The Middle East Council of American Chambers of Commerce Encourages the International Working Group of the House Ways and Means Committee to Protect and Expand the Foreign Earned Income Exclusion

(Submission as Prepared by W. John Sabin, CPA, CMA, PMP for MECACC)

Thursday, April 4, 2013

Respectfully Submitted to the International Working Group of the Ways and Means Committee
The Honorable Congressman Devin Nunes, Chairman
The Honorable Congressman Earl Blumenauer, Vice Chairman

Introduction:

Exports play a key role in fueling job creation. United States (U.S.) expatriates (people who live outside their native country) working overseas make a vital contribution to sustain and increase trade by influencing exports with the countries where they reside and work. There are changes to the U.S. Internal Revenue Code (the Code) being contemplated that could drastically impact the competitiveness, and therefore the number of U.S. citizens working abroad. Some of these measures, while well intended to help balance the U.S. budget, may end up "shooting America in the foot" by significantly decreasing the U.S. expatriate workforce triggering a decrease in U.S. exports.

This testimony addresses the following points:

1) The role of U.S. exports in the U.S. economy.
2) American competitiveness overseas.
3) The benefits of U.S. citizens working abroad.
4) History of the Foreign Earned Income Exclusion (FEIE) .
5) What's next for the FEIE.

Role of U.S. Exports in the U.S. Economy

The National Export Initiative (NEI)[1] was established by Executive Order in March 2010 with an ambitious goal of doubling exports to $3.1 trillion by 2015. The central premise of this initiative was a simple correlation that exports create U.S. jobs and that an increase in exports should lead to substantial new job creation. When the initiative was implemented, exports represented approximately 14% of the U.S. Gross Domestic Product (GDP). A doubling of exports would lead to a significant expansion of the GDP which in turn would put many more Americans to work. A special focus of the initiative was to increase the competitiveness and participation of small and medium business enterprises (SMEs) overseas. SMEs were the leading job creators in the U.S. and from 1992-2009 creating 64% of the nation's net new jobs.

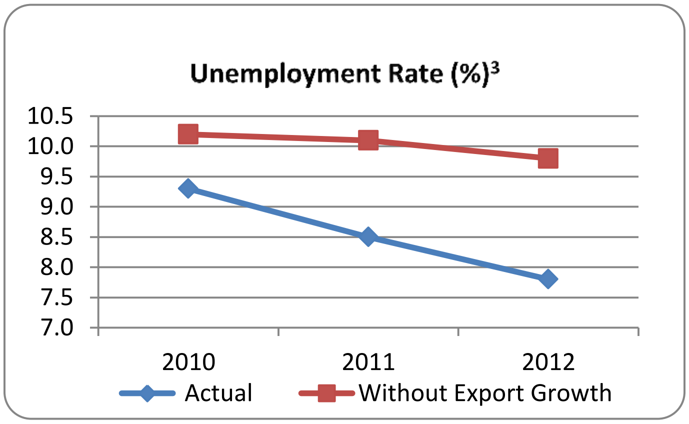
Congressman Dave Camp (R-MI) said "I welcome the Administration's focus on ensuring that our trading partners play by the rules and that we use ongoing and new negotiations to increase exports of American-made goods and services. I will be strongly pushing my legislation which focuses on making American companies more competitive around the globe as well".

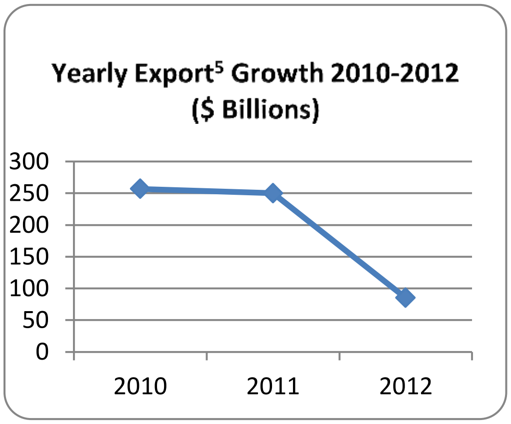
Why do we need an NEI that appears to be focused on overseas activity instead of focusing all of our efforts on projects at home? According to the report, 95% of the world's customers for goods and services reside outside the U.S. While U.S. consumption remains an important driver of world economies, the most significant opportunity for U.S. business growth clearly lies with capturing part of the substantial emerging overseas markets. We, as a nation, need to move from a 'borrow and consume' economy to one that focuses on selling to the rest of the world.

Has the NEI been successful? Since January 2010, annual U.S. exports have increased by almost $600 billion to a level of $2.2 trillion in 2012. What does this mean in terms of job creation? According to the U.S. Labor Bureau, each additional $1 billion in exports adds between 5,000 and 5,500 U.S. jobs. This could imply that the $600 billion increase in exports has added over three million new U.S. jobs[2].

The Unemployment Rate chart shown herein demonstrates how important this 3 million job addition has been to the U.S. Without this significant addition of jobs to the U.S. labor market, the unemployment rate at the end of 2012 would have been approximately 9.8%.

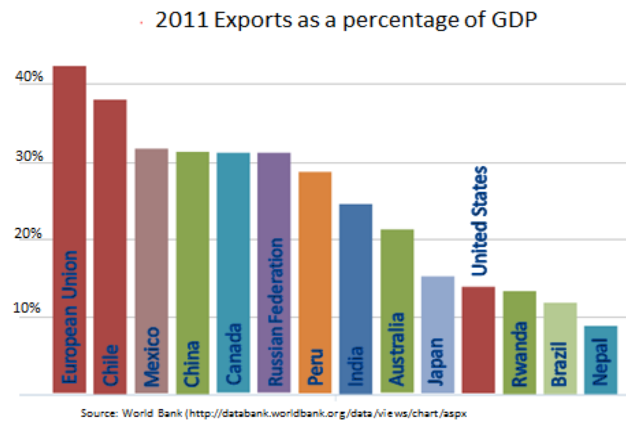
Unfortunately, the pace of export growth decreased significantly in 2012 to provide an addition of only $85 billion from the $2.1 trillion level of exports achieved in 2011. By comparison, exports increased by $257 billion in 2010 and $250 billion in 2011[4,5].





Some argue that U.S. businesses may be reaching the maximum share of the international market that they can expect to capture and that we, as a nation, should focus internally on increasing tax revenues to pay our bills and using government stimulus to create U.S. based jobs; however, the world trade statistics do not support this conclusion.

The 2011 Exports as a Percentage of GDP chart below highlights the relevance of exports to the national economy (as measured by GDP) of various nations around the world. Only approximately 14% of the U.S. GDP is derived from exports. By comparison, the European Union economy, which represents a population base and size similar to the U.S., derives over 40% of its GDP from exports. Taking this into consideration, along with the multiple trillion dollar economic development initiatives announced for China, the Middle East, North Africa and other emerging economies, leads one to a different conclusion - that U.S. trade policy still has ample opportunity to catalyze an expansion of GDP by continuing to increase exports.



American Competitiveness Overseas

While the NEI appears to be having a positive impact on U.S. business capturing a greater share of the world's markets, there are factors outside of the NEI that continue to place U.S. firms at a disadvantage to their foreign competition. This foreign competition, notably the countries of the European Union, the U.K., Canada, India, China, and Russia, aggressively targets exports as a major source of earnings and employment. These countries have been legally subsidizing their exports through any means possible including the elimination of taxes on the foreign earned income of their citizens working abroad. By actively encouraging and facilitating their nationals to take expatriate jobs, these nations realize a substantial 'pull effect' on exports, as well as opening additional domestic job opportunities for its citizens in jobs that would have otherwise been filled by these expatriate workers.

In a recent conversation with U.S. Representative Mick Mulvaney (R-SC) he stated, "America should be encouraged to go abroad and our government should ensure they compete on a level playing field. When Americans compete on a level playing field, our goods and services win. Americans abroad are Ambassadors of our country, our economy and the American way of life. More Americans abroad is not just a key component to promoting exports and creating U.S. jobs, it is a key to a solid foreign policy as well".

H. Delano Roosevelt, grandson of former President Franklin Delano Roosevelt and Vice Chairman of MECACC (Middle East Council of American Chambers of Commerce), stated, "Americans living and working abroad promote trade around the world and help strengthen the U.S. economy and are our foremost proponents of export driven commerce."

Unfortunately, the U.S. is the only major industrialized nation that taxes the income of its citizens earned abroad. While the FEIE provided in Section 911 of the IRS Code provides for a tax exemption against a portion of these foreign earnings, the benefit provided by the FEIE is out of step with global competition. After consideration of the FEIE, U.S. expatriate workers abroad still pay a significant portion of their earnings in tax to the U.S. As foreign workers do not face a similar tax burden, the net result is that employers for jobs overseas end up having to pay substantially less for a foreign worker than a U.S. worker with equivalent skills. This means far fewer Americans are beating the competition for jobs overseas; consequently, there are far fewer Americans overseas helping influence the export of U.S. goods and services. Many U.S. firms have announced to their U.S. employees that they will no longer be considered for expatriate jobs inasmuch as it is much more expensive than filling these jobs with foreign nationals.

By comparison, the difference in cost to an employer overseas of a U.S. expatriate who is taxed and a foreign national expatriate who is not taxed is between 15% and 20%.

Hypothetical Compensation & U.S. Income Tax Comparison
American Working Overseas vs. Foreign Worker in Same Job
Family of Four - Equivalent Net Take Home Pay

		American Working Overseas	Foreign Competition
Take Home Pay	(1)	$ 100,000	$ 100,000
Allowances			
Travel Home	(2)	20,000	20,000
Schooling	(2)	36,000	36,000
Cost of Living Adjustment	(2)	24,000	24,000
Rent in Foreign Country	(2)	50,000	50,000
Total Salary plus allowances		$ 230,000	$ 230,000
Equalization for US Taxes	(3)	35,315	-
Total Cost to Employer		$ 265,315	$ 230,000

Higher Cost of US Expatriate vs. Foreign Competition (4)	115%

(1) Illustration uses equal take home pay at $100,000 for a foreign-based job.

(2) Cost of additional items that must be purchased locally (employer allowances)

(3) The extra amount of money an employer pays to the American worker to compensate them for taxes owed to the U.S. Government on foreign earned income of $265,315.

(4) Calculated => Total Cost to Employer of American Working Overseas / Total Cost to Employer of Foreign Worker in same job ($265,315 / $230,000)

Additionally, it is an allegory that the FEIE allows U.S. expatriates to escape paying their fair share of taxes. By comparison, a U.S. expatriate with the same salary as a U.S. resident pays almost twice more in taxes to the U.S. (see below table).

Hypothetical Compensation & U.S. Income Tax Comparison
Family of Four
Comparable Living Conditions for US Expat Family

		American Working in the US	American Working Overseas
Salary		$ 138,000	$ 138,000
Travel Home	(1)	-	20,000
Schooling	(1)	-	36,000
Cost of Living Adjustment	(1)	-	24,000
Rent in Foreign Country	(1)	-	50,000

Total Compensation	$	138,000	$	268,000
2012 FEIE		-		(95,100)
Estimated Foreign House Exclusion		-		(13,314)
Standard Deduction		(11,900)		(11,900)
Personal Exemptions		(15,200)		(15,200)
Taxable Income	$	110,900	$	132,486
Taxes Calculated		(19,785)		(37,240)
Child Credit	$	600	$	-
Taxes Paid		(19,185)		(37,240)
Take Home Pay		118,815		100,760

(1) Assumes total amount paid to employee is paid out by employee for expense

US Expatriate Tax Payments Vs. US Resident Tax Payments	194%

We will speak more about the FEIE and its impact later in this testimony.

The Benefits of U.S. Citizens Working Abroad

The employment of each American overseas directly reduces the ranks of unemployed Americans through what is termed an "absent worker" effect. For every American who is gainfully employed overseas, there is one less person seeking work in the U.S. For example, if one leaves an overseas position and take a job back home, they are taking a job in the U.S. from someone else. However, it is much broader than just U.S. citizens working for U.S. companies overseas. Many U.S. citizens work for non-U.S. companies overseas. Ultimately, it comes down to basic economic theory of supply and demand: reduce cost, consumption increases. Reducing the cost of a U.S. citizen to an employer (a U.S. or non-U.S. owned company), creates the opportunity for more demand of U.S. citizens abroad which has a direct effect on that overseas U.S. citizen being able to influence purchasing of American products.

This "absent worker" and his (or her) family also has a substantially reduced demand on government services and benefits such as public education, infrastructure construction and maintenance, police services, medical and unemployment benefits, etc. Additionally, the recycling of the earnings of Americans working abroad provides a further boost to the U.S. economy through purchases of goods, services, and investments in the U.S. Also, as noted earlier, U.S. expatriate workers pay taxes to the U.S. that are significantly greater than that paid by a comparable U.S. resident worker.

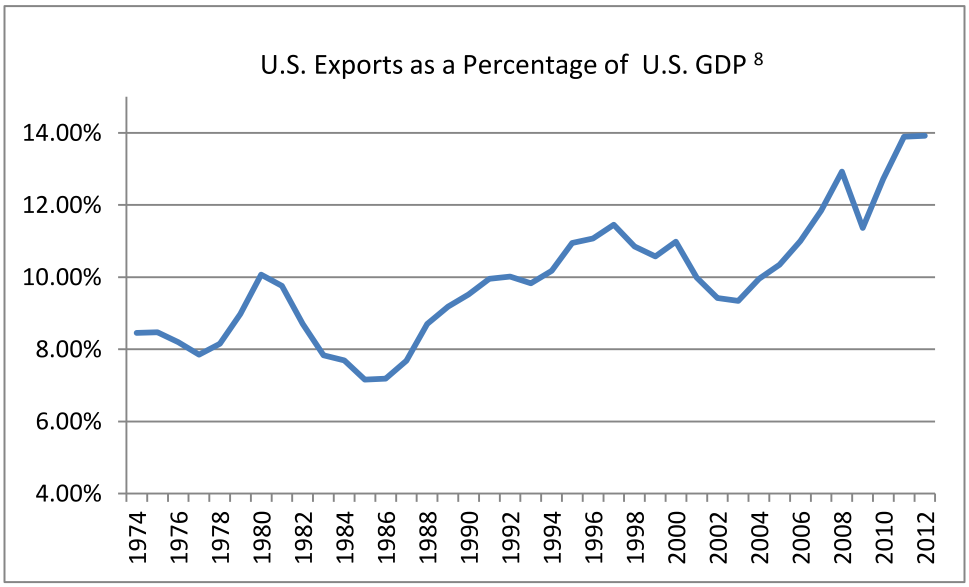
Another less obvious, but substantial benefit of U.S. workers abroad is their positive impact on U.S. trade and diplomacy in their unofficial role as goodwill ambassadors of the U.S. Americans are still valued very highly overseas for their hard work, ethics, work quality, business models and their ability to deliver projects on time and within budget. Accordingly, despite their higher cost, Americans have been hired in senior advisory roles by many of the large international and local firms, as well as by many of the local government bureaus and ministries that are engaged in the world's major economic and industrial development programs. In these senior advisory capacities, U.S. workers are very influential in both sourcing U.S. goods and services along with the utilization of U.S. fair trade and business practices being taken into consideration for these economic and industrial development programs.

Many U.S. workers abroad can relate stories where they have personally been involved and have had significant influence in a decision relating to a material amount of U.S. business being awarded or of U.S. business practices being adopted. Unfortunately, there is no objective way to quantify how much additional U.S. business was generated as a result of this expatriate influence. However, there is strong empirical evidence which occurred in the late 1970s after Congress shortsightedly reduced, and then abolished, the FEIE completely[6].

As a direct result of the FEIE elimination, U.S. expatriate workers came home in significant numbers; some key industries saw a decrease of 34% in America's share of the expatriate workforce[7]. The negative impact was so quick and substantial that in 1979, Congress required the Carter Administration to provide a report on the detrimental impact of legislation and regulations on its citizens abroad. In response, the

President's Export Council issued a report in December 1979 that studied the rationale for taxing U.S. citizens abroad and concluded that Americans: "are being taxed out of competition in overseas markets. The result is a sharp loss in the United States' share of overseas business volume in vital economic sectors. The current situation contributes to our negative balance of payments, a loss of U.S. jobs to our competitors, and the decline in U.S. presence and prestige abroad."

Among the Council's recommendations was that "Work should begin immediately to encourage enactment of a new tax law to put Americans working overseas on the same tax footing as citizens of competing industrial nations." Congress responded and in the Economic Recovery Tax Act of 1981 the FEIE was reinstated. However, the damage was done. U.S. exports as a percentage of U.S. GDP did not reach 1979 levels until 1989[8].



Another very important aspect that U.S. workers abroad bring is the idea of peace through commerce. What better way to foster peace than by living and working by people that might look, speak and possibly worship differently then you. While potentially shocking at first, overtime, both the American and the foreign country host generally find that they have much more in common with each other than they have differences. Learning about other cultures (and sharing yours) and developing friendships is key to building a more interconnected, peaceful, existential world.

History of the Foreign Earned Income Exclusion (FEIE)

Section 911 of the Code addresses citizens and residents of the U.S. living abroad. As mentioned in the Code, the term "foreign earned income" with respect to any individual means the amount received by such individual from sources within a foreign country or countries which constitute earned income attributable to services performed by such individual during the period.

Following is a brief history of the origins of the US taxing authority and the FEIE:

- 1918. Efforts are made in the House of Representatives to exempt foreign source income from the U.S. taxation because of alleged competitive disadvantages suffered by American corporations operating branches abroad.
- 1926. Legislation is enacted giving full exclusion of overseas income from U.S. taxation if an American citizen is absent from the United States more than six months in any calendar year.
- 1962. Congress enacts a cap of $20,000 per year on the exclusion granted on the foreign income of U.S. workers abroad rising to a cap of $35,000 after a citizen had spent three years abroad.
- 1964. Congress enacts new legislation reducing the exclusion for physical presence and bona fide residents to $20,000, rising to $25,000 after three years abroad. Feb. 26, 1964, Pub. L. 88-272, title II, Sec. 237(a), 78 Stat. 128.
- 1975. The House continues consideration of abolishing the FEIE.
- 1976. The Senate resists the abolition of the FEIE, but accepts that the exclusion should be modified to "prevent abuse".
- 1976. Congress decides to amend the tax law so that the FEIE will be reduced to $15,000.
- 1978. Congress votes for a *total elimination of overseas earned income exclusion* to be replaced by the specific deductions. This act proved to be an export and job killer.
- 1979. Congress requests a new report from the President on Federal statutes and regulations that "treat United States citizens living abroad differently from United States citizens residing within

the United States or which may cause, directly or indirectly, competitive disadvantages for Americans working abroad relative to the treatment by other major trading nations of the world of their nationals who are working outside their territory”.

- 1979, The President’s Export Council issues a report in December 1979 that studied the rationale for taxing U.S. citizens abroad and concludes that Americans: "..are being taxed out of competition in overseas markets. The result is a sharp loss in the United States’ share of overseas business volume in vital economic sectors. The current situation contributes to our negative balance of payments, a loss of U.S. jobs to our competitors, and the decline in U.S. presence and prestige abroad." Among the Council’s recommendations is the following: "Work should begin immediately to encourage enactment of a new tax law to put Americans working overseas on the same tax footing as citizens of competing industrial nations".
- 1980. President Carter submits a new report to Congress on the treatment of U.S. citizens living abroad. He does provide some general observations on U.S. tax treatment of Americans overseas. These include the following: One major goal of an income tax is equity. In addition, income tax systems frequently depart from the equity objective in specific instances to achieve other desirable goals. An income tax that provides incentives to expatriate employees, relative to other expatriates and to residents, is generally justified on the grounds of export promotion. Finally, the principal argument for tax exemption of Americans employed abroad is export promotion. Given that objective, exempting from tax the foreign earnings of Americans employed abroad is one possible policy tool, which should be evaluated and compared with other possible alternative measures.
- 1981. Congress re-introduces a $75,000 FEIE for "physical presence" and "bona fide" residents abroad (rising by $5,000 per year until $95,000 in 1986). There are additional deductions or exclusions for excess cost of foreign housing.

- 1986. Congress passes the "Tax Reform Bill of 1986" which introduces a number of significant changes affecting U.S. citizens residing abroad. The section 911 FEIE was reduced to $70,000.
- 1997. Congress passes the "Taxpayer Relief Act of 1997" which increased the FEIE by $2,000 per year (from 1998 to 2002) to a new maximum of $80,000 and indexes for cost of living increases after 2002.
- 2005. Congress passes the "Tax Increase Prevention and Reconciliation Act of 2005". As a compromise to achieve passage of the Act, the inflation-adjustment provision for the FEIE set to begin in 2008 was advanced. However, the Act also included a "stacking provision" that requires the FEIE to be excluded against the lowest income tax brackets first. Effectively, the first dollar of income that becomes taxable after the FEIE is taken into consideration is taxed at a much higher rate than the first dollar of taxable income for a resident U.S. citizen of comparable income.

The goal of U.S. trade policy is to harmonize international taxes and tariffs to promote a level playing field in international trade. This is the primary reason why the US does not levy a tax on product exports. Consequently, our current tax policies on the foreign earned income of Americans working abroad places a tax on exported services which put Americans at a significant disadvantage and also damages our export competitiveness.

According to PricewaterhouseCoopers (PwC), the U.S. is the only industrialized country to tax foreign earned income based on citizenship rather than on residence. PwC further stated that this is a major example of the failure of the U.S. to harmonize its tax policies with international tax practice. As we have discussed earlier in the article, the taxation of the foreign earned income of Americans working abroad places them at a significant competitive disadvantage to foreign national expatriates which has reduced, and continues to reduce, the number of Americans oversees. As a result, the positive trade pulls and goodwill ambassador benefits of Americans overseas have also been substantially impaired.

What's Next For the FEIE

There is a lot of discussion taking place in Washington, D.C. on the need for reforming the tax code to help balance the budget and avoid the U.S. going over one or more future fiscal cliffs to its ruin. Much of this discussion uses the buzzwords of the revised tax system being "balanced" and "fair" to all U.S. citizens and businesses. Special interest groups and the tax loopholes favoring their causes which have been added to the tax code are primary targets for elimination. Under the static scoring system used by Congress to determine the benefit or detriment of changes to the tax code, the FEIE is viewed as a tax loophole which, if closed, could create an additional $6 billion per year of tax revenues for the U.S.

Unfortunately the static scoring system does not take into consideration the much greater negative impact that elimination of the FEIE is likely to have on US exports and therefore on U.S. job creation. Neither does this system calculate the increased costs of U.S. expatriate workers that will need to return home as they become too expensive for their employers to maintain. Congress has empirical evidence of the recent increases in U.S. exports and their significant positive impact on job creation. Congress also has the evidence of the significant deleterious impact of the FEIE elimination during the Carter Administration. Both of these need to be taken into consideration before any change in the FEIE is entertained. Hopefully, if Congress finds itself once again in a position where it will have to make difficult compromises on tax reform to move the Nation forward, we hope that such consideration on the FEIE will be given.

On the positive side for the FEIE, there has also been bipartisan discussion on tax reform which could lead to an increase of the FEIE or the full elimination of taxation on the foreign earned income of U.S. citizens abroad which would put the U.S. in line with other taxation systems around the world and substantially increase U.S. competitiveness overseas.

The House Ways & Means Committee under Chairman Dave Camp (R-MI) held several hearings on comprehensive tax reform in the 112th Congress, released an international tax reform discussion draft in October 2011 and released a financial products discussion draft in January 2013. In February, Chairman Camp and Ranking Minority Member Sander Levin (D-MI) announced the formation of 11 separate Ways and Means Committee Tax Reform Working Groups. It is hoped that the work of these Tax Reform Working Groups will result in a comprehensive tax reform bill which can be voted upon this year and meet with broad bipartisan support.

As one of its centerpiece arguments, the Ways and Means committee has advocated for the U.S. to switch from a "worldwide" taxation system on U.S. businesses to a "territorial" tax system[9]. Such a system would result in an elimination of the earnings of U.S. businesses in foreign jurisdictions and an immediate increase in the ability of U.S. business to compete overseas; however, the territorial tax proposals being discussed have not yet specifically addressed how the taxation of the foreign earned income of individual U.S. citizens would be treated. It would be logical and fair for individual U.S. citizens to be treated the same as U.S. businesses under a territorial tax system as this would also be a substantial boon to U.S. competitiveness.

A new bill, which may also bring light to the need to retain and/or increase the FEIE, was very recently assigned to a congressional committee on February 8, 2013 (House Resolution 597[10]). The bill, which is named the Commission on Americans Living Abroad Act, will require that Congress systematically study the impact of government policies on the six million American citizens living abroad. It is sponsored by

Representative Carolyn Maloney (D-NY). With the passage HR 597 lawmakers could be much better informed about the unintended consequences laws have on American taxpayers overseas.

CONCLUSION

U.S. expatriate workers are an important part of the U.S. trade equation and the creation of jobs that maintain and grow our U.S. economy. Current tax regulations put U.S. workers at a competitive disadvantage to foreign national workers overseas and, as a result, impede the growth of U.S. exports and impair the ability of U.S. businesses to compete overseas. Elimination of the FEIE will have a further harmful impact on the number of U.S. citizens working abroad and on the growth in U.S. trade. Tax reform should take these negative impacts into consideration and hopefully tax reform will result in an increase in the FEIE or a full elimination of the tax on foreign earned income, which in turn will increase American competitiveness and yield substantial positive benefits to the U.S. economy.

Statistical Support

[1] http://www.whitehouse.gov/sites/default/files/nei_report_9-16-10_full.pdf

[2] Calculation of the Jobs Supported by Cumulative Export Growth 2010, 2011, 1nd 2012 as follows:

A	B	C = B (cum)	D	E = C X D
Year	Yearly Export Growth ($B)	Cumulative ($B)	Jobs/$1billion	Jobs Supported
2010	$257	$257	5,500	1.413 Million
2011	$250	$507	5,080	2.576 Million
2012	$ 85	$592	(f)5,080	3.012 Million

Jobs/$1billion for 2010 and 2011 obtained from "Jobs Supported by Exports: An Update", Office of Competition and Economic Analysis, Manufacturing and Services, International Trade Administration, US Department of Commerce. (f) – 2012 data is not available, used 2011 data for the purposes of calculating 2012 figures.

[3] Data referenced and 2010-2012 data in the "Unemployment Rate" chart was obtained from US Bureau of Labor Statistics, Seasonally Adjusted Unemployment Rate (Series ID: LNS14000000).

Data referenced in the "Unemployment Rate Without 2010-2012 Export Growth" calculated as follows (numbers in thousands):

A	B	C	D = B + C	E	F = D / E

Year	Unemployment Level	Jobs Supported by Cumulative Export Growth 2010 11 & 12	Unemployed if no Export growth	Labor Force	Unemployment Rate If No Export Growth
2010	14,354	1,413	15,767	153,649	10.2%
2011	13,049	2,625	15,625	153,945	10.1%
2012	12,206	3.012	15,218	155,511	9.8%

'Column B' obtained from US Bureau of Labor Statistics, Seasonally Adjusted Unemployment Level (Series ID: LNS13000000).

'Column C' calculated in note 4 (above)

'Column E' obtained from US Bureau of Labor Statistics, Seasonally Adjusted Civilian Labor Force Level (Series ID: LNS11000000).

[4]US Census Bureau www.tradingeconomics.com

[5]Calculation of "Yearly Exports Growth 2010-2012" as follows:

Year	Table 1.1.5 Exports ($B)	Yearly Growth ($B)
2009	$1,587	
2010	$1,844	$257
2011	$2,094	$250
2012	$2,179	$ 85

[6]http://www.gao.gov/assets/140/132160.pdf

[7]http://www.gao.gov/assets/100/99731.pdf, Table 6

[8]http://www.bea.gov/ , National Income and Product Accounts Tables

[9] http://waysandmeans.house.gov/uploadedfiles/discussion_draft.pdf

[10]http://www.govtrack.us/congress/bills/113/hr597#overview