

TAX POLICY

Economic Benefits of Income Exclusion for U.S. Citizens Working Abroad Are Uncertain

Why GAO Did This Study

Since 1926, special tax benefits have been available for U.S. citizens working abroad. Internal Revenue Code section 911—which cost an estimated \$4.4 billion in 2013—provides a tax exclusion for foreign earned income, as well as an exclusion and deduction for foreign housing costs. GAO was asked to assess section 911.

This report (1) describes the number and types of taxpayers using the tax expenditure, and analyzes how the tax expenditure may interact with other provisions of the tax code, such as the foreign tax credit; (2) describes what is known about how the tax expenditure may affect business decisions about the employment of U.S. workers abroad, and U.S. exports; and (3) evaluates the potential advantages and disadvantages of modifying or removing the tax expenditure.

To address these objectives, GAO analyzed 2011 IRS statistical data; reviewed the tax code and relevant government and academic literature; and interviewed government officials, experts, and stakeholders, including groups representing citizens working abroad and employers. As its criteria for good tax policy, this report uses GAO's tax expenditures evaluation guide, *Tax Expenditures: Background and Evaluation Criteria and Questions*, GAO-13-167SP.

What GAO Recommends

GAO made no recommendations in this report. IRS and Treasury provided technical comments that were incorporated as appropriate. Commerce said it had no comments.

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What GAO Found

For tax year 2011 (the most recent data available), an estimated 445,000 tax returns claimed the foreign earned income exclusion (FEIE), which is 0.3 percent of all individual tax returns filed. About 17 percent of FEIE filers also claimed the foreign housing exclusion or deduction. Over half of FEIE filers reported working for a foreign employer, and less than one-third reported working for a U.S. company; the balance reported working as self-employed or for other entities. Taxpayers were able to exclude from taxable income about \$30 billion in foreign earned income and housing costs, with about 45 percent excluding all or most of their foreign earned income. The FEIE reduces the tax liability of U.S. taxpayers working abroad even if they paid no foreign income taxes to another country. U.S. taxpayers in higher tax countries can eliminate their U.S. tax liability using the foreign tax credit, which is intended to prevent double taxation when foreign income is taxed by both the United States and a foreign country.

While tax costs could influence employment for some U.S. workers overseas, there is little evidence the tax expenditure affects exports. A few studies have asserted the tax expenditure benefits U.S. exports. For example, this would happen if the expenditure encouraged U.S. companies to hire more Americans abroad by making it cheaper for them to do so, and if Americans working abroad promoted exports through the nature of their work and other activities. The extent to which the tax expenditure influences employment of U.S. workers abroad and U.S. exports depends on several factors, including the role of tax-related costs in hiring decisions and whether workers are involved in activities contributing to U.S. export promotion. Experts and stakeholders GAO interviewed expressed differing views on the emphasis employers place on specific overseas hiring factors. While about half of those GAO interviewed said that employers make overseas hiring decisions based first on the candidates' qualifications, or that the cost of prospective employees was not a primary consideration, about half also told us the added tax costs of employing U.S. citizens could influence some employment decisions. Most experts interviewed stated that the tax expenditure's effect on exports is likely small at most.

In terms of good tax policy, there is room for debate regarding how potential revisions to the current tax expenditure may affect choices about where to work and who to hire. The current tax expenditure may have positive and negative effects on both the efficient allocation of labor resources and on equity. The magnitude of these effects is unknown, making it unclear whether the tax expenditure provides any net economic benefits. These uncertainties also make it difficult to draw definite conclusions about certain policy alternatives. Repealing the tax expenditure would reduce the tax inducement for U.S. citizens to relocate to lower tax countries, but would also make U.S. citizens more costly for any employer to hire than citizens of most other countries, which do not tax foreign earned income. Removing the maximum limit (\$99,200 for 2014) for the exclusion would eliminate the tax cost differential with other countries, but would allow high-income individuals to avoid U.S. taxes on foreign earned income. Targeted tax relief may be justified for extreme cost of living areas, and the design of any alternative would affect the complexity for taxpayers and the Internal Revenue Service (IRS), as well as the federal tax cost.