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To: Members of the Committee on Administrative Policies
From: The Committee Secretary
Subject: Interim Report on Review of Tax Reimbursement Policies

The attached interim report, prepared by the Administration Department, is circulated at the request of the Chairman for the information of Executive Directors.

Att: (1)

Other Distribution:
Members of the Executive Board

August 6, 1976

Interim Report on Review of Tax Reimbursement Policies

Prepared by the Department of Administration

In EB/CAP 76/6, March 8, 1976, the Managing Director indicated that a joint Fund-Bank staff working group was reviewing the two organizations' policies of tax reimbursement to staff members, primarily U.S. nationals who are subject to income taxes on their Fund salaries. He indicated that a report should be ready in the fall. Some Directors, however, requested an interim report. Accordingly, this summary of the current status of that review has been prepared.

The review has dealt with tax reimbursements to U.S. nationals since they constitute the overwhelming majority of cases. Those nationals are subject to federal, state and local income taxes in respect of salaries and other taxable allowances paid by the Fund. Pursuant to the Articles of Agreement, the salaries of non-U.S. staff members are exempt from such income taxes. In order to provide U.S. staff members with net-of-tax organization incomes equivalent to those of their non-U.S. colleagues earning the same organization incomes, it is the policy of the Fund (and the Bank) to reimburse U.S. nationals for the taxes that apply. Under the present system of reimbursement, organization income is regarded as "first income", i.e., income that is subject to tax in the lowest applicable income tax brackets. ^{1/} To take advantage of the "income-splitting" provisions of the U.S. Internal Revenue Code, spouse income from all sources is taken into consideration in computing the reimbursement. Outside income of the staff member is disregarded. Both organizations use the standard deduction ^{2/} rather than the actual deductions used by the staff member, except where the state or local income tax (a deductible item), also computed on the basis of the applicable standard deduction, is greater than the federal standard deduction, in which case the amount of state or local income tax reimbursed to the employee is used in its place. The same system is used for reimbursement of state and local income taxes.

The effect of the present policy is that in many cases the tax reimbursement probably does not match the actual income tax for which the U.S. staff member is liable in respect of his Fund income, taken as the staff member's only income. Depending on individual circumstances this could produce inequities of treatment between U.S. nationals and non-U.S. nationals and between U.S. nationals receiving the same amount of net-of-tax income

^{1/} Fund By-Laws, Section 14 (b).

^{2/} As approved by Executive Board, December 1946. At present the standard deduction is 16 per cent of adjusted gross income, up to a maximum allowable deduction of \$2,200 for a single taxpayer, \$2,400 for a married person filing a joint return, \$1,200 for a married person filing separately, or \$2,200 for a head of household.

1. Net-after-tax organization income of a U.S. staff member should be equal to that of a contemporary non-U.S. staff member. This should be true even when there is outside income involved.

2. The income tax reimbursement should be the difference between total tax liability of the staff member with his organization income considered and the tax liability without his organization income.

3. In order to prevent windfall reimbursements to U.S. staff members, the reimbursement policies should reflect the same U.S. tax treatment that the individual would use for determining his actual tax liability. This will achieve equity among U.S. staff members in the sense that they will not be reimbursed in excess of their actual tax liability."

If those postulates were achieved, equity among U.S. staff members would also be evident when comparing their net-after-tax income. With these objectives as the basis of their study, the consultants then arrived at the following principal recommendations:

a. In order to put the organization income of a U.S. citizen on the basis comparable to that of a non-U.S. citizen, the organization income should be considered as "last" or "top" income.

b. To eliminate the possibility of excessive reimbursement, actual deductions used by a staff member on his tax return should be taken into account when computing his tax reimbursement.

c. All income subject to U.S. taxes should be included when computing a staff member's reimbursement.

d. The staff member should inform the organization of the total amount of his income tax liability and method by which the tax was computed.

These recommendations conform to the systems applied by the United Nations, some of its specialized Agencies and the Organization of American States.

A working group of Fund and Bank staff members was established in 1974 to consider the Price Waterhouse consultants' report. It concluded that while the UN system would place U.S. and non-U.S. staff members on the same footing for U.S. tax treatment in respect of organization income, there were a number of negative features which would need to be considered in any decision for the Fund and Bank to adopt the U.N. system, the main ones being:

1. To regard organization income as "last" or "top" income for tax purposes seemed artificial in that it would consider the incidental income of most staff members as the base while the fundamental source of support would be put at the upper end in computing reimbursement.

2. The organization would bear the burden of high reimbursement in years when a staff member had unusually high outside income and would reap the benefit of unusually high non-recurrent deductions, such as casualty losses or medical costs.

3. The organization would have to be involved to a greater extent than hitherto in the staff member's private affairs.

4. Since the organization income would be taxed at higher marginal tax rates, adoption of the UN system might result in higher total reimbursement costs. In the case of the UN and other international organizations, the UN system had no budgetary implications since budgetary assessments on member governments include the specific amount of tax reimbursements paid to their nationals on the staff of the organizations. For the Fund and the Bank any added reimbursement costs would raise administrative expenditures.

Following consultations between the two managements, the recommendations contained in the Price Waterhouse report were not pursued further. Subsequently, a working group from the two organizations was instructed to look at possible alternatives to the Fund-Bank system and the UN system. Initially, an intensive study was made of a possible solution based on actual deductions together with a reimbursement of the tax on the income received from the organizations at the average tax rate paid by the taxpayer on his and his spouse's total income, which is referred to as the pro-rata system.

The pro-rata system would differ from the present Fund-Bank and the UN systems in a number of respects:

1. All sources of income, including outside as well as spouse income, would be taken into account. Under the present system, spouse income is counted for the purpose of determining applicable tax rates for calculating reimbursements but other outside income is disregarded.

2. The pro-rata system would take full account of the deductions and exclusions actually used by the taxpayer rather than apply the standard deduction.

3. Deductions and exclusions would apply to all incomes on a pro-rata basis. The exclusions, exemptions and the standard deductions are applied entirely to reduce tax reimbursement on organization income under the Fund-Bank system, while under the UN system the actual deductions and exemptions are applied first to offset spouse and outside income.

Thus, the pro-rata system would treat all income on equal terms rather than treating one as "first" income and another as "last" income. The present system does this for spouse income of whatever type but not for any outside income the Fund employee may have. It would similarly assume that deductions and exemptions should be the actual ones and should apply proportionately to offset organization income, outside and spouse income.

In considering the merits of a pro-rata system, the working group was concerned not only with the equity of such a system, but also with the practical

aspects of developing a workable procedure. It was recognized that in order to pro-rate on the basis of total income, it would be necessary to require actual income and deduction data from all individuals concerned, which would be distasteful, and to go into a complicated process of grossing up organization net-of-tax salaries and allowances, taking into account the impact of an increased number of factors affecting the calculation which are not included in the present system. The method would also have to take into account the differential tax rates that apply to certain types of income (capital gains and maximum tax on earned income). Also, although assuming generally that deductions and exclusions would apply equally to all income sources, there could be instances where certain deductions would be fully attributable to a particular source of income.

The working group considered that a manageable system of pro-rating taxes should be simple with a minimum of variables. A simple system, however, would have to be arbitrary in the handling of such questions as deductions and method of tax calculation, unless special considerations were given to individual cases. Such special consideration would require the disclosure of personal financial affairs of the individuals concerned as well as entail greater administrative costs. On those grounds the working group did not believe that a pro-rata system would be preferable to the present system.

The staff is continuing its review of other possible alternatives. It should be recognized that the matter of finding a system that is both equitable and simple is very difficult. Any system of tax reimbursement would almost inevitably result in some inequities either between U.S. nationals or between U.S. and non-U.S. staff members, and certain alternatives might well necessitate larger administrative machinery. In the case of most of what appear to be the reasonable alternatives, whether another system would result in larger or smaller total reimbursements could not be determined in advance in the absence of a census of relevant information from the staff, and in any event could change over time. Consideration will be given to other possible alternatives to the present system and the trade-offs that would result between equity, simplicity and required disclosure of personal affairs. For example, one way of minimizing the distastefulness of required disclosure of aggregate actual deductions taken by a taxpayer would be to use an outside tax advisory firm to receive such information and calculate the reimbursements payable. Finally, if a different system is to be adopted, a reasonable period of notice should be given to staff members, apart from the lead time that will be necessary in connection with administering the system.