

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

SUMMARY

The United States is the only industrialized nation to tax the foreign-earned income of its citizens who reside overseas. As such, its overseas citizens are in the unique situation of being subject not only to the tax rules in their country of residence, but also to those of the U.S. The U.S. Tax Code, particularly Title 26, Section 911, has attempted to mitigate excessive burdens on overseas taxpayers, but over time, this and other measures have failed to adapt to global economic changes and provide fair treatment of U.S. citizens living abroad.

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. 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 and 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.

Comparison of tax trends between the U.S. and eight OECD countries

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, ACA compared tax trends in eight OECD countries, where an estimated 40 percent of overseas U.S. 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 U.S.

- **Tax as Percentage of GDP has risen steadily since 1965** – In OECD Europe 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 from 26.3 percent to 38.0 percent. In OECD Pacific, the corresponding figures

- were from 21.1 percent to 30.5 percent. By comparison, the ratio in Canada, Mexico and the United States barely increased from 25.2 percent to 27.3 percent.
- **Tax structures outside the U.S. have shifted from income tax towards social security and general consumption taxes** - 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. In 2006, Canada, Switzerland and the United States stand out with the share of personal income taxes in total taxation exceeding 35 percent. The declining share of the personal income tax was paralleled by the growing share of social security contributions, which by 2006 accounted for 25 percent of total tax revenues. In some countries, such as Switzerland, private pension plans are required. Such plans represent a *de facto* tax not addressed by the U.S. Tax Code. Another fast growing revenue source has been general consumption taxes, especially the value-added tax (VAT) which is now found in all OECD countries except the United States. General consumption taxes produced 19 percent of total tax revenue in 2006. The United States is the big exception with consumption taxes in 2006 representing only 7.8 percent of total taxation. As the U.S. 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 percent while they exceed 10 percent of GDP in many other countries.

Implications for American citizens living overseas

The following six points 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 U.S. 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.

Second, while Social Security taxes overseas have increased significantly, no deduction is allowed for them. A U.S. citizen who is a *bona fide* resident overseas and has a gross salary identical to that of a U.S. 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.

Furthermore, 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 must add the foreign employers' contributions 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. 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, 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 U.S. marginal rates (which is highly possible in 2010) would shift this balance. Such a shift in tax rates would increase the amount of taxes due to the U.S. 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. The devaluation of the dollar artificially inflates the taxable income of U.S. *bona fide* residents overseas.

Sixth, many foreign countries do not have a tax on capital gains. As only foreign taxes on capital gains can be credited against U.S. capital gains tax, in many countries Americans residing overseas are subject to full U.S. 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 U.S. 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 U.S. capital gains tax.

The capital gains tax is particularly perverse for Americans residing abroad due to the declining value of the U.S. dollar. Americans who are long-term overseas residents – and this represents the majority of U.S. citizens abroad – buy homes, build up pension funds and invest in the local currency securities, but due to the U.S. taxation, they are required to assume a currency risk on future U.S. 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 U.S. dollars, leading to a U.S. tax liability.

Conclusion

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.