Section 911 Tax Reform

Minn. L. Rev. Editorial Board

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Section 911 Tax Reform

I. INTRODUCTION

Since the growth of foreign trade is vital to the political interests of the United States, United States Government policy should be designed to implement and encourage expansion of international trade insofar as it is realistically possible considering the short term restrictive measures necessary to alleviate balance of payment problems. An increase in foreign trade will not only generate domestic growth but will serve United States foreign policy by increasing the economic strength of those countries which can assist the United States in preserving world peace. In addition, continuing problems with our balance of payments indicate that the prosperity of the United States is, to a large extent, dependent upon our ability to offset imports and other expenditures abroad with an equal or greater expansion of exports.

In the past, a number of programs have utilized tax incentives to induce desired behavior from individuals and corporations in order to encourage foreign trade. Section 911 of the Internal Revenue Code, exempting certain foreign income from federal income taxes, is one of the measures adopted to increase foreign trade. The section operates as an incentive for Americans to work in countries with a lower tax rate and as a mechanism to achieve tax equality with nonresident citizens of countries who tax only on the basis of residence.

The exemption offered by section 911 grants, in theory at least, tax benefits that will raise after-tax income to cover increased living expenses and also yield an additional amount which will constitute a bonus to work abroad. These benefits will indirectly accrue to United States corporations since the necessity of increasing salaries for foreign employees is at least partially alleviated.

Theoretically, the section 911 exemption serves as an incentive because unlike the tax credit which merely prevents double taxation, the exemption directly increases after-tax income.
taxation, the exemption allows Americans to benefit from reduced foreign taxes and to avoid the danger of double taxation when foreign nations rely on taxes different from our income tax.

The purpose of this Note is to examine the operation of section 911 and to determine its effectiveness in accomplishing these objectives. It will be urged that the section be altered and incorporated into a comprehensive tax incentive and aid program which would operate with substantially greater effectiveness in inducing the desired economic behavior. In addition, it will be suggested that section 911 would be more effective if its benefits were available primarily to underdeveloped countries.

II. THE BENEFITS OF INTERNATIONAL TRADE

Trade, according to the classical theories of comparative advantage, results in a "general increase of the productive powers of the world." It is, therefore, in the best interests of all countries to foster the growth of international trade. In an expanding world market, demand for goods increases, resulting in greater production and economic growth in the international economy. The United States has, in the past, recognized that its future

6. Comparative advantage can be defined in terms of comparative cheapness. A country will produce and export those goods which are cheapest to produce in terms of the physical resources required. If a country has absolute advantage in the production of all goods, its total well-being is still increased by producing those goods in which it has comparative advantage. World resources are used most efficiently if all countries produce those goods for which their resources are best adapted, and this results in an increase in total production and income. L. Reynolds, Economics 371-73 (1963).

7. 2 J. Mill, Principles of Political Economy ch. XVII, § 5 (1848). This approach to trade basically recognizes the advantages accruing to each country and the international economy in general when international specialization occurs, with each country producing those goods for which its comparative advantage is greatest. However, there are other growth transmitting aspects of international trade. By widening markets, sources of supply and the scope of the division of labor, trade becomes a dynamic force, permitting greater use of machinery, stimulating innovation, overcoming technical divisibilities, raising the productivity of labor and enabling the trading country to enjoy increased returns and development. See also Myint, The "Classical Theory" of International Trade and the Underdeveloped Countries, 68 Econ. J. 318-19 (June 1958).

8. In addition to economic benefits, a growing and vigorous trade among nations will enhance political understanding and cooperation. A. Cairncross, supra note 2, at 203. But see C. Kindleberger, Foreign Trade and the National Economy 209 (1962).
security and ultimate economic benefit are dependent upon the welfare of other amicable or neutral nations. Both foreign aid programs and sporadic attempts to create freer international trade have reflected this policy.\(^9\) However, the protectionist policies of most countries, including the United States, have resulted in the erection of a number of barriers, including tariffs, double taxation and quotas, which restrict the free movement of international trade.\(^{10}\) If these protectionist policies were discarded, the resulting increased trade and accompanying economic yield would increase international efficiency and redistribution of wealth.\(^11\)

Of more immediate interest to the United States, however, is the balance of payments deficit that currently endangers the value of the dollar. The limitations on private foreign investment abroad,\(^{12}\) the reduction of government expenditures abroad\(^{13}\) and greater restrictions on the flow of loans abroad\(^{14}\) are designed to support our current balance of payments position. Since financial transfers of dollars abroad have exceeded real transfers of goods by substantial margins in recent years,

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10. H. Newcomer, International Aids to Overseas Investment and Trade 45-50 (1964) [hereinafter cited as International Aids]. Given the assumption of free trade, countries will tend to specialize increasingly in the particular categories and subclassifications of manufacturing in which they enjoy a comparative advantage. Overall standards of living increase because consumers can obtain lower prices. Some industries in the United States which may be at a comparative disadvantage will be pressured by increased growth and industrialization abroad; the patterns of trade will change. Generally, however, there will be growth in the trade of manufactured goods in the international economy, causing economic growth in the United States. Id. at 5-6, 19-20. See also Int'l Chamber of Commerce, Avoidance of Double Taxation 15 (1955).


12. In order to reduce balance of payments deficits, the Voluntary Cooperation Program for Business, was initiated in 1965 and made mandatory as of January 1, 1968, under the control of the Commerce Department. This program was designated to restrict new capital commitments abroad by United States investors. See CCH 1969 Balance of Payments Reporter ¶ 173, at 135.

13. The Government is attempting to reduce spending abroad by government personnel and the military. See id. ¶¶ 4605-31, at 4601-4701.

14. An effort is also being made to restrict the outflow of foreign loans under the Voluntary Foreign Credit Restraint Program, administered by the Federal Reserve, which has proven effective in limiting foreign loans and investments by banks. See id. ¶ 151, at 133.
the Government is trying to limit both public and private foreign expenditures that have an unfavorable balance of payments effect. Within these restrictive guidelines, however, continuing efforts are being made to encourage exports of goods—real transfers—which will help restore a favorable balance of payments. In this sense, the encouragement of foreign trade remains an element of our foreign policy.

III. OPERATION AND PURPOSE OF SECTION 911

A. HISTORY OF SECTION 911

The Government has a number of methods available to encourage investment activity abroad by inducing desired investment behavior. These methods include tax exemptions, reduced tax rates by grant and tax deferral, all of which may increase after-tax dollars if taxes at the source of income are lower.

Since the sixteenth amendment has always been read to allow the United States to tax its citizens regardless of their residence, Congress in 1926 enacted section 116(a) of the Internal Revenue Code “to help our foreign trade and to put all Americans who are working abroad in a position of equality with their competitors . . . .” All income earned abroad was exempt if a

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15. The ideal investment for balance of payments purposes produces corresponding real and financial transfers within a reasonably short time.

16. The Government is encouraging increased efforts to expand exports, and is endeavoring to reduce import barriers abroad which restrict export growth. See Balance of Payments Reporter, supra note 12, ¶¶ 171-185, at 134-38.

17. There have been few efforts to grant tax exemptions, reduced taxation or favorable deductions to encourage investment abroad. L. Krause & K. Dam, Federal Tax Treatment of Foreign Income 27-29 (1964) [hereinafter cited as Krause & Dam]. One of these is section 911 and another is the favorable treatment granted Western Hemisphere Trade Corporations under sections 921 and 922 of the Code. Examples of this type of incentive used domestically are more prevalent. The favorable depletion allowance granted to the extraction industries, sections 611-13, and the investment credit, sections 38 and 46-48, are examples.


The predecessor of section 911 was designed to equate the tax burden on Americans with that placed on foreigners whose country of citizenship taxed on the basis of residence. In addition, a tax incentive was thought necessary to encourage Americans to participate in foreign trade in view of the hardships encountered when living and working abroad.

Congress has amended section 911 on several occasions since 1926. Initially, six months' nonresidence was sufficient to qualify for the exemption but abuses by those who stayed abroad for short periods solely to use the tax benefit led to a requirement of bona fide foreign residency. The "physical presence" exemption was introduced in 1951 to allow an exemption for all compensation earned abroad if the taxpayer could show that he was present in a foreign country or countries for 180 days (6 months) of an 18-month period. To qualify for preferential treatment as a foreign resident, a citizen had to be a bona fide

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7 (1926); see Tax Institute, Taxation and Operations Abroad 245 (1960); 75 Cong. Rec. 10410–11 (1932) (remarks of Senator Reed).
22. See 67 Cong. Rec. 3781 (1926) (remarks by Senator Smoot). Portugal, Italy and Ireland are examples of countries which do not tax citizens abroad. After limited periods of up to four years of foreign residency, nearly all European countries do not tax foreign income. Organization for Economic Cooperation and Development, Fiscal Incentives for Private Investment in Developing Countries 98 (1965) [hereinafter cited as Fiscal Incentives].
23. The absence of the many comforts of life, the lack of sanitation in certain communities and other unhealthy conditions, the inadequacy of educational facilities in others, the difficulty of mastering foreign languages, the impossibility of harmonizing with the customs of foreign peoples, the disappointments in business ventures—these are but a few of the many motives which contribute to the early return of so many Americans to this country after a comparatively brief foreign residence.
67 Cong. Rec. 3783 (1926) (article by Richard P. Momsen). It is not cheaper to live abroad if one desires to maintain the same standard of living. See Note, Section 911 of the Internal Revenue Code and the Foreign-Based Partner, 74 Yale L.J. 956, 957 (1965).
resident for an uninterrupted period of three years. To prevent abuse of the "physical presence" provision as a tax avoidance device, primarily by wealthy entertainers, Congress in 1951 imposed a ceiling of $20,000 per year on the amount of income eligible for exemption. The section also limited tax exempt income of citizens who were bona fide foreign residents to $35,000 (and, in 1964, $25,000) to prevent excessive tax-free compensation from escaping United States taxing authority. The history of these amendments indicates that the major thrust of section 911 is to encourage managers, technicians and skilled workmen to go overseas to complete specific projects in furtherance of national political and economic objectives.

B. ADDITIONAL COMPENSATION FOR FOREIGN EMPLOYMENT

When large amounts of capital are invested in projects requiring sophisticated technology and difficult marketing and distribution plans, an investor wants management to be entrusted to individuals with the necessary skills and experience. Thus, while the enterprise will probably recruit nationals for staff positions, it will import expatriates for the managerial and technical positions. In order to attract qualified men to work abroad, the generally adopted procedure is to compensate for the cost of maintaining a standard of living equivalent or superior to that enjoyed in the United States.

28. Id.
29. Id. The House recommended repeal because although the measure was designed to induce those with technical skill to go abroad, it was being abused by nontechnical people for tax avoidance schemes. However, the Senate thought it particularly desirable to encourage men with technical skills to go abroad, and a limit on the amount exemptable was thought sufficient to curb abuses. S. REP. No. 685, 83d Cong., 1st Sess. 5 (1953).
32. INT'L CHAMBER OF COMMERCE, TAXATION POLICIES IN RELATION TO INTERNATIONAL INVESTMENT 24 (1961).
33. BUSINESS INT'L CORP., WORLDWIDE EXECUTIVE COMPENSATION 7 (1967). Roughly 73 percent of United States firms with employees abroad pay a premium as an inducement to work abroad. Id. at 30.
34. A substantial number of additional costs are involved. Because of the temporary nature of residency abroad, men often must maintain financial contacts, sometimes even a residence, in the United States, which double costs. Education and general maintenance costs are
C. The Function of Skilled Personnel Abroad

If it is assumed that section 911 is a factor in inducing skilled personnel to go abroad, it must still be determined whether United States technicians and managers contribute to the growth of American investment activity. Several factors may be considered. First, in industrialized and developing nations, American personnel can at least use their marketing abilities to increase the distribution of American manufactured goods. Second, in underdeveloped nations, a deficiency of knowledge itself is often the greatest handicap to economic growth; contact with more advanced economies provides an expeditious way of overcoming this deficiency. One of the principal merits of private as opposed to public investment is that it carries with it an "integral ingredient of technical assistance—the managerial and technical knowledge which are usually in even shorter supply than capital." The low level of education makes the importation of technical knowledge and skills an indispensable prerequisite to technological progress. It seems probable, then, that the diffusion of United States technical and managerial assistance can supply a factor needed for international economic growth.

higher, and state insurance, pension schemes and social security (all of which give no benefit to the short-term resident) must be paid to the foreign country. Id. at 24.

35. A. Cairncross, supra note 2, at 179-180. See also International Economics, supra note 11, at 220.

36. International Economics, supra note 11, at 135, 141.

37. Fatouros, Government Guarantees to Foreign Investors 6 (1962) [hereinafter cited as Government Guarantees]. This shortage of trained persons often inhibits growth in a developing economy. Trained management is scarce even when capacity is not fully used, since managerial talents are not closely related to output levels. This bottleneck can be overcome by relative changes in factor rewards, but the process will be slow if it must be overcome by internal resources alone because it rests mainly on the educational system. Krause & Dam, supra note 17, at 61.

38. British Institute of International and Comparative Law, The Encouragement and Protection of Investment in Developing Countries 1 (1962) [hereinafter cited as Encouragement and Protection].

Even though only a small amount of private capital, relative to government loans and grants, has gone to poor countries, the belief persists that capital from official sources is only a transitional arrangement, and that foreign economic aid should be gradually replaced by a flow of private financial resources. To this end, considerable interest is being shown in measures that might promote foreign investment and allow it to contribute more effectively to the development of the recipient countries. International Economics, supra note 11, at 133. Practically speaking,
IV. LIMITATIONS AND EFFECTIVENESS OF SECTION 911

A. EXEMPTIONS AS INCENTIVES TO ASSIST FOREIGN TRADE AND EFFECTIVENESS OF SECTION 911

A personal incentive such as section 911 will not entice people to work abroad unless they or the corporation for whom they work are able to predict a profit. In making a decision on the profit making potential of a projected enterprise, taxes are only one factor to be considered in the total investment climate, and incentives are only one element of the tax structure. Thus, the link between the section 911 exemption and actual investment or employment abroad is tenuous because of the complexity of considerations concerning the general investment climate.

Perhaps the only time the investment decision would be affected by the exemption is where the projected profit would be too low to encourage investment without the exemption.

The investment decision is particularly complex in those underdeveloped countries where the political, economic, social and cultural background presents additional problems. A tax incentive cannot be a significant inducement to investment of labor or capital until at least a minimal infrastructure of social overhead capital has been constructed. A lack of basic utilities, skilled labor and sufficient market demand will make modern industrial or commercial enterprises most unprofitable.

private investment is much easier for the people of an underdeveloped area to accept than United States foreign aid, and it is not as open to public censure. H. Johnson, Economic Policies Toward Less Developed Countries 126 (1957).

39. There is evidence that factors indicating generally favorable and fair tax treatment in a foreign country are considered to have greater attraction than the existence of tax incentives. Encouragement and Protection, supra note 38, at 3.

40. The tax incentive approach alters net yields from work and therefore has some value in terms of the economic man who judges his output on the basis of his net return and thus goes where he receives the best net return for his work. See Fiscal Incentives, supra note 22, at 25.

41. Factors other than taxes such as political and monetary stability, present and potential markets, adequacy of credit, and the availability of social overhead capital like raw materials, labor, power, transportation and technicians and managerial personnel in the area, are significant in investment decisions. J. Heller & K. Kauffman, Tax Incentives for Industry in Less Developed Countries 5 (1963). [hereinafter cited as Tax Incentives].

42. B. Bittker & L. Ebb, United States Taxation of Foreign Income and Foreign Persons 20-26 (2d ed. 1968) [hereinafter cited as Bittker & Ebb].
Certainly, as an infrastructure develops and opportunities for commercial and industrial enterprises emerge, tax incentives to encourage these activities will also become more effective. Consequently, tax incentives for investment in any country, particularly developing countries, cannot by themselves suffice to convert the flow of capital from a trickle to a stream. Unless the developing countries have an atmosphere which is receptive to foreign investment and technology, incentives adopted by capital exporting countries will not be effective.

There is, however, reasonable justification for believing that fiscal incentives may have some effect in inducing desired behavior. In countries such as the United States where both tax morality and rates are high, a possibility of substantial tax savings is a strong inducement for taxpayers to engage in the desired activity. Even in instances where tax considerations are unimportant to a business decision, a tax incentive may publicize and enhance the country's favorable attitude towards investment. Also, even an ineffective tax incentive has one advantage over direct foreign aid since the tax is generally not subject to annual review by Congress.

In order to maximize the effectiveness of any tax incentive, one author asserts that the incentive requires: (1) sufficient size to attract attention and provoke new consideration of developing

43. Tax Incentives, supra note 41, at 10. An industrialist trying to establish himself in an underdeveloped country may find his market too limited, the variety of his output too wide to allow him to use the most advanced techniques, and the investment necessary to train labor and provide ancillary services too large to make it possible to raise capital on reasonable terms. These factors apply with less force after the initial stages of industrialization. A. Cairncross, supra note 2, at 206.

44. Some sources would disagree. One study using interviews with businessmen failed to disclose any instance in which federal tax policy prevented a particular investment from being undertaken or in which a rejected investment could have been induced by exemption from United States taxes. E. Barlow & I. Wender, Foreign Investment and Taxation 170 (1954). Another study also indicates that tax incentives are not credited with substantial increases in investment. "The almost unanimous opinion of tax officials from numerous countries... has been that the incentives in their countries have been ineffectual, administratively cumbersome, and costly in revenues and fairness." Tax Incentives, supra note 41, at 223. See also Tax Institute, supra note 20, at 227.

45. The investment credit, the depletion allowance and special tax treatment for small business companies are examples of preferential tax treatment in the Code. There are the same possibilities for application of effective incentives for investment in developing areas. See Fiscal Incentives, supra note 22, at 25.
countries (an attempt to economize will waste potential benefits); (2) a rational design in which the incentive goes directly to the desired activity; (3) coordination with our economic aid program and tailoring in accord with economic aid principles; (4) high selectivity to reduce windfalls which may waste tax revenue and cause tax inequity, and to limit investments to those giving the most significant contribution to growth, and (5) initial research to examine the effects of the incentive to ensure its proper performance. If an exemption meets the above requirements, it is probable that the exemption does influence economic activity, although to what exact degree remains uncertain.

B. THE BENEFIT OF THE SECTION 911 EXEMPTION

The effectiveness of section 911 in inducing skilled men to go abroad depends primarily on the tax structure of the individual foreign country. Section 911 becomes less effective as tax rates are increased and is of no value when foreign taxes are equal to or greater than United States taxes.

In nearly all instances, the exemption offered in section 911

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47. It is possible to know approximately how much is lost by creating an exemption, but we can only guess how much investment and trade is generated to benefit an economy. The effect of section 911 is particularly difficult to measure in terms of corporate personnel abroad, for this type of tax incentive would be a very minor consideration in corporate plans. The basic problem is that little study has been done and our knowledge of the effects of taxation and foreign investment on employment decisions is inadequate. Blough, General Analyses of Issues Facing Management, in Tax Institute, supra note 20, at 74-75 (1960). See Hellawell, supra note 46, at 1412. It may be that until an extensive study is conducted on the effects of incentives on investment, only logic is available to assess one form of tax incentive against another. See Hellawell, supra note 46, at 1413. See also BITTKER & EBB, supra note 42, at 41.


49. Taxation of Incomes in Selected Countries—expressed as dollars and in percent of Total Income paid in tax. (1967 income taxes computed with standard deductions and exemptions using exchange rates of December, 1968.). For explanation of "(A)," see note 50 infra.

<table>
<thead>
<tr>
<th></th>
<th>$10,000</th>
<th>$15,000</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tax in $</td>
<td>% of Inc.</td>
<td>Tax in $</td>
</tr>
<tr>
<td>(A) Great Britain</td>
<td>2535.7</td>
<td>25.4</td>
<td>4587.2</td>
</tr>
<tr>
<td>(A) Germany</td>
<td>1962.5</td>
<td>19.8</td>
<td>3830.5</td>
</tr>
<tr>
<td>Turkey</td>
<td>3545.4</td>
<td>38.5</td>
<td>6587.6</td>
</tr>
<tr>
<td>Argentina</td>
<td>2475.20</td>
<td>24.8</td>
<td>4739.2</td>
</tr>
<tr>
<td>(A) Canada</td>
<td>1567.0</td>
<td>15.7</td>
<td>3292.2</td>
</tr>
<tr>
<td>Columbia</td>
<td>2531.2</td>
<td>25.3</td>
<td>4469.0</td>
</tr>
</tbody>
</table>
would appear to be no inducement whatever because income
taxes imposed abroad are equal or higher than those imposed
in the United States. The disparity between the United States
and a foreign country's income tax normally widens as income
reaches the upper brackets, particularly in developing coun-
tries.\textsuperscript{50}

\begin{tabular}{ |c|c|c|c|c|c| } 
\hline
Country & Income & Tax & Income & Tax & Income & Tax \\
\hline
Greece & 2051.1 & 20.5 & 4714.3 & 31.4 & 7846.1 & 39.2 \\
Mexico & 1154.0 & 11.5 & 2192.0 & 14.6 & 3499.0 & 17.5 \\
Ceylon & 4733.4 & 47.5 & 8732.0 & 58.3 & 12753.0 & 63.8 \\
Pakistan & 2337.3 & 23.6 & 5302.3 & 34.7 & 8464.5 & 42.3 \\
India & 4391.2 & 43.9 & 8225.5 & 54.9 & 11982.0 & 59.9 \\
Ghana & 3377.2 & 33.8 & 6653.5 & 44.4 & 10153.1 & 50.3 \\
\textbf{(A) New Zealand} & 3003.6 & 30.0 & 6125.0 & 40.8 & 9500.4 & 47.5 \\
Philippines & 1980.0 & 19.0 & 3940.0 & 29.4 & 6130.0 & 33.2 \\
Venezuela & 671.5 & 6.7 & 1210.9 & 8.1 & 1802.6 & 9.0 \\
Uruguay & 3040.8 & 30.4 & 5515.8 & 36.8 & 7980.8 & 40.0 \\
\textbf{(A) Japan} & 3003.6 & 30.0 & 5865.7 & 39.1 & 8931.5 & 44.7 \\
United States & 1556.0 & 15.6 & 2993.2 & 20.0 & 4422.3 & 22.1 \\
\hline
\end{tabular}

The tax computations used in this study were from the most recent
available data, and although some figures may not represent taxes abroad
exactly as they would be today, the general picture at least is a true one.
Tax comparisons are always dangerous because of differing structures
of local and national taxes, differing types of taxes imposed, and differ-
ning levels of tax morality. The objective here was not a precise statisti-
cal study, but rather an effort to point out alternative possible improve-
ments in section 911 based on observation of facts available. Given
the state of knowledge concerning the effects of tax incentives, exemp-
tions like section 911 are a speculation, and whether a country opts for
them may simply depend on the relative positions in the scale of values
of conserving public revenue as opposed to the development of the less
developed world. Further detailed study is obviously necessary to
determine the effects of tax incentives on foreign investments so that a
more cohesive total approach to foreign aid, making maximum use of
tax incentives, can be designed. See Hellawell, \textit{supra} note 46, at 1413;
Kurtz, \textit{Tax Incentives: Their Use and Misuse}, in \textit{S. CAL. TWENTIETH
TAX INSTITUTE, MAJOR TAX PLANNING FOR 1968} 4.

50. \textbf{The Ratio of Tax to Total Income at Varying Income Levels}

<table>
<thead>
<tr>
<th>Income Level</th>
<th>Developed Countries*</th>
<th>Undeveloped Countries*</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>25.9</td>
<td>29.3</td>
</tr>
<tr>
<td>$15,000</td>
<td>32.8</td>
<td>32.3</td>
</tr>
<tr>
<td>$20,000</td>
<td>33.8</td>
<td>43.0</td>
</tr>
</tbody>
</table>

*excludes United States but includes Countries above marked "(A)"

*excludes Venezuela but includes the remainder not marked "(A)"

In other countries, tax tables are computed on the basis of standards
of living and average incomes found in that country. Therefore, a rea-
sonable salary for a technician or a manager in the United States may be
in the highest, most heavily taxed bracket abroad because the standards
of living are lower there, and the technician's income reflects the high
standard of living here. If income taxes abroad are higher than those
in this country, no revenue is lost by section 911 because sections 901 to
904 of the Code—the tax credit for taxes paid to foreign countries—
would credit the foreign income taxes paid against the United States in-
come tax. The tax credit provided by these sections gives credit for
foreign income and profits taxes paid against United States taxes that
These statistics may be deceptive, however, because in many instances, section 911 does offer a tax benefit to a United States citizen. First of all, a few countries recognize that employment of expatriates, especially those with technical skills, is an aid to their economy. Consequently, by statute or custom, they may afford special tax relief to such individuals for the first few years of employment. Though in general, expatriates are given the same tax treatment as nationals, the section 911 exemption at least allows other countries to use this type of tax relief to attract skilled people. Second, the informal tax administration of many foreign countries leads to disparity between published tax rates and taxes actually paid. Third, the exemption eliminates the possibility of double taxation for those citizens who meet its standards. Citizens who are abroad for less than 18 months, however, will pay the high indirect taxes of foreign countries in addition to United States income taxes because the foreign tax credit, (sections 901 to 904), does not recognize these indirect taxes. The tax credit also nullifies the benefits of inducement exemptions granted by developing countries because United States citizens abroad who do not qualify

are to be paid. If foreign income and profits taxes are in excess of United States taxes due, no United States tax need be paid.

51. At least one writer is in direct disagreement with these tax figures: stating that many developing countries do have lower taxes or the fiscal incentive would make no sense. To the extent that rates in a developing country are lower than in an industrialized country using the exemption approach, its investors enjoy a tax advantage by investing in developing countries. Fiscal Incentives, supra note 22, at 18.

52. India, Pakistan and Ceylon are examples of this type of tax relief. Indonesia normally grants tax relief by custom rather than by statutory authority. This tax incentive is somewhat of a dilemma for a developing country which must decide whether to tax income now or anticipate that a tax incentive may induce future economic growth. Government Guarantees, supra note 37, at 57.


55. The foreign tax credit granted United States citizens applies only to foreign income and excess profits taxes paid. To the extent that other nations may rely on higher sales, wealth, excise, property or other indirect taxes for revenue, rather than the income tax, and also to the extent other nations have a different basis for their income tax and differing concepts of subordinate taxing authority, a United States citizen is subject to double taxation. See 67 Cong. Rec. 3781 (1926). In many countries, because of low income tax morality, other taxes are relied upon for government revenue which are easier to collect, for example, sales, property, use, wealth, or excise taxes. Fiscal Incentives, supra note 22, at 16.

56. See text accompanying note 81 infra.
for section 911 benefits will still pay full United States taxes.\footnote{57} A fourth factor, which mitigates the effect of high foreign taxes imposed on citizens employed by United States corporations, is the practice of paying part of an employee's salary to a depositary in the United States.\footnote{58} The expatriate pays taxes only on that portion of income received in the foreign country from services rendered in that country.\footnote{59}

If tax rates are oppressive, the employee will report as income only that minimal amount which is reasonable to tax authorities of the foreign country.\footnote{60} A foreign taxing authority has only one way to find out whether a taxpayer has omitted part of his income. If his country has a tax treaty with the United States, he can ask his United States counterpart for information on an individual's total income. It is not clear, however, to what extent this provision of the tax treaties has been used.\footnote{61} Companies also favor stock plans, pension benefits, life insurance and unlimited expense accounts to avoid oppressive

\footnote{57} The tax credit was probably not intended to reduce the tax burden on United States taxpayers to the level chosen by any foreign country. It was adopted to prevent a lack of uniformity because of high foreign tax rates. Surrey, \textit{Current Issues in Taxation of Corporate Foreign Investment}, 56 COlum. L. Rsv. 815, 824 (1956). The very premise of taxation on the basis of citizenship seems subject to attack, however. See text accompanying note 79 \textit{infra}. The credit in the instance of developing countries is also in conflict with our political and economic objective. See text accompanying notes 82-86 \textit{infra}. These overriding political and economic considerations indicate that United States citizens working in developing areas should be compensated through the tax system to assist in offsetting hardships and providing an incentive.

\footnote{58} Ninety percent of the companies who have men abroad use splitting, but it is done for other reasons in addition to tax saving:

(1) The need for dollars in the United States to pay obligations here.

(2) Inflation, foreign exchange controls, and currency depreciation make it desirable to protect money in United States banks with foreign branches.

(3) The need to equalize payment in the foreign country with that received by the foreign nationals.

\textit{Business International Corp., Worldwide Executive Compensation} 26 (1967). The result is that part of the employee's income is taxed at the high rates abroad, and the remainder under $20,000 or $25,000 is not taxed.

\footnote{59} The section 911 exemption coupled with the potential tax savings of splitting income allows corporate employees increased after-tax compensation. The corporation, therefore, can deduct tax savings to the employee from the premium it would normally have to pay foreign employees.

\footnote{60} \textit{Worldwide Executive Compensation}, supra note 58, at 26.

\footnote{61} Id. at 24.
overseas tax rates. The employee might include in the latter all of his living expenses, including residence and transportation. Most nations demand that this type of reimbursed expense be included in income, but detection of this type of tax avoidance without access to the corporation’s accounts is almost impossible.

Section 911 may be of more benefit to partnerships or sole proprietors, particularly “if the business consists of the performance of personal services, and capital is not a material income-producing factor . . .”62 If capital is a material income producing factor, only a certain amount, in no case exceeding 30 percent of an individual’s share of the net profits of the business, may be treated as compensation for services rendered by him.63 In the case of a sole proprietor or a partnership earning income solely through personal services, all profits qualify as compensation under section 911 and receive the full benefit of the exemption. Since the tax rates are frequently higher abroad, however, it may be that the section has diminished influence on all smaller enterprises and individuals because they lack the capability to split their incomes or utilize unreported expense accounts, especially when all their income is generated and transferred within the foreign country. Often even the tax incentives given by developing countries are of little value because the incentives normally expire in two to five years, and smaller enterprises may earn no income for several years.

As the previous discussion has indicated, the exemption does not have the necessary scope to act as an effective incentive to induce citizens to work abroad. As tax morality increases, and as more tax treaties are negotiated, avoidance techniques will prove less successful, and section 911 will cease to function as an incentive in most foreign nations. Although the provision is of some current value to corporations in reducing salary costs, it is probably a minor element of the investment decision. The provision is of even less value to small enterprises because there are fewer opportunities to escape high foreign taxes through income splitting and other avoidance techniques.

The inadequacy of the exemption in fulfilling its stated ob-

62. Lyons, Private Investment Abroad and the Federal Income Tax, 37 Va. L. Rev. 909, 916 (1951). See note 41 supra. Although with a corporation the exemption allowed by section 911 may be a very minor consideration, the total income of a partnership or of an individual may be directly affected.

jective of increasing foreign trade is apparent. Unless the section is to be restricted to its role as an equalizing mechanism which operates more equitably than the tax credit, the section should be altered so that it can accomplish at least its original objectives.

C. THE ECONOMIC EFFECTS OF SECTION 911

To the extent that section 911 is presently effective, it may be encouraging American technicians and managers to go abroad and thus increase foreign trade. This result may not be entirely beneficial, however, to the United States economy, and other more negative aspects should be weighed in any policy re-evaluation. Tax exemptions like section 911 which are directed at encouraging United States citizens to go abroad are suspect currently because the limitation of United States foreign private investment is a plank of our foreign economic policy designed to support our balance of payments position.64 The presence of skilled personnel abroad would not of itself result in balance of payments problems if their compensation is paid by sources within the foreign country. However, if payment comes from the United States, the dollars would be spent abroad in a financial transfer of currency for foreign goods. To the extent that this financial transfer is not offset by increased exports from the United States generated by our citizens abroad, balance of payments difficulties will result.

In addition to possible balance of payments ramifications, if the supply of labor resources is barely sufficient for full satisfaction of demand in the domestic economy, but labor resources are continuing to be sent abroad, there is some potential for damaging shortages of trained personnel, resulting in inflationary tendencies.65 If labor resources are not fully employed, however, their utility is greater abroad where they may create opportunities for domestic growth through international trade.

These potential problems of balance of payments and labor bottlenecks are not likely, nor are they large. Investment in less developed countries should be accorded special treatment as the United States has already done with the interest equalization tax, the voluntary programs to limit investment abroad,66 the

65. Krause & Dam, supra note 17, at 61.
66. See Hellawell, supra note 46, at 1393.
Revenue Act of 1962,67 and the Western Hemisphere Trade Corporation provisions.68 Programs to help those countries in particular should not be hampered because of the vital political interest and the immense economic possibilities inherent in their development.

V. POSSIBLE ALTERNATIVES TO SECTION 911

Tax neutrality and tax equality are two issues which must be considered when discussing any tax provision which grants preferential treatment to certain taxpayers. The doctrine of tax neutrality demands that taxation cause as little interference as possible with economic decision making.69 A broader definition of tax neutrality would find a tax efficiently structured so long as it does not cause taxpayers to change their behavior in socially undesirable ways.70 The doctrine of tax equality demands that substantially the same tax burden be imposed on all citizens within the same tax jurisdiction who earn equivalent incomes.71 Although concepts of tax equality may rebel against allowing tax benefits to citizens abroad, arguments for international tax neutrality, fairness in assessing taxes only for government services received72 and foreign policy considerations73 justify allowing exemptions for foreign income, particularly in the case of developing countries.

The past denial of tax reduction for foreign personal income has been based on several theories—primarily the fact that not

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69. See Hellawell, supra note 46, at 1409. See Krause & Dam, supra note 17, at 45. World resource allocation, if not domestic resource allocation, is most efficient if each country taxes income earned in that country; resources can then seek the highest return. Krause & Dam, supra note 17, at 50.
70. Surrey & Brannon, Simplification and Equity as Goals of Tax Policy, 9 Wm. & Mary L. Rev. 915, 916 (1968).
71. Hellawell, supra note 46, at 1410. See Krause & Dam, supra note 17, at 54; Surrey & Brannon, supra note 70, at 915.
72. Domestic and international tax neutrality demand that risk and hardship beyond normal conditions be taken into account in assessing a tax, and more important, that a tax should reflect the goods and services provided by the government, and these are definitely reduced when a citizen is abroad. In the ideal economic model, taxes should not exceed the market value of government services. Krause & Dam, supra note 17, at 48, 50.
73. Under the broader definition of tax neutrality, a tax exemption designed to encourage investment in developing countries would be acceptable in any case because it parallels our foreign policy.
all foreign investment involves more risk than domestic enterprises, and the United States does not differentiate among the latter except for natural resources. Furthermore, there is no concrete proof that tax reduction will increase foreign investment, and it is argued that the United States should not violate tax equality without substantial evidence that investment will occur which would not occur absent the reduction.  

Critics also point out that not all incentives can be granted or the tax system would be incapable of producing income. In addition to the sacrifice of revenue, such a change would allow foreign countries to determine the rate of tax on United States citizens and result in loss of control of the international economic effects of our tax policy. There is a possibility that resources will be misallocated because an enterprise could decide which jurisdiction to enter solely for tax avoidance purposes. All arguments opposing this reduction of taxes neglect the fundamental point that the taxation of foreign income should not be analogous to the taxation of domestic income; taxation of foreign income should occur at the origin, not on the basis of citizenship. The international economy will be best served by such a policy. Arguments in favor of the maintenance of tax equality carry some weight, but other policy considerations seem more important. In the balance, tax equality should be subordinated to them in the instances set forth in the following discussion.

The ideal international tax system, allowing for the most efficient allocation of resources, would be one which rejects the historical test of taxation on the basis of citizenship and taxes in proportion to the contribution to the production of income. The concept is basically one of international tax neutrality, where taxes primarily reflect the economic benefits received from the taxing government. This would allow free flow of

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74. Surrey, *The United States Taxation of Foreign Income*, 1 J. of Law & Econ. 72, 82 (1958).
75. Kurtz, supra note 49, at 5.
76. INT'L CHAMBER OF COMMERCE, AVOIDANCE OF DOUBLE TAXATION 5 (1955). The country of origin provides peace and order and the conditions in which income could be produced. The country of citizenship can claim nothing except a reasonable sum for government services given a citizen abroad.
capital and labor to those areas where it is in the most need and would be most usefully employed.\textsuperscript{78}

Following this reasoning, the country of origin would have the exclusive right to tax all income produced within its borders.\textsuperscript{79} In order to prevent double taxation or tax avoidance, the allocation of income between countries must be defined, either by bilateral treaties or by applying unilateral rules to each country's citizens. The most reasonable unilateral approach may be to subject American citizens to tax until they meet residency requirements abroad, usually six months, and then grant an exemption.

The present lack of tax morality in many countries, however, makes it impractical to pursue a complete elimination of taxation on foreign personal income. It is necessary to restrict the potential benefit so that abuses similar to those encountered in the original version of section 911 will not recur. There are several possible programs which, if combined with or incorporated into section 911, would aid in overcoming the limitations set forth earlier. Two minimum modifications are immediately apparent. First, since compensation of many skilled technicians and managers is above the unrealistically low ceilings that are currently imposed on the exemption, these ceilings should be raised.\textsuperscript{80} Second, to complement section 911, the tax credit in section 901 should not be limited to income taxes alone, but should encompass, in a flexible manner, the entire tax structure of a foreign country. Many nations utilize primarily indirect taxes rather than the income tax, and the result is double taxation.\textsuperscript{81}


\textsuperscript{79} The alternative solution of not allowing the country in which income is produced to tax the income of aliens, even if the aliens meet the residency requirements, is clearly inequitable as long as the citizens of the United States are the predominant factor in the international economy. This would allow the United States Government to collect taxes from its citizens abroad when the larger part of the government services used in producing the income are provided by the foreign nation. It does not appear as inequitable to maintain that aliens be taxed in their country of citizenship until they meet the residency requirements of another nation.

\textsuperscript{80} If the objective of these limits is to prevent excessive tax avoidance, certainly $30,000 to $40,000 ceilings are not excessive but rather fair compensation for a skilled man who receives a premium for working abroad.

\textsuperscript{81} \textit{See} text accompanying notes 55-56 \textit{supra}. There continues to be a great need for research into this area to find workable and de-
These modifications suffice to allow fair treatment of those United States citizens employed in other industrial nations. Due to the balance of payments problem, it is no longer in the national interest to grant additional inducements to invest capital or labor in developed countries.\cite{82} The immediate interest of increasing domestic investments, thereby increasing the purchasing power of domestic consumers and meeting budgetary obligations, outweighs the long term interest in foreign investments. However, foreign policy considerations demand increased efforts to foster economic growth in underdeveloped nations. Developing countries should also be favored for economic reasons: (1) such investment has a better short-run balance of payments effect, particularly in increasing United States exports;\cite{83} (2) this type of investment secures a long range position in new markets and sources of supply, and (3) these markets are in some instances more open to entrepreneurs.\cite{84}

Ten years ago, it could be argued that the minimal benefits which accrued from tax incentives for investment in developing countries could not justify a departure from traditional notions of tax equality—particularly when the United States was dispensable criteria for selection among foreign taxes for credit purposes. If the credit extends to all taxes, there may be large windfalls to some taxpayers. Surrey, supra note 57, at 819–22.

\begin{itemize}
  \item \textbf{82.} It is no longer appropriate for our tax laws to offer incentives to invest in developed countries, since there is now a growing similarity in the investment climate of the United States and the developed world. Our interests are not served by encouraging investment capital to leave the United States for other industrialized countries rather than to remain here. Surrey, supra note 67, at 24. The 1962 legislation was aimed at dampening enthusiasm for foreign investment—except in less developed countries, indicating an awareness that less developed countries should continue to receive preferred treatment. Krauss & Dam, supra note 17, at 22.
  \item \textbf{83.} Hellawell, supra note 46, at 1393. This is because there are shortages of foreign exchange in developing areas, causing money to be spent immediately on manufactured goods which are not available locally and must be purchased in industrial countries like the United States.
  \item \textbf{84.} Id. The lack of entrepreneurial skills in many less developed areas means that excellent potential opportunities often go neglected until foreign investors take advantage of them. In addition to helping the development of the unindustrialized nations, American private investment and trade abroad will benefit the United States through an increase in international trade and the eventual return in the form of dividends and interest.
  \item \textbf{85.} Professor Surrey has emphasized in the past that tax incentives run counter to tax equality, and incentives are not a proper vehicle to induce desired economic behavior. “[O]ur tax laws would soon degenerate into an endless array of different rate schedules for different activ-
tributing abundant amounts of foreign aid to many underdeveloped countries. The point was emphasized that private investment could not meet many of the pressing needs of the underdeveloped areas, specifically social overhead projects which require government financing. Present conditions do not support the same conclusion. A number of less developed countries have constructed infrastructures of social overhead capital which can meet the minimum requirements of certain industries despite a decreasing flow of foreign aid. In these countries private industry and investment could now assume a leading role in generating economic growth.

Previous tax differentials have helped to induce desired economic behavior in spite of the alleged complexity of the variables. Considering the importance of skilled labor resources to developing countries, it appears worthwhile to formulate tax incentives which may influence skilled personnel to work abroad, even at the risk of windfall tax avoidance to a few United States citizens.

The stress on the capital needs of underdeveloped areas may well obscure other and more pressing needs. These countries are acutely in need of industrial skills at all levels. It may well be that a flow of efficient corporate vice-presidents is far more important to our foreign economic policy than a flow of corporate dollars.

Even though section 911 is not presently directed at developing countries, these factors suggest that the design of section 911 be altered so as to reflect policy considerations which have arisen since its enactment.
An intensified effort at negotiating bilateral trade and tax treaties with underdeveloped countries is probably the most effective method of dealing with problems of double taxation and establishing a favorable investment climate. However, very few treaties have been concluded between capital-importing and capital-exporting countries, indicating difficulties which may prevent a reliable network of bilateral protection. Unlike the United States, most developing countries have no enterprises or citizens abroad in need of protection from double taxation. These nations seek other concessions, in the form of aid or trade agreements, before accepting a tax treaty; such concessions are often not forthcoming. As an interim measure, it is urged that the residency requirement for defined underdeveloped countries be reduced to the time the country itself requires for income tax purposes. If no residency requirement exists, the section 911 exemption would be available immediately. This will largely eliminate double taxation on personnel who are employed in developing areas for periods of less than eighteen months.

Since tax incentives in general are inverse methods of inducing desired behavior, a direct subsidy would be a rational method of encouraging specific activities. Such a subsidy would probably exclude the larger international corporations, at least until tax treaties are negotiated or underdeveloped countries increase their tax enforcement. Employees of international corporations enjoy the benefits of tax splitting, unreported expense accounts and other devices, and the tax exemption already results in substantial tax savings. These tax avoidance schemes

Buchanan & H. Ellis, Approaches to Economic Development 442-43 (1955); See International Aids, supra note 10, at 19-20. Well-designed tax incentives can be most helpful in increasing United States business activity in these countries. Krause & Dam, supra note 17, at 80.


91. The United States has some 24 tax treaties with other nations, most of which are industrially developed. H. Steiner & D. Vagts, Transnational Legal Problems 1016 (1968).

92. Encouragement and Protection, supra note 38, at 5. "[T]akes time to negotiate bilateral tax treaties, . . . both through 'positive' steps of providing tax inducements or through the 'negative' approach of eliminating existing tax obstacles to such investment . . . ." Fiscal Incentives, supra note 22, at 15.

93. M. Taylor, Industrial Tax-Exemption in Puerto Rico 142-43 (1957). For advantages and disadvantages of a subsidy, see id. at 152. Generally, it is important that the subsidy not be indiscriminate and that it have selectivity and flexibility.
are unavailable to the smaller units, and a subsidy would provide a more certain incentive. A subsidy proposal, however, faces several barriers unconnected with its usefulness but which might hinder its passage. Most evident is a Congressional reluctance to grant direct foreign aid, and this form of subsidy is basically direct foreign aid.\textsuperscript{94}

Certainly section 911 is not of crucial importance to continuing increases in foreign trade, but an overall plan of encouraging skilled people to go to developing countries is essential. This objective of inducing technicians and managers to work in underdeveloped nations can be most effectively reached if section 911 is incorporated into a general program combining subsidies, foreign aid to develop social overhead capital and continuing efforts at treaty negotiation. Section 911 functions best as an incentive when the creation of minimal social overhead capital has been undertaken and entrepreneurial opportunities are available. A tax incentive cannot help until taxable income can be generated. The Government may be best advised in some poorer countries to undertake additional public expenditures to provide a favorable climate for private investment of labor and capital abroad. These expenditures will initially be more effective inducements than tax reduction.\textsuperscript{95}

When section 911 cannot function adequately as an inducement, a subsidy can provide a more direct inducement. The United States can also make valuable contributions to the effectiveness of section 911 by reducing import barriers and promoting free multilateral trade. This will help to open up new opportunities abroad. A first step in the direction of free movement of labor and the equal treatment of resident and nonresident aliens would be the elimination of double taxation through treaties, alterations in section 911 and the foreign tax credit.

Although too much administrative procedure will raise costs unworthy of the benefits, it would be desirable to grant some discretion to the executive branch in the administration and coordination of these programs.\textsuperscript{96} It is evident that some countries do not want our assistance; with those that do, the executive

\textsuperscript{94} See Kurtz, \textit{supra} note 49, at 4. Congress dislikes the establishment of new administrative bodies because of the expense involved. When tax measures are involved, the administering body is already in existence.

\textsuperscript{95} \textit{International Economics}, \textit{supra} note 11, at 149.

\textsuperscript{96} See \textit{Int. Rev. Code of 1954}, § 955(c)(3) which allows the President to name developing countries.
VI. CONCLUSION

The United States, as evidenced by changes made in the tax laws in 1962 and 1966, is in the process of developing rules to produce a rational system of taxing international transactions in order to provide as much certainty as possible to those engaged in international trade. In the instance of section 911, there continues to be a need for equitable and workable guidelines. The rising rate of taxes abroad makes it doubtful whether the original objectives of section 911 are attainable as the section is presently constructed. Only minor revisions, however, are required to enable the exemption to grant Americans abroad a position of equality with their competitors.

It seems possible that if the exemption given in section 911 were coordinated to a greater degree with other programs, it may be able to make a significant contribution to our foreign policy objectives in regard to developing countries. The long-run development of these countries will be beneficial to United States trade, although initial adjustments may be painful. It is possible for the United States to do far more with invisible tax incentives to promote growth in developing countries. These indirect methods of granting government aid are perhaps the only alternative to direct government aid.

97. See text accompanying note 93 supra. As social overhead capital grows, administrative discretion could increase exemptions to maximize their effectiveness.

98. BITTKER & EBB, supra note 42, at 21-22.