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Russell Stephen Dunegan

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THE FOREIGN EARNED INCOME ACT OF 1978: NONBENEFITS FOR NONRESIDENTS

The Foreign Earned Income Act of 1978 (FEIA)\(^1\) significantly alters the taxation of U.S. citizens residing abroad. It adds a new section to the Internal Revenue Code, section 913,\(^2\) to provide a series of living expense deductions for U.S. expatriates in place of the traditional limited exemption available under prior section 911.\(^3\) It also liberalizes the moving expense deductions and the deferral of gain on the sale of a principal residence for such U.S. citizens.\(^5\) The purpose of the law is two-fold. First, it seeks to promote foreign trade by U.S. businesses by reducing the tax costs of employing U.S. citizens overseas. Second, it attempts to tax U.S. expatriates more fairly by providing them relief in the form of deductions that more accurately reflect the expenses of living and working overseas.\(^6\)

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2. I.R.C. § 913.

FEIA retains I.R.C. § 911 as an elective provision providing an exemption of up to $20,000 for taxpayers residing in "camps" located in "hardship areas." FEIA § 202(a)-(b), I.R.C. § 911(a), (c). Of course, taxpayers may not take both the § 911 exemption and the § 913 deductions. Id. § 203(a), I.R.C. § 913(l).

4. For "foreign moves," defined as "the commencement of work by the taxpayer at a new principal place of work located outside the United States" and its possessions, FEIA § 204(a), I.R.C. § 217(h)(3)-(4), the reasonable costs of storing household goods and personal effects for part or all of the period of foreign employment and the costs of transporting such goods and effects to and from storage are deductible. Id., I.R.C. § 217(h)(2). The limitation on the deductions for temporary living expenses and househunting expenses for such moves increased from $1,500 to $4,500, and the period for which those expenses are deductible increased to 90 days from 30 days. Id., I.R.C. § 217(h)(1). The ceiling on deductions for these expenses plus the costs of selling and purchasing a personal residence, or settling an old lease and obtaining a new one, increased to $6,000 from $3,000. Id. In addition, for the first time, moving expenses incurred by qualified retiring employees or survivors when moving back to the United States are deductible. Id., I.R.C. § 217(i).

5. The running of the period for deferring gain on the sale of a principal residence is suspended while the taxpayer has a tax home outside the United States, but the deferral period as so suspended may not exceed four years. Id. § 206, I.R.C. § 1034(k).

6. The Senate Report accompanying the FEIA stated:
FEIA will have a substantial impact. Currently more than one million Americans reside abroad, of whom more than 140,000 file U.S. tax returns. The change in tax liability caused by FEIA could reach several thousand dollars for each return. This Note will analyze the operation and impact of FEIA and the regulations promulgated thereunder to evaluate their effectiveness in achieving the dual goals of encouraging U.S. business overseas and taxing expatriates more equitably. It first reviews the history of U.S. taxation of foreign earned income. The Note then examines the nature and scope of the deductions and exemptions provided by FEIA and the operation of the foreign tax credit. It next evaluates FEIA in light of its declared goals. Finally, the Note proposes alternative methods of achieving these goals.

I

TAXATION OF FOREIGN EARNED INCOME

A. History

The United States is one of the few countries that taxes its citizens because of the extraordinary costs of overseas living in many situations, special consideration must be given to individuals working abroad in order to treat them equitably for tax purposes. Relief based on a flat exclusion is arbitrary and unfair. The amount excluded is the same regardless of whether the individual's living expenses abroad are higher than, the same as, or lower than comparable costs in the United States. Equitable treatment of individuals working abroad requires that relief be more closely related to the actual increased expenses which the individual must incur while working abroad. Moreover, the tax treatment of U.S. workers abroad should not place them at a disadvantage in relation to foreign workers with whom they compete for jobs. In certain situations employers may find it impossible to continue to employ U.S. citizens abroad instead of foreign nationals unless some form of relief is provided.


wherever they reside.\footnote{11} Thus U.S. expatriates may be subject to multiple income taxation by their country of residence, by their country of citizenship, and, possibly, by the countries from which their income is derived, if different from their countries of citizenship and residence.\footnote{12} Because of this potential "double-taxation," the need to provide some sort of tax relief to U.S. expatriates materialized early in the development of the law of income taxation. Although the foreign tax credit\footnote{13} provided partial relief in some situations,\footnote{14} it did not address the expatriates' concern with the additional expenses associated with going overseas. Moreover, Congress showed an interest in encouraging U.S. business overseas\footnote{15} as well as providing fair tax treatment for U.S. expatriates. To achieve these goals, Congress enacted the ancestor of FEIA in 1926, excluding all foreign earned income from U.S. taxation if the taxpayer was a bona fide nonresident of the United States for more than six months of the taxable year.\footnote{16}

Since 1926, Congress has modified the law several times, usually in response to the discovery of an abuse of the system.\footnote{17} In 1932, the law was amended to exclude federal employees from its scope because their status usually exempted them from foreign income taxes.\footnote{18}

\footnote{11}{The sixteenth amendment has always been read to allow taxation on the basis of citizenship. Cook v. Tait, 265 U.S. 47, 56 (1924); Treas. Reg. § 1.1-1(b), T.D. 7332, 1975-1 C.B. 206. The alternative bases of taxation, residence and source of income, are discussed in Note, The Foreign Earned Income Act of 1978, 19 HARV. INT'L L.J. 633, 639 n.47 (1978).}

\footnote{12}{The fellow resident of the U.S. expatriate also is potentially subject to double-taxation in this last sense. If the foreign country of residence taxes its residents on their worldwide income, they will be subject to double-taxation on income, the source of which is a country that taxes on the source-of-income basis, unless exempted by a foreign tax credit from the country of residence or by a treaty provision. See Note, supra note 11, at 642 n.59.}

\footnote{13}{I.R.C. §§ 901-908. The foreign tax credit is discussed more fully at pp. 114-116, infra. If the foreign tax credit is not elected, the taxpayer may instead deduct the foreign income taxes, I.R.C. § 164(a)(3), but I.R.C. § 275(a)(4) prohibits the use of both the credit and the deduction during the same taxable year. The discussion in this Note is limited to the credit.}

\footnote{14}{For example, the foreign tax credit fails to alleviate double-taxation where a portion of the foreign taxes levied are not "income" taxes and thus are not creditable. This situation is most common in those countries that use value-added taxes, notably the members of the European Economic Community.}

\footnote{15}{As originally proposed by the House Ways and Means Committee, the exclusion would only have been available to taxpayers engaged in selling U.S. products abroad. H.R. REP. NO. 1, 69th Cong., 1st Sess. 7 (1925). See also 67 CONG. REC. 3,781 (1926) (remarks of Sen. Smoot); id. at 3,782 (statement of Richard P. Momsen, Pres., American Chamber of Commerce in Brazil).}

\footnote{16}{Revenue Act of 1926, ch. 27, § 213(b)(14), 44 Stat. 9, 26.}

\footnote{17}{For a review of the legislative history of these changes, see Krichbaum v. United States, 138 F. Supp. 515, 518-23 (E.D. Tenn. 1956); Levine, Section 911: The Foreign Earned Income Exclusion—Death Blow or Recovery?, 56 TAXES 169 (1978); Slowinski & Williams, The Formative Years of the Foreign Source Earned Income Exclusion: Section 911, 51 TAXES 355 (1973), and Note, supra note 11, at 676 app.}

\footnote{18}{Revenue Act of 1932, ch. 209, § 116(a), 47 Stat. 169, 204.}
Abuses by those who moved overseas only long enough to claim the benefits of the exclusion 19 prompted Congress, in 1942, to require that a taxpayer must be not only a nonresident of the United States, but also a bona fide resident of a foreign country for the entire taxable year to qualify for the exclusion. 20 Thus a taxpayer who became a bona fide resident of a foreign country on July 1, 1943, and remained so continuously until September 30, 1946, was denied the use of even a prorated portion of the exclusion for the six months of 1943 and nine months of 1946 spent in the foreign country. 21 To ameliorate this harsh result, Congress, in 1951, modified the test to require residency in a foreign country only for "an uninterrupted period which includes an entire taxable year." 22 The 1951 Act also extended the exclusion to cover taxpayers who, during any period of eighteen consecutive months, were present in a foreign country for at least 510 days (seventeen months)—the "physical presence" test. 23 This amendment was designed to encourage employees with technical knowledge who worked on specific projects for stated periods of time, such as engineers and skilled technicians, to go abroad, thus bolstering the U.S. business presence overseas. 24

Until 1953, no limit existed on the amount of foreign earned income that could be excluded. In that year, Congress placed a ceiling of $20,000 on the income excludable by those taxpayers qualifying under the physical presence test. 25 In response to President Kennedy's urged cutback in the

24. S. REP. No. 781, supra note 21, at 53, reprinted in [1951] U.S. CODE CONG. & AD. NEWS at 2024. This policy of encouraging employment of skilled Americans abroad continues to date. One Congressman stated:

"Our witnesses also stressed the advantage of having an overseas American in the right spot at the right time. An American purchasing agent looks toward the United States to fill his orders. When U.S. tax policies make it less expensive to hire a European or other foreign national, the orders may well go elsewhere. The result . . . is . . . lost business for the United States . . . at a time when we are struggling to boost our exports to match a sharp increase in our imports."

scope of the exclusion.\textsuperscript{26} Congress, in 1962, similarly limited the exclusion available to taxpayers meeting the bona fide residence test to $20,000 for the first three years abroad and $35,000 thereafter.\textsuperscript{27} This ceiling was further reduced in 1965 to $20,000 for the first three years of foreign residence and $25,000 thereafter.\textsuperscript{28}

The drastic reduction of benefits under the 1976 Tax Reform Act (TRA) represented the first significant modification of the exclusion after 1965. The 1976 TRA reduced the amounts excludable to $15,000 annually\textsuperscript{29} and disallowed the credit for foreign taxes paid to the extent that these taxes were attributable to the excluded income.\textsuperscript{30} This Act also revised the method for computing the U.S. tax due on foreign income in excess of the exclusion so as to tax the nonexcluded income at the higher rates that would have applied if the income had not been excluded.\textsuperscript{31} These cutbacks raised such a hue and cry\textsuperscript{32} from U.S. expatriates and U.S. firms doing business overseas that Congress twice postponed the effective date of these changes.\textsuperscript{33} In the end, FEIA preempts them.\textsuperscript{34}
B. THE FOREIGN EARNED INCOME ACT OF 1978

FEIA creates a new section of the Internal Revenue Code: section 913. In a significant alteration of prior law, it provides five new classes of deductions for taxpayers satisfying either the bona fide residence test or the physical presence test. The five new deductions are: 1) qualified cost-of-living differential, 2) qualified housing expenses, 3) qualified schooling expenses, 4) qualified home leave travel expenses, and 5) qualified hardship area deduction. The aggregate deductions cannot exceed the amount of net foreign source earned income.

The qualified cost-of-living differential is the amount by which the reasonable living expenses (excluding housing and education) of a GS-14, step 1 federal employee (current salary $32,442) residing in the taxpayer’s locale exceed those incurred in the city in the continental United States with the highest cost of living. The differential considers differences based on the composition of the taxpayer’s family living with him and attempts to reflect expenses actually incurred by the taxpayer. Because the Treasury Department predetermines in tabular form the standards to be applied, the “reasonableness” requirement should create no interpretive difficulties for the taxpayer.

35. For a discussion of these tests, see notes 20-23 supra and accompanying text. Taxpayers eligible for § 913 deductions include U.S. citizens satisfying either the bona fide residence or physical presence test, FEIA § 203(a), I.R.C. § 913(a)(1)-(2), resident aliens in the United States satisfying the physical presence test, id., I.R.C. § 913(a)(2), and individuals qualifying for the § 911 camp exclusion who do not elect that exclusion, id., I.R.C. § 913(l). For those taxpayers so qualifying, § 913 may be mandatory, not elective. See Wehrenberg, Rogers, Schmid & Gajek, The Foreign Earned Income Act of 1978: A Step Forward for Expatriates and their Employers, 10 TAX ADVISER 4, 8 (1979) [hereinafter cited as Wehrenberg].

36. FEIA § 203(a), I.R.C. § 913(d).

37. Id., I.R.C. § 913(e).

38. Id., I.R.C. § 913(f).

39. Id., I.R.C. § 913(g).

40. Id., I.R.C. § 913(h).

41. “Net foreign earned income” is defined as all foreign earned income (not including income excluded under § 119) less all deductions other than those allowed by § 913. FEIA § 203(a), I.R.C. § 913(c); Temp. Treas. Reg. § 5b.913-4, 1979-24 I.R.B. 19.


43. New York City currently qualifies. JOINT COMM., supra note 9, at 24, Table 6.

44. For example, the regulations require the differential to be computed on a daily basis, reducing family size for those days in which dependents are not living with the taxpayer or have their meals and lodging reimbursed by the employer (excludable expenses under I.R.C. § 119). Temp. Treas. Reg. § 5b.913-5, 1979-24 I.R.B. 19. Prescribed tables can be found in Instructions for Form 2555, Exemption of, or Deduction from, Income Earned Abroad 7 (1978).

45. It is argued that the cost-of-living differential represents a bonanza to the U.S. expatriate that is not available to citizens remaining in the United States because the latter are not taxed differently despite divergent costs-of-living within the United States. But many foreign
The qualified housing expense deduction is the excess of the taxpayer's "reasonable" foreign housing expenses over a standard "base housing amount" (BHA). The BHA is designed to approximate the housing costs that the taxpayer would incur if he lived in the United States. The BHA represents approximately one-sixth of his net earned income. Thus, keeping the taxpayer's housing expenses fixed, as earned income rises, the BHA also increases, causing a commensurate reduction in the housing expense deduction. FEIA creates uncertainty among taxpayers by imposing a reasonableness standard on these expenses that simply excludes expenses that are "lavish or extravagant under the circumstances." The temporary regulations narrow this uncertainty by listing several expenses not considered to be housing expenses, but much uncertainty remains.

Qualified schooling expenses are the reasonable expenses incurred by expatriates who send their children to kindergarten through twelfth grade in an American-type school. The costs of tuition, fees, books, local transportation, and other expenses required by the school are deductible. If no adequate American-type school exists within a reasonable commuting distance of the taxpayer's home, the additional costs of room, board, and non-

countries, particularly those in the European Economic Community, raise a substantial portion of their revenue through value-added taxes (VAT). Expatriates cannot credit these VATs because they do not fall within the statutory definition of "income tax." I.R.C. § 901(b)(1). Thus for expatriates residing in countries using the VAT, the cost-of-living differential, to the extent that its calculations include VATs, merely corrects this deficiency in the foreign tax credit. See Patton, United States Individual Income Tax Policy as it Applies to Americans Resident Overseas, 1975 DUKE L.J. 691, 722-27.

Curiously, the tables prescribed by the Secretary of the Treasury allow no cost-of-living differential for Canada, a country that Patton, id. at 736 app.1, cites as raising a much more substantial portion of its revenue through consumption taxes than the United States. To the extent that these taxes are not creditable, they represent a clear example of double-taxation that neither the foreign tax credit nor the cost-of-living differential alleviates.


47. BHA is defined as 20% of worldwide earned income (less deductions other than § 913 deductions) less total housing expenses and § 913 deductions other than housing. FEIA § 203(a), I.R.C. § 913(e)(3)(A). This amount equals 16% of earned income after deducting the above expenses but substituting excess housing costs for total housing costs.

48. One commentator noted that this characteristic of the BHA results in an inadequate reflection of the actual housing expenses of highly-paid expatriates. Wehrenberg, supra note 35, at 6-7.

49. FEIA § 203(a), I.R.C. § 913(e)(2)(B).

50. Temp. Treas. Reg. § 5b.913-6(b)(1), 1979-24 I.R.B. 20. The regulations exclude some items that, under certain circumstances, should be deductible as excess costs because they would not have been incurred but for the fact of foreign residence. A prime example is rental expense for furniture, excluded by id. § 5b.913-6(b)(1)(ii).

51. Temp. Treas. Reg. § 5b.913-6(b)(3), 1979-24 I.R.B. 20 also defines reasonableness in terms of "not lavish or extravagant under the circumstances."
local transportation can be deducted. Although this provision offers much-needed relief to the U.S. expatriate with school-age children, it is replete with terms like "adequate" and "reasonable" that give rise to uncertainty. In addition, if the taxpayer decides to send a child to boarding school rather than to an adequate American-type school in his locale, he is burdened with the task of determining the costs charged by the local school because the provision limits the deduction to this amount.

The qualified home leave travel expense deduction allows the taxpayer to deduct the cost of one round trip per year from the foreign country to the United States for the taxpayer and each dependent. Round trips originating in the United States do not qualify for the deduction. The deduction is limited to a "reasonable amount," and, if air transportation is used, this means the lowest coach or economy fare available. Thus the taxpayer is given the burden of discovering the lowest-fare flight available, whether or not he chooses to take it.

Finally, FEIA allows a qualified hardship area deduction of up to $5,000, computed on a daily basis, for taxpayers residing in a "hardship area." A hardship area is defined as any foreign location designated by the Secretary of State as one in which "extraordinarily difficult living conditions, notably unhealthful conditions, or excessive physical hardships exist," and for which a post differential of fifteen percent or more would be

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53. The temporary regulations reduce much of this uncertainty. An American-type school is defined as one that offers a curriculum taught in English, comparable to that offered by accredited schools in the United States, and that would qualify the student for graduation if he were to transfer to a U.S. school. Id. § 5b.913-7(e). The school is not considered "available" if it will not accept the taxpayer's dependents for enrollment, id. § 5b.913-7(d), and is not considered "adequate" if it lacks special facilities required by a mentally or physically handicapped dependent of the taxpayer, or if the school does not offer a college preparatory curriculum and the dependent desires one. Id. The regulations define "reasonable commuting distance" as a distance capable of being travelled by automobile or available water transportation in one hour. Id. § 5b.913-3(f). Further clarifications of "reasonableness" are provided by id. § 5b.913-7(c).
54. FEIA § 203(a), I.R.C. § 913(f)(4).
55. Id., I.R.C. § 913(g). The costs of trips to the taxpayer's principal residence in the United States (whether owned or rented), or to his most recent principal U.S. residence if he no longer maintains one, are deductible. Id., I.R.C. § 913(g)(1)(A). If the taxpayer never maintained a principal residence in the United States, the deduction is limited to the reasonable expenses of a round trip between the foreign country and "the nearest port of entry in the continental United States." Id., I.R.C. § 913(g)(1)(B).
56. FEIA § 203(a), I.R.C. § 913(g)(1).
57. In determining the reasonableness of other forms of transportation, the lowest air fare available without advance booking on the day and at the time of day that the taxpayer or dependent travels remains the standard. Temp. Treas. Reg. §§ 5b.913-8(c), 5b.913-7(c), 1979-24 I.R.B. 22-23.
58. FEIA § 203(a), I.R.C. § 913(h).
provided to any officer or employee of the U.S. Government residing there. The hardship area deduction is allowed in addition to the other section 913 deductions.

In addition to creating section 913, FEIA retains the section 911 exclusion from gross income (with a limitation of $20,000), but limits its availability to taxpayers residing in "camp[s] located in a hardship area" who also satisfy either the bona fide residence or physical presence test. The Act's restrictive definition of "camps" generally limits the exclusion to taxpayers residing at construction sites or other remote workplaces. The section 911 exclusion is elective for each tax year; the taxpayer may choose instead the section 913 deductions. One advantage of electing the latter is that the foreign tax credit is unavailable for foreign taxes attributable to income excluded under section 911 but is allowed if section 913 deductions are taken. The availability of this election also offers a tax-planning opportunity: the taxpayer should maximize deductible expenses in the year in which he elects the section 913 deductions and minimize them in the year in which he elects the section 911 exclusion.

FEIA contains numerous additional details, most of which are not

59. Id., I.R.C. § 913(h)(2); Temp. Treas. Reg. § 5b.913-3(e), 1979-24 I.R.B. 18-19. The Internal Revenue Service has published a list of qualifying hardship areas in Instructions for Form 2555, supra note 44, at §.

60. FEIA § 202(b), I.R.C. § 911(c)(1)(A).

61. Id. § 202(a), I.R.C. § 911(a).

62. Id. § 202(b), I.R.C. § 911(c)(1)(B) defines "camp":

   (i) provided by . . . the employer for the convenience of the employer because the place [of taxpayer's employment] . . . is in a remote area where satisfactory housing is not available on the open market,
   (ii) located, as near as practicable, in the place [of taxpayer's employment] . . ., and
   (iii) furnished in a common area (or enclave) which is not available to the public and which normally accommodates 10 or more employees.


64. FEIA § 202(d), I.R.C. § 911(d).

65. Id. § 202(a), I.R.C. § 911(a) explicitly prohibits the use of the foreign tax credit for foreign taxes allocable to income excluded under that section. Section 913 contains no comparable prohibition, thereby implying that the election of its deductions does not bar the use of the foreign tax credit.


67. For a discussion of FEIA's changes in moving expense deductions, see note 4 supra. For a discussion of FEIA's provisions on the deferral of gain on the sale of a principal residence, see note 5 supra. The Act also includes special rules for taxpayers who maintain a separate household for their spouses and dependents because of adverse living conditions at their tax home. See FEIA § 203(a), I.R.C. § 913(i); Note, supra note 11, at 664. In addition, note that since the § 913 deductions reduce adjusted gross income, the zero bracket amount (standard deduction) can still be used. See FEIA § 203(b), I.R.C. § 62(14).
significant to the discussion herein. In sum, FEIA apparently provides an impressive list of benefits for the U.S. citizen residing overseas. Before analyzing the substance of these benefits, however, the nature of the foreign tax credit and its role in equalizing the tax burdens of U.S. expatriates and their counterparts in the United States must be examined.

C. THE FOREIGN TAX CREDIT

The combined impact of the foreign tax credit (FTC) and the exclusion and deductions provided by sections 911 and 913 substantially differs from the effect of each considered alone. The FTC, unlike sections 911 and 913, is not designed to provide special relief for the U.S. expatriate. Rather, it is intended to prevent the double-taxation that results when income is subject to taxation by two or more countries, as is the case with income earned by a U.S. citizen residing in a foreign country.

Section 901 provides a credit against U.S. income taxes for foreign income taxes paid. This credit is limited, however, to insure that taxpayers do not use the FTC to lower what would otherwise be the effective tax rate on their U.S. source income. This limitation, embodied in section 904, provides that the credit cannot exceed the amount of tax that the

68. I.R.C. §§ 901-908.
69. Patton, supra note 45, at 713.
70. I.R.C. § 901(b)(1). Section 901 also provides a credit for U.S. corporate taxpayers for foreign taxes paid by a foreign subsidiary to the extent that such taxes are paid on earnings distributed to the U.S. corporate taxpayer. See House Comm. on Ways and Means, 95th Cong., 1st Sess., Recommendations of the Task Force on Foreign Source Income 31-32 (Comm. Print 1977) [hereinafter cited as Task Force].
71. I.R.C. § 904(a). The FTC is limited to the following amount (the “allowable fraction”):

\[
\text{taxable foreign income} \times \text{U.S. tax liability before FTC.}
\]

\[
\text{worldwide taxable income}
\]

The result of this calculation is known as the “overall limitation” because it allows the taxpayer to average all of his foreign income and foreign taxes. Task Force, supra note 70, at 32. Prior to the 1976 TRA, an alternative limitation existed, the “per-country” limitation, which provided that the allowable fraction was to be determined on a country-by-country basis. I.R.C. § 904(a)(1) (amended 1976). Under this limitation the first term in the above equation was

income from Country A

\[
\text{worldwide taxable income}
\]

The taxpayer could choose either limitation. The per-country limitation restricted the taxpayer’s ability to average the income from and tax bills of high- and low-tax countries by imposing a ceiling on the amount of income taxes paid to Country A that could be credited against his U.S. tax bill. It allowed him to offset losses generated in any one country against U.S. source income without affecting the amount of the FTC available to him on the basis of income earned in and taxed by a second foreign country. See Task Force, supra note 70, at 32. The 1976 TRA repealed the per-country limitation and required taxpayers to “recapture”
United States would impose on the foreign income. In those cases where only a portion of the foreign taxes are creditable, section 904(c) allows a two-year carryback and a five-year carryforward for the noncreditable portion of the foreign taxes paid.\textsuperscript{72}

The FTC’s impact on a taxpayer’s U.S. tax bill depends upon the relative effective tax rates of the United States and the foreign country levying the tax. When the foreign country levies taxes at the same effective rate as the United States, the foreign tax credit will exactly offset the U.S. tax on the foreign income, thereby eliminating any double-taxation.\textsuperscript{73} When the effective foreign tax rate exceeds the effective U.S. rate, the section 904 limitation operates to limit the credit, thereby creating an FTC carryover.\textsuperscript{74} When the effective foreign tax rate falls below the comparable U.S. rate, however, an interesting result appears.\textsuperscript{75} The taxpayer is allowed a full

any tax benefit received from a year of net foreign losses in a subsequent year of foreign profits by reducing the amount of the FTC available in the later year by the amount of the tax benefit received in the earlier year. \textit{Id.}

72. I.R.C. § 904(c). Use of the carryover is subject to the overall limitation described in note 71 \textit{supra}. Thus it will be useful only for years in which the foreign earned income is taxed at rates lower than the U.S. effective tax rate. Only in such a situation will the U.S. tax bill, to which the carryover can be applied, be larger than that year’s FTC. \textit{See} Example 3, note 75 \textit{infra}. Corporations often attempt to move executives from high-tax countries to low-tax countries to enable them to utilize the FTC carryovers accrued during years worked in the high-tax country. \textit{See} Wehrenberg, \textit{supra} note 35, at 11.

73. The examples in this note and notes 74-75 \textit{infra} illustrate this discussion. \textit{See} Wehrenberg, \textit{supra} note 35, at 12-14 for additional examples.

Example 1: The foreign tax rate equals the U.S. tax rate.

Assume T earns $20,000 taxable income in Country A and $5,000 taxable income in the United States. If the effective tax rates in both Country A and the United States are 20%, T will pay $4,000 (20% of $20,000) in taxes to Country A and will owe $5,000 (20% of $25,000) in taxes to the United States. The FTC will be $4,000, the exact amount of foreign taxes paid, which equals the overall limitation on the FTC, \textit{see} note 71 \textit{supra}:

\[
\frac{20,000}{25,000} \times 5,000 = 4,000.
\]

Thus no double-taxation occurs and T will owe the United States $1,000 ($5000 - $4000 FTC).

74. Example 2: The foreign tax rate exceeds the U.S. tax rate.

Assume the same facts as in note 73 \textit{supra} except that the effective tax rate in Country A now is 50%. T will pay $10,000 (50% of $20,000) in taxes to Country A and will owe the United States $5,000 (20% of $25,000) before the FTC is subtracted. The credit will again be $4,000 because of the overall limitation imposed by § 904, \textit{see} note 71 \textit{supra}. The $6,000 excess foreign tax paid ($10,000 - $4,000 FTC) can, subject to this limitation, be carried back two years and forward five years to offset U.S. tax liability. Once again there is no double-taxation and T will owe the United States $1,000 ($5,000-$4,000 FTC).

75. Example 3: The foreign tax rate is lower than the U.S. tax rate.

Assume the same facts as in note 73 \textit{supra} except that Country A’s effective tax rate is now 10%. T will pay $2,000 (10% of $20,000) in taxes to Country A. This $2,000 will be creditable towards his U.S. tax liability of $5,000 (20% of $25,000), thereby avoiding double-taxation. But T will owe the United States $3,000 ($5,000 - $2,000 FTC) in taxes although his U.S. source income amounted to only $5,000.
credit for the foreign taxes paid, but, because this amount is less than the U.S. tax on the same income, the taxpayer must pay the difference to the United States. Although the taxpayer earned the income in a low-tax country (and, in the case of many U.S. expatriates, will spend it there), the United States increases the tax on this income to U.S. levels. Thus the U.S. system operates to tax the foreign source income at the higher of the U.S. effective tax rate and the foreign country's effective tax rate.  

A major shortcoming of the FTC is its limited scope. It provides a credit towards U.S. income tax bills only for foreign income taxes paid, not for other types of taxes levied by foreign countries, most notably the value-added taxes (VAT) of the European Economic Community. Unless Congress provides some other mechanism to offset these taxes, the U.S. expatriate will continue to be subject to some degree of double-taxation. The extent to which FEIA provides such a mechanism will be explored in the next section.

II

EFFECTIVENESS OF FEIA

Congress designed sections 911 and 913 to encourage foreign trade by U.S. businesses, thereby easing our chronic balance-of-payments problem, and to give equitable relief to U.S. citizens who incur the double-taxation and higher costs associated with living abroad. Congress saw the reduction of the cost to U.S. businesses of hiring U.S. citizens to work overseas as a means of enhancing the competitive position of these businesses and achieving the first goal. Congress attempted to equalize the taxation of U.S. citizens residing at home and abroad by limiting the expatriate's tax burden to that borne by a similarly-situated resident taxpayer. The success of FEIA should be measured in terms of how effectively it achieves these goals.

76. For Example 3, see note 75 supra, this translates into a 20% effective tax rate on the $20,000 foreign source income. The total tax liability on the foreign income is $4,000: $2,000 goes to Country A and $2,000 goes to the U.S. Treasury. The $1,000 U.S. tax on the $5,000 of U.S. source income remains the same.

77. See notes 14 & 45 supra.


80. Id.
A. ENHANCING FOREIGN TRADE

The decision to go abroad, whether made by a business or an individual, involves the consideration of many factors, of which a U.S. tax incentive is only one. The potential for sales, availability of labor, facilities and raw materials, attitude of the foreign government, living conditions, and the tax structure in the foreign country are but a few. Given the variety of factors involved, it is unlikely that the availability of any except quite substantial exemptions or deductions under sections 911 and 913 heavily influences this decision. Thus sections 911 and 913 effectively encourage foreign trade only to the extent that they offer a substantial benefit above that available without them.

In 1977, the General Accounting Office conducted a study of the effects on U.S. foreign trade of the 1976 TRA revisions to section 911. The GAO divided the study into two sections. The first was a selective survey of taxpayers working abroad and their employers. The results indicated substantial concern that the reduction in tax benefits for expatriates under the 1976 TRA would increase the cost of employing U.S. citizens overseas and result in a withdrawal of Americans from overseas jobs, a loss of foreign business for some U.S. firms, and a consequent decrease in U.S. exports.

The second section of the study somewhat contradicted these results. The GAO developed an econometric model of the American economy to

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81. In a less-developed country, the transportation system, the communications network, and the potential for political upheaval and expropriation of assets are additional factors that must be considered. See Note, Section 911 Tax Reform, 54 MINN. L. REV. 823, 830-37 (1970).
82. The authors of one study described the limited influence of tax laws on the decision to do business abroad:

We believe that tax incentives can only counteract the factors limiting investment by making companies more active in investigating opportunities. We do not believe that the added advantage which might be given through any tax measures would be effective in encouraging any substantial amount of investment where detailed investigation of a proposition has resulted in a decision against investment.

83. GAO REPORT, note 7 supra.
84. For a brief discussion of these revisions, see notes 29-31 supra and accompanying text. For a detailed discussion, see 1976 TRA EXPLANATION, supra note 31, at 212-89.
85. GAO REPORT, supra note 7, at 2.
86. Id. at 11-27.
87. Id. at 13-18. The model made the following assumptions:
1) all U.S. citizens affected by the reductions are engaged in selling U.S. exports;
2) all reductions in disposable income resulting from the 1976 TRA would be offset by increases in gross salaries;
3) the employer's increased costs resulting from salary increases would be passed on to the consumer in the form of higher prices;
4) the exports most likely to be affected are industrial supplies, capital goods, and consumer goods.
test the effect of the 1976 TRA reductions. The conclusions indicated that, at worst, the effects of the reductions were small and actually cost the United States less than continuing the pre-1976 law.\textsuperscript{88} The contradiction between the results of the two parts of this study indicates that modifying the tax burden of U.S. expatriates is not the best means of enhancing foreign trade. Moreover, despite the expressed fears of U.S. businessmen, the second section of the study demonstrated that a reduction of the tax benefits of expatriates might actually cost the United States less than the type of increase in these benefits provided by FEIA.\textsuperscript{89}

An examination of the effect of the FTC also demonstrates that FEIA is an ineffectual incentive to foreign trade. FEIA is designed to reduce the U.S. tax otherwise payable on foreign earned income. The FTC produces the same result when foreign income taxes are paid on this income.\textsuperscript{90} Thus the relief provided by FEIA must be measured in terms of the marginal increase in relief above that supplied by the FTC.

When the effective income tax rate of the foreign country equals that of the United States, the FTC exactly offsets the U.S. tax liability on the foreign income.\textsuperscript{91} Adding the benefits of FEIA to this situation, the U.S. effective tax rate will be lowered because there will be less income subject to U.S. taxation. Thus there will be an unused foreign tax credit to be carried over,\textsuperscript{92} but the taxpayer will see no significant immediate change in his

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\textsuperscript{88} The model predicted a slower growth rate for U.S. exports, a slight rise in imports, and an improvement in the U.S. balance of payments. This last prediction, seemingly paradoxical, rested on the assumption that the increased price of U.S. exports would more than compensate for the decreased volume sold. \textit{Id.} at 22.

\textsuperscript{89} Such benefits can be detrimental to U.S. trade. U.S. citizens employed by foreign companies also receive the benefits of FEIA and indirectly pass them along to these companies. Similarly, providing benefits to individuals working for U.S. businesses that are export-replacing or import-increasing injures U.S. trade. \textit{See Note, supra} note 11, at 654-55.


\textsuperscript{90} \textit{See} notes 68-75 \textit{supra} and accompanying text.

\textsuperscript{91} \textit{See} Example I, note 73 \textit{supra} and accompanying text.

\textsuperscript{92} If income is excluded under § 911, the benefit is reduced because the FTC is disallowed to the extent that foreign taxes paid are attributable to excluded income. \textit{FEIA § 202(a), I.R.C. § 911(a).}
When the effective foreign income tax rate exceeds that of the United States, the taxpayer already has an FTC carryover before adding the effects of FEIA. FEIA will simply create a negligible decrease in overall tax liability and a large increase in this carryover.

Only when the effective foreign income tax rate is lower than that of the United States will FEIA provide an immediate benefit. In this case, the taxpayer must pay a U.S. tax on his foreign income. The exclusion or deductions of FEIA will reduce this tax liability. The amount of this reduction will vary depending on the relative effective tax rates and the amount of deductions available (if section 913 is used). Taxpayers living in

93. Example 4: The foreign tax rate equals the U.S. tax rate.
Assume the same facts as in Examples 1-3, notes 73-75 supra: $20,000 income earned in Country A, $5,000 U.S. source income, and effective tax rates in both countries of 20%. If T can deduct $10,000 of his foreign earned income under § 913, the effective U.S. tax rate will decrease from 20% to, for example, 15%. T will still pay $4,000 (20% of $20,000) in taxes to Country A, but T's U.S. tax bill will decrease from $5,000 (20% of $25,000) to $2,250 (15% of $15,000). The overall limitation on the FTC, see note 71 supra, will be:

$$\frac{10,000}{15,000} \times 2,250 = 1,500.$$ 

Thus T will be able to credit only $1,500 of the $4,000 foreign taxes paid against his U.S. tax bill of $2,250. T will owe the U.S. $750 ($2,250 - $1,500 FTC) and will get a carryover FTC of $2,250 ($4,000 - $1,500), subject to the overall limitation, see note 71 supra. The net effect of FEIA will be to decrease T's total tax bill $250 ($5000 - $4750), a 5% reduction, and provide him with a $2,250 FTC carryover.

94. See Example 2, note 74 supra and accompanying text.

95. Example 5: The foreign tax rate exceeds the U.S. tax rate.
Assume the same facts as in Example 4, note 93 supra, except that the effective tax rate in Country A now is 50%. T will pay $10,000 (50% of $20,000) in taxes to Country A. If T can deduct $10,000 of his foreign earned income under § 913, the effective U.S. tax rate will decrease from 20% to 15%. T's U.S. tax bill will again be $2,250 (15% of $15,000). The overall limitation on T's FTC will again be $1,500. Thus T will owe the United States $750 ($2,250 - $1,500 FTC) and get a carryover FTC of $8,500 ($10,000 - $1,500), subject to the overall limitation, see note 71 supra. The net effect of FEIA will be to decrease T's total tax bill $250 ($11,000 - $10,750), a 2.3% reduction, and provide him with an $8,500 FTC carryover.

96. This situation occurs in only a minority of the countries in which U.S. expatriates reside. See TASK FORCE, supra note 70, at 14. Moreover, these countries raise a much greater percentage of their revenue from consumption taxes than does the United States. See Patton, supra note 45, at 736 app.1 & 2. Thus the benefits provided by FEIA generally will simply offset these taxes.

97. See Example 3, note 75 supra and accompanying text.

98. Example 6: The foreign tax rate is lower than the U.S. tax rate.
Assume the same facts as in Example 4, note 93 supra, except that the effective tax rate in Country A now is 10%. T will pay $2,000 (10% of $20,000) in taxes to Country A. If T can deduct $10,000 of his foreign earned income under § 913, the effective U.S. tax rate will decrease from 20% to 15%. T's U.S. tax bill will again be $2,250 (15% of $15,000). The overall limitation on T's FTC will again be $1,500. T will again owe the U.S. $750 ($2,250 - $1,500 FTC) and get a carryover FTC of $500 ($2,000 - $1,500). The net effect of FEIA will be to decrease T's total tax bill $2,250 ($5,000 - $2,750), a 45% reduction, and provide him with a $500 FTC carryover.
low-tax, high-cost countries, such as those in the Middle East and Western Europe, will benefit most. But with an average tax effect of less than $2,000 per taxpayer, it is unlikely that FEIA will significantly alter business decisions about employing U.S. citizens overseas.

B. Equitable Treatment of Taxpayers

The equity of FEIA must be judged on three dimensions. The first considers the tax treatment of the U.S. expatriate vis-à-vis other residents of the foreign country. Equity demands that the U.S. taxpayer bear the same tax burden as a fellow resident earning the same salary and incurring the same expenses. This will occur only if the American pays no U.S. taxes on his foreign earned income and pays only the same income and other taxes as his fellow resident. In countries with effective tax rates equal to or greater than the U.S. rate, the FTC alone achieves this result. FEIA improves this dimension of tax equity only in isolated high-cost, low-tax countries when the sections 911 and 913 exclusions and deductions reduce U.S.-taxable income, thereby reducing the effective U.S. tax rate on foreign earned income. Thus FEIA does little to improve this dimension of tax equity.

The second equity dimension is that of the U.S. expatriate vis-à-vis a similarly-situated taxpayer living in the United States. If the effective tax rate of the foreign country exceeds the effective U.S. rate, FEIA can never adjust the taxpayer's total tax burden below that imposed by the foreign country. Thus the U.S. expatriate will pay more in taxes than his counterpart at home. If the foreign tax rate is lower than the U.S. rate, FEIA will allow the expatriate to take advantage of this lower rate and might even

99. At a total revenue cost of $255 million, see note 9 supra, the average benefit to the 140,000 U.S. taxpayers residing abroad is $1,821.

100. The textual discussion is limited to horizontal equity, or the equity of the tax treatment of one taxpayer vis-à-vis a similarly-situated taxpayer. Another type of tax equity is vertical equity, or progressivity, which requires that the tax burden on an individual increase as his taxable income increases. Gravelle & Kiefer, supra note 89, at 44-46. Some analysts argue that FEIA and similar proposals are inequitable in the vertical equity sense, see, e.g., id.; Note, supra note 11, at 667 n.184, because their deductions and exemptions favor high-bracket taxpayers more than those in lower brackets and most U.S. expatriates are in higher brackets. But this argument ignores the fact that the high costs of living abroad help put U.S. expatriates in high tax brackets. Employers generally reimburse employees for excess costs in the form of taxable allowances, thereby elevating employees into higher tax brackets, but give them no additional cash with which to pay the higher taxes. For examples of the effects of these allowances, see Wehrenberg, supra note 35, at 12-14.

101. See notes 73-75 & 93-95 supra and accompanying text.

102. See notes 96 & 98 supra and accompanying text.

103. FEIA offers the U.S. expatriate relief from U.S. taxation, not a subsidy to offset foreign taxation.
reduce his total income tax liability below that of the U.S. resident. But this income tax advantage may merely offset the double-taxation effects of value-added taxes rather than give the expatriate a true windfall. 104

The third equity dimension on which FEIA must be judged is that of the U.S. citizen residing abroad vis à vis his fellow U.S. expatriate. Prior law allowed a flat exclusion of $15,000 to all taxpayers satisfying the bona fide residence or physical presence test. 105 This exclusion reflected neither the country of residence nor the particular circumstances of the individual taxpayer. The U.S. expatriate living in a high-cost country received the same exclusion as one living in a low-cost country. The single taxpayer was given the same exclusion as the married taxpayer with two children despite obvious differences in housing, cost-of-living, and educational expenses. This failure to distinguish between individuals clearly worked unfairly.

FEIA remedies much of this unfairness. It reallocates the U.S. tax burden on U.S. expatriates to reflect more accurately the different expenses faced by different taxpayers. The cost-of-living differential considers differences in living costs from country to country. The housing expense deduction accounts for both different levels of housing expenses and different housing sizes required by different families. The educational expense deduction accounts for the high costs of educating children overseas. The retained section 911 exclusion upsets this reallocation to some extent by providing a flat $20,000 exclusion to expatriates residing in camps located in hardship areas regardless of the actual costs incurred. But the eligibility requirements for this exclusion are so restrictive that the qualifying taxpayers will almost all be similarly situated—taxpayers living alone in construction camps. Thus the misallocation will not be extreme, and those for whom the flat exclusion would work a hardship can instead elect the section 913 deductions. The $5,000 hardship area deduction is subject to similar criticism, but the deduction is tied to a common factor—residence in a hardship area—thus treating similarly-situated taxpayers in a similar way.

FEIA's complexity represents an additional flaw. 106 It requires the taxpayer to discover costs charged by a local American-type school if his children attend another school, and the costs of the lowest available air fare

104. See notes 14 & 45 supra. A consideration of the U.S. expatriate's standard of living reinforces the conclusion that FEIA does not necessarily provide him with a windfall. The expatriate must incur the potentially high costs associated with going abroad and may be denied government-funded services, such as educational benefits, to which his counterpart at home is entitled. Thus, although FEIA might decrease the expatriate's U.S. tax bill, it need not result in an increase in his standard of living. See TASK FORCE, supra note 70, at 15.


106. This type of objection may seem trivial at first blush, but it is amply supported by the experiences of a professional who was involved in the preparation of numerous returns for overseas Americans. See Patton, supra note 45, at 727-28.
even if he uses another means of transportation. It also substantially increases the taxpayer's burden of keeping records. Moreover, the taxpayer will require the assistance of competent counsel in filing his return. Under prior law, a reasonably well-informed taxpayer could compute his own tax liability and avoid all of these costs. FEIA will also increase administrative and enforcement costs.

III

ALTERNATIVES TO FEIA

FEIA only partially achieves its dual goals of tax equity and encouragement of foreign trade. It represents a political compromise between those favoring stronger support of U.S. expatriates and those favoring the virtual abolition of such support. Perhaps the twin goals of FEIA could be best achieved by independent action.

The effects of tax incentives on the decision to hire overseas Americans are difficult to measure because this decision involves a consideration of many additional factors. A better approach to achieving the goal of supporting U.S. foreign trade might be a direct subsidy aimed at those industries deemed most worthy of support.

The goal of tax equity probably is more difficult to achieve because of both the variety of factors affecting the expenses of U.S. expatriates and the difficulty of determining the standard against which to measure their tax treatment. Any U.S. taxation of foreign income is inequitable to the extent that it results in double-taxation. Moreover, taxing foreign income at the


109. Senator Kennedy said, "The Internal Revenue Code is not a pot of gold at the end of a foreign rainbow for the far-flung operations of American multinational corporations. . . . [American expatriates] enjoy the full benefits of American citizenship, and they should not be allowed to shirk their fair share of the tax burden." 124 CONG. REC. S7310 (daily ed. May 11, 1978).

110. See notes 81-82 supra and accompanying text.

111. The Comptroller General recognized that the burden of promoting foreign trade falls on the tax laws almost by default:

Because of the seriousness of the deteriorating U.S. international economic position, the relatively few policy instruments available for promoting U.S. exports and commercial competitiveness abroad, and uncertainties about the effectiveness of these, serious consideration should be given to continuing Section 911-type incentives of the Internal Revenue Code, at least until more effective policy instruments are identified and implemented.

GAO REPORT, supra note 7, at vi.
higher of the U.S. rate and the foreign rate interferes with the tax incentives of other countries.

A possible solution would be to expand the FTC to take into account the consumption taxes imposed by other countries. The existing FTC, coupled with a substantial cost-of-living credit,112 might serve this purpose. If the goal of tax equity is seen as placing U.S. expatriates in the same position as their fellow residents of the foreign country, a total exemption of foreign income from U.S. taxation—the exemption as originally enacted in 1926—would be appropriate.113 Application of the stricter bona fide residence and physical presence tests now available could largely avoid the abuses that accompanied the earlier law. Regardless of the methods adopted, the goals of tax equity and foreign trade support should be dealt with separately since they are different problems that require different solutions.

CONCLUSION

FEIA is a partial success. It provides greater benefits for U.S. expatriates than did the 1976 TRA. A substantial portion of these benefits probably accrues to U.S. export-inducing businesses. In addition, FEIA’s new deductions reallocate the U.S. tax burden among expatriates more equitably and reduce the double-taxation aspect of value-added taxes. But in attempting to achieve the dual goals of encouraging foreign trade and promoting tax equity, FEIA does not completely succeed in achieving either. It represents a step forward in the taxation of U.S. expatriates, but it will almost certainly not be the last one.

Russell Stephen Dunegan

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112. A credit is suggested to make the method comport with the principle of progressivity. See note 100 supra.
113. See Patton, supra note 45, at 730.