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To: Members of the Executive Board

From: The Secretary

Subject: Tax Allowances Under the Average Deduction System

Attached for the information of the Executive Directors is the second annual report on the operation of the average deduction system with respect to 1981.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Tax Allowances Under the Average Deduction System

Prepared by the Administration Department
and the Treasurer's Department

Approved by Walter O. Habermeier and R. Tenconi

December 14, 1982

In accordance with the decision of the Executive Board of January 18, 1980 (EBAP/79/360, Sup. 1, 1/17/80), there follows a report on the operation of the Average Deduction System (ADS) with respect to 1981. This is the second annual report called for under the five-year transitional period of implementation of ADS.

The World Bank is making a similar report to its Executive Board.

I. Operation of ADS for 1981

In the first report on implementation of the new tax allowance system it was noted that, during 1980, modifications were made to the computer program and implementation of the ADS proceeded without major technical difficulties. During the second year of operation of the ADS, the focus was mainly on the proper administration of the system and monitoring of the effect of U.S. Tax Code changes on the operation of the system. The impact of such changes is discussed in Section III of this report.

The average deduction statistics applied for 1981 were provided by the United States Internal Revenue Service (IRS) and were based on 1978 U.S. tax returns. Arthur Andersen & Co., the tax consultants, were of the opinion that the statistics could be used without modification for 1981 although they provided a refinement of the IRS average deduction statistics to apply to income intervals of $500.

There were no major operational problems encountered in the ADS for 1981.

II. Payment of Tax Allowance for 1981

1. Payments to U.S. nationals

For the year ended December 31, 1981, a total of 481 U.S. staff members received tax allowances under the Average Deduction System. Those U.S. nationals appointed before January 1, 1980 were eligible for the transitional payment and were also eligible for the safeguard provision. The tax allowances for all 481 U.S. staff members totaled $11.6 million for federal, state or D.C. income taxes and social security tax. This compares with 431 staff members who received a total of $8.1 million in 1980. The $3.5 million increase in tax allowance payments from tax year 1980 to 1981 is due to three factors: a sizeable general salary adjustment, a large retroactive salary payment and the impact of a 27th pay period, all in 1981. Of the U.S. staff members receiving 1981 tax allowance payments, 393 were eligible for the transitional payment and their tax allowances totaled $10.9 million ($8.6 million under the ADS and $2.3 million under the transitional arrangements).

Under the safeguard provisions, U.S. staff members appointed before January 1, 1980 may claim an additional tax allowance under certain conditions. For tax year 1981, the second year of the transition, those conditions were generally satisfied if actual deductions were less than one third of the assumed average deduction. In 1982, 55 staff members applied under the safeguard provision with respect to the 1981 tax allowances. Of these, 37 staff members were found eligible after review of their tax returns by the Fund and received additional payments totaling $27,000. This compares with 21 staff members who received such payments with respect to 1980, totaling $6,000.

Those staff members who joined the Fund after December 31, 1979 were eligible for the ADS tax allowance but not the transitional payment or safeguard provisions. There were 88 U.S. staff members in that category who received tax allowance payments for 1981 which totaled $670,000. Last year, there were 28 such staff members receiving tax allowance payments totaling $84,000.

2. Payment to other nationals

During 1981, 9 French nationals received tax allowances totaling $96,000. Consistent with the principles applied in the past, the minimum statutory deductions prescribed under French income tax codes were applied in 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 his tax allowance was calculated using the minimum statutory deduction. These procedures are identical to those followed for 1980.

III. Effect of the Economic Recovery Tax Act of 1981 on the Average Deduction System

The Fund and the Bank asked the Tax Consultants to review the Economic Recovery Tax Act of 1981 (ERTA) and to report on any U.S. tax code changes which could affect the operation of the Average Deduction System. The reports provided by the Tax Consultants were subsequently reviewed and discussed within the Administration and the Treasurer's Departments of the Fund and with representatives of the Staff Association Committee (SAC) and the World Bank.

The majority of tax changes resulting from ERTA are in the form of direct credits or adjustments to gross income. As such, they do not directly affect the average deduction statistics which are provided to the Fund and the Bank by IRS.

There are, however, two provisions of ERTA which clearly affect the current system of tax allowance payments and for each of these an approach has been worked out for reflecting the changes in the tax allowance system. Similar procedures are being adopted by the Bank.

1. Foreign earned income exclusion

Beginning in 1982, qualified U.S. nationals may exclude $75,000 of foreign earned income. This amount will increase by $5,000 per year, up to $95,000 in 1986. In order to qualify for the exclusion, U.S. nationals must physically reside in a country outside the United States for a mimimum of 330 days in a consecutive 12-month period. In view of the potential savings under the tax allowance system whereby most, if not all, Fund income to a U.S. staff member assigned overseas will be exempt from taxation, a procedure is being established to ensure that, but in exceptional cases, the exclusion requirements are met. The procedures will in no way place the staff member concerned at a disadvantage with respect to his other colleagues as regards entitlements or assignments overseas.

2. Two wage-earner adjustment

Under the U.S. tax system, the combined income tax liability of a married couple who both work is generally higher filing a joint return than the combined taxes they would pay if they were both single. The ERTA has partially offset this so-called "marriage penalty" by providing an adjustment to joint returns in situations where both husband and wife have earned income. The adjustment to gross income is equal to 5 per cent for 1982, and 10 per cent after 1982, of the first $30,000 earned by the spouse with the smaller income. Since a significant tax reduction can apply under these circumstances it was determined that an adjustment is required on account of the two wage-earner provision in calculating tax allowances under the ADS.

The specific methodology adopted allocates one half of the two wage-earner adjustment to the staff member's Fund income. Consistent with current practices, the adjustment, which is applicable only to couples who file joint returns, would be applied only in cases where the tax allowance is calculated on the basis of married filing jointly. It would not be applied in cases where the spouse has higher income than the staff member and the current tax allowance calculation assumes married filing separate status.

IV. Future Issues Affecting the ADS

As during the past two years of operation of the new tax allowance system, we expect new issues to arise as we continue to monitor the system. In this connection, some of the following issues will be focused upon:

1. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)

The Fund and the Bank have already requested and received preliminary data from the Tax Consultants with respect to the effect of this new U.S. tax act on the ADS. The issues are being reviewed and will be discussed as appropriate in the 1983 report on the ADS.

2. Safeguard

The staff will continue to monitor payments under the safeguard provision. The number of payments for the second year of operation was 37 compared with 21 for the first year. It is likely that the number of safeguard applications and payments will continue to increase as payments under the transitional arrangements decrease. Also, in the third year of the ADS, the proportion of U.S. nationals not covered by the transitional arrangements and safeguard provision will increase. The impact of ADS on this group of U.S. staff members will continue to be monitored.

3. Other issues

Some of the changes resulting from ERTA may raise more general issues concerning the adequacy of the ADS. One such issue is the appropriateness of the treatment of spouse income under the ADS in cases where the spouse has a greater income than the staff member. It was agreed with the Bank that this question would not be taken up until such time as the total system is reviewed at the end of the transition period, namely, in 1985. Other issues arising from ERTA which are now judged to be of little significance to the tax allowances paid by the Fund will also be taken up at the time of the general review.