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The Foreign Earned Income Exclusion

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Introduction

Section 911 of the Internal Revenue Code (IRC) allows a "qualified individual" to elect to exclude a portion of earned income attributable to his or her presence in a foreign country. A "qualified individual" is defined as a:

- citizen of the United States and establishes to the satisfaction of the Secretary that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, or
- citizen or resident of the United States and who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period.[1]

Generally, the bona fide residence test is met if an individual is either a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year and if such individual is either a

- U.S. citizen, or
- U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect.

However, it is noteworthy that neither does one *automatically* acquire bona fide resident status merely by living in a foreign country or countries for one year nor is a bona fide residence the same as domicile which is defined as the permanent home where one returns or intend to return. The IRS determines the bona fide residency based on facts and circumstances on a case-by-case basis.[2]

The total exclusion is generally limited to the lesser of:

- the individual's foreign earned income for the year, or
- the overall maximum exclusion allowed for the year, which for the 2016 tax year is $101,300.[3]

Even if a qualified individual's foreign-source earned income is above the maximum allowed exclusion for the year, he/she may still be able to potentially claim a credit for foreign income taxes paid on the excess (of the annual exclusion) foreign-earned income.

There have been a number of recent challenges regarding the eligibility of a person to claim the foreign earned income exclusion. Two such cases are discussed in this article.

Failure to File a Return and its Impact on Eligibility

[1] IRC § 911(d)(1).
[2] See examples of situations where taxpayers may not be considered to have obtained bone fide resident status (Foreign Earned Income Exclusion – Bona Fide Residence Test) at: https://www.irs.gov/individuals/international-taxpayers/foreign-earned-income-exclusion- bona-fide-residence-test.
[3] Rev. Proc. 2015-53, § 3.32, 2015-44 IRB 615.

In a 2016 court case, a U.S. citizen who was a full-time resident of Philippines had not filed US tax returns for the years 2000 to 2006 under the belief that he owed no taxes.[4] Consequently, the IRS prepared "substitute" tax returns for the individual for the years 2000 through 2006 which failed to factor the foreign taxes that the individual had paid, thereby resulting in a tax deficiency of over $1.3 million. After the individual's death, his estate (the taxpayer) late-filed income tax returns for those years and claimed the foreign income exclusion (as well as the foreign tax credit) and requested a tax refund for the years 2000 through 2006.

Per Federal law, American taxpayers living and working overseas are, under certain circumstances, permitted to adjust their U.S. tax liabilities by excluding some of the foreign-earned income as well as through the application of a credit for foreign taxes actually paid.[5]

The issue before the court was whether the taxpayer was entitled to the benefit of the exclusion and/or foreign tax credit.

One of the important requirements for claiming the foreign income exclusion is that the taxpayer must normally claim the exclusion election on a timely filed income return, in an amendment to a timely filed return, or within one year after the due date of the return.[6] Here the taxpayer did not do either of these and the IRS therefore contended that the taxpayer failed to qualify for the exclusion.

However, the taxpayer noted that the IRS had ignored the exception to the three normal filing deadlines for claiming the exclusion. The pertinent regulations do have a special exception which stipulates that when an income tax return is filed after the normal prescribed periods, a §911 election to exclude foreign-sources income can still be made allowed if the taxpayer:

- owes no federal income tax after taking into account the exclusion and files the required a return with the claimed exclusion either before <u>or</u> after the IRS discovers that the taxpayer failed to elect the exclusion, or
- even if the taxpayer owes federal income tax after taking into account the exclusion, they file the return with the claimed exclusion <u>before</u> the IRS discovers that the taxpayer failed to elect the exclusion.[7]

In addition to the above Treasury Regulation,[8] the taxpayer also relied on an IRS Chief Counsel Advice to claim the exclusion.[9]

In analyzing the taxpayer's arguments, the court focused on these two, taxpayer-friendly prongs of the regulation. Under the first prong, if taxpayer owes no federal income tax after taking into account the exclusion, he can file late returns and take advantage of the exclusion whether or not the IRS has discovered his failure to elect the exclusion. Here, the taxpayer had interest and dividend income not subject to the foreign income exclusion, in addition to his foreign earned

[4] *Estate of Herrick v. U.S.*, 117 AFTR 2d 2016-1142 (DC UT).
[5] IRC § 901(a).
[6] Treas. Reg. § 1.911-7(a)(2).
[7] Treas. Reg. § 1.911-7(a)(2)(i)(D).
[8] Ibid.
[9] IRS Chief Counsel Advice 200226010 (3/20/2002), which includes a reference to Treas. Reg. § 1.911-7(a)(2)(i)(D): "The intent of this regulation is to allow a taxpayer whose only income at issue is excluded foreign earned income to file a late section 911 election."

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income, which by itself produced a tax liability of approximately $73,000 for the years 2000-2006 - even with the application of the exclusion. Thus first prong of the exception did not apply to this case.

The second prong of the exception, however, applies if there is still some tax liability owing but the IRS has not discovered that taxpayer failed to elect the exclusion before the taxpayer claims the exclusion. The IRS did not apply the foreign earned income exclusion when it filed the substitute returns for the taxpayer and the court suggested that this was indicative of the fact that the IRS overlooked that the taxpayer's failure to elect the exclusion. In fact, the IRS was notified about the potential applicability of the exclusion only when the exclusion was applied for by the taxpayer in their late-filed tax returns. Therefore, the court concluded that the taxpayer had made a timely §911 election of the foreign earned income exclusion under the second prong of Subsection (D) of Treas. Reg. §1.911-7(a)(2)(i) and therefore the foreign earned income exclusion applied to the taxpayer's 2000-2006 tax returns.

<u>Exception of the Income Exclusion Provisions to Employees of United States</u>

Another area of contention regarding the foreign income exclusion has been around the rule that the exclusion does not apply to the amounts paid by the United States or an agency thereof to an employee of the United States or an agency thereof.[10] The purpose of the exception was designed to prevent U.S. Government employees from escaping taxation on their income by both the United States and foreign governments. This limitation only applies to *employees* of the United States and not to *independent contractors* of the U.S. government.

In a recent tax court case, the taxpayer, a U.S. citizen, performed contract work for U.S. State Department's Office of Overseas Buildings Operations ("OBO") in various foreign locations.[11] The taxpayer and the OBO had executed a non-negotiable Personal Service Contract ("PSC") which specified the duties, the scope of the taxpayer's work, and the evaluation process. The taxpayer worked under direct supervision of an OBO project manager and could neither delegate nor freelance elsewhere. The salary was based on a 40-hour week and was based on time rather than on the building inspected.

During the years at issue, the OBO was responsible for providing the taxpayer with office space, a desk, office equipment, standard office supplies and utilities that would ordinarily be used by similar Government employees. The OBO was also responsible for giving the taxpayer access to Government-furnished equipment such as word processors, computers, typewriters, calculators, and copying machines, including necessary supplies.

The OBO issued the taxpayer Forms W-2, Wage and Tax Statement, and withheld Federal income tax and payroll taxes. The taxpayer had filed his US returns by claiming the foreign earned income exclusion.

Although there was no dispute that the taxpayer was paid by an agency of the United States, the taxpayer argued that he was an independent contractor and that therefore was entitled to exclude

[10] IRC §911(b)(1)(B)(ii).
[11] *Alfred S. Co v. Commissioner*, TC Memo 2016-19.

his income from the OBO as "foreign earned income" within the purview of §911(b)(1)(A). On the contrary, the IRS argued that the taxpayer was a government employee and therefore not entitled to the exclusion.

The issue before the court was whether the taxpayer was an employee or an independent contractor of the U.S. government.

The court noted that the definition of an employee or independent contractor was not provided in the Internal Revenue Code and consequently it relied on other guidance. The court listed the common law rules and other enumerated factors indicative of employee-employer relationship which was analyzed as below:

a. Degree of Control

The court declared that of all of the factors the "right to control" was the "master test" in determining the nature of a working relationship.

The court analyzed this factor and noted the following:

- The OBO dictated the duties and supervised the performance of the taxpayer.
- The taxpayer worked under the direct supervision of an OBO project director and was required to maintain and complete daily and monthly reports,
- The taxpayer was not permitted to delegate the duties,
- The OBO dictated all terms of the service contracts,[12] and
- The OBO dictated the taxpayer's hours, pay, and leave.[13]

Although the amount of control the OBO had over the taxpayer's day-to-day activities was limited, the taxpayer was subject to substantial control by the OBO during the years at issue. It was therefore concluded that the OBO had the right to exercise control over the taxpayer and in fact it exerted a substantial amount of control over him.

b. Investment in Facilities

The fact that a worker provides his or her own tools or goods generally indicates independent contractor status. Conversely, the fact that a worker has no investment in the facilities used in the work is indicative of an employer-employee relationship.[14] During the years at issue, taxpayer actually had invested in the equipment needed for his work which did not involve a risk of financial loss as he was able to keep his purchased tools after the termination of his employment. The OBO,

[12] This included the taxpayer's duties, scope of work, process by which taxpayer would be evaluated, reimbursement policies, travel policies, and termination policies. The taxpayer, in fact, could not negotiate the terms of the PSCs and was required to abide by all terms and conditions mandated by the PSCs. For instance, the OBO set taxpayer's work schedule, including the specific days on which taxpayer was required to work, as well as the specific hours during which he was required to work. Additionally, the OBO determined the countries to which taxpayer would be sent to work as well as when he would be sent there. Moreover, taxpayer was paid a fixed annual salary in biweekly increments and in accordance with the Foreign Service Scale. In addition to his salary, the OBO permitted taxpayer to earn and accrue, among other things, home leave, annual leave, and sick leave. If taxpayer wished to take time off from work—to use either annual leave or sick leave—he had to request and obtain permission from the OBO.
[13] For instance, the OBO set taxpayer's work schedule, including the specific days on which taxpayer was required to work, as well as the specific hours during which he was required to work. Additionally, the OBO determined the addition to his salary, the OBO permitted taxpayer to earn and accrue, among other things, home leave, annual leave, and sick leave. If taxpayer wished to take time off from work—to use either annual leave or sick leave—he had to request and obtain permission from the OBO.
[14] *Ewens & Miller, Inc. v. Commissioner*, 117 T.C. 263, 271 (2001).

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on the other hand, provided the taxpayer with government-furnished quarters, training services, and other supplies. Overall, this factor was considered neutral.

c. Opportunity for Profit or Risk of Loss

An opportunity for profit or the risk of loss on the basis of the worker's own efforts and skill indicates independent contractor status.[15] In contrast, earning an hourly wage or fixed salary indicates an employer-employee relationship.[16] During the years at issue the OBO paid the taxpayer an annual salary was not contingent on taxpayer's performance or completion of projects. Further since he made no monetary investment in the buildings, this factor indicates that the taxpayer was an employee.

d. Right to Discharge

The principal's retention of the right to discharge a worker is indicative of a common law employer-employee relationship.[17] During the years at issue the OBO had the right to terminate the PSC at any time for cause as well as upon 30 days' advance notice for the convenience of the United States. Accordingly, this factor indicated that the taxpayer was an employee.

e. Integral Part of Regular Business

Where a type of work is part of the principal's regular business, it is indicative of employee status.[18] Here, the taxpayer served as a mechanical engineer and performed a wide range of mechanical engineering functions in support of the planning, implementation, and oversight of the assigned projects. This type of work was within the scope of the OBO's regular business. Accordingly, this factor indicated that taxpayer was an employee.

f. Permanency of Relationship

A continuing relationship indicates an employment relationship, while a transitory relationship may be indicative of independent contractor status.[19] Here, the taxpayer worked exclusively for the OBO for five years in accordance with the PSCs. He did not offer his services to the public and did not perform services for any individual or entity other than the OBO, as would an independent contractor.[20] Accordingly, this factor was indicated that the taxpayer was an employee.

g. Relationship Contemplated by the Parties

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15 *Simpson v. Commissioner,* 64 T.C. 974 (1975); see also *Rosato v. Commissioner,* TC Memo. 2010-39.
16 *Robinson v. Commissioner,* TC Memo. 2011-99 (citing *James v. Commissioner,* 25 T.C. 1296, at 1300 (1956)), aff'd, 487 F. App'x 751 [110 AFTR 2d 2012-5194] (3d Cir. 2012).
17 *Rodriguez v. Commissioner,* TC Memo. 2012-286 (citing *Weber v. Commissioner,* 103 T.C. at 391); see also *Ellison v. Commissioner,* 55 T.C. 142, 152 (1970).
18 *Simpson v. Commissioner,* 64 T.C. 974(1975); *Rosemann v. Commissioner,* TC Memo. 2009-185.
19 *Ewens & Miller, Inc. v. Commissioner,* 117 T.C. 263, (2001); *Rosemann v. Commissioner,* TC Memo. 2009-185 [2009 RIA TC Memo ¶2009-185].
20 *Jacobs v. Commissioner,* TC Memo. 1993-570; *Casety v. Commissioner,* TC Memo. 1993-410; *Gamal-Eldin v. Commissioner,* TC Memo. 1988-150 [¶88,150 PH Memo TC], aff'd without published opinion, 876 F.2d 896 (9th Cir. 1989).

The withholding of taxes is consistent with a finding that an individual is a common law employee.[21] Here, the OBO provided taxpayer with Forms W-2, withheld Federal income tax and payroll taxes, and remitted these amounts to the IRS. On the contrary, the record indicated that during the years at issue taxpayer personally believed that he was not an employee of the OBO. Overall, this factor was considered neutral.

After considering all the evidence, the court concluded that the taxpayer was indeed an employee of the OBO and accordingly not entitled to the exclusion of income under IRC §911(a).

Conclusion

Both of these cases have application beyond IRC §911. It can be observed that at a broad level the cases reflect the importance of being compliant and cognizant of the tax rules so as to be able to avail the tax saving opportunities offered by the law. The *Herrick* case highlights the importance of understanding the compliance obligations, including special taxpayer-friendly provisions, and observing those requirements. The *Alfred* case is a reminder of the complexity in describing employer and employee relationship as it relates to the new age economy and reiterates long-standing factors established by IRS and the courts in resolving this issue. As the tax law is wrangled with numerous exceptions, reliefs and conditions, understanding and interpreting of the law poses new challenges and opportunities to tax professionals in providing the appropriate assistance to clients.

[21] *Packard v. Commissioner*, 63 T.C. 621, 632 (1975); *Rosato v. Commissioner*, TC Memo. 2010-39.

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