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Taxing Citizens in a Global Economy

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TAXING CITIZENS IN A GLOBAL ECONOMY

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This Article addresses a fundamental issue underlying the U.S. tax system in the international context: the use of citizenship as a jurisdictional basis for imposing income tax. As a general matter, the United States is the only economically developed country that taxes its citizens abroad on their foreign income.

Despite this broad assertion of taxing jurisdiction, Congress allows citizens abroad to exclude from taxation a limited amount of income earned from working outside the United States. Influential lobbying groups, including businesses that employ significant numbers of U.S. citizens abroad, argue that this exclusion is necessary in order to keep American business competitive overseas. Recently, these groups have argued that modern developments, including lowered barriers to trade and the increased mobility of workers, strengthen this argument, and that the United States must allow an unlimited foreign earned income exclusion, or perhaps abandon citizenship-based taxation altogether, in order to remain competitive.

This Article analyzes how modern developments in the global economy affect the case for citizenship-based taxation. The Article concludes that recent globalization trends strengthen, rather than weaken, the case for taxing U.S. citizens living abroad. Moreover, it concludes that these modern developments weaken the case for giving preferential treatment to income earned by citizens working abroad.

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INTRODUCTION

In recent years, policymakers and commentators have increasingly asked whether existing U.S. income tax principles are adequate to handle the challenges posed by an ever-more globalized economy.[1] In particular, they have questioned whether tax policies developed in the early or mid-twentieth century are appropriate in an era of instantaneous communication and information sharing, inexpensive and rapid transportation, and lowered barriers to cross-border flows of capital investment, goods, and personal services.[2]

These recent developments raise significant jurisdictional issues in the international context. A fundamental question concerns the extent to which the United States exercises taxing jurisdiction over persons with connections to more than one country. Recent analysis of this threshold question has focused on the business income of U.S.-based multinational corporations.[3]

This Article instead focuses on individuals, addressing the United States' longstanding use of citizenship as a jurisdictional basis upon which to impose income tax. With certain exceptions, the United States taxes the worldwide income of its citizens regardless of whether the citizen lives in the United States or abroad. On this issue, the United States has long been an outlier in the international community. No other economically developed country utilizes citizenship as a basis upon which to tax income arising outside its borders.[4] Even among less economically developed countries, only Eritrea exercises general income-taxing jurisdiction over its citizens living abroad.[5]

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[1] *See, e.g.*, OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE 3 (1996), *available at* http://www.ustreas.gov/offices/tax-policy/library/internet.pdf ("[T]echnological developments dictate that the Internal Revenue Code and generally accepted principles of international tax policy be reexamined."); *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 657–58 (2006) (report authored by task force convened by American Bar Association, Section of Taxation) [hereinafter *ABA Task Force Report*] (describing need for tax policy to consider recent changes in global economy and business practice).

[2] For a more detailed discussion of these economic and political changes, see *ABA Task Force Report*, *supra* note 1, at 657; *infra* Part II.

[3] *See, e.g.*, *ABA Task Force Report*, *supra* note 1, at 746–55 (focusing on whether longstanding test for defining corporate residence continues to make sense in world of modern multinational corporate groups); Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 544–80 (2005) (same).

[4] *See infra* note 15. Some countries apply an expanded definition of "resident" to continue taxing such income, but only to citizens who move abroad for limited periods of time. *See infra* note 15.

[5] *See* STAFF OF J. COMM. ON TAXATION, 104TH CONG., ISSUES PRESENTED BY PROPOSALS TO MODIFY THE TAX TREATMENT OF EXPATRIATION app. B, at 1 (Comm. Print 1995) ("The Philippines and Eritrea also tax their nonresident citizens on their worldwide

The Internal Revenue Code (the Code) contains certain limitations on this broad assertion of citizenship-based taxation. In particular, since 1926 Congress has allowed U.S. citizens living and working abroad to exclude at least some earned income (i.e., income from work, rather than investments) from tax.[6] Although the original foreign earned income exclusion contained no cap, during the past half century Congress has limited the amount that can be excluded from income under this provision.[7]

Influential groups opposed to the U.S. taxation of citizens abroad would like to focus public and legislative attention on this issue.[8] In particular, they would like Congress to abandon citizenship-based taxation altogether or, at a minimum, allow an unlimited exclusion for income earned by citizens working abroad.

Calls for the elimination (or significant curtailment) of income tax on U.S. citizens living overseas share a core argument with recent calls for lessening the tax burden on U.S.-based multinational corporations. In both contexts, advocates argue that existing rules fail to account for modern developments in the global economy, thereby

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income."); Mihir A. Desai et al., *Sharing the Spoils: Taxing International Human Capital Flows*, 11 INT'L TAX & PUB. FIN. 663, 678 (2004) ("[T]hree countries—the United States, the Philippines, and Eritrea—use citizenship as the basis of ongoing taxation."). Although these sources list the Philippines as a country that generally taxes citizens abroad, the Philippines abandoned that approach in 1997. Tax Reform Act of 1997, Rep. Act No. 8424, § 23(c) (Phil.); *cf.* Dennis C. Serfino, *Govt Drafting Bill to Take Back OFWs' Tax-Exempt Privilege*, MANILA TIMES, Dec. 7, 2005, *available at* http://www.manilatimes.net/national/2005/dec/07/yehey/business/20051207bus3.html (describing recent Philippine legislative proposals to reinstate taxation of nonresident citizens). Mexico taxed the income of its citizens abroad until 1981. STAFF OF J. COMM. ON TAXATION, *supra*, app. B, at 1. The Eritrean regime has met with little success. Desai et al., *supra*, at 689 n.39. Interest groups representing U.S. citizens overseas have also asserted that North Korea and Vietnam tax their citizens working abroad. *See* AM. CHAMBER OF COMMERCE IN H.K., TAXATION OF AMERICANS WORKING OVERSEAS 1–2, *available at* http://www.amcham.org.hk/pr/position_papers/taxation-of-americans.pdf. Given the unique circumstances in North Korea, it can be assumed that the purported tax rule for that country has little practical effect.

6 *See infra* Parts I.B–C. Another important limitation is the foreign tax credit, which reduces a U.S. citizen's tax to the extent that a foreign country also taxes the citizen's foreign income, thereby avoiding double taxation. I.R.C. §§ 901(a)–(c), 903, 904(a) (2000). The foreign tax credit is discussed *infra* notes 46–51 and accompanying text.

7 For example, under current law a U.S. citizen who satisfies certain foreign residency tests can exclude up to $82,400 of foreign earned income, plus some housing expenses in excess of a threshold amount. I.R.C. § 911(a)–(c) (West Supp. 2006); Rev. Proc. 2006-51, 2006-47 I.R.B. 945. Other income remains taxable, including a citizen's foreign earned income in excess of the excluded amounts, as well as income earned from working in the United States and any investment income. Recent amendments to the foreign earned income exclusion are discussed *infra* notes 85–94 and accompanying text.

8 In May 2006, Congress modified the foreign earned income exclusion as a last-minute revenue raiser in an unrelated tax bill, generating significant postenactment opposition from overseas citizens and business interests. *See infra* notes 85–98 and accompanying text.

hampering the economic competitiveness of the United States in the worldwide marketplace.[9] Because the most recent large-scale congressional reconsideration of the taxation of citizens overseas occurred more than a quarter century ago, before these globalization developments, the time is ripe for a reexamination of the issue.

This Article considers whether recent economic, technological, and other developments support calls to abandon or significantly curtail individual taxation based on citizenship.[10] Whereas this author and others have argued that modern developments undermine the continuing viability of place of incorporation as the principal touchstone for imposing worldwide taxation on corporations,[11] this Article suggests, perhaps counterintuitively, that these modern developments *strengthen* the case for using citizenship as a basis for taxing individuals who live outside the United States.

Part I of this Article discusses the historical development of the United States' reliance on citizenship as a jurisdictional basis for taxation. By focusing on the contemporaneous justifications provided for the expansion and contraction of citizenship-based taxing jurisdiction, the historical analysis provides an important frame of reference for addressing citizenship-based taxation in the modern era. Part II pro-

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[9] For example, a recent op-ed article at washingtonpost.com begins with the warning that "[g]lobalization is sending tax rates tumbling across the world, as jobs and capital migrate across borders . . . . [This] makes it all the more imperative not only to roll back the recent tax increases on U.S. expatriates, but to eliminate double-taxation of overseas Americans altogether." Daniel J. Mitchell, Editorial, *Tax Me Once, Shame on You . . . Tax Me Twice and the System Needs Fixing*, WASHINGTONPOST.COM, June 28, 2006, http://www.washingtonpost.com/wp-dyn/content/article/2006/06/27/AR2006062701022.html. A *Wall Street Journal* op-ed piece appearing on the same day claimed that the taxation of citizens abroad "make[s] American business less competitive in the global economy." Newt Gingrich & Ken Kies, Editorial, *Our Taxed Expats*, WALL ST. J., June 28, 2006, at A14; *see also*, *The Tithes That Bind*, ECONOMIST, June 24, 2006, at 12–13 (citing globalization as principal reason for eliminating tax on citizens working abroad).

[10] International law generally focuses on "nationality" rather than "citizenship." As a technical matter, a person can be a national of a country yet not be a citizen, although under U.S. law the distinction has little practical relevance today. *See* Miller v. Albright, 523 U.S. 420, 467 n.2 (1998) (Ginsburg, J., dissenting) ("The distinction has little practical impact today . . . for the only remaining noncitizen nationals are residents of American Samoa and Swains Island."); *cf.* Alison Christians, *Taxing the Global Worker: Three Spheres of International Social Security Coordination*, 26 VA. TAX REV. 81, 105 n.102 (2006) (noting that several U.S. social security totalization agreements apply to both citizens and nationals). In accordance with the general usage in the Code, this article focuses on citizenship. Federal tax law generally relies on the Immigration and Nationality Act (INA) to determine whether a person is a citizen. *See* Treas. Reg. § 1.1-1(c) (as amended in 1974); Michael S. Kirsch, *The Tax Code as Nationality Law*, 43 HARV. J. ON LEGIS. 375, 380–83 (2006) (discussing historic reliance on INA). *But see id.* (criticizing recently enacted I.R.C. sections 877(g) and 7701(n), which in rare circumstances create special definitions of citizenship for tax purposes).

[11] *See supra* note 3.

vides a brief summary of recent economic, technological, and other changes in the international context, with particular emphasis on those factors relevant to the taxation of citizens abroad.

Part III considers a broad array of potential justifications for citizenship-based taxation. It concludes that developments in the past few decades strengthen, rather than weaken, the case for taxing the income of citizens abroad, regardless of whether the income is earned from working or arises from investments. Part IV addresses whether other considerations—specifically, concerns about American competitiveness in the twenty-first century global economy—warrant the exclusion of income earned by U.S. citizens working abroad. The analysis concludes that these concerns do not present a convincing case for the foreign earned income exclusion. Part V briefly discusses possible legislative proposals that flow from the analysis in the prior parts.

I
The Rise and (Partial) Fall of Citizenship-Based Taxation

While each country establishes its own income tax regime in accordance with its unique needs,[12] its choices reflect a significant amount of convergence regarding the parameters for taxing income that arises in an international setting. For example, all countries recognize (and most countries, including the United States, exercise) the right of a country to tax income of a foreign person that arises within the country's borders (so-called source-based taxation).[13] In addition, all countries recognize (and many countries, including the United States,[14] exercise) the right of a country to tax residents' income

12 As Professor Graetz observed in the general context of international tax policy, "Tax policy decisions, including decisions regarding a country's tax treatment of international income, should be, and inevitably are, decided based on a nation's capacity, culture, economics, politics, and history." Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev. 261, 279 (2001).

13 *See* Fed. Income Tax Project, Am. Law Inst., International Aspects of United States Income Taxation: Proposals on U.S. Taxation of Foreign Persons and of the Foreign Income of United States Persons 4–7 (1987); Restatement (Third) of the Foreign Relations Law of the United States § 411 & rep. notes (1987). Despite the unquestioned right to exercise source-based jurisdiction, some countries, including the United States, choose not to exercise that right with respect to certain income arising within their borders. For example, in order to encourage foreign persons to invest in U.S. portfolio debt securities and to hold U.S. bank deposits, the United States generally does not tax their interest income from these instruments. I.R.C. § 871(h)–(i) (West Supp. 2006).

14 *See* I.R.C. § 1 (West Supp. 2006) (establishing tax rates); Treas. Reg. § 1.1-1(b) (as amended in 1974). Section 1 of the Code does not differentiate among citizens, residents, and nonresidents, thereby implying that all individuals are subject to tax on all of their

(regardless of citizenship), even if that income arises outside of the country's borders (so-called residence-based taxation). Almost all countries ignore citizenship in creating taxing jurisdiction.[15]

The United States, however, has a long history of taxing citizens on at least some of their worldwide income, even if the citizen resides outside the United States and the income is from foreign sources. This Part examines the historical development of citizenship-based taxation, paying particular attention to the contemporaneous justifications given for the expansion and contraction of this jurisdictional exercise. This brief overview illustrates how the country's tax policy has responded to changing perceptions of citizens abroad, as well as changing developments in global economic affairs.

A. *Establishing Citizenship as a Jurisdictional Basis*

1. *Civil War Tax Acts*

Although historical analysis of the income tax (and the taxation of citizens abroad) usually begins with the enactment of the "modern" income tax in 1913,[16] citizenship-based income taxation of overseas Americans dates back to the Civil War. Congress enacted the first U.S. income tax in 1861, shortly after the outbreak of the war.[17] The

income. Other sections of the Code, however, make clear that only source-based taxation applies to nonresident alien individuals. I.R.C. § 2(d) (2000).

[15] *See* STAFF OF J. COMM. ON TAXATION, *supra* note 5, at app. B (describing other countries' practices); HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 347 (2d ed. 2004) ("Unlike other jurisdictions, the United States . . . asserts personal [taxing] jurisdiction based on citizenship."). As a practical matter, this statement must be qualified. Many countries, including Australia, Canada, Denmark, Finland, Italy, Norway, Spain, Sweden, and the United Kingdom, use expansive definitions of "resident" to continue to tax citizens who move abroad for temporary periods. *See* STAFF OF J. COMM. ON TAXATION, 108TH CONG., REVIEW OF THE PRESENT-LAW TAX AND IMMIGRATION TREATMENT OF RELINQUISHMENT OF CITIZENSHIP AND TERMINATION OF LONG-TERM RESIDENCY 140–48 (Comm. Print 2003) (explaining various regimes); AULT & ARNOLD, *supra*, at 351–53 (same); *see also* Charles I. Kingson, *A Somewhat Different View*, 34 TAX LAW. 737, 738 (1981) (pointing out that claims that "only the US does it" are slightly exaggerated); *cf.* Case C-513/03, Heirs of M.E.A. van Hilten, ¶¶ 45–52 (European Court of Justice Feb.23, 2006), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62003J0513:EN:HTML (upholding Dutch law that continues to treat national as resident for inheritance tax purposes for ten years after terminating residence).

[16] The 1913 tax was "modern" in the sense that it was enacted after ratification of the Sixteenth Amendment to the U.S. Constitution. An income tax has been in effect at all times since.

[17] Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 292, 309, *repealed by* Act of July 1, 1862, ch. 119, § 89, 12 Stat. 432, 473. Although a federal income tax had been proposed by the Secretary of the Treasury during the War of 1812, that proposal never became law. EDWIN R.A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD 430 (2d ed. 1914); Joseph A. Hill, *The Civil War Income Tax*, 8 Q.J. ECON. 416, 416 (1894). For early discussions of the legislative

statute taxed residents of the United States (including resident citizens) on their worldwide income, imposing a three percent rate on income in excess of eight hundred dollars.[18] In contrast, nonresident citizens were taxed only on income arising from "property, securities, or stock owned in the United States,"[19] but with no exemption amount and at a five percent rate.[20] Congress repealed the statute the following year, before any taxes were actually collected, and enacted a new one in its place.[21] The 1862 income tax statute[22] contained a similar distinction between citizens residing in the United States and those residing abroad.[23]

Because nonresident citizens were taxed only on their U.S. source income (rather than their worldwide income), these provisions appear to reflect a failure to assert citizenship-based jurisdiction. In context, however, the statutes reflect an attempt to ensure that citizens abroad paid their fair share of taxes under very roughly defined equity princi-

background of the Civil War tax acts, see SELIGMAN, *supra*, at 430–92; HARRY EDWIN SMITH, THE UNITED STATES FEDERAL INTERNAL TAX HISTORY FROM 1861 TO 1871, at 45–97 (1914); Hill, *supra*, at 416–44. For more recent treatments, see generally SIDNEY RATNER, TAXATION AND DEMOCRACY IN AMERICA 57–110 (1967); STEVEN R. WEISMAN, THE GREAT TAX WARS 9–104 (2002); Joe Thorndike, *An Army of Officials: The Civil War Bureau of Internal Revenue*, 93 TAX NOTES 1739 (2001).

18 Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 292, 309, *repealed by* Act of July 1, 1862, ch. 119, § 89, 12 Stat. 432, 473.

19 *Id.* Nonresident aliens were not taxed on their income arising from U.S. property.

20 *Id.*

21 Act of July 1, 1862, ch. 119, § 90, 12 Stat. 432, 473 (repealed 1865). Because no income tax was actually assessed under the 1861 legislation before its repeal, the 1862 Act is often viewed as the first income tax. *See* RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 9 (1954) (describing political pressure to enact effective income tax in 1862); SELIGMAN, *supra* note 17, at 435 (describing Treasury Secretary's reluctance to enforce 1861 law); Hill, *supra* note 17, at 423 ("Under [the 1862 legislation] the income tax first went into operation. The income tax sections of the act of 1861 had never been enforced, and were now repealed.").

22 The 1862 tax act was actually enforced. For a comprehensive history of the implementation of the Civil War tax administration apparatus, see generally Thorndike, *supra* note 17.

23 The 1862 legislation imposed progressive rates on persons (including citizens) residing in the United States: a three percent rate for persons with incomes up to $10,000, and five percent for incomes in excess of $10,000. Act of July 1, 1862, ch. 119, § 90, 12 Stat. 432, 473. In both situations, a person residing in the United States was allowed to exclude the first $600 of income. *Id.* With respect to citizens residing abroad, the 1862 Act imposed a five percent rate on all income arising from U.S. sources with no exemption amount. *Id.* Thus, for incomes up to $10,000, the nonresident citizen incurred a higher tax rate than did a resident citizen, while for incomes over $10,000, the rates were the same (although the nonresident citizen was not allowed to exclude the first $600 of income). *Cf.* CONG. GLOBE, 37th Cong., 2d Sess. 2486 (1862) (statement of Sen. Simmons) (suggesting, in response to ultimately unsuccessful attempt to add seven and one-half percent rate bracket for incomes over $50,000, that all income of citizens residing abroad should be taxed at that highest rate).

ples. In the context of the war and the realities of nineteenth-century communications and international relations, it would have been extremely difficult to collect tax on the foreign-source income of a domestic citizen, let alone a citizen living abroad.[24] The tax base from which the government could realistically collect taxes centered largely on income arising from property in the United States. By subjecting this income of citizens abroad to a higher rate and denying the exemption amount, the net result was a higher effective rate on citizens abroad than on those in the United States with respect to the income over which the United States could most easily collect tax.

A senator who served as a manager in the conference committee that adopted the 1861 tax law described the purpose of taxing citizens abroad at a higher rate:

> [A] distinction is made as to the income tax between resident citizens and non-resident citizens of the United States. We do not desire that our citizens who have incomes in this country . . . should go out of the country, reside in Paris or elsewhere, avoiding the risk of being drafted or contributing anything personally to the requirements of the country at this time, and get off with as low a tax as anybody else. The law . . . makes a difference to those persons of two percent in the income tax on account of the obligations which are avoided by those who reside abroad, and endured by those who stay at home. . . . If a man draws his income from our public debt, or from property here, and resides in Paris, skulking away from contributing his personal support to the Government in this day of its extremity, he ought to pay a higher income tax.[25]

Thus, the 1861 and 1862 legislation reflect a desire to make citizens abroad pay extra tax as a way to compensate for failing to contribute their personal efforts to the Union "in this day of its extremity."[26]

In 1864 Congress revised the tax laws to apply to income of "every person residing in the United States, or of any citizen of the United States residing abroad," regardless of whether the income arose "in the United States or elsewhere."[27] With this modification,

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24 As discussed *infra* Part III.A.3, these enforcement concerns still exist.

25 CONG. GLOBE, 38th Cong., 1st Sess. 2661 (1864) (statement of Sen. Collamer) (reflecting on 1862 legislation).

26 *Id.*; *cf.* RATNER, *supra* note 17, at 86 (referring in passing to 1862 Act's "invidious distinction" between rates on citizens living in United States and those living abroad). Congress could also have imposed the higher rate on citizens abroad "with the idea . . . that these citizens by spending their incomes in a foreign country were evading the taxes on consumption which our laws imposed." Hill, *supra* note 17, at 426; *see also* Thorndike, *supra* note 17, at 1746 n.49 (claiming that higher rate for overseas citizens compensated for U.S. consumption taxes avoided while living abroad).

27 Act of June 30, 1864, ch. 173, § 116, 13 Stat. 223, 281, *amended by* Act of Mar. 3, 1865, ch. 78, § 1, 13 Stat. 469, 479 (providing for tax collection until December 31, 1866)

the 1864 legislation eliminated the disparity in rates between residents and U.S. citizens abroad but extended the tax base for nonresident citizens to include foreign source income rather than just income arising in the United States. Thus, for the first time, Congress used citizenship as a jurisdictional basis for imposing income tax on an individual's worldwide income. Although the 1864 legislative record does not provide an explicit rationale for the move to worldwide taxation based on citizenship,[28] the shift occurred at a time when the meaning and importance of federal citizenship had seized the national consciousness.[29] Congress included similar provisions taxing the worldwide income of citizens abroad in subsequent amendments to the tax laws[30] until the Civil War–era income taxes eventually expired in 1872.[31] Ultimately, the Civil War–era statutes collected only a small amount of income tax from citizens residing abroad.[32]

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and Act of Mar. 2, 1867, ch. 169, § 13, 14 Stat. 471, 478 (providing for tax collection until December 31, 1868). Four days after the enactment of the 1864 Act, Congress passed an additional one-time five percent income tax on both "persons residing within the United States, [and] citizens of the United States residing abroad" in order to fund military enlistment bonuses. H.R.J. Res. 77, 38th Cong. (1864); SELIGMAN, *supra* note 17, at 446 (noting purpose of additional tax).

28 Senator Collamer, who preferred the 1862 legislation's approach (i.e., taxing only the U.S. source income of the citizen abroad, but at a higher rate) stated that he did "not know exactly upon what ground" the House proposed the 1864 approach. CONG. GLOBE, 38th Cong., 1st Sess. 2661 (1864). Senator Collamer did not address the possibility that a broader tax base (i.e., the inclusion of foreign source income of citizens abroad), while raising significant compliance and enforcement issues, might result in a greater relative tax liability than would a smaller tax base with a higher rate.

29 *See generally* ROGERS M. SMITH, CIVIC IDEALS: CONFLICTING VISIONS OF CITIZENSHIP IN U.S. HISTORY 243–346 (1997) (discussing changing views of federal citizenship during Civil War and Reconstruction eras). *See also* CONG. GLOBE, 38th Cong., 1st Sess. app. at 1 (1863) (message from President Lincoln) (discussing diplomatic problems that had arisen with respect to protecting U.S. citizens overseas); Act of July 27, 1868, ch. 249, § 3, 15 Stat. 223, 224 (emphasizing President's duty to intervene whenever foreign government unjustly deprives U.S. citizen of liberty).

30 *See* Act of Mar. 3, 1865, ch. 78, § 1, 13 Stat. 469, 479 (imposing five percent tax on income between $600 and $5000, and ten percent tax on income in excess of $5000); Act of Mar. 2, 1867, ch. 169, § 13, 14 Stat. 471, 478 (imposing five percent tax on income over $1000); Act of July 14, 1870, ch. 255, § 6, 16 Stat. 256, 257 (imposing 2.5% tax on income in 1870 and 1871).

31 The Act of July 14, 1870 lowered the previously existing rates and provided that the income tax would no longer apply after 1871. Act of July 14, 1870, ch. 255, § 6, 16 Stat. at 257.

32 According to the annual reports of the Commissioner of Internal Revenue, during the years 1863–65, citizens residing abroad paid only $230,470 of income taxes (out of a total $84,015,918 of income taxes paid by all taxpayers during those years). *See* SELIGMAN, *supra* note 17, at 480 tbl. 1 (compiling data from Commissioner of Internal Revenue annual reports). Because of the difficulty of estimating the relative actual incomes of citizens abroad and citizens within the United States during that period, it is not possible to determine the relative level of tax compliance of citizens abroad for those years.

2. *1894 Tax Act*

In 1894, more than twenty years after the Civil War income tax had expired, Congress again enacted an income tax.[33] Although the 1894 income tax was held to be unconstitutional the following year[34] and thus was never enforced,[35] it adopted an approach to citizenship-based taxation similar to the 1864 tax law, taxing the worldwide income of "every citizen of the United States, whether residing at home or abroad."[36]

During the brief legislative discussion over the language of the 1894 Act, Senator George Hoar stated that the purpose of the provision was to ensure that "if an American citizen went abroad and carried the protection of his country, of his citizenship with him, he did not escape its burdens."[37] Echoing the concerns that had been raised thirty years earlier,[38] Senator Hoar observed:

> There are a great many people, I am sorry to say, who go abroad for that very purpose [of avoiding tax], and some of them went abroad during the late [Civil W]ar. They lived in luxury, at the same time at less cost, in a foreign capital; they had none of the voluntary obligations which rest upon citizens, of charity, or contributions, or supporting churches, or anything of that sort, and they escaped taxation.[39]

Thus, the legislative history of the Civil War tax acts and the 1894 legislation reflect unfavorable views of citizens living abroad, portraying them as living in luxury while avoiding the burdens of citizenship. Unlike the original tax acts in 1861 and 1862, which purported to penalize citizens abroad by subjecting some of their income to higher rates, the subsequent nineteenth-century provisions focused on equity, attempting to ensure that citizens abroad did not receive more favorable tax treatment than those at home.

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33 Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 509, 553, *invalidated by* Pollack v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895).

34 *See Pollack*, 158 U.S. at 637 (holding entire income tax scheme invalid because certain aspects, unrelated to taxation of citizens abroad, violated Apportionment Clause).

35 *See* Charlotte Crane, *The Income Tax and the Burden of Perfection*, 100 Nw. U. L. Rev. 171, 171 & n.2 (2006) (describing delay in 1894 Act's enforcement pending Supreme Court decision on its validity).

36 § 27, 28 Stat. at 553.

37 26 Cong. Rec. 6632 (1894) (statement of Sen. Hoar); *cf. id.* at 6632–33 (discussing change in statutory language to clarify that tax applied to citizens "whether residing at home or abroad").

38 *See supra* text accompanying note 25.

39 26 Cong. Rec. 6632–33 (1894) (statement of Sen. Hoar).

3. *The "Modern" Income Tax*

Shortly after the ratification of the Sixteenth Amendment in 1913, Congress enacted the first "modern" income tax. Continuing the tradition of the 1864 and 1894 laws, the 1913 Act applied to "every citizen of the United States, whether residing at home or abroad," imposing tax on "the entire net income arising or accruing from all sources."[40] All subsequent versions of the federal tax laws have continued to use citizenship as a jurisdictional basis for taxing worldwide income.[41]

Unlike the earlier income tax provisions applicable to citizens abroad that generated little attention, the relevant provisions of the 1913 Act and subsequent legislation were taken more seriously by tax authorities and taxpayers.[42] Several factors might explain the heightened attention given to these provisions. One factor is the very different position in international affairs the United States occupied in

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40 Act of Oct. 3, 1913, ch. 16, § II(A)(1), 38 Stat. 114, 166.

41 *See, e.g.*, Revenue Act of 1916, ch. 463, § 1(a), 39 Stat. 756, 756 (repealed 1918) (taxing both citizens and residents of United States); Revenue Act of 1918, ch. 18, § 210, 40 Stat. 1057, 1062 (1919) (same); Revenue Act of 1921, ch. 136, § 210, 42 Stat. 227, 233 (repealed 1924) (same). When the federal income tax laws were codified as the Internal Revenue Code of 1939, and later as the Internal Revenue Codes of 1954 and 1986, the general use of citizenship as a jurisdictional basis to tax was retained. *See* Internal Revenue Code of 1939, ch. 2, §§ 11, 211, 53 Stat. 1, 5, 75 (superseded by Internal Revenue Code of 1954) (imposing tax on all individuals, with section 211 setting out guidelines and limitations for nonresident aliens); Internal Revenue Code of 1954, ch. 736, § 1, 68A Stat. 3, 5 (imposing tax on all individuals, while maintaining certain exemptions permitted in I.R.C. § 2(d) (2000) for nonresident aliens); Tax Reform Act of 1986, Pub. L. No. 99-514, § 1, 100 Stat. 2085, 2096–99 (codified as amended at I.R.C. § 1 (West Supp. 2006)) (same); *see also supra* note 14 (noting that source-based taxation only applies to nonresident alien individuals, not citizens).

42 *See infra* notes 47–65 and accompanying text. The citizenship-based tax provision of the 1913 Act also received attention from U.S. diplomatic officials. Under the then-existing nationality law, a citizen was presumed to have abandoned U.S. citizenship if he resided abroad for a protracted period, unless he overcame the presumption with "satisfactory evidence." ROGER FOSTER, A TREATISE ON THE FEDERAL INCOME TAX UNDER THE ACT OF 1913, at 153 n.5 (2d ed. 1915). Soon after enactment of the 1913 Act, Secretary of State William Jennings Bryan informed consular officers overseas that payment of income tax liability was a relevant factor in determining whether a person could overcome this presumption and therefore obtain a passport or receive consular protection. Letter from W.J. Bryan, Sec'y of State, to The American Diplomatic and Consular Officers (Mar. 18, 1914), *in* FOSTER, *supra*, at 153 n.5. For earlier examples of the Secretary of State treating nonpayment of taxes as a factor in determining abandonment of citizenship, and therefore denying a person U.S. consular protection, see PRENTISS WEBSTER, A TREATISE ON THE LAW OF CITIZENSHIP IN THE UNITED STATES 221–22 (Albany, Matthew Bender 1891). Today, as a result of the Supreme Court's decision in *Afroyim v. Rusk*, 387 U.S. 253 (1967), a person no longer can lose U.S. citizenship merely by committing a particular act, unless the act is done with the intention to lose citizenship. *See generally* Kirsch, *supra* note 10, at 381–83 (describing current constitutional, statutory, and administrative procedures for renouncing U.S. citizenship).

1913 than it had during the Civil War era. During the earlier period, the country was not yet a major power; indeed, it was struggling for its very existence. In contrast, by 1913, and particularly after World War I, the United States had become a significant world power that was more engaged in international business and political affairs.[43] Consequently, many U.S.-based manufacturing corporations that were attempting to expand sales into foreign markets took an interest in the tax treatment of the U.S. citizens they employed abroad. Another important factor concerned the machinery of tax administration. During the Civil War era, significant effort was needed to create a basic tax enforcement agency,[44] whereas an existing tax collection agency already was in place in 1913.[45]

Because the United States taxed the worldwide income of its citizens and residents, the potential for multiple taxation existed.[46] In particular, if a U.S. taxpayer had income from foreign sources, that foreign country might impose its own tax under source-based principles. In the Revenue Act of 1918,[47] Congress enacted a credit for foreign taxes paid by a U.S. taxpayer. The House debate over this legislation indicates that the foreign tax credit was enacted not only out of a sense of fairness,[48] but also to maintain the competitiveness of U.S. corporations and to eliminate an incentive for U.S. citizens to

[43] Even during the late-nineteenth century, some U.S.-based companies had already begun expanding abroad. *See infra* note 106 (discussing Singer Sewing Machine Company). Even by the time of the short-lived 1894 tax act, tax policymakers were comparing the "former times" when things were relatively "simple" with the "modern" times of increasing capital and labor mobility. EDWIN R.A. SELIGMAN, ESSAYS IN TAXATION 98–99 (Augustus M. Kelley Publishers 1969) (1895).

[44] Indeed, the original 1861 income tax failed principally because of a lack of an effective collection and enforcement mechanism. *See* SELIGMAN, *supra* note 17, at 435 (noting income tax provisions of 1861 Act were never enforced); Hill, *supra* note 17, at 423 (same).

[45] For example, the Bureau of Internal Revenue already was enforcing the Corporation Excise Tax Act of 1909. *See* Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 132–33 (1990) (describing Bureau's role in enforcing 1909 legislation); *cf.* SELIGMAN, *supra* note 17, at 529 (having learned from slow administrative start-up during Civil War era, Commissioner of Internal Revenue had made "comprehensive preparations" in anticipation of 1894 Act, but those efforts became moot due to Supreme Court's prompt invalidation of 1894 Act). Of course, even with improved administrative capabilities, significant enforcement issues remained inherent in collecting tax from citizens residing abroad. *See infra* notes 228–32 and accompanying text.

[46] Numerous commentators focused on this potential for double taxation soon after the enactment of the 1913 statute. *See, e.g.*, SELIGMAN, *supra* note 17, at 517–18 (basing opposition to citizenship-based taxation, in part, on potential for multiple taxation).

[47] Revenue Act of 1918, ch. 18, § 222(a), 40 Stat. 1057, 1073 (1919) (repealed 1921).

[48] The foreign tax credit was referred to as a "just provision." 56 CONG. REC. app. at 677–78 (1918) (statement of Rep. Kitchin); *see also* Graetz, *supra* note 12, at 296 (quoting recollections of T.S. Adams, influential figure in adoption of foreign tax credit).

renounce their citizenship.[49] The foreign tax credit remains a fundamental part of U.S. income tax law today, although in much altered form.[50]

The foreign tax credit reflects an acknowledgment that the country in which income arises has the first claim on taxing that income, and that a country exercising residence-based (or citizenship-based) taxation will only collect tax on that foreign income to the extent the source country does not. As a result of the foreign tax credit, U.S. taxpayers who pay relatively high rates of foreign income tax on their foreign-source income owe little or no residual U.S. income tax on that income.[51] However, U.S. taxpayers who pay relatively low rates of foreign income tax on their foreign-source income would owe residual U.S. tax on that income even after claiming the credit.

4. *Constitutional Validation*

The Supreme Court's 1924 decision in *Cook v. Tait*[52] marked the final stage in the establishment of U.S. citizenship as a jurisdictional basis to impose income tax. A U.S. citizen residing in Mexico challenged Congress's power to tax his income arising in Mexico.[53] In upholding the tax, the Court stated that the power to tax did not depend on the situs of the property or the domicile of the citizen but is instead based "upon his relation as citizen to the United States and the relation of the latter to him as citizen."[54] In explaining that relationship, the court focused on the benefits of citizenship, observing that "the government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete."[55]

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[49] 56 CONG. REC. app. at 677–78 (1918) (statement of Rep. Kitchin). Soon after the enactment of the 1913 Act, the *New York Times* reported that the new tax law had induced several individuals residing abroad to renounce their U.S. citizenship and obtain citizenship in their countries of residence. *To Become British Because of Tax*, N.Y. TIMES, Mar. 7, 1914, at 4.

[50] *See* I.R.C. §§ 901, 903–904 (2000) (setting out credit allowance and limitations).

[51] Indeed, because of the broad manner in which the original foreign tax credit was structured, such a taxpayer might also have been able to use the foreign tax credit to minimize his U.S. income tax on his U.S.-source income. In 1921 Congress enacted a limitation on the foreign tax credit in order to address this problem. Revenue Act of 1921, ch. 136, § 222(a)(5), 42 Stat. 227, 249 (repealed 1924); *cf.* I.R.C. § 904 (setting out current version of foreign tax credit limitation, under which potential tax planning benefits remain).

[52] 265 U.S. 47 (1924).

[53] *Id.* at 54. The tax had been imposed under the Revenue Act of 1921, ch. 136, § 210, 42 Stat. 227, 233 (repealed 1924) (cited in *Cook*, 265 U.S. at 53).

[54] *Cook*, 265 U.S. at 56.

[55] *Id.*

B. Eighty Years of Exceptions

With the global spread of U.S. business interests after World War I, affected taxpayers launched active political campaigns against U.S. taxes on overseas activities,[56] targeting citizenship-based taxation. For example, in 1923 the Associated American Chambers of Commerce of China adopted a resolution criticizing the tax's practical impact on business interests and competition.[57] It noted that other governments did not require their citizens abroad to pay income taxes and that "[t]he handicap which this places upon the American citizen in his competition with the British, Japanese, French, German and other foreigners interested in foreign trade in this part of the world is self-evident."[58] The resolution concluded with a call for "Congress in framing the next Revenue Bill [to] exempt Americans residing overseas and deriving their income from non-American sources from the operation of current domestic income tax law."[59] As this resolution illustrates, although the early arguments criticized the tax's impact on business operations, the requested relief was phrased in terms of exempting citizens abroad from all U.S. income tax, rather than just tax on foreign earned income.[60]

After legislative hearings in which business interests emphasized the importance of keeping American business competitive in the world economy,[61] Congress provided very generous relief in the Revenue Act of 1926.[62] A U.S. citizen was allowed to exclude all "earned

[56] *See* 67 CONG. REC. 3782 (1926) (statement of Richard P. Momsen, president of American Chamber of Commerce for Brazil) (noting that affected taxpayers began emphasizing congressional action after their defeat in courts).

[57] *See* Am. Chamber of Commerce of the Phil. Is., *American Chambers of China Approve Income Tax Stand*, 3 AM. CHAMBER OF COM. J. (Manila), Dec. 1923, at 9.

[58] *Id.* According to a study conducted in the early 1920s by the National Foreign Trade Council (NFTC), the United States at the time was the only country that taxed its nationals abroad on income that they earned from working in their country of residence. *See Revenue Revision, 1925: Hearing Before the H. Comm. on Ways & Means*, 69th Cong. 178 (1925) [hereinafter *1925 Ways & Means Hearing*] (statement of O.K. Davis, NFTC representative).

[59] Am. Chamber of Commerce of the Phil. Is., *supra* note 57, at 9.

[60] *See* Am. Chamber of Commerce of the Phil. Is., *Congressman Dyer Addresses Chamber*, 3 AM. CHAMBER OF COM. J. (Manila), Mar. 1923, at 7 (summarizing position of Congressman L.C. Dyer that "the American trader abroad should be relieved of all domestic taxes, particularly the income tax").

[61] The NFTC representative, after emphasizing the new importance of foreign trade, criticized national policies, such as the taxation of citizens abroad, that "hamper and restrict" the sales of U.S.-produced goods abroad. *1925 Ways & Means Hearing*, *supra* note 58, at 180–81 (statement of O.K. Davis); *see also* 67 CONG. REC. 3782 (1926) (statement of Richard P. Momsen, president of American Chamber of Commerce for Brazil) (describing negative impact of national policies on American business abroad).

[62] Revenue Act of 1926, ch. 27, § 213(b)(14), 44 Stat. 9, 24–26. For evidence that the Senate might have agreed to an unlimited exclusion at least in part because of misstate-

income" received from sources outside the United States, provided that the individual was a bona fide nonresident of the United States for more than six months of the taxable year.[63] Earned income included any "wages, salaries, professional fees, and other amounts received as compensation for personal services."[64] Thus, despite the strong focus on foreign trade during the legislative hearings, the final legislation covered a broad range of income from the performance of services and was not limited to income derived from the sale abroad of U.S.-produced goods.[65]

The testimony supporting the 1926 foreign earned income exclusion painted a very different picture of citizens abroad than had the Civil War and 1894 legislative debates. Whereas earlier discussions had focused on independently wealthy individuals residing abroad for personal pleasure (or even tax avoidance),[66] the 1926 testimony described an army of hardworking salesmen moving abroad, often at great personal discomfort and sacrifice,[67] in order to expand their U.S. employers' (and, accordingly, America's) interests throughout the world.[68]

Following the enactment of the unlimited foreign earned income exclusion in 1926, Congress embarked on a still-ongoing struggle with the provision. Although at times this debate has centered on whether to repeal the exclusion,[69] most of the legislative activity has focused

ments by the Chairman of the Finance Committee regarding its effects, see ELISABETH A. OWENS, THE FOREIGN TAX CREDIT 549–50 (1961).

63 Revenue Act of 1926 § 213(b)(14).

64 Revenue Act of 1926 § 209(a)(1).

65 *See* H. COMM. ON WAYS & MEANS, 95TH CONG., RECOMMENDATIONS OF THE TASK FORCE ON FOREIGN SOURCE INCOME 16 (Comm. Print 1977) (noting irony of fact that 1926 law was called "foreign trader" exemption, although it was not limited to U.S. citizens working abroad to sell U.S.-made goods).

66 *See supra* notes 25, 37–39 and accompanying text.

67 The NFTC representative testified that "it has always been difficult to induce competent Americans to take up long residence abroad in such countries. They know just as well as we do that this is God's country, and they would rather live here." *1925 Ways & Means Hearing*, *supra* note 58, at 182 (statement of O.K. Davis).

68 This shift in attitude was evident in remarks by a U.S. Congressman speaking to U.S. business representatives in the Philippines a few years earlier. Reports of the speech described the Congressman as stating:

> The old notion that the American who goes abroad to do business must have something wrong with him . . . no longer holds with a great majority of the American people. He is no longer regarded as acting from some unworthy motive, but is looked upon as a trade emissary and as such entitled to every encouragement.

Am. Chamber of Commerce of the Phil. Is., *supra* note 60, at 7.

69 *See* Walter A. Slowinski & B. John Williams, Jr., *The Formative Years of the Foreign Source Earned Income Exclusion: Section 911*, 51 TAXES 355, 355 (1973) (observing that "whenever one of the houses of Congress proposed elimination or drastic alteration of Section 911 or its predecessors, the other house restored the exclusion"). As recently as

on defining its contours.[70] The changes have focused on eligibility for relief,[71] the amount of earned income that can be excluded,[72] and issues concerning administration and potential abuses.[73]

For a brief period, from 1978 through 1981, Congress experimented with an alternative to the foreign earned income exclusion approach.[74] Under the 1978 legislation, Congress continued to

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2003 the Senate passed legislation that would repeal the exclusion. *See* H.R. 2, 108th Cong. § 350 (as passed by Senate, May 15, 2003) (incorporating S. 1054). The repeal was dropped by the Conference Committee. *See* H.R. REP. No. 108-126, at 132–33 (2003) (Conf. Rep.).

[70] The details of these statutory changes to the provision (section 911 of the current Internal Revenue Code) have been described elsewhere. *See* OWENS, *supra* note 62, at 547–52 (legislative history from 1926 through 1960); Pamela B. Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 TAX L. REV. 1, 60–61 & n.176 (1982) (legislative history from 1926 through 1980); Slowinski & Williams, *supra* note 69, at 356–62 (legislative history from 1926 through 1966); Renée Judith Sobel, *United States Taxation of Its Citizens Abroad: Incentive or Equity*, 38 VAND. L. REV. 101, 119–46 (1985) (legislative history from 1926 through 1981).

[71] Eligibility for relief has usually hinged on the amount of time that a person spends abroad and whether the person is a bona fide resident of a foreign country. *See* Revenue Act of 1942, ch. 619, § 148(a), 56 Stat. 798, 841–42 (tightening eligibility by requiring that taxpayer be "bona fide resident of a foreign country" and increasing length of time to be spent abroad from six months to one year); Revenue Act of 1951, ch. 521, § 321(a), 65 Stat. 452, 498 (loosening eligibility requirements by providing alternative standard for individuals who were physically present in foreign country or countries for at least 510 days—approximately seventeen months—during an eighteen-month period). The alternative standard added in 1951 was directed at technicians and other skilled workers who might go abroad for a particular long-term project but not have the requisite intent to become bona fide residents of the foreign country. *See* Slowinski & Williams, *supra* note 69, at 359.

[72] The issue has been whether the exclusion should be unlimited, as it was for some citizens from 1926 through 1962, or whether it should be capped at a specific dollar amount as it generally has been since 1962. *See 1925 Ways & Means Hearing*, *supra* note 58, at 178 (question by Rep. Hull) (suggesting limit to exclusion); Technical Changes Act of 1953, ch. 512, § 204(a), 67 Stat. 615, 618 (capping exclusion at $20,000 for citizens claiming eligibility through physical presence test); Revenue Act of 1962, Pub. L. No. 87-834, § 11(a), 76 Stat. 960, 1003–04 (capping exclusion at $20,000 per year for first three years and at $35,000 thereafter for citizens claiming eligibility through bona fide residence test); Revenue Act of 1964, Pub. L. No. 88-272, § 237(a), 78 Stat. 19, 128 (lowering $35,000 cap to $25,000); Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(a), 90 Stat. 1520, 1610 (lowering caps to $15,000).

[73] *See* Technical Amendments Act of 1958, Pub. L. No. 85-866, § 72(b), 72 Stat. 1606, 1660 (amending I.R.C. § 6012(c)) (requiring filing of tax return by individuals with gross income of at least $600 to ensure compliance with foreign earned income exclusion); Revenue Act of 1962, Pub. L. No. 87-834, § 11(a), 76 Stat. 960, 1005 (codified as amended at I.R.C. § 6012 (Supp. 2002)) (ensuring that taxpayer takes consistent position in United States and foreign country regarding bona fide residence status); Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(b)(1), 90 Stat. 1520, 1610 (eliminating foreign tax credit for excluded foreign earned income); Tax Reform Act of 1976 § 1011(b)(3) (modifying tax calculation to tax included income at marginal rate that would have applied had no earned income been excluded).

[74] The Foreign Earned Income Act of 1978 was the result of extensive congressional hearings in the wake of complaints that the 1976 legislation, which had significantly low-

acknowledge that citizens living outside the United States should receive some kind of tax relief. However, instead of providing an exclusion for foreign earned income, Congress required all income to be included and allowed deductions targeted at five specific areas reflecting the potentially higher costs of living abroad: cost-of-living differentials, housing expenses, schooling expenses, home leave travel expenses, and hardship area pay.[75]

As a practical matter, the targeted relief of the 1978 provisions generally increased the tax benefits available to taxpayers in low-tax, high-cost jurisdictions.[76] However, those in low-tax, low-cost areas received less relief than they had been receiving under the pre-1976 earned income exclusion.[77] In response to complaints from this latter group that the new rules handicapped U.S. businesses by failing to give sufficient tax relief[78] and general dissatisfaction with the complexity of the regime,[79] Congress reinstated the foreign earned income exclusion in 1981.[80] In its new form, the provision was much more generous than the pre-1978 legislation had been. The provision raised the exclusion limitation to $75,000 and scheduled the limitation to increase to $95,000 by 1986.[81] For individuals whose foreign earned income exceeded this limitation, the legislation allowed an additional exclusion for the amount of "excess" housing costs above a threshold level.[82]

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ered the exclusion limits and added other limitations, was too restrictive. *See* Gann, *supra* note 70, at 61 n.176. Because of concerns about the 1976 legislation, Congress subsequently delayed its effective date until it was replaced by the 1978 legislation. *Id.* In 1978 taxpayers had the option of applying either the lower exclusion of the 1976 law, or the targeted deductions of the 1978 law.

75 *See* Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, § 203(a), 92 Stat. 3097, 3100 (1978), *repealed by* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 112(a), 95 Stat. 172, 194. Under the 1978 legislation, a citizen living and working in a designated hardship area could exclude $20,000. *See* Tax Treatment Extension Act of 1977 § 202(a) (amending I.R.C. § 911). Alternatively, the citizen could claim other deductions as well as an additional $5000. *See* § 203(a) (adding I.R.C. § 913(h)).

76 *See* U.S. DEP'T OF THE TREASURY, TAXATION OF AMERICANS WORKING OVERSEAS: THE OPERATION OF THE FOREIGN EARNED INCOME EXCLUSION IN 1983, at 7 (1989).

77 *Id.*

78 *See* Sobel, *supra* note 70, at 138–40 (describing political pressure to reinstate foreign earned income exclusion).

79 *Id. But cf.* Philip F. Postlewaite & Gregory E. Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for Its Repeal*, 65 VA. L. REV. 1093, 1095, 1114–15 (1979) (arguing that 1978 legislation was too beneficial to taxpayers and that all special exclusions and deductions for citizens residing overseas should be repealed).

80 Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 111(a), 95 Stat. 172, 190–94 (codified as amended at I.R.C. § 911 (West Supp. 2006)).

81 *Id.*

82 *Id.*

C. Recent Developments

The basic structure of the foreign earned income exclusion created in 1981 remains in effect today.[83] However, as a result of subsequent budgetary concerns, the exclusion limitation has never reached the anticipated sum of $95,000. Instead, through a series of legislative changes, the limitation has fluctuated between $70,000 and $80,000 for the past twenty-five years.[84]

In May 2006, Congress enacted several changes to section 911, the foreign earned income exclusion, as a last-minute revenue raiser for an unrelated tax bill.[85] These changes provided a small benefit to taxpayers by accelerating cost-of-living adjustments, thereby increasing the exclusion limitation from $80,000 to $82,400 in 2006.[86] However, the law simultaneously reduced benefits in two ways. First, the legislation modified the tax calculation so that any income that remains taxable after application of the exclusion will be taxed at the marginal rates that would have applied had no earned income been excluded.[87] Second, it imposed a cap on the additional exclusion for

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[83] *See* I.R.C. § 911 (West Supp. 2006) (describing exclusion).

[84] Economic Recovery Act of 1981 § 111(a) (establishing $75,000 limitation for 1982 and $80,000 limitation for 1983); Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 17, 98 Stat. 494, 505 (stabilizing limitation at $80,000 through 1987); Tax Reform Act of 1986, Pub. L. No. 99-514, § 1233(a), 100 Stat. 2085, 2564 (reducing limitation to $70,000 after 1987); Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1172(a)(1)–(2), 111 Stat. 788, 988 (increasing limitation to $72,000 in 1998 and scheduling $2000 annual increases until it reached $80,000 in 2002, where it was scheduled to remain until 2008, when cost-of-living increases would begin).

[85] Tax Increase Prevention and Reconciliation Act of 2005 § 515; *see also* Keith Bradsher & David Cay Johnston, *Americans Living Abroad Get a Nasty Tax Surprise*, N.Y. TIMES, May 30, 2006, at C3 (stating that "[i]n an effort to raise revenues," Congress had added "a last-minute provision . . . [t]he suddenness of [which] meant that [lobbying groups] did not have a chance to mobilize against the idea as they had in previous sessions of Congress"). These changes were based on recommendations by the staff of the Joint Committee on Taxation. *See* STAFF OF J. COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 174–77 (Comm. Print 2005).

[86] I.R.C. § 911(b)(2)(D); Rev. Proc. 2006-51, 2006-47 I.R.B. 945–46 (explaining that increase resulted from statute's acceleration to 2006 of cost-of-living adjustments that previously had been scheduled to begin in 2008); *see also* Press Release, Senate Comm. on Fin., Background Fact Sheet on Section 911 (May 25, 2006), *available at* http://finance.senate.gov/press/Gpress/2005/prg052506.pdf (describing 2006 amendments generally).

[87] I.R.C. § 911(f). This is the same approach that had been adopted in the 1976 legislation before its repeal in 1978. *See supra* note 73.

"excess" housing costs.[88] The cap was $11,536 for 2006 and is subject to future cost-of-living adjustments.[89]

Because this change will potentially have a significant impact on those citizens residing in foreign countries with relatively low taxes and high housing costs,[90] the legislation authorizes the Treasury Department to provide relief in such circumstances by issuing "regulations or other guidance providing for the adjustment of the [maximum housing cost exclusion] on the basis of geographic differences in housing costs relative to housing costs in the United States."[91] A Senate Finance Committee press release stated that this provision was included so that the "Treasury can appropriately address the concerns of those living and working in higher-housing-cost locations like Hong Kong, Paris or Dubai."[92] The IRS published guidance under this provision in October 2006,[93] establishing significantly higher housing expense caps for individuals residing in many high-cost foreign locales.[94]

[88] I.R.C. § 911(c) (West Supp. 2006). Under prior law, the only limitation on the foreign housing cost exclusion was that the housing expenses be "reasonable" (i.e., not "lavish or extravagant"), I.R.C. § 911(c)(2)(A), and that the total of the foreign earned income exclusion and housing cost exclusion not exceed the taxpayer's foreign earned income, I.R.C. § 911(d)(7).

[89] The maximum housing cost exclusion equals thirty percent of the $82,400 general exclusion amount ($24,720), minus a floor of sixteen percent of the $82,400 general exclusion amount ($13,184), resulting in a $11,536 maximum exclusion. *See* I.R.C. § 911(c). The $13,184 nonexcludable floor "represents an estimate of housing costs that taxpayers would incur on housing regardless of whether they decided to live and work abroad." Press Release, Senate Comm. on Fin., *supra* note 86. The legislation also made technical changes to the way the floor is calculated. *See* I.R.C. § 911(c)(1)(B)(i) (calculating floor as function of exclusion limitation amount rather than as function of government employee salary levels).

[90] Those citizens living in high-tax jurisdictions, such as much of Europe, do not rely as heavily on the foreign earned income exclusion because the U.S. foreign tax credit eliminates much or all of their U.S. tax liability. *See* Bradsher & Johnston, *supra* note 85; Tom Herman & Jane Spencer, *U.S. Expatriates Puzzle over New Tax Rule*, WALL ST. J., Oct. 11, 2006, at D1 (noting that American citizens working in Europe are unlikely to be affected by recent changes to foreign earned income exclusion).

[91] I.R.C. § 911(c)(2)(B).

[92] Press Release, Senate Comm. on Fin., *supra* note 86.

[93] I.R.S. Notice 2006-87, 2006-43 I.R.B. 766; *see also* I.R.S. Notice 2007-25, 2007-12 I.R.B. 760 (modifying and supplementing I.R.S. Notice 2006-87). The housing expense amounts in the guidance are based on Living Quarters Allowance tables prepared by the State Department for overseas foreign service personnel. I.R.S. Notice 2006-87.

[94] For example, U.S. citizens residing in Hong Kong (the highest-cost jurisdiction identified in the guidance) can exclude $101,116 of housing expenses, in addition to the general $82,400 foreign earned income exclusion amount. I.R.S. Notice 2006-87, 2006-43 I.R.B. 768 (setting housing expense limitation for Hong Kong at $114,300); I.R.C. § 911(c)(1)(B) (West Supp. 2006) (setting $13,184 floor). Although the guidance provides increased housing expense limits for many foreign locales, it is not comprehensive. For example, no

Organizations and lobbyists representing overseas citizens and multinational corporations reacted quickly to the unfavorable 2006 legislative changes.[95] Numerous articles and op-ed pieces emphasized that, in an era of globalization, the taxation of citizens outside the United States—in particular those who are working abroad for U.S. companies—is harmful to U.S. businesses and the U.S. economy, and that the 2006 changes exacerbated this problem.[96] In response, at least one bill was introduced in Congress to provide an unlimited exclusion for U.S. citizens' foreign earned income,[97] and a *Washington Post Online* op-ed piece optimistically claimed that the bill had "a decent chance of getting enacted in the next two years."[98]

II
The Changing Landscape

Groups opposed to the taxation of citizens abroad would like Congress to reconsider the issue. As reflected in the response to the 2006 legislation, these groups are likely to emphasize modern developments in the global economy and the United States' role in it. Advocates will claim that the United States must either eliminate citizenship-based taxation or, at least, exclude all income earned by U.S. citizens working abroad in order to enable America to compete in the modern global economy. Given the many changes in the global economy since Congress enacted the existing framework more than a quarter century ago, a debate over the proper scope of citizenship-based taxation might be useful.[99]

However, it is important that statements regarding globalization do not become bromides justifying the uncritical abandonment of, or significant retreat from, longstanding U.S. tax principles. This Part briefly summarizes the relevant changes that have occurred in the past few decades, particularly as they relate to the factors that influenced

Russian cities other than Moscow are included. Brian Knowlton, *New Rules Grant Tax Relief to Some American Expats*, Int'l Herald Trib., Oct. 12, 2006, at 4.

[95] *See* Am. Chamber of Commerce in H.K., *supra* note 5, at 2 (urging revision of section 911); Brian Knowlton, *Cap For Expat Taxes Is Lifted in New Plan: U.S. Firms Would Benefit, Senator Says*, Int'l Herald Trib., June 15, 2006, at 5 (describing lobbying efforts of American Business Council of Gulf Countries and other organizations).

[96] *See supra* note 9.

[97] S. 3496, 109th Cong. § 2 (2006).

[98] *See* Mitchell, *supra* note 9.

[99] As the *ABA Task Force Report* recently observed in a broader context, "[o]ur international tax rules need to take account of the economic and political context in which they are applied, including our relations with other countries and their peoples." *ABA Task Force Report*, *supra* note 1, at 657; *see also* Graetz, *supra* note 12, at 334 ("The taxation of wages earned abroad . . . merits reexamination in light of the increasing mobility of workers.").

Congress's treatment of citizenship-based taxation in earlier generations. This Part does not purport to engage in a comprehensive analysis of these changes. Rather, it highlights the changes that are relevant to the arguments for and against citizenship-based taxation.

The recent *ABA Task Force Report* provides a succinct summary of many of the relevant economic and political changes that affect international tax policy:

> Over the last half century, elimination of exchange controls and adoption of free exchangeability of currencies, increasingly efficient global capital markets, revolutions in communications and information processing, reductions in barriers to trade and movements of people, and faster and cheaper transportation of goods and people have contributed to a reconfiguration of our economy and its relationship to the global economy. The transaction costs of cross-border economic activity have been dramatically reduced.[100]

When Congress first adopted the foreign earned income exclusion in 1926, it did so with a particular business model in mind: U.S. companies employing U.S. workers in the United States to manufacture tangible goods, which U.S. citizen-salesmen abroad would sell in foreign markets.[101] Indeed, during the course of his Ways and Means Committee testimony, the principal witness representing U.S. business interests repeatedly clarified that the foreign earned income exclusion envisioned this model: "I am interested, sir, solely in Americans who are promoting in foreign countries the foreign trade of the United States. . . . They are the only people that I am interested in . . . . The ones that are promoting the sale in foreign countries of the products of American labor here at home."[102] This same paradigm served as an underlying premise in subsequent congressional reconsiderations of the foreign earned income exclusion, including the most recent major revisions in the late 1970s and early 1980s.[103]

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100 *ABA Task Force Report*, *supra* note 1, at 657.

101 *See supra* notes 66–68 and accompanying text.

102 *1925 Ways & Means Hearing*, *supra* note 58, at 177 (statement of O.K. Davis, NFTC representative). In expressing agreement with Davis, Representative John Nance Garner clarified that the premise underlying the exclusion was "that Americans would become business men in foreign countries, therefore selling a larger proportion of American goods." *Id.*

103 *See* S. REP. NO. 97-144, at 35–36 (1981), *quoted in* Gann, *supra* note 70, at 62 n.179; OWENS, *supra* note 62, at 551 ("The arguments of the proponents of the exemption in 1942 were not substantially different from what they had been in 1926, although they were presented in much greater detail."); Slowinski & Williams, *supra* note 69, at 362 ("In 1973, with emphasis on export expansion, it should be noted that many U.S. citizens are working abroad to build markets for U.S. manufactured products and services. They should be encouraged because U.S. marketing and selling techniques are still among the best in the world.").

The recent *ABA Task Force Report* observed that "[i]nternational tax rules based on a paradigm of property being manufactured and sold do not readily accommodate the deconstruction of economic functions that characterizes modern business."[104] The report explained that "[s]ervices are outsourced to related or unrelated providers[, and m]anufacturing is performed at multiple locations, using related or unrelated vendors and employing just-in-time inventory and modern logistics."[105] Although the report was not discussing the foreign earned income exclusion specifically, its description of how modern business has shifted away from the old paradigm is relevant for purposes of the citizenship-based taxation inquiry. In particular, the fact that a company is incorporated in the United States does not per se imply that its products are necessarily manufactured in the United States or that its income generated outside the United States through the performance of services will make its way into the U.S. economy.[106]

This "deconstruction of economic functions" has also evolved in tandem with a globalization of corporate management and ownership for many companies. Whereas an "American" company in the 1920s would typically have been incorporated in the United States, had its management and headquarters in the United States, and have been owned primarily by U.S. persons, an "American" company today often looks nothing like this.[107] Consequently, an approach that treats

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[104] *ABA Task Force Report*, *supra* note 1, at 658.

[105] *Id.*

[106] The purported unity of interests did not always exist even in 1926 when Congress relied on the traditional paradigm as a reason for enacting the foreign earned income exclusion. During the Ways and Means Committee hearing, the only company explicitly mentioned by the representative of U.S. business interests was the Singer Sewing Machine Company. *See 1925 Ways & Means Hearing*, *supra* note 58, at 179 (statement of O.K. Davis, NFTC representative). Although the Singer company was billed as the prototypical U.S. company operating abroad, the company billed itself as a multinational corporation, with salespersons abroad arranging orders in Germany and Russia that would be filled by factories in Scotland. *See* Andrew Godley, *Selling the Sewing Machine Around the World: Singer's International Marketing Strategies, 1850–1920*, 7 ENT. & SOC'Y 266, 272–75 (2006) (describing Singer's expansion in Europe). Even today, the company's website describes Singer as "the world's first international company." Singer Sewing Co. History, http://www.singerco.com/company/history.html (last visited Jan. 1, 2007).

[107] These changes are starkly apparent in the recent corporate inversion phenomenon, in which well-known "American" companies attempted to restructure their ownership so that a foreign parent would be at the top of the corporate group. *See generally* Kirsch, *supra* note 3 (discussing congressional response to corporate expatriation). This effect can also result from cross-border mergers and acquisition. Perhaps the most well-known example involves the 1998 merger of Chrysler Corporation, one of the "big three" "American" automobile manufacturers, with Daimler-Benz AG, resulting in DaimlerChrysler AG, a German company. *See* David Steinhart, *Daimler-Chrysler Merger Puts an End to 'Big Three': North American Market May Open Up, Analysts Predict*,

the interests of U.S. companies, their citizen-employees abroad, domestic workers, and the U.S. economy as interchangeable is no longer tenable.

In addition to the changes in corporate business practice and structure, modern technological advances have had a significant impact on citizens living and working overseas. For example, in the 1920s a citizen living overseas had very limited, and expensive, opportunities for communicating with family members or friends in the United States. Accordingly, residence abroad often caused a significant disruption in ties to communities in the United States. In contrast, citizens abroad today can speak to someone in the United States for pennies per minute,[108] and, with the increasing availability of the Internet,[109] can correspond instantaneously by e-mail. Moreover, persons with access to the Internet can keep in touch with developments in the United States by accessing national and local news via the many online newspapers and other news sources.

In addition, technology has had a significant impact on the global spread of American culture in the past twenty-five years. In the early twentieth century, many foreign persons' only immediate contact with American culture was through contact with a U.S. citizen living overseas or a relative living in the United States. As the century

NAT'L POST, Nov. 13, 1998 (noting end of "big three" American automakers following merger between Daimler-Benz and Chrysler). An extreme example of the changes in corporate structure from the 1920s until today is provided by the Singer Sewing Machine Company which, as discussed *supra* note 106, was explicitly mentioned during the 1926 legislative hearings on the foreign earned income exclusion. In 1926, it was a New Jersey corporation with its headquarters in an eponymous skyscraper in Manhattan and significant factories in the United States (as well as abroad). Today, after restructurings and a bankruptcy, ownership of the Singer brand and worldwide sewing business is split among several foreign companies. *See Singer Sewing Company Sold to Affiliate of Kohlberg & Company*, P.R. NEWSWIRE, Oct. 1, 2004, *available at* http://www.prnewswire.com (go to "Archive Search" and enter full title of article in the "Headline" field) (describing sale of Singer brand and principal operations by Singer, N.V., to KSIN Holdings, Ltd.); RETAIL HOLDINGS, N.V., SUMMARY SEMI-ANNUAL REPORT: FOR THE SEMI-ANNUAL PERIOD ENDED JUNE 30, 2006, at 3–4, (2006) *available at* http://www.retailholdings.com/disclosure Statements/disclosureStatementsFile_57.pdf (summarizing current ownership of Singer brand and operations).

108 For persons with access to the Internet, programs such as Skype permit free computer-to-computer calls from anywhere in the world. Skype, http://www.skype.com (last visited Mar. 21, 2007). Moreover, technology now permits individuals moving abroad to retain their U.S. telephone number, with its calls automatically forwarded to their phone abroad—the caller need never be aware that the call recipient is outside the United States. *See, e.g.*, David Pogue, *Overseas Calls Made Cheap, If Not Easy*, N.Y. TIMES, Feb. 1, 2007, at C1 (describing voice-over-Internet protocol technology).

109 *See* Doris Estelle Long, *"Democratizing" Globalization: Practicing the Policies of Cultural Inclusion*, 10 CARDOZO J. INT'L & COMP. L. 217, 229 (2002) ("[O]f the ten fastest growing countries for Internet penetration for the year 2001, almost all of them are so-called developing countries.").

progressed, the increasing export of American-branded goods, as well as Hollywood movies and other entertainment, provided additional points of contact. Today, with the expanding availability of satellite television networks, as well as the increasing spread of the Internet, technology has facilitated an unprecedented saturation of U.S. culture, as well as the English language, into ever-expanding parts of the globe.

The spread of the Internet also has important consequences for tax compliance by citizens abroad. Through much of the twentieth century, citizens living outside the United States had difficulty complying with U.S. tax laws because of limited access to tax forms and guidance.[110] With the widespread availability of the Internet, citizens abroad can download relevant tax forms and obtain extensive information on the tax obligations of citizens living outside the United States.

Professor Peroni concludes that, given these modern developments and the increasing difficulty of "associating items of income and expense with a particular geographic location," international tax policy should move away from source-based taxation.[111] To the extent tax policy principles move away from source-based taxation in the future, additional pressure will be placed on the definition of who is a U.S. person for tax purposes. Accordingly, the question of whether citizens living abroad should be taxed in the same way as persons residing in the United States becomes even more important.

III
The Strengthened Validity of Citizenship as a Jurisdictional Basis

Part I demonstrated how political and economic developments have influenced the way citizens abroad are taxed. During the Civil War era, with the United States focused on survival and the evolving importance of federal citizenship, income tax law emphasized citizenship as a jurisdictional tool. In the early twentieth century, U.S. business interests convinced Congress that relaxing citizenship-based taxation would facilitate global expansion by U.S. companies in a newly internationalized world economy. This latter view has continued to influence U.S. tax policy for the last eighty years.

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110 For example, soon after enactment of the 1913 tax act, the Commissioner of Internal Revenue instructed tax collectors to allow nonresident citizens extensions of time to file returns and pay taxes. *See* T.D. 1953, 16 Treas. Dec. Int. Rev. 34 (1914); T.D. 2028, 16 Treas. Dec. Int. Rev. 134 (1914).

111 Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. Miami L. Rev. 975, 984 (1997).

This Part examines the continuing viability of citizenship-based taxation in light of the recent developments described in Part II. In particular, it evaluates citizenship as a jurisdictional basis to tax citizens living abroad, regardless of whether the income is earned from working in a foreign country or derives from passive investments. The question of whether income from working abroad should receive special treatment, e.g., a foreign earned income exclusion, is reserved for Part IV.

Although most analyses of citizenship-based taxation focus almost exclusively on the merits of the foreign earned income exclusion,[112] it is important to treat the threshold question of citizenship-based jurisdiction separately from the analysis of the exclusion for two reasons. First, some critics of the current tax regime advocate the elimination of U.S. tax on *all* foreign income of citizens abroad.[113] Second, the inquiry into the appropriate treatment of foreign earned income cannot be answered in isolation. Rather, as discussed in Part IV, it requires a trade-off between the purported benefits of favorable treatment for earned income against the underlying rationale for imposing citizenship-based taxation. Accordingly, it is important to discuss the threshold issue in this Part before turning to the special case of earned income in Part IV.

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112 Perhaps in recognition of the political difficulties of eliminating tax on the investment income of wealthy Americans living abroad, many have focused on the narrower goal of eliminating tax only on foreign *earned* income. Testifying before the House Subcommittee on International Operations, one advocate of eliminating tax on foreign earned income argued that:

> Politically, I think that [exemption of overseas citizens' passive income] is a non-starter. Certainly the idea that an American with an investment portfolio can choose to become a bona fide resident overseas—and be exempted from United States tax [sic] is nonsense. Those coming [to this hearing] and asking for it are fooling themselves. Our group does not so request.

U.S. Citizens Overseas: Hearing Before the Subcomm. on International Operations of the H. Comm. on Foreign Affairs, 102d Cong. 65 (1991) [hereinafter *Hearing, U.S. Citizens Overseas*] (statement of Peter Alegi, Chair, Federated League of Americans Around the Globe). Recently introduced legislation would accomplish this goal by making the foreign earned income exclusion unlimited. *See* S. 3496, 109th Cong. § 2 (2006).

113 *See, e.g.*, Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483, 486 (2004) ("It is doubtful . . . whether the United States should continue to insist on taxing its citizens living overseas."). For an earlier, more extensive argument for the elimination of U.S. taxation on all income of overseas citizens, see Brainard L. Patton, Jr., *United States Individual Income Tax Policy as It Applies to Americans Resident Overseas*, 1975 DUKE L.J. 691, 730–35; for a presentation of the position of the World Federation of Americans Abroad see *Hearing, U.S. Citizens Overseas*, *supra* note 112, at 49–51. As Elisabeth Owens recognized, legislative debate sometimes confuses arguments for exempting *all* foreign income with arguments for exempting only foreign *earned* income. *See* OWENS, *supra* note 62, at 551–52 (explaining that there was "no obvious logical connection" between 1942 Senate Finance Committee arguments generally relating to citizens living overseas and exemption that applies only to foreign earned income).

A final preliminary note concerns international law. At the most fundamental level, citizenship-based taxation might be justified by reason of the United States' inherent sovereign powers with respect to its citizens. This relationship creates a recognized basis to tax under customary international law,[114] and the Supreme Court has relied on it in upholding jurisdiction over citizens abroad.[115] While this principle permits the United States to tax its citizens abroad, it does not, standing alone, provide a useful basis for determining whether the United States should exercise that power.[116] Accordingly, the following subparts consider theories that might provide a normative basis for taxing citizens abroad.

A. *Tax Policy Principles*

This subpart considers whether the taxation of citizens abroad is justified by traditional tax policy criteria—equity (fairness), neutrality, and administrability.[117] In addressing the equity criterion, the analysis

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[114] *See, e.g.*, L. VON BAR, THE THEORY AND PRACTICE OF PRIVATE INTERNATIONAL LAW 247 (G.R. Gillespie trans., Edinburgh, William Green & Sons 2d rev. ed. 1892) ("On principles of public law, no objection can be taken to the State taxing its citizens, who are living in a foreign country . . . ."). For a more recent discussion, reluctantly concluding that citizenship-based taxation is permissible, see F.A. MANN, FURTHER STUDIES IN INTERNATIONAL LAW 14 (1990). Note also that each of the United States' income tax treaties make clear that the United States reserves the right to tax its citizens as if the treaty had not entered into effect, even though the citizen might be a resident of the other treaty country. Additionally, the United States reserved this right in the Commentaries to the OECD Model Income Tax Treaty. MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, Commentary on Art. 1, ¶ 28 (OECD Comm. on Fiscal Affairs 2005) [hereinafter OECD MODEL INCOME TAX TREATY]. While the treaty partner agrees to allow the United States to impose worldwide tax on U.S. citizens, some treaty partners refuse to allow U.S. citizens who do not have a substantial residence connection to the United States to claim benefits against the treaty partner. *See, e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.-Fr., Aug. 31, 1994, art. 4, ¶ 2(a), S. TREATY DOC. NO. 103-32.

[115] *See supra* notes 54–55 and accompanying text; *see also* Blackmer v. United States, 284 U.S. 421, 436 (1932) (holding that U.S. citizen residing abroad remained subject to legislative and judicial power of United States because "[h]e continued to owe allegiance to the United States [and, b]y virtue of the obligations of citizenship, the United States retained its authority over him").

[116] As long ago as 1923, a League of Nations report concluded that in "the modern age . . . political allegiance no longer forms an adequate test of individual fiscal obligation. It is fast breaking down in practice, and it is clearly insufficient in theory." *Report Presented by the Econ. and Fin. Comm'n on Double Taxation and Tax Evasion*, League of Nations Doc. F.19 at 19 (1923); *see also* Robert L. Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 HARV. INT'L L.J. 1, 23 (1989) (claiming that "[c]urrently, the sovereignty theory has few followers" as basis for taxation).

[117] As Professor Graetz observed, "since Adam Smith, it has been commonplace to say that a tax system should be fair, economically efficient, and reasonably easy to administer and comply with." Graetz, *supra* note 12, at 294. Professor Graetz makes the important

focuses on the frequently cited benefits and ability-to-pay theories,[118] with particular emphasis on how they are affected by modern developments.

1. Equity

a. Benefits Theory

One of the earliest arguments for taxing citizens abroad is that these individuals continue to enjoy the benefits of citizenship while abroad and, accordingly, should continue to bear the corresponding burdens—in particular, the payment of taxes. Both the Civil War income tax and 1894 income tax were justified, at least in part, on this basis. Moreover, in *Cook v. Tait*,[119] the Supreme Court explicitly relied on a benefits theory as a principal justification for upholding Congress's right to tax the foreign income of citizens abroad.[120] More recently, some commentators have suggested in passing that the benefits theory justifies worldwide taxation of citizens,[121] while others have briefly posited that it does not.[122] The following analysis provides a more thorough consideration of the benefits theory in light of modern developments.

In today's world, do the benefits of U.S. citizenship accruing to a citizen abroad justify the taxation of that person's worldwide income? In addressing this question, it is important to acknowledge the theory's limits in the context of an income tax. Benefits theory gener-

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point that claims regarding fairness remain important in the analysis of an income tax, despite the recent focus on economic efficiency in the international context. *Id.* at 307.

118 For recent debates regarding the general relevance of benefits and ability-to-pay theories as justifications for a progressive income tax, compare Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399 (2005), with Deborah A. Geier, *Time to Bring Back the 'Benefit' Norm?*, 33 TAX NOTES INT'L 899 (2004). *See generally ABA Task Force Report*, *supra* note 1, at 678 n.27 (discussing literature regarding benefits and ability-to-pay theories).

119 265 U.S. 47 (1924).

120 *See supra* notes 52–55 and accompanying text.

121 *See, e.g.*, Peroni, *supra* note 111, at 1009 (arguing that foreign earned income exclusion "violates fairness by allowing U.S. citizens . . . to retain the benefits of their citizenship . . . without paying their fair share of the costs of providing those benefits"); *cf.* STAFF OF J. COMM. ON TAXATION, 109TH CONG., THE IMPACT OF INTERNATIONAL TAX REFORM: BACKGROUND AND SELECTED ISSUES RELATING TO U.S. INTERNATIONAL TAX RULES AND THE COMPETITIVENESS OF U.S. BUSINESSES 4 (Comm. Print 2006) (suggesting that benefits theory might support citizenship-based taxation); Stephen E. Shay et al., *"What's Source Got to Do with It?" Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 90–91 (2002) (arguing that benefit rationale supports source-based taxation of nonresident aliens).

122 Professor Avi-Yonah recently implied in passing that the benefits might not be sufficient to justify taxation. Avi-Yonah, *supra* note 113, at 484 ("[A]re these benefits really so great?"); *see also* Gann, *supra* note 70, at 66 (implicitly expressing doubt by asking, "[I]s [this nexus] sufficient politically?").

ally arises in the context of fee-for-service transactions, where there is a quid pro quo.[123] In the context of an income tax, where the tax level does not directly depend on the benefits received, there is no necessary correlation between the benefits and the taxes paid.[124] Accordingly, while the existence of significant benefits might provide a strong basis to claim that the overseas citizen should pay some level of tax by reason of his citizenship,[125] it might not dictate the form or amount of that tax.

i. Personal Protection

The benefits received by a U.S. citizen include both collective benefits and individualized benefits. Throughout much of the twentieth century, collective benefits—in particular, military expenditures—were often cited as justifying citizenship-based taxation.[126] However, commentators have observed that it is difficult to defend citizenship-based taxation based solely on collective benefits because

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123 *See* John F. Witte, The Politics and Development of the Federal Income Tax 31 (1985) (suggesting that even though usually associated with fee-for-service situations, benefits theory often plays role in analysis of income taxes "where the issue is who benefits from broad government programs").

124 Some scholars have argued that a correlation might exist in the sense that a high-income person can be viewed as receiving greater benefits than a low-income person from the stability provided by the government. *See* Geier, *supra* note 118, at 900–01 (justifying progressive income tax on theory that high-income taxpayers benefit disproportionately from country's regulated capitalist system). *But see* Dodge, *supra* note 118, at 427–28 (disagreeing with Professor Geier's theory); Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 Am. J. Tax Pol'y 221, 225–26 (1995) (rejecting benefits argument as justification for imposing progressive tax rates on high-income individuals).

125 As Professor Dodge recently observed in a more general context, "The 'benefit' idea is just a kind of relevant 'minimum contact' that supports tax jurisdiction, just as other kinds of contacts support the jurisdiction of courts." Dodge, *supra* note 118, at 440 n.161; *see also* Owens, *supra* note 62, at 565–66 (suggesting that benefits rationale is valid method for determining generally whether people should come within government's taxing jurisdiction, even though income tax does not directly correlate to benefits received); Palmer, *supra* note 116, at 40–41 ("At most, application of the [benefits] doctrine leads to the view that some levy on nationals is appropriate . . . .").

126 In 1959, at the height of the Cold War, a paper published in a Ways and Means Committee compendium on tax reform observed that "the argument [against citizenship-based taxation] might be more convincing if military expenditures did not constitute so large a fraction of the total U.S. budget. Expenditures devoted to military and other foreign policy purposes are as important to U.S. business abroad as they are to domestic business." H. Comm. on Ways & Means, 86th Cong., Tax Revision Compendium 2147 (Comm. Print 1959) (report of Roy Blough, Taxation of Income from Foreign Sources); *see also* Postlewaite & Stern, *supra* note 79, at 1121 (arguing that expenditures for national defense and other collective societal goals benefit Americans abroad as much as, if not more than, they benefit domestic citizens).

these collective benefits are not limited to U.S. citizens, but also accrue to residents and nationals of other countries.[127]

The individualized benefits available to citizens abroad are often of significant value and therefore provide a stronger justification for taxing citizens abroad. Historically, the most frequently cited benefit for citizens overseas is protection—both personal and property—in times of crises outside the United States. As previously noted, this benefit served as a principal justification for utilizing citizenship-based taxation in the earliest U.S. income tax laws.

The relevant question for purposes of the present analysis is whether this right to protection constitutes a meaningful benefit in the twenty-first century. One commentator, writing in the mid-1970s, stated that the protection benefit referred to in the 1924 *Cook v. Tait* decision had lost its value: "[I]t now appears that the days when United States citizens had need to call upon the government to come forth to protect their foreign personal and property rights are gone forever, at least at the level of the individual citizen in all but the most extraordinary cases."[128]

Developments in the last thirty years suggest that the commentator's optimistic observation may have been premature. For example, the United States recently helped thousands of U.S. citizens evacuate Lebanon in response to fighting there.[129] Moreover, the heightened focus on terrorism in recent years suggests an increased role for governmental protection of individual citizens overseas. Indeed, a Senate subcommittee recently held a hearing addressing the State Department's efforts to protect overseas U.S. citizens from terrorism.[130] Some aspects of the U.S. government's efforts to combat

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127 *See, e.g.*, Gann, *supra* note 70, at 65 (stating that "collective benefit argument proves too much, since the benefits . . . are not confined to U.S. citizens").

128 Patton, *supra* note 113, at 700.

129 *See, e.g.*, Gary Gately, *Plucked to Safety from Lebanon, American Evacuees Return and Lament the Destruction*, N.Y. TIMES, July 21, 2006, at A8 (describing State Department evacuation of U.S. citizens from Lebanon).

130 *Protecting U.S. Citizens Abroad from Terrorism: Hearing Before the Subcomm. on International Operations and Terrorism of the S. Comm. on Foreign Relations*, 107th Cong. (2002) [hereinafter *Hearing, Protecting Citizens*]. The personal protection and benefits provided by the U.S. government also extend to overseas citizens in many less drastic circumstances, such as situations involving arrest, medical evacuation, and other emergencies. *See* Bureau of Consular Affairs, U.S. Dep't of State, U.S. Consuls Help Americans Abroad, *available at* http://travel.state.gov/travel/tips/brochures/brochures_1222.html (last visited Dec. 29, 2006) (listing services provided by State Department for citizens abroad); *see also Dep't of State Appropriations Authorization, FY 1974: Hearings Before the S. Comm. on Foreign Relations*, 93d Cong. 526 (1973) ("Every case of the arrest of an American citizen abroad on whatever charge is an actual or potential 'protection' case for the consular officer."). *But see* Patton, *supra* note 113, at 699 n.28 (claiming that general services provided by U.S. consular officials overseas may be of little practical use to citizen

terrorism—such as sharing intelligence with other countries—might be viewed as collective benefits that accrue to both citizens and noncitizens alike. To the extent that the U.S. government focuses its efforts on threats directed primarily at U.S. persons abroad—such as the protection of U.S. citizens working in the Persian Gulf[131]—the benefits to citizens are more direct.

More fundamentally, even assuming that some citizens will never need the services of the U.S. government for personal protection, it does not necessarily follow that this benefit has no value. Just as homeowner's insurance has value because the possibility exists that a home will be destroyed by fire or other casualty, so does government protection have value because it might be needed. In addition, the mere fact that the United States provides protection for its citizens abroad might deter at least some harm to U.S. citizens, although this assertion might be less persuasive in an age of global terrorism than it was in the Cold War era.

ii. Property Protection

Another modern development, which provides a more practical benefit to citizens overseas, is the protection of personal property abroad. In the past two decades the United States has greatly expanded the protection afforded to property such as the investments and business operations of U.S. citizens overseas. For example, the State Department has negotiated dozens of Bilateral Investment Treaties, which ensure that nationals (as well as companies incorporated in the United States) receive basic protection for their investment and business operations in other countries, including protections against discriminatory treatment, restrictions on expropriation, and the right to transfer funds into and out of the host country.[132]

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residing abroad who often has locally established legal and social connections to assist him).

131 *See, e.g.*, Bureau of Consular Affairs, U.S. Dep't of State, Travel Warning: Saudi Arabia (Dec. 19, 2006), *available at* http://travel.state.gov/travel/cis_pa_tw/tw/tw_932.html. This example is particularly relevant because organizations representing U.S. citizens in Persian Gulf countries are among the most vocal critics of citizenship-based taxation. *See* Knowlton, *supra* note 95 (describing recent lobbying efforts of American Business Council of the Gulf Countries).

132 Of particular relevance to citizens working abroad for a foreign branch of a U.S. company, the treaties guarantee a company's right to hire top managerial personnel of its choice, regardless of nationality. Thus, it is possible that a U.S. citizen working for a U.S. company abroad might, at least indirectly, owe his position to the investment treaties negotiated by the United States. *See, e.g.*, U.S. DEP'T OF STATE, 2004 U.S. MODEL BILATERAL INVESTMENT TREATY, *available at* http://www.state.gov/documents/organization/38710.pdf.

iii. Right to Vote

The political rights enjoyed by U.S. citizens abroad provide another justification for citizenship-based taxation. A U.S. citizen residing abroad retains the right to vote for President, Vice President, and members of Congress. Pursuant to the Uniformed and Overseas Citizens Absentee Voting Act,[133] a citizen abroad can exercise this right by casting an absentee ballot in the state in which he last resided prior to moving outside the United States. In order to ease the process for registering and requesting a ballot, the Act mandates a uniform postcard that all states must accept. Modern technology has also eased the burden of absentee voting—the postcard, as well as detailed instructions, are available on a website sponsored by the U.S. government.[134]

Some overseas citizen advocacy groups contend that inherent limitations on the voting right undermine its value for purposes of any benefits-based taxing jurisdiction. In particular, they argue that overseas citizens have no effective voice in the legislative process because their votes are spread among the fifty states rather than channeled into electing a single member of Congress (or nonvoting delegate) who represents the interests of overseas citizens.[135]

Both theoretical and practical considerations undermine this argument. It is reasonable to assume that overseas citizens are a diverse group, with a broad range of views on most social, political, and economic issues. They just happen to share common interests in certain issues, such as the tax treatment of citizens living abroad, by reason of their circumstances.[136] In this regard, they are like any

133 42 U.S.C. § 1973ff (2000 & Supp. II 2002).

134 U.S. Dep't of Defense, Federal Voting Assistance Program, http://www.fvap.gov (last visited Dec. 29, 2006). In addition, several overseas citizens groups have created extensive websites that enable any citizen abroad with Internet access to obtain necessary information instantly and easily print the necessary absentee registration forms. *See, e.g.*, Overseas Vote Foundation, http://overseasvotefoundation.org (last visited Jan. 4, 2007) (enabling overseas citizens to enter necessary information, print, and sign form for absentee voter registration); Vote from Abroad, http://www.votefromabroad.org (last visited Jan. 3, 2007) (containing online wizard that guides viewer through steps necessary to complete and print absentee ballot requests).

135 *See, e.g.*, Am. Citizens Abroad, Congressional Representation for Overseas Americans, http://www.aca.ch/op10a.htm (last visited Mar. 20, 2007) (advocating proposal to permit overseas citizens to elect their own congressional delegate).

136 Even with respect to citizenship-based taxation, the interests of overseas citizens are not identical. The issue is of greater concern to those citizens living in low- or no-tax countries because they will owe more residual U.S. tax after taking the foreign tax credit. *Cf. 1925 Ways & Means Hearing*, *supra* note 58, at 179 (statement of O.K. Davis) (noting that U.S. citizens living in London did not lobby for foreign earned income exclusion because British income taxes were higher than U.S. income tax).

other interest group that has an interest in a particular tax policy but whose political strength is diluted among the fifty states.

Moreover, Congress has acted on several significant concerns of overseas citizens' groups, suggesting that claims of underrepresentation are overstated.[137] For example, the Uniformed and Overseas Citizens Absentee Voting Act itself reflects significant lobbying by overseas citizens' groups. Not only does it provide a practical method by which overseas citizens can exercise their voting rights, but it also contains a tax-related provision long desired by overseas citizens: The state in which the citizen casts an absentee ballot for a federal election cannot treat the individual as a state resident, subject to state taxes, merely because of that federal vote.[138] Overseas citizens also have had some success in their attempt to be included in the 2010 decennial census,[139] although a sampling conducted by the Census Bureau sug-

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[137] Indeed, during a recent hearing seeking to have overseas citizens included in the 2010 census, a witness cited a list of "past battles and victories" achieved on behalf of citizens abroad "with the active support of Congress," including the absentee voting provisions discussed in the text, securing the right of overseas citizens to work in U.S. embassies and consulates, streamlined provisions for naturalizing the children of overseas citizens when the U.S. citizen-parent had spent insufficient time in the United States to pass citizenship by birth, and the provision of educational materials to certain American and international schools around the world that educated the children of overseas citizens. *Americans Abroad, How Can We Count Them?: Hearing Before the Subcomm. on the Census of the H. Comm. on Government Reform*, 107th Cong. 74–75 (2001) [hereinafter *Hearing, How Can We Count Them?*] (statement of T.B. McClelland, Member of the Board of Directors, American Business Council of the Gulf Countries); *see also* AM. CITIZENS ABROAD, A HANDBOOK FOR CITIZENS LIVING ABROAD 4 (1990) (claiming that American Citizens Abroad has "been very active and successful in proposing changes to U.S. laws and regulations that affect overseas citizens"). Of course, the interests of overseas citizens do not always prevail, as evidenced by the May 2006 modifications to the foreign earned income exclusion. *See supra* notes 85–89 and accompanying text.

[138] 42 U.S.C. § 1973ff-5 (2000). Prior to 1975, when a predecessor of this statute was enacted, some states attempted to treat an overseas citizen as a state resident for tax purposes based on voter registration in the state, even if the individual only voted for federal offices. *Voting by U.S. Citizens Residing Abroad: Hearings Before the Subcomm. on Privileges and Elections of the S. Comm. on Rules and Administration*, 93d Cong. 23 (1973) [hereinafter *Hearing, Voting Abroad*] (statement of William G. Whyte, Vice President, United States Steel Corporation). A state still can use a citizen's vote or registration as evidence of state residence for tax purposes if the individual also votes for state officeholders, rather than just federal candidates. *See* 42 U.S.C. § 1973ff-5 (providing that protection from state tax residence determination applies only to exercise of rights under relevant subchapter, which addresses federal, not state, elections).

[139] *See* U.S. GEN. ACCOUNTING OFFICE, 2010 CENSUS: OVERSEAS ENUMERATION TEST RAISES NEED FOR CLEAR POLICY DIRECTION 2 (2004) (describing response to requests from representatives of overseas American citizens to include U.S. citizens living abroad in census). Overseas citizens groups argue that the lack of an official census of U.S. citizens living overseas not only skews apportionment and redistricting but also causes a misallocation of federal benefit distributions. *See Hearing, How Can We Count Them?*, *supra* note 137, at 51–54 (statement of Thomas W. Fina, Executive Director, Democrats Abroad).

gests that practical limitations might prevent their inclusion.[140] Finally, particular legislators have been willing to advocate the interests of overseas citizens, despite the fact that they do not exclusively represent overseas citizens.[141]

iv. Right to Enter

Another important right possessed by U.S. citizens overseas is the ability to enter the United States at any time.[142] Again, different citizens might place different value on this right, depending on how frequently they visit the United States and the likelihood that they might return permanently. A person who has lived abroad most of his life with no intention of settling in the United States might place little value on this benefit, whereas a citizen who was raised in the United States might place great value in eventually returning. The right is also valuable for citizens who live in areas beset by political turmoil or subject to terrorist threats due to the higher possibility that these persons might suddenly need to leave such areas. While it is impossible to place a precise value on this benefit, variable among individuals, the right to enter the United States as a U.S. citizen undoubtedly has some value.

v. Past Benefits

A more tenuous argument can be made based on prior benefits received by citizens abroad. For example, a commentator in the late 1950s argued that in addition to the benefits of protection while overseas, "[a] person who was born and reared in the United States, educated at public expense, [and] trained in U.S. industry . . . derives his income in part from the United States regardless of the geographical

140 *See Lessons Learned from the 2004 Overseas Census Test: Hearing Before the Subcomm. on Technology, Information Policy, Intergovermental Relations and Census of the H. Comm. on Government Reform*, 108th Cong. 12–13 (2004) (statement of Charles Louis Kincannon, Director, U.S. Census Bureau) (identifying obstacles to attaining data, such as inability to produce address files and mapping system for citizens abroad); *Survey Abroad Disappoints Census Bureau*, WASH. POST, June 7, 2004, at A21 (reporting disappointing response rate, with only 4500 forms completed since initiation of test).

141 For example, between 1999 and 2003, Representative Carolyn Maloney of New York sponsored at least five bills to facilitate the inclusion of overseas citizens in the 2010 census. *See* H.R. 1619, 108th Cong. (2003); H.R. 680, 107th Cong. (2001); H.R. 4568, 106th Cong. (2000); H.R. 3649, 106th Cong. (2000); H.R. 2444, 106th Cong. (1999).

142 As Professor Gann has observed, "A significant value of U.S. citizenship is the ability to return to a nation with particular social and economic institutions and to a nation that is a going concern." Gann, *supra* note 70, at 65–66; *see also* Peroni, *supra* note 111, at 1009 (noting value of "ability to return to the United States without limitation and enjoy the legal, economic, and social institutions of this country").

area of his operations."[143] More recently, commentators concerned about the "brain drain" in less economically developed countries have used this rationale to suggest that the less economically developed countries should tax the foreign income of their nationals living overseas. In particular, these advocates note that "[a]n important benefit often received by LDC [less-developed country] citizens before they emigrate is state-subsidized educational services. . . . [Some] tax should be imposed to compensate LDCs for the loss of human capital that they experience as a result of emigration."[144]

The assumptions underlying this approach for nonresident nationals of less-developed countries do not necessarily apply to the overseas U.S. citizen population. While many citizens abroad were raised in the United States and benefited from its education system, others might have lived abroad for most or all of their lives, receiving little or no education in the United States. Even if a U.S. citizen was raised and educated in the United States, he would have received different levels of government benefits based on whether he attended a private or public school, and whether he funded his education using federally guaranteed student loans. Moreover, some citizens may have already lived and worked in the United States for many years, paying taxes well in excess of the value of past benefits, while others may go abroad straight from college, without having yet contributed significantly to U.S. tax revenues. Because of these significant differences among citizens, relying on past benefits as a justification for citizenship-based taxation is dubious.

vi. Additional Considerations

Opponents of citizenship-based taxation often focus on the benefits that are available to citizens within the United States but not to those outside the country.[145] For example, citizens abroad do not

143 *See* H. Comm. on Ways & Means, 86th Cong., Tax Revision Compendium 2146 (Comm. Print 1959) (report of Roy Blough, Taxation of Income from Foreign Sources); *see also* Kingson, *supra* note 15, at 740 ("Many of these people may have grown up in FHA-insured homes [and] are having their parents cared for by federal programs rather than having to pay the medical expenses themselves . . . . As American citizens, they know how to take. Now let them, as American citizens, learn how to give.").

144 Income Taxation and International Mobility 5 (Jagdish N. Bhagwati & John Douglas Wilson eds., 1989); *cf.* Desai et al., *supra* note 5, at 682–83 (advocating potential use of citizenship-based taxation to address less-developed countries' concerns about brain drain).

145 *See, e.g.*, John D. Maiers, *The Foreign Earned Income Exclusion: Reinventing the Wheel*, 34 Tax Law. 691, 726 (1981) ("Americans abroad must often use after-tax income to buy substitutes for government and municipal services, such as Medicare and public education, which their taxes buy at home."); Patton, *supra* note 113, at 699 ("[I]t should be clear that an American overseas is not benefiting from the expenditure of any government

enjoy infrastructure benefits, such as highways and schools, that are financed, at least in part, with federal revenue. Moreover, certain individual benefits—in particular, Medicare benefits[146]—are not available to U.S. citizens residing overseas.

While citizens abroad do not enjoy some of the benefits available to citizens within the United States, U.S. citizens at home do not enjoy some of the benefits provided to citizens abroad such as the personal and property protection discussed above. More fundamentally, as discussed above, a benefits analysis generally does not dictate the proper level of income-based taxation. Rather, it merely determines whether sufficient grounds exist for exercising some kind of tax jurisdiction. In this regard, as long as citizens abroad receive significant benefits from holding citizenship, the fact that other citizens might receive greater benefits is not directly relevant.[147] In the domestic context, not all citizens enjoy identical benefits from the federal government, yet benefits theory is sometimes used to justify taxing jurisdiction over residents of the United States.

The foreign tax credit further weakens the argument that citizens abroad should not be subject to taxation because they receive fewer benefits. As Elisabeth Owens noted in her work on the foreign tax credit, "If a national of the United States with foreign income does receive a lesser amount of benefit from the United States than one who has only domestic source income, he also pays less tax to the United States because of the foreign tax credit."[148] The foreign tax credit's reduction of U.S. tax does not necessarily correlate to the lesser benefits a citizen abroad might enjoy.[149] Nonetheless, the for-

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funds in the United States . . . ."); *see also* Avi-Yonah, *supra* note 113, at 484 (asking whether benefits received by citizens abroad are sufficient to justify citizenship-based taxation).

146 U.S. GEN. ACCOUNTING OFFICE, *supra* note 139, at 3. According to recent testimony by a representative of overseas citizens, the denial of Medicare to citizens abroad is "[o]ne of the sorest points . . . for overseas American[s]." *Hearing, How Can We Count Them?*, *supra* note 137, at 46 (statement of Thomas W. Fina, Executive Director, Democrats Abroad).

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> In order to support the position that extraterritorial taxation is wrong in principle . . . it is necessary to show not that a United States national receiving only foreign source income receives fewer benefits than one receiving only domestic source income, but that he receives no benefits whatever from the United States government, or benefits so insubstantial that they should be disregarded for practical purposes.

OWENS, *supra* note 62, at 565–66.

148 *Id.* at 565; *see also* Postlewaite & Stern, *supra* note 79, at 1121 (noting that U.S. government through foreign tax credit acknowledges benefits received by American citizens abroad from host governments).

149 Rather, the credit depends on the extent to which the foreign country chooses to exercise its source-based taxing rights. Accordingly, a U.S. citizen residing in a high-tax

eign tax credit can be viewed as a rough acknowledgment that the United States does not confer full benefits on a U.S. citizen living abroad with respect to his foreign source income (or, perhaps more accurately, an acknowledgment that the foreign country benefits the U.S. citizen to some extent).

In summary, the benefits available to U.S. citizens residing abroad provide a basis for concluding that the United States is justified in exercising some type of taxing jurisdiction over those citizens.[150] The next subpart considers whether the United States is justified in taxing citizens abroad under another familiar theory of equity: ability-to-pay.

b. Ability-to-Pay Theory

This section considers the extent to which ability-to-pay principles support the extension of the income tax to citizens living abroad. Although traditionally applied to questions of distribution,[151] ability-to-pay principles raise the jurisdictional question in two ways. First, before asking whether one person has the same ability to pay taxes as another, one must identify the universe of comparison. The jurisdictional question becomes equivalent to asking *whose* ability to pay. Second, assuming citizens abroad are properly included within this universe, the question remains whether unique aspects of living abroad require the United States to impose no more than a nominal tax burden on these citizens.

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foreign jurisdiction might pay little or no U.S. income tax after the foreign tax credit, while a U.S. citizen residing in a low-tax foreign jurisdiction might pay significant U.S. income taxes, even though both citizens might receive the same benefits from the United States.

[150] The list of benefits in this subpart is not intended to be exhaustive. For example, a U.S. citizen also has the benefit of traveling on a U.S. passport. *See* Stephen Gray, *Second Citizenships*, *in* LEGAL ISSUES IN OFFSHORE FINANCIAL SERVICES 41, 41–58 (Rose-Marie B. Antoine ed., 2004) (summarizing costs and merits of various countries' citizenship acquisition programs); Marshall Langer, *Introduction to Economic Citizenship/Second Citizenship*, *in* LEGAL ISSUES IN OFFSHORE FINANCIAL SERVICES, *supra*, at 37–40 (same); Marie Tyler, *U.S. Visitor Crackdown Spurs Passport Scrutiny*, WASH. TIMES, June 22, 2006, at A1 (noting practical limitations on traveling with U.S. passport).

[151] *See* CONG. RESEARCH SERV., U.S. TAXATION OF CITIZENS WORKING IN OTHER COUNTRIES: AN ECONOMIC ANALYSIS 44 (1978), *reprinted in Taxation of Americans Working Abroad: Hearing Before the S. Comm. on Finance*, 95th Cong. 171 (1978) ("U.S. tax system is progressive, based on the notion of ability to pay . . . ."). This Article does not revisit the debates regarding the underlying merits of ability-to-pay principles. *See generally supra* note 118 (citing sources debating ability-to-pay and benefits theories); *cf.* J. Clifton Fleming et al., *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299 (2001) (applying ability-to-pay principles to justify worldwide taxation of U.S. residents).

i. Defining the Community

Before comparing people's ability to pay, the relevant universe must be defined. The threshold question is whether ability-to-pay analysis should adopt a worldwide perspective, which would consider the relative incomes of all individuals worldwide, or whether it should adopt a national perspective, looking only at the incomes of members of U.S. society (however defined). Commentators who have addressed this issue have generally concluded that, for both practical and theoretical reasons, U.S. tax policy should take a national perspective.[152] As the *ABA Task Force Report* observed, "It would be an impossible goal for U.S. tax policy to achieve global distributive justice."[153]

Given this, the question still remains: Do citizens residing outside the United States fit within this national perspective? Is their connection to "U.S. society . . . so substantial that fundamental fairness requires their net incomes to be compared with the net incomes of . . . U.S. residents for purposes of making an equitable allocation of the tax burden under an ability-to-pay system[?]"[154] Commentators often make general references to citizens and residents as coming within this definition.[155] Professor Gann, however, has questioned whether citizens residing abroad are necessarily a part of U.S. society for the purposes of this inquiry.[156] For example, a U.S. citizen who has resided for many years in a foreign country might argue that she should be compared to other residents of that foreign country, rather than to persons residing in the United States.

The fact that a person might be considered a member of another country's society for purposes of ability-to-pay analysis—whether because he is a dual citizen of that other country or because he resides there—should not necessarily preclude the United States from treating him as a member of U.S. society in this context. Given modern improvements in communication and mobility, an individual

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152 *See, e.g.*, *ABA Task Force Report*, *supra* note 1, at 679 (stating that U.S. tax policy should focus on citizens and residents because it cannot achieve global distributive justice); Graetz, *supra* note 12, at 301 (arguing that "national rather than worldwide perspective seems appropriate").

153 *ABA Task Force Report*, *supra* note 1, at 679.

154 Fleming et al., *supra* note 151, at 309.

155 *See* Gann, *supra* note 70, at 64 (noting that many commentators merely "assume that the appropriate comparison is of all U.S. citizens, regardless of where they live").

156 *Id.* at 64–65 (raising question about proper equity comparison but concluding that this is question of judgment that cannot be answered objectively). Professors Fleming, Peroni, and Shay also raise this issue, although they do not address it in detail because it only tangentially relates to their principal analysis and therefore is "outside the scope of [their] article." Fleming et al., *supra* note 151, at 309–10 & n.18.

might have significant ties to more than one place. Indeed, this phenomenon often occurs in the context of residence-based (as opposed to citizenship-based) taxation. Because there is no uniform definition of residence for tax purposes, a taxpayer who spends significant time in two countries over the course of the year may be treated as a resident under each country's tax law.[157] Just as residence-based taxation does not necessarily preclude multiple countries from taxing an individual's worldwide income under ability-to-pay principles, citizenship-based taxation should not preclude this potential result. This conclusion is reinforced by the fact that the United States allows a foreign tax credit with respect to foreign taxes paid on foreign income.[158] By providing this unilateral relief, the United States ensures that citizenship-based taxation (as well as residence-based taxation) generally does not result in double taxation of income for taxpayers with residence or dual citizenship in another country.[159]

There are strong arguments for treating citizens abroad as members of U.S. society for purposes of the distributional equity analysis. The individual, by retaining his U.S. citizenship, is expressing a voluntary identification with the United States.[160] After all, a citizen living abroad has the right to renounce U.S. citizenship if he desires.[161] Accordingly, it is reasonable to conclude that the retention of U.S. citizenship reflects a self-identification with the population of the United States (or the belief that the benefits of citizenship are worth the tax cost).

In addition to this implicit voluntary expression by the individual himself, organizations representing the interests of U.S. citizens abroad often highlight the significant ongoing ties between overseas

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157 Indeed, bilateral tax treaties generally contain a provision to address these situations. *See* OECD Model Income Tax Treaty, *supra* note 114, art. 4(2) (establishing how to determine residency status of individuals who are residents of two countries). While each country's tax law might mitigate the potential double taxation in this setting unilaterally, a tax treaty, by establishing tiebreaker rules that treat the taxpayer as a resident of only one country, provides more comprehensive relief.

158 *See supra* notes 47–51 and accompanying text.

159 While the foreign tax credit eliminates double taxation in most situations, it might fail to do so in rare circumstances. For example, if both the United States and the taxpayer's country of residence consider the income to have a domestic source under their tax laws, neither country might be willing to give a foreign tax credit for tax paid to the other country. Such problems can often be addressed through a bilateral tax treaty if one is in force between the two countries.

160 This conclusion is reinforced by the fact that many citizens living abroad express significant interest in ensuring that any children born abroad have U.S. citizenship, reflecting a continued identification by the parent with the United States. *See* Am. Citizens Abroad, *supra* note 137, at 24–35 (answering variety of questions concerning citizenship status of children born abroad).

161 *See infra* notes 216–19 and accompanying text.

citizens and U.S. society.[162] In the context of congressional hearings aimed at securing legislation that would benefit overseas Americans, these organizations stressed the relationship of these individuals to U.S. society. In a typical example, a witness testified:

> Most Americans living overseas are just as "home grown" as I am, and many have family situations similar to mine. . . . We keep our links to the United States as strong as possible, visiting "home" as often as possible, educating our children in U.S. schools if we can afford it and if they are available where we live. We go to great lengths to make sure that our children have U.S. citizenship and valid passports. We struggle to ensure that our U.S. tax obligations are met. We vote in U.S. elections despite the difficulties with absentee balloting.[163]

More recently, during hearings addressing the feasibility of conducting an official census of U.S. citizens residing overseas, a witness stated that such a census "will respond to the patriotic desire of the American community around the world to be counted, to be measured, to be seen in its proper proportions as a *dynamic part of our society*."[164] Another witness, stating that his family's story, "as Americans abroad, is not unusual," explained that "American institutions and the American way of life remain very important to me and my family."[165] Granted, these statements might reflect self-serving declarations in the context of lobbying for desired legislation. Nonetheless, to the extent these assertions regarding societal ties are relevant in securing legislation favored by overseas citizens, they seem equally relevant in less favorable contexts, such as defining societal ties for tax equity purposes.

Recent technological developments create even stronger links between citizens residing abroad and those living in the United States.

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162 In its guide for citizens abroad, American Citizens Abroad includes an extensive list of "U.S. organizations of a benevolent or social nature abroad" and assures citizens who are considering moving abroad that "[u]nless it is in the most remote spot, you will not have to worry about getting homesick." AM. CITIZENS ABROAD, *supra* note 137, at 3–4.

163 *Hearing, U.S. Citizens Overseas*, *supra* note 112, at 38 (statement of Stephanie H. Simonard).

164 *Hearing, How Can We Count Them?*, *supra* note 137, at 46 (statement of Thomas W. Fina, Executive Director, Democrats Abroad) (emphasis added).

165 *Id.* (statement of T.B. McClelland). Similarly, overseas citizens groups, in advocating an expansion of the foreign earned income exclusion, often stress the benefits to U.S. society that purportedly accrue when U.S. citizens reside abroad. In particular, they argue that U.S. citizens abroad act as cultural ambassadors on behalf of the United States and have a natural tendency to prefer the purchase of U.S.-manufactured goods. Although this Article suggests that these arguments are insufficient to justify an expansion of the foreign earned income exclusion, *see infra* notes 344–52 and accompanying text, they nonetheless suggest that overseas citizens view themselves as having ongoing ties to U.S. society.

More than three decades ago, a witness testifying for absentee voting legislation presciently commented on the correlation between technological improvements and overseas citizens' membership in U.S. society. In assuring a 1973 Senate subcommittee that overseas citizens were informed about issues and candidates, she observed that,

> [I]n this jet age the world is getting smaller and smaller, and the media is stronger and stronger. Everything that daily occurs in [the United States] is brought to the attention of Americans overseas just as promptly and just as completely as read in your morning newspaper or heard in your evening television or radio newscast.[166]

Of course, the growth of the Internet has expanded these ties tremendously, enabling a citizen abroad to view U.S. websites that provide up-to-date national and local news.[167] Similarly e-mail and inexpensive international telephone service enable citizens overseas to maintain constant contact with friends and relatives living in the United States.

Citizens living in the United States also view U.S. citizens living overseas as part of U.S. society, particularly in times of crisis. For example, during the recent conflict in Lebanon, U.S. media focused extensively on efforts by the State Department and U.S. Marines to help thousands of U.S. citizens evacuate the country, implying that citizens abroad are viewed as having special connections to the United States that persons of other nationalities do not.[168]

This tendency of citizens in the United States to consider citizens abroad to be part of their society might, at least in part, be due to the country's history as a nation of immigrants.[169] Unlike other countries that have experienced significantly greater emigration than immigration, the United States does not have a long history of its citizens leaving the country permanently.[170] Accordingly, even those citizens

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166 *Hearing, Voting Abroad*, *supra* note 138 (statement by Mitchell H. Cohen, Federation of American Women's Club Overseas).

167 *See supra* notes 108–09 and accompanying text; *cf.* Ford O'Connell, *Dual Citizenship Comes with Dual Voting Responsibilities*, MEDILL NEWS SERV., June 7, 2006, http://mesh.medill.northwestern.edu/mnschicago/archives/2006/06/dualcitz_the_u.html (noting how dual U.S.-Italian citizen who lives in United States and voted in Italian election keeps abreast of Italian politics by watching 24-hour cable news).

168 *See, e.g.*, Gately, *supra* note 129 (describing evacuation of U.S. citizens from Lebanon); Sudarsan Raghavan, *For Evacuees from Lebanon, a Bittersweet Arrival at BWI*, WASH. POST, July 21, 2006, at A11 (same).

169 *Cf.* Desai et al., *supra* note 5, at 665, 687 n.2 (noting that United States is one of few "traditional" immigration countries).

170 In contrast to the approximately 889,000 foreign persons who acquired U.S. citizenship in a recent year, approximately 48,000 U.S.-born citizens emigrate to foreign countries each year. *See* U.S. CITIZENSHIP & IMMIGRATION SERVS., U.S. DEP'T OF HOMELAND SEC., CITIZENSHIP IN THE UNITED STATES 30, 32 (2004), *available at* http://www.uscis.gov/files/nativedocuments/Citizenship_2004.pdf. The vast majority of these emigrants retain their

who move abroad for extended periods might be viewed as likely to return (whether this assumption is, in fact, true or not), and therefore might be considered to be a continuing part of U.S. society by persons who live here.

Of course, some persons living abroad who hold U.S. citizenship might have only a tenuous connection to U.S. society under the above factors. For example, a person born abroad who holds dual nationality in the United States and his country of birth might never have lived in the United States and might have no family or friends there.[171] Nonetheless, given that large segments of the U.S. citizen population abroad do have connections with the United States under the factors discussed above, and that persons with few personal ties to the United States maintain the option of voluntarily surrendering their U.S. citizenship,[172] the general inclusion of U.S. citizens within U.S. society for purposes of applying tax equity principles seems reasonable.

ii. Unique Aspects of Living Abroad

Even if, as suggested in the prior subpart, citizens abroad should be included within the universe of people whose ability to pay is relevant for purposes of the U.S. income tax, equity principles might support special tax relief for these citizens.[173] This subpart considers the possibility of providing tax relief based on equitable treatment of the citizen abroad. Whereas other arguments might support tax relief for a particular type of taxpayer or income (e.g., earned income of a cit-

U.S. citizenship. *See* Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 Iowa L. Rev. 863, 890 n.127 (2004) (noting that between 1995 and 2001, approximately 600 people lost U.S. citizenship annually). In addition, between 220,000 and 300,000 foreign-born residents emigrate from the United States annually, although this number includes noncitizens. *See* U.S. Citizenship & Immigration Servs., *supra*, at 30.

171 In some cases, the person might not realize that he derived U.S. citizenship by reason of birth to a U.S. citizen-parent. *See* Office of Tax Policy, U.S. Dep't of the Treasury, Income Tax Compliance by U.S. Citizens and U.S. Lawful Permanent Residents Residing Outside the United States and Related Issues 38–40 (1998) (suggesting that tax relief might be appropriate for some of these "unknowing citizens" who demonstrate that they were unaware of citizenship status and never claimed benefits of citizenship). In the interest of disclosure, it should be noted that the author participated in the drafting of the previously cited study while working at the Internal Revenue Service and later at the Treasury Department.

172 *See infra* notes 216–19 and accompanying text.

173 The 1978 tax act, which temporarily replaced the foreign earned income exclusion with a set of targeted deductions aimed at the excess costs incurred by citizens working abroad, reflected an attempt to achieve rough equity between citizens in the United States and those abroad. It bears noting, however, that these deductions were available only to citizens working abroad and not to those merely living off of investment income. *See generally* Postlewaite & Stern, *supra* note 79 (critiquing 1978 act on equity and other grounds).

izen working abroad) general equity-based arguments might, if applicable, support relief for all citizens living abroad, including those receiving passive investment income.[174]

Citizens abroad might argue that they are not comparable to citizens living in the United States merely because their gross incomes are the same. Due to additional expenses and foreign taxes associated with living overseas, a citizen living abroad might be more properly compared to a domestic citizen receiving a lower income. If such a comparison is proper, the overseas citizen's U.S. tax liability should be correspondingly reduced.[175]

While many citizens residing abroad incur living expenses that are substantially higher than those paid by citizens living in certain parts of the United States, it is difficult to generalize.[176] For example, the cost of living in Moscow is significantly higher than the cost of living in Winston-Salem, North Carolina.[177] However, some citizens residing abroad might have lower living expenses than citizens living in certain parts of the United States. For example, the cost of living in New York City is much higher than that of Melbourne, Australia, or Asunción, Paraguay.[178]

Relief (such as a deduction) targeted at citizens living in high-cost foreign jurisdictions might not be justified under equity principles. In the domestic context, the Code generally does not differentiate

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[174] At least one commentator has previously argued for tax relief based on equity. *See* Patton, *supra* note 113, at 730–32 (concluding that "[t]he simplest and fairest answer . . . is to exempt the American citizen resident overseas from United States income tax jurisdiction altogether"). Most advocacy of special tax relief for overseas citizens, however, has focused on other policy concerns such as competitiveness. These concerns are addressed in Part IV.

[175] This could be viewed as either a horizontal equity or a vertical equity argument. To the extent it compares two persons who have the same nominal income, the one in the higher-cost jurisdiction could argue that his ability to pay is less, and therefore that his tax liability should be lower under vertical equity ability-to-pay criteria. *Cf.* Michael S. Knoll & Thomas D. Griffith, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 HARV. L. REV. 987, 988 (2003) (using ability-to-pay language with respect to proposal for cost-of-living adjustments in domestic context). To the extent a person in a higher-cost jurisdiction suggests that he is similarly situated to a person with lower nominal income in the United States and should be taxed accordingly, it could be viewed as a horizontal equity argument.

[176] *See* Sobel, *supra* note 70, at 107 ("Because the circumstances of the expatriate may vary greatly from one locale to another, little definite can be said . . . .").

[177] *See* Mercer Human Resource Consulting, Worldwide Cost of Living Survey 2006—City Rankings (June 26, 2006), http://www.mercerhr.com/referencecontent.jhtml?idContent=1142150 (listing Moscow as most expensive city worldwide and Winston-Salem as cheapest U.S. city). This survey claims to be the "world's most comprehensive cost-of-living survey and is used to help multinational companies and governments determine compensation allowances for their expatriate employees." *Id.*

[178] *See id.* (ranking New York City as most expensive, Asunción as least, and Melbourne as squarely in between).

between high-cost and low-cost cities.[179] A person living in New York City and earning $50,000 does not receive a special cost-of-living deduction even though his real purchasing power may be less than that of a person earning $50,000 in Springfield, Missouri. Because these concerns are endemic to the tax system even in a domestic context,[180] it is difficult to justify granting relief on these grounds solely to citizens living abroad.[181] Moreover, to the extent that the costs of living are higher abroad, these higher costs might generate larger deductions under existing tax provisions.[182]

Another possible equity-based argument is that a citizen residing abroad incurs unique expenses that warrant tax relief.[183] For example, a person living abroad might incur expenses if he flies back to the United States periodically to visit friends or family. Also, citizens living abroad might have to pay tuition to send their children to a private school if the local schools are inadequate or in order to ensure that their children are taught in English.[184] While the 1978 tax act provided deductions for these particular expenses,[185] it is important to note that they too are not unique to citizens living abroad. For example, many citizens might be raised in one region of the United States and then move to another region for employment purposes. These people might incur costs if they fly "home" periodically, yet the

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179 *See* H. Comm. on Ways & Means, 95th Cong., Recommendations of the Task Force on Foreign Source Income 14 (Comm. Print 1977) ("[N]one of the deductions, credits, exemptions, or exclusions provided in the Code are predicated upon cost-of-living differences that may exist between different localities in the United States."); Cong. Research Serv., *supra* note 151, at 14 ("The U.S. tax system is not . . . indexed to account for variations in costs of living among areas within the United States . . . .").

180 *Cf.* Knoll & Griffith, *supra* note 175, at 989 (proposing tax adjustments to reflect regional cost-of-living differences within United States, based on efficiency rather than equity grounds). To the extent Congress ever adopted this type of relief in the domestic context, similar cost-of-living adjustments might also be warranted for citizens living outside the United States.

181 The argument for equity-based relief is even weaker when a citizen is working abroad for a company that provides an incentive package to offset the higher costs. *See* Postlewaite & Stern, *supra* note 79, at 1119–21 (making similar arguments).

182 For example, the home mortgage interest deduction applies regardless of whether the residence is in the United States or a foreign country. I.R.C. § 163(h) (2000); *cf.* I.R.C. § 121 (2000) (stating that exclusion for gain from sale of principal residence is not limited to U.S. residences).

183 This argument often is made in the context of ensuring American competitiveness overseas. However, it also raises issues of equity to the extent it compares the status of citizens residing abroad to that of citizens living in the United States. *See* Postlewaite & Stern, *supra* note 79, at 1114–18 (critiquing cost-of-living differential and related benefits of 1978 tax act on equity grounds).

184 *See supra* note 163 and accompanying text.

185 *See supra* note 75.

Code provides no deduction for these expenses.[186] Similarly, a large number of people living in the United States send their children to private school in lieu of public school for a variety of reasons,[187] yet the costs of private elementary and secondary school tuition are generally not deductible.[188] In this context, it is difficult to justify on equity grounds special tax benefits only for citizens abroad who incur these expenses.

Finally, a potential equity argument is that citizens abroad pay other taxes in addition to the U.S. federal income tax. Commentators have suggested that citizens living abroad should not be subject to U.S. income tax because they often incur high foreign taxes.[189] Of course, to the extent these foreign taxes are income taxes, the foreign tax credit generally ensures equity by reducing the U.S. tax accordingly.[190] However, to the extent that foreign taxes are consumption-based, as is the case with value-added taxes (VATs), the foreign tax credit will not apply.

Several factors reduce the adverse equitable impact of foreign VATs. First, many countries with VATs also have high income tax rates,[191] in which case the foreign tax credit might eliminate all U.S.

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186 *See* CONG. RESEARCH SERV., *supra* note 151, at 42–43 (noting that home travel tax benefit for citizens working abroad is difficult to defend under such circumstances).

187 In 2006, approximately 6.4 million students were enrolled in private elementary and high schools in the United States, representing just under twelve percent of the total U.S. school enrollment. *See* Thomas D. Snyder et al., Nat'l Ctr. for Educ. Statistics, DIGEST OF EDUCATION STATISTICS 2005, at 15 tbl.3 (2006), *available at* http://nces.ed.gov/programs/digest/d05/tables/dt05_003.asp.

188 *Cf.* I.R.C. § 222 (Supp. III 2003), *amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922 (allowing deduction only for certain college-level tuition). Moreover, unlike the citizen in the United States, the citizen abroad is not subject to the U.S. state property taxes that often support public schools. *See* Postlewaite & Stern, *supra* note 79, at 1118 (arguing that any tax relief for schooling of citizens abroad should be reduced by domestic property taxes avoided). However, the taxes paid by the citizen abroad to his country of residence might offset this potential advantage.

189 *See, e.g.*, Patton, *supra* note 113, at 697–98, 730 (discussing high income and consumption taxes paid by many U.S. citizens living in foreign countries).

190 *See supra* notes 46–51 and accompanying text. If the effective foreign income tax rate exceeds the U.S. tax rate, the citizen living abroad might pay higher total income taxes than a citizen living in the United States. This result, however, is a function of the high rates imposed by the foreign country, not the imposition of U.S. tax, because the foreign tax credit generally would eliminate all of the U.S. income tax on that foreign income.

191 For a recent summary of the VAT rates in various OECD countries, see ORG. FOR ECON. CO-OPERATION & DEV., CONSUMPTION TAX TRENDS: VAT/GST AND EXCISE RATES, TRENDS AND ADMINISTRATION ISSUES 30–31 tbl.3.5 (2006). Among OECD countries, the standard VAT rates range from five percent (Japan) to twenty-five percent (Denmark, Hungary, Norway, and Sweden), *id.*, although "a wide range of lower rates, exemptions and special arrangements" are often available, *id.* at 24. The unweighted average VAT rate in OECD countries is approximately 17.7%. *Id.* at 31 tbl.3.5.

income tax. Thus, this equity argument would apply only with respect to high-VAT, low-income-tax countries. As a practical matter, many low-income-tax jurisdictions for which overseas citizens groups seek U.S. tax relief do not fit this category.[192] Furthermore, a citizen living in the United States might incur both state and local income taxes. Unlike foreign income taxes, which are creditable (whether imposed at the federal or local level in the foreign country), U.S. state and local income taxes are only deductible.[193] In addition, a citizen living in the United States might pay significant consumption taxes in the form of state sales taxes. For many taxpayers, these sales taxes are not deductible for federal income tax purposes.[194] Because of these various factors, it is difficult to determine the extent, if any, that citizens living abroad bear a heavier overall tax burden than those living in the United States[195] and therefore difficult to justify eliminating citizenship-based taxation on equity grounds.

2. *Neutrality—Where to Live and Whether to Renounce Citizenship*

Questions of neutrality play an important role in tax policy analysis. These inquiries generally focus on the efficient allocation of capital investment.[196] However, the threshold question of whether the

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192 For example, Saudi Arabia and Hong Kong do not have VATs, while Singapore has only a five percent consumption tax (in the form of a goods and services tax). The Fed'n of Int'l Trade Ass'n, Country Profiles and Resources, http://www.fita.org/countries/ (last visited Jan. 22, 2007).

193 I.R.C. § 164(a) (2000). A deduction only reduces the net federal tax liability by an amount equal to the state tax multiplied by the taxpayer's marginal tax rate, whereas a credit would reduce the federal tax liability by the full amount of the creditable tax.

194 I.R.C. § 164(b)(5) (West Supp. 2005), *amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 103, 120 Stat. 2922. Because a taxpayer electing to deduct state sales taxes must forego the deduction for state and local income taxes, this deduction generally is of benefit only for taxpayers who reside in the few states without income taxes.

195 *See* H. COMM. ON WAYS & MEANS, 95TH CONG., RECOMMENDATIONS OF THE TASK FORCE ON FOREIGN SOURCE INCOME 15–16 (Comm. Print 1977) ("[I]t is difficult to determine whether individuals working abroad are generally better off or worse off than those working in the United States from a tax standpoint.").

196 There are two principal competing approaches for determining whether a U.S. tax is "neutral" with respect to capital investment: capital export neutrality (CEN) and capital import neutrality (CIN). *See* CHARLES H. GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT AND PROBLEMS 17–19 (3d ed. 2006) (describing these and third approach, "national" neutrality). CEN focuses on whether a U.S. person (however defined) pays the same total tax (U.S. and foreign) on his investment income, regardless of where the income is earned, leaving that person's decision on whether to invest in the United States or abroad dependent only on the risk-adjusted return of the investment, rather than on tax considerations. *Id.* at 18. CEN generally supports taxing U.S. persons on their worldwide income, with some form of foreign tax credit to alleviate double taxation from foreign investments. In contrast, CIN attempts to achieve neutrality from the perspective of the country where investments are made. *Id.* Under a CIN perspective, all investments made within a particular country should be taxed the

United States should use citizenship as a jurisdictional basis does not fit squarely within this capital-focused framework.[197] Instead, the threshold jurisdictional question impacts more fundamental aspects of neutrality: the effect of this tax policy on where a citizen chooses to live and whether those living abroad choose to renounce their U.S. citizenship.

A person might choose to live in a particular country for a variety of reasons including personal and family history, social or cultural connections, nationality status, economic opportunities, and climate preferences. A person's nationality is usually a function of his place of birth and/or the nationality of his parents, but he might choose to acquire a new nationality (and possibly renounce an existing one) for similar reasons. Because of the personal nature of these issues, this analysis assumes that a neutral tax policy—one that neither encourages nor discourages decisions regarding place of residence or nationality—is preferable to a policy that actively attempts to influence these decisions.[198] Moreover, in order to isolate the threshold jurisdictional question from additional issues that may arise in the context of foreign earned income,[199] the neutrality inquiry in this subpart focuses on a hypothetical U.S. citizen who principally receives investment-type income.

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same (i.e., at the rate imposed by the destination country of the investment). Accordingly, CIN supports a territorial system where the United States would not tax the foreign investment income of U.S. persons (however defined). *Id.* Economists and analysts disagree as to which approach is preferable. *Id.* at 17–19; *cf.* Graetz, *supra* note 12, at 269–97 (explaining competing theories and suggesting that less reliance should be placed on them).

[197] Whereas the jurisdictional question asks whether a U.S. citizen abroad should be considered a U.S. person, CEN, by focusing on neutral treatment of a U.S. person's domestic and foreign investments, presupposes that the taxpayer whose investment decision is being examined is a U.S. person. The jurisdictional determination undoubtedly will have economic effects. For example, if the United States decides not to tax based on citizenship, a U.S. citizen abroad might prefer an investment in a no-tax jurisdiction over a slightly better investment in the United States that would be subject to U.S. source-based taxation. However, this result is no different than that faced by any nonresident alien (who also is treated as a non-U.S. person by the Code), and is a function of the United States' decision to impose source-based taxation on non-U.S. persons (however defined), with the resulting possibility that it might lose some investments at the margin from foreign persons.

[198] Some commentators have suggested that under certain circumstances—in particular, when economically less developed countries face the "brain drain" of educated persons leaving to accept jobs in more developed countries—a country's tax code should be used to offset the adverse impacts of emigration. *See* Desai et al., *supra* note 5, 682–83 (discussing theoretical benefits and practical enforcement difficulties of economically developing countries taxing worldwide income of citizens abroad).

[199] For a discussion of these issues, see *infra* Part IV.

a. Choice of Residence

A citizenship-based tax regime minimizes the role of taxes in a citizen's residency decision. If a citizen is subject to U.S. tax regardless of where he lives, his residency decision will be governed primarily by the nontax factors discussed in the preceding paragraph. In contrast, a tax system that does not use citizenship as a basis to tax might significantly impact a U.S. citizen's choice of where to live.[200] While many citizens, for the personal reasons listed above, might choose to continue residing in the United States, and thereby be taxed as residents on their worldwide income, many might decide that significant tax savings justify moving from the United States to a low- or no-tax jurisdiction.[201] Indeed, other economically developed countries that generally do not tax their citizens abroad face significant problems with citizens moving abroad to avoid tax liability.[202]

This concern was raised during the 1926 hearings regarding the foreign earned income exclusion, although at the time one commentator insisted that, in light of the difficulties American companies encountered trying to induce American employees to relocate abroad, he had "no fear" of tax-motivated changes in residence.[203] Similarly, in 1975 a commentator claimed that such concerns were unwarranted, because "the frequent occurrence of abuse would require a mobility of population which probably does not exist."[204] Regardless of the accuracy of these assertions when they were made in 1926 and 1975, subsequent improvements in communication and travel may have so increased individual mobility that a significant number of persons today might be willing to move abroad, at least for relatively short

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200 *See* Peroni, *supra* note 111, at 1008 (noting "social behavior" effect regarding citizen's choice of residence in context of section 911 foreign earned income exclusion).

201 *Cf.* Shay et al., *supra* note 121, at 111 n.96 (citing corporate inversion phenomenon as evidence that "if it is possible for a resident to achieve higher after-tax income by earning it as a nonresident, then resident taxpayers will take steps to do so"). Similarly, citizens who live abroad and would like to return to the United States for personal reasons might be discouraged from doing so under such a system because reestablishing U.S. residence would subject them to U.S. income taxation.

202 For example, the French government estimates that at least one millionaire per day abandons French residence in order to avoid French taxes. Molly Moore, *Old Money, New Money Flee France and Its Wealth Tax*, WASH. POST, July 16, 2006, at A12. Another recent example involves members of the Rolling Stones, who, despite their U.K. nationality, reportedly have paid an effective U.K. tax rate of only 1.6% on their royalties and other income during the past twenty years because they have maintained their tax residence outside the United Kingdom. Katie Hind, *A Rolling Stone Gathers No Tax (Or Just 1.6pc on E354m)*, DAILY MAIL (London), Aug. 2, 2006, at 29.

203 67 CONG. REC. 3782 (1926).

204 Patton, *supra* note 113, at 733.

periods, if doing so resulted in significant tax savings (e.g., arranging to sell a significantly appreciated asset during that period).[205]

The number of citizens who would establish foreign residence under such a system would depend, in part, on the extent to which they could continue to spend time in the United States without being treated as a "resident" for tax purposes. This would put significant pressure on the definition of resident. If the current "substantial presence" residence test applicable to aliens were extended to citizens,[206] a citizen could spend approximately four months in the United States without becoming a U.S. resident and still avoid taxation on both investment and earned income from foreign sources.[207] Such a test might encourage many high-income Americans to relocate outside the United States for eight months per year. Even if a more stringent standard were used for citizens leaving the country, such as requiring the citizen to establish "bona fide" residence outside the United States for a minimum length of time,[208] a significant number of people might do so if the tax savings were high enough.

In order to avoid abuses that might occur if Congress were to eliminate the taxation of citizens abroad, some commentators suggest coupling the elimination of citizenship-based tax with an anti-abuse tax regime targeting citizens who cease to be U.S. residents.[209] For example, Congress could extend Code section 877 (the special regime that taxes certain U.S.-source income for ten years following a

[205] After all, significant numbers of (presumably high income) "snow birds" already move from colder areas of the United States to Florida or the U.S. Southwest during the winter months without any federal tax incentive (although some of them might seek state tax benefits by claiming a Florida domicile).

[206] The substantial presence test treats an alien as a U.S. tax resident if the individual has at least 183 days of physical presence in the United States under a three-year weighted formula (the number of days of physical presence in the current year, plus 1/3 of the days of physical presence in the immediately prior year, plus 1/6 of the days of physical presence in the second prior year). I.R.C. § 7701(b)(3) (2000).

[207] Presumably, the U.S. citizen would continue to be taxed on U.S. source income in the same manner as nonresident aliens. This approach would enable the U.S. citizen to receive interest from U.S. banks and U.S. corporate debt obligations without tax, because nonresident aliens generally are not taxed on these items of U.S. source income. I.R.C. § 871(h)–(i) (2000).

[208] *See* Patton, *supra* note 113, at 733 ("[T]wo full years of bona fide residence should be sufficient . . . ."). Some legislative proposals to eliminate citizenship-based taxation have focused on a combination of these tests. *See* H.R. 4562, 102d Cong. (1992) (proposing to eliminate most taxation of foreign income of U.S. citizen who is either bona fide resident of foreign country for entire taxable year or present in foreign countries for at least seventeen months in eighteen-month period); H.R. 2430, 102d Cong. (1991) (same); *supra* note 4 (describing other countries' extension of "residence" test to prevent citizens from escaping tax by leaving for short periods).

[209] *See* Gann, *supra* note 70, at 67–68 (suggesting revision of section 877 to apply to citizens who shift residence abroad and addition of departure tax on unrealized gains).

person's renunciation of citizenship) to these citizens or treat the loss of residence as a realization event, requiring the citizen to pay tax on the gain in certain appreciated assets at the time of residence termination.[210]

This approach has difficulties, both from a practical and theoretical perspective. As a practical matter, despite several rounds of legislative changes, section 877 has been largely unenforceable against individuals who renounce their citizenship.[211] Although enforcement might be easier in the proposed context because an ongoing citizen might be more willing to comply than would a former citizen, it would allow a person with significant foreign holdings, or one who is patient enough to wait ten years before selling his stock, to reap significant tax benefits.[212] A mark-to-market approach, treating the residence change as a realization event, might have an impact on some citizens, particularly if most of their assets consist of highly appreciated property.[213] However, it would not affect individuals whose assets consist primarily of unappreciated property.[214]

Thus, to the extent these proposals are intended to introduce neutrality into a citizen's decision to establish residence abroad, they accomplish their goal in an unpredictable and selective way.[215] Some citizens might trigger a significant tax burden by changing residence, and therefore would have a strong incentive to avoid it. Others would face no significant adverse tax consequences and could reap significant future benefits by moving abroad.

Even if such an approach succeeded in achieving neutrality, it would merely remove one objection to eliminating the citizenship tax. Unlike retaining the tax, a choice already neutral with respect to residence decisions, eliminating the tax and imposing an anti-abuse regime fails to comport with the fundamental justifications discussed in the previous subparts for imposing citizenship-based taxation. As discussed previously, a citizen who moves abroad continues to be a part of U.S. society in a significant sense and retains the benefits of

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210 *Id.*

211 *See* Kirsch, *supra* note 170, at 886–87 (describing enforcement issues and other problems with section 877 regime).

212 *Id.* Indeed, this provision would encourage a citizen contemplating moving abroad to shift his investments to foreign assets well in advance of the move.

213 For a discussion of mark-to-market proposals in the context of citizens surrendering citizenship, see *id.* at 883–85.

214 That is, property whose value does not significantly exceed its tax basis. Many fixed-income instruments might fit this category, as well as property that was recently inherited (because the recipient generally receives a stepped-up basis upon inherited property).

215 *Cf.* Alice G. Abreu, *Taxing Exits*, 29 U.C. DAVIS L. REV. 1087, 1109–20 (1996) (discussing nonneutrality of proposed mark-to-market regime for individuals who surrender citizenship for tax-avoidance purposes).

U.S. citizenship. An anti-abuse regime, focusing only on "settling up" a citizen's existing tax liabilities at the time he ceases to reside in the United States and not taxing the citizen thereafter, allows the nonresident citizen to continue being a part of U.S. society and retain the benefits of U.S. citizenship for subsequent periods without supporting the country through tax payments.

b. Renunciation of Citizenship

Whereas citizenship-based taxation is neutral with regard to residency decisions, it might not be neutral with regard to a person's decision to retain or surrender citizenship. A citizen living abroad might decide that the privilege of returning to the United States, as well as the other benefits of citizenship, do not justify the "price" of that citizenship in the form of taxes. If so, he could obtain another nationality[216] and subsequently renounce or otherwise terminate his U.S. citizenship.[217] In contrast, a tax system that does not use citizenship as a basis to tax would not impact a person's citizenship decision.

The number of U.S. citizens who have renounced their citizenship under the current citizenship-based tax regime is relatively small,[218] although the list includes several high-profile, wealthy individuals.[219] This reluctance to renounce citizenship for tax purposes might be the result of various factors such as a perception that the benefits of citizenship justify the taxes, patriotism or other feelings of personal attachment to the country, or a concern about potentially adverse consequences under existing tax and immigration laws.

Despite the low incidence of renunciation, this issue has received significant political attention, with Congress enacting several provi-

216 An active market currently exists for those seeking to purchase citizenship in a second country. *See* Gray, *supra* note 150, at 45–56 (summarizing costs and merits of various countries' citizenship acquisition programs); Langer, *supra* note 150, at 37–40 (presenting basic rationales for second citizenships).

217 *See* Kirsch, *supra* note 10, at 381–83 (describing current constitutional, statutory, and administrative procedures for renouncing U.S. citizenship). In contemplating the adoption of citizenship-based taxation by economically less developed countries, Professors Desai, Kapur, and McHale noted that "many citizens of rich countries working overseas have the incentive to remain tax compliant because of their intention to return home," whereas citizens of less developed countries might not place as much value on the right to return home and therefore might view the "price of citizenship" as too high, resulting in waves of citizenship renunciations by the latter group. Desai et al., *supra* note 5, at 683.

218 Between 1991 and 2001, an average of fewer than 600 individuals per year (0.00023% of the citizenship population) renounced or otherwise lost U.S. citizenship. Kirsch, *supra* note 170, at 876. No reliable data exist to indicate how many of these individuals renounced citizenship for tax purposes, but it is believed that the large majority were not tax motivated. *See id.* at 876 & n.51 (providing examples of citizens who surrendered citizenship for nontax purposes).

219 *See id.* at 893 n.142, 897–98 nn.156–59 (listing selective names).

sions aimed at penalizing individuals who surrender citizenship for tax purposes. For example, legislation enacted in 1996 attempts to publicly shame these expatriates via name publication[220] and bans them from future entry into the United States by including them on a no-admit list with terrorists, World War II–era Nazis, practicing polygamists, and others.[221] Legislation enacted in 2004 creates a special definition of "citizenship" that applies only for tax purposes, providing that under certain circumstances a person might continue to be taxed on his worldwide income as a "citizen" even when he is actually no longer a citizen under U.S. nationality law.[222]

Although most people probably find the thought of renouncing citizenship to save taxes highly objectionable,[223] it is important that Congress not enact tax provisions penalizing it or making it overly burdensome. The right to renounce citizenship has played an important role in U.S. history. More importantly for purposes of this Article, the right to renounce citizenship plays an important role in the earlier analysis of the equitable grounds for imposing citizenship-based taxation. As discussed above, an important justification for treating an overseas citizen as a member of U.S. society for purposes of ability-to-pay equity analysis is the fact that the person, by retaining citizenship, voluntarily remains a part of that society. If unreasonable barriers are imposed on citizenship renunciation, a person's retention of citizenship might not reflect a voluntary retention of ties with the United States. Thus, the possibility that some citizens might find the tax costs of citizenship too high, and might choose to surrender citizenship, is a necessary corollary to this justification for citizenship-based taxation.

The extent to which the United States could impose some tax consequences on a person's loss of citizenship without undermining the case for citizenship-based taxation is unclear. Of course, the elimination of all special tax consequences, as Professor Abreu has advocated,[224] would be consistent with imposing taxation based on the fact

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220 I.R.C. § 6039G (West Supp. 2005); *see also* Kirsch, *supra* note 170, at 888–89, 906–12 (criticizing shaming sanctions).

221 8 U.S.C. § 1182(a)(10) (2000); *see also* Kirsch, *supra* note 170, at 890–92, 896–906 (criticizing banishment sanction).

222 *See* I.R.C. §§ 877(g), 7701(n) (West Supp. 2005); *see generally* Kirsch, *supra* note 10 (suggesting that provision is inconsistent with jurisdictional bases to tax under international law and may violate Constitution).

223 As Professor Abreu observed, "Expatriation, like flag burning, seems like a good thing to be against." Abreu, *supra* note 215, at 1162.

224 In analyzing the merits of various proposals targeting tax-motivated renunciations, Professor Abreu concluded that no tax consequences should flow from a person's renunciation of citizenship because it is not possible to create neutral tax rules in this area and,

that an overseas citizen has voluntarily retained citizenship. Legislative proposals that would treat renunciation of citizenship as a realization event, and thereby cause the recognition of gain with respect to certain assets, might also be consistent with equity principles. Such provisions cannot be fully neutral and might have disparate impacts because some persons with significantly appreciated assets would owe significant taxes, while those holding cash or nonappreciated assets might not. Nevertheless, these provisions generally reflect an effort to collect tax only with respect to economic appreciation that has accrued during the period of citizenship and therefore can be viewed as nonpunitive.[225] Moreover, to the extent these provisions mitigate significant hardships, as, for example, when they allow the taxpayer to delay payment of tax until the asset is actually sold, they might not interfere with a person's decision to renounce citizenship. While this type of anti-abuse measure is inappropriate for citizens *residing* abroad,[226] the criticisms of these measures do not apply in the context of renouncing citizenship. In the earlier analysis, because the taxpayer continued to hold citizenship and thereby retained its benefits and remained a part of U.S. society, an attempt to "settle up" and impose no future taxes once residency was lost was inconsistent with equity and benefits concerns. Where the person is actually losing citizenship, an attempt to "settle up" and impose no future taxation might be consistent with the equity concerns as well as the benefits analysis.

Accordingly, if no special tax regime applied upon surrender of citizenship, or even if a reasonably restricted mark-to-market provision were enacted with respect to persons who surrender citizenship, a person who continues to hold citizenship could be viewed as doing so voluntarily, thereby supporting the imposition of citizenship-based taxation for citizens living abroad. However, provisions such as those present in current immigration law that attempt to punish or impose significant sanctions on tax-motivated renunciations undermine the case for taxing those persons who live abroad and retain citizenship.

3. *Compliance and Enforcement*

The third traditional tax policy criterion focuses on administration and enforcement. In particular, it looks to whether a tax is reasonably easy for the IRS to administer and enforce, and for taxpayers

more importantly, because the loss of citizenship has high inherent costs (i.e., the loss of citizenship benefits). *See* Abreu, *supra* note 215, at 1109–20, 1158.

[225] *But see id.* at 1120–31 (discussing potential penal nature of proposed mark-to-market regime in context of tax-motivated citizenship renunciation).

[226] See *supra* notes 213–15 and accompanying text for this criticism.

to comply with. While there are frequent calls to simplify the Code in order to improve enforcement and compliance,[227] these criteria are often overlooked in the actual legislative process.

In the context of taxing citizens overseas, questions of enforcement play a critical role.[228] To the extent the tax on citizens living abroad cannot be enforced, the equity and efficiency concerns discussed above may be moot.[229] Almost a century ago, Professor Seligman, in questioning the advisability of the 1894 Act's purported taxation of citizens abroad, noted that it might be "virtually impossible" to reach the foreign income of a nonresident citizen.[230] The Philippines faced significant enforcement problems in the years before it abandoned citizenship-based taxation in 1997.[231] Even today, concerns about enforcement might provide the strongest argument against taxing the foreign source income of citizens residing abroad.[232]

As a very broad generalization, citizens overseas can be viewed in one of two categories with respect to compliance and enforcement issues: those citizens who work for U.S. multinationals and those who do not. Those who work for U.S. multinational corporations often have employment contracts that make compliance more likely, containing tax equalization or tax protection clauses that entitle them to additional compensation to offset extra taxes and other expenses

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227 *See, e.g.*, PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 2–3 (2005) (criticizing complexity of federal tax system); STAFF OF J. COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 (Comm. Print 2001) (analyzing sources of complexity in tax code and making simplification recommendations).

228 For a general discussion of the enforcement problems that arise in an international context with respect to both individual and corporate taxpayers, see David R. Tillinghast, *Issues of International Tax Enforcement*, *in* THE CRISIS IN TAX ADMINISTRATION 38, 38–60 (Henry J. Aaron & Joel Slemrod eds., 2004).

229 A recent study on the relationship between tax administration and tax design noted that without considering administration issues, "the efficiency cost and the equity impact of a real world tax system cannot be assessed." Arindam Das-Gupta, *Implications of Tax Administration for Tax Design: A Tentative Assessment*, *in* THE CHALLENGES OF TAX REFORM IN A GLOBAL ECONOMY 363, 368 (James Alm et al. eds., 2006).

230 SELIGMAN, *supra* note 17, at 517. In addition to this practical concern, Seligman, writing in the period before the foreign tax credit had been enacted, opposed citizenship-based taxation on principle because of the potential for double taxation. *See id.* at 517–18.

231 *See* Richard D. Pomp, *The Experience of the Philippines in Taxing Its Nonresident Citizens*, *in* INCOME TAXATION AND INTERNATIONAL MOBILITY, *supra* note 144, at 43, 45 ("The Philippines appears to have been markedly unsuccessful in enforcing its tax on emigrants. Noncompliance among this group is apparently widespread, and the Philippines lacks any effective response or sanctions.").

232 Professor Avi-Yonah recently cited enforcement difficulties as a factor in concluding that the advisability of citizenship-based taxation is "doubtful." Avi-Yonah, *supra* note 113, at 486.

incurred by reason of accepting overseas employment.[233] Moreover, if citizens are working abroad for a U.S. employer, the IRS will receive wage data from that employer,[234] making it easier to enforce reporting requirements.[235] However, this aspect of enforcement might decrease in the future to the extent that the Code, by defining whether a corporation is a U.S. person based on place of incorporation, encourages more corporations to incorporate outside the United States.

Citizens who do not work for U.S.-based multinationals do not have this latter check on underreporting. This check will be entirely absent for a citizen who derives all of his income from foreign sources and has little ongoing contact with the United States. The IRS might not be aware of the overseas citizen's existence, and even if the IRS is aware, it might have significant difficulty determining the individual's income and tax liability.[236] Even if the IRS determines that an overseas citizen owes taxes, collection problems arise to the extent the individual's assets are outside the United States.[237]

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[233] For a recent summary of these clauses and the way that they help tax compliance, see Desai et al., *supra* note 5, at 681.

[234] *See* Office of Tax Policy, *supra* note 171, at 13 (describing limitations on wage and salary information received by IRS); U.S. Gen. Accounting Office, Tax Administration: Non-Filing Among U.S. Citizens Abroad 13 (1998) (same). In addition, the U.S. employer might be required to withhold U.S. income tax from the U.S. citizen's pay unless foreign income tax withholding is also required. Internal Revenue Serv., U.S. Dep't of the Treasury, Publ'n No. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad 7 (2005). Research in the domestic context suggests that individuals "covered by information reporting and tax withholding pay a far greater share of their true tax liabilities than those who are not subject to them." U.S. Gen. Accounting Office, *supra*, at 13.

[235] A recent analysis focusing on citizens employed by U.S. firms concludes that "the U.S. experience demonstrates the possibility of an expansive definition of individual taxation in a world characterized by global labor mobility." Desai et al., *supra* note 5, at 682. Of course, the filing of the return does not necessarily mean that the return is accurate, particularly with respect to income not related to the employment abroad. More generally, a commentator observed that corporate executives transferred abroad might "quickly catch the spirit of tax 'avoidance' found in parts of Europe." Patton, *supra* note 113, at 734.

[236] *See* Office of Tax Policy, *supra* note 171, at 13–14 (describing these difficulties). The mere fact that a citizen overseas does not file a tax return does not necessarily indicate that he is failing to pay U.S. taxes that are owed. In particular, the foreign earned income exclusion and the foreign tax credit might eliminate any residual U.S. tax. *See id.* at 2–4 (noting that fifty percent of returns filed by overseas citizens or resident aliens report no tax liability due to foreign earned income exclusion and foreign tax credit); *cf.* Treas. Reg. § 1.911-7(a)(2) (as amended in 1993) (describing circumstances when foreign earned income exclusion is conditioned on filing return). For a discussion of additional administrative problems faced by the IRS in enforcing the tax laws against citizens overseas, see generally Office of Tax Policy, *supra* note 171.

[237] *See* Office of Tax Policy, *supra* note 171, at 14. For detailed discussions of the issues raised with offshore collection, see Susan A. Berson, Federal Tax Litigation

These difficulties combine to render almost impossible any estimate of compliance by citizens residing overseas.[238] Moreover, the lack of a reliable estimate of the number of U.S. citizens residing abroad only compounds the problem. In recent congressional testimony, State Department officials provided estimates in the three to four million range.[239] As noted above, the U.S. Census Bureau conducted, with disappointing results, a preliminary test in 2004 to determine the feasibility of counting citizens abroad for purposes of the 2010 census.[240]

Despite the lack of reliable data, studies suggest that "nonfiling may be relatively prevalent in some segments of the U.S. population abroad."[241] The IRS has attempted various initiatives in order to increase compliance by overseas citizens, such as simplifying reporting requirements, increasing taxpayer education, and enlisting the assistance of overseas organizations with U.S. citizen members.[242] Although these efforts might improve compliance among certain citizens, they generally will not help the IRS enforce the laws against those who actively seek to evade taxes. Indeed, even in the case of

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§ 13.10[3] (2003) and William M. Sharp, Sr. & Hale E. Sheppard, *Defending Against IRS Discovery in the International Arena*, 101 TAX NOTES 889, 890, 897–900 (2003).

238 *See* U.S. GEN. ACCOUNTING OFFICE, *supra* note 234, at 21 ("The extent and impact of nonfiling abroad remain largely unknown . . . .").

239 *Hearing, Protecting Citizens*, *supra* note 130, at 5 (statement of Dianne M. Andruch, Deputy Assistant Secretary of State, Overseas Citizens Service, Bureau of Consular Affairs). The U.S. Census Bureau submitted a report to Congress in 2001 in which it mentioned a State Department estimate that there were 3.8 million nonofficial U.S. citizens living abroad, although the Census Bureau stated that "this number is not accurate" because "[t]he Department of State does not officially track either the number or location of U.S. citizens living in other countries." U.S. CENSUS BUREAU, ISSUES OF COUNTING AMERICANS OVERSEAS IN FUTURE CENSUSES 9 (2001), *available at* http://www.census.gov/population/www/socdemo/overseas/overseas-congress-report.pdf. Other less reliable estimates in proposed legislation or congressional testimony range as high as ten million, although their providers might have had incentives to inflate the numbers. *See, e.g.*, H.R. 1619, 108th Cong. (2003) (estimating three to six million in "Findings" section of bill advocating inclusion of citizens abroad in 2010 census); S. 1682, 108th Cong. (2003) (same); *Hearing, How Can We Count Them?*, *supra* note 137, at 63 (testimony of T.B. McClelland, Member of the Board of Directors, American Business Council of the Gulf Countries). The U.S. Census Bureau collected data on private citizens living abroad in 1960 and 1970. *See* KAREN M. MILLS, U.S. DEP'T OF COMMERCE, TECHNICAL PAPER 62, AMERICANS OVERSEAS IN U.S. CENSUSES 37, 45–46 (1993), *available at* http://www.census.gov/population/www/socdemo/overseas/techn62-3.pdf, http://www.census.gov/population/www/socdemo/overseas/techn62-4.pdf. However, the data was deemed to be unreliable and was not used for apportionment purposes. *Id.* For example, the Census Bureau estimated that the 1970 data collection might have missed ninety percent of the U.S. citizens residing in Canada and Mexico. *Id.* at 46.

240 *See supra* notes 139–40 and accompanying text.

241 U.S. GEN. ACCOUNTING OFFICE, *supra* note 234, at 21.

242 *See* OFFICE OF TAX POLICY, *supra* note 171, at 8–13 (discussing various IRS overseas compliance intiatives).

citizens living in the United States, the IRS has significant difficulties preventing tax evasion with respect to income-producing assets held outside the United States.[243]

While compliance and enforcement remain very real concerns in evaluating the merits of citizenship-based taxation, recent developments indicate that compliance by and enforcement against citizens residing abroad is improving. For example, to the extent noncompliance was a function of a lack of information or the difficulty of obtaining necessary forms, the widespread availability of the Internet provides significant relief.[244] With respect to the collection of information for enforcement, the IRS has undertaken high-profile efforts to obtain information through third parties on offshore credit cards held by U.S. persons.[245] Although this effort may have little direct impact on citizens living abroad,[246] it reflects creative approaches to the difficulties of enforcement in an international context.[247] As Stephen Shay has observed, to the extent the IRS is able to obtain information through new enforcement methods, it is important that "successes be publicized. In the international arena, success in obtaining information can have a high deterrence effect, particularly after a long period of inactivity."[248]

More importantly, the United States and other jurisdictions have undertaken significant efforts to increase international cooperation in

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243 *See* Staff of Permanent Subcomm. on Investigations, S. Comm. on Homeland Sec. and Governmental Affairs, 109th Cong., Tax Haven Abuses: The Enablers, The Tools and Secrecy 1–2 (Comm. Print 2006) (describing use of offshore tax havens and secrecy jurisdictions); David Cay Johnston, *Tax Cheats Called Out of Control*, N.Y. Times, Aug. 1, 2006, at C1 (describing Senate subcommittee hearings on offshore tax haven abuses).

244 *See supra* note 110 and accompanying text; *see also* Office of Tax Policy, *supra* note 171, at 10 (including improved Internet access to tax forms among "numerous [IRS] measures to improve voluntary compliance by taxpayers overseas").

245 *See* Tillinghast, *supra* note 228, at 51–54 (discussing IRS's use of summonses to obtain information about taxpayers from American credit card companies); Internal Revenue Serv., Offshore Credit Card Program, http://www.irs.gov/newsroom/article/0,,id=105698,00.html (last visited Jan. 2, 2007) (detailing measures taken by IRS's Offshore Credit Card Program "to combat tax-avoidance schemes involving credit cards issued by offshore banks").

246 For example, a John Doe summons issued on American Express required the company to provide records where the mailing address was in certain tax haven countries but the transactions occurred in the United States. Internal Revenue Serv., *supra* note 245. To the extent a U.S. citizen living abroad did not have transactions in the United States, the information resulting from this summons would not identify him.

247 *See* Tillinghast, *supra* note 228, at 54 (arguing that United States "needs to further extend these innovations to keep up with a more complex financial world, in an era of diminishing resources for tax law enforcement").

248 Stephen E. Shay, *Comment* on David R. Tillinghast, *in* The Crisis in the Tax Administration, *supra* note 228, at 38, 66.

tax enforcement matters.[249] The United States has continued to expand its income tax treaty network[250] and has placed significant emphasis on negotiating Tax Information Exchange Agreements (TIEAs).[251] These agreements are primarily aimed at increasing enforcement against U.S. citizens living in the United States who fail to report income from outside the United States. However, the TIEAs may also be useful with respect to an overseas citizen who fails to report income from a country covered by a TIEA.[252] The expansion of the TIEA network is particularly noteworthy because recent agreements have been signed with low- or no-tax jurisdictions that might be viewed as possible locales for tax evasion, including Antigua & Barbuda, Aruba, the Bahamas, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man, Jersey, and the Netherlands Antilles.[253] These TIEAs, however, will not necessarily eliminate all tax evasion by citizens with investments in these coun-

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[249] These efforts correspond with efforts undertaken by the European Union as well as the OECD. *See* Tillinghast, *supra* note 228, at 40–44 (discussing IRS measures to improve exchange of information and implement "mutual-agreement procedure" for tax treaties).

[250] In addition, the IRS has increased administrative efforts to secure information under existing income tax treaties. *See, e.g.*, Cynthia Blum, *Sharing Bank Deposit Information with Other Countries: Should Tax Compliance or Privacy Claims Prevail?*, 6 FLA. TAX REV. 579, 600–01 (2004) (describing recent mutual agreement for enhanced information sharing under U.S.-Switzerland tax treaty).

[251] *See* Donald L. Korb, Chief Counsel, IRS, Remarks at the 18th Annual George Washington University/IRS Institute on Current Issues in International Taxation (Dec. 8, 2005), *in* TAX NOTES TODAY, Dec. 9, 2005, *available at* http://www.lexis.com (commercial electronic database requiring registration) (enter "2005 TNT 236-24" in "Get by Citation") (describing recent increase in TIEAs). In addition, the IRS, in cooperation with U.S. embassies located in countries that are members of the Organization of American States (OAS), is attempting to revise the OAS Mutual Legal Assistance Treaty so that member states will provide information in criminal tax cases (currently the treaty requires them to provide information if the tax offense involves laundering of proceeds from certain specified nontax offenses). *See Corporate and Partnership Enforcement Issues: Hearing Before the S. Finance Comm.*, 105th Cong. (2006) (statement of Eileen J. O'Connor, Assistant Att'y Gen., Tax Division), *available at* http://finance.senate.gov/hearings/testimony/2005test/061306testeo.pdf (discussing international cooperation in tax evasion investigations).

[252] For example, some TIEAs explicitly state that the country will provide information "without regard to whether the person to whom the information relates is . . . a resident of a party [to this agreement]." *E.g.*, Agreement for the Exchange of Information Relating to Taxes, U.S.-Jersey, art. 2, Nov. 4, 2002, 3 Tax Treaties (CCH) ¶ 5303, at 116,601; Agreement for the Exchange of Information Relating to Taxes, U.S.-Guernsey, art. 2, Sept. 19, 2002, 2 Tax Treaties (CCH) ¶ 3613, at 88,601. The omission of this language from some TIEAs does not necessarily indicate that the country would not exchange information with respect to the income of a nonresident (e.g., a U.S. citizen who lives in a third country but has income in the TIEA country), but it "leaves an open question that could result in future litigation." William M. Sharp, Sr. et al., *A Comparative Analysis of the Channel Islands and Isle of Man Treaties*, 98 TAX NOTES 737, 740 (2003) (comparing inclusion of language in Guernsey/Jersey TIEAs with omission in Isle of Man TIEA).

[253] Korb, *supra* note 251. *See generally* Sharp et al., *supra* note 252 (comparing Guernsey/Jersey TIEAs with Isle of Man TIEA); William M. Sharp, Sr. et al., *U.S. Tax*

tries. In particular, many TIEAs narrowly define the circumstances in which an exchange is required, thereby limiting their usefulness with respect to citizens residing abroad.[254] Nonetheless, the fact that the United States is undertaking these significant efforts to expand international cooperation in tax matters "provides a powerful deterrent to taxpayers contemplating evasion by moving funds offshore."[255]

The difficulties of enforcing a tax against citizens abroad—particularly those who intentionally structure their activities to evade taxation—should not be underestimated. Nonetheless, given the equity-based arguments addressed above, it is difficult to justify abandoning all taxation of citizens abroad merely because of these enforcement concerns, particularly when it is difficult to evaluate how widespread the problem actually is.

B. *Effect on Social Norms*

Tax law's expressive effects on social norms provide a further justification for taxing citizens residing abroad.[256] In particular, the taxation of citizens abroad might have important implications for tax compliance among citizens living in the United States.[257] An exten-

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Information Exchange Agreements: A Comparative Analysis, 97 TAX NOTES 827 (2002) (comparing Cayman Islands, Bahamas, and British Virgin Islands TIEA).

[254] For example, the U.S.-Cayman Islands TIEA requires the Cayman Islands to provide information only if the IRS has a "valid reason" for suspecting a specific taxpayer of criminal tax evasion. *See* Martin A. Sullivan, *U.S. Citizens Hide Hundreds of Billions in Cayman Accounts*, 103 TAX NOTES 956, 962 (2004) (discussing practical limitations of U.S.-Cayman Islands TIEAs).

[255] *Id.* at 961. Sullivan, however, tempers his observation by noting that statements claiming that offshore bank secrecy is evaporating are "probably overly optimistic assessments of the current situation." *Id.*; *see also* Sharp et al., *supra* note 252, at 738 ("The . . . most recent TIEAs clearly signal that the sun is setting on the abusive tax haven industry."); Paula N. Singer, *U.S. Policy on Taxing Citizens and Residents Abroad: A Closer Look*, 42 TAX NOTES INT'L 1033, 1040 (2006) ("Taxes on [income from assets that U.S. citizens and residents maintain abroad] can be expected to increase substantially over the next few years through improved IRS processes using automated exchange of information with treaty partners and income reported by qualified intermediaries."); Tillinghast, *supra* note 228, at 42 ("[T]he tax haven agreements are a big step forward and will prove useful to the IRS. If nothing else, [they] may scare some taxpayers away from these tax havens.").

[256] *See* Kirsch, *supra* note 170, at 913–16 (summarizing literature discussing expressive effects of law); *see also* Paul Schiff Berman, *The Globalization of Jurisdiction*, 151 U. PA. L. REV. 311, 424 (2002) (observing in context of exercise of legal jurisdiction in cyberspace that "assertion of jurisdiction, like all legal acts, can also be viewed as a meaning-producing cultural product").

[257] The assertion of taxing jurisdiction over all citizens, both at home and abroad, might also be viewed as a statement about the importance of citizenship itself. This was perhaps most evident in the Civil War income tax acts, where the exercise of citizenship-based taxation could be viewed as a statement about the meaning of federal citizenship at a time when the country was struggling with that issue. *See supra* note 29.

sive body of literature suggests that people's willingness to comply with tax law depends in part on their perception that others are paying their fair share of taxes.[258] As discussed above, it is reasonable to believe that citizens living in the United States view citizens living abroad as members of a common society.[259] If the United States were to eliminate taxation of citizens living abroad, those at home might conclude that citizens abroad are "getting away with something" and consequently lose confidence in the tax system and the social norm of tax compliance.

Nonetheless, Congress should be cautious of relying on the expressive function of tax law because it sometimes can have unintended effects.[260] For example, an argument can be made that the exercise of citizenship-based taxation might undermine, rather than further, social norms in the United States regarding tax compliance. As discussed above, the IRS faces significant enforcement challenges with respect to overseas citizens. If the public believes that a significant number of citizens overseas are failing to comply with their filing and payment obligations, citizens in the United States might become less willing to comply with their own.

Thus, tax compliance norms might be undermined if Congress eliminates citizenship-based taxation altogether, but they also might be undermined if Congress imposes citizenship-based taxation and the IRS is viewed as failing to enforce it. Given a choice between the two, the risks seem greater in the first instance. If Congress eliminates citizenship-based taxation so that citizens living abroad are no longer subject to U.S. tax, the media is likely to highlight people who move from the United States in order to escape taxes.[261] Indeed, such stories occur frequently in those jurisdictions that do not tax their citizens abroad.[262] In contrast, the norm-altering effect in the latter circumstance would occur only to the extent citizens already living overseas

[258] *See, e.g.*, John S. Carroll, *How Taxpayers Think About Their Taxes: Frames and Values*, *in* WHY PEOPLE PAY TAXES 43, 47 (Joel Slemrod ed., 1992) (citing studies); Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U. L. REV. 333, 341 & n.33 (2001) (same); *see also* Kirsch, *supra* note 170, at 917–18, 937 (same).

[259] *See supra* notes 169–70 and accompanying text.

[260] I have argued this point elsewhere. *See* Kirsch, *supra* note 170, at 916–21 (discussing problems with banishment and shaming sanctions targeting tax-motivated expatriates).

[261] It could be argued that the change in the tax law itself, by de-emphasizing citizenship, might cause citizens in the United States to stop viewing citizens abroad as part of a common society. If so, citizens in the United States would be less likely to view the nonpayment of taxes by citizens abroad as an abuse, and the adverse effects on compliance within the United States would be minimized. However, given the strong identification most U.S. citizens attach to citizenship, *see supra* notes 169–70, it is doubtful that a change in the tax law itself would have this expressive effect.

[262] *See supra* note 202 and accompanying text.

are publicly identified as not complying with their U.S. tax obligations, a relatively rare occurrence given the uncertainty regarding the general level of noncompliance. Thus, eliminating citizenship-based taxation would probably have a greater adverse impact on tax compliance norms than would its retention.

IV
THE WEAKENED CASE FOR EARNED INCOME EXCLUSIONS

As Part III demonstrates, the case for using citizenship as a jurisdictional basis to tax remains in the twenty-first century. This Part focuses on income earned by taxpayers living and working abroad and considers whether that income should receive special treatment if the United States continues to impose citizenship-based taxation. In particular, it focuses on whether foreign earned income (as opposed to investment income) should be excluded from an overseas citizen's gross income. As noted earlier, the Code currently excludes up to $82,400, plus a limited amount attributable to housing costs.[263] Many overseas citizens groups and business organizations, however, advocate making the foreign earned income exclusion unlimited.[264] The following analysis evaluates the merits of such an unlimited exclusion.[265]

A. *Double Taxation Arguments*

Advocates of an unlimited foreign earned income exclusion, perhaps in an effort to simplify the issues and make their position more appealing to legislators and the general public, often overstate the problem of double taxation.[266] For example, a recent legislative press

[263] *See supra* notes 85–89 and accompanying text.

[264] *See, e.g.*, AM. CHAMBER OF COMMERCE IN H.K., *supra* note 5, at 2 ("Ideally, the U.S. should revise its tax laws to join the international norm of not taxing the foreign earned income of citizens who are working and living overseas."); AM. CITIZENS ABROAD, STOP KILLING THE GOOSE THAT LAYS THE GOLDEN EGG, STOP THE DOUBLE TAXATION ON AMERICANS WORKING ABROAD 5–6 (2007), *available at* http://www.aca.ch/goldgoos.pdf (supporting legislation making exclusion unlimited).

[265] Because the exclusion applies only to "earned" income, the U.S. citizen would continue to have U.S. tax liability on investment income. *Cf. supra* note 87 and accompanying text (describing alternative methods for determining applicable marginal tax rate on income not excluded). While focusing on an unlimited exclusion, the following analysis highlights areas where a capped exclusion for foreign earned income would lead to significantly different results.

[266] An earlier commentator, observing the legislative debate on this issue a quarter century ago, cited other examples of overstatements made by advocates of an unlimited foreign earned income exclusion, concluding that "[t]he sad part about expatriate taxation is that many of the arguments may be justified; but so many of them are infuriating that the good ones are often lost." Kingson, *supra* note 15, at 738.

release[267] and several op-ed pieces,[268] as well as earlier legislative testimony,[269] complain about the "double taxation" faced by citizens abroad and advocate an unlimited foreign earned income exclusion as necessary to eliminate this problem. This double taxation emphasis fails to acknowledge that many foreign countries impose little or no income tax on a U.S. citizen working there.[270] Indeed, the press release accompanying a recent legislative proposal implies the opposite, claiming that once an unlimited exclusion is enacted, "[o]ther nations would continue to tax that income, just as the United States taxes the income of foreigners who live and work in America."[271] Thus, these arguments fail to acknowledge that in the case of U.S. citizens living in certain countries, the U.S. tax is the only income tax they pay and that if an unlimited exclusion were enacted, these individuals would pay *no* income tax to any country on their foreign earned income.[272]

Even in the context of citizens living and working in relatively high-tax jurisdictions, such as many European countries, the double taxation emphasis is misplaced. As discussed earlier, a citizen with foreign source income may claim a foreign tax credit for income taxes

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267 Press Release, Senator Jim DeMint, DeMint Bill Would End Double Tax on Americans Working Abroad (June 13, 2006), *available at* http://demint.senate.gov/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=387&Type=Press%20Release&Month=6&Year=2006.

268 *See, e.g.*, Gingrich & Kies, *supra* note 9 ("We are subject not only to U.S. tax on these amounts, but also to taxes imposed by the foreign country."); Mitchell, *supra* note 9 ("Since U.S. citizens living overseas are already, in most cases, paying local taxes in the countries where they work, that means they end up being taxed twice . . . .").

269 For example, Representative Bill Alexander, in testimony before a House subcommittee, was asked by a congressional colleague, "[H]ow many Americans abroad are subject to double taxation? Are most of them in that position? Do most countries tax their earnings in addition?" *Hearing, U.S. Citizens Overseas*, *supra* note 112, at 12 (question of Rep. Snowe). In response, Representative Alexander stated, "All of them . . .[, a]ll Americans pay double taxation, whereas their competitors do not." *Id.* (statement of Rep. Alexander).

270 *See* Bradsher & Johnston, *supra* note 85 (citing "Bermuda, the Middle East, Singapore and Hong Kong" as low-tax jurisdictions); Sharon Reier, *Uncle Sam Takes a Bite out of Expatriate Incomes: Burden of New Tax Law Expected to Fall on the Middle Class and Semi-Retired*, INT'L HERALD TRIB., May 27, 2006, at 19 (citing "no-tax and low-tax areas like much of the Middle East, some Caribbean nations and Hong Kong").

271 Press Release, Senator Jim DeMint, *supra* note 267.

272 As a technical matter, the advocates of these arguments might be referring to the high VATs imposed by some countries as the "second" tax. However, such usage would be misleading for several reasons: The context of the arguments usually conveys the impression that "double taxation" involves both countries imposing an income tax; whereas the arguments generally focus on all of the income (including cost-of-living adjustments) earned by the citizen, a VAT only applies to the amount of consumption in the foreign country; and the arguments never mention the U.S. state sales and income taxes that a citizen abroad avoids. *See supra* notes 189–95 and accompanying text.

paid to the foreign government and thereby reduce his U.S. income tax liability by a corresponding amount.[273] Accordingly, even without a foreign earned income exclusion, the United States' imposition of tax generally does not result in a second layer of tax on the foreign income of a citizen working abroad.

B. *Tax Policy Principles Revisited*

1. *Equity*

As discussed above, an important premise underlying equity arguments is that U.S. citizens living abroad remain a part of U.S. society and therefore should be included in allocating tax burdens based on ability to pay. The ongoing connection with U.S. society is often strongest in the case of a U.S. citizen raised in the United States who is transferred abroad by a corporate employer. Even if the assignment is open-ended with no fixed return date, these individuals often maintain significant family and other personal contacts in the United States and often intend to return to the United States once their assignment is over. Moreover, several of the factors often invoked for providing tax relief to citizens abroad, such as the high cost of sending children to an "American" rather than local school, or the cost of annual flights "home" to the United States, underscore the ongoing societal connection of these individuals to the United States.[274] Accordingly, the equity-based arguments for taxing overseas citizens is often strongest in the typical fact pattern used to justify the foreign earned income exclusion.

When applying principles of equity, it is important to acknowledge that some citizens working abroad, whether in high- or low-income tax jurisdictions, might face other costs in excess of those faced by resident citizens such as costs of living higher than in many areas of the United States or VATs greater than U.S. state sales taxes.[275] The same equity concerns discussed in Part III, however,

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[273] *See supra* notes 47–51 and accompanying text.

[274] For example, a recent op-ed piece by Newt Gingrich and Ken Kies, which advocates an unlimited foreign earned income exclusion, refers to "'stranger in a strange land' assistance that our employer[s] may provide (e.g., the cost of sending our kids to an English-speaking school, or airfare for an annual trip home)." Gingrich & Kies, *supra* note 9.

[275] Currency exchange controls might also be viewed as creating equity disparities to the extent the citizen is paid in a foreign currency that is subject to significant restrictions. This issue was raised during the legislative debates leading to the enactment of the current foreign earned income regime in 1981. *See* STAFF OF S. COMM. ON FOREIGN RELATIONS, 96TH CONG., U.S. LAW AFFECTING AMERICANS LIVING AND WORKING ABROAD 21 (Comm. Print 1980) (describing issue); *see also* Sobel, *supra* note 70, at 108 (describing case in which currency conversion to satisfy U.S. tax obligations exposed taxpayer to risk of imprisonment in country of residence). However, there have been significant reductions

apply in the present context of earned income.[276] As with the earlier analysis,[277] it is difficult to generalize regarding these potential burdens. For those incurring lower costs than individuals in the United States, and even for many incurring higher costs abroad, an unlimited foreign income exclusion might result in disproportionate tax savings. To take a simplified example, consider a U.S. citizen living in the United States and earning $300,000 as a corporate executive who pays $90,000 of federal income taxes, leaving him with $210,000 after taxes. If he were to move abroad to work in a no-income-tax jurisdiction and there was an unlimited foreign earned income exclusion, he would pay no income tax. Accordingly, even if he were to incur up to $90,000 of extra expenses and VAT abroad, he would still be better off financially living and working abroad.[278] To the extent his expenses abroad were lower than those in the United States, his windfall would be that much greater. For lower income taxpayers, the amount saved by avoiding an income tax would be lower, and, consequently, there would be fewer opportunities to incur additional expenses. Again, the fact-dependent nature of the results indicates that an unlimited foreign earned income exclusion is difficult to justify on equity grounds.

An argument might be made that a limited foreign earned income exclusion, such as that available under current law, might be justifiable to the extent it results in tax savings that more closely approximate the additional costs associated with working abroad. While this approach might provide fewer extreme windfalls for very high-earning citizens, it still suffers from unpredictable and selective results. In particular, persons with lower expenses overseas, and even those with moderately higher expenses overseas, might receive windfalls. More fundamentally, as discussed above, it may not be equitable to give citizens living abroad tax benefits for higher expenses given that citizens who move from a low-cost to a high-cost city within the United States generally do not get to claim additional federal tax benefits.[279]

in currency exchange controls in the past decades, see *ABA Task Force Report*, *supra* note 1, at 657, thereby reducing the significance of this argument for many taxpayers.

276 The equity arguments might be weaker in the case of a citizen transferred abroad to the extent his employer provides a tax equalization package, thereby relieving the citizen of potentially higher taxes. *See supra* note 181.

277 *See supra* notes 176–88 and accompanying text (discussing burdens of higher living expenses); *supra* notes 189–95 and accompanying text (discussing burdens of foreign VAT).

278 He might be able to incur even more than $90,000 in additional expenses and VAT to the extent he is no longer subject to U.S. state taxes by moving abroad.

279 *See supra* notes 179–81 and accompanying text.

A related argument concerns housing costs incurred by citizens who move abroad for employment reasons. If housing costs are a significant cost increase faced by citizens transferred abroad by their employers, it might be argued that the May 2006 legislative changes, which place a dollar cap on the housing cost exclusion,[280] violate principles of equity. Employers often provide additional compensation to the employee to offset this increase in housing costs,[281] but that housing allowance is included in gross income under general tax principles. Accordingly, equity might suggest that the pre-2006 rules should be reinstated, allowing an exclusion for all housing costs above a relatively low floor.

As others have observed, the principal problem with an unlimited housing cost exclusion is that it also violates equity principles by creating a tax benefit that is available only to citizens working abroad.[282] For example, a person transferred to New York City from a lower-cost U.S. city might receive a higher salary at the new location, in part to compensate for the higher housing costs. The higher salary will be included in the domestic taxpayer's income. Although the citizen abroad might have his extra compensation for housing costs listed as a separate part of his compensation package, the economic result is the same as the person who moves to New York City. Thus, it is difficult to justify a special tax benefit for the person moving abroad.

The one circumstance in which equity might support an exclusion or deduction for housing costs is when the foreign housing costs are significantly higher than those in the highest-cost city in the United States.[283] In that situation, the citizen moving abroad incurs a disadvantage beyond any faced by a domestically based citizen. This situation, however, does not justify the pre-2006 unlimited housing cost exclusion in excess of a relatively low floor. Rather, it would support an exclusion only for the amount by which housing costs exceed the costs in the most expensive U.S. housing market.[284] The possibility of

280 *See supra* notes 88–94 and accompanying text.

281 Equity arguments in favor of the citizen abroad are undermined to the extent that the employer pays not only the extra housing cost amount, but also the tax with respect to that amount.

282 *See, e.g.*, Postlewaite & Stern, *supra* note 79, at 1117 ("[S]uch an approach deviates from horizontal equity for those domestic taxpayers living in areas of the United States that have higher than average housing costs.").

283 *Id.*

284 Even this more restricted housing cost exclusion might not be warranted under equity principles. If the concern is that the move abroad results in higher housing costs, perhaps the equity comparison should be between the increase in housing costs, not the absolute amount of the costs. For example, a person moving from New York City to a higher-cost foreign city might receive a $20,000 allowance for the increased housing costs and, under this more restricted housing cost exclusion (which would use New York City

implementing a deduction for these expenses in lieu of a foreign earned income exclusion is discussed in more detail in Part V.

Equity concerns might support one other criticism leveled against the May 2006 legislative changes. As noted above, the recent legislation changes the way in which a person claiming the foreign earned income exclusion calculates his tax liability with respect to his nonexcluded income.[285] Prior to the 2006 legislation, the taxpayer simply applied the regular tax rates to the taxable income that remained after the exclusion. The 2006 legislation, in order to subject the remaining income to higher progressive tax rates (and thereby generate higher tax revenues), requires the taxpayer to calculate his tax liability as if there were no exclusion, and then subtract the amount of tax liability that would apply to the income that is excluded. In effect, this causes the income that is included after application of the exclusion to be taxed at the higher marginal rates that would have applied had no earned income been excluded.

This so-called "exemption with progression" approach[286] might be inequitable. In particular, to the extent that a limited exclusion is warranted as a proxy for increased expenses, its purpose should be to return the citizen's tax base to that which it would have been had he remained in the United States. This is most evident in the simple case where an individual claims an $80,000 foreign earned income exclusion based on an $80,000 salary increase that his employer gives him to offset the higher costs of living overseas. To the extent that Congress believes that the foreign earned income exclusion is justified on equity grounds, requiring this individual to apply higher marginal tax rates to the remaining income (which is the same as his base income before the foreign transfer) seems inappropriate.

This equity-based argument against exemption with progression is subject to two significant limitations. First, the $82,400 cap on the exclusion is itself an arbitrary number that does not necessarily guarantee equitable treatment with respect to extra expenses incurred abroad. As noted above, some individuals will receive a windfall from the provision, while others might not receive full relief. Thus, the new exemption with progression method of calculating tax liability might

housing expenses as its floor, assuming it is the highest-cost U.S. market), could exclude that full $20,000. However, a person moving from Springfield, Missouri to New York City might experience an increase in housing costs even greater than that $20,000, most or all of which might be reflected in a higher salary, yet he will not be able to exclude any portion of his salary increase under the Code.

285 *See supra* note 87 and accompanying text.

286 *See* Staff of J. Comm. on Taxation, 109th Cong., *supra* note 121, at 9 (discussing exemption with progression in context of territorial tax systems).

merely reflect an alternative way of tweaking an already arbitrary line in a way that costs higher-bracket taxpayers more than it does lower-bracket taxpayers. Under this view, it might be justified under vertical equity principles as restoring a bit of progressivity to a flawed provision that generally benefits higher-income taxpayers—even if it does so in a roundabout and complex way.

Second, equity principles may not be relevant. An equity-based argument against exemption with progression is strongest when the underlying provision itself is based on equity concerns. However, as discussed above, the foreign earned income exclusion is difficult to justify on equity grounds. To the extent the earned income exclusion is based on other considerations, such as the "competitiveness" concerns discussed in the next subpart,[287] the use of exemption with progression seems justified to remove some of the benefit of an exclusion that itself is not supported on equity grounds.

2. *Neutrality*

The neutrality concerns raised by an unlimited foreign earned income exclusion—in particular, the possibility that a citizen might establish residence abroad in a low-tax jurisdiction—are similar to those that arose in the discussion of taxing citizens abroad in general.[288] These concerns, however, are somewhat less persuasive here than they were in the general case. If foreign earned income (and not investment income) is excluded from the tax base, a person would seek tax benefits by moving abroad only if he is able to work effectively outside the United States, whereas a termination of all citizenship-based taxation would also allow retirees and others living off of investment income to move abroad for tax purposes. Additional neutrality concerns surrounding a foreign earned income exclusion—in particular, its effect on business decisions regarding the location of jobs and the hiring of employees—arise in the more detailed discussion of "competitiveness" arguments in Part IV.C, *infra*.

3. *Compliance and Enforcement*

As others have noted, a foreign earned income exclusion creates administrative complexities, particularly with respect to the definition of who is qualified to claim its benefits.[289] Indeed, the early legislative changes to the foreign earned income exclusion primarily focused on

[287] *See infra* Part IV.C.

[288] *See supra* notes 200–08 and accompanying text.

[289] *See, e.g.*, Peroni, *supra* note 111, at 1009 (describing complications regarding qualifications and exclusions).

efforts to properly define the scope of eligible beneficiaries.[290] Even today, both taxpayers and the IRS must often dedicate significant administrative and legal resources to determinations of whether a U.S. citizen is a "qualified individual" under section 911.[291] The calculations necessary to determine the amount of the exclusion add additional complexity.

These administrative concerns, however, do not point toward a single response. Some commentators suggest that the complications arising from the need to define a qualified individual and calculate the amount of the exclusion support the complete abandonment of the foreign earned income exclusion.[292] Of course, if the exclusion were abandoned, citizens living abroad would be taxable on all of their income, whether earned or from investments. On the other hand, as discussed above, significant compliance and enforcement problems exist with respect to citizens living abroad.[293] It could be argued that the limited foreign earned income exclusion, as it currently exists, might reduce some of these compliance and enforcement concerns by eliminating the need for many citizens abroad—particularly those with relatively modest incomes—to comply with (and for the IRS to enforce) potentially complicated rules.

This argument, however, taken to its extreme, implies that the United States should not tax *any* foreign income of a citizen abroad, whether earned or from investments. After all, if no citizenship-based taxation is imposed on foreign income, the only enforcement problem the IRS would have to deal with would be answering the threshold question of whether an individual qualifies as a nonresident. Of course, such an approach would place even greater pressure on the definition of who is a nonresident. In the end, concerns about enforcement and compliance are ultimately subsumed within the larger equity and efficiency considerations addressed in this Article, at least as long as a reasonable expectation exists that whatever rules are

290 *See supra* note 71 and accompanying text.

291 For example, individuals relying on the physical presence prong of the I.R.C. § 911(d) (West Supp. 2006) test must keep detailed records to ensure that they are present in foreign countries for at least 330 full days during any consecutive twelve-month period, while those relying on the bona fide resident test must often seek legal advice to determine if this standard is satisfied. *See* Tobias M. Lederberg, *The Qualified Individual Under I.R.C. Section 911(d) After* Jones v. Commissioner*: Rethinking Characteristics of Eligibility for the Foreign Earned Income Exclusion*, 10 B.U. INT'L L.J. 143, 154–57 (1992) (noting recordkeeping requirement of physical presence test and discussing vagueness of bona fide resident test).

292 *See, e.g.*, Peroni, *supra* note 111, at 1008–09 (arguing that complexity is one of three principal reasons for repealing provision).

293 *See supra* Part III.A.3.

adopted can be enforced without an unacceptable level of noncompliance.

C. *Competitiveness Concerns*

1. *In General*

As the preceding subpart demonstrates, many of the potential justifications for a foreign earned income exclusion are similar to those discussed and generally rejected in the context of using citizenship as a basis to tax foreign income of citizens living abroad. Under this analysis, there is no significant reason for taxing U.S. citizens *working* abroad more favorably than those living on investment income abroad.

This subpart considers the principal argument advanced for not taxing the income earned by citizens working outside the United States. According to this "competitiveness" argument, the tax burden imposed on U.S. citizens overseas harms the ability of American business to compete in the world economy, and therefore hurts the United States as a whole. To the extent that proponents of this theory acknowledge any equity, efficiency, or administration problems arising from an unlimited foreign earned income exclusion,[294] they contend that such concerns are outweighed by the economic benefits to the United States from the exclusion.[295]

These competitiveness arguments are not new. Indeed, they were at the core of testimony supporting the original 1926 foreign earned income exclusion.[296] The short-lived 1978 legislation, in eliminating the foreign earned income exclusion and replacing it with deductions for certain excess living costs abroad, moved closer to the equity principles discussed previously.[297] Acknowledging that it was driven by

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[294] Many proponents of the competitiveness argument would not necessarily concede that a foreign earned income exclusion creates equity problems and, instead, would claim that the absence of an exclusion creates unfairness for citizens abroad. *See, e.g.*, Patton, *supra* note 113, at 706–12 (citing examples of unfairness for citizens abroad resulting from exceptions to foreign earned income exclusion). *But see supra* notes 275–82 and accompanying text (rejecting claims of unfairness for citizens abroad, particularly in context of unlimited foreign earned income exclusion).

[295] *See, e.g.*, Maiers, *supra* note 145, at 727 ("[T]he tax equity issue should not block the approval of significant new tax incentives for Americans to work abroad where foreign trade or other policy considerations warrant more favorable tax treatment.").

[296] *See supra* note 61 and accompanying text.

[297] The 1978 provisions were criticized as being overly complex, and some argued that they did not go far enough toward horizontal equity. *See* Postlewaite & Stern, *supra* note 79, at 1114–15 (stating that 1978 "deductions are an improvement over the flat exclusion because they more accurately reflect costs actually incurred by the taxpayer," but asserting that they continued to violate horizontal equity principles by "granting preferential treatment to Americans abroad"); *see also supra* notes 76–77 and accompanying text (noting

competitiveness concerns, Congress made a quick about-face in 1981 and enacted a more generous exclusion and housing allowance than had existed under the pre-1978 law.[298]

2. *Effect of Modern Developments*

The claim that taxing U.S. citizens overseas prevents American businesses from competing effectively, and thus hurts the United States, rests on several premises.[299] As the following discussion explains, to a large extent these premises are interdependent, so the weakness of one might significantly undermine the general argument.

Commentators have recently suggested that modern developments in the global economy, in particular the increased mobility of capital and labor, create an even stronger imperative than previously existed for an unlimited foreign earned income exclusion based on competitiveness concerns.[300] Accordingly, in discussing the premises underlying competitiveness arguments, the following analysis pays particular attention to the effects of these modern trends. The analysis concludes that, rather than strengthening the case for an unlimited foreign earned income exclusion, these recent developments tend to weaken that case.

a. Direct Effects on Citizens Abroad and U.S. Multinationals

Consider the case of a U.S.-based multinational corporation that transfers a U.S.-based employee to a foreign country whose effective tax rate is lower than the U.S. rate.[301] In isolation, this transfer will not result in any increased taxes for the citizen (assuming his base

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that citizens in low-tax, high-cost jurisdictions were better off under 1978 legislation, whereas those in low-tax, low-cost jurisdictions received fewer benefits).

[298] *See* S. Rep. No. 97-144, at 35–37 (1981) (describing changes and justifying them on competitiveness grounds).

[299] For example, the argument envisions a simplified view of an "American" company, where benefits to the company result in benefits to the U.S. population as a whole. It also rests on the premise that an increase in hiring of U.S. citizens abroad results in increases in U.S. exports and the spread of goodwill toward the United States. For alternative formulations of the premises underlying competitiveness arguments, see, for example, Gann, *supra* note 70, at 62–63, and Sobel, *supra* note 70, at 113.

[300] *See, e.g.*, Gingrich & Kies, *supra* note 9 (arguing that recent limitations on foreign earned income exclusion make U.S. companies less competitive in modern global economy); Mitchell, *supra* note 9 (arguing that "[g]lobalization is sending tax rates tumbling across the world, as jobs and capital migrate across borders . . . mak[ing] it all the more imperative" to eliminate U.S. tax on citizens working abroad); *The Tithes That Bind*, *supra* note 9, at 12–13 (claiming that economic advantages of international experience of workers will be lost unless Congress eliminates taxes on citizens working abroad).

[301] *See* S. Rep. No. 97-144, at 35–36 (discussing alleged competitive disadvantage resulting from need of U.S.-based multinationals to compensate U.S.-based employees for higher costs of living abroad).

salary remains the same) because he will continue to pay U.S. taxes on his salary just as he did in the United States. However, a citizen abroad might incur higher expenses for housing, children's education, and other items when compared to what he would have paid in the United States.[302] Under these circumstances, the U.S. corporation often compensates the citizen for the transfer, increasing his post-transfer salary by an amount equal to the excess costs.[303] Under general tax principles, this extra pay is itself subject to taxation, and the corporation typically compensates the individual for this tax burden as well. Thus, while advocates of competitiveness arguments often speak broadly about the extra tax costs passed on to multinationals in the absence of an earned income exclusion,[304] in this basic overseas transfer scenario the only direct additional tax-related cost to the employer is the gross up with respect to the tax imposed on the reimbursement of excess housing, education, and other expenses. Neither the amount of the extra expenses themselves nor the tax imposed on the employee's base salary reflects additional taxes attributable to the overseas transfer.[305]

At the margin, this might prevent some companies from transferring a U.S. citizen abroad even though, in the absence of this additional cost, business considerations might have justified it. However, this marginal effect is further diminished to the extent the employer can deduct this additional cost as a compensation expense.[306]

At the other extreme, if the United States were to enact an unlimited foreign earned income exclusion, not only would the tax on excess expense reimbursements be eliminated, but the tax on the base salary itself would be eliminated as well. In effect, the exclusion

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302 *See supra* notes 183–84 and accompanying text.

303 *See* PRICEWATERHOUSECOOPERS, ECONOMIC ANALYSIS OF THE FOREIGN EARNED INCOME EXCLUSION 9–10 (2005) (listing elements of typical compensation package for married employees sent overseas).

304 *See, e.g.*, S. REP. NO. 97-144, at 35–36 ("[Because] the policy of these businesses is to make their employees whole for any extra tax expenses the employees incur because of overseas transfers[,] . . . an extra tax cost to the employees becomes a cost to the business . . . .").

305 As a very simplified example, consider a U.S. employee with a base salary of $200,000 who is transferred to a foreign country and incurs $30,000 of additional housing and other expenses. In addition to the $200,000 base salary that the employer was already paying the employee in the United States, the employer would pay an additional $45,000 (approximately, based on a thirty-three percent marginal rate) to compensate for the additional expenses plus the tax thereon. Thus, the employer would pay a total of $245,000 to the employee abroad, but only $15,000 of this amount would be attributable to the United States' taxation of the citizen abroad.

306 In the prior example, if the U.S. employer deducted the $15,000 additional expense, its after-tax cost would be only $9750 (assuming a thirty-five percent marginal corporate rate).

would act as an indirect subsidy to employers transferring employees abroad[307] because the corporation could pay the employee a significantly lower (untaxed) salary outside the United States instead of a higher (taxed) salary within the United States.[308] As long as the foreign location's living expenses are comparable to, or even somewhat higher than, U.S. expenses, the total compensation expenses of the corporation will be lower if the employee moves abroad.[309] Thus, an unlimited foreign earned income exclusion might create a strong incentive for U.S. corporations to move existing U.S.-based employees to foreign locations, particularly those that impose low or no income taxes. A limited exclusion, such as the one that currently exists, might have similar effects, although the specific consequences would depend on both the amount of the exclusion and the excess foreign living expenses.[310]

The foregoing critique of an unlimited foreign earned income exclusion focuses on an existing employment relationship between a corporation and a U.S. citizen in which the U.S. employee is transferred abroad. Given that U.S.-based companies frequently transfer U.S.-citizen employees abroad under existing tax provisions—including executives whose compensation significantly exceeds the current foreign earned income exclusion—these transfers, and the corresponding windfalls described above, should increase if an unlimited foreign earned income exclusion were enacted.

[307] *See* Peroni, *supra* note 111, at 1008 (noting that resulting distortion in location of business operations violates capital export neutrality); *see also* Hale E. Sheppard, *Perpetuation of the Foreign Earned Income Exclusion: U.S. International Tax Policy, Political Reality, and the Necessity of Understanding How the Two Intertwine*, 37 VAND. J. TRANSNAT'L L. 727, 743–44 (2004) (discussing violations of capital export neutrality in this context).

[308] Alternatively, the corporation could continue to pay the same salary as before, effectively conferring a significant after-tax pay increase on the employee and creating an incentive to move to a foreign location.

[309] Returning to the example in note 305, *supra*, where the employer pays a $200,000 base salary in the United States, the employee's after-tax income is approximately $150,000 (ignoring deductions). If the foreign earned income exclusion were unlimited, the employer could transfer the employee abroad, pay him $150,000 of (untaxed) salary, plus $30,000 for excess living expenses, and thereby incur only $180,000 of cost (rather than $200,000 if the employee worked in the United States). The employer could share a portion of this $20,000 savings with the employee as an inducement to move and would still have lower costs after the transfer.

[310] For example, under the pre-2006 law, with its unlimited housing cost exclusion (above a relatively low floor) and $80,000 earned income exclusion, the citizen (and hence the reimbursing corporation) would incur no additional tax-related expenses as long as the nonhousing excess costs resulting from the transfer were less than $80,000 (regardless of how high the housing costs were). To the extent the nonhousing excess costs were less than $80,000, the exclusion would effectively offset a portion of the tax on the individual's base salary.

Proponents of competitiveness arguments do not focus only on the transfer of existing U.S. employees abroad.[311] They also posit a situation in which the U.S.-based multinational[312] is considering whether to fill a new position in a low- or no-tax[313] foreign country and whether to fill the position with a U.S. citizen or a noncitizen from a third country. Because a U.S. citizen will be subject to U.S. income tax, he will demand a higher salary than the noncitizen and, accordingly, the corporation will hire the noncitizen.[314]

Before addressing the alleged adverse consequences to the U.S. economy that flow from this hypothetical hiring decision, it is important to address the implicit assumptions underlying the argument.[315] The argument, by focusing on the U.S. tax regime as the determining factor in this hiring decision, generally assumes that both individuals are equally qualified and that both will demand similar after-tax compensation.[316] If, instead, the noncitizen is better qualified and willing to accept the same net salary as the U.S. citizen, or if he is equally qualified and willing to accept a lower net salary, the company will hire him regardless of the U.S. tax system. With the increasing availability of skilled workers from economically less developed countries,[317] it is reasonable to assume that a significant number of overseas positions might be filled by noncitizens, regardless of the U.S. tax regime.

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311 *See, e.g.*, Sheppard, *supra* note 307, at 743 (noting incompatibility of foreign earned income exclusion with capital export neutrality).

312 The analysis does not necessarily require that the employer be a U.S. multinational, but some aspects of the competitiveness argument discussed *infra* are stronger if it is a U.S. company.

313 The competitiveness argument is less relevant when the U.S. citizen is working in a country with an effective income tax rate in excess of the U.S. rate. In such circumstances, the foreign tax credit generally will eliminate any residual U.S. tax, and both the U.S. citizen and the noncitizen will be subject to the same tax in the host country.

314 For example, in the absence of a foreign earned income exclusion, a U.S. citizen working in Saudi Arabia would be subject to significant U.S. income taxes, while a French national working (and residing) in Saudi Arabia would not be subject to French income taxes. Neither individual would be taxed by Saudi Arabia, as that country generally does not impose income taxes on foreign nationals working there.

315 For example, Newt Gingrich and Ken Kies briefly acknowledge that their competitiveness claims depend on "all things being equal." Gingrich & Kies, *supra* note 9.

316 Whereas the cost of living in a foreign country is an important factor for the equity analysis, it is not directly relevant to this aspect of the competitiveness argument because both the U.S. citizen and the noncitizen presumably will face the same costs in the foreign country.

317 *See* Org. for Econ. Co-operation & Dev., International Mobility of the Highly Skilled 1–2 (2002), *available at* http://www.oecd.org/dataoecd/9/20/1950028.pdf (discussing prevalence of migration of highly skilled workers from developing countries to OECD member states).

At the other extreme, if the U.S. citizen is significantly better qualified for the position than is the noncitizen, the company might hire the citizen regardless of the extra cost of grossing up his U.S. taxes. Given the significant number of U.S. citizens currently working abroad for U.S. companies, it seems safe to assume that this situation is common. It is not possible to know how many overseas hires of U.S. citizens are economically viable only by reason of the limited foreign earned income exclusion, although it is reasonable to assume that a significant number would continue to be employed in the future even if the earned income exclusion were completely eliminated.

Accordingly, in many cases the assertion of citizenship-based taxation and the existence of a foreign earned income exclusion are not the deciding factors when a company considers whether to hire a noncitizen rather than a U.S. citizen. Under such circumstances, reliance on competitiveness-based arguments in support of an unlimited foreign earned income exclusion is misplaced.

b. Direct Effects on U.S. Economy

Proponents of the competitiveness argument assert that, to the extent citizenship-based taxation causes U.S. companies to hire noncitizens instead of U.S. citizens, it will lead to a drop in U.S. exports. This, in turn, will result in the loss of a significant number of manufacturing jobs in the United States. This was the principal argument in favor of the original foreign earned income exclusion in 1926,[318] and it remains a principal argument today.[319]

It is difficult to quantify to what extent, if any, citizenship-based taxation reduces exports in this manner. Advocates often cite studies prepared years ago that purport to demonstrate that a tax-induced reduction in U.S. workers abroad would have a significant negative impact on exports.[320] These studies, several of which were prepared on behalf of business groups advocating an unlimited foreign earned

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318 *See* 67 CONG. REC. 3782–83 (1926) (statement of Richard P. Momsen, president of the American Chamber of Commerce for Brazil) (discussing connection between foreign earned income exclusion, U.S. exports, and domestic manufacturing); *1925 Ways & Means Hearing*, *supra* note 58, at 180 (statement of O.K. Davis) (same).

319 The argument is based on the assertion that "Americans are best at selling America." Gingrich & Kies, *supra* note 9; *see also* 67 CONG. REC. 3782 (1926) (statement of Richard P. Momsen) (describing same); *1925 Ways & Means Hearing*, *supra* note 58, at 181–82 (statement of O.K. Davis) (same). However, as other commentators have noted, this assertion is questionable. For example, in some circumstances a national of a foreign country might be more effective at selling products in that market because he is more familiar with the local language and customs. Postlewaite & Stern, *supra* note 79, at 1122.

320 For example, the Gingrich & Kies op-ed piece cites a 1980 study by the Chase Econometric Group and a 1995 study by PriceWaterhouse. Gingrich & Kies, *supra* note 9. PriceWaterhouseCoopers issued an updated study in 2005, discussed *infra* note 323.

income exclusion, have been critiqued elsewhere, with many articles questioning both their methodology and conclusions.[321] These critiques generally conclude that while the elimination of the foreign earned income exclusion might lead to some reduction in U.S. exports, the studies fail to establish that any such reduction would be significant.[322]

Recent competitiveness arguments fail to reflect the significant changes in the global economy that have occurred since most of these studies were conducted.[323] The traditional case for the foreign earned income exclusion envisions a world of clearly delineated economic functions and corporate structures, with U.S. companies employing U.S. workers in the United States to manufacture tangible goods, which U.S. citizen-salesmen abroad sell in foreign markets.[324] This model was reflected in the legislative debate leading to the initial enactment of the foreign earned income exclusion in 1926,[325] as well as in the legislative history of the current regime's enactment in 1981.[326] However, as discussed in detail in Part II above, modern

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[321] *See, e.g.*, *Taxation of Foreign Earned Income: Hearing on S. 2283, S. 2321, and S. 2418 Before the Subcomm. on Taxation and Debt Management Generally of the S. Comm. on Finance*, 96th Cong. 65–67 (1980) [hereinafter *Hearing, Foreign Earned Income*] (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy) (providing detailed critique of Chase and other studies); Sobel, *supra* note 70, at 146–55 (analyzing thoroughly several studies); Victor Thuronyi, *A Critique of the Chase Study of the Tax Treatment of U.S. Workers Overseas*, 10 TAX NOTES 979, 981 (1980) ("All that the Chase study does is to run an assumed number through a computer model . . . . The study does not, however, evaluate the soundness of the claim that our current tax rules cause a decrease in exports."). A principal criticism of several studies is that they rely on self-interested estimates by corporate executives regarding the potential negative impact on exports.

[322] *See, e.g.*, Sheppard, *supra* note 307, at 746 (claiming that although "[m]any studies regarding the economic effects of the [exclusion] have been conducted by both governmental agencies and the private sector," provision's effectiveness in increasing exports or otherwise helping economy remains "unproven"); Sobel, *supra* note 70, at 146 ("[N]o study has linked these tax incentives definitively with the overseas presence of those expatriates who influence and promote exports from the United States.").

[323] This failure to account for modern developments is reflected in a recent study prepared by PriceWaterhouseCoopers on behalf of several organizations representing U.S. business interests overseas. PRICEWATERHOUSECOOPERS, *supra* note 303. The study concludes that the repeal of the foreign earned income exclusion would reduce U.S. exports by 1.14%, resulting in the loss of 77,115 U.S. manufacturing jobs. *Id.* at 24 tbl.III.4. However, the study's underlying calculations regarding the sensitivity of U.S. exports to changes in overseas compensation levels are based on export data originally collected more than 30 years ago. *See id.* at 17, 24 tbl.III.4 n.1. Because of the significant changes in the global economy in the last quarter century, this old data has limited applicability today. *See infra* notes 327–31 and accompanying text.

[324] *See supra* note 101 and accompanying text.

[325] *See supra* note 102 and accompanying text.

[326] *See supra* note 103 and accompanying text.

developments in the global economy undermine the usefulness of this traditional model in analyzing tax policy.

In a world where a U.S.-based multinational corporation's "[m]anufacturing is performed at multiple [worldwide] locations, using related or unrelated vendors and employing just-in-time inventory and modern logistics,"[327] the activities of a U.S. citizen employed in a foreign country by a U.S. corporation may result in relatively little direct economic benefit to the United States. For example, a significant number of products branded as "American" are being manufactured in foreign countries[328] due to the availability of lower real labor costs overseas, lowered trade barriers, "faster and cheaper transportation of goods,"[329] and other factors unrelated to citizenship-based taxation.[330] Thus, the prototypical U.S. citizen-salesman's activities abroad might result in the sale of goods manufactured by a foreign subsidiary of the company (or an unrelated foreign vendor) in a foreign country. Indeed, a U.S. citizen-employee acting in an executive position abroad (and receiving the benefits of the foreign earned income exclusion) might be supervising a manufacturing operation in a foreign country. Not only will the overseas sales of that operation not directly benefit the U.S. economy, but its sales into the U.S. market might displace competing products actually manufactured in the United States.[331]

Moreover, the fact that overseas employment may result in additional profits to an "American" company does not necessarily equate to a direct economic benefit to the U.S. economy. As the *ABA Task Force Report* noted in the context of international tax reform generally, "the fact that a policy may advance . . . the interests of U.S. corporations . . . should not be determinative unless there is a reasonable basis to conclude that individual U.S. citizens and residents will realize

327 *ABA Task Force Report*, *supra* note 1, at 658.

328 For example, Black & Decker, an "American" brand of power tools, has manufacturing operations in eleven countries. Black & Decker, Company Overview, http://www.ir.bdk.com/phoenix.zhtml?c=100780&p=IRol-IRHome (last visited Jan. 2, 2007); *see also* Interview by Frontline with Ray Bracy, Vice President for Fed. and Int'l Pub. Affairs, Wal-Mart Stores, Inc. (Sept. 17, 2004), *available at* http://pbs.org/wgbh/pages/frontline/shows/walmart/interviews/bracy.html (discussing Black & Decker's manufacture of products in China for sale at Wal-Mart stores in United States).

329 *ABA Task Force Report*, *supra* note 1, at 657.

330 The overseas production might, in part, be due to U.S. tax considerations other than citizenship-based taxation. *See, e.g.*, *id.* at 705 (citing studies showing that business tax rules affect production location decision).

331 This concern was raised in the 1981 legislative hearings. *See Hearing, Foreign Earned Income*, *supra* note 321, at 68 (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy); Thuronyi, *supra* note 321, at 982, *reprinted in Hearing, Foreign Earned Income*, *supra* note 321, at 197.

a benefit in relation to overall costs."[332] Well-advised multinational companies with business operations abroad generally conduct those activities through foreign subsidiaries, thereby deferring U.S. taxation until a (possibly distant) future time when those earnings are repatriated.[333] A U.S. company's profits derived from a U.S. citizen-employee abroad may provide little direct benefit to persons in the United States.[334]

Finally, it is important to consider other negative effects that an unlimited earned income exclusion might have on the U.S. economy. For example, some consultants and other service providers might have flexibility with respect to the location where they perform services. While such people might generally prefer to live in the United States, an unlimited earned income exclusion might entice them to move abroad. As a practical matter, by establishing residence outside the United States, these citizens might receive up to a fifty percent after-tax increase in income by reason of the exclusion.[335] If significant numbers of individuals relocated under these circumstances, the loss of their buying power, and the jobs of those who support them, might have significant negative implications for the U.S. economy.

This analysis does not claim that the employment of U.S. citizens abroad has no direct positive impact on the U.S. economy, nor does it purport to quantify the extent of any such impact. However, it does assert that the competitiveness argument oversimplifies the case for such an effect and that recent developments in the global economy suggest that the argument is even less persuasive than it was when

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[332] *ABA Task Force Report*, *supra* note 1, at 660 n.20.

[333] *See id.* at 663 ("[T]axpayers that earn low-tax foreign income can benefit from deferral of the imposition of the higher U.S. rate through use of foreign corporations that avoid the anti-deferral rules of current law."). This factor significantly undermines a recent op-ed piece by a leading advocate of an unlimited foreign earned income exclusion, which asserted that with an unlimited exclusion "American companies would create more jobs and boost their exports—and most likely end up paying more in taxes as a result of their improved economic performance." Mitchell, *supra* note 9.

[334] Of course, that U.S. citizen-employee, as well as his family, will benefit from his employment abroad. Eventually, the citizen and his family might repatriate that money to the United States, spending it to support the U.S. economy. However, this is a very indirect effect on the economy, a far cry from the direct effects promised by advocates of the exclusion. Moreover, given the possible delay in repatriating the earnings to the United States while residing and working abroad, the individual's receipt of salary might have a much more direct impact on the U.S. economy if he were employed in the United States—even if he held a lower-paying job.

[335] For example, a person with $300,000 of income in the United States would pay (approximately) $90,000 of federal income tax, leaving him with $210,000 of after-tax income. By moving abroad and utilizing an unlimited foreign earned income exclusion, that person's after-tax income would increase from $210,000 to $300,000, a forty-three percent increase. This simple example assumes that all other factors, such as level of income and cost of living, remain the same.

Congress last relied on it a quarter century ago. To the extent an unlimited foreign earned income exclusion would help the U.S. economy through increases in U.S. exports, it is important to balance any such benefits against the likelihood that it would encourage U.S. companies to transfer some employees abroad or independent service providers to move abroad.

c. Secondary Effects on Trade

Proponents of the competitiveness arguments also predict that an unlimited foreign earned income exclusion would produce a secondary benefit for the U.S. economy.[336] U.S. citizens abroad, it is argued, have a tendency to buy "American" products, both for their business operations and for their personal use. Thus, U.S. exports will increase to the extent that an unlimited exclusion encourages multinational corporations to hire U.S. citizens instead of noncitizens to fill an overseas position. As with the prior argument, this assertion also dates back to the debate over the 1926 legislation, where a proponent of an unlimited exclusion noted that U.S. citizens abroad have a "tendency . . . to get what supplies they use from the United States."[337]

Just as recent developments in the global economy weaken the argument regarding the foreign earned income exclusion's direct effect on trade, they also undermine this secondary effect.[338] For example, as discussed above, the purchase of a product branded as "American" does not necessarily benefit the U.S. economy, particularly if the product is manufactured outside the United States.[339]

[336] *See, e.g.*, CONG. RESEARCH SERV., *supra* note 151, at 61 ("It has been represented to us that many overseas Americans occupy positions in which they are well placed to influence procurement decisions for millions of dollars of goods and services. In these positions they are said to favor American suppliers . . . .").

[337] *1925 Ways & Means Hearing*, *supra* note 58, at 183 (statement of O.K. Davis, NFTC representative). Davis acknowledged that this was a "very minor" proposition compared to his principal argument regarding the direct effect on trade. *Id.* This argument has also been made in more recent congressional testimony. *See Hearing, U.S. Citizens Overseas*, *supra* note 112, at 83–84 (statement of Peter Alegi, Chair, Federated League of Americans Around the Globe) (arguing that employees of all nationalities seek first to buy goods from their home countries).

[338] For a skeptical view of this argument at the time of the last major legislative debate on this issue, see Kingson, *supra* note 15, at 738. Kingson writes that "as to the expatriates I know, preference for American goods is rather difficult to infer from their clothes, watches, and cars."

[339] *See, e.g.*, Interview by Frontline with Ray Bracy, *supra* note 328 (giving Black & Decker as example of "American" manufacturer that builds its products in China for sale in United States). This example is particularly apt considering that a commentator criticizing this secondary effect argument in 1981 was, at that time, at least willing to concede that the argument might be valid with respect to "electric saws." Kingson, *supra* note 15, at 738.

Moreover, U.S. citizens abroad might be less committed to buying "American" goods for personal use than they were in prior decades.[340] After all, even citizens living within the United States are exposed to an increasing supply of foreign products.[341]

This effect also might have decreased in recent decades with respect to purchases for business operations.[342] The assertion assumes that the person making the purchasing decision has only limited information about, or access to, supplies or inputs manufactured elsewhere, or that the U.S. citizen will purchase the American product notwithstanding a better quality-adjusted price for the non-American product. However, in an era of improved information and price competition, the strength of this argument has likely diminished.

Finally, this focus on purchases by U.S. citizens overseas ignores an important offsetting effect. To the extent a foreign earned income exclusion encourages U.S. companies to transfer existing U.S. citizen-employees abroad,[343] those citizens who previously purchased a significant amount of U.S.-produced goods while living in the United States might shift their buying patterns to incorporate at least some additional foreign-produced goods (with a corresponding reduction in U.S. products) once they are transferred overseas.

d. Ambassador Role

A final assertion is that citizens living abroad act as goodwill ambassadors for the United States, spreading American values and culture, and that an unlimited foreign earned income exclusion will enable more Americans to play this role. Although this is not necessarily an economic argument,[344] it often is included within general competitiveness arguments in favor of the exclusion.[345]

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[340] Of course, some citizens abroad will continue to prefer to purchase American products, at least on a periodic basis. For example, an online "Foreign Buyers' Club" enables U.S. citizens living in Japan to purchase "[f]ood and [f]un from home." Foreign Buyers' Club, http://www.fbcusa.com (last visited Jan. 2, 2007).

[341] For example, it has been estimated that Wal-Mart, the United States' largest retailer, derives more than fifty percent of its nongrocery sales from imported products. *See* Interview by Online Visitors with Hedrick Smith, Senior Producer, Frontline, on WASHINGTONPOST.COM (Nov. 17, 2004), http://washingtonpost.com/wp-dyn/articles/A45855-2004Nov12.html (estimating that imports have "accelerated dramatically" since death of founder Sam Walton in 1992).

[342] *But see* Sobel, *supra* note 70, at 114–15 (citing study indicating that citizens overseas were more likely to buy "American made equipment for their projects").

[343] *See supra* notes 307–10 and accompanying text.

[344] This ambassador role arguably could have indirect economic effects if the positive image conveyed by these citizens encourages persons abroad to purchase more U.S. goods.

[345] *See, e.g.*, AM. CITIZENS ABROAD, THE LEVEL PLAYING FIELD INITIATIVE 15 (2005), *available at* http://www.aca.ch/levelpl.pdf ("Overseas employees of American business are seen as representatives of our country. Through their participation and visibility in inter-

Although this argument might once have had some validity, its current applicability is much weaker. In the early part of the twentieth century, a U.S. citizen living in a foreign country might have represented one of the few contacts that nationals of a foreign country had with the United States. However, in the modern world of satellite television, the Internet, and widespread dissemination of U.S. movies, music, fast food chains, and other products, nationals of other countries have significant exposure to American culture on a scale unimaginable at the time the foreign earned income exclusion was first enacted.

Of course, not all of this exposure to American culture produces a favorable view in foreign countries, and it could be argued that having U.S. citizens "on the ground" might dispel any negative impressions. Two considerations weaken this argument. First, not all citizens abroad will foster a positive image of the United States.[346] Second, U.S. citizens living in some countries tend to live and socialize primarily among other U.S. persons, rather than the local population, for safety or other reasons.[347] Ironically, these countries are often the places most in need of cultural ambassadors providing a positive U.S. image, and some are the jurisdictions in which U.S. citizens most strongly advocate an unlimited foreign earned income exclusion.[348]

Another possible argument is that broader foreign policy goals support an unlimited exclusion. One commentator has suggested that "key senators and a high Administration official" wanted to increase tax benefits for citizens overseas in the late 1970s to encourage Americans to stay in Iran.[349] Similarly, the exposure to foreign cultures and foreign languages might benefit the country once the citizen

national business affairs, they can function as goodwill ambassadors whose work exemplifies America's ideals and values."); *see also* Sobel, *supra* note 70, at 113 (citing assertion that "a greater number of Americans abroad generates greater international understanding and goodwill").

346 *See* Sheppard, *supra* note 307, at 748–49 (citing examples of U.S. citizens abroad creating unfavorable impression of United States); *see also* Sobel, *supra* note 70, at 114 ("[O]n occasion the American presence overseas has been viewed as neocolonial with the perception of exploitation of the local population.").

347 *See, e.g.*, Bureau of Consular Affairs, *supra* note 131 (strongly urging Americans in Saudi Arabia to stay in secure housing compounds with "hardened security perimeter"); Karen Lowry Miller, *The Gilded Cities Club*, NEWSWEEK (Int'l Ed.), July 3, 2006/July 10, 2006, at 68 (stating that in many countries "expats and locals run in circles so different that the foreigners endure their own pockets of inflation"). Ironically, the need to live in higher-priced communities tailored to the lifestyle of expatriates, rather than in lower-priced accommodations among the local population, is one of the factors cited by advocates of an unlimited housing cost exclusion. *See supra* note 274 and accompanying text.

348 *See supra* note 131.

349 Kingson, *supra* note 15, at 738.

returns to the United States.[350] To the extent that these assertions are correct, a broad, across-the-board foreign earned income exclusion, which provides benefits regardless of the foreign country in which citizens reside, is still a very inexact and inefficient way to achieve the desired results.

As a final note, to the extent a person's contribution to the community is relevant, a person who remains in the United States might make a greater contribution than those living abroad.[351] For example, citizens in the United States might participate in local volunteer organizations, financially support local charities, or make other efforts to improve life in the United States. Of course, the magnitude of this difference is not close to that envisioned by legislators enacting the Civil War-era income taxes who sought to penalize citizens living abroad for evading their military and other obligations to the country.[352] Nonetheless, this factor undermines arguments in favor of an earned income exclusion that are based solely on overseas citizens' limited role as goodwill ambassadors.

V
Legislative Implications

This Part briefly summarizes the legislative proposals that flow from the foregoing analysis.[353] It is important that Congress, in adopting legislation in this area, avoid making last-minute, retroactive changes as it did in May 2006. While retroactive tax legislation is sometimes appropriate,[354] it is difficult to justify the retroactive removal of an intended tax benefit almost halfway through the tax year. Accordingly, any change to the foreign earned income exclusion should be done prospectively only.

A. Elimination of Foreign Earned Income Exclusion

As demonstrated in the foregoing analysis, modern developments strengthen the case for taxing the income of citizens abroad under traditional equity concerns, as well as under neutrality and benefits

350 For example, reports suggest that U.S. security agencies are in need of additional Arabic speakers. *See* Dan Ephron, *Smart, Skilled, Shut Out*, Newsweek, June 26, 2006, at 28 (noting dearth of Arabic speakers among Department of Homeland Security recruits).

351 A lack of contribution to the domestic community was cited during the 1894 debates as a justification for taxing citizens living abroad. *See supra* note 39 and accompanying text.

352 *See supra* notes 25–26 and accompanying text.

353 Some of these suggestions were previously mentioned in the context of the analysis in Parts III and IV, *supra*.

354 *Cf.* United States v. Carlton, 512 U.S. 26, 32 (1994) (upholding legislation that retroactively closed unintended loophole in estate tax).

principles. Additionally, recent developments in the global economy significantly weaken the "competitiveness" arguments that have been used to justify special treatment of foreign earned income for the past eighty years. Accordingly, the foreign earned income exclusion should be eliminated because there is no convincing policy reason for allowing citizens working abroad to exclude all or a portion of their income merely because it is earned outside the United States. As the *ABA Task Force Report* observed, "To justify lower U.S. tax on foreign income, an overriding benefit should be expected or a more important objective specified."[355]

If the foreign earned income exclusion is eliminated, compliance and enforcement concerns support simplifying the rules for claiming a foreign tax credit. Currently, taxpayers whose entire foreign income is sheltered by the foreign earned income exclusion need not rely on the foreign tax credit. However, in the absence of the exclusion, more citizens residing abroad will utilize the credit to avoid double taxation. Under current law, the rules for claiming the credit are complicated due to limitations aimed at preventing potential abuses.[356] Just as it enacted simplified rules for claiming the foreign tax credit when an individual pays only a limited amount of foreign taxes on investment income,[357] Congress could simplify the rules for a citizen working abroad whose foreign earned income and foreign investment income are below a threshold level.[358]

B. *Equity-Based Relief*

While earlier analysis suggested that equity might justify providing deductions for specific excess costs incurred by citizens (instead of a broad foreign earned income exclusion),[359] the mere fact that expenses are higher overseas does not necessarily justify relief. The concern is most easily illustrated by the case of a U.S. citizen who accepts long-term work in a high-cost foreign jurisdiction as an

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[355] *ABA Task Force Report*, *supra* note 1, at 679.

[356] *See* I.R.C. § 904 (West Supp. 2006) (setting forth limitations on claiming foreign tax credit). Although these limitations were simplified by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 402–404, 118 Stat. 1418, 1491–97 (codified as amended at I.R.C. §§ 535, 864, 904 (West 2004)), they still can be complicated.

[357] *See* I.R.C. § 904(j) (eliminating foreign tax credit limitation if individual paid less than $300 of foreign taxes, or $600 in case of joint return, and certain other requirements are satisfied).

[358] *See* Graetz, *supra* note 12, at 335 (mentioning briefly that simplified foreign tax credit might be appropriate for citizens with foreign earned income).

[359] *See supra* notes 283–84 and accompanying text.

independent consultant.[360] In accepting a job in a location where the living costs will be higher, the citizen presumably expects that any increase in his living costs will be offset by an increase in his compensation. Under such circumstances, when the additional compensation more than offsets the additional living expenses, equity does not require tax relief.[361]

To the extent Congress seeks to enact equity-based relief notwithstanding the preceding arguments, the relief should be narrowly targeted. The short-lived 1978 legislation adopted an equity-based approach by allowing deductions in specific areas where citizens abroad were considered to be disadvantaged.[362] However, as the above analysis indicates, several deductions permitted by the 1978 Act were overly broad and are particularly difficult to justify today. For example, many citizens who are raised in one part of the United States move to another part of the country for employment reasons, and yet they are not allowed to deduct the cost of periodic visits "home."[363] Similarly, a significant number of citizens in the United States pay private school tuition for the elementary and secondary education of their children,[364] and yet they generally are not allowed to deduct the cost of that tuition. It is difficult to justify deductions for home travel or private school tuition incurred by citizens living abroad when a significant number of citizens in the United States do not get deductions for similar expenses.

Some commentators have suggested that these deductions might be targeted to allow deductions only for an "excess" above a U.S. baseline.[365] For example, home travel expenses might be deductible only to the extent they exceed the cost of the longest flight possible in

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360 Similar principles apply when a corporation employs a U.S. citizen abroad and pays him additional amounts to compensate for the higher costs.

361 Conceptually, an argument can be made that his extra living costs should be considered a business expense. However, such an argument goes against the general approach of the Code, which treats housing and living expenses as nondeductible personal expenses. *Cf.* I.R.C. § 162(a) (2000) (allowing deduction for travel away from home for temporary periods).

362 *See supra* notes 74–75 and accompanying text.

363 It might be argued that the home travel expenses are higher for citizens living abroad. While this may be true in many circumstances, it will not be true in others. For example, it often is less expensive to fly between a major foreign city and a major U.S. city than it is to fly between two smaller market cities in the United States. *See* Postlewaite & Stern, *supra* note 79, at 1118 (noting in this context that "[r]ound trip air fare in the United States from coast to coast . . . is greater than that from Washington to London").

364 *See supra* note 187. While many private schools in the United States are less expensive than private "American" schools abroad, some domestic private schools, particularly in large cities, might be more expensive.

365 *See, e.g.*, Postlewaite & Stern, *supra* note 79, at 1118 (suggesting deduction only for "the excess of the actual travel costs over a 'base' United States air fare").

the United States.[366] Such an approach, however, might be extremely difficult to apply in practice, particularly with the ever-changing price structure of modern air travel.[367] Moreover, for the reasons discussed above, the mere fact that citizens abroad incur expenses in excess of those incurred in the United States does not necessarily justify a tax benefit.[368] Accordingly, such a deduction is difficult to justify today.

Although horizontal equity does not support a deduction for foreign private school tuition, it does suggest that citizens living abroad should be entitled to similar education-related benefits as citizens living in the United States. The most relevant benefit might be Coverdell Education Savings Accounts,[369] often a key concern of citizens abroad. Although the IRS has not issued explicit guidance, the language of the statute suggests that excludable distributions can be made only for primary and secondary schools within the United States.[370] To the extent it would be consistent with administration and enforcement concerns, this provision should be extended (either administratively or through legislation) to citizens abroad who send their children to foreign primary and secondary schools.

Excess housing and other cost-of-living expenses might provide another case for relief. The 1978 legislation treated these two items separately, providing separate deductions for each. However, this separate treatment of housing and other costs can itself lead to inequitable windfalls. Consider, for example, a citizen living in a foreign location with relatively low general costs but high housing costs.

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366 Postlewaite and Stern provide the example of a flight from Honolulu to New York. *Id.* at 1118 n.122. Similarly, they suggest a citizen abroad might be allowed a deduction for private school tuition to the extent it exceeds a baseline amount of U.S. property taxes because citizens in the United States pay for public school education through property taxes. *Id.* at 1117–18. However, citizens in the United States who send their children to private schools in the United States are not allowed to reduce their nondeductible private school tuition by the amount of state property taxes. Accordingly, horizontal equity does not support the deduction for citizens abroad, even if it were reduced by a baseline property tax amount.

367 Postlewaite and Stern made their proposal in 1979, before the Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (codified as amended in scattered sections of 49 U.S.C.), was fully implemented. Today, particularly with the increased use of the Internet, airline ticket prices fluctuate frequently and significantly, and do not necessarily correspond to the distance of the flight.

368 *See supra* notes 359–61 and accompanying text.

369 *See* I.R.C. § 530 (West Supp. 2006) (allowing savings to accumulate and be distributed tax-free for primary and secondary school education).

370 In particular, for purposes of primary and secondary education, the term "school" is defined by reference to "State law." § 530(b)(3)(B). The statute uses different language to define eligible higher education institutions, which the IRS has acknowledged can apply to certain foreign colleges and universities that participate in the Federal Student Aid program. INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUBL'N NO. 970, TAX BENEFITS FOR EDUCATION 40 (2005).

When the two items are separated, the citizen would not be eligible to claim a deduction for the general cost of living, but he might qualify for the excess housing cost deduction, even though the overall costs are not significantly different from the comparable overall costs in the United States. Accordingly, any potential equity-based relief for high living expenses should treat housing as an integrated component of overall costs.

As discussed earlier,[371] horizontal equity supports a deduction[372] only to the extent the costs of living overseas exceed the costs in the most expensive city in the United States. Even within this framework, equity considerations might require additional refinements. Different citizens moving to a foreign location might have widely different expenses. For example, a high-income person might rent a large, expensive house, while a lower-income person might rent a small apartment. In some circumstances the lower-income person might incur a larger actual increase in housing costs by moving abroad than does the higher-income person.[373] Thus, a wide range of approaches could be adopted to calculate the amount of a deduction for excess costs. For example, the deduction might equal the excess of actual costs in the foreign location over the average costs in the highest-cost U.S. city. Alternatively, in the case of a highly compensated executive, it might equal the excess of actual costs in the foreign location over the average cost in a more upscale neighborhood in the highest-cost U.S. city. As these examples demonstrate, efforts to refine the definition of "excess" costs for equity purposes might add significant complexity to the provision.

Ultimately, both equity and administration concerns favor a calculation where both the floor and the ceiling for cost-of-living deduc-

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[371] *See supra* note 283–284 and accompanying text. While concerns about deducting foreign housing costs often arise in the context of a citizen performing personal services abroad, because this proposal is grounded in equity (rather than competitiveness) concerns, it might apply equally to a citizen residing abroad but not receiving earned income from work. However, as a practical matter this would be relevant primarily in a low-tax, high-cost location, and, for political reasons, Congress might be reluctant to provide any tax benefit for a person who could afford to live in such a location without working. Moreover, a person's move abroad for work purposes might be viewed as having at least some element of involuntariness, particularly when an employee already working for a company in the United States is transferred abroad (although, ultimately, an employee who does not want the foreign transfer retains the right to decline the transfer and look for another job in the United States).

[372] This benefit could be structured as either a deduction or, if attributable to amounts from an employer, as an exclusion.

[373] For example, in some places the choice of available American-style housing might be limited, in which case the high- and low-income employee might live in similar housing. To the extent this housing is relatively expensive, the lower-income person will have a larger increase in housing costs.

tions are based on indices.[374] For example, a citizen satisfying a foreign residence test could deduct the excess, if any, of the average (or, if lower, the actual) cost of living in the foreign location[375] over the average cost of living in the highest-cost U.S. city.[376] The averages in the foreign city could be based on the average cost of living for an "American" lifestyle,[377] rather than a local lifestyle. If the average cost in the foreign city were lower than that in the highest-cost U.S. city, no deduction would be allowed.

Under such an approach, a person living in higher-than-average housing in the foreign jurisdiction might not be able to deduct a significant portion of his expenses. However, this result does not necessarily violate the equity concerns underlying the deduction. After all, the choice to rent a more expensive house is, to a large extent, a personal decision, and the Code generally does not allow deductions for personal expenditures. This approach accounts for a basic cost-of-living increase attributable to an average "American" lifestyle in the foreign location, but it does not provide for a benefit beyond that. Moreover, by capping the deduction, this approach prevents

374 The 2006 amendments to the section 911 housing cost amount exclusion also rely on indices. *See supra* notes 90–92 and accompanying text. There are, however, several differences between the 2006 amendments and the proposal described above. Unlike the 2006 amendments, the proposal would incorporate both housing costs and other costs of living, and the particular indices used in the proposed approach might differ from those used in the 2006 amendments. As a general note, the amendments are more favorable than the proposed approach because they take into consideration the actual housing costs up to $24,720 (30% X $82,400) before subtracting the floor amount—even if the average costs in the foreign jurisdiction are less than $24,720. *See supra* note 89. Moreover, the amendments, in adjusting for foreign costs, refer generally to "costs in the United States," *see* I.R.C. § 911(c)(2)(B) (West Supp. 2006), whereas the proposal focuses on the highest-cost U.S. city.

375 Such an average could be based on the cost of living for an "American" lifestyle, rather than a local lifestyle.

376 This need not necessarily be the average cost for the entire U.S. city. Rather, it could be the average cost in the city for a typical professional who is likely to be transferred abroad. The housing cost exclusion floor under pre-2006 law (which was based on sixteen percent of a GS-14 government employee's salary) might serve as a model for the housing component of the cost-of-living calculation. *See* I.R.C. § 911(c)(1)(B). Because this floor is intended to achieve only rough equity, it is important that any such calculation (or tables published by the IRS) be relatively easy to utilize. Although it would add complexity, the calculations could take family size into account.

377 Admittedly, this is an inexact standard. The housing cost component might, for example, be based on the living cost and quarters allowances for a particular level of State Department employee. *See* U.S. Dep't of State, Quarterly Report Indexes, http://www.state.gov/m/a/als/qtrpt/ (last visited Dec. 29, 2006) (explaining quarterly allowance calculations); *see also supra* notes 93–94 and accompanying text (discussing recent IRS guidance on foreign housing cost expenses that relies on this State Department data).

employers and employees from shifting a disproportionate amount of the overall compensation package into high-end housing.[378]

A final equity concern involves the calculation of tax on the income that is subject to tax. As discussed above,[379] an "exemption with progression" approach is difficult to justify to the extent income is excluded or deducted on equity grounds. For example, to the extent a citizen abroad is allowed to deduct excess costs of living under the equity-based proposal discussed above, that deducted amount should not be added back in order to push the taxpayer into a higher marginal tax bracket for the remaining income. After all, the purpose of such a cost-of-living deduction would be to place the taxpayer in approximately the same tax position as a comparably situated citizen in the United States. For similar reasons, any amount that is deducted or excluded based on equity concerns should not be added back into income for purposes of determining whether the taxpayer qualifies for other tax code benefits that are subject to income-based phaseouts.[380]

Conclusion

The tax treatment of overseas citizens in the past century and a half reflects changing perceptions of citizens abroad and their relationship with the United States, as well as the changing role of the United States in world economic affairs. During the Civil War, when citizens abroad were viewed as skulkers evading their civic duties, Congress adopted a punitive approach. In contrast, for the past eighty years Congress has viewed citizens abroad as vital economic emissaries of the United States and has excluded significant amounts of their foreign earned income from taxation. Recently, representatives of overseas citizens groups and business interests have called for the elimination of all citizenship-based taxation,[381] claiming that the modern global economy necessitates its abandonment.

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378 While the "lavish or extravagant" standard in the current version of section 911(c)(3) might prevent egregious abuses, it is much more difficult to enforce than a dollar cap.

379 *See supra* note 286 and accompanying text.

380 For example, contributions to Coverdell Education Savings Accounts are deductible only to the extent a taxpayer's "modified adjusted gross income" does not exceed certain levels. I.R.C. § 530(c)(1) (West Supp. 2006). Under current law, the "modified adjusted gross income" includes any amount excluded under the foreign earned income exclusion provisions. I.R.C. § 530(c)(2). Because the current foreign earned income exclusion is not necessarily based on equity principles, the current add-back is not objectionable. For a list of current-law tax benefits whose phaseout provisions require an add-back of the foreign earned income exclusion, see PRICEWATERHOUSECOOPERS, *supra* note 303, at 4.

381 While some advocate a complete elimination of citizenship-based taxation, others only recommend the elimination of tax on foreign earned income. *See supra* notes 112–13 and accompanying text.

This Article refutes this most recent argument, concluding that changes in business practices and technology strengthen, rather than weaken, the case for taxing citizens abroad. It also demonstrates that these modern developments significantly undermine the eighty-year-old competitiveness arguments advanced for the broad exclusion of foreign earned income. The Article does not advocate, however, a return to the punitive approach of the Civil War era. Instead, it suggests a more measured middle ground, where citizens abroad are treated in a similar manner to those living in the United States. In a few limited situations, this equity focus might justify narrowly targeted benefits for overseas citizens.

More generally, this Article demonstrates that Congress, in evaluating a tax provision, must consider the changing environment in which the statute applies. As Professor Seligman observed more than a century ago, "A system of taxation . . . which may have been perfectly just under . . . older and simpler conditions, may now be entirely inadequate because of the failure of government to take account of . . . new complications . . . ."[382] Given that the competitiveness arguments advanced by proponents of the foreign earned income exclusion were not necessarily convincing before the modern developments of the past few decades, perhaps this Article demonstrates a corollary to Professor Seligman's observation: A system of (non)taxation that was not necessarily just under older conditions may now be entirely inadequate because of the failure of government to take account of new developments.

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382 SELIGMAN, *supra* note 43, at 99.