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Crippling Tax Consequences of the 2006 TIPRA Legislation

Analysis and Case Studies



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The 2006 TIPRA tax hike has had a dramatic impact on Americans living and working overseas

- Four real-life case studies illustrate the devastating impact of this legislation; some owe US tax for the first time, others have seen tax bills rise by 100% or more
- These increased tax bills are on top of country of residence income tax bills of 20 – 25%, and substantial yet non-deductible social security contributions
- “Net” income is subjected to further taxation in the form of VAT rates on consumption as high as 25%
- Additionally, many of these taxpayers live in jurisdictions that impose wealth taxes, which are also not deductible for US tax purposes
- These problems have been dramatically compounded by the weak dollar, which has resulted in a stable €100 000 annual income rising 36% from a dollar equivalent value of \$118 396 to \$151 898 over the 15 month period ending 1 March 2008

Impact of TIPRA on Salaried Individuals: Two Case Studies

Case name
Personal info
Career Status

Sam Taxpayer

30 years old, single, no children
Overseas since 1996, working for a multinational

Peter Taxpayer

38 years old, married with 2 children
Overseas since 1999, working for a bank

Observations

Highest tax rate jump in lower income levels
US tax rate jumps from 13.5% to 28%
US tax rate now exceeds local tax rate
Sam Owes U.S. taxes for first time

Peter's income has increased by only 3%
US tax rate jumps from 21.1% to 28.9%
Taxes are higher even though taxable income is lower
Peter's US taxes have nearly doubled to \$25,805

	<u>2006</u>	<u>2005</u>	<u>difference</u>	<u>% change</u>		<u>2006</u>	<u>2005</u>	<u>difference</u>	<u>% change</u>
Filing status	single	single				MFJ	MFJ		
# dependents	0	0				2	2		
Wages	116 073	113 248	2 825			269 799	262 475	7 324	
Other Income	17	5	12			-198	-158	-40	
Total Income	116 090	113 253	2 837	3%		269 601	262 317	7 284	3%
Less:									
Foreign earned income exclusion	-82 400	-80 000	-2 400			-89 583	-80 000	-9 583	
Housing exclusion	0	-911	911			0	0	0	
Other adjustments to income	0	0	0			0	0	0	
Adjusted Gross Income	33 690	32 342	1 348	4%		180 018	182 317	-2 299	-1%
Less:									
Standard / Itemized deductions	-5 150	-5 000	-150			-21 081	-17 664	-3 417	
Personal exemption	-3 300	-3 200	-100			-13 200	-12 800	-400	
Taxable income	25 240	24 142	1 098	5%		145 737	151 853	-6 116	-4%
US tax rate applicable	28,0%	13,5%				28,9%	21,2%		
Tax before foreign tax credit	7 060	3 254	3 806			42 128	32 196	9 932	
Less: Foreign Tax Credit	-5 988	-3 254	-2 734			-16 323	-19 078	2 755	
Total US Tax	1 072	0	1 072	n/a		25 805	13 118	12 687	97%
US Tax as % of Total Income	0,9%	0,0%				9,6%	5,0%		

Impact of TIPRA on Self-Employed Individuals: Two Case Studies

Case name	John Taxpayer				Joe Taxpayer			
Personal info	29 years old, single, no children				33 years old, single, no children			
Career Status	Overseas since 2002, self-employed, tax consultant				Overseas 2004-2008, self-employed; returned to USA in part because of tax effects of TIPRA			
Observations	Tax rate increased from 21.7% to 27.1% Unable to take full benefit of Foreign Earned Income Exclusion US taxes increased by 39%				Total income was down 17% and taxable income declined by 23% Unable to take full benefit of Foreign Earned Income Exclusion US taxes increased by 29%			
	2006	2005	difference	% change	2006	2005	difference	% change
Filing status	single	single			single	single		
# dependents	0	0			0	0		
	\$	\$	\$		\$	\$	\$	
Self-employment income	163 396	156 651	6 745		185 782	223 685	-37 903	
Other Income	5 092	2 973	2 119		1 161	1 012	149	
Total Income	168 488	159 624	8 864	6%	186 943	224 697	-37 754	-17%
Less:			0					
Foreign earned income exclusion	-51 914	-58 191	6 277		-58 495	-62 578	4 083	
Housing exclusion	0	0	0		0	0	0	
Other adjustments to income	-2 974	-5 363	2 389		-4 492	-4 519	27	
Adjusted Gross Income	113 600	96 070	17 530	18%	123 956	157 600	-33 644	-21%
Less:								
Standard / Itemized deductions	-19 039	-5 000	-14 039		-5 150	-5 000	-150	
Personal exemption	-3 300	-3 200	-100		-3 300	-3 200	-100	
Taxable income	91 261	87 870	3 391	4%	115 506	149 400	-33 894	-23%
US tax rate applicable	27,1%	21,7%			28,4%	24,4%		
Tax before foreign tax credit	24 765	19 045	5 720		32 836	36 428	-3 592	
Less: Foreign Tax Credit	-10 324	-8 630	-1 694		-17 117	-24 199	7 082	
Total US Tax	14 441	10 415	4 026	39%	15 719	12 229	3 490	29%
US Tax as % of Total Income	8,6%	6,5%			8,4%	5,4%		

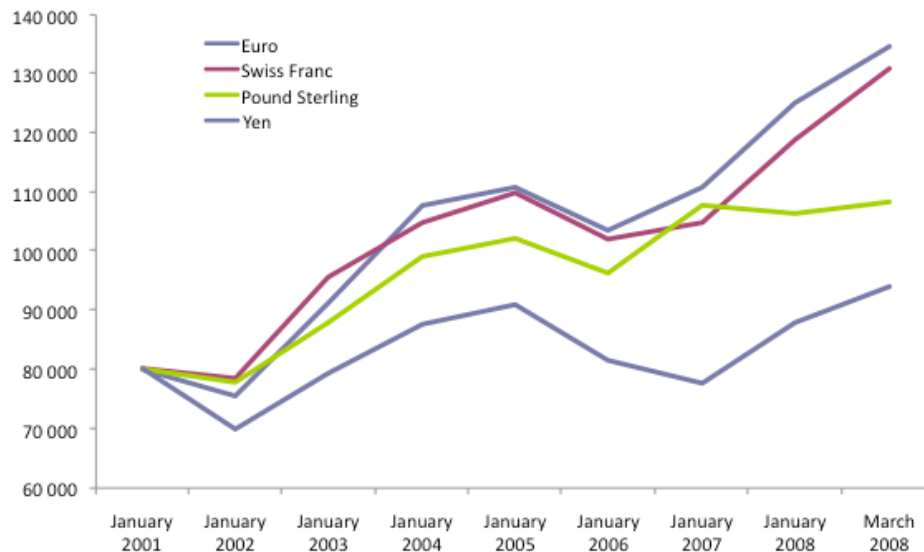
Exchange Rate Impact on U.S. Tax Liability

Illustrative example of Married Filing Jointly with Salary of €120,000, Housing Allowance of €45,000 and Other Income of €5,000

- Stable Euro income all three years - €170,000
- US tax jumps from 0 in 2005 to \$18,531 in 2006, due to TIPRA limit on housing exclusion and stacking rule – i.e. higher tax rate
- Taxes increase another 10.7% to \$20,506 in 2007 due to 9% dollar devaluation and the stacking rule
- Exclusions/deductions in fixed dollars are insufficient
- Foreign tax credits no longer protect from double taxation
- Another hike programmed for 2008 if Euro maintains January 2008 level of €1 = \$1.55

Forex rates: €1 =	\$1.3686	\$1.2546	\$1.2429
\$ tax return	<u>2007</u>	<u>2006</u>	<u>2005</u>
Total Income	232,611	213,282	211,293
FEIE	- 85,700	- 82,400	- 80,000
Housing exclusion	- 11,998	- 11,536	- 43,130
Adj. Gross Income	134,913	119,346	88,163
Standard deductions	- 17,500	- 16,900	-16,400
Taxable Income	117,413	102,446	71,763
US Marginal tax rate	33%	33%	16%
Tax before FTC	50,187	44,788	11,274
Foreign Tax Credit*	29,681	26,256	11,274
(*based on 22% of AGI)			
Tax due to USA	20,506	18,531	0
Annual Increase	10.7%	n/a	

Taxation in one currency on income in another leads to unfair distortions in tax liabilities



- Due to the continuing deterioration in the value of the dollar, the nominal value of incomes in nearly every major currency has skyrocketed when translated into dollars
- Even though this has minimal impact on purchasing power, it has caused U.S. dollar-based tax bills to balloon by close to 70%

Salary Currency	Total Additional Taxable "Income" 2001 – 2008 for taxpayer earning equivalent of US\$80,000 in 2001
Euro	\$218,764
Swiss Franc	\$204,814
Pound Sterling	\$145,486
Japanese Yen	\$27,810

Illustrative Model of Social Security Double Taxation

Self-Employed Americans Overseas Face Complex Reporting Requirements, Double Taxation and a Tax-Policy Driven Competitive Disadvantage

- Self-employed Americans overseas are subject to taxation in their country of residence and by the United States for:
- Income Taxes
- Social Security (FICA) taxes
- A US citizen working in a country which does not have a "totalization" agreement with the United States must pay full self-employment social security taxes in both countries
- Only a few countries have totalization agreements in place; as of January 1, 2008, the US has entered into totalization agreements with 21 countries*, mostly in Europe, in order to eliminate double-taxation of income for social security purposes
- Self-employed Americans attempting to compete in low- or no-tax jurisdictions, such as Dubai, Singapore or Hong Kong, are at an even greater disadvantage

	US Taxes if resident overseas		US Taxes if resident in the USA
	US Taxes	Local Taxes	US Taxes
Filing Status	Single	Single	Single
No. Of Dependents	0	0	0
Self-Employment Income	200 000	200 000	200 000
Other Income	-	-	-
Less:			
Foreign earned income exclusion	-82 400		
Housing Exclusion	-		
Other Adjustments	-9 000	-9 000	-9 000
Adjusted Gross Income	108 600	191 000	191 000
Less:			
Standard/Itemized Deductions	-5 350	-5 350	-5 350
Personal Exemption	-1 250	-1 250	-1 250
Taxable Income	102 000	184 400	184 400
Tax before Foreign Tax Credit	30 600	55 320	55 320
Less Foreign Tax Credit	-30 600	0	0
Total Income tax due	0	55 320	55 320
Self-Employment Taxes	18 000	18 000	18 000
Total Tax Due By Country	18 000	73 320	73 320
Total Tax Due		91 320	73 320

*Australia, Austria, Belgium, Canada, Chile, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, The Netherlands, Norway, Portugal, South Korea, Spain, Sweden, Switzerland and UK

How H.R. 4752 and S. 1140 – the Working Americans Competitiveness Act – would remedy unfair double taxation and restore American competitiveness

- The U.S. is the only OECD country which taxes its citizens residing overseas; this reduces the competitiveness of Americans working overseas
- The Foreign Earned Income Exclusion (FEIE) was introduced in 1962 to remedy double taxation of overseas Americans; however, the FEIE has never kept up with inflation
- In 1981, the FEIE was set at \$75,000; that \$75,000 adjusted to inflation would amount to \$181,065 today, more than double the 2007 cap
- The FEIE has been indexed to inflation only since 2006, on an unrealistically low base of 80,000 2005 dollars
- The declining dollar has further eroded the protection of a capped FEIE; the 1981 FEIE of \$75,000 was worth the DM equivalent of €86,686; the 2007 FEIE of \$85,700 is currently worth only €54,541, a **37% reduction**
- The **Working Americans Competitiveness Act** eliminates the FEIE cap
- Eliminating the cap reduces double taxation on income earned overseas and allows Americans to compete abroad on an equitable basis
- Reversing the stacking rule in TIPRA would reinforce the effect of FEIE in reducing double taxation

The Cap on the Housing Exclusion: Why it Should be Eliminated

- Up through 2005, « reasonable housing expenses » paid to an overseas American by his employer (less a base amount of \$12,800 in 2005) were not taxable, just as housing allowances of American diplomats are not taxed today
- In 2006 TIPRA introduced a net cap of \$11,536 (gross cap \$24,720 less base amount \$13,184) on the housing exclusion, raised to \$11,998 in 2007
- This cap penalizes in particular American employees of American companies in high rent cities such as Tokyo, Hong Kong, London
- The cap is set so low that Treasury is mandated to create a list of cities with higher exclusions
- This seriously increases arbitrariness for Americans overseas; for example Geneva is allowed a gross cap of \$70,900 and Zurich only \$39,219 while rent in both cities is approximately equivalent
- Administrative cost of the law probably outweighs any extra tax revenue collected - Treasury has to evaluate rents worldwide and the law adds 5 pages and a worksheet to instructions for Form 2555.
- Tax reform should go back to the original law allowing « reasonable housing expenses ».