

Sound and Fury, Signifying What? The U.S. Foreign Earned Income Exclusion Debate

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Congress possesses the constitutional authority to tax American citizens on their worldwide income.¹ Adopting and seeking to enforce such a policy of worldwide citizenship-based taxation has placed the United States at odds with the tax practices of all of its major allies and trading partners, whose territorial systems of taxation do not reach income that their citizens earn abroad.² At the same time, a range of policy concerns and political pressures have resulted in legislation that seeks to avoid the double taxation of U.S. taxpayers with foreign income and to reduce or eliminate whatever adverse tax consequences might flow to a U.S. taxpayer from accepting an overseas work assignment.³ One such provision of the Internal Revenue

Code is section 901, the foreign tax credit, which allows U.S. residents to offset their U.S. taxes owed by the amount of tax paid to a foreign jurisdiction.⁴ Another is section 911, which allows U.S. taxpayers to elect to exclude a specified amount of foreign earned income from U.S. taxation and also provides an additional exclusion for qualified housing costs.⁵

also long enough to constitute a presumptive (but rebuttable) abandonment of permanent residence absent advance receipt from U.S. Customs and Immigration Services of a returning resident declaration. It seems likely that few permanent residents claim exempt income under section 911. Throughout this article, the term "U.S. taxpayer" will be used to refer both to U.S. citizens and U.S. permanent residents, who are equally subject to U.S. taxation on their worldwide income. See Robert L. Sommers, "Update: Foreign Earned Income Exclusion (2006)," available at http://www.taxprophet.com/newsletters/Foreign_Earned_Income_Exclusion.pdf.

⁴Although a U.S. taxpayer can only claim a foreign tax credit up to the amount of U.S. taxes paid in any given tax year, section 904 (limitation on credit) allows a one-year carryback and a 10-year carryover of any excess foreign taxes disallowed in a given tax year. IRC section 904(c). In contrast, section 911 allows only a one-year carryover of any housing amounts disallowed in a given tax year. IRC section 911(c)(4)(C)(i).

⁵For tax year 2008, the foreign earned income exclusion is \$87,600. Rev. Proc. 2007-66, 2007-45 IRB 970; IRC section

¹*Cook v. Tait*, 265 U.S. 47, 56 (1924).

²No other economically advanced country practices worldwide taxation. See Jill Meyer, comment, "2006 Amendments to the Foreign Earned Income Exclusion: Effects, Reactions, and Suggestions for Change," 60 *SMU L. Rev.* 1667, 1668 (2007); Michael S. Kirsch, "Taxing Citizens in a Global Economy," 82 *N.Y.U. L. Rev.* 443, 455 n. 5.

³The United States taxes not only U.S. citizens but U.S. permanent residents (green card holders) on their worldwide income. This can present unique issues for green card holders regarding section 911, since the length of absence from the United States required to qualify for section 911 income exclusion is

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While section 901 has provoked its own share of controversies, no serious critic has advocated its complete abolition; on the contrary, its basic rationale of avoiding double taxation remains one of the fundamental goals of any fair tax regime.⁶ Section 911, however, has proven both remarkably durable — some form of foreign earned income exclusion has been part of the Internal Revenue Code without interruption since 1926 — and remarkably controversial.⁷ Calls for the abolition of the foreign earned income exclusion began almost immediately after its initial adoption and have persisted to this day.⁸ Most recently, Sen. Chuck Grassley, R-Iowa, sought to repeal the foreign earned income exclusion as part of the Jobs and Growth Tax Relief Reconciliation Act of 2003, calling section 911 “a tax loophole that forces you and me . . . to subsidize high-paid corporate employees and their companies.”⁹ Vigorous advocacy on the part of U.S. taxpayers working overseas and the corporations that employ them ultimately thwarted Grassley’s proposal; section 911 remains in force, although altered as a result of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) in ways that have likely resulted in a higher tax burden for many U.S. taxpayers with foreign earned income.¹⁰

The intensity of the debate surrounding the foreign earned income exclusion might lead the casual student of tax policy (if such a creature exists or can be imagined) to assume that the exclusion affects a large number of taxpayers, or that it denies Treasury a significant source of tax revenue. In fact, the opposite is true. Only a small number of overseas U.S. taxpayers elect

911(b)(2)(D)(i). Reasonable housing costs exceeding \$14,016 but not in excess of \$26,280 may also be deducted or excluded. IRC section 911(c).

⁶For example, some House Democrats criticize the one-year carryback and 10-year carryforward provisions of section 901 as an overseas tax break that rewards businesses for investing abroad. See Heidi Glenn, “House Dems Eyeing Foreign Tax Credit Changes,” *Tax Notes Int’l*, Nov. 27, 2006, p. 676, *Doc 2006-23249*, or *2006 WTD 222-3*.

⁷See Renee Judith Sobel, “United States Taxation of Its Citizens Abroad: Incentive or Equity,” 38 *Vand. L. Rev.* 101, 130 (1985).

⁸See *id.* at 119-123; Jeffrey Evans, “911: The Foreign Earned Income Exclusion — Policy and Enforcement,” 37 *Va. J. Int’l L.* 891, 891-892.

⁹See Jorge L. Riera, “Agencies for Purposes of Section 911 of the Internal Revenue Code: The Foreign Earned Income Exclusion Survives 2003 Controversial Proposal to Repeal,” 10 *ILSA J. Int’l & Comp. L.* 161, 162 (2003); 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, 732-733 (2004).

¹⁰See Eileen Sheer and Andrew M. Mattson, “International Provisions of TIPRA,” 37 *Tax Adviser* 400 (2006). See also Meyer, *supra* note 2 at 1679.

to claim a section 911 income exclusion in a given year; those who do so constitute an even smaller percentage of total U.S. taxpayers. At the same time, while the foreign earned income exclusion is included as a tax expenditure in the annual lists of tax expenditures released by the Treasury Department and the Joint Committee on Taxation, its fiscal impact is comparatively small — an estimated \$4 billion for tax year 2008, compared with approximately \$80 billion for the home mortgage interest deduction.¹¹ The student of tax policy — casual or otherwise — must therefore wonder: Why has such a comparatively underutilized and fiscally minor provision of the tax code attracted so much controversy, while remaining so resilient?

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This article seeks to answer that question by arguing that the importance of the foreign earned income exclusion lies not in its utilization rate by individual taxpayers or its fiscal impact, but in the fundamental questions it raises about the policy and equity implications for businesses and individuals regarding the exercise of Congress’s taxing authority beyond the borders of the United States. The established constitutionality of that authority only serves to further accentuate the differences between America’s tax policies and those of its principal allies and trading partners. As a result, the debate about section 911 is part of a much larger debate about the role and exercise of American sovereignty in an increasingly globalized world, and the effects on the United States of the ways in which it chooses to exercise that sovereignty. As long as that debate continues, no technical fixes will resolve the controversy over the foreign earned income exclusion.

Part I of this article establishes the comparatively small role of section 911 in the overall U.S. tax picture, and discusses the types of taxpayers who benefit either directly or indirectly from the exclusion of foreign earned income and foreign housing costs. Part I also argues that the debate over section 911 must be understood by first identifying the subsets of overseas U.S.

¹¹Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011,” JCS 3-07 at 24, 27 (Sept. 24, 2007).

taxpayers most affected by any attempts to extend, restrict, or eliminate the section's provisions. Part II summarizes the historic and current debate over section 911. This summary follows up on some earlier analyses of section 911 by emphasizing the basic conceptual categories to which the various arguments on both sides of the controversy can be assigned: comparative domestic equity, comparative international equity, and promotion of American trade and interests abroad. Part II then identifies the larger unresolved debates that underlie these specific policy considerations. Finally, Part III offers some suggestions for reform and concludes by conceding that the lack of resolution of the larger debates effectively precludes any reforms of section 911 that could satisfy all the interested parties.

I. The Section 911 Taxpayer: A Portrait

The national population of the United States is approximately 300 million. In 2001 approximately 130 million individual tax returns were filed with the IRS.¹² That same year, approximately 3.9 million individual tax returns claimed a foreign tax credit under section 901.¹³ In contrast, approximately 295,000 U.S. taxpayers claimed the foreign earned income exclusion in 2001, of whom just under 55 percent had no U.S. income tax liability after taking the foreign earned income and housing cost exclusions.¹⁴ The average foreign-source salary of a taxpayer claiming the foreign earned income exclusion was \$82,804 in 2001, when the income exclusion was \$78,000.¹⁵ Taken together, the foreign earned income and housing cost exclusions protected approximately \$16 billion out of \$27 billion in declared foreign earned income that year.¹⁶ In summary, less than 10 percent of U.S. taxpayers with overseas income claimed the foreign earned income exclusion in 2001, and less than one-fourth of 1 percent of all filed individual returns claim it. Of that one-fourth of 1 percent, fewer than half had foreign earned income in excess of \$82,804. Explaining this apparently low utilization rate for section 911 requires consideration of the factors that might dissuade an overseas U.S. taxpayer from making a section 911 election, and an examination of the subsets of those taxpayers for whom it is a particularly attractive option.

Three factors in particular explain the limited appeal of section 911 to overseas U.S. taxpayers. First, the

taxpayer must decide to declare his foreign earned income — indeed, to file a U.S. tax return at all. For overseas U.S. taxpayers whose income is not otherwise reported to the IRS because they are self-employed or work for foreign organizations that do not submit income information to the IRS, the likelihood of getting caught is very low. The IRS has recognized underreporting of foreign income as a serious problem for the Treasury,¹⁷ and Government Accountability Office studies have confirmed that underreporting is extensive.¹⁸ Long-term residents of foreign jurisdictions with no U.S. assets or fixed plans to return to the United States are particularly likely to succumb to the temptation not to report foreign income to the IRS.¹⁹ Ironically, these are also the overseas U.S. taxpayers who would most easily qualify for a section 911 exclusion, since eligibility for section 911 requires the taxpayer to establish that he has either a bona fide residence in a foreign country or at least 330 days of physical presence in that country during a consecutive 12-month period.²⁰ Many overseas U.S. taxpayers whose term of overseas employment lasts less than a year or who return frequently to the United States will not qualify for a section 911 exclusion even if they wanted to take one. For these taxpayers, a section 901 foreign tax credit is the only option. Still other taxpayers who do qualify for section 911 may find section 901 more attractive if they pay high enough foreign income taxes to offset their U.S. tax liability. Finally, the IRS has recognized that the statutory requirement that a taxpayer make an election under section 911 has resulted in some eligible taxpayers failing to take advantage of its benefits.²¹ There are rational explanations for U.S. overseas taxpayers' failure to make a section 911 claim — for some U.S. overseas taxpayers, it is rational (if ethically dubious) not to report their foreign income to the IRS at all; for others, section 911 is either unavailable or a less attractive option than section 901. Which taxpayers, then, choose section 911 when reporting their foreign earned income?

The typical profile, in academic analysis, of a section 911 taxpayer is a resident of a foreign jurisdiction with low taxes and a high cost of living, in particular

¹²Scott Hollenbeck and Maureen Keenan Kahr, "Ninety Years of Individual Income and Tax Statistics, 1916-2005," 27 *IRS Stat. of Income Bull.* 136, 145 (Winter 2008).

¹³Jeff Curry and Maureen Keenan Kahr, "Individual Foreign-Earned Income and Foreign Tax Credit, 2001," 23 *IRS Stat. of Income Bull.* 98, 105 (Spring 2004).

¹⁴*Id.* at 100, 103.

¹⁵*Id.* at 102; IRC section 911(b)(2)(D)(i).

¹⁶Curry and Kahr, *supra* note 13 at 98.

¹⁷Transcript for May 9, 2006, show: "International Issues and U.S. Taxpayers," available at <http://www.taxtalktoday.tv/index.cfm?page=5.71> (IRS webcast); see also postshow news release for May 9, 2006, show, available at <http://www.taxtalktoday.tv/index.cfm?page=5.71> (summary of IRS webcast).

¹⁸GAO, "Tax Administration: Nonfiling Among U.S. Citizens Abroad," GAO/GGD 98-106 (1998); GAO, "Tax Administration: IRS Activities to Increase Compliance of Overseas Taxpayers," GAO 93-93 (1993). See also Kirsch, *supra* note 2 at 495-500.

¹⁹Meyer, *supra* note 2 at 1686.

²⁰IRC section 911(d)(1). See also 26 C.F.R. section 1.911-2.

²¹IRC section 911(a), (e). See postshow news release, *supra* note 17. See also Meyer, *supra* note 2 at 1674.

high housing costs.²² Singapore, Hong Kong, and Dubai are the most frequently cited locations, although U.S. taxpayers living in less notoriously expensive locales such as Almaty, Kazakhstan have also sought expanded section 911 protections.²³ Political advocacy on behalf of the foreign earned income exclusion confirms this characterization,²⁴ whereas critics appeal to images of rich expatriates enjoying tax breaks denied their fellow citizens at home. Grassley perfectly captured this populist caricature of a section 911 taxpayer in a letter to *The Wall Street Journal Asia*, in which he stated, “An American in Peoria can’t exclude any salary or housing costs from taxable income. Why should an American in Paris not face reasonable limits?”²⁵ For U.S. taxpayers residing in many overseas jurisdictions, then, low local tax rates or high housing costs make the section 901 foreign tax credit unattractive compared with section 911. Also, section 911 grants Treasury the authority to adjust the statutory housing cost exclusion upward to reflect local real estate markets.²⁶ As of tax year 2007, more than 100 foreign cities or regions had housing cost allowances that exceed the statutory maximum of \$25,710.²⁷ For example, the current maximum exclusion for Dubai is \$42,452; for Paris, \$87,200; for Hong Kong, \$114,300.²⁸ Although many overseas U.S. taxpayers have argued that even these more generous amounts still fail to reflect actual local housing costs, section 911 nonetheless offers at least a partial offset available nowhere else in the code.²⁹ Its appeal — even with its otherwise less generous provisions in the wake of TIPRA — to this particular group of overseas U.S. taxpayers is therefore obvious.

IRS studies of taxpayers who claim foreign earned income on their individual tax returns add substance to

these portraits (and self-portraits) of section 911 taxpayers. First, more than half of the foreign earned income reported in tax year 2001 came from eight countries.³⁰ These included Singapore and Hong Kong, the focus of much attention in the section 911 debate. They also included the United Kingdom, Japan, and France, all of which have capital cities with large populations of overseas Americans and high housing costs. While they did not include Dubai, they did include Saudi Arabia, another high-cost Persian Gulf state. At the same time, however, Canada and Germany — rarely mentioned in discussions of section 911³¹ — ranked third and fifth in foreign earned income, respectively. While this concentration of foreign earned income in a small number of countries is not necessarily surprising given the large numbers of overseas Americans living in countries such as Canada and the United Kingdom,³² what is striking is the range of average salaries of the section 911 taxpayers living in these countries. Average salaries and wages for 2001 for section 911 taxpayers in the top eight countries for foreign earned income exclusion claims ranged from more than \$120,000 in the United Kingdom and nearly \$100,000 in Hong Kong to just over \$46,000 in Germany. France, Japan, and Canada ranged from \$70,000 to \$76,000.³³ The appeal of the foreign earned income exclusion is more widespread than either popular or academic debate often acknowledges: It encompasses many taxpayers whose income places them well within the ranks of the middle-income earners, and includes overseas U.S. taxpayers in countries such as Canada and Germany with housing costs in many communities comparable to those in the United States.³⁴ Moreover, many of these countries have comparatively high personal income tax rates as well. Explanations for these taxpayers’ section 911 elections remain speculative in the absence of further empirical research, but it is worth noting the possibility that taxpayers may have more extended absences or even permanent residence in countries like Canada, and yearlong or longer assignments to countries like Saudi Arabia or Japan, thus simplifying their qualification for the foreign earned

²²Meyer, *supra* note 2 at 1681; Kirsch, *supra* note 2, at 485-486.

²³Clinton Quarles, “Writer Reiterates Need for Adjustment to Housing Cost Exclusion for Kazakhstan Cities,” *Doc 2008-4969* or *2008 WTD 49-19*.

²⁴See American Chamber of Commerce in Singapore, “White Paper on the Taxation of the Earned Income of US Citizens Abroad,” available at http://www.amcham.org.sg/resources_us_tax_changes.html; Middle East Council of American Chambers of Commerce, “American Citizens Abroad: Stop Killing the Goose That Laid the Golden Egg,” available at <http://www.abccg.us/issuesandresources.html>.

²⁵Chuck Grassley, letter to the editor, *The Wall Street Journal Asia*, Oct. 3, 2007, p. 18.

²⁶IRC section 911(c)(2)(B).

²⁷See Meyer, *supra* note 2 at 1676.

²⁸IRS Notice 2006-87, 2006-43 IRB 766; see also IRS Notice 2007-25, 2007-12 IRB 760; IRS Notice 2007-77, 2007-40 IRB 735.

²⁹See Jake Vanderkamp, “American Expats Should Give the Taxman a Call and Raise the Roof,” *S. China Morning Post*, Oct. 17, 2006, p. 18.

³⁰Curry and Kahr, *supra* note 13 at 101. The study for the 2006 tax year has not yet been published. However, for data on the number of returns claiming the foreign earned income exclusion and the total amount claimed for tax years after 2001, see IRS, “Selected Income and Tax Items for Selected Years 2001-2005,” available at <http://www.irs.gov/pub/irs-soi/05intba.xls>.

³¹See Sobel, *supra* note 7 at 107.

³²See GAO, “2010 Census: Counting Americans Overseas as Part of the Decennial Census Would Not Be Cost-Effective,” GAO-04-898 (2004).

³³Curry and Kahr, *supra* note 13 at 102.

³⁴See Glenn Kurlander, “The Foreign Earned Income Exclusion: Redefining the Exception for Amounts Paid by the United States Under IRC 911,” 68 *Cornell L. Rev.* 592, 597 (1983).

income exclusion and increasing the likelihood that their entire employment income is foreign sourced and thus offset by the section 911 exclusion.

More than half of the foreign earned income reported in tax year 2001 came from eight countries.

This statistical profile of a section 911 taxpayer is helpful in understanding the individuals who make a section 911 election on their personal income tax returns, and further analysis of the real beneficiaries of section 911 will contribute to an understanding of the politics of the section 911 debate discussed in Part II below. First, although many large corporations (foreign and U.S.-based) offer tax equalization programs in which they provide subsidies for employees who accept a foreign work assignment so that they will not suffer adverse tax consequences from relocating overseas compared with their domestic counterparts, many overseas U.S. taxpayers, often self-employed, have no access to such employer-funded programs.³⁵ Instead, they are liable upfront for their entire foreign tax burden and cost of living, and are therefore dependent on section 911 and the foreign tax credit to offset their foreign tax liabilities. Unsurprisingly, this group of overseas U.S. taxpayers, often speaking through local American chambers of commerce in their host countries, has been particularly vocal in its support of maintaining or expanding section 911 and in its opposition to the increased U.S. tax burden under TIPRA.³⁶ A second, related group consists of overseas U.S. taxpayers who may enjoy tax equalization programs from their employers but who complain that even the more generous housing cost allowances authorized for particular locales fail to reflect the true local cost of housing. For this group, the housing cost exclusion may be as important as, or more important than, the income exclusion in determining a section 911 election.³⁷ In short, one group of overseas U.S. taxpayers is dependent on

section 911 without any outside assistance; the other has outside assistance but nonetheless still finds section 911 inadequate.

Both groups have a powerful ally in the third major beneficiary of section 911: businesses that employ U.S. taxpayers overseas and that feel compelled to offer these employees tax equalization programs as part of their compensation packages. Although some debate exists about the total net cost to employers of these programs,³⁸ it remains the case that because of the uniqueness of the U.S. policy of worldwide taxation of the income of its citizens and permanent residents, overseas employees from no other major industrial power require comparable tax equalization to make overseas employment at least theoretically zero-sum from a tax perspective. As a result, tax equalization programs are an additional cost of doing business borne by employers of U.S. taxpayers overseas.³⁹ These employers are an important indirect beneficiary of section 911 because the foreign earned income exclusion, by reducing the tax burden on the U.S. taxpayer employed overseas, allows a corresponding reduction in the size of the tax equalization package the employer must offer. This benefit is no less important for being indirect, since it affects the bottom line of international businesses that employ U.S. taxpayers overseas, and brings powerful corporate interests into the debate over section 911 alongside individual taxpayers who are often frustrated by their lack of collective influence on the political process.⁴⁰

The appeal of section 911 is therefore both limited in terms of taxpayers affected, but more complex than is often acknowledged because of the political forces at work. Both its qualification requirements and the precise nature of the benefits it confers limit its appeal even for those individuals among the minority of U.S. taxpayers with foreign earned income. Moreover, those same structural limitations preclude widespread abuse of section 911 — a taxpayer able and desiring to claim a section 911 exclusion likely falls within the subset of taxpayers that section 911 actually intends to benefit.⁴¹ For those taxpayers, section 911 represents a powerful tax benefit otherwise unavailable in the code. Whether and why such taxpayers deserve — or don't deserve — this benefit has been controversial since a foreign earned income exclusion was first established in 1926. The next section examines that debate and suggests

³⁵ See Keith Bradsher and David Cay Johnston, "Americans Living Abroad Get a Nasty Tax Surprise," *The New York Times*, May 29, 2006, p. C3.

³⁶ See American Chamber of Commerce in Thailand, "APCAC Leads Coalition to Eliminate Unfair Taxation of U.S. Citizens Working Abroad," available at <http://www.amchamthailand.com/ACCT/asp/reports.asp?SponsorID=333>.

³⁷ While the foreign earned income exclusion and the housing cost exclusion are both part of section 911, a qualified taxpayer must make a separate election for each benefit. IRC section 911(a).

³⁸ See Evans, *supra* note 8 at 911-912.

³⁹ See Bradsher and Johnston, *supra* note 35 at C3.

⁴⁰ See American Citizens Abroad, "Congressional Representation for Overseas Americans," available at <http://www.aca.ch/op10a.htm>.

⁴¹ See Elise Tang, "Solving Taxpatriation: 'Realizing' It Takes More Than Amending the Alternative Tax," 31 *Brooklyn J. Int'l L.* 615, 622-624. *But see* Evans, *supra* note 8 at 913-916.

that much more is at stake than a \$4 billion tax expenditure for a restricted minority of taxpayers.

II. Section 911: Why or Why Not?

The foreign earned income exclusion directly benefits only a small subset of U.S. taxpayers, yet the intensity of the debate surrounding its provisions and the legitimacy of its presence in the Internal Revenue Code has not diminished. If anything, the comparatively small constituency of section 911 taxpayers has only increased the affected taxpayers' sense of being an unfairly targeted minority as well as the critics' conviction that section 911 represents an unnecessary and unfair subsidy to a privileged special interest group. The political voice⁴² and influence of the corporate interests indirectly benefited by section 911 has ensured that any political efforts at further restriction or outright abolition of the foreign earned income exclusion will meet with powerful opposition.⁴³ Because of this interplay between affected beneficiaries and attempts at legislative reform, the debate over section 911 has been conducted largely on traditional and specific policy grounds of equity and incentive. Academic analysis has mirrored this political debate; law review articles on section 911 generally take sides and offer more detailed rationales for the arguments offered in public debate.⁴⁴ While such analysis is useful in critiquing and providing more substance to popular perceptions and political advocacy, it fails to account fully for the intensity of the controversy over section 911. In fact, section 911 raises fundamental questions about how the United States taxes its taxpayers and about how it defines its role in the world. The lack of resolution of those controversies suggests that mere technical adjustments to section 911, however important as political and policy matters, will not end the debate over the exemption's basic legitimacy.

The traditional policy arguments over section 911 concern the equitable treatment of comparably situated taxpayers (horizontal and vertical equity), and the encouragement of the overseas employment of U.S. taxpayers (incentives).⁴⁵ Equity arguments about section 911 focus on its impact on individual overseas U.S. taxpayers. Proponents of the earned income and the housing cost exclusions use two control groups with

whom they compare section 911 taxpayers: domestic U.S. taxpayers, and overseas taxpayers who are not from the United States (for example, Australians working in Japan). An overseas U.S. taxpayer, they argue, faces numerous costs her domestic counterpart does not. These include tuition at local American schools and expensive expatriate medical care as well as high housing costs.⁴⁶ As a result, she may receive a higher income to compensate her for a higher local cost of living, and absent a foreign earned income exclusion, all of this income will be taxed through the same graduated rate structure applied to a domestic U.S. taxpayer.⁴⁷ When she compares herself to the Australian or Canadian overseas taxpayers who may be her neighbors or colleagues, she is subject to a tax on her foreign income that they are not. Simple fairness argues in favor of some relief for her higher costs and unique tax burden.⁴⁸

Despite the apparent fairness of these arguments, counterarguments abound. In general, these arguments focus on the difficulty of making universal comparisons between the expenses of domestic and overseas taxpayers. Costs of living vary widely within the continental United States, not to mention Alaska and Hawaii; employers may pay higher local wages to offset some of those costs, but a domestic U.S. taxpayer enjoys no relief from a higher marginal tax rate as a result.⁴⁹ Similarly, many domestic U.S. taxpayers pay out of pocket for private services such as schooling and medical care that they believe the public systems in the United States are not adequately providing; although they may enjoy some tax relief as a result (for example, for unreimbursed medical expenses), they cannot exempt the first \$87,600 of their earned income to offset these privately incurred costs.⁵⁰ Moreover, there is nothing unique about the tax burden of the overseas U.S. taxpayer: She is being taxed in precisely the way all U.S. taxpayers in the same situation would be taxed. Other countries are free to adopt their own systems of taxation, but equalizing the tax burden of a U.S. and

⁴² See Newt Gingrich and Ken Kies, "Our Taxed Expats," *The Wall Street Journal*, June 28, 2006, p. A14.

⁴³ See Sheppard, *supra* note 9 at 754-755; see PricewaterhouseCoopers, "Economic Analysis of the Foreign Earned Income Exclusion," available at http://www.amcham.org.sg/resources_us_tax_changes.html.

⁴⁴ See Kirsch, *supra* note 2; Sheppard, *supra* note 9; Sobel, *supra* note 7; Meyer, *supra* note 2.

⁴⁵ See Kirsch, *supra* note 2 at 470-488; Sheppard, *supra* note 9 at 738-741; Sobel, *supra* note 7 at 103-119.

⁴⁶ Kirsch, *supra* note 2 at 486.

⁴⁷ Indeed, with the introduction of "stacking" under TIPRA, her marginal rate will be identical to that of a U.S. domestic taxpayer with the same income (*supra* note 5).

⁴⁸ See Daniel J. Mitchell, "Territorial Taxation for Overseas Americans: Section 911 Should Be Unlimited, Not Curtailed," *Prosperitas*, May 2005, at 2; see also Sheppard, *supra* note 9 at 739; Evans, *supra* note 8 at 905-906. However, the American Bar Association Section of Taxation Task Force on International Tax Reform has stated that "only U.S. citizens and residents should be taken into account" when applying fairness criteria to taxation policy. See ABA tax section, "Report of the Task Force on International Tax Reform," 59 *Tax Law* 649, 679 (2006); see also Kirsch, *supra* note 2 at 480.

⁴⁹ See Kirsch, *supra* note 2 at 486-487; Sheppard, *supra* note 9 at 739; Sobel, *supra* note 7 at 110.

⁵⁰ See Kirsch, *supra* note 2 at 487 n. 187.

an Australian taxpayer is not a legitimate equity goal for the Internal Revenue Code.⁵¹ Critics making these arguments assert that horizontal equity should compare U.S. taxpayer to U.S. taxpayer, and no more.⁵²

Section 911 raises fundamental questions about how the U.S. taxes its taxpayers and about how it defines its role in the world.

Reasonable actors on both sides of the equity debate can acknowledge that complete equity between overseas and domestic U.S. taxpayers is not obtainable, given the huge variation in living expenses both overseas and within the United States (and, indeed, between U.S. taxation and that of other countries). Proponents of section 911 can then point to another rationale for the foreign earned income exclusion: as an incentive to encourage the employment of U.S. taxpayers overseas.⁵³ Interestingly, this argument in favor of section 911 can be deployed on either side of the equity debate. Either overseas employment places an undue burden on the U.S. taxpayer for which she must be compensated to incentivize her to accept an overseas assignment, or section 911 confers on her an advantage compared with her domestic counterpart that is appropriate in light of the importance of her overseas work. In either case, proponents argue, employment of U.S. taxpayers overseas promotes American business and exports, creates expanded job opportunities, and more generally serves to advance American interests abroad and encourage goodwill toward the United States.⁵⁴ In other words, overseas employment helps U.S. taxpayers, American businesses, and American society as a whole. Section 911 is an appropriate tool for advancing these interests, since it provides a double incentive — to the employee to accept the overseas assignment, and to the employer to offer it in the first place. Therefore it is not surprising that much of the business advocacy on behalf of section 911 has

invoked these lofty but ultimately self-interested goals, offering praise of American citizens as America's "very best natural asset," possessing "skills and expertise that parts of the world would like."⁵⁵

The only problem with this argument, which has been prominent in the debate on the foreign earned income exclusion since its inception, is that there is little conclusive data to support it.⁵⁶ In part, this reflects an unfortunate lack of empirical studies of the relationship between tax benefits for overseas U.S. taxpayers, taxpayer behavior in response to those incentives, and the benefits overseas employment confers on the American economy.⁵⁷ In part, it also reflects a more theoretical uncertainty about the relationship between a targeted tax benefit like the foreign earned income exclusion, the behavior it intends to encourage, and the achievement of the desired result. Would the business have hired the U.S. taxpayer absent section 911, and would that taxpayer have accepted under those circumstances? In other words, assuming the desirability of the stated goals, is section 911 an effective way of achieving them? Recently, scholars have even argued that an expanded foreign income exclusion might actually work against U.S. domestic economic interests by encouraging overseas employment of highly compensated U.S. taxpayers and thereby both expatriating U.S. intellectual capital and reducing tax revenue.⁵⁸ Moreover, in the post-September 11 era, the effect of Americans overseas is not unequivocally positive, serving to advance U.S. interests and as a magnet for international tensions.⁵⁹ Therefore, although advancing the economic and broader political interests of the United States overseas is a desirable policy goal, the place of the foreign earned income exclusion in that agenda is far from clear.

The foregoing discussion suggests many conceptual and empirical reasons why the section 911 debate is unlikely to end any time soon. Even if many of these uncertainties could be resolved — if, for example, accurate comparisons between domestic and overseas U.S. taxpayers could be made or if the larger economic impact of section 911 on U.S. interests could be determined — the controversy would not abate. Beneath the disagreements over the individual arguments for and against the foreign earned income exclusion lies a more basic disagreement over the legitimacy and the application of the U.S. policy of worldwide taxation. Even

⁵¹This is the view of the ABA Task Force on International Tax Reform. See "Report of the Task Force on International Tax Reform," *supra* note 48 at 679.

⁵²See Sheppard, *supra* note 9 at 740.

⁵³See Evans, *supra* note 8 at 900-905; Kirsch, *supra* note 2 at 515; Meyer, *supra* note 2 at 1684.

⁵⁴See Kirsch, *supra* note 2 at 521-523; Sheppard, *supra* note 9 at 748-749.

⁵⁵Karen Hughes, undersecretary of state for public diplomacy and public affairs, as quoted in PricewaterhouseCoopers, *supra* note 43, at E-6.

⁵⁶See Evans, *supra* note 8 at 901-905; Sheppard, *supra* note 9 at 749-753.

⁵⁷See Sobel, *supra* note 7, at 146-155.

⁵⁸See Kirsch, *supra* note 2 at 514-519.

⁵⁹See Sheppard, *supra* note 9 at 760-761.

when this issue does not break the surface of the debate, as it increasingly does in a globalized world in which U.S. taxpayers work overseas alongside nationals of other countries with territorial taxation regimes, it informs the perspectives of both the proponents and opponents of section 911.⁶⁰

The legitimacy of U.S. worldwide taxation involves two distinct issues: its legality and its desirability.

The legitimacy of U.S. worldwide taxation involves two distinct issues: its legality and its desirability. In 1924 the Supreme Court upheld in *Cook v. Tait* the constitutionality of Congress's power to tax the worldwide income of U.S. citizens; neither courts nor commentators have questioned the constitutional underpinnings of worldwide taxation since.⁶¹ The Supreme Court has also upheld residence-based taxation: "The receipt of income by a resident of the territory of a taxing sovereignty is a taxable event. . . . Domicile itself affords a basis for such taxation."⁶² Since U.S. permanent residency by definition implies U.S. domicile (intent to remain permanently in the United States), the worldwide taxation of permanent residents is also fully within Congress's authority. However, establishing possession of a given legal authority does not necessarily entail the decision to exercise that authority.⁶³ Indeed, the foreign earned income exclusion was first enacted in the wake of *Cook* — a perhaps all too rare instance of congressional restraint in the face of Court sanction of expansive congressional power. The tension between Congress's broad power of worldwide taxation of U.S. taxpayers and its willingness to exercise or constrain that power is therefore embedded in the legal and legislative history surrounding the foreign earned income exclusion.

Early on, both Congress and the Court established that Congress could and might refrain from taxing the worldwide income of U.S. taxpayers; the question of the selective application of that taxing authority becomes very important. This is one of the key underlying disagreements animating the section 911 debate:

⁶⁰See Mitchell, *supra* note 48 at 2.

⁶¹Indeed, a state's sovereign power to tax its citizens living overseas is recognized in customary international law. See Kirsch, *supra* note 2 at 469 n. 114.

⁶²*New York ex rel. Cohn v. Graves*, 300 U.S. 308, 312-313 (1937).

⁶³See Kirsch, *supra* note 2 at 469.

What group of U.S. taxpayers, if any, should enjoy not simply a foreign earned income exclusion, but an exemption from such a supposedly universal principle of U.S. taxation? Even if it can be shown that a particular group of taxpayers does bear an undue or unusual burden, does this justify conferring on them a status enjoyed by no other taxpayers? Even more fundamentally, is a foreign earned income exclusion conceptually compatible with worldwide taxation in the first place? If it is not — and this is a point on which many critics and proponents of section 911 would agree — then one of the two policies must go. Either the United States must abandon worldwide taxation of its taxpayers, thereby aligning itself with all of its major trading partners and effectively creating the unlimited foreign earned income exclusion enjoyed by taxpayers in territorial tax regimes, or the foreign earned income exclusion and attendant housing cost exclusions must be repealed, and overseas U.S. taxpayers taxed on their worldwide income must rely on section 901 foreign tax credits to offset any double taxation.⁶⁴ No political compromises that simply amend section 911 can resolve this fundamental tension between established constitutional authority and inconsistently applied policy choices.

In recent years, bitter international disputes have arisen from the United States' exercise of its asserted sovereign authority in the world and the counterassertions of the international community, both from individual countries and multinational organizations. No such conflicts are likely to rend the tax world, since the United States' sovereign authority to tax its residents as it deems appropriate and necessary remains an issue of domestic policy. Moreover, U.S. worldwide taxation applies to U.S. citizens, who are either birth or elective members of the domestic political community, and to permanent residents, who enjoy fewer political rights and privileges but have elected to domicile themselves in the United States. The United States does not attempt to tax Dutch taxpayers living in Russia, or Malaysian taxpayers living in Brazil. In this sense, the debate over section 911 is purely a debate about the domestic U.S. tax regime, which may be extraterritorial in the income that it affects and in its claims on overseas U.S. taxpayers, but the domestic U.S. tax regime does not seek to extend U.S. taxing authority beyond that community of taxpayers. The United States should be free to make its own decisions about how to tax its citizens and permanent residents, subject only to its own judgment and the will of its political community.

Those decisions, however, do not take place in an international vacuum on either a policy or an individual level. On the contrary, they take place in a world in which increased international mobility and communications ensure that interested and affected

⁶⁴See *id.* at 449.

U.S. interests (both persons and corporations) know through direct contact and access to comparative data how their foreign counterparts' home countries tax their overseas income and operations.⁶⁵ Moreover, they take place in a world in which the United States, while remaining the world's largest and richest economy, faces an increased competitive threat from newly emergent powers and well-established, advanced economic blocs. In such a context, U.S. overseas taxpayers are right to ask whether worldwide taxation, if ever justified on policy grounds, remains an appropriate exercise of national sovereignty in an increasingly integrated world economy in which U.S. tax policy stands as a stark outlier. Recent scholarship on the subject has established that the best answer from a policy perspective is far from clear.⁶⁶ This disagreement about the extent to which the United States should respond and adapt to the policies of other jurisdictions when deciding whether and how to exercise its sovereign taxing authority represents the second unresolved debate at the heart of the section 911 controversy. Should the United States change its tax policies so that they harmonize not only domestic and overseas U.S. taxpayers, but also overseas U.S. taxpayers and their foreign counterparts — and in so doing, elect not to assert a sovereign authority it indisputably enjoys?

Seen in this light, the debate over the foreign earned income exclusion is part of a much larger debate about how the United States should respond to a globalized and integrated world that it was largely responsible for creating. It is one of the ironies of international affairs that the one country most responsible for the architecture of the current international order remains one of the countries whose domestic and foreign policies most often conflict with that order. In the tax realm, a policy of promoting American interests by encouraging American businesses to expand overseas and encouraging U.S. taxpayers to accept work overseas has caused those businesses and taxpayers to question the very underpinnings of U.S. tax policy and placed them at odds with their fellow U.S. residents to whom no comparable tax benefits are offered. Far from defending U.S. tax policy, they feel unfairly treated compared with their foreign counterparts, while domestic U.S. taxpayers wonder why expatriates enjoy special tax breaks. The political process responds by tightening or loosening the foreign earned income exclusion as the political and fiscal winds shift. No one is happy, and the debate continues in its current form. The next section suggests some possibilities for reform.

III. The Future of the Foreign Earned Income Exclusion

Many debates over tax policy concern the specific contours of a tax provision that enjoys broad support across the political spectrum and does not provoke strong opposition on a theoretical level. For example, structuring tax benefits for taxpayers with dependent children or high unreimbursed medical expenses may generate disagreement, but few would dispute the basic legitimacy of including such benefits in the code. Other existing provisions, such as the deductibility of home mortgage interest, may offer interesting fodder for academic debate but remain so politically popular that they face no serious threat of elimination.⁶⁷ The foreign earned income exclusion, however, while continuing to enjoy powerful support, stands on much weaker ground politically and conceptually. In spite of the convictions of its defenders, many of its critics believe that it does not belong in the code in the first place.⁶⁸ Both positions rely on selective use of the already limited data available about utilization of section 911. Discussions of possible adjustments to section 911 (including both its elimination and its unlimited expansion) that do not address these fundamental differences of perspective and conflicting empirical claims are doomed to gridlock, and to resulting "reforms" that simultaneously loosen and tighten section 911 benefits. For example, the introduction of stacking under TIPRA has increased the tax burden for many section 911 taxpayers at the same time the expansion of the number of cities with high housing cost allowances has allowed many overseas U.S. taxpayers to escape the restrictive statutory limits on the housing cost exclusion. Future discussions of the foreign earned income exclusion should therefore address the multiple issues raised by the current status of section 911 and include an examination of the possible evidence relevant to a discussion of foreign earned income, an analysis of the consistency and internal fairness of the current statutory regime, and a reasoned debate about the rationale for or against taxing worldwide income. While such an approach is unlikely to result in consensus, it can at least produce a more informed discussion.

Empirical evidence consists of more than the personal narratives offered by individual section 911 taxpayers and the facially persuasive appeals to the cost of

⁶⁵ See *id.* at 466.

⁶⁶ See *id.* at 447.

⁶⁷ See President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," xvii, available at http://www.taxreformpanel.gov/final-report/TaxReform_ExSumm.pdf; David Brunori, "Bush's Tax Panel Has a Crazy Idea. Let's Go for It," *The Washington Post*, Oct. 23, 2005, p. B04.

⁶⁸ See Kirsch, *supra* note 2 at 530.

living in cities such as Singapore, Tokyo, San Francisco, and New York. First, it must include more complete analysis of the available IRS data. Neither academic analysis nor political advocacy makes full use of the existing IRS studies of foreign earned income.⁶⁹ Yet these studies present a complex picture of the utilization of the foreign earned income exclusion that defies simple characterization. For example, why do middle-income taxpayers in high-tax countries make a section 911 election when the foreign tax credit in many cases would presumably offset their entire U.S. tax burden? Do tax equalization programs have a distorting effect on taxpayer choices? Also, empirical evidence includes census, demographic, and tax data about the variation in costs of living across the United States, as well as controlled and transparent studies of the effective tax burdens and costs of living in a range of foreign locales. While choosing “representative” U.S. and foreign cities for comparison would be difficult and subject to charges of politically motivated selectivity, a comparison of six foreign locations — urban and rural, developed and underdeveloped — with six demographically distinctive U.S. locations would provide a useful starting point. As these examples suggest, much useful empirical data already exist and therefore have the further advantage that, in not being assembled to defend or critique the foreign earned income exclusion, are free of prior assumptions or bias regarding section 911. The same is true of comparative data about how foreign jurisdictions tax their overseas taxpayers. Aggregating and assembling these data in the context of the section 911 debate would allow actors on both sides to present their own viewpoints more persuasively and to challenge their opponents more effectively. Academic analysis of such data above the partisan fray would be valuable in this regard as well.⁷⁰

At the same time, the current provisions of section 911 need to be analyzed independently of any larger debate over the taxation of worldwide income. Two issues in particular raise questions about the fairness of the application of section 911 among its intended beneficiaries. The first concerns the relationship between the foreign earned income exclusion and the housing cost allowance. While the foreign earned income of some overseas U.S. taxpayers is undoubtedly high because those taxpayers work in highly compensated professions, it is equally true that many foreign incomes include upward adjustments to reflect high local costs of living. Yet the housing cost allowance can be adjusted upwards at the discretion of the Treasury, while the income exclusion remains the same worldwide. Particularly with the advent of stacking under TIPRA,

some overseas U.S. taxpayers with cost of living adjustments reflected in their salaries but who are living in locations without an increased (or adequate) housing cost allowance are therefore subject to an increased tax burden with no recognition that their higher salaries reflect high local costs as much as the housing cost allowances do. In other words, TIPRA’s added burden is unequally distributed.⁷¹ Second, as the debate over the comparative housing costs in Hong Kong and Singapore suggests, the discretion that Congress granted Treasury to raise the housing cost allowance when appropriate has provoked its own questions of fairness.⁷² This includes the amount and the determination of the increased housing cost allowance in a given city and the decision to select a city for an increased allowance in the first place. Moreover, the expanding list of included cities not only throws into high relief the perceived unfairness felt by those not so included but also calls into question the continuing relevance of the base line statutory amount. Have the exceptions swallowed the rule?⁷³ Perhaps ironically, both defenders and critics of section 911 can agree that its current provisions raise important questions of internal consistency and horizontal equity across the community of overseas U.S. taxpayers.

Of course, no amount of empirical data and statutory fine-tuning can fully resolve the theoretical questions at the heart of the controversy over the foreign earned income exclusion. Should the United States continue its policy of worldwide taxation of its taxpayers? Should it matter to the United States in making this determination that this policy is unique among the major industrialized powers that constitute its principal allies and trading partners? If the U.S. does continue to practice worldwide taxation, should it exempt one subset of its taxpayers from the full burdens that the policy imposes? These questions raise important policy issues that extend far beyond the specifics of the foreign earned income exclusion to how the United States chooses to characterize its place and exercise its tax sovereignty in the world. Nonetheless, the debate over section 911 should embrace rather than skirt the theoretical challenge posed by the foreign earned income exclusion. Locating section 911 within these larger policy questions will bring more players to the table than just its beneficiaries and opponents. It will therefore force defenders and detractors of section 911 to justify their positions within a larger framework and persuade a broader audience of the superiority of their convictions. None of this is likely to end the controversy, because the underlying questions have no easy

⁷¹ See Kirsch, *supra* note 2 at 526-527; Meyer, *supra* note 2 at 1690-1691.

⁷² See Meyer, *supra* note 2 at 1691.

⁷³ See editorial, “Uncle Sam’s Long Arm,” *The Wall Street Journal Europe*, Sept. 25, 2007, p. 11.

⁶⁹ See PricewaterhouseCoopers, *supra* note 43.

⁷⁰ See Sobel, *supra* note 7 at 160.

answers. Indeed, the result may be a continuation of the status quo, with the perpetuation of a foreign earned income exclusion subject to many restrictions and technicalities being the best available political compromise.⁷⁴ Contextualizing section 911 in this way will,

however, accord it the importance it deserves: Far from an obscure provision affecting a small minority of taxpayers who do not represent the population as a whole, the foreign earned income exclusion offers a unique vantage point from which to examine not only how the United States taxes its residents globally, but what type of global resident the U.S. wishes to be. ◆

⁷⁴See Meyer, *supra* note 2 at 1693; Kirsch, *supra* note 2 at 530; Sheppard, *supra* note 9 at 763-764; Evans, *supra* note 8 at 916-917.