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United States Taxation of Its Citizens Abroad: Incentive or Equity

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United States Taxation of Its Citizens Abroad: Incentive or Equity

*Renée Judith Sobel**

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I. INTRODUCTION

The United States, unlike many sovereignties, has exercised worldwide income tax jurisdiction over its individual citizens since the inception of the income tax.[1] Since 1926, however, United

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1. In 1913, the enactment of the sixteenth amendment to the United States Constitution gave Congress "the power to lay and collect taxes on income, from whatever source

States citizens working abroad have received special treatment in the taxation of their foreign earned income.[2] By the use of a tax credit,[3] direct double taxation has been avoided. In addition, various exclusions and deductions have been permitted.[4] Such tax

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derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI. After ratification of this constitutional provision, Congress imposed a tax on the net income of every United States citizen. *See* Revenue Act of 1913, ch. 16, § IIA, 38 Stat. 166. The income tax is a personal tax, which focuses on the individual and his ability to pay. *See* H.R. REP. No. 5, 63d Cong., 1st Sess. 1 (1913). In Cook v. Tait, 265 U.S. 47, 56 (1924), the Supreme Court stated:

> [T]he government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete. Or to express it another way, the basis of the power to tax was not and cannot be made dependent upon the situs of property in all cases, it being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen.

2. *See* Revenue Act of 1926, ch. 27, § 213(b)(14), 44 Stat. 9, 26.

3. *See* I.R.C. § 901 (1982). It could be said that the foreign income tax credit unfairly benefits overseas taxpayers since residents of different states may be subjected to great differences in state and local taxation but may receive only a deduction, rather than an outright tax credit, for payments of state and local income taxes, sales taxes, and real estate taxes. *See* I.R.C. §§ 164, 901 (1982). The foreign income tax credit, however, may not fully help those overseas taxpayers who must pay taxes for which neither a credit nor a deduction is allowed, such as the general rates tax of the United Kingdom, which is levied on the occupant of real property, not upon the real property itself, and is not deductible. INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, PUB. No. 54: TAX GUIDE FOR U.S. CITIZENS ABROAD 53 (Dec. 1981) [hereinafter cited as 1981 IRS PUBLICATION 54]. *But see* Treas. Reg. § 1.913-6(b)(1) (1982) (otherwise nondeductible occupancy taxes could be deducted as a qualified housing expense under the Foreign Earned Income Act of 1978). Other foreign taxes that would be deductible if levied by an American state, such as sales taxes, are not deductible from the overseas taxpayer's income unless incurred in a trade or business. 1981 IRS PUBLICATION 54, *supra*, at 39. In addition, a relatively basic taxation system in a given country might not permit equity with our system because non-income taxes may constitute a large proportion of that country's tax basis. *See Taxation of Foreign Earned Income: Hearings Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 96th Cong., 2d Sess. 193 (1980) [hereinafter cited as *1980 Senate Hearings*]; Patton, *United States Individual Income Tax Policy As It Applies to Americans Overseas: Or If I'm Paying Taxes Equal to 72 Percent of My Gross Income, I Must Be Living in Sweden*, 1975 DUKE L.J. 691, 698; *see also* Vickrey, *Alternatives to the International Tax Credit*, in UNITED STATES TAXATION AND DEVELOPING COUNTRIES 153, 153-54 (R. Hellawell ed. 1980). *But see* Note, *A Proposal for the Elimination of Section 911*, 11 CASE W. RES. J. INT'L L. 139 (1979) (suggesting elimination of the foreign earned income exclusion under the theory that the foreign income tax credit is adequate).

4. *See, e.g.*, Revenue Act of 1926, ch. 27, § 213(b)(14), 44 Stat. 9, 26; Revenue Act of 1962, Pub. L. No. 87-834, § 11(a), 76 Stat. 960, 1003-04; Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011, 90 Stat. 1520, 1610-11 (repealed 1978); Foreign Earned Income Act of 1978, Pub. L. No. 95-615, §§ 201-203, 92 Stat. 3097, 3098-3106, *as amended by* Technical Corrections Act of 1979, Pub. L. No. 96-222, § 108, 94 Stat. 194, 223 (1980); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 111-115, 95 Stat. 172, 190-96, *as amended by* Technical Corrections Act of 1982, Pub. L. No. 97-448, § 101(c), 96 Stat. 2365, 2366, *and by* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 17, 98 Stat. 494, 505.

preferences have been justified on the grounds that they promote tax equity and that they serve as incentives to encourage Americans to work overseas.[5]

This Article considers whether the special treatment of United States expatriate[6] citizens is justified on either equity or incentive grounds. It begins by reviewing the concept of tax equity as it relates to the United States tax system and its taxation of American citizens living abroad. It then considers the use of tax incentives to encourage American citizens to work in foreign countries. The Article then traces the history of the foreign earned income provisions, concluding that Congress, over the years, has come to justify this tax preference primarily on incentive grounds. Finally, it analyzes whether, in fact, the provisions have served the congressional goal of acting as an incentive to encourage exports and to further American public interests.

II. The Concept of Tax Equity

It is virtually a maxim of taxation that in addition to being fair, a good tax system must be perceived as fair.[7] Generally, this means that persons who are similarly situated will be similarly taxed.[8] Behind this deceptively simple concept, however, lies the problem of establishing when taxpayers are similarly situated. Two different equity perspectives come into play in determining when taxation is fair: horizontal and vertical.[9]

A. *Horizontal Equity*

Horizontal equity reflects the elusive goal that people who receive comparable economic rewards and who are alike in other

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5. *See* Postlewaite & Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for Its Repeal*, 65 Va. L. Rev. 1093, 1093-95 (1979).

6. The term "expatriate," as used in this Article, refers to citizens who leave the United States to reside but retain their American citizenship.

7. *See* Note, *Citizenship as a Jurisdictional Basis for Taxation: Section 911 and the Foreign Source Income Experience*, 8 Brooklyn J. Int'l L. 109, 132 (1982); *see also* Gravelle and Kiefer, *U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis*, Economics Div., Congressional Research Service, Library of Congress (Apr. 20, 1978), *reprinted in* 124 Cong. Rec. 11,208 (1978).

8. *See* Hellawell, *United States Income Taxation and Less Developed Countries: A Critical Appraisal*, 66 Colum. L. Rev. 1393, 1410 (1966); Surrey and Brannon, *Simplification and Equity as Goals of Tax Policy*, 9 Wm. & Mary L. Rev. 915, 915 (1968).

9. *See* Hellawell, *supra* note 8, at 1410-11; Surrey & Brannon, *supra* note 8, at 917; Note, *United States Expatriates—The Foreign Earned Income Act of 1978*, 19 Harv. Int'l L.J. 633, 648 (1978).

characteristics should be taxed equally.[10] If people who are not similarly situated are subject to an equal tax obligation, then horizontal equity is violated.[11] Of course, horizontal equity is difficult to determine and even may be impossible to achieve in many cases.[12] Not only does income take many forms and come from many sources, but people's family circumstances differ greatly.[13] As a result, equity determinations often turn into essentially ethical—and inherently subjective—decisions.[14] Nevertheless, because the United States taxes its citizens on their worldwide income, an equity determination must be made regarding whether, or to what extent, the nonresident American is really in the same position as his domestic counterpart. The differences in the cost of living abroad and in the quality and variety of goods and services made available by government spending suggest that the American expatriate is not in the same position as his domestic counterpart.[15] Thus, the taxation of foreign source income of expatriate Americans raises three questions of horizontal equity:[16] (1) should Americans abroad be treated the same as their United States counterparts;[17] (2) if so, how would this equality of treatment be achieved;

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10. Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,213; *see* Hellawell, *supra* note 8, at 1410; Note, *supra* note 9, at 648-49. Characteristics such as family size would be relevant taxing considerations while hair color would not be. *See* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,213.

11. *See* Note, *supra* note 7, at 138. It has been suggested that provisions which violate horizontal equity also violate tax neutrality. *See* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,213. Tax neutrality is the principle of structuring the tax system to minimize unintended economic effects. *Id.* at 11,210. A neutral tax system is conducive to neither incentive nor disincentive reasons for deciding where to seek employment or how to invest funds, *id.*, and the choice of work or investment situs would not affect the income tax burden, *see* Hellawell, *supra* note 8, at 1409; *see also* Blough, U.S. Policy Toward the Taxation of Foreign Earnings of U.S. Citizens, at 13 (June 27, 1978) (manuscript prepared for the Bureau of Int'l Economic Policy and Research, U.S. Dep't of Commerce).

12. *See* Blough, *supra* note 11, at 13.

13. *Id.*

14. *See id.*; *see also* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,210.

15. *See* Note, *Taxation of Foreign-Earned Income in Kind: Henry Taxpayer Goes to Japan*, 54 IND. L.J. 481, 481 (1979). For example, a very modest American style apartment in Japan might cost $20,000 per annum. *Id.* Since the expatriate will have brought his American frame of reference with him, he will not feel $20,000 richer merely because this apartment has been made available either through a rent subsidy or through payment in kind. *See id.*

16. *See 1980 Senate Hearings*, *supra* note 3, at 36.

17. The question arises as to whom equity would compare to the expatriate taxpayer: all other Americans, all expatriate Americans, all the nationals in the foreign jurisdiction who compete with the expatriate, or all the other expatriates and nationals who compete with him in the foreign jurisdiction. *See* Note, *supra* note 7, at 132-33.

and (3) if not, what factors would justify different treatment?

To examine horizontal equity, a comparison must be made between the expatriate American and other taxpayers who, it might be argued, are similarly situated.[18] The domestic taxpayer, for example, finds that it is fair for him to pay tax because his neighbors also are paying tax under the same system to the United States.[19] In contrast, if the nonresident taxpayer looks at his expatriate neighbors from most other countries, he finds that they are not being taxed by their home countries.[20] This lack of taxation enables the third country national to work for less than the American expatriate, giving the third country national a competitive advantage.[21] From the American's point of view, tax equity can be achieved only if his tax burden is no greater than the tax burden of other workers in the same country who have similar costs of living. He regards the obligation to pay United States taxes on his foreign earned income to be unjust.

Tax equity also can be viewed through a comparison of expatriates to domestic taxpayers. Those speaking for domestic taxpayers might argue that the expatriate should be treated the same as a domestic United States citizen at a similar income level.[22] The expatriate, however, may be carrying a higher tax burden than his domestic counterpart because of taxation by the foreign state. Although the tax credit takes the income tax of other countries into account,[23] the expatriate may be living in a country that derives some of its revenue from taxes other than income taxes, such as the value-added tax.[24] These additional fiscal burdens may weigh

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18. Blough, *supra* note 11, at 12-16.

19. *Id.* at 15; Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,208, 11,213; REPORT OF THE PRESIDENT, EXPORT PROMOTION FUNCTIONS AND POTENTIAL EXPORT DISINCENTIVES 8-5 (Sept. 1980) [hereinafter cited as EXPORT PROMOTION REPORT].

20. *See* COMPTROLLER GENERAL OF THE UNITED STATES, REPORT TO THE CONGRESS: AMERICAN EMPLOYMENT ABROAD DISCOURAGED BY U.S. INCOME TAX LAWS 8-16 to 8-20, annex B, ch. 8 (Feb. 1981) (summarizing the expatriate taxation of Canada, France, the Federal Republic of Germany, Japan, and the United Kingdom) [hereinafter cited as COMPTROLLER GENERAL 1981 REPORT]; REPORT OF THE PRESIDENT, EQUITABLE TAX TREATMENT OF UNITED STATES CITIZENS LIVING ABROAD 7-12 (Jan. 1980) [hereinafter cited as EQUITABLE TAX TREATMENT REPORT].

21. *See* Maiers, *The Foreign Earned Income Exclusion: Reinventing the Wheel,* 34 TAX LAW 691, 692 (1981).

22. *See* Blough, *supra* note 11, at 15.

23. *See* Patton, *supra* note 3, at 713-17. Tax treaties also may reduce the incidence of double taxation. Because each treaty can be tailored to the specific country's tax system and needs, treaties may be more equitable than the unilateral credit given by the United States.

24. *Id.* at 717-27. For example,

a value-added tax [may be] imposed on the value added to a commodity by a producer

heavily in the expatriate's overall tax responsibility, yet are not taken into account by the tax credit.[25]

Furthermore, expatriate families may have to pay for services that would be provided by the public sector in the United States.[26] Although many of these services, such as education, would be mainly provided by the states, the federal government subsidizes many local services through revenue sharing and grants-in-aid.[27] This benefits received approach has intuitive appeal, but is limited to those government services which produce benefits that are direct in nature; it does not take into account those services that are

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> or the value of services rendered where products are not involved. In Europe, with the exemption provided for exports, the VAT becomes a tax on consumption in the domestic economy collected in stages as goods are sold or services rendered . . . . The net effect of this, offsetting purchases and sales, is to impose a tax on the sum of wages, interest, rents, profits, and other factors of production not previously furnished by suppliers subject to the tax—hence a tax on value added.

Id. at 722 n.89 (quoting Sanden, *The Value-Added Tax—What It Is; How It Works—Experience in Foreign Countries*, 39 TAX POLICY Nos. 10-12, at 2 (1972)). Some countries derive a large percentage of their total tax revenues from consumption taxes, which are not creditable against United States income taxes. *Id.* at 723; *see supra* note 3. France, for example, derives almost 60% of its national revenues from such indirect taxation of income. *See 1980 Senate Hearings, supra* note 3, at 201-02 (statement of Milan Ordrus, Council of American Chambers of Commerce, Europe and the Mediterranean). Professor Patton has concluded that of the 15 countries whose tax policies he has considered, the United States places the greatest emphasis on income taxes as a means of collecting the national fisc. *See* Patton, *supra* note 3, at app. 1.

25. To qualify for the tax credit, a foreign tax must be either an income tax or a tax in lieu of an income tax. I.R.C. §§ 901, 903 (1982). *See generally* THE STUDY OF FEDERAL TAX LAW: TRANSNATIONAL TRANSACTIONS 75-145 (R. Hellawell & R. Pugh ed. 1981) (discussing the tax credit). A label or designation placed on the tax by the foreign country is not controlling. THE STUDY OF FEDERAL TAX LAW: TRANSNATIONAL TRANSACTIONS, *supra*, at 87. To be creditable as an income tax, the tax must not be payment for a specific economic benefit and must be based on realized net income. Treas. Reg. § 4.901-2 (a)(ii) (1983); *see* INTERNAL REVENUE SERVICE, U.S. DEP'T OF TREASURY, PUB. NO. 514, FOREIGN TAX CREDIT FOR U.S. CITIZENS AND RESIDENT ALIENS 2 (1981) [hereinafter cited as 1981 IRS PUBLICATION 514]. A tax imposed in lieu of an income tax will qualify for the credit if: (1) it is not payment for a specific economic benefit; (2) it is imposed in place of, not in addition to, any income tax; and (3) it is not significantly more than the amount that persons would pay if instead an income tax generally were imposed. *See* THE STUDY OF FEDERAL TAX LAW: TRANSNATIONAL TRANSACTIONS, *supra*, at 111-12.

The expatriate taxpayer may choose to take a deduction for foreign income taxes rather than to utilize the foreign income tax credit. *See* I.R.C. § 164 (1982). Whether the taxpayer takes the credit or the deduction, however, he will not receive either tax benefit for any amount in excess of the tax that the United States would impose on his foreign income.

26. Expatriate families may be loathe to consider the possibility that they may require special services of the federal government such as evacuation from their work location in times of political chaos. *See 1,350 Americans Evacuated*, N.Y. Times, Feb. 1, 1979, at A-12, col. 2.

27. Blough, *supra* note 11, at 20.

humanitarian or social.[28] The United States income tax is based on the principle of ability to pay, not the principle of benefits received. Because most of the expenditures funded by the income tax provide general social benefits to all Americans,[29] it is difficult to assert with strong conviction that expatriate workers do not share in those benefits.

It also has been suggested that horizontal equity is violated because expatriates may be burdened with higher costs such as those involved in moving to a new locale and setting up a new household.[30] While these costs may be higher than for a taxpayer who moves to a new locale within the United States, they would not always be higher. For example, a large percentage of expatriates live and work in Canada.[31] A move from Detroit to Toronto would not be more costly than one from Seattle to New York. The start-up costs for New York housing would far exceed the costs in many overseas areas.[32] Because the circumstances of the expatriate may vary greatly from one locale to another, little definite can be said about his moving costs.

Although it is difficult to list the factors to be considered, a requirement that the expatriate be taxed in the same manner as his domestic counterpart nevertheless will seem to violate horizontal tax equity. If we compare the American expatriate to other third country expatriates living and working where he does, we find equity is violated because his higher tax burden has made him noncompetitive. If we compare the American expatriate to other domestic taxpayers, we find that the differences in his real economic burden due to his overseas tax burden also violate horizontal equity. Finally, the individual circumstances of the country in

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28. Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,214. *See generally* Krauss, *The Benefit Theory of Taxation*, 11 TENN. L. REV. 226 (1933) (taxes are justified to the degree that people benefit from government).

29. *See* Krauss, *supra* note 28, at 235. Government expenditures funded by the federal income tax system primarily benefit all Americans rather than specific Americans. It may be argued either way whether American citizens living abroad benefit from national defense, expenses of running the government, foreign aid, basic research, natural resource development, and health care.

30. *See* Note, *supra* note 7, at 134-35.

31. Estimates show that 15% to 20% of all expatriate taxpayers live in Canada. EQUITABLE TAX TREATMENT REPORT, *supra* note 20, at 5 (Jan. 1980). This percentage excludes United States government civilian and military personnel and their dependents. *Id.*

32. When compared with 20 cities in countries with large numbers of expatriate Americans, New York City's cost of living was equal to or greater than 11 of the cities. *See* COMPTROLLER GENERAL OF THE UNITED STATES, REPORT TO THE CONGRESS: IMPACT ON TRADE OF CHANGES IN TAXATION OF U.S. CITIZENS EMPLOYED OVERSEAS 99 app. I (Feb. 1978) [hereinafter cited as COMPTROLLER GENERAL 1978 REPORT].

which the expatriate resides may change his circumstances vis-a-vis his American counterpart.

The situation of George Constantine, a dual citizen of the United States and Greece, dramatically illustrates the problem of horizontal equity.[33] George was employed by a Greek bank and was receiving his pension from that bank. Although George was willing to pay United States income taxes, his salary and pension were paid in Greek currency, which he could convert to United States currency only by violating the Greek Penal Code. Nevertheless, as soon as he used any of his pension money or salary for his personal expenditures, his United States taxes were due, and they had to be paid in United States dollars.[34] If George was to be treated as a resident United States taxpayer, the fact that he was subject to criminal charges in Greece for compliance with our law would not be of concern. However, few would argue that horizontal equity is not violated when a taxpayer, such as George, must risk imprisonment for his tax obligation to the United States while his domestic counterpart does not.

B. *Vertical Equity*

Another equity standard is that of vertical equity, which examines the distribution of the tax burden by income class.[35] The goal of vertical equity is to distribute the tax load fairly among persons with substantially different economic rewards or resources.[36] In the United States income tax system, vertical equity's attempt to make the inequalities of the tax burden correspond to the community's concept of economic justice has led to a schedule

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33. *See* Constantine v. Commissioner, 43 T.C.M. (CCH) 158 (1981).

34. INTERNAL REVENUE SERVICE, U.S. DEP'T OF TREASURY, PUB. NO. 54, TAX GUIDE FOR U.S. CITIZENS ABROAD 20 (Nov. 1982) (explaining that residents of countries, such as Greece, that restrict conversion of funds may defer their tax payments until the income becomes unblocked or readily convertible; but if, as was the case with George Constantine, they actually spend the money for living expenses, then the income is considered "unblocked and reportable") [hereinafter cited as 1982 IRS PUBLICATION 54]; *see 1981-1982 Miscellaneous Tax Bills, IV: Hearings on S. 408, S. 436, S. 598, and S. 867 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 97th Cong., 1st Sess. 402-11 (1981) (statement of Roger D. Conklin, Cook Electric Int'l) [hereinafter cited as *1981 Senate Hearings*]; *see also 1980 Senate Hearings*, *supra* note 3, at 468-69, 473-75 (statement of Roger D. Conklin, Cook Electric Int'l) (discussing problem of paying taxes in United States currency while a resident of Brazil and Peru).

35. *See* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,214-15; Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 581-86 (1965).

36. Blough, *supra* note 11, at 12.

of personal exemptions and progressive tax rates.[37] Thus, a wealthier individual will be required to pay a larger fractional share of his earnings as taxes than a poorer individual. When an individual is taxed at a higher or lower rate than his real economic reward would mandate, vertical equity is violated.[38]

The United States income tax, when applied to expatriate taxpayers, makes no adjustments for differences in purchasing power that may exist.[39] The cost of living may vary from region to region and from country to country. A given income will provide less where the cost of living is higher, and for true vertical equity to exist, the income tax obligation also should be less.[40] When a higher cost of living results in a higher income in order to provide the so-called "cost equalizers," the progressive tax rate imposes a higher rate on individuals who do not have higher income in a real economic sense.[41]

Many expatriates live in areas where they receive artificially inflated incomes because of their higher costs of living.[42] Their expenses often are reimbursed by an employer who wishes to place them in the same economic position as the domestic taxpayer. Such equalization payments are fully taxable as additional income[43] although they do not represent real economic gain. Thus, these cost equalizers may artifically shift the expatriate to a higher tax bracket.[44] A larger percentage of his income will be subject to being paid as taxes without his having received any accompanying

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37. *Id.* For a discussion of progressive taxation, see Blum, *Revisiting the Uneasy Case for Progressive Taxation,* 60 TAXES 16 (1982); Blum and Kalven, *The Uneasy Case for Progressive Taxation,* 19 U. CHI. L. REV. 417 (1952); and Vickrey, *The Meaning of Progression,* 20 U. FLA. L. REV. 437 (1968).

38. *See* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,214; Sneed, *supra* note 35, at 584-86.

39. *See* Blough, *supra* note 11, at 18. "Ability to pay is a function of real *economic income*, not of the number of dollars of monetary income." *Id.* (emphasis in original).

40. *See id.*

41. *Id.*

42. *See* Note, *supra* note 7, at 137.

43. If the employer provides free housing instead of reimbursement, the housing would be includible in the expatriate's income at its fair market value in the local overseas market. *See* McDonald v. Commissioner, 66 T.C. 223 (1976). *But see* Adams v. United States, 585 F.2d 1060 (Ct. Cl. 1978) (because taxpayer residing in Japan was required as a condition of employment to live in a particular residence, which had certain rooms set up for business purposes, its value could be excluded under I.R.C. § 119).

44. *See 1980 Senate Hearings, supra* note 3, at 279. Additionally, nonresident taxpayers often are reimbursed for the taxes paid on these cost equalizers, which results in an additional spiral of taxable payments.

addition to his standard of living or his ability to pay taxes.[45] Such taxation violates vertical equity.

This problem of differing costs of living also exists within the United States. In New York City, for example, a modest apartment might cost $15,000 annually while a similar apartment in Philadelphia might cost only $7000. Although salaries in New York would be artificially inflated to account for the difference in cost of living,[46] the federal tax system does not correct such inequities within the United States. The difference between this phenomenon and taxation of overseas citizens is that the New Yorker's neighbors also are subject to the increased tax spiral, while the expatriate's neighbors, in contrast, usually will not be taxed on such cost equalizer payments. As a result, the expatriate looking at his co-workers will feel that vertical equity is violated because the nontaxation of their cost equalizers allows the foreign nationals with whom he works to increase their income in a real sense or to work for less compensation than he can.

C. Achievement of Equity

Although the achievement of equity is a goal of tax policy, it must compete with the sometimes conflicting goals of efficiency and simplification.[47] To achieve a purely equitable result, all circumstances that might bear on the fairness of the tax should be examined.[48] Simplicity, however, requires that some facts be ignored, while efficiency may determine the possible compromises between equity and simplicity.[49]

For many years, the goal of equity seemingly was ignored, and

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45. Note, *supra* note 7, at 138.

46. In fall 1984, the annual salary for recent law graduates was approximately $49,000 in major New York City law firms and only $37,000 in major Philadelphia law firms. *See Annual Survey of the Nation's Largest Law Firms*, NAT'L L.J., Sept. 24, 1984, at 6, 9 (New York: Cleary, Gottlieb, Steen & Hamilton, $50,000; Davis, Polk & Wardwell, $49,000; Milbank, Tweed, Hadley & McCloy, $49,000; Paul, Weiss, Rifkind, Wharton & Garrison, $47,000. Philadelphia: Blank, Rome, Comisky & McCauley, $36,000; Pepper, Hamilton & Scheetz, $37,000; Schnader, Harrison, Segal & Lewis, $37,000; Wolf, Block, Schorr & Solis-Cohen, $37,000). Since the work would be quite similar for a beginning attorney whether in New York or in Philadelphia, the $12,000 salary difference to some extent must reflect the cost difference between the two cities.

47. *See* Surrey and Brannon, *supra* note 8, at 915-16; *see also* Goldstein, *An Overview of Basic Tax Reform Possibilities*, 14 HOUS. L. REV. 1059, 1060 (1977).

48. *See* Surrey and Brannon, *supra* note 8, at 916; *cf.* Coven, *The Decline and Fall of Taxable Income*, 79 MICH. L. REV. 1525, 1545 (1981) (a number of factors must be considered in devising an equitable tax schedule for married couples).

49. *See* Surrey and Brannon, *supra* note 8, at 916.

expatriates could exclude amounts ranging from $15,000 to $35,000 of foreign earned income if they met certain criteria of presence or residence abroad.[50] Since the exclusions applied to all Americans who met those tests, the exclusions could serve as incentives to work in low tax, low expense areas of the world. In contrast, a neutral adjustment to render expatriate taxation equitable[51] would seek to minimize those characteristics that serve as disincentives or incentives for expatriates working abroad.[52]

In 1978 a system with a series of deductions for items perceived as the nonequity features of the taxation of foreign earned income was attempted.[53] The system was unpopular because of its complexity,[54] but no attempt was made to simplify it. Instead, in 1981 the lump-sum exclusion was returned for certain expatriates who met foreign residence or presence qualifications.[55] The new exclusion was hailed not for its equity features, but for its features as an incentive for employment abroad.[56]

III. The Use of Tax Incentives

A. *Tax Preferences*

Tax incentives, or preferences, have varied objectives.[57] Nearly all of them, however, seek to diminish the income tax liabilities of taxpayers in special situations or to encourage certain economic activities.[58] Some preferences have favorable effects on the distribu-

50. See *infra* notes 108-240 and accompanying text for the history of the foreign earned income exclusion.

51. *See* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,210 (suggesting that only a neutral standard would he equitable).

52. *Id.*

53. Foreign Earned Income Act of 1978, Pub. L. No. 95-615, §§ 201-203, 92 Stat. 3097, 3098-3106, *as amended by* Technical Corrections Act of 1979, Pub. L. No. 96-222, § 108, 94 Stat. 194, 223 (1980) (discussed *infra* notes 165-213 and accompanying text).

54. *See 1980 Senate Hearings, supra* note 3, at 45.

55. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 111-115, 95 Stat. 172, 190-96 (1981), *as amended by* Technical Corrections Act of 1982, Pub. L. No. 97-448, § 101(c), 96 Stat. 2365, 2366, *and by* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 17, 98 Stat. 494, 505 (discussed *infra* notes 214-39 and accompanying text).

56. *See* H.R. REP. No. 201, 97th Cong., 1st Sess. 60 (1981).

57. *See* Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 309 (1972). These incentives or preferences often are called "tax expenditures and evaluated as if they involved direct government expenditures equivalent in amount and distribution to the revenue reduction they produce." *Id.*

58. *Tax Expenditures: Special Analysis in President Carter's Fiscal 1979 Budget*, DAILY TAX REPORT (BNA), at J-1 (Jan. 23, 1978), *reprinted in* POLICY READINGS IN INDIVIDUAL TAXATION 361, 362 (P. Postlewaite ed. 1980) [hereinafter cited as *Tax Expenditures Special Analysis*].

tion of income by way of socioeconomic categorization.[59] These preferences include those that meet special circumstances of the taxpayer, such as the personal exemptions for the blind and the aged and the deductions for medical expenses. Questions of equity arise in the creation of these preferences.[60] Other tax preferences seek to encourage certain economic activities. These tax incentives are advocated because they influence behavior and thereby alter resource allocation.[61] These preferences fall into three main categories: those influencing household behavior,[62] those influencing business behavior,[63] and those influencing state and local government behavior.[64]

Many economic groups are not satisfied with neutral taxation and seek a favored tax preference as an incentive.[65] The burden of proving that an incentive is wise should rest heavily on those taxpayers supporting that particular incentive.[66] In the case of a tax incentive encouraging the employment of United States citizens abroad, two threshold determinations must be shown: (1) that it is in the United States public interest to have foreign employment of its citizens; and (2) that tax incentives are needed and justified in achieving this result.[67]

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59. *See* Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures,* 83 HARV. L. REV. 705, 708 n.2 (1970) (quoting Aaron, *Inventory of Existing Tax Incentives: Federal,* in TAX INST. OF AMERICA, SYMPOSIUM ON TAX INCENTIVES 39, 40-41 (1971)).

60. *See id.* Commentators have written about the payment of medical expenses as a departure from the aggregate personal consumption of the taxpayer. *See, e.g.,* Andrews, *supra* note 57, at 309-10; Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World,* 31 STAN. L. REV. 831, 865 (1979). Under Professor Andrews' analysis, the money used for medical expenses is a legitimate exclusion from income as money not available for consumption. He would justify this special status as being a refinement on the concept of taxable income. *See* Andrews, *supra* note 57, at 341-44.

61. *See* Surrey, *supra* note 59, at 708 n.2; *see also* Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance,* 84 HARV. L. REV. 352 (1970).

62. Among the influences of such tax incentives on household behavior would be the effect of the charitable contribution on spending patterns, the effect of the foreign earned income exclusion on place of employment, and the effect of capital gains treatment on investment choices. Surrey, *supra* note 59, at 708 n.2.

63. Influences on business behavior might include the effect of the excludability of certain employer contributions on the wage offer. *Id.*

64. *Id.*

65. Blough, *supra* note 11, at 28.

66. Surrey, *supra* note 59, at 734; *see* Blum, *Federal Income Tax Reform—Twenty Questions,* 41 TAXES 672, 679 (1963); Kurtz, *Tax Incentives—Their Use and Misuse,* 20 S. CAL. TAX INST. 1, 9 (1968).

67. Blough, *supra* note 11, at 29-30.

B. The Desirability of Foreign Employment of United States Citizens

It is difficult to ascertain the importance of foreign employment of United States citizens.[68] The assertion that foreign employment of American citizens is favorable to the United States relies on several premises:[69] that foreign employment increases the total volume of employment available to Americans;[70] that a greater number of Americans abroad generates greater international understanding and goodwill;[71] and that overseas employment has economic advantages such as an increase in exports[72] or a favorable effect on the balance of payments.[73]

In theory, sending Americans to work abroad has both a direct and an indirect effect on domestic employment opportunities. The direct effect is expansion of the total employment opportunities of Americans. The indirect effect would be felt as a result of the domestic opportunity that the expatriate leaves behind.[74] This indirect effect is advantageous if there is a domestic surplus of the skills that the expatriate takes abroad, so that if he had remained in the United States, the expatriate would have been unemployed or would have taken the position of another domestic employee.[75] On occasion, there may be domestic unemployment in certain fields in which expatriates are employed abroad, such as teaching or, more recently, construction. Americans overseas, however, do not merely represent the unskilled and often in effect export skills that are not in excess domestically.[76] Because Americans abroad

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68. *Id.* at 31. The great variety of circumstances under which expatriates work makes it difficult to state any maxims. Americans' foreign employment will have differing impacts depending on their employers, the type of work, the country where employed, and the nature and intensity of the competition meeting the worker and his employer. *See id.* at 31-36.

69. *See id.* at 36; EXPORT PROMOTION REPORT, *supra* note 19, at 8-5 to 8-7, 8-12.

70. *See* EQUITABLE TAX TREATMENT REPORT, *supra* note 20, at 18.

71. *Id.*; *see* Blough, *supra* note 11, at 36.

72. EQUITABLE TAX TREATMENT REPORT, *supra* note 20, at 18; *see* OFFICE OF TAX ANALYSIS, U.S. DEP'T OF TREASURY, PAPER NO. 33, THE AMERICAN PRESENCE ABROAD AND U.S. EXPORTS (Oct. 1978) (John Mutti, author) [hereinafter cited as Mutti].

73. Blough, *supra* note 11, at 36; Note, *Section 911 Tax Reform*, 54 MINN. L. REV. 823, 825-26 (1970). *But see* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,210-13 (suggesting that tax incentives do not have a permanent effect on the balance of payments).

74. *See* Blough, *supra* note 11, at 36.

75. *See id.*; EQUITABLE TAX TREATMENT REPORT, *supra* note 20, at 35.

76. Of Americans filing tax returns from abroad in 1980, approximately 16% were filed by business managers, 7% were filed by persons working in law, accounting, or finance, and 7% were filed by researchers and journalists. *1981 Senate Hearings*, *supra* note 34, at 69 (statement of John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy).

work under so many varying circumstances, no generalization can explain whether their employment does or does not expand the overall job market for Americans or whether it creates a need that cannot be satisfied at home.[77]

The second premise underlying the contention that foreign employment of Americans is advantageous—that is, that the presence of Americans abroad promotes goodwill—is a two-edged sword. While attempts to foster international understanding are important,[78] on occasion the American presence overseas has been viewed as neocolonial with the perception of exploitation of the local population.[79] On the whole, however, it probably enhances United States prestige to have American workers abroad, particularly if they are in fields such as teaching or science and contribute otherwise unavailable skills to the local economy.[80] Notwithstanding, many Americans abroad who contribute to a favorable presence are visitors, travelers, retired persons, and others who do not earn income abroad and are not affected by special laws for taxation of foreign earned income. Under these circumstances, the use of tax incentives to promote goodwill appears to be somewhat tenuous.[81] In light of the above, the primary reason for encouraging Americans to work abroad would appear to be that their foreign employment has economic advantages inasmuch as it promotes exports and encourages a favorable balance of payments.[82] The presence of Americans abroad does seem to increase the overall number of exports because such expatriates tend to order American made equipment for their projects.[83] Because approximately one-

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77. *See* Blough, *supra* note 11, at 37; EQUITABLE TAX TREATMENT REPORT, *supra* note 20, at 36.

78. *See* Note, *supra* note 73, at 824-25.

79. *See* Blough, *supra* note 11, at 40; *see also* Hellawell, *supra* note 8, at 1424 (suggesting that some countries view United States presence and investment as colonial and unwelcome). *But see* COMPTROLLER GENERAL 1978 REPORT, *supra* note 32, at 72-73 (officials of Saudi Arabian government indicated that a decline in United States presence and investment in that country could bave a possible detrimental impact on United States-Saudi Arabian relations).

80. Blougb, *supra* note 11, at 41.

81. EQUITABLE TAX TREATMENT REPORT, *supra* note 20, at 36.

82. *See* Mutti, *supra* note 72, at 2; *see also* Blough, *supra* note 11, at 9-11; Maiers, *supra* note 21, at 710 n.122; Note, *supra* note 15, at 493-94; EXPORT PROMOTION REPORT, *supra* note 19, at 8-7; EQUITABLE TAX TREATMENT REPORT, *supra* note 20, at 36. *But see* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,208 (suggesting that the relationship between the tax treatment of expatriates by the United States and exports is uncertain).

83. *See* EXPORT PROMOTION REPORT, *supra* note 19, at 8-7. In 1978, George Schultz, then president of Bechtel Industries and presently Secretary of State, told the Senate Fi-

eighth of all jobs in the domestic manufacturing sector depend on exports, their importance should not be underestimated.[84] Additionally, an estimated one-third of United States corporate profits are derived from international activities,[85] and according to one study, nearly one-quarter of total United States exports are purchased by foreign subsidiaries and affiliates of United States corporations.[86] In another study, a significant direct relationship between the presence of Americans abroad and exports for the United States came to light.[87] This study found that a ten percent decrease in the number of Americans abroad would result in a five percent decrease in the value of total exports.[88] Even if the presence of Americans abroad does encourage exports, the question of whether to grant an incentive is complicated because some expatriates may be engaged in creating a flow of goods that penetrates the United States market.[89]

An advantageous money flow, which results in a favorable balance of payments, also has been attributed to the foreign employment of American expatriates. An expanded inflow of money would result from any addition to exports from the United States. An increased inflow also would occur when expatriate workers who are self-employed or have foreign employers repatriate part of their

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nance Committee:

> Referring . . . to my own experience, it is important to emphasize the extent to which U.S. goods tend to follow projects that U.S. firms plan and carry out. For example, in constructing gas-gathering systems or an hydroelectric facility in a foreign country, or a host of other projects, U.S. engineers are more likely to use technology and techniques that require U.S. produced equipment and parts (and this will result in U.S. replacement parts being used throughout the life of the project). The engineers and constructors had to become personally known and their work trusted. This leads to future contracts, as well as follow-on work, with additional positive benefits for the U.S. balance of trade.

124 CONG. REC. 13,385 (1978).

84. Henry, *Who Represents Americans Abroad?, reprinted in 1980 Senate Hearings, supra* note 3, at 652, 667 (indicating that nearly ten million domestic jobs depend on exports).

85. *Id.*

86. EXPORT PROMOTION REPORT, *supra* note 19, at 8-6 (citing U.S. DEP'T OF COMMERCE, POLICY ASPECTS OF FOREIGN INVESTMENT BY U.S. MULTINATIONAL CORPORATIONS (Mar. 1972)).

87. *See* Mutti, *supra* note 72 (discussed *infra* notes 245-61 and accompanying text).

88. *Id.* at 3. *But see* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,208 (suggesting that the relationship between exports and the tax treatment of expatriates by the United States is uncertain).

89. For example, although it is estimated that less than seven percent of overseas plant production is returned to the United States, some overseas plants of American corporations produce for the stateside market in addition to foreign markets. *See* Blough, *supra* note 11, at 39.

earnings for purchases or savings.[90] Likewise, payments by American employers to expatriate workers tend to reduce the outflow of funds that would result from paying foreign employees.[91]

C. The Utility of the Incentive Approach

Whatever the economic advantages to having Americans work abroad, the question still remains whether a tax incentive is the best means of encouraging this activity. Tax incentives generally are less exact than direct government disbursements for specified programs.[92] Rather than having a committee with expertise in the area design the program, the House Committee on Ways and Means and the Senate Committee on Finance plan the incentives.[93] Nevertheless, incentives are utilized because business, Congress, and the executive branch think that they work,[94] and it is difficult to prove these proponents wrong.[95]

In the case of expatriate workers, a direct expenditure alternative would be difficult to design because a great variety of circumstances affect the employment of Americans abroad. For example, a United States multinational corporation could be reimbursed or could receive some other direct benefit for hiring American expatriates,[96] but this would not assist the expatriate working for a foreign corporation.[97] In contrast, a program could be designed to reimburse directly those Americans working overseas. Both of these

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90. *See id.*; Note, *supra* note 73, at 825-26. *But see* Gravelle and Kiefer, *supra* note 7, *reprinted in* 124 CONG. REC. at 11,208 (suggesting that the market eventually will adjust itself and that a tax incentive would not have a permanent effect on the balance of payments).

91. It would seem that expatriates working for domestic employers also would repatriate certain amounts for purchases and savings.

92. Sneed, *supra* note 35, at 602.

93. *See* Surrey, *supra* note 59, at 728.

94. *See, e.g., 1981 Senate Hearings, supra* note 34, at 69; *1980 Senate Hearings, supra* note 3, at 60; *Taxation of Americans Working Abroad: Hearing Before the Senate Comm. on Finance*, 95th Cong., 2d Sess. 19 (1978); *Act to Reform Tax Law: Hearings on H.R. 10,612 Before the Senate Comm. on Finance*, Pt. 2, 94th Cong., 2d Sess. 662 (1976).

Although there presently is talk of imposing a flat-rate income tax without any special exclusions or deductions, special interest groups already are trying to insure that their protected status via tax preferences will remain. *See, e.g., Treasury Secretary Regan to Recommend Modified Flat Tax*, FED. TAXES REP. (P-H) ¶ 60,487 (Oct. 11, 1984).

95. *See* Hellawell, *supra* note 8, at 1412.

96. *See* Kingson, *A Somewhat Different View*, 34 TAX LAW. 737, 739 (1981).

97. Expatriates working for foreign corporations may do more for the balance of payments by repatriating funds to the United States that were not initiated from American sources and by ordering American goods and machinery that otherwise would not be exported. On the other hand, such expatriates may hurt the balance of payments if they work in an industry that exports goods to the United States.

direct expenditure programs, however, might be viewed with displeasure by the host country as being neocolonial. Both programs would appear to be the United States encouraging its citizens to claim employment in the host country that should belong to the host's own citizens.[98] By giving direct benefits to its citizens, the United States might be imposing itself on a country that does not regard the influx of American workers as a blessing.[99] A tax incentive would be more subtle in such circumstances, and it would be of benefit only when the host chose to tax the expatriate at a lower rate than he would pay in the United States. If a host country did not want an influx of workers, it could create its own tax disincentives—which would be difficult to implement under a direct disbursement program.

Tax incentives also are appropriate for a variety of psychological reasons. With the current budget deficit, it would be difficult to create new programs requiring government spending to subsidize citizens going overseas. A tax incentive, which is in substance a tax expenditure, can be a method to create a program that otherwise would not have sufficient political support for passage.[100] In fact, it may be the very regressive nature of tax expenditures that makes them appropriate as an incentive for the overseas employment of Americans. The business sector and Congress both have stated that American middle and upper level personnel are more likely to use and promote American products, equipment, and professional services than similar personnel from other countries. If the promotion of American exports is a motivating reason for wanting expatriates in foreign countries, then to some extent it is these citizens in the better paid strategic positions who should be encouraged to take jobs abroad. A direct expenditure program giving benefits of $3000 to a taxpayer earning $20,000 and benefits of $40,000 to a taxpayer earning $110,000 probably never would be enacted by

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98. If the competition for employment in the foreign country were other third country nationals, direct grants would not have the same neocolonial impact. The United States need not he neutral when the issue is employment of other third country nationals over American nationals. *See* Blough, *supra* note 11, at 44.

99. *See* Hellawell, *supra* note 8, at 1424 (not all lesser developed countries regard United States investment as an "unmitigated blessing").

100. *See* Sneed, *supra* note 35, at 602. In 1967, for example, Senator Robert Kennedy sponsored S. 2100, which featured tax incentives to urge housing for urban poverty areas. The plan essentially was an attempt to spend large amounts of federal money through tax rebates, which Kennedy did not think would pass if openly sought. *See* Stone, *Tax Incentives as a Solution to Urban Problems*, 10 WM. & MARY L. REV. 647, 654 (1969).

Congress.[101] Nevertheless, with a tax preference the greater benefit will go to the higher income taxpayer in this same fashion.[102] The use of preferences, therefore, allows Congress to give more encouragement to take jobs abroad to those expatriates in positions where they can exercise export influence than to other expatriates without subjecting the nature of the subsidy to the scrutiny of the general public.[103]

An incentive in the form of a tax preference also has the advantage of eliminating some of the costs of the goal because it limits government interference.[104] By camoufiaging the degree of government involvement, the expatriate believes that he has exercised a free choice in going overseas, and the erosion of self-reliance that more heavily supervised programs may cause is prevented.[105] Moreover, there is no need to create a specially designed bureaucracy to administer the tax incentive program[106] because the Internal Revenue Service already has the necessary apparatus.[107]

Separate from the question of how to justify a tax preference is the question of how it actually has been rationalized. The practice of past years has been to give the American expatriate certain tax benefits in the form of exclusions or deductions from his income. Because of differing views of tax equity, of trade and export policy, and of the effectiveness of the tax law to further such policy, different Congresses have used different rationales to explain the varying taxation of expatriate Americans. As we shall see in the next part discussing the history of the foreign earned income exclusion, for only one brief period was an equity model designed that created deductions for the special costs of overseas living. Essentially the expatriate has received a tax preference that is justifiable only if it is effective in its role as an incentive. A look at the changing views of Congress since this special preference first was enacted follows.

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101. Because the mere proposal of such a direct expenditure program might prevent reelection, it is unlikely that it ever would be suggested.

102. *See* Surrey, *supra* note 61, at 366-70 (discussing the regressive nature of tax incentives when applied to several specific preferences).

103. *Id.* at 379 (indicating that the hidden character of the financial assistance may be of importance).

104. *See* Sneed, *supra* note 35, at 603.

105. *Id.*

106. *Id.*

107. *See* Hellawell, *supra* note 8, at 1426.

IV. The History of the Foreign Income Exclusion

A. *The First Fifty Years: 1926 to 1976*

Legislation giving a tax preference to Americans working abroad was first enacted in 1926,[108] partly in response to lobbying efforts by American industry seeking to secure incentives for overseas industrial expansion. Although most of the pressure came from the export industries, other sectors also were interested in pursuing their interests abroad.[109] As a result, the House Ways and Means Committee proposed an exclusion for certain income earned abroad. Under its bill, a citizen of the United States who was resident abroad for at least six months would not have been taxed on the amounts received as salary or as a commission from the overseas sale or export of goods produced in the United States.[110] While the Senate Finance Committee believed the existing foreign tax credit, which merely permitted Americans living abroad to avoid double taxation, provided sufficient protection,[111] Congress ultimately adopted the House approach[112] providing for the total exclusion of any foreign earned income[113] for citizens who were

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108. *See* Revenue Act of 1926, ch. 27, § 213(b)(14), 44 Stat. 9, 26. The statute provided for an exclusion

> [i]n the case of an individual citizen of the United States [who was] a bona fide nonresident of the United States for more than six months during the taxable year, [of] amounts received from sources without the United States if such amounts constitute earned income as defined in section 209; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

Id.

109. Levine, *Section 911: The Foreign Earned Income Exclusion—Death Blow or Recovery?*, 56 Taxes 169, 170 (1978); *see* Postlewaite & Stern, *supra* note 5, at 1118-25.

110. *See* H.R. Rep. No. 1, 69th Cong., 1st Sess. 7 (1926).

111. *See* S. Rep. No. 52, 69th Cong., 1st Sess. 20-21 (1926).

112. *See* H.R. Conf. Rep. No. 356, 69th Cong., 1st Sess. 33 (1926).

113. The term "earned income" included:

> wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered, but [did] not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer, not in excess of 20 per centum of his share of the net profits of such trade or business, shall be considered as earned income.

Revenue Act of 1926, Ch. 27, § 209(a)(1), 44 Stat. 9, 20.

Until recently courts have been very strict in finding that income was "earned income" in the context of taxpayers engaged in a trade or business abroad. *See, e.g.*, Foster v. United States, 221 F. Supp. 291 (S.D.N.Y. 1963), *aff'd*, 329 F.2d 717 (2d Cir. 1964) (although partner's income is called "salary," the exclusion is not permitted since such "salary" actually

nonresidents of the United States for at least six months during the taxable year.[114]

The stated purpose of the foreign earned income exclusion was to equate the tax burden of United States citizens abroad with that of United States citizens at home.[115] The provision, however, did not result in such equity.[116] If the foreign country's tax rates were higher than the rates of the United States, the expatriate citi-

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represents profits); Rev. Rul. 71-183, 1971-1 C.B. 215 (income from artist's sale of paintings is not earned income unless he paints them pursuant to a prior commitment), *rev'd*, Tobey v. Commissioner, 60 T.C. 227 (1973), *acq.* 1979-10 I.R.B. 6. *But see* Robida v. Commissioner, 24 T.C.M. (CCH) 451 (1965) (income from playing slot machines constitutes earned income because it is derived from personal expenditure of time, energy, and skill), *vacated and remanded on other grounds*, 371 F.2d 518 (9th Cir. 1967).

114. Employees of the federal government, in effect, received a bonus under the 1926 exclusion as compared to other citizens living abroad. Through tax treaties and other international agreements, federal employees usually were exempt from any foreign government taxation of their income; through the foreign tax exclusion they were exempt from United States taxation of their foreign earned income. Because of the virtually complete exemption of these citizens from income taxes, in 1932 the Senate Finance Committee proposed to eliminate the exclusion in its entirety. *See* S. REP. No. 665, 72d Cong., 1st Sess. 31 (1932), *reprinted in* 1939-1 (vol. 2) C.B. 496, 518. Other senators, believing that the Finance Committee proposal went too far, suggested that the exclusion be continued for those who were not employees of the United States. *See* 75 CONG. REC. 10,410 (1932) (remarks of Sen. Reed). Senator Reed stated:

> [T]he provision had been stretched to the point of exempting an American naval officer or Army officer who was stationed . . . in the embassy in London or in some foreign country, like our troops in China. Those people were getting complete exemption from the American income tax. We discovered further, to our surprise, that it had been held that American ambassadors and ministers and officers of the Foreign Service were getting clear out of the payment of any income tax by virtue of the same provision, which nobody in the world ever intended when the provision was first adopted. These people do not deserve the exemption, because they are not subject to the income taxation of the foreign countries in which they are stationed, any more than we would tax the British ambassador here in Washington on his income.

Id. Reed would have added the words "other than compensations paid by the United States or an agency thereof" to the provision, thereby preventing federal employees from excluding their salaries from taxable income. *Id.* at 10,410-11. Senator Reed's

> understanding of the law [was] that if a British citizen were working here in the United States and lived here more than six months of the year we would tax him on his full earnings here just as Great Britain would tax an American living over there, but Great Britain [would] not tax her British citizen here if he live[d] here more than six months. This amendment [was to] put our law on the same basis.

Id. at 10,411.

Although Senator Reed subsequently withdrew his proposal, a majority of Congress shared his ideas, and his amendment ultimately was enacted into law. *See* I.R.C. § 116(a) (1932). Therefore, the foreign earned income exclusion remained in full effect but did not apply "to amounts paid by the United States or any agency thereof." H.R. CONF. REP. No. 1492, 72d Cong., 1st Sess. 15 (1932), *reprinted in* 1939-1 (vol. 2) C.B. 539, 543.

115. 67 CONG. REC. 796 (1926) (remarks by Sen. Smoot); *see* Note, *supra* note 73, at 826-27.

116. *See* Levine, *supra* note 109, at 170.

zen would pay more tax than a resident citizen would pay; if the foreign rates were lower, the nonresident citizen would pay less tax than a resident citizen.[117] The other asserted purpose of the exclusion—to provide impetus for American participation in foreign trade[118]—was accomplished when the host country taxed at a lower rate than the United States. For expatriates residing in such a country, the exclusion could operate as a tax incentive.

Despite the exclusion's inability to satisfy all of its objectives, it remained[119] as initially drafted until 1942. During this period, the six-month nonresidency requirement increasingly resulted in abuses of the system,[120] with some taxpayers living abroad solely for tax evasion purposes. As a result, the House Ways and Means Committee proposed the repeal of the foreign earned income exclusion to remove the tax discrimination that favored individuals receiving compensation for services abroad.[121] In a reversal of its earlier position, the Senate Finance Committee opposed repeal of the exclusion *in toto* fearing that it would create "a hardship in the case of citizens of the United States who [were] bona fide residents of foreign countries,"[122] and who would be subject fully to the in-

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117. *Id.* Actually, although one of the motives behind the exclusion may have been the avoidance of double taxation, the payment of taxes to a foreign government was not then, and is not now, a prerequisite to the exclusion. *See, e.g.*, Matthew v. Commissioner, 38 T.C. 417 (1962), *rev'd on other grounds*, 335 F.2d 231 (5th Cir. 1964); Rose v. Commissioner, 16 T.C. 232 (1951).

118. *See* Note, *supra* note 73, at 827.

119. While the Revenue Act of 1932 had incorporated the definition of "earned income" into § 116(a), the Revenue Act of 1934 defined the term by means of cross reference to § 25 of the 1934 Act. *See* Slowinski & Williams, *The Formative Years of the Foreign Source Earned Income Exclusion: Section 911*, 51 TAXES 355, 358 (1973) (citing 48 Stat. 680). Section 116(a) remained intact through the Revenue Act of 1936 and the Revenue Act of 1938. The Internal Revenue Code of 1939 codified the exclusion exactly as it appeared in the 1934 Act. The exclusion would apply

> [i]n the case of an individual citizen of the United States, [who was] a bona fide nonresident of the United States for more than six months during the taxable year, [to] amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts would constitute earned income as defined in section 25(a) if received from sources within the United States; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection.

Int. Rev. Code of 1939, ch. 1, § 116(a), 53 Stat. 1, 48; *see also supra* note 114 (discussing 1932 amendment relating to federal employees living abroad).

120. S. REP. No. 1631, 77th Cong., 2d Sess. 54 (1942), *reprinted in* 1942-2 C.B. 504, 548-49; *see* Note, *supra* note 9, at 676.

121. H.R. REP. No. 2333, 77th Cong., 2d Sess. 50 (1942), *reprinted in* 1942-2 C.B. 372, 412.

122. S. REP. No. 1631, 77th Cong., 2d Sess. 54 (1942), *reprinted in* 1942-2 C.B. 504,

come taxes of their residence country. In order to avoid unduly penalizing those taxpayers, the Senate Finance Committee proposed that the exclusion be retained for persons who were bona fide residents of a foreign country[123] during the entire taxable year.[124] Congress adopted this one-year bona fide resident test in 1942,[125] and it has remained in effect to the present day.[126]

Unfortunately, Congress found that this one-year foreign residency requirement was difficult for taxpayers to meet in at least two respects. First, because the overseas taxpayer's foreign residency had to be established as of January 1 of a given taxable year and had to continue for the entire year, a taxpayer arriving in country *X* on January 3, 1950, and departing from that country on December 10, 1951, would not have been able to take advantage of the exclusion. Although the taxpayer would have been a resident of country *X* for more than twenty-three consecutive months, the period would not have included an entire taxable year. Second, many

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548-49.

123. The term "foreign country" refers to a territory under the sovereignty of a government other than the United States. The term does not include territories considered to be free of the sovereignty of all governments. *See, e.g.*, Martin v. Commissioner, 50 T.C. 59 (1968) (Antarctica is not a foreign country for purposes of the exclusion). The continental shelf adjacent to the land of a country will qualify as a part of tbat country if the taxpayer is engaged in developing or extracting natural resources from tbe seabed or the shelf, *see* I.R.C. § 638 (1982), but not if he is engaged in fishing, *see* Plaisance v. United States, 433 F. Supp. 936 (E.D. La. 1977) (tugboat captain on the North Sea denied an exclusion); Rev. Rul. 73-181, 1973-1 C.B. 347.

124. S. REP. No. 1631, 77th Cong., 2d Sess. 54 (1942), *reprinted in* 1942-2 C.B. 504, 548-49.

125. Revenue Act of 1942, ch. 619, § 148, 56 Stat. 798, 841-42.

In addition to the one-year bona fide resident test, Congress adopted a new subsection to § 116, which provided that United States citizens who had been foreign residents for at least two years prior to their return to the United States could exclude amounts received from foreign sources attributable to the period of foreign residence. *See id.* at 842 (adding § 116(a)(2)).

126. To be a resident of a country, the expatriate taxpayer had to be physically present in the country *and* had to have an intent to make a home in that country. Taxpayers demonstrated this intent by adjusting to the daily business and social life of the residence country. *See, e.g.*, Weible v. United States, 244 F.2d 158 (9th Cir. 1957). For example, courts determining residence have considered whether the taxpayer learned tbe language, joined a local church or social club, or purchased a permanent bome in the foreign country. *See, e.g.*, *id.* (joining local church or social club); Fuller v. Hofferbert, 204 F.2d 592 (6th Cir. 1953) (learning language and taking part in community); Schoneberger v. Commissioner, 74 T.C. 1016 (1980) (learning language); Stierhout v. Commissioner, 24 T.C. 483 (1955); (learning language and taking part in community); Rose v. Commissioner, 16 T.C. 232 (1951) (joining local church or social club); Baehre v. Commissioner, 15 T.C. 236 (1950) (purcbase of permanent home); Adams v. Commissioner, 22 T.C.M. (CCH) 1215 (1963). Temporary vacations or business trips back to the United States did not break foreign residency once established. *See* Powell v. Commissioner, 10 T.C.M. (CCH) 928 (1951).

workers, such as construction workers, who went abroad for a stated period to work on a specific project were unable to establish a residence for purposes of the exclusion.[127] In response to these perceived problems, Congress amended the exclusion in 1951.[128] To aid the plight of the taxpayer who was a resident of a foreign country for more than one calendar year but not for an entire taxable year, Congress modified the language of the provision so that a taxpayer had to be a bona fide resident of a foreign country only for "an uninterrupted period which include[d] an entire taxable year."[129] To induce people with technical knowledge to go abroad, Congress amended the exclusion so that those persons who were physically present[130] in a foreign country for seventeen months in an eighteen-month period would qualify for the exclusion.[131]

In enacting the 1951 legislation, Congress compared the American expatriate with similarly situated third country nationals whose own countries would not tax expatriates working abroad, and fashioned more liberal bona fide resident and physical presence tests.[132] Therefore, the 1951 reforms left the exclusion at its most generous level in twenty-six years, but as a result opened a number of unforeseen tax havens. For the sole purpose of federal income tax avoidance, some individuals with large earnings were prompted to meet the physical presence test and perform services abroad that customarily were performed domestically.[133] In particular, movie personalities were taking great advantage of the exclusion. By making films at various foreign country locations, they often were able to avoid meeting any minimum residence requirements and thereby avoided paying any income taxes. As a result of this refusal to make films in the United States, work ordinarily performed in the past by United States technicians was being un-

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127. S. REP. No. 781, 82d Cong., 1st Sess. 52-53 (1951), *reprinted in* 1951-2 C.B. 458, 495-96; *see* Note, *supra* note 9, at 676.

128. *See* Revenue Act of 1951, Pub. L. No. 82-183, § 321, 65 Stat. 452, 498-99.

129. *Id.* at 498.

130. A taxpayer was regarded as physically present in a foreign country even while present in that country's airspace, *see* Rev. Rul. 58-233, 1958-1 C.B. 271, or while traveling between foreign countries or between cities in one country so long as he did not spend a full twenty-four hour period on the high seas, *see* Bebb v. Commissioner, 36 T.C. 170 (1961). Time spent on the high seas, even traveling from one city to another within the foreign country, did not constitute presence in a foreign country. *See id.* at 172-73.

131. Revenue Act of 1951, Pub. L. No. 82-183, § 321, 65 Stat. at 498; *see* H.R. CONF. REP. No. 1213, 82d Cong., 1st Sess. 77 (1951), *reprinted in* 1951-2 C.B. 622, 630.

132. *See* S. REP. No. 781, 82d Cong., 1st Sess. 52-53 (1951), *reprinted in* 1951-2 C.B. 458, 495-96.

133. *See* Levine, *supra* note 109, at 172.

dertaken by foreign technicians.[134] In addition, dramatic supporting roles and parts as "extras" were going to foreigners while United States film workers were deprived of employment.[135] For the first time, an industrial interest was aligned on the side supporting repeal of the foreign earned income exclusion.[136]

Because of the exclusion's adverse impact upon the American film industry, and because the exclusion failed to attain its objective of encouraging citizens to go abroad to increase technical knowledge in less developed countries, the House Ways and Means Committee proposed repeal.[137] The Senate Finance Committee, however, believed that outright repeal was not necessary to correct the existing abuses. Instead, it proposed that the amount of earned income excluded should be limited to $20,000.[138] Congress ultimately adopted the Senate approach, retaining the exclusion for those taxpayers who met either the bona fide resident test[139] or the physical presence test,[140] but imposing a ceiling of $20,000 on the amount of excludable income for those meeting the physical presence test.[141]

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134. 99 CONG. REC. 3078-79 (1953) (remarks of Rep. King of California); *see* Note, *supra* note 9, at 677.

135. 99 CONG. REC. 3078-79 (1953) (remarks of Rep. King).

136. Levine, *supra* note 109, at 173.

137. H.R. REP. No. 894, 83d Cong., 1st Sess. 4-5 (1953), *reprinted in* 1953-2 C.B. 508, 511.

138. S. REP. No. 685, 83d Cong., 1st Sess. 5 (1953), *reprinted in* 1953-2 C.B. 526, 528-29.

139. *See supra* notes 123-26 and accompanying text.

140. *See supra* notes 127-31 and accompanying text.

141. Technical Changes Act of 1953, Pub. L. No. 83-287, § 204(a), 67 Stat. 618, *amending* Int. Rev. Code of 1939, ch. 1, § 116(a), 53 Stat. 48, *as amended by* Pub. L. No. 82-183, § 321, 65 Stat. 498. If the taxpayer was abroad only a portion of the taxable year, the $20,000 limit was prorated. *Id.*

The foreign earned income exclusion was incorporated in the Internal Revenue Code of 1954 intact but was redesignated as section 911:

EARNED INCOME FROM SOURCES
WITHOUT THE UNITED STATES.

(a) GENERAL RULE.—The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) BONA FIDE RESIDENT OF FOREIGN COUNTRY.—In the case of an individual citizen of the United States, who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

In the 1960's, as part of the Kennedy administration's general reconsideration of tax policy, the foreign earned income exclusion was reexamined again.[142] Initially, President Kennedy proposed that the exclusion be limited to those Americans working in lesser developed countries.[143] The House Ways and Means Committee,

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(2) PRESENCE IN FOREIGN COUNTRY FOR 17 MONTHS.—In the case of an individual citizen of the United States, who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid hy the United States or an agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributahle to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph. If the 18-month period includes the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed $20,000. If the 18-month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year.

(b) DEFINITION OF EARNED INCGME.—For purposes of this section, the term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of tbe compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.

Int. Rev. Code of 1954, ch. 1, § 911, 68A Stat. 289-90 (current version at I.R.C. § 911 (West Supp. 1984).

Soon after the adoption of the 1954 Code, an enforceability problem surfaced that Congress had failed to foresee. Some taxpayers were excluding amounts in excess of the $20,000 limit, while other taxpayers were excluding amounts not from personal service income as required by § 911. *See* H.R. REP. No. 775, 85th Cong., 1st Sess. 27 (1957), *reprinted in* 1958-3 C.B. 811, 850-51. The Treasury had no means of obtaining information about excluded foreign source income. *Id.* Therefore, Congress adopted an amendment to the Code requiring taxpayers receiving more than $600 of gross income to file a return. *See id.*; *see also* S. REP. No. 1983, 85th Cong., 2d Sess. (1958), *reprinted in* 1958-3 C.B. 922, 1014-15. For purposes of this provision, gross income included earned income excludable by reason of having been earned outside the United States. *See* Technical Amendments Act of 1958, Pub. L. No. 85-866, § 72(a), 72 Stat. 1606, 1660, *amending* Int. Rev. Code of 1954, ch. 61, § 6012(c). This filing requirement permitted Treasury scrutiny of claims for the exclusion because even a taxpayer who could exclude all of his income was required to file a return.

142. Note, *supra* note 9, at 677.

143. *See* H.R. REP. No. 1447, 87th Cong., 2d Sess. 54 (1962), *reprinted in* 1962-3 C.B. 405, 458. The Carter administration also wanted to use the exclusion as an incentive for Americans working in lesser developed countries. *See infra* notes 208-13 and accompanying text.

however, did not adopt Kennedy's distinction between developed and underdeveloped countries.[144] Instead, it suggested that the $20,000 exclusion continue for those taxpayers meeting either the bona fide resident or the physical presence test, but that the limit be enlarged to $35,000 for those taxpayers meeting the bona fide resident test for more than three consecutive years. The theory underlying this change was that those Americans residing in a foreign country for more than three years would be more dependent on that country's economy than those living there for a shorter time.[145]

The Senate Finance Committee accepted the House proposals without change.[146] In order to prevent those expatriates who took inconsistent residency positions with the United States and the foreign country from avoiding taxation altogether, however, the Senate Committee proposed that the foreign earned income exclusion be denied to any taxpayer who earned income from sources within the foreign country of residence, filed a statement with the authorities of that foreign country proclaiming that he was a nonresident, and was not subject to income tax as a resident of that country.[147]

Although there were few changes prior to 1976,[148] the Tax Re-

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144. *See* H.R. REP. No. 1447, 87th Cong., 2d Sess. 54 (1962), *reprinted in* 1962-3 C.B. 405, 458.

145. *Id.* It is not clear that those American citizens resident overseas for more than three years would have any different need for an exclusion from United States taxation than a contractor living in a foreign country for the duration of a six-year project. Although in most cases the contractor would intend to return to the United States after the completion of his project, he would be dependent on the foreign country's economy during the time period abroad even though he might be able to meet only the physical presence and not the bona fide resident test because of the definite term of his employment abroad. It would seem that if the durational distinction was valid, its benefits should have been available to *all* taxpayers overseas for three years or more in one country.

146. *Id.* The bill included several other provisions. For example, taxpayers to whom community property rules applied could not exclude more than the amount that would be excludable if they were not under community property rules. In addition, deferred compensation received more than one taxable year after the year in which the services were performed was not eligible for the exclusion. The exclusion's purpose as an incentive for Americans to work abroad would not be served by exempting from taxation amounts received long after the period in which the foreign employment occurred. *Id.* at 55, *reprinted in* 1962-3 C.B. at 459.

147. S. REP. No. 1881, 87th Cong., 2d Sess. 74-75 (1962), *reprinted in* 1962-3 C.B. 707, 780-81.

148. The only further change in the foreign earned income exclusion before 1976 was a decrease in the limit for taxpayers meeting the bona fide resident test for more than three years to $25,000. *See* Revenue Act of 1964, § 237(a), Pub. L. No. 88-272, 78 Stat. 19, 128. At the time, a proposal was made to reduce the exclusion to $4000 for those taxpayers abroad less than three years and to $6000 for those Americans abroad more than three years on the

form Act of 1976[149] greatly reduced the exclusion's benefits. At that time Congress was concerned that the expatriate taxpayer was being treated far more favorably than the domestic taxpayer. Both legislative branches felt that reform was essential to prevent further abuses and that such reform should reduce the benefits of the exclusion.[150] The House proposed total repeal of the exclusion, but the Senate felt that retention of the exclusion was necessary to protect the position of American business abroad.[151] As a result, Congress enacted the Tax Reform Act of 1976, which reduced the ceiling of the exclusion to $15,000 per year.[152] In addition, to the extent that foreign taxes were allocable to the excluded income, expatriates received no credit for such taxes.[153] Congress also changed the applicable tax rate: compensation above the excluded amount would be taxed at the marginal rate that would apply to the taxpayer had he not excluded the foreign income.[154] Previ-

theory that the existing exclusion was unfair. *See* 110 CONG. REC. 1745-84 (1964) (remarks of Sen. Gore).

149. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011, 90 Stat. 1520, 1610-11 (repealed 1978) [hereinafter all citations to § 911 of the Code in effect between the effective dates of the Tax Reform Act and the Foreign Earned Income Act of 1978 shall be in the form of TRA § 911]. For a general discussion of the 1976 changes in taxation of foreign earned income, see Hooton, *The Disappearing Foreign Earned Income Exclusion*, 55 TAXES 522 (1977).

150. Although various commentators have suggested that taxing the overseas sector is inequitable, Congress seemingly did not consider this possibility in drafting the 1976 amendments to the exclusion. *See, e.g.*, Maiers, *supra* note 21, at 692-93; Patton, *supra* note 3, at 702-03. *But see* Postlewaite & Stern, *supra* note 5, at 1095 (suggesting that preferential treatment violates tax equity).

One unforeseen problem with the exclusion as written before the enactment of the Tax Reform Act was that an expatriate taxpayer could exclude $20,000 or $25,000 of income *plus* receive a tax credit in the amount of foreign income taxes paid on the full amount earned—including the excluded income—which resulted in giving the overseas sector a double benefit. *See* JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 212-13, *reprinted in* 1976-3 (vol. 2) C.B. 1, 224-25; HOUSE COMM. ON WAYS AND MEANS, 95TH CONG., 1ST SESS., RECOMMENDATIONS OF THE TASK FORCE ON FOREIGN SOURCE INCOME 11-12 (Comm. Print 1977).

151. *See, e.g*, S. REP. No. 938, 94th Cong., 2d Sess. 210 (1976), *reprinted in* 1976-3 (vol. 3) C.B. 57, 248; H.R. 10,612, 94th Cong., 1st Sess. § 1011 (1975); H.R. 17,488, 93d Cong., 2d Sess. § 311 (1974).

152. As an exception to tbe ceiling, employees of qualified domestic charities could exclude $20,000 of foreign earned income. *See* TRA § 911(c).

153. *Id.* § 911(a). The foreign tax credit, which was previously available only to itemizers, now also would be available to those taxpayers taking the standard deduction.

154. A new subsection (d) stated:

(d) AMOUNT EXCLUDED UNDER SUBSECTION (a)
INCLUDED IN COMPUTATION OF TAX.—

(1) COMPUTATION OF TAX.—If for any taxable year an individual has earned income which is excluded from gross income under subsection (a), the tax imposed by section 1

ously, if a taxpayer had earned $15,100 and was entitled to exclude $15,000, the excess $100 would have been taxed at rates applicable to a $100 bracket; under the Tax Reform Act, the $100 would be taxed at the rates applicable to a $15,100 bracket. This application of the higher marginal tax rate probably caused a greater increase in the tax liability of the overseas contingent than any of the other 1976 changes.[155]

The Tax Reform Act of 1976 amended the foreign earned income exclusion in two other respects. First, the Act closed an additional loophole. Because some countries do not tax income of noncitizens that is received outside of the country, overseas taxpayers were able to avoid foreign taxes by receiving income in a location outside of the country in which they had performed ser-

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or section 1201 shall be the excess of—

(A) the tax imposed by section 1 or section 1201 (whichever is applicable) on the amount of net taxable income, over

(B) the tax imposed by section 1 or section 1201 (whichever is applicable) on the amount of net excluded earned income.

(2) DEFINITIONS.—For purposes of this subsection—

(A) the term "net taxable income" means an amount equal to the sum of the amount of taxable income for the taxable year plus the amount of net excluded earned income of such individual for such taxable year; and

(B) the term "net excluded earned income" means the excess of the amount of earned income excluded under subsection (a) for the taxable year over the amount of the deductions disallowed with respect to such excluded earned income for such taxable year under subsection (a).

Id. § 911(d).

155. *See* Maiers, *supra* note 21, at 696-97; Postlewaite & Stern, *supra* note 5, at 1098. For example, assume that an individual living in country *X* and working for a qualified charity had $40,000 of taxable income after exemptions and deductions but without regard to the foreign earned income exclusion. Assume further tbat country *X*'s tax rates were $2500 on the first $20,000 and $2500 on the second $20,000. Assume also that without the exclusion tbe United States tax on the $40,000 would have been $12,140, with $4380 attributable to the first $20,000 and $7760 attributable to the second $20,000. The pre-1976 exclusion eliminated the United States tax on the incremental $20,000, leaving the taxpayer with a United States tax obligation of $4380, against which he could take all $5000 of foreign taxes as a credit. The taxpayer would have paid no United States tax on the $40,000 of income and would have paid total taxes of only $5000. Moreover, he would have had an excess foreign tax credit of $620 to carry over to future years.

After the Tax Reform Act, however, the same taxpayer would have had an increased tax burden. Although being a worker for a qualified charity still would entitle him to exclude $20,000, he would pay United States taxes on the *second* $20,000 increment, or $7760. He would have been entitled to a credit for only one-half of the taxes paid to country *X* because the other one-half would have been paid for the excluded income. He, therefore, would have a United States tax liability in tbe amount of $5260 after the credit and exclusion, and a total tax liability of $10,260.

For a similar example, see HOUSE COMM. ON WAYS AND MEANS, 95TH CONG., 1ST SESS., RECOMMENDATIONS OF THE TASK FORCE ON FOREIGN SOURCE INCOME 11-12 (Comm. Print 1977).

vices. To insure that those citizens made some payment of tax, the Tax Reform Act amended the statute to provide that income would not qualify for the exclusion if the taxpayer received it in a country other than where earned, and if tax avoidance was a purpose for the selection of the location for receipt.[156] Second, the Tax Reform Act gave the taxpayer, for the first time, the choice of whether to exclude the foreign source income.[157] This choice could assist an individual who had paid high foreign taxes and who would benefit by not having the tax credit reduced to the extent of the foreign tax allocable to the excluded income.[158]

These 1976 amendments were very controversial. Some believed that Congress had not considered adequately the financial hardship confronting United States citizens abroad and that American expatriates would be disadvantaged in competing with foreign nationals for employment.[159] It also was said that these amendments did not resolve the problem of how to tax expatriates, but merely resulted from a compromise between the House Ways and Means Committee's view that the exclusion gave an unfair tax advantage to expatriates[160] and the Senate Finance Committee's view that the exclusion protected the position of United States business abroad.[161] Opponents of the changes predicted substantial unem-

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156. *See* TRA § 911(c)(8).

157. *See id.* § 911(e)(1).

158. *See* Levine, *supra* note 109, at 174. The provision also could benefit a taxpayer such as Anne Brewster, who ran a farm in Ireland. *See* Brewster v. Commissioner, 473 F.2d 160 (D.C. Cir. 1972), *aff'g* 55 T.C. 251 (1970). Both personal services and capital produced income on tbe farm, and the Commissioner determined that 30% of income would be eligible for the exclusion as personal service income. *Id.* at 160. The Brewster farm, however, had been operating at a loss, and Ms. Brewster wanted to deduct all of her loss. Since she was required to exclude 30% of her farm income, however, the court held that 30% of the farm expenses were attributable to tbe excluded income and would be disallowed. *See* Brewster v. Commissioner, 607 F.2d 1369 (D.C. Cir. 1979). By losing the use of 30% of her Irish farming losses as an offset against her other income, Ms. Brewster of course incurred a greater tax liability than if she had been able to elect not to exclude her foreign earned income. For a discussion of the *Brewster* case, see Patton, *supra* note 3, at 708-10.

Note that under the Tax Reform Act, once an election not to exclude foreign earned income had been made, it could be revoked only with the consent of the Internal Revenue Service. *See* TRA § 911(e)(2).

159. *See* Note, *supra* note 9, at 636-37; *see, e.g., Causes and Consequences of the U.S. Trade Deficit and Developing Problems in U.S. Exports: Hearings Before the Subcomm. on Trade of the House Comm. on Ways and Means*, 95th Cong., 1st Sess. 450-69 (1977) [hereinafter cited as *1977 House Hearings*].

160. H.R. REP. No. 658, 94th Cong., 1st Sess. 199-201 (1976), *reprinted in* 1976-3 (vol. 2) C.B. 695, 891-93.

161. S. REP. No. 938, 94tb Cong., 2d Sess. 210 (1976), *reprinted in* 1976-3 (vol. 3) C.B. 57, 248.

ployment of Americans abroad, reduced economic influence of American corporations abroad, and a further increase in the balance of payments deficit.[162] In response to this criticism, Congress delayed the effective date of the amendments from taxable years beginning in 1976 to those years beginning in 1977.[163] Congress later delayed the effective date for another year to taxable years beginning in 1978.[164]

B. *The Foreign Earned Income Act of 1978*

Immediately after the Tax Reform Act exclusion went into effect in 1978, Congress passed the Foreign Earned Income Act of 1978,[165] which dramatically changed the income tax treatment of the nonresident taxpayer. According to Senator Ribicoff, the Act's author, its purpose was to establish a "fair[er] system of taxing the income earned by Americans who work overseas . . . [that would] enable Americans to compete more effectively in overseas job markets."[166] First, the foreign earned income exclusion was limited to those Americans living in camps in hardship areas or working for qualified domestic charities in lesser developed countries.[167] Second, Congress for the first time devised a system of deductions to take into account the actual additional expenses that the overseas contingent incurred by reason of their nonresident status.[168] Expa-

162. *See* Maiers, *supra* note 21, at 701-02.

163. Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 302, 91 Stat. 126, 152.

164. Maiers, *supra* note 21, at 701.

165. *See* Foreign Earned Income Act of 1978, Pub. L. No. 95-615, §§ 201-210, 92 Stat. 3097, 3098, *as amended by* Technical Corrections Act of 1979, Pub. L. No. 96-222, § 108, 94 Stat. 194, 223 (1980) [bereinafter cited as FEIA].

FEIA has been a rich source for commentary. *See, e.g.*, Cunningham & Landt, *The Foreign Earned Income Act of 1978*, 65 A.B.A. J. 109 (1979); Feinschreiber, *New Deductions for Overseas Americans*, 5 INT'L TAX J. 93 (1978); Maiers, *supra* note 21, at 691; Postlewaite & Stern, *supra* note 5, at 1093; Note, *The Foreign Earned Income Act of 1978: Nonbenefits for Nonresidents*, 13 CORNELL INT'L L.J. 105 (1980); Note, *supra* note 9, at 633; Note, *supra* note 15; Comment, *The Foreign Earned Income Act of 1978*, 7 SYRACUSE J. INT'L L. & COMM. 87 (1979).

166. 124 CONG. REC. 13,375, 13,378 (1978). Senator Ribicoff was FEIA's original sponsor.

167. *See* I.R.C. § 911, *as amended by* FEIA, *supra* note 165, *and by* Pub. L. No. 96-595, 94 Stat. 3464, 3466-67 (1980), *and by* Economic Recovery Tax Act of 1981, § 111(a) [hereinafter all citations to § 911 of the Code in effect between the effective dates of Pub. L. No. 96-595 and the Economic Recovery Tax Act sball be in the form of FEIA § 911].

168. *See* I.R.C. § 913, *as added by* FEIA, *supra* note 165, *repealed by* Economic Recovery Tax Act of 1981, § 112(a) [hereinafter all citations to § 913 of the Code in effect between the effective dates of FEIA and the Economic Recovery Tax Act shall be in the form of FEIA § 913].

triates were entitled to these deductions whether or not they chose to itemize other deductions. The goal was to place the overseas taxpayer in an equitable position vis-a-vis his domestic counterpart.

1. The Exclusion for Camps and Charities in Lesser Developed Countries[169]

As a result of a compromise between the Senate and the House, Congress continued the exclusion (now limited to $20,000) only for taxpayers residing in camps located in hardship areas and for certain employees of charities in lesser developed countries. Such persons, it was felt, would be "typically required to make an unusual sacrifice in their standard of living when they [went] overseas."[170] By statutory definition a camp was substandard lodging that an employer provides in a remote area where housing is not available on the open market. The camp had to be as near as possible to the taxpayer's work, in a common area not available to the public, and for accomodation of at least ten employees.[171] In determining whether the housing qualified as substandard, the relevant factors to consider were a lack of privacy, an unhealthy environ-

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169. FEIA § 911.

170. S. REP. No. 746, 95th Cong., 2d Sess. 12 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 7612, 7623. The taxpayer had to meet either the bona fide resident test or the physical presence test to be eligible for the camp or charity worker exclusion. For a discussion of these tests, see *supra* notes 123-31 and accompanying text. If meals and lodging qualified for an exclusion under I.R.C. § 119, as being primarily for the convenience of the employer and a condition of employment, hardship area workers could exclude their value in addition to the $20,000 personal income exclusion of FEIA § 911.

The Foreign Earned Income Act retained certain Tax Reform Act changes in the exclusion, such as the requirement that income could not be excluded if received in a country other than where the services were performed if tax avoidance was a reason for the choice of location of payment. Notwithstanding, it repealed § 911(d) of the 1976 Act, and thus reinstated the practice of taking the exclusion off the top and paying tax on the nonexcluded income at the same rates as if the taxpayer had not received the excluded income.

The method for calculating the actual limit on the exclusion differed according to whether the taxpayer worked in a qualified camp or for a charity in a lesser developed country. Although the overall limit was $20,000 for either situation, the exclusion for taxpayers employed in hardship area camps was limited by a provision stating that the exclusion was to be "computed on a daily basis . . . for days during which [the taxpayer] reside[d] in a camp." FEIA § 911(c)(1)(A)(i). A weekend away from the camp would cost the taxpayer approximately $109.58 of the exclusion; a week's consultation in the United States with his employer would cost him approximately $383.53. On the other band, if the taxpayer performed charitable services in a lesser developed country, he could exclude up to $20,000 of his income, prorated according to the number of qualifying days during the tax year. Unlike the hardship area worker, the charity worker did not have to decrease his exclusion because of a weekend away from his work site.

171. FEIA § 911(c)(1)(B).

ment, and inadequate living space.[172] In order for a camp to be considered to provide substandard housing, it had to be located in a remote area.[173]

In addition to the requirement that the camp provide substandard housing, it had to be located in a hardship area. A "hardship" area was one in which federal government employees would be eligible to receive a hardship pay differential as determined by the Secretary of State.[174] Although in theory any country could appear on the State Department's list of hardship areas, apparently only those countries in which United States government personnel are stationed actually do appear on the list.[175] This limiting factor results in a large number of countries not being on the list even though they otherwise would qualify as hardship areas.[176]

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172. FEIA Treas. Reg. § 1.911-1(c)(2), T.D. 7736, 1981-1 C.B. 412, 415. In an attempt to clearly define substandard housing, the Treasury was overly generous to taxpayers. Few would dispute that some of the factors considered, such as unhealthy conditions due to inadequate sewers or an unusual risk of danger due to civil unrest, would cause housing to be inadequate or substandard. *See id.* § 1.911-1 (c)(2)(i)(D), (E), T.D. 7736, 1981-1 C.B. at 415. The Treasury, however, presumed that housing which lacked private sleeping quarters and private toilets or bath facilities for unrelated individuals would be substandard housing. *See id.* § 1.911-1(c)(2)(ii)(D), T.D. 7736, 1981-1 C.B. at 416. Even in modern American cities, luxurious one-bedroom apartments often are shared by unrelated roommates, and these apartments likely would not be termed substandard. *See* Comment, *The Taxation of Americans Living Abroad: The Foreign Earned Income Act of 1978 and §§ 911 and 913 of the Internal Revenue Code*, 19 COLUM. J. TRANSNAT'L L. 79, 91 (1981) (suggesting that the shared-facilities presumption operate only when four unrelated individuals share toilet and bath facilities).

173. The regulations defined a remote area as "a place where satifactory housing is unavailable." FEIA Treas. Reg. § 1.911-1(c)(3), T.D. 7736, 1981-1 C.B. 412, 416; *see* H.R. CONF. REP. No. 1798, 95th Cong., 2d Sess. 17 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 7632, 7637. This broad definition limited the impact of the remote requirement and saved the provision for much of the construction industry. *Id.*; *see* Comment, *supra* note 172, at 91; *see also* Maiers, *supra* note 21, at 711 (noting that the camp provision was created largely because of the problems of American construction companies operating abroad). If limited to expatriates in truly remote areas, the exclusion would not have served the construction industry. Many construction projects in the Middle East would bave met all the other requirements of the camp provision, but because of their location in or near metropolitan areas, would not have qualified for the exclusion if the more traditional meaning of remote had been applied.

174. FEIA §§ 911(c)(1)(C), 913(h)(2).

175. *See* Comment, *supra* note 172, at 92-93.

176. *Id.* at 93. Some of the countries that were not on the 1981 list include: Albania, Bhutan, Cambodia, Cyprus, Dominica, East Germany, Grenada, Malawi, Namibia, Rhodesia, Swaziland, Tonga, Trinidad and Tobago, and Uganda. *See id.*; 1981 IRS PUBLICATION 54, *supra* note 3, at 8. It is interesting to note that because State Department personnel must be assigned to a region before it will be called a hardship area, Kingston, Jamaica is the only hardship area in Jamaica—the more rural areas do not qualify. Moreover, the fact that all areas of the Soviet Union, Egypt, and China qualify as hardship areas reflects more on the postings of American diplomats than on the quality of life in Leningrad as opposed

Although the purpose of the exclusion for hardship area employees and charitable workers was to subsidize certain public activities, the method Congress chose to achieve this goal is subject to question. If Congress sought to aid underdeveloped regions by the exclusion for hardship area workers, for example, it also could be said that hardship areas in our own country should receive such aid as well. With respect to charitable workers, moreover, all the qualified charities that indirectly would benefit from the exclusion already would have received special benefits through their tax exempt status and the tax deductibility of gifts that they receive.[177] It therefore is unclear why overseas charities performing services in lesser developed countries should have been favored over domestic charities performing similar services in lesser developed parts of the United States. In addition, many expatriate charitable workers raise funds successsfully from within the United States, which results in a greater amount of United States funds leaving the country than if such projects were undertaken by third country nationals.[178] In short, the overall effect of a special incentive for charitable employees may be an increase in the outflow of funds from the United States.

2. The Itemized Deductions for Excess Foreign Living Costs[179]

Although the 1978 Act dramatically limited the categories of persons who could exclude their foreign earned income, overseas American workers who met either the bona fide resident test or the physical presence test[180] generally were granted special deductions

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to Albania. Perhaps the Service should have prepared its own list of hardship areas in order to give it the flexibility to meet the needs of the expatriate taxpayer. *See* Comment, *supra* note 172, at 94.

For purposes of the exclusion for charitable workers in lesser developed countries, the Internal Revenue Service has formulated an independent list of eligible areas. The Service defines lesser developed country as any country not on the following list: Australia, Austria, Belgium, Britain, Canada, Czechoslovakia, Denmark, Finland, France, East and West Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Liechtenstein, Luxemhourg, Monaco, Netherlands, New Zealand, Norway, Poland, Republic of South Africa, San Marino, Spain, Sweden, Switzerland, U.S.S.R., and any country within the Sino-Soviet bloc. 1981 IRS PUBLICATION 54, *supra* note 3, at 20.

177. *See generally* Andrews, *supra* note 57; Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation,* 85 YALE L.J. 299 (1976); Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation,* 91 YALE L.J. 54 (1981).

178. *See* Blough, *supra* note 11, at 40.

179. FEIA § 913.

180. FEIA § 913(a)(1), (2).

for certain qualified foreign living expenses.[181] This change was the result of a bill that Senator Ribicoff initially proposed which sought to eliminate the income exclusion altogether and to create a series of deductions for certain special expenses that the expatriate taxpayer incurs: cost of living, education expenses for dependent children, home leave travel, hardship area expenses, and cost of housing.[182] The theory behind this proposal was that since most employers paid cost equalizers to their employees, allowing these deductions would strengthen the competitiveness of American industry abroad.[183] The idea was essentially one of simple equity—those special expenses incurred because of living overseas should not be taxed.

In practice, however, the special deductions system was extremely complicated.[184] Although the system helped those who really did incur special expenses as a result of living abroad, it favored those who lived in high-expense, low-tax jurisdictions.[185] In the formulation of some of the deductions, the Foreign Earned Income Act favored the nonresident taxpayer over the domestic taxpayer, yet still failed to give expatriates tax equity with overseas workers from other countries.

a. *Qualified Cost of Living Differential*[186]

Under the Foreign Earned Income Act, the nonresident taxpayer could deduct an amount equal to the difference between the cost of living in his tax home and the cost of living in the continental United States metropolitan area having the highest cost of living. Since Alaska and Hawaii were not considered in determining the highest cost of living figure,[187] the area with the highest cost of living was New York. The deduction took family size into account and calculated the amount on a daily basis with reference to the

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181. *See* FEIA § 913(b)(1)-(5).

182. *See* S. 2115, 95th Cong., 1st Sess., 123 CONG. REC. 30,202 (1977); Note, *supra* note 9, at 661 n.153.

183. *See* S. REP. No. 746, 95th Cong., 2d Sess. 6-7 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 7612, 7618.

For a discussion of the taxation of income received in kind, see Note, *supra* note 15, at 484-87.

184. The average tax return was approximately 25 pages and required accounting services costing more than $750. *1981 Senate Hearings, supra* note 34, at 65.

185. *See* Maiers, *supra* note 21, at 715; Postlewaite & Stern, *supra* note 5, at 1110-13.

186. FEIA § 913(d).

187. *Id.* § 913(d)(1).

spendable income of a person employed at a GS-14 salary.[188] The great fluctuations in the cost of living differential, however, made it very difficult for expatriates to predict their yearly tax liability and to negotiate with their employers for the correct income adjustment in their salaries.[189] In addition, the adjustment was unfair to the domestic taxpayer residing in Alaska or Hawaii because, although he incurred a greater cost of living than taxpayers residing in New York and in some overseas places where expatriates were entitled to the deduction, he did not receive any special adjustment to his taxable income.[190]

b. *Educational Expenses*[191]

The expatriate taxpayer also could deduct reasonable expenses for primary or secondary school education of his dependent children.[192] The amount allowed as a deduction was the cost of the least expensive American-type school in the area. To qualify for the deduction, the school had to use English as its primary language of instruction and had to be comparable to an accredited school in the United States. If no such school existed within a one-hour commute from the taxpayer's home, then the taxpayer could deduct tuition, room, board, and transportation costs for a boarding school anywhere in the world.[193] Although the statute did not address the matter, it would seem that the cost of a foreign day school in the area would have been deductible if there were no lo-

188. See *infra* note 235 for a discussion of the annual salary of a federal government employee at grade GS-14.

189. *See* 1981 IRS PUBLICATION 54, *supra* note 3, at 5 (1981 cost of living differential tables); *see also* FEIA Treas. Reg. § 1.913-13, *reprinted in* [1984] FED. TAX REP. (CCH) ¶ 4341 Q. 10 (1980 cost of living differential tables). For example, note how the differentials of the four countries listed below changed from 1980 to 1981:

	1980		1981	
family size	1	4	1	4
Angola	0	0	$3,100	$4,900
Antigua	0	0	$1,100	$1,800
Argentina	$5,000	$7,900	0	0
Austria	$5,900	$9,400	$2,600	$4,100

190. The special cost of living deduction might have had the effect of encouraging American employers and employees to go abroad at the expense of discouraging them from going to Alaska and Hawaii. *See* Comment, *supra* note 171, at 101.

191. FEIA § 913(f).

192. *Id.* § 913(f)(1).

193. FEIA § 913(f)(3). In addition, if the local school would not accept the taxpayer's dependent children or if it did not have special facilities required because of the child's physical or mental disabilities, it would not have been considered an adequate "American-type" school for purposes of the deduction.

cal American-type school.[194]

Of course, many domestic taxpayers also feel that they must send their children to private schools because the local public schooling is inadequate. Since they do not receive any tax deductions for tuition and other expenses, the deduction for the educational expenses of expatriates' children may have seemed unfair from the domestic taxpayer's point of view. At least in theory, however, most domestic taxpayers do have the option of having their children attend adequate English language schools without charge. In contrast, most taxpayers abroad do not have that option.[195]

c. *Home Leave Travel Expense*[196]

If the nonresident taxpayer traveled to his last principal residence in the United States or to the nearest point of entry, he could deduct the cost of round trip plane fare for himself, his spouse, and each of his dependents. Since the goal of the Foreign Earned Income Act was to create equity between the domestic and the expatriate taxpayer, the home travel deduction had little, if any, justification. In the United States people move to Hawaii from Florida—a distance greater than that from New York to England—yet they do not get the benefit of a tax deductible round trip home each year. Moreover, the nonresident taxpayer was not required to spend any time at his former home. He could fly to the nearest point of entry and from there to a vacation in Bermuda. The theory supporting the provision may have been that a trip home each year would lessen the difficulties of living abroad and thereby would serve as an *incentive* to the overseas taxpayer.[197]

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194. The special travel expenses of a dependent college age child attending school in the United States was one problem that the provision did not address. Although a California resident whose child goes to an east coast college does not get a deduction for travel expenses, he has the option of sending the child to adequate universities nearer to home. On the other hand, a taxpayer living in Saudi Arabia who has a college age daughter really does not have the option of sending her to a local university. Thus, as an equitable matter, the cost of transportation to the nearest United States entry point would have been a suitable deduction in such cases.

195. One problem with federal tax relief for the cost of schooling is that school systems largely are supported by state and local taxes, not by federal taxes. If, however, the funds spent on schooling for American children abroad are viewed as departures from the aggregate personal consumption of the taxpayer, the special status of the deduction could be considered to be a refinement on the notion of taxable income. *See* Andrews, *supra* note 57, at 320-25; *see also infra* text accompanying notes 316-17.

196. FEIA § 913(g).

197. There does not appear to be any reason why the provision could not have been

d. *Qualified Hardship Area Deduction*[198]

A taxpayer living in a qualified hardship area could deduct an additional $5000 from his income. The deduction was available on a pro rata basis for each day the taxpayer spent in the area. The Secretary of State designated the qualified hardship areas.[199]

e. *Excess Housing Cost Deduction*[200]

For the period that the taxpayer's tax home was in a foreign country, he could deduct the excess of his reasonable housing expenses over a base housing amount.[201] If the taxpayer maintained a separate home for his immediate family because of adverse living conditions, he could deduct the full cost of his own housing and the excess costs of his family's household.[202] Housing expenses eligible for the deduction included rent, repairs, utilities other than telephone bills, real property insurance, occupancy taxes, and parking.[203] If in fact there were excess housing costs, such a formula incorporating a base amount of the taxpayer's own salary in the calculation would be equitable. It is very unlikely that a corporate executive living in the United States and earning $300,000 a year would wish to live in the same housing as someone earning $25,000 a year. Presumably, these differences in housing expenditures exist for overseas taxpayers as well. Therefore, a full deduction for all housing expenses essentially would have been a tax subsidy for the higher standard of living of the $300,000 annual earner[204] and not a deduction for his housing expenses that were genuinely in excess of those which would have been incurred in the United States.

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more tightly drafted so that nonresidents could take the deduction only for genuine home leave travel.

198. FEIA § 913(h).

199. For a discussion of the problem of using the State Department list of hardship areas, see *supra* notes 174-76 and accompanying text. *See also* Blough, *supra* note 11, at 49 (suggesting that there is no justification for special hardship area deductions).

200. FEIA § 913(e).

201. The base housing amount was equal to 20% of the taxpayer's worldwide earned income reduced by deductions allocated to such income and further reduced by the total actual housing cost, the excess cost of living deduction, the educational costs deduction, the home leave travel expenses, and the hardship area deduction. FEIA § 911(e)(3).

202. FEIA § 911(e)(3)(B).

203. FEIA Treas. Reg. § 1.913-6(b), T.D. 7736, 1981-1 C.B. 412, 423.

204. Although the housing could not be "lavish or extravagant under the circumstances," FEIA § 913(e)(2)(B), the high wage earner still would be able to claim higher housing expenditures.

3. Response to the Foreign Earned Income Act

The response to the Foreign Earned Income Act was unanimous—no one liked it. The expatriates, business, Congress, and even the Internal Revenue Service thought that it was too complex.[205] According to one study, the allowances did not achieve the

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205. *1981 Senate Hearings*, *supra* note 34, at 45.

To emphasize the overwhelming complexity of the FEIA rules, a few simple calculations follow, which are based on FEIA Treas. Reg.] 1.9]13-6(e), T.D. 7736, 1981-1 C.B. 412, 424-25. In each example, assume that the taxpayer qualifies for the FEIA deductions by meeting either the bona fide resident or the physical presence test.

Example 1: *B*'s tax home is in town *X*, which is not in a hardship area. *B*'s spouse and their one-year old child live in a qualified second household in city *Y*.

B's annual earned income is $40,000. *B* also receives from his employer a $4000 cost of living allowance and housing with a fair local market rental value of $10,000 for which *B* pays $6000. Therefore, *B*'s total earned income is $48,000. The housing value is not excluded under § 119. Assume also:

Spouse's and child's housing costs	$15,000
IRS cost of living differential	3,000
There are no other deductions.	

(a) *B's Housing Expenses.*

Base housing amount is 20% of:

Worldwide earned income	$48,000
Less:	
Cost of living differential	3,000
Housing expenses	10,000
	$35,000

B's base housing amount is $7,000 ($35,000 x 20%).
B's qualified housing expense is $3,000 ($10,000 − $7,000).

(b) *Second Household.*

Base housing amount is 20% of:

Worldwide earned income	$48,000
Less:	
Cost of living differential	3,000
Housing expense of *B*'s tax home	10,000
Housing expense of second home	15,000
	$20,000

Base housing for second bome is $4000 ($20,000 x 20%). Qualified housing expense for second home is $11,000 ($15,000 - $4000). Total amount of qualified housing expense is $14,000 ($3000 + $11,000). *B*'s taxable income is $31,000 ($48,000 - $14,000 - $3000 IRS cost of living differential).

Example 2: If *B*'s housing were in a hardship area, then he could deduct the full $10,000 of housing expenses. The qualified housing expense for his second household would be calculated as in example 1 and thus is $11,000. *B*'s total housing deduction is $21,000 ($10,000 + $11,000). *B*'s taxable income is $24,000 ($48,000 - $21,000 - $3000 IRS cost of living differential).

Example 3: *B* lives in a hardship area, but his family lives with him. *B* cannot claim the full value of his housing as qualified housing expenses since he does not have a qualified

desired result, and nonresidents still were being taxed on portions of income reflecting the excess costs of living abroad.[206] This heavy tax burden, the study concluded, made overseas Americans noncompetitive with other foreign nationals because the Americans required larger tax reimbursements from the employers. The extreme complexity of the deduction system made compliance difficult and expensive. Moreover, in countries where the expatriate's tax burden was equal to or greater than that of the domestic American taxpayer, it was advantageous for him to use the foreign tax credit instead of the Foreign Earned Income Act exclusions.[207]

During the Senate Hearings of both 1980 and 1981, the overseas sector repeated the same theme: if the United States wanted its nationals abroad, then the tax cost of maintaining nonresident American citizens would have to be no greater than the tax cost for nationals of any other developed nation competing in the same international marketplace.[208] As a result, in August 1980, as part of

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second household. Base housing amount is 20% of:

Worldwide earned income	$48,000
Less:	
Cost of living differential	3,000
Housing expenses	10,000
Hardship area deduction	5,000
	$30,000

Base housing is $6000 ($30,000 x 20%). Qualified housing expense is $4000 ($10,000 - $6000). *B*'s taxable income is $34,000 ($48,000 - $6000 - $3000 IRS cost of living differential - $5000 hardship area deduction).

To add to the complication of the taxpayer's calculations, he had to convert all amounts to United States currency from the local currency at the time he received or made payment. The taxpayer had to keep detailed records of rent, utilities, insurance payments, and educational expenses.

Another calculation that the taxpayer often had to make concerned the cost of living allowance, which had to he prorated on a daily basis if a change of residence or family size occurred. If, for example, a child attended hoarding school, the family size would be reduced during the student's time away from home for purposes of the cost of living allowance. See FEIA Treas. Reg. § 1.913-5(c)(2), (d)(2), T.D. 7736, 1981-1 C.B. 412, 422-23, for illustrations of the calculation of the cost of living differential.

206. *See* Comptroller General 1981 Report, *supra* note 20.

207. The initial results of a study of all tax returns showed an increase in the use of the foreign tax credit for the years that FEIA was in effect. Telephone conversation with staff memher, Office of Assistant Secretary for Tax Policy, Department of Treasury (Jan. 6, 1983) (expressing personal, not official, views). The findings are preliminary, and the staff memher expects results to vary depending on the country, with taxpayers in low or no tax countries such as Ahu Dhabi taking the FEIA deductions and taxpayers in equal or high tax countries such as Canada taking the tax credit.

208. *See 1981 Senate Hearings, supra* note 34, at 43-49; *1980 Senate Hearings, supra* note 3, at 29-33. There is some circularity in the expatriates' argument. If the employer reimburses the United States expatriate for any extra taxation, then the expatriate does not need tax relief from the government. If this reimbursement makes it expensive to employ

its Economic Program for the Eighties, the Carter administration outlined a proposal for a tailored reform: Americans living in lesser developed countries, or in developed countries if working in charitable, export related, or natural resource activities such as oil exploration, would get an earned income exclusion and a separate housing cost allowance.[209] At the same time, the Senate Finance Committee approved a foreign earned income exclusion for persons living in lesser developed countries and for taxpayers in developed countries who worked in charitable, export related, or natural resource activities.[210] The Senate Committee's exclusion was tailored and limited for persons working in developed countries so that it would not be "more attractive to work in developed countries . . . than in the United States."[211] To prevent abuses by performers and athletes, a ceiling of $50,000 was placed on the exclusion.[212] The proposal, however, did not clear the floor before the end of the Ninety-Sixth Congress because of opposition to tax cut legislation.[213]

C. The Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act of 1981[214] made bold liberalizing changes in the taxation of nonresident Americans, which gave

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Americans, it might he said that aid should be tailored to be received directly by the multinational corporations. *Cf.* Kingson, *supra* note 96, at 739 (suggesting that the higher standard of living that American workers require is the real basis of most claims that tax costs make it prohibitively expensive for foreign companies to hire Americans).

209. The Carter proposal limited the total exclusion to $61,000 for persons earning over $85,000. The first $25,000 and 60% of the next $60,000 could be excluded. Maiers, *supra* note 21, at 724.

210. S. REP. No. 940, 96th Cong., 2d Sess. 113 (1980).

211. *Id.*

212. *Id.*

213. Maiers, *supra* note 21, at 725.

214. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 111-115, 95 Stat. 172, 190-96, *as amended by* Technical Corrections Act of 1982, Pub. L. No. 97-448, § 101(c), 96 Stat. 2365, 2366, *and by* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 17, 98 Stat. 494, 505 (codified in various sections of the Internal Revenue Code) [hereinafter cited as ERTA]. Sections 111 to 115 of ERTA amended I.R.C. § 119 and § 911 and repealed I.R.C. § 913 in its entirety. Sections 119 and 911 as amended by ERTA are cited herein as ERTA § 119 and ERTA § 911 respectively.

For a discussion of the foreign earned income provisions of ERTA, see Fuller, *Rules Governing Income Earned Abroad And Employer Allowances Simplified by ERTA*, 56 J. TAX'N 20 (1982); Gornall & Rubinoff, *Practical Guidelines Under the Economic Recovery Tax Act of 1981 Regarding the Taxation of U.S. Citizens and Resident Aliens Employed in a Foreign Country*, 17 INT'L LAW. 345 (1983); Henry, *Visit Abroad Professor and Pay No Income Tax*, 52 CIN. L. REV. 700 (1983); Klein, *Tax Changes Affecting United States Expatriates*, 41 INST. ON FED. TAX'N ch. 29 (1983); Komlyn and Minges, *Economic Recovery Tax*

those taxpayers more equity in relation to third country nationals and which should serve as an incentive for Americans to work abroad.[215] Simplification was a major goal in these sweeping changes because the complexities of the prior law had made it unduly difficult for an American expatriate to estimate his tax liability and to prepare his own tax return.[216]

Both the incentive[217] and the simplification goals have been met under the Economic Recovery Tax Act provisions. Congress repealed the Foreign Earned Income Act deductions *in toto* and enacted new provisions, including a shortened period of time that a taxpayer is required to spend abroad to qualify for its benefits, an increase in the earned income exclusion, a new exclusion or deduction of housing costs, an extension of exclusion benefits to individuals receiving payments from the United States government but who are not federal employees, and a liberalization of the requirements for excluding the value of employer provided meals and lodging from taxable income.

1. Residence Requirement

Although the nonresident taxpayer still may qualify for the income exclusion by being a bona fide resident of a foreign country for one year,[218] the Economic Recovery Tax Act's liberalized physical presence test may have rendered the residence test superflu-

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Act of 1981: United States Citizens Working Abroad, 12 TAX ADVISER 708 (1981); Russo and Ellenbogen, *Expatriate Taxation: The 1981 Statutory Rules,* 8 INT'L TAX J. 85 (Dec. 1981); Note, *supra* note 7; Note, *The Foreign Earned Income Exclusion: Redefining the Exception for Amounts Paid by the United States Under I.R.C. § 911,* 68 CORNELL L. REV. 592 (1983); Recent Development, *Income Tax: Foreign Earned Income Exclusion,* 12 GA. J. INT'L & COMP. L. 107 (1982); Recent Development, *Taxation: Treatment of Foreign Earned Income Under United States Law,* 23 HARV. INT'L L.J. 170 (1982).

215. *See* H.R. REP. No. 201, 97tb Cong., 1st Sess. 60 (1981). Because of the relatively bigh taxation of tbe American sector overseas, it was said tbat American expatriates had become virtually noncompetitive abroad. *See 1981 Senate Hearings, supra* note 34, at 47-49 (remarks of Malcolm Baldridge, Secretary of Commerce); *see also id.* at 43 (remarks of Sen. Dole).

216. *See* JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 43 (Joint Comm. Print Dec. 1981) [hereinafter cited as GENERAL EXPLANATION OF ERTA].

217. The Treasury has been preparing a study on the economic effect of tax incentives entitled *Americans Working Abroad,* but they have yet to complete it. Telephone conversation with staff member, Office of Public Affairs, Department of Treasury (Jan. 4, 1983). The study is not expected to be completed in the near future. Telephone conversation with staff member, Office of Assistant Secretary for Tax Policy, Department of Treasury (Jan. 6, 1983).

218. *See supra* notes 123-26 and accompanying text (discussion of the bona fide resident test).

ous.[219] Under the new provisions, the expatriate taxpayer who is present in a foreign tax home for 330 full days in a twelve-month period will satisfy the physical presence test. The 330 days need not be consecutive, and the taxpayer can select the day on which the twelve-month period begins.[220]

Congress established the liberalized test in response to the needs of construction and other industries that might require the services of a specialist on a project for a year. In the past, many engineers and other technicians going abroad did not qualify for any special tax treatment.[221] The requirement of 330 days in twelve months was selected because it would give relief in deserving industries, yet would be a long enough period to prevent abuse by entertainers, athletes, and the film industry.[222]

2. Exclusion of Foreign Earned Income

Taxpayers meeting the residence or physical presence tests may exclude foreign earned income ranging from $75,000 in 1982, to $95,000 in 1990 and thereafter.[223] To be excludable, the income

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219. *See* ERTA § 911(d)(1), (3).

220. For example, assume that *A* goes to country *X* at 2 p.m. on April 6, 1982. He leaves *X* for the United States at 3 p.m. on June 1, 1982. He returns to *X* by plane and arrives at 2 p.m. on July 31, 1982, and stays until June 30, 1983. For the 12 month period beginning April 6, 1982, *A* was present in *X* only 295 days. But *A* is able to meet the physical presence test for the 12 month period beginning June 30, 1982, and ending June 30, 1983.

221. *See 1981 Senate Hearings, supra* note 34, at 284, 307, 363 (statements of Alexander Perry, Association of American Chambers of Commerce in Latin America; Thomas Hughes, American Chamber of Commerce in Venezuela; and Warren Wentworth, Deloitte, Haskins & Sells).

222. *Id.* at 282. One proposal not adopted by Congress was to create a new bona fide resident definition for taxpayers abroad for more than three years. *See id.* at 293 (statement of Council of American Chambers of Commerce, Europe and Mediterranean). Persons abroad for 11 months in each of at least three successive 12 month periods would have been deemed temporary residents and thus would have been almost totally exempt from United States taxation. The theory supporting this proposal was that since expatriate Americans' center of economic activity would have shifted to the residence country, they should not pay any United States tax. *See id.*

223. ERTA § 911(b)(2)(A). The exclusion increases to $80,000 for 1983 to 1987, $85,000 for 1988, $90,000 for 1989, and $95,000 for 1990 and thereafter. *Id.* The available amount is computed daily. If the taxpayer and spouse qualify, they each may exclude their own foreign earned income up to the limit. If the income is community property, however, the taxpayer may not exclude more than the amount that would be excludable if the income was not community property. *See id.* § 911(b)(2)(C).

To prevent the taxpayer from defeating the maximum limit by postponing the receipt of income, payments are attributed to the taxable year in which the services are performed. *Id.* § 911(b)(1)(B)(iv). If, for example, *A* goes abroad in 1982 and 1983 and receives a payment in 1983 of $140,000 of which $85,000 is for 1982 work and $55,000 is for 1983 services,

must be earned income received as compensation for personal services.[224] Pensions, annuities, trust income, and payments made to federal employees by the United States may not be excluded.[225] Payments made by the United States to persons other than federal employees, however, are excludable. Consequently, an independent contractor performing a job for the federal government could exclude his income under the Economic Recovery Tax Act—a change from prior law.

The payment must be from a source *within* a foreign country in order to be eligible for the exclusion.[226] For purposes of the exclusion, the country where the taxpayer performs the work determines the source of the payment. For example, under the current definition, income derived from services performed in a territory that is not a foreign country, such as Antarctica, or on the high seas seemingly would not qualify for the exclusion[227] even if the taxpayer meets the bona fide foreign resident test. Extended to its fullest, the requirement of payment from a source within a foreign country could mean that a scientist who is a bona fide resident of a European country for five years could not exclude income derived from his research in the Antarctic, and a fishing boat captain who meets the bona fide resident test in Greece could not exclude income from fishing, while a pianist touring Europe for eleven months of the year could take advantage of the exclusion.[228] It seems that a distinction should have been drawn between taxpayers meeting the bona fide resident test who would be subject to residence country taxation on their income, and those taxpayers merely meeting the physical presence test.

A may exclude an aggregate of $130,000. *A* could exclude $75,000 of the $85,000 received for 1982 and all $55,000 of the amount received for 1983.

224. *See id.* § 911(d)(2)(A). If the taxpayer is engaged in a business in which capital is a material income producing factor, he may take an allowance for personal services not exceeding 30% of his share of the profits. *Id.* § 911(d)(2)(B).

225. *Id.* § 911(b)(1)(B). Fellowships and academic grants from foreign institutions also do not qualify for the exclusion. *See* Treas. Doc. 84-5337 (summarized in TAX NOTES 532 (Aug. 6, 1984)). An individual pursuing a degree at a qualified institution may exclude the grant under I.R.C. § 117. If not pursuing a degree, the taxpayer still might be able to exclude up to $300 of the grant per month for up to 36 months.

226. *Id.* § 911(b)(1)(A). Note that the requirement of previous exclusions that the income be from sources *without* the United States was somewhat easier to meet.

227. Neither the high seas nor Antarctica is considered to be a foreign country. *See* Martin v. Commissioner, 50 T.C. 59 (1968); Bebb v. Commissioner, 36 T.C. 170 (1960).

228. *See* Treas. Reg. § 1.911-3(a), T.D. 8006 (1984) ("the term 'foreign earned income' means income . . . from sources within a foreign country").

3. Housing Cost Exclusion[229]

In addition to excluding a portion, if not all, of his foreign earned income, the nonresident taxpayer might be able to exclude his special housing costs.[230] Because the income and housing exclusions are separately elected under the Economic Recovery Tax Act, the taxpayer can elect to exclude one or the other (or both or neither).[231] Housing expenses must be reasonable and not lavish under the circumstances, and may include utilities, real property insurance, rent payments, furniture rental, and repairs.[232] The excluded amount may not include the cost of purchased furniture,[233] domestic help, or telephone bills. If the nonresident taxpayer lives in dangerous or adverse conditions and maintains a second household outside of the United States for his or her spouse and dependents, the cost of the second household may be included when calculating housing expenses.[234]

The housing deduction is the excess of actual reasonable expenses over a base amount that is the same for all taxpayers—sixteen percent of the salary of a federal employee at grade GS-14.[235] If the housing expense is unreimbursed, the taxpayer will

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229. See THE STUDY OF FEDERAL TAX LAW: TRANSNATIONAL TRANSACTIONS, ch. 2, pt. VII (R. Hellawell & R. Pugh ed. 1983), for a discussion of the housing exclusion.

230. ERTA § 911(a)(2), (c). The taxpayer may be entitled to a full exclusion under ERTA § 119 for employer-provided meals and lodging instead of the housing cost allowance. For purposes of § 119, lodging furnished in a camp will be considered to be provided on the employer's business premises and for his convenience. Thus, the taxpayer will be entitled to exclude its value from gross income if the camp is in a remote area where other suitable housing is not available, is close to the taxpayer's work site, is in a common area that is not available to the public, and normally accommodates 10 or more persons. *See id.* § 119(c). The requirement that the camp be in a hardship area or provide substandard housing no longer exists. *Cf.* FEIA § 119 (discussed *supra* note 170). Therefore, an employer apparently could supply very comfortable facilities in a camp setting, such as a townhouse development with a swimming pool and tennis courts, that still could qualify for the § 119 exclusion.

231. ERTA § 911(a), (e). The taxpayer may revoke an election, but if he does so, he may make no further election for six years without the permission of the Secretary of the Treasury. *Id.*

232. *Id.* § 911(c)(2); *see* Treas. Reg. § 1.911-4(b)(1), T.D. 8006 (1984).

233. The provision excluding the cost of rental furniture tends to favor the person meeting the physical presence test over the bona fide resident who may want to set up a permanent home in the foreign country. See Treas. Reg. § 1.911-4(b)(2), T.D. 8006 (1984) for a list of items excluded form the permissible housing expenses.

234. ERTA § 911(c)(2)(B)(ii).

235. The federal salary is determined on January 1 of the tax year in question. On January 1, 1982, the salary of a government employee at grade GS-14 was $39,689 per year; the 1982 base housing amount thus was $6350, or $17.40 per day. 1982 IRS PUBLICATION 54, *supra* note 34, at 5. On January 1, 1983, the GS-14 annual salary was $41,277; the 1983 base housing amount thus was $6604, or $18.98 per day. *See* U.S. Office of Personnel Management, Optional Form 281 (Oct. 1982).

be able to deduct the housing amount to the extent that it does not exceed his foreign income.[236] If the total is under the exclusion's ceiling, he would be able to take the full housing amount without subtracting the base amount from it. To the extent that the housing amount exceeds the ceiling, the base amount is triggered.[237] In addition, if the unreimbursed housing amount exceeds the taxpayer's foreign earned income, he may carry the excess over for one year. In the case of a reimbursed housing expense, the taxpayer would be able to exclude the full housing amount if the total of it and his foreign earned income does not exceed the ceiling of the earned income exclusion. If the total exceeds the ceiling, the base amount is triggered.

One troubling aspect of the calculation of the housing cost exclusion is the use of one base housing amount for all taxpayers. Since the goal of the housing cost exclusion is to permit the deduction of the special expenses that the overseas taxpayer incurs over those of the domestic taxpayer, the assumption that all taxpayers

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236. *See* ERTA § 911(d)(7). The Technical Corrections Act of 1982, Pub. L. No. 97-448, § 101(c), 96 Stat. 2365, 2366, amended § 911 by providing that the total amount which may be excluded in any year, including the housing and income exclusions, could not exceed the taxpayer's foreign earned income for that year. *See* H.R. REP. No. 794, 97th Cong., 2d Sess. (1982), *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 4149, 4151.

For example, if John Taxpayer had foreign earned income of $60,000 including total housing expenses of $10,000 in 1982, then he simply would exclude the $60,000. If, however, he had foreign earned income of $90,000 including total housing expenses of $10,000, then he could deduct $75,000 of foreign earned income plus his $10,000 housing amount over the base housing amount of $6350, or $3650. Therefore, his total deduction for 1982 would be $78,650. In addition, if the income exclusion plus the unreimbursed special housing expenses exceed the taxpayer's total foreign earned income, then he may carry the excess amount of such housing expenses over for one year. *See* Russo & Ellenbogen, *Expatriate Taxation: The 1981 Statutory Rules*, 8 INT'L TAX J. 85, 87 (1982). For example, if *A*'s 1982 foreign earned income is $90,000 and his unreimbursed housing cost (over the base amount) is $25,000, then he may deduct $15,000 of the special housing expenses ($90,000 foreign earned income less $75,000 maximum 1982 foreign earned income exclusion). The remaining $10,000 of special housing expenses may be carried over for one year. *See* GENERAL EXPLANATION OF ERTA, *supra* note 216, at 146.

237. Thus, if in 1982 Henry Taxpayer earned $55,000 and lived in employer provided housing with a value of $10,000, he could exclude a total of $65,000 under the ERTA provisions. If, however, Henry earned $68,000 in 1982 and received employer provided housing with a value of $10,000, he could exclude a total of $78,000: the $75,000 foreign earned income exclusion plus the excess of Henry's total foreign earned income of $78,000 over that exclusion ($3000). Therefore, although Henry's special housing expense amount would be $3650 ($10,000 actual housing amount less $6350 base housing amount), he may deduct it only to the extent that it, combined with his foreign earned income exclusion, does not exceed his total foreign earned income. If, however, Henry had a salary of $70,000, he could exclude the full $78,350 since his total foreign earned income then would have been $80,000. *See* ERTA § 911(d)(7); see Treas. Reg. § 1.911-4(f), T.D. 8006 (1984) for illustrative examples of the operation of the housing cost exclusion or deduction.

would spend the same amount on housing is too simplistic. A high salaried executive will get a free ride under this provision while a lower salaried worker may face an unjustly high base amount.[238] Simplification was a purpose of the 1981 changes, but this provision goes too far.[239] A formula should be devised for determining the base housing amount that would incorporate the taxpayer's actual income. Although a calculation taking into account the taxpayer's wages (and partnership profits) would not be without some problems, it would be more equitable than the present provision.

D. Summary of Historical Developments

Congress has rationalized the special tax treatment of expatriate Americans on both equity and incentive grounds, but as this Article seeks to show, the only real justification for the type of provisions which have been enacted is that they are a tax incentive. Equity requires a system that accounts for the specific characteristics which distinguish the foreign taxpayer from the domestic taxpayer. The Foreign Earned Income Act[240] attempted to create deductions for the special costs of living abroad, but those deductions were unduly complicated and, accordingly, are no longer in effect. A general exclusion of an amount of foreign earned income from taxation, the form that the special treatment of nonresident Americans most often has taken, does serve as an incentive to work in low tax countries. Before an incentive should be given, however, there must be some evidence that it will implement government policy. Recently, several analytic studies have attempted to determine whether the special treatment of expatriate taxpayers indeed is justified as a positive government policy.

V. The Effectiveness of the Exclusion

A. Quantitative Studies

Nearly sixty years have passed since the nonresident sector first received special tax preferences. Yet no study has linked these tax incentives definitively with the overseas presence of those expatriates who influence and promote exports from the United States. After the 1976 and 1978 attempts to limit the benefits to

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238. *See supra* notes 200-04 and accompanying text. The high income taxpayer ordinarily might spend over $30,000 on annual housing expenses and should be entitled to exclude only those expenses that are in addition to his usual ones.

239. *See* Surrey & Brannon, *supra* note 8.

240. *See supra* notes 165-213 and accompanying text.

the foreign sector caused a public outcry,[241] several studies were undertaken to assist in determining the balance of private and public interests that should be considered in achieving an optimal tax policy.[242] Those studies sought to compare the tax burden in the present system with the burdens imposed by various hypothetical alternatives, including the changes in taxpayers' activities that were likely to result.[243] Such studies, by attempting to quantify taxpayer reactions to changes in their tax burdens, present difficult technical problems not only because current economic statistics may be difficult to obtain or may not exist, but also because individual taxpayer behavior in response to differing tax incentives is hard to predict. The studies rely on a variety of information, including income tax return tabulations, interviews with multinational employers and their workers, and econometric models. Several of these studies will be discussed briefly insofar as they relate to the utility of tax preferences for expatriate Americans.

1. The Mutti Study

The most sophisticated study of the relationship of expatriates to economic benefits is the study prepared by Professor John Mutti[244] for the Department of Treasury.[245] Mutti attempted to quantify whether the presence of Americans abroad contributes to the overall level of United States exports while controlling for other relevant factors affecting export patterns.[246] Variables such as the per capita income of foreign countries, the distance to foreign markets, the assets of the foreign subsidiaries of United States corporations, and cultural communication ties with foreign countries were evaluated.[247] He used a multiple regression framework[248]

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241. *See* U.S. DEP'T OF TREASURY, TAXATION OF AMERICANS WORKING OVERSEAS: REVENUE ASPECTS OF RECENT LEGISLATIVE CHANGES AND PROPOSALS 6 (1978). *See generally 1981 Senate Hearings, supra* note 34; *1980 Senate Hearings, supra* note 3.

242. *See, e.g.*, Gravelle and Kiefer, *supra* note 7; Mutti, *supra* note 72; COMPTROLLER GENERAL 1981 REPORT, *supra* note 20; COMPTROLLER GENERAL 1978 REPORT, *supra* note 32; Chase Econometrics Associates, Economic Impact of Changing Taxation of U.S. Workers Overseas (June 1980).

243. *See* Blough, *supra* note 11, at 51.

244. *See 1980 Senate Hearings, supra* note 3, at 66 (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

245. *See* Mutti, *supra* note 72. Professor Mutti, an economist, spent a year at the Department of Treasury analyzing the American presence abroad and United States exports. His findings are preliminary and do not reflect the policy of the Department of Treasury. *Id.* at 1, 28-29.

246. *Id.* at 3.

247. *Id.*

and cross-sectional data for the year 1977 to examine the effect of the expatriate presence on domestic exports. The analysis is based on the exports of fourteen categories of manufactured goods to twenty-six foreign countries for 1974 and on tax data for 1975.[249]

The study found that Americans abroad make "an independent and statistically significant contribution to . . . exports."[250] A one percent decline in expatriates overseas would result in slightly more than a one-half percent decline in the value of United States exports; likewise, a ten percent decline in expatriates overseas was projected to cause a five percent decline in the value of United States exports.[251] The study offered preliminary explanations for the relationship between the American presence abroad and the demand for American exports. First, Americans overseas tend to purchase American goods. For foreign purchasers, the effective price of American goods includes more than production costs, transportation charges, and import duties.[252] There is an additional information cost of determining characteristics such as the quality of the good, the reliability of any provided maintenance service, and the certainty of specified delivery dates.[253] Since the American expatriate has greater familiarity with American goods than with foreign goods, the purchase of foreign goods includes some information costs; thus the purchase of American products identically priced with foreign products will result in a lower effective price of the American product to him.[254] Second, the presence of Americans abroad also increases the purchases of American goods by foreigners by reducing the foreigners' information costs; they learn much of the information that is needed to make a comparison between American and other goods from Americans living abroad.[255]

The Mutti study specifies that its findings do not support any particular tax policy because its model does not "indicate the extent to which any tax increase might result in fewer American workers abroad."[256] Nevertheless, it discusses some possible implications for tax policy. The study finds that the increase in the willingness of expatriates to work abroad in response to higher wages

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248. *Id.*
249. *Id.* at 17.
250. *Id.* at 3.
251. *Id.*
252. *Id.* at 13.
253. *Id.* at 14.
254. *Id.*
255. *See id.* at 13-14.
256. *Id.* at 4.

is two to three times as great as the reduction in demand for their services when wages rise. Thus, more than one-half of any tax increase facing Americans abroad would be offset by a before-tax wage increase.[257] Because the supply elasticity of overseas Americans is low, any tax increase probably would have only a small effect on the total number of Americans working abroad.[258] Even if the foreign earned income tax preferences were repealed, moreover, the value of manufactured exports might decline only about three percent.[259] Expatriates, however, would experience an increase in before-tax wages of six percent with a decline in after-tax wages of five percent. This potential decline in available income would make them quite interested in any changes in United States taxation.[260]

The Mutti study emphasizes that its findings are preliminary and that much more attention should be paid to the question of how foreign earned income should be taxed. It suggests that these findings should be reexamined with more complete data.[261] To date, no such work has been done.

2. The Comptroller General's Reports

Another method of forecasting how taxpayers will react to tax changes is simply to interview them or the personnel managers who have watched taxpayers' reactions to tax changes in the past or who have heard the planned reactions to proposed or current changes.[262] The interview method can be unreliable if sufficiently large samples of information are not collected. Even if the sample is adequate, moreover, it is difficult for people to judge in advance what they or others would do if a hypothetical change actually were to occur. Finally, and probably most importantly, there is a tendency, depending upon the sample population and the issue, for answers to questions to be consciously or subconsciously self-serving.[263]

Despite these limitations, the Comptroller General undertook a comprehensive study in 1978[264] utilizing detailed questionnaires

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257. *Id.* at 5, 27.
258. *Id.* at 5, 27-28.
259. *Id.* at 27-28 (2.7% estimated decline).
260. *Id.* at 28.
261. *Id.* at 5-6.
262. Blough, *supra* note 11, at 60.
263. *Id.*
264. *See* COMPTROLLER GENERAL 1978 REPORT, *supra* note 32.

and conducting interviews with 367 expatriate Americans working in eleven foreign countries and the 187 American firms that employed these expatriates.[265] The study attempted to examine the effect of the changes wrought by the Tax Reform Act of 1976[266] on anticipated tax liability, overseas employment, exports, balance of payments, revenues, and other economic indicators. Unfortunately, the sample was too small to merit any extrapolation of the figures on a national scale,[267] and the results are in part speculative, impressionistic, and self-serving. For example, the companies were asked to estimate whether the tax changes would result in at least a five percent reduction in United States exports worldwide. Although an affirmative response was received from approximately eighty-eight percent of the participating overseas affiliates,[268] most of the companies surveyed believed that the tax changes would cause other overseas American companies in their industries to close—not them.[269] The response from individuals was likewise self-serving: fifty-one percent of the expatriates responding to the survey expected to return to the United States because of the tax increase, even though twenty-six percent of those individuals who planned to return expected reimbursements from their employers for any increased cost resulting from the 1976 changes.[270]

An additional component of the Comptroller General's 1978 study was an econometrical model that purported to show the effects of three options: (1) the repeal of the foreign earned income exclusion; (2) the retention of the Tax Reform Act provisions with housing costs valued at their full local market value; and (3) the retention of the Tax Reform Act provisions with housing costs valued at the cost of equivalent housing in the United States.[271] The analysis only considered those expatriates who were engaged directly in selling American exports.[272] The model assumed that the

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In addition to the findings considered in this Article, the study included a short discussion of the history and purpose of tax incentives for nonresident Americans, a survey of the major government agencies for assessing the financial impact of the tax changes on private sector participation in their programs, and a summary of the varying methods for taxing foreign source income. *Id.*

265. *Id.* at 2.

266. See *supra* notes 149-64 and accompanying text for a discussion of the 1976 Act's changes.

267. *See* Blough, *supra* note 11, at 63.

268. COMPTROLLER GENERAL 1978 REPORT, *supra* note 32, at 10.

269. *Id.*

270. *Id.* at 46.

271. *Id.* at 10-27.

272. *Id.* at 14.

employees would be reimbursed by their employers for any increase in income tax and that the employers would pass the additional cost on by increasing export prices.[273] The increases in export prices were used in a macroeconomic model.[274] The results were examined under two different assumptions. First, it was assumed that all foreign governments tax income at fifty percent rates. This assumption would make any tax relief unnecessary since the foreign income tax credit[275] would tend to absorb any United States taxes. Second, a worst case assumption was made that no foreign governments tax the income of expatriates. The model found that if exchange rates were fixed, the effect of the 1976 tax changes on exports would be less than the cost of the preference to the government fisc.[276]

Although a Congressional Research Service study[277] reached similar conclusions, the Comptroller General's 1978 Report has had its detractors.[278] Professor Mutti, for example, found that the report's focus on the price effect represented only part of the full effect because it completely ignored the likelihood that expatriates abroad might have a greater tendency to purchase American products for business and household use than would other third country nationals or citizens of the host country.[279]

In 1981, the Comptroller General issued a report on the problems of expatriate taxation under the Foreign Earned Income Act of 1978[280] and the impact on the overseas employment of

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273. *Id.* at 14-15.

274. The macroeconomic model the Comptroller General used was developed by Data Resources, Inc. The model has been criticized, and its results have been discredited. Telephone conversation with staff member, Office of Assistant Secretary for Tax Policy, Department of Treasury (Jan. 6, 1983) (expressing personal, not official, views); *see* Blough, *supra* note 11, at 66-67; Mutti, *supra* note 72, at 2-3; Note, *supra* note 9, at 656 n.130. For example, the model did not break down its results by countries or areas, and it allowed for only cost considerations in its projections. *See id.*

275. *See* I.R.C. §§ 901, 903 (1982) (discussed *supra* notes 3 & 25).

276. COMPTROLLER GENERAL 1978 REPORT, *supra* note 32, at 25-26.

277. *See* Gravelle & Kiefer, *supra* note 7 (which adopted and reprinted the Comptroller General's macroeconomic exercise). The neutrality of the Gravelle and Kiefer study, however, has been questioned. Telephone conversation with staff member, Office of Assistant Secretary for Tax Policy, Department of Treasury (Jan. 6, 1983) (expressing personal, not official, views). Professor Blough suggests that their analysis is an effort "to marshall all available evidence or arguments to rebut proposals" that would favor the continuance of the tax preference for expatriate Americans. Blough, *supra* note 11, at 65 n.22. The Gravelle and Kiefer study appears to present the view that a tax neutral system is essential and that it can be achieved only through a system without preferences for overseas Americans.

278. *See* Blough, *supra* note 11, at 65-67; Mutti, *supra* note 72, at 2-3.

279. Mutti, *supra* note 72, at 3.

280. See *supra* notes 165-213 and accompanying text for a discussion of the changes

Americans.[281] The study utilized an interview method.[282] Surveys were sent to sixty-three companies; forty-one companies replied.[283] Comments regarding the problems of the Foreign Earned Income Act were received from approximately ninety expatriate taxpayers, sixty overseas employers, and several major accounting firms.[284]

The 1981 study found that most firms provided tax reimbursements[285] designed so that employees would not bear tax burdens in excess of their home country taxes on their base salaries,[286] and that the reimbursements were more expensive for American employees than for other third country nationals.[287] Although the level of reimbursements for American employees and for other employees varied from country to country, in all cases the difference between the two was substantial and made it more expensive to hire American workers even if their base compensation was lower than that of third country nationals.[288] The American firms stated that this cost differential was a major cause of the decrease in the employment of Americans abroad.[289] The study also concluded that the Foreign Earned Income Act deductions had not achieved their stated goals and that the system was unduly complicated.[290]

Considering the small size of its sample, the 1981 study should be followed with caution. Furthermore, the reasons underlying some of the study's conclusions may lie in the nature of the limited sample itself — only those persons who would benefit from generous tax treatment for foreign income were interviewed.[291] Never-

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wrought by the 1978 Act.

281. *See* COMPTROLLER GENERAL 1981 REPORT, *supra* note 20, at 5.

282. *Id.* at 5-6.

283. The companies that replied were very large and bad a worldwide expatriate workforce of 36,818, including 16,322 American employees and 20,496 third country national employees. *Id.* at 6.

284. *Id.* at 5-6.

285. *Id.* at 18. Of the 41 companies responding to the survey, 39 provided tax reimbursement payments to overseas Americans; 36 of those companies made the payments available to most American employees while the other three companies made the payments available only to some American employees. *Id.*

286. *Id.*

287. *Id.* at 13, 20.

288. *Id.* at 21-23. The third country nationals with whom Americans were compared were citizens of Canada, the United Kingdom, France, Japan, and West Germany. *See id.* at 23 (table 6).

289. *Id.* at 8-14.

290. *Id.* at 14.

291. For example, the study found that the allowable FEIA housing cost amount often was less than the amount the employee actually received. The study blamed this differential on the Act's method of calculating the base housing amount at 20% of foreign earned income net of actual housing expenses, tbe four other FEIA deductions, and other allocable

theless, the report recommended a generous exclusion from taxation in order to make overseas Americans more competitive with third country nationals.[292]

3. The Chase Econometrics Studies

A study prepared by Chase Econometrics[293] in 1980 drew its conclusions from responses to a survey it sent to two groups: members of the overseas construction industry and members of the American Chamber of Commerce Overseas.[294] Chase received thirty-seven responses from thirty different countries.[295] Although the limited nature of this sample should have tempered the study's conclusions, its authors drew ambitious inferences from the data.[296]

The first part of the Chase study discussed the equity issues of the taxation of overseas Americans in general and the Foreign Earned Income Act deductions in particular.[297] The second part of the study analyzed the effect of the tax law on economic variables.[298] The study's main finding was that the change from a general exclusion to the Foreign Earned Income Act deductions had caused an overall reduction in tax receipts because of a reduction in exports.[299] This had happened because the increased cost of employing American expatriates led to a reduction in the number of Americans overseas, which in turn resulted in a corresponding reduction in exports. Moreover, employers who retained American expatriates were passing the higher cost of the employment to consumers in higher priced products, which resulted in a loss of busi-

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deductions. *See id.* at 10. It did not consider the possibility that the reason the housing allowance often exceeded the deductible amount might be that the expatriates received amounts to cover nondeductible expenses such as the salaries of maids, cooks, and gardeners. For examples of the calculation of the FEIA housing deduction, see *supra* note 205.

292. COMPTROLLER GENERAL 1981 REPORT, *supra* note 20, at 28.

293. *See* Chase Econometrics Associates, *supra* note 242.

294. *Id.* at app. A.

295. *Id.*

296. High level Treasury officials and some commentators have criticized the Chase study as heing based on inappropriate methodology and insufficient data. *See 1981 Senate Hearings*, *supra* note 34, at 75 (statement of John Chapoton, Assistant Secretary of the Treasury for Tax Policy); *1980 Senate Hearings*, *supra* note 3, at 66-71 (statement of Donald C. Luhick, Assistant Secretary of the Treasury for Tax Policy); *see also* Gravelle, *Estimating the Impact of Section 911 on Exports*, 11 TAX NOTES 134 (1980); Thuronyi, *A Critique of the Chase Study of the Tax Treatment of U.S. Workers Overseas*, 10 TAX NOTES 979 (1980).

297. *See* Chase Econometrics Associates, *supra* note 242, at 4-10.

298. *See id.* at 24-35.

299. *Id.* at 30-32.

ness to American firms.[300] Based on the "surveys and . . . prior studies . . . [a] reduction in exports . . . on the order of 5 percent" had resulted,[301] and the lost tax receipts from this decrease in exports was greater than the loss to the federal fisc if expatriates were not taxed.[302] The study then projected the impact of this five percent reduction in exports on other aspects of the economy.[303] Unfortunately, most of the findings cannot be relied upon because it is unclear on what basis, if any, the five percent figure was reached.[304]

In 1981, Chase Econometrics again attempted to study the impact of changes in the tax law and surveyed 250 overseas American firms.[305] The attempt to draw conclusions from the data was more modest than in the earlier Chase study. The 1981 study found that the increase in equalization payments was reflected in an increased cost of products.[306] Moreover, the 1981 study found that the impact of this increase on the cost of exported products could not be estimated with precision.[307]

One weakness of the 1981 Chase study and its 1980 prototype is their tendency to use "guesstimates" from the surveys to reach specific conclusions.[308] For example, estimates prepared by Ameri-

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300. *Id.* at 24.

301. *Id.* at 30.

302. *Id.* at 33.

303. *Id.* at 34.

304. *See* Thuronyi, *supra* note 296, at 980-81; *see also 1980 Senate Hearings, supra* note 3, at 67 (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

305. *See* Chase Econometrics Associates, Taxation of U.S. Workers Overseas: Survey of U.S. Firms in 30 Countries, at 5 (Apr. 24, 1981), *reprinted in 1981 Senate Hearings, supra* note 34, at 96, 103.

306. *Id.* at 8, *reprinted in 1981 Senate Hearings, supra* note 34, at 106.

307. *Id.* at 15, *reprinted in 1981 Senate Hearings, supra* note 34, at 113.

308. The 1981 Chase Econometrics questionnaire consisted of the following:

1. What is primary activity of your firm in this country (e.g. construction, accounting, manufacturing, banking, etc.)?
2. How many Americans did firm employ locally each year—1976 through 1979?
3. In what capacities did they serve (e.g. sales, engineering, management, etc.)?
4. What was value of imports from U.S. sold or purchased by your firm locally in 1976, 1977, 1978 and 1979?
5. For following questions, please estimate as best you can, amount involved for each year, 1976 through 1979.

A. If your employer has tax equalization plan for American employees, what was total additional cost to your firm for these employees in country as result of changes from pre-1976 tax provisions?

B. If you did not tax equalize, what was average change in after-tax income (in U.S. dollars) for your firm's American employees locally as result of these tax changes?

C. What percentage of tax equalization costs to your company locally were

can firms were used to determine the average change in costs of products attributable to increased tax and equalization payments. It is unlikely, however, that these firms had accurate figures on which to base such estimates, and their underlying figures and assumptions are not revealed. Indeed, the firms had a clear incentive to predict a significant effect resulting from changes in the exclusion. As in all cases of studies based on questionnaires, it is important to remember that the opinions of taxpayers and their employers regarding their anticipated reactions to various hypothetical tax proposals may not be entirely reliable.

B. Defects of the Foreign Earned Income Exclusion

Despite these preliminary efforts, no study with appropriate methodology has linked the special tax treatment of expatriates to their overseas presence. Although Professor Mutti's model did link the presence of Americans abroad to an increase in exports and economic benefits that thereby result, it did not find that the special tax treatment of expatriates was a factor in luring them overseas.[309] The other studies appear to be speculative and unreliable because of the nature of their samples.[310] Thus, the virtue of the special tax treatment of expatriates is unproven. Because of the structure of the present foreign earned income exclusion, as generally revised by the Economic Recovery Tax Act of 1981,[311] it promotes waste, inefficiency, and inequity, which can be defended only if there is merit in the expatriate presence overseas *and* if the foreign earned income exclusion is the appropriate means of encouraging Americans to take overseas employment. If the exclusion

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I. Absorbed by your company as decreased profits? and/or

II. Passed on to your customers in higher prices in each year, 1976-79?

D. What percent increase in costs of your products sold locally stemmed from additional costs of these tax changes in each year, 1976-1979?

6. Please estimate dollar value of any lost sales (U.S. exports) attributable to:

A. Higher unit costs discussed in previous questions, and/or

B. Any reduction that may have occurred in number of Americans employed locally by your firm.

7. Does employment of third country nationals, instead of Americans, in overseas operations result in lower level of exports from U.S. operations? If so, please estimate percentage change in your sales or purchase of U.S. products locally that would result from a 20 percent replacement of your American employees by TCNs.

8. Any additional comments welcome.

Id. at exhibit 1, *reprinted in 1981 Senate Hearings, supra* note 34, at 116.

309. *See supra* text accompanying notes 256-61.

310. *See supra* notes 262-308 and accompanying text.

311. See *supra* notes 214-39 and accompanying text for a discussion of the changes wrought by the 1981 Act.

is not successful as an incentive, then three unjustified vices result from its use: (1) it is inequitable and regressive; (2) it is a windfall to some taxpayers; and (3) it may distort the choice of the marketplace.[312]

1. The Regressive Nature of the Exclusion

Because of progressive tax rates, tax incentives are worth more to the high income taxpayer than to the low income taxpayer.[313] For example, if a fifty percent marginal rate taxpayer receives a deduction for a pretax expenditure of $10,000, the item will cost him only $5000 after tax. The government in effect will finance the expenditure to the tune of $5000. If, however, a fifteen percent marginal rate taxpayer receives a deduction for a pretax expenditure of $10,000, the item will cost him $8500 after tax, and the government will finance only $1500 of the expenditure.[314] Most incentives have not been structured carefully and are created without serious consideration of whether they are fair to the taxpayers whom they are meant to reach.[315]

One line of analysis would look at tax preferences as departures from the definition of income.[316] According to this logic, the income tax is designed to reach private preclusive appropriations of resources that in some way improve the taxpayer's position beyond a baseline level.[317] Examined from this perspective, the Foreign Earned Income Act deductions, which were meant merely to place the taxpayer at the status quo prior to his living abroad, would not have a regressive effect. The expatriate taxpayer would not benefit from these deductions but would be placed in the position of someone who did not have the additional expense, much as the medical deduction is considered equitable as a mere return to a baseline standard of basic health. A general exclusion of foreign earned income is not tied to any return to a baseline standard and would not be warranted under this approach.

Another viewpoint holds that taxable income should equal net

312. *See* Surrey, *supra* note 59, at 719-26.

313. *See id.* at 720.

314. *See* Kelman, *supra* note 60, at 831-33 (discussing the regressive effect of the charitable contribution and medical expense deductions); *see also* Surrey, *supra* note 61, at 386-87.

315. Surrey, *supra* note 59, at 720.

316. *See* Andrews, *supra* note 57, at 320-25.

317. *See id.* at 325-27.

receipts minus the cost of obtaining the receipts.[318] All other sums that the taxpayer disposes would go to taxable income in the form of savings or personal consumption.[319] Under this thesis, a series of deductions similar to those of the Foreign Earned Income Act would negate the special cost to the expatriate taxpayer of obtaining foreign earned income. They therefore would not violate tbe progressive tax system. A broad exclusion of income, not tied to any specific costs, however, would have a regressive impact on our system and would result in undue benefits to certain taxpayers.

The regressive nature of the Economic Recovery Tax Act exclusion has an adverse effect on equity as between domestic and overseas taxpayers at the same income level, and with respect to overseas taxpayers on different income levels.[320] If implemented as a direct expenditure program, the exclusion would appear to be irrational.[321] In some cases, a tax incentive could be structured along direct expenditure contours and operate somewhat more equitably.[322] For instance, a uniform tax credit could be given to expatriate taxpayers for a fiat percentage of their foreign earned income. This credit would more closely resemble a direct expenditure program and still would take into account the increased expenses that result in inflated income in some areas.[323] Theoretically, tax preferences should attempt to be equitable in their structure.

2. The Exclusion as a Windfall

The second problem with the general exclusion of foreign earned income is that certain taxpayers will receive a windfall for doing what they would do anyway.[324] There may be some taxpayers who enjoy living abroad because the cultural differences or sense of adventure appeal to them. For these people, the exclusion will not increase foreign activity, and the resulting benefit is a pleasant bonus. This criticism, however, can be levied at most direct expenditure programs. In some programs, it may be desirable

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318. *See* Kelman, *supra* note 60, at 834.

319. *See id.* at 833-34.

320. *See* Surrey, *supra* note 59, at 721.

321. *See id.* at 721-22. For a discussion of the possibility that the regressive impact of the exclusion adds to its benefit as an incentive, see *supra* notes 100-03 and accompanying text.

322. *See* Surrey, *supra* note 59, at 723.

323. The incentive also could be a fiat credit tied to a cost of living index, or it could be a uniform tax credit so that all overseas expatriates would be treated equally.

324. *See Surrey, supra* note 59, at 719.

to overlook this inefficiency.[325] Nevertheless, the question must be faced of whether the benefits of the foreign earned income exclusion are such that the potential windfall to certain taxpayers should be overlooked.

3. Distortion of Choices

A third criticism of tax incentives is that they may distort the choices of the marketplace. To some extent, tax incentives are designed to achieve such distortion.[326] In the case of the broad foreign earned income exclusion, however, there may be a tendency for expatriates to locate in low tax countries where they will receive the greatest tax benefits. The exclusion was in part designed with the hope that expatriates would go to low tax countries such as Saudi Arabia and Abu Dhabi[327] and fill available positions in construction and petroleum that might be advantageous for Americans to hold. It may fulfill this goal. The exclusion, however, also may create a tax haven for Americans choosing to reside in low tax countries such as Switzerland with little, if any, economic benefit returning to the United States. If the purpose of the incentive is to encourage exports, then its broad design may result in unneutralities.[328]

VI. Conclusion

For almost sixty years, the overseas sector has received special tax preferences. This treatment is based on a general belief that tax incentives promote certain results,[329] such as encouraging Americans to work overseas. No study, however, has been able to link this tax incentive definitively with the presence abroad of any expatriates who influence and promote exports from the United

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325. *See id.* at 720.

326. *See id.* at 725.

327. Telephone conversation with staff member, Office of Assistant Secretary for Tax Policy, U.S. Dep't Treasury (Jan. 6, 1983) (expressing personal, not official, views).

328. Although Professor Mutti's model, discussed *supra* text accompanying notes 244-61, found that the overseas presence of Americans encourages exports, at least one other commentator has suggested that the overseas contingent buys predominantly foreign-made products. *See* Kingson, *supra* note 96, at 738-39. Under this theory that the presence of Americans abroad does not stimulate a significant increase in exports from the United States, the broad exclusion presents inequities by attracting expatriates to low-tax countries.

329. *See* Stone, *supra* note 100, at 647-49; *see also* Shifrin, *Tax Breaks Boost Historic Preservation*, Wash. Post, Apr. 9, 1983, at Fl, F25, col. 1 (private investment in the preservation of historic buildings growing dramatically because of federal tax incentives; without the incentives 53% of the projects would not have been instituted).

States. Moreover, under the generous provisions of the Economic Recovery Tax Act of 1981, the estimated loss of revenue was 299 million dollars for 1982 and will increase substantially each year.[330] Furthermore, the structure of the present exclusion raises serious equity questions of regressivity, distortions of market incentives, and windfalls. It seems, therefore, that the efficacy of the foreign earned income exclusion as a tax incentive should be established if its use is to be maintained. It is difficult to imagine a direct expenditure program of similar magnitude that would not receive strict congressional scrutiny of its effectiveness before being refunded,[331] and thus the foreign earned income provisions should be put to a similar test.

Fortunately, Congress now may be in the best position ever to judge whether this tax expenditure for expatriate Americans is cost effective and achieves its goals.[332] The effectiveness of a tax incentive may be maximized if the incentive is large enough to attract attention and draw new participants to its program.[333] An additional advantage of a large incentive is that an empirical study of its effects can be made that should result in appropriate data about its consequences.[334] Accordingly, the exceedingly generous Economic Recovery Tax Act provisions for citizens abroad should promote the attractiveness of overseas employment. If the Act succeeds in drawing citizens overseas who will promote American economic growth through exports, then the expenditure will achieve its goal. If, however, scrutiny reveals that the Act's provisions merely create windfalls or tax havens, then it should be redesigned in a rational manner to achieve its goal as an incentive, even if that task requires direct expenditures or preferences tailored to rectify

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330. *See* STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., SUMMARY OF H.R. 4242: THE ECONOMIC RECOVERY TAX ACT OF 1981, at 58, table 2 (Joint Comm. Print 1981). The estimated revenue losses from the ERTA changes in the taxation of foreign earned income are as follows:

Year	Amount
1982	$299,000,000
1983	$544,000,000
1984	$563,000,000
1985	$618,000,000
1986	$696,000,000

Id. Note that the table does not consider the changes wrought by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 17, 98 Stat. ____.

331. *See* Surrey, *supra* note 59, at 732-33.

332. *See* Hellawell, *supra* note 8, at 1417; *see also* Note, *supra* note 73, at 831.

333. *See* Hellawell, *supra* note 8, at 1417.

334. *See id.* at 1417, 1423.

the actual problem. For example, the exclusion could be made available only to those Americans who work in lesser developed countries and in charitable, export related, or natural resource activities in developed countries.[335] Such a limitation would prevent the windfall to the musician residing in Switzerland and to the technician working for Hitachi in Japan.

The foreign earned income exclusion should not be permitted to continue without the development of acceptable data to determine its effectiveness. In order to facilitate such a determination, Congress should improve its oversight of this tax preference by creating a system for evaluation and periodic review of the incentive's consequences. The evaluation should include comparisons with possible substitute programs such as direct expenditure alternatives, trade fairs, and Domestic International Sales Corporations.[336] The absence of a thorough analysis of the economic effect of the special income tax provisions for expatriate Americans has hindered effective policymaking for more than fifty years. Ambivalence will persist, paving the way for bowing to lobbying pressure,[337] until the overall effect of this incentive is carefully evaluated.[338]

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335. The Carter administration proposed this limitation. *See supra* notes 208-13 and accompanying text. The Commissioner of Internal Revenue of course would have to adopt regulations indicating jobs that would qualify for this special status.

336. *See* COMPTROLLER GENERAL 1978 REPORT, *supra* note 32, at 96-97, 102-04 app. III. Of course, the problem of those expatriates who reside in blocked income countries merits special consideration. *See, e.g.*, Constantine v. Commissioner, 43 T.C.M. (CCH) 158 (1981) (discussed *supra* text accompanying notes 33-34). Perhaps merely permitting them to pay their United States taxes in the currency of the residence country might alleviate the problem in many cases.

337. Professor Mutti has suggested that proponents of the special preference lobby for its continuance with pictures of foot-long cockroaches, while its opponents lobby with pictures of mink clad expatriates. *See* Mutti, *supra* note 72, at 1.

338. It has been recommended that all tax incentives be subjected to careful oversight and periodic affirmative reauthorization by Congress. *See* Common Cause, *"Gimme Shelters": Reviewing Tax Expenditures by Congressional Tax Committees*, DAILY TAX REP. (BNA) (May 7, 1978), *reprinted in* POLICY READINGS IN INDIVIDUAL TAXATION 382, 383-84 (P. Postlewaite ed. 1980). Of course it would be very cumbersome for Congress to reauthorize every preference in the Internal Revenue Code. Nevertheless, where, as here, there is ambivalence about the effectiveness of the preference, then a study of that incentive should be developed to assist Congressional policymaking.