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## Perpetuation of the Foreign Earned Income Exclusion

Hale E. Sheppard

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# Perpetuation of the Foreign Earned Income Exclusion: U.S. International Tax Policy, Political Reality, and the Necessity of Understanding How the Two Intertwine

Hale E. Sheppard\*

## ABSTRACT

*This Article discusses Section 911 of the Internal Revenue Code, also known as the Foreign Earned Income Exclusion (FEIE), as an example of a provision that has been sustained, not on the basis of sound economic analysis and compliance with established U.S. international tax policy, but rather because of effective lobbying and political circumstance. First providing an overview of the U.S. system of worldwide taxation, and the place of the FEIE within that framework, Mr. Sheppard explores the forces underlying the perpetuation of the FEIE. He demonstrates that the FEIE is inconsistent with each of the primary components of U.S. international tax policy, including meeting the revenue needs of the U.S. government in a fair and equitable manner, minimizing the burden of tax compliance and administration by reducing tax complexity, fostering economic efficiency through international tax neutrality, and ensuring the competitiveness of U.S. multinational businesses, but explains that the repeal of the FEIE is nevertheless improbable in the foreseeable future as a result of various political realities, such as the rebuilding of Iraq, the upcoming elimination or radical modification of major tax-based export promotion programs, a dwindling global presence of U.S. citizens due to fatal diseases and terrorism, and significant U.S. unemployment rates. He concludes by reemphasizing the complexity of tax policy issues, and by reminding the tax practitioner that a failure to*

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*comprehend the policy rationales behind a particular provision or set of provisions compromises the ability to dispense accurate and thorough advice.*

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## I. INTRODUCTION

Why? This question is undoubtedly the hallmark of curious children, those inquisitive youngsters tugging at coattails while incessantly asking, "Why, Mommy? Why, Daddy?" As fastidious as this inquiry may be to some, it should be foremost on the mind of all tax practitioners, especially those working in the ultra-complicated field of international taxation. For if one fails to comprehend the policy rationales behind a particular provision or set of provisions of the Internal Revenue Code (the Code), it is highly improbable that he or she will be able to dispense accurate and thorough advice in this area.<sup>1</sup> Equally (if not more) important for tax professionals in many cases is to understand the political climate existing at the time that specific parts of the Code were introduced, modified, or repealed. Indeed, to answer the pivotal question of why the Code functions in a certain manner or why a particular group of taxpayers receives special treatment, it is imperative to examine the applicable political realities.

Section 911 of the Code, which is also known as the Foreign Earned Income Exclusion (FEIE), is an example of a provision that has been sustained, not on the basis of sound economic analysis and compliance with established U.S. international tax policy, but rather because of effective lobbying and political circumstance. In an attempt to underscore the importance of thinking well beyond the express words of the Code, this Article explores in considerable depth the forces (both patent and latent) underlying the perpetuation of the FEIE.

Part II of this Article provides an overview of the U.S. system of worldwide taxation, as well as an explanation of how the FEIE relates to this system. Part III gives details regarding the recent congressional attempt to repeal the FEIE. Part IV describes the primary components of U.S. international tax policy, including meeting the revenue needs of the U.S. government in a fair and equitable manner, minimizing the burden of tax compliance and administration by reducing tax complexity, fostering economic efficiency through international tax neutrality, and ensuring the competitiveness of U.S. multinational businesses. Part V demonstrates that, despite ardent arguments by FEIE backers to the contrary, Section 911 is inconsistent with each of the international tax policies. Part VI then explains that the repeal of the FEIE is nevertheless improbable in the foreseeable future as a

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1. Unless otherwise indicated, all references in this Article to the "Code" are to the Internal Revenue Code of 1986, as amended. Unless otherwise indicated, all references in this Article to "Section" or "Sections" are to sections in the Code.

result of various political realities, such as the rebuilding of Iraq, the upcoming elimination or radical modification of major tax-based export promotion programs, a dwindling global presence of U.S. citizens due to fatal diseases and terrorism, and significant U.S. unemployment rates. This Article concludes by reemphasizing the fact that understanding U.S. international taxation in general, and the FEIE in particular, requires that tax practitioners never stop posing the question of utmost importance—why?

## II. OVERVIEW OF THE FOREIGN EARNED INCOME EXCLUSION

In the international context, countries generally base their capacity to tax persons on either the source of the income or the residence of the person who earns the income. In other words, in determining whether a country has the power to impose a tax on a particular item of income, a nation's tax system will focus on where the income was earned or, alternatively, on the nationality of the person earning the income. Under a source-based system (which is also known as "territorial taxation"), a country taxes the income that is earned within its borders, regardless of the nationality of the person who earns it. By contrast, a residence-based system (which is also known as "worldwide taxation") allows a country to tax the income earned by its citizens or residents, irrespective of the country in which it is earned. To the chagrin of many, the United States is one of the few nations that utilizes a system of worldwide taxation. Section 1 of the Code imposes a tax on the "taxable income" of every individual.<sup>2</sup> The term "gross income," the base from which an individual's taxable income is determined, encompasses "all income from whatever source derived," including for services performed by the individual.<sup>3</sup>

Despite the apparent harshness of worldwide taxation, there are exceptions that mitigate its severity. Among these exceptions is the FEIE, a device that has been the target of dramatic modifications and considerable controversy since its introduction in 1926.<sup>4</sup> As

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2. I.R.C. § 1 (1986).

3. I.R.C. § 61(a)(1) (1986).

4. For a detailed description of the evolution of the foreign earned income exclusion, see *Impact of U.S. Tax Rules on International Competitiveness: Hearing Before the House Comm. on Ways & Means*, 106th Cong. 126 (1999) (statement by David Hamond, Executive Director, Section 911 Coalition) [hereinafter *House Ways & Means Hearing*]; Jeffrey Evans, 911: *The Foreign Earned Income Exclusion—Policy and Enforcement*, 37 VA. J. INT'L L. 891, 895-98 (1997); Glenn Kurlander, *The Economic Recovery Tax Act of 1981: The Foreign Earned Income Exclusion: Redefining the Exception for Amounts Paid by the United States Under I.R.C. § 911*, 68 CORNELL L.

mentioned above, the general rule is that the government taxes all of the income that a U.S. person earns each year, regardless of whether the income is derived from sources in the United States or elsewhere.<sup>5</sup> Under the FEIE, however, U.S. taxpayers who live and work abroad for extended periods of time are allowed to omit from gross income \$80,000 per year of certain types of income, as well as a housing allowance.<sup>6</sup> In other words, the Code permits a “qualified individual” to exclude from gross income for a given year “foreign earned income” and “housing cost amount.”<sup>7</sup>

To be considered a “qualified individual” and thus eligible for the FEIE, a person must meet two conditions.<sup>8</sup> First, that person must have a “tax home” in a foreign country.<sup>9</sup> For purposes of the FEIE, a person’s tax home is the location of his or her regular or principal place of business or, if the person has no regular or principal place of business, then the location of that person’s place of abode “in a real and substantial sense.”<sup>10</sup> Second, the person must be a U.S. citizen who is a bona fide resident of a foreign country for an entire year, a resident alien who is a citizen of a foreign country with which the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country for an entire year, or a U.S. citizen or resident alien who is physically present in a foreign country for at least 330 full days during the year.<sup>11</sup>

Provided that the person satisfies the definition of a “qualified individual,” that person may avoid being taxed on as much as \$80,000 annually of “foreign earned income.”<sup>12</sup> The term “foreign earned income” means income (in the form of wages, salaries, fees,

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REV. 592, 594-97 (1983); Renee Judith Sobel, *United States Taxation of Its Citizens Abroad: Incentive or Equity*, 38 VAND. L. REV. 101, 119-46 (1985).

5. The FEIE is available both to qualified U.S. citizens and to resident aliens. I.R.C. § 911(d)(1)(B) (1986).

6. *Id.*

7. § 911(a).

8. The FEIE does not apply to the salaries paid by the U.S. government. See § 911(b)(1)(B)(ii). The purpose of this policy is to prevent U.S. government employees who are stationed abroad from obtaining a double benefit: exclusion from U.S. tax under the FEIE and an exemption from foreign taxes based on the practice that sovereigns will not tax employees of another sovereign. See CHARLES H. GUSTAFSON ET AL., *TAXATION OF INTERNATIONAL TRANSACTIONS* 377 (2d ed. 2001).

9. § 911(d)(1).

10. Treas. Reg. § 1.911-2(b) (2004).

11. § 911(d)(1); see also Rev. Rul. 91-58, 1991-2 C.B. 340. This Ruling, which relates to a citizen of the United Kingdom, expressly states that it applies to citizens of all countries that have an income tax treaty with the United States. For the sake of simplicity, U.S. citizens and resident aliens who meet one of these three tests are occasionally referred to in this Article as “Americans.”

12. § 911(b)(2)(D)(i). The excludable amounts have increased over the years, as follows: 1998 - \$72,000; 1999 - \$74,000; 2000 - \$76,000; 2001 - \$78,000; 2002 - \$80,000. The \$80,000 exclusion remains intact until 2008, at which time it will be increased in proportion to the rate of inflation. See § 911(b)(2)(D)(ii).

commissions, etc.) that a person receives as compensation for performing personal services while overseas.<sup>13</sup> However, the term "foreign earned income" does not include investment income (dividends or interest), pension or annuity payments, or certain deferred compensation.<sup>14</sup>

In addition to excluding the foreign earned income, a qualified individual may exclude each year from gross income the "housing cost amount," which is the amount by which actual "housing expenses" exceed a fixed figure that is intended to approximate the typical housing costs of a person living in the United States.<sup>15</sup> The term "housing expenses" includes the reasonable expenses paid during the year by or on behalf of a qualified individual for housing in a foreign country, as well as those of the individual's spouse and dependents.<sup>16</sup> The reasonable expenses may include rent, most utilities, real and personal property insurance, occupancy taxes, nonrefundable security deposits, furniture rental, household repairs, and residential parking.<sup>17</sup> Reasonable housing expenses do not include, however, the cost of items that are "lavish or extravagant under the circumstances."<sup>18</sup>

### III. RECENT ATTEMPTS TO REPEAL SECTION 911

The FEIE has been a catalyst for significant controversy since its introduction nearly a century ago, with its opponents calling for major modifications to, or the outright elimination of, this tax program.<sup>19</sup> This clamor for change invariably intensifies at times when the national budget seems imperiled. True to history, the FEIE was recently attacked as the Bush Administration championed an economic stimulus package based in tax reform. In particular, during the legislative battle to devise the Jobs and Growth Tax Relief and

13. § 911(b)(1)(A).

14. § 911(b)(1)(B); § 911(d)(2)(A).

15. § 911(c)(1). The "housing cost amount" is the excess of the taxpayer's "housing expenses" for the year, divided by 16 percent of the annual salary of a U.S. governmental employee at level GS-14. For instance, if the annual salary of a person at grade GS-14 is \$70,000, then the housing cost amount is the excess of that person's housing expenses over \$11,200 (i.e., 16 percent of \$70,000).

16. § 911(c)(2)(A).

17. Treas. Reg. § 1.911-4(b)(1) (2004).

18. § 911(c)(2)(A).

19. See e.g., Evans, *supra* note 4, at 916-17; Kurlander, *supra* note 4, at 613-15; Sobel, *supra* note 4, at 155-58. See generally Yoseph Edrey & Adrienne Jeffrey, *Taxation of International Activity: Over Relief from Double Taxation Under the U.S. System*, 9 INT'L TAX & BUS. LAW. 101 (1991); Philip F. Postlewaite & Gregory E. Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for Its Repeal*, 65 VA. L. REV. 1093 (1979).

Reconciliation Act of 2003 (JGTRRA), the U.S. Senate approved a bill that would have completely repealed the FEIE as of December 31, 2003.<sup>20</sup> Along with numerous other changes to the existing international tax provisions in the Code, revocation of the FEIE was designed to counteract the \$350 million in tax cuts contained elsewhere in the economic stimulus legislation.<sup>21</sup> In other words, if Congress was prepared to lower the amount of revenue that the U.S. Treasury would collect in the future as a result of special depreciation allowances, increased credits for certain taxpayers, and reduced tax rates on particular capital gains and dividends found in the JGTRRA, then it needed to craft methods by which to obtain more tax money from other areas. The abolition of the FEIE was thus proposed. In the end, this proposal did not survive the legislative process, and the JGTRRA was enacted without revoking this longstanding tax benefit to U.S. taxpayers working overseas.<sup>22</sup>

#### IV. SUMMARY OF U.S. INTERNATIONAL TAX POLICY

To comprehend the arguments made in support of and against the FEIE, it is necessary to first have a basic understanding of the policies that guide the United States in making decisions related to international taxation. While general principles abound, some of the primary goals of the international tax system include meeting the revenue needs of the U.S. government in a fair and equitable manner, minimizing tax compliance and administrative burdens by reducing tax complexity, promoting economic efficiency through international tax neutrality, and taking into account the competitive needs of U.S. multinational businesses.<sup>23</sup> Each of these tax objectives is briefly examined below.

##### A. Fairness and Equity

The concepts of fairness and equity are paramount to the credibility of the U.S. tax system because perceptions that revenue is being raised unjustly or that certain persons are not paying their share thanks to lobbying by special-interest groups lead to

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20. Jobs and Growth Tax Relief and Reconciliation Act of 2003, 28 U.S.C. § 350 (2003); see also Johnathan Rickman & Herman Ayayo, *U.S. Senate Keeps Foreign Earned Income Exclusion Repeal*, 2003 WORLDWIDE TAX DAILY 95-1 (May 16, 2003).

21. *Id.*

22. U.S. Senate & U.S. House of Rep., *Managers' Statement and Explanation of Final Tax Cut Bill*, 2003 TAX NOTES TODAY 101-40 (May 27, 2003).

23. See GUSTAFSON ET AL., *supra* note 8, at 16-27; Donald C. Lubick, *Remarks to the Tax Executives Institute*, in FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 19-21 (2003).



generalized noncompliance with tax laws and an unwillingness voluntarily to report income and pay taxes. As high-ranking Treasury Department officials explain, "When some taxpayers game the tax system, the honest taxpayers who foot the bill lose confidence in the tax system and in the government."<sup>24</sup>

To determine if certain tax provisions are fair, policy analysts use two predominate measurements: horizontal equity and vertical equity. The former requires that all U.S. taxpayers with equal amounts of income bear equal tax burdens; that is, all persons who earn essentially the same amount of income in a given year should be obligated to pay the same amount in taxes.<sup>25</sup> The latter centers on the fair allocation of the tax burden among U.S. taxpayers with different levels of income and demands that each person pay an appropriate amount of taxes. In the United States, the tax system is "progressive" or "gradual," meaning that a person's income is subjected to higher rates of taxation as that person earns more income.<sup>26</sup> This theory is based on premise that a person's greater ability to pay makes it "fair" to require that person to bear a larger portion of the country's overall revenue needs.<sup>27</sup>

### *B. Minimizing Tax Complexity and Tax Compliance Burdens*

To say that the U.S. tax system is complicated would be a tremendous understatement. Indeed, as one commentator accurately puts it, "Some problems are so complex that you have to be highly intelligent and well informed just to be undecided about them."<sup>28</sup> The international tax rules constitute perhaps the most perplexing provisions in the Code for several reasons. First, many of the tax provisions are designed to implement some economic or political policy other than raising revenue.<sup>29</sup> In addition, transactions in the international arena are apt to be quite complicated by themselves,

24. Pamela F. Olson, *New Partnership Will Restore Faith in Tax System*, *Olson Says*, 2003 TAX NOTES TODAY 180-13 (Sept. 17, 2003). Ms. Olson is the Assistant Secretary for Tax Policy, U.S. Treasury Department.

25. GUSTAFSON ET AL., *supra* note 8, at 23.

26. I.R.C. § 1 (1986); *see also* MICHAEL J. MCINTYRE, 1 THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 1-9 (2d ed. 1992). This author explains that the concept of vertical equity generally means that "the poor should be exempt from tax and that the rich should pay a higher proportion of their income in taxes than members of the middle class." *Id.*

27. U.S. JOINT COMM. ON TAXATION, THE U.S. INTERNATIONAL TAX RULES: BACKGROUND AND SELECTED ISSUES RELATING TO THE COMPETITIVENESS OF U.S. BUSINESSES ABROAD, PUB. NO. JCX-68-03, at 3 (2003).

28. Ron Pearlman, *Transition Issues in Moving to a Consumption Tax: A Tax Lawyer's Perspective*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 393 (Henry J. Aaron & William G. Gale eds., 1996).

29. GUSTAFSON ET AL., *supra* note 8, at 24.

even before applying any tax rules.<sup>30</sup> Finally, the United States has adopted international tax rules over time on the basis of competing, often radically inconsistent, policies.<sup>31</sup> This complexity is damaging to the U.S. economy because it increases the cost of tax compliance for taxpayers, obligates the Internal Revenue Service (IRS) to spend additional funds on tax enforcement, and encourages taxpayers to engage in considerable amounts of tax planning.<sup>32</sup> These heightened tax-related expenses result in elevated prices of U.S. goods and services in the international market, thereby making U.S. citizens less competitive in the international trade context.<sup>33</sup> In light of these negative consequences, tax experts argue that “simplification of the international tax provisions should be a serious goal of tax policy analysts.”<sup>34</sup>

### C. *Economic Efficiency and International Tax Neutrality*

Instituting tax policies that maximize global economic welfare is the “best way” to maximize U.S. economic welfare.<sup>35</sup> A recent study by the U.S. Treasury Department indicates that it is unadvisable for the United States to establish tax policies that produce short-term national benefit at the expense of worldwide financial well-being because doing so would certainly precipitate tit-for-tat retaliation by other nations.<sup>36</sup> This study warns, moreover, that a “broad global view” is especially important for countries, like the United States, characterized by open economies and substantial inbound and outbound investment.<sup>37</sup>

The movement of money and other assets across borders in response to tax policies, instead of in response to economic fundamentals, causes a reduction in global economic welfare. In other words, tax rules that serve to distort where capital is located are detrimental to the worldwide economy.<sup>38</sup> The type of economic distortion depends on a country’s system of taxing international investment. On one hand, if a pure source-based system is used (i.e., a territorial taxation whereby a country taxes only the income that is earned within its borders), then capital would naturally be transferred to the country with the lowest tax rate instead of flowing

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30. *Id.* at 25.

31. *Id.* at 24.

32. *Id.*

33. *Id.*

34. *Id.*

35. U.S. TREASURY DEPT., THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 25 (2000), available at <http://www.ustreas.gov/offices/tax-policy/library/subpart.f.pdf>.

36. *Id.*

37. *Id.*

38. U.S. JOINT COMM. ON TAXATION, *supra* note 27, at 17-18.

to investment projects that would render higher pre-tax profits. On the other hand, if a pure residence-based system is used (worldwide taxation whereby a country taxes the income earned by its residents irrespective of the country in which it is earned), then business enterprises located in low-tax countries would likely attract more capital investment or increase their global market share because of their ability to offer lower prices than business competitors located in high-tax countries, even though the latter may be more economically efficient.<sup>39</sup>

As one may suspect, there is no consensus regarding which method of taxing income best minimizes distortions in the location of capital investment in a world, like ours, where nearly every country imposes a different tax rate.<sup>40</sup> However, two main approaches for achieving international tax neutrality have emerged: capital export neutrality and capital import neutrality.<sup>41</sup>

The goal of capital export neutrality is reached when U.S. persons pay the same total amount of tax on income from foreign sources (to the foreign government or the U.S. government) as they pay on their income from U.S. sources (to the U.S. government). Stated differently, U.S. persons pay the same amount of tax on all income, irrespective of where it is earned. As a result, the decisions of where to invest, in what countries to build manufacturing plants, and how to structure business transactions should not be influenced by taxes.<sup>42</sup> The idea that capital export neutrality should be a foundation of U.S. international tax policy was initially espoused by the Kennedy Administration in 1962,<sup>43</sup> and the U.S. Treasury Department has demonstrated its support of capital export neutrality as recently as the year 2000.<sup>44</sup>

39. *Id.*

40. *Id.*

41. U.S. JOINT COMM. ON TAXATION, PUB. NO. JCX-13-99, OVERVIEW OF PRESENT-LAW RULES AND ECONOMIC ISSUES IN INTERNATIONAL TAXATION (1999), available at <http://www.house.gov/jct/x-13-99.htm>. This study clarifies that “[t]he literature on the theory of international taxation provides no clear direction as to the better of the two principles.” *Id.* § IV.D.

42. GUSTAFSON ET AL., *supra* note 8, at 16-17.

43. MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 25-26 (2003).

44. U.S. TREASURY DEP’T, *supra* note 35, at 53 (providing that a “basic economic analysis indicates that capital export neutrality is probably the best policy for promoting economic efficiency in a tax system that includes taxes on income of capital”); see also U.S. JOINT COMM. ON TAXATION, *supra* note 41, at 26 (acknowledging that, in a world of unequal tax rates in various nations, it is impossible to accomplish both capital export neutrality and capital import neutrality). This latter study further recognizes that while there is no consensus with regard to which system is preferable from the perspective of global economic efficiency, the U.S. Treasury Department has historically championed capital export neutrality. *Id.*

The concept of capital import neutrality dictates that all firms operating in the same industry in a particular country, regardless of whether they are owned by local parties or foreigners, are taxed at the same level.<sup>45</sup> In other words, under this system of neutrality, investment income derived in each country is subjected to the same tax rate irrespective of the residence of the investor. Capital import neutrality is accomplished where the investor's country of residence completely exempts from taxation income earned in foreign countries, thereby allowing only the country in which the income originates to levy a tax.<sup>46</sup> U.S. multinational businesses advocate this standard, arguing that all, not just some, of their foreign-source income should be exempt from taxation by the U.S. government in order to make their operations abroad competitive with local rivals.<sup>47</sup>

#### *D. Promoting the Competitiveness of U.S. Multinational Businesses*

Policymakers, business groups, and economists have argued for many years that increasing the international competitiveness of the U.S. economy should be a major tax policy goal.<sup>48</sup> This urgency is primarily based on certain trends during the last two decades, including large U.S. trade deficits, increased foreign investment in the United States, low national savings rates, and corporate transactions resulting in the expatriation of U.S. businesses.<sup>49</sup> Although definitions of "competitiveness" vary, in the commercial context, this term refers to the ability of U.S. multinational businesses that locate production facilities in other countries to compete in foreign markets.<sup>50</sup> In particular, the idea of competitiveness often focuses on the after-tax profitability of investment in foreign production.<sup>51</sup>

### V. VIOLATIONS OF U.S. TAX POLICY BY SECTION 911

Champions of the FEIE maintain that Section 911 is consistent with the components of U.S. international tax policy described above. An analysis of these arguments, as well as the evidence on which such arguments are based, renders a contrary conclusion. Provided below is a critique of the principal claims regarding the FEIE.

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45. GUSTAFSON ET AL., *supra* note 8, at 17.
  46. U.S. JOINT COMM. ON TAXATION, *supra* note 27, at 20.
  47. GUSTAFSON ET AL., *supra* note 8, at 17.
  48. U.S. JOINT COMM. ON TAXATION, *supra* note 27, at 16.
  49. *Id.*
  50. *Id.* at 17.
  51. *Id.*

### A. Fairness and Equity

The U.S. income tax system is predicated on the notion that individual enrichment is the best method of measuring a taxpayer's ability to bear the costs of the federal government.<sup>52</sup> A taxpayer's gross income provides some indication of that person's annual enrichment, but it would be unfair to utilize this figure as the guidepost for assessing taxes for the following reason. An attorney who earns \$100,000 in annual fees would actually derive less overall economic benefit since such work necessarily requires the attorney to incur many expenses in the process, including those for office space, employees' salaries, insurance, parking, professional memberships, research, and travel.<sup>53</sup> Determining the annual enrichment of the attorney requires that the expenses first be deducted from the receipts, thus rendering the attorney's net income, which is considered the "only suitable measure of the taxpayer's 'income' properly so-called."<sup>54</sup> This idea is codified in Section 162 of the Code, which provides that taxpayers may take deductions for all "ordinary and necessary expenses" that they paid or incurred during a year in the process of carrying on any trade or business. Based on the personal enrichment concept, taxpayers are allowed to take deductions for a variety of other reasons, too.<sup>55</sup>

Proponents of the FEIE rely on the net income theory in arguing that U.S. taxpayers abroad should not be taxed on the portion of their income that reasonably reflects the added costs of working abroad, such as those associated with foreign housing, education of children in private English-speaking institutions, home-leave expenses, and maintaining storage or housing in the United States while overseas.<sup>56</sup> In other words, they argue that, were it not for the FEIE, U.S. taxpayers abroad would end up paying higher taxes than their compatriots working in the United States since they have larger gross incomes as a result of the international-assignment allowances (cost-of-living adjustments) that they receive from their multinational employers.<sup>57</sup> This argument has also appeared in congressional debates, such as when the Ways and Means Committee of the U.S. House of Representatives stated the following:

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52. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 101 (9th ed. 2002).

53. *Id.*

54. *Id.*

55. See I.R.C. §§ 161-223 (1986).

56. See *House Ways & Means Hearing*, *supra* note 4; see also U.S. JOINT COMM. ON TAXATION, *supra* note 27.

57. PRICE WATERHOUSE LLP, ECONOMIC POLICY CONSULTING SERVICES, ECONOMIC ANALYSIS OF THE FOREIGN EARNED INCOME EXCLUSION E-6 (Oct. 1995).

The Committee recognizes that for U.S. businesses to be effective competitors overseas it is necessary to dispatch U.S. citizens or residents to sites of foreign operations. Being stationed abroad typically imposes additional financial burdens on the employee and his family. These burdens may arise from maintaining two homes (one in the United States and one abroad), additional personal travel to maintain family ties, or the added expenses of living in a foreign location that has a high cost of living. Businesses often remunerate their employees for these additional burdens by paying higher wages. Because the increased remuneration is offset by larger burdens, the remuneration does not truly reflect an increase in economic well-being. The Committee, therefore, believes that the exclusion of section 911 is a simple way to prevent taxpayers from facing an increased tax burden when there has been no increase in economic well-being by accepting an overseas assignment.<sup>58</sup>

When U.S. multinationals operate abroad, they may generally choose to hire people from three groups: U.S. expatriates (for example, Americans working in Chile), third-country nationals (for example, Canadians working in Chile), or locals (for example, Chileans working in Chile). In addition to the net income argument described in the preceding paragraph, FEIE backers suggest that the concept of tax fairness should involve a comparison between U.S. expatriates and the third-country nationals working in a particular foreign nation, as opposed to a comparison between U.S. taxpayers abroad and their domestic counterparts.<sup>59</sup> Since third-country nationals are generally not taxed on their foreign-source income (because their countries apply a territorial taxation system under which income earned abroad is not subject to income tax at home) while U.S. taxpayers are taxed on their worldwide income, FEIE supporters claim that the only way to institute equity is to enlarge the FEIE such that all of the income earned by U.S. taxpayers abroad is exempt from taxation.<sup>60</sup>

As explained above, the concept of tax fairness encompasses the theories of horizontal equity and vertical equity. Opponents of the FEIE argue that this program should be completely repealed because it violates both horizontal and vertical equity.<sup>61</sup> With regard to horizontal equity, this principle is violated because the FEIE removes an item of income (the "foreign earned income") from the U.S. tax base, thereby allowing U.S. taxpayers with similar amounts of income to bear different tax burdens.<sup>62</sup> Moreover, the FEIE does not comport with the notion of horizontal equity because it provides a tax benefit

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58. Revenue Reconciliation Act of 1997, H.R. REP. NO. 105-148 (1997).

59. John A. Papahronis, *Taxation of Americans Abroad Under the ERTA: An Unnecessary Windfall*, 4 NW. J. INT'L L. & BUS. 586, 593-94 (1982).

60. *Id.* at 594.

61. GUSTAFSON ET AL., *supra* note 8, at 371.

62. *Id.* at 373; *see also* MCINTYRE, *supra* note 26, at 7-27 to 7-29 (explaining that the FEIE has been a favorite target for tax reformers for many years since it is an "obvious violation of horizontal equity").

to U.S. taxpayers working abroad in a manner that bears no relationship to any hardship that supposedly impairs a taxpayer's ability to pay. Allowing qualified U.S. citizens abroad a flat exclusion of \$80,000 per year ignores the possibility that many U.S. taxpayers living and working in the United States (such as those in Alaska or Hawaii) may experience higher costs of living. Unlike their expatriate brethren, however, the Alaskan and Hawaiian workers do not qualify for any tax benefits under the FEIE.<sup>63</sup> This flat exclusion amount also yields inequity when comparing U.S. citizens working in different foreign countries since the cost of living in the Dominican Republic is quite low, whereas living expenses in parts of Europe are exorbitant. Despite these disparities, qualified U.S. citizens working and living in each of these nations will be able to exclude \$80,000 (plus their "housing cost amount") from their annual income under the FEIE.<sup>64</sup>

The FEIE also constitutes a transgression of vertical equity since it affords a greater benefit to highly-compensated individuals. Section 911 provides that the total exclusion from gross income (for the "foreign earned income" and "housing cost amount") may not exceed the amount of a person's "foreign earned income" for the year.<sup>65</sup> This limitation produces certain inequitable results. For example, assume that a U.S. citizen overseas receives from his or her employer \$100,000 in wages and \$50,000 for housing expenses. Under the FEIE, the person would be able to exclude \$80,000 of the wages, but only \$20,000 of the housing expenses. By contrast, a U.S. citizen abroad who receives \$150,000 in wages and \$50,000 for housing expenses would be able to exclude \$80,000 of the wages and the entire \$50,000.<sup>66</sup>

Finally, the idea presented by FEIE backers that determining tax fairness should not involve a comparison between U.S. taxpayers abroad and their domestic counterparts, but rather between U.S. citizens and the third-country nationals working in a particular foreign nation also lacks merit for two main reasons. First, since third-country nationals do not enjoy the benefits of U.S. citizenship they naturally do not bear the costs for them.<sup>67</sup> Second, the situation between third-country nationals and U.S. citizens abroad may not be sufficiently similar to make a comparison of tax benefits and burdens.<sup>68</sup> For example, although the third-country nationals may be exempt from tax in their home countries, they ordinarily must satisfy various requirements to benefit from this exempt status, including

63. Papahronis, *supra* note 59, at 593.

64. *Id.*

65. I.R.C. § 911(d)(7) (1986).

66. U.S. JOINT COMM. ON TAXATION, *supra* note 27, § VI.C.

67. Papahronis, *supra* note 59, at 594.

68. *Id.*

living and working abroad continuously for at least two years, being accompanied by an immediate family member, formally relinquishing residence in their home countries, and severing other ties such as property ownership and financial interests.<sup>69</sup>

### B. *Minimizing Tax Complexity and Tax Compliance Burdens*

As mentioned above, one of the United States' primary international tax goals is to minimize tax complexity, thereby reducing the expense of tax compliance (for U.S. taxpayers) and of tax enforcement (for the IRS). Proponents of the FEIE claim that complexity in the U.S. tax laws is itself a disguised tax levied in the form of additional hours that a taxpayer must spend to properly complete the relevant tax forms and the fees that taxpayers often pay to professional tax preparers.<sup>70</sup> They further suggest that complexity is equally detrimental to the IRS, which must allocate considerable public resources to process tax and information returns, conduct examinations and audits, impose tax assessments, and handle the resulting litigation and appeals.<sup>71</sup> Succinctly put in one recent study, "[c]omplexity is very poor tax policy, indeed, as it imposes costs on taxpayers and on the budget and produces no revenue for the government."<sup>72</sup> Supporters of Section 911 acknowledge that earlier designs of the FEIE were desirable in theory but "disastrous" in application; however, they argue that the current structure and function of the FEIE achieves greater tax simplicity.<sup>73</sup> Echoing this sentiment, other FEIE backers claim that Section 911 simplifies the tax deductions associated with doing business abroad.<sup>74</sup> Still other champions of the FEIE suggest that using Section 911 often eliminates the need to compute the foreign tax credit, which constitutes an extremely complex undertaking for less sophisticated taxpayers working abroad, such as rank-and-file employees and middle managers of small and medium-sized business.<sup>75</sup>

There is little argument that excessive complexity is negative for taxpayers and the IRS alike. The FEIE's ability to lessen tax complexity, however, is questionable. Indeed, it is evident that Section 911 serves to make the already-complicated U.S.

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69. *Id.* According to the author, "[w]hile a comparison of relative tax burdens of expatriate Americans vis-à-vis third country nationals may have some relevance in a trade promotion context, the comparison is inappropriate when applied to tax equity." *Id.*

70. PRICE WATERHOUSE LLP, *supra* note 57, at 29.

71. *Id.*

72. *Id.*

73. *Id.*

74. *House Ways & Means Hearing, supra* note 4, at 124.

75. Letter from American Institute of Certified Public Accountants to Senator Charles E. Grassley (May 14, 2003), available at <http://www.aicpa.org>.



international tax system even more complex, and makes tax compliance and enforcement more challenging for taxpayers, U.S. courts, and the IRS.<sup>76</sup> As explained above, to take advantage of the FEIE, a taxpayer must undertake a variety of formidable tasks, including satisfying all of the fact-specific tests to be considered a "qualified individual," identifying and calculating the items that constitute "foreign earned income," determining the expenses falling within the definition of the "housing cost amount," completing the appropriate forms officially to make the election to benefit from the FEIE, and avoiding the plethora of additional restrictions related to the FEIE.<sup>77</sup> In addition, after expending all the effort to take advantage of the FEIE, many U.S. taxpayers overseas must then invest a significant amount of time and resources to obtain the proper foreign tax credit.<sup>78</sup> As described earlier, the FEIE is not unlimited; rather, it allows qualified taxpayers to avoid being taxed by the IRS on as much as \$80,000 of their annual foreign earned income.<sup>79</sup> To address the issue of how the IRS handles any foreign taxes paid on any income above this threshold, the taxpayer must apply the rules regarding the foreign tax credit.<sup>80</sup> Like those of the FEIE, the requirements and rules associated with the foreign tax credit are extremely complex.<sup>81</sup> These conclusions are supported by a report from the U.S. General Accounting Office, which concluded that the FEIE is unreasonably complex, many U.S. taxpayers overseas are unable accurately to prepare their own tax returns, many U.S. companies incur substantial costs for the preparation of the tax

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76. Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 1009 (1997); see also GUSTAFSON ET AL., *supra* note 8, at 373 (suggesting that the FEIE makes the tax system more complex not just for U.S. taxpayers, but also for U.S. courts, which are charged with interpreting the complexities, and the IRS, which is responsible for administering them).

77. Peroni, *supra* note 76, at 1009; see also I.R.S. Form 2555 (Foreign Earned Income); I.R.S. Instructions for Form 2555; I.R.S. Pub. 54: Tax Guide for U.S. Citizens and Resident Aliens Abroad (2002); I.R.S. Form 673 (Statement for Claiming Benefits Provided by Section 911 of the Internal Revenue Code).

78. GEN. ACCOUNTING OFFICE, TAX ADMINISTRATION: NONFILING AMONG U.S. CITIZENS ABROAD, GGD-98-106, at 24 (May 1998) (finding that those Americans abroad who elected to use the FEIE and the foreign tax credit still had an average U.S. tax liability of \$6,700).

79. I.R.C. § 911(b)(2)(D)(i). The excludable amounts have increased over the years, as follows: 1998 - \$72,000; 1999 - \$74,000; 2000 - \$76,000; 2001 - \$78,000; 2002 - \$80,000. The \$80,000 exclusion remains intact until 2008, at which time is increased in proportion to the rate of inflation. See §911(b)(2)(D)(ii).

80. No exclusion, deduction or credit is allowed to the extent that it is properly allocable to or chargeable against amounts excluded from gross income under the FEIE. §911(d)(6).

81. I.R.C. §§ 901-08.

returns of their employees, and the risk of incorrect completion of tax and information returns is great.<sup>82</sup>

### C. Economic Efficiency and International Tax Neutrality

As explained earlier in the Article, capital export neutrality is achieved when a U.S. person pays the same amount of tax on all income, irrespective of where it is earned. The decision of whether to invest in the United States or abroad, therefore, is based on non-tax business considerations.<sup>83</sup> The idea that capital export neutrality serves as a foundation of U.S. international tax policy was first introduced in 1962<sup>84</sup> and still enjoys strong governmental support.<sup>85</sup> In fact, a recent study by the U.S. Treasury Department concluded that "basic economic analysis indicates that capital export neutrality is probably the best policy for promoting economic efficiency."<sup>86</sup>

Attempts by FEIE supporters to justify this program on the basis that it meets the concept of capital export neutrality are noticeably scarce. Moreover, of the few arguments that they have espoused, most are perplexing or downright self-defeating. From this, one may speculate that FEIE backers are willing to concede that Section 911 violates capital export neutrality since this divergence from U.S. international tax policy is arguably not fatal in light of the "conflicting policy objectives" in this area.<sup>87</sup> For example, representatives of the Section 911 Coalition focus on the idea of economic efficiency, suggesting that U.S. tax law should not interfere with the efficient allocation of resources.<sup>88</sup> According to studies sponsored by this organization, without Section 911, U.S. taxpayers abroad would generally pay considerably higher taxes than their domestic counterparts, and their multinational employers would bear a large portion of these added tax costs.<sup>89</sup> As a result, were the FEIE to be repealed, federal tax law would serve to discourage U.S. multinationals from hiring U.S. citizens for overseas projects.<sup>90</sup>

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82. GEN. ACCOUNTING OFFICE, AMERICAN EMPLOYMENT ABROAD DISCOURAGED BY U.S. INCOME TAX LAWS, ID 81-29, 3 (Feb. 1981) [hereinafter AMERICAN EMPLOYMENT]. These conclusions were based on the functioning of earlier versions of the FEIE.

83. GUSTAFSON ET AL., *supra* note 8, at 16-17.

84. GRAETZ, *supra* note 43, at 25-26.

85. U.S. TREASURY DEP'T, *supra* note 35, at 53.

86. *Id.*

87. AMERICAN EMPLOYMENT, *supra* note 82, at iv. According to this report, whether and how to tax Americans working abroad is part of the "continuing conflict among the tax policy objectives of raising revenue, achieving tax equity, simplifying tax returns, and other special aims of public policy, such as promoting U.S. exports and competitiveness [of U.S. multinationals] abroad. *Id.*

88. *House Ways & Means Hearing, supra* note 4, at 2.

89. PRICE WATERHOUSE LLP, *supra* note 57, at E-6-E-7.

90. *Id.*

Concurring with the idea that revoking Section 911 would alter investment and other business decisions of U.S. multinationals, respected tax experts harshly criticize the FEIE, labeling it “an example of a tax preference provision in the U.S. international tax system that distorts economic behavior in violation of capital export neutrality.”<sup>91</sup> This transgression of tax policy occurs on two levels. First, with respect to individual U.S. taxpayers working abroad, Section 911 distorts economic and social behavior—thereby making it inefficient—by encouraging them to decide where to live and work based in large part on tax considerations. Put differently, the FEIE manipulates international labor flows by providing an incentive to mobile U.S. workers to relocate to nations that impose few, if any, income taxes in order to reduce their worldwide tax liabilities.<sup>92</sup> Second, with regard to U.S. multinational companies, Section 911 acts as a subsidy to the companies themselves, rather than to the U.S. employees thereof, to the extent that this program allows the companies to lower the workers’ salaries. This encourages U.S. multinationals to locate their operations in low-tax countries, which violates capital export neutrality.<sup>93</sup>

#### *D. Promoting the Competitiveness of U.S. Multinational Businesses*

At first glance, Section 911 appears to benefit individual U.S. taxpayers working overseas. In reality, however, large U.S. multinationals are usually the beneficiaries of this program. Proponents of the FEIE explain the situation in the following manner. The foreign tax burdens and extra living costs for U.S. taxpayers abroad make it more expensive for U.S. multinationals to hire U.S. employees. If the companies employ U.S. citizens, they must ordinarily reimburse these workers for the additional taxes (through so-called “tax neutralization programs”) and for the added living costs (through higher salaries). These expenses incurred by the U.S. company are then passed on to customers worldwide in the form of higher product prices. As a result of these elevated prices, U.S. multinationals are unable to compete with their foreign competitors

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91. Peroni, *supra* note 76, at 1008; *see also* GUSTAFSON ET AL., *supra* note 8, at 372.

92. *Id.*; *see also* GUSTAFSON ET AL., *supra* note 8, at 372 (stating that the FEIE “may distort the workings of the free market by causing [Americans] to accept overseas employment in situations in which they would not have done so in the absence of this tax preference”).

93. Peroni, *supra* note 76, at 1008; *see also* GUSTAFSON ET AL., *supra* note 8, at 372 (suggesting that we question why the U.S. tax system should provide a tax subsidy to U.S. multinational businesses that leads to an understatement of the actual costs of operating overseas, thereby encouraging these businesses to relocate operations abroad in what is a patent violation of capital export neutrality).

from countries that exempt the foreign earned income of their citizens since these foreign rivals can charge lower prices for comparable products.<sup>94</sup> This argument centers on the competitiveness of U.S. businesses in the global market and recognizes that in most cases “the ultimate beneficiaries of the Section 911 exclusion are the employers of the U.S. worker, who are able to pay lower total compensation to the U.S. worker than if the exclusion were not available.”<sup>95</sup>

The competitiveness justification has also been a traditional favorite among certain politicians. For instance, in analyzing the FEIE in 1981, congressional reports stated:

American business faces increasing competitive pressures abroad, and [ ] in view of the nation's continuing trade deficits, it is important to allow Americans working overseas to contribute to the effort to keep American business competitive. The tax burdens imposed on these individuals . . . have made it difficult for U.S. businesses to utilize American employees abroad. In many cases, the policy of these businesses is to make their employees whole for any extra tax expenses [that] the employees incur because of overseas transfers. Thus, an extra tax cost to the employees becomes a cost to the business, which cost often must be passed through to customers in the form of higher prices. In intensely competitive industries, such as construction, this leads to higher, and thus often noncompetitive bids for work by American firms . . . As a result, some U.S. companies either have to cut back their foreign operations or have replaced American citizens in key executive positions with foreign nationals.<sup>96</sup>

The importance of competitiveness as a rationale for the tax break provided (albeit indirectly) to U.S. multinationals is also recognized in numerous other sources, which have called this argument the “main justification” for the FEIE,<sup>97</sup> the “primary purpose” of this tax provision,<sup>98</sup> one of “the relatively few policy instruments available for promoting U.S. exports and commercial competitiveness abroad,”<sup>99</sup> and the “driving force” behind preserving Section 911.<sup>100</sup>

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94. GUSTAFSON ET AL., *supra* note 8, at 371; *see also House Ways & Means Hearing, supra* note 4, at 126. This organization claims that U.S. multinationals face a dilemma: pay U.S. workers more than foreigners with comparable qualifications or utilize a tax-equalization program to compensate U.S. workers for the additional tax burden. Either way, this group argues, U.S. businesses will face an increased financial burden, one which “many employers are unwilling to accept even if the American worker is more productive and has better professional qualifications.” *Id.*

95. GUSTAFSON ET AL., *supra* note 8, at 371.

96. S. REP. NO. 97-144, at 35-36 (1981), *reprinted in* 1981-2 C.B. 412, 419-20.

97. PRICE WATERHOUSE LLP, *supra* note 57, at 31.

98. MCINTYRE, *supra* note 26, at 7-27.

99. AMERICAN EMPLOYMENT, *supra* note 82, at 35.

100. Evans, *supra* note 4, at 900; *see also* Martin A. Sullivan, *The Five Uneasy Pieces of U.S. International Tax Reform*, 31 TAX NOTES INT'L 418, 422 (2003) (explaining that “[f]or decades, well-funded multinationals and their highly

Simultaneously safeguarding the competitiveness of U.S. multinationals (by providing an indirect tax subsidy to these businesses) and achieving capital export neutrality (where the decision to operate in the United States or abroad is not made on the basis of tax considerations) appears impossible. Indeed, the concepts themselves seem to stand in obvious contradiction. Instead of simply admitting that favoring particular U.S. citizens abroad is incongruent with accepted international tax policy, the U.S. government justifies this favoritism by explaining that its entire international tax policy is inconsistent. Studies by the U.S. Government Accounting Office explain,

Taxation of Americans working abroad is part of the *continuing conflict among the tax policy objectives* of raising revenue, achieving tax equity, simplifying tax returns, and other special aims of public policy, such as promoting U.S. exports and competitiveness [of U.S. multinationals] abroad. In considering the question of whether, and to what extent, Americans working abroad should be taxed, the Congress must decide what priority should be assigned to each of the *conflicting policy objectives*.<sup>101</sup>

Assuming, for the sake of argument, that subsidizing U.S. multinationals falls within accepted national tax policy, this practice is still suspect since its overall value to the U.S. economy is still unsubstantiated.<sup>102</sup> In the opinion of tax experts, Congress has historically rationalized the special tax treatment of U.S. taxpayers abroad on a variety of bases, but the "only real justification" for Section 911 is that it is an incentive.<sup>103</sup> Accordingly, the evaluation of the FEIE should focus exclusively on the economic effectiveness of this tax regime; that is, whether it has generated more national benefits than it has cost the U.S. Treasury in terms of lost tax revenues. Many studies regarding the economic effects of the FEIE have been conducted by both governmental agencies and the private sector.<sup>104</sup> Despite these efforts, the true monetary virtue of the FEIE remains "unproven," which is quite disconcerting in light of the

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compensated lobbyists have take advantage of America's apprehensions about its own competitiveness and used it to promote their own self-interests").

101. AMERICAN EMPLOYMENT, *supra* note 82, at 28.

102. Evans, *supra* note 4, at 900-06 (arguing that even if Section 911 achieves its stated goals, the key question is whether the U.S. economy as a whole is better off with or without this provision). In short, Evans recognizes the laudable aspirations of the FEIE, but questions whether any have truly been achieved. *Id.* at 916; *see also* Papahronis, *supra* note 59, at 586.

103. Sobel, *supra* note 4, at 146.

104. *Id.* at 150-56 (referring to studies by the U.S. Treasury Department, the U.S. General Accounting Office, and Chase Econometrics).

magnitude of this subsidy for particular U.S. multinational companies.<sup>105</sup>

### E. Tax Benefit Concept

This Article explained earlier that one of the chief goals of the U.S. international tax system is to promote fairness. A subcategory of fairness is the tax benefit concept, which basically means that there should exist a reasonable relationship between the amount of tax that one pays and the measure of governmental benefits that one receives in return. Advocates of the FEIE claim that this program makes logical adjustments for the fact that U.S. citizens working abroad receive fewer benefits in terms of U.S. government goods and services than their counterparts who reside and work in the United States.<sup>106</sup> They argue, in particular, that “Americans living abroad do not receive the same level of benefits from the U.S. government as domestic residents. Thus, if the [tax] benefits principle were applied, Americans working abroad should be subject to lower U.S. income taxes.”<sup>107</sup>

While this argument may have some immediate allure, further analysis clearly reveals its shortcomings.<sup>108</sup> The FEIE violates the tax benefits principle, and thus is unfair and in violation of accepted U.S. international tax policy, because it allows U.S. workers working abroad to retain the tremendous (yet often unappreciated) benefits of U.S. citizenship without paying their share of the costs of providing these benefits.<sup>109</sup> This argument is based on the fact that U.S. citizenship offers enormous benefits regardless of where a citizen resides and works. For instance, irrespective of where a citizen currently works, that person is deriving certain benefits from U.S. government expenditures on foreign affairs, international development assistance, and national defense.<sup>110</sup> Any U.S. citizen who has traveled abroad and required assistance from a U.S. embassy or local consulate can surely appreciate this argument. Those citizens who have been defended or evacuated by the U.S. armed forces in hostile countries will clearly understand this argument, too. More importantly perhaps, U.S. citizenship provides one with the ability (priceless in many cases) to return to the United

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105. *Id.* at 156 (urging a moratorium on Section 911 until reliable studies are conducted since inadequate information regarding the overall economic effect of the FEIE “has hindered effective policymaking for more than fifty years”).

106. PRICE WATERHOUSE LLP, *supra* note 57, at E-6.

107. *Id.* at 28.

108. JOSEPH ISENBERGH, INTERNATIONAL TAXATION 189 (2000) (describing the FEIE as a “windfall” and suggesting that most claims in support of the FEIE, including the tax benefits argument, lack merit).

109. Peroni, *supra* note 76, at 1009.

110. *Id.*

States to take advantage of the existing legal, economic, and social institutions.<sup>111</sup> In short, the FEIE allows certain U.S. taxpayers to be “free riders” with respect to the vast array of benefits, both apparent and obscure, provided by the U.S. government.<sup>112</sup>

#### F. Cultural Ambassadors

Supporters of the FEIE claim that the mere presence of citizens abroad promotes U.S. interests because they “foster a positive image” of the United States the world over<sup>113</sup> and serve as “unpaid ambassadors for American values.”<sup>114</sup> This favorable impression, they argue, is created by all U.S. citizens overseas, regardless of whether they are employees of major corporations, representatives of cultural or religious institutions, educators, entrepreneurs, directors of charitable organizations, or homemakers.<sup>115</sup>

Evoking patriotism and exploiting the inherent desire of most citizens to propagate U.S. culture and values can be effective techniques, particularly in the aftermath of the terrorist attacks on September 11, 2001. However, in the context of the FEIE, these tactics are undercut by the fact that little, if any, tangible evidence exists to support the sweeping assertion that all U.S. citizens abroad will foster a positive U.S. image or enhance international goodwill and increased understanding between nations and people.<sup>116</sup> Moreover, even a cursory review of major newspapers will indicate that certainly not all U.S. citizens abroad are fostering a positive image of the United States. For instance, an eighteen year-old U.S. dependent living in Singapore was the focus of worldwide media in 1994 when he was arrested, interrogated, imprisoned, fined, and caned for stealing Singaporean street signs and spray-painting over fifty cars.<sup>117</sup> This event undoubtedly tarnished the U.S. image since this youngster represented “a modern-day Ugly American, a stereotypical expatriate kid reviled in the Singaporean media as a

111. *Id.*

112. *Id.*

113. *House Ways & Means Hearing, supra* note 4, at 131.

114. *Democrats Abroad Join Opposition to Elimination of Foreign Earned Income Exclusion Perceive Threat to Hundreds of Thousands of Jobs for Americans Living and Working Overseas*, 2003 WORLDWIDE TAX DAILY 98-11 (May 21, 2003) (statement by Senator John Breaux) [hereinafter *Democrats Abroad*].

115. *House Ways & Means Hearing, supra* note 4, at 131; *see also* U.S. JOINT COMM. ON TAXATION, *supra* note 27, § VI.C.

116. Evans, *supra* note 4, at 904.

117. Jason Vest, *Justice under the Lash; Did Singapore Beat a Confession out of a Young American?*, WASH. POST, Apr. 15, 1994, at D1.

foreign vandal."<sup>118</sup> Another incident involving U.S. expatriates that filled newspaper headlines and created a negative perception of the United States occurred in Brunei in 1995. In this case, an U.S. corporate jet pilot living abroad was charged by the Brunei authorities with reckless driving and attempted murder after he engaged in a high-speed car chase with U.S. embassy officials, who were assisting the pilot's wife and daughter escape domestic violence.<sup>119</sup>

### G. Increase U.S. Exports and Domestic Jobs

In an attempt to simplify a deceptively convoluted argument, proponents of the FEIE offer the following formula:

$$\text{U.S. citizens abroad} = \text{U.S. exports} = \text{domestic jobs.}^{120}$$

The logic underlying this argument is that the FEIE causes U.S. multinational business operating abroad to hire U.S. workers, who will purchase supplies from and retain the services of other U.S. companies. This, in turn, will generate a higher demand for U.S. exports, thereby creating more domestic jobs. In support of this position, FEIE backers cite two 1995 studies. According to a study by academics at the Johns Hopkins University, U.S. citizens employed overseas are more likely to order goods and services from other U.S. companies.<sup>121</sup> Likewise, the report by PriceWaterhouse alludes to an earlier study by the U.S. Treasury Department in concluding that the repeal of the FEIE would cause the number of U.S. taxpayers working abroad to decrease by 2.83 percent, the amount of U.S. exports to diminish by 1.89 percent, and the total domestic employment associated with U.S. exports to fall by nearly two percent.<sup>122</sup> In other words, abrogating the FEIE would occasion a loss of 6,800 jobs abroad, an \$8.7 billion drop in U.S. exports, and the disappearance of 143,000 domestic jobs in the export sector.<sup>123</sup> Certain Washington-based conservative think tanks have also

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118. *Id.* As an executive for Federal Express in Singapore, it is quite possible that the young man's parents (as well as the young man himself indirectly) benefited from the FEIE.

119. Jack Horan, *Charlottean's Kin May Face Caning in Brunei; Pilot, U.S. Embassy Dispute Car Chase*, CHARLOTTE OBSERVER, Apr. 29, 1995, at 1A.

120. *House Ways & Means Hearing*, *supra* note 4, at 133 (arguing that Section 911 paves "the way for more U.S. citizens overseas to buy American, sell American, specify American, hire American, and create opportunities for other Americans abroad") (emphasis in original).

121. Report by Charles Pearson & James Riedel to the Section 911 Coalition, *The Importance of Section 911 for U.S. International Competitiveness § I* (Aug. 1995).

122. PRICE WATERHOUSE LLP, *supra* note 57, at E-6 (on file with the author) [hereinafter Pearson & Riedel].

123. *Id.*



supported this argument. According to the Heritage Foundation, ridding the U.S. tax system of the FEIE would increase the cost for U.S. multinational businesses of hiring U.S. citizens, thereby making the hiring of foreigners more probable.<sup>124</sup> This, it is argued, will result in fewer U.S. exports since U.S. citizens working abroad, particularly company executives, “are likely to purchase U.S. products.”<sup>125</sup> The American Institute of Certified Public Accountants has also made similar statements. In a recent letter to Congress, this professional organization warned that if U.S. multinationals substitute foreigners for U.S. workers at their foreign operations, the result will be decreased domestic employment and U.S. exports because “foreign nationals are less likely to purchase U.S. goods and services because they are more familiar with their local suppliers.”<sup>126</sup>

The formula offered by FEIE proponents possesses a certain degree of persuasiveness. However, this theory may be discredited in several ways. First, the modern world is characterized by global travel, satellite television, cellular telephones with worldwide coverage, and the Internet. As a result, most U.S. citizens are exposed to an abundance of different ideas, products and services, all of which are readily accessible. In terms of business, the modern world is characterized by ever-increasing competition where price and quality are normally the determinative factors. Therefore, accepting the premise of FEIE supporters that U.S. citizens abroad will automatically purchase goods and services from U.S. companies is troublesome. Indeed, do U.S. workers truly prefer U.S. products? Think about Americans’ penchant for French wine, Italian clothing, German luxury cars, and Swiss chocolate. Similarly, do foreigners really prefer products from their own countries? Think about foreign demand for American jeans, fast food, movies and music.<sup>127</sup>

Second, getting to the root of the argument, it is unclear whether, or to what extent, the expansion of foreign operations by U.S. multinationals benefits the entire U.S. economy. Advocates of tax-based incentive programs aspire to create the impression with Congress and the public that most U.S. multinational businesses

124. Daniel J. Mitchell, International Provisions of Senate Tax Bill Undermine U.S. Competitiveness, Executive Memorandum from Daniel J. Mitchell (May 12, 2003) No. 878.

125. *Id.* Mitchell claims that the proposed repeal of the FEIE is simply bad tax policy based on “greed” since its repeal could increase U.S. tax revenues by more than \$32 million over the next decade.

126. Letter from American Institute of Certified Public Accountants to Senator Charles E. Grassley, *supra* note 75; see also U.S. JOINT COMM. ON TAXATION, *supra* note 27, § VI.C (reporting that FEIE proponents argue that Americans abroad are likely to create additional business for U.S. exporters and service providers because they are “knowledgeable about and accustomed to” working with these companies).

127. GUSTAFSON ET AL., *supra* note 8, at 372.

conduct research in the United States (which creates high-paying U.S. jobs) and invest overseas only to establish sales subsidiaries (which increases U.S. exports).<sup>128</sup> While this may be true in certain cases, "it is by no means the complete story."<sup>129</sup> Moreover, according to a study by the U.S. General Accounting Office, export promotion programs do not produce a substantial change in the level of domestic employment since this is determined by macroeconomic policies of the United States and its trading partners, including exchange rates, and interest rates.<sup>130</sup> The Congressional Research Service has reached similar conclusions. In one of its recent reports, this group explained that economic theory indicates that the ultimate overall welfare of the United States does not depend on exporting as much as possible or on maximizing the competitiveness of U.S. multinationals operating overseas.<sup>131</sup> Instead, the United States' general economic well-being depends largely on whether investment locations are distorted in inefficient manners, and on whether the benefits of subsidies are obtained by U.S. individuals and businesses or whether they flow out of the United States.<sup>132</sup> In the case of an export subsidy (which the FEIE is in many senses), economic theory indicates that its repeal would enhance the economic welfare of the United States.<sup>133</sup>

Third, it may not be necessary to maintain a large number of U.S. workers abroad in order to promote U.S. exports. On the contrary, studies by the Congressional Research Service indicate that local workers in foreign countries may serve as more effective salespersons of U.S. products than a U.S. citizen living abroad since the locals possess more in-depth knowledge regarding the native language, culture, and market.<sup>134</sup>

Finally, Section 911 may be overly broad in that it benefits many U.S. expatriates whose potential influence in terms of exports is

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128. Sullivan, *supra* note 100, at 422.

129. *Id.*

130. GEN. ACCOUNTING OFFICE, EXPORT PROMOTION: RATIONALES FOR AND AGAINST GOVERNMENT PROGRAMS AND EXPENDITURES, GAO/T-GGD-95-169 (May 1995).

131. David L. Brumbaugh, *International Tax Provisions of the American Competitiveness and Corporate Accountability Act (H.R. 5095)*, as reprinted in 2002 WORLDWIDE TAX DAILY 188-231 (Sept. 27, 2002).

132. *Id.*

133. *Id.* (explaining that export subsidies artificially distort the allocation of investment dollars, thereby causing an inefficient amount of capital to the export sector and encouraging the country providing the subsidy to export more products than is justified by economic analysis, and that a portion the subsidy is enjoyed by foreign consumers as U.S. exporters transfer part of the benefit in the form of lower product prices).

134. Papahronis, *supra* note 59, at 596 (citing a study by the Congressional Research Service entitled "U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis").

practically nil. For instance, one survey concluded that forty-one percent of those utilizing the FEIE are not in export-influencing categories, among them teachers, preachers, lawyers, doctors, and entertainers.<sup>135</sup>

#### H. Additional Arguments against Section 911

In addition to the fact that the FEIE is inconsistent with U.S. international tax policy, this program, and many of the arguments made in support thereof, are suspect for a number of reasons. Of extreme importance is the fact that the very studies relied on by FEIE backers explicitly question or qualify their own conclusions. For example, the report presented by professors at the Johns Hopkins University School of Advanced International Studies acknowledges that the firms comprising the subject group were not "scientifically selected" and their responses were not "necessarily reflective of the universe of U.S. firms engaged in overseas activities."<sup>136</sup> This report further acknowledges that many of the questions presented to these firms were subjective or hypothetical and that "no attempt [was] made to confirm the accuracy of the responses."<sup>137</sup> Like the report produced by the Johns Hopkins University, the reports by the U.S. General Accounting Office also expressly recognize their own shortcomings, as well as those of other related studies. For instance, the GAO report in 1981 explains that the evaluation of the effectiveness of personal tax incentives for promoting exports and commercial competitiveness abroad has been scant.<sup>138</sup> What's worse, the few studies that have been made "have not been generally accepted as authoritative" and "cannot be accepted with great confidence" because of the limitations of these studies in terms of data and methodologies.<sup>139</sup> With regard to its own research, this GAO report acknowledges that "[t]he data suffers from the weaknesses of much survey data in that it was collected without verification from parties with a vested interest in the outcome of the study."<sup>140</sup> An earlier report by the GAO was equally frank in recognizing its own limited value. In its 1978 report, this organization

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135. *Id.* at 597 (concluding that Section 911 represents "a government bonus for temporary foreign employment which is unrelated to any specific national objective [since] the incentives of the exclusion apply equally to all situations, whether they promote exports or not").

136. Pearson & Riedel, *supra* note 121, at § IV.

137. *Id.* (arguing that, despite the limitations of this report and the evidence-collection methods utilized, it still "sheds useful light" regarding the benefits of the FEIE to U.S. international competitiveness, exports, and employment).

138. AMERICAN EMPLOYMENT, *supra* note 82, at 3-4.

139. *Id.*

140. *Id.* at 6.

admitted that the full economic impact of the reduction of the FEIE could not be measured with any precision “not only because needed data are lacking but also because the secondary benefits to the Nation from having Americans abroad are so difficult to determine.”<sup>141</sup> The principal studies used to support the FEIE may also suffer from decreased legitimacy since they were both paid for by the Section 911 Coalition, the leading special-interest group in this area.<sup>142</sup>

The FEIE is also questionable since it is not restricted such that it only benefits U.S. employees of U.S. multinational businesses. Indeed, a “qualified individual” who works for a foreign employer can also take advantage of the FEIE.<sup>143</sup> In cases where U.S. citizens work for foreign companies, the U.S. tax system is effectively providing a tax subsidy to the foreign companies, which encourages them (by allowing them to pay lower compensation to U.S. employees who can exclude certain amounts of income from U.S. taxation) to invest in business operations in a foreign country instead of in the United States.<sup>144</sup> Putting it lightly, this is “certainly a strange use of the U.S. tax system.”<sup>145</sup>

The “housing cost amount” constitutes another point of criticism of the FEIE. As explained above, Section 911 allows U.S. taxpayers abroad to exclude from gross income the “foreign earned income” and the “housing cost amount.”<sup>146</sup> Permitting an exemption for the “housing cost amount” is odd from a tax policy perspective since one of the principal justifications for the \$80,000 annual foreign earned income exclusion is to compensate U.S. citizens living and working abroad for their increased costs of living.<sup>147</sup> In other words, the housing cost amount is somewhat duplicative of foreign earned income, thereby permitting certain persons to receive a double tax benefit. The housing cost amount is also called into question since these expenses would not normally meet the criteria for exclusions in cases of employer-provided housing.<sup>148</sup> Under Section 119 of the Code, an employee may exclude from gross income the value of any lodging furnished by the employer, but only if the employee is required to accept such lodging as a condition of employment, the lodging is located on the business premises of the employer, and the

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141. AMERICAN EMPLOYMENT, *supra* note 82, at 10.

142. *House Ways & Means Hearing*, *supra* note 4, at 132. The leader of this group acknowledged that the Section 911 commissioned in 1995 two “independent” studies by PriceWaterhouse LLP and professors at the Johns Hopkins University to examine the impact of the FEIE on U.S. business.

143. GUSTAFSON ET AL., *supra* note 8, at 372.

144. *Id.*

145. *Id.*

146. I.R.C. § 911(a) (2004).

147. GUSTAFSON ET AL., *supra* note 8, at 378.

148. *Id.* at 379.

lodging is provided for the convenience of the employer.<sup>149</sup> In defending the housing cost amount under the FEIE, one could argue that certain living expenses of U.S. taxpayers abroad should be attributed to the work itself such that the taxpayer meets, in a certain sense, the requirements of Section 119.<sup>150</sup> The more credible response, however, is that the FEIE in general and the “housing cost amount” in particular are mainly the byproducts of effective lobbying by U.S. multinationals. Stated more bluntly, “the exclusion of the housing cost amount is yet another tax subsidy granted to U.S. persons who work abroad (and their employees).”<sup>151</sup>

## VI. POLITICAL REALITIES SURROUNDING SECTION 911

Those who would be negatively affected by the repeal of the FEIE have battled fervently for its continued existence, including Democrats Abroad,<sup>152</sup> the Construction Coalition to Save American Jobs Overseas,<sup>153</sup> the Center for Freedom and Prosperity,<sup>154</sup> various business lobbyists,<sup>155</sup> American Citizens Abroad,<sup>156</sup> the Section 911 Coalition,<sup>157</sup> Americans for Tax Reform,<sup>158</sup> the U.S. Council for International Business,<sup>159</sup> the American Council of Engineering

149. I.R.C. § 119(a) (2004).

150. GUSTAFSON ET AL., *supra* note 8, at 378.

151. *Id.*

152. *Democrats Abroad*, *supra* note 114.

153. Johnathan Rickman & Herman Ayayo, *U.S. Senate Keeps Foreign Earned Income Exclusion Repeal*, 2003 WORLDWIDE TAX DAILY 95-1 (May 16, 2003).

154. *Id.*

155. Richard Simon & Janet Hook, *Senate Bill Would End Tax Break for Overseas Workers*, L.A. TIMES, May 14, 2003, at A20 (reporting that business lobbyists were angered about the proposed repeal of Section 911 since they considered themselves a “driving force behind President Bush’s economic growth initiative”).

156. Lauren Foster, *Expats Face Big Increase in Tax Payments*, FIN. TIMES, May 10, 2003, at A2 (reporting that the leader of this group claimed that the repeal of the FEIE and the resulting double taxation of Americans abroad would be “an economic weapon of mass destruction”).

157. *House Ways & Means Hearing*, *supra* note 4; Susan Milligan, *Panel’s Bill Boosts Expatriates’ Taxes Group Says Hike Would Hurt US Competitiveness*, BOSTON GLOBE, May 9, 2003, at A2; *Proposal to Add Taxes for US Citizens Abroad Draws Fire*, AGENCE FRANCE PRESSE, May 15, 2003.

158. Milligan, *supra* note 157 (reporting that the president of this organization categorized the idea of repealing the FEIE as “economically destructive” and “stupid”).

159. Letter from Dan Nichols, Chair U.S. Council for International Business Tax Committee, to The Honorable William Frist, Majority Leader, U.S. Senate (May 12, 2003), available at <http://www.uscib.org/index.asp?DocumentID=2606> (last visited March 20, 2004) (explaining that this group understands the political pressure to generate revenues to offset the tax-relief measures recently introduced in the Jobs and Growth Tax Relief and Reconciliation Act of 2003, but arguing that targeting U.S.

Companies,<sup>160</sup> the American Business Council of the Gulf Countries,<sup>161</sup> the U.S. Chamber of Commerce,<sup>162</sup> the National Association of Manufacturers,<sup>163</sup> certain U.S. senators,<sup>164</sup> and numerous U.S. expatriate individuals.<sup>165</sup> Despite their support for this program, the analysis contained in the preceding pages clearly illustrates that the FEIE violates established U.S. international tax policy for a multiplicity of reasons. In particular, the FEIE fails to achieve tax fairness because it achieves neither vertical equity nor horizontal equity, it does not minimize tax complexity or facilitate tax compliance, and it lacks economic efficiency because it does not generate capital export neutrality. In addition, the claims that the FEIE promotes U.S. exports, benefits the United States by disseminating cultural ambassadors, or represents a cost-efficient subsidy for U.S. multinational businesses are all based on scarce or questionable research. Perhaps more telling, the studies on which FEIE backers heavily rely expressly acknowledge their own shortcomings and biases.

Notwithstanding the validity or number of reasons for repealing the FEIE immediately, it is highly improbable that such a legislative

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multinationals and their U.S. workers fails to recognize the importance of the U.S. export sector to the national economy).

160. *ACEC Continues Opposition to Proposed Repeal of Section 911 Tax Code*, LAST WORD, May 19, 2003, at <http://www.acec.org/publications/lastword/lw051903.htm> (last visited Mar. 20, 2004).

161. Brian Knowlton, *Congress Nears Deal on Tax Cuts; In Expatriate Victory, Exclusion Stays Alive*, INT'L HERALD TRIB., May 22, 2003, at A1.

162. U.S. Chamber of Commerce, *Letter to Senator Charles Grassley*, May 6, 2003, available at <http://www.uschamber.com> (last visited Mar. 20, 2004) ("At the same time we are searching for ways to encourage and increase employment of U.S. workers, this measure [i.e., the repeal of the FEIE] appears to undercut that important objective. In a similar vein, raising income taxes on these [expatriate] workers would be at odds with the income tax cuts that the President wishes to grant them."); see also Alex Nicholson, *U.S. to Keep Expat Tax Exemption*, MOSCOW TIMES, May 22, 2003, available at <http://www.lexis.com> (reporting that the U.S. Chamber of Commerce in Moscow indicated that repealing the FEIE would hinder the work of non-governmental organizations in Russia, which would damage the U.S. contribution to "Russia's transition to a democratic market economy").

163. Letters from National Association of Manufacturers to Senator Bill Frist (May 15 and 21, 2003) available at <http://www.nam.org> (last visited Mar. 20, 2004).

164. 149 CONG. REC. S72,6174-6175 (daily ed. May 14, 2003) (statement by Sen. Breaux).

165. Similar to the case in 2003, the proposed modification or repeal of the FEIE in 1996 incited strong opposition from Americans working abroad. In response to their letters, the Deputy International Tax Counsel of the U.S. Treasury Department assured these Americans abroad that the Clinton Administration's final budget for 1997 did not contain any changes to the FEIE. See Daniel M. Berman, *Administration Has No Plans to Repeal Exclusion, Treasury Says*, 13 TAX NOTES INT'L 883, 883 (1996); Daniel M. Berman, *Repeal of Foreign Earned Income Exclusion Not in the Offing*, 13 TAX NOTES INT'L 513, 513 (1996); Daniel M. Berman, *Treasury Says President's 1997 Budget Doesn't Propose to Repeal Exclusion*, 12 TAX NOTES INT'L 2039, 2040, June 14, 1996.

maneuver will occur in the near future for economic and political reasons; some apparent, others more obscure. As certain tax experts astutely point out, no thorough evaluation of income tax policy may overlook political realities, among them the fact that even international tax proposals supported by sound economic analysis and income tax theory must confront "difficult political hurdles."<sup>166</sup>

### A. *The Rebuilding of Iraq*

The benefits of Section 911 are ordinarily unavailable in cases where a U.S. taxpayer is earning income in a foreign country that is essentially "blackballed" by the U.S. government under the Trading with the Enemy Act or the International Emergency Economic Powers Act.<sup>167</sup> Consequently, a U.S. citizen working in Iraq would normally be prohibited from benefiting from the tax advantages of the FEIE.<sup>168</sup> However, in light of the recent war with and reconstruction of Iraq, the U.S. Treasury Department has radically changed this policy.<sup>169</sup> In particular, the Office of Foreign Assets Control publicly acknowledged that it had issued several licenses authorizing persons to engage in transactions related to Iraq and that such activities do not violate the International Emergency Economic Powers Act.<sup>170</sup> Therefore, the normal limitation under Section 911 would not apply.<sup>171</sup>

To say that the Bush Administration has made the rebuilding of Iraq a high priority would be a gross understatement. In fact, many political analysts believe that this issue will be the focus of the presidential election in 2004.<sup>172</sup> In order to ensure that this

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166. CHARLES H. GUSTAFSON ET AL., *TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXTS AND PROBLEMS* 27 (2nd ed. 2001).

167. I.R.C. § 911(d)(8) (2004).

168. Iraqi Sanctions Regulations, 31 C.F.R. § 575 (1992); Rev. Rul. 92-63, 1992-2 C.B. 195.

169. I.R.S. Notice 2003-52 (July 11, 2003); Press Release, U.S. Treasury Department, Office of Public Affairs, Treasury and IRS Issue Guidance for U.S. Individuals Working in Iraq." (July 11, 2003).

170. Internal Revenue Service, *Guidance on the Application of Section 911 to Individuals Working in Iraq*, 2003 WORLDWIDE TAX DAILY 136-14 (July 16, 2003).

171. *Id.*

172. See, e.g., Bob Kemper, *Bush, GOP Revel in Medicare, Economy; But War on Terror, Iraq Developments Loom Over '04 Race*, CHICAGO TRIB., Nov. 26, 2003, at C11 (stating that the issues of Iraq and the economy "rank very high with voters"); Adam Nagourney, *Campaign Tactics Being Reversed as Events Shift*, N.Y. TIMES, Nov. 4, 2003, at A1; Richard A. Ryan, *NASCAR Dads May Drive Race to White House for Democrats; Group Key to Carrying Mich., Southern States*, DETROIT NEWS, Nov. 30, 2003, at 13A (explaining that Democrats believe that President Bush is vulnerable "on a sour economy that has cost the nation nearly 3 million jobs" and the war in Iraq that is resulting in deaths of U.S. soldiers on a daily basis); Howard Fineman and Tamara

reconstruction project is successful, the Bush Administration continues to use U.S. companies to perform work that the United Nations and not-for-profit organizations could handle at a lower cost.<sup>173</sup> For instance, the Bush Administration is paying hundreds of millions of dollars to U.S. companies to do assorted projects, including major infrastructure projects (such as roads and bridges), harbor dredging, repairs to electrical systems, reconstructing buildings, restructuring the Iraqi school system, and providing health services.<sup>174</sup> With regard to why the Bush Administration prefers that U.S. businesses complete the projects in Iraq, commentators speculate that the president “wants to show the Iraqi people that benefits are flowing to them from the United States, something that wouldn’t happen if the United Nations and private aid groups played a leading role.”<sup>175</sup>

In October 2003, Congress approved an \$87.5 billion spending package in connection with the reconstruction of Iraq.<sup>176</sup> Although U.S. companies have been awarded the contracts for nearly all of the major reconstruction projects to date, the recent legislation provides that bids from foreign companies must be considered.<sup>177</sup> This possibility of ferocious foreign competition is worrisome to many U.S. companies, especially in light of the fact that complaints of cronyism involving Vice President Cheney’s former company abound.<sup>178</sup>

Many U.S. companies claim that Section 911 is essential for them to be competitive in the international bidding process. The Construction Coalition to Save American Jobs Overseas, for example, recently sent a letter to Congress stating that President Bush has made rebuilding Iraq “a cornerstone of his foreign policy,” and that U.S. construction companies are eager to obtain contracts to help

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Lipper, *The Right Stuffing*, NEWSWEEK, Dec. 8, 2003, at 30-35; James Carney, *The Politics of War*, TIME, Dec. 8, 2003, at 30-33.

173. Mark Matthew, *U.S. Defends Private Sector’s Iraq Contracts*, BALTIMORE SUN, Aug. 10, 2003, at 1A.

174. *Id.*

175. *Id.*

176. Neil King, Jr., *Few Companies May Lead Iraq Work*, WALL ST. J., Nov. 10, 2003, at A3, A11.

177. *Id.*

178. *Id.* (stating that the Bush Administration has already endured harsh criticism for alleged cronyism and mismanagement in the handling of approximately \$2 million in Iraqi reconstruction projects); see also Nelson Antosh, *Halliburton Employee Dies in Iraq*, HOUSTON CHRON., Aug. 6, 2003, at A13; Neela Banerjee, *Bechtel Ends Move for Work in Iraq, Seeing a Done Deal*, N.Y. TIMES, Aug. 8, 2003, at C1; David Ivanovich, *Bidders Hope to Grab What’s Left of Iraq Work*, HOUSTON CHRON., Aug. 13, 2003, at A1; David Streitfeld, *New Iraq Contracts Offer Just ‘Scraps’*, L.A. TIMES, Aug. 14, 2003, at A1. (stating that upon withdrawing from the competitive bidding process for work in Iraq, one executive at the Bechtel Group explained that the remaining contracts offer merely “bits and scraps” and that they “were too small to bother with”).



with this effort.<sup>179</sup> However, this organization underscores the fact that the competition for these opportunities is fierce as companies the world over attempt to outbid one another for such lucrative contracts.<sup>180</sup> This group concludes, therefore, that repealing the FEIE “not only weakens the President’s stated objective to rebuild and strengthen a democratic Iraq, but it further hurts Americans attempting to find jobs all over the world.”<sup>181</sup> Seconding this opinion, the Associated General Contractors of America point out that quickly restoring Iraqi infrastructure is a major foreign policy initiative of the Bush Administration and that revoking Section 911 “impedes the attempts of American construction and engineering companies to help the President achieve his goals.”<sup>182</sup>

In view of the Bush Administrations’ desire successfully to rebuild Iraq and the importance of the FEIE for those U.S. companies involved in this process, serious possibilities of repealing Section 911 may not appear for years. Meanwhile, virtually all reconstruction-related projects in Iraq will continue to be performed by U.S. entities through U.S. government contracts.<sup>183</sup>

### B. Historical Support of Tax-Based Export Promotion

The United States has a long history of providing incentives that serve to lessen the overall tax burden on export income, thereby enabling U.S. exporters to charge lower prices for their goods and services without reducing their net profit.<sup>184</sup> Export incentives have

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179. Construction Coalition to Save American Jobs Overseas, *U.S. Construction Coalition Letter to Grassley Opposing End to 911 Income Exclusion*, 2003 WORLDWIDE TAX DAILY 95-12 (May 16, 2003).

180. *Id.*

181. *Id.*

182. *Repeal of Section 911 Would Compromise U.S. Construction Industry’s Efforts to Help Rebuild Iraq, Says AGC*, U.S. NEWSWIRE, May 13, 2003; see also, *What Would the Tax Cut Bills Mean for Contractors?*, CONTRACTOR’S BUS. MGMT. REP., June 2003, at 1; Sherie Winston, *Senate Passes Tax Bill That House May Find Hard to Swallow*, ENGINEERING NEWS-REC., May 26, 2003, at 15.

183. Kenneth E. Mack, *Opportunities Abroad for U.S. Companies in Iraq*, J. INT’L TAX’N, Nov. 2003, at 7-11 (explaining that reconstruction effort in Iraq is a “high priority” of the Bush Administration and that U.S. government contracts are presently the “primary means of performing reconstruction activity in Iraq”).

184. GUSTAFSON ET AL., *supra* note 166, at 853 (noting that “[o]ver the years Congress has followed a fairly consistent pattern of providing tax incentives to encourage exports . . . [t]he most obvious examples [being] the Western Hemisphere trade corporations, the export trade corporation, the DISC, the FSC and, most recently, the exclusion of qualifying foreign trade income”). See also BORIS BITTKER & LAWRENCE LOKKEN, *FUNDAMENTALS OF INTERNATIONAL TAXATION* 71-73 (2002); Mihir A. Desai & James R. Hines, Jr., *The Uneasy Marriage of Export Incentives and the Income Tax*, in 15 *TAX POLICY AND THE ECONOMY* 43 (National Bureau of Economic Research 2001); *BACKGROUND AND HISTORY OF THE TRADE DISPUTE RELATING TO THE PRIOR-LAW*

come in several forms over the years, including tax reductions of various degrees, outright tax exemptions, and tax deferrals on the income earned from exportation.<sup>185</sup> These tax-based export incentives have been introduced under a variety of names, such as Western Hemisphere Trade Corporations, Domestic International Sales Corporations, Foreign Sales Corporations, and the Extraterritorial Income Regime.<sup>186</sup> Notwithstanding the differences in name and design, each of these four programs has met the same fate over the years: rejection by the World Trade Organization (WTO) as a violation of the relevant international trade rules.<sup>187</sup> As a manifestation of the importance of these export-enhancement programs to the United States, congressional debate regarding the Extraterritorial Income Regime continues to rage despite that fact that, pursuant to the WTO ruling in 2001, the European Union is entitled to take retaliatory action against the United States in the amount of four billion dollars annually.<sup>188</sup>

As discussed previously, one of the major policy reasons behind the FEIE is that it allegedly increases U.S. exports. According to formula presented by FEIE supporters, Section 911 causes U.S. multinational businesses operating abroad to hire U.S. workers, who will purchase supplies from and retain the services of other U.S. companies. This, in turn, will generate a higher demand for U.S. exports.<sup>189</sup> The numerous holes in this argument are examined earlier in this article. Despite theoretical weaknesses and a scarcity of corroborating evidence, Section 911, in its capacity as a tax-based export promotion program, has proven historically difficult to repeal.<sup>190</sup> Now, during a period in which other export-enlargement

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FOREIGN SALES CORPORATION PROVISIONS AND THE PRESENT-LAW EXCLUSION FOR EXTRATERRITORIAL INCOME AND A DESCRIPTION OF THESE RULES, BEFORE THE JOINT COMM. ON TAXATION, JCX-10-02, at 2 (Feb. 25, 2002) [hereinafter BACKGROUND AND HISTORY].

185. BACKGROUND AND HISTORY, *supra* note 184, at 2.

186. *Id.*

187. *Id.*

188. Daniel Pruzin, *U.S. Says Up to \$1.1 Billion in Sanctions May Be Justified for FSC/ETI Retaliation*, DAILY TAX REP., Feb. 28, 2002, at G-6; Myrna Zelaya-Quesada, *U.S. Disputes EU Claim of \$4 Billion As Compensation in FSC Trade Sanctions*, DAILY TAX REP., Feb. 11, 2002, at G-10. The United States unsuccessfully argued that \$4 billion per year in retaliation was exorbitant, urging the WTO to reduce this amount to approximately \$1 billion per year. Warren Rojas, *Growing GOP Factions Continue to Thwart U.S. House ETI Push*, 2003 WORLDWIDE TAX DAILY 219-1 (Nov. 13, 2003) (noting that the European Union formally announced in late 2003 that it intends to impose trade sanctions on particular U.S. industries as of March 1, 2004).

189. *House Ways & Means Hearing*, *supra* note 4, at 131 (arguing that Section 911 paves "the way for more U.S. citizens overseas to buy American, sell American, specify American, hire American, and create opportunities for other Americans abroad") (emphasis in original).

190. For a description of the evolution of the FEIE, see Evans, *supra* note 4, at 895-98; Kurlander, *supra* note 4, at 594-97; Sobel, *supra* note 4, at 119-46.

initiatives such as the Extraterritorial Income Regime face potential extinction, revoking the FEIE could prove to be even more arduous.

### C. Dwindling U.S. Global Presence in Times of Terrorism and SARS

As discussed above, FEIE supporters claim that the presence of U.S. citizens in foreign countries may benefit the U.S. government by generating increased U.S. exports and spreading international goodwill. To the dismay of FEIE backers, the allure of living and working abroad is waning these days for at least two reasons. First, living in certain countries may expose U.S. citizens to potentially fatal diseases such as Severe Acute Respiratory Syndrome, which is better known as SARS. In the Chinese capital of Beijing, more than fifty cases of SARS were officially diagnosed in 2003, and many suspect that the true incidence of the disease was significantly higher.<sup>191</sup> As a result of this health threat, conferences and tours were canceled in China and “many expatriates are considering moving their families out.”<sup>192</sup> For its part, the U.S. Embassy in China announced that it would pay for the evacuation of all non-emergency personnel and their dependents due to the uncertainty regarding the SARS outbreak in that country.<sup>193</sup> Despite these precautions, at least one American teaching in China died from the disease.<sup>194</sup> Along with China, the World Health Organization identified at least thirty other nations infected with SARS.<sup>195</sup> Noteworthy to many U.S. citizens was the SARS outbreak in Toronto, Canada, which killed nearly fifty people and dissuaded many U.S. travelers from heading north in 2003.<sup>196</sup>

The second reason for the decline in the number of U.S. citizens living abroad is terrorism. A poignant example of this international terrorism recently occurred in Saudi Arabia, where more than forty Americans were injured in a series of bombings and shootings.<sup>197</sup> In

191. Elisabeth Rosenthal & Lawrence Altman, *A Respiratory Disease: The Disease; Beijing's Total of Infected Is Revised, to Over 50*, N.Y. TIMES, Apr. 5, 2003, at A7.

192. *Id.*

193. *Id.* The White House took that disease so seriously that President Bush issued an executive order authorizing the Secretary of the Department of Health and Human Services to quarantine people exposed to SARS.

194. John Pomfret, *Doctor Says Health Ministry Lied About Disease; Chinese Military Physician Accuses Beijing of Hiding Extent of Outbreak to Promote Tourism*, WASH. POST, Apr. 10, 2003, at A26.

195. Kathleen Doheny, *Is SARS Still an Issue?*, L.A. TIMES, Sept. 21, 2003, at L12.

196. *Travel Updates*, SEATTLE TIMES, Oct. 26, 2003, at M2.

197. Corky Siemaszko, *Bombings Injure 40 Americans*, N.Y. DAILY NEWS, May 13, 2003, at 6; see also Helen Kennedy, *Saudis Turned Deaf; U.S. Blames Kingdom for Ignoring Security Requests*, N.Y. DAILY NEWS, May 15, 2003, at 9.

response to these attacks, the U.S. State Department warned U.S. citizens to leave the country if possible, a suggestion heeded by hundreds.<sup>198</sup> Likewise, the U.S. Embassy in Nairobi, Kenya, recently underwent an emergency closure as a result of a threatened attack by al Qaeda operatives.<sup>199</sup> In a related event, on the same day that the Spanish police arrested sixteen suspected international terrorists, the U.S. State Department issued an alert to all U.S. citizens abroad: prepare to evacuate.<sup>200</sup> On other occasions, the U.S. State Department has informed U.S. citizens overseas of the heightened danger of terrorism and antiwar sentiment.<sup>201</sup>

Supporters of the FEIE have capitalized on the increased incidence of terrorism to challenge those advocating its repeal. For example, exploiting the intensifying unrest of certain militant groups and its effect on the U.S. psyche, the leader of the Section 911 Coalition has argued,

As the recent terrorist attacks in Saudi Arabia made clear, Americans abroad are putting their lives on the line to promote U.S. interests. Except for the president, no one plays a more important role in projecting a positive image of the United States around the globe than do the more than 4 million private Americans residing abroad . . . In service to their country, Americans abroad have faced every kind of threat imaginable. Despite these dangers, they have refused to be intimidated into retreating to the United States. But overseas Americans are not accustomed to being targeted by their own government. Let's hope it never happens again. Otherwise, the U.S. government may succeed in driving Americans home in droves where Osama bin Laden, Saddam Hussein and the others all failed.<sup>202</sup>

Under normal circumstances, it is unlikely that such antagonistic comments would influence U.S. decision makers. However, during this period characterized by bravado, single-mindedness, and extreme patriotism, this type of argument could sway the decisions of those in Congress and the Bush Administration.

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198. Dave Montgomery, *For Expats in Saudi Arabia, Good Life Suddenly Vanishes*, PITTSBURGH POST-GAZETTE, May 25, 2003, at A8.

199. *U.S. Cites Terror Threat in Shutting Embassy*, L.A. TIMES, June 21, 2003, at A4.

200. Helen Kennedy, *Americans Abroad Get Terror Alert*, N.Y. DAILY NEWS, Jan. 25, 2003, at 6.

201. David Ballingrud, *Troops Push Into Iraq; Copter Crash Kills 16*, ST. PETERSBURG TIMES, Mar. 21, 2003, at 1A.

202. David Hamod, *Americans Abroad Merit Their Lifeline: A Tax Attack*, INT'L HERALD TRIB., June 5, 2003, at A6.

### D. High Unemployment Rates

As discussed earlier, enticing highly-qualified U.S. citizens to work abroad has been a component of U.S. policy for many years. History has proven that achieving this goal can be difficult. From the perspective of the potential U.S. employee, engaging in international endeavors may be unappealing for various reasons, including problems with assimilating to new cultures and languages, considerable anti-Americanism in many regions of the world, lack of physical proximity to the corporate power base resulting in decreased influence and upward mobility due to the out-of-sight-out-of-mind phenomenon, and the increase in two-career families.<sup>203</sup> Similarly, from the U.S. multinational companies' point of view, hiring a U.S. taxpayer may be unattractive since to do so a company must ordinarily reimburse these workers for the additional taxes and for the added living costs.<sup>204</sup> Many U.S. businesses operating abroad thus face a dilemma: pay U.S. workers more than foreigners with comparable qualifications or utilize a tax-equalization program to compensate U.S. workers for the additional tax burden. Either way, U.S. businesses will face an increased financial burden, one which "many employers are unwilling to accept even if the U.S. worker is more productive and has better professional qualifications."<sup>205</sup>

Due to certain disadvantages of hiring U.S. taxpayers for international assignments (both from the employees' and the employers' perspectives), logic dictates that fulfilling the U.S. policy of placing skilled U.S. citizens abroad would be implausible without an incentive such as Section 911. Certain studies have also reached this conclusion, estimating that the repeal of the FEIE would result in a loss of approximately 7,000 overseas jobs and 140,000 domestic jobs in the export sector.<sup>206</sup> The U.S. Council for International Business employed this argument when criticizing a recent bill that would have abolished the FEIE. According to this organization, repeal of the FEIE would lead to the shifting of "tens of thousands" of jobs now held by U.S. citizens abroad to foreign workers or to increased costs for U.S. multinationals.<sup>207</sup> To ensure that the point did not escape the attention of the public, Congress, and the Bush

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203. *Overseas 'Plums'; Leave a Sour Taste*, INDUSTRY WK., Sept. 5, 1983, at 39 (explaining that a male candidate must consider how accepting an international assignment will affect his wife's career since women may be ignored as job candidates in certain male-dominated societies).

204. GUSTAFSON ET AL., *supra* note 8, at 371.

205. *House Ways & Means Hearing*, *supra* note 4, at 127.

206. PRICE WATERHOUSE LLP, *supra* note 57, at E-4.

207. Letter from Dan Nichols, *supra* note 159.

Administration, this group further explained that higher taxes for U.S. citizens abroad and/or increased costs for U.S. businesses would undoubtedly “add to the growing numbers of Americans unable to find work at home.”<sup>208</sup> This, it is argued, would “send the wrong signal” to U.S. multinationals and U.S. taxpayers who already must cope with a sluggish economy.<sup>209</sup>

Aside from its handling of the war on terrorism, the slow domestic economy that has plagued the United States during recent years represents the Achilles’ heel of the Bush Administration. Indeed, presidential hopefuls for the 2004 election have continually emphasized the negative impact of the current economy on the U.S. public, hoping in this manner to exploit a vulnerability of President Bush.<sup>210</sup> Mindful of this, the Bush Administration has taken various steps to stimulate the economy, including introducing tax cuts designed, among other things, to create new jobs. Lest there be any doubt regarding the focus of the recent economic stimulus package, the legislation itself is called the *Jobs and Growth Tax Relief and Reconciliation Act of 2003*.<sup>211</sup> According to a recent release by the U.S. Treasury Department, ensuring that any economic growth resulting from the tax cuts generates additional jobs for U.S. workers is pivotal.<sup>212</sup> Although certain studies indicate the creation of over 300,000 positions during the last quarter of 2003, the national unemployment rate is still significant.<sup>213</sup> Therefore, with a presidential election approaching rapidly, political wisdom would indicate that the Bush Administration will be reluctant, or outright unwilling, to endorse any legislation that would repeal the FEIE and focus public attention on the possibility of additional job loss.

## VII. CONCLUSION

The FEIE may be well-intentioned, but the majority of the evidence demonstrates that this program violates many aspects of U.S. international tax policy. Furthermore, when analyzed as a pure tax incentive, the FEIE’s cost effectiveness is circumspect. Nonetheless, repeal of the FEIE in the near future is unlikely because of the existing political realities. The identification of this *non*

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208. *Id.*

209. *Id.*

210. *See, e.g.,* Kemper, *supra* note 172; Nagourney, *supra* note 172; Ryan, *supra* note 172.

211. Jobs and Growth Tax Relief and Reconciliation Act of 2003, Pub.: No. 108-27, 117 Stat. 712 (2003).

212. U.S. Treasury Secretary John Snow, Remarks to the Albuquerque Chamber of Commerce (Nov. 12, 2003), available at <http://www.ustreas.gov/press/releases/js994.htm>.

213. *Id.*

*sequitur* is not aimed at maligning the FEIE or those who benefit therefrom. Instead, the purpose of this Article is to remind (or perhaps encourage) all of those involved or interested in the field of international taxation to embrace their child-like curiosity and never stop asking “why?”