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Special Reports

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The Impact of Recent Events on the U.S. Foreign Earned Income Exclusion: Rocking The Boat or Capsizing the Vessel?

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Don't rock the boat — a common motto of those benefited by the status quo. One such group is comprised of those taxpayers allowed to exclude from U.S. income taxation a significant amount of their salaries and housing costs while living and working abroad under IRC section 911, also known as the foreign earned income exclusion (FEIE).[1] The FEIE has been a catalyst for political controversy since its enactment in the 1920s. During periodic tempests, supporters of the FEIE have fervently battled in Washington, D.C., to defend the tax program that favors certain expatriates and U.S. multinational businesses. Conversely, during calm periods, FEIE proponents have made few waves. In that manner, the FEIE, although in modified forms, has managed to stay afloat for nearly a century. Unbeknownst to many, however, the longevity of the FEIE may have been jeopardized recently by a combination of events.

This article first provides a brief description of the U.S. system of worldwide taxation and the FEIE's relevance thereto. The article then describes the congressional movement in 2003 to repeal the FEIE that clearly rocked the FEIE boat. Next, the article analyzes a series of recent events that have forced the FEIE to take on additional water. Among those events are recent court decisions rejecting far-fetched claims based on the FEIE, the issuance of Rev. Rul. 2004- 28 that labels some FEIE claims as "frivolous" and threatens civil and criminal penalties, and the inclusion of particular FEIE positions on the U.S. Internal Revenue Service's list of the "dirty dozen" tax scams. Finally, the article concludes that, because of the current circumstances, it may behoove those taxpayers that have traditionally benefited from the FEIE to consult a tax professional regarding alternative tax planning. Stated more directly, with the heightened possibility of major changes to the FEIE, taxpayers should grab that tax-planning lifejacket before the FEIE boat completely capsizes.

I. Overview of the FEIE

In the international context, countries generally base their capacity to tax persons on either the source of the income or the residence of the person earning the

[1] Unless otherwise indicated all references in this article to the term IRC are to the U.S. Internal Revenue Code of 1986, as amended, and all references to the term "section" are to the IRC.

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income. In other words, in determining whether a country has the power to impose a tax on a particular item of income, a nation's tax system focuses on where the income was earned or, alternatively, on the residency of the person earning the income. Under a source-based tax system (which is also known as "territorial taxation"), a country taxes the income that is earned within its borders, regardless of the nationality or residence of the person who earns it. By contrast, a residence-based tax system (which is also known as "worldwide taxation") allows a country to tax the income earned by its citizens or residents, irrespective of the country in which it is earned.

The United States is one of the few nations that uses a system of worldwide taxation. That global taxing capacity is derived from the following authority. IRC section 1 imposes a tax on the "taxable income" of every individual.[2] The term "gross income," the base from which an individual's taxable income is determined, encompasses "all income from whatever source derived," including income for services performed by the individual.[3] Lest there be any doubt on that point, the Treasury regulations provide that generally "all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the IRC whether the income is received from sources within or without the United States."[4]

Despite the apparent harshness of worldwide taxation, some exceptions mitigate its severity. Among those exceptions is the FEIE, a device that has been the target of dramatic modifications and considerable controversy since its introduction in 1926.[5] As mentioned above, the general rule is that the United States taxes all of the income that a U.S. person earns each year, regardless of whether the income is derived from sources in the United States or elsewhere. Under the FEIE, however, some U.S. individual taxpayers living and working abroad for extended time periods are allowed to omit from gross income $80,000 per year of some types of income, as well as a housing allowance. Stated in tax lingo, the IRC permits a "qualified individual" to exclude from gross income for a given year his or her "foreign earned income" and "housing cost amount."[6]

'Foreign earned income' means income that a person receives as compensation for performing personal services while abroad, but it does not include investment income, pension or annuity payments, or some deferred compensation.

To be considered a "qualified individual" and thus eligible for the FEIE, a person must meet two conditions. First, he or she must have a "tax home" in a foreign country.[7] For FEIE purposes, a person's tax home is the location of his or her regular or principal place of business or, if he or she has no regular or principal place of business, then the tax home is the location of his or her place of abode "in a real and substantial sense."[8] Second, the person must be a U.S. citizen who is a bona fide resident of a foreign country for an entire year, a resident alien who is a citizen of a foreign country with which the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country for an entire year, or a U.S. citizen or resident alien who is physically present in a foreign country for at least 330 full days during the year.[9] The key to meeting the second condition is being a true resident of or physically present in a "foreign country."

Provided that the person satisfies the definition of a "qualified individual," he or she may avoid being taxed on as much as $80,000 annually of "foreign earned income."[10] The term "foreign earned income" means income (in the form of wages, salaries, fees, commissions, and so forth) that a person receives as compensation for performing personal services while abroad.[11]

[2]Section 1.

[3]Section 61(a)(1).

[4]Treas. reg. section 1.1(b).

[5]For a detailed description of the evolution of the FEIE, *see* Renee Judith Sobel, "United States Taxation of Its Citizens Abroad: Incentive or Equity," 38 *Vanderbilt Law Review* 101 (1985); Glenn Kurlander, "The Economic Recovery Tax Act of 1981: The Foreign Earned Income Exclusion: Redefining the Exception for Amounts Paid by the United States Under I.R.C. §911," 68 *Cornell Law Review* 592 (April 1983); Jeffrey Evans, "911: The Foreign Earned Income Exclusion — Policy and Enforcement," 37 *Virginia Journal of International Law* 891 (Summer 1997).

[6]Section 911(a).

[7]Section 911(d)(1).

[8]Treas. reg. section 1.911-2(b).

[9]Section 911(d)(1). *See also* Rev. Rul. 91-58, 1991-2 C.B. 340. That ruling, which relates to a citizen of the United Kingdom, expressly states that it applies to citizens of all countries that have an income tax treaty with the United States.

[10]Section 911(b)(2)(D)(i). The excludable amounts have increased over the years, as follows: 1998 - $72,000; 1999 - $74,000; 2000 - $76,000; 2001 - $78,000; 2002 - $80,000.

[11]Section 911(b)(1)(A).

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But the term "foreign earned income" does not include investment income (for example, dividends or interest), pension or annuity payments, or some deferred compensation.[12]

In addition to excluding the foreign earned income, a qualified individual may exclude each year from gross income the "housing cost amount," which is the amount by which his or her actual "housing expenses" exceed a fixed figure intended to approximate typical housing costs in the United States.[13] The term "housing expenses" includes the reasonable expenses paid during the year by or on behalf of a qualified individual for his or her housing in a foreign country, as well as those of the individual's spouse and dependents.[14] The reasonable expenses may include rent, most utilities, real and personal property insurance, occupancy taxes, nonrefundable security deposits, furniture rental, household repairs, and residential parking.[15] But reasonable housing expenses do not include the cost of items that are "lavish or extravagant under the circumstances."[16]

II. Rocking the Boat in 2003

As mentioned above, the FEIE has been the focus of significant controversy since its introduction nearly a century ago, with its opponents calling for major modifications to, or the outright elimination of, this tax program.[17] That clamor for change invariably intensifies at times when the national budget seems imperiled. True to history, the FEIE was recently attacked as the Bush administration championed an economic stimulus package based in tax reform. In particular, during the legislative battle to craft the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the U.S. Senate approved a bill that would have completely repealed the FEIE as of 31 December 2003.[18] Revocation of the FEIE was designed to partially counteract the US $350 million in tax cuts contained elsewhere in the economic stimulus legislation. Simply stated, if Congress was prepared to lower the amount of revenue that the U.S. Treasury would collect in the future resulting from the special depreciation allowances, increased tax credits, and reduced rates on particular capital gains and dividends found in the JGTRRA, then it needed to devise methods by which to obtain more tax money from other areas.[19] The abolition of the FEIE was thus proposed. In the end, that proposal did not survive the legislative process and the JGTRRA was enacted without revoking that longstanding tax benefit to Americans working abroad.[20]

Although it did not completely capsize the FEIE, the recent congressional initiative to revoke that tax program undoubtedly rocked the boat. Some groups that are direct beneficiaries of the FEIE did not overlook the fact. For instance, relying on a medical metaphor, American Citizens Abroad stated that:

> Section 911 is out of the emergency room, but it would be premature to say that the provision has been restored to good health. . . . In short, it was that confluence of factors that enabled friends of section 911 to move that provision "off the table" almost as quickly as it landed on the table in the first place. But we may not always be so lucky. Now that the exclusion has been identified as a possible revenue raiser, it may only be a matter of time before section 911 comes "under the knife" again. Americans abroad may breathe a sigh of relief today, but we need to remain vigilant in the months ahead. Otherwise, section 911 may once again find itself on the operating table and fighting for its life.[21]

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[12]Section 911(b)(1)(B) and section 911(d)(2)(A).

[13]Section 911(c)(1). The "housing cost amount" is the excess of the taxpayer's "housing expenses" for the year, divided by 16 percent of the annual salary of a U.S. governmental employee at level GS-14. For instance, if the annual salary of a person at grade GS-14 is $70,000, then the housing cost amount is the excess of his or her housing expenses over $11,200 (for example, 16 percent of $70,000).

[14]Section 911(c)(2)(A).

[15]Treas. reg. section 1.911-4(b)(1).

[16]Section 911(c)(2)(A).

[17]*See, for example*, Renee Judith Sobel, "United States Taxation of Its Citizens Abroad: Incentive or Equity," 38 *Vanderbilt Law Review* 101 (1985); Glenn Kurlander, "The Economic Recovery Tax Act of 1981: The Foreign Earned Income Exclusion: Redefining the Exception for Amounts Paid by the United States Under I.R.C. §911," 68 *Cornell Law Review* 592 (April 1983); Jeffrey Evans, "911: The Foreign Earned Income Exclusion — Policy and Enforcement," 37 *Virginia Journal of International Law* 891 (Summer 1997); Postlewaite and Stern, "Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for Its Repeal," 65 *Virginia Law Review* 1093 (1979); Yoseph Edrey and Adrienne Jeffrey, "Taxation of International Activity: Over Relief From Double Taxation Under the U.S. System," 9 *International Tax & Business Lawyer* 101 (1991).

[18]Jobs and Growth Tax Relief and Reconciliation Act of 2003 (S. 1054), section 350, 13 May 2003. *See also* Johnathan Rickman and Herman Ayayo. "U.S. Senate Keeps Foreign Earned Income Exclusion Repeal," *2003 WTD 95-1* or *Doc 2003-12319* (16 May 2003).

[19]Martin A. Sullivan, "Economic Analysis: Republican Revenue Raisers Frame Autumn Tax Debate," *2003 TNT 179-12* (16 Sept. 2003). That article bluntly explains the reality of tax changes: "[I]f you want to get some tax relief enacted into real law, you are going to have to find some tax increases to pay for it. (In the current jargon of Capitol Hill, these provisions are called 'offsets.')."

[20]U.S. Senate and U.S. House of Representatives. "Managers' Statement and Explanation of Final Tax Cut Bill," *2003 TNT 101-40* (27 May 2003).

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Some tax practitioners are also cognizant of the precarious situation facing the FEIE. They speculate that, although the proposed repeal of the FEIE died in congressional committee in 2003, the abolition of the tax program may be imminent. In the words of one tax practitioner, "[i]t is clear the Bush administration has targeted this provision," whose repeal it views more as a closing of a loophole than as a tax increase to expatriates.[22] Likewise, the Section 911 Coalition is acutely aware of the possible peril confronting the FEIE.[23] That organization theorizes that the political assault of the FEIE in 2003 was simply a "huge mistake" caused by the fact that some members of Congress confused the tax program with abusive offshore tax shelters, which were recently the focus of intense IRS scrutiny.[24]

III. Taking On Water in 2004

A. Definition of 'Foreign Country'

As explained in greater detail above, to be considered a "qualified individual" and thus eligible for the FEIE, a person must satisfy two conditions. First, he or she must have a tax home in a foreign country.[25] Second, the person must be either a U.S. citizen who is a bona fide resident of a foreign country for an entire year, a resident alien who is a citizen of a foreign country with which the United States has an income tax treaty and who is a bona fide resident of a foreign country for an entire year, or a U.S. citizen or resident alien who is physically present in a foreign country for at least 330 full days during the year.[26] The ability to meet any of those conditions hinges on the definition of "foreign country."

Unlike many words, phrases, and concepts in the IRC, the term "foreign country," at least in the context of the FEIE, is clearly defined. For example, Treasury regulation section 1.911-2(g) provides that the term "United States" means any territory under the sovereignty of the United States, including the states, the District of Columbia, and the possessions and territories of the United States. As a complement thereto, Treasury regulation section 1.911-2(h) defines the term "foreign country" to include any territory under the sovereignty of a government other than that of the United States. Echoing that definition, the IRS instructions to Form 2555, the tax form that must be completed by those taxpayers claiming benefits under the FEIE, state that a "foreign country" is any territory (including the air space, territorial waters, seabed, and subsoil) under the sovereignty of a government other than the United States. The instructions to Form 2555 then clarify that the term foreign country "does not include U.S. possessions or territories." The precise meaning of foreign country for FEIE purposes is further elucidated in IRS Publication 54, "Tax Guide for U.S. Citizens and Resident Aliens Abroad." According to that document, a foreign country "usually is any territory . . . under the sovereignty of a government other than that of the United States."[27] The publication also explains that Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, the Virgin Islands, and U.S. possessions such as American Samoa are not considered foreign countries.[28] Lest there be any confusion on this point, IRS Publication 54 then proceeds to state that, for FEIE purposes, "[r]esidence or presence in a U.S. possession does *not* qualify you for the foreign earned income exclusion."[29]

B. Relevant Cases

Despite the precision and clarity with which the term "foreign country" is defined in Treasury regulations, the instructions to Form 2555, and IRS Publication 54, several recent cases have involved taxpayers attempting to classify U.S. possessions as foreign countries to take advantage of the FEIE. For instance, in *Farrell v. United States*[30] the taxpayer lived and worked on Johnston Island, a small island located about 700 miles southwest of Hawaii. Based on the FEIE, the taxpayer excluded from gross income $70,000 of his earnings. The IRS disallowed the exclusion, and the district court sided with the IRS, holding that the FEIE did not apply because Johnston Island is a U.S. possession and thus, by definition, not a foreign country.[31] The appellate court also readily dismissed the taxpayer's argument, stating that "[s]ince Johnston Island is a U.S. possession, not a

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[21] American Citizens Abroad, "Section 911: Still Alive and Kicking," *ACA News Update*, Issue 129, June 2003, available at www.aca.ch.

[22] Sharon Reier, "Expatriates Weather Threat to Tax Exclusion; But Change Would Have Had Minor Effect," *International Herald Tribune*, 29 May 2003, p. 4.

[23] David Hamod, Executive Director of the Section 911 Coalition, Hearing on the Impact of U.S. Tax Rules on International Competitiveness, House of Representatives, Committee on Ways and Means, 30 June 1999.

[24] "Proposal to Add Taxes for US Citizens Abroad Draws Fire," *Agence France Presse*, 15 May 2003.

[25] Section 911(d)(1).

[26] Section 911(d)(1). *See also* Rev. Rul. 91-58, 1991-2 C.B. 340. That ruling, which relates to a citizen of the United Kingdom, expressly states that it applies to citizens of all countries that have an income tax treaty with the United States.

[27] IRS Publication 54, p. 13.

[28] *Id.*

[29] *Id.* (emphasis in original).

[30] *Farrell v. United States*, 313 F.3d 1214 (9th Cir. 2002).

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foreign country, income earned there cannot be excluded under [section] 911."[32]

Also, in *Umbach and Specking v. Commissioner*[33] the taxpayers worked on Johnston Island and excluded from gross income $70,000 of their earnings under the FEIE. The IRS disallowed the exclusions because Johnston Island is not a foreign country, and the U.S. Tax Court affirmed the IRS's position. On appeal, the taxpayers did not dispute that Johnston Island is a U.S. possession as opposed to a foreign country. Instead, the taxpayers claimed their eligibility under the FEIE on the basis of a regulation promulgated under IRC section 931. Under section 931, individuals who are bona fide residents of Guam, American Samoa, or the Northern Mariana Islands for the entire tax year may exclude from U.S. gross income amounts derived from sources within any of those three possessions.[34] The regulation at issue provided that:

> a citizen of the United States who cannot meet the . . . requirements of section 931 but who receives earned income within a possession of the United States, is not deprived of the benefits of the provisions of section 911 (relating to the exemption of earned income from sources outside the United States), provided he meets the requirements thereof. In that case none of the provisions of section 931 is applicable in determining the citizen's tax liability.[35]

The appellate court considered the taxpayers' reliance on that regulation misplaced because, contrary to the taxpayers' assertion, it does not purport to expand the benefits of the FEIE. Rather, explained the court, the regulation provides that failure to qualify for benefits under section 931 does not by itself disqualify a citizen from the benefits of the FEIE. The court further held that, by the regulation's very terms, a citizen may receive the benefits of the FEIE only if he or she first meets the requirements under section 911, which neither of the taxpayers did.[36]

In *Jones v. Commissioner*[37] the taxpayer made the identical argument that was unsuccessfully raised in *Umbach and Specking*. The court made an identical ruling, too. Rejecting the taxpayer's deductions under the FEIE, the court held that "[a] taxpayer who resides in Johnston Island does not qualify for the section 911 exclusion because Johnston Island is a U.S. possession and not a foreign country. Section 1.931-1(b)(2) . . . does not provide otherwise."[38]

If there remained any doubt concerning the court's distaste for dubious claims under the FEIE after examining the preceding three cases, *Hautzinger v. Commissioner*[39] suffices to confirm the issue. In this case the taxpayer, who lived and worked in both American Samoa and Johnston Island during the tax years at issue, attempted to exclude from gross income his earned income under section 931. Interestingly, the fact that the taxpayer chose not to raise the FEIE argument did not stop the court from rejecting it. The court acknowledged that the FEIE was not really at issue, but determined its inapplicability merely "for the sake of completeness."[40]

C. Rev. Rul. 2004-28

In response to the preceding cases, the IRS recently issued Rev. Rul. 2004-28,[41] which announces that the IRS is aware that some taxpayers are attempting to reduce their federal tax liability by taking the position that their wages are excluded from gross income under the FEIE because the state, commonwealth, or territory of the United States in which they resided or performed services is a foreign country. The IRS further announced that it knows that promoters (including some tax return preparers) are advising taxpayers to take those positions, which the IRS considers "frivolous" and "meritless."

The revenue ruling presents the following three common fact patterns:

- A, an individual, resides in State X, a state or commonwealth of the United States, and performs services exclusively in State X. A was present in State X for all of his tax year and is therefore not eligible in that year for the FEIE. Nonetheless, based on the advice of a promoter, A files a return including a Form 2555

[31] *Id.* at 1215.

[32] *Id.* at 1218.

[33] *Umbach and Specking v. Commissioner*, 83 Fed. Appx. 274, 2003 U.S. App. LEXIS 24936 (10th Cir. 2003).

[34] Section 931. Before 1986, section 931 permitted U.S. citizens to exclude income derived from sources within various U.S. possessions, including Johnston Island. But section 931 was amended by the Tax Reform Act of 1986 (P.L. 99-514, section 1272(a)) to apply only to income derived from sources within Guam, American Samoa, and the Northern Mariana Islands (not Johnston Island).

[35] Treas. reg. section 1.931-1(b)(2).

[36] *Umbach and Specking v. Commissioner*, 83 Fed. Appx. 274, 2003 U.S. App. LEXIS 24936 (10th Cir. 2003).

[37] *Jones v. Commissioner*, T.C. Memo 2003-14.

[38] *Id.*

[39] *Hautzinger v. Commissioner*, T.C. Memo 2003-236.

[40] *Id.* at footnote 6.

[41] Rev. Rul. 2004-28; 2004-12 IRB 1; *see also* U.S. Internal Revenue Service. "IRS Warns Against Relying on Frivolous Foreign Residence Argument," *2004 WTD 41-11* or *Doc 2004-4307* (1 Mar. 2004).

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on which A asserts that he is entitled to the FEIE because he earned that income by performing services in, is a bona fide resident of, and has a tax home in a foreign country (that is, State X).

- The following is the same as above except that A claims an exclusion from gross income under the FEIE based on his physical presence in State X. Specifically, A claims he satisfies the physical presence test of the FEIE because he was in a foreign country for at least 330 days during his tax year.
- B, an individual, performed services in and resided on Johnston Island, one of the islands on Johnston Atoll, which is a U.S. territory. B files a Form 2555 asserting that he is entitled to the exclusion from gross income under the FEIE because he performed services in, is a bona fide resident of, and has a tax home in a foreign country (that is, Johnston Atoll).

The IRS explains that to qualify for the FEIE, a U.S. citizen or resident working abroad must have a tax home in a foreign country and must satisfy either the bona fide residence test or the physical presence test. Citing Treasury regulation section 1.911-2(g) and (h), the IRS explains that, for FEIE purposes, states, commonwealths, and territories of the United States are not foreign countries. Accordingly, the taxpayers are not eligible for the FEIE, and their arguments "have no basis in law or fact."

The IRS's position on the dirty dozen, as expressed by IRS Commissioner Mark W. Everson, is unequivocal: 'There is no secret way to escape paying taxes.'

Regarding potential liability, the IRS explains that it will include in gross income the earned income that taxpayers attempt to exclude based on frivolous FEIE arguments, plus interest. Also, the IRS expressed its willingness to impose civil penalties, including (1) the section 6662 accuracy-related penalty, equal to 20 percent of the amount of taxes the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, equal to 75 percent of the amount of taxes the taxpayer should have paid; (3) a US $500 penalty under section 6702 for filing a frivolous return; and (4) a penalty of up to US $25,000 under section 6673 in cases in which the taxpayer makes frivolous arguments in the U.S. Tax Court. The IRS also threatens to impose criminal penalties (including imprisonment or substantial fines) for tax evasion under section 7201 and for making false statements on a return under section 7206.

The IRS further warns that promoters of the FEIE schemes could also face penalties. In particular, the IRS may impose a US $250 penalty for each return prepared by an income tax return preparer who knew or should have known that the taxpayer's argument was frivolous, a US $1,000 penalty under section 6701 for aiding and abetting the understatement of tax, and a fine of up to US $100,000 and imprisonment for up to three years under section 7206 for assisting or advising about the preparation of a false return or other document.

D. 'Dirty Dozen' Designation

Along with issuing Rev. Rul. 2004-28 in March 2004, the IRS released its updated list of the "dirty dozen" tax scams.[42] Among those notorious 12 are "frivolous arguments and false arguments that are unsupported by the law," such as the recent FEIE claims made in *Farrell*, *Umbach and Specking*, *Jones*, and *Hautzinger*. According to that release, the IRS is taking multiple steps to attack those tax scams, including augmenting its enforcement resources, issuing numerous injunctions, and imposing severe civil or criminal penalties. The IRS's position on the dirty dozen, as expressed by IRS Commissioner Mark W. Everson, is unequivocal: "There is no secret way to escape paying taxes."[43]

IV. Conclusion

The FEIE has been polemical since its introduction in 1926, yet it has managed to stay afloat (albeit in various forms) for nearly a century. As this article demonstrates, the congressional debate in 2003 on the potential repeal of this tax program clearly rocked the FEIE boat. The FEIE took on additional water in 2004 when several courts dismissed baseless claims involving section 911, the IRS issued Rev. Rul. 2004-28 in response to the "frivolous" and "meritless" taxpayer positions, and the IRS identified misuse of the FEIE as one of its "dirty dozen" tax abuses. What is not entirely clear, though, is whether the FEIE will completely sink in the near future. Nevertheless, in view of the present circumstances, it would be prudent for taxpayers that have historically benefited from the FEIE to consult a tax professional. In other words, taxpayers may be wise to seize that life jacket called anticipatory tax planning before the FEIE completely capsizes. ✦

[42]U.S. Internal Revenue Service. "IRS Updates the 'Dirty Dozen' for 2004: Agency Warns of New Scams," IR-2004-26, *2004 TNT 41-28* (1 Mar. 2004). Frivolous arguments, including baseless FEIE claims, are listed as number 10 of the dirty dozen.

[43]*Id.*

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