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IMMEDIATE ATTENTION

EBAP/87/238

November 2, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Review of the Average Deduction System and Proposed Modifications Resulting From the 1986 Tax Reform Act

There is attached for consideration by the Executive Directors a paper on the review of the average deduction system and proposed modifications resulting from the 1986 Tax Reform Act.

In the absence of a request for discussion by an Executive Director by the close of business on Friday, November 6, 1987, the proposal set out in Section II, paragraph 5 will be deemed approved by the Executive Board and it will be so recorded in the minutes of the next meeting thereafter.

Ms. D. Anderson (ext. 7257) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Review of the Average Deduction System and Proposed Modifications Resulting from the 1986 Tax Reform Act

Prepared by the Administration Department
(In consultation with the Treasurer's Department)

Approved by Graeme F. Rea

October 30, 1987

I. Introduction

When the Fund and the Bank commenced operations, the two organizations established a tax reimbursement system designed to compensate those staff members who were subject to national taxation on their salaries. 1/ The overwhelming majority of staff members covered by the system were--and are--U.S. nationals. The system for reimbursing staff members for taxes remained the same, except for minor changes, from 1948 until 1979. That system provided for the computation and reimbursement of income taxes due, based on (i) the staff member's income received from the organization, (ii) the staff member's marital status, (iii) the number of exemptions to which the staff member was entitled, (iv) the staff member's tax filing status, (v) the amount of spouse income, if any, to determine whether to take advantage of the split-income provision of the U.S. tax code, (vi) applicable state or D.C. taxes, and (vii) the standard deduction applicable.

In 1979, the Joint Committee on Staff Compensation Issues (the Kafka Committee) considered a number of systems of tax reimbursement, or tax allowances, and concluded that the major elements of the then-current system should remain the same, except that the standard deduction assumed

1/ Attachment I sets out an excerpt from the 1979 Report of the Joint Committee on Staff Compensation Issues that describes the background to the system of tax allowances in the Fund and Bank.

under the system would be replaced by the average deduction. 1/ Average deductions are reported by the U.S. Internal Revenue Service (IRS) for all U.S. taxpayers by income level. Because the system is based on averages, it accepts that U.S. staff members will have deductions which are more or less than the level of the average. It is important, however, to ensure that the tax allowances paid to U.S. staff are reasonably related to their tax liability on income from the Bank or Fund, and that they are based on fairly realistic average deductions. Since the new system was implemented, each year the Bank/Fund tax consultants, Arthur Andersen & Company, have reviewed the average deduction statistics provided by the IRS. They have also reviewed changes in U.S. tax laws and reported on the impact of those changes on the tax allowance system. In addition, annual reports have been made to the Executive Boards for each year beginning with 1980; those reports have reviewed the operation of the system, noted any changes in tax laws, and requested approval of the Executive Board when modifications were required. Furthermore, when the present tax allowance system was adopted, it was decided that a more thorough review of its operation would be conducted at the end of a five-year transition period.

II. Joint Bank/Fund Review of the Average Deduction System

During the past year a Joint Bank/Fund Working Group has conducted a review of the average deduction system with the assistance of Arthur Andersen & Company and in consultation with members of the tax working groups of the Bank and Fund Staff Association Committees.

1/ Recommendations of the Joint Committee on Staff Compensation Issues--Tax Reimbursement, January 1979, p.39.

"6.42 We recommend therefore, that:

(i) the Bank and Fund should adopt an Average Deduction System of tax reimbursement - based on the average deductions claimed by United States nationals generally, with modifications to reflect conditions in the Washignton area - with allowance being made for spouse income in the same way as happens under the present system;

(ii) the Bank and Fund, in implementing an Average Deduction System, should search for all means of ensuring more equitable treatment amongst all staff;

(iii) The Bank and Fund should again discuss with the Governments concerned the possibility of their taking the necessary steps to eliminate the burden that results from the taxation by those Governments of their nationals employed in their own countries by the Bank and Fund."

Attachment II sets out the decision taken in 1980 by the Executive Board as a result of the above recommendations.

The report of the Joint Working Group is attached as an Appendix to this paper. It focuses on two main issues:

1. The operation of the average deduction system since its implementation on January 1, 1980 and the improvements that are recommended in the current methodology; and

2. the impact of the U.S. 1986 Tax Reform Act and recommended adjustments that stem directly from that Act in the average deductions claimed by U.S. taxpapers generally.

This paper summarizes the findings and recommendations of the Joint Working Group and discusses the need for additional study of the tax allowance system. A similar paper, together with the Working Group's Report, is being submitted to the Executive Board of the Bank.

1. *Findings and recommendations on the operation of the average deduction system*

From an administrative standpoint, the average deduction system has operated smoothly since it was put into effect. During a period in which important changes were made in the U.S. tax regime, it proved possible to incorporate these changes into the tax allowance system without major difficulty. The cost of the system is now about 69 percent of what it would have been had the organizations continued with the system based on standard deductions, and this reduction is in line with the estimate made by the tax consultants when the average deduction system was introduced. The Working Group also examined several specific issues related to the operational aspects of the system during the first five years, and it is recommended that the following minor modifications be adopted.

a. Nonpay income items (Appendix pages 14-15)

The average deductions that apply under the average deduction system relate to a staff member's total income from the Bank or Fund. There are, however, certain items included in staff members' income that would not be expected to affect the level of their tax deductions. These nonpay income items include spouse travel on points, imputed income for high-income staff from the Fund and Bank group life insurance plans, and the difference between the "employed" and the "self-employed" Social Security tax that is reimbursed by the organizations. The Fund decided in 1984 to exclude the additional Social Security tax from the income on which the calculation of average deductions is based. In 1986 the Bank decided to exclude spouse travel, imputed income from group life insurance, and the reimbursed Social Security tax from the average deduction calculations. It is recommended that spouse travel and imputed income from life insurance be excluded from Fund income in determining the level of average deductions to be used in the tax allowance calculations. The total annual cost of these changes for the Fund is expected to be less than US$2,000.

b. <u>All-returns average deduction data and lower-salaried single staff</u> (Appendix pages 15-18)

The average deduction data reported by IRS include deductions claimed by <u>all</u> taxpayers--married, single, those who itemize deductions, and those who claim a standard deduction. In 1976, when it was decided that the all-returns average deductions for U.S. taxpayers provided a close fit with the average deductions of Bank and Fund staff, the U.S. income tax system varied in important respects from that of more recent years. The major shift stems from changes in the level of the standard deduction. In 1976 the standard deduction was the same for both married-filing-jointly and single taxpayers. Changes in the U.S. tax code between 1977 and 1984 created a significant gap between the standard deduction for married-filing-jointly and single taxpayers. Under the Tax Reform Act of 1986, the difference between the standard deduction for married and single taxpayers will be US$2,000. The majority of U.S. taxpayers claim a standard deduction at adjusted gross incomes below US$25,000. Between US$25,000 and US$40,000, the use of the standard deduction declines steadily, and above US$40,000 fewer than 10 percent of U.S. taxpayers claim a standard deduction. Below an adjusted gross income level of US$40,000, the difference between all-returns average deductions and single average deductions is significant. Because of the high percentage of taxpayers claiming a standard deduction, and because of the gap between the standard deduction for single taxpayers and for married-filing-jointly taxpayers, the all-returns average is no longer representative of average deductions for single taxpayers. Above an adjusted gross income of US$40,000, single deductions tend to converge around the all-returns average. This difference appears to account for a problem voiced frequently by single staff in the lower-salary levels that the "all-returns" average deductions seem too high for their income level and their tax allowances are consistently less than the tax they pay.

It is recommended that the Bank and the Fund apply an average single deduction schedule in calculating tax allowances for single staff below that adjusted gross income where the proportion of taxpayers claiming a standard deduction does not have a significant impact on the average deduction data. In other cases the all-returns average deductions would be used as at present. The level below which single deductions would be used would be reassessed periodically by the tax consultants. It is proposed on the basis of recommendations made by the consultants that tax allowance calculations be based on average single deduction schedules for single staff members up to an adjusted gross income level of US$40,000, where all-returns deductions and the single deductions presently converge. Because of the need for computer programing changes and the need for the tax consultant to prepare new average deduction schedules the proposed change would be implemented in 1988. The cost of adopting this approach for the Fund is estimated at less than $15,000.

c. Proposed change in the safeguard calculation (Appendix page 19)

In calculating staff members' tax allowances during their final year of employment, the Bank and Fund do not take certain one-time severance payments, such as accrued leave and separation grant, into account in determining the level of income for calculation of the deductions to be assumed for that year. In the final year of employment, it is now proposed to treat any safeguard payment received in the final year with respect to the previous year's tax allowance in the same way as other one-time payments.

2. Impact of 1986 U.S. Tax Reform (Appendix pages 19-27)

The U.S. Tax Reform Act of 1986 is considered to be the most far-reaching set of tax changes ever enacted by the U.S. Congress. The major provisions of reform will be phased in over a three-year period. The Bank and Fund plan to incorporate changes affecting the average deduction system as they are implemented in the U.S. tax system. However, given the phase-in of the changes and the three-year lag in the average deduction statistics provided by the U.S. Internal Revenue Service, it will be several years before the full impact of the reform on the average deduction system can be fully assessed. In the meantime, with guidance from the tax consultants, the effects of specific changes resulting from the reform will be factored into the annual tax tables prepared by Arthur Andersen & Company for use in calculating tax allowances as well as netting down comparator compensation. The tax allowance system automatically takes account of many provisions in the U.S. income tax system, and certain changes brought about by the tax reform will be reflected in the tax tables used by the organizations. However, when changes in the tax law have a major effect on average deductions or the adjusted gross income, adjustments to the lagged data are required to reasonably approximate the current tax environment. The adjustments recommended by the tax consultants to reflect the reform for the 1987 tax year are described below. These adjustments have been incorporated in the Bank's tax allowance calculations since April 1987 because the Bank pays allowances on a current basis during the year. The Fund pays tax allowances for the first three quarters of each year based on the total tax allowance received the previous year (one fourth of the previous year's total allowance is paid in April, June, and September) and applies the new tax tables to the final payment for the fourth quarter, making any necessary adjustments in that payment.

The adjustments made by the tax consultants for 1987 are:

(i) The Tax Reform Act of 1986 eliminated the two-earner married couple deduction and made the Individual Retirement Account (IRA) more restrictive for taxpayers participating in a qualified pension or profit-sharing plan. After examining the effect of the IRA and the two-earner deduction on the adjusted gross income (AGI), it was decided that the average deduction system (ADS) should be adjusted to reflect the changes made by the reform. The reform eliminated IRA deductions for married taxpayers with AGIs greater than US$50,000 who participate in an employer maintained retirement plan. The full deduction is allowed for AGI levels of US$40,000 and below, and there is a phase-out between AGI levels of US$40,000-50,000. Since the organizations both have qualified pension plans, a change to the adjusted gross income to reflect the reform was considered appropriate. Similarly as the two-earner deduction was eliminated, the average adjustment for the two-earner deduction and the average IRA adjustment were added to the original IRS adjusted gross income level to arrive at an adjusted level. These AGI levels were then used as the basis to determine IRS average deductions.

(ii) The federal average deductions were then adjusted in the following four areas to accord with changes made in the law by the 1986 reform. The methodology applied is described in detail on pages 13 and 14 of the Appendix.

Medical Deduction - Since the reform increased the floor for medical deductions from 5 percent of adjusted gross income to 7 1/2 percent, the additional limit was factored into the net average deduction calculations based on the 1984 IRS statistics. The higher floor has essentially eliminated medical deductions and the amounts have been subtracted from the 1984 IRS deduction statistics.

Sales Tax Deduction - Because sales tax is no longer a deductible expense in 1987, the entire average sales tax deduction was subtracted from the IRS average deduction amount.

Interest Expense Deduction - The 1986 reform phases in an elimination of consumer interest expense as an itemized deduction. Owing to the phase-out period of the consumer interest expense deduction, there is a 35 percent reduction in 1987. Thus, 35 percent of the average nonmortgage interest was subtracted from the IRS average deductions in deriving the net average deduction amount.

Miscellaneous Itemized Deductions - The 1986 reform made several changes to miscellaneous itemized deductions. Unreimbursed employee business and moving expenses were moved from above-the-line adjustments to gross income to miscellaneous itemized deductions. In addition, a 2 percent adjusted gross income floor was included for all miscellaneous itemized deductions except moving expenses. Since the employee business and moving expenses are currently included in the organization's calculations to arrive at the adjusted gross income, it was decided that no adjustments should be made to either the adjusted gross income or IRS deductions for these amounts.

It is recommended that these adjustments be approved for 1987 tax allowance calculations, and it is further recommended that the procedure developed by the tax consultants to take account of specific adjustments to average deductions data as they are phased in under the Tax Reform Act of 1986 be applied until the new law is fully implemented. 1/

3. Further study

The review of the Joint Working Group focused on operational aspects of the average deduction system and on the need to take account of the effects of the 1986 Tax Reform Act on the average deductions currently used to calculate tax allowances and to net down comparator pay in the compensation exercise. There are, however, several issues that need to be carefully examined in light of the broader impact of the reform, and the need to phase in its implementation suggests that the system should be subject to continuing review. For example, the Working Group considered the question of extending the safeguard provision of the current system and concluded that such safeguard was clearly intended for staff employed prior to 1980 when the average deduction system became effective. The Working Group believes, however, that the need for some additional "safety net" cannot be ruled out, pending further study of the effect of the tax changes on the current system. Other general and specific issues for consideration in respect of equity among all staff include the effect of the Act's increases in personal exemptions on the spouse and dependency allowances (tax equivalency allowances) for Bank and Fund staff, as well as a review of the extent to which U.S. tax changes affecting G-IV visa holders might have a bearing on the tax allowance system.

The longer-term effect of changes in average deductions under the new tax law may be very significant. Under the new law, the standard deduction is gradually increased and certain itemized deductions are eliminated immediately. Other itemized deductions are phased out, or must exceed a level set so high that the vast majority of taxpayers are precluded from claiming a deduction. The effects of the Tax Reform Act of 1986 on the operation of the average deduction system will continue to be evaluated as the new law is phased in.

1/ The Bank has already included these adjustments to the average deduction data used to make the three quarterly payments in 1987. The changes created by the 1986 reform were reviewed with the Bank Board Committee on Staff Compensation at the time of the 1987 salary review.

4. Communications

The Working Group has recommended that improvements be made in communicating to staff the provisions of the tax allowance system. The Group has also recommended the development of an interactive computer program to provide staff with individualized tax allowance calculations based on their personal circumstances. The Administration Department is examining ways in which improvements in communication with staff can be implemented.

5. Summary of Recommendations

It is proposed that the Executive Board approve the recommendations set forth in the paper as summarized below.

(1) Two nonpay income items, spouse travel and imputed income from life insurance, be excluded from Fund income in determining the level of average deductions to be applied in tax allowance calculations.

(2) The Fund apply from 1988, an average single deduction schedule in calculating tax allowances for single staff below the level of adjusted gross income where the proportion of taxpayers claiming a standard deduction has a significant impact on the average deduction data. The level of adjusted gross income would be reassessed periodically by the tax consultants.

(3) In the final year of employment, any safeguard payment made with respect to the previous years' tax allowance should be treated in the same way as other one-time payments. That is, it will not affect the leve of income for the calculation of the deductions for that year.

(4) Adjustments proposed by the tax consultants for 1987 tax allowance calculations as well as future changes proposed by consultants to take account of specific adjustments to average deductions as they are phased in under the Tax Reform Act of 1986 be applied until the new law is fully implemented.

(5) Additional work should be undertaken to improve communication to staff of the provisions of the system and to review specific issues in respect of equity among all staff including the effect of U.S. tax law on the spouse and dependency allowances and the extent to which tax changes affecting G-IV visaholders might have a bearing on the tax allowance system.

Attachments

6. TAX REIMBURSEMENT

Background

6.1 When the Bank and Fund were set up in 1946, the two Boards of Governors accepted that measures to eliminate or equalize the burden of taxation on Bank and Fund compensation were indispensable to achievement of equity among members and equality among the personnel of the two institutions. Whilst it was recognized that elimination of the burden of taxation would achieve both these aims, it was accepted that all the necessary legal and other processes would take time and it was provided therefore that, in the meantime, equal treatment should be achieved by the reimbursement of taxes payable on organization income by those with a continuing liability to taxation. It was further agreed that organization income could be recognized for this purpose as a staff member's only income. It was a natural corollary of these measures that salaries should be set on a net-of-tax basis.

6.2 The constitutional and legal measures taken in furtherance of these aims are as follows:

6.2.1 The Articles of Agreement of the two bodies were so drafted as to preclude a Member Government from taxing compensation paid by the Bank or Fund to anyone who was not a national of the country concerned.

6.2.2 Under the Convention on Privileges and Immunities, most member countries waived their rights to tax the compensation paid by the Bank and Fund to their own nationals working in their own countries.

6.2.3 Virtually all Member Governments (except the United States) provide in their tax codes that income earned abroad by their nationals working abroad is not taxable.

6.3 The Governments of the United Kingdom, France, and the United States - amongst others - have, however, not acceded to the Convention on Privileges and Immunities; nor does the United States Government exempt from taxation the salaries earned abroad by Americans working abroad.

6.4 The Bank and Fund are, therefore, left with a system under which most of their staff are exempt from tax on their organizational income while the rest are reimbursed for taxes which they are still liable to pay. In precise terms what this means is that the only Bank and Fund staffs liable to pay tax on their organization income are United States nationals, whether employed in America or elsewhere, and the few French and United Kingdom nationals working for the Bank and Fund in Paris and London, respectively. All these account for just over one-quarter of the staff of the Bank and Fund.

6.5 The tax reimbursement system, which was adopted as a stop-gap in 1946, was intended to enable the same objectives to be achieved as total exemption would have achieved.

6.6 The main features of the tax reimbursement system adopted in 1946 were that, as has already been noted, no account was taken of outside income (except to a limited extent spouse income) and that, in assessing the amount of tax to be reimbursed, standard deductions were used.

Decision on Tax Allowance

Adopted by the Executive Board January 18, 1980 (EBAP/79/360, Sup.1)

1. The Executive Board after consideration of the proposals in EBAP/79/360 decides, in accordance with the terms of Section 14(b) of the By-Laws and the decision of the Executive Board adopted May 22, 1979, that the principles and assumptions set forth below shall be used for the computation of tax allowances to be paid to United States nationals on the staff.

(a) The income received from the Fund shall be assumed to be the staff member's total income.

(b) The staff member will be assumed to file his income tax return in the most economical manner for his filing status.

(c) The computation of the tax allowance for each staff member will be made on the basis of (i) the staff member's marital status, (ii) the number of exemptions to which the staff member is entitled, (iii) the staff member's actual filing status, consistent with (b) above, except that where there is spouse income, the filing status will be determined in accordance with the method in effect before January 1, 1980, (iv) the amount of average deductions taken by a taxpayer with an equivalent level of income as shown by the most recent publication of the relevant statistics by the United States Internal Revenue Service for "All Returns" modified by the use of the computed tax allowance with respect to state income taxes for each staff member in place of the national average.

(d) During a five-year transitional period beginning with 1980, the computation of the tax allowance for each U.S. staff member appointed before January 1, 1980 shall be made both in accordance with (c) above and the method of computing the tax reimbursement in effect before January 1, 1980. The staff member shall receive in addition to the tax allowance computed under (c) above, a fraction of the amount by which the computation under the former system exceeds the tax allowance. The fraction shall be 5/6 for 1980 and shall be decreased by 1/6 for each subsequent year.

(e) Any U.S. staff member appointed before January 1, 1980 who considers the tax allowance received under (c) above, including any amount under (d) above, with respect to 1980 or any subsequent year to be less than the tax liability on his income received from the Fund for that year may claim an additional tax allowance. The staff member making a claim for an additional tax allowance will be required to submit such documentation of income taxes actually paid for that year and such further documentation as the Managing Director determines to be necessary to substantiate the claim and to make the necessary computations. The staff member will receive an additional tax allowance computed on the basis of the principles and assumption in (a), (b), and (c) above, except that the actual deductions claimed will be used but reduced by the proportion that the staff member's income from sources other than from the Fund bears to the total of the income reported on the staff member's return.

2. The principles and assumptions set forth above shall be applied to the extent practicable in the computation of tax allowances for those staff members who must pay income taxes to jurisdictions outside the United States on their salary and allowances received from the Fund.

3. The Managing Director shall report to the Executive Board with respect to each tax year of the five-year transitional period on the implementation of this tax allowance system.

Report of the Joint Working Group on the Average Deduction System

I. Introduction

After an extensive review in the context of the Joint Committee on Staff Compensation Issues (the Kafka Committee), the Executive Boards of the Bank and the Fund approved the introduction, beginning in 1980, of a new tax allowance system based on the average deductions claimed by U.S. taxpayers generally. The new system replaced a system based on standard deductions that had been in effect since the early days of the two institutions.

At the time the average deduction system was introduced, it was decided that a comprehensive review of that system would be undertaken at the end of a five-year transitional period. That review was due in 1985, but it was postponed in view of the major revisions of the U.S. tax code, which were then being considered, and which led to the adoption on October 22, 1986 of the far-reaching Tax Reform Act of 1986. The present paper has the twofold objective of (i) undertaking the review of the implementation of the average deduction system that was to have taken place at the end of the five-year transition period, and (ii) considering the implications of the Tax Reform Act on the average deduction system.

This paper is limited to the review of the operation of the tax allowance system and the adjustments to the existing system needed to take account of the 1986 Tax Reform Act. Other issues, such as equity considerations arising outside the tax allowance system, including the appropriateness of the dependency allowance, treatment of spouse income, and the implications of the 1984 Tax Act for G-IV visa holders are not included. These subjects raise more fundamental issues of the impact of the tax allowance system in relation to the equitable treatment of all staff with respect to the income they earn from the Bank and Fund. Furthermore, this paper does not examine the difficult and more fundamental issue of the longer-term feasibility of the average deduction system in the light of the far-reaching implications of the 1986 Tax Reform Act for average deductions generally after the law is fully implemented. Accordingly, these issues of equity and the future feasibility of the average deduction system will be taken up by the Bank and Fund staff as the full implications of the Act become clearer.

II. Considerations in Establishing the Average Deduction System

1. The previous tax reimbursement system based on standard deductions was considered to be broadly reasonable when it was established in 1946. Over time, however, standard deductions did not keep pace with nominal incomes

can present more difficult problems. As noted in the next section, the changes introduced by the Tax Reform Act of 1986 were so far-reaching that the system could not have been credible if they were not taken into account. Consequently, in line with the policy of making adjustments when there is a compelling need to do so, the adjustments set forth in Section V have been incorporated in the average deduction system. 1/ It remains the intention of the organizations to continue to adjust IRS data only when there are clear and compelling reasons to do so, and Executive Directors will be kept informed of any such adjustments.

2. Average deduction system methodology

Experience in the implementation of the average deduction system has brought to light two problems concerning the basic methodology of the system. The first concerns the treatment of nonpay items, and the second relates to the use of all-returns IRS data for lower-salaried staff.

3. Nonpay income items

a. When the new tax allowance system was introduced, it was decided that the level of deductions used in calculating tax allowances should take into account all of the staff member's income from the Bank or Fund. 2/ This decision reflected the fact that the IRS statistics on adjusted gross income include all types of taxable income.

b. Upon further consideration, however, it would seem that both symmetry and internal equity require that nonpay income items, which are not taken into account in netting down comparator salaries, should also not affect the average deductions assumed for U.S. nationals in the tax allowance calculations. At present the only nonpay items that are taxable for U.S. nationals and affect average deductions are the cost of spouse travel on points and, for high-income staff, the imputed income from the organizations' group life insurance.

c. At present, for example, when a staff member uses his benefits under the spouse travel policy, his gross income in that particular year will be higher than his normal gross income by the cost of the spouse travel plus the amount by which this cost is grossed up. The average deductions used for that year will reflect this higher gross income, and

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1/ In the Bank, the adjustments are already being used as the basis for quarterly payments to U.S. staff. In the Fund, the adjustments will be put into effect for the full year in connection with the payment to U.S. staff for the fourth quarter of 1987.

2/ An exception was made in respect of one-time severance payments, such as termination grants and payments of accrued annual leave, which it was decided should not be taken into account in determining the level of deductions used in calculating allowances for the final year of employment.

especially cost but also ease of administration and comprehensibility to staff. The system adopted in 1980 was intended to strike a balance between these various objectives. On the one hand, it takes into account in the calculation of tax allowances each staff member's actual circumstances with respect to state of residence, number of personal exemptions, 1/ and, with one important exception discussed below, filing status (e.g., single and head of household). On the other hand, in order to provide substantial symmetry with the compensation process, the average deduction system assumes that each U.S. staff member claims the same level of personal deductions, other than federal deductions for state income taxes, that is claimed on average by U.S. taxpayers nationwide in the same adjusted gross income bracket. The deductions used in grossing up are, therefore, the same as those used in netting down for compensation purposes. As part of the review that led to the adoption of the average deduction system, a survey of U.S. nationals' actual tax returns for 1976 was undertaken in 1977 and compared with the most recent Internal Revenue Service (IRS) national data then available, which were for 1973. It was found that on average the personal deductions (including state and local income taxes) claimed by U.S. staff members followed the national averages fairly closely, although the dispersion in deductions claimed by individual U.S. staff at each income level was quite wide.

4. Nonorganization income

a. Spouse income

A further way in which the average deduction system diverges from strict symmetry is in the treatment of spouse income. The somewhat complex system employed with respect to spouse income can best be understood in terms of its historical evolution. When the Bank and the Fund first introduced a tax allowance system in 1946, there was only one tax rate schedule in the U.S. tax code, and each individual, married or single, was taxed on his own income. This aspect of the U.S. tax code was, however, called into question by a court determination that married couples residing in states that had community property laws could divide family income equally between them in filing federal as well as state income taxes. With progressive tax rates, this "income splitting" could result in significant tax savings. In order to provide more equitable treatment between residents of states with different legal provisions, the United States Revenue Act of 1948 introduced the married-filing-jointly tax rates, extending to all married couples the possibility of income

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1/ Every taxpayer is entitled to one personal exemption, e.g., married couples filing jointly are entitled to two exemptions. In addition, both married and single taxpayers can claim a personal exemption for each dependent child or other qualifying dependent residing in the taxpayer's household. The personal exemption is subtracted from gross income in determining taxable income.

splitting and the corresponding tax savings. 1/ In deciding to take advantage of the reduced rates for married taxpayers who file jointly, the Bank and Fund concluded that they, also, needed to take into account the impact of the spouse's income, both earned and investment, because the actual rate at which income from the organizations was taxed reflected their combined income. The provisions introduced by the organizations for taking account of spouse income were thus deemed to be consistent with the provision of the By-Laws, that, in calculating the amount in respect of taxes, the staff member's income from the Bank and Fund should be presumed to be his total income. The net result of these changes was a significant savings to the Bank and Fund. Therefore, in cases where the spouse had no income or less income than the staff member, the organizations (1) used the new income-splitting provision in calculating the joint tax liability, (2) calculated the spouse's tax liability by assuming the spouse filed at the higher separate rates, and (3) paid the staff member the difference as a tax allowance. Where spouse income was greater than the staff member's, the organizations ignored the new income-splitting provisions and calculated the staff member's tax allowance based on organization income and on the assumption that he filed separately. This method of taking into account the income-splitting provisions available under the U.S. tax code was retained as a feature of the average deduction system on the recommendation of the Kafka Committee. The only change introduced with the average deduction system in 1980 was that average, instead of standard, deductions would be used in each of the required calculations with respect to staff or spouse income.

b. Staff member's nonorganization income

The report of the Kafka Committee recognized that one of the most difficult problems posed in analyzing alternative tax allowance systems was the allocation of tax liability between organization income and nonorganization income, both spouse and investment income. After weighing the various alternatives, the Committee recommended that spouse income

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1/ The U.S. individual income tax has four rate schedules. Listed in order from the lowest to the highest tax rates, these are: married filing jointly, head of household, single, and married filing separately. The head-of-household rates are available to single parents with dependent children. The married-filing-separately tax rates are designed so that any given marginal tax bracket is reached at half the taxable income level as under the married-filing-jointly schedule, e.g., in 1986 the 50 percent marginal tax bracket applied to taxable income above $175,250 for married couples filing jointly and to taxable income above $87,625 for married individuals filing separately. Given progressive tax rates, it is generally advantageous for married couples--unless they are at the same income level--to file jointly. The high married-filing-separately rates are, therefore, rarely used in practice; they do, however, play an important role in the tax allowance systems of the Bank and Fund.

continue to be treated as described above but that no account be taken of the staff member's non-Bank/Fund income. The Kafka Committee's report acknowledged that, given the tax provisions in place at that time, the system would result in less favorable treatment of U.S. staff members than non-U.S. staff with respect to non-Bank/Fund income. 1/ With respect to spouse income, this difference resulted primarily from the fact that, in most cases, the tax allowance system attributed tax to the spouse of the U.S. staff member on the basis of the high married-filing-separately rates, while working spouses of most non-U.S. staff could at that time file using the married joint rates. 2/ With respect to investment income, the difference resulted from the fact that for U.S. staff members all such income was taxed at the marginal rates on top of their gross organization income.

5. The new system was made fully effective for U.S. nationals joining the Bank or Fund after December 31, 1979. For those U.S. nationals already employed on that date two special features were adopted. First, because the new system was expected to result in tax allowances which would be significantly less than under the old system, a five-year transitional period was provided to avoid a sudden sharp reduction in income from the organization. Thus, in 1980 eligible staff received as tax allowance, in addition to the amount calculated under the new system, a supplemental transitional payment which was five sixths of the difference between the amounts calculated under the old and new systems. This additional payment was reduced each subsequent year by one sixth of the difference between the two amounts, the last transitional payment being

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1/ International Bank for Reconstruction and Development/International Monetary Fund, Report of Joint Committee on Staff Compensation Issues, CSCI/79/1 (January 1979); (pp. 37-38) 6.38.2: "Two important advantages of an average deduction scheme would be that Bank and Fund equivalent gross salaries could be seen to have a direct connection with those payable in the United States market and that net salaries could continue to be set at the same level for all staff. From the point of view of internal equity, however, the latter argument should not be taken too far, since the aftertax net salaries of non-expatriates would vary according to their individual circumstances and expatriates would still receive more favored treatment in respect of outside income. The system would not alter the fact that, compared with United States nationals, expatriates would have the advantage of paying lower rates of tax on outside income. Any feeling of divisiveness which might be caused between expatriates and local nationals on this score, however, could be alleviated, to some extent at least, if local nationals were allowed to take spouse income into account for reimbursement purposes in the same way as at present."

2/ Since 1985 most staff members holding G-IV visas have been taxed by the United States as nonresident aliens. Where such staff member has a working spouse who also has a G-IV visa, the spouse is now obligated to file a separate tax return and is taxed at a higher rate.

made in 1984. Second, U.S. nationals serving the organizations before the introduction of the new system were made eligible (without time limit) for safeguard (or safety net) payments. These payments are aimed at ensuring that the staff member receives a total tax allowance that is at least equal to the taxes imputed to his organization income based on actual deductions from the actual tax returns he files. This feature was introduced to ensure that the provisions of the applicable By-Laws of the two organizations were met for staff members hired while those By-Laws were in effect. (The relevant By-Laws were amended with the introduction of the new system.)

III. Results of the Average Deduction System During the Period 1980-85

1. Relevant data on tax allowance payments and changes in gross pay for the period 1980-85 are set forth in Tables 1 through 5. Data are shown separately for the Bank (B) and Fund (F) in Tables 1-3. It will be seen that the only significant differences between the two organizations during the period covered were those resulting from the numbers of U.S. nationals employed by each organization.

2. Cost of tax allowances

a. From 1979 to 1985 the number of U.S. nationals employed by the Bank and the Fund increased slightly from 2,074 to 2,141. In the same period, total tax allowance payments to U.S. nationals rose by 18 percent, from US$33.2 million to US$39.1 million (Table 1). However, this increase was much smaller than the increase in the total salary bill for U.S. staff. The Fund's computerized database on tax allowances, but not that of the Bank, permits an analysis of such allowances relative to net income levels. Between 1979 and 1985, total stated net salaries of U.S. nationals employed by the Fund rose by 74.5 percent. Over this same period, total income tax allowances paid to U.S. nationals in the Fund rose by only 20.5 percent. As a result, tax allowances as a percent of staff net compensation declined from 71 percent in 1980 to 49 percent in 1985. Although this reduction in tax allowances as a percent of staff net compensation reflects primarily the change in the tax allowance system, it also reflects reductions in federal tax rates (Tables 4 and 5).

b. All U.S. staff hired before 1980 were eligible for transitional payments during the five years 1980 through 1984. Transitional payments during this period amounted to US$24.7 million for the Bank and US$7.4 million for the Fund (Table 2). Pre-1980 staff whose actual deductions are less than the average deductions assumed are also eligible to apply for supplementary payment under the safeguard provisions. During the five-year transition, such safeguard payments were made only to the extent that the amount the staff member was entitled to under the safeguard calculations exceeded the amount he had received from the Bank or Fund, including the tax allowance payment and transition payment. The percentage of pre-1980

APPENDIX

Table 1. Tax Allowance Payments for U.S. Staff, 1980-85

		1980	1981	1982	1983	1984	1985
Total Tax Allowances							
Number of staff	B	1,643	1,672	1,718	1,610	1,633	1,654
	F	431	481	464	466	478	487
		(Millions of U.S. dollars)					
Tax allowance payments 1/	B	25.4	36.6	32.4	28.7	28.9	29.7
	F	7.8	11.3	9.5	8.8	9.1	9.4
Average payment	B	0.016	0.022	0.019	0.018	0.018	0.018
	F	0.018	0.024	0.021	0.019	0.019	0.019
Pre-1980 staff							
Number of staff/per-cent of total	B	1,545/94	1,400/84	1,326/77	1,102/68	1,059/65	975/60
	F	403/94	393/82	349/75	328/70	312/65	305/63
		(Millions of U.S. dollars)					
Tax allowance payments	B	24.9	34.2	28.5	23.7	22.7	21.1
	F	7.7	10.7	8.5	7.4	7.2	7.0
Average payment	B	0.016	0.024	0.021	0.021	0.021	0.022
	F	0.019	0.027	0.024	0.023	0.023	0.023
Post-1979 staff							
Number of staff/per-cent of total	B	98/6	272/16	392/23	508/32	574/35	679/41
	F	28/6	88/18	115/25	138/30	166/35	187/37
		(Millions of U.S. dollars)					
Tax allowance payments	B	0.488	2.393	3.878	5.067	6.266	8.604
	F	0.078	0.635	1.011	1.365	1.841	2.445
Average payment	B	0.005	0.009	0.010	0.010	0.011	0.013
	F	0.003	0.007	0.009	0.010	0.011	0.013

Summary

(Data for Bank and Fund combined; millions U.S. dollars)

	1980	1981	1982	1983	1984	1985	Totals 1980-85
Pre-1980 staff	32.6	44.9	37.0	31.1	29.9	28.1	203.6
Post-1979 staff	0.6	3.0	4.9	6.4	8.1	11.0	34.0
All staff	33.2	47.9	41.9	37.5	38.0	39.1	237.6

1/ The substantial increase in tax allowance payments from 1980 to 1981 is largely attributable to the fact that in 1981 sizable general salary increases were approved by the two organizations, retroactive to March 1980. The resulting payments were made to the staffs in 1981 and for U.S. income tax purposes were in their entirety for 1981 income, thus incurring taxes at the highest marginal rates applicable for the year.

Table 2. Composition of Tax Allowance Payments to Pre-1980 Staff, 1980-85

		1980	1981	1982	1983	1984	1985
Average deductions							
Number of staff	B	1,545	1,400	1,326	1,102	1,059	975
	F	403	393	349	328	312	305
		(Millions of U.S. dollars)					
Total payments	B	18.1	26.8	22.8	20.2	20.5	21.1
	F	5.7	8.3	7.0	6.3	6.6	7.0
Average payment	B	0.011	0.019	0.017	0.018	0.019	0.022
	F	0.014	0.021	0.020	0.019	0.021	0.023
Supplemental transitional payments							
Number of staff	B	1,545	1,400	1,326	1,102	1,059	0
	F	403	393	349	328	312	0
		(Millions of U.S. dollars)					
Total payments	B	6.7	7.4	5.6	3.3	1.7	0
	F	2.1	2.3	1.5	1.0	0.5	0
Average payment	B	0.004	0.005	0.004	0.002	0.002	0
	F	0.005	0.006	0.004	0.003	0.002	0
Safeguard (safety net) payments							
No. of staff qualifying/ percent of pre-1980 staff	B	78/5	114/8	125/9	134/12	206/19	244/25
	F	21/5	37/9	36/10	54/16	72/23	87/29
		(Millions of U.S. dollars)					
Total payments	B	0.014	0.059	0.104	0.195	0.440	0.781
	F	0.006	0.027	0.044	0.094	0.180	0.331
Average payment	B	0.0002	0.0005	0.0008	0.0015	0.0021	0.0021
	F	0.0003	0.0007	0.0012	0.0017	0.0025	0.0038

Summary

(Data for Bank and IMF combined; millions of U.S. dollars)

	1980	1981	1982	1983	1984	1985	Totals 1980-85
Average deduction system	23.8	35.1	29.8	26.5	27.1	28.1	170.4
Supplemental transitional payments	8.8	9.7	7.1	4.3	2.2	0	32.1
Safeguard (safety net) payments	0	0.1	0.1	0.3	0.6	1.1	2.2
Total payments to pre-1980 staff	32.6	44.9	37.0	31.1	29.9	29.2	204.7

Table 3. Total Payments to Pre-1980 Staff Under Average Deductions Method Compared with Standard Deductions Method

(1980-84)

Year		Actual Average Deductions Method (1)	Hypothetical Standard Deductions Method (2)	Column (1) as Percent of Column (2) (3)
		(Millions of U.S. dollars)		(Percent)
1980	B	18.1	26.2	69
	F	5.7	8.4	68
1981	B	26.8	37.9	71
	F	8.3	12.1	69
1982	B	22.8	32.6	70
	F	7.0	10.3	68
1983	B	20.2	29.9	68
	F	6.3	9.7	68
1984	B	20.5	30.7	67
	F	6.6	9.5	69
		142.3	206.9	69

Table 4. Tax Allowance Payments in the Fund as Percentage of Net Salaries

(1980-85)

Year	Total Tax Allowance Payments (1)	Total Net Salaries (2)	Column (1) as Percent of Column (2) (3)
	(Millions of U.S. dollars)		(Percent)
All staff			
1980	7.8	11.0	71
1981	11.3	15.3	74
1982	9.5	15.9	60
1983	8.8	17.7	50
1984	9.1	18.3	50
1985	9.4	19.2	49
Pre-1980 staff			
1980	7.7	10.8	71
1981	10.7	14.1	76
1982	8.5	13.5	63
1983	7.4	14.0	53
1984	7.2	13.9	52
1985	7.0	13.4	52
Post-1979 staff			
1980	0.078	0.225	35
1981	0.635	1.250	51
1982	1.011	2.394	42
1983	1.365	3.469	39
1984	1.841	4.663	39
1985	2.445	5.837	42

Table 5. Tax Allowance Payments to all U.S. Staff in the Fund as a Percentage of Their Total Gross Income

(1980-85)

Year	Total Tax Allowance Payments (1)	Total Gross Income 1/ (2)	Column (1) as Percent of Column (2) (3)
	(Millions of U.S. dollars)		(Percent)
1980	7.8	19.4	40
1981	11.3	27.7	41
1982	9.5	26.5	36
1983	8.8	27.9	32
1984	9.1	29.0	31
1985	9.4	28.6	33

1/ Including, inter alia, tax allowance payments and Social Security tax reimbursements.

staff receiving safeguard payments increased steadily from 5 percent in 1980 to 25 percent in 1985 for the Bank and from 5 percent to 29 percent for the Fund. If the actual deductions of Bank and Fund staff followed closely the national averages, about 50 percent of pre-1980 staff might be expected to qualify for safeguard payments. However, it is possible that staff may not bother to apply when the difference between actual and assumed deductions is small. Staff may also decide not to apply because they or their spouses are concerned about the confidentiality of their income tax returns or because they do not understand the safeguard provisions. Total safeguard payments by the Bank and the Fund during the five-year transition amounted to US$812,000 and US$350,000, respectively. A further US$1.1 million was paid by the two organizations in 1986 with respect to the 1985 tax allowances.

c. Before the average deduction system was introduced, the Bank/Fund tax consultants, Arthur Andersen & Company, had estimated that, apart from any transition and safeguard payments, tax allowance payments under the system would on average be about 70 percent of what they would have been had the previous system based on standard deductions remained in effect. During the transition period, tax allowances for pre-1980 staff were calculated under both systems. As can be seen from Table 3, for the years 1980-84 the tax allowance payments calculated under the average deductions method were about 69 percent of those calculated under the previous system.

IV. Review of Operation Up to 1986

The average deduction system was adopted by the Bank and Fund following the Recommendations of the Joint Committee on Staff Compensation Issues--Tax Reimbursement (January 1979, p.39). The report concluded:

"6.42 We recommend, therefore, that:

(i) the Bank and Fund should adopt an Average Deduction System of tax reimbursement - based on the average deductions claimed by United States nationals generally, with modifications to reflect conditions in the Washington area with allowances being made for spouse income in the same way as happens under the present system;

(ii) the Bank and Fund, in implementing an Average Deduction System, should search for all means of ensuring more equitable treatment amongst all staff;

(iii) the Bank and Fund should again discuss with the Governments concerned the possibility of their taking the necessary steps to eliminate the burden that results from the taxation by those Governments of their nationals employed in their own countries by the Bank and Fund."

During the past six years several issues have arisen in connection with the application of the new tax allowance system. The main issues can be categorized as either operational (i.e., related to IRS data, methodology, calculation of allowances, and adjustments), or policy-related issues (i.e., tax treatment of U.S. and non-U.S. staff, equity, and safeguard provisions).

The specific issues discussed in the following sections are related to the operational aspects of the average deduction system. The staff intends to begin work forthwith on a further report that will deal with important issues concerning the equitable treatment of staff, including the impact of recent tax law changes on the taxation of nonorganization income of U.S. and G-IV staff members and their families, and the impact of the average deduction system on net pay of U.S. staff hired since January 1, 1980. The issues to be examined could indicate revisions in the tax allowance system itself. However, this report is intended to review the operation of the system, not to explore new systems.

1. IRS average deduction data

Use of IRS data on average deductions has posed two types of problems for the organizations' tax allowance system. The first is that the national average deductions for each income bracket do not increase smoothly as one goes from lower to higher income brackets. The second is that they are available only with a three-year lag.

a. Smoothing of IRS data

To avoid discontinuities in the tax allowance and net salary calculations, the tax consultants have used a smoothing technique to ensure that an increasing progression of average deductions at increasing levels of adjusted gross income is maintained. Generally, more smoothing is required in the upper-income brackets. The smoothing is achieved by fitting a line between the high and low points, using a midpoint methodology to remove outlying points. In addition, the overall variance between the original and smoothed deductions is analyzed to ensure that no bias toward higher or lower deductions is created. While this form of fitting a line is not wholly satisfactory, it seeks to retain as many actual observations as possible.

b. Three-year lag

(1) The fact that the data used in the average deduction system and in netting down comparator salaries are available only with a three-year lag means that the tax allowances paid to U.S. staff, as well as the indicated net salaries for all staff, reflect developments in the economy (e.g., changes in interest rates) and in the U.S. tax code with the same three-year lag. Consistent with the decisions of the two Executive Boards, the premise of the organizations in implementing the average deduction system has been that, apart from the smoothing procedures discussed above, adjustments to the IRS data on deductions should be made by the organizations only when the need for them is clear and compelling. In some cases, there has been a clear and compelling need for adjustments, and these have been made on the advice of the consultants. In other cases, where the extent of the required adjustment would have been quite unclear, no adjustments have been made.

(2) The fact that the system reflects developments in the economy with a three-year lag means that movements in the organizations' net pay scales, and in the actual after-tax income of U.S. staff members, will not be closely synchronized with those of U.S. comparators; these effects should, however, tend to average out over time. Changes in the tax code

can present more difficult problems. As noted in the next section, the changes introduced by the Tax Reform Act of 1986 were so far-reaching that the system could not have been credible if they were not taken into account. Consequently, in line with the policy of making adjustments when there is a compelling need to do so, the adjustments set forth in Section V have been incorporated in the average deduction system. 1/ It remains the intention of the organizations to continue to adjust IRS data only when there are clear and compelling reasons to do so, and Executive Directors will be kept informed of any such adjustments.

2. Average deduction system methodology

Experience in the implementation of the average deduction system has brought to light two problems concerning the basic methodology of the system. The first concerns the treatment of nonpay items, and the second relates to the use of all-returns IRS data for lower-salaried staff.

3. Nonpay income items

a. When the new tax allowance system was introduced, it was decided that the level of deductions used in calculating tax allowances should take into account all of the staff member's income from the Bank or Fund. 2/ This decision reflected the fact that the IRS statistics on adjusted gross income include all types of taxable income.

b. Upon further consideration, however, it would seem that both symmetry and internal equity require that nonpay income items, which are not taken into account in netting down comparator salaries, should also not affect the average deductions assumed for U.S. nationals in the tax allowance calculations. At present the only nonpay items that are taxable for U.S. nationals and affect average deductions are the cost of spouse travel on points and, for high-income staff, the imputed income from the organizations' group life insurance.

c. At present, for example, when a staff member uses his benefits under the spouse travel policy, his gross income in that particular year will be higher than his normal gross income by the cost of the spouse travel plus the amount by which this cost is grossed up. The average deductions used for that year will reflect this higher gross income, and

1/ In the Bank, the adjustments are already being used as the basis for quarterly payments to U.S. staff. In the Fund, the adjustments will be put into effect for the full year in connection with the payment to U.S. staff for the fourth quarter of 1987.

2/ An exception was made in respect of one-time severance payments, such as termination grants and payments of accrued annual leave, which it was decided should not be taken into account in determining the level of deductions used in calculating allowances for the final year of employment.

the tax allowance will be based on the corresponding higher assumed deductions. This is inconsistent with the compensation system, because the deductions used in the calculation of his tax allowance will be higher than the deductions that were used in netting down comparator salaries at his pay level. It is also inconsistent with internal equity, as the U.S. national--but not the non-U.S. staff member--will have his actual after-tax income reduced as a result of having used the spouse travel benefit. A similar analysis applies with respect to tax on imputed income from the group life insurance schemes.

d. It was for these same reasons that the Fund decided in 1984, and the Bank in 1986, to exclude from income for purposes of determining the assumed average deductions the difference between the employee and the self-employed Social Security tax, which is reimbursed by the organizations. The Bank also decided in 1986 to exclude spouse travel and imputed income from the group life insurance from the calculations. It is now intended to exclude these two remaining nonpay income items from Fund income for purposes of determining the level of average deductions to be used in the tax allowance calculations. The total annual cost of the changes with respect to spouse travel and to imputed income from group life insurance is expected to be negligible (less than US$2,000).

4. All-returns average deduction data and lower-salaried single staff

a. IRS data are available by type of return filed, i.e., single, married filing jointly, head of household, etc. In addition, the data are published in aggregate form on an all-returns basis. The question of which IRS series to use was considered carefully at the time of the introduction of the average deduction system, and the all-returns basis was chosen for several reasons: it was simple; it was based on the largest possible sample; and it provided a close fit with the deductions actually reported by both married and single staff members in the survey of their 1976 tax returns. However, certain changes in the U.S. tax code since the survey year now call into question the appropriateness of using all-returns data for lower-salaried single staff.

b. The average deductions reported by IRS include both taxpayers who claim the standard deduction and those who itemize. In 1973, the base data year used for comparison with the 1976 staff survey data, the maximum standard deduction was the same (US$2,000) for single taxpayers and for married taxpayers filing jointly (Table 6). In 1976 the standard deduction for both single and married filing jointly was 16 percent of adjusted gross income, with certain maxima and minima that were higher for married filers than for single filers. From 1979 through 1984, however, the tax code established standard deductions of US$2,300 for singles and US$3,400 for married couples filing jointly. It is this introduction of higher standard deductions for marrieds than for singles that calls into question the use of the all-returns data for lower-salaried single staff.

Table 6. Evolution of Standard Deductions and Personal Exemption, 1973-90

	Standard Deduction		Personal Exemption
	Single	Married (Filing jointly)	
1973	15 percent of AGI 1/ (minimum 1,300) (maximum 2,000)	15 percent of AGI 1/ (minimum 1,300) (maximum 2,000)	750
1974	15 percent of AGI 1/ (minimum 1,300) (maximum 2,000)	15 percent of AGI 1/ (minimum 1,300) (maximum 2,000)	750
1975	16 percent of AGI 1/ (minimum 1,600) (maximum 2,300)	16 percent of AGI 1/ (minimum 1,600) (mazimum 2,300)	750
1976	16 percent of AGI 1/ (minimum 1,700) (maximum 2,400)	16 percent of AGI 1/ (minimum 2,100) (maximum 2,800)	750
1977	2,200	3,200	750
1978	2,200	3,200	750
1979	2,300	3,400	1,000
1980	2,300	3,400	1,000
1981	2,300	3,400	1,000
1982	2,300	3,400	1,000
1983	2,300	3,400	1,000
1984	2,300	3,400	1,000
1985	2,390	3,540	1,040
1986	2,480	3,670	1,080
1987	2,540	3,760	1,900
1988	3,000	5,000	1,950
1989	Indexed	Indexed	2,000
1990	Indexed	Indexed	Indexed

1/ Adjusted Gross Income.

c. In 1984, the majority of U.S. taxpayers with adjusted gross incomes below US$25,000 claimed the standard deduction. For those levels between US$25,000 and US$40,000, the proportion of taxpayers claiming the standard deduction remains important but declines steadily as income rises; it drops off sharply for adjusted gross incomes above US$40,000. Because of the effect of the large percentage of taxpayers claiming a standard deduction below an adjusted gross income of $40,000 and because of the large difference between the standard deduction for married taxpayers and single taxpayers, single deductions are well below the all-returns deduction statistics that are used in the tax allowance calculations. This finding adds weight to the rather frequently voiced complaint of lower-salaried single staff that their assumed deductions are too high, resulting in consistently lower tax allowances than the amounts of tax they pay. In fact, the tax consultants have determined that at the lower-salary levels the all-returns deductions exceeded the single deductions by US$600 to US$1,000, or from 15 percent to 30 percent of the all-returns deductions. As a result, assuming that the staff member's actual deductions are equal to the IRS average deductions for a single taxpayer at the staff member's income level, the typical single staff member at the lower levels had to add to his 1986 tax allowance from his own resources about US$250 to meet his actual tax liability. This problem, if unaddressed, would be compounded by the Tax Reform Act, because the difference between the standard deductions for singles and marrieds would rise to US$2,000 in 1988, compared with US$1,100 in 1983.

d. Although there would appear to be a good argument for using a single average deduction schedule in calculating tax allowances for lower-salaried staff, there are also strong statistical reasons not to adopt this procedure for all staff. As noted above, even the all-returns data do not produce a smooth relationship between average deductions and adjusted gross income. Sharp upward and downward movements in average deductions as income increases are a more serious problem in the higher brackets. This problem would be greatly accentuated by using the single-returns data, because single taxpayers account for less than 10 percent of the returns filed with an adjusted gross income above US$40,000. An even more fundamental problem is posed by the fact that the relationship between married and single deductions, within the same adjusted gross income range, shifts from year to year in ways that are difficult to explain and certainly impossible to anticipate. Given these statistical problems, the use of the single deduction series for calculating tax allowances for single staff, other than those in the lower brackets where standard deductions weigh heavily, would subject staff to an unnecessarily high degree of variability in, and uncertainty about, their organization income. Moreover, there would seem to be no advantage to the organizations from using separate schedules for the two groups; despite erratic movements between brackets and between years, at the higher salary levels the two series, on average and over time, do bear a very similar relationship to adjusted gross income.

e. In light of the foregoing, it is proposed that the Bank and Fund use single average deduction schedules in calculating tax allowances for single staff below a specified adjusted gross income, which would have to be reassessed periodically. To avoid discontinuities, the tax consultants would need to prepare separate smoothed series for singles, with the singles and the all-returns series converging at the specified adjusted gross income. This procedure should not pose difficulties, because the underlying data do converge. It is considered that this approach would go some way to addressing the problem that has arisen regarding tax allowances for lower-salaried staff while, at the same time, being simple to administer and easy for staff to understand.

f. The review also showed that for each year (1982-84) at an adjusted gross income above US$40,000, the single and all-returns schedule tended to converge as taxpayers claiming the standard deduction declined. It is proposed that beginning with the 1988 tax allowance calculations, the two series be smoothed to converge at US$40,000. This level should be reviewed and the appropriate changes made in the future as the percentage of taxpayers claiming the standard deduction at various levels changes.

5. Tax allowance on Social Security reimbursement

a. Under the U.S. Social Security System, employees and employers make equal contributions to the system. In 1987, for example, the employee and his employer are each subject to a Social Security tax of 7.15 percent of the employee's gross earnings, up to a maximum tax for each of US$3,131.70. However, because international organizations are not subject to U.S. taxes, including Social Security, U.S. nationals employed at the Fund and the Bank are classified as "self-employed" for purposes of Social Security taxation, and the organizations reimburse U.S. nationals for the difference between the Social Security tax they would pay if they were employed elsewhere and the higher self-employed rates that they pay because they are employed by the organizations. In 1987 the self-employed Social Security tax is 12.3 percent of gross earnings from employment up to a maximum tax of US$5,387.40. Because the Social Security reimbursement paid by the organizations is taxable income to the U.S. national, it is included in net income and grossed up in the tax allowance calculation. The organizations pay, therefore, not only the excess Social Security tax but also income tax on that tax.

b. Prior to 1984, the self-employed Social Security tax rate was 150 percent of the employee rate. The Social Security Amendments Act of 1983 substantially altered the provisions for self-employed persons. Under that Act the self-employed rate is being increased each year until, beginning in 1990, the self-employed rate will be 15.3 percent and equal to the combined employee and employer contribution. Beginning in that same year, however, those who pay Social Security at the self-employed rates will be able to take one half of the Social Security tax paid as an adjustment to their gross income in arriving at taxable income for income tax purposes.

This provision was introduced to put self-employed persons on the same footing with respect to income tax as employees generally, since the employer's contribution to Social Security is not deemed to constitute taxable income to the employee. It is proposed that, when this provision takes effect in 1990, the organizations take the corresponding adjustment to income into account in calculating income tax allowances. 1/ This will mean, in effect, that the organizations will pay no income taxes on the Social Security reimbursement paid to U.S. nationals, because no income tax liability will accrue therefrom. The organizations would, of course, continue to reimburse the full excess Social Security tax paid by staff as a result of the tax status of the organizations.

6. Proposed change in the safeguard calculation

In calculating staff members' tax allowance during their final year of employment, the organizations do not take certain one-time severance payments, such as accrued leave and any termination grant, into account in determining the deductions to be assumed for that year. It is proposed to treat in the same way any safeguard payment received in the final year of employment with respect to a shortfall in the tax allowance for the preceding year. Although it is true that in any year the inclusion of the safeguard payment in income for purposes of determining the average deduction tends to bias upward the deduction level assumed, the safeguard system itself would in years prior to the final year fully protect the staff member from any underreimbursement owing to this factor.

V. Implications of Tax Reform Act of 1986

1. The Tax Reform Act of 1986 is generally considered to be the most far-reaching set of tax code changes ever enacted by the U.S. Congress. While the Act is intended to be revenue-neutral overall, it was also designed to

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1/ Alternatively, self-employed persons will from 1990 be allowed the option, in calculating their Social Security tax due, of excluding from income 50 percent of the normal combined employee and employer rate. This option will be beneficial to those whose marginal income tax rate is less than 15.3 percent. Since the bottom marginal rate under the Tax Reform Act of 1986 is 15 percent, this could result in a benefit for lower-salaried staff equal to 0.3 percent of that part of income subject to a marginal income tax rate of 15 percent, i.e., a maximum benefit of US$89. However, so long as Maryland, Virginia, and the District of Columbia continue to follow IRS practice in determining taxable income, this option would not be taken by any staff member residing in those jurisdictions. It is, therefore, proposed that this option be ignored by the organizations.

produce a major shift in the incidence of the overall tax burden. It has been estimated that the Act will reduce individual income taxes by US$120 billion over its first five years, offset primarily by increases in corporate taxes. 1/ This section considers the implications of the Tax Reform Act for the organizations' tax allowance system. Two points should be noted in this connection. First, the numerous provisions of the Act have different effective dates; some provisions will be phased in and others will be effective on different dates between January 1, 1987 and January 1, 1990. In this connection, the Bank and Fund can only plan to incorporate changes to the average deduction system as they occur, because there remains the possibility that the Tax Reform Act's transition schedules and effective dates may be revised under future tax legislation. The second point is that the tax allowance system is designed to take account automatically of year-to-year changes in tax rates, exemptions, and other provisions in the U.S. personal income tax system. Therefore, certain changes brought about by the tax reform can be readily reflected in the tax allowance system under the current methodology, and the necessary changes are described briefly in Section 2 below. Other implications of the reform on the tax allowance system do involve changes in methodology, and these have been carefully reviewed with the tax consultants and are dealt with in more detail in the subsequent sections.

2. Changes that do not require adjustment to methodology

a. Reduction in personal income tax rates

(1) The new law has retained the four different filing schedules discussed earlier, i.e., married filing jointly, single, head of household, and married filing separately. The applicable rates have, however, been reduced substantially in all cases. Under prior law each schedule had 15 tax brackets, with a top marginal rate of 50 percent. In 1987--a transition year--there will be 5 brackets, with a top marginal rate of 38.5 percent. Beginning in 1988 there will be only 2 brackets of 15 percent and 28 percent. 2/

1/ It should be noted that the Tax Reform Act could also have the effect of raising state income taxes, although by less than the reduction in federal taxes. This reflects the fact that many states, including Maryland, Virginia, and the District of Columbia, base their allowed deductions on those permitted on the federal return. Since the Act reduces allowable deductions, income tax revenues will rise in such states unless they enact offsetting tax cuts.

2/ In 1988, the effective marginal rate will be 33 percent for gross income levels between US$43,150 and US$100,480 for single staff with no dependents and for gross income levels between US$71,900 and US$192,930 for married staff with two children.

(2) Although the top tax bracket will be 28 percent when the law is fully in effect, many taxpayers and many U.S. staff will actually be paying federal income tax at marginal rates of 33 percent. This reflects two phase-out provisions incorporated in the law. First, the impact of the 15 percent tax bracket is phased out for higher-income taxpayers by applying a 5 percent surcharge on top of the 28 percent marginal rate until the point is reached where the average tax rate paid on taxable income is 28 percent. At that point, a second 5 percent surcharge is applied to phase out the effect of personal exemptions for self, spouse, and dependents. Only thereafter is the marginal rate truly 28 percent.

(3) The tax rate reductions pose no methodological problems, and in accordance with established procedures of adapting to tax changes as they occur, they are being reflected in the calculation of tax allowances. In the Bank, the quarterly payments to staff are based on the reduced tax rates; in the Fund, the change will be reflected in the final quarterly payment for the year.

b. Increase in personal exemptions

(1) One personal exemption each may be claimed for the taxpayer, spouse, and each eligible dependent. The personal exemption has been raised from US$1,080 in 1986 to US$1,900 in 1987, to US$1,950 in 1988, and to US$2,000 in 1989. Thereafter, it is to be indexed for inflation. The sharp increase in the personal exemption will, ceteris paribus, result in somewhat larger tax cuts for larger families. However, as described above, a 5 percent surcharge is applied to higher-income taxpayers until the benefits of the personal exemptions have been phased out.

(2) The change in the personal exemption also poses no methodological problems and is being taken into account in the calculation of tax allowances.

c. Standard deduction

The standard deduction that can be claimed by taxpayers who do not itemize deductions has been raised for all four types of return, although it has been raised proportionately more for married taxpayers, whether they file jointly or separately, and for heads of households than it has for single taxpayers. The standard deduction for single taxpayers is being increased from US$2,480 in 1986, to US$2,540 in 1987, and to US$3,000 in 1988. The deduction for married taxpayers filing jointly will rise from US$3,670 in 1986, to US$3,760 in 1987, and to US$5,000 in 1988 (Table 6).

(1) The organizations have, since the introduction of the average deduction system, followed the practice of calculating tax allowances on the basis of either the current year's allowable standard deduction or the three-year lagged data on average deductions, whichever is higher. Because the current procedures already take into account increases in the standard deduction, no further modification of the system in this respect is considered to be necessary.

(2) Tax allowances are calculated on the basis of published IRS average deduction statistics for the all-returns group of U.S. taxpayers, with actual allowances paid to staff members reflecting the state income taxes according to where they reside rather than the national average for state income taxes. Until 1987, the adjustment for actual state taxes has been the only adjustment made to the IRS data on average deductions since the adoption of the average deduction system. 1/ When the system was implemented, it was recognized that changes in tax codes could affect current deductions which would not be reflected in three-year-old IRS statistics. It was agreed, therefore, that when changes appeared significant the Bank and Fund would consider whether any adjustment was warranted. Since the average deduction system was adopted, there have been several changes in the U.S. tax laws, including the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and the Deficit Reduction Tax Bill of 1984.

(3) Following the changes in U.S. tax laws, the tax consultants evaluated the probable effects of the tax changes on the operation of the average deduction system to determine if adjustments were warranted. The tax consultants have been very cautious in recommending any adjustment to the IRS statistics or to the calculation of tax allowances. With respect to the IRS deduction statistics, the position of the tax consultants has been that changes made in the kinds or amounts of tax deductions allowed to U.S. taxpayers generally have not been substantial enough to cause the three-year-old data to be unrealistic, and adjustments that might have been contemplated would have been necessarily arbitrary given the absence of information on U.S. taxpayer behavior patterns under any new provisions. However, the tax consultants have reviewed the Tax Reform Act of 1986 and concluded that certain adjustments to the IRS data now appear to be warranted. These are explained below.

1/ The average deduction statistics are provided by the IRS at income intervals of US$1,000, US$2,000, US$5,000 or US$10,000 depending on income level. The IRS data are refined by the tax consultants to produce income intervals of US$500 and, at the same time, they are smoothed to minimize erratic changes from interval to interval.

3. Changes requiring adjustment

a. Itemized deductions

The Tax Reform Act will reduce significantly allowable itemized personal deductions. Some deductions have been eliminated immediately, others are being phased out, and still others are being sharply curtailed. Because the IRS data on which the average deductions are based are available only with a three-year lag, the question of how to take these changes into account poses the only important methodological problems in adapting the tax allowance system to the Act. For example, the most recent data available in 1987 will reflect average deductions in 1984. It is, therefore, necessary to make adjustments to the 1984 data for the system to reflect adequately the deductions that can actually be claimed in 1987. The IRS data are, however, available in sufficient detail, by US$1,000 income brackets, to permit reasonable adjustments to be made. The changes in itemized deductions introduced by the Tax Reform Act are discussed below and, where required, the new method of adjustment is described and discussed.

(1) State sales taxes

Effective in 1987, state sales taxes can no longer be taken as an itemized deduction. Since data are available on the average sales tax deduction claimed in 1984 in each income bracket, this change can easily be taken into account. The average state sales tax deduction claimed will be subtracted from the average deduction for each adjusted gross income level.

(2) Medical deduction

Previously taxpayers could itemize medical expenses to the extent that those expenses, excluding any amounts for which they were reimbursed under a medical insurance plan, exceeded 5 percent of their adjusted gross income. The Tax Reform Act raised that floor to 7.5 percent of adjusted gross income. No information is available on the dispersion of ratios of medical deductions to adjusted gross income for those who did itemize deductions over the 5 percent floor, and there is, therefore, no way to make a precise adjustment for this change. However, on the basis of the most recent IRS statistics, the average medical deduction of those who itemize medical expenses would exceed 7.5 percent of mean adjusted gross income in very few brackets. Because of this, and because only under the most exceptional circumstances would any staff member covered by the organizations' medical plans have out-of-pocket medical expenses in excess of 7.5 percent of adjusted gross income, it is proposed that during the next three years the organizations not take medical deductions into account in calculating average deductions. The amounts involved are not large. The average 1984 deduction before any adjustment is about US$200 for adjusted gross incomes of US$50,000-55,000 and about US$600 for those of US$100,000-105,000.

(3) Interest deductions

(a) The changes in provisions regarding interest deductions are likely to have the biggest impact on the overall level of deductions. These changes are also the most complicated. In terms of IRS provisions, personal interest deductions can be divided into three categories: mortgage interest, consumer interest, and investment interest. The latter would include, for example, money borrowed to buy stocks or other portfolio investments. The IRS data on average deductions, however, distinguishes only between mortgage interest and other interest, i.e., it does not provide a breakdown of consumer and investment interest. Previously, deduction of any amount of consumer interest was permitted, and the deduction of investment interest of up to US$10,000 plus the earnings on such investments was also allowed. When the new law comes fully into effect in 1991, no deductions will be allowed for consumer interest and an investment interest deduction will be permitted only up to the amount of net investment income. In the intervening years these deductions will be phased out. In 1987, 65 percent of consumer interest will be deductible as will 65 percent of the amount by which investment interest exceeds investment income (up to a maximum of US$6,500, i.e., 65 percent of US$10,000). These percentages will be 40 percent in 1988, 20 percent in 1989, and 10 percent in 1990. In 1987, 1988, and 1989 the Bank and Fund will be adjusting the IRS statistics for nonmortgage interest by reducing them by the corresponding percentages. From 1991 onward, only mortgage interest deductions would be taken into account in calculating average deductions to be used for tax allowances and in netting down comparator salaries. Although interest on borrowings used to purchase investments will continue to be deductible up to the amount of earnings on such investments, it would not be appropriate to treat such interest as deductions against organization income.

(b) The Tax Reform Act maintains the deduction for mortgage interest on a first and second home, and as a result no adjustment is required to reflect the change in the tax law.

(4) Moving expenses

(a) Previously, moving expenses required by one's employment, i.e., either to take up a new job or in connection with a reassignment, could be taken by the taxpayer as an adjustment to income. Beginning in 1987, such moving expenses will be an itemized personal deduction. The organizations provide settling-in allowances to new staff recruited from outside the Washington area and resettlement allowances to such staff when they leave the organizations. Similarly, allowances are paid to staff on assignment overseas or on return to Washington. These allowances, which are specified in terms of a certain number of weeks' salary depending on marital status and number of dependents, are taxable income for U.S. staff. The policy of the organizations to date has been to assume in calculating the staff member's tax allowance that he is able to claim an adjustment to income equal to the settling-in or resettlement allowance that he received. 1/ Certain other expenses, such as airfares and shipment of effects, are paid directly or reimbursed by the organizations and neither constitute taxable income nor can be taken as an adjustment to income by the taxpayer.

(b) Because moving expenses are directly related to organization employment, it is proposed to continue the present practice notwithstanding that such expenses are now an itemized deduction rather than an adjustment to income. In years in which such an allowance was actually paid to a staff member, the organizations would assume a personal deduction for moving expenses equal to the allowance received. Consistent with this approach, the organizations would not take into account the average deduction for moving expenses claimed by U.S. taxpayers generally.

(5) Other miscellaneous itemized deductions

(a) All deductions other than medical, state and local taxes, interest, charitable contributions, casualty and theft losses, and moving expenses are classified as other miscellaneous deductions. Under the Tax Reform Act, expenses that fall in this category are deductible only to the extent that the total of such deductions exceeds 2 percent of adjusted gross income. The changes introduced by the Act with respect to these other miscellaneous deductions pose two problems for the organizations' tax allowance system.

(b) The first problem is how to take account of the new 2 percent of adjusted gross income floor during the three years until its impact is reflected in the lagged IRS data. This is similar to the problem posed by the increase in the floor for medical deductions discussed above. Again, the only information available is the average amount of miscellaneous deductions claimed by taxpayers in each income bracket in 1984, and these data show that in very few cases does the deduction claimed exceed 2 percent of adjusted gross income. It is, therefore, proposed that during the three years until the IRS data reflect the impact of this floor, the organizations not take into account miscellaneous itemized deductions in the average deductions used for calculating tax allowances and netting down comparator salaries.

(c) The second problem relates to employee business expenses. Previously, employee business expenses were an adjustment to income. Beginning in 1987 they are to be included in miscellaneous deductions subject

1/ Resettlement allowances paid upon retirement are not allowed as an adjustment to income and the organizations do not assume such an adjustment in calculating the tax allowance.

to the 2 percent floor. Deductible employee business expenses consist primarily of business travel expenses, e.g., airfares, hotels, and out-of-town meals, that are not reimbursed by the employer. Since the organizations fully reimburse expenses for approved travel, staff members would generally not be entitled to claim any deductions under this category. It is, therefore, proposed--as with moving expenses--that the organizations not take the employee business expense item into account in the average deductions used either for calculating tax allowances or for netting down comparator pay. Because deductions for employee business expense will not be reflected as an itemized deduction until 1990, when the 1987 IRS data are available, no adjustment will be necessary before that time. Thereafter, the tax consultants will review the effect of the changes and make a recommendation as to whether and how to take account of these deductions.

b. Adjustments to income

(1) Two-earner adjustment

From 1982 to 1986 the U.S. tax code permitted an adjustment to income for two-earner families filing a joint return. The adjustment allowed was 10 percent of the earned income of the spouse with the lower earnings, up to a maximum adjustment of US$3,000. The organizations took this adjustment into account in the tax allowance calculations for staff members whose spouses had earned income. The specific methodology adopted by the Bank and Fund allocates one half of the allowable adjustment to the staff member's organization income. The adjustment is applicable only where the tax allowance is calculated on the basis of married filing jointly. This adjustment has been eliminated by the Tax Reform Act and the effect of this change will be offset, at least in part, by the impact of lower tax rates on the tax allowances paid to staff with working spouses. In addition, it will be necessary to adjust the three-year lagged data relating deductions to adjusted gross income to take account of the fact that this adjustment is no longer available. IRS data permit the organizations to make the necessary adjustment to the adjusted gross income associated with each deduction level.

(2) Individual Retirement Accounts

From 1982 to 1986 taxpayers were permitted to defer taxation on up to US$2,000 of earned income for each wage earner (US$2,250 for one-income families). Amounts contributed to an Individual Retirement Account were an adjustment to income in the year of the contribution and taxable income in the year (after age 59 1/2) they were withdrawn. Under the Tax Reform Act, adjustments to income for an IRA are permitted only if (1) neither the taxpayer nor the spouse belongs to a qualified pension plan, or (2) adjusted gross income is less than US$35,000 (US$50,000 for married couples filing jointly). Because the organizations' staff retirement plans are qualified plans, no staff member with an adjusted gross income above these levels--i.e., above a net salary level of about US$28,000 for a single staff member--can take an adjustment to income for an IRA contribution. A single taxpayer whose adjusted gross income is below US$25,000 (US$40,000 for married filing jointly) can take a full IRA adjustment as under prior law. In between these income levels, the permitted IRA adjustment is eliminated.

(3) It is proposed that the adjusted gross income for each deduction level be raised by the average IRA adjustment at that income. It is, moreover, proposed that this adjustment be made at all income levels. The rationale for making the adjustment at all levels is not the changes introduced by the Tax Reform Act, but rather that such an adjustment should have been made in any case. Unlike a personal deduction, an IRA adjustment does not eliminate the tax liability on that income; rather, it only defers it. By basing the tax allowances on adjusted gross income after adjustment for IRAs, the organizations implicitly benefit from part of the reduction in taxes that occurred in the year of an IRA contribution, but with no corresponding provision for the organizations to pay a part of the tax liability on IRA amounts withdrawn. The IRS statistics will permit the adjustments to be made at each adjusted gross income level.

VI. Communications with Staff

The Working Group recognized that much greater efforts must be made in communicating to the staff the provisions of the tax allowance system and its implications in individual cases. Because the income tax provisions are complex, the tax allowance system is also complex. It is, therefore, essential that carefully prepared communications be presented to the staff, supplemented by personal contacts. In addition to better written materials, including illustrative calculations where appropriate, the Working Group considers that presentations explaining the broad policy provisions would be useful. Also, the development of an interactive computer program that could be used by staff to calculate actual tax liability should be considered. The Working Group recommends the development of better communication materials as soon as possible, especially in light of the current and future changes that result from tax legislation.