EBAP/85/82

March 29, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: Tax Allowance Under the Average Deduction System

There is attached for the information of the Executive Directors the fourth 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

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Administration Department

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March 28, 1985

In accordance with the decision of the Executive Board of January 18, 1980 (EBAP/80/360, Sup. 1, 1/17/80), there follows a report on the operation of the Average Deduction System (ADS) with respect to the tax year ended December 31, 1983, for which payments were made through September 1984. This is the fourth annual report called for under the five-year transition period of implementation of the ADS.

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

I. Operation of the Tax Allowance for 1983

During the fourth year of operation, the ADS posed no material problems. As in past years, the average deduction statistics applied for 1983 were provided by the U.S. Internal Revenue Service (IRS) through the Fund's tax consultants, Arthur Andersen & Company. The tax consultants were of the opinion that the IRS statistics, based on 1980 U.S. tax returns (the latest available) could be applied without modification and, consistent with past practice, the consultants provided a refinement of the statistics from $1,000 income intervals provided by IRS to income intervals of $500 which was applied in the tax allowance calculations.

The ADS has been in effect for four years of the five-year transition period. The most significant factor to date in the operation of the system has been the effect on the ADS of changes in the U.S. tax code. As envisaged when the ADS was implemented in 1980, a major review of the ADS will be conducted at the end of the transition period (after 1984 payments have been made). The impact of tax code changes will be examined as part of that review. Certain points related to that review are discussed in Section IV of this report.

II. Payment of Tax Allowance for 1983

1. Payment to U.S. nationals

For the tax year ended December 31, 1983, a total of 466 U.S. staff members received tax allowances that totaled $9.2 million. U.S. nationals appointed before January 1, 1980 were eligible for the transitional payment 1/ and were also eligible for the safeguard provision. 2/ Of the U.S. staff members receiving 1983 tax allowances, 328 were eligible for the transitional payment and their total tax allowances were $7.7 million ($6.7 million under the ADS and $1.0 million under transitional arrangements). Under the safeguard provision, 54 staff members received an additional allowance with respect to 1983 taxes, totaling $94,300. Those U.S. staff members who joined the Fund after December 31, 1979 were eligible for the ADS tax allowance but for neither the transitional nor the safeguard payments. For 1983, there were 138 staff members in that category and their tax allowance payments totaled $1.46 million. Table 1 hereafter summarizes tax allowance payments for the years 1980 through 1983.

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 1983 the fraction was 2/6.

2/ Under the safeguard provisions, U.S. staff members appointed before January 1, 1980 may claim an additional tax allowance if their actual deductions are less than the assumed average deductions. This claim must be documented by copies of the relevant parts of the actual tax returns filed. 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 safeguard 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
1. Total tax allowances				
Number of staff	431	481 1/	464	466
Total allowances	$8.1 m	$11.6 m	$9.9 m	$9.2 m
As percent of net salaries paid to these staff	73.6%	75.7%	62.2%	52.0%
2. Transitional				
Number of staff	403	393	349	328
Transitional allowances	$2.1 m	$2.3 m	$1.5 m	$1.0 m
3. Safeguard				
Number of staff	21	37	36	54
Safeguard payments	$6,000	$27,000	$44,000	$94,300
4. Staff not eligible for the transitional arrangements				
Number of staff	28	88	115	138
As percent of all staff receiving a tax allowance	6.5%	18.3%	24.8%	29.6%
Total allowances	$84,000	$670,000	$1,075,000	$1,457,000
As percent of net salaries paid to these staff	37.4%	53.6%	44.9%	42.0%

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, all in 1981.

2. Payment to other nationals

For the year 1983, seven French nationals employed by the Fund in France received tax allowances totaling $78,000. 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.

III. Modifications to the Average Deduction System in 1984

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 contribution.

IV. Future Issues Affecting the Average Deduction System

As noted earlier, December 31, 1984 marks the end of the five-year transition period of the ADS. A major review of the system will be initiated, in the second half of 1985, after all of the 1984 payments have been made. The review will focus inter alia on the following issues:

1. The impact of U.S. tax code changes on the operation of the system

Since 1981, changes in U.S. tax law may have affected the general levels of average deductions taken by U.S. taxpayers as well as the relationship between adjusted gross income and average deductions as reported by the IRS. Because of the three-year lag before these tax changes affect the statistics provided by the IRS, it has not been possible to determine whether significant changes have occurred. Following the changes in U.S. tax law, the tax consultants have evaluated the probable effects of the tax changes on the operation of the ADS to determine if adjustments were warranted. Since the inception of the ADS, the tax consultants have been very cautious in recommending any adjustment to the IRS statistics or to the calculation of tax allowances. The system was adjusted in 1982, however, to take into account the deduction for two-earner married couples. The benefit of the deduction, 10 percent of the lesser of (a) $30,000 or (b) the lower earning spouse's income is shared equally between the Fund and the staff member. It should also be noted that the U.S. Tax Reform proposals being studied by the U.S. Congress could have a significant impact on the basic principles underlying the ADS. Although it is difficult to predict how quickly the tax reform proposals will be acted on, or which proposals will be enacted, to the extent possible the outcome of these proposals will be taken into account in the forthcoming major review.

2. The safeguard provision

At the end of 1983, 70 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, and 17 percent for 1983. This trend corresponds to the decline in the transition payment which came to an end

in 1984. In the major review the safeguard system, including its underlying assumptions and its application including the question of whether the safeguard or variations of it should be applicable to all staff that receive a tax allowance, will be studied.

3. Impact of U.S. tax legislation on foreign nationals

The U.S. Deficit Reduction Tax Bill of 1984 effectively classifies G(iv) visa holders on the Fund staff as nonresident aliens for U.S. income tax purposes. While not directly related to the operation of the ADS, the effect if this legislation will be reviewed particularly insofar as it bears on the relationship between the net compensation levels of U.S. and non-U.S. staff.

4. Future impact of U.S. Social Security Tax reimbursement

The rate used in the calculation of the social security tax payment 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. Table II below summarizes social security tax rates and the maximum amount of social security tax contributed by the Fund for the years 1980 through 1985.

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

Year	Taxable Base	Rate (Percent)	Maximum Fund Contribution
1980	$25,900	1.97	$510.23
1981	$29,700	2.65	787.05
1982	$32,400	2.65	858.60
1983	$35,700	2.65	946.05
1984	$37,800	4.60	1,738.80
1985	$39,600	4.75	1,881.00

Because of the U.S. social security tax increase in the self-employed category, the Fund's participation in social security payments for U.S. staff is expected to rise to 50 percent of the staff member's social security contribution by 1990--at present (in 1985) this contribution amounts to about 40 percent. For the 1990 tax year, however, there will also be a tax deduction available to U.S. staff members equivalent to the amount of the Fund's contribution. The implications of these provisions will also be examined in the major review.