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John A. Papahronis

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Taxation of Americans Abroad Under the ERTA: An Unnecessary Windfall

INTRODUCTION

The Economic Recovery Tax Act of 1981 (ERTA) contains significant provisions liberalizing the taxation of American citizens living abroad.[1] These changes mark the completion of Congress' four year turnabout in its taxation policy towards expatriate Americans, and reflect a Congressional desire to resolve the conflicting objectives involved: tax equity, revenue requirements, trade and export promotion, and simplification of tax returns.[2] The ERTA changes are the result of Congress' recent emphasis on the promotion of trade and exports. Congress concluded that a substantial exclusion of the foreign earned income of expatriate Americans is necessary to encourage more Americans to work abroad.[3] Congress expects that a larger number of American citizens abroad will lead to increased American trade and exports.[4]

This comment will argue that the ERTA provisions applicable to the taxation of expatriate American citizens represent an overbroad and ineffective means of accomplishing Congress' objectives. The foreign earned income exclusion plainly violates the principle of tax equity by granting preferential treatment to expatriate Americans without regard to the degree of economic hardship suffered as a result of living abroad. Moreover, the methods of implementing the trade promotion policy do not justify the departure from tax equity because they do not effectively achieve the purported goals. Finally, this comment will suggest various alternatives to a foreign earned income exclusion which may be focused enough to minimize the deviation from tax equity but still accomplish the objective of export promotion.

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1 Pub. L. No. 97-34, §§ 111-114, 95 Stat. 172, 190-96 (amending I.R.C. § 911, repealing § 913) [hereinafter cited as ERTA].

2 U.S. GENERAL ACCOUNTING OFFICE, REPORT TO THE CONGRESS BY THE COMPTROLLER GENERAL OF THE U.S., AMERICAN EMPLOYMENT ABROAD DISCOURAGED BY U.S. INCOME TAX LAWS iv (1981) [hereinafter cited as GAO REPORT].

3 SENATE FINANCE COMM., ECONOMIC RECOVERY ACT OF 1981, S. REP. NO. 144, 97th Cong., 1st Sess. 36, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 142 [hereinafter cited as S. REP. NO. 144].

4 *Id.*

BACKGROUND

The United States generally taxes American citizens and residents on all income earned at home or abroad,[5] and allows a tax credit for foreign taxes paid.[6] The foreign earned income exclusion for Americans living abroad, section 911, was first enacted in 1926.[7] Section 911 was originally designed to encourage Americans to work outside of the United States, and presumably to promote exports by placing the expatriate Americans in an equal position with third country nationals not taxed by their own countries.[8]

The foreign earned income exclusion proved to be an expensive policy tool, however. By 1975, the section 911 exclusion resulted in a $498 million revenue loss to the Treasury for the taxable year.[9] Moreover, a majority of the exclusion benefits went to those taxpayers in the wealthiest fifteen percent of the population.[10] These revenue and equity concerns led to the amendment of section 911 in the Tax Reform Act of 1976.[11]

The 1976 version of section 911 reduced the maximum foreign earned income exclusion available to United States citizens working abroad to $15,000, while retaining a $20,000 exclusion for employees of

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5 I.R.C. § 61(a) (1976) defines gross income as "all income from whatever source derived." The United States is the only major industrial country that taxes foreign source income on the basis of citizenship. Maiers, *The Foreign Earned Income Exclusion: Reinventing the Wheel*, 34 TAX. LAW. 691, 692 (1981).

6 I.R.C. § 33(a) (1976 & West Supp. 1981) (amount of taxes imposed by foreign countries and possessions of the United States is allowed as a credit against the tax imposed).

7 Revenue Act of 1926, ch. 27, § 213(b)(14), 44 Stat. pt. 2, at 1, 9, *amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011, 90 Stat. 1520, 1610, *repealed by* Foreign Earned Income Act of 1978, 95-615, §§ 201-210, 92 Stat. 3097, 3100, *amended by* Technical Corrections Act of 1979, Pub. L. No. 96-222, § 108, 94 Stat. 194, 223 (1980), *repealed by* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 111-15, 95 Stat. 172, 190-96 (1981)). Congress did not place a ceiling on the amount of foreign earned income excludable from gross income until 1962. After 1962, nonresident Americans could exclude up to $20,000 of earned income a year if they were present in a foreign country for 510 days out of a period of 18 consecutive months, or if they were *bona fide* residents of a foreign country for a period which included an entire taxable year. The exclusion was increased to $25,000 of earned income for individuals who had been *bona fide* residents of foreign countries for three years or more. Revenue Act of 1962, Pub. L. No. 87-834, § 11, 76 Stat. 960, 1003. *See generally* Slowinski & Williams, *The Formative Years of the Foreign Source Earned Income Exclusion-Death Blow or Recovery?*, 56 TAXES 169 (1978); Patton, *United States Individual Tax Policy as it Applies to Americans Resident Overseas*, 1975 DUKE L.J. 691.

The foreign earned income exclusion, as presently codified, is discussed *infra* in text accompanying notes 29-39.

8 *See* S. REP. No. 781, 82d Cong., 1st Sess. 52-53 (1951). As used in this comment, "third country national" refers to non-Americans living outside their home country.

9 U.S. DEP'T OF TREASURY, TAXATION OF AMERICANS WORKING OVERSEAS 2 (1978).

10 *Id.* at 9.

11 Pub. L. No. 94-455, § 1011, 90 Stat. 1250, 1610 (1976), *amended by* PUB. L. No. 97-34, tit. I, subtit. B, § 111(a), 95 Stat. 172, 190 (1981).

domestic charitable organizations.[12] The amendment also provided that non-excluded income be taxed at the higher bracket rates that would apply if there were no exclusion.[13] Thus, the amount over the $15,000 exclusion was taxed at the marginal rates that would have applied if the exclusion amount plus the excess were considered taxable income. Foreign income taxes allocable to excluded income were no longer allowed as a credit against the taxpayer's tax liability.[14] Altogether, the amendments would have, had they not been later withdrawn,[15] doubled the tax liability of nonresident American citizens in comparison with their tax liabilities under pre-1976 law.[16]

In addition to the statutory changes, two Internal Revenue Service tax court victories also significantly changed the taxation of expatriate Americans in 1976.[17] These cases clearly established that employee benefits, such as housing and dependent education, were generally subject to United States income taxes at their full value in the locality where provided.[18] This ended an apparently longstanding practice of expatriate Americans not reporting such allowances or reporting them at the lower value of equivalent benefits in the United States.[19]

The 1976 legislative and judicial tax changes triggered an eruption of protests by overseas taxpayers and their employers regarding the timing and the substance of the changes.[20] The retroactivity of these changes to tax years beginning in 1976 and the increased overseas auditing capability of the Internal Revenue Service[21] made them particularly painful. Congress responded to the complaints by postponing the

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12 *Id.* § 1011(a), 90 Stat. at 1610, *amended by* PUB. L. No. 97-34, tit. I, subtit. B, § 111(a), 95 Stat. 172, 190 (1981).

13 *Id.* § 1011(b)(3), 90 Stat. at 1611, *amended by* PUB. L. No. 97-34, tit. I, subtit. B, § 111(a), 95 Stat. 172, 190 (1981).

14 *Id.* § 1011(b)(1), 90 Stat. at 1610, *amended by* PUB. L. No. 97-34, tit. I, subtit. B, § 111(a), 95 Stat. 172, 190 (1981).

15 *See infra* text accompanying notes 20-25.

16 U.S. DEP'T OF TREASURY, *supra* note 9, at 2.

17 McDonald v. Commissioner, 66 T.C. 223 (1976); Stephens v. Commissioner, 35 T.C.M. (P-H) 39 (1976). In *McDonald*, the Tax Court held that the value of lodgings in Japan, furnished by the taxpayer's employer, were not excludable from the taxpayer's income under section 119. The court also held that the value of lodgings furnished by the employer was the arm's length rental value in Japan rather than the value of equivalent lodgings in the United States. 66 T.C. at 234.

In *Stephens*, the Tax Court held that the payment of the taxpayer's rent in Japan should be included in the taxpayer's gross income. The court reasoned that the taxpayer realized financial benefit because the employee paid for housing which the taxpayer would otherwise have had to pay. 35 T.C.M. (P-H) at 39-40.

18 GAO REPORT, *supra* note 2, at 2.

19 *Id.*

20 Maiers, *supra* note 5, at 700.

21 *See generally* Newman, *Tax Administration in Striped Trousers: The International Operations Program of the Internal Revenue Service*, 12 TAX L. REV. 171 (1957).

effective date of the Act to tax years beginning in 1977, in order to mitigate the "surprise" element of the original effective date.[22] The substantive provisions, however, were not amended, and the intense lobbying by the now organized expatriate community continued.[23] Congressional policy shifted again, and a new statute, the Foreign Earned Income Act of 1978 (FEIA), resulted.[24] The FEIA replaced the section 911 earned income exclusion with a more complex system of itemized deductions for the excess costs of working overseas. This excess living cost deduction system allowed deductions in four categories: general cost of living, housing, education, and home leave costs.[25]

The FEIA did not silence complaints that United States tax laws

22 Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 302, 91 Stat. 126, 152. Congress thought that the increased tax burden may have caught many overseas Americans unaware, and those taxpayers may not have the cash available to pay the higher taxes for 1976. S. REP. No. 66, 95th Cong., 1st Sess. 84, *reprinted in* 1977 U.S. CODE CONG. & AD. NEWS 185, 261.

23 Knorr, *Foreign Earned Income—Policy Improved But Not Resolved*, 1979 TAX EXECUTIVE, *reprinted in Taxation of Foreign Earned Income: Hearings on S. 2283, S. 2321, and S. 2418 Before the Subcomm. on Taxation and Debt Management of the Comm. on Finance*, 96th Cong., 2d Sess. 34, 39 (1980) [hereinafter cited a *Hearings on* S. 2283]. The lobbying effort included American expatriates, their employers, business groups, the engineering and construction industries, chamber of commerce organizations from around the world, and a number of *ad hoc* groups. *Id.*

24 Foreign Earned Income Act of 1978, Pub. L. No. 95-615, §§ 201-210, 92 Stat. 3097, 3098, *amended by* Technical Corrections Act of 1979, Pub. L. No. 96-222, § 108, 94 Stat. 194, 223 (1980) [hereinafter cited as FEIA]. *See generally* P. POSTLEWAITE & M. COLLINS, INTERNATIONAL INDIVIDUAL TAXATION ch. 4 (1982); Bruce, *New Rules Taxing Americans Working Abroad*, 57 TAXES 79 (1979); Comment, *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 (1981). For a short explanation of the regulations promulgated for the FEIA provisions, see Reiner & Zimmerman, *Operation of Tax Provisions Affecting Those Working Abroad Are Clarified by Final Regs.*, 55 J. OF TAX. 112 (1981).

25 I.R.C. § 913(b) (1978) (repealed in 1981 by ERTA, *supra* note 1). The cost of living deduction is the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a federal employee of grade level GS-14, Step 1, regardless of the taxpayer's actual income. I.R.C. § 913(d) (1978) (repealed in 1981 by ERTA, *supra* note 1). The housing deduction was the excess of the taxpayer's reasonable housing expenses over his base amount (one-sixth of his net earned income). I.R.C. § 913(e) (1978) (repealed in 1981 by ERTA, *supra* note 1). The education deduction was the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. I.R.C. § 913(f) (1978) (repealed in 1981 by ERTA, *supra* note 1). The deduction for annual home leave equaled the reasonable cost of coach air fare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States. I.R.C. § 913(g) (1978) (repealed in 1981 by ERTA, *supra* note 1).

Some taxpayers were allowed a fifth category of deductions. Taxpayers living and working in certain hardship areas were allowed a special $5,000 deduction in order to compensate them for hardships involved and to encourage United States citizens to accept employment in these areas. I.R.C. § 913(h) (1978) (repealed in 1981 by ERTA, *supra* note 1). As an exception, however, the FEIA permitted employees who resided in camps in hardship areas to elect to claim a $20,000 earned income exclusion under section 911 in lieu of the excess living cost and hardship area discouraged Americans from living abroad, however. Moreover, expatriates complained that the FEIA system of deductions was so complex that taxpayers were forced to hire costly tax professionals to complete their tax returns.[26] The pressure generated several legislative proposals in 1980 designed to liberalize and simplify the taxation of Americans abroad.[27] It was not until a change of administration, however, that a proposal finally came to fruition. Citing its concern for the competitiveness of American business in the world market and its effect on the United States balance of trade, Congress passed the foreign earned income exclusion of the Economic Recovery Tax Act.[28]

THE ECONOMIC RECOVERY TAX ACT

The Foreign Earned Income Exclusion

The ERTA has replaced the FEIA system of excess living cost deductions by excluding a portion of a qualifying taxpayer's foreign income attributable to a period of foreign residence.[29] To qualify for the foreign earned income exclusion and the housing provisions, an individual must either be a *bona fide* resident of the foreign country,[30] or be present in a foreign country for at least 330 days during a consecutive twelve month period.[31] Furthermore, a qualified individual must also maintain a tax home in a foreign country during the *bona fide* residence

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deductions. The foreign tax credit was not allowed for foreign taxes attributable to the excluded amount. I.R.C. § 911 (1978) (amended in 1981 by ERTA, *supra* note 1).

26 GAO REPORT, *supra* note 2, at iv.

27 *See generally* JOINT COMM. ON TAXATION, 96TH CONG., 2D SESS., DESCRIPTION OF BILLS (S. 2283, S. 2321, AND S. 2418) RELATING TO TAX TREATMENT OF FOREIGN EARNED INCOME (Comm. Print 1980). S. 2283 would have provided a $50,000 annual exclusion for foreign earned income. *Bona fide* residents of a foreign country for three or more consecutive years would have been allowed an annual exclusion of up to $65,000 per year. *Id.* at 6. Housing allowances in excess of 20% of earned income would have qualified for an additional exemption. S. 2418 would have provided a $60,000 annual exclusion for foreign earned income. *Id.* at 9. It would have retained the housing expense deductions allowed under section 913 of the FEIA and modified the tax treatment of lodging furnished to employees living in camps under section 119. S. 2321 would exclude all foreign earned income of certain individuals. *Id.* at 8.

28 S. REP. No. 114, *supra* note 3, at 34, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS at 142.

29 I.R.C. § 911 (1981).

30 I.R.C. § 911(d)(1) (1981). The *bona fide* resident test is the same as that under prior law. The ERTA also retains the FEIA provision that an individual making a statement to the foreign authorities that he is not a resident of that country, resulting in avoidance of taxation there as a resident, will be evidence to deny qualification under the *bona fide* resident test. I.R.C. § 911(d)(5) (1981).

31 I.R.C. § 911(d)(1) (1981). The new physical presence test is a liberalization of the FEIA requirement that the individual be physically present in the foreign country for at least 510 full days during any period of eighteen consecutive months. FEIA, *supra* note 24, § 913(a)(2), 92 Stat. at 3100 (repealed in 1981 by ERTA, *supra* note 1).

or physical presence time period.[32]

Beginning in the taxable year 1982, the exclusion was subject to a limitation computed on a daily basis of an annual rate of $75,000.[33] The annual rate increases by $5,000 a year to a maximum of $95,000 for 1986 and thereafter.[34] Since the limitation is computed on a daily basis, the annual rate must be reduced *pro rata* for the number of days spent in the United States during the year.[35]

The ERTA does not change the FEIA definition of earned income; thus, compensation for services rendered, as well as a maximum of thirty percent of the profits in a trade or business in which the taxpayer renders services, are both considered earned income.[36] Under the new provisions, however, earned income does not include amounts received as pension or annuity payments, or amounts paid by the United States to its employees.[37] Moreover, each qualifying member of a married couple may compute the exclusion separately.[38] Nevertheless, no deduction or credit may be taken for amounts attributable to the excluded amounts (such as foreign taxes paid on the excluded income).[39]

Housing Exclusion or Deduction

The ERTA also allows a separate exclusion for the "housing cost amount" of a taxpayer living abroad who is reimbursed by his employer for housing expenses.[40] The housing cost amount is calculated as the excess of the individual's housing expenses for the taxable year over sixteen percent of the salary of a Step 1, grade GS-14 United States employee,[41] computed on a *pro rata* basis for the number of days spent abroad during the year.[42] Housing expenses include all reasonable ex-

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32 An individual's tax home is generally the location of his business or employment. Rev. Rul. 91-247, 1971-1 C.B. 54. However, the ERTA creates an exception to the general rule in that an individual shall not be treated as having a tax home in a foreign country for any period for which his abode is in the United States. I.R.C. § 911(d)(3) (1981).

33 I.R.C. § 911(b)(2) (1981).

34 *Id.*

35 The provision can be formulated as follows:

$$\begin{matrix}\text{exclusion}\\\text{limitation}\end{matrix} = \text{annual rate} - \left(\text{annual rate} \times \frac{\text{number of days in U.S.}}{365}\right)$$

36 I.R.C. § 911(d)(2)(B) (1981).

37 I.R.C. § 911(b)(1)(B) (1981).

38 S. REP. No. 144, *supra* note 3, at 37, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS at 143.

39 I.R.C. § 911(d)(6) (1981).

40 I.R.C. § 911(c) (1981).

41 Currently, the salary of a GS-14 is $37,871. S. REP. No. 114, *supra* note 3, at 37, *reprinted in* U.S. CODE CONG. & AD. NEWS at 143.

42 *Id.* The provision can be formulated as follows:

penses paid or incurred by the taxpayer during the taxable year for housing in a foreign country, except those expenses deductible under other sections of the Internal Revenue Code.[43] Thus, utilities and insurance would be eligible housing expenses, but interest and taxes would not.[44]

In cases in which the taxpayer is not reimbursed by his employer for the housing cost amount for the taxable year, the amount will be treated as a deduction in computing adjusted gross income to the extent of the excess of the taxpayer's foreign earned income over his foreign-earned income exclusion for the year.[45] The excess of the housing cost amount over the limitation can be carried over to the succeeding taxable year.[46]

Employees Living in Camps

The ERTA provisions in some respects discontinue the preference of employees living in camps abroad over other American employees. While under the FEIA camp employees received a $20,000 income exclusion that was unavailable to other expatriates, anyone who can meet the previously discussed requirements is eligible for the ERTA annual exclusion. The ERTA does, however, favor camp employees by providing that the camps shall be considered to be part of the business premises of the employer.[47] Thus, assuming the other requirements of section 119 are met, the new provision allows the value of meals and lodging furnished in camps to be excluded from an individual's income, though the camp may in fact not be part of the business premises of the employer.

$$\begin{array}{l}\text{housing}\\\text{cost}\\\text{amount}\end{array} = \begin{array}{l}\text{housing expenses}\\\text{for the individual}\\\text{for the taxable}\\\text{year}\end{array} - \left(\begin{array}{l}\text{16\% of the salary}\\\text{of a Step 1, grade}\\\text{GS-14 employee of}\\\text{the U.S.}\end{array} \times \begin{array}{l}\text{number of days during}\\\text{the taxable year in}\\\text{which individual}\\\text{resided abroad}\end{array} \right)$$

43 I.R.C. § 911(c)(2)(A) (1981). Housing expenses are not allowed to the extent they are lavish or extravagant. *Id.*

44 I.R.C. § 911(c)(2)(A)(i)-(ii) (1981).

45 I.R.C. § 911(c)(3)(A) (1981).

46 I.R.C. § 911(c)(3)(C) (1981).

47 I.R.C. § 119(c)(1) (1981). To qualify as a "camp" for this purpose, the lodging must meet three requirements. First, the lodging must be furnished for the convenience of the employer because the place at which the services are to be performed is in a remote area without satisfactory housing. Second, the camp must be located as close as possible to the worksite, although the camp need not be in a hardship area nor be substandard housing. Finally, the camp must be a common area which accommodates at least ten employees and which is not available to the general public. I.R.C. § 119(c)(2) (1981).

EQUITY CONSIDERATIONS

The above review of the ERTA provisions reveals that expatriate Americans will enjoy a substantial tax benefit that resident Americans will not. This state of affairs might appear unfair to a layman taxpayer. On an academic level, an important factor in evaluating the fairness of a particular tax measure is the concept of horizontal tax equity.[48] Horizontal tax equity requires that similarly situated individuals receive the same tax treatment unless economic hardship exists that would decrease a taxpayer's ability to meet his tax obligation.[49] Proponents of this view have argued that the higher salaries paid by employers to induce their employees to work abroad should constitute sufficient reimbursement for the higher cost of living abroad.[50] Thus, the special deductions allowed to expatriates under the FEIA deviated from this principle, creating unnecessary inequities between domestic and foreign based taxpayers.[51]

The ERTA foreign earned income exclusion exacerbates the inequity by bestowing benefits in a manner that bears no relationship to the hardship of the taxpayer. First, a flat exclusion of income for nonresident Americans ignores the possibility that some resident Americans may experience a higher cost of living, for example in Alaska, and thus, more hardship than some Americans abroad. Yet, these residents receive no tax breaks for the hardship they bear. Further, the ERTA creates an inequity among expatriate Americans by setting a single fixed exclusion amount for all taxpayers, regardless of the number of dependents, or where the taxpayer is stationed. For example, the exclusion will usually provide much greater benefit to a single person with no dependents living in a low cost of living country than for a married taxpayer with school age children located in a high cost of living country.[52] Consequently, the ERTA foreign earned income exclusion contravenes the hardship exception to the horizontal equity concept because it benefits most those taxpayers who have the least amount of hardship.

On the other hand, proponents of the foreign earned income exclusion argue that the appropriate context for a tax equity analysis is a

[48] *See generally* Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567 (1965); Postlewaite & Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for its Repeal*, 65 VA. L. REV. 1093, 1115 (1979); Comment, *An Intergovernmental Approach to Tax Reform*, 4 N.M.L. REV. 189, 193 (1974).

[49] Postlewaite & Stern, *supra* note 48, at 1119.

[50] *Id.*

[51] *Id.*

[52] *Id.* at 1114; Comment, *Taxation of Americans Living Abroad*, *supra* note 24, at 83 (1981).

comparison of the relative tax burdens of expatriate Americans and their foreign counterparts.[53] Since Americans are generally taxed on their foreign earned income and third country nationals generally are not,[54] the argument follows that true tax equity between American and foreign expatriates will occur only if Americans pay no tax on their foreign earned income.[55]

While a comparison of the relative tax burdens of expatriate Americans vis-à-vis third country nationals may have some relevance in a trade promotion context, the comparison is inappropriate when applied to tax equity. Third country nationals do not enjoy the benefits of American citizenship,[56] and, thus, naturally would not bear the costs that go along with the benefits. Moreover, the circumstances of third country nationals and nonresident Americans may not be sufficiently similar so as to make a comparison of the relative tax burdens meaningful. For example, some third country nationals may be exempt from their home country income taxes, but they usually must pass several tests to achieve this nonresident tax exempt status: they must work abroad continuously for more than two years, must be accompanied abroad by immediate family members, must give up their home country residence, and must sever other ties, such as property ownership and financial interests.[57]

Justifications for the Return to a Foreign Earned Income Exclusion

Having concluded that there has been a departure from principles of tax equity, the next step is to examine the countervailing policy reasons that justify the departure. One of the primary Congressional concerns leading to the ERTA foreign earned income exclusion was the increasingly competitive pressure that American business faces abroad, and its effect on the nation's continuing trade deficits.[58] Congress believed that American firms were less competitive in the international market because American products reflect the cost of employing Amer-

53 Maiers, *supra* note 5, at 714.

54 GAO Report, *supra* note 2, at ii.

55 Maiers, *supra* note 5, at 715.

56 "Many [expatriate Americans] may have grown up in FHA-insured homes, are having their parents cared for by federal programs rather than having to pay medical expenses themselves, benefit from a large defense establishment and the maintenance of consulates, or first went abroad on Fulbright Scholarships." Kingson, *A Somewhat Different View*, 34 Tax Law. 737, 740 (1981).

57 GAO Report, *supra* note 2, at 36.

58 S. Rep. No. 144, *supra* note 3, at 91, *reprinted in* 1981 U.S. Code & Cong. Ad. News at 142.

icans who pay higher income taxes than their foreign counterparts.[59] As a result, American companies have had to reduce their foreign operations or to replace American employees with foreign nationals.[60]

Moreover, Congress believed that, in many cases, these foreign nationals may purchase goods and services for their companies from their home countries, rather than from the United States, because they often are more familiar with those goods and services. Thus, Congress concluded that the appropriate incentive to make American business competitive is to allow expatriate Americans a substantial exclusion from United States taxes for their foreign earned income.[61]

Given the desirability of promoting exports in order to decrease the United States trade deficit, however, it is not clear that the foreign earned income exclusion is the most effective means of accomplishing this goal. Congress' rationale may be based on the exaggerated assumption that United States taxation of Americans abroad significantly affects exports of goods and services.[62] The primary support for this assumption comes from a recent General Accounting Office survey of United States companies having substantial operations abroad.[63] The results of the survey showed that the companies believed that United States taxes were an important factor in reducing the number of Americans abroad both because the FEIA did not relieve the excessive living costs of working abroad, and because it was more expensive for companies to employ Americans who would have to be reimbursed for the additional tax burdens.[64] The self-admitted weakness of the GAO study is, however, that the survey data was collected from companies who have a vested interest in the outcome of the study.[65] Obviously, there is a risk that the companies' responses may have been influenced because they stand to gain if their employees pay less tax.[66]

The practical problem of any study of this matter is the difficulty

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59 *Id.*

60 *Id.*

61 *Id.*

62 *See supra* text accompanying notes 58-61.

63 GAO REPORT, *supra* note 2.

64 *Id.* at i.

65 *Id.* at 6.

66 The same problem exists in the Chase Econometric Study. *See Hearings on S. 408, S. 436, S. 598 and S. 867 Before the Subcomm. on Taxation Debt Management Generally of the Comm. on Finance*, 97th Cong., 1st Sess. 95, 100 (1981) (statement of Robert D. Shriver, Ph.D., Director of Washington Operations, Chase Econometrics). The Chase Report was prepared for a construction industry group, the United States and Overseas Tax Fairness Committee, and concluded that FEIA changes in United States tax policy increased domestic unemployment by 80,000 jobs and reduced federal income collections by $6 billion. *Id.* at 2. The Chase Study methodology and results have been severely criticized. *See* GAO REPORT, *supra* note 2, at 49; Thuronyi, *A Critique*

of isolating the effect of United States taxation of Americans abroad from other economic factors affecting exports. For example, trade barriers,[67] United States anti-bribery and anti-boycott laws, the political upheavals in Iran, the increased competitiveness of lesser developed countries, and the lack of aggressiveness[68] of American companies have all affected United States foreign trade in recent years. Moreover, there is very little hard evidence that the number of Americans abroad increased exports any more than did foreign nationals. For example, an internal Fluor study ranked United States suppliers fifth behind their Japanese and German competitors in terms of quality and reliability.[69] Clearly, it would be much too simplistic to suggest that expatriate Americans have a natural propensity to buy American products.

A Congressional Research Service report concluded that it is not necessary to maintain a large force of Americans abroad to maintain United States exports.[70] The report cited the success of foreign companies in exporting automobiles, televisions, and similar products to the United States without a large sales force of foreign nationals stationed domestically.[71] In many cases, a national of the importing country may be a more effective salesman than an American because the national will know the language and customs of his market better.[72]

Further, it is not difficult to imagine several situations in which Americans abroad may have a negative impact on the United States trade deficit. For example, an Aramco study suggested that Aramco's United States contractors relied more on United States suppliers of material and equipment than did its foreign contractors, but that the United States suppliers may be sourcing from their foreign and not their United States plants.[73] Thus, buying products from American companies does not ensure that the products were manufactured in and exported from the United States. Another possibility is that encouraging more Americans to work abroad may decrease imports by encouraging the establishment of foreign subsidiaries to be supervised by

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of the Chase Study of the Tax Treatment of U.S. Workers Overseas, 1980 TAX NOTES 979, *reprinted in Hearings on S. 2283*, *supra* note 23, at 194.

67 *Crucial Campaign to Increase Exports*, 70 NATION'S BUS. 22 (1982).

68 *U.S. "Arrogance" Costs Firms Billions*, 203 ENGINEERING NEWS REC. Nov. 29, 1979, at 26, 29 (1979).

69 *Id.*

70 CONGRESSIONAL RESEARCH SERVICE, U.S. TAXATION OF CITIZENS WORKING IN OTHER COUNTRIES: AN ECONOMIC ANALYSIS 49 (1978), *cited in* Postlewaite & Stern, *supra* note 48, at 1022.

71 *Id.*

72 Postelwaite & Stern, *supra* note 48, at 1122.

73 *U.S. "Arrogance" Costs Firms Billions, supra* note 68, at 32; *see also New Tax Law Should Help Overseas*, Wall St. J., Aug. 25, 1981, at 35, col. 2.

Americans.[74] Once again, the United States economy would be denied the beneficial effects of the exports lost to overseas subsidiaries of American companies..

Even if we assume that the best way to promote exports is to encourage Americans to go abroad, the foreign earned income exclusion seems to be an inefficient and overbroad way to realize these goals. Only forty-three percent of the expatriate American income tax returns are filed by Americans in presumably export influencing employment categories: construction, management, and sales groups.[75] Moreover, categories that might be assumed to have no export influence, such as teachers, preachers, office workers, lawyers, entertainers, and doctors, account for forty-one percent of the returns.[76] Of course, there is some overlap in the export promotion capability of the categories. In many cases, however, the ERTA foreign earned income exclusion amounts to a government bonus for temporary foreign employment which is unrelated to any specific national objective. The incentives of the exclusion apply equally to all situations, whether they promote exports or not. Such inadequacies in the ERTA provisions suggest that an examination of alternative measures may be appropriate.

Alternatives to the Foreign Earned Income Exclusion

Modification of the Foreign Earned Income Act

One proposal calls for the modification of the deductions allowed under the FEIA.[77] The suggestion is to vary the cost of living deduction with a recipient's earnings, rather than pegging it to the salary level of a GS-14 civil servant, as in the FEIA.[78] This modification should probably be accompanied by an increase in the deduction for housing expenses because the cost of living and housing deductions have both been cited as the most seriously inadequate deductions of the FEIA.[79] A properly functioning system of adequate living cost deductions should eliminate the need for employers to compensate their overseas employees for excess taxes incurred as a result of working overseas.

[74] Thuyronyi, *supra* note 66, at 982, *reprinted in Hearings on S. 2283, supra* note 23, at 197.

[75] *Taxation of Foreign Earned Income: Hearings on S. 408, S. 436, S. 598 and S. 867 Before the Subcomm. on Taxation Debt Management of the Comm. on Finance*, 97th Cong., 1st Sess. 371 (1981) (statement of John Chapoton, Assistant Treasury Secretary for Tax Policy).

[76] *Id.*

[77] *Hearings on S. 2283, supra* note 23, at 67 (statement of Donald Lubick, Assistant Treasury Secretary for Tax Policy).

[78] *Id.*

[79] GAO REPORT, *supra* note 2, at iii. The schooling and home leave deductions were generally adequate, according to data provided by United States company officials. *Id.*

The proposal does not simplify the Act. It should be noted, however, that the new ERTA provisions in many respects are as complicated as the old law. A United States taxpayer must still meet the qualification tests, allocate his earned income between United States and foreign sources, and disallow a portion of otherwise allowed deductions, credits, and exclusions.[80] The ERTA also retains the housing deduction, perhaps the most complicated deduction in the FEIA.[81]

The modification proposal is, to a certain extent, less objectionable on equity grounds than the flat exclusion because the deduction system bestows benefits in relation to the hardship of the taxpayer. Under the earned income exclusion, however, the benefits of the deduction system fall on all qualifying Americans living abroad, regardless of their occupation or relation to export promotion. Thus, the modified deduction system focuses on trade promotion no more than the foreign earned income exclusion.

Targeted Jobs Credit

Another possible alternative to the foreign earned income exclusion is special relief directed to the employer in the form of a targeted jobs credit for export-promoting employees.[82] By shifting the focus from individual taxpayers to eligible employers, this approach would reduce the number of eligible recipients and thus be easier to administer. Moreover, this program could be drafted to permit administrative flexibility by specifying the general criteria in the statute, while allowing the Secretary of the Treasury and/or Commerce to designate qualifying employers. This device, however, may be vulnerable as an illegal export subsidy under Article XVI of GATT[83] and Article 10 of the Multilateral Trade Negotiations (MTN) Subsidies Code.[84]

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80 *See supra* text accompanying notes 29-46.

81 *Id.*

82 *Hearings on S. 2283, supra* note 23, at 70 (statement of Donald Lubick, Assistant Treasury Secretary for Tax Policy).

83 General Agreement on Tariffs and Trade, *opened for signature* Oct. 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 187. Article XVI provides that export subsidies to primary products are prohibited if the subsidy results in the subsidizing country having more than an equitable share of the world export trade of that product.

84 AGREEMENTS REACHED IN THE TOKYO ROUND OF THE MULTILATERAL TRADE NEGOTIATIONS, H.R. DOC. NO. 153, 96th Cong., 1st Sess. (1979). Article 10 forbids signatory countries from granting "directly or indirectly any export subsidy on certain primary products in a manner which results in the signatory . . . having more than an equitable share of the world export trade in the product." The illustrative list of export subsidies includes "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes." *Id.* at 295.

Severance Taxation

Another alternative is to switch from citizenship taxation to residency taxation. American citizens who leave the United States to work abroad would be taxed on the unrealized appreciation of all their assets, as is the practice in Canada and several other countries. Only after a citizen has passed several stringent tests would his foreign income be exempted.[85]

The switch from citizenship taxation would certainly discourage the abuse to which the foreign earned income exclusion lends itself[86] because of the strict requirements of a residency taxation system. On the other hand, there is no evidence that a person who meets the rigorous severance tax requirements would tend to promote exports any more than a person who did not meet the standards. Without such assurance, a departure from citizenship taxation is just another way of discriminating among taxpayers without any discernable furtherance of Congressional policy.

Targeted Exclusion

The targeted exclusion is probably the most promising proposal because it is the most limited departure from tax equity while still promoting export-related activities. Some United States trade competitors, including France and Germany, use targeted foreign earned income exclusions.[87] While these countries generally retain income tax jurisdiction over individuals who work abroad but keep a home in the country, they provide a special exemption for such individuals if they are employed abroad by local companies in selected export promoting activities, such as construction and installation projects, and natural resource exploration and extraction.[88]

The targeted exclusion has the advantage of being a narrowly focused relief to only trade-promoting employment categories. First, this proposal is a much more limited departure from the tax equity standard. There would still be a departure from tax equity because certain individuals will be benefited, but this group would be smaller in number. Also, as a limited relief, the targeted exclusion would cost less

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[85] *See supra* note 57 and accompanying text.

[86] Donald C. Lubick noted that a foreign earned income exclusion would allow persons who can arrange to receive very high income while working abroad in tax havens to avoid tax. *Hearings on S. 2283, supra* note 23, at 55-67 (statement of Donald Lubick, Assistant Treasury Secretary for Tax Policy).

[87] *Id.* at 67-68 (statement of Donald Lubick, Assistant Treasury Secretary for Tax Policy).

[88] *Id.* For a discussion of income tax laws of major United States trade competitors, see GAO REPORT, *supra* note 2, at 36-37.

in revenue than the total foreign earned income exclusion under the ERTA.[89] The targeted exclusion approach also has the further advantage that it probably would not be subject to GATT and MTN objections as a subsidy. The fact that the targeted exclusion is being used by France and Germany certainly lends credence to the approach and decreases the chances that others will object to the exclusions. Second, the targeted exclusion should not be any more offensive than the foreign earned income exclusion of the ERTA as an export promotion subsidy because Congress has clearly labelled the ERTA provision as an export promotion device.[90]

CONCLUSION

The new provisions for the taxation of Americans living abroad represent an overbroad and ineffective means of accomplishing the arguably valid Congressional objective of trade promotion. The foreign earned income exclusion plainly violates the principle of tax equity by granting preferential treatment to expatriate Americans without regard to the degree of hardship suffered. An analysis of the reasons for adopting the exclusion does not vindicate this departure from equity. Not only is there an absence of concrete evidence that the number of Americans abroad significantly affects the level of United States exports, but the exclusion indiscriminately grants a tax windfall to any American who works abroad, regardless of the individual's relation to export promotion.

Several other tax measures are available to Congress that are more focused in trade promotion, yet not as broad as the exclusion in granting benefits. Perhaps the most promising is a targeted exclusion of foreign earned income allowed to expatriate Americans in export promoting capacities, because the targeted exclusion would be a much more limited departure from the principle of tax equity than is the new law. Perhaps this method is the next step in the evolution of United States tax policy towards expatriate Americans.

John A. Papahronis

89 *Hearings on S. 2283, supra* note 23, at 63 (statement of Donald Lubick, Assistant Treasury Secretary for Tax Policy).

90 S. REP. No. 114, *supra* note 3, at 36.