 911(d), the calculation of tax on the nonexcluded income is made as follows:

Example 1.

Taxable income		$35,000
Add: Excluded income	$15,000	
Less: Disallowed deductions	—0—	15,000
		$50,000
Tax on $50,000		17,060
Less: Tax on $15,000 excluded income		3,004
U.S. tax before credit		$14,056

12. *See* IV. IMPACT ON EMPLOYERS' TAX REIMBURSEMENT PLANS *infra*.

In determining the amount of excluded income to be added back for this purpose, deductions applicable to the excluded income are deducted as follows:

Example 2.

Taxable income		$35,000
Add: Excluded income	$15,000	
Less: Disallowed deductions	3,000	12,000
		$47,000
Tax on $47,000		15,560
Less: Tax on $12,000 excluded income		2,255
U.S. tax before credit		$13,305

The first of these examples shows that the remaining $15,000 exclusion no longer saves the U.S. citizen tax in his top tax bracket, but only at the rates applicable to the first $15,000 of taxable income, which for a married couple filing a joint return is $3,004. For a U.S. taxpayer in the 50 percent tax bracket, this change costs an additional tax of $7,500 less $3,000, *i.e.*, $4,500. Thus the two basic changes cost the medium and highly compensated U.S. employee abroad an extra $9,500 before foreign tax credits are taken into consideration.

C. *Foreign Tax Credit Disallowance*

Amended section 911(a) provides that the taxpayer will not be allowed a deduction or credit for foreign income taxes "to the extent that such deduction or credit is properly allocable or chargeable against amounts excluded from gross income under this subsection."[13] The TRA did not indicate how the amount of foreign taxes disallowed in this way is to be computed. The Senate Finance Committee Report states that since the nonexcluded income is now taxed at the higher rates (under the "exemption with progression" concept), the taxes disallowed are to be considered as those taxes paid on the first $15,000 of excluded income ($20,000 in the case of charities).

Prior to the Technical Corrections Bill of 1977, the IRS issued instructions to the revised form 1116 (on which the foreign tax credit for individuals is computed) prescribing the

13. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011, 90 Stat. 1610.

manner in which U.S. citizens claiming the earned income exclusion must compute their disallowed foreign tax. Many practitioners questioned whether the method adopted by the IRS was consistent with the intent of the TRA. This issue may be settled by the Technical Corrections Bill of 1977, which prescribes the manner in which the amount of disallowed foreign tax is to be determined. The amount disallowed is to be calculated in the following manner:

$$\frac{\text{U.S. tax on excluded income}}{\text{U.S. tax on excluded income plus foreign tax credit limitation for the year}} \times \text{Foreign taxes paid on earned income}$$

If the Bill is enacted, it is presumed that the IRS will issue new instructions to revised form 1116 which will follow the above method.

D. *Income Received Outside Country in Which Earned*

Under a new anti-avoidance provision, aimed presumably at employees on "split payrolls" who are not reporting their full salary to the foreign government, the TRA provides that foreign earned income which is received outside the country in which earned is not eligible for exclusion if one of the purposes of receiving such income outside that country is to avoid local income tax. The fact that the country in which the income is earned does not tax amounts received outside is, according to the Senate Finance Committee Report, to be viewed as a strong indication of a tax avoidance purpose. No indication is given as to how the exclusion would be limited where at least $15,000 is received in the country of service. For example, if an employee is paid $25,000 by the U.S. parent company and $25,000 by a foreign subsidiary, it would appear that, regardless of the motive for the "split payroll," $15,000 should be available for exclusion. It should be noted that the exclusion is limited if the income is received outside the country in which it is earned (*i.e.*, the country in which the employee performs the services may not necessarily be the same country in which he is a resident). This restriction could, thus, have an adverse and perhaps unintended impact on employees who are resident in one country but travel extensively in other countries.

If the provision is intended to apply to the countries which tax on a "remittance" basis, it is somewhat behind the times.

The principal user of that method, the United Kingdom, ended this basis of taxing foreigners in 1974 except for limited situations, for example, when a U.K.-based employee has an additional employment outside the United Kingdom.

This provision is a difficult one for tax advisers to handle under our self-assessment procedure, except perhaps in the most obvious situations.

E. *Electing Out*

Figure 1 illustrates a situation where the U.S. citizen abroad would be better off not claiming the section 911 exclusion. In most cases it will be necessary to make two calculations in order to determine whether it would be advantageous not to claim the exclusion. Generally, if the foreign tax is very much higher than the U.S., the restriction in the TRA will simply reduce excess foreign tax credits. However, if the employee can use these excess tax credits, the new provision could result in additional U.S. tax. In general, since the exclusion is now worth only $3,000 in tax savings, any loss of foreign tax credit over $3,000 would require consideration of the election. But since the decision not to claim the exclusion is binding for future years unless the consent of the Internal Revenue Service is secured, it should not be elected without due consideration of where the employee may be assigned from time to time. As rapidly changing world economic conditions may make this difficult to anticipate, it would seem only equitable that the Service provide in its regulations for a change of election when an employee moves to a different location.

Another way of avoiding the application of section 911 without making the election and, thus, retaining flexibility may be to disqualify for its application. For example, section 1304(b)(3) prohibits a taxpayer who elects "income averaging" from claiming the section 911 exclusion in the same year.

Figure 1

Effect of Tax Reform Act of 1976 on
U.S. citizens working abroad
Assumptions

1. U.S. citizen married with 2 children.
2. Total salary and allowances: $50,000.
3. U.S. investment income: $1,000.
4. Itemized deductions: Nil.
5. Foreign income tax is:
   - A. $17,000
   - B. 9,000
   - C. 0
6. Credit for personal exemptions ignored.

Effect of changes

	1976	New law 1977[1]	
	Prior law	Exclusion	No Exclusion
	$	$	$
1. Salary and allowances	50,000	50,000	50,000
2. Less exclusion	20,000	15,000	0
3. Earned income after exclusion	30,000	35,000	50,000
4. U.S. investment income	1,000	1,000	1,000
5. Adjusted gross income	31,000	36,000	51,000
6. Itemized or standard deduction	0	(3,200)[2]	(3,200)[2]
7. Personal exemptions	(3,000)	(3,000)	(3,000)
8. Taxable income	28,000	29,800	44,800
9. U.S. tax before credit	7,100	11,456[3]	14,460
		A[1]	
10. Foreign tax paid	17,000	17,000	17,000
11. Foreign tax available	17,000	13,771[4]	17,000
12. U.S. tax before credit	7,100	11,456	14,460
13. Foreign tax credit[5]	6,870	11,138	14,177
14. Net U.S. tax due	230	318	283
15. Excess foreign tax credit (line 11 – 13)	10,130	2,633	2,823
		B[1]	
10. Foreign tax paid	9,000	9,000	9,000
11. Foreign tax available	9,000	7,291[4]	9,000
12. U.S. tax before credit	7,100	11,456	14,460
13. Foreign tax credit[5]	6,870	7,291	9,000
14. Net U.S. tax due	230	4,165	5,460
15. Excess foreign tax credit (line 11 – 13)	2,130	0	0

		C(1)	
10. Foreign tax paid	0	0	0
11. Foreign tax available	0	0	0
12. U.S. tax before credit	7,100	11,456	14,460
13. Foreign tax credit	0	0	0
14. Net U.S. tax due	7,100	11,456	14,460

Notes:

1. The results under A and B illustrate the need to make two computations to determine whether it might be preferable to elect not to claim the earned income exclusion. Where foreign taxes are relatively high (example A), the election may reduce U.S. tax due and increase excess foreign tax credits. Where foreign taxes are relatively low (example C), the exclusion is still beneficial.
   The general increase in U.S. tax before credit is a result of the reduction in the exclusion and application of exemption with progression in applying the tax rates.
   The U.S. tax on the U.S. investment income is also increased because of exemption with progression.
2. The standard deduction can now be taken even when the foreign tax credit is claimed.
3. Computation of U.S. tax before foreign tax credit:

Taxable income	$29,800
Add excluded income	15,000
Total	$44,800
Tax on $44,480	$14,460
Less tax on $15,000	3,004
U.S. tax before credit	$11,456

4. Foreign tax available for credit:

$$\frac{\text{Foreign earned income after exclusion}}{\text{U.S. tax on excluded income plus foreign tax credit limitation for the year}} \times \text{Foreign taxes paid on earned income}$$

A

$$\frac{11{,}456}{3{,}004 + 11{,}138} \times 17{,}000 = \$13{,}771$$

B

$$\frac{11{,}456}{3{,}004 + 11{,}138} \times 9{,}000 = \$7{,}291$$

5. Limitation on foreign tax credit allowable:

$$\frac{\text{Foreign source taxable income}}{\text{Total taxable income (before exemptions)}} \times \text{U.S. tax}$$

IV. IMPACT ON EMPLOYERS' TAX REIMBURSEMENT PLANS

In many countries the foreign income tax burdens on U.S. citizens are higher than the U.S. tax, and any U.S. tax due is eliminated by foreign tax credits. This will be the case even after the TRA except in those situations where the foreign tax credit disallowance will now result in some additional U.S. tax. In many cases the U.S. citizen will bear the additional tax costs himself. In most cases, however, the U.S. employers will pay the extra tax burden of maintaining their employees overseas under a variety of reimbursement plans. Reimbursement is considered necessary to enable employees to be assigned to high tax countries without loss of income. Tax costs are aggravated by the fact that housing and other allowances are taxable in most foreign countries as well as in the United States; it is necessary to gross them up by the U.S. and foreign tax in order to give an employee a guaranteed net disposable income.

Until recent years, most employers reimbursed their employees for excess taxes under so-called "tax protection" plans. Under a tax protection plan, an employee is reimbursed for U.S. and foreign taxes in excess of a hypothetical U.S. tax on his base salary had he remained in the United States. Today, "tax equalization," a more sophisticated method of reimbursing an employee's extra tax on foreign assignment, is winning favor with U.S. multinationals as they review their international personnel arrangements in light of the TRA. Under a tax equalization plan, the hypothetical tax is deducted from the gross compensation and "retained" by the employer to pay some or all of the excess taxes. By reducing gross compensation, the U.S. and foreign taxes are reduced. Tax equalization overcomes the seemingly impossible task of giving an employee a certain net disposable income by means of the following steps:

1. Compute the U.S. tax that the employee would have paid on his U.S. base salary if he had remained in the U.S.—the "hypothetical tax." This gives the figure of net disposable income that he would have had in the United States.
2. Establish his overseas compensation package by *first deducting the hypothetical tax from his U.S. base pay.* His U.S. base pay is now in the form of net after tax disposable income.
3. Add to this amount all the allowances that he needs to receive net of tax, as well as any overseas or incentive premiums. The sum of these amounts is his *gross* pay for U.S. and foreign tax purposes.

4. Reimburse him for all U.S. and foreign taxes actually paid. The reimbursement is taxable in the United States and abroad and will increase his tax base in the year received.

The following example illustrates the tax equalization method.

YEAR ONE

1. *Compute Hypothetical Tax*	
Employee's base salary	$40,000
Hypothetical tax	(10,000)
Net after tax disposable income in U.S.	$30,000
2. *Establish Overseas Compensation Package*	
Base salary	$40,000
Hypothetical tax	(10,000)
	30,000
Add allowances	20,000
Gross compensation (taxable)	$50,000
3. *Reimburse for U.S. and Foreign Taxes*	
U.S. and foreign taxes (assumes a high tax country)	$22,000

YEAR TWO

1. *Compute Hypothetical Tax* (same as Year One)	
2. *Establish Overseas Compensation Package*	
Base salary	$40,000
Hypothetical tax	(10,000)
	30,000
Add allowances	20,000
Add tax reimbursement (from Year One)	22,000
Gross compensation (taxable)	$72,000

The advantage of tax equalization is that it neutralizes the tax factor in moving employees from the United States to overseas locations and between foreign locations. Since the employer retains the $10,000 hypothetical tax by reducing the employee's actual compensation by this amount, the $22,000 tax reimbursement inthe example represents an extra tax cost of "only" $12,000. By deducting it from compensation in Year One and reimbursing it in Year Two the increase in the em-

ployee's taxable compensation (so-called "pyramid" effect) is delayed and reduced. The deduction of the hypothetical tax from compensation is the major feature which differentiates tax equalization from tax protection.

The disadvantages are those inherent in any effort to reimburse employees for expenses and taxes abroad, especially where large numbers of employees are sent abroad. First of all, the employer must become more involved in the employee's personal tax affairs than used to be considered desirable. This involvement is usually mitigated by engaging outside consultants to prepare the calculations and the U.S. and foreign tax returns. This is one way employers can ensure that their employees comply fully with foreign tax laws.

The TRA will in many cases result in an acceleration of payment of U.S. taxes and, consequently, in the reimbursement by employers under tax equalization plans. By accelerating the reimbursement, the foreign tax base is also increased. The acceleration in U.S. tax payments will generally result from the U.S. wage withholding on that part of the U.S. salary paid by the U.S. parent which exceeds the exclusion, now only $15,000.

V. FURTHER LEGISLATIVE ACTION

U.S. citizens working abroad have responded to the TRA with understandable outrage. There has been considerable adverse comment in the press. *The Wall Street Journal* devoted an editorial to the implications for foreign trade.[14] *Business Week* called it a "foreign aid bill," because U.S. employees would be replaced by foreign nationals.[15] These complaints have come to the attention of members of Congress in Washington, and further proposals may be made in this area. There are two schools of thought in Washington on U.S. business abroad, with proposals reflecting these interests. There are those who want American businesses to withdraw from abroad, and who see no reason to give tax allowances along the lines of section 911. One can, therefore, expect further proposals for the complete repeal of section 911.

On the other hand, there is now a feeling in some quarters

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14. Wall St. J., Nov. 1, 1976, at 14, col. 1.
15. BUS. WEEK, Oct. 11, 1976, at 31.

that U.S. citizens working abroad are taxed excessively because of the inclusion in income of their housing and other allowances. Thus, it seems possible that further proposals may be made to liberalize the tax law, which should give recognition to the fact that an expatriate employee's compensation package is made up not only of a base salary but also of allowances, which are fully taxable, for housing, cost-of-living, education, and home leave. Most of these allowances only enable the employee to live as he would have lived in the United States, and it seems quite inequitable to treat as a taxable benefit the full cost of Western-style living abroad. Such costs are in reality business expenses and should not be taxed as benefits.

Meanwhile, for 1977 it appears that U.S. citizens abroad, their employers, and their tax advisors must live with the complex and costly changes of the Tax Reform Act of 1976.