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Report to Congressional Requesters

May 2014

TAX POLICY

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

GAO-14-387

GAO Highlights

Highlights of GAO-14-387, a report to congressional requesters

May 2014

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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.

View GAO-14-387. For more information, contact James R. McTigue, Jr. at (202) 512-9110 or mctiguej@gao.gov.

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.

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Abbreviations

AGI	adjusted gross income
CBO	Congressional Budget Office
Commerce	Department of Commerce
CRS	Congressional Research Service
FEIE	foreign earned income exclusion
FTC	foreign tax credit
IRC	Internal Revenue Code
IRS	Internal Revenue Service
JCT	Joint Committee on Taxation
OMB	Office of Management and Budget
SOI	Statistics of Income
Treasury	Department of the Treasury

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

May 20, 2014

The Honorable Jim McDermott
House of Representatives

The Honorable Michael Honda
House of Representatives

The Honorable Carolyn Maloney
House of Representatives

The United States taxes its citizens on their worldwide income, regardless of where they reside. Since 1926, certain special tax benefits have been available for U.S. citizens working abroad. Section 911 of the Internal Revenue Code (IRC) permits a tax exclusion for foreign earned income, as well as an exclusion or deduction for foreign housing costs. Because section 911 reduces income tax liability through special tax provisions, both the Department of the Treasury (Treasury) and the Joint Committee on Taxation (JCT) identify section 911 as a tax expenditure. The costs and benefits of this tax expenditure have been the subject of policy and economic discussion. Some have defended the tax expenditure on the grounds that it enables U.S. workers overseas to better compete for jobs with non-U.S. foreign nationals (who typically pay no taxes on overseas earned income) and that it thereby encourages the overseas employment of Americans, who play an important role in promoting exports. However, others have highlighted that some of these claims lack evidence, or are based on outdated assumptions, given changes in the global economy over the past several decades. From a tax policy perspective, some have debated whether or not the tax expenditure provides economic and other benefits to the United States when compared to its costs.

Our previous work has shown that, once enacted, tax expenditures—special tax credits, deductions, exclusions, exemptions, deferrals, and preferential tax rates—and their relative contributions toward achieving federal missions and goals are often less visible than spending programs, which are subject to more systematic review.[1] One reason for this is that

[1]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005), and *Tax Policy: Tax Expenditures Deserve More Scrutiny*, GAO/GGD/AIMD-94-122 (Washington, D.C.: June 3, 1994).

in practice, tax expenditures often operate like entitlement programs not subject to annual appropriations. Since 1994, we have recommended greater scrutiny of tax expenditures, as periodic reviews could help determine how well specific tax expenditures work to achieve their goals and how their benefits and costs compare to those of spending programs with similar goals. In prior reports, we have described how program evaluations could be conducted to measure progress toward achieving a program's intended purpose.[2] Even if a tax expenditure is meeting its intended purpose, broader questions can be asked about its effects beyond that purpose. Specifically, the long-standing criteria of economic efficiency, fairness, transparency, simplicity, and administrability can be used to evaluate whether a tax expenditure is good tax policy.[3]

You asked us to examine section 911—the foreign earned income exclusion (FEIE) as well as an exclusion or deduction for foreign housing costs. Specifically, 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 describe the number and types of taxpayers using section 911, we analyzed Internal Revenue Service (IRS) Statistics of Income Division (SOI) publications and obtained aggregated data tabulations for individual tax returns for tax year 2011 (the most recent year available). Our analysis of SOI statistical data is subject to sampling errors because the SOI data set is based on a sample of tax returns as filed and does not reflect IRS audit results or any net operating loss carrybacks from future

[2]See GAO, *Corporate Tax Expenditures: Evaluations of Tax Deferrals and Graduated Tax Rates*, GAO-13-789 (Washington, D.C.: Sept. 16, 2013); *Tax Expenditures: Background and Evaluation Criteria and Questions,* GAO-13-167SP (Washington, D.C.: Nov. 29, 2012); *Designing Evaluations: 2012 Revision*, GAO-12-208G (Washington, D.C.: January 2012); and *Executive Guide: Effectively Implementing the Government Performance and Results Act,* GAO/GGD-96-118 (Washington, D.C.: June 1996).

[3]GAO, *Understanding the Tax Reform Debate: Background, Criteria & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005). This report describes how the criteria can be used to evaluate tax policy.

years.[4] To assess the reliability of the data we analyzed, we reviewed IRS documentation and interviewed agency officials familiar with the data. We determined that these data were sufficiently reliable for the purposes of this report. To determine how the tax expenditure may interact with other provisions of the tax code, we reviewed the Internal Revenue Code, IRS guidance, and tax advisor literature to analyze how the tax expenditure affects eligibility for other income tax provisions.

To determine what is known about how the tax expenditure may affect business decisions about the employment of U.S. workers abroad, and U.S. exports, we reviewed related literature and available information on business practices used in employing U.S. citizens abroad, including government reports, academic literature, and surveys. We also interviewed Department of Commerce (Commerce) officials as well as nine experts and nine stakeholders.[5] (We define stakeholders as individuals or groups who may offer a valuable perspective on how the tax expenditure may affect business decisions concerning the employment of U.S. workers abroad, and exports, but who may also have a vested interest in the issue.) We selected experts based on various factors, including their affiliation with leading higher education or research institutions and their publication or research experience associated with the FEIE or related topics, such as international taxation, international business strategy, trade, or U.S. labor. One consideration in the selection process was to talk with experts whose views varied from one to another. We selected a range of stakeholder organizations that represent the interests of relevant entities, such as U.S. citizens working overseas and U.S. businesses. Appendix I provides more information on the experts and stakeholders we interviewed.

To evaluate options to modify or remove the tax expenditure, we reviewed a variety of sources, including studies by GAO, the Congressional Research Service (CRS), JCT, Treasury, IRS, the Taxpayer Advocate, and other government reports as well as academic

[4]Unless otherwise noted, all percentage estimates based on the SOI have 95 percent confidence intervals that are within 10 percentage points of the estimate itself, and all numerical estimates other than percentages have 95 percent confidence intervals that are within 10 percent of the estimate itself.

[5]In our reporting of expert and stakeholder views, we refer to “most” experts or stakeholders as representing 7 or more; “about half” as representing 4 to 6; and “several” or “some” as representing 2 or 3.

literature on the tax expenditure and related options. We also interviewed the nine experts and nine stakeholders discussed above on the advantages and disadvantages of modifying the tax expenditure. We used the tax expenditure evaluation guide we developed to evaluate the performance of the FEIE and possible options for modifying or removing it.[6] This report focuses on the guide's criteria for evaluating whether the tax expenditure is good tax policy and meets its purpose, namely,

- Does the tax expenditure generate net economic benefits for society?
- Is the tax expenditure fair and equitable?
- Is the tax expenditure transparent, simple, and administrable?
- How well does the tax expenditure achieve its purpose?

The tax policy criteria may sometimes conflict with one another; in addition, some are subjective. As a result, there are likely to be trade-offs between the criteria when evaluating a particular tax expenditure. We also considered how the federal budget is affected by the tax expenditure and how the budget would be affected by options to modify or remove the tax expenditure. We analyzed Treasury's tax expenditure estimates from 1986 to 2014, and reviewed available JCT estimates and interviewed JCT staff about the revenue effects of modifying the tax expenditure. Detailed information on our scope and methodology can be found in appendix I.

We conducted this performance audit from July 2013 to May 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The United States requires its citizens and resident aliens, regardless of where they reside, to file U.S. tax returns and pay federal income taxes

[6] GAO-13-167SP. Our tax expenditure evaluation guide outlines a series of questions and criteria that can be used to evaluate tax expenditures. To develop the questions, we reviewed our prior work on tax expenditures, tax reform, results-oriented government, and program evaluation and interviewed experts in tax policy and program evaluation. GAO-05-1009SP summarizes the long-standing criteria used to evaluate tax policy.

on their worldwide income.[7] To prevent double taxation on foreign source income, U.S. citizens and resident aliens are allowed a credit or deduction against U.S. tax for foreign income taxes paid to other countries—the foreign tax credit (FTC).[8] Under section 911 of the tax code, U.S. citizens who live and work abroad are also permitted an exclusion of foreign earned income and an exclusion or deduction of certain foreign housing costs.[9] In contrast to U.S. policy, most other countries do not tax their citizens if they reside in a country other than their country of citizenship.

Exclusion for Foreign Earned Income and Exclusion or Deduction for Foreign Housing Costs

The income that U.S. citizens and resident aliens may exclude under section 911 is generally limited to amounts earned for services performed abroad, including salaries and wages (except wages from the U.S. government[10]). It does not include income derived from capital, such as interest, dividends, capital gains, or retirement distributions.[11] To qualify for the FEIE, the U.S. citizen or resident alien's tax home[12] must be in a

[7]Permanent resident aliens are required to file U.S. tax returns on their worldwide income, generally using the same forms as U.S. citizens, regardless of where they reside. Nonresident aliens are required to file U.S. tax returns on their U.S. source income in some circumstances, using Forms 1040NR. (Forms 1040NR are counted and tracked separately.)

[8]26 U.S.C. § 901. Taken as a credit on Form 1116, *Foreign Tax Credit*, foreign income taxes reduce the U.S. tax liability dollar for dollar. Taken as a deduction on Form 1040, *Schedule A, Itemized Deductions*, foreign income taxes reduce the U.S. taxable income.

[9]This report focuses on U.S. federal income taxation. Some states also tax foreign earned income. According to tax advisor materials, among the states that tax citizens overseas are California, New Mexico, South Carolina, and Virginia.

[10]26 U.S.C. 911(b)(1)(B)(ii).

[11]26 U.S.C. § 911(d)(2).

[12]For purposes of the FEIE, "tax home" has the same meaning which it has for purposes of IRC section 162(a)(2) (relating to travel expenses away from home). Thus, an individual's tax home is considered to be located at his regular or principal (if more than one regular) place of business or, if the individual has no regular or principal place of business because of the nature of the business, then at his regular place of abode in a real and substantial sense. An individual shall not, however, be considered to have a tax home in a foreign country for any period for which the individual's abode is in the United States. Temporary presence of the individual in the United States does not necessarily mean that the individual's abode is in the United States during that time. Maintenance of a dwelling in the United States by an individual, whether or not that dwelling is used by the individual's spouse and dependents, does not necessarily mean that the individual's abode is in the United States. 26 C.F.R. § 1.911-2(b).

foreign country[13] and, if a U.S. citizen, must be a bona fide resident[14] of a foreign country or countries for an uninterrupted period which includes an entire taxable year or, if a U.S. citizen or resident alien, must be physically present in a foreign country for at least 330 days over a 12-month period.[15]

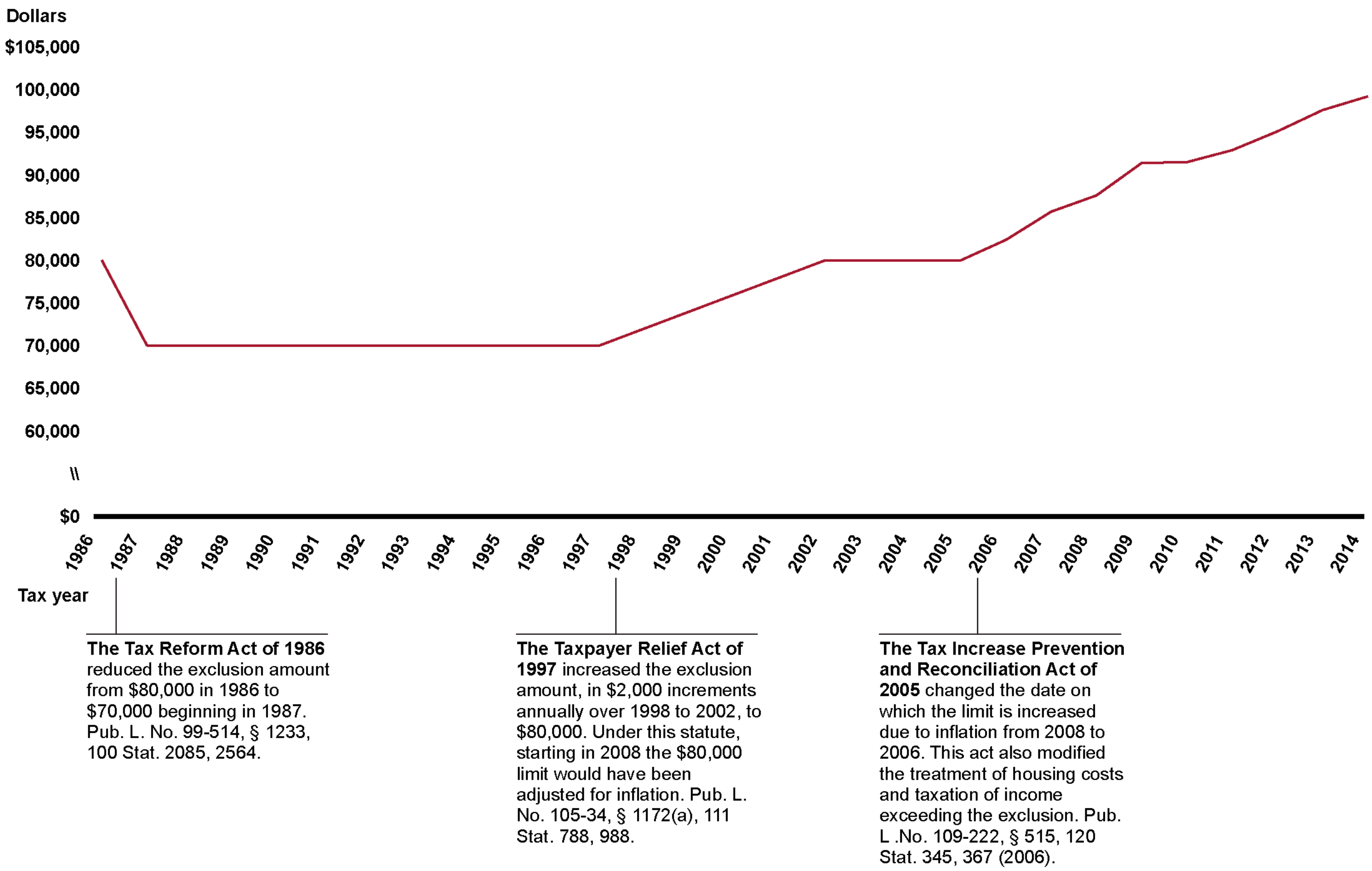
As shown in figure 1, tax legislation enacted since 1986 has changed the maximum amount of foreign earned income that can be excluded from federal income taxation. Since 2006, the exclusion amount has been indexed for inflation. For 2014, the amount is $99,200.

[13]The term “foreign country” includes any territory under the sovereignty of a government other than that of the United States. 26 C.F.R. § 1.911-2(h). For this purpose, it does not include Antarctica or U.S. possessions such as Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, the U.S. Virgin Islands, American Samoa, and Johnston Island. It also does not include international waters or the airspace above them.

[14]For purposes of section 911, residence is determined by applying, to the extent feasible, the principles of section 871 of the tax code and regulations thereunder, which involve factors including the taxpayer’s intention, establishment of a home in the foreign country for an indefinite time, and participation in the activities of the community. Bona fide residence in a foreign country or countries for an uninterrupted period may be established, even if temporary visits are made during the period to the United States or elsewhere on vacation or business. 26 C.F.R. § 1.911-2(c). An individual would not be considered a resident if a statement was submitted to the tax authorities of the foreign country indicating nonresidency and the foreign country did not subject the individual to foreign income taxation.

[15]If an individual’s tax home was in a foreign country and he or she was a bona fide resident of, or physically present in, a foreign country and had to leave because of war, civil unrest, or similar adverse conditions, the minimum time requirements specified under the bona fide residence and physical presence tests may be waived. If an individual has not met either the physical presence test or the bona fide residence test by the due date of his or her return, the individual can file his or her return timely without claiming the exclusion and then file an amended return after qualifying.

Figure 1: Effect of Tax Legislation on the Amount of the Foreign Earned Income Exclusion (1986-2014)



Source: GAO analysis of public laws.

Taxpayers claiming the FEIE may also be eligible to claim an exclusion or deduction for foreign housing costs. Taxpayers may claim the exclusion if their employers paid their housing costs, or they may claim the deduction if their housing costs were paid from self-employment earnings.[16] Housing expenses must exceed a base amount of 16 percent of the maximum FEIE for the tax year, computed on a daily basis for the number of days in

[16]The sum of the FEIE and the housing exclusion or deduction is limited to total foreign earned income.

the qualifying period that falls within the tax year.[17] For 2014, the base housing amount is $15,872 (16 percent of $99,200), or $43.48 per day. Since 2006, foreign housing expenses in excess of the base that are eligible for the housing exclusion or deduction have been limited generally to 30 percent of the maximum FEIE; however, the maximum has varied depending on the location of the home. Treasury was given the authority to raise the maximum housing exclusion to reflect actual housing costs in higher-cost foreign cities.[18]

The amendments to the FEIE in 2006 changed the taxation of income exceeding the exclusion by imposing a stacking rule. Amounts claimed under the exclusions for foreign earned income and foreign housing costs reduce taxable income, and a taxpayer does not owe U.S. income taxes on the amounts excluded. For taxpayers that have taxable income after claiming the FEIE and foreign housing exclusion, the applicable tax rate is determined by calculating taxable income without taking these exclusions into account.[19] This stacking rule results in taxpayers who claim FEIE exclusions being subject to the same marginal tax rates as taxpayers with the same level of income who are not eligible for (or do not elect to claim) the exclusions.[20]

[17]26 U.S.C. § 911(c)(1)(B). Eligible housing expenses include rent, the fair rental value of housing provided in kind by the employer, utilities (other than telephone charges), real and personal property insurance, rental of furniture and accessories, repairs, and residential parking. Expenses must be reasonable and incurred during the period eligible for the exclusion. 26 C.F.R. § 1.911-4(a), (b).

[18]Treasury updates the local maximums each year using publicly available information from the Living Quarters Allowances Tables prepared by the Department of States' Office of Allowances. See U.S. Department of State, *Summary Of Allowances And Benefits For U.S.G. Civilians Under The Department Of State Standardized Regulations (DSSR)*, accessed January 24, 2014, http://aoprals.state.gov/content.asp?content_id=134&menu_id=75. IRS publishes these amounts in bulletins. See Internal Revenue Service, *Determination of Housing Cost Amount Eligible for Exclusion or Deduction for 2013,* Internal Revenue Bulletin 2013-21 (Washington D.C.: May 20, 2013).

[19]26 U.S.C. § 911(f).

[20]For example, if a taxpayer excludes $80,000 of foreign earned income and has $20,000 in other taxable income, he will pay tax on the $20,000 at the tax rate applicable to a person with $100,000 in income rather than at the rate applicable to a person with $20,000 in income.

IRS collects data on use of the FEIE on Form 2555, *Foreign Earned Income*, filed with the taxpayer's income tax return.[21] Taxpayers who have income within the exclusion limit, are not self-employed, and do not claim the foreign housing exclusion or deduction may file the 2555-EZ. IRS publishes some aggregate information on the FEIE in its annual statistical publication.[22] Every 5 years, IRS augments its sample and publishes a mandated study with additional detail about taxpayers claiming the FEIE.[23] Prior special studies—the last study based on 2006 tax data was published in 2009[24]—show that the FEIE has been claimed on an increasing number of tax returns. IRS plans to issue the 2011 tax year study during 2014.

Treasury and JCT both calculate the estimated revenue losses for the tax expenditure assuming that all other parts of the tax code remain constant and taxpayer behavior is unchanged.[25] Both tax expenditure estimates assume that taxpayers would be allowed to use the next best tax treatment and claim the FTC. Tax expenditure estimates do not incorporate any behavioral responses and thus do not represent the amount of revenue that would necessarily be gained if the tax expenditure

[21]On a joint return, one or both spouses may have claimed the FEIE. When two spouses live apart and maintain separate households and both qualify to claim the FEIE, the foreign housing exclusion, or the foreign housing deduction, they must file two separate Forms 2555.

[22]Internal Revenue Service, *Individual Income Tax Returns 2011*, Publication 1304 (Washington D.C.: August 2013).

[23]Foreign Earned Income Act of 1978, Pub. L. 95–615, § 208. 92 Stat. 3097, 3108, as amended by the Economic Recovery Tax Act of 1981, Pub. L. 97–34, §114, 95 Stat. 172, 195–196; and the Revenue Reconciliation Act of 1990, Pub. L. 101–508, §11833, 104 Stat. 1388, 1388–560. *See* 26 U.S.C. § 911 note.

[24]Scott Hollenbeck and Maureen Keenan Kahr, *Individual Foreign-Earned Income and Foreign Tax Credit, 2006*, Statistics of Income (SOI) Bulletin (Washington D.C.: Internal Revenue Service, Spring 2009).

[25]While, in general, the tax expenditure lists Treasury and JCT publish annually are similar, they differ somewhat in the number of tax expenditures reported, and the estimated revenue losses for particular expenditures. The organizations use different (1) income tax baselines, (2) *de minimis* amounts (which is the minimum revenue loss threshold for Treasury and JCT to report a tax expenditure), and (3) economic and technical assumptions. For more information on how Treasury and JCT estimate revenue loss, see appendix III in GAO-05-690.

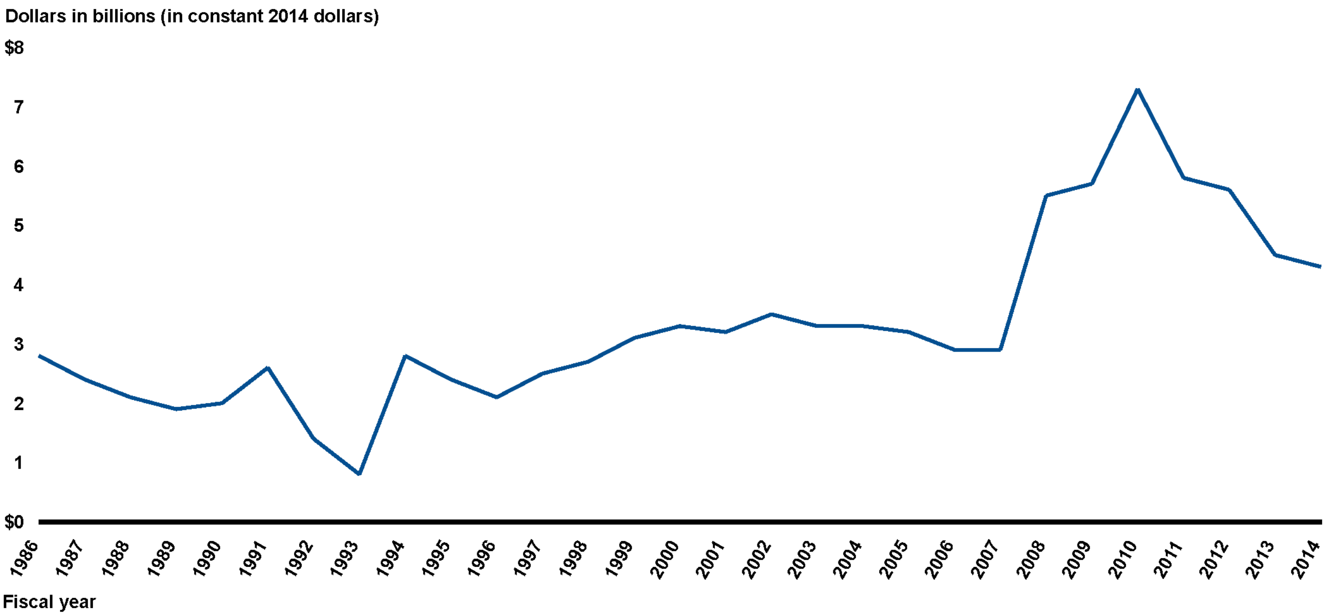
was repealed.[26] Figure 2 shows the revenue losses estimated by Treasury for the tax expenditure since 1986.[27] For 2014, Treasury estimated revenue losses of $4.3 billion (about 0.4 percent of the sum of all tax expenditures), and JCT estimated revenue losses of $5 billion for the FEIE and $1 billion for the foreign housing costs.[28] The revenue forgone through tax expenditures requires higher tax rates to raise any given amount of revenue, reduces resources available to fund other federal activities, increases the budget deficit, or reduces any budget surplus.

[26]Changes in taxpayer behavior are taken into account when Treasury and JCT prepare revenue estimates for proposed legislation.

[27]Changes in economic conditions and estimation techniques can affect revenue loss estimates for tax expenditures, making them differ from year to year. Also, legislation affecting tax rates or the tax structure affects tax expenditure estimates. When statutory rates increase, a taxpayer's ability to avoid tax on a portion of income is worth more; consequently, tax expenditures are worth more. Likewise, when rates decrease, tax expenditures are worth relatively less.

[28]Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2015* (Washington, D.C.: 2014); and Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13 (Washington, D.C.: Feb. 1, 2013).

Figure 2: Tax Expenditure Revenue Loss Estimates (Fiscal Years 1986-2014)



Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1986-2015.

Note: Changes in economic conditions and estimation techniques can affect revenue loss estimates for tax expenditures, making them differ from year to year. Also, legislation affecting tax rates or the tax structure affects tax expenditure estimates. When statutory rates increase, a taxpayer's ability to avoid tax on a portion of income is worth more; consequently, tax expenditures are worth more. Likewise, when rates decrease, tax expenditures are worth relatively less.

Employment Overseas and Exports

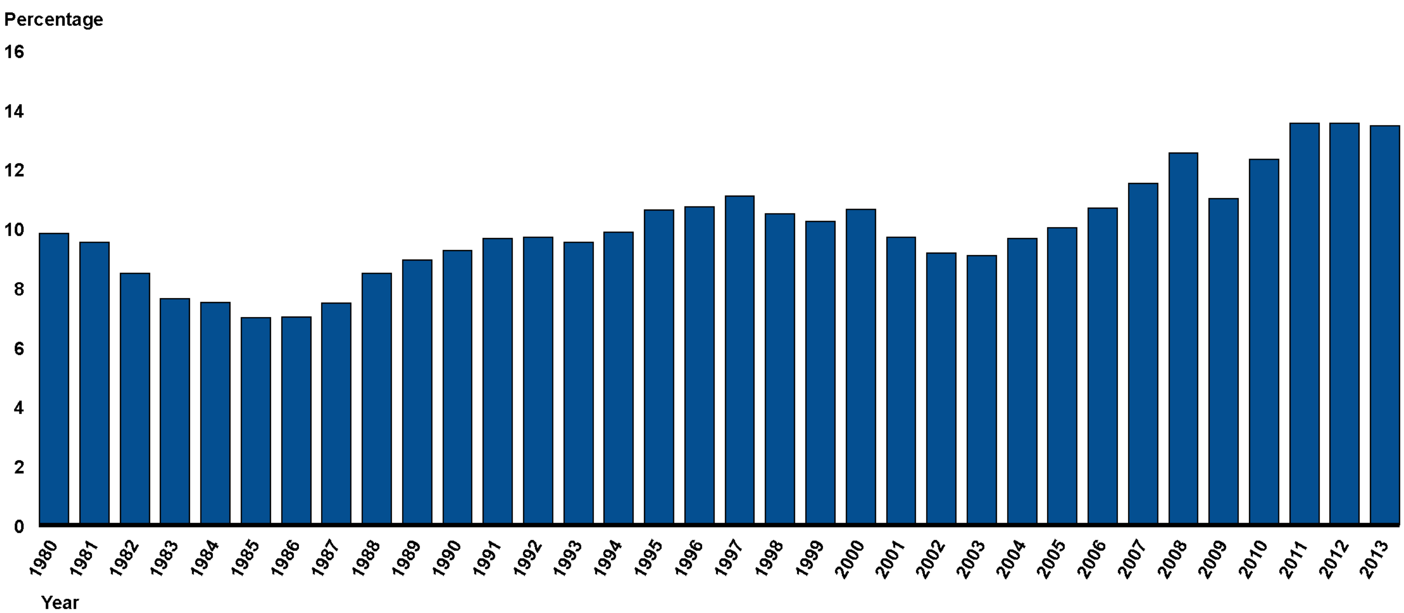
Historically, the tax expenditure has been defended on the grounds that it encourages the employment of U.S. workers abroad who play an important role in promoting U.S. exports.[29] Companies use international assignments for various reasons, such as to fill managerial or technical gaps, or to transfer skills to local staff. U.S. and foreign-owned companies have reported growth in international assignments in the past few years,

[29]See U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 111-58 (Washington, D.C.: Congressional Research Service, December 2012). For more on the tax expenditure's history, see Michael S. Kirsch, "Taxing Citizens in a Global Economy," *New York University Law Review*, vol. 82, no. 2 (2007).

according to survey data concerning global relocation trends.[30] According to the same survey data, international assignees are increasingly scattered globally, with a growing number of assignments in emerging markets such as Southeast Asia and Africa.

According to data from Commerce's Bureau of Economic Analysis, U.S. exports have increased in the past few decades, growing at a rate of about 7 percent between 1980 and 2013.[31] During that period, exports as a share of U.S. gross domestic product fluctuated, reaching the highest level in the last few years (see figure 3).

Figure 3: Share of Exports in U.S. Gross Domestic Product, 1980-2013



Source: GAO analysis of Bureau of Economic Analysis data.

[30]See Brookfield Global Relocation Services, *Global Relocation Trends: 2013 Survey Report* (Chicago, IL: Brookfield Consulting Services Group, 2013), and Cartus, *2012 Trends in Global Relocation,* Global Mobility Policy and Practices Survey (Cartus Corporation: May 2012).

[31]Besides cross-border exports, U.S. companies can also sell to foreign countries through affiliate sales abroad.

While U.S. exports have grown, the value of imported intermediate goods used in their production has also increased. The nature of export production, particularly in the manufacturing sector, has changed in recent decades. For example, according to literature on global trade, factors such as more efficient global communication and transportation systems have made it easier for companies to allocate their production globally to take advantage of lower input prices, including labor cost. These factors also have facilitated the flow of intermediate production inputs across global supply chains, creating more integrated manufacturing. In turn, the foreign content of U.S. exports has increased from the 1990s to 2000s.

In recent years the administration has emphasized export promotion as a high priority for the federal government. In 2010, President Obama launched the National Export Initiative via Executive Order. The initiative is aimed at doubling the dollar value of U.S. exports by the end of 2014.[32] The Office of Management and Budget subsequently identified the National Export Initiative's goal of doubling U.S. exports as one of 14 interim crosscutting priority goals under the GPRA Modernization Act of 2010.[33] We have reported that federal agencies that promote exports face coordination and management challenges, which could hinder their effectiveness in supporting the initiative's goal.[34] Concurrent with the release of the President's fiscal year 2015 budget, the administration released new crosscutting goals which focus on new priorities.[35] However, according to information on Performance.gov, the cross-agency effort to double exports will remain an administration priority, and efforts related to this goal will continue to be led by the Export Promotion

[32]Exec. Order No. 13534, 75 Fed. Reg. 12,433 (Mar. 11, 2010).

[33]Pub. L. No. 111-352, 124 Stat. 3866 (2011) (updating the Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285 (1993)). This act calls upon the Office of Management and Budget to develop long-term, outcome-oriented goals for a limited number of cross-cutting policy areas, and to provide information on how they will be achieved. Under the act, tax expenditures are to be included in identifying the range of federal agencies and activities that contribute to crosscutting goals.
31 U.S.C. § 1115(a)(2).

[34]For more on our work on export promotion, see our export promotion Key Issue page, at http://www.gao.gov/key_issues/export_promotion/issue_summary. The Key Issue page highlights our relevant reports and multimedia content.

[35]A new crosscutting goal focuses on increasing foreign direct investment in the United States.

Cabinet and the Trade Promotion Coordinating Committee. Export promotion also continues to be an agency goal for the Department of Commerce.

Relatively Few Individual Taxpayers Claimed the Foreign Earned Income Exclusion, and Claiming It Is More Beneficial Than the Foreign Tax Credit for Those in Lower Tax Countries

A Relatively Small Number of Tax Returns Claimed the Foreign Earned Income Exclusion and over Half Reported Working for Foreign Employers

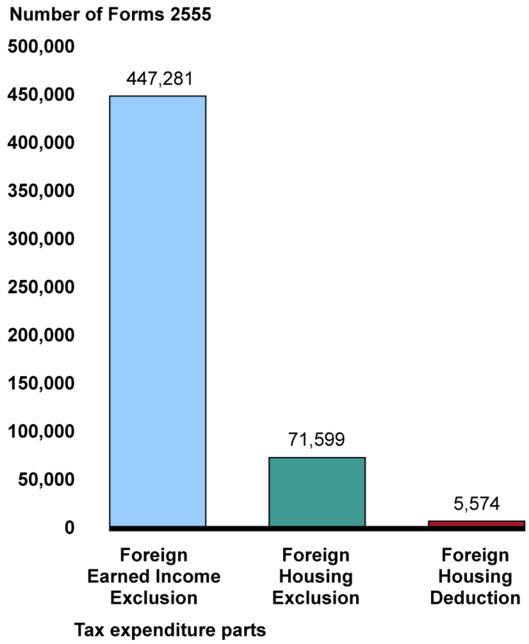
In tax year 2011 (the most current data available), the FEIE was claimed on an estimated 445,000 tax returns, which is 0.3 percent of about 145 million individual tax returns filed that year. We could not estimate the FEIE filers as a share of U.S. citizens abroad or the subset of citizens working abroad because reliable population figures are not available.[36] An estimated 45 percent of returns claiming the FEIE were married filing jointly (where one or both spouses may have claimed the FEIE), and 36 percent were single filers.[37] As shown in figure 4, an estimated 17 percent[38] of filers claiming the FEIE also claimed the foreign housing exclusion or foreign housing deduction.

[36]The U.S. Census Bureau has typically counted overseas military and federal civilian employees and their dependents, but it has usually excluded private citizens residing abroad. As of January 2013, the U.S. Department of State estimated 6.8 million American citizens live abroad.

[37]The balance filed as head of household, married filing separately, or surviving spouse. The percentage estimates have 95 percent confidence intervals that are within 2 percentage points of the estimate itself.

[38]Out of FEIE filers, percent estimates for filers claiming a housing exclusion or housing deduction have 95 percent confidence intervals that are within 16 percent (within 3 percentage points) of the estimate itself.

Figure 4: Estimated Number of Forms 2555 with the Foreign Earned Income Exclusion, Housing Exclusion, and Housing Deduction, Tax Year 2011

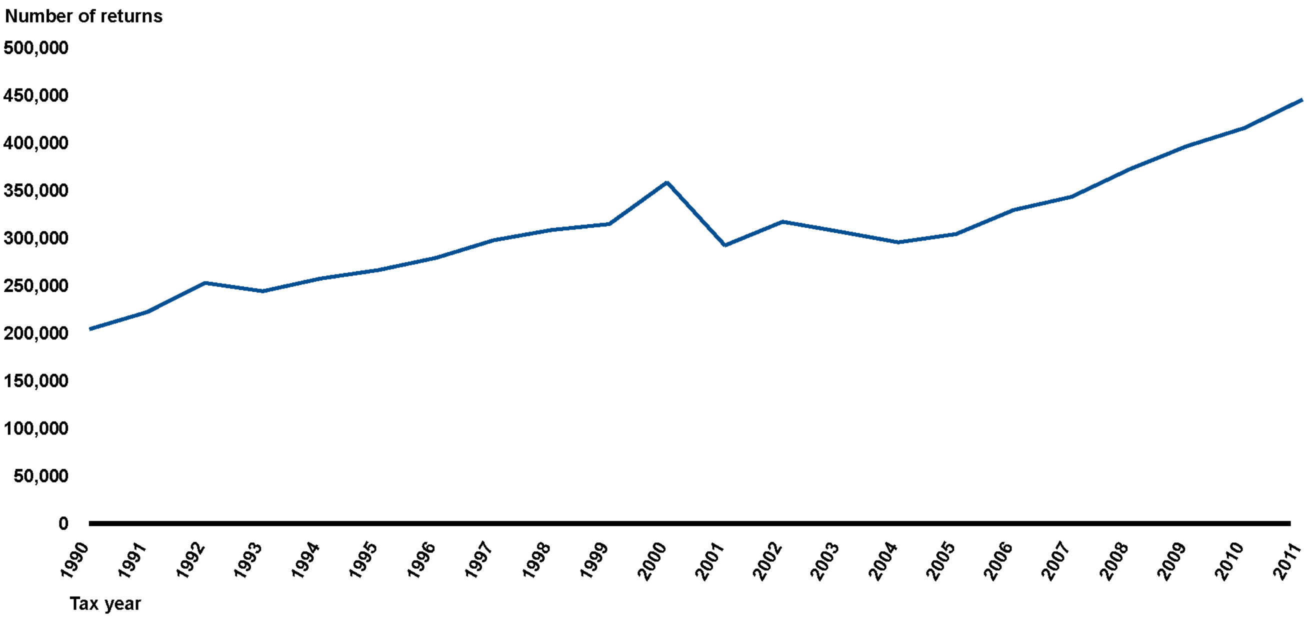


Source: GAO analysis of IRS Statistics of Income 2011 data.

Note: Taxpayers may file up to two Forms 2555. When comparing the number of tax returns claiming these amounts in IRS's Publication 1304 to the number of Forms 2555 filed, the difference was less than one percent. Estimates for the number of returns with a FEIE, foreign housing exclusion, and foreign housing deduction, respectively, have 95 percent confidence intervals that are within 14 percent of the estimate itself.

The number of tax returns claiming the FEIE has increased since the early 1990s, as shown in figure 5. During this period, the total number of individual tax returns filed also increased.

Figure 5: Estimated Number of Returns Claiming the Foreign Earned Income Exclusion (Tax Years 1990- 2011)



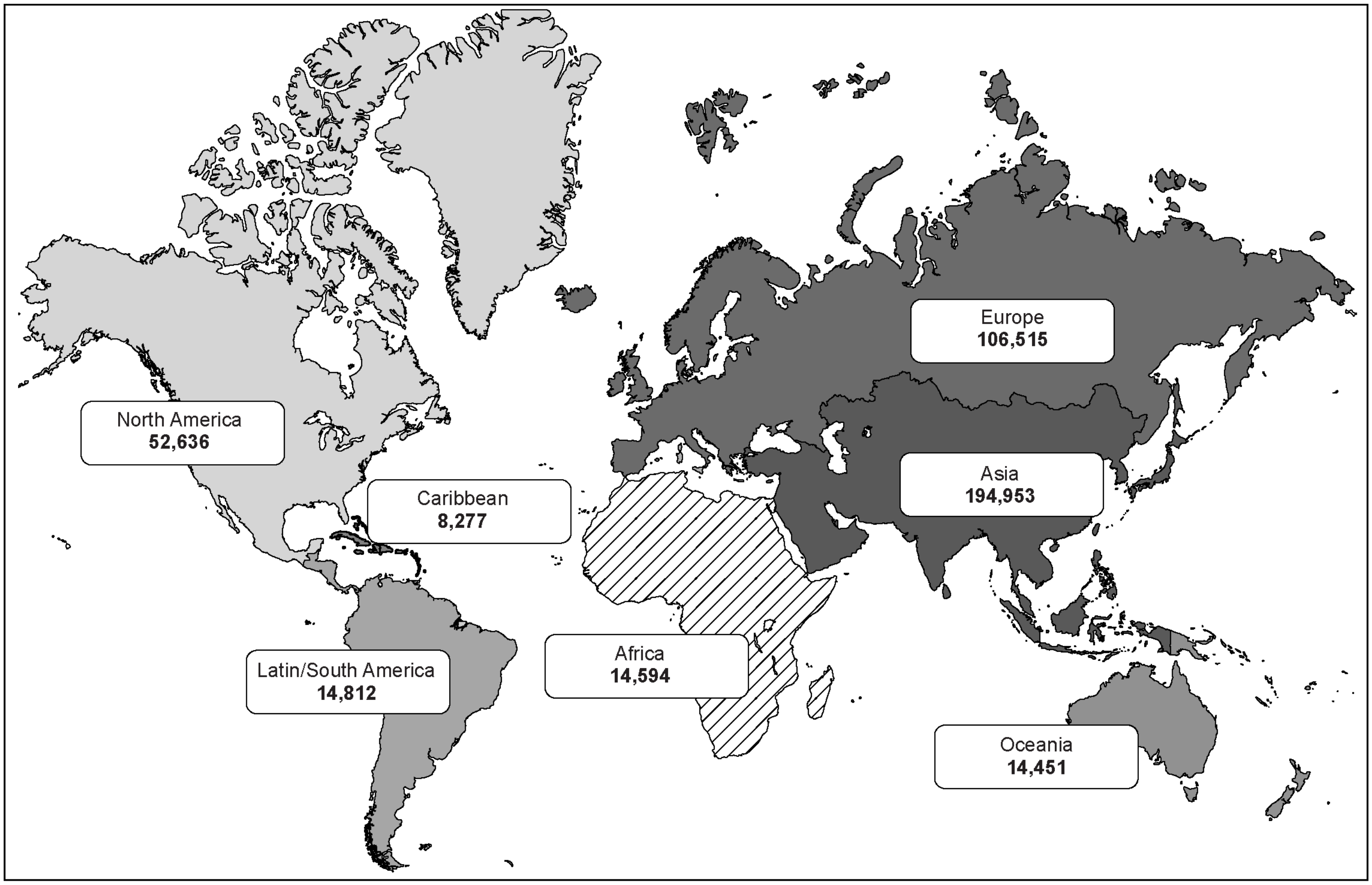
Source: GAO analysis of IRS Statistics of Income data, tax years 1990-2011.

Note: Estimates for the number of returns claiming the foreign earned income exclusion (FEIE) by year, from 1992 to 2011, have 95 percent confidence intervals that are within 12 percent of the estimate itself. Estimates for the number of all Forms 1040 filed by year, from 1992 to 2011, have 95 percent confidence intervals that are within 0.2 percent of the estimate itself. The sampling errors for the estimates of the number of returns claiming the FEIE and the number of all 1040 filers in 1990 and 1991 were not available. Given almost 20 subsequent years of such estimates with available sampling errors, we report the estimated number of filers overall and who claim the FEIE for these 2 years without assessing the margins of error, but do not make any statistical comparisons for 1990 and 1991.

Over half of Form 2555 filers in 2011 reported that their employer was a foreign entity (including foreign affiliates of U.S. companies). Less than one-third reported that their employer was a U.S. company, and the balance reported working as self-employed or for other entities. Taxpayers self-report the type of employer they work for, based on IRS guidance. IRS had not published information on the type of employer in its 5-year special studies, but data provided by IRS show that the employer pattern was generally consistent over the 2001, 2006, and 2011 studies.

In tax year 2011, about two-thirds of Form 2555 filers were in Asia (43 percent) and Europe (24 percent); see figure 6. Canada and the United Kingdom have relatively large numbers of Form 2555 filers; see table 1.

Figure 6: Estimated Number of Forms 2555 with Foreign Earned Income Filed by Geographic Region, Tax Year 2011



Source: GAO analysis of IRS Statistics of Income 2011 data.

Note: All other countries not counted in the region totals accounted for 42,311 tax returns. Estimates for the number of returns with foreign earned income filed with geographic regions Asia, Europe, and North America have 95 percent confidence intervals that are within 10 percent of the estimate itself. All other regions and other countries have 95 percent confidence intervals that are within 20 percent except for the Caribbean, which is within 24.65 percent of the estimate itself.

Table 1: Estimated Number of Forms 2555 with Foreign Earned Income Filed by Countries with the Most Filings, Tax Year 2011

Country	Region	Number of Forms 2555
Canada	North America	45,740
United Kingdom	Europe	30,861
Japan	Asia	23,073

Country	Region	Number of Forms 2555
Afghanistan	Asia	22,987
China	Asia	22,362
Germany	Europe	19,091
Iraq	Asia	13,938
South Korea	Asia	13,671
Hong Kong	Asia	13,274
United Arab Emirates	Asia	12,126

Source: GAO analysis of IRS Statistics of Income 2011 data.

Note: While Canada and the United Kingdom have more estimated filings than the other countries (and Canada is higher than the United Kingdom), the number of forms filed are not necessarily statistically different among the remaining eight countries.

Some Filers Were Able to Exclude All Income, and Foreign Earned Income Exclusion Filers Had Higher Average Income and Lower U.S. Tax Rates than the Average Form 1040 Filer

In tax year 2011, taxpayers claimed about $30 billion for the FEIE, foreign housing exclusion, and foreign housing deduction.[39] About 45 percent of FEIE 2555 filers had an adjusted gross income (AGI) of less than $10,000, as shown in table 2. This reflects that some taxpayers were able to exclude all or most of their foreign earned income in calculating their AGI.

Table 2: Comparison of Estimated Distribution of Returns for the FEIE and All Form 1040s, Tax Year 2011

Adjusted gross income	Distribution of returns claiming FEIE	Distribution of all 1040 returns
No adjusted gross income	23.5	1.7
$1 under $10,000	21.9	15.9
$10,000 under $25,000	11.3	24.1
$25,000 under $50,000	11.3	23.7
$50,000 under $200,000	21.9	31.4
$200,000 under $1,000,000	8.8	3.0
$1,000,000 or more	1.2	0.2
All returns	100.0	100.0

Source: GAO analysis of IRS Statistics of Income 2011 data.

Note: Percentage estimates have 95 percent confidence intervals that are within 1 percentage point of the estimate itself. Totals for all returns may not add to 100 due to rounding.

[39]Most of the amount claimed was for the FEIE. For 2011, the maximum exclusion for foreign earned income was $92,900.

Taxpayers claiming the FEIE had higher average income ($163,450) than the average Form 1040 filer ($58,706), as shown in table 3.[40]

Table 3: Comparison of Estimated Income of Returns for the FEIE and All Form 1040s, Tax Year 2011

Adjusted gross income	Average income of FEIE filers	Average income of all 1040 filers
Under $25,000	$55,409	$9,011
$25,000 under $50,000	$109,239	$36,497
$50,000 under $200,000	$182,680	$92,604
$200,000 under $1,000,000	$505,453	$344,323
$1,000,000 or more	$2,932,212	$3,187,604
All returns	$163,450	$58,706

Source: GAO analysis of IRS Statistics of Income 2011 data.

Note: The average income of FEIE filers with adjusted gross income of $25,000 under $50,000 has a 95 percent confidence interval that is within 11 percent of the estimate itself.

For the average U.S. tax rate (based on U.S. income tax amounts), taxpayers claiming the FEIE had lower average U.S. tax rates (6.8 percent) than all Form 1040 filers (12.3 percent), as shown in table 4. Table 4 also shows that while the average U.S. tax paid by FEIE filers is lower than the average tax paid by U.S. 1040 filers in all AGI categories, the average total tax paid—including both U.S. and foreign income taxes—by FEIE filers is lower than U.S. 1040 filers only among taxpayers with AGIs less than $50,000. In tax year 2011, 24 percent of taxpayers filing Forms 2555 also filed for the FTC.

Table 4: Comparison of Estimated Tax Rates for Returns Claiming FEIE to All Form 1040 Returns, Tax Year 2011

Adjusted gross income	Average U.S. tax rate of FEIE filers	Average U.S. tax rate of all 1040 filers	Average total tax rate of FEIE filers	Average total tax rate of all 1040 filers
Under $25,000	0.2	2.3	0.3	2.3
$25,000 under $50,000	2.1	5.1	3.0	5.1
$50,000 under $200,000	6.7	10.4	10.4	10.4

[40]The 2011 results in tables 3 and 4 are similar to prior analysis of tax year 2006 Statistics of Income data. See Eric Toder, “Taxes on Foreign Earned Income,” *Tax Notes Today* (Washington, D.C.: Tax Policy Center, July 16, 2013), accessed February 10, 2014. http://www.urban.org/publications/1001689.html.

Adjusted gross income	Average U.S. tax rate of FEIE filers	Average U.S. tax rate of all 1040 filers	Average total tax rate of FEIE filers	Average total tax rate of all 1040 filers
$200,000 under $1,000,000	9.4	20.5	22.1	20.8
$1,000,000 or more	11.4	23.0	26.9	23.9
All returns	**6.8**	**12.3**	**14.6**	**12.5**

Source: GAO analysis of IRS Statistics of Income 2011 data.

Note: The average U.S. tax rate is based on income tax amounts. The average total tax rate is based on income tax amounts plus the FTC. Worldwide income was used for income tax amounts for FEIE filers, and total income was used for all 1040 filers. Percentage estimates for tax rates have 95 percent confidence intervals within 10 percent of the estimate itself, except for estimates for the average U.S. tax rate of FEIE filers with AGI of $25,000 under $50,000, which has a confidence interval within 11 percent of the estimate itself.

The Foreign Earned Income Exclusion Is More Beneficial Than the Foreign Tax Credit for U.S. Taxpayers in Lower Tax Countries

Depending on their earned income and the tax rate of the foreign country where they live and work, U.S. taxpayers may choose to use the FEIE, the FTC, or a combination of both to reduce their U.S. tax liability.[41] In low tax countries, the FEIE is more beneficial to taxpayers than the FTC. In high tax countries, the FTC may be more beneficial. This is illustrated in table 5 where we compare the U.S. income tax liability for a U.S. employee working in the United States to U.S. citizens working in three hypothetical countries with differing tax rates. In countries with no income tax (country A) a citizen using only the FEIE would owe no U.S. taxes on earned income up to the exclusion maximum. The same citizen using only the FTC would have the same U.S. tax liability and total taxes as the employee in the United States. In countries with lower tax rates than the United States (country B), a citizen using only the FEIE would owe no U.S. taxes. Using only the FTC, the same citizen would owe less U.S. taxes but the same total taxes as the employee in the United States. In countries with a higher tax rate than the United States (country C), the citizen has no U.S. income tax liability in either case.[42]

[41]Taxpayers who choose to claim the FEIE cannot double dip and claim the FTC for foreign taxes on the income excluded.

[42]Taxpayers that cannot use the full amount of qualified foreign taxes paid or accrued in the tax year are allowed a 1-year carryback and then a 10-year carryover of the unused foreign taxes.

Table 5: Comparison of the FEIE and FTC by Hypothetical Country, Tax Year 2013

Country where U.S. taxpayer resides and earns income[a]	United States	Country A No income tax	Country B Income tax lower than the United States	Country C Income tax higher than the United States
Earned income	$107,600	$107,600	$107,600	$107,600
Less: Standard deduction $6,100 and one exemption $3,900	($10,000)	($10,000)	($10,000)	($10,000)
U.S. taxable income without FEIE	$97,600	$97,600	$97,600	$97,600
Using FEIE only				
U.S. taxable income with FEIE	$97,600	$0	$0	$0
Foreign income tax	$0	$0	$10,670	$26,900
U.S. income tax	$20,628	$0	$0	$0
Total worldwide income tax	$20,628	$0	$10,760	$26,900
Effective foreign income tax rate	0%	0%	10%	25%
Effective (residual) U.S. income tax rate	19%	0%	0%	0%
Effective worldwide income tax rate	19%	0%	10%	25%
Using FTC only				
U.S. taxable income without FEIE	$97,600	$97,600	$97,600	$97,600
Foreign income tax	$0	$0	$10,760	$26,900
U.S. income tax after foreign tax credit	$20,628	$20,628	$9,868	$0
Total worldwide income tax	$20,628	$20,628	$20,628	$26,900
Effective foreign income tax rate	0%	0%	10%	25%
Effective (residual) U.S. income tax rate	19%	19%	9%	0%
Effective worldwide income tax rate	19%	19%	19%	25%

Source: GAO.

Notes: For each example, we computed the effective income tax rates by dividing the corresponding income taxes by earned income. Some U.S. citizens may face no or lower tax rates in a foreign country as a result of tax treaty benefits or special arrangements for workers of international organizations and nonprofits.

[a]This comparison includes certain assumptions, including that each employee (1) holds the same qualifications, (2) receives the same income, (3) has a single tax filing status, (4) would pay the same tax rates as local citizens of the hypothetical country, and (5) does not claim the foreign housing exclusion or deduction.

As illustrated above, some U.S. citizens working abroad have no foreign income tax liability because they live and work in countries that do not have income taxes. Other U.S. citizens working abroad may also face no or reduced foreign taxes. Some tax treaties may reduce tax liabilities for U.S. citizens abroad. For example, U.S. students, teachers, and trainees may be exempt from a treaty country's income tax. Workers of international organizations and nonprofits also may be exempt in some treaty countries. Some countries have introduced special tax incentives broadly targeted to attract or retain high-skilled workers—such as scientists, researchers and engineers—to locate in otherwise high-tax jurisdictions.[43] U.S. citizens in these situations benefit from the exclusion similar to taxpayers in lower tax countries and may have no or reduced foreign taxes to claim under the foreign tax credit method.

Excluded Income Counts in Determining Eligibility for Tax Benefits with Income Limits

U.S. citizens and resident aliens living outside the United States generally are allowed the same deductions and tax credits as citizens and residents living in the United States. For example, taxpayers living abroad who itemize can claim deductions for mortgage interest and real estate property taxes paid for owner-occupied homes. However, taxpayers claiming the FEIE are not eligible for the earned income tax credit.[44] To prevent double dipping, a taxpayer cannot deduct, exclude, or claim a credit for any item that can be allocated to or charged against the foreign earned income excluded.[45] For example, if a taxpayer in 2013 had $90,000 of foreign earned income, took the FEIE, and had $7,000 of moving expenses, the taxpayer could not claim any deductions allocable to her foreign earned income (including the moving expenses on her tax return) because she excluded all of her foreign earned income. However, if the taxpayer made more in foreign earned income than the FEIE limit, then she would be eligible to deduct the portion of the moving expenses allocable to the foreign earned income in excess of the FEIE limit.

In determining applicable tax rates and eligibility for some tax provisions, excluded foreign earned income is added back in when calculating a modified adjusted gross income for certain tax credits and deductions that phase out (gradually limited until eliminated) at higher levels of income. For example, the excluded income is counted in determining eligibility for tax benefits which help pay for higher education, such as the American opportunity tax credit, lifetime learning credit, and student loan interest deduction. (Appendix II lists tax code provisions that interact with section

[43]As of 2010, 16 countries had special tax incentives, such as deductions, exemptions, and reduced tax rates, for high-skilled workers. See Organisation for Economic Co-operation and Development, *Taxation and Employment*, OECD Tax Policy Studies, No. 21 (OECD Publishing, 2011) accessed July 25, 2013, *http://dx.doi.org/10.1787/9789264120808-en*.

[44]26 U.S.C § 32(c)(1)(C).

[45]26 U.S.C. § 911(d)(6).

911.) When excluded amounts are added back in to calculate income eligibility for tax benefits and to determine marginal tax rates for included income, then taxpayers claiming the exclusion are in the same tax position as those taking the FTC on total foreign earned income.

U.S. Tax Costs Could Influence Some U.S. Overseas Employment Decisions, though There Is Little Evidence the Tax Expenditure Affects Exports

The FEIE's effects on hiring U.S. workers abroad and on exports can depend on various factors. Experts and stakeholders we interviewed expressed varying views on the emphasis employers place on certain overseas hiring factors, such as tax costs. Most experts we interviewed told us there was little evidence to indicate the tax expenditure could have more than a limited effect on exports.

The Tax Expenditure's Effects on Hiring of U.S. Workers Abroad and Exports Depends on Various Factors

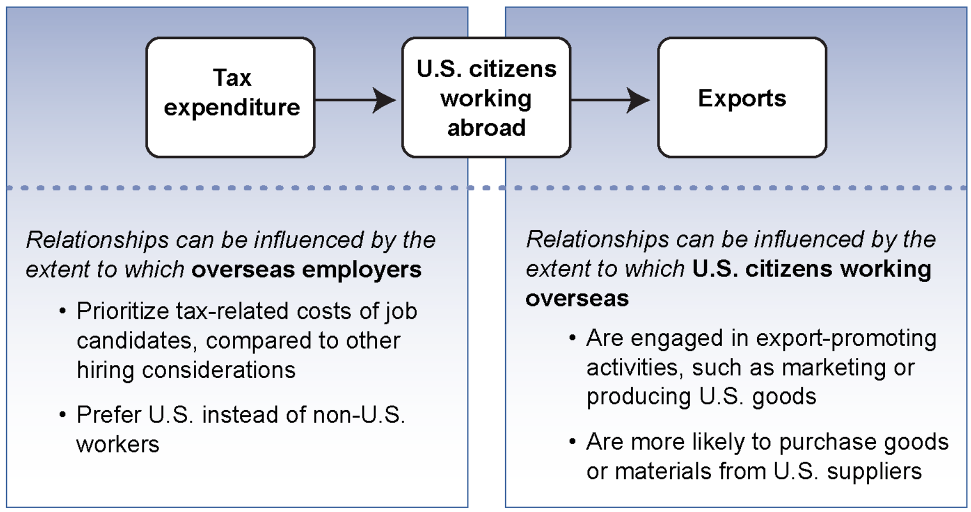
A few studies that we reviewed for this report asserted that the tax expenditure leads to more Americans working abroad, which in turn increases U.S. exports.[46] For example, this could happen if the tax expenditure encouraged U.S. companies to hire more Americans abroad by making it cheaper to do so, and if Americans abroad promoted exports through the nature of their work and other activities. However, because the tax expenditure applies to workers employed by any type of employer, it could also increase the number of Americans working abroad for employers other than U.S. companies and their affiliates or subsidiaries. Those workers could affect U.S. exports adversely by working for foreign competitors or by facilitating imports.

However, the extent to which the tax expenditure influences employment of U.S. workers abroad and U.S. exports can depend on a number of

[46]For example, see PricewaterhouseCoopers (PwC), *Economic Analysis of the Foreign Earned Income Exclusion* (National Economic Consulting: November 7, 2005); and John H. Mutti, "The American Presence Abroad and U.S. Exports," *Southern Economic Journal*, vol. 47 (July 1980), pp. 40-50. These studies, however, have several weaknesses, which are discussed later in this report.

factors, which can vary across different settings, according to articles we reviewed and the experts and stakeholders we interviewed (see figure 7).

Figure 7: Various Factors Can Influence the Tax Expenditure's Relationship to U.S. Citizens Working Abroad and Exports



Source: GAO.

For example, the extent to which the tax expenditure may encourage companies to hire U.S. citizens abroad can be influenced by the degree to which companies prioritize costs, including tax-related costs, compared to other factors, when making hiring decisions. This relationship can also be influenced by companies' preference for U.S. workers, compared to non-U.S. employees, when staffing certain positions abroad, or by the foreign tax rates in different foreign countries where certain jobs are located. Similarly, the tax expenditure's relationship to U.S. exports can be influenced by the extent to which Americans working abroad are employed by U.S. companies or by foreign entities. As noted earlier, many U.S. workers abroad do not work for U.S. companies, and may affect U.S. exports adversely.

The relationship can also be influenced by the extent to which U.S. workers abroad have jobs directly relating to export promotion, such as selling products or making sourcing decisions, or the extent to which they are more or less likely to purchase goods or materials from U.S. suppliers compared to foreign competitors. Finally, broader factors such as changes in overseas assignment patterns and information technology advances can affect the tax expenditure's relationship to the hiring of

Americans abroad and exports. For example, information technology improvements that make it easier to communicate and access information remotely can influence the extent to which companies assign employees overseas, or the nature of these assignments.

Tax-Related Costs Could Influence Employment for Some U.S. Citizens Abroad in Certain Locations

U.S. Workers Abroad Can Incur a Higher Overall Tax Liability Than Non-U.S. Workers in Some Cases

U.S. overseas workers' tax costs can vary across locations, and in some cases can exceed the tax liabilities of non-U.S. workers. An employee on an employer-sponsored international assignment may receive allowances and reimbursements for housing and other expenses. These allowances can vary across locations, depending on local housing and other costs of living. The increased compensation causes the employee's income to be higher than when working in the United States, and can move the employee into a higher tax bracket. For illustrative purposes, table 6 compares the tax liability of a U.S. worker with that of a non-U.S. worker, at different income levels and with application of the FEIE, in a hypothetical country (which is not the home country of a non-U.S. worker) that has a lower effective tax rate than the United States. The example assumes the non-U.S. worker is not taxed by his or her home country on foreign-earned income; as we noted previously, the citizens of most other countries are not taxed by their country of citizenship if they reside in another country.[47] As table 6 shows, the FEIE can eliminate the U.S. income tax liability for some taxpayers residing overseas with foreign earned income. At higher income levels, taxpayers could incur a U.S. tax liability after applying the FEIE, which could result in an overall tax liability greater than that of non-U.S. workers who have the same earned income but are not taxed on income earned abroad.

[47]Appendix III provides additional examples comparing the tax costs of U.S. and non-U.S. workers, at different income levels and different host country effective tax rates, and also compares the difference between U.S. worker's income tax liability in the United States and abroad.

Table 6: Comparison of Tax Costs of U.S. and Non-U.S. Workers under the Foreign Earned Income Exclusion in a Hypothetical Host Country and at Different Income Levels

Nationality of employee[a]	U.S.	Non-U.S.	U.S.	Non-U.S.
Earned income[b]	$107,600	$107,600	$175,000	$175,000
Less FEIE	$97,600	N/A	$97,600	N/A
Less: standard deduction $6,100 and one exemption $3,900	$10,000	$10,000	$10,000	$10,000
Host country effective tax rate	10%	10%	10%	10%
Host country income tax	$10,760	$10,760	$17,500	$17,500
U.S. effective tax rate[c]	19%	N/A	23%	N/A
U.S. income tax after FEIE	$0	N/A	$18,865	N/A
U.S. income tax after Foreign Tax Credit	N/A	N/A	$9,105[d]	N/A
Total income after tax	$107,600	$107,600	$148,395	$157,500
Difference between U.S. worker after-tax income and that of a non-U.S. worker	**$0**	**N/A**	**-$9,105**	**N/A**

Source: GAO analysis.

Notes: This comparison includes certain assumptions, including that each employee (1) holds the same qualifications, (2) receives the same income, and (3) has a single tax filing status. The example also assumes the non-U.S. employee is not taxed by his or home country on foreign-earned income.

[a]The comparison focuses on home country tax rates for U.S. citizens and non-U.S. foreign nationals. U.S. citizens and non-U.S. foreign nationals would generally face the same local taxes as local citizens of the hypothetical host country.

[b]Housing costs are not explicitly included in the example. Differences in housing costs can be offset by applicable housing exclusions or deductions. However, in some cases the differences in housing costs can affect overall tax liability.

[c]The U.S. effective tax rate listed is that which applies to the earned income level provided in the example, without application of the tax expenditure.

[d]A U.S. citizen in this circumstance could also claim the foreign tax credit with respect to income that was not excluded using the foreign earned income exclusion.

The additional U.S. tax liability illustrated in table 6 could result in different actual after-tax income for U.S. employees, depending on whether and how companies adjust compensation. For example, some companies may increase compensation to fully or partially offset the U.S. employee's additional tax costs in order to attract U.S. citizens to work abroad. A company's willingness to do so could be shaped by the value it places on U.S. workers—its demand for U.S. overseas labor—relative to non-U.S. workers. A U.S. employee's willingness to work abroad—to supply U.S. overseas labor—could be influenced by how his or her after-tax income in the foreign country would compare to his or her after-tax income in the United States. According to survey data, most U.S. and foreign-owned companies use a tax equalization policy for their overseas assignees.[48] Under such a policy, employers pay their employees to cover higher taxes on working overseas than the employee would have been paid if they worked in the United States.

Experts and Stakeholders Have Varying Views on the Emphasis Employers Place on Certain Overseas Hiring Factors

Experts and stakeholders expressed differing views on the emphasis or value employers place on certain overseas hiring factors. In particular, about half of the experts and stakeholders we interviewed said that employers make hiring decisions concerning overseas assignments based first on the candidates' job skills or qualifications, or that the cost of prospective employees was not a primary consideration. Specifically,

- One expert told us that in most cases involving senior-level employees, companies will first try to find the right person for the position, and then address cost and compensation issues.
- One stakeholder told us his firm's experience indicated costs were just one of several key hiring criteria used by most large companies, and that taxes were just one element of cost considerations, alongside costs for education, housing, and other expenses that could be associated with a given employee.

Nonetheless, about half of the experts and stakeholders we interviewed told us the additional tax costs of employing U.S. citizens could in some cases influence employment decisions; of these, two stakeholders told us tax costs were a predominant reason why some companies were hiring fewer Americans overseas. Specifically,

- One expert stated that skill-wise, the broadening of the global education base has made non-U.S. workers more competitive with U.S. workers in recent decades, creating more opportunities for companies to select less costly (yet equally skilled) foreign nationals over Americans.
- Related to that point, one stakeholder noted that certain large multinational firms have identified pools of qualified job candidates from different countries around the world; when compelled by cost considerations, they will hire from this pool.

[48]See Brookfield Global Relocation Services, *Global Relocation Trends: 2013 Survey Report* (Chicago, IL: Brookfield Consulting Services Group, 2013); KPMG International Cooperative, *Global Assignment Policies and Practices Survey* (International Executive Services: July 2013); and Cartus, *2012 Trends in Global Relocation,* Global Mobility Policy and Practices Survey (Cartus Corporation: May 2012).

Experts and stakeholders also noted that companies' preference for, and the value of, U.S. employees could vary across different situations. While about half of the stakeholders we interviewed said that U.S. citizens overseas have value for companies, compared to non-U.S. employees, about half of the experts we interviewed said such a value may be limited to certain types of jobs or companies and may not exist in certain contexts. Specifically,

- About half of the stakeholders we interviewed asserted there is a value in having Americans abroad, or that Americans are better able to facilitate U.S. companies' business transactions with foreign entities abroad than are non-U.S. employees.
- Several experts and a stakeholder stated that U.S. employees may have particular value for certain positions or for certain U.S. companies. For example, new companies without established trade partners or companies with American identities or interests, such as military contractors or companies in the entertainment industry, may have greater demand for U.S. employees.
- About half of the experts and several stakeholders said that in some cases U.S. workers had little or no comparative value relative to equally capable non-U.S. employees, such as for global companies, or that some companies may prefer hiring local citizens for certain positions.

Most Experts Interviewed See Little Evidence the Tax Expenditure Affects Exports

Most experts we interviewed and Commerce officials stated there was little evidence to indicate the tax expenditure could have more than a limited effect on exports. As noted previously, a few studies have asserted that the tax expenditure affects U.S. exports through effects on the number of Americans working abroad. Some articles have also asserted that exports in turn lead to increases in U.S. employment and to reductions in the trade deficit, justifying the tax expenditure. Moreover, stakeholders we interviewed offered examples of ways Americans abroad can promote exports, including by facilitating trade, purchasing source materials from U.S. suppliers, and advertising U.S. products. However, most experts we interviewed stated that it is difficult to determine the tax expenditure's effect on exports, or that there is little evidence to suggest any effect would be significant. Moreover, none of the experts we interviewed said they believed the tax expenditure was likely to have a significant effect on exports. Specifically,

- One expert stated most arguments asserting the tax expenditure's positive effect on exports were theoretical in nature and lacked evidence.

- Two experts stated it may be impossible to obtain data to establish such an effect.
- One expert stated that the relationship between U.S. employees abroad and exports has diminished in the past several decades, due in part to advances in information technology, which have made access to information relating to export suppliers much more widely accessible globally.

Commerce officials were not aware of any data on the relationship between the tax expenditure and exports.[49] One Commerce official stated that he believed the tax expenditure's effect on exports, if any, was small. Another Commerce official told us he was not aware of the tax expenditure being discussed during development of the National Export Initiative launched in 2010. In addition, the tax expenditure was not identified as a potential contributor towards the administration's crosscutting goal of doubling U.S. exports over 5 years.[50]

The few empirical analyses that have asserted a relationship between the tax expenditure and exports have weaknesses.[51] A 1980 study concluded that repealing the tax expenditure would lead to a decline in exports.[52] A 2005 analysis, which relied on the model results from the 1980 study to estimate the effects of the tax expenditure on the number of Americans employed abroad and on U.S. exports, drew a similar conclusion.[53] However, the model from the 1980 study has several limitations. For example, the model drew on export data from 1974, when more recent

[49]Commerce has studied the relationship between short-term business travel and exports, and found U.S. outbound international business travel has a positive effect on U.S. merchandise exports. See Maksim Belenkiy and David Riker, *U.S. International Business Travel: Its Impact on U.S. Merchandise Exports,* Manufacturing and Services Economics Brief (Washington, D.C.: Office of Competition and Economic Analysis, November 2012).

[50]See Performance.gov, "Cross-Agency Priority Goal: Exports" accessed May 30, 2013 http://goals.performance.gov/content/exports.

[51]Our prior reports drew on surveys of U.S. companies with foreign operations. Those results were not representative of all employers at that time and given changes in the global economy, are outdated. See GAO, *American Employment Abroad Discouraged By U.S. Income Tax Laws*, ID-81-27 (Washington, D.C.: Feb. 27, 1981), and *Tax Policy and Administration: Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas*, ID-78-13 (Washington, D.C.: Feb. 21, 1978).

[52]Mutti, "American Presence Abroad."

[53]PricewaterhouseCoopers (PwC), *Economic Analysis*.

data might more accurately reflect the current relationship between the tax expenditure and exports. In addition, the model incorporated assumptions relating to the activities of Americans employed abroad in relationship to U.S. exports that may not be applicable today. For instance, while the tax expenditure is not limited to individuals working in positions that promote U.S. exports, the model assumed Americans abroad are engaged in such activities. The model also assumed non-U.S. workers were not close substitutes for American workers, though several experts we interviewed indicated that for certain overseas positions, U.S. employees have no comparative advantage, in relation to non-U.S. employees.

Moreover, even if the tax expenditure had a positive effect on exports, its effect on overall U.S. employment could depend on the current employment rate. As we noted in a recent report, Commerce[54] and trade policy researchers have asserted that in a high unemployment economy—which the United States has experienced for several years—additional exports may result in additional jobs; in contrast, in a low unemployment economy, additional exports may result in jobs shifting from one firm to another without increasing total employment.[55]

[54]John Tschetter, "Exports Support American Jobs: Updated Measure Will Quantify Progress As Global Economy Recovers," International Trade Research Report no. 1 (Washington, D.C.: Department of Commerce, International Trade Administration, Undated).

[55]See GAO, *Export-Import Bank: More Detailed Information about Its Jobs Calculation Methodology Could Improve Transparency*, GAO-13-446 (Washington, D.C.: May 23, 2013).

The Tax Expenditure's Net Effects on Economic Efficiency and Equity Are Uncertain; Some Alternatives Could Better Target Benefits but Would Add Complexity

Using criteria from our tax expenditure evaluation guide, we evaluated whether the tax expenditure[56]

- generates net economic benefits for society;
- is fair and equitable;
- is simple, transparent, and administrable; and
- is achieving its purpose.

The tax expenditure affects a variety of resource allocation decisions; it also affects equity in several different ways. Some of these effects are positive, while others are negative, and the magnitudes of all these effects are unknown. As a result, the tax expenditure's overall effect is uncertain. For a more detailed explanation of our assessment of these questions, see appendix IV.

Does the Tax Expenditure Generate Net Economic Benefits for Society?

A tax system reduces economic efficiency to the extent that it affects the relative prices of goods, services, or factors of production and thereby induces individuals or businesses to alter economic decisions.[57] No tax system can avoid affecting some relative prices to some extent; however, it is important to minimize these price effects unless they are intended to achieve some other beneficial social purpose. We found that the tax expenditure had effects on the following.

Choices about where to work and who to hire: The tax expenditure potentially influences the choice of some U.S. citizens between working abroad or in the United States, because it lowers the total tax that these individuals would pay on foreign earned income. These tax reductions make working abroad in lower-tax countries more attractive to U.S.

[56]Unless otherwise specified, the term "tax expenditure" here refers to the foreign earned income exclusion as well as the exclusion and deduction for excess foreign housing costs.

[57]Resources are used most efficiently when they provide the greatest possible benefit or well-being. The concept of economic efficiency recognizes that when resources are not underemployed, decisions about their use involve tradeoffs. See GAO-13-167SP and GAO-05-1009SP for a more detailed discussion of economic efficiency.

citizens than doing so otherwise would be, and as a result could interfere with the efficient allocation of U.S. labor between locations.[58]

The tax expenditure also potentially influences employers' choices as to whether they should fill positions abroad with U.S. citizens or with citizens of countries that do not tax earned income on a worldwide basis. The reduction in efficiency can occur when the employer hires a less productive worker for a lower pretax salary than the U.S. citizen would demand, due to the foreign worker paying no tax to his home country. The tax expenditure counteracts these effects, but we found no evidence in the economic literature that would indicate how the magnitude of the counteracting effects compares to the negative efficiency effects we discussed earlier. Consequently, we are not able to say whether the tax expenditure improves or reduces overall economic efficiency.

Differences in costs of living: Tax relief may be justified for U.S. citizens working in countries where the costs of living are significantly higher than the United States' highest-cost locations.[59] If these taxpayers' wages are sufficiently greater than they would earn at home (reflecting higher costs of living abroad), they may be pushed into higher tax brackets. This increase in the tax bracket is another way that the tax system could reduce efficiency by affecting location and hiring decisions. Tax relief targeted to the effects of this bracket change would remove an efficiency-reducing influence on U.S. citizens' employment decisions at a lower revenue cost than the more broad tax relief provided by the tax expenditure. This same efficiency problem arises domestically with respect to cost-of-living differences within the United States. Given that the U.S. tax system does not address this problem domestically, those who have proposed a means of addressing cost-of-living differences between the United States and foreign locations note that it may only be

[58]If policymakers are concerned that tax rate differences across countries already cause inefficiencies that need to be addressed by U.S. tax policy, then the United States would also have to compensate U.S. citizens working in high-tax countries (to the extent that the taxes they pay there exceed what they would have paid in the United States).

[59]See U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 112-45 (Washington, D.C.: Congressional Research Service, December 2012) and Jane G. Gravelle and Donald W. Kiefer, *U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis* (Washington, D.C.: Congressional Research Service, Apr. 20, 1978).

justified if the differences are much greater internationally than domestically.

Is the Tax Expenditure Fair and Equitable?

We assessed the tax expenditure against three criteria—horizontal equity, vertical equity, and the benefits received principle—all of which require some subjective judgments. Determining who benefits from the tax expenditure, and how those benefits affect equity, can be more complicated than simply identifying which taxpayers claim the tax expenditure.[60] Given that the ultimate distribution of benefits from the FEIE is unknown, it is difficult to draw conclusions about its net effect on the equity of the tax system.[61]

Horizontal equity: Individuals with equal incomes and who are the same in terms of other characteristics deemed relevant to the ability to pay tax (such as number of dependents) should pay the same tax. Conclusions about the tax expenditure's effect on horizontal equity depend, in part, on judgments about appropriate comparison groups. For U.S. policymakers, one relevant comparison is the treatment of U.S. citizens working abroad, relative to similar U.S. citizens working in the United States. The FEIE violates this principle between these two groups unless those working abroad are deemed to be sufficiently different from their domestic counterparts due to either the potentially extreme cost-of-living differences or the differences in U.S. government services they receive.

Vertical equity: Similar to horizontal equity, individuals with higher income—or who have other characteristics that increase their ability to pay—should pay more tax than those with less ability to pay. The tax expenditure decreases vertical equity to the extent that individuals who

[60]The ultimate burden or benefit is known as the incidence of the tax policy and it depends on how various individuals and businesses respond to the policy. In the case of the tax expenditure, even though individual employees claim the exclusion on their own tax returns, the resulting reduction in their total taxes may make them willing to work abroad for a lower pretax income than they would have accepted without the tax expenditure. As a result, the employers may share in at least some of the benefit by being able to pay lower salaries than would otherwise have been needed to hire U.S. citizens.

[61]Determining the actual incidence of the FEIE would be difficult because it would require information on how two factors—the amount of labor that U.S. citizens are willing to supply to employers abroad and how those employers' demand for that particular type of labor—respond to changes in pretax and post-tax rates of compensation. We know of no study that has attempted to estimate such responsiveness.

benefit from the exclusion tend to have higher incomes than those living in the United States, unless the ultimate tax benefit falls entirely on employers. In comparison to an unlimited exclusion, the current design of the tax expenditure—specifically the dollar limit and the stacking rule[62]—moderates this negative effect.

Benefits received principle: An individual's tax payments should bear some relationship to the government benefits that individual receives. Some experts we interviewed noted that U.S. citizens working abroad for the long term receive significantly smaller benefits from U.S. government services than those living in the United States, and that this difference may justify some tax relief for the former. However, other experts said that U.S. citizens living and working abroad benefit from federal services—such as national defense, foreign affairs, income maintenance, and basic research—that produce social or humanitarian benefits that are not directly apportioned to specific individuals. For example, citizens abroad benefit from years of public investment in their education, the cost of which is typically recaptured over their lifetimes. Regardless of the benefits they receive, U.S. citizens overseas must file a U.S. tax return and pay taxes owed unless they renounce their citizenship.[63]

Is the Tax Expenditure Simple, Transparent, and Administrable?

There is widespread agreement that the U.S. worldwide tax system is complex and adds burden for taxpayers and IRS. The tax expenditure adds complexity with its eligibility rules and interactions with the FTC and other tax provisions.[64]

Transparency: Taxpayers may not fully understand their obligations under the tax expenditure. According to IRS, there is a common

[62]For taxpayers that have taxable income after claiming the FEIE and foreign housing exclusion, the applicable tax rate is determined by calculating taxable income without taking these exclusions into account. This stacking rule results in these taxpayers claiming the tax expenditure being subject to the same marginal tax rates as taxpayers with the same level of income who are not eligible for (or do not elect to claim) the tax expenditure.

[63]Expatriation tax provisions apply to U.S. citizens who have relinquished their citizenship and long-term residents who ceased to be lawful permanent residents. The rules that apply are based on the date of expatriation, as described in IRS Publication 519—*U.S. Tax Guide for Aliens (available at http://www.irs.gov/publications/p519/ar01.html).*

[64]Appendix IV contains additional detail on our assessment of transparency and simplicity for taxpayers and administrability for IRS.

misconception that potentially excludable foreign earned income does not have to be reported on a U.S. tax return. IRS said that this misconception contributes to the tax gap, which is the difference between taxes owed and those paid on time. However, data do not indicate the portion of the U.S. tax gap—most recently estimated by IRS at a net $385 billion as of 2006—that is attributable to international taxpayers who fail to file U.S. tax returns, underreport their foreign income, or fail to pay U.S. taxes owed. IRS has undertaken research to study the needs of international taxpayers in helping them comply with their U.S. tax liabilities.[65]

Simplicity: According to some experts interviewed, the tax expenditure may simplify the tax compliance burdens of U.S. citizens abroad who would otherwise have to claim the FTC to avoid double taxation on foreign earned income. According to stakeholders and some experts we interviewed, the FTC can be more complex. However, this effect is uncertain for several reasons, including that we did not find evaluative studies that compare the compliance burden of the tax expenditure with the FTC.

Administrability: IRS faces challenges in administering the tax expenditure, because IRS does not have the same level of information reporting to detect noncompliance on foreign source income as it does for U.S. source income. IRS special compliance projects have found substantial noncompliance among high-risk taxpayers who are miscalculating or are ineligible to claim benefits from the tax expenditure. The Treasury Inspector General for Tax Administration has reported on the challenges in administering the bona fide residence and physical presence tests.[66]

[65]Tiffanie N. Reker, David C. Cico, and Saima S. Mehmood, *2012 Taxpayer Experience of Individuals Living Abroad: Service Awareness, Use, Preferences, and Filing Behaviors*, Research Study Report (Internal Revenue Service, W&I Research & Analysis: June 21, 2012).

[66]Treasury Inspector General for Tax Administration, *Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims,* Reference Number 2010-40-091 (Washington, D.C.: Aug. 16, 2010).

How Well Does the Tax Expenditure Achieve Its Purposes?

As discussed earlier, the tax expenditure's effect on foreign trade, employment, and competitiveness is uncertain. There is little evidence to indicate that the tax expenditure could have more than a limited effect on exports. Thus, it is not clear that special tax relief for the relatively small population of U.S. citizens living and working abroad positively benefits the overall well-being of the United States.

Some Alternatives to the Tax Expenditure Would Increase Efficiency and Equity, While the Effect of Others Would Depend on Details of the Reform

An assessment of the tax expenditure against criteria for good tax policy leaves room for debate regarding potential alternatives to improve the efficiency and equity, as well as to reduce complexity for taxpayers and IRS. Alternatives to the current tax expenditure range from eliminating it entirely—as proposed in several deficit reduction and tax reform proposals—to removing the maximum limit for the exclusion. We also considered alternatives to target tax relief to high cost areas and address the benefits received principle.[67]

Alternative: Eliminating the Tax Expenditure

The net effect on economic efficiency of eliminating the tax expenditure and taxing all foreign earned income is uncertain. This alternative would largely remove the influence of taxes on location decisions by U.S. citizens to work abroad, which would increase efficiency; however, at the same time, it would decrease efficiency by increasing the effect of the differential tax treatment by the United States and other countries on businesses' decisions regarding whom to hire for positions abroad. The effect of the alternative on equity is also uncertain. Elimination could be viewed as improving equity if two conditions are met: (1) there are few or no foreign locations where living costs are significantly higher than in the highest-cost locations within the United States, and (2) the additional federal taxes (in excess of the amounts offset by foreign tax credits) are broadly commensurate with the benefits that U.S. citizens working abroad receive from the U.S. government. If either of these conditions is not met, then some form of tax relief may be justified on equity grounds.

The effect on compliance burden will vary with the circumstances of the taxpayers. To the extent that the FTC form is more complicated than the FEIE form, eliminating the exclusion could increase the compliance burdens of some taxpayers who currently use the exclusion rather than

[67]To identify and analyze alternative policy options, we conducted an extensive literature search and interviewed a range of stakeholders and experts; see appendix I for more on our methodology and a list of the options discussed with those we interviewed.

the FTC. However, it would not significantly affect the compliance burden of taxpayers with earned income exceeding the exclusion limit or investment income of those who already use the FTC. IRS officials said that repealing the tax expenditure would simplify challenges associated with the FEIE bona fide residence and physical presence tests that do not apply to the FTC. Citizens working abroad in lower tax countries would face higher taxes. Those facing higher taxes or compliance costs may choose not to comply, and noncompliance could undercut the expected revenue gain from repeal.[68]

Alternative: Targeting Tax Relief for Extreme Cost of Living Differences

Economic efficiency and equity could be improved by modifying the current tax expenditure design or replacing it with an alternative tax relief that adjusts for foreign costs of living that significantly exceed those in the highest-cost U.S. locations. One approach would be to make Treasury responsible for annually determining the amount by which costs of living in foreign locations may exceed those in the highest-cost U.S. locations and for publishing adjustment factors for determining tax liabilities.[69] Whether a system of cost-of-living adjustments would be more burdensome for Treasury or taxpayers than the current tax expenditure, which already has some adjustments for higher housing expenses, depends on the degree of accuracy and completeness desired in the adjustments.[70] The federal revenue change would depend on the cost of tax reductions targeted to citizens working in higher-cost foreign areas, instead of the current preferential treatment for all citizens working abroad, and—depending on policy priorities and preferences—the redesign could aim for the same or a lower overall cost to the federal government.

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[68]The staff of the Joint Committee on Taxation estimate that repealing the exclusion would increase federal revenue by $6.2 billion in 2015 and $89 billion over 2014 through 2023; see Congressional Budget Office, *Options for Reducing the Deficit: 2014 to 2023 (Washington, D.C.: November 2013)*. Unlike a tax expenditure estimate, revenue estimates generally reflect changes in behavior by individuals and firms.

[69]Such an approach is discussed in Gravelle and Kiefer (1978). Certain cost differences—such as those relating to education and certain types of taxes—present complications that may not be adequately addressed by comparing available cost-of-living indexes.

[70]The Foreign Earned Income Act of 1978 replaced an income exclusion with a system of allowances for costs of living abroad, such as cost of living in general, housing, education, and home leave transportation. This system was replaced in 1981 with the income exclusion and separate housing exclusion.

Alternative: Targeting Tax Relief Based on Benefits Received and Obligations as Citizens

It would be difficult to design an alternative to the tax expenditure that better targeted tax relief based on benefits received. The tax expenditure itself is not designed specifically to address the benefits received principle, and the federal income tax in general is not based on the benefits received principle. Indeed, it would be very difficult to incorporate the principle in a tax that funds such a broad array of functions, many of which provide broad social benefits. Moreover, the values of these benefits are not easily allocable to specific individuals. Any attempt to determine a fair reduction in federal tax obligations of U.S. citizens living abroad—relative to similar citizens living in the United States—would involve a considerable amount of value judgment. Depending on policy priorities and preferences, any redesign targeted for reduced benefits received by citizens working overseas could aim for the same or a lower overall cost to the federal government. A revision deemed to result in a more equitable distribution of the tax burden would not necessarily have negative consequences for economic efficiency. The effects of the revision on simplicity and administrability would largely depend on the extent to which it is designed to account for the characteristics of individual taxpayers. One possible change in the current tax expenditure design would be to increase the time abroad required for eligibility. This would target tax relief to those abroad for longer periods.[71]

Alternative: Uncapping the Exclusion

Removing the maximum limit on the exclusion—that is, uncapping the tax expenditure—and excluding all foreign earned income from taxation would have multiple counteracting effects on employment decisions. These effects would be opposite to those that would result from eliminating the tax expenditure. In this case, inefficiency due to tax effects on location decisions would increase while inefficiency due to the tax effects on hiring would decrease. Once again, because the relative magnitudes of the counteracting effects are indeterminable, the net effect on overall economic efficiency would be uncertain. The effect on equity will depend on value judgments. Uncapping the tax expenditure could be viewed as reducing both horizontal and vertical equity because it would reduce the federal tax liabilities of some high-income U.S. citizens working in countries with effective rates of income tax below that of the United States, regardless of the cost of living differences. On the other

[71]Currently, the physical presence test is for at least 330 days over a 12-month period. In the 1950s, the FEIE physical presence test was for 510 days (17 months) out of 18 consecutive months. In 1962, the exclusion was tiered allowing a larger exclusion for those overseas for 3 years or more.

hand, it would increase equity if U.S. citizens working abroad are viewed as receiving no benefits for which they should pay federal taxes. To the extent that the exclusion is easier to use than the FTC, uncapping the exclusion could simplify compliance burdens for citizens abroad with only earned income, although they would still have to file a U.S. tax return to claim the tax benefit. However, uncapping the exclusion could compound the challenge that IRS has in administering the tax expenditure, given the misconception that those with excluded income do not have to file and report income to IRS. According to some experts we interviewed, uncapping the exclusion could create incentives for higher-income professionals to move abroad to deliver their services and to shift some investment income to be paid as earned income. It would also reduce federal tax revenue, and any perceived unfairness could erode voluntary compliance for domestic taxpayers. Experiences of other countries that do not tax foreign earned income may be useful in adopting tax rules and compliance practices to prevent or limit income shifting to lower tax countries.[72]

Uncapping the exclusion and not taxing any foreign earned income would be consistent with broader proposals to change the current U.S. worldwide system of taxation into a territorial or source based income tax system. One proposal to move from “citizen-based” to “resident-based” taxation would exclude all foreign income for individuals living abroad; this could make the tax expenditure unnecessary.[73] Such an approach would impose a departure tax for citizens working abroad who reside in a foreign country for a minimum period of time.[74] Some proposals have implications not only for U.S. individual income tax filing, but also for information reporting about foreign financial accounts and assets that are

[72]GAO, *International Taxation: Study Countries That Exempt Foreign-Source Income Face Compliance Risks and Burdens Similar to Those in the United States,* GAO-09-934 (Washington, D.C.: Sept. 15, 2009).

[73]American Citizens Abroad (ACA), *ACA Submission to the Senate Finance Committee on International Tax Reform* (Washington, D.C.: Jan. 15, 2014). ACA also supports increasing the current exclusion limit.

[74]Under the ACA proposal, an individual would be deemed to have disposed of property at its fair market value on the day of departure and then reacquired the property for the same amount immediately thereafter. The person would include in U.S. income the capital gain or loss that resulted from the deemed disposition. Alternatively, the person could defer the tax without interest until his or her return to the United States.

beyond the scope of this report.[75] The larger debate about broader changes to the U.S. international tax system focuses chiefly on the taxation of corporate income, and such reforms may have implications for the tax treatment of the wage income of U.S. citizens working abroad; however, they are beyond the scope of this report.

Concluding Observations

The design of the tax expenditure has shifted over time as policymakers have sought to balance the costs of special tax relief to cover higher costs of living overseas with benefits for individuals seeking employment overseas and potentially, benefits for U.S. exports. Currently, the federal government is forgoing billions in federal tax revenue for a small but growing population of U.S. citizens working abroad that claim section 911 tax benefits. Yet, there is little evidence that the tax expenditure has a significant effect on export promotion.

It is clear that the current tax expenditure, or any option to increase the exclusion limit, does not target precisely the two potential conditions that might justify continuing tax relief for some U.S. citizens living and working abroad. First, potentially negative effects on efficiency and equity could arise if the cost of living in foreign locations significantly exceeds that of the highest-cost locations in the United States. Determining whether extreme cost of living differences justify special tax relief, and how to tailor the alternative relief is—to some extent—an empirical question. Second, a possible inequity could arise if U.S. citizens working abroad receive a reduced level of U.S. government benefits compared to what they would receive if they were living in the United States. Considering special tax relief based on benefits received by citizens abroad requires broader value judgments about the extent to which U.S. citizens should contribute to government services from which they may receive no direct private benefit. In addition, any alternative to better target special tax relief must balance added complexity for taxpayers and IRS, as well as revenue implications for the federal government.

[75] Subtitle A of Title V of the Hiring Incentives to Restore Employment Act (HIRE Act), commonly known as the Foreign Account Tax Compliance Act, requires foreign financial institutions to report on certain foreign financial accounts and offshore assets, while the Bank Secrecy Act and implementing regulations require individuals to report on certain foreign financial accounts and imposes penalties on the failure to meet these reporting requirements. 26 U.S.C. §§ 1471–1474; 31 U.S.C. § 5314; 31 C.F.R. §§ 1010.350, 1010.820.

Eliminating any special tax relief could reduce the employment of U.S. citizens in some international job markets and might lead to a small reduction in U.S. businesses' foreign activities. However, there is no clear evidence that such effects would have negative consequences for the overall well being of the U.S. population.

Agency Comments and Our Evaluation

We provided a draft of this report to the Secretary of the Treasury, Commissioner of Internal Revenue, and the Secretary of Commerce for comment. Treasury and IRS provided technical comments, which we incorporated as appropriate. Commerce said it had no comments.

We are sending copies of this report to the Secretary of the Treasury, Commissioner of Internal Revenue, and Secretary of Commerce and other interested parties. This report will also be available at no charge on GAO's website at http://www.gao.gov.

If you have any questions on this report, please contact me at (202) 512-9110 or mctiguej@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix V.

James R. McTigue, Jr.
Director, Tax Issues
Strategic Issues

Appendix I: Objectives, Scope, and Methodology

You asked us to examine section 911—the foreign earned income exclusion (FEIE) as well as an exclusion or deduction for foreign housing costs. Specifically, 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 describe the number and types of taxpayers using the FEIE, we reviewed Internal Revenue Service (IRS) forms and publications. We did not try to count the population of U.S. citizens working abroad. We also analyzed data from the IRS's Statistics of Income (SOI) *Individual Income Tax Returns 2011 publication*, and from data obtained from SOI on Form 2555, Foreign Earned Income and Form 2555-EZ, Foreign Earned Income Exclusion, for tax year 2011(the most recent year available). These SOI samples were based on returns as filed, and did not reflect IRS audit results or any net operating loss carrybacks from future years. Each Form 2555/EZ is treated as a separate return which, in the case of joint returns, may be composed of more than one taxpayer. The SOI data in this report is based on SOI's probability sample of unaudited individual income tax returns—Forms 1040, 1040A, and 1040EZ (including electronic returns) filed by U.S. citizens and residents[1]—and thus is subject to some imprecision owing to sampling variability. Using SOI's summaries of sampling weights and coefficient of variations, we estimated sampling errors for our estimates. However, SOI did not provide coefficient of variations for all of the data we obtained. As a result, when possible, estimates were obtained using the coefficients of variations of other items. Some data could not be reported and some had to be aggregated. Unless otherwise noted, all percentage estimates based on the SOI have 95 percent confidence intervals. Caution should be used when comparing estimates because not all differences between estimates are statistically significant.

[1]Forms 1040-NR are counted and tracked separately by IRS and are not part of the SOI sample. IRS officials told us that a small number of taxpayers claiming the FEIE incorrectly file a 1040NR.

SOI is a data set widely used for research purposes. SOI data are not available to the public except in aggregate form via published tables. These data tables are publicly available either in printed form or on the IRS website (http://www.irs.gov). IRS performs a number of quality control steps to verify the internal consistency of SOI sample data. For example, it performs computerized tests to verify the relationships between values on the returns selected as part of the SOI sample, and manually edits data items to correct for problems, such as missing items. To assess the reliability of the data we analyzed, we reviewed IRS documentation and interviewed agency officials familiar with the data. We concluded that the data were sufficiently reliable for the purposes of this report.

To determine how the tax expenditure may interact with other provisions of the tax code, we reviewed the Internal Revenue Code (IRC) for references to section 911. We also reviewed section 911 for references to other provisions of the U.S. Code, including the IRC. Although we identified provisions that reference section 911, not all provisions may have been identified. We did not attempt to identify provisions that refer to other provisions which refer to section 911. Through interviews and review of IRS and other materials, we identified some provisions of law that, while not referencing section 911 or referenced in section 911, may interact in some way with section 911; however, not all such provisions may have been identified. As procedural requirements, information reporting about foreign financial accounts and offshore assets—such as under the Foreign Account Tax Compliance Act or the Report of Foreign Bank and Financial Accounts—affects U.S. citizens living and working abroad but is beyond the scope of this report, which is examining section 911. To analyze how the tax expenditure affects eligibility for other tax provisions, we reviewed IRS publications, guidance, and tax advisor literature. We did not try to quantify the number and types of taxpayers using the tax expenditure that are specifically affected by the interactions.

To determine what is known about how the tax expenditure may affect business decisions about the employment of U.S. workers abroad, and U.S. exports, we reviewed related literature and available information, including government reports, academic literature, and surveys. In particular, we identified literature by conducting searches of academic literature databases, such as ProQuest, Econlit, and ABI/INFORM; searches of our prior work and work from the Congressional Budget Office (CBO), Congressional Research Service (CRS), Joint Committee on Taxation (JCT), Department of Treasury (Treasury), and Internal Revenue Service (IRS); or searches of bibliographies from literature already identified, such as the tax expenditure compendium prepared by the Congressional Research Service.[2] Although there is an extensive literature on the United States' taxation of worldwide income, much of that literature is focused on the taxation of corporations.[3] The literature related to the FEIE is more limited in volume. Prior GAO and CRS in-depth reports are more than 30 years old.[4] Other studies and articles were derived from or sponsored by industry groups or other organizations that may benefit from adjustments to laws and regulations governing the FEIE. Subsequently, we interviewed a selection of agency officials, experts, and stakeholder organizations and entities, and asked all interviewees for their suggestions on available literature and data concerning the FEIE to supplement our own literature review. (We define stakeholders as individuals or groups who may offer a valuable perspective on how the tax expenditure may affect business decisions concerning the employment of U.S. workers abroad, and exports, but who may also have a vested interest in the issue.) We interviewed Department of Commerce officials. We also identified a pool of 33 experts, whom we selected based on various factors including their affiliation with leading higher education or research institutions and their publication or research experience associated with the FEIE or related topics. These experts included economists, attorneys, and business professors, among others. One consideration in the selection process was to talk with experts with different areas of expertise among the issues of international taxation, international business strategy, trade, or U.S. labor. Another consideration was to talk with experts whose overall views on the FEIE varied from one another. While we were able to include some experts with a range of views based on their published work, most that we identified had not published articles specifically on the FEIE. Therefore, we did not know their overall opinions of FEIE in advance of our interview.

[2]U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 111-58 (Washington, D.C.: Congressional Research Service, December 2012).

[3]For an example of GAO work on the worldwide taxation of corporate income, see GAO, *Corporate Tax Expenditures: Evaluations of Tax Deferrals and Graduated Tax Rates*, GAO-13-789 (Washington, D.C.: Sept. 16, 2013).

[4]See GAO, *American Employment Abroad Discouraged By U.S. Income Tax Laws*, ID-81-27 (Washington, D.C.: Feb. 27, 1981), *Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas*, ID-78-13 (Washington, D.C.: Feb. 21, 1978), and Jane G. Gravelle and Donald W. Kiefer, *U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis*, CRS-78-91 (Washington: D.C.: Congressional Research Service, April 20, 1978).

We interviewed nine of these experts who we determined provided the range of background and experiences that we were seeking. However, the views and opinions of the experts we interviewed may not represent those of all the experts in this area. We interviewed the following experts:

- Reuven Avi-Yonah, Professor of Law, University of Michigan
- Jamie Bonache, Professor of Organization Studies, Carlos III University of Madrid
- Kimberly Clausing, Professor of Economics, Reed College
- Gary Hufbauer, Senior Fellow, Peterson Institute for International Economics
- Michael Kirsch, Professor of Law, University of Notre Dame
- Daniel Mitchell, Senior Fellow, Cato Institute
- John Mutti, Professor of Economics, Grinnell College
- Maury Peiperl, Professor of Leadership and Strategic Change, IMD Business School
- Eric Toder, Institute Fellow, Urban Institute

In addition, we interviewed representatives from nine stakeholder organizations that represent the interests of relevant entities, such as U.S. citizens working overseas and U.S. businesses. These organizations represent businesses in different geographical regions, and of different sizes. This sample of stakeholder perspectives covers a range of views, but is not generalizable to all stakeholders. In particular, we interviewed representatives from the following organizations:

- American Citizens Abroad, Inc.
- Association of Americans Resident Overseas
- Business Roundtable
- Middle East Council of American Chambers of Commerce
- National Foreign Trade Council
- National Small Business Association
- KPMG LLP
- PricewaterhouseCoopers LLP
- U.S. Chamber of Commerce, Asia

We used our review of the literature and available information described above to inform our development of sets of questions and discussion topics for the interviewees. Our discussion topics and questions for experts and stakeholders covered different areas such as the tax expenditure’s costs, benefits, and other characteristics; its relationship to U.S. workers and companies; and its relationship to exports. We analyzed all expert and stakeholder responses, and generally reported on areas where interviewees provided information that was most relevant to our final reporting objectives. In our reporting of expert and stakeholder views, we refer to “most” experts or stakeholders as representing 7 or more; “about half” as representing 4 to 6; and “several” or “some” as representing 2 or 3. While we are presenting approximate proportions of all experts and stakeholders, not every expert and stakeholders directly addressed each issue.

To identify and analyze alternative policy options, we reviewed the same literature described above to determine what is known about the advantages and disadvantages of modifying the foreign earned income exclusion. We also obtained the views of the nine experts and nine stakeholders we interviewed on the advantages and disadvantages of modifying the tax expenditure.

Our discussion topics and questions for experts and stakeholders covered a range of possible options for modifying the tax expenditure, as shown in table 7. We focused our analysis on the most common options discussed in the literature and by those we interviewed—eliminating the tax expenditure with taxing all foreign earned income and uncapping the exclusion with no taxation of foreign earned income. We also examined options that could address two arguments that may justify providing some tax relief: (1) targeting extreme costs of living to improve efficiency, and (2) adjusting taxes to reflect lower benefits to improve equity.

Table 7: Various Possible Options to Modify the Design of the Current Exclusion

Repeal the FEIE, foreign housing exclusion, or both, and tax all foreign earned income.
Reduce the maximum exclusion, housing cost amount, or both.
Increase the maximum exclusion, housing cost amount, or both.
Restrict eligibility, for example, by lengthening the required time of the bona fide residence test and the physical presence test for U.S. citizens and U.S. resident aliens living in a foreign country or by targeting employees who work in specific industries.
Expand eligibility, for example, by shortening the required time of the bona fide residence test and the physical presence test for U.S. citizens and U.S. resident aliens living in a foreign country or by extending eligibility to maritime and aviation workers who do not meet the current physical presence test.
Change the way the exclusion and housing cost limits are computed. The foreign earned income exclusion is currently indexed for inflation using the Consumer Price Index, and housing cost limits are computed by geography. One possibility would be to change how the tax expenditure is indexed for the cost of living.
Change the interactions with other tax provisions. Currently, claiming the tax expenditure affects taxpayer eligibility for other tax provisions with income thresholds, such as individual retirement accounts and the earned income tax credit. Since 2006, a stacking rule or provision requires that marginal tax rates apply to earnings beyond the limits of the tax expenditure, as if the tax expenditure had not been claimed. One way to change the interaction and stacking order would be to convert the exclusion to a credit.

Replace the exclusion with an overseas employment tax credit targeted to employees of selected industries. For example, Canadians can claim an overseas employment tax credit if they are a resident or deemed resident of Canada at any time in the year and have income from certain kinds of work—such as oil and gas exploration, construction, engineering, and work under contract with the United Nations, among others—performed in another country.
Uncap the exclusion and exclude all foreign earned income from taxation.
Impose an exit fee on U.S. citizens and U.S. resident aliens living in a foreign country. Usually part of broader tax reform, this option would exclude all foreign income for eligible individuals living overseas.

Source: GAO analysis.

We used the tax expenditure evaluation guide we developed to evaluate the performance of the foreign earned income exclusion and possible options.[5] This report focuses on the guide's criteria for evaluating whether the tax expenditure is good tax policy and meets its purpose, namely,

- Does the tax expenditure generate net economic benefits for society?
- Is the tax expenditure fair and equitable?
- Is the tax expenditure simple, transparent, and administrable?
- How well does the tax expenditure achieve its purpose?

The tax policy criteria may sometimes conflict with one another and some are subjective. As a result, there are likely trade-offs between the criteria when evaluating a particular tax expenditure. We also considered the consequences for the federal budget of the tax expenditure and possible options. We analyzed Treasury's tax expenditure estimates from 1986 to 2014, and reviewed available JCT estimates and interviewed JCT staff about the revenue effects of modifying the tax expenditure.

[5]GAO, *Tax Expenditures: Background and Evaluation Criteria and Questions*, GAO-13-167SP (Washington D.C.: Nov. 29, 2012). Our tax expenditure evaluation guide outlines a series of questions and criteria that can be used to evaluate tax expenditures. To develop the questions, we reviewed our prior work on tax expenditures, tax reform, results-oriented government, and program evaluation and interviewed experts in tax policy and program evaluation. GAO, *Understanding the Tax Reform Debate: Background, Criteria, and Questions,* GAO-05-1009SP (Washington D.C.: September 2005) summarizes the long-standing criteria used to evaluate tax policy.

Appendix II: Provisions That Interact with Section 911

There are different types of tax provisions that interact with section 911. Some tax provisions apply to Americans working abroad. Other tax provisions use the Foreign Earned Income Exclusion (FEIE) to determine the taxpayer's tax rate and the applicability for other tax provisions. There are also tax provisions that provide definitions, some of which are relevant in interpreting section 911. The tables below describe provisions that interact with section 911.

Table 8 lists select tax provisions and tax treaties which affect income tax treatment for U.S. taxpayers with income from foreign sources.

Table 9 lists other tax provisions which specifically reference section 911. In general, these provisions require calculating the taxpayer's income for a specific purpose, such as for determining eligibility for a credit or deduction, and require some or all of the exclusions or deductions allowed under section 911 to be included in the calculation. Most of the provisions listed in table 9 would not be affected by amendments to section 911, as changing the allowable exclusion or deduction under section 911 would not affect the net resulting calculation of income for purposes of most of these provisions.

Table 10 lists provisions, including two non-tax statutes which provide definitions or other context relevant for interpreting section 911.

Table 11 lists tax provisions which incorporate by reference a definition established in section 911, such as "earned income" and "tax home".

Table 8: Selected Provisions Affecting Income Tax Treatments for Americans Working Abroad

Description of provision	Description of provision	Interaction with section 911
Foreign tax credit 26 U.S.C § 901	The foreign tax credit is intended to relieve double taxation when foreign income is taxed by both the United States and the foreign country. Only foreign income taxes (including war taxes and excess profits taxes) paid or accrued to any foreign country or any possession of the United States can be claimed for the foreign tax credit. If the foreign tax rate is higher than the U.S. rate, there will be no U.S. tax on the foreign income. If the foreign tax rate is lower than the U.S. rate, U.S. tax on the foreign income will be limited to the difference between the rates. Taxpayers can choose to claim the foreign tax credit on IRS Form 1116 or as an itemized deduction on the Form 1040 schedule A.	Taxpayers who choose to claim the foreign earned income exclusion cannot take a foreign tax credit or deduction for foreign taxes on the income excluded. There is no double taxation because the excluded income is not subject to U.S income tax.

Description of provision	Description of provision	Interaction with section 911
Exemption for certain federal employee allowances 26 U.S.C § 912.	Special allowances—cost of living, housing, travel, and education—for federal civilian employees who work abroad are excluded for federal income taxes. Federal employees are generally exempt from foreign taxes.	Federal employees are not eligible for the foreign earned income or housing exclusion.
Tax treaties[a]	The United States has tax treaties with other countries that allow residents of those countries, including U.S. citizens and residents, to enjoy certain benefits, such as reduced rates of withholding and exemption from tax on certain items of income. Tax treaties may provide benefits to Americans working abroad, specifically: • compensation from short-term business trips may be excluded from taxation in the foreign country, and • pay for teachers, professors, students, trainees, and apprentices may be excluded from taxation in the foreign country.	Treaty benefits may also be available for U.S. citizens working abroad with U.S. tax home who do not meet the residency requirements for the foreign earned income and housing exclusion.
Expatriation tax 26 U.S.C § 877 and 877A	Expatriation tax provisions apply to U.S. citizens who have relinquished their citizenship and to long-term residents who have ceased to be lawful permanent residents. The rules that apply are based on the date of expatriation, as described in IRS Publication 519—U.S. Tax Guide for Aliens.	An expatriate who is considered a “covered expatriate” and whose expatriation date is after June 16, 2008 is generally subject to tax—on the net unrealized gain in his or her property as if the property had been sold for its fair market value on the day before the expatriation date. An expatriate may avoid being considered a “covered expatriate” if the section 911 exclusion reduces the expatriate’s U.S. income tax liability below a certain threshold for the five years prior to expatriation.

Source: GAO analysis of the United States Code.

[a]Taxpayers using the foreign tax credit for income taxes can claim only taxes paid. The qualified foreign tax is the amount figured using the lower treaty rate and not the amount actually paid, because the excess tax is refundable.

Table 9: Foreign Earned Income Excluded Is Used to Determine Tax Rates and Applicability for Other Tax Provisions

Other provision and citation to reference in provision to section 911	Description of provision	Interaction with section 911
Requirement to file a U.S. income tax return 26 U.S.C § 6012(c)	Income, filing status, and age generally determine whether a taxpayer must file an income tax return. For 2013, a single taxpayer under age 65 with worldwide income of $10,000 must file a U.S. tax return.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining whether a taxpayer's income is high enough to trigger the requirement to file a tax return.
Figuring tax on income not excluded 26 U.S.C § 1[a]	Worldwide income of U.S. citizens or resident aliens is generally subject to U.S. income tax regardless of where they are living. The marginal rate of tax increases for higher amounts of income.	Taxpayers claiming the foreign earned income exclusion, the housing exclusion, or both, must compute the tax on their nonexcluded income using the tax rates that would have applied had they not claimed the exclusions.
Alternative minimum tax[a] 26 U.S.C § 5581	The alternative minimum tax is a separate income tax calculation intended to ensure that higher-income taxpayers pay at least a minimum tax. Individuals with high levels of exemptions, deductions, and credits relative to income may be subject to the alternative minimum tax.	Taxpayers claiming the foreign earned income exclusion, the housing exclusion, or both, must compute the alternative minimum tax on their nonexcluded income using the tax rates that would have applied had they not claimed the exclusions.
Earned income credit[b] 26 U.S.C § 32(c)(1)(C)	The earned income tax credit is a refundable credit available to low income workers. Qualifying working taxpayers may receive a refund greater than the amount of income tax they paid for the year.	Taxpayers that claim the foreign earned income exclusion cannot also claim the earned income credit.
Child tax credit 26 U.S.C. §24(b)(1)	The child tax credit is a credit that can reduce tax by as much as $1,000 for each qualifying child under age 17. The additional child tax credit is refundable for taxpayers that owe no taxes. The amount of the credit is phased-out at higher levels of income.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the phase-out.
Adoption Credit 26 U.S.C. §23(b)(2)(B)	A tax credit of up to $12,970 is allowed for qualified expenses paid to adopt an eligible child, including a child with special needs. The amount of the credit is phased-out at higher levels of income.	Foreign earned income and foreign housing amounts, or both, that can be excluded under section 911 are included in determining income for purposes of the phase-out.
Adoption Exclusion 26 U.S.C. §137(b)(3)	A taxpayer may be able to exclude from income amounts paid or expenses incurred by their employer for qualified adoption expenses in connection with adopting a child. The maximum amount of the exclusion is phased-out at higher levels of income.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the phase-out.
Hope Scholarship Credit, Lifetime Learning Credit, and American Opportunity Credit 26 U.S.C. § 25A(d)(3)	These tax credits are available to taxpayers who pay expenses for higher (postsecondary) education expenses. For 2009 to 2017, a special type of Hope Scholarship Credit (with higher minimums and called the American Opportunities Credit) is available. The maximum amount of the credits is phased-out at higher levels of income.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the phase-out.

Other provision and citation to reference in provision to section 911	Description of provision	Interaction with section 911
Student Loan Interest Deduction 26 U.S.C. § 221(b)(2)(C)	Generally, personal interest, other than certain mortgage interest, is not deductible. This special deduction is allowed for paying interest on a student loan (also known as an education loan) used for higher education. The maximum allowable deduction is phased-out at higher income levels.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the phase-out.
Tuition and Fees Deduction 26 U.S.C. § 222(b)(2)(C)	This deduction is allowed for qualified higher education expenses paid during the year for the taxpayer, spouse, or dependents. The maximum allowable deduction for taxpayers decreases at higher levels of income.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in calculating the level of income used to determine the maximum deduction.
Coverdell Education Savings Account (ESA) 26 U.S.C. § 530(c)(2)	A Coverdell ESA is a tax-preferred account created or organized in the United States only for the purpose of paying qualified education expenses. The total annual contribution limit starts at $2,000 per beneficiary (through age 17 unless he or she is a special needs beneficiary) and is phased-out at higher levels of income. Distributions used to pay qualified education expenses are tax-exempt.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the phase-out.
Interest from U.S. savings bonds used to pay higher education expenses 26 U.S.C. § 135(c)(4)	All or part of the interest received on the redemption of qualified U.S. savings bonds used to pay qualified higher educational expenses during the same year is excluded from income. The maximum allowable exclusion is phased-out at higher income levels.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the phase-out.
Deduction phase-out for individual retirement account contributions 26 U.S.C. § 219(g)(3)	If individuals or their spouses actively participate in certain other retirement arrangements during a year, their deductions for contributions to traditional IRAs are subject to a phase-out range based on income.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the phase-out.
Saver's credit 26 U.S.C. § 25B(e)	The amount of the saver's credit is equal to the applicable percentage of the individual's qualified retirement savings contributions. The maximum possible credit is $1,000. The higher the income of the taxpayer, the lower the applicable percentage is.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of applicable percentage.
Contribution phase-out for Roth individual retirement account contributions 26 U.S.C. § 408A(c)(3)(B)(i)	Taxpayers may make contributions to Roth individual retirement accounts up to an annual contribution limit. There is no deduction for contributions, but earnings of the account are not taxed when earned and are excluded from income when distributed. Otherwise allowable contributions are subject to a phase-out range based on income.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the phase-out.

Other provision and citation to reference in provision to section 911	Description of provision	Interaction with section 911
Annuities 26 U.S.C. § 72(f)	Annuity payments may be fully or partially taxable depending in part on the tax treatment of the initial contributions. When an employer contributes to an employee's annuity, these contributions do not count towards the amount of the exclusion unless they were included in the employee's income when made.	If contributions to an annuity by an employer would not be includible in the income of the employee at the time they were made because of section 911, the contributions are not counted towards the exclusion.
Refundable credit for coverage under a qualified health plan 26 U.S.C. § 36B(d)(2)(B)	In general, taxpayers with household income between 100 and 400 percent of the national poverty line are allowed a refundable tax credit for coverage under a qualified health plan.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining household income.
Unearned Income Medicare Contribution 26 U.S.C. § 1411(d)(1)	Individuals with adjusted gross income—as modified under this section—above certain threshold amounts and with net investment income owe a tax equal to the lesser of 3.8 percent of that net investment income or 3.8 percent of the excess of the individual's modified adjusted gross income over the applicable threshold amount.	Foreign earned income excluded under section 911(a)(1) (if any) is included in determining the amount of income that is compared against the applicable threshold amount in applying this section, but only to the extent the excluded income exceeds the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts excluded from gross income under 911(a)(1).
Penalty under the requirement to maintain minimum essential coverage 26 U.S.C. § 5000A(c)(4)(C)	Individuals who do not maintain minimum essential healthcare insurance coverage are subject to a penalty. The penalty amount is the greater of a flat dollar amount or a percentage of income. Individuals with income below certain thresholds are not subject the penalty.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the penalty and thresholds.
Self-Employed Health Insurance Deduction 26 U.S.C. § 162(l)	In general, self-employed individuals are allowed to deduct the cost of health insurance. The deduction cannot exceed the taxpayer's earned income derived from the trade or business in which the taxpayer is self-employed.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining the amount of earned income for purpose of the allowable deduction for self-employed health insurance.
Social security and tier 1 railroad retirement benefits 26 U.S.C § 86(b)(2)	A percentage of social security and certain railroad retirement benefits paid to individuals with incomes above certain thresholds is considered income and is taxed accordingly. Above one set of income thresholds, 85 percent of the benefits are considered income. Above a lower set of thresholds, 50 percent of the benefits are considered income. Individuals with income below an even lower set of thresholds are not taxed on these benefits.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining income for purposes of the thresholds.

Other provision and citation to reference in provision to section 911	Description of provision	Interaction with section 911
Includible compensation for purposes of taxation of employee annuities 26 USC § 403(b)(3)	Annuity contracts purchased by a tax exempt non-profit or public school for certain employees are excluded from the income of the employee until a distribution is made. The amounts an employer can contribute to the employee's annuity are limited, in part, by the amount of compensation received by the employee from the employer.	Foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining the amount of compensation received by the employee from the employer.
Limitation on benefits under qualified defined benefit plans 26 USC § 415(b)(3)	Trusts which form part of a defined benefit pension plan of an employer and meet certain requirements are considered qualified trusts and provide certain tax benefits. A trust is not a qualified trust if it is a defined benefit plan and provides benefits in excess of a certain limitation. Benefits exceed the limitation if, on an annual basis, they are greater than the lesser of $160,000 (subject to cost-of-living adjustments) or 100 percent of the participant's average compensation for high 3 years.	For a self-employed individual, foreign earned income and foreign housing amounts that can be excluded under section 911 are included in determining average compensation for high 3 years.
Qualified individual present in foreign country or countries, applicability of exclusion from gross income provided by this section for self-employment tax purposes 26 U.S.C § 1402(a)(8), (11)	Self-employed individuals owe a tax on their self-employment income, consisting of an old-age, survivors, and disability insurance tax and a hospital insurance tax. In general, an individual's self-employment income is the net earnings from self-employment subject to certain limitations.	Foreign earned income that can be excluded under section 911(a)(1) is included in determining net earnings from self-employment. Additionally, net earnings from self-employment for ministers are determined without regard to section 911.

Source: GAO analysis of the United States Code.

[a]These provisions do not include a reference to section 911. Subsection (f)(1) of section 911 sets forth these interactions.

[b]Unlike the other entries in this table, amendments to section 911 could potentially affect the earned income credit. For instance, if the foreign earned income exclusion was eliminated, some taxpayers who had been taking the foreign earned income exclusion might be newly eligible for the earned income credit.

Table 10: Provisions Which Provide Definitions Relevant in Interpreting Section 911

Other provision and citation	Description of other provision	Interaction with section 911
Social security and tier 1 railroad retirement benefits 26 U.S.C § 86(f)(4)	A percentage of social security and certain railroad retirement benefits paid to individuals with incomes above certain thresholds is considered income and is taxed accordingly. In addition, this provision provides that for purposes of section 911, any social security benefit shall be treated as an amount received as a pension or annuity.	Under section 911, amounts received by an individual as a pension or annuity are not considered foreign earned income.
Taxability of beneficiary of employees' trust 26 U.S.C § 402(b)	Under section 402(b) benefits under a non-tax exempt employees' trust may be included in the gross income of the employees before they are actually distributed. The provision specifies the amount and timing of this income.	Under section 911, amounts included in gross income because of section 402(b) are not considered foreign earned income.
Taxation of employee annuities 26 U.S.C § 403(c)	In general, if an employer purchases an annuity contract for an employee and that annuity meets certain requirements, the employee will be taxed on amounts distributed from the annuity to the employee in the year the distributions are made. Under section 403(c), premiums paid by an employer for an annuity contract which fails to meet these requirements are to be included in the gross income of an employee and are governed by different timing rules.	Under section 911, amounts included in gross income because of section 403(c) are not considered foreign earned income.
Trade or business expenses 26 U.S.C § 162(a)(2)	Taxpayers are allowed to deduct ordinary and necessary business expenses including traveling expenses while away from home in the pursuit of a trade or business. In interpreting "while away from home", the courts have developed a body of case law defining a taxpayer's "tax home". In general, a person's tax home for determining deductible traveling expenses is the vicinity of his or her principle place of business and not where his or her personal residence is located.	For purposes of section 911, an individual's "tax home" is the home from which travel is a deductible business expense under section 162, with the caveat that an individual's tax home is not considered to be in a foreign country for purposes of section 911 for any period for which his or her abode is within the United States. To be eligible for an exclusion under section 911, a taxpayer's tax home must be in a foreign country, among other requirements.
Cost of living adjustment 26 U.S.C § 1(f)(3)	The IRC requires certain dollar amounts to be adjusted annually for inflation according to a statutory formula based on the difference between the consumer price index in a given year and the consumer price index for a reference year. This formula is set forth in section 1(f)(3).	For taxable years beginning after 2005, the maximum foreign earned income exclusion amount is adjusted for inflation according to the calculation set forth in section 1(f)(3) with 2004 as the reference year.
Mortgage Interest 26 U.S.C § 163	In general, under section 163, individuals can deduct business or investment interest, but not personal interest unless it is qualified residence interest on a home mortgage loan.	Housing expenses for purposes of section 911 do not include interest deductible under section 163.
Property Tax 26 U.S.C § 164	In general, individuals can deduct certain taxes, including state, local, and foreign real property taxes, state and local personal property taxes, and state, local, and foreign income taxes.	Housing expenses for purposes of section 911 do not include taxes deductible under section 164.

Other provision and citation	Description of other provision	Interaction with section 911
Deduction of taxes, interest, and business depreciation by cooperative housing corporation tenant-stockholder 26 U.S.C § 216(a)	Under section 216(a) a tenant-stockholder can deduct amounts paid or accrued to a cooperative housing corporation to the extent such payments represent the tenant-shareholder's proportional share of deductible real estate taxes or deductible interest.	Housing expenses for purposes of section 911 do not include amounts deductible under section 216(a).
Gain from dispositions of certain depreciable realty 26 USC § 1250	In general, taxpayers can deduct depreciation on certain real property that is more than the depreciation figured using the straight line method. This excess depreciation is referred to as additional depreciation. Gain on the disposition of real property with the additional depreciation is treated as ordinary income to the extent of the additional depreciation and is taxed at a maximum 25 percent rate.	When determining the amount of tax owed, unrecaptured section 1250 gains are determined after increasing the amount by any capital gain excess.
Wages defined for income tax withholding provisions in relation to exclusion from gross income under this section 26 U.S.C § 3401(a)(8)	Generally, for income tax withholding purposes, wages mean all remuneration for services performed by an employee for an employer.	For income tax withholding purposes, wages do not include services for an employer if, at the time of the payment of such remuneration, it is reasonable to believe that such remuneration will be excluded from gross income under section 911.
Place where persons claiming benefits of this section file returns 26 U.S.C § 6091	In general, individuals file tax returns in the internal revenue district of their legal residence of principle place of business or at a service center serving that internal revenue district as the Secretary by regulation may designate.	Persons claiming exclusions or deductions under section 911 file tax returns where designated by regulations, which direct taxpayers to file in accordance with the applicable Forms and Instructions.
Trading With the Enemy Act 50 U.S.C. App. §§ 1–44	Restricts trade with countries hostile to the United States. The act also authorizes the use of economic sanctions against foreign nations, citizens and nationals of foreign countries, or other persons aiding a foreign country.	If travel or any transaction in connection with such travel with respect to any foreign country is regulated under the Trading with the Enemy Act, then income from that country is not considered foreign earned income, and, therefore, not excludable. Further expenses for housing in that country or for a spouse or dependents in another country while the taxpayer is in the regulated country are not considered housing expenses, and, therefore are not excludable or deductible. Individuals in a regulated country are not considered bona fide residents of that country or present in that country.

Other provision and citation	Description of other provision	Interaction with section 911
International Emergency Economic Powers Act (50 U.S.C. 1701 et seq.),	Authorizes the President to regulate commerce after declaring a national emergency in response to any unusual and extraordinary threat to the United States which has a foreign source. It gives the President broad authority over financial transactions and property in which any foreign country, any citizen or national of a foreign country, or any other person aiding the foreign country, has any interest, provided that the president first declares a national emergency under the act.	If travel or any transaction in connection with such travel with respect to any foreign country is regulated under the International Emergency Economic Powers Act, then income from that country is not considered foreign earned income, and, therefore, is not excludable. Further expenses for housing in that country or for a spouse or dependents in another country while the taxpayer is in the regulated country are not considered housing expenses, and, therefore are not excludable or deductible. Individuals in a regulated country are not considered bona fide residents of that country or present in that country.

Source: GAO analysis of the United States Code.

Table 11: Section 911 Definition Is Used in Defining Earned Income or Tax Home

Description of provision	Wording of provision	Interaction with section 911
Certain unearned income of children taxed as if parent's income 26 U.S.C § 1(g)(2)(A)(ii)(II), (4)(A)(i).	For certain children, unearned income over $2,000 is taxed at the parent's rate if the parent's rate is higher than the child's. This applies to certain children who did not have earned income that exceeded half of their support.	This provision adopts by reference the definition of earned income in section 911(d)(2).
Alternative minimum tax treatment of unearned income of minor children 26 U.S.C. § 59(j)(1)(A)	For children for whose income is taxed at their parent's rate, the allowable exemption under the alternative minimum tax cannot exceed the sum of the child's earned income and a set amount.	This provision adopts by reference the definition of earned income in section 911(d)(2).
Treatment of community income property 26 U.S.C § 66 (d)(1).	A married couple may earn community income as defined under the community property laws of a U.S. state or possession or a foreign country. If the spouses live apart at all times during the calendar year, do not file a joint return, have earned income which is community income, and do not transfer any portion of that earned income between themselves, then the community income is treated in accordance with section 879(a).	This provision adopts by reference the definition of earned income in section 911(d)(2).

Description of provision	Wording of provision	Interaction with section 911
Accident and health plans 26 U.S.C § 105(h)(3)(B)(v).	In general, employees can exclude certain health benefits offered by their employers from their income. However, certain highly compensated employees may not exclude the value of health benefits in certain cases. If health benefits are provided under a self-insured medical expense reimbursement plan which discriminates in favor of highly compensated individuals, a portion of those benefits may not be excludable. When determining whether a plan is discriminatory, certain classes of employees need not be considered, including employees who have not completed three years of service, employees under the age of 25, part-time and seasonal employees, and nonresident alien employees who received no U.S.-source earned income from the employer.	This provision adopts by reference the definition of earned income in section 911(d)(2).
Qualified pension, profit-sharing, and stock bonus plans minimum coverage requirements 26 U.S.C. § 410(b)(3)(C)	Employers may establish qualified pension, profit-sharing or stock bonus plans (such as 401(k) plans) with certain tax advantages. A plan is not a qualified plan unless it meets certain requirements, including minimum coverage requirements. When determining whether a trust meets the minimum coverage requirements, certain classes of employees can be excluded, including nonresident alien employees who received no U.S.-source earned income from the employer.	This provision adopts by reference the definition of earned income in section 911(d)(2).
Qualified pension, profit-sharing, and stock bonus plans definitions and special rules 26 U.S.C. § 414(q)(8)	Employers may establish qualified pension, profit-sharing or stock bonus plans (such as 401(k) plans) with certain tax advantages. A plan is not a qualified plan unless it meets certain requirements, including minimum coverage requirements. If an employer is operating separate lines of business during a year, the employer may apply the minimum coverage requirements to each separate line of business. Nonresident alien employees who received no U.S.-source income from the employers are not considered employees for purposes of determining who highly compensated employees are and for determining whether the employer is engaged in a separate line of business.	This provision adopts by reference the definition of earned income in section 911(d)(2).

Description of provision	Wording of provision	Interaction with section 911
Exempt organizations 26 U.S.C § 505(b)(2)(E)	Organizations organized and operated for certain purposes are tax exempt. Tax exempt organizations include voluntary employee beneficiary associations providing certain benefits and trusts to provide group legal services. If these types of exempt organizations are part of a plan, they must meet certain additional requirements to maintain their tax exempt status, including that the plan of which they are a part be nondiscriminatory. When determining whether a plan is discriminatory, certain classes of employees need not be considered, including employees who have not completed three years of service, employees under the age of 21, less than half-time and seasonal employees, and nonresident alien employees who received no U.S.-source earned income from the employer.	This provision adopts by reference the definition of earned income in section 911(d)(2).
Group-term life insurance provided by an employer 26 U.S.C § 79(d)(3)(B)(iv)	Employer provided group-term life insurance for employees is excludable from the income of the employees up to a certain amount. This exclusion is not available for certain key employees if the plan is discriminatory. When determining whether a plan is discriminatory, certain classes of employees need not be considered, including employees who have not completed three years of service, part-time and seasonal employees, and nonresident alien employees who received no U.S.-source earned income from the employer.	This provision adopts by reference the definition of earned income in section 911(d)(2).
Passive activity losses and credits 26 U.S.C § 469(e)(3)	In general, taxpayers may not take losses from passive activities in excess of aggregate income from passive activities or certain credits from passive activities in excess of regular tax liability allocable to all passive activities. When calculating income or loss from a passive activity, earned income is not taken into account.	This provision adopts by reference the definition of earned income in section 911(d)(2)(A), but not subsection 911(d)(2)(B).
Community income of nonresident alien individuals 26 U.S.C § 879(a)(1)	A married couple may earn community income as defined under the community property laws of a U.S. state or possession or a foreign country. If one or both spouses of a married couple are nonresident aliens, any community income that is earned income (other than trade or business income and a partner's distributive share of partnership income) is treated as income of the spouse who rendered the personal service.	This provision adopts by reference the definition of earned income in section 911(d)(2).
Tax on group health plans which fail to satisfy continuation coverage requirements 26 U.S.C. § 4980B(g)(1)(C)	Group health plans which fail to meet certain continuation coverage requirements with respect to any qualified beneficiary are subject to a tax. A nonresident alien who received no U.S.-source earned income is not considered a qualified beneficiary when determining whether this requirement tax is imposed.	This provision adopts by reference the definition of earned income in section 911(d)(2).

Description of provision	Wording of provision	Interaction with section 911
Source rules for personal property sales 26 U.S.C § 865(g)(1)(A)(i)(I)	In general, income from the sale of personal property by a U.S. resident is sourced to the United States and the sale of personal property by a nonresident is sourced outside the United States. For purposes of this provision, an individual is a U.S. resident if he or she is a U.S. citizen or alien resident and who does not have a tax home in a foreign country or is a nonresident alien with a tax home in the United States.	This provision adopts by reference the definition of tax home in section 911(d)(3).
Residence and source rules involving possessions 26 U.S.C. § 937(a)(2)	In general, to be a bona fide resident of Guam, American Samoa, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands, an individual must meet two requirements. First, the individual must be present for at least 183 days during the taxable year in that possession. Second, the individual must not have a tax home outside the possession where they were present for 183 days and not have a closer connection to the United States or a foreign country than to the possession.	This provision adopts by reference the definition of tax home in the first sentence of section 911(d)(3), but without regard to the second sentence of section 911(d)(3).
Treatment of certain foreign currency transactions 26 U.S.C § 988(a)(3)(B)(i)(I)	In general, the source of ordinary income or loss from foreign currency transaction is determined, in part, by the residency of the taxpayer on whose books the relevant asset, liability, or item of income is properly reflected. For purposes of this provision, an individual's residency is the country in which the individual's tax home is located.	This provision adopts by reference the definition of tax home in section 911(d)(3).
Penalty under the requirement to maintain minimum essential coverage 26 U.S.C. § 5000A(f)(4)(A)	Individuals who do not maintain minimum essential healthcare insurance coverage are subject to a penalty. An individual is considered to have minimum essential coverage for any month in which the individual's tax home is in a foreign country and who is a bona fide resident of a foreign country or countries for the entire year or is present in a foreign country or countries during at least 330 full days during that year.	This provision adopts by reference section 911(d)(1) which provides that a qualified individual is an individual who is a bona fide resident of a foreign country or countries for the entire year or is present in a foreign country or countries during at least 330 full days during that year.
Resident alien and nonresident alien defined. 26 U.S.C § 7701(b)(3)(B)(ii)	In general, an alien individual is considered a resident alien of the United States if he or she meets certain requirements, including the substantial presence test. An individual will not be considered to meet the substantial presence test if he or she is present in the United States on fewer than 183 days during the current year, has a tax home in a foreign country (as defined in section 911(d)(3) without regard to the second sentence thereof), and has a closer connection to that foreign country than the United States.	This provision adopts by reference the definition of tax home in the first sentence of section 911(d)(3), but without regard to the second sentence of section 911(d)(3).

Source: GAO analysis of the United States Code.

Appendix III: Comparison of Tax Costs of U.S. and Non-U.S. Workers under the Foreign Earned Income Exclusion in Different Hypothetical Host Countries and at Different Income Levels

U.S. overseas workers' tax costs can vary across locations, and exceed the tax liabilities of non-U.S. workers. The foreign earned income exclusion (FEIE) can eliminate the U.S. income tax liability for some taxpayers residing overseas with foreign earned income. However, taxpayers with foreign earned income higher than the FEIE limit can, after applying the FEIE, incur a U.S. tax liability, in addition to the taxes they may owe to the foreign host nation. Tables 12 and 13 compare the tax liabilities of U.S. and non-U.S. workers in three hypothetical locations with varying effective tax rates. For each of the three locations, or host countries, both the U.S. and non-U.S. workers are assumed to be in a country other than their home country. The example in table 12 uses a level of foreign earned income sufficiently low that application of the FEIE eliminates the U.S. worker's U.S. tax liability. Table 13 uses a higher level of foreign earned income, illustrating that after applying the FEIE, the U.S. worker can incur a U.S. tax liability in addition to the taxes he or she may owe to the foreign host nation. In addition to comparing the tax liabilities of U.S. and non-U.S. workers in different locations, tables 12 and 13 also compare the U.S. worker's after-tax income abroad against what it would be were the worker employed in the United States. The tables also illustrate the U.S. worker's after tax income in three locations without use of the FEIE.

The examples included in the tables include certain assumptions, including that each employee (1) holds the same qualifications, (2) receives the same income, and (3) has a single tax filing status. The examples also assume the non-U.S. employee is not taxed by his or her home country on foreign-earned income, as the citizens of most other countries are not taxed by their country of citizenship if they reside in another country. The comparison focuses on home country tax rates for U.S. citizens and non-U.S. foreign nationals. U.S. citizens and non-U.S. foreign nationals would generally face the same local taxes as local citizens of the hypothetical host country. The U.S. effective tax rate listed is that which applies to the earned income level provided in the example, without application of the tax expenditure. Housing costs are not explicitly included in the example. Differences in housing costs can be offset by applicable housing exclusions or deductions. However, in some cases the differences in housing costs can affect overall tax liability. Finally, the example for table 13 assumes that the U.S. citizen working in country B would claim the foreign tax credit for any income not excluded through the FEIE, while, for both tables, the U.S citizen working in country C could claim the foreign tax credit instead of the tax expenditure since doing so would eliminate his or her U.S. tax obligation.

Table 12: Comparison of Tax Costs of U.S. and Non-U.S. Workers in Three Hypothetical Locations, at $107,600 Foreign Income Level

Country of employment	United States	Country A		Country B		Country C	
Effective tax rate	19%	0%		10%		25%	
Nationality of employee	**U.S. Citizen**	**U.S. Citizen**	**Non-U.S. Foreign National**	**U.S. Citizen**	**Non-U.S. Foreign National**	**U.S. Citizen**	**Non-U.S. Foreign National**
Earned income	$107,600	$107,600	$107,600	$107,600	$107,600	$107,600	$107,600
Less standard deduction $6,100 and one exemption $3,900	($10,000)	($10,000)	N/A	($10,000)	N/A	($10,000)	N/A
Less FEIE	N/A	($97,600)	N/A	($97,600)	N/A	N/A	N/A
Host country taxable income	N/A	$0	$0	$107,600	$107,600	$107,600	$107,600
Host country income tax	N/A	$0	$0	$10,760	$10,760	$26,900	$26,900
U.S. and total tax when FEIE is available							
U.S. taxable income	$97,600	$0	N/A	$0	N/A	$97,600	N/A
U.S. income tax after foreign tax credit	$20,628	$0	N/A	$0	N/A	$0	N/A
Total income after tax	$86,972	$107,600	$107,600	$96,840	$96,840	$80,700	$80,700
Difference between U.S. citizen after-tax income abroad and in the U.S.	N/A	$20,628	N/A	$9,868	N/A	($6,272)	N/A
Difference between U.S. citizen after-tax income and that of a non-U.S. citizen	N/A	$0	N/A	$0	N/A	$0	N/A
U.S. and total tax if FEIE if was not available							
U.S. taxable income	$97,600	$97,600	N/A	$97,600	N/A	$97,600	N/A
U.S. income tax after foreign tax credit	$20,628	$20,628	N/A	$9,868	N/A	$0	N/A
Total income after tax	$86,972	$86,972	$107,600	$86,972	$96,840	$80,700	$80,700
Difference between U.S. citizen after-tax income abroad and in the U.S.	N/A	$0	N/A	$0	N/A	($6,272)	N/A
Difference between U.S. citizen after-tax income and that of a non-U.S. citizen	N/A	($20,628)	N/A	($9,868)	N/A	$0	N/A

Source: GAO analysis.

Table 13: Comparison of Tax Costs of U.S. and Non-U.S. Workers in Three Hypothetical Locations, at $175,000 Foreign Income Level

Country of employment	United States	Country A		Country B		Country C	
Effective tax rate	23%	0%		10%		25%	
Nationality of employee	**U.S. Citizen**	**U.S. Citizen**	**Non-U.S. Foreign National**	**U.S. Citizen**	**Non-U.S. Foreign National**	**U.S. Citizen**	**Non-U.S. Foreign National**
Earned income	$175,000	$175,000	$175,000	$175,000	$175,000	$175,000	$175,000
Less standard deduction $6,100 and one exemption $3,900	($10,000)	($10,000)	N/A	($10,000)	N/A	($10,000)	N/A
Less FEIE	N/A	($97,600)	N/A	($97,600)	N/A	N/A	N/A
Host country taxable income	N/A	$0	$0	$175,000	$175,000	$175,000	$175,000
Host country income tax	N/A	$0	$0	$17,500	$17,500	$43,750	$43,750
U.S. and total tax when FEIE is available							
U.S. taxable income	$165,000	$67,400	N/A	$67,400	N/A	$165,000	N/A
Foreign Earned Income excluded	N/A	$97,600	N/A	$97,600	N/A	NA	N/A
U.S. income tax (no FEIE or foreign tax credit)	$39,493	$39,493	N/A	$39,493	N/A	$39,493	N/A
U.S. tax on excluded income	N/A	$20,628	N/A	$20,628	N/A	N/A	N/A
U.S. income tax after FEIE	$39,493	$18,865	N/A	$18,865	N/A	$39,493	N/A
Foreign tax allocable to excluded income	N/A	$0	N/A	$9,760	N/A	N/A	N/A
U.S. income tax after foreign tax credit	$39,493	$18,865	N/A	$9,105	N/A	$0	N/A
Total income after tax	$135,507	$156,135	$175,000	$148,395	$157,500	$131,250	$131,250
Difference between U.S. citizen after-tax income abroad and in the U.S.	N/A	$20,628	N/A	$12,888	N/A	($4,257)	N/A
Difference between U.S. citizen after-tax income and that of a non-U.S. citizen	N/A	($18,865)	N/A	($9,105)	N/A	$0	N/A
U.S. and total tax if FEIE if was not available							
U.S. taxable income	$165,000	$165,000	N/A	$165,000	N/A	$165,000	N/A
U.S. income tax after foreign tax credit	$39,493	$39,493	N/A	$21,993	N/A	$0	N/A
Total income after tax	$135,507	$135,507	$175,000	$135,507	$157,500	$131,250	$131,250
Difference between U.S. citizen after-tax income abroad and in the U.S.	N/A	$0	N/A	$0	N/A	($4,257)	N/A

Country of employment	United States	Country A		Country B		Country C	
Effective tax rate	23%	0%		10%		25%	
Nationality of employee	**U.S. Citizen**	**U.S. Citizen**	**Non-U.S. Foreign National**	**U.S. Citizen**	**Non-U.S. Foreign National**	**U.S. Citizen**	**Non-U.S. Foreign National**
Difference between U.S. citizen after-tax income and that of a non-U.S. citizen	N/A	($39,493)	N/A	($21,993)	N/A	$0	N/A

Source: GAO analysis.

Appendix IV: Assessment of the Current Tax Expenditure and Four Alternatives

Using criteria from our tax expenditure evaluation guide, we evaluated whether the tax expenditure[1]

- generates net economic benefits for society;
- is fair and equitable;
- is simple, transparent, and administrable; and
- is achieving its purpose.

The tax expenditure affects a variety of resource allocation decisions; it also affects equity in several different ways. Some of these effects are positive, while others are negative, and the magnitudes of all these effects are unknown. As a result, the tax expenditure's overall effect is uncertain.

Does the Tax Expenditure Generate Net Economic Benefits for Society?

A tax system reduces economic efficiency to the extent that it affects the relative prices of goods, services, or factors of production, and thereby induces individuals or businesses to alter economic decisions.[2] No tax system can avoid affecting some relative prices to some extent; however, it is important to minimize these price effects unless they are intended to achieve some other beneficial social purpose. We found that the tax expenditure had effects on the following.

Choices about where to work and who to hire: The tax expenditure potentially influences the choice of some U.S. citizens between working abroad or in the United States, because it lowers the total tax that these individuals would pay on foreign earned income. These tax reductions make working abroad in lower-tax countries more attractive to U.S.

[1]Unless otherwise specified, the term "tax expenditure" here refers to the foreign earned income exclusion as well as the exclusion and deduction for excess foreign housing costs.

[2]Resources are used most efficiently when they provide the greatest possible benefit or well-being. The concept of economic efficiency recognizes that when resources are not underemployed, decisions about their use involve tradeoffs. See GAO, *Tax Expenditures: Background and Evaluation Criteria and Questions,* GAO-13-167SP (Washington, D.C.: Nov. 29, 2012) and *Understanding the Tax Reform Debate: Background, Criteria & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005) for a more detailed discussion of economic efficiency.

citizens than doing so otherwise would be and as a result, could interfere with the efficient allocation of U.S. labor between locations.[3]

The tax expenditure also potentially influences employers' choices as to whether they should fill positions abroad with U.S. citizens or with citizens of countries that do not tax earned income on a worldwide basis. The reduction in efficiency can occur when the employer hires a less productive worker for a lower pretax salary than the U.S. citizen would demand, due to the foreign worker paying no tax to his home country. The tax expenditure counteracts these effects, but we found no evidence in the economic literature that would indicate how the magnitude of the counteracting effects compares to the negative efficiency effects we discussed earlier. Consequently, we are not able to say whether the tax expenditure improves or reduces overall economic efficiency.

Differences in costs of living: Tax relief may be justified for U.S. citizens working in countries where the costs of living are significantly higher than the United States' highest-cost locations.[4] If these taxpayers' wages are sufficiently greater than they would earn at home (reflecting higher costs of living abroad), they may be pushed into higher tax brackets. This increase in the tax bracket is another way that the tax system could reduce efficiency by affecting location and hiring decisions. Tax relief targeted to the effects of this bracket change would remove an efficiency-reducing influence on U.S. citizens' employment decisions at a lower revenue cost than the more broad tax relief provided by the tax expenditure. This same efficiency problem arises domestically with respect to cost-of-living differences within the United States. Given that the U.S. tax system does not address this problem domestically, those who have proposed a means of addressing cost-of-living differences between the United States and foreign locations note that it may only be

[3]If policymakers are concerned that tax rate differences across countries already cause inefficiencies that need to be addressed by U.S. tax policy, then the United States would also have to compensate U.S. citizens working in high-tax countries (to the extent that the taxes they pay there exceed what they would have paid in the United States).

[4]See U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 112-45 (Washington, D.C.: Congressional Research Service, December 2012) and Jane G. Gravelle and Donald W. Kiefer, *U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis* (Washington, D.C.: Congressional Research Service, Apr. 20, 1978).

justified if the differences are much greater internationally than domestically.

Is the Tax Expenditure Fair and Equitable?

Equity is a subjective criterion. There are differing views on what an equitable tax system should look like, which can affect judgments on the fairness of a particular tax expenditure. Determining who benefits from the tax expenditure, and how those benefits affect equity, can be more complicated than simply identifying which taxpayers claim the tax expenditure. Three principles can inform judgments about the fairness of the tax expenditure:

Horizontal equity: Individuals with equal incomes and who are the same in terms of other characteristics deemed relevant to the ability to pay tax (such as number of dependents) should pay the same tax.

Vertical equity: Similar to horizontal equity, individuals with higher income or who have other characteristics that increase their ability to pay should pay more tax than those with less ability to pay. Identifying the characteristics that are relevant to an individual’s ability to pay can involve value judgments. For that reason, among others, different observers may diverge in their assessments of how well a particular tax policy meets either of these equity criteria.[5]

Benefits received principle: An individual’s tax payments should bear some relationship to the government benefits that individual receives. Once again, observers can differ in their judgments regarding the degree to which tax payments and benefits should be related, particularly because this criterion often conflicts with the other two equity criteria.

In order to apply any of these equity principles, it is necessary to identify individuals who benefit from the exclusion. This identification is complicated by the fact that the individual or business that is legally obligated to pay a tax—or that receives a tax benefit—is not always the one (or, at least, not the only one) that bears the ultimate burden of the tax or receives the ultimate benefit. The ultimate burden or benefit is known as the incidence of the tax policy, and it depends on how various

[5]Another value judgment relates to the progressivity of a tax—the degree to which taxes should increase as the ability to pay increases.

individuals and businesses respond to the policy. For example, in the case of the tax expenditure, even though individual employees claim the exclusion on their own tax returns, the resulting reduction in their total taxes may make them willing to work abroad for a lower pretax income than they would have accepted without the tax expenditure. As a result, the foreign employers may share in at least some of the benefit by being able to pay lower salaries than would otherwise have been needed to hire U.S. citizens.

Determining the actual incidence of the tax expenditure would be difficult because it would require information on how two factors—the amount of labor that U.S. citizens are willing to supply to employers abroad and how those employers' demand for that particular type of labor—respond to changes in pretax and post-tax rates of compensation. We know of no study that has attempted to estimate such responsiveness. Given this uncertainty relating to the tax expenditure's incidence, it is difficult to draw conclusions about its effect on the equity of the tax system.

Conclusions about the tax expenditure's effect on horizontal equity depend, in part, on judgments about appropriate comparison groups. For U.S. policymakers, one relevant comparison is the treatment of U.S. citizens working abroad relative to similar U.S. citizens working in the United States. Unless all of the benefit from the tax expenditure is passed on to employers or unless those working abroad are deemed to be sufficiently different from their domestic counterparts due to either the potentially extreme cost-of-living differences discussed above or the differences in U.S. government services they receive, the tax expenditure violates the principle of horizontal equity between these two groups of individuals.

The tax expenditure decreases vertical equity to the extent that individuals who claim the exclusion tend to have higher incomes than those living in the United States, unless the incidence of the tax benefit falls entirely on employers. In comparison to an unlimited exclusion, the current design of the tax expenditure—specifically the dollar limit and the stacking rule[6]—moderates this negative effect.

In terms of the benefits principle, some of the experts we interviewed noted that U.S. citizens working abroad for the long term receive significantly smaller benefits from U.S. government services than those living in the United States, and that this difference may justify some tax relief for the former. Other experts noted that a large portion of federal revenues pay for services—such as national defense, foreign affairs, income maintenance, and basic research—that produce social or humanitarian benefits that are not directly apportioned to specific individuals. U.S. citizens living abroad likely benefit from some of these services. Many of those citizens also benefitted from years of public investment, for example, in their education, the cost of which is typically recaptured from citizens over their lifetimes. Moreover, some observers note that the choice to retain U.S. citizenship while living abroad provides some insurance with respect to being able to return and live within the United States whenever one wants. They maintain that citizens abroad should be willing to pay some tax for this insurance. Currently, U.S. citizens overseas must file a U.S. tax return and pay taxes owed unless they renounce their citizenship.[7] The National Taxpayer Advocate has reported that the numbers of those giving up their U.S. citizenship are growing.[8]

Citizens living abroad benefit from services provided by their host-countries' governments to which they pay taxes. Given that credits for foreign income taxes paid reduce the amount of tax that these citizens

[6]For taxpayers that have taxable income after claiming the FEIE and foreign housing exclusion, the applicable tax rate is determined by calculating taxable income without taking these exclusions into account. This stacking rule results in these taxpayers claiming the tax expenditure being subject to the same marginal tax rates as taxpayers with the same level of income who are not eligible for (or do not elect to claim) the tax expenditure.

[7]Expatriation tax provisions apply to U.S. citizens who have relinquished their citizenship and long-term residents who ceased to be lawful permanent residents. The rules that apply are based on the date of expatriation, as described in IRS Publication 519—*U.S. Tax Guide for Aliens (available at http://www.irs.gov/publications/p519/ar01.html).*

[8]Taxpayer Advocate Service, *2012 Annual Report to Congress,* (Washington D.C.: Dec. 31, 2012). Based on analysis of IRS quarterly reports listing those giving up citizenship, the Taxpayer Advocate reported that expatriations increased substantially from 2008 to 2011. The latest IRS report available listed 1,001 citizens and long-term residents losing U.S. citizenship in the quarter ending March 31, 2014. 79 Fed. Reg. 25,176 (May 2, 2014).

pay to the U.S federal government, any attempt to quantify discrepancies between federal benefits received and federal taxes paid should account for the foreign tax credit.[9]

The tax expenditure results in more comparable treatment between U.S. citizens working in a low-tax foreign country and foreign workers in that country that have similar characteristics; however, it is not clear that comparisons between these two groups would be of equal interest to U.S. policymakers as the domestic taxpayer comparison. If this second comparison is considered relevant, the equity assessment would not be limited to a review of differences in the tax policies of various countries; it would also consider differences in the benefits that each government provides to citizens working abroad.

Is the Tax Expenditure Simple, Transparent, and Administrable?

There is widespread agreement that the U.S. worldwide tax system is complex and adds burden for taxpayers and IRS. The tax expenditure adds complexity with its eligibility rules and interactions with the foreign tax credit (FTC) and other tax provisions.

Transparency: Taxpayers may not fully understand their obligations under the tax expenditure. According to IRS, there is a common misconception that potentially excludable foreign earned income does not have to be reported on a U.S. tax return. IRS said that this misconception contributes to the tax gap, which is the difference between taxes owed and those paid on time.[10] However, data do not indicate the portion of the U.S. tax gap—most recently estimated by IRS at a net $385 billion as of 2006—that is attributable to international taxpayers who fail to file U.S. tax returns, underreport their foreign income, or fail to pay U.S. taxes owed. The National Taxpayer Advocate has called attention to the need to improve access and service for taxpayers located outside of the United

[9]In the absence of the tax expenditure, some employers might raise the pretax salaries of its employees who are U.S. citizens to offset losses in services that the latter would incur by accepting a position abroad. As we noted in the discussion of incidence, the likelihood of this occurring is unknown. In such cases the tax expenditure does not provide any improvement in equity; it would simply reduce costs for those particular employers.

[10]For more on GAO's work on the tax gap, see our Tax Gap Key Issue page, at http://gao.gov/key_issues/tax_gap/issue_summary#t=1.

States. IRS has undertaken research to study the needs of international taxpayers in helping them comply with their U.S. tax liabilities.[11]

Simplicity: According to some experts interviewed, the tax expenditure may simplify the tax compliance burdens of U.S. citizens abroad who would otherwise have to claim the FTC to avoid double taxation on foreign earned income. According to stakeholders and some experts we interviewed, the FTC can be more complex. However, this effect is uncertain for several reasons. First, we did not find evaluative studies that compare the compliance burden of the tax expenditure with the FTC. Second, taxpayers who claim the tax expenditure may bear the burden associated with claiming the FTC for capital income not covered by the tax expenditure. Additionally, taxpayers with only earned income may also do the FTC computations to determine which tax provision is the less costly option. Taxpayers with earned income exceeding the maximum exclusion face complexity in properly claiming both the tax expenditure and FTC.[12] Furthermore, taxpayers who claim the tax expenditure need to calculate their modified adjusted gross income (AGI) to determine eligibility for other tax benefits. In addition, taxpayers claiming the exclusion face additional recordkeeping to demonstrate that they meet the bona fide residence or to track days for the physical presence test.[13] Although the net effect of the tax expenditure on compliance burden may be uncertain, some experts have suggested that the compliance burden could be simplified by replacing the tax expenditure with a modified FTC or simplified FTC form.[14]

Administrability: IRS faces challenges in administering the tax expenditure, because IRS does not have the same level of information

[11]Tiffanie N. Reker, David C. Cico, and Saima S. Mehmood, *2012 Taxpayer Experience of Individuals Living Abroad: Service Awareness, Use, Preferences, and Filing Behaviors*, Research Study Report (Internal Revenue Service, W&I Research & Analysis: June 21, 2012).

[12]Foreign earned income excluded cannot be deducted, excluded a second time, or used to claim a credit, so taxpayers are required to compute the fraction of foreign taxes that are not allocable to the excluded income.

[13]Treasury Inspector General for Tax Administration, *Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims,* Reference Number 2010-40-091 (Washington, D.C.: Aug. 16, 2010).

[14]Whereas the form 2555 for the exclusion has an EZ version, the foreign tax credit form 1116 does not have an EZ version.

reporting on foreign source income as it does for U.S. source income to detect noncompliance. Like U.S. citizens working in the United States, citizens abroad working for U.S. companies would be subject to U.S. employer wage reporting and tax withholding.[15] However, IRS does not receive the same wage reports or tax withholding for U.S. citizens abroad working for foreign employers. Tax treaties and tax information exchange agreements with other nations can facilitate the exchange of taxpayer information. Additionally, recent information reporting requirements are an effort to improve transparency and provide tools for IRS to identify Americans abroad and address potential tax noncompliance.[16] However, the National Taxpayer Advocate reports and stakeholders we interviewed raised concerns that these reporting requirements add burden for citizens overseas as well as the third parties submitting the information.

IRS special compliance projects have found substantial noncompliance among high-risk taxpayers miscalculating or ineligible to claim benefits from the tax expenditure. Specifically, during 2009 through 2011, about 3,000 noncompliant tax returns identified by IRS special compliance projects were found to have miscalculated the exclusion or were not eligible resulting in an additional $21 million, according to the Treasury Inspector General for Tax Administration.[17] IRS said audits of exclusion claims are factually intensive and require information, for example, about a taxpayer's travel and domestic ties. The Treasury Inspector General for Tax Administration has reported on the challenges in administering the bona fide residence and physical presence tests.[18] IRS began including

[15]Wages are subject to withholding to the extent that they exceed the amount of the exclusion. An exemption from withholding on excluded wages is available for citizens abroad but not resident aliens. Employers do not have to withhold U.S. taxes if they are required to withhold taxes for a foreign government.

[16]Subtitle A of Title V of the Hiring Incentives to Restore Employment Act (HIRE Act), commonly known as the Foreign Account Tax Compliance Act, requires foreign financial institutions to report on certain foreign financial accounts and offshore assets, while the Bank Secrecy Act and implementing regulations require individuals to report on certain foreign financial accounts and imposes penalties on the failure to meet these reporting requirements. 26 U.S.C. §§ 1471–1474; 31 U.S.C. § 5314; 31 C.F.R. §§ 1010.350, 1010.820.

[17]Treasury Inspector General for Tax Administration, *The Referral Process for Examinations of Tax Returns Claiming the Foreign Income Exclusion Needs to Be Improved,* Reference Number 2013-30-112 (Washington, D.C.: Sept. 27, 2013).

[18]Treasury Inspector General for Tax Administration, *Improvements Needed to Reduce Erroneous Claims.*

international taxpayers in its National Research Program in 2008 and plans to use the results to target enforcement on noncompliant taxpayers.[19]

How Well Does the Tax Expenditure Achieve Its Purposes?

As discussed earlier, the tax expenditure's effect on hiring and employment decisions is uncertain. There is little evidence to indicate that the tax expenditure could have more than a limited effect on exports. Moreover, there is no evidence to indicate that this effect is positive or that it would exceed any effect that the tax expenditure has on imports. Thus, it is not clear if the special tax relief for the relatively small population of U.S citizens living and working abroad positively benefits the overall well-being of the United States.

Some Alternatives to the Tax Expenditure Would Increase Efficiency and Equity, While the Effect of Others Would Depend on Details of the Reform

An assessment of the tax expenditure against criteria for good tax policy leaves room for debate regarding potential alternatives to improve the efficiency and equity as well as reduce complexity for taxpayers and IRS. Alternatives to the current tax expenditure range from eliminating it entirely—as proposed in several deficit reduction and tax reform proposals—to removing the maximum limit on the exclusion. We also considered alternatives to target tax relief to high cost areas and address the benefits received principle. [20]

Alternative: Eliminating the Tax Expenditure

The net effect on economic efficiency of eliminating the tax expenditure and taxing all foreign earned income is uncertain. This alternative would largely remove the influence of taxes on location decisions by U.S. citizens to work abroad, which would increase efficiency; however, at the same time, it would decrease efficiency by increasing the effect of the differential tax treatment by the United States and other countries on businesses' decisions regarding whom to hire for positions abroad. The

[19]The National Research Program uses audits of a stratified, random sample of tax returns to produce statistically valid estimates of noncompliance for the entire population of tax return filers. For tax years 2006 through 2010, IRS sampled each year about 450 international taxpayers in its National Research Program. IRS plans to use these results for workload planning. The relatively small sample is not representative for estimating the international component of the tax gap.

[20]To identify and analyze alternative policy options, we conducted an extensive literature search and interviewed a range of stakeholders and experts; see appendix I for more on our methodology and a list of the options discussed with those we interviewed.

effect of the alternative on equity is also uncertain. Elimination could be viewed as improving equity if two conditions are met: (1) there are few or no foreign locations where living costs are significantly higher than in the highest-cost locations within the United States, and (2) the additional federal taxes (in excess of the amounts offset by foreign tax credits) are broadly commensurate with the benefits that U.S. citizens working abroad receive from the U.S. government. If either of these conditions is not met, then some form of tax relief may be justified on equity grounds.

The effect on compliance burden will vary with the circumstances of the taxpayers. Eliminating the exclusion could increase the compliance burdens of some taxpayers who currently use the exclusion rather than the FTC to the extent that the FTC form is more complicated than the FEIE form. However, it would not significantly affect the compliance burden of taxpayers with earned income exceeding the exclusion limit or investment income who already use the FTC. IRS officials said that repealing the tax expenditure would simplify challenges associated with the FEIE bona fide residence and physical presence tests that do not apply to the FTC. Citizens working abroad in lower tax countries would face higher taxes. Those facing higher taxes or compliance costs may choose not to comply, and noncompliance could undercut the expected revenue gain from repeal.[21]

Alternative: Targeting Tax Relief for Extreme Cost of Living Differences

Economic efficiency and equity could be improved by modifying the current tax expenditure design or replacing it with an alternative tax relief that adjusts for foreign costs of living that significantly exceed those in the highest-cost U.S. locations. One approach would be to make Treasury responsible for annually determining the amount by which costs of living in foreign locations may exceed those in the highest-cost U.S. locations and for publishing adjustment factors for determining tax liabilities.[22] Whether a system of cost-of-living adjustments would be more burdensome for Treasury or taxpayers than the current tax expenditure,

[21]The staff of the Joint Committee on Taxation estimate that repealing the exclusion would increase federal revenue by $6.2 billion in 2015 and $89 billion over 2014 through 2023; see Congressional Budget Office, *Options for Reducing the Deficit: 2014 to 2023* (Washington, D.C.: November 2013). Unlike a tax expenditure estimate, revenue estimates generally reflect changes in behavior by individuals and firms.

[22]Such an approach is discussed in Gravelle and Kiefer (1978). Certain cost differences—such as those relating to education and certain types of taxes—present complications that may not be adequately addressed by comparing available cost-of-living indexes.

which already has some adjustment for higher housing expenses, depends on the degree of accuracy and completeness desired in the adjustments.[23] The federal revenue change would depend on the cost of tax reductions targeted to citizens working in higher cost foreign areas in place of the current preferential treatment for all citizens working abroad, and—depending on policy priorities and preferences—the redesign could aim for the same or a lower overall cost to the federal government.

Alternative: Targeting Tax Relief Based on Benefits Received and Obligations as Citizens

It would be difficult to design an alternative to the tax expenditure that better targeted tax relief based on benefits received. The tax expenditure itself is not designed specifically to address the benefits received principle, and the federal income tax in general is not based on the benefits received principle. Indeed, it would be very difficult to incorporate the principle in a tax that funds such a broad array of functions, many of which provide broad social benefits. Moreover, the values of these benefits are not easily allocable to specific individuals. Any attempt to determine a fair reduction in federal tax obligations of U.S. citizens living abroad relative to similar citizens living in the United States would involve a considerable amount of value judgment. Depending on policy priorities and preferences, any redesign targeted for reduced benefits received by citizens working overseas could aim for the same or a lower overall cost to the federal government. A revision deemed to result in a more equitable distribution of the tax burden would not necessarily have negative consequences for economic efficiency. The effects of the revision on simplicity and administrability would largely depend on the extent to which it is designed to account for the characteristics of individual taxpayers. One possible change in the current tax expenditure design would be to increase the time abroad required for eligibility. This would target tax relief to those abroad for longer periods.[24]

Alternative: Uncapping the Exclusion

Removing the maximum limit on the exclusion—that is, uncapping the tax expenditure—and excluding all foreign earned income from taxation

[23]The Foreign Earned Income Act of 1978 replaced an income exclusion with a system of allowances for costs of living abroad, such as cost of living in general, housing, education, and home leave transportation. This system was replaced in 1981 with the income exclusion and separate housing exclusion.

[24]Currently, the physical presence test is for at least 330 days over a 12-month period. In the 1950s, the FEIE physical presence test was for 510 days (17 months) out of 18 consecutive months. In 1962, the exclusion was tiered, allowing a larger exclusion for those overseas for 3 years or more.

would have multiple counteracting effects on employment decisions. These effects would be opposite to those that would result from eliminating the tax expenditure. In this case, inefficiency due to tax effects on location decisions would increase, while inefficiency due to the tax effects on hiring would decrease. Once again, because the relative magnitudes of the counteracting effects are indeterminable, the net effect on overall economic efficiency would be uncertain. The effect on equity will depend on value judgments. Uncapping the tax expenditure could be viewed as reducing both horizontal and vertical equity because it would reduce the federal tax liabilities of some high-income U.S. citizens working in countries with effective rates of income tax below that of the United States, regardless of the cost of living differences. On the other hand, it would increase equity if U.S. citizens working abroad are viewed as receiving no benefits for which they should pay federal taxes. To the extent that the exclusion is easier to use than the FTC, uncapping the exclusion could simplify compliance burdens for citizens abroad with only earned income, although they would still have to file a U.S. tax return to claim the tax benefit. However, uncapping the exclusion could compound the challenge that IRS has in administering the tax expenditure, given the misconception that those with excluded income do not have to file and report income to IRS. According to some experts we interviewed, uncapping the exclusion could create incentives for higher-income professionals to move abroad to deliver their services and to shift some investment income to be paid as earned income. It would also reduce federal tax revenue, and any perceived unfairness could erode voluntary compliance for domestic taxpayers. Experiences of other countries that do not tax foreign earned income may be useful in adopting tax rules and compliance practices to prevent or limit income shifting to lower tax countries.[25]

Uncapping the exclusion and not taxing any foreign earned income would be consistent with broader proposals to change the current U.S. worldwide system of taxation into a territorial or source-based income tax system. One proposal to move from “citizen-based” to “resident-based” taxation would exclude all foreign income for individuals living abroad; this

[25]GAO, *International Taxation: Study Countries That Exempt Foreign-Source Income Face Compliance Risks and Burdens Similar to Those in the United States,* GAO-09-934 (Washington, D.C.: Sept. 15, 2009).

could make the tax expenditure unnecessary.[26] Such an approach would impose a departure tax for citizens working abroad who reside in a foreign country for a minimum period of time.[27] Some proposals have implications not only for U.S. individual income tax filing but also for information reporting about foreign financial accounts and assets that are beyond the scope of this report. The larger debate about broader changes to the U.S. international tax system focuses chiefly on the taxation of corporate income, but such reforms may have implications for the tax treatment of the wage income of U.S. citizens working abroad that are beyond the scope of this report.[28]

[26]American Citizens Abroad, *ACA Submission to the Senate Finance Committee on International Tax Reform*, (Washington, D.C.: Jan. 15, 2014). ACA also supports increasing the current exclusion limit.

[27]Under the ACA proposal, an individual would be deemed to have disposed of property at its fair market value on the day of departure and then reacquired the property for the same amount immediately thereafter. The person would include in U.S. income the capital gain or loss that resulted from the deemed disposition. Alternatively, the person could defer the tax without interest until return to the United States. For other exit tax proposals, see Patrick W. Martin and Reuven Avi-Yonah, "Tax Simplification: The Need for Consistent Tax Treatment of All Individuals (Citizens, Lawful Permanent Residents and Non-Citizens Regardless of Immigration Status) Residing Overseas, Including the Repeal of U.S. Citizenship Based Taxation," *Procopio News Room* 09.17.2013 (San Diego, CA: Procopio, September 2013), accessed March 10, 2014, http://www.procopio.com/news/tax-simplification-the-need-for-consistent-tax-treatment-of-all-individuals-citizens-lawful-permanent-residents-and-non-citizens-regardless-of-immigration-status-residing-overseas-including-the-repeal-of-u.s.-citizenship-based-taxation; Bernard Schenider, "The End of Taxation without End: A New Tax Regime for U.S. Expatriates," *Virginia Tax Review, Vol. 32 No. 1* (London, UK: Queen Mary University of London, Summer 2012); and Cynthia Blum and Paula N. Singer, "A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals," *Vanderbilt Journal of Transnational Law* vol. 41, no. 3 (2008).

[28]See Joint Committee on Taxation, *Present Law and Issues in U.S. Taxation of Cross-Border Income*, JCX-42-11 (Washington, D.C.: Sept. 6, 2011).

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

James R. McTigue, Jr., (202) 512-9110 or mctiguej@gao.gov

Staff Acknowledgments

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