A Tax Haven in the Friendly Skies?

By: Yan Jiang, *MST student*

You may know that U.S. expatriates are eligible for special tax benefits, but have you ever wondered about the tax treatment for flight attendants who fly intermittently between the U.S. and foreign countries? In 2012, the United States Tax Court issued a memorandum opinion, *Christina J. Letourneau v. Commissioner,* TC Memo 2012-45, addressing the use of the IRC §911 Foreign Earned Income Exclusion and IRC §901 Foreign Tax Credit as applied to flight attendants whose work causes them to travel between countries and in international air space.

The Taxpayer, a U.S. citizen, was a permanent resident of France. In 2005, the year in question, she commuted from France to London for her work as a flight attendant for United Airlines, Inc. She primarily flew between London and the United States. Her work time could, therefore, be allocated among activities such as flying over the United States, flying over international waters, and flying over foreign countries. The Taxpayer allegedly paid income taxes to the tax authorities in France and the U.K. In her 2005 U.S. tax return, the Taxpayer applied the IRC §911 Foreign Earned Income Exclusion and excluded her entire W-2 wages from her gross income. Under audit, the IRS determined that only a portion of her wages were eligible for the exclusion and denied her Foreign Tax Credit.

The issues involved in this case were:

1. Whether the Taxpayer's wages were exempt from U.S. taxation according to Article 15(3) of the 1994 U.S.-France Income Tax Treaty ("Treaty");
2. Whether she was entitled to a larger Foreign Earned Income Exclusion than the IRS had allowed; and
3. Whether she was entitled to any amount of Foreign Tax Credit.

In analyzing the first issue, the Tax Court rejected the Taxpayer's contention that her total wages were exempt from U.S. tax under Article 15(3) of the Treaty. This article generally exempts from U.S. income taxation wages earned by a French resident who is a crew member of an aircraft operated in international traffic. The court agreed with the IRS that the "saving clause" contained in Article 29(2) of the Treaty takes precedence and the U.S. reserves the right to tax its own citizens as though Article 15(3) of the Treaty does not exist. The Tax Court also objected to the Taxpayer's argument that the application of the saving clause discriminated against her in violation of Article 25(1) (Non-Discrimination clause) of the Treaty. The court explained that the clause is not intended to provide the Taxpayer relief from U.S. income taxation; it merely ensures that France does not impose a more burdensome tax on a U.S. taxpayer than it would impose on French citizens and residents.

On the issue of Foreign Earned Income Exclusion, the Taxpayer contended that her entire wages earned in the year was foreign earned income as defined under IRC §911(b)(1)(A); hence eligible for exclusion. The IRS, however, only allowed exclusion for wages attributed to activities performed in a foreign country and over foreign airspace calculated using United's standard time apportionment tables. Because only income earned from sources within a foreign country is eligible for exclusion,[1] the key issue evaluated by the Tax Court was whether or not international airspace meets the definition of a foreign country under IRC §911. The court cited *Rogers v. Commissioner*[2] which concluded that international airspace is not under the sovereignty of a foreign government; hence it is not a "foreign country" under IRC §911. Therefore, the wages earned by the Taxpayer while working in international airspace is not treated as foreign earned income and ineligible for IRC §911 exclusion.

Wages earned by the Taxpayer while working in international airspace is not treated as foreign earned income and ineligible for IRC §911 exclusion

The Taxpayers also contended that the use of United's apportionment tables to calculate the allowable foreign income amount does not accurately reflect her actual times spent on specific flights. This contention was discounted by

1 IRC §911(b)(1)(A) provides that the "foreign earned income" is amount received by a taxpayer from sources within a foreign country.

2 TC Memo 2009-111.

the court because the Taxpayer failed to provide any proof that it is inaccurate or present other more reliable methods.

As a last resort, the Taxpayer suggested that she was entitled to exclude all her wages from gross income in 2005 because she did so in prior years without any challenge from the IRS. The court reminded the Taxpayer that IRS is “not precluded from challenging treatment of an item merely because he has failed to challenge it in the past.”

On the last issue regarding Foreign Tax Credit, the court found that the French taxes allegedly paid by the Taxpayer in 2005 were for tax liability of a previous year and were refunded to her later in that year. Furthermore, the Taxpayer failed to provide any evidence that she paid taxes to France in 2005. With respect to taxes paid to the U.K., the court agreed with the IRS that the Taxpayer is not entitled to the IRC §901 Foreign Tax Credit because the Taxpayer already excluded the income earned in the U.K. from gross income under IRC §911. Double benefits is denied under IRC §911(d)(6).

The most significant message from this Tax Court decision is that international airspace is not a tax haven. Income earned in international airspace is not eligible for IRC §911 Foreign Earned Income Exclusion because it is not earned within a foreign country. Recent similar cases, including this one, indicate that there has been confusion surrounding the definition of “foreign country” in the context of IRC §911. Perhaps Congress will clarify the definition down the road. Meanwhile, it is advisable for practitioners to ensure that U.S. expatriates are not erroneously taking double benefits in applying the IRC §901 Foreign Tax Credit and IRC §911 Foreign Earned Income Exclusion on the same income.