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To: Members of the Executive Board

From: The Secretary

Subject: Tax Allowance Under the Average Deduction System

There is attached for the information of the Executive Directors the third annual report on tax allowances under the Average Deduction System (ADS).

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Tax Allowances Under the Average Deduction System

Prepared by the Treasurer's Department and the
Administration Department

Approved by Walter O. Habermeier and R. Tenconi

December 9, 1983

In accordance with the decision of the Executive Board of January 18, 1980, (EBAP/80/360, Sup. 1, 1/17/80), there follows a report on the operation of the Average Deduction System (ADS) for the 1982 tax year. This is the third annual report called for under the five-year transitional period of implementation of the ADS.

The World Bank is preparing a similar report for its Executive Board.

I. Operation of Tax Allowance for 1982

Three years of operation under the five-year transitional period of the ADS have now been completed. The question of the Fund sharing one half of the two-earner married couple deduction, up to a maximum of $1,500, has arisen and has been accommodated. The main focus continues to be on the careful monitoring of the effect of the system on individuals, and of changes in the U.S. tax code. The most significant tax code changes will be discussed in Section III of this report.

As in past years, the average deduction statistics applied for 1982 were provided by the U.S. Internal Revenue Service (IRS) and were based on 1979 U.S. tax returns. In the past, these statistics were supplied by the IRS in $1,000 intervals, and Arthur Andersen & Co., the tax consultants, provided a refinement of them to apply to income levels of $500. On the recommendation of Arthur Andersen & Co., the statistics provided by the IRS for 1982 were in $500 intervals. Some questions arose in this connection and these are discussed in Section IV of this report.

II. Payment of Tax Allowance for 1982

1. Payments to U.S. nationals

For the year ended December 31, 1982, a total of 464 U.S. staff members received tax allowances which totaled $9.9 million. This compares with 431 staff members for 1980 and 481 for 1981 who received allowances of $8.1 million and $11.6 million, respectively (Table 1). Those U.S.

nationals appointed before January 1, 1980 were eligible for the transitional payment and also eligible for the safeguard provision. Of the U.S. staff members receiving 1982 tax allowances, 349 were eligible for the transitional payment and their tax allowances totaled $8.8 million ($7.3 million under the Average Tax Deduction System and $1.5 million under the transitional arrangements). Under the safeguard provision, 47 U.S. staff members applied for additional allowance with respect to 1982 taxes. Of these, 36 were found eligible after review of their tax returns by the Fund and received additional payments totaling $44,000.

Those U.S. staff members who joined the Fund after December 31, 1979 were eligible for the tax allowance but not the transitional payment or safeguard provision. As noted in the attached Table 1, there were 115 staff members in that category who received tax allowance payments for 1982 which totaled $1,075,000 as compared with 28 in 1980 and 88 last year receiving tax allowance payments of $84,000 and $670,000, respectively. Table 1 summarizes the 1980, 1981, and 1982 data on tax allowance payments.

2. <u>Payment to other nationals</u>

During 1982 eight French nationals employed by the Fund in France received tax allowances totaling $62,000 which was equivalent to 35.5 percent of their salaries. Consistent with the principles applied in the past, the minimum statutory deductions prescribed under French income tax codes were applied on the tax allowance calculations for local staff whose salaries are based on OECD salaries. One French national assigned to France received a salary based on the headquarters dollar salary scale and the tax allowance was calculated using the minimum statutory deduction. The procedures are identical to those applied in 1980 and 1981.

III. Effect of U.S. Tax Code Changes on the Average Deduction System

The Tax Equity and Fiscal Responsibility Act of 1982

As noted in EBAP/82/434, 12/1/82, the Fund and Bank asked Arthur Andersen & Co. to review the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and to report on any implications for the ADS. The tax consultants were of the opinion that the most significant potential impact under TEFRA was the new regulation concerning itemized deductions for medical expenses. TEFRA increased the minimum above which itemized medical expenses are deductible and eliminated the separate $150 deduction for one half of health insurance premiums. After computing the impact of the change in medical deductions, the tax consultants concluded that the effect of TEFRA upon allowed medical deductions would not by themselves significantly increase tax allowances under the current system. These tax code changes will, of course, have some marginal impact on the IRS average deduction statistics which will be provided by the IRS in 1986.

For these reasons no changes have been made in the current tax allowance system, but the impact of these changes and other changes will be evaluated in the general review foreseen of the tax allowance system in 1985.

IV. Future Issues Affecting ADS

1. Social security changes effective January 1, 1984

Effective January 1, 1984 the IRS will allow a credit for a part of the social security tax paid by individuals as "self-employed." The current status of Fund U.S. staff members for social security purposes is that of self-employed individuals and the change could therefore affect tax allowances under the Fund system. With the advice of the tax consultants and in conjunction with the World Bank, this issue is now being studied for application in January 1984. The impact of these changes on the operation of the ADS will be reported to the Executive Board in the 1984 Annual Report on the Average Deduction System.

2. Safeguard

At the end of 1982 almost 25 percent of U.S. nationals were covered by the average deduction system without the benefit of the safeguard provisions. This proportion will increase over time. The impact of the average deduction system on this group will of course continue to be monitored.

3. Average deduction statistics from IRS

As noted earlier, some questions arose regarding the refinement of IRS statistics by the tax consultants. It has been agreed with the consultants that although the statistics are available at income intervals smaller than the $1,000 intervals used previously, for the sake of consistency we will continue to apply refinement techniques to the IRS data at $1,000 intervals. Should a satisfactory smoothing technique be developed, the IRS could then supply the Fund/Bank directly with average deductions claimed at various income levels which could be smoothed using Fund programs at considerable savings in consultant fees.

4. Review in 1985

As indicated in this and in previous reports, a review of the average deduction system will be performed in 1985.

Attachment

Table 1. Tax Allowance Payments for U.S. Staff

	1980	1981 1/	1982
1. Total tax allowances			
Number of staff	431	481	464
Total allowances	$8.1 m	$11.6 m	$9.9 m
As percent of salaries paid to these staff	73.6%	75.7%	62.2%
2. Transitional			
Number of staff	403	393	349
Transitional allowances	$2.1 m	$2.3 m	$1.5 m
3. Safeguard			
Number of staff	21	37	36
Safeguard payments	$6,000	$27,000	$44,000
4. Staff not eligible for the transitional arrangements			
Number of staff	28	88	115
As percent of all staff receiving a tax allowance	6.5%	18.3%	24.8%
Total allowances	$84,000	$670,000	$1,075,000
As percent of salaries paid to these staff	37.4%	53.6%	44.9%

1/ The $3.5 million increase in tax allowance payments from tax years 1980 to 1981 is due to three factors: a sizable general salary adjustment, a large retroactive payment, and the impact of a 27th pay period, all in 1981.