NOTES

THE FOREIGN EARNED INCOME ACT OF 1978— SECTIONS 911 AND 913

I. INTRODUCTION

The Foreign Earned Income Act of 1978[1] (FEIA) deals with the tax treatment of U.S. expatriates.[2] Its purpose is to restructure those sections of the Internal Revenue Code dealing with foreign source income[3] which lost much, if not all, of their effectiveness as a result of the Tax Reform Act of 1976 (TRA).[4] The stated purpose of the foreign earned income exclusion provisions is "to encourage citizens to go abroad and to place them in an equal position with citizens of other countries going abroad who are not taxed by their own countries."[5]

In recent years, the United States has seen a marked increase in its trade deficit. Programs to boost our exports and decrease this deficit are imperative. "An increase in foreign trade [would] not only generate domestic growth but [would] serve United States foreign policy by increasing the economic strength of those countries which can assist the United States in preserving world peace."[6] Effective tax benefits to U.S. expatriates will serve to our nation's best advantage. With a partial alleviation of the need for increased compensation to employees to offset higher living costs incurred abroad, corporations will be more likely to expand operations in foreign countries. The result would be increased exportation of U.S. goods and technology.

This Note will examine the United States tax treatment of foreign source income, under sections 911 and 913 of the Internal

1. Foreign Earned Income Act of 1978, Pub. L. No. 95-615, 92 Stat. 3098 [hereinafter cited as FEIA].

2. H.R. REP. NO. 1463, 95th Cong., 2d Sess. 7 (1978) [hereinafter cited as H.R. REP. NO. 1463].

3. Prior to the Foreign Earned Income Act of 1978, I.R.C. § 911 was the primary source of law governing the treatment of foreign source income. Additionally, I.R.C. §§ 901 and 904 allow a credit for taxes paid to foreign countries. See note 14 *infra*.

4. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

5. S. REP. NO. 781, 82d Cong., 1st Sess. 53 (1951) *reprinted in* [1951] U.S. CODE CONG. & AD. NEWS 1969, 2024 [hereinafter cited as S. REP. NO. 781].

6. Note, *Section 911 Tax Reform*, 54 MINN. L. REV. 823 (1970); *see* A. CAIRNCROSS, FACTORS IN ECONOMIC DEVELOPMENT 203 (1962).

Revenue Code, to determine the effectiveness of either or both provisions with respect to the individual taxpayer and United States government objectives. Three stages of development of section 911 shall be discussed herein. The first of these is section 911[7] prior to the Tax Reform Act of 1976 (TRA). At that time, section 911 was functioning as it was intended to function—achieving its articulated objective of encouraging Americans to work abroad, while keeping their spending power on parity with that of foreigners.[8] As shall be seen later, the Foreign Earned Income Act of 1978 (FEIA) has reformed section 911 and promulgated section 913[9] in an attempt to revitalize and reestablish the effect that similar provisions[10] possessed prior to the Tax Reform Act of 1976. Stage two refers to section 911 subsequent to the Tax Reform Act of 1976.[11] Stage three is the post-FEIA section 911, in concert with the newly promulgated section 913. This stage discusses the various aspects of FEIA as originally proposed by the House Ways and Means Committee,[12] as well as the final form of the bill. Stages one and two are given purely for background and comparison purposes so that the reader may more fully understand the progression of events leading to the revision of section 911 and the resultant treatment of foreign source earned income.

The first earned income exclusion[13] enacted into law was section 213(b)(14) of the Revenue Act of 1926.[14] Antecedent to certain disagreements among members of the House and Senate,[15] the sec-

7. Internal Revenue Code of 1954, ch. 1, § 911, 68A Stat. 289 [hereinafter cited as I.R.C.].

8. S. REP. NO. 781, *supra* note 5.

9. I.R.C., *supra* note 7, § 913.

10. I.R.C. (1975), *supra* note 7, § 911.

11. I.R.C. (1978), *supra* note 7, § 911.

12. H.R. REP. NO. 1463, *supra* note 2.

13. The term 'earned income exclusion' refers generally to a tax law provision which in some manner or form allows the taxpayer to exclude a portion of his earned income from federal tax liability.

14. Revenue Act of 1926, Pub. L. No. 69-20, § 213(b)(14), 44 Stat. 9 [hereinafter cited as Revenue Act of 1926]. The Revenue Act of 1926 reads in pertinent part:

> In the case of an individual citizen of the United States, a bona fide nonresident of the United States for more than six months during the taxable year, amounts received from sources without the United States if such amounts constitute earned income as defined in section 209; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this paragraph. *Id.* at 26.

15. The original proposition of the House Ways and Means Committee concerning the purpose of section 213(b)(14) stated:

> In an endeavor to take one further step toward increasing our foreign trade it is

tion, as enacted, placed no limitation on the amount of the exclusion. However, it did require that the taxpayer be a nonresident of the United States for a period exceeding six months during the taxable year, and, further, that the income excluded be earned income.[16]

The development of section 911,[17] from its inception in 1926 as section 213(b)(14), to its current form has not been smooth.[18] The form of the provision just prior to the Tax Reform Act of 1976 shall be the point of departure.

II. STAGE ONE: PRE-TRA SECTION 911

Section 911[19] provided that any citizen of the United States who was a bona fide resident of a foreign country for an uninterrupted period which included the taxable year,[20] or who resided outside the United States for a period of at least 510 days out of 18 consecutive months,[21] could qualify for the benefits of section 911.[22] The aforementioned residence and presence requirements are applicable in all three stages of section 911's development.[23]

---

recommended in this paragraph that there shall be excluded from gross income in the case of our citizens employed abroad in selling our merchandise amounts received as salary or commission for the sale for export of tangible personal property produced in the United States in respect of such sales made while they are actually employed outside the United States, if they are so employed for more than six months during a taxable year.

H.R. REP. No. 69-1, 69th Cong., 1st Sess. 7 (1925). The Senate Finance Committee disagreed with the House on the grounds that the provision was wholly unnecessary. "The committee sees no reason for such an exemption, inasmuch as a citizen so employed abroad, if required to pay any income tax to the foreign country on his salary, receives a credit against his United States tax of the amount of tax paid to the foreign country." S. REP. No. 52, 69th Cong., 1st Sess. 20, 21 (1926).

16. Revenue Act of 1926, *supra* note 14.

17. I.R.C. (1978), *supra* note 7, § 911.

18. *See* Slowinski & Williams, *The Formative Years of the Foreign Source Earned Income Exclusion: Section 911*, 51 TAXES 355 (1973), for a detailed discussion of the legislative history of the foreign earned income exclusion.

19. I.R.C. (1975), *supra* note 7, § 911.

20. I.R.C. (1975), *supra* note 7, § 911(a)(1). *See* Treas. Reg. § 1.911-1(b)(8-11) (1975).

21. I.R.C. (1975), *supra* note 7, § 911(a)(2). *See* Treas. Reg. § 1.911-1(b)(8-11) (1975).

22. The "510 day rule" was added to section 911 to correct a defect in the old law. For example, where the nature of an individual's work is such that it makes the establishment of a "residence" in the strict sense of the word difficult, the taxpayer could not qualify for application of the earned income exclusion. The "510 day rule" facilitates application of section 911 to managers, technicians, and skilled workers who are induced to go abroad for periods of eighteen to thirty-six months to complete specific projects, but who do not establish residency. S. REP. No. 781, *supra* note 5.

23. See text accompanying notes 64, 65, 72 & 73 *infra*.

Assuming qualification under the provision, section 911(c) provided certain limitations on the amount of the exclusion.[24] This is one of the sections in the provision that bears an extreme impact on the effect of section 911 as a whole. In 1975, any taxpayer who qualified under section 911 was allowed a maximum annual exclusion of $20,000[25] if he was, in fact, a bona fide resident of a foreign country. Subsequent to an uninterrupted three year residency abroad, this exclusion would increase to $25,000.[26] Individuals who were not bona fide residents, but who met the 510 day requirement,[27] were allowed a maximum annual exclusion of $20,000 as well.[28] Section 911, read coextensively with sections 901[29] and 904,[30] also allowed a foreign tax credit[31] with respect to foreign taxes allocable to the amounts that were excluded from gross income under the earned income exclusion.[32]

In 1975, prior to TRA, section 911 had the effect of reducing a taxpayer's income at the highest marginal rates.[33] The exclusion

---

24. I.R.C. (1975), *supra* note 7, § 911(c) provided in part:

(1) LIMITATIONS ON AMOUNT OF EXCLUSION—The amount excluded from the gross income of an individual under subsection (a) for any taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of—

(A) except as provided in subparagraph (B), $20,000, in the case of an individual who qualifies under subsection (a), or

(B) $25,000 in the case of an individual who qualifies under subsection (a)(1), but only with respect to that portion of such taxable year occurring after such individual has been a bona fide resident of a foreign country or countries for an uninterrupted period of 3 consecutive years.

25. I.R.C. (1975), *supra* note 7, § 911(c)(1)(A).

26. I.R.C. (1975), *supra* note 7, § 911(c)(1)(B).

27. See note 9 *supra* and accompanying text.

28. I.R.C. (1975), *supra* note 7, § 911(c)(1)(A).

29. I.R.C. (1975), *supra* note 7, § 901.

30. I.R.C. (1975), *supra* note 7, § 904.

31. The foreign tax credit is directed at the taxation of the foreign source income of domestic taxpayers. Foreign governments are regarded as having the primary right to tax income earned within their borders. The foreign tax credit serves to eliminate double taxation of foreign source income. *See* J. CHOMMIE, FEDERAL INCOME §§ 258-262 (2d ed. 1973).

32. I.R.C. § 901(b)(1) states that taxes paid by individuals to foreign countries will be allowed as a credit against their U.S. tax liability, subject to the limitations of I.R.C. § 904. Section 904 limits the credit to the same proportion of the U.S. tax liability, which the foreign source income bears to the total U.S. and foreign source incomes combined. For example, if "T" earns $20,000, $10,000 of which is foreign source, and the U.S. tax liability on the full $20,000 is $4,000, then "T's" foreign tax credit would be limited to $2,000. Since "T's" foreign source income constitutes one-half of his total income, his foreign tax credit will be limited to one-half of his U.S. tax liability. I.R.C. (1975), *supra* note 7, § 911(a) did not specifically disallow tax credits allocable to or chargeable against amounts excluded from gross income. *But see* I.R.C. (1977), *supra* note 7, § 911(a) where tax credits specifically allocable to the amounts excluded from gross income are denied.

was taken off the top of the taxpayer's gross income in a manner similar to deductions under section 62 (*e.g.*, trade deductions, losses from sale or exchange of property or alimony).[34] This method of computation may be best illustrated with the following example:

> *Example*: John Shell is an American citizen who is married and has two children. He earns $40,000 base salary and receives an additional allowance for housing and education of $4,000. John has been overseas for just over two years in country A. He has an additional U.S. source income of $2,000. In 1975 he has no itemized deductions. The calculation of John's taxable income would be:
>
> | | |
> |---|---|
> | Salary Income | 40,000 |
> | Housing and Education Allowance | 4,000 |
> | Total Earned Income | 44,000 |
> | Less Section 911 Exclusion | (20,000) |
> | | 24,000 |
> | Add Investment Income | 2,000 |
> | Adjusted Gross Income | 26,000 |
> | Less Standard Deduction | (0)* |
> | Less Personal Exemptions | 3,000 |
> | Taxable Income | 23,000 |
>
> * In years prior to January 1, 1976, the standard deduction could not be taken if the foreign tax credit was claimed.[35]

As the example illustrates, John's gross income is immediately reduced by the $20,000 exclusionary amount. Thus, his marginal tax rate will be reduced from 48% to 32% as a result of the exclusion.[36] John's tax on taxable income before foreign tax credits would be $5,340.[37]

III. STAGE TWO: TAX REFORM ACT OF 1976

In 1975, controversy arose between the House and Senate

---

33. I.R.C. (1975), *supra* note 7, § 911(d)(1).

34. I.R.C. (1975), *supra* note 7, § 62.

35. I.R.C. (1975), *supra* note 7, § 36 (repealed 1976).

36. These marginal tax rates are based upon the income tax tables applicable to a married individual filing a joint return for the tax year 1975.

37. Tax liability is computed in accordance with I.R.C. § 1(a) (1975).

Tax on $20,000	$4,380
Tax on $3,000 (3,000 × 32%)	960
Tax liability	$5,340

over the legitimacy of section 911.[38] The House of Representatives pushed for the phasing out of the earned income exclusion.[39] It was the position of the House that U.S. expatriates were being provided with an unfair tax advantage as compared with Americans living and working at home.[40] The Senate, on the other hand, felt that the competitive position of the U.S. firms operating abroad would be imperiled if the section were removed.[41] There was an eventual compromise with a modified adoption of the Senate proposal.[42] The Tax Reform Act of 1976 was passed as a result of this compromise.

The TRA made five major changes in section 911. First, it reduced the ceiling on the exclusion for bona fide residents of foreign countries from $20,000 to $15,000.[43] It also abolished the increased exclusionary benefit of $25,000 formerly afforded to bona fide residents who had spent in excess of three years abroad.[44] Employees of charitable organizations, however, were allowed to exclude up to $20,000 per year.[45] Second, it changed the method of computing the taxpayer's tax liability.[46] Third, it disallowed the foreign tax credit[47] for foreign taxes paid on excluded income.[48] Fourth, it excepted from the exclusion provision any income received outside the country in which the services were performed.[49] Finally, it enacted an "elect out" provision to enable the expatriate, at his/her discretion, to avoid application of the section.[50] The computa-

38. *See* S. REP. NO. 938, 94th Cong., 2d Sess. 210 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3440; H.R. REP. NO. 658, 94th Cong., 2d Sess. 199 (1975), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 2897, 3093.

39. H.R. REP. NO. 658, *supra* note 38, at 200.

40. *Id.*

41. S. REP. NO. 938, *supra* note 38, at 210.

42. S. REP. NO. 938, *supra* note 38, at pt. II, 454.

43. I.R.C. (1978), *supra* note 7, § 911(c)(1); *see id.* and I.R.C. (1975) § 911(c)(1) *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(a), 90 Stat. 1520.

44. *Id.*

45. I.R.C. (1978), *supra* note 7, § 911(c)(1)(B) *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(a), 90 Stat. 1520.

46. I.R.C. (1978), *supra* note 7, § 911(d)(1) *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(b)(3), 90 Stat. 1520.

47. See note 31 *infra*.

48. I.R.C. (1978), *supra* note 7, § 911(a) *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(b)(1), 90 Stat. 1520.

49. I.R.C. (1978), *supra* note 7, § 911(c)(8) *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(b)(2), 90 Stat. 1520.

50. I.R.C. (1978), *supra* note 7, § 911(e) *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(b)(3), 90 Stat. 1520.

tional change, along with the reduction on the ceiling of the earned income exclusion, are the changes which most detrimentally affected section 911's vitality.

A. *Reduction on Ceiling of the Exclusion*

Taxpayers who meet the bona fide residents' test or qualify under the 510 day rule may only exclude up to $15,000 of foreign source income under section 911(c)(1)(A).[51] The increased exclusion for U.S. citizens residing abroad for periods in excess of three years, which was available prior to TRA, has been abolished.[52]

Employees of qualified charitable organizations, however, are entitled to an exclusion of $20,000 under section 911(c)(1)(B).[53] Section 911 requires that in order for a charitable service to be "qualified" the employer organization must be created or organized in the United States.[54] Furthermore, the charitable organization must meet the requirement of section 501(c)(3)[55] (the organization must be organized and operated exclusively for religious, charitable, scientific, educational, or other enumerated similar purposes).[56]

B. *Change in Computation of Tax Liability*

Taxpayers will no longer have the benefit of reducing their tax liability at the highest marginal rates as they could under pre-TRA section 911.[57] The newly promulgated method of tax liability computation results in higher cost to the taxpayer. Once again, an example of John Shell shall be used to illustrate this computation.

> *Example*: John Shell is an American citizen who is married and has two children. He earns $40,000 base salary and receives an additional allowance for housing and education of $4,000. John has been overseas for just over two years in country A. He has additional U.S. source income of $2,000. In 1978 he has no item-

51. I.R.C. (1978), *supra* note 7, § 911(c)(1)(A).

52. See note 43 *supra*.

53. Charitable organizations are non-profit organizations; however, like all other organizations, they must incur the expense of day to day operations. It is expected that the allowance of the $20,000 exclusion for employees of charitable organizations will lessen the expense to charities of retaining employees overseas. *See* H.R. REP. NO. 658, *supra* note 38, at 201.

54. I.R.C. (1978), *supra* note 7, § 911(c)(1)(D).

55. I.R.C. (1978), *supra* note 7, § 501(c)(3).

56. *Id.*

57. See example in text accompanying note 35 *supra*.

ized deductions. The calculation of John's taxable income would be:

Salary Income	40,000
Housing and Educational Allowance	4,000
Total Earned Income	44,000
Less Section 911 Exclusion	(15,000)
	29,000
Add Investment Income	2,000
Adjusted Gross Income	31,000
Standard Deduction	(0)**
Less Exemptions	(4,000)
Taxable Income	27,000

** It is assumed that the taxpayer claims the standard deduction. The zero figure is shown since the standard deduction now corresponds to the zero bracket amount.

For the tax years beginning in 1978 only, taxpayers may opt either to be taxed under the law as amended by the Tax Reform Act of 1976 or under the new provision of the Foreign Earned Income Act of 1978.[58] In the above example, it is assumed that the taxpayer has chosen to be taxed in accordance with TRA.

The impact of TRA comes to light in the computation of the tax on taxable income. For illustration purposes, the tax tables for the year 1978 will be used.[59] John's taxable income after exemptions and the section 911 exclusion have been subtracted is $27,000. The first step in the tax computation is to add back the $15,000 exclusion which was subtracted as per section 911. This figure is $42,000. The tax liability on $42,000 is then computed as $11,600. The next step is to compute the tax liability for the $15,000 exclusionary amount, which totals $2,216. The final step is to subtract $2,216 (tax liability on $15,000) from $11,600 (tax liability on $42,000) to arrive at $9,384, which is John Shell's tax on taxable income before foreign tax credits. Had the tax on taxable income been computed under pre-TRA section 911, the tax liability would have been $5,340.[60]

58. [1978] 65 STAND. FED. TAX REP. (CCH) ¶ 453 (Extra Edition #48).

59. I.R.C. (1978), *supra* note 7, § 1(a).

60. This difference is attributable to the reduction in the exclusionary amount from $20,000 to $15,000, coupled with the change in the method of tax liability computation. See note 37 *supra* for the pre-TRA computational method.

C. *Elect Out Provision*

In previous years, application of section 911 was not optional. That is, all taxpayers who met its basic requirements[61] were required to compute their United States tax liability according to its provisions. This is no longer so. The effect of TRA has made it likely that the application of section 911 would be disadvantageous to certain taxpayers. For example, if the foreign tax credits[62] (which would be disallowed if section 911 were applied), were far in excess of the tax saved by claiming the exclusion, the taxpayer would be best off electing-out of section 911 and realizing the benefits of his foreign tax credits. Thus, subsection 911(e) was promulgated.[63] This section allows the taxpayer, at his discretion, to avoid application of the section. Once this election is made, it will apply to all subsequent taxable years as well.[64] Revocation of the election may only be effectuated with the consent of the Secretary of the Treasury or his delegate.[65]

The TRA was introduced to increase federal tax revenues[66] and reduce the alleged preferential treatment accorded to U.S. expatriates.[67] The argument has been made that the Act went a little too far and resulted in placing most Americans abroad in a disadvantageous position.[68]

IV. STAGE THREE: FOREIGN EARNED INCOME ACT OF 1978

The FEIA had been proposed to return the American expatriate to a competitive financial position. The House Ways and Means Committee stated in its report to the Senate that:

> because of the extraordinary costs of overseas living in many situations, special consideration must be given to Americans working abroad in order to treat them equitably for tax pur-

61. See text accompanying notes 20 & 21 *supra*.

62. See note 31, *supra*.

63. I.R.C. (1978), *supra* note 7, § 911(e) *as amended by* Tax Reform Act of 1976, Pub. L. No. 94-455 § 1011(b)(3), 90 Stat. 1520.

64. I.R.C. (1978), *supra* note 7, § 911(e)(2).

65. *Id.*

66. *See* S. REP. NO. 938, *supra* note 38, at 2.

67. H.R. REP. NO. 658, *supra* note 38, at 200.

68. 26 CONG. Q. WEEKLY NO. 6, at 333 (1978). This argument was advanced by Senator Ribicoff in discussion on the Senate floor. *Id.*

poses. Moreover, the tax treatment of U.S. workers abroad should not place them at a disadvantage in relation to foreign workers with whom they compete for jobs.[69]

A. The Proposed Bill

Under the proposed bill,[70] all changes in section 911 as a result of TRA 1976 were to be repealed. The method of calculation used prior to TRA would be reinstituted and certain other modifications would also be enacted.[71]

Prior to FEIA, a U.S. citizen who was a bona fide resident of any foreign country and who met certain other requirements was permitted to take advantage of section 911.[72] Under the new section 911, as proposed, only bona fide residents of "qualified"[73] foreign countries would be eligible for the exclusion.[74]

The enumeration of "unqualified" foreign countries would have served to encourage Americans who were planning to work abroad to consider countries which were economically underdeveloped.[75] The unqualified foreign countries are, for the most part, economically strong countries in which American businesses have operated for years.

The proposed changes in section 911 also made provisions for Americans working on offshore drilling equipment. The subsection stated in pertinent part:

> Presence for any full day on equipment for exploring or exploiting natural resources from the seabed and subsoil of the submarine areas of the North Sea shall be treated as presence in a qualified foreign country (and the individual shall be treated as satisfying the requirement of subsection (a)(2) with respect to such day) if—(i) the individual's principal place of work is such equipment, and (ii) such day falls within a period for which the individual would satisfy the requirements of subsection (a)(2) if

69. H.R. REP. NO. 1463, *supra* note 2, at 7.

70. References to the "proposed bill" are to the bill as amended by the House Ways and Means Committee, and presented in H.R. REP. NO. 1463, *supra* note 2, at 7.

71. H.R. REP. NO. 1463, *supra* note 2, at 9.

72. I.R.C. (1978), *supra* note 7, § 911(a)(1).

73. Under the proposed provision, a qualified foreign country would be any foreign country other than: Andorra, Austria, Belgium, Canada, Denmark, Finland, France, Germany (Federal Republic), Greece, Iceland, Ireland, Italy, Liechtenstein, Luxembourg, Monaco, The Netherlands, Norway, Portugal, San Marino, Spain, Switzerland or The United Kingdom. H.R. REP. NO. 1463, *supra* note 2, at 9.

74. H.R. REP. NO. 1463, *supra* note 2, at 27.

75. *See id.* at 9.

presence in any foreign country constituted presence in a qualified foreign country.[76]

Any income received for work described in the above subsection would be considered income derived from work within a qualified foreign country and excludable on a pro-rata basis. Without this change, offshore drillers would not qualify under the presence requirement since offshore rigs are not within the physical boundaries of any foreign country.

Presently, section 911(c)(1) does not allow an increased exclusion to bona fide residents of foreign countries who remain abroad for periods exceeding three years as did the pre-TRA section 911(c)(1)(B). Under the proposed bill, this increase for extended residency would be reenacted to allow an individual qualifying as a bona fide resident of a qualified foreign country to take an increased exclusion of $25,000.[77]

The "elect out" provision,[78] which was adopted under TRA in 1976, would be deleted from section 911 under the proposed bill.[79] Consequently, as of the effective date of FEIA, all persons qualifying under section 911 would have to compute their tax liability in accordance with its provisions.

It appears that the bill, as proposed, makes no provisions to aid those Americans working in one of the enumerated unqualified foreign countries. (Section 911(a) would only extend the $20,000 exclusionary benefit to citizens working in qualified foreign countries). Under the FEIA bill, however, the newly promulgated section 913, "Deduction for Certain Expenses of Living Abroad," was proposed.[80] This section would apply to American citizens working in both qualified and unqualified foreign countries. The section would extend certain differential benefits to a citizen or resident of the United States whose tax home was in any foreign country.

The House Ways and Means Committee enumerated four specific cost incurrances for which the section would allow a differential deduction. They are: (1) qualified cost-of-living differential[81] (2)

76. *Id.* at 29 (proposed section 911(d)(3)).

77. *Id.* at 28 (proposed section 911(c)(1)(B)).

78. *See* notes 61-65 *supra* and accompanying text.

79. The House Ways and Means Committee Report states that "Under the bill, the changes in the earned income exclusion (sec. 911) made by the 1976 Act will be repealed." H.R. REP. NO. 1463, *supra* note 2, at 9.

80. H.R. REP. NO. 1463, *supra* note 2, at 30 (proposed I.R.C. § 913).

81. *Id.* (proposed I.R.C. § 913(a)(1)).

qualified housing expenses[82] (3) qualified schooling expenses,[83] and (4) qualified home leave travel expenses.[84] The proposed limitation on the aggregate deductions was that they could not exceed the taxpayer's net earned income from sources outside the United States.[85]

Opponents of the FEIA insisted that it would result in the dispensation of double benefits to workers in qualified foreign countries. Their argument, although unconvincing at the House Ways and Means Committee level, later gained acceptance and resulted in the codification of rules concerning the application of sections 911 and 913 to obviate the double benefit problem.

B. The Enacted Bill

The enacted form of sections 911 and 913 differ to some extent from that which was presented in the House Report.[86] Opponents of the bill[87] argued that the FEIA, in its original form, would result in a double benefit to individuals in a qualified foreign country who could qualify for the benefits of both sections 911 and 913. The opponents won a compromise in their favor.

1. SECTION 911

The exclusion under section 911, the title of which has been amended to read "Income Earned By Individuals In Certain Camps,"[88] will only be available to those expatriates residing in a camp[89] located in a hardship area.[90] Thus, the classification of coun-

82. *Id.* (proposed I.R.C. § 913(a)(2)).

83. *Id.* (proposed I.R.C. § 913(a)(3)).

84. *Id.* (proposed I.R.C. § 913(a)(4)).

85. "Net earned income," as used here, is defined as the taxpayer's earned income from sources outside the United States less the sum of any applicable section 911 exclusion, any earned income which is excluded under section 119 for meals or lodging furnished for the convenience of the employer, and any allocable deductions (e.g., dependents exemptions, etc.). I.R.C. (1978), *supra* note 7, § 913(c)(1). For the Internal Revenue Service definition of "allocable deductions," *see* I.R.C. *supra* note 7, § 913(c)(2).

86. H.R. REP. NO. 1463, *supra* note 2.

87. *See* H.R. REP. NO. 1463, *supra* note 2. Representatives Otis G. Pike, Charles Rangel, Pete Stark, Jr., Andrew Jacobs, Abner J. Mikva, Martha Keys, and William Brodhead were the authors of the dissent to the bill.

88. FEIA, *supra* note 1, § 202(f)(1).

89. According to I.R.C. § 911(c)(1)(B), *as amended by* the FEIA, *supra* note 1, § 202(b), a camp is defined as an abode of substandard lodging provided by or on behalf of the employer for the employer's convenience, where satisfactory housing is not available, and located as near as is practicable to the place where the individual renders his services and which is a place not available to the general public and generally accommodates 10 or more employees.

90. A "hardship area" is defined as

tries as qualified or unqualified[91] is now defunct. It will be left to the determination of the Secretary of State as to what areas constitute "hardship areas."[92] Assuming that an area is so classified, the requirements of bona fide residency[93] or duration of residency[94] must still be met by the taxpayer in order to receive the exclusion.

The life expectancy of section 911 is short. For the tax year 1977, the $20,000/25,000 exclusion amounts that existed prior to TRA will apply. For the tax year 1978, the exclusion will be reduced to $15,000; however, the taxpayer will be given the option to take a deduction under section 913 in lieu of the exclusion. Finally, in all tax years subsequent to 1978, section 911 will expire and section 913 will apply exclusively in the area of foreign source earned income.[95]

2. SECTION 913

Section 913, "Deductions For Certain Expenses of Living Abroad,"[96] as codified, recognizes five cost incurrances for which the taxpayer may be entitled to a deduction. These deductions apply to the cost-of-living differential,[97] housing expenses,[98] schooling expenses,[99] home-leave travel expenses,[100] and hardship area deductions.[101]

The same qualifications for the application of section 911 are

---

any foreign place designated by the Secretary of State as a hardship post where extraordinarily difficult living conditions, notably unhealthful conditions, or excessive physical hardships exist and for which a post differential of 15 percent or more—

(A) is provided under section 5925 of Title 5, United States Code, or

(B) would be so provided if officers and employees of the Government of the United States were present at that place.

I.R.C. (1978), *supra* note 7, § 913(h); *see* I.R.C. § 911(c)(1)(C) *as amended by* FEIA, *supra* note 1, § 202(b).

91. See note 47, *supra*.

92. I.R.C. (1978), *supra* note 7, § 913(h)(2).

93. I.R.C. (1978), *supra* note 7, § 911(a)(1); *described in* I.R.C. § 913(a)(1).

94. I.R.C. (1978), *supra* note 7, § 911(a)(2); *described in* I.R.C. § 913(a)(2).

95. [1978] 65 STAND. FED. TAX REP. (CCH) ¶ 451 (Extra Edition #48).

96. I.R.C. (1978), *supra* note 7, § 913.

97. I.R.C. (1978), *supra* note 7, §§ 913(b)(1), 913(d).

98. I.R.C. (1978), *supra* note 7, §§ 913(b)(2), 913(e).

99. I.R.C. (1978), *supra* note 7, §§ 913(b)(3), 913(f).

100. I.R.C. (1978), *supra* note 7, §§ 913(b)(4), 913(g).

101. I.R.C. (1978), *supra* note 7, §§ 913(b)(5), 913(h).

required for application of section 913. Specifically, the individual must be a bona fide resident of a foreign country for an uninterrupted period that includes a taxable year,[102] or he must be physically present in a foreign country for at least 510 days during a period of 18 consecutive months.[103]

a. Cost-of-Living Differential

The American expatriate shall be permitted to take a deduction equal to the amount by which his reasonable living expenses abroad exceed what they would have been had the taxpayer resided in the metropolitan area of the United States having the highest cost of living.[104] The method used to compute this differential shall be determined by the Secretary of State, subject to change annually.[105]

The differential is computed using the income level of a U.S. Government employee at step 1 of GS-14.[106] Thus, the deduction will inure more beneficially to those employees whose earnings are below the GS-14 level. An example will illustrate the determination of the cost-of-living differential.

Assume that John Shell is an American citizen working in France, who meets all the requirements of section 913(a).[107] His reasonable cost of living expenses in France are $10,000 for the taxable year. If John had lived in New York City (highest cost-of-living in the U.S.) his expenses would have been $9,000. Had he remained in his home town in Idaho, his expenses would have been merely $6,500. But John will be allowed a deduction based upon the New York-France differential. The fact that his home town expenses would have been lower is given no consideration for tax purposes. Thus, the differential deduction will be less beneficial to individuals originally from lower cost-of-living areas.

b. Qualified Housing Expenses

The qualified housing expense deduction seeks to place the

102. I.R.C. (1978), *supra* note 7, § 913(a)(1).
103. I.R.C. (1978), *supra* note 7, § 913(a)(2).
104. I.R.C. (1978), *supra* note 7, § 913(d)(1).
105. I.R.C. (1978), *supra* note 7, § 913(d)(1).
106. I.R.C. (1978), *supra* note 7, § 913(d)(2)(C)(ii).
107. I.R.C. (1978), *supra* note 7, § 913(a) establishes the "bona fide residents" test and the "presence" test or "510 day rule."

costs attributable to housing[108] on a parity level with costs incurred within the United States. The provision provides for the calculation of a base housing amount[109] which approximates a taxpayer's normal housing expense, based on his income. The taxpayer will be allowed a deduction for any excess housing expenses over the base housing amount.[110]

In certain limited situations the base housing amount will be zero.[111] This occurs if the taxpayer's tax home is in a hardship area,[112] thus necessitating a second household for his spouse and dependents. The base housing amount for the household situated in the hardship area will be zero.[113]

The caveat to application of this section occurs where the employee receives meals and lodging furnished for the convenience of the employer, such that these services are excludable under section 119.[114] In this situation, the housing expense deduction will be denied.

c. Qualified Schooling Expenses

The qualified schooling expense deduction[115] is available to the taxpayer for the reasonable costs attributable to the education

---

108. Housing expenses are defined as rent paid or incurred during the year on behalf of the individual for housing (and if they reside with him, for his spouse and other dependents) in a foreign country. Items such as utilities and insurance will be included as attributable to housing. I.R.C. (1978), *supra* note 7, § 913(e)(2)(A).

109. The "base housing amount" is defined as 20% of an amount which is computed by deducting the sum of foreign living expenses allowable under I.R.C. (1978), *supra* note 7, § 913 from an individual's earned income (as reduced by other allowable deductions from such income, other than deductions allowed under § 913). I.R.C. (1978), *supra* note 7, § 913(e)(3)(A).

110. I.R.C. (1978), *supra* note 7, § 913(e)(1).

111. I.R.C. (1978), *supra* note 7, § 913(e)(3)(B).

112. See note 62 *supra*.

113. I.R.C. (1978), *supra* note 7, § 913(e)(3)(B).

114. I.R.C. (1978), *supra* note 7, § 119 allows an exclusion from the gross income of the taxpayer for the value of meals and lodging furnished him for the convenience of his employer. The employee must be required to accept lodging from the employer, on the business premises of his employer, and as a condition of his employment to be eligible for the exclusion. For example, an individual is employed by an oil company to continuously monitor gauges at an oil pump station one hundred miles from any city. The employer supplies sleeping facilities and meals to the employee, who is required to be on 24 hour call. Here, the meals and lodging furnished the employee would qualify under section 119, resulting in their tax-free receipt. Any taxpayer qualifying under section 119 would have no excess housing cost incurrence for which remuneration in the form of a differential deduction could be allowed.

115. I.R.C. (1978), *supra* note 7, § 913(f).

of each dependent at the elementary and secondary school level. Expenses specifically included are tuition fees, books, and local transportation.[116] If the taxpayer and his family reside in an area where no adequate U.S.-type school[117] is available within a reasonable commuting distance, the statute permits the deduction of room and board of the dependent, as well as the costs of transportation of the dependent to and from school each year.[118] Where the taxpayer's tax home is within a reasonable distance of a U.S.-type school, the taxpayer will be ineligible for the extended boarding school deduction.[119] If the taxpayer in these circumstances chooses to send his dependent to a boarding school or any other educational facility, the excess educational costs[120] will not be deductible.

Where the taxpayer resides in a hardship area under adverse living conditions,[121] thereby necessitating a second household for his spouse and dependents, the requirements of section 913(j)(3)—that the dependent reside with the taxpayer at his tax home[122]—will be treated as met if the dependent is residing at the qualified second household.

d. Home Leave Transportation Deduction

The travel expense deduction[123] will be afforded to the taxpayer, his spouse, and all his dependents, for the reasonable cost of transportation from the foreign country which is the tax home of the taxpayer to the individual's principal residence within the United States.[124] If the individual does not have a principal resi-

116. I.R.C. (1978), *supra* note 7, § 913(f)(2).

117. Although no definition of the term "U.S.-type school" is given, it would be a fair assumption that the school would have to conform to the same or similar standards applied to schools within the United States in order to qualify.

118. I.R.C. (1978), *supra* note 7, § 913(f)(3).

119. *Id.*

120. The excess educational costs would be the difference between the boarding school charges and the amount that would be charged by the U.S.-type school for the same period. I.R.C. (1978), *supra* note 7, § 913(f)(4).

121. "The term 'adverse living conditions' means living conditions which are dangerous, unhealthful, or otherwise adverse." I.R.C. (1978), *supra* note 7, § 913(j)(1)(D).

122. "The term 'tax home' means, with respect to any individual, such individual's home for purposes of section 162(a)(2) (relating to traveling expenses while away from home). An individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the United States." I.R.C. (1978), *supra* note 7, § 913(j)(1)(B).

123. I.R.C. (1978), *supra* note 7, § 913(g).

124. I.R.C. (1978), *supra* note 7, § 913(g)(1).

dence in the United States, then he may deduct the transportation cost to the nearest port of entry in the continental United States.[125]

The taxpayer may deduct the cost of one round trip for each individual, within each continuous period of twelve consecutive months.[126] The statute does not require that a person be away from the United States for twelve months before he can take his first deductible trip, however, he will only be allowed a deduction for one trip during each twelve month period.

To avoid extravagant travel expense deductions, the statute provides that where the mode of transportation is air, the rate upon which the deduction must be based shall not exceed the lowest coach or economy fare available during the month in which the transportation is furnished.[127] The statute further states that where a physical handicap or other reason requires the use of first class, the lowest rate available in first class shall be the amount used.[128]

The statute does not clearly articulate how it would treat a situation where the principal residence of the taxpayer and his dependents are in different places. The statute uses the word "individual" in its discussion of the principal residence,[129] yet it extends elligibility to the individual as well as his spouse and dependents.[130] This seems to infer that in such a situation the taxpayer's residence will be determinative.

e. Qualified Hardship Area Deduction

The hardship area deduction[131] will be granted to any taxpayer who lives in a designated hardship area. This designation is assigned by the Secretary of State to areas where extraordinarily difficult living conditions, notably unhealthful conditions or excessive physical hardships exist.[132]

The taxpayer will be allowed a deduction based on $5,000 an-

125. I.R.C. (1978), *supra* note 7, § 913(g)(1)(B).
126. I.R.C. (1978), *supra* note 7, § 913(g)(2).
127. I.R.C. (1978), *supra* note 7, § 913(j)(2).
128. *Id.*
129. I.R.C. (1978), *supra* note 7, § 913(g)(1)(A).
130. I.R.C. (1978), *supra* note 7, § 913(g)(1).
131. I.R.C. (1978), *supra* note 7, § 913(h)(2).
132. In addition there must be a post differential of 15 percent or more as provided under section 5925 of Title 5, United States Code, or would be so provided if officers and employees of the Government of the United States were present at the place. I.R.C. (1978), *supra* note 7, § 913(h)(2).

nually, computed on a daily basis for each day he is actually present in a hardship area.[133] The taxpayer must meet the bona fide residence test[134] or physical presence test[135] in order to qualify for this deduction.

V. CONCLUSION

The new tax treatment for foreign source income of U.S. expatriates has the potential to effectively deal with the multifarious financial situations of foreign-based taxpayers. Instead of allocating a set dollar amount to taxpayers on a per diem basis, the new law allocates deductions among five cost incurrences, the primary areas of expense in which the taxpayer residing abroad needs assistance.[136]

Unfortunately, in its present form, section 913 will have some difficulty displaying this potential flexibility. Portions of the section are hamstrung by certain qualifications and requirements. The increased cost-of-living differential is computed in a manner which reflects the income of a family whose income is equal to that of a government employee at the GS-14 salary level. This rule provides added benefits to taxpayers earning less than GS-14; however, it also serves to limit the benefit for those taxpayers earning in excess of GS-14.

The application of a sliding scale or continuum of income levels, as opposed to the single GS-14 level, might precipitate the application of this cost incurrence deduction on a more flexible and equitable basis. This approach is similar to the position taken by the House bill which provided:

> that this element of the deduction consists of an amount determined under IRS tables showing the excess cost of living in various foreign places for families of various sizes. It is based on the excess of costs in the foreign place over costs in the highest cost metropolitan area in the continental United States (excluding

133. I.R.C. (1978), *supra* note 7, § 913(h)(1).

134. I.R.C. (1978), *supra* note 7, § 913(a)(1).

135. I.R.C. (1978), *supra* note 7, § 913(a)(2).

136. The Senate Finance Committee stated that the provisions of section 911, which both before and after the passage of TRA 1976, provided relief based on a flat annual exclusion, were "arbitrary and unfair." The committee recognized the need for tax treatment which was more closely related to the actual increased expenses incurred while working abroad. S. REP. No. 746, 95th Cong., 2d Sess. 7 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 7612, 7618.

Alaska). The deduction would be proportional to the spendable income of the taxpayer (that is, larger for high-income taxpayers than for low-income taxpayers).[137]

If the regulations not yet promulgated for section 913 can clarify the section's ambiguities, as well as expand the sections flexibility, then our treatment of foreign source income will have progressed to a superior position. The international ramifications of this new tax law are that once again Americans may be restored to a competitive financial position with respect to other foreigners. Further, the cost of American products may also be kept down, resulting in increased exports of U.S. goods and technology to countries around the world.[138]

Gary P. Scharmett

137. H.R. REP. NO. 1798, 95th Cong., 2d Sess. 14 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 7632, 7634.

138. A more effective foreign source income exclusion permits an employer to pay lower salaries to employees, thus reducing the labor costs incurred, which are generally reflected in the cost of goods sold. In the long run, if costs are reduced, retail prices will be lower (assuming that the reduction in costs is not absorbed in increased profits). In accordance with the law of supply and demand, a reduction in retail prices would result in increased sales. *See* P. SAMUELSON, ECONOMICS 61 (9th ed. 1973).