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REPORT

EQUITABLE TAX TREATMENT OF UNITED STATES CITIZENS LIVING ABROAD

as required by

Section 406, Public Law 96-60, amending

Section 611, Public Law 95-426

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EQUITABLE TREATMENT OF AMERICANS LIVING ABROAD

EQUITABLE TREATMENT OF U.S. EXPATRIATES

A report submitted to Congress in August 1979, required by section 611 of Public Law 95-426, compared the treatment of Americans living abroad to that of American citizens living in the United States. 1/ A detailed review was made in the areas of citizenship, education, veterans° benefits, employment, social security, and taxation. Changes were recommended or have been undertaken to correct discriminatory aspects of the citizenship rights of children of expatriates, the use of the military postal service by certain non-Defense Department schools abroad, vocational rehabilitation benefits to veterans living abroad, and social security qualifications and coverage of Americans abroad.

Section 406 of Public Law 96-60 amended the scope of section 611 to require that the President report to the Congress those Federal statutes and regulations which treat Americans living abroad in a way that may cause them "competitive disadvantage" relative to the treatment accorded by other major trading countries to their citizens abroad. The major area where competitive disadvantages are claimed pertains to taxation, particularly the taxation of income. The United States is the only major industrialized country which taxes on the basis of citizenship. Consequently, income taxation is the focus of this report. The foreign countries whose laws are considered are Canada, France, Germany, Japan, and the United Kingdom.

U.S. EXPATRIATES

Why they live abroad

Many Americans live outside the United States for some period of their lives. The circumstances vary widely. Some U.S. citizens born abroad of American parents may never live in the United States. At the other end of the scale, many students live abroad for short periods. Two large components of the expatriate community (excluding U.S. Government civilian and military personnel) are Americans employed abroad and Americans who retire abroad. Those who work abroad include those who move abroad because that is where their work

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1/ Report, Equitable Treatment of United States Citizens Living Abroad, August 1979.

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takes them, and those who choose to live abroad for other reasons and find employment there. The range of occupations is wide, as is the range of employers. They include exporters, importers, manufacturers, bankers, teachers, researchers, journalists, lawyers, doctors, engineers, storekeepers, consultants, construction workers, office workers, and entertainers, to name a few. They include employees of U.S. corporations, of affiliated foreign subsidiaries, of independent foreign corporations, of international organizations, of charitable organizations. Some are self-employed, including partners in law, accounting and other professional associations.

How many?

There is no accurate count of how many Americans live overseas other than as U.S. Government civilian or military employees. The State Department compiles estimates reported from each consular district abroad, but cautions that its figures are by no means a census. The State Department tabulation includes all U.S. citizens who register with a consular post, without regard to how long they stay in the foreign location. It also includes estimates of resident Americans who may not have registered. The number of those who do not register is estimated using such available evidence as membership in an American club, Chamber of Commerce, or other organizations available to Americans. Fluctuations, up and down, in the yearly estimates for a given country suggest that these are at best "ball park" figures. The State Department estimate as of June 1979 is 1.5 million non-government individuals, including dependents.

The 1970 Census of Population, on the other hand, reports 236 thousand U.S. citizens abroad (other than U.S. Government civilians and military personnel) including dependents, but cautions that this reporting was done on a voluntary basis and is probably incomplete.

Tax return data offer a partial source of information, but they are subject to delays and do not include persons not subject to tax or who, though subject to tax, fail to report. For tax year 1976, there were 174 thousand income tax returns filed by Americans abroad (including the Panama Canal Zone and Virgin Islands but not including returns filed from military post offices), representing a total of 440 thousand individuals including dependents. In that year, about 140 thousand taxpayers claimed the exclusion of foreign earned income under section 911 of the Internal Revenue Code. The other 34 thousand may have derived various types of other income (dividends, etc.), or they may have planned to remain

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abroad for a shorter time than necessary to qualify under section 911. For tax year 1977, preliminary figures show a drop in the number of returns filed abroad to about 150 thousand. This drop presumably reflects, at least in part, the delayed filing of returns claiming section 911 benefits due to the change in law in November 1978 and the extension to February 15, 1979, of the filing deadline for most qualifying taxpayers.

There is also a large number of Americans living abroad who receive social security benefits, many of whom may not be required to file a tax return because they do not have taxable income of $750 or more (for 1979, $1000 or more) per person for the taxpayer and dependents. It is difficult to estimate how many are in this category. The total number of social security recipients overseas is currently about 312 thousand, of which 125-140 thousand, or 40-45 percent, are estimated to be U.S. citizens. Adding this number to the number of tax returns filed from abroad would double count those social security recipients who file a tax return to report other income. On the other hand, the number of social security recipients does not take into account dependents of those recipients who do not themselves receive social security benefits and who do not file tax returns.

On the expansive assumption that there are 140 thousand U.S. citizen social security recipients who have no taxable income and, therefore, should be added to the estimated 440 thousand persons accounted for by tax returns from abroad, the total of non-government Americans abroad would be close to 600 thousand, including dependents. This is less than 40 percent of the State Department estimate. Students and persons living on investment income or inheritances may add 50-100 thousand to this total, but there still is a large gap.

Some Americans abroad may fail to file tax returns. Under the tax rules applicable prior to 1978, Americans eligible to claim the exclusion of foreign earned income were exempt from tax on the first $20,000 or $25,000 of such income. Although legally obliged to file a return if their gross income before the exclusion exceeded the allowable amount of personal exemptions (whether or not there was any tax liability), persons whose income was fully excludable may not have been aware of the requirement. (Under the 1978 Foreign Earned Income Act, the exclusion is for most persons replaced by special deductions which must be claimed on the return, which should eliminate this cause of failure to file.) Others may have had a high enough local tax that there would be no net U.S. tax after foreign tax credit, and may have concluded that a penalty was unlikely when no tax was owed. And, in general,

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compliance is more difficult to enforce among persons who live for prolonged periods outside the United States.

In short, it is difficult to explain the discrepancy between the data reported by the State Department and the tax return and social security data.

Where do they live?

As indicated above, there is no precise count of Americans living overseas (excluding U.S. Government civilian and military personnel and their dependents). However, by all available measures, the country with the largest population of such American citizens is Canada, which appears to account for about 15-20 percent of the total. Mexico and the United Kingdom are also major locations. The State Department and social security data show Mexico following Canada with 12-14 percent of the total. Tax return data show a considerably lower percentage of U.S. expatriates in Mexico. The United Kingdom accounts for about 7-8 percent of the total, according to State Department and tax return data. Together, Canada, Mexico and the United Kingdom account for nearly 40 percent of the total, according to State Department data, one-third of the total according to social security data, and one-fourth of the total according to (1975) tax return data. Italy and Germany also have large U.S. populations. Saudi Arabia, (and formerly Iran), Australia, France, Belgium, Japan, Israel, Greece, Spain, Switzerland, Brazil and Venezuela are among other relatively large centers of U.S. expatriates, with smaller numbers spread throughout the world.

CONCEPTS OF INCOME TAX JURISDICTION

There is no unanimous view of where taxing jurisdiction should lie when income involves international transactions. The two major views are referred to as 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 on income derived from sources in that country. The United States, as previously indicated, is virtually unique in taxing income not only on the basis of both residence and source, but on the basis of citizenship as well.

Source basis taxation

Pure source basis taxation would assign the right to tax income exclusively to the country where the income arises.

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Residents would be exempt from tax on all foreign source income, while nonresidents and residents alike would be taxed on income arising in the country. Pure source basis taxation is rarely practiced, but a number of income tax systems, especially of capital importing countries, do rely heavily on taxing income at the source. Argentina is an example of a country which taxes income almost exclusively on the basis of source. In such a case, source rules are very important. For example, if the country views employment income as having its source where the services are performed, it will only tax income from services performed within its territory; but if it views the source of employment income as where the payment originates, it will also tax income from employment abroad if paid for by a local person or company. The latter view is not uncommon among countries which emphasize source basis taxation.

Residence basis taxation

In contrast, pure residence basis taxation would assign the right to tax exclusively to the country of residence of the recipient. Residents would be subject to tax on their worldwide income; nonresidents would not be taxed. Source rules are important to avoid international double taxation of residents, but in addition, a definition of residence is essential. In practice, pure residence basis taxation is rarely if ever practiced. Perhaps the closest example is the Soviet Union, although it taxes on the basis of citizenship rather than residence. The Soviet Union taxes the income of Soviet citizens, including those who work abroad, and is generally willing to exempt from tax on a reciprocal basis income derived within the Soviet Union by persons who are not Soviet citizens. Most countries use both residence and source basis taxation, taxing residents on their worldwide income, and also taxing nonresidents on income having its source in that country.

Residence vs. domicile vs. citizenship

Few countries have a single precise definition of residence for tax purposes; generally a number of factors are relevant, such as the place of permanent residence or center of economic interests as well as the period of physical presence. A number of countries employ a broader concept of "domicile" to describe persons who retain ties of family or home ownership to the country or show an intent to return there even though they may spend prolonged periods abroad. The United States exercises a still broader jurisdiction in taxing nonresidents and nondomiciliaries who are U.S. citizens (and in special circumstances certain former citizens with

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U.S. income). It is common in such cases to provide special exemptions or deductions to residents, domiciliaries, or citizens who are employed abroad. These special rules are described in the next section.

On the other hand, some countries provide special tax relief to certain categories of residents. Japan taxes "nonpermanent residents" and the United Kingdom taxes persons "not ordinarily resident" on a more limited basis than other residents. Belgium and the Netherlands provide special deductions to foreign nationals. These reliefs are not necessarily limited to persons employed in the country, but may also apply to persons receiving pensions or investment income. Diplomats are generally treated as residents of the sending country by the country to which they are assigned, even if resident in the latter for a long period.

TAXATION OF EXPATRIATES

Canada

Canada taxes nonresidents only on their Canadian source income, while residents are subject to tax on their worldwide income. The criteria for determining residence are not spelled out in the law, but may be found in court cases. The main criteria are:

--time spent in the country during the tax year in question and preceding years;
--why the individual was in Canada and/or absent from Canada;
--whether he has a place of abode in Canada;
--origin and background;
--way of living;
--what other ties he has to Canada.

One court case concerned a man who lived in Canada until he was 51, then left and set up a home in the United States. He subsequently purchased a home in Canada where his wife lived all year round. Although he never spent more than 150 days a year in Canada, the court held him to be a Canadian resident. Another case concerned a student at the University of Toronto who was abroad for 11 months studying languages as part of her course work. When she returned to Canada, she discontinued her studies and took an apartment in Montreal. She was held to have remained a resident of Canada during the period of her studies abroad. Other court cases have held that a person can be resident in two countries at the same time, and that at any given time, an individual has to be

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resident in some country. The Canadian Income Tax Act also extends the meaning of "resident" for the taxable year to Canadian diplomats, members of the Canadian Armed Forces, and individuals who "sojourned in Canada in the year for a period of, or periods the aggregate of which is, 183 days or more."

When an individual works abroad without sufficiently severing his ties to Canada to be considered a nonresident, he remains subject to Canadian tax in full, with relief from international double taxation but with no special exclusions or deductions related to overseas employment. Moreover, Canada imposes a "departure tax" on certain income, including unrealized capital gain on certain property, when a resident of Canada moves abroad.

The Canadian Government recently proposed to amend its tax treatment of expatriate employees beginning in 1980 to allow an exemption of one half of foreign earnings up to a maximum annual exemption of $50,000 for employees of taxable Canadian employers who worked in prescribed countries for more than six consecutive months on a construction, installation, agricultural, or engineering project; in oil or gas exploration and extraction; or in other prescribed activities. However, this proposal was not acted upon. It was part of the 1980 budget which included controversial fiscal measures and brought about a vote of no confidence, defeating the government.

France

France taxes individuals who are neither resident nor domiciled in France, and who do not have a residence in France, only on their French source income.

In general, France taxes individuals who have their domicile in France on their worldwide income, whether or not they reside there. Individuals are considered domiciled in France if their home or place of principal abode is there; if they perform personal services there, whether as an employee or self-employed, unless it can be shown that those services are of minor importance; or if their center of economic interests is in France.

However, France provides special tax relief to certain domiciliaries who work abroad. French nationals domiciled in France who are sent abroad by an employer established in France are exempt from French tax on the income for the services performed abroad if they meet one of two conditions: (1) the foreign earned income is taxed by the country of employment in an amount equal to at least two-thirds of what

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the French tax would be on that amount; or (2) the services are performed abroad during a period of more than 183 days in twelve consecutive months in a qualifying activity. Qualifying activities are construction or assembly projects, installation and operation of industrial plant, planning and engineering services connected with either construction or industrial operations, and exploration for and extraction of natural resources.

Domiciliaries of France working overseas for an employer based in France who do not qualify for exemption under either of these two conditions are taxable in France on the salary that would have been received in France for those services. Special allowances attributable to employment outside the country are not taxed; this same rule applies to French Government employees stationed abroad.

Although these exceptions to worldwide taxation are by statute granted only to French nationals, they are also available to nationals of countries with which France has an income tax treaty requiring nondiscriminatory treatment of foreign nationals. They are not available with respect to business or self-employment income or with respect to employment abroad by a foreign employer.

An individual who is neither resident nor domiciled in France but who has one or more residences in France, whether owned or rented, directly or through a third party, is subject to tax on a minimum French income of three times the rental value of the French residence(s). Where actual French source income is higher, the actual amount is the base for the tax. The tax rate applied is the rate applicable to dividends, currently 25 percent. This tax does not apply if the individual can show that he is subject to tax in another country on his worldwide income in an amount equal to at least two-thirds of the French tax on that amount. Nor does it apply to U.S. residents, under the terms of the U.S.-France income tax treaty.

Federal Republic of Germany

Germany taxes nonresidents only on their income from German sources, with the exception that, beginning in 1975, German citizens (and relatives belonging to their households) who are employed abroad by a German public (governmental) entity are subject to tax on their worldwide income if the country in which they reside taxes them only on income arising in that country.

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German nationals who emigrate to a low tax country but retain significant commercial interests in Germany may be taxed more heavily than other nonresidents on their German source income for ten years. (The United States has a similar provision applicable to former citizens.)

In general, Germany taxes residents on their worldwide income. An individual is considered to be a resident if he has his domicile or his principal place of abode in Germany, whether or not he is physically present in Germany. Domicile is defined as the place an individual resides under circumstances leading to the conclusion that he will continue to use his residence there. A principal place of abode is where a person is located under circumstances that show more than a temporary presence. Any individual who is physically present in Germany for more than six months of the tax year is generally considered to be a resident from the beginning of the tax year.

However, a resident who is employed abroad for more than three months but not more than two years in the construction, operation or repair of plant or equipment or in exploring for or extracting natural resources is exempt from tax on the foreign earnings for those services.

Where exemption does not apply, an allowance for the overall added cost of living abroad may be excluded from the tax base. The amount excludable is fixed by the government and based on the cost of living differential allowed to government employees at the foreign location.

Japan

Japan taxes individuals who are neither resident nor domiciled in Japan only on their Japanese source income.

In general, Japan taxes individuals who maintain their domicile ("jusho") in Japan on their worldwide income, whether or not they reside in Japan. Domicile is determined on the basis of facts and circumstances which indicate that the individual intends and has taken actions to make his habitual home in Japan.

However, Japan provides special tax relief to certain residents who work abroad. When a Japanese domiciliary works outside the country as an employee, he is not taxed on special allowances paid him to compensate for higher price levels abroad or to compensate for extra costs incurred to maintain his living standard, allowances which do not put him in a more beneficial position than he would have enjoyed in Japan. This

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exclusion is only available where such allowances are received; it would not, for example, be applicable in the case of self-employed persons.

United Kingdom

The United Kingdom taxes nonresidents only on their U.K. source income, which includes income derived on the U.K. continental shelf.

In general, the United Kingdom taxes individuals who are domiciled or resident in the United Kingdom on their worldwide income. However, individuals who are resident but "not ordinarily resident" are only taxable on remuneration for services performed abroad for a foreign employer to the extent that the earnings are remitted to the United Kingdom. Remuneration for services performed in the United Kingdom for a foreign employer are taxed on one half of the amount net of expenses or on three-fourths if the recipient was a resident of the United Kingdom for nine of the ten preceding years. Individuals who are "ordinarily resident" are in principle taxed at the normal rates on their worldwide income, with the exceptions noted below.

"Ordinary residence" is not defined in the Tax Acts, but as interpreted by the Courts it involves the intention and evidence of habitual residence in the United Kingdom. A person can be ordinarily resident in the United Kingdom while physically absent for the entire year. Persons moving to the United Kingdom are treated as ordinarily resident as of the third year of their arrival or from the date of arrival if there is a clear intent to take up permanent residence or to remain at least three years.

An individual who is ordinarily resident in the United Kingdom and who performs personal services outside the United Kingdom as an officer or employee is exempt from U.K. tax on the remuneration for such services if the individual remains outside the United Kingdom for at least 365 days, including return visits for not more than 1/6 of the number of days from the first departure from the United Kingdom, and in any event, for not more than 62 continuous days in the 365 day period. Thus, when the individual has been absent from the United Kingdom for 60 days, he may return for 10 days, and on returning abroad may count his period of absence as 70 days. After another 20 days abroad, he would be allowed to return for 5 more days (1/6 x 90 = 15 - 10 = 5) without interrupting his period of qualification toward the 365 days. Where a person qualifying for the exemption also performs some services within the United Kingdom, the portion of compensation

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qualifying for the exemption as earned abroad is defined as reasonable compensation for the duties performed abroad.

Employees who do not qualify for the full exemption may deduct 25 percent of their foreign earned income if they spend at least 30 days working outside the United Kingdom during the tax year (including days off in a full work week) or have a separate employment with a nonresident firm for which they perform services wholly outside the United Kingdom (with no minimum time period).

The deduction is also available to persons ordinarily resident in the United Kingdom who carry on a trade or business abroad or who are self-employed. Such persons may deduct 25 percent of their foreign earnings if they derive income from a trade or profession carried on wholly outside the United Kingdom, or if they perform services through a nonresident partnership. Losses from a foreign business or profession (reduced by 25 percent if the 25 percent deduction applies to profits) may be offset against other foreign earned income of the same or the following year or subsequent profits of the same business or profession. Foreign losses may not reduce income from U.K. sources.

The 25 percent deduction is computed by taking 25 percent of a reasonable amount for the foreign services gross of any special overseas allowances and tax equalization payments but after otherallowable business expense deductions. For persons who work both in the United Kingdom and abroad for the same employer or for related companies, the "reasonable amount" of foreign earnings is initially presumed to be that portion of the annual earnings which the days worked overseas bears to the total days worked.

United States

The United States taxes individuals who are neither residents nor citizens only on their U.S. source income. Like Germany, the United States continues for a period of 10 years to tax certain nonresident former citizens (in Germany it is former residents) on U.S. source income, defined more expansively than for other nonresidents, at the rates applicable to citizens.

In general, the United States taxes residents and nonresident citizens on their worldwide income. Residence depends on the intent and actions of the individual with respect to making his home in the United States. Relevant factors include the terms of his visa, length of stay, and ties in the community.

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However, the United States provides special tax relief to certain residents and citizens who work abroad. Citizens who are bona fide residents of a foreign country for at least a full taxable year and citizens or resident aliens who are physically present outside the United States for at least 510 days in an 18 month period may deduct from the tax base certain added expenses incurred abroad for housing, education, general cost of living differentials, and home leave travel. Those in hardship areas may deduct an additional $5,000 per year. Employees living in camps in hardship areas may elect, instead of the special deductions for excess costs and hardship conditions, to exclude $20,000 of foreign earned income plus the value of the meals and lodging furnished by the employer. To qualify as a camp, the housing must be substandard and in a remote area where satisfactory housing is not available on the local market.

The deductions or exclusion are not limited to cases where the employer pays allowances. The deductions are also available to self-employed persons and persons engaged in business, on the portion of profit attributed to their labor.

Summary

Bona fide foreign residents

The United States provides tax relief to Americans employed abroad who qualify under either of two categories: as bona fide foreign residents or as physically present in one or more foreign countries for a prescribed time period. Under current law, the relief is generally the same for both groups, but in the other countries reviewed here, a similar distinction results in different tax treatment.

An individual who permanently leaves his home in Canada, France, Germany, Japan or the United Kingdom, moves with his family to another country and takes up permanent residence there will not be subject to tax by his country of former residence on income derived outside its territory. The exemption is a result of abandoning residence or domicile. In contrast, for an American, comparable exemption from U.S. tax on foreign income requires giving up U.S. citizenship.

Physical presence abroad

An individual who moves from one of the above-mentioned countries but leaves his family there, retains a home there, or otherwise indicates an intention to resume residence there in the future generally does remain subject to the tax

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jurisdiction of his country of former residence. However, the tax imposed is typically lower than the tax applicable to residents.

The degree of relief varies. An individual who works abroad but continues to be a Canadian resident for Canadian tax purposes is taxed on the same basis as residents who are physically present in Canada. On the other hand, an individual who is "ordinarily resident" in the United Kingdom and works abroad is fully exempt from U.K. tax on his foreign earnings in some cases and is allowed a 25 percent deduction in other cases. France and Germany exempt from tax the foreign earnings of individuals who work abroad in selected activities, such as construction and oil exploration and extraction.

In other cases, France taxes the salary which would have been received if the individual were working in France, exempting special allowances received for overseas employment. Germany and Japan exclude from the tax base certain overseas allowances which compensate for added living costs abroad.

The United States allows special deductions for certain added living costs abroad, applicable to both bona fide foreign residents and those physically present in one or more foreign countries the requisite time. Employees living in camps in hardship areas may elect instead to exclude $20,000 of foreign earned income and the value of lodging and meals furnished by the employer. Given that such individuals typically earn more than $20,000 a year, the U.S. approach is almost always less generous than exemption; depending on the foreign living costs, it may be comparable to the approaches which exclude certain allowances or provide a flat deduction.

The different national provisions are summarized in the chart on the following page.

FAIRNESS AND COMPETITION

Fairness

One major goal of an income tax is equity, or fairness, in the sense of equal treatment of persons with equal incomes and in equal circumstances. But the perception of equity depends on who is being compared.

For many countries, the relevant comparison is among residents. Such countries do not tax the foreign income of nonresidents. Thus, individuals residing in the same country

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Conditions Under Which Foreign Income Is Exempt From Tax
or Receives Special Relief

Country	All Foreign Income: Complete Exemption of Foreign Source Income	Special Relief Limited to Foreign Employment Income: Exemption of Foreign Employment Income	Special Relief Limited to Foreign Employment Income: Reduced Taxation of Foreign Employment Income
nada	nonresidents	no	no
ance	nondomiciliaries	sent abroad by a French employer for more than 183 days in 12 consecutive months and engaging in selected activities; or if foreign tax = 2/3 of French tax	base salary only
ermany	nonresidents (not domiciled or usually resident)	abroad more than 3 months but less than 2 years and engaging in selected activities	a specified cost of living allowance is exempt
apan	nondomiciliaries	no	net of cost of living allowances
ited Kingdom	nonresidents and nondomiciliaries	if work abroad more than 365 days	taxed on 3/4 if abroad more than 30 days
ited States	nonresident aliens	no	deductions for certain added foreign living costs; $20,000 alternative exclusion in certain camps

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face the same tax rules, regardless of their nationality or domicile. Canada and the United Kingdom follow the residence criterion; but, as noted above, both extend the meaning of residence to include certain persons living abroad who maintain significant ties to the home country, and Canada imposes a tax on departing residents.

For other countries, the relevant comparison is among domiciliaries, a somewhat broader concept than residence. Japan, France, and Germany use this approach, although France and Germany exempt nonresident domiciliaries who are employed abroad in certain activities.

For the United States the relevant comparison is among citizens. Thus, a U.S. citizen residing abroad is, like a U.S. resident, subject to U.S. income tax on his worldwide income (with certain adjustments in the case of foreign earned income), rather than being taxed like a nonresident alien only on income from U.S. sources. Income taxes paid to foreign countries on foreign income may be credited against the U.S. tax on that income.. As a result, a U.S. citizen whose foreign income tax liability is as high as or higher than the U.S. tax will have no net U.S. tax liability and will be in the same position as other nationals in that country. But U.S. citizens whose foreign income tax is lower than the U.S. tax will have to pay an additional tax to the United States beyond the income tax liability of other nationals in that foreign country. For Americans living abroad who tend to compare their tax burden with that of their immediate neighbors and colleagues, this situation is not perceived as equitable.

Is it fair to ask Americans living abroad where the local income tax is less than the U.S. tax to pay more than other nationals living there? The defense of citizenship basis taxation rests on the belief that U.S. citizenship confers benefits independently of residence. It is not necessary that the amount of benefit received be reflected precisely in the amount of tax charged. Income tax liability is measured by ability to pay, not, like a user charge, by the amount of services used during the tax year. But benefit is an important consideration in the scope of an income tax. Taxing the income of nonresident citizens is justifiable only if they derive significant benefit from their U.S. citizenship.

The infrequency with which U.S. citizenship is renounced suggests that it does have value even for permanent residents of other countries. At a minimum it assures the right to re-enter and remain in the United States. Many, probably most, Americans abroad are there temporarily; i.e., they

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retain a U.S. domicile. For them, the benefits of U.S. citizenship are more extensive. Typically, they grew up and attended school in the United States, their children may attend U.S. colleges, and they expect to return to the United States eventually. They derived benefits from U.S. Government expenditures while in the United States at a time when their income, and therefore their income tax, was generally relatively low, and they will derive benefits as residents again when they return. Moreover, even during the period of nonresidence, there is no fixed pattern of distribution of benefits. For example, the benefits of government spending on education and police and fire protection, which are derived largely by residents, are financed largely by state and local governments, which tax on a residence basis and not on the basis of citizenship; while the principal Federal expenditures, for defense and social security programs, benefit nonresident citizens as well.

It may be worth noting that changing to residence basis taxation would not be an unmitigated blessing to Americans abroad. If the practice of other countries were followed in defining residence or domicile in terms of permanent home rather than present location, most Americans employed abroad would continue to be treated as residents or domiciliaries. Special rules would be needed to exempt their foreign income. Alternatively, if residence were defined more narrowly, for example, by treating Americans absent from the United States for 17 out of 18 months as nonresidents for tax purposes, their tax on U.S. income could increase. Nonresidents are subject to U.S. tax at 30 percent of the gross amount of certain U.S. source income such as dividends, interest, and royalties. Income tax treaties generally reduce this rate reciprocally, and are in effect with most industrial countries. But there would be cases where U.S. nonresident citizens, if taxed like nonresident aliens, would incur a heavier tax than at present on their U.S. investment income.

Competition

Income tax systems frequently depart from the equity objective in specific instances to achieve other desirable goals. An income tax which provides incentives to expatriate employees, relative to other expatriates and to residents, is generally justified on the grounds of export promotion.

One consequence of taxing the foreign income of nonresident citizens is that, when those individuals live in a country where the income tax is lower than in the home country, they will have a higher tax burden than their neighbors, who are subject only to the lower host country

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income tax. Thus, they will either be more costly to employ or less willing to work abroad. In either case, it is argued, exports will suffer. Firms which hire the more expensive employees will lose contracts to firms using the cheaper labor, which can, accordingly, submit lower bids. Firms which hire the cheaper foreign nationals will find themselves using more foreign materials as well, as their employees will turn to suppliers in their own countries with which they are more familiar. For these reasons, some take the position that the United States should give up citizenship basis taxation, at least in the case of Americans employed abroad, in the interests of promoting U.S. exports.

Subsidiary reasons advanced for providing incentives to Americans to work abroad are that overseas employment increases the total volume of employment available to Americans and generates greater international understanding and good will. Sending Americans to work abroad expands the total employment of Americans only if there is a domestic surplus of the skills of those who go abroad to work so that they would otherwise be unemployed or would replace other domestic employees, making the latter unemployed. From time to time this may be the case in certain employments, teaching for example, but Americans working abroad have a variety of skills. Many Americans employed abroad by U.S. multinationals have supervisory skills which are not in excess supply at home. Employment of Americans abroad may or may not generate good will. It would be inaccurate to generalize. In some environments, the presence of Americans abroad has a favorable impact; in other environments, the impact may be negative. In any event, there is no evidence that American employees abroad have an advantage in this respect over Americans abroad in other capacities, as permanent residents, invited visitors, or travellers.

Thus, the principal argument for tax exemption of Americans employed abroad is export promotion. Given that objective, exempting from tax the foreign earnings of Americans employed abroad is one possible policy tool, which should be evaluated and compared with other possible alternative measures.

A case where the impact of present U.S. tax policy on exports could be significant is in labor intensive industries operating in low tax jurisdictions. One such example is the construction industry in Saudi Arabia (where foreign employees are not subject to any local income tax). In such cases, the added U.S. tax cost could increase the total cost of the project by an important margin. If equally competent foreign nationals can be hired without the added tax cost, they will

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tend to replace Americans in such situations. And if foreign suppliers can produce goods of equal quality at no higher price than U.S. firms, the employment of foreign nationals will reduce U.S. exports as the foreign nationals direct orders to the firms they know best. This type of situation gave rise to a special relief provision in the U.S. Foreign Earned Income Act of 1978. The provision of section 911, as amended, which allows employees living in camps in hardship areas to exclude $20,000 of foreign earnings, plus the value of lodging and meals furnished by the employer, was intended to benefit the construction industry abroad, especially in the high cost, low tax Middle East. Unusual hardship was also an important factor in enacting this provision. Similar concern is reflected in the provisions of French and German law exempting employees engaged in construction work abroad.

But it is not clear how prevalent this type of situation is, or what its impact is in terms of overall exports (even assuming no offsetting changes such as exchange rate adjustments). Americans employed abroad engage in many activities, some of which may be entirely export related and others of which may have no connection with exports. For those in export activities, the added U.S. tax cost may cause a significant increase in the export price or it may have an insignificant effect. And the employment of foreign nationals rather than Americans will divert demand to foreign rather than U.S. suppliers (and conversely, the employment of Americans will result in orders to U.S. suppliers) only if the foreign and U.S. equipment are very good substitutes in terms of both quality and price. A competent engineer or purchasing agent will not write specifications or place orders for inferior supplies or be ignorant of differences in quality.

One approach to evaluating tax exemption of some or all expatriate American employees as an export incentive would be to gather more information on the export impact of Americans employed abroad; for example: precisely how many Americans are employed abroad; what they do; in which countries their local income tax is below their U.S. tax; how much the added U.S. tax increases the export price; and how much exports would be likely to increase if there were no U.S. tax. A related consideration is the significance of the non-tax costs of hiring Americans; how would the cost of hiring Americans compare to the cost of hiring third country nationals if there were no U.S. tax on foreign earnings? Other aspects to be considered include the effects of such other U.S. rules as the anti-boycott and anti-bribery regulations. Is the availability of credit and insurance a constraint on U.S. exports? How effective are the marketing efforts of the U.S. firms themselves? Gathering the necessary data and

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disentangling these various strands would be a complicated assignment. It is further complicated by the fact that the new rules of income tax treatment of Americans working abroad introduced by the Foreign Earned Income Act of 1978 were fully effective for the first time in 1979.

A more limited approach would be to identify activities which can be shown to be export sensitive and to devise selective incentives for the targeted areas. As indicated earlier, construction appears to be the primary area of concern. Even in such cases, however, further tax relief should be compared with direct spending alternatives. (One obvious drawback to the use of tax relief is that it entrusts to the Internal Revenue Service decisions which are outside its area of expertise. For example, the special "camp" provision of section 911 of the Internal Revenue Code as amended by the Foreign Earned Income Act of 1978, requires the Internal Revenue Service to administer a program of aid to the overseas construction industry, a field in which the Commerce Department, not the IRS, has expertise.)

The studies done to date on the issue of Americans employed abroad do not permit conclusive policy judgements on what changes, if any, would most effectively encourage exports. 1/ Moreover, they all predate the Foreign Earned

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1/ In February 1978, the Treasury Department published a report "Taxation of Americans Working Overseas: Revenue Aspects of Recent Legislative Changes and Proposals" which analyzed the 1975 tax returns filed by Americans claiming the foreign earned income exclusion under section 911 and compared the effect by income level and geographic area of various alternative tax rules.

Also in February 1978, the General Accounting Office published "The Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas," which included both the results of interviews with affected taxpayers and employers and of an econometric study using a model of Data Resources, Inc. (DRI). The DRI model indicated that repeal of the relief for Americans employed abroad would increase the value of U.S. exports because the drop in demand would fail to offset the increase in price. The methodology of this model has been widely criticized.

In April 1978, the Congressional Research Service of the Library of Congress issued "U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis" by Jane G. Gravelle and Donald W. Kiefer (Report 78-91E) which evaluated section (continued)

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Income Act of 1978. That law requires the Treasury Department to report to Congress on the operation of the new provisions, beginning with the tax returns filed for 1979 and at two year intervals thereafter. The report will seek to identify, to the extent the data permit, the economic effects as well as the revenue cost of the new provisions.

A Task Force of the Subcommittee on Export Expansion of The President's Export Council issued a report on December 5, 1979, which makes three recommendations on the taxation of expatriate Americans:

"1) Regulations and interpretations in force under the current tax law concerning Americans living in camps in hardship areas (Section 911) should be simplified and made less restrictive, in keeping with the intent of Congress.

2) The current tax law concerning allowances to employees for excess living costs incurred while working abroad (Section 913) should be interpreted in the least restrictive and simplest manner.

3) Work should begin immediately to encourage enactment of a new tax law to put Americans working overseas on the same tax footing as citizens from competing industrial nations."

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911 and various alternative proposals on the basis of tax neutrality, equity and national economic goals. The study found that tax incentives to Americans to work abroad appear to occur at the expense of other Americans and that the impact on exports is indirect, temporary and small.

In August 1978, the Commerce Department issued, "U.S. Policy Toward the Taxation of Foreign Earnings of U.S. Citizens," by Dr. Roy Blough, which reviews the various policy considerations and concludes that incentives to meet competition by third country nationals can be justified as analagous to "anti-dumping" measures, but that relief for hardship conditions is not justified on competitive grounds and too difficult to measure to adjust for on equity grounds.

In October 1978, the Treasury Department issued "The American Presence Abroad and U.S. Exports" by Professor John Mutti, which attempts to quantify the "buy American" factor of the presence of U.S. nationals abroad and tentatively concludes that such presence does have a significant impact on exports. The author cautions that his results are preliminary, and do not directly address the tax factor.

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The first recommendation is well taken. The proposed regulations were too restrictive. The temporary regulations issued on December 31, 1979, are substantially less restrictive and are believed to accurately reflect the intent of Congress in directing special relief to this situation.

The second recommendation is also being followed. The law is complex and highly detailed in this area, so the regulations have little flexibility. But the comments received are being carefully considered in preparing the revised regulations. And improvements have already been made in the cost of living calculations.

The third recommendation, that Americans working overseas be taxed more lightly, if at all, is expressed in general terms. It assumes that tax exemption would reduce U.S. export prices, prompting an increase in demand sufficient to make a significant increase in the value of U.S. exports. As noted above, the evidence to date does not support this assumption. Any such proposal should be compared with other tax or non-tax measures in terms of likely effectiveness and relative simplicity. Most U.S. export activity takes place in the United States, so measures to reduce domestic taxes or costs of production may be more effective and preferred by exporters. Non-tax measures have administrative advantages. Selective tax exemption for certain overseas earnings may be beneficial to exports if targeted to be cost effective, but the impact may not be large enough to appreciably improve the overall U.S. export position.

Some relevant documents

Canada: Income Tax Act, Sections 114 and 212, and Regulation Section 105. Canadian Tax Reporter, published in the United States by Commerce Clearing House; A.B. McKie, "Canadian Tax Commentary: A Question of Residence," The Tax Executive Vol. XXVII, No. 3, April 1975, pp. 263-274. (Published in Washington D.C. by the Tax Executives Institute)

France: Law 76-1234 of December 29, 1976, (Journal Officiel of December 30, 1976).

Germany: Income Tax Law, Section 6, paragraphs 34 and 50; U.K. Board of Inland Revenue, Taxes Outside the United Kingdom, published in the United States by Commerce Clearing House.

Japan: Income Tax Law, Article 9(1)(vii); "An Outline of Japanese Taxes, 1979."

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United Kingdom: Finance Act of 1977, Schedule 7; Inland Revenue publications 10 and 25.

United States: Internal Revenue Code sections 911 and 913; Internal Revenue Service publication 54.

See also the studies cited in footnote 1, pp. 20 and 21.

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Actions Undertaken on Recommendations Set Out
in the President's Report to the Congress
of August 27, 1979
Equitable Treatment of United States Citizens
Living Abroad

1. Loss of Citizenship Guarantees by Children When Parents File for Foreign Citizenship Abroad

The August 1979 report recommended a change in Section 349 of the Immigration and Nationality Act which now provides that a citizen, who, while under the age of 21, acquires foreign nationality upon an application of a parent or through naturalization, will lose United States citizenship if he or she fails to enter the United States to establish a permanent residence prior to age 25.

The Justice Department will reiterate its support of a change in Section 349 which would provide that loss of nationality shall occur only when a citizen applies for naturalization in a foreign nation on his own behalf after the age of 21. The Department will work with the Congress toward enactment of this provision in the current session of the Congress.

2. Transmission of Citizenship to Children Born Abroad

The August 1979 report recommended a change in Section 301 of the Immigration and Nationality Act which now limits the ability of citizens to transmit citizenship to children born abroad by, among other things, stipulating that a citizen parent must have been physically present in the United States for ten years for his or her child to receive United States citizenship.

The Justice Department will reiterate to the Congress its support of legislation reducing the requirement for the parent of physical presence in the United States to two years. The Department will work with the Congress toward enactment of this provision during the current session of Congress.

3. Military Postal Service (MPS) Privileges for Certain Schools Sponsored by Americans Abroad

The August report recommended the services of the MPS be provided American sponsored schools having dependents of military and civilian employees of the United States.

The Departments of State and Defense have notified all United States diplomatic missions that American sponsored schools having dependents of United States Government employees enrolled are authorized to use the MPS for first class mail weighing less than sixteen ounces and

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containing official school correspondence, test materials, student records, etc. In addition, such schools can seek full APS service upon exceptional circumstances.

4. Vocational Rehabilitation Benefits to Veterans Living Abroad

The August 1979 report pointed out that the Administration had proposed legislation to remove certain limiting provisions of current law which inhibit veterans from obtaining vocational rehabilitation training abroad. The House of Representatives has favorably acted on the matter in H.R. 5288 and the Senate will soon consider the Administration's proposal in S. 1138.

The Veterans Administration intends to work with the Congress toward enactment of these bills during the current session of the Congress.

5. Seven-day Earnings Tests for Social Security Beneficiaries Abroad

The August 1979 report pointed out that the Administration had proposed legislation to change the seven-day a month post-retirement work test to a 45-hour work test is being sought from the Congress as part of the Administration's proposed Social Security Amendments of 1979. The change in law would permit beneficiaries engaged in non-covered employment outside the United States to work up to 45 hours a month without having their benefits reduced.

The Department of Health and Human Services will actively seek enactment of this change in law during the current session of the Congress.

6. Social security protection for Americans abroad

The August 1979 report recommended that international bilateral agreements (called "totalization agreements") be entered into with foreign countries so that gaps in U.S. social security protection for American citizens working outside the United States may be remedied. Under these agreements, coverage and earnings of nationals of both countries may be combined to establish benefit eligibility, and increase benefit amounts, while dual coverage and taxation of the same work (which now occurs frequently) is eliminated.

Agreements with Italy and the Federal Republic of Germany are in effect and an agreement with Switzerland will be submitted to Congress in early 1980. Discussions with Canada, Belgium, Denmark, Finland, France, Iceland, Israel, Japan, Spain Sweden and the United Kingdom are underway, and initiation of discussions with other countries is being considered.

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