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Recommended Citation

Glenn Kurlander, *Foreign Earned Income Exclusion: Redefining the Exception for Amounts Paid by the United States Under I.R.C 911*, 68 Cornell L. Rev. 592 (1983)

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THE FOREIGN EARNED INCOME EXCLUSION:
REDEFINING THE EXCEPTION FOR AMOUNTS
PAID BY THE UNITED STATES UNDER
I.R.C. § 911

The United States, unlike most other major industrialized nations, taxes on the basis of citizenship.¹ American citizens are taxed on their worldwide income, regardless of where they reside.² Citizens who pay income tax to a foreign country may elect to deduct those taxes from income,³ or to claim foreign taxes paid as a credit against United States income tax.⁴ In addition, section 911 of the Internal Revenue Code allows a qualified individual to exclude foreign earned income from gross income.⁵ Certain amounts paid by the United States, however, are excepted from the exclusion.⁶

The foreign earned income exclusion and the exception for amounts paid by the United States have been part of the Code for over fifty years.⁷ Despite this long history, section 911 frequently has been the subject of scholarly criticism⁸ and congressional reform.⁹ Although this controversy has centered primarily on how best to implement the

¹ See, e.g., P. MCDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 79 (1981); P. POSTLEWATE & M. COLLINS, INTERNATIONAL INDIVIDUAL TAXATION 3-4 (1982); Maiers, *The Foreign Earned Income Exclusion: Reinventing the Wheel*, 34 TAX LAW. 691, 692 (1981).

² I.R.C. § 61 (1976).

³ *Id.* § 164(a).

⁴ *Id.* § 901(a) (1976 & West Supp. 1983).

⁵ *Id.* § 911(a)(1) (Supp. V 1981) ("At the election of a qualified individual . . . there shall be excluded from the gross income of such individual, and exempt from taxation under this subtitle, for any taxable year . . . the foreign earned income of such individual.")

⁶ *Id.* § 911(b)(1)(B)(ii) ("The foreign earned income for an individual shall not include amounts . . . paid by the United States or an agency thereof to an employee of the United States or an agency thereof.")

⁷ The foreign earned income exclusion was first passed in 1926. Revenue Act of 1926, ch. 27, § 213(b)(14), 44 Stat. 9, 26. The exception for amounts paid by the United States was added in 1932. Revenue Act of 1932, ch. 209, § 116(a), 47 Stat. 169, 204.

⁸ See, e.g., Maiers, *supra* note 1; Patton, *United States Individual Income Tax Policy as it Applies to Americans Resident Overseas*, 1975 DUKE L.J. 691; Postlewaite & Stern, *Innocents Abroad? The 1978 Foreign Earned Income Act and the Case for its Repeal*, 65 VA. L. REV. 1093 (1979); Note, *A Proposal for the Elimination of Section 911*, 11 CASE W. RES. J. INT'L L. 139 (1979); Note, *The Taxation of Americans Living Abroad: The Foreign Earned Income Act of 1978 and §§ 911 and 913 of the Internal Revenue Code*, 19 COLUM. J. TRANSNAT'L L. 79 (1981) [hereinafter cited as Note, *Taxation of Americans Living Abroad*]; Note, *Section 911 Tax Reform*, 54 MINN. L. REV. 823 (1970).

⁹ For a detailed discussion of the legislative history of the foreign earned income exclusion, see Hooton, *The Disappearing Foreign Earned Income Exclusion*, 55 TAXES 522 (1977); Levine, *Section 911: The Foreign Earned Income Exclusion—Death Blow or Recovery?*, 56 TAXES 169 (1978); Slowinski & Williams, *The Formative Years of the Foreign Source Earned Income Exclusion: Section 911*, 51 TAXES 355 (1973).

goals of section 911, part of the difficulty can be traced to disagreement as to what those goals are.¹⁰ The legislative history indicates that the foreign earned income exclusion, at least initially, was intended to foster foreign trade by providing an incentive for American workers to go abroad, and by placing them in an equal position with citizens of other nations going abroad who are not taxed by their native countries.¹¹

While Congress and commentators have wrestled with the efficacy and function of section 911, the courts have had great difficulty in determining when an amount has been paid by the United States or its agency and is thus fully includable in gross income. The case law reflects two distinct approaches. Some courts attempt to identify the source of the funds from which the taxpayer has been paid ("source approach"). Other courts place primary reliance on the existence of an employer-employee relationship and attempt to identify the entity that has the ultimate legal obligation to pay the taxpayer ("obligation approach").

Both approaches have produced arbitrary and unprincipled results. They are formalistic and turn on distinctions that are not based on considerations of tax policy. Neither the determination of the ultimate source of the funds from which the taxpayer is paid, nor the determination of which body is ultimately responsible for that payment, adequately addresses the congressional concerns that the exclusion embodies.

This Note examines the legislative history of both the foreign earned income exclusion and the exception for amounts paid by the United States or its agency. According to this analysis, the exclusion reflects Congress's intent to provide an incentive for workers to go abroad, and the exception reflects Congress's desire to deny this benefit to certain American workers for whom no incentive to go abroad is necessary. The Note suggests that in determining whether a taxpayer is entitled to the benefits of section 911, a court should consider the type of work the taxpayer does, and whether he is within the class of individuals

¹⁰ [T]he rationale behind giving Americans overseas tax advantages has never been unanimously agreed upon. Probably the most influential reasons for giving tax advantages are that they are required to spur United States trade overseas; to provide equitable treatment for Americans facing escalating costs abroad; and to combat a perceived balance-of-payments problem.

P. POSTLEWATTE & M. COLLINS, *supra* note 1, at 114.

¹¹ See S. REP. NO. 781, 82d Cong., 1st Sess. 52-53 (1951), *reprinted in* 1951-2 C.B. 458, 495; *see also supra* note 10; Hooton, *supra* note 9, at 522-23; Levine, *supra* note 9, at 170; Maiers, *supra* note 1, at 692; Postlewaite & Stern, *supra* note 8, at 1122.

The foreign earned income exclusion only functions as an incentive when the tax rate of the foreign country is lower than the rate at which the individual would have been taxed had he remained in the United States. Congress, however, has never taken the rate structures into account, and has always viewed the provision as an incentive. Many commentators, on the other hand, have advanced other rationales for the exclusion; *see supra* note 10; *infra* note 17 and accompanying text.

that Congress has sought to benefit. This approach would be more effective in implementing the goals of the foreign earned income exclusion than either the source or obligation approach.

I

SECTION 911: ORIGINS AND LEGISLATIVE HISTORY

A. Formative Years: 1926-1932

In 1926, the House Ways and Means Committee, "[i]n an endeavor to take one further step toward increasing our foreign trade,"¹² first proposed an exclusion for foreign source income. As originally conceived, the exclusion would have been available only to United States citizens residing abroad who were engaged in selling tangible personal property produced in, and exported from, the United States.¹³

The Senate Finance Committee at first questioned the need for such a provision on the ground that expatriates who paid income tax to a foreign country were entitled to the foreign tax credit.¹⁴ The conference committee report, however, reveals that the Senate declined to follow the suggestion of the Finance Committee, and instead conceived of an even broader exclusion than that originally contemplated by the House.¹⁵ Although the House version was limited to salary and commis-

¹² H.R. REP. NO. 1, 69th Cong., 1st Sess. 7 (1926), *reprinted in* 1939-1 (Part 2) C.B. 315, 320.

¹³ [I]t is recommended . . . that there shall be excluded from gross income in the case of our citizens employed abroad in selling our merchandise amounts received as salary or commission for the sale for export of tangible personal property produced in the United States in respect of such sales made while they are actually employed outside the United States, if they are so employed for more than six months during a taxable year.

Id.

¹⁴ S. REP. NO. 52, 69th Cong., 1st Sess. 20-21 (1926), *reprinted in* 1939-1 (Part 2) C.B. 322, 348. The foreign tax credit then in existence as § 222 provided that

(a) The tax computed under Parts I and II of this title shall be credited with:
 (1) In the case of a citizen of the United States the amount of any income, war-profits and excess-profits taxes paid or accrued during the taxable year to any foreign country. . . .

Revenue Act of 1924, ch. 234, 43 Stat. 253, 279.

The Code also provided in § 214 an alternative deduction for foreign taxes paid:

(a) In computing net income there shall be allowed as deductions:

(3) Taxes paid or accrued within the taxable year except . . .
 (B) so much of the income, war-profits and excess-profits taxes, imposed by the authority of any foreign country . . . as is allowed as a credit under section 222.

Id., ch. 234, 43 Stat. at 269-70.

¹⁵ The House bill provides that there shall be excluded from gross income in cases of our citizens employed abroad in selling our merchandise amounts received as salary or commission for the sale for export of tangible personal property produced in the United States in respect of such sales made while actually employed outside the United States, if so employed for more than six months during the taxable year. The Senate amendment strikes out this pro-

sions received from the sale of merchandise abroad, the Senate version provided that a qualified individual would be able to exclude from gross income amounts derived and received from any business conducted without the United States. As finally enacted, the foreign earned income exclusion embodied the Senate proposals.¹⁶

This first chapter in the history of section 911 suggests two important points. First, Congress's primary purpose in enacting the exclusion was to provide incentives for increased foreign trade. Second, Congress did not consider the exclusion a redundant benefit despite the existence of the foreign tax credit. These factors suggest that Congress's concern went beyond saving Americans residing abroad from double taxation;¹⁷ the exclusion would have been redundant had double taxation been their sole concern.

The Senate Finance Committee proposed the repeal of the exclusion in 1932.¹⁸ The Committee renewed its earlier criticism that the exclusion was unnecessary, given the existence of the foreign tax

vision and substitutes one providing that there shall be excluded from gross income in the case of an individual citizen of the United States, a bona fide nonresident for more than six months during the taxable year, amounts derived and received from business conducted without the United States. The House recedes with an amendment which provides in the case of an individual citizen of the United States, a bona fide nonresident of the United States for more than six months during the year, there shall be excluded from gross income items of income received from sources without the United States which are classified as "earned income" under section 209.

H.R. REP. NO. 356, 69th Cong., 1st Sess. 33 (1926), *reprinted in* 1939-1 (Part 2) C.B. 361, 364.

¹⁶ Section 213(b)(14) of the Revenue Act of 1926, ch. 27, § 213(b)(14), 44 Stat. 9, 24-26, provided:

(b) The term "gross income" does not include the following items, which shall be exempt from taxation under this title:

. . . .

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

Section 209(a)(1) provided:

(1) The term "earned income" means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered.

Id. ch. 27, § 209(a)(1), 44 Stat. at 20.

¹⁷ Some commentators have offered additional rationales. *See supra* notes 10-11.

¹⁸ Four years earlier Congress had redesignated the foreign earned income exclusion as section 116(a), but otherwise left the section unchanged. Revenue Act of 1928, ch. 852, § 116(a), 45 Stat. 791, 823.

credit.¹⁹ The Committee also argued that the section exempted certain individuals from all taxes.²⁰

Senator Reed disagreed with the proposed repeal of the exclusion. He contended that the section served the interrelated functions of "help[ing] our foreign trade and [placing] all Americans who are working abroad in a position of equality with their competitors."²¹ This latter concern for equality referred to citizens from other countries working abroad who were not taxed by their native countries. Senator Reed recognized, however, that the exclusion had led to some unintended results:

[T]he [exclusion] had been stretched to the point of exempting an American naval officer or Army officer who was stationed . . . in [an] embassy . . . or in some foreign country American ambassadors and ministers and officers of the Foreign Service were getting clear out of the payment of any income tax by virtue of the same provision, which nobody in the world ever intended when the provision was first adopted. These people do not deserve the exemption, because they are not subject to the income taxation of the foreign countries in which they are stationed²²

As a way of "cur[ing] the wart [without] cutting off the whole leg," Senator Reed proposed a compromise amendment that would retain the exclusion, but would exempt from its coverage compensation paid by the United States or an agency thereof.²³ The amendment would "tax Americans who . . . are unfairly exempted now, like officers of our military service and our Diplomatic Service."²⁴ Senator Reed withdrew his amendment, however, in the face of substantial opposition, and the Senate voted to repeal the exclusion.²⁵

Although Senator Reed lost the battle in the Senate, his views ultimately prevailed. In conference committee the House proposed an amendment that restored the exclusion "except as to amounts paid by the United States or any agency thereof."²⁶ Congress incorporated the

¹⁹ S. REP. NO. 665, 72d Cong., 1st Sess. 31 (1932), *reprinted in* 1939-1 (Part 2) C.B. 496, 518.

²⁰ [A] considerable proportion of the individuals previously benefited by this subsection have been employees of the United States who, because of their status as such, were usually exempt from any foreign tax upon their compensation received from the United States; these citizens are not believed by your committee to be entitled to a complete exemption from the Federal income tax upon such compensation.

Id.

²¹ 75 CONG. REC. 10,410 (1932).

²² *Id.*

²³ *Id.*

²⁴ *Id.* at 10,411.

²⁵ *Id.* at 10,412.

²⁶ H.R. REP. NO. 1492, 72d Cong., 1st Sess. 15 (1932), *reprinted in* 1939-1 (Part 2) C.B. 539, 543.

exception into section 116(a) by the Revenue Act of 1932.²⁷

Although certain statements in the legislative history suggest that Congress was concerned solely with employees of the United States, the language of the exception reveals a much broader concern. In amending section 116(a), Congress did not limit the exception to employees of the United States. Congress instead meant to deny the benefits of the exclusion to *certain kinds* of workers. The Senate Finance Committee characterized them as "employees of the United States who, *because of their status as such*, were usually exempt from any foreign tax upon their compensation received from the United States."²⁸ Not all United States employees residing abroad are exempt from income tax by the country of their residence. Only certain kinds of employees, such as "officers of our military service and our Diplomatic Service"²⁹ receive this deferential treatment because of their *special status*.

This specific identification of a certain kind of worker, combined with Congress's purpose to provide an incentive to foreign trade, suggests that Congress meant to deny the exclusion to those individuals who did not need any incentive to work abroad.³⁰ For these individuals, foreign service was an integral part of their work. When Congress first conceived of this matter, these individuals tended to be employees of the United States. There is nothing in the employer-employee relationship, however, that suggests Congress meant to draw the line there. In identifying these individuals as those who received amounts paid by the United States or any agency thereof, Congress was unaware of the problems it had created for courts attempting to define when an amount comes within the exception to the foreign earned income exclusion.

²⁷ As amended by the Revenue Act of 1932, ch. 209, § 116(a), 47 Stat. 169, 204-05, § 116(a) provided:

In addition to the items specified in section 22(b), the following items shall not be included in gross income and shall be exempt from taxation under this title:

(a) EARNED INCOME FROM SOURCES WITHOUT UNITED STATES.—In the case of an individual citizen of the United States, a bona fide nonresident of the United States for more than six months during the taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection.

²⁸ S. REP. NO. 665, 72d Cong., 1st Sess. 31 (1932), *reprinted in* 1939-1 (Part 2) C.B. 496, 518 (emphasis added).

²⁹ 75 CONG. REC. 10,411 (1932).

³⁰ Although Congress's primary concern may appear to have been to prevent the complete avoidance of taxation, Congress has never based qualification for the exclusion on the payment of *some* foreign tax, despite its awareness of individuals who pay no tax by virtue of the exclusion. *See infra* notes 44-47 and accompanying text.

B. Revision and Reaffirmation: 1932-1951

After surviving the Senate challenge, section 116(a) enjoyed a decade of neglect.³¹ In 1942, however, the House Ways and Means Committee sought repeal of the exclusion. The Committee believed that repeal would increase revenues and remedy perceived discrimination in favor of individuals receiving compensation from nongovernmental sources.³² The Senate Finance Committee reversed its earlier position and defended the exclusion. The Committee recognized that taxpayers had abused the section by leaving the country for six months and continuing to receive compensation from foreign sources for the sole purpose of avoiding taxes, but believed that complete elimination of the exclusion was unwarranted.³³ The Senate Committee proposed to cure the abuse by permitting the exclusion only for taxpayers who could establish bona fide foreign residency for the entire taxable year.³⁴ The Conference Committee adopted the Senate's proposal,³⁵ and the Revenue Act of 1942 retained the exclusion in section 116(a)(1), which changed the residency requirement from six months to one year.³⁶

³¹ The Revenue Act of 1934, ch. 277, § 166(a) 48 Stat. 680, 712, kept § 116(a) intact but defined earned income by cross reference to § 25. This section retained the definition of earned income, which had previously appeared in § 116(a), and added language regarding the applicability of an earned income credit, which did not affect the applicability of the exclusion. Slowinski & Williams, *supra* note 9, at 358.

Both the Revenue Act of 1936, ch. 690, § 116(a), 49 Stat. 1648, 1689, and the Revenue Act of 1938, ch. 289, § 116(a), 52 Stat. 447, 498, left § 116(a) unchanged. The Internal Revenue Code of 1939, ch. 2, § 116(a), 53 Stat. 1, 48, codified § 116(a) as it appeared in the Revenue Act of 1934.

³² H.R. REP. NO. 2333, 77th Cong., 2d Sess. 50 (1942), *reprinted in* 1942-2 C.B. 372, 412.

³³ S. REP. NO. 1631, 77th Cong., 2d Sess. 57 (1942), *reprinted in* 1942-2 C.B. 504, 548-49.

³⁴ *Id.*

³⁵ H.R. REP. NO. 2586, 77th Cong., 2d Sess. 44 (1942), *reprinted in* 1942-2 C.B. 701, 708.

³⁶ The Revenue Act of 1942, ch. 619, § 148, 56 Stat. 798, 841-42, provided:

(a) EXCLUSION OF EARNED INCOME FROM FOREIGN SOURCES.—Section 116 (a) (relating to earned income from sources without the United States) is amended to read as follows:

“(a) EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.—

“(1) FOREIGN RESIDENT FOR ENTIRE TAXABLE YEAR.—

In the case of an individual citizen of the United States, who establishes to the satisfaction of the Commissioner that he is a bona fide resident of a foreign country or countries during the entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts would constitute earned income as defined in section 25 (a) if received from sources within the United States; but such individuals shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection.

Subsection (a)(2) was a new addition. It provided that a United States citizen who had been a resident of a foreign country for at least two years before the date on which he becomes a United States resident could exclude amounts received from sources without the

The Revenue Act of 1951³⁷ changed section 116(a) in two ways. First, in response to the growing sentiment in various sectors of American industry that section 116(a)(1) discriminated by denying a taxpayer the benefit of the exclusion in his first year abroad,³⁸ Congress made the exclusion applicable to an individual who was a "bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year."³⁹ Second, because the strict construction of the bona fide residence abroad requirement had, in many cases, resulted in the obstruction of one of the section's primary objectives, "encourag[ing] citizens to go abroad,"⁴⁰ Congress passed a new section 116(a)(2).⁴¹ Under this section, income earned abroad by a United States citizen present in a foreign country or countries for at least seventeen out of eighteen consecutive months is to be excluded from income.⁴²

United States (except amounts paid by the United States or any agency thereof) that were attributable "to that part of such period of foreign residence before such date." *Id.* at 842.

The Revenue Act of 1943, ch. 63, § 107(b), 58 Stat. 21, 32, left §§ 116(a)(1) and (a)(2) intact and added a new subsection (a)(3) which defined earned income. This amendment did not embody new tax policy, but merely incorporated the earned income definition in § 116, rather than defining it by cross reference.

³⁷ Pub. L. No. 82-183, 65 Stat. 452.

³⁸ Levine, *supra* note 9, at 171.

³⁹ Revenue Act of 1951, Pub. L. No. 82-183, § 321(a), 65 Stat. 452, 498.

⁴⁰ S. REP. NO. 781, 82d Cong., 1st Sess. 53 (1951), *reprinted in* 1951-2 C.B. 458, 495.

⁴¹ [T]he term "bona fide" residence abroad has been construed quite strictly. . . . Sometimes this has occurred because the nature of the individual's work is such as to make it difficult to establish a "residence" in the more widely accepted use of the term. On other occasions it has resulted from the fact that individuals have gone abroad only for a stated period of time. Examples of this are managers, technicians, and skilled workmen who are induced to go abroad for periods of 18 to 36 months to complete specific projects. Your committee believes . . . that it is particularly desirable to encourage men with technical knowledge to go abroad.

S. REP. NO. 781, 82d Cong., 1st Sess. 53 (1951), *reprinted in* 1951-2 C.B. 458, 495-96.

⁴² S. REP. NO. 781, 82d Cong., 1st Sess. 53 (1951), *reprinted in* 1951-2 C.B. 458, 496. Section 321(a) of the Revenue Act of 1951 provided:

(a) EXCLUSION FROM GROSS INCOME.—Section 116 (a) (relating to earned income from sources without the United States) is hereby amended by striking out paragraphs (1) and (2) and inserting in lieu thereof the following:

"(1) BONA FIDE RESIDENT OF FOREIGN COUNTRY.—In the case of an individual citizen of the United States, who 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, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in paragraph (3)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

"(2) PRESENCE IN FOREIGN COUNTRY FOR 17 MONTHS.—In the case of an individual citizen of the United States, who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts

C. Retrenchment: 1951-1976

The House Ways and Means Committee proposed the repeal of section 116(a)(2) just two years after its enactment. The Committee believed that the section had already been subject to significant abuse. First, the exclusion had induced some individuals with substantial incomes to go abroad to perform services typically performed at home in order to avoid taxation.⁴³ Second, many individuals to whom section 116(a)(2) applied paid no foreign income tax either because they were not in the foreign country long enough to establish residence, or because the foreign country imposed no income tax.⁴⁴

The Senate Finance Committee agreed that section 116(a)(2) had been abused. The Senate Committee rejected outright repeal, however, and proposed instead that an individual present in a foreign country for seventeen out of eighteen consecutive months be limited to a \$20,000 exclusion.⁴⁵ Congress enacted the Senate Finance Committee's proposal into law in 1953.⁴⁶ As in 1932, Congress was aware that the exclusion enabled some individuals to avoid both foreign and domestic income tax; significantly, it did not make the exclusion turn on the payment of *some* foreign tax.⁴⁷

The exclusion remained unchanged for eight years after the codification of sections 116(a)(1) and (2) as sections 911(a)(1) and (2) of the Internal Revenue Code of 1954.⁴⁸ In 1962, Congress limited the amount

received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in paragraph (3)) attributable to such period; but such individual

shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this paragraph."

Pub. L. No. 82-183, § 321(a), 65 Stat. 452, 498.

⁴³ H.R. REP. NO. 894, 83d Cong., 1st Sess. 4-5 (1953), *reprinted in* 1953-2 C.B. 508, 511.

⁴⁴ *Id.*

⁴⁵ S. REP. NO. 685, 83d Cong., 1st Sess. 5 (1953), *reprinted in* 1953-2 C.B. 526, 529.

⁴⁶ The Technical Changes Act of 1953, Pub. L. No. 83-287, § 204, 67 Stat. 615, 618.

⁴⁷ The Technical Changes Act of 1953, Pub. L. No. 83-287, 67 Stat. 615, also provided that if the 18 month period did not include the entire taxable year, the taxpayer must prorate the amount of exclusion. *Id.*

⁴⁸ As enacted in 1954, § 911 provided:

(a) GENERAL RULE.—The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) BONA FIDE RESIDENT OF FOREIGN COUNTRY.—In the case of an individual citizen of the United States, who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemp-

that could be excluded under section 911(a)(1). Congress set a ceiling of \$20,000 a year for the first three years in which a taxpayer was a bona fide resident of a foreign country, and \$35,000 a year for each year thereafter.⁴⁹ Congress again reduced the amount of the exclusion two years later. Although it retained the \$20,000 ceiling for the first three years abroad, Congress reduced the limit for later years from \$35,000 to \$25,000.⁵⁰ Section 911 then remained unchanged until 1976.

D. Recent Developments: 1976-1983

The Tax Reform Act of 1976 made major changes in the treatment of foreign earned income. In the early stages of this legislation, the House Ways and Means Committee recommended phasing out section 911 for two reasons that echoed the position of the Senate Finance Committee in 1932.⁵¹ First, the exclusion enabled some citizens who paid no

tions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) PRESENCE IN FOREIGN COUNTRY FOR 17 MONTHS.—In the case of an individual citizen of the United States, who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph. If the 18-month period includes the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed \$20,000. If the 18-month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to \$20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year.

Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 3, 289.

The definition of earned income became § 911(b). The change favored a taxpayer engaged in a foreign trade or business in which both capital and personal services were income producing. Slowinski & Williams, *supra* note 9, at 359-60.

The Technical Amendments Act of 1958, Pub. L. No. 85-866, § 72, 72 Stat. 1606, 1660, contained an amendment to § 6012 which provided that in determining whether an individual has to file a return, gross income shall be computed without regard to the § 911 exclusion. Until this amendment, no return was required for an individual to exclude income under § 911. Hooton, *supra* note 9, at 173.

In 1961, the Kennedy administration recommended that individuals living in developed countries be denied the exclusion. H.R. DOC. NO. 140, 87th Cong., 1st Sess. 8, *reprinted in* 1961 U.S. CODE CONG. & AD. NEWS 1129, 1134. Although Congress rejected the proposal, *see* H.R. REP. NO. 1447, 2d Sess. 54 (1962), *reprinted in* 1962-3 C.B. 405, 458, the distinction between taxpayers residing in developed and underdeveloped countries became central to changes made in § 911 by the Foreign Earned Income Act of 1978. *See infra* notes 59-68 and accompanying text.

⁴⁹ Revenue Act of 1962, Pub. L. No. 87-834, § 11, 76 Stat. 960, 1004.

⁵⁰ Revenue Act of 1964, Pub. L. No. 88-272, § 237, 78 Stat. 19, 128.

⁵¹ *See supra* notes 19-20 and accompanying text.

foreign income tax to avoid United States income tax.⁵² Second, those who paid foreign income tax received a double benefit when the foreign tax credit was coupled with the exclusion.⁵³

The Senate Finance Committee recognized that section 911 had brought about certain "unintended results," yet argued for retention of the exclusion "so that the competitive position of U.S. firms abroad is not jeopardized."⁵⁴ The Committee proposed two major changes.

First, it recommended that an individual qualifying for the exclusion be denied the foreign tax credit with respect to foreign taxes allocable to amounts excluded from gross income.⁵⁵ Second, it proposed taking the amount of the exclusion "off the bottom" of gross income, leaving the remaining portion to be taxed at the marginal rate that would have applied without the exclusion.⁵⁶ The Conference Committee adopted the Senate proposals, and in addition, reduced the amount of the exclusion for most taxpayers from \$20,000 to \$15,000.⁵⁷ Several

⁵² H.R. REP. NO. 658, 94th Cong., 1st Sess. 200 (1975), *reprinted in* 1976-3 (Vol. 2) C.B. 695, 892.

⁵³ *Id.*

⁵⁴ S. REP. NO. 938, Part 1, 94th Cong., 2d Sess. 210 (1976), *reprinted in* 1976-3 (Vol. 3) C.B. 49, 248.

⁵⁵ *Id.* at 211, *reprinted in* 1976-3 (Vol. 3) C.B. at 249.

⁵⁶ "[A]ny additional income derived by individuals beyond the income eligible for the earned income exclusion is subject to U.S. tax at the higher rate brackets which would apply if the excluded earned income were not so excluded." *Id.*

Congress enacted the Tax Reform Act on October 4, 1976, and provided that § 911 and related sections applied retroactively to taxable years beginning after December 31, 1975. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(d), 90 Stat. 1520, 1611. Following enactment, Congress was beset with a tremendous outpouring of protest from United States citizens employed overseas concerning the timing and substance of the 1976 changes. Maiers, *supra* note 1, at 700. In response, Congress postponed the effective date of the changes to taxable years beginning after December 31, 1976. Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 302, 91 Stat. 126, 152.

In 1977, the Treasury discovered through a study of 1975 tax returns filed by overseas taxpayers that the Tax Reform Act changes were likely to have a greater impact than expected. Maiers, *supra* note 1, at 700-01. By the end of 1978, the effective date of the Tax Reform Act changes was postponed a second time, to taxable years beginning after December 31, 1977. Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, § 4(a), 92 Stat. 3097 (1978).

The Tax Reform Act amendments never went into general effect, because the Foreign Earned Income Act of 1978, *see infra* notes 60-68, replaced the exclusion with a deduction for the excess costs of working abroad, for taxable years beginning after December 31, 1977. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 41 (Comm. Print 1981). For any taxable year beginning after December 31, 1977, taxpayers could elect to be taxed either under the 1976 provisions or under the 1978 Act. Tax Treatment and Extension Act of 1977, Pub. L. No. 95-615, § 209(c), 92 Stat. 3097, 3109 (1978).

⁵⁷ H.R. REP. NO. 1515, 94th Cong., 2d Sess. 454 (1976). The exclusion remained at \$20,000 for employees of United States charitable organizations.

Congress also provided that an individual could make an irrevocable election not to have the benefits of § 911 apply. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(b), 90 Stat. 1520, 1611. Because foreign income taxes allocable to excluded foreign earned income were no longer creditable against the American income tax, it generally would be advantageous for

commentators believed that the Tax Reform Act changes fell only one step short of outright repeal of the exclusion.⁵⁸

The tremendous opposition by overseas employers and employees to the Tax Reform Act led to a drastic modification of the 1976 amendments⁵⁹ in the Foreign Earned Income Act of 1978.⁶⁰ The House Ways and Means Committee favored repeal of the Tax Reform Act changes,⁶¹ but proposed that the exclusion be available only to citizens not residing in Canada or Western Europe. The Committee argued that the exclusion was necessary

in order to compensate fully U.S. employees working abroad in areas other than Canada and Western Europe for the hardships they must endure and to encourage U.S. citizens to accept employment in those areas. The presence of U.S. citizens working abroad encourages the purchase of U.S., instead of foreign, goods and services, and, therefore, the incentive provided by this bill will produce substantial benefits for the U.S. economy.⁶²

The Committee also proposed deductions for excess foreign living costs such as housing and schooling⁶³ for Americans residing in countries other than Canada and those in Western Europe.

The Senate Finance Committee recognized that special consideration should be given to United States citizens working abroad, but argued that relief based on a flat exclusion was arbitrary and unfair, and that equitable relief would be more closely related to the actual increased expenses of working abroad.⁶⁴ In response to this problem, the Senate proposed to replace the flat exclusion with deductions for the increased cost of living abroad similar to those proposed by the House.⁶⁵ Under the Senate Finance Committee proposal, however, the deductions would also extend to Americans residing in Canada and Western Europe.⁶⁶

Congress ultimately adopted radical changes in the treatment of

an individual working in a country with a high tax rate to elect out of § 911. *See, e.g.*, Hooton, *supra* note 9, at 528.

⁵⁸ *See* Hooton, *supra* note 9, at 531; Levine, *supra* note 9, at 174; Maiers, *supra* note 1, at 697.

⁵⁹ *See* Postlewaite & Stern, *supra* note 8, at 1101.

⁶⁰ The Foreign Earned Income Act of 1978 was enacted as §§ 201-210 of the Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, 92 Stat. 3097 (1978). For extensive discussion of this act, see P. POSTLEWAITE & M. COLLINS, *supra* note 1, at 114-46; Maiers, *supra* note 1; Postlewaite & Stern, *supra* note 8; Note, *Taxation of Americans Living Abroad*, *supra* note 8, at 79.

⁶¹ H.R. REP. NO. 1463, 95th Cong., 2d Sess. 7 (1978).

⁶² *Id.*

⁶³ *Id.* at 10-15.

⁶⁴ S. REP. NO. 746, 95th Cong., 2d Sess. 7 (1978), *reprinted in* 1978-2 C.B. 422, 425.

⁶⁵ *Id.* at 8-11, *reprinted in* 1978-2 C.B. at 126-28.

⁶⁶ Generally, those who previously had qualified for the foreign income exclusion were eligible for the excess cost of living deductions. *Id.* at 8 (1978), *reprinted in* 1978-2 C.B. at 426.

foreign earned income. The deductions proposed by the House and the Senate were codified as section 913.⁶⁷ A revised section 911 provided a \$20,000 exclusion to residents of "a camp located in a hardship area."⁶⁸

The Foreign Earned Income Act attempted to provide a better "fit" between the expenses of working abroad and the tax benefits necessary to offset those additional expenses. This represented a shift away from the pure incentive aspect of section 911. The Act thus constituted the most dramatic event in the treatment of foreign earned income since the enactment of the exclusion in 1926. Its reign, however, was short lived. The Economic Recovery Tax Act of 1981⁶⁹ changed the rules once more, and restored the exclusion to its most favorable position since 1962.

In consideration of this legislation, the House Ways and Means Committee extensively reexamined the purposes of the exclusion.⁷⁰ It concluded that accomplishment of those purposes required significant modification in the treatment of foreign earned income.⁷¹ Fifty years

⁶⁷ Foreign Earned Income Act of 1978, Pub. L. No. 95-615, § 203, 92 Stat. 3097, 3100-06.

⁶⁸ The provisions for determining what constituted a "camp" and a "hardship area" were set forth in §§ 911(c)(1)(B) and 913(h)(2), respectively.

I.R.C. § 911(c)(1)(B) (Supp. V 1981) provided:

For purposes of this section, an individual shall not be considered to reside in a camp because of his employment unless the camp constitutes substandard lodging which is—

- (i) provided by or on behalf of the employer for the convenience of the employer because the place at which such individual renders services is in a remote area where satisfactory housing is not available on the open market,
- (ii) located, as near as practicable, in the vicinity of the place at which such individual renders services, and
- (iii) furnished in a common area (or enclave) which is not available to the public and which normally accommodates 10 or more employees.

I.R.C. § 913(h)(2) (Supp. V 1981) provided:

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

- (A) is provided under section 5925 of title 5, United States Code, or
- (B) would be so provided if officers and employees of the Government of the United States were present at that place.

⁶⁹ Pub. L. No. 97-34, 95 Stat. 172 (1981).

⁷⁰ H.R. REP. NO. 201, 97th Cong., 1st Sess. 59-60 (1981), *reprinted in* 1981-2 C.B. 352, 354.

⁷¹ The committee believes that it is necessary to change the tax law to encourage Americans to work abroad to help promote the export of U.S. manufactured goods and services. Reducing the tax burden on Americans working abroad will make American enterprises more competitive in foreign markets. The committee feels that a broad range of activities by Americans abroad benefit [sic] the U.S. economy and should be encouraged.

The committee concludes that an appropriate incentive, to replace the present excess foreign [sic] living cost deduction and exclusion, is to allow

after the enactment of the foreign earned income exclusion, Congress remained committed to the ideal of encouraging Americans to work abroad. As finally enacted, the exclusion was limited to \$75,000 for taxable years beginning in 1982, and increased each year in \$5,000 increments, until reaching a maximum of \$95,000 for taxable years beginning with 1986.⁷²

The Economic Recovery Tax Act of 1981 also made a change in the language of the exception for amounts paid by the United States. Since 1932, all versions of section 911 had contained an exception to the exclusion for "amounts paid by the United States or any agency thereof."⁷³ The 1981 Act amended the provision to except amounts "paid by the United States or an agency thereof to an employee of the United States or an agency thereof."⁷⁴

E. Conclusion

Certain principles emerge from this legislative history. First, with the exception of modifications made under the Foreign Earned Income Act of 1978, the exclusion's primary purpose was to provide Americans with an incentive to work abroad. Second, Congress was selective in deciding who would benefit from the exclusion, and withheld that benefit from individuals who needed no incentive to work abroad—the group which it characterized as individuals who were paid by the United States. Third, despite the availability of the foreign tax credit, Congress has never viewed the exclusion as a redundant benefit, thus underscoring the incentive aspect of section 911. Finally, although Congress has frequently recognized that section 911 may permit individuals to escape both foreign and domestic income tax, Congress has never proposed that eligibility for the exclusion be dependent upon the payment of some tax. These general principles should guide courts attempting to define the limits of the foreign earned income exclusion, and to determine when an amount has been paid by the United States or its agency.

qualifying Americans to elect a substantial exclusion from U.S. tax for their foreign earned income.

Id. at 60, reprinted in 1981-2 C.B. at 354.

⁷² Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 111(a), 95 Stat. 172, 190.

⁷³ See *supra* note 27.

⁷⁴ Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 111(a), 95 Stat. 172, 190.

Judge Forrester, dissenting in *Smith v. Commissioner*, 77 T.C. 1181, 1189 (1981), *aff'd*, 701 F.2d 807 (9th Cir. 1983), argued that the change helps to interpret the meaning of the pre-1981 ERTA exception. Properly viewed, the change is irrelevant to the question considered in this Note. See *infra* note 112 and accompanying text.

II

JUDICIAL ATTEMPTS TO DETERMINE WHEN AN AMOUNT
HAS BEEN PAID BY THE UNITED STATES

Courts determining when an amount has been paid by the United States within the meaning of the exception to the foreign earned income exclusion follow two distinct approaches. Courts following the source approach focus on the source of the funds from which the taxpayer has been paid. Courts following the obligation approach rely on factors such as which entity has the ultimate legal obligation to pay the taxpayer and the existence of an employer-employee relationship.

A. The Source Approach

The source approach was first applied in *Krichbaum v. United States*.⁷⁵ The taxpayer in *Krichbaum* was employed by the Bureau of Public Roads of the Department of Commerce, and from 1951 to 1953, worked for the Bureau on a road-building project in Ethiopia. To finance the project, the government of Ethiopia borrowed several million dollars from the International Bank. The Imperial Highway Authority of Ethiopia established a salary fund with some of the proceeds of this loan and transferred portions of this fund to the United States government, which paid Bureau employees working on the project.⁷⁶

The taxpayer argued that his salary had been paid by the government of Ethiopia, and thus was excludable from gross income under the foreign earned income exclusion. The government contended that because the Bureau of Public Roads—an agency of the United States—had paid the taxpayer's salary, the exception to the exclusion applied. The court held that the taxpayer was eligible for the exclusion because Ethiopia was the source of the payment.⁷⁷

⁷⁵ 138 F. Supp. 515 (E.D. Tenn. 1956).

⁷⁶ The American Embassy in Ethiopia issued Note No. 103, which contained the terms of the agreement between the governments of Ethiopia and the United States:

The obligation to pay the salaries of the personnel so provided and assigned by the Bureau and of post differential, post allowances, quarters allowances, and separation allowances . . . shall be assumed by the Authority [Ethiopia] subject to the manner and currency of payment hereinafter provided.

It is agreed that the Authority will authorize the Bank to provide within the Bureau a working fund in an amount to be mutually determined by them from which these and all other proper obligations for the account of the Authority can be paid by the Bureau.

138 F. Supp. at 518.

⁷⁷ The court noted that "[a]lthough a device was created by the Ethiopian government whereby the Bureau of Public Roads of the American government handled the salary fund, payment, nevertheless, was with Ethiopia's money." *Id.* The court likened the Bureau of Public Roads to the paymaster, and Ethiopia to the payer. *Id.* at 525.

Although the court's analysis is grounded firmly in the source approach, it does at one point use the language of obligation: "Payment in a legal sense relates to a debt or an obliga-

Other courts have adopted the source approach. For example, in *Teskey v. Commissioner*,⁷⁸ the taxpayer was a seaman in the Merchant Marine Service of the United States. The ship on which the taxpayer served was owned by the United States, but was operated by a private company as its agent. The ship was used in the shuttle service between ports in Japan and Korea during the Korean War.

The Tax Court found that the United States provided the funds from which the taxpayer had been paid.⁷⁹ In deciding for the Service, the court relied on a prior Revenue Ruling,⁸⁰ which held that "wages paid by a private shipping line as a general agent of the United States, from funds provided for that purpose by the United States . . . are not excludable from gross income."⁸¹

The Ninth Circuit adopted the source approach in an opinion that raises a number of questions concerning its interplay with the obligation approach. In *Erlandson v. Commissioner*,⁸² on facts identical to those in *Teskey*, the Ninth Circuit held that the exception to the foreign earned income exclusion applied because the United States was the source of the funds from which the taxpayer had been paid.⁸³ Although the court expressly rejected the obligation approach,⁸⁴ it stated in dictum that if

tion of the party who pays. Payment may be made by the debtor or by another in his behalf. If it is paid by another, but with the debtor's money, it is payment by the debtor." *Id.* The district court did not use the word "obligation" in the same sense as later used by other courts. *See, e.g., Commissioner v. Wolfe*, 361 F.2d 62, 65 (D.C. Cir.), *cert. denied*, 385 U.S. 838 (1966); *Smith v. Commissioner*, 77 T.C. 1181, 1186 (1981), *aff'd*, 701 F.2d 807 (9th Cir. 1983). The *Krichbaum* court was concerned with a moral obligation that accrues to the party who has benefited from some performance; more recently courts have used the term to indicate which party has the ultimate legal responsibility to pay. Given the dichotomy that later developed, the *Krichbaum* court's choice of language was unfortunate; despite that language, however, the court applied the source approach. *But see Johnson v. United States*, 6 FED. TAXES (P-H) ¶ 58,035 (Ct. Cl. 1967) (stating that *Krichbaum* is consistent with the obligation approach).

⁷⁸ 30 T.C. 456 (1958).

⁷⁹ *Id.* at 458.

⁸⁰ Rev. Rul. 58-4, 1958-1 C.B. 268.

⁸¹ *Id.* at 270 (emphasis added) (quoted in *Teskey*, 30 T.C. at 460-61 (emphasis added)).

The taxpayer in *Teskey* raised the issue of the employer-employee relationship, contending that because he was not a government employee, his salary was not paid by the United States. 30 T.C. at 461. The court responded that whether or not the taxpayer was an employee of the government, "[t]he crucial question is, was the payment made by the United States or any agency thereof." *Id.* The court cited *Suerdrup v. Commissioner*, 14 T.C. 859 (1950), which involved a partnership distribution, where the court held that an amount was "paid by the United States" even though the taxpayer was not a government employee. In *Suerdrup*, the court stated: "[i]t is significant that the words actually adopted in the amendment were broad. Neither the word 'employees' nor the word 'compensation' was used. Instead, the amendment as passed reads: 'except amounts paid by the United States or any agency thereof.'" 14 T.C. at 866 (emphasis in original).

⁸² 277 F.2d 70 (9th Cir. 1960), *aff'g*, 27 T.C.M. (P-H) ¶ 58,218 (1958).

⁸³ *Id.* at 72.

⁸⁴ [The Agent] was but a conduit for the payment of such wages by the United States to the taxpayer. Speculation as to where [the taxpayer] could have looked for relief if the payments had not been made is not helpful. The question is who paid the wages, not who would be liable if they were not paid.

the taxpayer had been an employee of the United States, "the conclusion necessarily follows that his wages were paid by the United States or an agency thereof";⁸⁵ a statement that opposes, at least to some extent, the court's disavowal of the obligation approach. The court held, however, that it was unnecessary for the Commissioner to demonstrate that the taxpayer was a government employee, because the Service had successfully shown that the taxpayer was paid by the United States.⁸⁶

The *Erlandson* court apparently believed that the existence of an employer-employee relationship is fatal to the claim of the government employee who asserts that he was not paid by the United States. The absence of such a relationship, however, does not mean that the taxpayer who was not such an employee will prevail; if the taxpayer is paid by the United States, he is not entitled to the exclusion. The court failed to explain why the existence of an employer-employee relationship is fatal in the first case but not determinative in the second: If all government employees are necessarily paid by their employer, why are not all nongovernment employees necessarily paid by *their* employer?⁸⁷ If there is something logically determinative about the employer-employee relationship in the first case, why is it not determinative in the second as well?

*Wolfe v. Commissioner*⁸⁸ presented substantially the same facts as *Krichbaum*. The taxpayer was an employee of the Bureau of Public Roads working on a road construction project in Iran. To finance the project, the Iranian government had borrowed from the Export-Import Bank of Washington. The credit agreement conditioned the loan upon arrangements satisfactory to the Bank under which the Bureau of Public Roads would provide American engineers and technicians to do the work. The credit agreement further specified that the Bureau and the Iranian government should arrange to account for the "loan of Bureau employees." Pursuant to this requirement, the Iranian government established a "Dollar Working Fund" from which the Bureau employees were paid.⁸⁹

Id. at 73. *But see* *Smith v. Commissioner*, 701 F.2d 807 (9th Cir. 1983) (adopting obligation approach); *see also infra* notes 113-16 and accompanying text.

⁸⁵ *Erlandson*, 277 F.2d at 72.

⁸⁶ *Id.*

⁸⁷ Advocates of both the source approach and the obligation approach have cited *Erlandson* with approval without attempting to resolve this logical inconsistency. *See Commissioner v. Mooneyhan*, 404 F.2d 522, 526 (6th Cir. 1968), *cert. denied*, 394 U.S. 1001 (1969); *United States v. Johnson*, 386 F.2d 824, 825 (5th Cir. 1967); *Smith v. Commissioner*, 77 T.C. 1181, 1186 (1981), *aff'd*, 701 F.2d 807 (9th Cir. 1983); *Mooneyhan v. Commissioner*, 47 T.C. 693, 703 (1967); *Wolfe v. Commissioner*, 43 T.C. 572, 578 (1965).

⁸⁸ 43 T.C. 572 (1965), *rev'd*, 361 F.2d 62 (D.C. Cir. 1966).

⁸⁹ 43 T.C. at 575. The agreement between the Iranian government and the Bureau provided:

The government argued that the appropriate interpretation of the "paid by" exception focuses on the question of which party had the primary legal obligation to pay the debt.⁹⁰ It also argued that the purpose of the exclusion was to eliminate the possibility of double taxation, and that because that possibility did not exist here, the exclusion should not apply.⁹¹ In finding for the taxpayer, the Tax Court held that the obligation approach was not the appropriate test.⁹²

B. The Obligation Approach

The obligation approach focuses on the employer-employee relationship to determine which party has the ultimate legal obligation to pay the taxpayer. The District of Columbia Circuit applied this approach in reversing the Tax Court's decision in *Wolfe*.⁹³ The court stated that the exception to the foreign earned income exclusion applies broadly to taxpayers who are employees of the United States govern-

V. COMPENSATION OF PERSONNEL ASSIGNED TO IRAN

The compensation of all personnel of the Bureau assigned to Iran from the date of assignment to the date of separation from the program will be paid or reimbursed out of the Dollar Working Fund to be established by your Government [Iran] as provided in Paragraph VII.

VII. DOLLAR WORKING FUND

To carry out the conditions of the \$5,000,000 loan from the Export-Import Bank signed on December 7, 1956 your Ministry [Iran] will establish a Dollar Working Fund in the maximum amount of \$500,000 with the Bureau to be at the disposal of the Bureau for the payments as set out in this Agreement.

The Dollar Working Fund shall be established in the amount of \$200,000 and shall be replenished by your Government [Iran] from time to time upon the request of the Bureau accompanied by an itemized statement signed by an authorized representative of the Bureau setting forth all expenditures made therefrom which have not been reported in any previous itemized statement. . . .

[Each] replenishment of the Dollar Working Fund by your Government shall be in an amount equal to the total of the expenditures set out in the itemized statement accompanying the request for replenishment.

Id.

⁹⁰ *Id.* at 577.

⁹¹ *Id.*

⁹² The Tax Court equated the obligation approach with the existence of an employer-employee relationship:

We are unable to agree with respondent's contention that the 'primary legal obligation' test will lead to a correct solution of our problem. Whether petitioner was an employee of the United States or of the Empire of Iran is immaterial. See *Erlandson v. Commissioner*, 277 F.2d 70, 72, affirming a Memorandum Opinion of this Court. *Id.* at 578 (other citations omitted).

The Tax Court concluded that

[i]f [the amounts] were paid by the United States they would be includable in petitioner's gross income . . . even though petitioner was not an employee of the United States. Conversely it would follow that if they were not paid by the United States or an agency thereof they would not be includable in petitioner's gross income even though petitioner was an employee of the United States.

Id.

⁹³ *Commissioner v. Wolfe*, 361 F.2d 62 (D.C. Cir. 1966).

ment. The court based its holding on three factors. First, the taxpayer was an employee of the United States.⁹⁴ Second, “[t]he United States had the primary and indeed sole obligation to pay taxpayer’s salary, and his rights were only against the United States.”⁹⁵ Third, a United States agency actually executed and delivered the salary checks to the taxpayer.⁹⁶ The court also pointed to the legislative history of the exception—specifically the 1932 report of the Senate Finance Committee and the remarks of Senator Reed on the floor of the Senate⁹⁷—and concluded that, as a government employee, the taxpayer came within the class to which the exception applied.⁹⁸

The Fifth and Sixth Circuits have also adopted the obligation approach. In *United States v. Johnson*,⁹⁹ on facts identical to those in *Wolfe*, the Fifth Circuit adopted the reasoning of the District of Columbia Circuit¹⁰⁰ and, pointing to the dictum from the Ninth Circuit’s opinion in *Erlandson v. Commissioner*,¹⁰¹ stated that “when one is ‘an employee of the United States, the conclusion necessarily follows that his wages were paid by the United States or an agency thereof.’”¹⁰²

In *Mooneyhan v. Commissioner*,¹⁰³ the Tax Court was presented with the same facts as in *Wolfe*. The court found for the taxpayer, endorsing its prior holding in *Wolfe*, and declining to follow the approach adopted by the District of Columbia Circuit. On appeal, the Sixth Circuit reversed the Tax Court.¹⁰⁴ In joining the other courts of appeals which had rejected the source approach, the Sixth Circuit pointed to the *Er-*

⁹⁴ *Id.* at 64.

⁹⁵ *Id.* at 65.

⁹⁶ *Id.*

⁹⁷ See *supra* notes 19-25 and accompanying text.

⁹⁸ 361 F.2d at 67.

Judge Fahy argued in dissent that the statute looked to the source of the funds, not to the employer-employee relationship. *Id.* at 68. He also quarreled with the majority’s interpretation of the legislative history of the exception:

When the exception “(except amounts paid by the United States or any agency thereof)” was added by the 72d Congress the legislators were focusing on those who were in the service of the United States and were abroad as a regular and ordinary incident of that service, namely, military and diplomatic personnel, not the volunteer who must be induced to go abroad.

Id. at 69.

⁹⁹ 386 F.2d 824 (5th Cir. 1967).

¹⁰⁰ *Id.* at 825.

¹⁰¹ 277 F.2d 70, 72 (9th Cir. 1960).

¹⁰² 386 F.2d at 825. The Fifth Circuit also noted the contradiction between this language and the Tax Court’s reliance on *Erlandson* to support the source approach. *Id.* The district court had found for the taxpayer on the authority of the Tax Court’s decision in *Wolfe*. 66-2 U.S. Tax Cas. (CCH) ¶ 9575, at 86,857 (M.D. Ala. 1966). The district court, however, rendered its decision before the District of Columbia Circuit reversed the Tax Court in *Wolfe*.

¹⁰³ 47 T.C. 693 (1967), *rev’d*, 404 F.2d 522 (6th Cir. 1968), *cert. denied*, 394 U.S. 1001 (1969).

¹⁰⁴ *Commissioner v. Mooneyhan*, 404 F.2d 522 (6th Cir. 1968), *cert. denied*, 394 U.S. 1001 (1969).

landson dictum regarding the employer-employee relationship.¹⁰⁵

The Tax Court, which had previously followed the source approach, adopted the obligation approach in *Smith v. Commissioner*.¹⁰⁶ The taxpayer in *Smith* was employed by the United States Customs Service at a customs preclearance station. Airlines frequently requested the services of customs inspectors during their off-duty hours to process passengers and baggage. The government required, before an airline's request would be granted, that the airline deposit money or post a bond to ensure payment for the services rendered.¹⁰⁷

The taxpayer claimed that because the airlines were the source of his overtime compensation, the compensation was excludable from gross income. In holding that the "paid by" exception applied, the Tax Court stated that it would no longer follow the source approach exemplified by its earlier decisions in *Wolfe* and *Mooneyhan*.¹⁰⁸ The court did not explicitly adopt the conclusion of the courts of appeals regarding the employer-employee relationship: "While it is true that the application of section 911(a) does not necessarily turn on an employer/employee relationship, it is also true that when there *is* such a relationship, one's salary usually comes from one's employer and the existence of such a relationship is a significant factor."¹⁰⁹ Despite this language, the existence of such a relationship was, in fact, conclusive. The court noted that "the U.S. Customs Service had the 'primary and sole obligation to pay'

¹⁰⁵ The Sixth Circuit held that

whenever an employee of the United States receives his wages from his employer—whether this be "the United States . . . or an [sic] agency thereof"—the exclusion and the exception to it are to be read together so that the source of the funds becomes immaterial to the question of who paid them.

404 F.2d at 526. The Sixth Circuit, however, misread the *Erlanson* dictum regarding the employer-employee relationship when it stated that "[t]he [Ninth Circuit] determined that [the taxpayer] was an employee of the United States . . ." *Id.* The Ninth Circuit never reached the question of the taxpayer's employment in *Erlanson*. See *supra* text accompanying note 86.

Despite its rigid reliance on the employer-employee relationship, the Sixth Circuit is virtually the only court to consider the position of the American worker in a foreign country and attempt to relate Congress's purpose in enacting the exclusion to that position:

United States employees do not become while working overseas employees of foreign countries competing as such with other employees of those countries for identical wages; nor do they travel abroad with that purpose in mind. To be entitled to the exclusion, there must be a direct relationship between the individual claiming it and his foreign employer; the absence of such a relationship defeats the claim. As we read its legislative history, the exception to the exclusion logically denies to employees of the United States a tax benefit that was enacted by Congress to help American citizens become foreign employees.

404 F.2d at 526.

¹⁰⁶ 77 T.C. 1181 (1981).

¹⁰⁷ This requirement is imposed by statute. See 19 U.S.C. § 1451 (1976).

¹⁰⁸ 77 T.C. at 1187.

¹⁰⁹ *Id.* at 1186 (citations omitted) (emphasis in original).

[the taxpayer]."¹¹⁰ Moreover, the court stated that when it had looked through a third-party payor to see the United States as the true source of the funds, as it did in *Teskey* and in *Erlandson*, the third party had been a disbursing agent of the United States.¹¹¹ The court, however, never explained why the same reasoning did not apply in *Smith*; it is easy to conceive of the airlines as the true source of the funds, and the government as the disbursing agent of the airlines. The court presumably felt that this reasoning did not apply because of the existence of an employer-employee relationship.¹¹²

On appeal, the Ninth Circuit affirmed the decision of the Tax Court.¹¹³ In so doing, the *Erlandson* dictum¹¹⁴ became holding,¹¹⁵ and the court effectively adopted the obligation approach.¹¹⁶

¹¹⁰ *Id.* at 1186 n.5.

¹¹¹ *Id.* at 1186.

¹¹² The dissent in *Smith* argued for the application of the source approach. In contending that the existence of an employer-employee relationship was irrelevant, the dissent pointed to the change in the language of the exception made by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 111(a), 95 Stat. 172, 190 (1981). Although the new Act did not apply in *Smith*, the dissent argued that the amendment helped to interpret the applicable statute:

The fact that there is to be a dual requirement of "paid by" and "employed by" as the condition for denial of the earned income exclusion clearly indicates that the current section 911(a)(2) exception for amounts "paid by" does not consider relevant the identity of one's employer as the United States.

77 T.C. at 1191 (Forrester, J., dissenting) (footnote omitted). Although the language of the new exception suggests that one can be an employee of the United States without necessarily being paid by the United States, the legislative history of the amendment to the exception suggests that the change casts no light on the problem. As the House Ways and Means Committee explained:

The bill extends the benefits of the exclusion to individuals who are paid by the United States but who are not eligible for any exclusion under section 912 or any other provision of U.S. law. *As a general rule*, therefore, employees of the Federal government will not be eligible for the exclusion.

H.R. REP. NO. 201, 97th Cong., 1st Sess. 62 (1981), *reprinted in* 1981-2 C.B. 352, 355 (emphasis added). Section 912 provides that certain allowances received by civilian officers and employees of the government are exempt from taxation. I.R.C. § 912 (Supp. V 1981). The amendment, therefore, was probably intended to enable nonemployees of the government who could not qualify under § 912 to exclude allowances under § 911, even though such amounts were paid by the United States. However, in support of the dissent's position, it should be noted that the House committee at least considered the possibility that government employees could be eligible for the exclusion. *See supra* H.R. REP. NO. 201, 97th Cong., 1st Sess. 62 (1981).

¹¹³ *Smith v. Commissioner*, 701 F.2d 807 (9th Cir. 1983).

¹¹⁴ *See supra* notes 84-87 and accompanying text.

¹¹⁵ The court rejected the argument that its prior holding in *Erlandson v. Commissioner*, 277 F.2d 70 (9th Cir. 1960), required a decision favorable to the taxpayer: "Although we focused [in *Erlandson*] on the source of the funds, we said that if a taxpayer is a United States employee, 'the conclusion necessarily follows that his wages were paid by the United States or an agency thereof.'" *Smith v. Commissioner*, 701 F.2d 807, 809 (9th Cir. 1983) (quoting *Erlandson v. Commissioner*, 277 F.2d 70, 72 (9th Cir. 1960)).

¹¹⁶ The court placed ultimate reliance on the fact that the United States government, rather than the individual customs inspector, bore the ultimate risk of nonpayment by the airlines. *Smith*, 701 F.2d at 808. It is instructive to contrast this with the court's earlier state-

III

A SUGGESTED APPROACH TO THE "PAID BY" EXCEPTION:
A FACTUAL INQUIRY INTO THE CIRCUMSTANCES
OF THE WORKER

Courts attempting to determine when an amount has been paid by the United States within the meaning of the exception to the foreign earned income exclusion have followed two different approaches. The Fifth, Sixth, and D.C. Circuits have followed the obligation approach. In *Smith v. Commissioner*, the Tax Court and the Ninth Circuit both adopted this approach. These courts have relied on the existence of an employer-employee relationship in holding that United States employees are paid by the United States. The Ninth Circuit and the Tax Court before *Smith*, as well as two district courts, have followed the source approach. These courts have considered the existence of an employer-employee relationship irrelevant, and have instead held that the source of the funds from which the taxpayer has been paid is determinative. Both of these approaches are flawed.

The obligation approach is logically inconsistent. Although it assumes that all United States employees necessarily are paid by their employer, it does not accordingly assume that all nongovernment employees are paid by *their* employer. The obligation approach is also overly formalistic; it places undue emphasis on questions such as which party executed and delivered salary checks, or which party has the ultimate legal obligation under an employment contract. More fundamentally, the obligation approach fails to properly address the congressional purposes underlying the foreign earned income exclusion.

Although the source approach is neither logically inconsistent nor formalistic, it too fails to adequately consider congressional goals. Resolving the issue based on which party was the ultimate source of the funds from which payment was made does not address issues of tax policy.

An alternative approach is preferable. In determining when an amount has been paid by the United States, and is thus excepted from the exclusion, courts should attempt to implement congressional purposes based on the legislative history of both the exclusion and the exception. This approach should entail a factual inquiry into the circumstances of the individual worker. Using the principles deduced from the legislative history as a guide, courts should determine to which class the worker belongs: Is he a member of that class for which Congress supplied an incentive to work abroad; or, conversely, is he a mem-

ment in *Erlandson*: "Speculation as to where [the taxpayer] could have looked for relief if the payments had not been made is not helpful. The question is who paid the wages, not who would be liable if they were not paid." 277 F.2d at 73.

ber of that class for which Congress thought no incentive to work abroad was necessary? The former class is difficult to define with precision but consists at least of highly skilled workers and technicians, and those involved in the export and sale of American-made goods. The latter class is easier to define; it consists of individuals for whom foreign service is a normal and expected incident of their career, such as those in the diplomatic corps. This latter class also includes individuals for whom the decision to work abroad is not truly voluntary, such as those in the military.

This "classification approach" should involve an objective inquiry; it should focus on the nature of the class, and should not allow the taxpayer to introduce evidence of whether he *personally* needed an incentive to work abroad. A subjective inquiry would prove unmanageable, raising questions of personal motive.

The classification analysis is preferable to either of the approaches that the courts currently follow. It avoids the logical inconsistencies and formalism of the obligation approach, and seeks to implement the congressional intent that both the source and obligation approaches ignore. The classification approach has one additional advantage: because the existence of an employer-employee relationship is irrelevant, this approach focuses on the same factors regardless of whether or not the taxpayer is an employee of the United States.

Application of the classification approach would alter the analysis in some cases under section 911. For example, the merchant seamen in *Teskey* and *Erlandson* are within that class of workers for whom no incentive to work abroad is necessary. Extensive travel and time away from home are the natural incidents of a sailor's life. On the other hand, the road builders in *Krichbaum*, *Wolfe*, *Johnson*, and *Mooneyhan* are the kinds of workers Congress had in mind when it stated that "it is particularly desirable to encourage men with technical knowledge to go abroad."¹¹⁷ The classification approach dictates that their salary would qualify for the foreign earned income exclusion.

Smith is a more difficult case in which to apply the classification approach. Although customs officers do not fall readily into either of the two classes, it is clear that as a *class*, such an occupation contemplates the possibility of foreign service. The customs officer thus should be placed in that category for which no incentive to work abroad is necessary. The classification approach, therefore, would be likely to lead to the same result reached by the Tax Court in *Smith*. Even if courts disagreed on the proper result given such facts, the classification approach would at least focus their inquiry, and would be more likely to lead to a result consonant with congressional intent.

¹¹⁷ S. REP. NO. 781, 82d Cong., 1st Sess. 53 (1951), *reprinted in* 1951-2 C.B. 458, 496.

CONCLUSION

Courts attempting to determine when an amount has been paid by the United States within the meaning of the exception to the foreign earned income exclusion follow two different approaches. Some courts follow the source approach and identify the source of the funds from which the taxpayer has been paid. Other courts follow the obligation approach and rely primarily on the existence of an employer-employee relationship in identifying who has the ultimate legal obligation to the taxpayer. Both approaches are misguided because they turn on abstract distinctions not rooted in the congressional purpose underlying section 911. The classification approach suggested in this Note better implements congressional purpose by inquiring into the factual circumstances of the particular worker and determining whether he is a member of that class which Congress sought to benefit by the exclusion.

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