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GES NewsFlash

United States – President suggests trimming benefits of foreign earned income exclusion

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Summary

President Obama on September 19 recommended scaling back a wide range of tax benefits for high-income individuals, including those provided by the foreign earned income exclusion.

Specifically, the tax savings provided to high-income taxpayers (those singles and married couples with adjusted gross income in excess of $200,000 and $250,000, respectively) by the foreign earned income exclusion under section 911 would be limited to 28 percent. To illustrate, in the case of an individual with income subject to a top individual income tax rate of 39.6 percent in 2013, the proposal would effectively add back up to 11.6 percent of a portion of the income excluded under section 911.

The proposed changes would be part of his plan to cut the federal deficit by $3.2 trillion (net) over the next 10 years and fully offset the cost of a $447 billion job creation and infrastructure spending package (the American Jobs Act of 2011) that he outlined earlier this month in an address to a joint session of Congress.

Overall, the plan includes some $1.5 trillion in revenue provisions – some new and some recycled from earlier budget packages – that would, among other things, increase taxes on high-income individuals, tighten the international tax rules, change certain rules affecting life insurance companies and their products, eliminate provisions that benefit the oil and gas industry as well as the coal industry, and repeal certain longstanding tax accounting methods.

A 'principled' call for tax reform

On the tax side, the President's deficit reduction plan calls on the Joint Select Committee on Deficit Reduction, informally known as the 'supercommittee,' to pursue comprehensive tax reform that follows five principles: (1) lower individual and corporate tax rates, (2) broaden the tax base by eliminating "inefficient and unfair" tax breaks, (3) contribute $1.5 trillion toward deficit reduction over the next decade, (4) spur economic growth and job creation, and (5) observe the "Buffett Rule" – a principle that takes its name from billionaire investor Warren Buffett and is rooted in the general concept that households with annual income in excess of $1 million should not have a lower effective tax rate than a typical middle-class family.

The plan then recommends a set of revenue raisers – all of which have been proposed by the President in the same or similar form as part of previous budget submissions to Congress – that would allow lawmakers to meet the $1.5 trillion deficit reduction goal. Importantly, Congress would have to finance lower tax rates by further reducing or eliminating tax expenditures.

The ‘Buffett rule’ and other individual tax provisions

As expected, the President’s deficit reduction plan includes familiar provisions intended to increase taxes on high-income earners, but also adds the enigmatic “Buffet rule.” The White House’s explanation of the plan provides few details on the Buffet rule, other than to say that “[n]o household making over $1 million annually should pay a smaller share of its income in taxes than middle-class families pay.” The plan calls for the Buffet rule to be observed when Congress considers the revenue offsets proposed to raise an additional $700 billion on top of the $800 billion that would result from allowing the 2001 and 2003 tax rates to expire for upper-income taxpayers.

During a press briefing following the President’s address on September 19, Treasury Secretary Timothy Geithner stated that the Buffet rule is merely a principle rather than a specific proposal that the White House intends to introduce. Nonetheless, the concept could indicate significant changes to existing provisions affecting high-income taxpayers.

Expiration of Bush-era tax rates for high-income individuals

Similar to recent budget proposals, the President’s plan would allow the 2001 and 2003 ordinary income tax rates to expire for high-income individuals beginning in 2013. As a result, the current-law 33 percent and 35 percent brackets would increase to 36 percent and 39.6 percent, respectively, while rates on capital gains and qualified dividends would rise to 20 percent and 39.6 percent, respectively. However, the President has proposed capping the dividend rate at 20 percent. Expiration of upper-income tax rates also likely includes reinstating the personal exemption phase-out (PEP) and itemized deduction limitation (Pease). According to the plan, the tax rate increases
would apply to those with “household income above $250,000 per year” (and likely to singles earning above $200,000 based on past White House proposals).

Under the plan, the estate tax exemption and top rate ($5 million and 35 percent top rate under current law) would revert to 2009 law ($3.5 million and 45 percent top rate) beginning in 2013.

The White House estimates that allowing the top rates to expire in 2013 would raise $866 billion over 10 years.

American Jobs Act offsets

The tax incentives in the American Jobs Act – an extended payroll tax holiday for employees, a new payroll tax holiday for employers, various credits to encourage hiring of veterans and the long-term unemployed, and a delay in the implementation of 3 percent withholding on payments to government contractors – are fully offset with $467 billion in tax increases drawn largely from prior budget blueprints and proposals that the administration promoted as part of debt ceiling negotiations earlier this summer.

Limitation on the benefits from certain deductions and exclusions

The administration drew on previous budget proposals that would limit to 28 percent the tax rate at which itemized deductions reduce tax liability for high-income taxpayers. However, the latest iteration expands the proposal’s reach to include certain above-the-line deductions, the exclusions provided for tax-exempt municipal bond interest under section 103 and foreign-earned income under section 911, and the aggregate cost of employer-sponsored group health plan coverage.

In simplest form, a high-income taxpayer’s liability would be recomputed without consideration of the targeted tax expenditures and compared to the taxpayer’s regular tax liability increased by 28 percent of those same expenditures. The excess of the former over the adjusted regular tax liability would be an additional tax. In the case of a potential top rate of 39.6 percent for 2013, the proposal would effectively add back 11.6 percent of the targeted expenditures. An adjustment would also be made if the taxpayer were subject to the alternative minimum tax. The provision would be effective January 1, 2013. The White House estimates that the limitation would raise $410 billion over 10 years.

Lines in the sand

With the release of his plan, the President has reiterated his insistence that revenue measures be included in any comprehensive deficit reduction plan and has set the stage for another standoff with congressional Republicans.

For his part, House Speaker John Boehner, R-Ohio, panned the White House's latest proposal in a September 19 news release.

"The Joint Select Committee is engaged in serious work to tackle a serious problem: the debt crisis that is making it harder to get our economy growing and create more American jobs. Unfortunately, the President has not made a serious contribution to its work today," Boehner said. "This administration's insistence on raising taxes on job creators and its reluctance to take the steps necessary to strengthen our entitlement programs are the reasons the President and I were not able to reach an agreement previously, and it is evident today that these barriers remain."

Deloitte's view

The President's proposal, particularly the section related to trimming the benefits of the foreign earned income and housing exclusions, continues the trend of the last few years of limiting the overall benefit of the exclusions for international assignees. In addition, after considering foreign allowances and foreign tax reimbursements, many middle-income expatriate taxpayers may find themselves in the high income category, thereby impacted by these proposed changes even if they would not have been had they continued working in the United States. Companies who tax equalize their international assignees and cover the actual tax liabilities of their assignees may bear the brunt of this additional cost.

Nevertheless, as already indicated, this proposal will face stiff opposition in Congress and may be modified and adjusted multiple times before it is passed as law. This Newsflash is designed to keep the reader abreast of the U.S. tax proposals and their potential impact on international assignees and international assignment programs. However, specific tax planning should be kept on hold until further negotiations are completed between the President and Congress.

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