

**A research paper prepared by**

**American Citizens Abroad**

*The Voice of Americans Overseas*

**A comparison of tax trends (1962-2006)  
between the United States  
and eight major countries where overseas Americans reside**

**Introduction**

The United States is the only industrialized nation to tax the foreign-earned income of its citizens who reside overseas. This policy presents many unique questions because its impact on overseas Americans is partly tied to tax policies of the countries in which they reside and over which the U.S. government has no control. One such question, raised by a high ranking official at the Internal Revenue Service, is whether US laws (particularly US Code, Title 26, Section 911 and other mitigating measures in the US tax code) have adapted to global economic changes over time so as to provide fair treatment of US citizens living abroad. This note aims to provide insight into those changes.

**The U.S. citizenship-based tax framework**

In 1962 the United States initiated a cap on the Foreign Earned Income Exclusion for bona fide overseas residents; tax credits were allowed on passive income and foreign earned income in excess of the cap; new rules were introduced for Subpart F for controlled foreign corporations. Since 1962 the cap has been modified several times, but has not kept up with inflation or taken into consideration the devaluation of the U.S. dollar. The tax treatment for housing cost exclusion has become significantly more restricted with caps in place. Employer compensation for educational expenses and high cost of living expenses are now included in taxable income. As a consequence, the United States collected \$4.2 billion dollars in tax revenue from Americans residing overseas who filed Form 2555 in 2006. No doubt additional taxes were collected from Americans overseas who file only Form 1116, but this specific data is not available.

**The United States is the only country which taxes its citizens residing overseas on a citizenship basis.**

To respond to the question raised above, this paper is comprised of three parts.

- Part I makes a comparative analysis of tax regimes of selected OECD member states
- Part II highlights the implications of the analysis for overseas Americans
- Part III makes recommendations for further study and the development of additional data

## Part I Comparison of tax trends between the United States and eight OECD countries

### Countries selected for comparison

The Organization for Economic Co-operation & Development (OECD) publishes annually a report on taxation among its members. The latest report available covers the period from 1965 to 2006. Based on this report, comparisons have been made of tax trends in eight OECD countries, where an estimated 40% of overseas US citizens live. They show a substantial increase in consumption taxes (VAT) and in social security charges as well as higher overall taxation compared to the US.

The eight OECD countries selected for this comparison represent those with the largest number of US taxpayers filing IRS form 2555. The most recent data relate to 2006.<sup>1</sup> Significant countries such as China with 12,430 filings of Form 2555 and Hong Kong with 10,992 filings are not included as they are not members of OECD, and comparative data is not available.

Of the total 334,851 filings of Form 2555 in 2006, Europe accounts for 99,732 (30.0%), the Western Hemisphere account for 57,413 (17.1%), Asia for 138,795 (41.4%), Oceania for 9,724 (2.9%) and Africa for 9,697 (2.9%).

<b>Form 2555 filings</b>		
<b>Country</b>	<b>No. of filings</b>	<b>% of total</b>
Australia	6,420	1.9
Canada	30,067	9.0
France	9,653	2.9
Germany	21,735	6.4
Japan	23,529	7.0
Mexico	6,112	1.8
Switzerland	7,093	2.1
United Kingdom	28,409	8.5
<b>Total of selection</b>	<b>133,018</b>	<b>39.7</b>
Other OECD countries	37,038	11.1
Non-OECD countries	164,795	49.2
<b>All 2555 filings</b>	<b>334,851</b>	<b>100.0</b>

### Tax as Percentage of GDP has risen steadily since 1965

As stated in the OECD annual report on taxation<sup>2</sup>, over the past four decades the total tax level as percentage of GDP – including social security contributions, federal, state and local taxes on individuals and corporations and VAT – has risen almost continuously in OECD countries. Enabled by steady income growth, the tax level in the OECD area

increased by 3.9 percentage points in the first decade after 1965. In Europe, those levels continued to rise in the 1980s as governments responded to recession with increased spending. Even after the mid-1980s, when most OECD countries substantially reduced the statutory rates of their personal and corporate income tax, total tax level as a percentage of GDP increased because governments reduced or abolished tax reliefs to offset the negative revenue impact. Between 1995 and 2006 the tax level in the OECD area increased on average by 1.2 percent. Thus, after 30 years of sustained growth, it appears that the average un-weighted tax level in the OECD area as a whole may finally be slowing down.

While averages for the OECD area as a whole tell a compelling story, the implications for overseas Americans is better viewed in light of the great variety in national tax levels. As shown in the table below, the United States has experienced the lowest increase in tax revenue over 40 years and has the lowest overall tax rate among OECD countries, except for Mexico. Comparing the ratio of tax to GDP between 1965 and 2006, as the un-weighted average for Canada, Mexico and the United States rose two points from 25.2 to 27.3 percent, in OECD Europe the corresponding ratio increased nearly 12 points from 26.3 percent to 38.0 percent. During the same period, the ratio for OECD Pacific rose nearly 10 percent, from 21.1 percent to 30.5 percent. The trend towards higher tax levels over this period reflects the sizeable increase of public sector outlays in almost all industrialized countries.<sup>3</sup>

<b>Total tax revenue as a percentage of GDP</b>			
<b>Country</b>	<b>1965</b>	<b>2006</b>	<b>Change</b>
Australia	21.0	30.6	9.6
Canada	25.7	33.3	7.6
France	34.1	44.2	10.1
Germany	31.6	35.6	4.0
Japan	18.2	27.9	10.3
Mexico	16.2 (1980) <sup>2</sup>	20.6	4.4
Switzerland	17.5	29.6	12.1
United Kingdom	30.4	37.1	6.7
<b>United States</b>	<b>24.7</b>	<b>28.0</b>	<b>3.3</b>

1. Source of data for OECD countries: 2008 annual report of the Organization for Economic Co-operation & Development (OECD) titled *Revenue Statistics 1965-2007*
2. First year reported for Mexico was 1980.

### **Tax structures have shifted from income tax towards social security and general consumption taxes**

Changes in tax structure (share of major taxes in total tax revenue) show an over-all trend where personal income taxes account for a declining share of overall revenue collection by all governments, while social security contributions and general consumption taxes account for progressively increasing shares of the same revenue. For OECD countries as a whole the share for personal income taxes has shrunk from 30 percent of total taxes in the early 1980s to 25 percent in 2006, at which point personal income taxes were no

longer the largest single source of revenue. Among the countries under review, only Canada and France show an increase in personal income taxes as a percentage of total taxation from 1980 to 2006. In 2006, Canada, Switzerland and the United States stand out with the share of personal income taxes in total taxation exceeding 35% compared to the OECD average of 25%. Australia shows a high share of personal income taxes as social security contributions are not collected separately.

<b>Personal income taxes as a percentage of total taxation</b>			
<b>Country</b>	<b>1965</b>	<b>1980</b>	<b>2006</b>
Australia	34.4	44.0	37.4
Canada	22.6	34.1	36.3
France	10.6	11.6	17.5
Germany	26.0	29.6	24.5
Japan	21.7	24.3	18.5
Mexico <sup>1</sup>		29.8	25.1
Switzerland	33.4	38.9	35.6
United Kingdom	33.1	29.4	28.6
<b>United States</b>	<b>31.7</b>	<b>39.1</b>	<b>36.5</b>

1. Includes personal and corporate income tax. OECD was not able to separate the two taxes. First year reported for Mexico was 1980.

As shown in the table below, social security contributions have increased as a share of overall taxes even while the share for personal income tax was declining. By 2006 social security contributions accounted for 25 percent of total tax revenues. In eight countries – Austria, the Czech Republic, France, Germany, Japan, the Netherlands, the Slovak Republic and Spain – social security contributions are now the largest single source of general government revenue.<sup>4</sup> In some countries, such as Switzerland, private pension plans are required. While these pension plans are not included in tax statistics, they represent a complementary contribution to savings for retirement.

<b>Social security contributions as a percentage of total taxation</b>			
<b>Country</b>	<b>1965</b>	<b>1980</b>	<b>2006</b>
Australia <sup>1</sup>	0.0	0.0	0.0
Canada	5.6	10.5	14.8
France	34.2	42.7	37.0
Germany	26.8	34.3	38.4
Japan	21.8	29.1	36.6
Mexico <sup>2</sup>		14.1	14.9
Switzerland	14.9	23.4	23.3
United Kingdom	15.4	16.7	18.5
<b>United States</b>	<b>13.3</b>	<b>21.9</b>	<b>23.8</b>

1. Australia does not have a separate contribution for social security; such payments are included in general income taxes
2. First year reported for Mexico was 1980.

General consumption taxes, especially the value-added tax (VAT) which is now found in all OECD countries except the United States have become a major revenue source. General consumption taxes produced 19 percent of total tax revenue in 2006, compared with only 14 percent in the mid-1960s. The United States is the big exception with consumption taxes in 2006 representing only 7.8% of total taxation. As the US total taxation as a percent of GDP is significantly lower than in other countries, the share of consumption taxes as a percent of GDP is only 4.7% while they exceed 10% of GDP in many other countries.

<b>Taxes on general consumption as percentage of total taxation</b>			
<b>Country</b>	<b>1965</b>	<b>1980</b>	<b>2006</b>
Australia	7.4	11.5	14.0
Canada	17.8	11.5	14.0
France	23.3	21.1	16.9
Germany	16.5	16.6	17.8
Japan		4.4 (1990) <sup>1</sup>	9.2
Mexico		51.2 <sup>2</sup>	56.3
Switzerland	10.6	10.3	13.2
United Kingdom	5.9	14.7	18.1
<b>United States</b>	<b>4.8</b>	<b>7.0</b>	<b>7.8</b>

1. First year reported for Japan was 1990.
2. First year reported for Mexico was 1980.

## **Part II Implications for American citizens residing overseas**

The tax trends reviewed have several implications for the taxation of overseas Americans. The six points highlighted in this section illustrate how Section 911 has not kept pace with the evolution of tax regimes in other countries, why Section 911 does not provide sufficient protection against double taxation for overseas Americans and how other elements of the US tax code lead to higher taxation of overseas Americans.

**First**, the total amount of taxes paid in most OECD countries far exceeds that of the United States. Hence most Americans living overseas pay a higher total percentage of their income in taxes (direct and indirect) than do Americans living in the United States. The difference is a function of different marginal tax rates and definitions of taxable income. Yet Americans residing overseas and filing Form 2555 paid over \$4 billion in U.S. taxes in 2006 in addition to the taxes in the countries where they reside. Many more overseas Americans file using only Form 1116 for foreign tax credits and no doubt also pay US taxes, but the IRS does not provide information splitting out domestic US filers and overseas residents.

**Second**, the significant increase in Social Security taxes overseas weighs very heavily on Americans abroad, not only because of the levels, but also because of the tax treatment in

the United States. For income tax purposes, no deduction is allowed for Social Security taxes. A US citizen who is a *bona fide* resident overseas with a gross salary identical to that of a US citizen residing in the United States will be taxed on the presumption that social security contributions are the same, but the American overseas will in fact have a significantly lower take-home pay due to the larger social security contributions. For example, in France and Germany, total taxes as a percentage of GDP (respectively 44% and 36%) are already significantly higher than in the United States (26%), and on top of that Social Security taxes represent 37% of total taxation for France and 38.4% for Germany compared to just 23.8% for the United States. Hence, Social Security taxes as a percent of GDP amount to 16.3% in France and 13.7% in Germany, but only 6.7% in the United States.

Furthermore, contributions to pension funds are significant, often as important if not greater than contributions to social security. They are not technically taxes but are significant for individuals to save for retirement and are obligatory in certain foreign countries. For US tax purposes, contributions to pension funds are treated differently for U.S. citizens living overseas and for those residing in the United States. Americans residing overseas cannot deduct their contributions to foreign pension plans and furthermore must add the foreign employers' contributions to pension plans to their gross income, as foreign pensions are not recognized by the United States. Americans residing in the United States, to the contrary, can deduct their contributions to pension plans for U.S. tax purposes and there is no addition for employers' contributions. This leads to an Adjusted Gross Income which is substantially higher for the overseas American than for U.S. residents with a comparable salary.

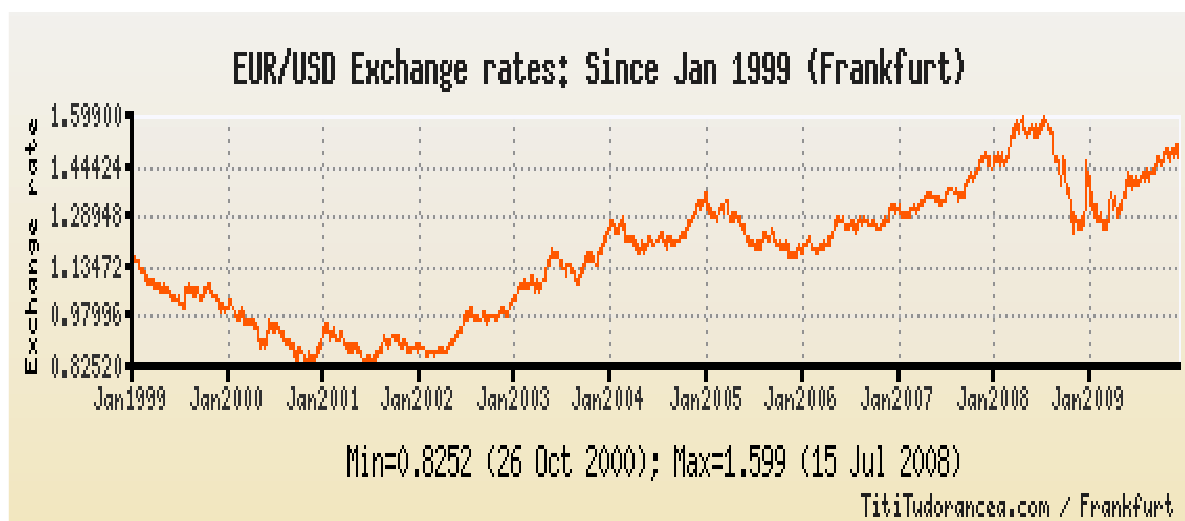
**Third**, taxes on general consumption in OECD countries, which include VAT and other indirect taxes on gasoline and other specific consumer products, are more than double the percentage share the United States. VAT tax rates alone exceed 18%. Gasoline in Europe is more than three times more expensive than in the United States, and the difference is due exclusively to taxes on gasoline. Americans living overseas not only pay more in general consumption taxes, but cannot take any deduction on their 1040 for these taxes, whereas Americans residing the United States have the option to deduct state sales taxes on their 1040.

**Fourth**, personal income taxes represent a significantly higher percentage of total tax revenue in the United States than in most other OECD countries. However, due to overall lower level of taxation in the United States, personal income tax as a percent of GDP in the United States (10.2%) is actually lower than in Canada (12.1%), the United Kingdom (10.8%) and Switzerland (10.5%) and is the same as Australia (10.2%). If the United States decides it must raise additional tax revenue, it is most likely that personal income taxes will be a key source through an increase in marginal rates. While today marginal tax rates in the United States are generally lower than in most European countries, any increase in US marginal rates (which is highly possible in 2010) would shift this balance, particularly since the trend in Europe has been to reduce personal tax income tax rates and to rely more on social security and consumption taxes. Such a shift in tax rates would increase the amount of taxes due to the US by overseas Americans,

thereby increasing the total tax burden of citizens working and living abroad. This is particularly true since the TIPRA act, which requires that any Foreign Earned Income Exclusion be added back to taxable income in order to determine the applicable tax rate.

**Fifth**, when the cap on Foreign Earned Income Exclusion was put in place in 1962, the U.S. dollar and other currencies were fixed to the gold standard. Under these conditions, the translation of foreign salaries into U.S. dollars for tax purposes was made on a stable basis. Since the gold standard broke down and currencies began fluctuating in 1971, the dollar has devalued substantially. For example, in 1962 the fixed rate for USD 1.00 was Swiss Francs (CHF) 4.32. Today, the Swiss Franc trades on a par value with the US dollar. Hence, a Swiss Franc salary of CHF 100,000 translated into USD 23,148 in 1962; today it corresponds to USD 100,000. And this does not take into consideration the inevitable increase in the CHF 100,000 salary over 40 years due to inflation. The devaluation of the dollar artificially inflates the taxable income of US *bona fide* residents overseas. This has become particularly problematic in recent years with the rapid fall of the US dollar and the stacking measure introduced in TIPRA, pushing overseas Americans into higher tax brackets. Just in 2009, the dollar has lost 15% of its value against the Euro. The chart below shows the evolution of the Euro against the US Dollar since the inception of the Euro.

#### Dollars required to buy 1.00 Euro



**Sixth**, many foreign countries do not have a tax on capital gains. A review of capital gains taxation in 36 countries showed that 21 had a capital gains tax, but 15 did not.<sup>5</sup> Among the eight OECD countries reviewed here, only Switzerland (which has a capital gains tax only on real estate transactions) and the UK are listed as having capital gains taxes under OECD revenue category 1120. This situation highlights one of the key incompatibilities of US taxation with foreign taxation that leads to double taxation for Americans residing abroad. As only foreign taxes on capital gains can be credited against US capital gains tax, Americans residing overseas in many countries are subject to full

US taxation on capital gains in addition to paying higher personal income taxes, social security taxes and consumption taxes abroad. They may have an excess foreign tax credits on income that are not applicable against US income tax and at the same time owe capital gains tax to the United States. In certain countries such as the Netherlands and Switzerland, which have a capital gains tax only on real estate transactions and none on securities transactions, but an annual tax on net assets or net wealth (assets less liabilities), the penalty is even greater as the tax on wealth cannot be credited against US capital gains tax. France also has a tax on wealth (ISF).

The capital gains tax is particularly perverse for Americans residing abroad due to the declining value of the US dollar. Americans who are long-term overseas residents – and this represents the majority of US citizens abroad<sup>6</sup> – normally consider the currency where they reside as their reference currency. They buy homes, build up pension funds and invest in the local currency securities, but due to the US taxation, they are required to assume a currency risk on future US capital gains taxes. With the long-term decline in the dollar, it is even possible to have an investment loss in the local currency, but a capital gain in US dollars, leading to a US tax liability.

**Summary:** Different countries have different tax structures and different terminology. Any attempt by the United States to match terminology outside the United States will necessarily fail. This is an inevitable consequence of citizenship-based taxation, and it always works to the disadvantage of overseas Americans.

### **Part III Recommended additional study**

#### **Need for study of Asian and Middle East Countries**

This review has not covered the rapidly developing Asian and Middle East countries. Asian countries in the IRS statistics, which include the Middle East countries, represent 41% of all Americans filing form 2555 today. In many of these countries, the personal income tax rates are lower than in the United States. However, often there are high sales taxes, hidden taxes in the form of excessively high rents for foreign nationals living in government owned housing, and other indirect taxes, not recognized by the US for foreign tax credits. Hence, American citizens will be paying personal income taxes to the United States at high marginal rates and high indirect taxes to the local economy. With the growing importance of these economies in the world economy and the increasing need for Americans to reside and work there, a detailed review is merited if comparable source data can be found. However, even without such a study, it is clear that the inadequate level of the Foreign Earned Income Exclusion, which has been indexed to inflation only since 2006 and does not reflect economic reality, penalizes in particular middle-income Americans working in low income tax rate countries, exactly where business is growing the most today.

#### **Need for more detailed data from the IRS**

To allow for a more refined view of the taxation of overseas Americans, the IRS statistics published should be enhanced in at least three ways:

1. The statistics concerning Form 1116 should be organized so as to separate US residents from overseas residents. An additional table should show taxes paid by country of residence for Americans overseas filing Form 1116 only. This would allow for a more complete view of the taxation of the overseas community.
2. The statistics concerning Form 2555 should show in a separate column the amount of income or US tax deriving from capital gains.
3. The Form 2555 statistics by country should show tax revenue collected for each country. Currently, the tax revenue collected appears only in the table showing total income and taxes by groups of Adjusted Gross Income categories. As tax regimes vary substantially from one country to another, showing the tax collected by country would highlight more clearly the influence of American citizenship based taxation on Americans residing abroad.

### **Final comment**

**American Citizens Abroad** looks forward to comments on this research and remains fully available for further dialogue and research efforts to clarify the tax situation of American citizens who reside abroad.

### **December 2009**

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<sup>1</sup> Source of IRS 2555 filing data: Go to <http://www.irs.gov>. Look for tax stats on the home page; select individual personal wealth.

<sup>2</sup> Source: 2008 publication of the Organization for Economic Co-operation & Development (OECD) titled *Revenue Statistics 1965-2007*. The full report can be downloaded from <http://www.oecd.org>. Go to Publications and search for “Revenue Statistics 1965-2007.”

<sup>3</sup> Ibid

<sup>4</sup> Ibid

<sup>5</sup> Source: [http://en.wikipedia.org/wiki/capital\\_gains\\_tax](http://en.wikipedia.org/wiki/capital_gains_tax)

<sup>6</sup> Source: Overseas Vote Foundation Post Election 2008 Survey of overseas Americans showed that over 70% of Americans residing abroad classified themselves as long-term or permanent residents overseas.

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