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EB/CAP/92/11
Supplement 1

December 4, 1992

To: Members of the Committee on Administrative Policies

From: The Committee Secretary

Subject: Review of the Tax Allowance System - Comparison of Different Methods

The attached paper has been prepared in response to requests on the potential results of two methods that were suggested by members of the Committee on Administrative Policies during CAP meeting 92/5 on November 10, 1992. This note, together with the earlier paper on the review of the tax allowance system (EB/CAP/92/11, 10/15/92), will be taken up at a meeting of the Committee scheduled for 3:00 p.m., on Tuesday, December 8, 1992 in Committee Room 12-120.

Mr. J. Kennedy (ext. 34665) is available to answer technical questions relating to this paper prior to the Committee meeting.

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INTERNATIONAL MONETARY FUND

Review of the Tax Allowance System: Comparison of Different Methods

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Approved by Graeme Rea

December 3, 1992

I. Introduction

In EB/CAP/92/11 Review of the Tax Allowance System, detailed descriptions were provided of two forms of tax allowance system:

(a) the present system, generally described as the "average deduction system," and

(b) an alternative system, similar to that used by the U.N., which would treat Fund income as if it were exempt from taxation, thus placing U.S. staff on the same footing as non-U.S staff in respect of their Fund salaries.

In the discussion in the meeting of the Committee on Administrative Policies on November 10, 1992, some Executive Directors asked for an examination of other systems that would "individualize" tax allowances by taking into account staff members' actual income from sources other than the Fund or their actual deductions. Specifically, the staff was asked to examine the implications of two other methods of taking actual data into account:

(a) the application of the current Safeguard procedures 1/ to all U.S. staff, so that tax allowances would be based on staff members' actual deductions, and staff members would not reap any possible advantage they might now be judged to enjoy because their deductions exceed the average; and,

(b) a system taking all income and deductions into account, under which a proportion of the tax due on total income from all sources

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1/ Under the Safeguard mechanism, which is now available to staff employed before January 1, 1980, the allowances of staff may, at the option of the staff member, be recalculated with actual deductions being substituted for the average deductions used in the basic calculations. Where the actual deductions are smaller than the averages, this produces a larger tax allowance.

would be attributed to Fund income in accordance with the ratio of Fund to total income.

This supplementary paper reviews and compares these two suggested methods with the two methods that were examined in detail in EB/CAP/92/11.

II. Objectives and Criteria

It will be useful to restate the objectives and criteria against which the advantages and disadvantages of different tax allowance systems for U.S. staff should be judged.

The overriding objective is the requirement of the By-Laws that tax allowances should be "reasonably related" to the taxes paid on Fund salaries and allowances. There is, however, no commonly accepted method of calculating the taxes actually payable on Fund salaries. At a technical level, this depends on the way in which non-Fund ("outside") income and spouse income are taken into account and how deductions are treated. To the extent that the assumptions used to estimate the tax attributed to Fund income depart from the manner in which each staff member's tax is actually calculated in his or her tax return, the amount of tax the staff member pays will differ from the imputed tax on which the allowance is based. At the same time, the way in which any system of attribution treats deductions, outside income, and spouse income, will also affect the balance between the two other objectives of "internal" and "external" equity.

As explained in EB/CAP/92/11, in the course of the extensive review that led to the adoption of the present system, the Kafka Committee considered these two objectives very carefully. Internal equity primarily means that the tax allowance system should offset the tax due on Fund income in a manner that gives the U.S. staff member the same net, after-tax income as a similarly situated expatriate staff member. External equity (or external comparability), on the other hand, primarily means that the tax allowance system should give the U.S. staff member the same gross, pre-tax income as similarly situated persons employed outside the Fund. 1/ As discussed below, no system is equally effective in meeting both these objectives.

1/ With similar gross pay, Fund staff and staff of outside employers have broadly the same opportunity to maximize their deductions, and thus minimize their taxes. Differences between staff members' actual deductions and the average deductions used in the tax allowance system give rise to differences in taxes and net pay. However, because the same average deductions are used to net down gross pay in the comparator market used to set compensation, these differences among Fund staff are consistent with the differences that exist in the taxes and net pay of non-Fund employees in the comparator market.

Important additional criteria for judging the effectiveness of different systems include the direct costs of the allowances; ease of administration; and confidentiality, or what has been called "intrusiveness." Ease of administration has several aspects--in particular, the administrative costs of processing allowances, which in turn depends on the nature and extent of information required from staff and whether the system incorporates the same procedures for all staff or has to accommodate different groups of staff to whom grandfathering or transitional arrangements are being applied. These latter effects could be very burdensome if the present system were to be substantially revised in a manner that gives rise to the need for transitional arrangements in addition to the maintenance of the present Safeguard mechanism.

As regards intrusiveness, it may be possible to reassure staff members of the confidentiality of the personal information that they might be asked to supply; nevertheless, the confidentiality of tax returns is a major concern to U.S. staff. The traditional sensitivity of U.S. citizens on this point is reflected in strict legislation protecting the privacy of the returns. It arises, in part, because the U.S. system requires taxpayers to provide extensive documentation detailing income from all sources and substantiating many of the expenses claimed as deductions. A fairly straightforward return often requires more than ten pages of information, covering such diverse personal matters as income from individual investments, income and losses from rental properties or businesses, marital status, spouse income and deductions, alimony, child support, charitable contributions, and even, in some cases, the income of children.

It is against this background that the following sections set out a comparison of the advantages and disadvantages of the four systems mentioned above, as well as the proposal to extend the Safeguard within the present system.

A. The Present System

As intended by the Kafka Committee, the present system strikes a balance between, on the one hand, those elements that tend to understate the tax potentially payable on Fund income and, on the other hand, those elements that may offset the understatement, either partly or fully, or may overstate the tax payable on Fund income. Understatements arise mainly because outside income is ignored and the share of the joint tax that is attributed to spouse income is artificially raised by calculating the spouse tax on the basis of married-filing-separately rates. Offsetting overstatements may arise when staff members' actual deductions are larger than the assumed average deductions.

To balance these elements, and after careful study, the Kafka Committee struck a compromise between the objectives of internal equity and external comparability. Primary emphasis was placed by the Committee on external comparability. The same average deductions are used for the netting-down procedures of the compensation system and the grossing-up procedures for tax allowances; as a result, the gross pay of U.S. staff is aligned broadly with the gross pay in the market from which Fund net salaries are derived. 1/ With respect to internal equity, the Committee recognized that U.S. staff would be put in a less advantageous position than expatriate staff in the taxation of outside and spouse income. Accordingly, so as to narrow these differences and to alleviate any divisiveness among staff that arose from them, the Committee recommended the continued partial inclusion of spouse income in the tax allowance calculations. 2/

The present system--aside from the Safeguard mechanism for pre-1980 staff--minimizes both the administrative burden and the intrusiveness of processing allowances. The only information obtained from staff is the total amount of spouse income, personal exemptions, and state of residency; and married staff need only provide spouse income if they wish it to be taken into account. The Safeguard mechanism adds to the administrative burden, but the impact is manageable because the majority of eligible staff do not make use of it. Moreover, as regards intrusiveness, it is up to the staff member whether he or she wishes to access the mechanism and provide the confidential information that is needed.

B. Impact of the Extended Safeguard on the Present System

The principal proposal emanating from the review is to allow all U.S. staff access to the Safeguard mechanism. This is intended to address situations in which allowances fall significantly short of the tax estimated to be payable on Fund income. It leaves unchanged the elements of the present system which tend to understate the tax payable on Fund income; nevertheless, it provides a partial remedy when staff members' actual deductions also fall short of the assumed average deductions--that is, when all the elements of the system lead to the understatement of the tax.

The breadth of current dissatisfaction with the tax allowance system, and the need for some remedial action, has been convincingly demonstrated by the results of the recent Survey of Staff Views. More than 70 percent of U.S. staff expressed adverse views on the system; in addition to adverse responses to the relevant questions, the tax allowance system was a

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1/ The same symmetry could not be achieved by other systems. If average deductions were used to net down comparator salaries, while the tax allowance system used some system other than average deductions, the differences in taxes and net pay that would arise among U.S. staff would no longer reflect the same differences that would be arising among employees outside the Fund.

2/ At that time, Fund management supported the adoption of a U.N.-type system, which was also strongly supported by U.S. staff. In addition, there was, at that time, a strong concern about the divisive effect of different tax treatment as between U.S. and non-U.S. staff. Thus, in recommending the adoption of the average deduction method, the Committee felt that such compromises were essential.

significant topic of criticism in the "write-in" comments. As shown in Table 2a of EB/CAP/92/11, the allowances of nearly 40 percent of the staff fall short by an average of about $2,100 or 11.4 percent from the tax attributable to Fund income on the basis of the conservative rules of the present system. These shortfalls arise when a staff member's actual deductions are smaller than the assessed average deductions. The extent of these shortfalls could give rise to allegations by individual staff members that their allowances are not sufficiently related to the tax payable on Fund income to meet the standard set forth in the Fund's By-Laws.

Extending the Safeguard mechanism would not significantly alter the basic balance of the present system. The initial allowances would continue to be determined on the basis of the current procedures (ignoring outside income and understating the impact of spouse income on the staff member's tax) and the use of the average deductions, thus maintaining the balance established by the Kafka Committee between external comparability and internal equity. The continued use of average deductions in the initial calculations would effectively place a ceiling on gross pay, which the subsequent substitution of actual deductions in the Safeguard calculations would not significantly change. The primary effect would be to increase internal equity to a modest extent through the reduction of "underpayments."

In terms of the other objectives, the extended Safeguard would have a limited impact on the cost of the tax allowance system; current costs would be raised by 1.5-2.0 percent. It would, however, increase the burden of administering the system to some degree. It would be advantageous for up to an additional 20 percent of the U.S. staff to make use the safeguard mechanism. Though additional staff time will be needed to process the extended Safeguard, especially in the first year when staff will lack familiarity with the arrangement, the staff savings from the introduction of a new integrated payroll/personnel computer system should enable Treasurer's to process the extended Safeguard with only a limited, or perhaps temporary, increase in staff. Moreover, because the use of the extended Safeguard would be voluntary, intrusiveness would not be a major concern.

C. An Alternative Based on Tax Exemption

Data were provided in EB/CAP/92/11 on a U.N-type system that would, in effect, exempt U.S. staff from tax on their Fund income. The principal advantages of this method, which were fully recognized by the Kafka Committee, are (i) that it would place U.S. staff in the same position as expatriate staff, thereby achieving a substantial degree of internal equity; and (ii) that the allowances would in no case exceed the taxes actually paid. This approach continues to command the support of both Fund and Bank Staff Associations, and it is the only option that would eliminate both "overpayments" and "underpayments" in a way that U.S. staff would regard as non-controversial. It is also the method least open to challenge on grounds of principle. Other methods are bound to involve decisions on the various elements that would be open to serious dispute or would be regarded as creating arbitrary differences in the treatment of staff in different circumstances.

There are, however, important disadvantages of this system, and these were also recognized by the Kafka Committee. It would not meet the objective of external comparability; the gross pay of staff would not correspond to the gross pay of outside employees and could, in some cases, exceed it by substantial amounts. This system would also be significantly more costly than the present system; based on the 1989 survey data, it was estimated that a U.N-type system would raise direct costs by 20 percent.

The burden of administration would also be increased substantially; documentation on actual income and deductions would be required of all U.S. staff as compared with the minority who might be expected to use the (extended) Safeguard mechanism. Perhaps more importantly, however, because this system would reduce the current allowances of about one-third of the staff, it would require, at a minimum, a transitional period to allow current staff to adjust their financial situations to the changed terms of their employment. Grandfathering the present system for post-1979 staff might also need to be considered. Given that pre-1980 staff are assured of the continuation of the present Safeguard mechanism, the administration of two, and possibly three, separate methods of determining allowances could be required for an extended period.

The documentation required of staff would raise concerns regarding confidentiality and intrusiveness. It is likely that these could be eased by, for example, using outside accountants to examine tax returns and certify the necessary data, but such arrangements, when used by other international organizations, have proven to be cumbersome and time-consuming.

After considering very carefully all these implications, the working groups of the Fund and Bank that were charged with reviewing the Tax Allowance System felt that in light of the earlier Kafka Committee compromise it would not recommend pursuing this possibility in spite of the positions taken by the two Staff Associations in support of this system.

D. Alternative Methods

In the course of the review, the working groups examined a broad range of possible methods of incorporating data on staff members' actual income and deductions. These stopped short of the comprehensive U.N-type system; they employed a variety of different assumptions with respect to (i) the attribution of a proportion of total deductions to different sources of income and (ii) the method of allocating total taxes among those income sources. Extensive consideration of these alternatives by the joint working groups, and simulations of the potential outcomes, led to the conclusion that there were good reasons for not pursuing them at this time.

In the course of the Committee's discussion on November 10, information was sought on the impact of two specific methods of individualizing tax allowances by taking into account information on the actual income or deductions of staff members. This information is provided and discussed briefly in Annex I. These two methods are:

(a) A form of mandatory Safeguard mechanism, which retains the present procedures for allocating taxes while substituting the actual deductions of staff (pro-rated among Fund, outside, and spouse income on the basis of the Safeguard procedures) for the average deductions; and

(b) A system of pro-rated taxes, which incorporates the actual deductions of staff and pro-rates the total tax due on income from all sources in accordance with the ratio of Fund income to total income.

The apparent advantage of these methods is that they relate tax allowances more closely to what might be regarded as the actual tax payable on Fund income; compared to the present system, they appear to reduce or to eliminate both "underpayments" and "overpayments." In effect, however, this apparent symmetry is only achieved by redefining the meaning of over-or underpayments. Whether one considers that these systems do yield tax allowances that are more closely related to staff members' taxes on Fund income will depend, in reality, on what one assumes to be the "correct" amount of the taxes on Fund income. There can be reasonable differences of view on this issue.

Any of these methods would significantly modify the present distribution of tax allowances and materially alter the balance established by the Kafka Committee between the elements of the system that are advantageous and those that are disadvantageous to staff. The methods discussed in Annex I, for example, would not fully reflect the impact that non-Fund income has on the tax rates applied to Fund income; like the present system, the tax procedures in these alternatives would generally understate the tax payable on Fund income. On the other hand, the use of actual deductions rather than average deductions in the alternatives would eliminate the potential overstatement of taxes arising from differences in these amounts. Taking into account both sets of variables, the adoption of either method would significantly shift the overall system to one that generally understates the tax due on Fund income. The U.S. staff would very probably regard this as unfair and discriminatory.

In considering similar alternatives to the present tax allowance system, the Kafka Committee concluded that any notional apportionment of deductions and tax is, inevitably, arbitrary; as a result, these alternatives achieve neither internal equity nor external comparability. They do not achieve internal equity because they do not generally treat outside/spouse income as the first income, so this income of U.S. staff is taxed at less favorable rates than the equivalent income of expatriate staff. Nor do they achieve external comparability, because their use of actual deductions and their incorporation of outside income differ from the procedures followed in the netting-down process of the compensation system. As with the U.N-type system, the gross pay of U.S. staff under these alternatives may substantially exceed the gross pay of persons employed outside.

The overall cost of these systems generally falls within a range of 90-105 percent of current costs. As with the U.N-type system, these "hybrid" systems would substantially increase the burden of administering the system and raise problems of intrusiveness and confidentiality; documentation of the details of actual income and deductions would be required from all staff. Moreover, because these systems would substantially reduce the allowances payable to many staff, the complications of extended transitional periods, and possibly multiple grandfathering arrangements, would also need to be addressed.

III. Conclusions

The proposal to make the Safeguard mechanism available to all U.S. staff was reached after working groups of senior staff in the Fund and the Bank had conducted an extensive review of the tax allowance system and had carefully considered a wide range of alternatives. In doing so, the conclusions reached were essentially the same as those reached by the Kafka Committee. They were, however, reinforced to some extent by the probability of the added administrative complications of a major change in a system that had operated for close to thirteen years, and to which a large proportion of U.S. staff had adapted their financial situations.

The proposed extension of the Safeguard is a modest step, which is intended to alleviate the problem of serious "underpayments," which are clearly and justifiably a source of significant dissatisfaction among U.S. staff. All the alternatives examined in the course of the review were found to have considerable disadvantages. With the exception of the U.N-type system, none would achieve a much greater degree of internal equity than the average deduction system combined with the Safeguard mechanism, and none would maintain consistency with the compensation process or external comparability.

It is true that the alternatives would generally reduce the extent of "overpayments," at least as measured by the rules of the present system; but this would be achieved at the expense of abandoning the careful balance of the present system and substituting methods that primarily tend to understate the tax payable on Fund income. For this reason, achieving substantial symmetry, avoiding both "overpayments" and "underpayments," would require reconsideration of the tax procedures that now contribute to the understatement of staff members' taxes. The development of such a new system, based on a different balance of objectives and technical procedures, can be expected to be contentious and time-consuming, and there would be no guarantee that the end-result would differ significantly from the present arrangements. Moreover, it should be emphasized that the present system, with the proposed extended Safeguard, would continue to result in "underpayments" when these are measured by a more comprehensive standard, such as the presumption of tax exemption; by this measure, the extent of "overpayments" is substantially reduced, and the present system (particularly if the added cost of Social Security is taken into account) provides reasonably symmetrical results.

Given the disadvantages of more radical changes, the retention of the present system, accompanied by the extension of the Safeguard mechanism, is considered the most practical way to proceed.

One final concern that has been raised is that the proposed extension of the Safeguard is being justified on the grounds that the grandfathering provided when the system was adopted has created a disparity between "old" and "new" U.S. staff that now needs to be corrected, and that there is a danger that this will provide a precedent in respect of different terms and conditions of employment arising from other grandfathering arrangements. The present proposal could not and should not be justified on those grounds, although the elimination of this difference among U.S. staff may have some positive aspects. The circumstances of staff employed after 1979 clearly differ from those of the staff who were employed while the By-Laws stipulated that the Fund would "reimburse" the tax paid on Fund income, and there would be no basis for an argument by the post-1979 staff, who were employed under different conditions, that they were entitled to the same protection. The present proposal is not intended to duplicate that earlier action, but rather--in the context of the new By-law--to address the problem of substantial underpayments for the post-1980 staff. This objective could, perhaps, be met by other means, but this would require, as discussed above, the development of new procedures and the administration of dual systems. Extending the Safeguard is a more straightforward and administratively convenient means of achieving the objective.

Impact of Alternative Tax Allowance Systems

This Annex provides information on the impact of two alternative methods of "individualizing" tax allowances by taking data on the actual income or deductions of staff members into account. These methods are: (a) a type of mandatory Safeguard, and (b) a system of pro-rated taxes.

Table 1(a), (b), and (c) provide estimates of the impact of these two approaches on the overall level of tax allowances. 1/ Each of the alternatives would result in somewhat smaller tax allowances; on average, the mandatory Safeguard would result in a 5.7 percent reduction and the pro-rating system would result in a 7.5 percent reduction. Particularly under the mandatory Safeguard, relatively larger reductions would occur at lower than at higher levels of salary.

For purposes of comparison, Table 1 also includes estimates of the allowances needed to place U.S. staff in the situation where their Fund income would be treated as if it were tax exempt. Compared to the present system, both alternatives would move farther from this standard.

Because the mandatory Safeguard is based on the rules of the present system, allowances calculated on this basis would coincide with the estimated actual tax imputed to Fund income under these rules. Allowances calculated under the pro-rating system would, on average, fall below the actual tax estimated on the basis of the rules of the present system. Allowances under both of these methods fall far short of allowances under the assumption of tax exemption.

The impact of each alternative on allowances that, within the rules of the present system, are considered "overpayments" and "underpayments," has been examined. About 60 percent of current allowances are considered to be "overpayments;" under the mandatory Safeguard, these allowances would be reduced by 13-24 percent, with the larger reductions occurring at lower salary levels. On the other hand, about 40 percent of current allowances are considered to be "underpayments;" they would be raised by 7-15 percent under the mandatory Safeguard.

The pro-rating system would result in somewhat <u>larger</u> reductions in "overpayments" (16-21 percent) and, generally, in <u>smaller</u> reductions in "underpayments" (5-18 percent) than the mandatory Safeguard. It is worth noting, moreover, that not all allowances considered "overpayments" would be reduced, and not all allowances considered "underpayments" would be raised under the pro-rating system. The amount of about 7 percent of the "overpayments" would be increased relative to the present system, and the amounts of 18 percent of the "underpayments" would be increased.

1/ The estimates are based on data from the staff survey covering 1989 income and deductions. The data include both pre-1980 and post-1979 staff.

Table 1(a). Tax Allowances: Present System Compared with Alternatives Using Data on Actual Income and/or Deductions of Staff

(In U.S. dollars)

Net Pay ($ Thousands)	Percent of Survey Responses	Present System of Allowances	Alternative Allowances		
			Mandatory Safeguard	Pro-Rated Tax	Tax-Exempt Status
20-30	20.0	6,061	5,395	5,491	7,711
30-40	15.8	9,858	9,204	9,163	11,734
40-50	10.8	14,004	13,226	13,364	17,456
50-60	10.3	18,578	16,869	16,661	21,270
60-70	11.6	23,178	21,061	20,516	27,498
70-80	11.3	27,570	25,864	25,483	33,064
80-90	10.6	32,756	31,496	30,159	38,111
90-100	5.4	37,964	37,526	36,633	45,131
100-110	4.2	43,170	43,141	41,723	53,221
Overall	100.0	19,344	18,250	17,900	23,120

Table 1(b). Amounts of Excess (Shortfalls) of Alternative Tax Allowances Compared with Allowances under the Present System

(in U.S. dollars)

Net Pay ($ Thousands)	Excess (Shortfall) for Alternative Systems: Mandatory Safeguard	Pro-Rated Tax	Tax-Exempt Status
20-30	(666)	(570)	1,650
30-40	(654)	(695)	1,876
40-50	(778)	(640)	3,452
50-60	(1,709)	(1,917)	2,692
60-70	(2,117)	(2,662)	4,320
70-80	(1,706)	(2,087)	5,494
80-90	(1,260)	(2,597)	5,355
90-100	(438)	(1,331)	7,167
100-110	(29)	(1,447)	10,051
Overall	(1,094)	(1,444)	3,776

Table 1(c). Percentages of Excess (Shortfalls) of Alternative Tax Allowances Compared with Allowances under the Present System

(in U.S. dollars)

Net Pay ($ Thousands)	Percent Excess (Shortfall) for Alternative Systems: Mandatory Safeguard	Pro-Rated Tax	Tax-Exempt Status
20-30	(11.0)	(9.4)	27.2
30-40	(6.6)	(7.1)	19
40-50	(5.6)	(4.6)	24.7
50-60	(9.2)	(10.3)	14.5
60-70	(9.1)	(11.5)	18.6
70-80	(6.2)	(7.6)	19.9
80-90	(3.8)	(7.9)	16.3
90-100	(1.2)	(3.5)	18.9
100-110	(0.1)	(3.4)	23.3
Overall	(5.7)	(7.5)	19.5