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NOTES

A Proposal for the Elimination of Section 911

I. INTRODUCTION

THE UNITED STATES is one of the few countries in the world that taxes its citizens on their income no matter where it is earned, and regardless of the fact that they may not have resided within the United States for many years. Under the United States tax format a citizen working abroad is subject to both United States tax on his foreign source income and any foreign-imposed income tax. This system of total taxation creates a great discrepancy between foreign-employed American citizens and foreign citizens whose countries do not tax under the world-wide system. Needless to say, the existence of such a discrepancy, in the absence of any relief, would hinder expatriation on the part of American employees and United States foreign trade would suffer greatly.

The United States tax code alleviates this problem by incorporating a foreign earned-income exclusion, Internal Revenue Code (IRC) § 911, as well as a foreign tax credit, IRC § 901. Each provision provides relief from the threat of double taxation on foreign income, and one is prompted to question the necessity of having two sections of the code perform the same function. In point of fact, the exclusion and the credit do not operate identically. However, the belief persists that the use of the present § 911 exclusion more nearly insures that the foreign-based employee will be taxed to at least the same degree as the American-based worker, and that he will, consequently, receive greater benefits for his tax dollars than he will under blanket use of the foreign tax credit coupled with the abolition of the exclusion provision.¹

This study demonstrates that such a belief is falacious at best. It suggests that the tax-equalizing ends effectuated by § 911 will be manifested as well via the foreign tax credit alone.

Furthermore, the § 911 exclusion was most recently amended in the Tax Reform Act of 1977 whose express purpose it was to simplify the United States tax structure. Even though the scheme of § 911 as it

¹ See Hooton, *The Disappearing Foreign Earned Income Exclusion*, 55 TAXES 522 (1977).

exists today is the result of an effort to ensure that foreign-based American employees are, for tax purposes, affected in a manner closely analogous to that of their United States-based counterparts, this study demonstrates that the same result may be reached through the use of the § 901 credit alone. The paper notes that the use of the credit, absent the exclusion, will have minimal effect on an individual's income tax liability while taxpayers' revenues to the United States will be greatly enhanced. It further points out that the credit better discourages abuses of the tax system. Ultimately, the study suggests that in light of the recent tax reform and simplification efforts made by Congress², a single credit in lieu of a choice between complex provisions would more closely effectuate desired goals. To reach that end, the proposition is set forth that § 911 should be repealed.

II. DESCRIPTION OF THE EXCLUSION

Section 911 is an elective provision³ which allows the United States taxpayer who is either a bona fide resident of another country for one continuous taxable year, or is relocated in another country for a period not less than 17 of 18 consecutive months, to exclude from his income subject to United States taxation that portion of his earned income which is attributable to the services he has performed during his period abroad.⁴ The income to be excluded must arise from sources without the United States, be attributable to the period spent abroad and not be paid by the United States or any agency thereof.⁵ The total amount allowable as tax exempt may not exceed \$15,000 exclusive of any deductions allocable to the excluded amount,⁶ but in the case of an employee of a § 501(c)(3) charitable organization the allowable exclusion is limited to \$20,000.⁷

² See H.R. REP. NO. 95-263, 95th Cong., 1st Sess. (1977).

³ I.R.C. § 911(e).

⁴ I.R.C. § 911(a).

⁵ Treas. Reg. § 1.911-1(b)(1) (1963).

⁶ I.R.C. § 911(c)(1)(A). If no "earned income" arose during the taxable year any deduction which would normally be taken with respect to any earned income is allowed. See *Ivor v. Commissioner*, 63 T.C. 653 (1975), where Petitioner, a foreign resident, earned no income from biological research activities, yet, he deducted expenses related to these activities. The commissioner disallowed the deductions saying they were allocable to income which if earned would have been exempt under the then mandatory provisions of § 911(a). However, the Tax Court held that Petitioner was entitled to deduct his expenses where he received no "earned income" within the scope of § 911(a) even if they would otherwise be attributable to such income.

⁷ I.R.C. § 911(c)(1)(B).

In the instance where a taxpayer earns income which is considered community property under the laws applicable to such income, the taxpayer and his spouse, whether filing jointly or separately, may not exclude an amount which, in the aggregate, exceeds that sum which would be excludable were the community property laws not applicable.⁸ Furthermore, only that portion of earned income which is actually received by the taxpayer within the country in which he performed his income-earning services may be excluded from United States taxation under § 911.⁹

The test of what constitutes a bona fide resident for purposes of § 911 is not directly offered in the Code, but one judicial ruling has suggested a series of criteria to be considered in the determination of bona fide resident status. For the most part these criteria are subjective in nature and include such factors as the intent of the taxpayer not to be a mere transient, his good faith in making the trip abroad, the nature and reasons for any temporary absences from his temporary foreign home, and the extent of the taxpayer's participation in the social and cultural activities of his chosen community.¹⁰ The exclusion of the taxpayer from his host country's income tax laws has been held not sufficient enough a factor to prevent bona fide resident status.¹¹ However, if an individual who earns income in a foreign country is subject to the income tax laws of that country, but such individual has the option of delivering a statement to the authorities of the host nation that he is not a resident of the country for purposes of the income earned there, then, if the individual exercises his option he will not be deemed a bona fide resident of that foreign nation for purposes of United States taxation.¹²

Section 911(b) defines earned income for purposes of § 911 as any wages, salaries or fees received as compensation for services rendered.

⁸ I.R.C. § 911(c)(3). For example, if H earns \$30,000 during the taxable year, and W, his wife, earns nothing, and their marital domicile is in a community property state, then, whether H and W file jointly or separately, they are limited in their exclusion under § 911 to \$15,000, just as if they had domiciled in a non-community property state. If W also lives abroad and earns \$5,000 during the taxable year then H and W may exclude an aggregate of \$20,000 (\$15,000 attributable to H's income and \$5,000 to W's). For further examples of the applicability of § 911(c)(3) see *Treas. Reg. § 1.911-2(d)(4)(ii)* (1963).

⁹ I.R.C. § 911(c)(8).

¹⁰ *Sochurek v. Commissioner*, 300 F.2d 34 (7th Cir. 1962).

¹¹ *Scott, Jr. v. U.S.*, 432 F.2d 1388 (Ct. Cl. 1970).

¹² I.R.C. § 911(c)(6).

The section limits earned income to that remuneration which is reasonable with respect to the services performed.¹³ Any compensation in excess of what the Internal Revenue Service deems reasonable and which represents a distribution of earnings and profits is not excludable.¹⁴ The definition of "earned income" sounds very similar to that of "salaries" for purposes of § 162, business deductions. Thus, one might consider earned income as that amount received which, in light of § 162(a)(1) and the tests of reasonableness developed thereunder, will be deductible to the taxpayer's employer as an ordinary and necessary business expense. Amounts deemed to be dividends received will not be excludable from the taxpayer's income under § 911.

Section 911 steps beyond the mere authorization of an exclusion for foreign-source earned income and related definitions. It provides a scheme for the implementation of the exclusion allowed by this section into the general tax schedule authorized by § 1.¹⁵ The present structure of the Code allows a limited exclusion for § 911 earned income, however, any income which exceeds the limits imposed by this section is subject to the normal tax rates applicable to all United States taxpayers.¹⁶ The excess income is not taxed at the bottom rates as if the initial dollar of excess income was the first dollar earned by the taxpayer, rather, the excess income is grossed up by the excluded income and taxed accordingly. Consequently, the taxpayer will pay taxes on the excess income portion of his earnings as if he were subject to taxes on his entire income and the excess income were the last dollars earned.

The mechanics of § 911 with respect to the individual taxpayer may be illustrated by the following example of a family of four who files a joint return:

¹³ DEFINITION OF EARNED INCOME—[T]he term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation derived by the taxpayer for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation [other] than a reasonable allowance as compensation for the personal services actually rendered. I.R.C. § 911(b).

¹⁴ *Id.*

¹⁵ "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered; . . ."

I.R.C. § 162(a).

¹⁶ I.R.C. § 911(d).

Gross income	32,000
Deductions allowed	4,000
Personal exemptions	3,000
Net taxable income	25,000
<hr/>	
Earned income exclusion	15,000
Deductions allocable to amount excluded	1,000
Net excluded earned income	14,000
<hr/>	
Tax on net taxable income	4,956
Tax on net excluded earned income	1,996
Tax prior to foreign tax credit ¹⁷	2,960
Foreign taxes paid	2,000
Foreign tax allocable to excluded amount ¹⁸	805
Foreign tax credit	1,195
<hr/>	
U.S. tax	1,765
Aggregate tax liability	3,765 ¹⁹
<hr/>	

The final provision in § 911 authorizes the taxpayer who is entitled to the benefits of the foreign earned income exclusion to elect not to have the provision of that section apply.²⁰ In other words, the taxpayer is presumed to take advantage of the benefits of § 911 unless he elects otherwise. Such an election, however, can not be revoked unless the taxpayer obtains the consent of the Secretary of the Treasury.

III. DESCRIPTION OF THE CREDIT

By virtue of § 901, any United States taxpayer may elect to credit against the taxes imposed by the United States tax laws any income,

¹⁷ The foreign tax credit is described in the next section.

¹⁸ Section 911(a) disallows as a credit or deduction those foreign taxes paid which are attributable to the excluded income. The amount of the taxes disallowed is determined by multiplying the amount of foreign taxes paid by the United States tax on the excluded taxable income and dividing by the tax on the net taxable income. The effect of this procedure is to disallow foreign taxes in proportion to that ratio which would be imposed on a sum of taxable income equal to the foreign source income. JOINT COMMITTEE ON TAXATION STAFF, 95th CONG., 1ST SESS., DESCRIPTION OF H.R. REP. NO. 6715 (Comm. Print. 1977).

¹⁹ *Recommendations of the Task Force on Foreign Source Income: Hearings on U. S. Citizens Working Abroad Before the House Ways and Means Committee*, 95th Cong., 1st Sess. n.1 (1977).

²⁰ I.R.C. § 911(e).

war profits, and excess profits taxes paid or accrued during the taxable year,²¹ or any amounts paid in lieu of such taxes to any foreign country or possession of the United States.²² Taxes paid to a foreign country are deemed "in lieu" of an income tax if the foreign nation ordinarily enforces a general income tax law with respect to its citizens to which the United States taxpayer would be subject but for a specific provision made applicable to the taxpayer which requires that he pay a different tax.²³

As to what constitutes an income tax for purposes of § 901, the Code offers no definition. However, the Supreme Court has held that in order to qualify as a creditable income tax under § 901 the foreign tax paid must be substantially equivalent to the United States concept of an income tax.²⁴ That is to say, "the gain on which the foreign tax is levied must be realized in the United States sense, . . . the purpose of the foreign tax must be to reach net gain and it must be so structured as to be almost certain of doing so, . . . and [the] foreign tax must be imposed on the receipt of income by the taxpayer."²⁵ It should be noted that the credit allowed by § 901 encompasses a broader definition of income than does the exclusion provision of § 911. Dividends and capital gains income are specifically excluded from the beneficial treatment of § 911, although these forms of accession of wealth are clearly within the ambits of income for purposes of § 901.²⁶ This is a distinction of some import which at this point should be noted, but it will be discussed in more detail further on in this paper.

There is, of course, a limitation on the amount of foreign tax credit allowed to be taken against the taxpayer's United States tax liability. Such credit may not exceed that proportion of his total tax liability as his foreign source taxable income bears to his world-wide taxable income.²⁷ The effect of such a limitation is to ensure that the

²¹ I.R.C. § 901(b)(1).

²² I.R.C. § 903.

²³ Treas. Reg. § 1.903-1(a) (1963), T.D. 6275 (1957), *as amended by* T.D. 6780 (1964).

²⁴ *Biddle v. Commissioner*, 302 U.S. 573 (1938).

²⁵ *Id.*

²⁶ For purposes of computing the limitation on the taxpayer's allowable credit, capital gain treatment is distinctly treated according to § 904(b)(2).

²⁷ I.R.C. § 904(a). The limitation may be presented mathematically as follows:

$$\text{Maximum credit limitation} = \frac{\text{Total U.S. income tax liability}}{\text{World-wide taxable income}} \times \frac{\text{Taxable income from foreign sources}}{\text{World-wide taxable income}}$$

United States receives its fair share of the total tax revenue paid by a taxpayer. Its fair share is that which is proportionate to the amount of income actually earned domestically. This effect may be simply illustrated. Assume a non-corporate taxpayer (TP) earns \$200,000 of which \$150,000 is earned in a foreign country. TP pays \$50,000 income tax to the foreign nation while the United States imposes a 60 percent tax rate on his world-wide income. The maximum foreign tax credit allowed against TP's United States tax liability is computed as follows:

Total world-wide income	200,000
U.S. tax liability (200,000 x 0.60)	120,000
Foreign source income	150,000
Foreign taxes paid	50,000
Max. credit allowed $\frac{120,000 \times 150,000}{200,000}$	90,000

Ninety thousand dollars (\$90,000) is creditable against TP's \$120,000 tax liability giving the United States \$30,000 in tax revenue. Thus, \$30,000 is the fair share of tax revenue due the United States by virtue of the share of total income which was earned domestically, e.g., one-fourth. Note that the taxpayer who elects the foreign tax credit will never pay less total taxes than his United States tax liability. If he is taxed at a low foreign rate he will still pay the balance between taxes paid abroad and his United States tax liability. Thus, all taxpayers in the same income bracket will pay at least the same amount of tax dollars. The significance of this fact will be discussed later.

It should be mentioned that a § 901 credit against any foreign taxes paid on the first \$15,000 of earned income, as defined in § 911(b), may be taken only in lieu of the § 911 exclusion.²⁸ In this way the taxpayer is prevented from reaping the benefit of both a credit and exclusion on the same segment of earned income. This preventative measure was not always in effect, however, as will be shown later.

IV. HISTORY OF SECTION 911

The Foreign Source Earned Income Exclusion, § 911, was originally enacted in 1926 as § 213(b)(14) of the Revenue Act of 1926.²⁹ The exclusion was the result of Congress' awareness that foreign countries

²⁸ I.R.C. § 911(a).

²⁹ Revenue Act of 1926, ch. 27, 44 Stat. 9 (1926).

generally did not tax their nationals on income they earned abroad, and the absence of similar provisions in the United States Code meant discouragement of American foreign trade.³⁰ With the exception of the Revenue Act of 1962³¹ and the Tax Reform Act of 1976³² little modification has taken place in its structure despite a history of great Congressional scrutiny.³³ Its evolution has been very odd, though, because generally each time either house of Congress desired amendment of the provision the other house assumed a reactionary posture and few drastic alterations ever materialized.

The 1926 law imposed a mandatory exclusion on all foreign source earned income of a taxpayer who was a bona fide resident of a foreign country for six months. The law was not without its opponents even at that early date. The House Ways and Means Committee had introduced the provision, but the Senate Finance Committee objected to the inclusion of the section claiming that in light of the already existing foreign tax credit a further exclusion was unnecessary.³⁴

Section 213 became § 116(a) in the Revenue Act of 1928³⁵ and only a series of relocations of the "earned income" definition occurred between 1926 and 1932.

In 1932, in its report on the Revenue Act of 1932,³⁶ the Senate Finance Committee reiterated its position in opposition to the income exemption:

This section has been amended by the elimination of the subsection excluding from gross income amounts received by bona fide nonresidents of the United States from sources without the United States. Your committee believes that there is no reason for the continuance of this exemption in the case of citizens of the United States residing abroad for the reasons that under other sections of the Act such citizens are granted a credit for income taxes paid foreign countries and should not be further relieved from Federal income taxes. Furthermore, a considerable proportion of the individuals previously benefited by this subsection have been employees of the United States who, because of their status as such, were usually exempt from any foreign tax upon

³⁰ H.R. REP. NO. 1, 69th Cong., 1st Sess. (1926).

³¹ Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962).

³² Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525 (1976).

³³ Slowinski & Williams, *The Formative Years of the Foreign Source Earned Income Exclusion: Section 911*, 51 TAXES 355 (June 1973).

³⁴ S. REP. NO. 52, 68th Cong., 1st Sess. (1926).

³⁵ Revenue Act of 1928, ch. 852, 45 Stat. 791 (1928).

³⁶ Revenue Act of 1932, ch. 209, 47 Stat. 169 (1932).

their compensation received from the United States; these citizens are not believed by your committee to be entitled to a complete exemption from the Federal income tax upon such compensation.³⁷

As a result of the Senate position, amounts thereafter paid by the United States government or its agent to government employees were not to be excludable.³⁸ The 1932 Act marked the initial erosion of a potentially great tax shelter.

The Revenue Act of 1942³⁹ introduced a full year foreign residency requirement into § 116(a) thereby further limiting the availability of the foreign income exclusion. Interestingly enough, at this time it was the House that objected to the exemption. A report of the House Ways and Means Committee disclosed their opinion that not only would repeal of the exclusion serve revenue needs, but it would "remove the existing unjust discrimination favoring individuals receiving their compensation for services abroad from non-governmental sources."⁴⁰ The House went so far as to pass a bill repealing § 116(a),⁴¹ but the provision remained intact for nine years.

In 1951, Congress further tightened the restrictions on the exclusion provision by providing a requirement that bona fide residency be manifested for an uninterrupted period of one taxable year, or that the taxpayer be physically present in the foreign country for seventeen of eighteen months.⁴² The House, a short time later, sought to repeal the 17 month test due to what it felt were serious abuses of that provision. The belief was that the presence test provided loopholes which when exploited allowed certain taxpayers to be exempt from both United States taxes, and also, exempt from any foreign taxes if they had not remained in the foreign country for that nation's requisite period. However, the Senate Finance Committee, believing that legitimate business purposes prompted the inclusion of the provision, concluded that a few bad eggs were not going to spoil the bunch.⁴³

The greatest degree of deterioration in the impact of the foreign

³⁷ S. REP. NO. 665, 72d Cong., 1st Sess. (1932). The Senate proposition for the elimination of the exclusion was overridden in committee.

³⁸ Hooton, *supra* note 1, at 523, 524.

³⁹ Revenue Act of 1942, ch. 619, 56 Stat. 798 (1942).

⁴⁰ H.R. REP. NO. 2333, 77th Cong., 2d Sess. 50 (1942).

⁴¹ Revenue Act of 1942, § 134, H.R. 7378, 77th Cong., 2d Sess. (1942).

⁴² Hooton, *supra* note 1, at 524.

⁴³ S. REP. NO. 685, 83d Cong., 1st Sess. (1953).

source income exclusion occurred after 1953⁴⁴ when a \$20,000 exclusion limit was imposed on taxpayers who qualified for the § 116(a) exemption under the physical presence test.⁴⁵ This was followed in 1962 by an identical limit for those obtaining exemption status by virtue of the bona fide resident test,⁴⁶ except that the ceiling was extended to \$35,000 for those taxpayers whose period of foreign residency exceeded three years.⁴⁷ Nonetheless, even this benefit was soon mitigated when, in 1964, the provision was amended to reduce the ceiling to \$25,000.⁴⁸ It is interesting to note that during the Congressional debates surrounding the enactment of the Revenue Act of 1964 one Senator argued for, and the Senate later adopted, an amendment which would have dramatically limited the foreign earned income exclusion by placing a ceiling of \$4,000 on the exemption, and reducing the three-year limit to \$6,000.⁴⁹ The Senator argued, apparently quite persuasively, that, "[W]ith many thousands of individuals establishing residence in tax havens it is unfair to give them a tax exemption of \$35,000, particularly when the law allows only \$600 for the rearing and the education of a child at home."⁵⁰

While Congress did not enact the Senator's proposals the argument in opposition to the exclusion did evince a reaction from the Senate indicative, once again, of a desire to repeal the exemption provision for foreign source income. The two houses, however, simply have been unable to get together at any one point in time with respect to the repeal of the exemption.

Peculiarly enough, in 1975 it was the House Ways and Means Committee that proposed the elimination of the § 911 exclusion.⁵¹ The Committee pointed out that many United States taxpayers in addition to obtaining the benefits of the exclusion were residing in countries

⁴⁴ Section 116(a) became Section 911 in the codification of the Internal Revenue Code of 1954.

⁴⁵ Technical Changes Act of 1953, § 204, 67 Stat. 615.

⁴⁶ Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962).

⁴⁷ *Id.* § 12.

⁴⁸ Revenue Act of 1964, § 237(a), Pub. L. No. 88-272, 78 Stat. 19 (1964).

⁴⁹ Slowinski & Williams, *supra* note 33, at 361, 362.

⁵⁰ *Id.* at 362 (quoting remarks of Senator Gore) 110 CONGRESSIONAL RECORD 1764 (1964). A general proposition supporting the argument in favor of the foreign source earned income exclusion concerns the higher cost of living abroad, and the additional after-tax dollars needed to maintain an American-style home in a foreign country. This proposition will be examined in the following section.

⁵¹ H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 199 (1975).

which did not tax United States citizens employed in that country (particularly when their income was not received within the host nation, but rather was sent abroad to foreign banks). Consequently, the tax savings for those citizens was enormous. Furthermore, these taxpayers were allowed, in addition to the exemption, to take the foreign tax credit against any taxes paid on the excluded \$20,000. The resulting savings under that system could approach the equivalent of the amount of tax on \$40,000 of income.⁵² The Committee proposed a phaseout of the exclusion over four years. The \$20,000 exclusion was to be reduced to \$15,000 in the first year, \$10,000 in the second year, \$5,000 in the third year and zero in the fourth. The three-year \$25,000 exclusion, meanwhile, would have been cut to \$18,750, \$12,500, and \$6,250 over the same time span.⁵³

The Senate Finance Committee, however, was then of the opinion that the phaseout was undesirable. The Senate held to the, by then, time-worn proposition that the foreign source earned income exclusion needed to be retained "so that the competitive position of United States firms abroad is not jeopardized."⁵⁴ In conference, the House and Senate proposed a number of changes which, though not as severe as the House proposals, in effect, slashed considerably the tax advantages offered by § 911. These amendments may be summarized as follows: the limitation on the excludable amount was reduced to \$15,000, \$20,000 for charitable organization employees; foreign taxes paid which are allocable to the excluded income are not now creditable under § 901 against United States income tax liability; the taxpayer's liability for income earned in excess of the excluded amount is now determined at the higher rates which would be applicable to such income if the excluded amount were not excluded; only earned income received by the taxpayer in the country in which it was earned is excludable;⁵⁵ the entire § 911 exclusion is an elective provision.

⁵² *Id.* at 200.

⁵³ *Id.* at 201.

⁵⁴ S. REP. NO. 94-938, 94th Cong., 2d Sess. 210 (1976).

⁵⁵ Unless the purposes for receiving income outside of the country where it was earned were in no way tax avoidance purposes. The Senate noted:

The tax avoidance purpose does not have to be the only purpose for receiving the money outside of the country in which earned, nor does it have to be the principal reason for receiving the money outside of that country. It is sufficient that it be one of the purposes. It is the committee's intention that the fact that the country in which the income is earned does not tax amounts received outside of the country be viewed as a strong indication of a tax avoidance purpose.

Id. at 211, 212.

V. REPEAL OF SECTION 911

Nearly every amendment made to the Foreign Source Earned Income Exclusion by virtue of the Tax Reform Act of 1976 suggests that § 911 ought to be repealed. From the point of view of Congress, the deletion of § 911 would represent a great step toward the much desired goal of tax simplification. Whether such a repeal is feasible, however, requires an examination of just what effects the present § 911 exclusion has upon the taxpayer who avails himself of that provision as opposed to the consequences of choosing to employ the foreign tax credit alone.

For the individual residing abroad there is a significant difference between the exclusion provided by § 911 and the credit allowed according to § 901. The effect of either choice on the individual's overall tax liability may be roughly illustrated by the following chart:

level of foreign tax	Exclusion taken		Exclusion not taken	
	high	low	high	low
Earned Income	50,000	50,000	50,000	50,000
Personal Exemptions	3,000	3,000	3,000	3,000
Deductions:				
attributable to Sec. 911	1,000	1,000	--	--
not attributable to Sec. 911	1,000	--	1,000	1,000
Foreign Income Exclusion	15,000	15,000	--	--
Taxable Income	<u>30,000</u>	<u>30,000</u>	<u>46,000</u>	<u>46,000</u>
U. S. Tax before credit (no General Credit)	8,884	8,884	13,484	13,484
Foreign Taxes:				
amount paid	25,000	--	25,000	--
amount attributable to excluded income	6,236	--	--	--
amount allowable as a credit	18,764	--	25,000	--
creditable foreign tax	<u>8,884*</u>	--	<u>13,484*</u>	--
Total tax liability (U.S. plus foreign)	<u>25,000</u>	<u>8,884</u>	<u>25,000</u>	<u>13,484</u>
Liability of United States domestic resident taxpayer				13,004

*The difference between the amount allowable as a credit and the actual creditable amount may be carried over as provided in § 904(c).

It is apparent that for an individual working in a high effective tax rate country it is beneficial to elect out of § 911 while the resident of a low tax rate country will be more favorably treated if he chooses the exclusion. The practical significance of this differential in tax liability centers around the wide latitude afforded the expatriate in his decision as to the country in which he should settle. It can be noted that he has the opportunity to decide whether he will pay considerably more taxes than his domestically based counterpart (by residing in a high tax foreign country and choosing either the credit or exclusion) or considerably less taxes (by moving to a low tax country and taking the exclusion), albeit potential markets play a role to limit his decision.

It would seem that in an effort to simplify the overall United States tax structure the most logical approach, as far as the treatment of foreign earned income is concerned, is to eliminate the choice between two alternatives which may produce identical results. It appears that in the extreme situation represented by the high tax country the taxpayer will sustain the identical world-wide tax liability whether he chooses to use the exclusion or the credit. In this regard it should not matter to the taxpayer whether the exclusion is deleted from the Code.

On the other hand, in the country which imposes low foreign taxes on the United States citizen, the taxpayer will pay the same amount as the United States based employee if he chooses to elect the foreign tax credit. Should he elect the § 911 exclusion, however, he will benefit to such a degree that he will, in total, incur considerably less total tax liability than a United States resident earning the identical income. Needless to say, repeal of the exclusion provision will greatly affect the low tax country resident, for the treatment afforded by the election of the foreign tax credit clearly is not identical to that of the exclusion. Clearly, the loss of the exemption means the loss of a tremendous break for the foreign resident taxpayer. The important issue is whether the break is really desirable at all. If it is not, then the repeal of the § 911 exclusion must be deemed an effective means to a desirable end.

From a revenue earning standpoint the tax exemption provision clearly must be deemed an undesirable vehicle for providing a balance between sufficient inducements to work abroad and maximum tax collection. In 1972, for example, United States taxpayers living abroad excluded \$1.4 billion from income tax returns.⁵⁶ Had the exclusion not

⁵⁶ *Recommendations of the Task Force on Foreign Source Income: Hearings on U.S. Citizens Working Abroad Before the House Ways and Means Committee, 95th Cong., 1st Sess. (1977).*

been available the revenue lost to the United States through the foreign tax credit would have been \$60 million dollars less.⁵⁷ Meanwhile, statistics indicate that the number of individuals who claimed the exclusion totaled 102,000, resulting in an average tax exemption of \$14,000.⁵⁸ These figures suggest that while the revenue to be gained by the United States in the event of elimination of the exclusion totals \$60 million, the average increase in income taxes paid by the individual taxpayer would be only \$588, or 4.2 percent, per return.⁵⁹ Thus, it is apparent that elimination of § 911 would greatly benefit the United States in terms of tax revenue while causing only a relatively marginal increase in the individual's overall tax liability. This effect seems to hint that repeal of the foreign source income exclusion might be a very feasible means of simplifying the Code without doing any significant harm to the individual.

An elimination of the § 911 exclusion would end what proponents of the system have long felt is a necessary incentive to tempt workers to move abroad. It is felt that the cost of living differentials between the United States and foreign countries is significant enough to cause United States employees to shy away from foreign residency in the absence of the benefit provided by the exemption. This argument loses force, however, in light of the other sections of the Code, none of which grant any special treatment for individuals living in localities within the United States which boast higher costs of living than other areas. Supporters of the repeal of § 911 point to 1975 figures indicating that the cost of living in the New York metropolitan area hovered over 20 percent higher than the national average. At the other end of the spectrum, Houston displayed a standard of greater than 10 percent below the mean,⁶⁰ yet the tax treatment of United States citizens working in either city is identical. The fact of the matter is that living abroad is not always costlier than living in the United States,⁶¹ and it seems clear that a tax exclusion solely for the benefit of individuals working abroad due to cost of living differentials is highly unwarranted.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ This figure is determined by dividing the overall savings in taxes paid by taxpayers who use the exclusion rather than the credit (60 million) by the number of taxpayers who use the exclusion (102,000).

⁶⁰ *Recommendation of the Task Force on Foreign Source Income, supra*, note 56.

⁶¹ *Id.*

If employers must tempt employees to move abroad with the incentive of greater access to after-tax dollars, then these excess dollars ought to be attributable to higher salaries to the employees which are, in turn, deductible from employers' gross income as ordinary and necessary business expenses. In the alternative, if the increased salaries would place too great a burden on smaller business employers the excess revenue flowing to the Treasury by reason of the exclusion repeal might be used to some extent to provide a government subsidy for the increased costs to small employers. This solution would insure that the level of exported services and technologies would not be diminished due to the loss of the tax exemption incentive. There may, however, be some problems with this subsidy in regard to established principles of international law covering government grants and bounties.

There is a counterargument to the higher salaries proposal available to the large business employers centering around the notion that elimination of the exclusion will result in higher costs of production to the major exporting companies. These higher costs will, in turn, be reflected in the increased prices of goods sold abroad which will adversely affect the level of American exports. It is just this fear which has historically led to Congress' belief that "the exclusion for income earned abroad under present law should be retained so that the competitive position of United States firms abroad is not jeopardized."⁶²

However, despite its broader application, there can be little doubt that the foreign earned income exclusion is primarily an effort to benefit exporters of American manufactured goods. The House Ways and Means Committee reported in 1925, in reference to impending legislation to adopt the exclusion:

In an endeavor to take one further step toward increasing our foreign trade it is recommended in this paragraph that there shall be excluded from gross income in the case of our citizens employed abroad in selling our merchandise *amounts received as salary or commission for the sale for export of tangible personal property produced in the United States* in respect of such sales made while they are actually employed outside the United States if they are so employed for more than six months of the taxable year.⁶³

Any fear on the part of Congress that repeal of the exclusion might threaten the level of United States exports ought to be assuaged in

⁶² S. REP. NO. 94-938, 94th Cong. 2d Sess. 210 (1976).

⁶³ H.R. REP. NO. 1, 69th Cong., 1st Sess. (1925) (emphasis added).

light of the availability of the Domestic International Sales Corporation provisions of the Code,⁶⁴ which afford the truly export-oriented businesses valuable tax deferrals on their profits accumulated abroad.

A further benefit accruing to the foreign resident taxpayer by virtue of § 911 arises from the fact that income which is tax exempt serves to offset any high foreign sales or value-added taxes imposed by foreign governments. Normally, United States residents may deduct from their income any State and local, sales and property taxes they pay. United States residents, however, may not deduct Federal excise taxes on certain luxuries, which taxes are often the equivalent of foreign value-added taxes. Furthermore, the foreign resident may, as a result of § 901, credit against his United States tax any foreign local income taxes and any foreign equivalents of the United States social security taxes. United States residents are not allowed such credits. In light of the many creditable items available to the expatriate United States taxpayer any argument that the exclusion is necessary to offset burdensome foreign taxes loses credibility.

An additional reason for repealing § 911 introduced earlier in the discussion concerns the definition of earned income. It was noted that § 911(b) excludes from the benefits of the tax exemption dividends attributed to unreasonably excessive salaries. The reasonableness of salaries within the ambits of earned income is most likely determined in the same manner as the salaries allowable as a deductible business expense. The determination of what constitutes a reasonable salary for an employed individual residing abroad involves complicated administrative investigation which might easily be avoided in the absence of § 911. If the foreign tax credit alone is used there is no necessity for dividing the taxpayer's income and the problems of determination which accompany the allocation disappear. In keeping with the aims of Congress to simplify the tax structure, § 911 and its allocation complexities ought to be eliminated.

A review of the Tax Reform Act of 1976 reveals an amendment concerning the treatment of income received outside of the country in which it was earned.⁶⁵ Formerly, a taxpayer might have performed services in a country which imposed a high tax rate only on income received within that country, then having the compensation sent to

⁶⁴ Domestic International Sales Corporations, generally referred to as DISCs are authorized to receive special tax benefits under §§ 991-997.

⁶⁵ I.R.C. § 911(c)(8).

another country which had a low tax rate on earned income. In this way the taxpayer could take advantage of a particular large market in which to earn the income, yet, escape with paying little or no foreign income tax. In addition, if the taxpayer availed himself of the § 911 exclusion he was able to earn close to \$40,000 tax free.⁶⁶ In an effort to stop this "country hopping" Congress amended § 911. However, amendment was not necessary; rather, repeal of the section would serve to effect the same result because the tax credit may prevent "country hopping" for tax avoidance purposes entirely. It has been demonstrated that if the taxpayer resides in a low tax rate country he will have the same amount of overall tax liability as his United States counterpart. It would matter little if his country of residence did not tax "foreign earned" income received inside its borders since the taxpayer would still be subject to United States tax treatment on his income wherever received. In this way the foreign tax credit alone suffices to insure a lessening of "country hopping."

An interesting point to consider involves the current devaluation of the American dollar abroad and its effects on United States expatriates. The devaluation of the dollar means that American employees residing in foreign countries can buy less for their money than they could prior to the period of devaluation. It may be argued that the foreign tax credit is not reflective of this economic phenomenon which afflicts all American taxpayers living outside of the United States. For this reason the credit is unresponsive to the needs of the taxpayers. Nevertheless, had Congress truly enacted § 911 with a bent toward providing Americans overseas with extra dollars to spend, it ought to have increased the ceiling on the § 911 exclusion rather than have lowered it. By decreasing the exclusion Congress signified its absence of desire to reflect the spending power of the dollar in the overall tax scheme. It would appear, therefore, that from a monetary point of view it makes no difference whether it is the credit or exclusion that is available to the taxpayer living abroad.

Certainly, Congress cannot be said to be unconvinced that the foreign source earned income exclusion is, for all intents and purposes, an unnecessary provision in the Code in terms of the efficacy of Subchapter N in ensuring comparable taxation between foreign and domestic resident taxpayers. The recent amendments to § 911 in-

⁶⁶ Prior to the Tax Reform Act, the Code permitted an exclusion of up to \$20,000 plus a concurrent foreign tax credit.

roduced an elective element to the exclusion provision, whereas prior to the Tax Reform Act of 1976 the section had been mandatorily imposed. One might hypothesize that in transforming § 911 from a mandatory provision to an option Congress realized that sole use of the foreign tax credit in many instances will produce tax effects comparable to the use of the exclusion. It is fair to suggest that an available choice between the two tax equalizing sections of the Code affords the expatriate taxpayer an opportunity to simplify the calculation of his tax return by choosing to use only the tax credit as a means of minimizing his overall tax liability, rather than fiddling with a series of complex calculations and Code provisions. As we have seen, the amount of after-tax income lost to the taxpayer as a result of the sole use of the credit is, on the average, rather small, but the effect in terms of simplifying the United States tax structure is far greater. There seems to be little reason to stop the simplification process with the institution of an elective feature into § 911. The provision ought to be eliminated entirely.

It cannot be claimed, however, that there do not exist particular costs borne by a foreign resident taxpayer which are deserving of special tax relief. Unusual and excessive living costs incurred by taxpayers abroad might easily be dealt with by means of deductions from gross income. These deductible living costs might include some items as extraordinary rents, the cost of services normally provided by local government in the United States through the use of tax dollars, travel to family in the United States, or private schooling for children. It has been reported that the Carter administration has proposed a series of deductions designed to give relief to Americans working abroad who incur a number of these expenses.⁶⁷

VI. CONCLUSION

The United States taxes its citizens on their world-wide income. There can be no doubt that some manner of relief is appropriate in those instances when a taxpayer is subject to foreign taxation in addition to his United States tax liability. The current system provides for a choice between a tax exclusion and a credit in order to alleviate the double tax burden for the United States taxpaying foreign resident. Either method will produce comparable results, and the necessity for

⁶⁷ Wall St. J., Feb. 24, 1978 at 12, col. 2.

cluttering up the tax system with a series of alternative calculations is questionable. In view of recent Congressional attempts to simplify the United States tax structure it seems logical to eliminate one of the tax equalizing provisions, and the arguments set forth in this paper strongly suggest that the § 911 exclusion ought to be repealed.

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EDITORIAL COMMENT

As this Note went to press Congress passed and the President signed into law the Foreign Earned Income Act of 1978. The new law effectively repeals § 911 as it stood following the Tax Reform Act of 1976. In its place a series of deductions are now available to the American expatriate. These deductions are designed to compensate Americans living abroad for any excessive costs of living experienced. The new law takes effect in those taxable years beginning in 1978, although certain workers living in so-called 'hardship camps' will still be permitted to elect an income tax exemption similar to the old § 911.

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