U.S. SENATE COMMITTEE ON

Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

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Background Fact Sheet on Section 911
Prepared by Chairman Grassley's Finance Committee Staff

In General

Section 911 provides a tax subsidy for U.S. citizens who work abroad and for employers who send employees to work overseas. The question is how much of a subsidy the tax code should provide. Section 911 was amended by the *Tax Increase Prevention and Reconciliation Act of 2005* ("*TIPRA*").

U.S. citizens are generally taxed on their worldwide income. To avoid double taxation, U.S. tax on foreign income can be offset by a foreign tax credit. Except as provided in section 911, personal housing costs are not deductible, and if they are paid or reimbursed by an employer, they are taxable income.

However, section 911 allows citizens working and living abroad to (i) exclude all or a portion of their compensation; and (ii) exclude from taxable income housing costs paid or reimbursed by an employer over a base amount (or deduct unreimbursed housing costs). The aggregate amount excluded or deducted cannot exceed an individual's foreign compensation for personal services actually rendered.

According to IRS statistics, 306,393 tax returns claimed the section 911 foreign earned income exclusion in 2003. Of those returns, only 125,894 actually had any U.S. tax liability after the exclusion.

Many employers offer their overseas employees "tax equalization" packages under which the employer guarantees that the employees will not pay more taxes working overseas than they would pay if they were working in the U.S. This is where section 911 reduces the cost to employers. The amounts excluded under section 911 for compensation and housing would be fully taxable to the employee in the U.S. Thus, the section 911 exclusion relieves the employer from reimbursing the employee for U.S. tax on those amounts. In this respect, section 911 is a tax subsidy for the cost of sending an employee overseas.

It should also be noted that U.S. employees working overseas may receive other taxable benefits. These could include private school education for their children, car allowances, and other amenities.

Prior Law

Prior to *TIPRA*, the maximum amount of compensation that could be excluded was $80,000. Housing costs could be deducted or excluded to the extent they exceeded 16 percent of the annual salary earned by a GS-14, Step 1, U.S. government employee ($77,793 for 2006). There was no

upper limit on deductible or excludable housing costs; the only requirement was that they be "reasonable", a term that was subject to aggressive interpretation by taxpayers and allowed highly compensated individuals to exclude large amounts of housing benefits.

Individuals working abroad also benefited from lower income tax rates on their income that was not excluded – rates that ordinarily apply to individuals with substantially less economic income. These lower rates would apply even to U.S. source income.

***TIPRA* Changes**

TIPRA amended section 911 in three principal ways:

First, the $80,000 compensation exclusion is indexed for inflation starting in 2006 (instead of 2008, under prior law). Thus, the exclusion for 2006 is increased to $82,400.

Second, the housing cost exclusion (or deduction) now has an objective cap – 30 percent of the taxpayer's maximum compensation exclusion. This standard is based on what the U.S. Department of Housing and Urban Development considers maximum affordable housing costs in certain programs, including grant-making to subsidize rents.

Housing costs remain subject to a base amount, which is now 16 percent of the indexed compensation exclusion. Amounts under the base amount continue to be subject to U.S. taxation, because the base amount represents an estimate of housing costs that taxpayers would incur on housing regardless of whether they decided to live and work abroad.

In recognition of varying levels of housing costs in different parts of the world, the new provision gives Treasury the authority to adjust the 30% cap based on housing cost differences relative to housing costs in the U.S.

So, Treasury can appropriately address the concerns of those living and working in higher-housing-cost locations like Hong Kong, Paris or Dubai.

Absent such guidance, the exclusion for 2006 is $11,536. So the total amount that can be excluded from income in 2006 will be $93,936.

Third, the amount of income that is not excluded is now taxed at the marginal rates that would apply without the exclusion, rather than starting at the lowest tax bracket. For example, an individual with $82,400 of excluded income and $20,000 of taxable income will be taxed at rates that apply to taxable income in the range of $82,400 to $102,400 (25% or 28%), rather than $0 to $20,000 (10% or 15%). Thus, beneficiaries of section 911 will be subject to tax at the same rates that apply to individuals with the same economic income who live and work in the U.S.

***TIPRA* Amendment is Reasonable:**

It puts a reasonable and objective limit on the amount of the subsidy for housing cost reimbursement exclusions or deductions.

It allows individuals living and working abroad to continue to exclude a sizable amount of income – up to $93,936 – that those living and working in the U.S. cannot exclude.

The exclusion amount (including housing) will continue to rise with inflation, and the housing cost limit is also subject to adjustment by Treasury to take into account geographic differences in housing costs relative to housing costs in the U.S.

It subjects individuals who receive section 911 benefits to the same marginal tax rates applicable to those living and working in the United States who have the same amount of economic income. No one should be in a better position with respect to non-excluded income just because the individual lives and works outside the United States.

A recent Wall Street Journal editorial characterizes the changes made by *TIPRA* as having "revoked a large chunk of [expatriates'] protection from double taxation." This assertion is incorrect. First, double taxation relief is primarily achieved by the foreign tax credit mechanism, which section 911 beneficiaries opt out of with respect to excluded amounts. Second, section 911 after *TIPRA* still allows a significant exclusion for compensation and housing costs, which provides further relief from double taxation on the excluded amounts.

Many who claim section 911 benefits are subject to foreign tax at rates much lower than U.S. tax rates, if at all. Where the foreign country does not impose any tax, or imposes very low taxes, section 911 actually provides for **double non-taxation** with respect to excluded amounts.

Prior to the changes made by *TIPRA*, some who claimed section 911 benefits in higher tax jurisdictions may have done so to enable them to have their U.S. source or other income subject to lower marginal tax rates than the rates that would apply without the exclusion, a benefit not available to those living and working in the U.S.

Recent History of Section 911:

In 2003, the Senate passed full repeal of section 911. It was taken out in conference committee.

In 2004, the Senate passed a provision that would have limited the total exclusion under section 911 – the aggregate exclusion for compensation and housing costs – to the $80,000 earned income limitation. It was taken out in conference committee.

Except for the Treasury authority to adjust the housing cost cap, the *TIPRA* modifications were recommended by the nonpartisan staff of the Joint Committee on Taxation in its report "Options to Improve Tax Compliance and Reform Tax Expenditures" (JCS-02-05), January 27, 2005.

Except for the Treasury authority to adjust the housing cost cap, the *TIPRA* modifications were included in Senator Conrad's Democratic substitute amendment during the floor debate on the reconciliation bill, which received the support of all Democratic senators who voted.