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911 v. 913: HOW THE FLAWS OF THE FOREIGN EARNED INCOME EXCLUSION COULD BE CORRECTED BY A MODIFIED VERSION OF THE REPEALED SECTION 913

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This Article addresses the use of earned income as basis for allowing a tax benefit to individuals who live and work abroad. With the exception of a short period of time in the late 1970’s and early 1980’s, earned income has been used to provide a tax benefit for United States citizens and residents living and working abroad. The reasoning for this tax benefit has always been to provide assistance for the higher cost of living and higher tax rate of living in a foreign country, yet the tax benefit has been available to every individual living abroad, independent of whether they are need of tax assistance due to higher expenses.

This Article provides an analysis of the history of the foreign earned income exclusion and the flaws with using an individual’s income as the basis to provide a tax benefit. After identifying the problems with the use of earned income, the Article provides a solution that utilizes Section 913 as its foundation; the Tax Code Section that was in place in the aforementioned late 1970’s and early 1980’s. The Article concludes that using a modified version of Section 913 would provide the tax benefit to those individuals to whom the foreign earned income exclusion was designed to assist, while solving some of the concerns posed when Section 913 was repealed in 1981.

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Presume for a minute that the United States Congress was concerned about the
decreasing availability of pineapples being grown in Hawaii.\(^1\) It seems pineapple plantation
workers were heading for Costa Rica,\(^2\) due to high taxes and the costs associated with living in
Hawaii. A Congressional committee is formed to analyze the problem. Upon a quick review of
Hawaii’s economy, they learn that Hawaii has the highest state income tax rate\(^3\) of any state in
the nation and the highest cost-of-living in the United States.\(^4\) Based on these facts, Congress
passes a bill that allows any pineapple plantation worker to exclude from federal taxation their
income from the plantation. Congress feels that eliminating the worker’s earned income from
federal taxation will offset out the higher state taxes and general costs for workers in Hawaii, and
thus, more piña coladas for everyone.

Upon closer inspection of the bill, it is revealed that any pineapple plantation worker
subject to United States taxation can exclude their income. Thus, the pineapple plantation
workers working in Costa Rica who are United States citizens or residents can still exclude their
income from United States federal taxation, while enjoying a cost of living that is less than the
United States\(^5\) and a lower income tax rate.\(^6\)

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\(^1\) In fact, there has been a large decline in the number of pineapple plantations in Hawaii. See Derek Paiva, *End of an Era: Maui Land & Pineapple closing its pineapple operations*, [http://www.hawaiimagazine.com/blogs/hawaii_today/2009/11/4/Maui_Land_Pineapple_production_ends](http://www.hawaiimagazine.com/blogs/hawaii_today/2009/11/4/Maui_Land_Pineapple_production_ends), Hawaii Magazine.com (November 4, 2009 12:07 AM). However, for the sake of simplicity, this scenario will presume that there are sufficient jobs available for those seeking employment.


The above hypothetical scenario plays out in the United States in a similar fashion, but for a much larger contingency of individuals. Under Section 911 of the Internal Revenue Code,\(^7\) any United States citizen or resident living and working abroad may be able to deduct over $100,000 (subject to qualification rules) from their United States taxes, whether or not they are living in an area subject to high taxes and/or high cost of living. Yet, throughout Section 911’s history, the two primary reasons for providing a benefit to those living abroad have been that these individuals are often subject to a high tax rate and/or a high cost of living.

The goal of this article is to present a solution to the flawed logic of Section 911. In presenting a solution, a few assumptions must be made regarding the United States’ tax policy. First, it is presumed that the United States’ policy of taxing both its citizens and residents will continue.\(^8\) Second, it is presumed that the United States will continue to use income as the basis for taxation.\(^9\) Finally, it is presumed that Section 911 is a valid and necessary provision of the Internal Revenue Code.\(^10\)

In presenting the problems with Section 911 and the proposed solution, the article is broken down into six parts. The first part explains the basic structure of Section 911 and how it is applied today.\(^11\) The second part describes the history of the foreign earned income exclusion, which will provide the basis for and the development of Section 911, as well as provide the foundation for the proposed solution. The historical is subdivided into three smaller parts; the history of the foreign earned income exclusion from its creation to 1978, the portion of time between 1978 and 1981 in which the foreign earned income was abandoned and then re-

\(^7\) IRC §911 (2010).
\(^8\) The ability to tax both citizens and residents comes from an absence of any tax code provision prohibiting it, and is also known as worldwide taxation. For a discussion on whether the United States should use a worldwide tax system or a territorial tax system, see Paul R. McDaniel, *Territorial vs Worldwide International Tax Systems: Which is Better for the U.S.?*, 8 Fla. Law. R. 283 (2007).
\(^9\) In lieu of a flat tax, value added tax, or any other system of taxing.
\(^10\) The history section of this article reveals attempts to eliminate the foreign earned income exclusion in its entirety.
\(^11\) as of October 13, 2010
introduced, and Section 911’s recent history. In part three, problems with the current Section 911 are identified. Part four provides an explanation of why the changes made in 1978 were a more reasonable approach to providing a tax benefit to those individuals living abroad. In part five, a solution is presented that corrects the flaws of Section 911 and allows the exclusion to provide the benefits to which it was intended. Part six summarizes the article.

II. How the Foreign Earned Income Exclusion of Section 911 Works

The current foreign earned income exclusion is found under Section 911 of the Internal Revenue Code.\(^\text{12}\) It allows an individual taxpayer to exclude their foreign earned income and foreign housing costs from their gross income.\(^\text{13}\) Section 911 is an elective provision; the individual has the election of excluding their foreign earned income, housing, or both.\(^\text{14}\)

In order to determine the final exclusion, three steps must be taken. The first step is to determine who qualifies for the exclusion by defining who is a qualified individual under Section 911.\(^\text{15}\) After it is known who qualifies, the next step is to determine what amounts can be excluded by defining an individual’s foreign earned income and foreign housing costs. The final step is to determine whether the individual’s exclusion amount is limited.

A qualified individual is determined, in part, by the amount of time a person has their tax home in a foreign country (or countries).\(^\text{16}\) An individual’s tax home is considered to be located at his or her regular place of business.\(^\text{17}\) If an individual has more than one regular place of business, the principal place of business will be considered an individual’s tax home.\(^\text{18}\) If a person has an “abode” in the United States, they will not be considered to have a foreign tax

\(^{12}\) IRC §911 (2010).
\(^{13}\) IRC §911(a).
\(^{14}\) Id.
\(^{15}\) Id.
\(^{16}\) IRC §911(d).
\(^{17}\) IRC §911(d)(3), Reg. §1.911-2(b).
\(^{18}\) Id.
home.\textsuperscript{19} This is a tricky definition, as \textit{maintenance} of a home in the United States will not necessarily disqualify an individual from having a foreign tax home.\textsuperscript{20} Courts will look at the economic, familial, and personal ties an individual to determine whether their tax home is domestic or foreign.\textsuperscript{21}

Once a foreign tax home is established, the individual must be located at that foreign tax home for a significant time period to meet the definition of a qualified individual. There are two separate and distinct tests that can qualify an individual.\textsuperscript{22} First, an individual can be a resident of a foreign country for the entire tax year (called the bona fide residence test).\textsuperscript{23} Second, an individual can be physically present in a foreign country for the majority of a year-long time period (called the physical presence test).\textsuperscript{24}

To qualify under the bona fide residence test, an individual must meet two requirements. First, the individual must be a United States citizen.\textsuperscript{25} Second, the individual must reside uninterrupted in a foreign country (or countries) for one tax year.\textsuperscript{26} While Section 911 technically prohibits the individual from returning to the United States at any time during the year, temporary visits to the United States for either business or pleasure may be allowed without failing the test under the Regulations.\textsuperscript{27} Once an individual has met the test, that individual can

\begin{footnotes}
\footnotetext[19]{Id.}
\footnotetext[20]{Id.}
\footnotetext[21]{\textit{LeMay v. Comm.}, 837 F.2d 681, 684 (5th Cir. 1988). In this case, the Court determined that the petitioner did not have a foreign tax home based on the amount of time he spent in the United States, the fact that he voted in the United States, and that he maintained both a bank account and a driver’s license in the United States.}
\footnotetext[22]{IRC §911(d).}
\footnotetext[23]{IRC §911(d)(1)(A).}
\footnotetext[24]{IRC §911(d)(1)(B).}
\footnotetext[25]{IRC §911(d)(1)(A).}
\footnotetext[26]{Id.}
\footnotetext[27]{Reg. §1.911-2(c).}
\end{footnotes}
include a portion of the prior or subsequent year that corresponds to the portion of time they were abroad.\textsuperscript{28}

There is one specific circumstance that will disqualify an individual from the bona fide residence test, even if the individual resides abroad for an entire tax year. If an individual submits a statement to the foreign country in which they live stating that they are a nonresident of that country for the purpose of disqualifying their income from being subjected to income taxation in that foreign country, they will not meet the bona fide resident test.\textsuperscript{29} This disqualification prevents an individual from being able to escape foreign taxation by claiming non-residence status for the foreign country and being able to escape or minimize United States taxation by claiming foreign residence under Section 911.

The alternative test to meet the definition of a qualified individual is the physical presence test. The physical presence test requires the individual to be physically present in a foreign country (or countries) for 330 days over a period of 12 consecutive months.\textsuperscript{30} The 12 month period may begin on any day of the year.\textsuperscript{31} Additionally, the 330 day period need not begin or end with the beginning or ending of an individual’s presence in a foreign country.\textsuperscript{32} The 330 day requirement need not be continuous, so long as the individual totals 330 days in a period of 12 months.\textsuperscript{33} A “day” for purposes of the physical presence test requires a continuous 24 hour period.\textsuperscript{34} Note that unlike the bona fide residence test, the physical presence test is not limited to United States citizens; those who meet the definition of United States residents can claim the

\textsuperscript{28}Reg. §1.911-3(d)(3). For example, a citizen who establishes a foreign tax home on December 1, 2007 and stays until April 1, 2009 meets the bona fide residence test because they remained abroad for the entire 2008 tax year, and therefore, can also include the fractional portions of 2007 and 2009.
\textsuperscript{29}Reg. §1.911-2(c).
\textsuperscript{30}Reg. §911(d)(1)(B).
\textsuperscript{31}Reg. §1.911-2(c)(2).
\textsuperscript{32}Reg. §1.911-2(c)(3).
\textsuperscript{33}Reg. §1.911-2(c)(2).
\textsuperscript{34}Id.
foreign earned income exclusion so long as they meet the time requirements and have a foreign tax home.

Once an individual has established that they have had a tax home in a foreign country for the requisite time period under either the bona fide residence test or the physical presence test, the next step is to determine what can be excluded. Pursuant to Section 911(a), a qualified individual can exclude from their gross income two items: their foreign earned income and their foreign housing costs. Thus, the Section 911 exclusion is “above the line;” it is a credit that is taken out of an individual’s overall gross income. An individual’s foreign earned income is the amount received by that individual from sources within a foreign country that constitute payment for services. Specifically included are an individual’s wages, salaries, and other professional fees earned. Where the money is actually received is immaterial in making the determination; the key is where the services were actually rendered.

An individual’s foreign housing costs include their rent, utilities, real and personal property insurance, furniture rental, household repairs, and parking costs. The definition of utilities specifically does not include telephone charges and any paid television (i.e. cable, satellite, etc.). Also excluded are items otherwise deductible under Section 163 (mortgage interest) and Section 164 (property taxes paid). Without providing much insight, the regulations require housing expenses to be reasonable. The regulations reiterate that the housing expenses cannot be lavish or extravagant.

35 IRC §911(a).
36 IRC §911(b)(1)(A).
37 Reg. §1.911-3(b)(1).
38 Reg. §1.911-3(a-b).
39 Reg. §1.911-4(b).
40 Reg. §1.911-4(b)(1) and Reg. §1.911-(2)(ix).
41 IRC §911(d)(3)(A)(ii).
42 IRC §911(d)(3)(A).
43 Reg. §1.911-4(b)(4).
The final step is to determine the limitations placed on an individual’s foreign earned income and foreign housing exclusions. The technical language of Section 911 states the amount of foreign earned income that can be excluded for tax years after 2005 is an amount equal to $80,000 plus a cost of living adjustment.\(^4^4\) The amount for the 2010 tax year is $91,500.\(^4^5\) That is the maximum amount of income that can be excluded; if an individual has earned less than the maximum foreign income during the tax year, the individual can exclude their entire foreign earned income.\(^4^6\) Any income earned above the maximum exclusion will be included in an individual’s gross income and will be taxed at the rate that it would be taxed as if the maximum exclusion was included.\(^4^7\)

The housing costs exclusion is determined by a formula that utilizes the maximum foreign income exclusion amount. The amount of housing costs that can be excluded is limited by both a floor and a cap. First, the foreign housing costs must be more than 16 percent of the maximum foreign earned income exclusion for the relevant year to get a deduction.\(^4^8\) However, the amount of excludible housing costs is capped at 30 percent of the maximum foreign earned income exclusion.\(^4^9\) In essence, the maximum exclusion amount for foreign housing costs is simply 30 percent of the maximum foreign earned income exclusion less 16 percent of the maximum foreign earned income exclusion.\(^5^0\)

If an individual does not live abroad for the entire tax year (but still is a qualified individual), the income and housing exclusion are limited to the number of qualifying days the individual was abroad.

\(^{4^4}\) IRC §911(b)(2)(D)(ii) (201).
\(^{4^5}\) Rev. Proc. 2009-50, §3.28.
\(^{4^6}\) IRC §911(b)(2)(A).
\(^{4^7}\) IRC §911(f). For example, if an individual had $100,000 in foreign earned income for 2010, they would have to include $8,500 ($100,000-$91,500 maximum exclusion amount) in their taxable income, but that $8,500 would be taxed at the tax rate as if the individual had earned $100,000.
\(^{4^8}\) IRC §911(c).
\(^{4^9}\) IRC §911(c)(2)(A)(i).
\(^{5^0}\) For 2010, the maximum housing costs exclusion amount is $12,810, calculated as follows: $27,450 ($91,500 x .3) – $14,640 ($91,500 x .16).
individual lived abroad.\textsuperscript{51} The number of qualifying days is the number of days in a tax year which the individual met the tax home requirement of either the bona fide residence or physical presence test.\textsuperscript{52} The available foreign earned income exclusion and foreign housing costs exclusion amounts are reduced by multiplying the maximum limitation by a fraction of the number of qualifying days over the number of days in the tax year.\textsuperscript{53}

\textbf{III. History of Providing Tax Benefits to Individuals Living Abroad}

\textbf{A. 1924-1978}

The United States taxes the income of its citizens and resident aliens, whether they reside in the United States or aboard. Whether Congress could assess taxes on individuals living abroad was first litigated in the 1924 case of \textit{Tait v. Cook}.\textsuperscript{54} In rendering its decision, the United States Supreme Court stated that the United States government benefitted its citizens wherever they were, and therefore, the government had the “power to make the benefit complete.”\textsuperscript{55} In other words, the United States had the power to tax its citizens and resident aliens even if they resided and earned their income elsewhere, because the individuals still received the benefits of the United States.\textsuperscript{56}

The first codified exclusion of income earned abroad was enacted in the United States two years after the \textit{Tait v. Cook} decision, as part of the Revenue Act of 1926.\textsuperscript{57} It was found in the Tax Code as an item specifically excluded from the definition of gross income.\textsuperscript{58} Without any limitations, income earned by a United States citizen from income from sources outside the United States was excluded, so long as the individual was a bona fide nonresident for more than

\begin{footnotesize}
\begin{enumerate}
\item[51] Reg. §1.911-3(d)(2) and Reg. §1.911-4(c).
\item[52] Reg. §1.911-3(d)(3).
\item[53] Reg. §1.911-3(d)(3) and Reg. §1.911-4(c)(1).
\item[54] \textit{Tait v. Cook}, 265 U.S. 47 (1924).
\item[55] Id.
\item[56] Id.
\item[57] Revenue Act of 1926, 44 Stat. 24-26, Chapter 27, §213(b)(14).
\item[58] Id.
\end{enumerate}
\end{footnotesize}
six months during the taxable year.\textsuperscript{59} When it was enacted, the United States was the only country that taxed individuals who worked outside the taxing country.\textsuperscript{60}

Why did the 69\textsuperscript{th} Congress decide to exempt income earned abroad from the definition of gross income? The simplest explanation is that the United States Treasury estimated a $250,000,000 tax surplus for fiscal year 1926.\textsuperscript{61} The Revenue Act of 1926 was a bill intended to reduce income taxes and reduce the amount of the surplus.\textsuperscript{62} Beyond reducing taxes, the bill followed President Calvin Coolidge’s general theory on the economy.\textsuperscript{63} The President’s theory was that the economy would move more efficiently with less taxation and more income being placed in industry.\textsuperscript{64}

The Revenue Act of 1942 made the first major alteration to the exclusion of income earned from foreign sources for those living aboard.\textsuperscript{65} The Act required a citizen to be a bona fide resident of a foreign country or countries for the entire taxable year, not just the six month period originally imposed.\textsuperscript{66} Once that individual had been a bona fide resident of a foreign country for two years, their tax benefit changed.\textsuperscript{67} Once an individual has passed that threshold, the individual could return to reside in the United States and exclude the portion of their income that corresponded to the portion of that year in which they had returned to the United States.\textsuperscript{68}

The Senate, who added the provision as an amendment to the original House of Representative’s

\begin{itemize}
  \item \textsuperscript{59} Id.
  \item \textsuperscript{60} House Ways and Means Committee, 69\textsuperscript{th} Cong., Report on Revenue Act of 1926 178 (Comm. Print 1928).
  \item \textsuperscript{61} 67 Cong. Rec. 520 (daily ed. December 8, 1925) (statement of Rep. Green).
  \item \textsuperscript{62} Id.
  \item \textsuperscript{63} 67 Cong. Rec. 697 (statement of Rep. Treadway).
  \item \textsuperscript{64} Id.
  \item \textsuperscript{65} 67 Cong. Rec. 697 (statement of Rep. Treadway).
  \item \textsuperscript{66} Id.
  \item \textsuperscript{67} Revenue Act of 1942, Pub. L. No. 77-753, §148.
  \item \textsuperscript{68} Id.
\end{itemize}
bill, stated that the provision had “suffered considerable abuse” due to taxpayers moving out of the country for six months out of the year simply for the purpose of tax evasion.

The 1950’s proved to be an instrumental time period for the development of the foreign income exclusion. The Revenue Act of 1951 struck the entire foreign earned income exclusion from the Tax Code and rewrote it. The revised exclusion expanded the number of individuals eligible for the exclusion by creating the physical presence test as an alternative to the bona fide residence test. The physical presence test required a United States citizen to be in a foreign country for at least 17 months or 510 days during that 18 month period.

Two years after the physical presence tested was created, it was nearly repealed by the Technical Changes Act of 1953. As originally drafted, the bill would have completely eliminated the test. The House Ways and Means Committee reported that the physical presence test had been the subject of a great deal of abuse, and thus, suggested its elimination. Despite the desire to repeal, when the Technical Changes Act of 1953 was signed into law, the physical presence test had been retained. However, in an attempt to curb the abuse, there was a limitation placed on the amount that could be excluded for individuals using the physical presence test (i.e. the bona fide residence test still excluded an unlimited amount of foreign earned income). At the time, an individual taxpayer was limited to excluding $20,000 under the physical presence test if they were abroad for the entire tax year and a pro rata portion (based

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72 Id.
73 Id.
75 Id.
76 Id.
78 Id.
on the amount of time abroad) of the $20,000 if they were abroad for less than the full taxable year.\textsuperscript{79} This was the first dollar amount limitation placed on the foreign earned income exclusion.

Shortly after President Kennedy took office in 1961, he laid out a plan to drastically alter the foreign earned income exclusion.\textsuperscript{80} President Kennedy recommended that the foreign earned income exclusion be completely eliminated for individuals living in “developed countries.”\textsuperscript{81} He stated that the foreign earned income exclusion permitted unjustified tax benefits to be obtained by individuals who chose to live outside the United States solely by their desire to minimize taxes.\textsuperscript{82} The President’s plan suggested that the foreign earned income exclusion would remain for individuals residing in the less developed countries.\textsuperscript{83} Those individuals would be allowed to exclude $20,000, irrespective of whether the claim was coming under the bona fide residence or physical presence test.\textsuperscript{84}

Similar to the situation in 1953, instead of eliminating the foreign earned income exclusion as it applied to the majority of individuals, Congress placed a cap on it.\textsuperscript{85} This time the aim was at the individuals who were given the unlimited exclusion under the bona fide residence test.\textsuperscript{86} Congress placed a $20,000 limitation on all individuals claiming the exclusion, whether they met the bona fide resident test or physical presence test.\textsuperscript{87} An exception was created for

\textsuperscript{79} Id.
\textsuperscript{80} President’s 1961 Tax Recommendations: Hearings Before the House Comm. On Ways and Means, 87\textsuperscript{th} Cong. 8 (1961) (statement of President John F. Kennedy).
\textsuperscript{81} Id.
\textsuperscript{82} Id.
\textsuperscript{83} Id.
\textsuperscript{84} Sen. Report 87-1881 at Section XI (1962).
\textsuperscript{85} Id.
\textsuperscript{86} Id.
individuals meeting the bona fide residence test for three consecutive years or more. Those individuals were allowed to exclude $35,000 per year.

B. 1978-1981

i. Events Leading Up to 1978

The groundwork for the overhaul of the foreign earned income exclusion was laid in 1975 when the Tax Reform Act of 1976 (hereinafter the ‘76 Act) was first introduced. At that time, the limitations enacted in 1962 and 1964 were still in place; individuals could deduct up to $20,000 of foreign earned income if they were a bona fide resident or physically present in a foreign country for 17 out of 18 months. However, an individual who was a bona fide resident for three years or more was allowed to exclude up to $25,000 per year.

The original House of Representatives version of the ‘76 Act had proposed to completely phase out the exclusion (subject to certain situations) over a four year period, but the Senate Finance Committee felt the need to maintain some portion of it to maintain its competitiveness abroad. Instead, the ‘76 Act reduced the exclusion amount to $15,000 for both the bona fide and physical presence tests. Additionally, the extra $5,000 exclusion available for individuals meeting the bona fide residence test for three consecutive years was eliminated.

In addition to reducing the exclusion amount, the ‘76 Act also brought about four significant structural changes to foreign earned income exclusion. First, any individual claiming the foreign earned income exclusion could not take the Section 901 foreign tax credit

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88 Id.
92 Id.
93 Id.
95 Id.
on the same income the individual was excluding under the foreign earned income exclusion.97 Second, as a result of the Section 901 exclusion, the ’76 Act also made the foreign earned income exclusion an elective provision.98 If an individual could receive a greater tax benefit from taking the foreign tax credit than the foreign earned income credit, that individual could decline to use the foreign earned income exclusion. The only caveat was that once the election to utilize the foreign earned income exclusion was taken by the individual, it was irrevocable unless approved by the Secretary of the Treasury.99 Third, any foreign income in excess of the exclusion would be taxed at the tax bracket that would have been applicable but for the exclusion.100 This was accomplished by having the individual calculate their tax under Section 1101 and then subtracting the Section 1 tax that would have been imposed on the amount excluded by the foreign earned income.102 The final structural change was adding a tax avoidance provision.103 The avoidance provision stated that an individual could not use the foreign earned income exclusion if the income payment was received outside the country where the work was performed and if one of the purposes was to avoid income taxation by the country where the work was performed (emphasis added).104 Simply, an individual could not work in Country A and receive their check in Country B in order to avoid taxation in Country A if it was determined that one of their purposes was to avoid taxation.

97 Tax Reform Act of 1976, Pub L. No. 94-455, §1011, 90 Stat. 1520, 1610. The foreign tax credit allows an individual who paid income taxes to a foreign country a credit against his or her domestic (i.e. United States) taxes.
99 Id.
100 Id.
101 IRC §1, the income tax rate imposed on individual.
103 Id.
104 Id.
The ’76 Act became law on October 4, 1976, with the foreign earned income provisions effective for the 1976 tax year. However, The Tax Reduction and Simplification Act of 1977 changed the effective date of the ’76 Act from January 1, 1976 to January 1, 1977 (i.e. effective for the 1977 tax year). Congress believed that given the ’76 Act’s late date of passage, substantial inequities would be imposed on individuals living abroad if the changes were applied for the 1976 tax year.

But the tinkering with the ’76 Act was not finished. Just after its passage, the House of Representatives had passed H.R. 9251. H.R. 9251 became Public Law 95-615, although that was over a year after the initial passage in the House of Representatives. It is referenced by its public law number, instead of by name, because Public Law 95-615 actually is two Acts; the Tax Treatment Extension Act of 1977 and the Foreign Earned Income Act of 1978 (hereinafter the ‘78 Act). The Tax Treatment Extension Act of 1977 is a relatively short and straightforward Act. Among a few other non-related provisions, it further delayed the enactment of the ’76 Act, changing the effective date to January 1, 1978 (i.e. the 1978 tax year).

ii. The 1978 Overhaul of the Foreign Earned Income Exclusion

It is the latter half of Public Law 95-615 that radically altered the landscape of excluding income earned by an individual living abroad. The ‘78 Act made sweeping changes to the foreign earned income exclusion, eliminating the application of Section 911 to the majority of individuals. In its place, most individuals seeking a tax benefit for living and working abroad

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105 Id.
110 Id.
111 Id.
112 Id.
113 Id.
found the benefit as a series of itemized deductions under a new tax code section, Section 913. The ‘78 Act also made changes to the general moving expense deduction for those moving abroad and for those purchasing a new residence abroad, both of which are beyond the scope of this article.

Section 911 was amended to limit the income exclusion to individuals residing in a camp located in a hardship area, as defined by the new Section 913(h). A hardship area was defined as any place where extraordinarily difficult living conditions or unhealthy living conditions were present. The designation of a hardship area was made by the Secretary of State under Title 5, Section 5925 of the United States Code or if employees of the United States government would be given extra compensation based on their presence in that area.

For those individuals not living in a hardship area, the set dollar amount exclusion of Section 911 based was inapplicable. Instead, all of an individual’s foreign earned income was included, but then reduced by the Section 913 itemized deductions. Deductions were allowed for the difference in cost of living abroad, foreign housing expenses, foreign schooling expenses, and travel expenses to the United States, as well as a separate hardship area deduction. The sum of these deductions could not exceed the individual’s foreign earned income for the year less any other income deductions.

The deduction for cost of living, called a “qualified cost of living differential” was outlined in Section 913(d). The differential was stated as the amount by which general cost of

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114 Id.
115 Id. §§205-206.
117 Id.
118 Id. 5 U.S.C. §5925 provides employees of the federal government additional compensation if, by reason of their employment, they were required to reside in a hardship area.
119 IRC §§911-913, generally.
120 IRC §913(a)
121 IRC §§913(a), (d-h) (repealed by Pub. L. 97-34, Aug 13, 1981).
122 IRC §913(c).
living expenses for an individual living in a foreign place exceeded the general cost of living expense for the highest general cost of living city in the continental United States.\textsuperscript{123} The method for determining the annual cost of living differential for all foreign places was borne on the Treasury Secretary.\textsuperscript{124}

There were several factors spelled out in Section 913 that the Treasury Secretary was required to consider in calculating the cost of living differential. First, the differential was determined without regard to housing expenses or schooling expenses,\textsuperscript{125} since there were separate deductions for each.\textsuperscript{126} Second, the differential reflected the costs of living for a family whose total income was equal to that of a grade GS-14, Step 1 United States employee under the General Schedule.\textsuperscript{127} Third, while foreign place was undefined, it was the intention of Congress that the Treasury Secretary should not define a foreign place by national borders, instead focusing on contiguous areas that had similar cost of living expenses.\textsuperscript{128} Finally, the Treasury Secretary had to provide differentials dependent on the number of individuals in the taxpayer’s family unit (i.e. spouses and dependents).\textsuperscript{129} Section 913(d) presumed that the Treasury Secretary would produce tables to establish the cost of living differential, but allowed the Treasury Secretary to use other means to convey the differentials.\textsuperscript{130}

There were two exceptions which would limit or eliminate the available cost of living differential deduction. First, an individual’s deduction was limited to the number of days in a tax

\textsuperscript{123} IRC §913(d)(1). Oddly, the Code Section provided that the cost of living included the \textit{continental} United States, but repetitively excluded Alaska. Hawaii was not mentioned.
\textsuperscript{124} IRC §913(d)(1).
\textsuperscript{125} IRC §913(d)(2)(B).
\textsuperscript{126} IRC §913(d)(1), §913(f).
\textsuperscript{127} IRC §913(d)(2)(C)(ii). At the time, GS-14, Step 1 was $23,087. H. R. Rep. No. 95-1798 at 4 (1978) (Conf. Rep.).
\textsuperscript{128} Senate Rep. No. 95-746 at 8 (1978).
\textsuperscript{130} IRC §913(d)(1).
year that the individual had a tax home in a foreign country.\textsuperscript{131} The deduction was not available for individuals who were eligible to receive a meals and lodging exclusion under Section 119 of the Code.\textsuperscript{132}

Section 913(e) provided a deduction for an individual’s qualified housing expenses in a foreign country.\textsuperscript{133} It included some of the same basic provisions found in the qualified cost of living differential deduction; it excluded individuals utilizing the Section 119 housing and meals deduction and it was limited to the period of time in which the individual’s tax home was in a foreign country.\textsuperscript{134} Section 913(e) created a simple formula for qualified housing expenses, taking an individual’s foreign housing expenses and subtracting a base housing amount to arrive at the deduction.\textsuperscript{135}

Housing expenses were defined as any reasonable expense paid by an individual for housing in a foreign country.\textsuperscript{136} It included expenses such as utilities and insurance.\textsuperscript{137} However, it did not include mortgage interest or property taxes, which were deductible under Section 163 and Section 164, respectively.\textsuperscript{138} The housing expenses had to be reasonable;\textsuperscript{139} a requirement which was reiterated by excluding those expenses which were lavish or extravagant.\textsuperscript{140}

An individual’s base housing amount required a calculation which could not be made until all other Section 913 deductions were calculated. The individual needed to take their

\textsuperscript{131}IRC §913(d)(2)(A).
\textsuperscript{132}IRC §913(d)(2)(E). IRC §119 excluded (and still does) meals and lodging provided by the employer to the employee and his or her family for the convenience of the employer. See IRC §119, generally.
\textsuperscript{133}IRC §913(e).
\textsuperscript{134}IRC §913(e)(4).
\textsuperscript{135}IRC §913(e)(1).
\textsuperscript{136}IRC §913(e)(2)(A).
\textsuperscript{137}IRC §913(e)(2)(A)(i).
\textsuperscript{138}IRC §913(e)(2)(A)(ii). See also IRC §163 and §164.
\textsuperscript{139}IRC §913(e)(2)(A).
\textsuperscript{140}IRC §913(e)(2)(B).
foreign earned income (reduced by any deductions outside of Section 913) and then subtract the remaining four deductions allowed under Section 913.\textsuperscript{141} The base housing amount was 20 percent of that amount.\textsuperscript{142} Congress had determined that 20 percent was the correct amount of income that was normally attributable to an individual’s foreign housing costs.\textsuperscript{143} However, the base housing amount could also be deemed zero, resulting in the entire amount of housing costs to be deductible.\textsuperscript{144} This was available if an individual maintained a tax home for himself and another household for his spouse and/or dependents, with both houses in a foreign country and that country was deemed a hardship area.\textsuperscript{145} The result would be that the second home would be included as part of the individual’s housing expenses.\textsuperscript{146} Since the base housing amount is zero, all of the housing expenses for both houses were wholly deductible.

The third deduction, qualified schooling expenses, was statutorily defined as expenses paid by the individual on behalf of his or her dependents for elementary or secondary schooling under Section 913(f).\textsuperscript{147} Section 913(f) was straightforward, but required only a few definitions. First, elementary or secondary schooling was defined as an education equivalent to that of a child between kindergarten and twelfth grade in a United States type school.\textsuperscript{148} Second, school expenses included most education-related items, such as tuition, books, and transportation, as well as any additional items required by the school.\textsuperscript{149}

\begin{footnotes}
\item[141] IRC §913(e)(3)(A).
\item[142] Id.
\item[143] Sen. Rep. No. 95-746 at 9 (1978). Congress started with 16 2/3 percent, which was the percentage the Bureau of Labor Statistics had determined to be the average percentage used by a United States taxpayer to pay for housing costs. That number, run through a complicated formula, turned out to be on average about 20 percent, so Congress elected to simplify the calculation by making it 20 percent.
\item[145] Id.
\item[146] IRC §913(i).
\item[147] IRC §913(f)(1).
\item[148] IRC §913(f)(1).
\item[149] IRC §913(f)(2).
\end{footnotes}
Deductions were generally available only if the dependents resided at the individual’s tax home, thus excluding room and board.\textsuperscript{150} However, room and board could be included if an adequate United States-type school was not available within a reasonable commuting distance to the individual’s tax home.\textsuperscript{151} The only specifically enumerated limitation in the qualified schooling expense section was that if there was an adequate United States-type school within commuting distance of the individual’s tax home and their dependents attended a different school, the amount of deductible expenses would be limited to the aggregate amount that would be charged if the dependents attended the United States-type school.\textsuperscript{152}

The fourth deduction was for an individual’s expenses travelling home to the United States.\textsuperscript{153} Section 913(g) included reasonable amounts paid by the individual for transportation of the individual and/or their family (spouse and/or dependents) from the foreign tax home to their principal residence in the United States.\textsuperscript{154} If the individual did not currently have a principal residence, travel could be deducted if it was to the individual’s most recent principal residence in the United States.\textsuperscript{155} Finally, if the individual never had a principal residence in the United States, the travel deduction was limited to the nearest port of entry in the continental United States.\textsuperscript{156}

Expenses in any of the above situations included travel to the United States and back to the foreign country.\textsuperscript{157} The travel expense deduction was limited to one round trip per person for each contiguous 12 month period.\textsuperscript{158} Additionally, while not defining reasonable amounts, the

\begin{footnotes}
\item[150] IRC §913(j)(3).
\item[151] IRC §913(f)(3).
\item[152] IRC §913(f)(4).
\item[153] IRC §913(g).
\item[154] IRC §913(g)(1)(A).
\item[155] Id.
\item[156] IRC §913(g)(1)(B).
\item[157] IRC §913(g)(1).
\item[158] IRC §913(g)(2).
\end{footnotes}
deduction for transportation by air was limited to the lowest coach or economy rate for a commercial flight during the calendar month in which the individual flew. If there were no coach or economy rates or if the individual was required to use first class due to a physical impairment, the lowest first class fare for the month would be deemed reasonable.

The final deduction was for individuals whose tax home was in a hardship area, found under Section 913(h). This deduction was available in addition to the zero base housing amount allowance in the housing expenses deduction. The hardship area deduction was the simplest of the five, both in terms of calculating and in determining who qualified. A hardship area was designated by the Secretary of State. The determination was made by looking at the harshness of the living conditions and whether under Title 5, Section 5925 of the United States Code, the area had been designated an area subject to a 15 percent or more “post differential” for federal employees. The individual received a portion of a $5,000 deduction based on the percentage of days in which the individual’s tax home was in a hardship area.

iii. The 1981 Repeal of the 1978 Changes

Section 913 of the Internal Revenue Code was repealed as part of a larger piece of legislation called the Economic Recovery Tax Act of 1981 (hereinafter, the ’81 Act), placed into law on August 13, 1981. While a majority of the provisions were aimed at providing corporate incentives, foreign earned income was the focal point of the changes made to the

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159 IRC §913(j)(2).
160 Id.
161 IRC §913(h).
162 IRC §913(h)(2).
163 Id. See also 5 U.S.C. §5925. Federal employees can receive additional compensation if they have to live in an area in which there are substantially adverse environmental conditions.
164 IRC §913(h)(1).
individual income tax provisions. The ’81 Act repealed Section 913 and rewrote Section 911 to once again be applicable to all individuals.

A full dissertation of the provisions of the revised Section 911 in the ’81 Act is unnecessary because Section 911 in the ’81 Act was quite similar to Section 911 before the ’78 Act. However, a few items are noteworthy. First, the bona fide resident and physical presence test remained the key factors for determining eligibility, although the time period required to meet the physical presence test was reduced from 17 out of 18 months to 330 days in any 12 month period. Second, exclusion amount bore little resemblance to any previous limitations set out in Section 911. Third, a new housing exclusion was created, borrowing a majority of its concepts from Section 913. The latter two are discussed in detail below.

Recall that in 1976, the foreign earned income exclusion was limited to $15,000. Now, five years later, Congress had a completely different approach to the limit. The original House of Representatives version of the ’81 Act had proposed a $75,000 exclusion limit. The Senate version of the bill proposed that instead the limitation should be set at $50,000, with another $50,000 being subject to a 50 percent limitation. When the Joint Committee on Taxation convened, they agreed to the $75,000 limitation and thus the foreign earned income exclusion

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166 Id. While IRC §911 provides a benefit to individuals, it is often seen as a providing a business benefit, as it allows businesses to send individuals abroad.
167 Id. at §§111-112., 95 Stat. 190-194.
168 IRC §§911(d)(1), (d)(5).
169 IRC §911(b)(2).
170 IRC §911(c).
174 Staff of Joint Committee on Taxation, 97th Cong., Report of Joint Committee on Taxation 44 (Comm. Print 1981).
was limited to $75,000.\textsuperscript{175} In addition, the ’81 Act increased the $75,000 exclusion limit in annual $5,000 increments to a cap of $95,000 in 1986 and beyond.\textsuperscript{176}

In addition to more than tripling the available exclusion amount, the ’81 Act also provided individuals with a foreign housing exclusion.\textsuperscript{177} The exclusion provided that an individual could exclude their foreign housing expenses that were in excess of a base housing amount.\textsuperscript{178} The calculation would made as follows: the individual would take their foreign housing expenses for the tax year and subtract an amount equal to 16 percent of the GS-14, Step 1 pay rate of a United States governmental employee under the General Schedule.\textsuperscript{179} The resulting amount would be excludable. If the individual was not a foreign resident for the entire year, the base housing amount would be adjusted by multiplying by the fraction of days abroad over the entire tax year.\textsuperscript{180} In addition to being able to deduct the housing expenses of the “tax home,” the housing expenses of a second foreign home could be deducted for a spouse and dependents if the living conditions were unhealthy or dangerous.\textsuperscript{181}

The housing exclusion of the ’81 Act was similar to the previous Section 913 housing deduction in a number of ways. First, the calculation was essentially the same; housing expenses are deductible in an amount that exceeds the base housing amount. The ‘78 Act’s exclusion used 20 percent as the base housing amount,\textsuperscript{182} while the ’81 Act’s exclusion was 16 percent.\textsuperscript{183} By doing this, the ’81 Act decreased the amount disallowed from the calculation, resulting in a higher exclusion for the individual. Presumably, the 16 percent was based on the findings of the

\textsuperscript{176} Id.
Bureau of Labor Statistics, which estimated the average individual’s housing expenses to be 16 and 2/3 percent of their income at that time. However, the ’78 Act tied the base housing amount to an individual’s actual income, while the ’81 Act used the General Schedule, resulting in a set deduction amount for every individual.

Second, the individual items that are specifically excludible and includible as housing expenses are the same. Utilities and insurance were specifically included in an individual’s housing expenses, while property taxes and mortgages were explicitly excluded. The “lavish or extravagant” language found in the ’78 Act was retained in the ’81 Act, preventing unreasonable housing expenses from being excluded.

Finally, the ’81 Act borrowed the concern of individuals who have their spouses and dependents living separately because of the dangerous circumstances surrounding their tax homes. Under the ’78 Act, these individuals were allowed a zero base housing amount and could deduct the expenses of both homes, essentially giving them a 100 percent deduction their housing expenses. In a similar fashion, the ’81 Act allowed a second foreign household to be included in housing expenses, but retained the 16 percent base housing amount. While it appears that the ’78 Act provided a larger tax benefit, remember that the foreign housing deduction in the ’78 Act was an itemized deduction while the ’81 Act was an income exclusion.

1981-Present

Much of the subsequent legislation affecting the foreign earned income exclusion has been focused on the limitation amount. In 1984, the $5,000 per year increase was delayed and further drawn out.\textsuperscript{190} Instead of the ’81 Act’s $5,000 per year increase until 1986, the limitation was set at $80,000 until 1987, and then increased by $5,000 per year, reaching the $95,000 maximum in 1990.\textsuperscript{191} But that would never occur. Two years later, the major overhaul of the Internal Revenue Code in 1986 included changing the foreign earned income exclusion, removing the upward scale and establishing a constant $70,000 limitation.\textsuperscript{192} That limit would remain until 1998, when the Taxpayer Relief Act of 1997 became applicable.\textsuperscript{193} The Taxpayer Relief Act of 1997 provided a $2,000 per year increase until 2002, creating a maximum exclusion of $80,000.\textsuperscript{194} Pursuant to the Act, that amount would remain constant until 2007, when an annual inflation adjustment would increase the amount based solely on inflation.\textsuperscript{195}

The most recent major change to the exclusion amount occurred as a result of the passage of the Tax Increase Prevention and Reconciliation Act of 2005 (hereinafter TIPRA).\textsuperscript{196} It accelerated the date that inflation would adjust the $80,000 limitation by to years, to 2005.\textsuperscript{197} But TIPRA impacted more than just the exclusion amount. The exclusion for housing expenses was no longer pegged to the GS-14, Step 1 salary of a government official.\textsuperscript{198} Instead, the amount was of the base housing amount was 16 percent of the maximum foreign earned income

\textsuperscript{191} Id.
\textsuperscript{193} Taxpayer Relief Act of 1997, P.L. 105-34, §1172, 111 Stat. 788, 988.
\textsuperscript{194} Id.
\textsuperscript{195} Id.
\textsuperscript{196} Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, 120 Stat. 345. Given that TIPRA was signed into law in May of 2006 and effective for the 2006 tax year, the Internal Revenue Service issued a Notice (Notice 2007-16, February 20, 2007) that provided taxpayers relief for penalties resulting from the changes to §911, presumably to avoid delaying the enactment of the Act, as was previously seen in the ’76 Act.
\textsuperscript{198} Id.
exclusion. Likewise, the amount of housing expenses was also capped at 30 percent of the individual’s foreign earned income limitation. In essence, the exact amount of the housing expense could be calculated by simply looking at the foreign earned income exclusion for the given year, returning in part to the ’78 Act’s use of foreign earned income to determine the base housing amount.

TIPRA also borrowed an idea that was formulated in the ’76 Act. If, after the foreign earned income and housing exclusions are applied, the individual had taxable income, that income will be taxed as if the exclusion had not applied. In other words, an individual’s Section 1 tax rate would be determined without excluding the Section 911 deductions and any income above the Section 911 exclusion amount would be taxed at that rate.

III. Problems with the Current Foreign Earned Income Exclusion

To understand the problems with Section 911, one must understand the reason for Section 911. The goal of Section 911 is to provide an individual with a tax benefit that will either make it more attractive for an individual to live and work abroad, or at least make it income-neutral for the individual. If more individuals are working abroad, it is felt that exportation and overseas competitiveness will increase. It is important to remember that the perceived increase in global business is the resulting benefit; the individual is deemed to be the primary beneficiary of the foreign earned income exclusion.

The major problem with Section 911 is that it provides an exclusion based solely on an individual’s income, whether that individual lives in a country that has a higher cost of living or a

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199 Id.
200 Id. The passage of TIPRA created a situation in which the amount of the exclusion was a set amount. For example, the 2006 exclusion amount for housing expenses (assuming the taxpayer lived abroad for the entire year) was $11,536, calculated as follows. $82,400 (the amount of the foreign earned income for 2006 (after being adjusted for inflation)) x 30 percent= $24,700 (maximum amount of housing expenses allowed). Subtract from that amount the floor of $13,184 ($82,400 x 16 percent).
201 Id.
lower cost of living. As a result, some individuals will benefit more than other individuals with
the same income, based strictly on the fact that where they live (i.e. in a low cost of living
country) they can afford more. Therefore, Section 911 provides a tax benefit to all, but skews
the benefit to those living in a lower cost of living area, and as a result, benefits and encourages
companies to seek out countries that will maximize their employees’ benefits. In other words,
the goal of increasing global competition is not truly global; it is selective to locations that have a
lower cost of living.

So why is the exclusion for individuals working abroad income-based? The first reason
appears to be apathy. Except for the period of 1978-1981, the United States has used an income-
based tax credit for individuals working abroad. As previously mentioned, the original foreign
income exclusion arose, in large part, as a result of a budget surplus. In essence, the initial goal
behind using a foreign income exclusion was to reduce the amount of income subject to taxation,
and by extension, reduce the amount of tax paid. Since its inception, the foreign tax benefit
battle has focused on whether there should be a tax benefit for those working abroad and if so,
how much income should be excluded (with the exception of the ’78 Act). While President
Kennedy’s suggestion that the foreign income exclusion be tied to individuals living in less
developed countries was a step in the right direction, it still tied the tax benefit to the amount of
income a person was earning.

The second reason for favoring an income-based exclusion appears to be in the same
general category of indifference. It’s the thought that deducting or excluding income is an easier
calculation than any alternative method. This was one of the reasons put forth in favor of the ’81
Act; returning to an income-based exclusion system was just a simpler calculation. The drafter of

the revised foreign earned income exclusion, Senator Chafee, stated during the debate of the ’81 Act that Section 913 was too confusing and complex. That sentiment was echoed in the Senate Finance Committee’s report on the ’81 Act. In that report, the suggestion was made that due to the complexity of Section 913, it was difficult to estimate the tax liability before moving abroad and often required tax professionals to complete a return.

While that was a valid argument at the time it was made, technology has made that argument irrelevant. When the bill was passed in 1981, the first personal computer was being released. Last year, roughly 70 percent of individuals filed their federal taxes electronically. While this may indicate that complexity has given rise to the need for computers, it also demonstrates that the majority of United States taxpayers not only have access to computers, but also utilize computer technology to complete their tax returns. Therefore, the concern that the calculations required in Section 913 are too complex is no longer relevant.

Two additional reasons for returning to an income-based tax benefit were put forth by the Senate Finance Committee in its report on the ’81 Act. First, they believed that a change was necessary to reduce the tax burdens on individuals in order to minimize trade deficits. Second, they stated that the tax law needed to be changed to encourage the Americans to work abroad and promote United States exportation. While those may be valid reasons for making alterations to the Tax Code, neither provides a reason why an income-based system is necessary. In fact, Section 911 favors certain countries by creating a flat income-based exclusion amount.

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206 Id.
208 i.e. 2009, for the 2008 tax year.
211 Id.
giving a great benefit to individuals residing in low cost of living countries. Instead, alterations could have been made to Section 913 as it stood to increase the amount of tax breaks available to individuals working abroad that would favor all individuals working abroad equally.

If the overall goal of the foreign income exclusion is to promote United States interests abroad, why would the amount of the exclusion be limited? As said throughout the history of the foreign earned income exclusion, a specific dollar limitation is necessary to prevent abuse. This was the reason for the initial limitation in 1953\(^{212}\) and was the basis for the establishment of the limitation in the ’81 Act.\(^{213}\) The concern, according to the Senate Finance Committee, was that highly paid individuals would be able to move overseas in an effort to avoid United States taxation.\(^{214}\) But if income is not the basis by which a tax break is determined, then there is no need to be concerned about abuse. It is only by tying the tax break to the income an individual earns that the potential for income shifting becomes a concern.

In solving the problem of abuse by limiting the exclusion, Section 911 also limits exportation and foreign trade. As Senator Chafee said in his address to the Senate in 1981, Section 911 was designed to have a direct impact on the ability of American businesses to compete overseas.\(^{215}\) But while it is assumed that Senator Chafee was correct in stating that tax benefits to those working abroad increase exportation and foreign trade, placing a limitation on the benefit also limits the ability of American businesses to compete. Corporations may have to rely on lower-paid employees to work abroad because of the limited tax benefits available to their higher income employees.\(^{216}\) Of course, if the tax benefit is not tied to income, then the

\(^{214}\) Id.
\(^{216}\) If an employee earns more than the maximum income and foreign housing exclusion, than their tax benefits will be less than a lower-paid employee who can use the entire exclusion.
need to place a fixed dollar limitation across all individuals working outside the United States is eliminated.

The final argument against Section 911 is that tax provisions should provide equal economic benefits to taxpayers who should be tax equally.\textsuperscript{217} This concept is known as horizontal equity.\textsuperscript{218} Horizontal equity requires people who are earning similar incomes and with similar expenses to be treated the same in terms of their tax position. As a result, people in the same “group” would pay the same taxes. But using an income-based tax benefit system fails to do that. Instead, Section 911 provides a flat exclusion amount, whether the person is living in Sweden (the world’s highest cost of living country) or in Iraq (the world’s lowest cost of living country).\textsuperscript{219} As a result, the person living making the same money working in Iraq has more money after they pay their tax liability than the person in Sweden. The horizontal inequity created may result in an increased willingness to live in Iraq and get the tax benefit and a decreased willingness to live in Sweden to do the same job at the same rate.\textsuperscript{220}

IV. Why the Changes Made in 1978 Better Met the Goals Intended in Providing Benefits for Individuals Working Abroad

In 1978, the Senate Finance Committee advanced two compelling reasons for the complete overhaul of how to provide tax benefits to those individuals living abroad.\textsuperscript{221} The Committee felt that the relief provided by Section 911 was arbitrary and unfair and that equitable relief needed to be tied to the increased expenses. A few days after the Senate Finance Committee’s report was published, a report was presented from the Economics Division of the

\textsuperscript{217} Renee Judith Sobel, \textit{United States Taxation of Its Citizens Abroad: Incentive or Inequity}, 38 Vand. L. Rev. 103-104 (1985). For a thorough explanation of horizontal and vertical equity as it relates to Section 911, see Ms. Sobel’s article.

\textsuperscript{218} Id.

\textsuperscript{219} 2010 Quality of Living Index, \url{http://www1.internationalliving.com/qofl2010/?field=costofliving} (last visited October 13, 2010)

\textsuperscript{220} Assuming that person’s decision is made on a strictly tax perspective.

Library of Congress (hereinafter the Library of Congress Report) which reiterated the flaws with Section 911 and the need for change.\textsuperscript{222}

The Senate Finance Committee of 1978 realized that providing tax relief based on a flat exclusion was arbitrary.\textsuperscript{223} This is exactly how Section 911 worked prior to 1978 and how it works today. It ignores that the reason behind providing a tax benefit to those working abroad is to encourage individuals to live overseas \emph{wherever they live} in order to promote trade and exportation. As the Committee’s report stated, it is unfair for the amount excluded to be the same, whether an individual lived in an area that had a higher cost of living or lower cost of living.\textsuperscript{224} Without directly stating so, the Senate Finance Committee was concerned with the fact that Section 911 failed to provide horizontal equity.

While the Senate Finance Committee spoke about the need for horizontal equity without directly using that terminology, much of the Library of Congress Report spoke directly on the subject. The report used ability to pay as the measure of horizontal equity.\textsuperscript{225} Ability to pay simply states individuals in similar circumstances (based on family, income, and cost of living) should be able to pay the same income taxes.\textsuperscript{226} A flat exclusion amount does not achieve that goal. For example, Section 911 can create a situation in which the maximum exclusion amount will make the ability to pay the same for the person in Sweden and their counterpart in the United States.\textsuperscript{227} However, the person living in Iraq, who based on his or her cost of living alone

\begin{footnotesize}
\begin{itemize}
    \item[224]  Id.
    \item[226]  Id. at 11213-11214.
    \item[227]  Using a simplified calculation, a person living in Sweden named S pays double the overall cost of living expenses that person U, a person living in United States. They have the same expenses, have the same gross income of $100,000, and are both in a 20\% tax bracket. If person U has $20,000 in cost of living expenses, he has $80,000 to pay the $20,000 liability, or 25\% of his net income. S's cost of living expenses are $40,000 (2 x $20,000) meaning
\end{itemize}
\end{footnotesize}
has a greater ability to pay than the person living in the United States, now receives an added benefit of the exclusion amount.\(^{228}\) The Library of Congress Report reaches same conclusion; Section 911 simply is horizontally inequitable.\(^{229}\)

Instead of using a flat income-based tax exclusion, the 1978 Senate Finance Committee stated that the tax benefits should be more closely related to the actual additional expenses incurred for the individual working abroad.\(^{230}\) By doing this, the individual who is truly in need of tax benefits are given those benefits, while those who already have a greater ability to pay their tax liability are not afforded an additional unneeded benefit. Benefits that are more closely related to an individual’s actual expenses push the overall theory of providing tax benefits to individuals working overseas closer to horizontal equity.\(^{231}\)

V. Proposed Solution

The solution to this problem is to eliminate Section 911 of the Tax Code in its entirety and return to the system similar to now repealed Section 913. This proposal would not mimic Section 913 directly; rather borrow from the main concepts in an effort to provide a foreign tax benefit system that more closely resembles the intended goal. It would retain the flexible approach of Section 913, allowing Congress to increase or decrease the tax benefit as needed to continue exportation and global competition without overhauling the Tax Code.

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\(^{228}\) S only has $60,000 to pay the $20,000 owed in taxes (or roughly 33% of her net income). But presume there is a §911 income exclusion capped at $25,000. S’s taxable income is reduced to $75,000 and she owes $15,000 (20% of $75,000) in taxes. Thus, now she has the same 25% (15,000 ÷ 60,000) ability to pay as U.

\(^{229}\) Now add person I, a person living in Iraq, to the above equation. I has the same income, expenses, and tax bracket as both U and S. I only pay’s half of the cost of living that a person in the United States does, so he has $90,000 to pay $20,000 in taxes, or roughly 22%. In other words, before any §911 exclusion is computed, there is already horizontal inequity based on I’s higher ability to pay. When the §911 exclusion is added (because it is irrelevant whether I is in a higher or lower cost of living country), I’s taxable income is reduced to the same $75,000 as S, with the same tax liability of $15,000. Now I has an even higher ability to pay, as his percentage of net income going toward taxes is roughly 17%.


\(^{231}\) The theory of horizontal equity is an economic theory that seeks a “perfect world” goal, even if that goal cannot truly be achieved. Therefore, the goal is obtain a result that gets as close to meeting horizontal equity as possible.
As previously stated, Section 911 would be completely removed from the Tax Code. The ’78 Act retained Section 911 in a limited manner; allowing those individuals living in a camp located in a hardship area to keep the benefits of Section 911. But retaining Section 911 in any form creates additional confusion and doesn’t follow the theory of horizontal equity. A hardship area can be separately defined and provided for without necessitating the retention of an income-based deduction under Section 911.

The proposed solution would be to provide some of the same benefits under the repealed Section 913, however in the form of an income exclusion similar to Section 911. There would be an exclusion for a cost of living differential, a housing expense, and a schooling expense. However, the qualified travel expenses would be removed. In addition, new exclusions would be added for transportation costs and a separate moving expense exclusion would be created, apart from the current Section 217 moving expense deduction. All the exclusions would be “above the line,” reducing the individual’s taxable income. An individual’s tax rate would be considered after the deductions.

Most of the Section 913(d) deduction for a cost of living differential created under the ’78 Act would remain intact. The Treasury Secretary would retain the duty to create tables that the cost of living differential. In doing so, as with the Section 913 exclusion, the remaining exclusions provided under this section would not be included in making their determination. However, the statute should not provide discretion to the Treasury Secretary to create an alternate method, as Section 913(d) did. Adding this language is problematic. First, it is giving the Treasury Department the authority to devise an alternative method for calculating a

233 See IRC §217.
234 IRC §913(a), (d-h) (repealed by Pub. L. 97-34, August 13, 1981).
235 IRC §913(d)(2)(B).
cost of living differential without giving Congress the ability to ask the Treasury Department how they plan to do it. This kind of autonomy is unnecessary and has the potential to create a substantial amount of unneeded litigation. Second, if one of the original concerns regarding Section 913 was that it made it difficult to estimate the tax benefits, providing an alternative method to calculate a cost of living differential is likely to cause concern.

Instead of pegging the cost of living differential to the highest city in the continental United States, the differential would be pegged to the highest cost of living city in the entire United States. There is no basis provided as to why Hawaii and Alaska were excluded in the ’78 Act, but presumably it was because Honolulu and Anchorage generally have a higher cost of living than any city in the continental United States. But if the concept for providing a tax benefit is that the individual is paying more than any individual living in the United States, there is no reason to exclude Hawaii and Alaska.

The cost of living differential would still be pegged to the General Schedule published by the Office of Personnel Management. There are two primary advantages to using the General Schedule. First, it uses resources already available and reduces the need to create new calculations. Second, it allows the cost of living differential to be easily changed, if so necessary, to increase or decrease the tax benefit. By using the General Schedule, Congress can change Section 913 by simply adjusting the grade and step, without having to re-write or recreate any of the substance of Section 913.

The grade and step level used in determining the cost of living differential is more a matter of Congressional policy than it is a factual determination. Generally, it would make more sense to use a GS-12, step 1 employee instead of using the GS-14, step 1 level employee from

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the ’78 Act,\textsuperscript{238} because that level makes the amount of money earned more closely drawn to that of the median income for a person living in the United States.\textsuperscript{239} But policy and statistical analysis would determine whether the average income for a person working abroad is higher (and thus the need to use a higher General Schedule number) and whether the baseline needs to be set at a higher or lower amount to provide the correct tax benefit.

While using an \textit{income} based standard for determining a cost of living differential may seem to contradict the arguments advanced against the use of income in Section 911, it is important to point out the differences. The General Schedule is being used under Section 913(d) to determine the average cost of living for a family, not the amount of the exclusion. It is a baseline amount for use by the Treasury Secretary; the actual differential is based on the location of the individual, not the amount of money he or she makes. As a result, the individual is receiving the benefit based on their actual circumstances.

The final change to the original Section 913(d) is that the concept of the “foreign place” would be removed in favor of the more traditional approach of defining boundary based on a country’s borders.\textsuperscript{240} There are a number of reasons to using this approach. First, creating “imaginary” borders has the potential to lead to confusion as to in which foreign place an individual resides. As previously stated, one of the concerns with the original Section 913 was that it was difficult to estimate the potential amount of tax benefit available.\textsuperscript{241} Requiring an

\textsuperscript{241} 127 Cong. Rec. 17975 (statement of Sen. Chafee).
individual to use a non-traditional territorial map to determine the amount of the cost of living differential unnecessarily complicates matters.

But beyond simplifying things for the individual, using national borders is necessary for a more accurate determination of the expenses attributable to cost of living. Cost of living is determined both directly and indirectly by taxes. Few developed countries are self-sufficient; instead countries rely on imported goods to sustain the needs of their residents. Therefore, any country’s tariffs play a large role in determining the price of goods sold within that country. Additionally, while intended to be a neutral-cost policy to the end-consumer, a value added tax (VAT) can create a large difference in cost of living expenses versus countries that rely solely or primarily on an income tax. Finally, countries that have high property taxes, particularly in their commercial and industrial sectors, will force merchants to increase their prices, resulting in a higher cost of living for the average consumer.

Using national borders presents a counter-argument that smaller jurisdictions within a country still influence tax items such as property and sales, and thus, not defining a foreign area by its national borders allows a country to be subdivided. However, the local power to tax is generally much less than a nation’s power to tax, thus reducing the impact on cost of living. As such, there is a greater need to define a foreign place by national borders over the need to subdivide it by the relatively small taxing powers of a local jurisdiction.

Finally, using a national border decreases the chance for abuse. Creating a foreign “area” allows an individual to maximize their deduction by moving just within that area, irrespective of where they actually work. While that can still be accomplished across national borders, there is a heightened requirement for an individual to achieve this goal. Travel between countries often

requires heightened security measures and some countries expand their taxes on those residents or employees who reside or work in a different country. Using national borders makes it less likely that an individual will be willing and able to undertake this to maximize their cost of living deduction.

The proposed solution would keep the qualified housing deduction of Section 913(e) generally as it was written. The housing deduction created under Section 913(e) is essentially the same as the housing deduction under the current Section 911(c), except for the amount of base housing percentage. As with the cost of living differential, the amount of the base housing percentage should be tied to the General Schedule and should be a product of current tax policy and statistical analysis, instead of any rigid construction.

As with the cost of living differential, the argument arises that there is a reliance on the amount of income in calculating the amount of the housing expenses exclusion. But again, the focus is on the amount reasonable housing expenses differ from that of a person living in the United States, not the amount of income. Generally, an individual with a higher income will spend more on housing, whether they live in the United States or abroad. The Section 913(e) deduction properly reflects and accounts for that. Additionally, by retaining the “reasonable” provision of Section 913(e), abuse of the housing expenses deduction will be prevented.

The only alteration to the original housing expenses deduction of Section 913(e) would be to allow cable television to be included as an excludible utility. While not considered in the original Section 913(e), cable television is specifically excluded from being considered a housing cost under the regulations of the current Section 911(c). This is a technology-driven change.

When the ’78 Act came into being, there was probably little need to discuss whether cable

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243 See Supra notes 143 and 179. The base housing percentage for Section 913(e) was 20% of earned income, while the ’81 Act lowered it to 16 2/3%.
244 Reg. §1.911-4(b)(1) and Reg. §1.911-2(ix).
television should be included or excluded, because cable television was in less than one sixth of the homes it is today.\textsuperscript{245} The technology of broadcasting directly into people’s homes through the use of a satellite (i.e. satellite television) had just been released into the market.\textsuperscript{246} With nearly 60\% of homes having some form of cable television today,\textsuperscript{247} it should be considered a general utility, deductible under the housing expense deduction.

The amount allowable for cable television under the housing expenses exclusion would be limited to either the cost of local cable programming available to the individual in the area in which they reside or the cost of United States programming. Allowing the deduction to extend to United States programming not only puts the individual living abroad in a similar situation that they would be in if they lived in the United States, it can also provide educational programming to their children. As with the general housing expense deduction, the limitation requires the cost to be reasonable. Additional pay channels (such as HBO), upgraded and expanded packages, and pay-per-view programming would not be deductible.

The school expenses deduction of Section 913(f) would also remain generally as written. An argument can be raised that, like cost of living and housing, there should be a base amount that should be subtracted from the gross amount of school expenses to level the playing field. However, 85 percent of public school funding comes from taxes and appropriations.\textsuperscript{248} Given that a majority of taxes that fund public schools are paid without regard to whether or not an individual has a child using the educational system provided, the amount actually paid for

\begin{footnotes}
\item[245] Basic cable was in 9.7 million homes in 1978, while 62.1 million homes had either basic cable in 2009. See Basic Video Customers, \url{http://www.ncta.com/Stats/BasicCableSubscribers.aspx} (last visited October 13, 2010).
\item[246] Industry History, \url{http://www.sbca.com/receiver-network/history-satellite-providers.htm} (last visited October 13, 2010).
\item[248] Public Education Finance Report for 2008, page xi, United States Census Bureau, found at \url{http://www2.census.gov/govs/school/08f33pub.pdf} (last visited October 13, 2010). The 2008 report is the most recent available, as it was released in June 2010.
\end{footnotes}
education in the United States is minimal. As such, creating a base amount to reduce the amount of the deduction would be overly-burdensome, creating an additional needless calculation for the individual and not providing any significant income for the United States government.

The additional deduction for those individuals living in a hardship area, found under the original Section 913(h), would remain, although the calculation of the amount would change. Under the ‘78 Act, the amount of the deduction was based on a set amount of $5,000 and the individual claiming the deduction received a portion of that amount based on the number of days they lived in a hardship area.249 This did not account for inflation and was an arbitrary fixed amount. Instead of a flat amount, the Treasury Secretary would provide a table with the amount of hardship deduction available, based on each foreign area. The General Schedule amount used to calculate the cost of living differential would be multiplied by the percentage of pay increase allowed by the United States Department of State for their federal civil service positions at that location.250 For example, if $50,000 was the baseline amount used by the Treasury Secretary to determine a cost of living differential, a person working the entire year in the Democratic Republic of the Congo, which has a 30 percent post differential251 would be allowed an additional $15,000 deduction (30% of $50,000), assuming the post differential remained at 30 percent throughout the year.

This manner of calculating the deduction would be more cost efficient and provide a more accurate deduction based on location. By using the United States Department of State’s post differential and the General Schedule, the new Section 913(h) would be utilizing

250 Post Differential Hardships are given based on location, at increments of 5%, 10%, 15%, 20%, 25%, 30%, or 35%. Summary of Allowances and Benefits, http://aoprals.state.gov/content.asp?content_id=134&menu_id=75 (last visited October 13, 2010).
government information already available. By providing a table used to calculate the amount, it would simplify the calculations required by the individual. In addition, by tying the amount of the hardship deduction to the General Schedule amount used in determining the cost of living differential, the hardship exclusion is not an arbitrarily-assigned amount, as it was the case in the original Section 913(h).

The only deduction from the ’78 Act that would not be retained is the provision allowing travel to the United States once per year, found under Section 913(g). This provision provided a tax benefit unavailable to other United States taxpayers; the deduction of travel costs for pleasure. The only conceivable purpose in providing this deduction was to provide an added tax benefit to the individual. But there are more reasonable methods for accomplishing this goal without providing a stand-alone benefit that would otherwise be unavailable.

The provision in Section 913(g) was unnecessarily complicated and would be even more complicated today. Limiting the deduction to the lowest cost of an economy flight during the month in which the individual travelled was a cumbersome task at the time, but given the breadth of available travel fares available online today, determining the lowest coach fare available for an entire month would be a nearly impossible task. While Section 913(g) could be rewritten to include simply a “reasonable” amount, there is still no legitimate reason for providing this benefit to individuals living abroad.

In addition to the reinstated Section 913 exclusions, a new exclusion would be created for transportation expenses. The Bureau of Labor Statistics states that transportation expenses are the second most important item in determining the Consumer Price Index, behind only housing, and above education.252 A transportation expenses exclusion is necessary to compensate

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individuals employed abroad for the general costs of an automobile, fuel, public transportation, and/or acquiring the necessary license to drive. While this could be included in the general cost of living differential, the amounts expended in transportation vary to such a degree that simply including transportation in the general cost of living differential would not provide an accurate measure of the costs expended. For example, fuel prices for the majority of the world are higher than they are in the United States and roughly one third of the world pays more than double the average United States price.  

The transportation expenses exclusion would be similar in application to the general cost of living differential. The Treasury Secretary would create a table, providing a differential based on the foreign country in which the individual resides. Among the statutory factors the Treasury Secretary would consider is the reasonableness of transporting a vehicle to the new country (i.e. a person living in Canada should be able to drive their vehicle to their new location, while a person living across an ocean should be allowed a reasonable amount for the lease or purchase of a new vehicle), the cost and availability of public transportation, and any environmental issues that may cause a deviation in the cost of transportation.

VI. CONCLUSION

The foreign earned income exclusion was created as a response to a budget surplus and a desire to drive industry. Since its creation, the exclusion has remained income-based, with the exception of the time period between 1978 and 1981. When the income-based exclusion was reinstated in 1981, it was reasoned that Section 913 was too complex and that there was a need to increase the deductions to spur exportation and foreign trade. Technology has minimized the

concern about the complexity, if not made it obsolete. While the need to expand foreign trade was a legitimate purpose for altering the tax benefits to those individuals working abroad, it did not explain the need to end Section 913 in favor of Section 911 and its income-based exclusion.

Section 911 has been the subject of a great amount of abuse, resulting in a limitation being placed on the exclusion amount for over 50 years. As a result of the dollar amount limitation, foreign trade has been limited. If the deduction is not based on the amount of income earned, the dollar amount of the deduction does not need to be limited.

Section 911 creates horizontal inequity. The same exclusion is available to any individual working abroad, whether they live in an area that has a higher cost of living or a lower cost of living. As a result, Section 911 gives some individuals a higher ability to pay than other individuals in the same circumstances and with the same income.

The proposed solution recommends reinstating a modified version of Section 913. In recreating Section 913, it solves all the problems created by Section 911. The proposed solution provides a realistic series of exclusions that accurately reflect the additional costs borne on the individual in working abroad, without giving unnecessarily benefits to those who do not deserve such benefits. By creating a series of exclusions that are not dependent on the income of an individual, Section 913 removes the ability to abuse the exclusion. The proposed solution also provides a closer balance of the ability of all individuals to pay the same tax liability.

But the proposed solution goes beyond the original language of Section 913. It gives the individual a series of exclusions instead of itemized deductions. It provides more straightforward language, correcting some of the complexity created by the original Section 913, even if complexity is no longer a concern. The proposed solution also utilizes items already created by the United States government to minimize the effort and cost needed to be put forth
by the Treasury Secretary. In summation, the proposed solution both solves the concerns of the original Section 913 and eliminates the problems that Section 911 has created.