

TAX DEVELOPMENT JOURNAL

VOLUME 6

FALL 2016

64-82

IT'S SUPER EFFECTIVE: SECTION 911 AS A POLICY SILVER BULLET

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The United States is one of the few countries in the world that imposes tax on all of its citizens regardless of where they reside. U.S. citizens resident abroad must deal with the tax systems of both the United States and the country of their residence. The burden of so-called “worldwide taxation” is lessened by the Foreign Earned Income Exclusion, which allows U.S. citizens to exclude their actively earned income up to a cap. This paper explores the policy rationales that support the Foreign Earned Income Exception and recommends slight changes in the exclusion to further those policies.

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“The actions of men are subject to general immutable laws expressed in statistics. What is man’s responsibility to society, the conception of which results from the conception of freedom? That is the question of jurisprudence.”¹

-LEO TOLSTOI

INTRODUCTION

The United States is one of the small minority of countries in the world that uses citizenship as a basis for the imposition of federal income taxation.² Because “the government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete,”³ the courts have given their imprimatur to the use of citizenship as a jurisdictional tie strong enough to tax. The majority of countries, however, base their taxing jurisdiction on residence within the geographic area of their borders.⁴ This essential difference must be kept in mind in any discussion of international tax and the treatment of U.S. citizens who live and work abroad.

The sting of worldwide taxation for the American abroad is lessened by the foreign tax credit, which, subject to some limitations,⁵ allows U.S. citizens to reduce their U.S. federal income tax liability on a dollar-for-dollar basis with any foreign income tax paid.⁶ This results in no U.S. tax owed for those Americans residing in higher-tax jurisdictions than the United States.⁷ Americans resident in lower-tax jurisdictions,

¹ LEO TOLSTOI, *WAR AND PEACE* 511 (Richard Pevear and Larissa Volokhonsky, trans., 1992).

² See Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 449 n. 15 (2007).

³ *Cook v. Tait*, 265 U.S. 47, 56 (1924).

⁴ Kirsch, *supra* note 2, at 448-49.

⁵ See generally I.R.C. § 904.

⁶ I.R.C. § 901.

⁷ *Id.*

however, cannot use the credit to extinguish all of their U.S. tax owed.⁸ The practical result of the foreign tax credit is that Americans resident abroad pay the higher of either their foreign jurisdiction or U.S. tax.⁹ It should be remembered, in this context, that the foreign tax credit applies to citizens of the United States whether abroad or resident within the geographic bounds of the country.¹⁰

One olive branch directed specifically to U.S. citizens abroad is the foreign earned income exclusion (FEIE) of Section 911.¹¹ Section 911 excludes from a U.S. taxpayer's taxable income that amount of actively earned income in a foreign jurisdiction.¹² The exclusion is limited to a statutory amount pegged to inflation which for 2016 is \$101,300.¹³ While the FEIE should be judged on its own merits, it is important to remember that it does not function in a vacuum. In evaluating the effectiveness of the FEIE, it is essential to consider the interaction of the FEIE with both the foreign tax credit and applicable tax treaties. Because the foreign tax credit eliminates any U.S. income tax for those taxpayers living in higher-tax jurisdictions, Americans in higher-tax jurisdictions may prefer to use the foreign tax credit instead of the FEIE.¹⁴ Applicable tax treaties may also reduce the burden of double taxation and lessen the need for the FEIE.¹⁵ While this paper largely considers the FEIE in isolation, the true effect of the exclusion can only be understood in a given country by considering the effect of the foreign tax credit and tax treaties applicable to that jurisdiction.

Part I of this paper briefly sketches the background to and the history of Section 911. Part II explores direct policy rationales advanced by Section 911. Part III examines more indirect, or "meta," rationales for Section 911 in the context of the U.S.' unique citizenship-based system of international taxation. Part IV discusses the specific motivations of proponents and opponents of the FEIE.

⁸ I.R.C. § 904, which limits the foreign tax credit based generally upon a fraction, the numerator of which is the taxpayer's foreign-source income and the denominator of which is the taxpayer's worldwide income.

⁹ See Jeffrey Evans, Note, *911: The Foreign Earned Income Exclusion*, 37 VA. J. INT'L L. 891, 902 (1996-1997).

¹⁰ Compare I.R.C. §901(a) (applicable to all taxpayers), with I.R.C. § 911(d) (defining qualified individuals as those who are bona fide residents of a foreign country).

¹¹ All references to Sections, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended.

¹² I.R.C. § 911(a).

¹³ I.R.C. § 911(b)(2)(D)(ii); Rev. Proc. 2015-53, 2015-44 IRB 615, § 3.32.

¹⁴ See Evans, *supra* note 9, at 910-12. It should be noted that all Americans abroad can utilize the FEIE and may wish to do so to avoid the relatively more difficult foreign tax credit. See, *infra* note 88 and accompanying text.

¹⁵ See, for example, Elisabeth A. Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 RUTGERS L. REV. 428 (1962-63), for a discussion of the impact of tax treaties on double taxation.

I. ORIGINS OF THE FOREIGN EARNED INCOME EXCLUSION

The FEIE originated in the Revenue Act of 1926 as an unlimited exclusion of foreign-source earned income for those U.S. citizens who were abroad at least six months during the taxable year.¹⁶ The provision was spurred by the American export industry, which sought incentives for overseas expansion.¹⁷ While the Senate Finance Committee considered the foreign tax credit to be a sufficient protection from double taxation for U.S. citizens resident abroad, the House Ways and Means Committee's proposed exclusion was ultimately adopted by Congress and passed into law.¹⁸ The FEIE was born.

Congress tinkered with the eligibility criteria of Section 911 several times over the ensuing decades, often considering outright repeal though ultimately narrowing the benefits afforded by the FEIE. For example, in 1953 the House proposed repeal of the FEIE,¹⁹ while the Senate prevailed in its proposal of instead limiting the maximum amount of the exclusion to \$20,000.²⁰ Substantial change did not occur until the Tax Reform Act of 1976, when in addition to lowering the maximum amount of the exclusion, Congress introduced "exemption with progression," requiring that amounts of income remaining after application of the FEIE be taxed at the marginal rate that would apply had there been no exclusion.²¹ Those reforms proved so controversial that Congress returned to the problem of the FEIE in 1978.

The Foreign Earned Income Act of 1978 replaced the FEIE with a series of deductions targeting the higher costs associated with living abroad.²² In switching from an exclusion to a series of deductions, Congress sought a more targeted tool in maintaining equity between Americans abroad and their domestic counterparts.²³ The deductions targeted expenses relating to educational, home-leave travel, cost-of-living and housing expenses incurred while abroad.²⁴ The Foreign Earned Income Act was short-lived; Congress, the IRS, expatriates and business lobbies all agreed that its provisions were too complex.²⁵ In response, the FEIE was revived in a more generous form by the Economic Recovery

¹⁶ Revenue Act of 1926, Ch. 27, § 213(b)(14), 44 Stat. 9, 26.

¹⁷ Renée Judith Sobel, *United States Taxation of Its Citizens Abroad: Incentive or Equity*, 38 VAND. L. REV. 101, 119 (1985).

¹⁸ Revenue Act of 1926, Ch. 27, § 209(a)(1), 44 Stat. 9, 20.

¹⁹ See, e.g., H.R. REP. NO. 894, 83d Cong., 1st Sess. 4-5 (1953).

²⁰ S. Rep. No. 685, 83d Cong., 1st Sess. 5 (1953).

²¹ See Tax Reform Act of 1976, Pub. L. No. 94-455 (repealed 1978).

²² Pub. L. No. 95-615, §§ 201-210, 92 Stat. 3097, 3098 (1978).

²³ Sobel, *supra* note 17, at 131.

²⁴ *Id.* at 134-37.

²⁵ 1981-82 *Miscellaneous Tax Bills, IV: Hearings on S. 408, S. 436, S. 598, and S. 867 Before the Subcomm. On Taxation and Debt Management Generally of the Senate Comm. on Finance*, 97th Cong., 1st Sess. 402-11, 45 (1981).

Tax Act of 1981 and has remained fundamentally unchanged since that time.²⁶

Efforts to repeal the FEIE continue. Proposals to eliminate the provision were put forward during each of the Clinton,²⁷ Bush,²⁸ and Obama²⁹ administrations. Proposals to amend the provision continue as well: Congress reintroduced “exemption with progression” in 2006.³⁰ In 2008, a group of House Republicans proposed legislation to remove the FEIE’s cap.³¹ Beginning in 2008, the FEIE was, and continues to be, automatically adjusted for inflation, which may lead to less frequent congressional tinkering with the provision in the future.³² Despite these attempts at repeal and amendment, the FEIE has shown an uncanny ability to survive. A fundamental question remains though: what policy goals justify maintaining the FEIE and the generous, special treatment it provides to Americans living abroad?

II. DIRECT POLICY RATIONALES

In discussing the Earned Income Act of 1978, the House Ways and Means Committee produced one of the most succinct expressions of the policy intent behind Section 911:

The committee believes that, because of the extraordinary costs of overseas living in many situations, special consideration must be given to Americans working abroad in order to treat them equitably for tax purposes. 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 The presence of U.S. citizens working abroad encourages the purchase of U.S., instead of foreign, goods and services, and, therefore, the incentive provided by [the FEIE] will produce substantial

²⁶ Pub. L. No. 97-34, §§ 111-115 95 Stat. 172, 190-96 (1981). *See* Kirsch, *supra* note 2, at 511-12; Philip F. Postlewaite & Gregory E. Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for Its Repeal*, 65 VA. L. REV. 1093, 1095 (1979).

²⁷ Evans, *supra* note 9, at 891.

²⁸ Hale E. Sheppard, *Perpetuation of the Foreign Earned Income Exclusion: U.S. International Tax Policy, Political Reality, and the Necessity of Understanding How the Two Intertwine*, 37 VAND. J. TRANSNAT’L L. 727, 732-33 (2004).

²⁹ *See, e.g.*, Congressional Progressive Caucus, Back to Work Budget (2014), <https://cpc-grijalva.house.gov/uploads/Back%20to%20Work%20Budget%20-%20Executive%20Summary.pdf> (last visited Apr. 13, 2016).

³⁰ Kirsch, *supra* note 2, at 508.

³¹ H.R. 6614, 110th Cong. § 2 (2008).

³² I.R.C. § 911(b)(2)(D)(ii).

benefits for the U.S. economy. In addition, the presence of U.S. citizens working abroad provides considerable non-economic benefits, such as enhanced international goodwill and mutual understanding.³³

The Committee includes five policy rationales furthered by the FEIE: the higher cost of living overseas, aiding U.S. citizen employment abroad, treating Americans abroad equitably when compared with their local and third-country neighbors, increasing exports and, finally, the goodwill or “ambassadorial” effect of having Americans live and work in foreign countries. Yet these are only some of the direct and indirect policy rationales that support the continued existence of the FEIE. In this part, I explore seven plausible policy rationales that are furthered, at least in theory, by the FEIE.

A. *Spurring U.S. Employment Overseas*

An early and oft-cited policy aim of the FEIE was increasing the employment of U.S. citizens abroad.³⁴ This was a stated goal when the exclusion was first enacted³⁵ and continues to be cited in discussions of the relevance of the exclusion as a tax incentive.³⁶ In effect, the FEIE subsidizes some of the cost of employing U.S. citizens abroad by lessening the tax burden on those citizens, allowing employers to offer a lower wage to effect the same buying power.³⁷ In a global market where U.S. citizens must compete with local and third-country nationals for employment, the exclusion is one means of spurring their employment overseas.

Since the exclusion is targeted at the employee in the form of an individual income exclusion rather than at the employer, the subsidy affects both U.S.-based and other businesses seeking to employ U.S. citizens overseas. Improving the competitiveness of U.S.-based employers abroad is another policy goal of Section 911,³⁸ but the section is not narrowly tailored to that end, since the exclusion is available to all Americans working abroad regardless of their employer’s place of organization or primary place of business.

While by its terms the FEIE applies neutrally to employees of both U.S.-based and other employers, in practice much of U.S. citizen employment overseas likely is a result of an internal transfer or opportunity within a U.S. employer expanding abroad.³⁹ If so, Section 911 may in practice integrate the policy of encouraging U.S. citizen

³³ H. R. REP. NO. 1463, 95th Cong., 2d Sess. 7 (1978).

³⁴ Kirsch, *supra* note 2, at 458.

³⁵ H.R. REP. NO. 1, 69th Cong., 1st Sess. 7 (1924).

³⁶ Kirsch, *supra* note 2, at 513-14

³⁷ Evans, *supra* note 9, at 901.

³⁸ See *infra* notes 47-53 and accompanying text.

³⁹ See generally Kirsch, *supra* note 2, at 512-16.

employment with that of increasing the competitiveness of U.S. employers overseas. In this way, Section 911 may combine the goal of encouraging U.S.-based businesses to employ Americans overseas rather than local or third-country nationals and encouraging Americans to seek and accept opportunities overseas.⁴⁰ In addition, many U.S.-based businesses operate through foreign subsidiaries, and calibrating the FEIE to include those businesses while excluding true foreign-based employers would be difficult and would threaten to exclude employees of legitimate U.S. firms interested in operating abroad from the tax benefit of the FEIE.

A neutral targeting of the exclusion may further another policy goal of the FEIE as announced by Congress: increasing U.S. exports. The basic hypothesis is that Americans abroad prefer American products and will demand those products be brought to their local markets.⁴¹ This would hold regardless of for whom the U.S. citizen worked abroad. The general ease of implementing a tax exclusion and the benefits of increased U.S. employment abroad and, consequently, American exports all tell in favor of a regime like the FEIE.

The FEIE can be seen as a means of achieving economic equity, not only between Americans abroad and those within the United States, but also between Americans abroad and the local and third-country nationals with whom they compete for jobs.⁴² The United States, being one of very few countries to embrace worldwide taxation for its citizens, saddles Americans abroad with a tax burden that is shared by few of their peers.⁴³ Citizenship-based taxation harms the competitiveness of the American worker, and the FEIE is a means of lessening this burden. Though it may seem inequitable to treat Americans abroad differently than Americans who choose to remain in the United States, when the U.S. citizen abroad is compared to those workers he or she competes against, the inequity lies in the opposite direction.

In addition, the need to “even the playing field” between Americans abroad and local and third-country nationals with whom they compete for jobs is not as urgent in higher-tax jurisdictions. Those Americans will pay the host-country’s higher tax burden in the same way as their peers, and the foreign tax credit will ensure they pay no U.S. tax.⁴⁴ The FEIE is targeted at just those jurisdictions where worldwide taxation would put Americans abroad at a competitive disadvantage, and thus its practical application to only lower-tax jurisdictions does not undermine the policy goal of helping Americans compete for jobs overseas.

A question lingers behind these considerations. Should the U.S. tax code be used as a tool to spur citizen employment abroad? There are many reasons why this goal could further U.S. interests, including the increase in

⁴⁰ *Id.* at 513-14.

⁴¹ Kirsch, *supra* note 2, at 520.

⁴² Evans, *supra* note 9, at 895.

⁴³ See Kirsch, *supra* note 2, at 449 n. 15.

⁴⁴ See Evans, *supra* note 9, at 910-12.

American exports discussed briefly above.⁴⁵ In addition, at times when the United States experiences relatively high unemployment, encouraging U.S. citizens to seek employment abroad may lessen the competition for jobs at home. Other possible justifications will be discussed below. Yet it is an open question whether this or any policy goal of the FEIE is a proper use of the U.S. tax system.

B. *Helping U.S. Businesses Compete Overseas*

As described above,⁴⁶ the FEIE aids U.S. businesses abroad by allowing them to pay lower wages because their U.S. employees living abroad in jurisdictions with tax rates lower than those in the United States are able to exclude all or a portion of their compensation from U.S. income taxation.⁴⁷ From its inception, aiding U.S. businesses abroad has been a central goal of the FEIE.⁴⁸ By allowing American workers abroad to exclude a portion of their income from U.S. income taxation, the United States indirectly subsidizes businesses seeking to employ U.S. citizens abroad.⁴⁹

The vast majority of foreign businesses do not need to consider worldwide taxation and its impact on employees, in the same way that U.S. businesses must when expanding abroad. A non-U.S. business expanding overseas needs to consider only the local jurisdiction's taxes when making salary decisions for its workers living abroad. In contrast, without the FEIE, a U.S. business needs to compensate for the U.S. tax burden shouldered by the U.S. citizen abroad in making salary decisions. In lessening this burden on the taxpayer, the FEIE lessens the competitive disadvantage suffered by both American workers competing with local and third-country nationals and, indirectly, by American businesses competing with local and third-country businesses.⁵⁰

Boosting U.S. competitiveness is perennially cited by opponents when Congress considers limiting or abolishing the FEIE.⁵¹ For instance, as the Bush administration considered recommending repeal of the FEIE as part of overall tax reform in 2003, contractors seeking projects related to the rebuilding of Iraq following the U.S.' 2003 invasion championed the exclusion.⁵² Without the FEIE, U.S.-based contractors would have been forced to pay higher wages to their workers than would the third-

⁴⁵ See *supra* note 33 and accompanying text. For a fuller discussion, see *infra* notes 54-66 and accompanying text.

⁴⁶ *Supra* note 33 and accompanying text.

⁴⁷ Evans, *supra* note 9, at 895.

⁴⁸ See Kirsch, *supra* note 2, at 457-59; 511; 513-14.

⁴⁹ Postlewaite, *supra* note 26, at 1123.

⁵⁰ *Id.*

⁵¹ See, e.g., *The Section 911 Mirage: Why the Foreign Earned Income Exclusion and the Foreign Housing Exclusion should not be viewed as tax expenditures*, American Citizens Abroad, 5-6 (Dec. 2, 2013), http://americansabroad.org/download_file/-view/-583/468/.

⁵² Sheppard, *supra* note 28, at 756-58.

country contractors competing for the same projects.⁵³ Citizenship-based taxation would pose too great a drag on those contractors, who were forced to bid against firms that faced no such economic burden.

C. Increasing American Exports

A principal rationale for the FEIE touted at the time of its passage in 1926 was increasing U.S. exports.⁵⁴ In fact, some commentators argue that it was the primary justification for the exclusion at the time.⁵⁵ Proponents hoped that U.S. citizens would act as the sales force of American goods to the rest of the world.⁵⁶ Encouraging citizens to work abroad was a required step to boost exports.⁵⁷ The tax revenue lost by excluding that foreign sales force's salaries was seen as an investment in the long-term boon greater exports would have on the economy.⁵⁸

In addition to acting as a sales force for American goods, spurring U.S. employment abroad may increase exports by placing more Americans, who demand U.S. products with which they are familiar, in foreign environments.⁵⁹ U.S. citizens abroad are likely to demand and consume the consumer goods they used in the United States. And having these guaranteed consumers amongst expatriate communities gives U.S. exporters a beachhead from which to expand in foreign markets.

Substantiating Section 911's impact on exports has proven difficult. Professor John Mutti undertook the most sophisticated study of the effect of Section 911 on the export sector during a residency at the U.S. Department of Treasury.⁶⁰ The Mutti study⁶¹ found that, for the data under consideration in 1978, the repeal of Section 911 would result in a 2.7 percent decrease in overall U.S. exports.⁶² This was based on Mutti's findings that American expatriates increase exports both by consuming U.S. goods themselves and by lowering the cost for foreigners of acquiring those goods.⁶³ Mutti concluded that the repeal of Section 911 would result in the return of some expatriates to the United States, driving down exports as a result.⁶⁴

⁵³ *Id.*

⁵⁴ Sobel, *supra* note 17, at 119-21.

⁵⁵ Kirsch, *supra* note 2, at 516.

⁵⁶ *Id.*

⁵⁷ Sobel, *supra* note 17, at 119-21

⁵⁸ *Id.*

⁵⁹ U.S. DEP'T OF TREASURY, PAPER NO. 33, THE AMERICAN PRESENCE ABROAD AND U.S. EXPORTS 21 (Oct. 1978) (John Mutti, author) [hereinafter cited as "Mutti"].

⁶⁰ Sobel, *supra* note 17, at 147 n. 245.

⁶¹ See Mutti, *supra* note 59.

⁶² *Id.* at 27.

⁶³ *Id.* at 13-14.

⁶⁴ *Id.* at 3.

While the Mutti study is dated, it remains the most oft-cited evidence in favor of Section 911's effect on exports.⁶⁵ A more recent study from 2005, based on Mutti's analysis, found that the repeal of Section 911 would result in an \$8.1 billion decrease in U.S. exports, an amount that supports some 77,115 manufacturing and related jobs.⁶⁶ While such numbers may be disputed, there is evidence to back the claim that the FEIE increases U.S. exports.

D. *Compensate for Higher Cost of Maintaining American Standard of Living*

Americans enjoy a luxurious standard of living when compared to many of their peers around the world.⁶⁷ Such a lifestyle can be expensive to maintain outside of the United States. The FEIE may compensate for the relatively higher cost of maintaining a U.S. standard of living abroad.⁶⁸ While it is less discussed than rationales like increasing American exports, congressional appreciation of this reality can be glimpsed in the Foreign Earned Income Act of 1978,⁶⁹ in which Congress abolished the FEIE and substituted for the exclusion a number of deductions aimed at areas where the cost of living abroad would most affect American expatriates.⁷⁰ The deductions aimed solely at the "excess" cost of living abroad, included deductions for a cost-of-living differential, housing expense, schooling expenses, home leave travel expenses, and moving expenses.⁷¹ This experiment is the clearest indication that the FEIE, which was reinstated in 1981, shares the congressional purpose of compensating for the higher cost of living abroad.⁷²

Yet compensating for the higher cost of living abroad seems to violate equity principles, since U.S. citizens residing at home are given no such consideration. The cost of maintaining the same standard of living across differing localities within the United States can vary enormously. The Internal Revenue Code makes no provision for such variance and leaves it to market forces and the freedom of contract to compensate for

⁶⁵ See, e.g., *Economic Analysis of the Foreign Earned Income Exclusion*, Price Waterhouse Coopers (Nov. 7, 2005), available at <http://www.mecacc.org/pdfs/PriceCoopersWaterhouseReport.pdf>.

⁶⁶ *Id.* at E-1.

⁶⁷ The typical person in the bottom 5 percent of income earners in the United States is richer than 68 percent of the world's population. See BRANKO MILANOVIC, *THE HAVES AND THE HAVE-NOTS* 116 (2012).

⁶⁸ See Brainard L. Patton, Jr., *United States Individual Income Tax Policy as it Applies to Americans Overseas: Or, If I'm Paying Taxes Equal to 72 Percent of My Gross Income, I Must Be Living In Sweden*, 1975 DUKE L. J. 691, 695-700 (1975); Kirsch, *supra* note 2, at 505; Evans, *supra* note 9, at 898.

⁶⁹ Pub. L. No. 95-615, §§ 201-210, 92 Stat. 3097, 3098 (1978).

⁷⁰ Kirsch, *supra* note 2, at 459-60.

⁷¹ See Postlewaite, *supra* note 26, at 1101-08.

⁷² Kirsch, *supra* note 2, at 459.

such differences.⁷³ Yet, again, if Congress has reasons to incentivize Americans to work abroad, the FEIE may be justified on those grounds. Congress may not care where a particular American lives within the United States, and the federal tax system would treat U.S. citizens residing at home the same. But moving U.S. citizens abroad may aid the competitiveness of U.S. businesses abroad and increase American exports, and those factors may explain the special treatment given by Congress to U.S. citizens working abroad.

E. Rebate for Government Services Not Received While Living Abroad

A further reason for lessening the U.S. tax burden on Americans abroad is that those citizens receive fewer of the benefits of U.S. citizenship, and thus it is unfair to tax them at the full rate. While they are abroad, Americans do not travel the interstate highway system, for instance, or visit national parks. How is it just to ask such persons to contribute the full share of taxes? It may be that their fair share of tax owed is the lesser amount owed under the FEIE.

Such an argument is vulnerable to the fact that the U.S. tax burden is seldom levied on a “services rendered” basis. Taxation is not *a la carte* for those government services consumed. Such an arrangement is diametrically opposed to the general plan of an entitlement state, where those able to pay contribute to the maintenance of a government that benefits all, and especially the most disadvantaged in society. The general means of allocating taxation in the United States is the ability-to-pay based on income.⁷⁴ Giving Americans abroad special treatment based on their lesser overall consumption of government services violates this central tenet of tax policy, especially since the progressive nature of the income tax already provides tax relief to low earners.⁷⁵ A blanket exclusion is a windfall for Americans abroad when viewed in this light.

In 2006, Congress amended the FEIE in a manner that lessens this concern. The Tax Increase Prevention and Reconciliation Act of 2005⁷⁶ introduced the “exemption with progression” approach to the FEIE.⁷⁷ The change reduced the tax benefit of the FEIE by requiring that any income that remains after the exclusion is applied must be taxed at the marginal rates that would have applied to that income if the exclusion were not available.⁷⁸ Thus, a small measure of the ability-to-pay regime is restored, since Americans abroad will pay at their higher marginal rates on any income exceeding the FEIE.

⁷³ *Id.* at 486-89; Postlewaite, *supra* note 26, at 1119-21.

⁷⁴ Kirsch, *supra* note 2, at 479.

⁷⁵ *Id.* at 479; Postlewaite, *supra* note 26, at 1121.

⁷⁶ Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 515, 120 Stat. 345.

⁷⁷ Kirsch, *supra* note 2, at 461.

⁷⁸ *Id.*

More fundamentally, it is an open question whether Americans abroad are truly less able to enjoy government services and expenditures. Many federal government services are collective in scope and are unable to be valued on a per-taxpayer basis. Maintaining the U.S. military or foreign service, entitlements and other programs serve society at large rather than individual taxpayers. And the presence of U.S. embassies and consulates in foreign countries may provide more benefits to the American abroad than to Americans resident in the United States. Military evacuations in the case of unrest are a large help to Americans abroad, as is the right to return to the United States.⁷⁹

In addition, Americans abroad are able to utilize the government services of their foreign home. While they pay income or other taxes to the foreign jurisdiction, the foreign tax credit may be a better means of calibrating the proper balance between what taxes are owed to the foreign country and what taxes are owed to the United States. The foreign tax credit, by itself, would ensure that Americans abroad pay the higher of U.S. or foreign country taxes. Yet it may be true that some lower tax jurisdictions do not provide the level of services expected by Americans, or even any services, to the American abroad. In such a case, it may be reasonable to exclude some income from U.S. taxation as a compensation for that reality.

F. *Avoiding Double Taxation*

Another policy sometimes cited as a motivator for the FEIE is the avoidance of double taxation on Americans abroad.⁸⁰ These Americans generally are subject to taxation on their income by the foreign jurisdiction in which they work, and for the United States to tax their income in addition would result in a double tax burden. While this line of argument calls into question citizenship-based taxation in general, if such a taxation scheme is inevitable, at least for the foreseeable future, the FEIE is the best means of counteracting the double taxation effect.

Congress has been unsympathetic to this policy rationale in the past, noting that any double taxation concerns are obviated by the foreign tax credit.⁸¹ Since the foreign tax credit works a one-for-one alleviation of U.S. tax burden for each dollar of foreign tax paid, there should be no double income taxation.⁸² Only in low-tax jurisdictions does the foreign tax credit fail to eliminate all U.S. tax, and in those cases the foreign tax credit generally operates to ensure that the U.S. citizen has a total tax owed equal to what his U.S. tax would have been alone.

⁷⁹ *Id.* at 470-77.

⁸⁰ Evans, *supra* note 9, at 906-07.

⁸¹ *See id.* at 895.

⁸² Kirsch, *supra* note 2, at 505-07.

The foreign tax credit applies only to income-type taxes,⁸³ however, and many jurisdictions do not rely solely on an income tax. Value added or consumption taxes may levy a significant tax burden on Americans resident abroad—a burden that is not similarly felt by Americans resident in the United States.⁸⁴ If U.S. income tax is required for each dollar earned in addition to a consumption tax burden of 20 percent or more on purchases, the United State citizen abroad experiences a tax burden greater than the burden on local residents as well as U.S. citizens resident in the United States.⁸⁵ Principles of equity, both between the U.S. citizen abroad and the U.S. citizen at home, and between the U.S. citizen abroad and his or her neighbors, may favor the use of the FEIE to avoid a portion of this double taxation.

The FEIE may favor U.S. citizens living abroad but does not afford the same benefit to residents of states within the United States imposing a higher tax burden. States impose differing levels of income and consumption taxes on their residents, and the federal income tax system generally does not make special accommodation for such differences.⁸⁶ The U.S. citizen resident in New York is given no special tax consideration when compared with the taxpayer in Texas, though Texas imposes a lower overall tax burden on its residents than New York. The FEIE, on the other hand, singles out the U.S. citizen abroad for special treatment.

Given that U.S. citizens abroad cannot utilize the state and local tax deduction when burdened with value-added and consumption taxes,⁸⁷ some special treatment may be appropriate from a policy point of view. If Congress truly wishes to incentivize U.S. citizens to work abroad, both to help U.S. companies compete and to increase American exports, then granting special tax incentives may be an effective means of implementing that goal. Equalizing the tax burden of residents of the various states does not serve the same congressional purpose. Solving for the former goal does not require solving for the latter.

G. *Creating Goodwill Abroad: The Ambassador Effect*

U.S. citizens working and living abroad may act as informal ambassadors for the United States providing economic and cultural benefits to the country. U.S. citizens working abroad may interact in the workplace with local and third-country nationals, forging bonds of

⁸³ See I.R.C. § 901(b)(1) (allowing credit for “the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States”).

⁸⁴ Kirsch, *supra* note 2, at 505-07; Patton, *supra* note 68, at 722-25.

⁸⁵ Patton, *supra* note 68, at 722-25.

⁸⁶ With the exception, perhaps, of the state and local tax deduction. Since I.R.C. § 164 provides a deduction only for actual taxes paid, however, and so decidedly is less generous than the blanket exclusion of § 911.

⁸⁷ I.R.C. § 164(a)(3).

friendship and burnishing America's image. To recognize this, the FEIE provides an incentive to live abroad.

In an age where the spread and impact of American culture is nearly ubiquitous, the need to provide tax breaks for the recruitment of informal ambassadors may not be worth the cost. Of course, much of the value of informal ambassadors is subjective and depends on how exported American culture is viewed. The very subjectivity of the evaluation may undermine the use of this rationale in the first place: it is just too difficult to determine whether the few persons who are incentivized by the FEIE will have a beneficial or detrimental effect on the U.S.' image abroad.

III. INDIRECT POLICY RATIONALES

In addition to the more direct policy rationales discussed above, there are also two indirect rationales that may support retaining the FEIE as an element of U.S. taxation.

A. *Simplify Tax Preparation for Lower-Income Earners*

One rather simple justification for the FEIE is in the realm of tax preparation. The FEIE is much simpler to utilize and substantiate than the foreign tax credit.⁸⁸ For relatively low-income earners, the FEIE operates to exclude all income from U.S. tax. Given that Americans abroad often deal with two tax systems, that of their host country and that of the United States, it is reasonable to provide the FEIE alternative to the relatively complex rules associated with the foreign tax credit. Even in high-tax jurisdictions where the foreign tax credit would eliminate all U.S. tax, the FEIE would be preferable to taxpayers below its income cap.⁸⁹

B. *Moderate the U.S.' System of Worldwide Taxation*

The United States is one of only a handful of countries that tax their citizens on their worldwide income. Perhaps *the* overarching policy rationale for the FEIE is as a means of moderating worldwide taxation. Without the foreign tax credit and FEIE, U.S. citizens abroad would shoulder the full burden of two tax systems, a burden not shared by their peers abroad. And though equity can be seen through many lenses, surely such a scheme would violate basic notions of fairness.

It is difficult to calibrate the proper mix of equity when considering Americans abroad. It is one thing to compare them to their

⁸⁸ See *The Section 911 Mirage*, *supra* note 51, at 5 (comparing Form 2555 for FEIE to more complicated Form 1116 for the foreign tax credit).

⁸⁹ Just because it is easier to utilize the FEIE than the foreign tax credit does not mean that the FEIE is easy to utilize. Its provisions are complex and its language subject to court interpretation. Taxpayers have faced daunting litigation in arguing the meaning of key terms in Section 911, such as "bona fide residency." See, e.g., *Socurek v. Commissioner*, 300 F.2d 34 (7th Cir. 1962); *Evans*, *supra* note 9, at 894.

peers in the United States, and at that level the FEIE *does* provide special treatment. But those Americans abroad are living, working and competing with third-country and local nationals who have no corollary citizenship-based taxation. What violates equity principles in one context helps close the gap in the other. A central question is who the American abroad should be compared to: U.S. citizens at home or local and third-country nationals abroad.

It is interesting to note that Congress has never claimed this rationale as a motivating factor behind Section 911.⁹⁰ While Congress will couch the policy discussion in terms of competitiveness with foreign nationals, it does not see the FEIE as achieving fairness for Americans abroad compared to their overseas peers. Rather, the fairness is cast in terms of the special benefit given to Americans abroad at the expense of their fellow citizens.⁹¹ And this explains why the FEIE is under a near-constant threat of repeal:⁹² the FEIE is viewed by Congress as a special benefit provided to Americans abroad. The view is quite different when those Americans abroad are compared to their local and third-country national peers, yet Congress resists viewing the FEIE from that more sympathetic perspective.

IV. SUPPORT AND OPPOSITION

Beyond the policy grounds that may motivate the FEIE, Congress has been swayed in the past by vocal interest groups that support the FEIE, including business lobbies and American Citizens Abroad (ACA). Those groups have an interest in maintaining the FEIE to subsidize their operation or residence abroad. Those numbering amongst the opponents of the FEIE tend to be either academic scholars or politicians who believe that the FEIE violates tax equity theories. Yet these opponents do not have the vested interest that animates the supporters of the FEIE, which is understandable with a tax provision that provides a direct benefit to relatively few Americans while dispersing the cost amongst many.

A. *Support for Section 911 by U.S. Citizens Abroad*

American Citizens Abroad (ACA) is a nonprofit organization that advocates for expatriate Americans throughout the world.⁹³ While the organization supports the U.S.' move to a residence-based taxation scheme, until such time as the U.S. federal tax system is so changed, the

⁹⁰ Patton, *supra* note 68, at 702.

⁹¹ S. REP. NO. 938, 94th Cong., 2d Sess. 210 (1976); Sobel, *supra* note 17, at 127 (claiming that Tax Reform Act of 1976 was largely motivated by concern "that the expatriate taxpayer was being treated more favorably than the domestic taxpayer").

⁹² See, e.g., Energy Tax and Individual Relief Act of 1974, H.R. 17488, 93d Cong., 2d Sess. § 311 (proposing a three-year phase-out of the FEIE).

⁹³ See *About ACA, Inc.*, American Citizens Abroad, <http://americansabroad.org/about/> (last visited Apr. 20, 2014).

ACA supports the continued existence of the FEIE.⁹⁴ The ACA's position paper in support of the FEIE points to the double taxation, cost of living and employment policy goals as direct rationales in favor of Section 911.⁹⁵ The paper also argues that forcing the taxpayer abroad to file claiming the more onerous foreign tax credit would require the expense of professional tax preparation even in cases when the taxpayer owed no U.S. income tax.⁹⁶ At its core, the ACA holds that the FEIE is an essential part of moderating the burden of worldwide citizenship-based taxation for as long as such taxation continues.⁹⁷ "The simple, straightforward solution to the complexity and unfairness of citizenship-based taxation that the FEIE is meant to mitigate is the adoption of residence-based taxation."⁹⁸

Beyond policy rationales, the ACA position paper argues that the repeal of the FEIE would have little effect on tax revenues.⁹⁹ Though the Joint Committee on Taxation (JCT) estimated that repeal of Section 911 would raise some \$5.8 billion in annual tax receipts,¹⁰⁰ the ACA argues that this number is misleading in assuming that taxpayer behavior would not be altered as a result of the repeal of the FEIE.¹⁰¹ The JCT report is mistaken, by the ACA account, on a number of assumptions.

First, all taxpayers living in jurisdictions with income tax rates that are higher than those of the United States would simply replace the FEIE with the foreign tax credit with the same result: no U.S. income tax would be owed.¹⁰² The ACA estimates that 80 to 90 percent of Americans resident abroad live in countries that are members of the Organization for Economic Cooperation and Development (OECD), many of which have higher individual income tax rates than the United States.¹⁰³ Repeal of the FEIE would have a revenue neutral effect on those taxpayers. Second, for the small percentage of American workers in lower-tax jurisdictions, repeal of Section 911 would lead to an increased tax bill.¹⁰⁴ This increase would make them less competitive for jobs and could lead to their movement to other, higher-tax jurisdictions or return to the United States, resulting in decreased exports that could reduce tax receipts in the long term.¹⁰⁵

The ACA opposes repeal of Section 911 for both policy and practical reasons, which is understandable given its constituency. The ACA seeks to recast discussion of the FEIE from one of inequity between

⁹⁴ *The Section 911 Mirage*, *supra* note 51, at 5-6.

⁹⁵ *Id.* at 2-4.

⁹⁶ *Id.* at 5.

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *The Section 911 Mirage*, *supra* note 51, at 4.

¹⁰⁰ STAFF OF J. COMM. ON TAXATION, 113TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012-2017 30 (Comm. Print 2013).

¹⁰¹ *The Section 911 Mirage*, *supra* note 51, at 2.

¹⁰² *Id.* at 2.

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 3.

¹⁰⁵ *Id.*

U.S. citizens abroad and their domestic counterparts. Rather, the ACA views the FEIE as a means of decreasing the unfairness of citizenship-based taxation. While Congress seldom views the FEIE from this perspective, the ACA and other lobbies, such as the business community, have been loud enough in the past to continue the survival of the FEIE to the present time.

B. *Opposition to Section 911*

While support for Section 911 is concentrated amongst citizens abroad and employers seeking to do business abroad, opposition to the section is diffuse and less fervent. The most prevalent objection to the FEIE centers on its inequitable treatment of U.S. citizens abroad when compared with their domestic counterparts.¹⁰⁶ Yet such objections are seldom strongly felt by those espousing them.¹⁰⁷ The greatest threat to the FEIE is its status as low-hanging fruit available to offset reductions in tax revenue that result from tax relief legislation.¹⁰⁸ This fact, rather than any principled opposition, may go far in explaining the repeated threats of repeal that have occurred during the past 90 years.¹⁰⁹ Pointing to the inequity of the FEIE is a pretense for using it to make other tax decreases revenue neutral.

Yet the benefits given by the FEIE to businesses and citizens abroad ensure that any attempt to repeal the provision faces loud opposition. The concentration of benefits amongst a small group coupled with diffuse, unquantifiable costs almost guarantees that Congress will retain the FEIE try as it might to repeal it. It is an unlikely victory given to U.S. citizens resident overseas, a group that so stridently argues that its views lack representation in Congress.¹¹⁰

V. TINKERING WITH A BLUNT INSTRUMENT

Given the policies it serves, how might Congress improve the FEIE to further advance the U.S.' interests abroad? Given the unlikelihood of the repeal of worldwide taxation, I propose modifying the FEIE cap to

¹⁰⁶ CHARLES H. GUSTAFSON ET AL., *TAXATION OF INTERNATIONAL TRANSACTIONS* 377 (2d ed. 2001).

¹⁰⁷ A clear exception may be found in Michael Kirsch's scholarship relating to the stronger case of citizenship-based taxation in the modern world. Kirsch, *supra* note 2, at 523-24. Still, the fact that repeal of the FEIE is usually only considered as an offset for tax relief may bolster the case that objections to the provision are secondary motivators.

¹⁰⁸ See, e.g., Jobs Growth and Tax Relief and Reconciliation Act of 2003, 28 U.S.C. § 350 (2003); see also Jonathan Rickman & Herman Ayayo, *U.S. Senate Keeps Foreign Earned Income Exclusion Repeal*, 2003 *WORLDWIDE TAX DAILY* 95-1 (May 16, 2003); Tax Increase Prevention and Reconciliation Act, *supra* note 76.

¹⁰⁹ *Id.*

¹¹⁰ *Representation in Congress, American Citizens Abroad*, <http://americansabroad.org/representation/> (last visited Apr. 13, 2016) (arguing for direct congressional representation for U.S. citizens resident abroad).

dovetail the exclusion with its purported benefits: the FEIE cap should be increased but not abolished, and, rather than tie the cap amount to the rate of inflation, Congress should consider tying it to the health of U.S. exports.

First, as discussed above, Congress has considered abolishing the cap in the past.¹¹¹ Increasing the exclusion cap would greatly strengthen the FEIE's appeal in higher-tax jurisdictions, as U.S. citizens resident in those countries could exempt all of their actively earned foreign income from U.S. taxation. By the same token, abolishment of the cap would effectively doom the foreign tax credit. Removing the cap would undermine one of the key strengths of the interaction of the FEIE and foreign tax credit: preventing the effective use of lower-tax jurisdictions to shield income from U.S. taxation. Since the foreign tax credit ensures that no U.S. tax is owed in higher-tax jurisdictions, abolishing the cap would most strongly affect lower-tax jurisdictions. In those jurisdictions, the FEIE ensures that no U.S. tax is owed up to the FEIE cap, preventing high-income persons from exempting all of their incomes from U.S. tax. If Congress abolished the cap, high-income individuals abroad would have a strong incentive to shift their income to low-tax jurisdictions.

Though the FEIE's cap is important to prevent tax abuse, the cap at present captures far more incomes than is needed to prevent such abuse. Given its goals of increasing American competitiveness and exports abroad, the cap, presently \$101,300 in 2016, should be increased to include all but the most affluent. This would extend the competitive advantages granted by the FEIE to a greater share of U.S. citizen workers while still preventing the exemption from becoming an effective tax tool for the affluent. I would propose setting the cap to an amount equal to the 95th percentile of household incomes, an amount that for 2014 was \$206,568.¹¹²

Second, Congress should consider tying the cap to the strength of the U.S.' export market. The present cap is tied to the rate of inflation, allowing the cap to automatically adjust without the need for congressional tinkering. If the purpose of the FEIE is truly to boost U.S. exports, however, Congress might consider indexing the amount of the cap to the strength of U.S. exports rather than to inflation. For instance, Congress could tie the cap to the percentage change in the trade imbalance from some designated baseline.

I make this suggestion with reservations. First, tying the FEIE cap to the health of the export market would introduce a level of uncertainty that Americans resident abroad may find unsettling. In addition, the risk of the cap drifting over time and requiring congressional rebalancing is more likely if it is tied to an economic indicator other than inflation. Although tying the FEIE's cap to the health of U.S. exports would reinforce the

¹¹¹ H.R. 6614, 110th Cong. § 2 (2008).

¹¹² Camen DeNavas-Walt & Benadette D. Proctor, U.S. Dep't of Commerce, *Income and Poverty in the United States: 2014* 31 (Sept. 2015).

FEIE's policy rationales, it is likely more practical and preferable to tie the cap to the rate of inflation.

CONCLUSION

The FEIE achieves a level of equity between Americans abroad and the local and third-country nationals among whom they live and work. It does so in a measured way, helping relatively low-income earners while preventing high-income earners from making effective use of lower-tax jurisdictions for tax avoidance. In addition, the FEIE advances several policy goals that are of value and justify the cost of the exemption in tax revenues lost. The FEIE strikes a delicate balance considering it was forged with an instrument as blunt and unwieldy as the U.S. tax system. For all it achieves, it is well worth its cost, and Congress would do well to extend its reach.