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March 4, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Tax Allowance Under the Average Deduction System

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

If Executive Directors have technical or factual questions relating to this paper, they should contact Ms. D. Anderson (ext. 8222) or Mr. Sotelo (ext. 8441).

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INTERNATIONAL MONETARY FUND

Tax Allowances Under the Average Deduction System

Prepared by the Treasurer's Department and the Administration Department

Approved by Walter O. Habermeier and Graeme Rea

March 3, 1986

This report on the operation of the Average Deduction System (ADS) with respect to the tax year ended December 31, 1984 is submitted in accordance with the decision of the Executive Board of January 18, 1980 (EBAP/80/360, Sup. 1, 1/17/80). This is the fifth annual report called for under the five-year transition period of implementation of the ADS, and covers the last year of the transition.

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

I. Operation of the Tax Allowance for 1984

The five-year transitional period of the ADS has now been completed. There were no operational problems encountered during the fifth year of operation. As in past years, the average deduction statistics applied for 1984 were provided by the U.S. Internal Revenue Service (IRS) through the Fund's tax consultants, Arthur Andersen & Co. The tax consultants were of the opinion that the IRS statistics, based on 1981 U.S. tax returns, which were the latest available, could be applied without modification. Consistent with past practice, the consultants provided a refinement of the statistics; the data provided by the IRS is based on income at $1,000 intervals, and the consultant adapted these to $500 intervals for use in the tax allowance calculations.

II. Payment of Tax Allowance for 1984

1. Payment to U.S. nationals

For the tax year ended December 31, 1984, a total of 478 U.S. staff members received tax allowances totaling $9.7 million. U.S. nationals appointed before January 1, 1980 were eligible for the transitional payment and for the safeguard provisions. 1/ Of the U.S. staff members receiving 1984 tax allowances, 312 were eligible for the transitional payment and their total tax allowances were $7.6 million ($7.1 million under the ADS and $0.5 million under the transitional arrangement). Under the safeguard provision, 72 staff members received an additional allowance with respect to 1984 taxes, totaling $180,000. Those U.S. staff members who joined the Fund after December 31, 1979, who are, of course, eligible for the ADS tax allowance, are not eligible for the transitional or the safeguard payments. For 1984, there were 166 staff members in that category and their tax allowance payments totaled $2.05 million. The tax allowance payments for the years 1980 through 1984 are summarized in Table 1.

1/ Under the transitional arrangement, U.S. staff members appointed before January 1, 1980 receive, in addition to the tax allowances computed under the ADS, a fraction of the amount by which the computation under the standard deduction system exceeds the allowance under the ADS. For 1980 the fraction was 5/6 and for 1984 the fraction was 1/6.

The safeguard provisions allow U.S. staff members appointed before January 1, 1980 to claim an additional tax allowance if their actual deductions are less than the assumed average deductions. This claim must be documented by copies of signed and dated Form 1040 and the corresponding forms for State Tax Returns (Forms D-40 for District of Columbia; 502 for Maryland; 760 for Virginia). The tax allowance is then recomputed using the Fund gross income and actual deductions reported to the tax authorities. When the staff member or spouse has non-Fund income, actual deductions are prorated between Fund and non-Fund income. An additional amount is paid to the extent that the recomputed allowance exceeds the sum of the regular ADS allowance and any transitional amount already paid.

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

	1980	1981	1982	1983	1984
1. Total tax allowances					
Number of staff	431	481 1/	464	466	478
Total allowances	$8.1 m	$11.6 m	$9.9 m	$9.2 m	$9.7 m
As percent of net salaries paid to these staff	73.6	75.7	62.2	52.0	53.0
2.a. Total transitional					
Number of staff	403	393	349	328	312
Transitional allowances	$2.1 m	$2.3 m	$1.5 m	$1.0 m	$0.5 m
b. Safeguard					
Number of staff	21	37	36	54	72
Safeguard payments	$.006 m	$.027 m	$.044 m	$.094 m	$.180 m
Total transitional and safeguard payments	$2.106 m	$2.327 m	$1.544 m	$1.094 m	$0.680 m
As percent of net salaries paid to these staff	19.5	16.5	11.4	7.8	4.9
3. Staff not eligible for the transitional arrangement					
Number of staff	28	88	115	138	166
As percent of all staff receiving a tax allowance	6.5	18.3	24.8	29.6	34.7
Total allowances	$.084 m	$.670 m	$1.075 m	$1.457 m	$2.052 m
As percent of net salaries paid to these staff	37.4	53.6	44.9	42.0	44.0

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

2. Payment to other nationals

For the year 1984, seven French nationals employed by the Fund in France received tax allowances totaling $56,000, which is 25.2 percent of the net salaries paid to these staff. Consistent with the principles applied since 1980, the statutory deductions prescribed under French income tax codes were applied in the tax allowance calculations for local staff whose salaries are based on OECD salaries.

3. The safeguard provision

At the end of 1984, 65 percent of U.S. nationals on the staff were eligible for the safeguard provision. For those staff members who have been eligible for the safeguard provision since 1980, 5 percent received an additional payment for the 1980 tax year, 9 percent received an additional payment for 1981, 10 percent for 1982, 17 percent for 1983 and 23 percent for 1984.

4. U.S. Social Security tax reimbursement

Tax allowance payments to U.S. staff include a portion of the staff members' social security tax payment. The rate used in the calculation of the Fund's contribution to the social security tax payment of Fund staff is the difference between the rate applicable to a "self-employed" person (as Fund staff are defined under the social security law) and that of an "employed" person. This additional self-employed tax rate and the maximum amount of social security tax contributed by the Fund and the staff for the years 1980 through 1984 are summarized in Table 2. The amounts paid to staff are listed in Table 3.

Table 2. Social Security Rates and Amount of Contribution by the Fund and Staff

Year	Maximum Taxable Base	Maximum Fund Contribution		Maximum Staff Contribution	
		Rate (Percent)	Per Staff Member	Rate (Percent)	Per Staff Member
1980	$25,900	1.97	$ 510.23	6.13	$1,587.67
1981	29,700	2.65	787.05	6.65	1,975.05
1982	32,400	2.65	858.60	6.70	2,170.80
1983	35,700	2.65	946.05	6.70	2,391.90
1984	37,800	4.60	1,738.80	6.70	2,532.60

Table 3. Social Security Payments Made by the Fund to Staff

Year	Number of Staff	Amount of Fund Contribution	Fund Contribution as Percent of Net Salaries Paid to these Staff
1980	431	$230,000	2.1
1981	481	315,000	2.1
1982	464	345,000	2.2
1983	466	388,000	2.2
1984	478	725,000	3.9

III. Modifications to the Average Deduction System

Over the past five years changes in the U.S. tax codes have resulted in modifications to the ADS. The enactment of the Economic Recovery Tax Act of 1981 (ERTA) caused two changes made in the tax allowance system:

1. Foreign earned income exclusion

Beginning in 1982, qualified U.S. nationals were allowed to exclude up to $75,000 of their foreign earned income. In 1983, under the Tax Equity Fiscal Responsibility Act qualifying individual may exclude up to $80,000 of foreign earned income for each of the years 1985-1987. The maximum exclusion increases by $5,000 a year thereafter to a $95,000 maximum exclusion for 1990 and subsequent years. In order to qualify for the exclusion, U.S. nationals must physically reside in a country outside the United States for a minimum of 330 days in a consecutive 12-month period. In view of the potential savings under the tax allowance system whereby most, if not all, Fund income to a U.S. staff member assigned overseas will be exempt from taxation, a procedure has been established to ensure that, other than in exceptional cases, the exclusion requirements are met. The procedures will in no way place the staff member concerned at a disadvantage with respect to his other colleagues as regards entitlements or assignments overseas.

2. Two-earner married couple deduction

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

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

In addition to the changes implemented due to the Economic Recovery Tax Act, effective January 1, 1984, the portion of the U.S. Social Security tax payment contributed by the Fund was excluded from gross income in determining the average deduction used in the tax allowance calculation. This change was made in order to maintain a balance between the grossing-up calculation under the average deduction system and the netting-down process used in setting staff compensation levels. The relationships between gross income and average deductions in the ADS calculations are now consistent with the IRS statistics which do not include in gross salaries the employer's social security contributions.

IV. Future Issues Affecting the Average Deduction System

As explained in previous reports, a review of the ADS will be undertaken at the end of the transition period. While preliminary work will begin in consultation with the Bank, it would be preferable if the review could take into account the final results of the operation of the ADS applicable to 1985, the first year without any transitional payments. The relevant information is expected to be available before the end of the summer and the staff expects to complete the review during the second half of 1986. The review will focus, inter alia, on the following issues:

1. The President's tax proposals to Congress

The U.S Tax Reform Proposals being studied by the Congress could have a significant impact on the ADS. 1/ Certain features of the Tax Reform Proposal, if enacted, will affect the way in which the ADS operates and may suggest the need to examine some basic elements of the system. 2/ Decisions will certainly need to be made on how some of the proposed changes are to be incorporated in the system. At the very least, if the proposal to restrict the types and amounts of itemized deductions is enacted, this will affect the average deductions on which the tax allowance system is based. In this event, the average deduction statistics provided by the IRS will need to be modified until such time that the changes in the law are reflected in the statistics provided by the IRS.

1/ The U.S. House of Representatives has passed the Tax Reform Bill and the U.S. Senate is expected to take it up in 1986.

2/ The ADS system is also applied in netting comparator compensation for salary surveys and the examination of ADS will be undertaken in respect of the symmetrical internal and external application of the system.

2. Social Security tax

The review will also need to examine the impact on U.S. staff members as well as on the cost to the Fund of the scheduled increases in the U.S. Social Security tax, and the treatment of social security contributions for Federal tax purposes under the present policy of reimbursing a portion of this tax.

3. Taxation of nonresident aliens

Effective January 1, 1985, many non-U.S. employees of international organizations who hold G(iv) visas and their immediate families will normally be classified as non-residents for U.S. income tax purposes. One of the principles by which the tax allowance system is to be guided is equity as between U.S. nationals and expatriate staff, and recent tax changes affecting G(iv) visa holders would need to be examined in light of the principle of equity.