

# AGENCIES FOR PURPOSES OF SECTION 911 OF THE INTERNAL REVENUE CODE: THE FOREIGN EARNED INCOME EXCLUSION SURVIVES 2003 CONTROVERSIAL PROPOSAL TO REPEAL

Jorge L. Riera\*

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## I. INTRODUCTION

The United States, for over three-quarters of a century, has maintained a foreign trade policy concerning American citizens working abroad that provides for the foreign earned income exclusion.<sup>1</sup> Citizens of the United States engaged in the promotion of American foreign trade and residing in foreign countries, were subject to double taxation by the foreign country and the United States.<sup>2</sup> In an effort to stimulate foreign trade and to place Americans who work abroad on equal footing with competitors, Congress exempted the foreign earned income of its citizens working overseas from taxation.<sup>3</sup> Today, the policy remains unscathed despite the limitations on the exclusion and the controversial

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\* J.D. candidate 2004, Shepard Broad Law Center, Nova Southeastern University; C.P.A., State of Florida; M.Acc., Nova Southeastern University; B.B.A., Florida International University. The author wishes to extend a special thanks to his loving wife, Lissette Riera, for her unwavering support and understanding and his beloved children and parents. The author also wishes to thank Dean Gail Richmond for her guidance and wisdom as mentor, and Professor Elena Marty-Nelson for her role as advisor.

1. H.R. CONF. REP. NO. 69-356, at 33 (1926), *reprinted in* 97 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979).

2. *Krichbaum v. U.S.*, 138 F. Supp. 515, 523 (E.D. Tenn. 1956).

3. *Id.*

attempt to repeal section 911 of the Internal Revenue Code (IRC) under the Jobs and Growth Tax Relief Reconciliation Act of 2003.<sup>4</sup>

In this endeavor, the legislative history of the exclusion reflects sharp conflicting views of members of Congress.<sup>5</sup> As early as 1926, Senator Smoot, past chairman of the Senate Finance Committee, demonstrated strong opposition opining the tax exemption provision was unnecessary.<sup>6</sup> In May 2003 Senator Grassley, present chairman of the Senate Finance Committee, restated past opposition to the exemption by saying, "section 911 is a tax loophole that forces you and me, as well as every other taxpayer out there throughout the United States, to subsidize high-paid corporate employees and their companies."<sup>7</sup> However, the majority of the policy makers today continue to agree with the original policy as evidenced by the elimination of the amendment repealing the provision, thus allowing for the exclusion.

The purpose of this article is to analyze the policy for enacting and maintaining the foreign earned income exclusion. Beginning with Part II, this article assesses the legislative history and origins of section 911 of the IRC; including restrictions and limitations. Part III analyzes court issues regarding agencies of the United States as contemplated by section 911 of the IRC. Part IV examines the political and industry opposition to the repeal of the IRC provision wherein individuals were allowed to exclude foreign earned income from United States taxation. Part V discusses the conclusion that the policy and purpose of the provision excluding foreign earned income is beneficial to the economy of the United States and its citizens working abroad.

## II. LEGISLATIVE HISTORY AND DEVELOPMENT OF SECTION 911

### A. *Origins of Section 911*

In 1925, Congress projected that in the taxable year of 1926 they would over collect taxes by approximately \$200,000,000.<sup>8</sup> Congress enacted the Revenue Act of 1926 as a measure to reduce and equalize federal taxation.<sup>9</sup> United States citizens and residents are generally subject to taxation on world-

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4. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (2003).

5. *Krichbaum*, 138 F. Supp. at 519.

6. S. REP. NO. 69-52, at 21 (1926), *reprinted in* 97 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979).

7. 108 CONG. REC. S1054 (daily ed. May 14, 2003) (statement of Sen. Grassley), *available at* <http://thomas.loc.gov> (last visited June 21, 2003).

8. H.R. REP. NO. 69-1, at 1 (1926), *reprinted in* 97 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979).

9. *Id.*

wide income.<sup>10</sup> However, Congress excluded United States citizens working abroad from taxation on all foreign earned income under section 213(b)(14) of the IRC.<sup>11</sup> The foreign policy for the exclusion provision was to encourage employment of Americans abroad and place them on equal footing with their foreign competitors.<sup>12</sup>

Six years later, the Senate Finance Committee embarked on an attempt to repeal the exclusion.<sup>13</sup> The Committee expressed their concerns regarding certain United States citizens claiming the exclusion and consequently not paying any taxes.<sup>14</sup> The Finance Committee believed the exclusion was unnecessary because of the foreign tax credit provision.<sup>15</sup> Congress, under the Revenue Act of 1932, limited the exclusion “except as to amounts paid by the United States or agency thereof,” and codified the exclusion under section 116(a).<sup>16</sup>

In 1942, the exclusion was again under siege by the House Ways and Means Committee.<sup>17</sup> The Committee proposed a plan to repeal the exclusion to increase tax revenues and eliminate a tax benefit skewed toward United States citizens earning foreign income from nongovernmental employers and nongovernmental agencies.<sup>18</sup> Instead of repealing, Congress amended the exclusion and extended the residency requirement from six months to “the entire taxable year.”<sup>19</sup> Thus, the taxpayer must establish a bona fide residence for the entire taxable year to qualify for the exclusion.<sup>20</sup> Congress’ intended purpose in

10. *Cook v. Tait*, 265 U.S. 47, 56 (1924); *see also* I.R.C. § 61(a) (West 2003) (stating “gross income means all income from whatever source derived”).

11. H.R. CONF. REP. NO. 69-356, at 33 (1926), *reprinted in* 97 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979); I.R.C. §213(b)(14) (states: “There shall be excluded from gross income in the case of our citizens working 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”); *see also* *Foreman v. U.S.*, 60 F.3d 1559, 1562 (Fed. Cir. 1995).

12. H.R. CONF. REP. NO. 69-356, at 33 (1926), *reprinted in* 97 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979); *See also* *Comm’r v. Wolfe*, 361 F.2d 62, 66 (D.C. Cir. 1966).

13. S. REP. NO. 72-665, at 31 (1932), *reprinted in* 99 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979).

14. *Id.*

15. *Id.*

16. Revenue Act of 1932, Pub. L. No. 72-154, § 116(a), 47 Stat. 169, 39 (1932), *reprinted in* 99 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979).

17. H.R. REP. NO. 77-2333, at 50 (1942), *reprinted in* 108 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979).

18. *Id.*

19. Revenue Act of 1942, Pub. L. No. 77-753, § 148, 56 Stat. 798, 49 (1942), *reprinted in* 108 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979).

20. S. REP. NO. 77-1631, at 116 (1942), *reprinted in* 108 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS AND ADMINISTRATIVE DOCUMENTS (1979).

enacting the amendment of 1942 was to eradicate the misuse under the former requirement of absence from the United States instead of presence in a foreign country.<sup>21</sup> Congress, under the Revenue Act of 1951, attempted to remedy the strict application of the term "bona fide residence abroad."<sup>22</sup> Under the prior provision adopted in 1942, individuals with technical knowledge were having difficulty establishing residency, and could not qualify for the exclusion.<sup>23</sup> Examples of these individuals included, "managers, technicians and skilled [workers] induced to [work] abroad for periods of [eighteen] to [thirty-six] months to complete certain projects."<sup>24</sup> Because Congress intended to encourage individuals with technical knowledge to work abroad, it eased the bona fide residency requirement.<sup>25</sup> The residency requirement now permitted taxpayers working abroad to exclude foreign income if physically present in a foreign country for seventeen months during a period of eighteen months.<sup>26</sup>

Some American citizens with substantial earnings exploited the amended version of section 116(a) by working abroad.<sup>27</sup> These citizens went to foreign countries to perform tasks regularly performed within the United States, for the primary purpose of claiming the foreign earned income exclusion and evading taxation.<sup>28</sup> Individual citizens of the United States physically present in a foreign country for seventeen months, out of a period of eighteen months were able to exclude their entire foreign earned income from taxation.<sup>29</sup> Congress recognizing the need to limit the exclusion accordingly amended the provision "sufficient to correct the evils."<sup>30</sup> As a result, those taxpayers who were residents abroad for an entire taxable year qualify to claim the exclusion subject to a ceiling of \$20,000 of the foreign earned income.<sup>31</sup> In 1954, Congress amended and reenacted former section 116, earned income of citizens of the United States from sources without the United States, as section 911 of the IRC of 1954.<sup>32</sup>

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21. *Comm'r v. Matthew*, 335 F.2d 231, 234 (5th Cir. 1964).

22. S. REP. NO. 82-781, at 112 (1951), *reprinted in* 1951 U.S.C.C.A.N. 1968, 2024.

23. *Id.*

24. *Id.*

25. *Id.*

26. *Krichbaum*, 138 F. Supp. at 522.

27. S. REP. NO. 83-685, at 10 (1953), *reprinted in* 1953 U.S.C.C.A.N. 2423, 2427.

28. *Id.*

29. *Id.*

30. *Id.* at 11.

31. *Id.*

32. S. REP. NO. 83-1622, at 1043 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 5063. "This section is identical with section 911, relates to exclusion from gross income derived from sources without the United States by citizens of the United States and is, in substance, identical with section 116(a) [of] the 1939 [Internal Revenue] Code ...." See *Foreman v. U.S.*, 60 F.3d 1559, 1562 (Fed. Cir. 1995).

## B. Section 911 Revisions and Restrictions

During the Kennedy administration, President Kennedy proposed eliminating the exclusion except for citizens living abroad in undeveloped foreign countries allowing an unlimited exclusion of foreign income.<sup>33</sup> The Legislature disagreed and rejected the President's recommendation.<sup>34</sup> Instead, the Revenue Act of 1962 placed a ceiling on the exclusion amount of earned income for those citizens establishing a bona fide residence in a foreign country.<sup>35</sup> The amended provision permitted a taxpayer earning income abroad, who met the bona fide residence requirement, to exclude \$20,000 per year from taxation for the first three taxable years.<sup>36</sup> The excludable amount accrues throughout the taxable year, and is computed on a daily basis.<sup>37</sup> Therefore, the amount excluded is not to exceed \$20,000 for a United States' citizen with foreign income qualifying under either the bona fide residence or the physical presence requirement.<sup>38</sup> However, citizens working abroad, who qualify as a bona fide resident in a foreign country for more than three consecutive years, may exclude \$35,000.<sup>39</sup> The Revenue Act of 1964 reduced the maximum excludable amount to \$20,000 for citizens that remain abroad for an uninterrupted period of more than three years.<sup>40</sup>

The most radical changes to the foreign earned income exclusion can be attributed to the Tax Reform Act of 1976.<sup>41</sup> Congress imposed restrictions on foreign earned income to counter growing sentiment that the exclusion provided a tax advantage to citizens working abroad.<sup>42</sup> Moreover, Americans working abroad were not subject to double taxation because foreign countries did not tax

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33. S. REP. NO. 87-1881, at 166 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3297, 3377.

34. *Id.* at 167.

35. *Id.* at 171.

36. *Id.*

37. *Id.* The following example illustrates how to compute the excludable amount pursuant to section 911(a):

A, a U.S. citizen, who files his return on a calendar year basis, is privately employed, and is a bona fide resident of France for the period April 1, 1963, through June 30, 1968. The amounts excludable from gross income for the various calendar years, under the provisions of section 911(a) ... are computed by applying the special rules contained in section 911(c), are not to exceed the following amounts: For the year 1963, \$15,068.49 (275/365 X \$20,000); for the year 1964, \$20,000 (366/366 X \$20,000); for the year 1965, \$20,000 (365/365 X \$20,000); for the year 1966, \$31,301.37 (90/365 X \$20,000 plus 275/365 X \$35,000); for the year 1967, \$35,000; and for the year 1968, \$17,404.37 (182/365 X \$35,000).

S. REP. NO. 87-1881, at 527 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3297, 3535.

38. S. REP. NO. 87-1881, at 171.

39. *Id.*

40. *Id.*

41. H.R. REP. NO. 94-658, at 200 (1976), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3095.

42. *Id.*

the income of United States' citizens.<sup>43</sup> For example, an employee's compensation excluded under section 911 was not subject to taxation by the foreign country if the employer paid the compensation to a bank outside that foreign country.<sup>44</sup> The amendment disallowed the exclusion to taxpayers working abroad, receiving income outside the country, if the foreign country did not tax income received outside that country.<sup>45</sup>

The Committee recognized that citizens working abroad incurred higher cost of living expenses, since they did not benefit from services provided in the United States by state, local, or federal agencies.<sup>46</sup> Congress accordingly reduced the excludable amount to \$15,000 for individuals with foreign income.<sup>47</sup> In addition, the foreign income was subject to taxation based at the higher tax bracket for the non-excludable earned income.<sup>48</sup> For example, if a taxpayer earns \$20,000 of gross income and qualifies for the exclusion under section 911, the individual would reduce their gross income by \$15,000, thus would have taxable income of \$5,000.<sup>49</sup> That taxpayer would now pay taxes based on the higher tax bracket of \$20,000 not the tax bracket of \$5,000.<sup>50</sup> However, employees of charitable organizations working abroad maintained an exclusion amount of \$20,000 of their foreign earned income.<sup>51</sup>

The Foreign Earned Income Act of 1978<sup>52</sup> (FEI) liberalized the restrictions of its predecessor.<sup>53</sup> The FEI "generally replaced the section 911 ... earned income exclusion with a new deduction for the excess costs of working in a foreign country."<sup>54</sup> Under the FEI, taxpayers had the option of using the new provision, including deductions for the excess costs of working abroad, or the provisions under the Tax Reform Act of 1976.<sup>55</sup> The deductions for excess costs of living overseas, defined under section 913 of the IRC, consisted of separate factors for each of the following; general cost of living, housing,

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43. S. REP. NO. 94-938, at 210 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3438, 3640.

44. *Id.*

45. *Id.*

46. *Id.* at 211.

47. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011, 90 Stat. 1520, 1610 (1976).

48. S. REP. NO. 94-938, at 211 (1976). The manner of determining the applicable tax rate may be illustrated by the following example: "if a taxpayer has \$20,000 of gross income which is excluded under the income exclusion and also has \$5,000 of deductions not allowable ... the taxpayer is treated as having \$15,000 of taxable income for purposes of computing the tax rates on the non-excluded income." *Id.*

49. *Id.*

50. *Id.*

51. Tax Reform Act of 1976, 90 Stat. at 1610.

52. Foreign Earned Income Act of 1978, Pub. L. No. 95-615, 92 Stat. 3098 (1978).

53. S. REP. NO. 97-144, at 34 (1981), *reprinted in* 1981 U.S.C.C.A.N. 105, 141.

54. *Id.*

55. *Id.*

education, and, home leave costs.<sup>56</sup> The FEI defined the deductions for excess costs abroad as follows:

The [general] cost of living [deduction] is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). [The general] deduction [was] based on the spendable income of a person paid the salary of a federal employee at grade level GS-14, Step 1, regardless of the taxpayer's actual income. The housing [deduction] is the excess of the taxpayer's reasonable housing expenses over [their] base housing amount (generally one-sixth of [the] net income). The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable costs of coach airfare transportation for the taxpayer, spouse, and dependents from the taxpayer's home outside the United States to [their] most recent place of residence within the United States.<sup>57</sup>

To encourage United States citizens to accept positions in geographical hardship areas, the Congress carved out a special deduction of \$5,000 for taxpayer's working abroad and living in areas designated by the State Department as hardship areas.<sup>58</sup> Employees who reside in hardship areas may elect to claim a \$20,000 earned income exclusion in place of the excess living costs and hardship area deductions.<sup>59</sup> In addition, taxpayers under certain circumstances may qualify for a waiver of the time requirements for the excess living costs and hardship area deductions.<sup>60</sup> To qualify for the waiver the taxpayer must meet the three following requirements:

First, the individual actually must have been present in, or a bona fide resident of, a foreign country. Second, [the taxpayer] must leave the foreign country after August 31, 1978, during a period with respect to which the treasury department determines, after consultation with the state department, that [required] individuals to leave the foreign country because of war, civil unrest, or similar adverse conditions in the foreign country which precluded the normal conduct of business by those individuals. Third, the individual must establish to the satis-

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56. *Id.*

57. *Id.* at 34-35.

58. S. REP. NO. 97-144, at 35 (1981). "The term geographical hardship area means any foreign place designated by the Secretary of State as a hardship post where extraordinarily difficult living conditions, notably unhealthy conditions or excessive physical hardships exist." *Id.*

59. *Id.*

60. *Id.*

faction of the treasury that [they] reasonably could have ... expected to meet the time limitation requirements, but for the war, civil unrest, or similar adverse conditions.<sup>61</sup>

Although the FEI liberalized the tax burden, American businesses faced an intense competitive market abroad.<sup>62</sup>

Three years later, the Economic Recovery Tax Act of 1981<sup>63</sup> (ERTA) again revised taxation for citizens working abroad to encourage American businesses overseas and "promote the export of United States goods and services."<sup>64</sup> Congress recognized that although the FEI had liberalized the tax burden, American firms still experienced difficulty hiring American employees in foreign countries.<sup>65</sup> Most businesses, in an attempt to encourage employees to transfer to positions overseas, assumed the tax burden and incorporated those costs as part of the their compensation package.<sup>66</sup> Businesses such as the construction industry, facing overwhelming competition abroad, were unable to secure projects due to higher bids resulting from increased employee compensation packages.<sup>67</sup> Congress decided to modify the excess foreign living cost deduction and exclusion, and to provide qualifying United States citizens an appropriate incentive, by allowing them to elect a substantial exclusion from taxation.<sup>68</sup> However, Congress "placed a specific dollar limitation on the exclusion" to prevent abuse.<sup>69</sup> The provision also shortened the period of physical presence necessary to qualify for the exclusion.<sup>70</sup> The amended provisions allowed taxpayers to exclude foreign earned income and their housing expenses.<sup>71</sup> Under the revised provision, an individual qualified as physically present for the taxable year if present in a foreign country for 330 days in any period of twelve consecutive months.<sup>72</sup>

The Tax Reform Act of 1986<sup>73</sup> restricted the exclusion amount under section 911 to a maximum of \$70,000 in a taxable year.<sup>74</sup> However, Congress revised the exclusion again under the Taxpayer Relief Act of 1997,<sup>75</sup> recogniz-

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61. *Id.*

62. S. REP. NO. 97-144, at 35 (1981).

63. Economic Recovery Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

64. S. REP. NO. 97-144, at 36 (1981).

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. S. REP. NO. 97-144, at 35 (1981).

70. *Id.*

71. *Id.*

72. *Id.*

73. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

74. *Id.* at 2564.

75. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 988 (1997).



ing that working abroad imposed “additional financial burdens on the employees” of United States businesses, and increased the allowable exclusion amount of foreign earned income.<sup>76</sup> These burdens transpired from taxpayers maintaining two separate homes; one in the foreign country, and the other in the United States.<sup>77</sup> Additional burdens included the increased cost individuals incurred from traveling to maintain family relationships in the United States, or the increased cost of living in a foreign location.<sup>78</sup> Congress decided that an increase of the exclusion amount was appropriate because of the higher financial burden coupled with the increase of worldwide inflation.<sup>79</sup> The revised amendment increased the exclusion amount to “\$80,000 in increments of \$2,000 each year, beginning in 1998.”<sup>80</sup> Although Congress has dealt with section 911 after the 1997 Act, the provision has not suffered any further revisions or amendments to the exclusion for foreign earned income.

### III. AGENCY FOR PURPOSES OF EXCLUSION

#### A. *Payment of Earned Income from Agencies*

Section 911 of the IRC allows “citizens or residents of the United States” living and working abroad to exclude foreign earned income from income taxation.<sup>81</sup> Foreign earned income is an individual’s earnings from sources “attributable to services performed” within a foreign country, subject to the individual either establishing a bona fide residence or being physically present in the foreign country, as prescribed under section 911 of the IRC.<sup>82</sup> Foreign earned income does not include amounts “paid by the United States or an agency thereof to an employee of the United States or an agency thereof.”<sup>83</sup> The Treasury Regulations expands on the definition by exempting the amounts paid to an employee working for “any [United States] government agency or instrumentality.”<sup>84</sup> Moreover, employees working for a non-appropriated fund instrumentality (NAFI) and meeting the employee status test are employees of agencies of the United States and therefore are not entitled to the exclusion of foreign earned income.<sup>85</sup>

76. H.R. REP. NO. 105-148, at 519 (1997), *reprinted in* 1997 U.S.C.C.A.N. 678, 913.

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.* at 520.

81. I.R.C. § 911(a)(1) (West 2003).

82. I.R.C. § 911(b)(1)(A) (West 2003).

83. I.R.C. § 911(b)(1)(B)(ii) (West 2003) (emphasis added).

84. Treas. Reg. § 1.911-3(c)(3)(1985); *In re Nadybol*, 254 B.R. 352, 354 (Bankr. D. Md. 2000).

85. *Matthews v. Comm’r*, 907 F.2d 1173, 1176 (D.C. Cir. 1990). The court in *Nadybol* defined a NAFI as: “an entity created to administer non-appropriated funds. Non-appropriated funds ... are funds that have not been appropriated by Congress, but are generated instead by participation of [military] personnel and

Courts have broadly construed the term agency under section 911 of the IRC because a “narrow construction ... would be incompatible with a strict application of the exclusion.”<sup>86</sup> The term agency was defined by the Revenue Act of 1942 as follows: “(1) Faculty or state of acting or of exerting power; ... instrumentality; or (2) Office or function of an agent, or factor; relation between a principal and his agent; business of one entrusted with the concerns of another.”<sup>87</sup> The term instrumentality was defined as: “Quality or state of being instrumental; that which is instrumental; means; medium; agency.”<sup>88</sup> The Treasury regulations interpreting the definition of the terms agency and instrumentality stated: “[i]nstrumentality ... [equals] agency.”<sup>89</sup> The following are examples of recognized Government agencies; “United States Armed Forces exchanges, commissioned and non-commissioned officers’ messes, Armed Forces motion picture services and other organizations similarly organized and operated under Government regulations.”<sup>90</sup>

The United States Court of Claims established “essential characteristics” to identify an agency of the United States under the meaning of section 911.<sup>91</sup> The court, in determining “what constitutes an agency,” applied the following factors in considering the “degree of control” by the United States Government: (1) power of the United States to initiate and terminate; (2) effectuation of government purposes by the entity; (3) the exclusion of private profit; and, (4) limitation of employment to government connected persons.<sup>92</sup>

The United States Court of Appeals applied the “essential characteristics” test in *Kalinski v. Commissioner*,<sup>93</sup> and determined that a United States Air Force (USAF) child-care center located in Germany was an agency of the United States, within the meaning of section 911.<sup>94</sup> The USAF established and operated the center “to provide care for the disabled and handicapped children of its personnel.”<sup>95</sup> USAF exercised “pervasive control” of the centers’ financial decisions and monitored the functioning of the center.<sup>96</sup> The center, a not for

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others in [military], religious, morale, welfare, and recreation programs such as base exchanges, theatres, book departments, and restaurants.” 254 B.R. at 353.

86. *Groves v. U.S.*, 533 F.2d 1376, 1383 (5th Cir. 1976).

87. *Id.*

88. *Id.*

89. *Id.*

90. *Morse v. United States*, 443 F.2d 1185, 1190 (Ct. Cl. 1971) (internal citations omitted).

91. *Id.* at 1188 (internal citations omitted).

92. *Payne v. United States*, 980 F.2d 148, 150 (2d Cir. 1992); *see also Morse*, 443 F.2d at 1188 (internal citations omitted).

93. 528 F.2d 969, 973 (1st Cir. 1976).

94. *Id.* at 973.

95. *Id.*

96. *Id.*

profit enterprise, limited its services to Air Force personnel.<sup>97</sup> The court concluded that “the center was an agency” of the government and that employees of the center were not qualified to claim the foreign earned income exclusion.<sup>98</sup>

The Second Circuit in *Payne v. United States*<sup>99</sup> concluded that, “the Panama Canal Commission (PCC) was an agency of the United States Government.”<sup>100</sup> The United States Congress under the auspices of the Panama Canal Treaty enacted legislation and created the PCC.<sup>101</sup> The Treaty “required the United States to create the PCC” and referred to the PCC as “a United States Government agency.”<sup>102</sup> The United States initiated the PCC under its laws and regulations.<sup>103</sup> Furthermore, the majority of the board members are United States nationals and the President of the United States “appoints and terminates the administrator and the deputy administrator.”<sup>104</sup> Thus, the United States actually has the power to initiate and terminate the PCC by exerting control over the Board membership and its policies.<sup>105</sup>

The next factor used to determine whether the PCC is an agency, is whether the PPC was established to effectuate the United States Government purposes.<sup>106</sup> Article III of the Panama Canal Treaty states that “the United States of America shall ... carry out its responsibilities [under the Treaty] by means of a United States Government agency called the [PCC].”<sup>107</sup> The third factor is whether the PCC generates private profits or government revenues.<sup>108</sup> The United States statute creating the PCC affirms that the PCC will expense any profits it generates, solely for purposes of the PCC.<sup>109</sup> The final prong of the test is whether the “membership of the PCC is limited to government-connected persons.”<sup>110</sup> The PCC employees were subject to substantially the same responsibilities, duties, and laws applicable to federal employees.<sup>111</sup> Moreover, some United States citizens, working for the PCC, qualify for federal employment benefits packages.<sup>112</sup> Therefore, the court deemed the PCC an agency for purposes of section 911 because it was under the control of the United States

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97. *Id.*

98. *Kalinski*, 528 F.2d at 974.

99. 980 F.2d 148 (2d Cir. 1992).

100. *Id.* at 149.

101. *Id.* at 150.

102. *Id.*

103. *Id.*

104. *Payne*, 980 F.2d at 151.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.*

109. *Payne*, 980 F.2d at 151.

110. *Id.* at 151.

111. *Id.* at 151–52.

112. *Id.* at 152.

government and denied the taxpayer their claim to the foreign earned income exclusion.<sup>113</sup> Next, we will examine whether NAFI programs are agencies for purposes of section 911 of the IRC.<sup>114</sup>

### B. *Non-appropriated Fund Instrumentality*

The purpose of establishing NAFI programs is to maintain the “morale, welfare and recreation” for the benefit of the military.<sup>115</sup> The Bankruptcy Court for the District of Maryland determined that the Army Recreation Machine Fund (ARMF) a NAFI located in Germany, was an agency of the United States.<sup>116</sup> The United States Department of the Army established the ARMF for the morale, welfare, and recreation of soldiers and their family members, as a NAFI.<sup>117</sup> The debtor employed by the ARMF lived and maintained a residence in Germany.<sup>118</sup>

The *In re Nadybol*<sup>119</sup> court, acknowledged that the United States Army established the ARMF, and could terminate it at any time.<sup>120</sup> The effectuation of government purposes by the entity was the second factor the court analyzed.<sup>121</sup> The debtor interpreted the second prong in the following way: “only if the governmental purpose [achieved] by ARMF is essential or critical [emphasis added] can there be a finding that it is a section 911(a) agency.”<sup>122</sup> The debtor objecting to the notion that the ARMF was critical for the United States Army, referred to Army Regulation (AR) 215-1 maintaining the ARMF was “considered less essential from the perspective of the military mission.”<sup>123</sup> The court not persuaded by the debtor’s contentions, quoted from AR 215-1, “the Army considers every NAFI . . . integral and essential to the conduct of the military mission.”<sup>124</sup> Moreover, the court rejected the debtor’s line of reasoning

113. *Id.*

114. *In re Nadybol*, 254 B.R. 352, 354 (Bankr. D. Md. 2000); see I.R.C. § 911(a)(1).

115. *Id.* at 353.

116. *Id.* at 357. The ARMF mission statement and purpose is “to provide a highly controlled gaming operation designed to provide recreation for soldiers and family members overseas while generating revenue for the morale, welfare and recreation programs and projects.” *Id.* at 353.

117. *Id.* at 353; see I.R.C. § 911(a)(1).

118. *Id.*

119. 254 B.R. at 352.

120. *Id.* at 355.

121. *Id.*

122. *Id.*; see also *Morse*, 443 F.2d at 1188. The court in stated that the second element of control that identifies an agency is the effectuation of Government purposes is paramount over those of the organized members. Furthermore, the court stated that for taxpayers to succeed they “would have to show that the [entity taxpayers worked for] was established to provide essential morale and recreational facilities and services for personnel of an installation.” (internal citations omitted). *Id.*

123. *Nadybol*, 254 B.R. at 355.

124. *Id.*

that the ARMF must be essential to determine whether it was an agency of the government.<sup>125</sup> The court, discussing the element of whether the ARMF operated for private profit, determined that the revenues generated by the ARMF were for the benefit of other morale, welfare and recreational programs of the Army.<sup>126</sup> In addition, the ARMF funds were subject to the control of the Army.<sup>127</sup> The court concluded that in order to satisfy the governmental connection prong of the test, a sufficient showing of governmental connection is enough.<sup>128</sup> The debtor put forth a similar argument to that of the employee in *Payne*, that since foreign nationals could use the slot machines of the ARMF the purpose was not limited to "government connected persons."<sup>129</sup> The court used a similar analogy to that of the court in *Payne*.<sup>130</sup> First, the employees of the ARMF were subject to the same standards of conduct and regulations as those established by the Army.<sup>131</sup> Moreover, the court quoted from the AR 215-1, "[all] Army NAFI's operate under the authority of the United States Government and are administered by military or civilian personnel acting in an official capacity."<sup>132</sup> Although foreign nationals, persons other than the military personnel, had limited access to the ARMF, the court concluded that the evidence of government connection was sufficient so the ARMF satisfied the final prong of the government control test.<sup>133</sup>

Although NAFI's generally are agencies of the United States, depending on the particular facts, courts may hold that they are not agencies contemplated by section 911 of the IRC.<sup>134</sup> The Court of Claims in *Brummitt*,<sup>135</sup> concluded that the United States Officers' Open Mess, Tapei (USOOMT) located in Taiwan was not an agency of the United States.<sup>136</sup> The court reasoned that while the club possessed some characteristics of a NAFI because it was subject to the regulations of the military and received benefits from the military in the form of loans, the totality of the circumstances militated against determining the USOOMT an agency of the United States.<sup>137</sup> The court considered the following factors: (1) the military did not exercise "fiscal control over the club;" (2) the club was constructed on privately owned land, (3) the club negotiated

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125. *Id.* at 356.

126. *Id.*

127. *Id.*

128. *Nadybol*, 254 B.R. at 357.

129. *Id.* at 356.

130. *Id.* at 357.

131. *Id.*

132. *Id.*

133. *Nadybol*, 254 B.R. at 357; *see also Kalinski*, 528 F.2d at 973-74 (1st Cir. 1976).

134. *Brummitt v. U.S.*, 329 F.2d 966, 969 (Ct. Cl. 1964).

135. *Id.*

136. *Id.*

137. *Id.*

and was financially responsible for its loan, and, (4) “government employees and foreign nationals [alike] were entitled to membership” without limitation.<sup>138</sup> Therefore, the employees of the USOOMT, which is not an agency of the United States, are qualified to claim the exclusion.<sup>139</sup> Next, we will examine the political and industry opposition to repealing the IRC provision for foreign earned income exclusion.

#### IV. POLITICAL AND INDUSTRY OPPOSITION TO REPEAL THE EXCLUSION PROVISION

Amid the Senate Finance Committee debating the Jobs and Growth Tax Relief Reconciliation Act,<sup>140</sup> and limited to a budget of \$350 billion in tax relief to stimulate the economy and increase the number of jobs in the United States, there emerged a controversial plan to repeal section 911 of the IRC.<sup>141</sup> The proposed plan emerged as a potential revenue raising provision worth thirty five billion dollars over the next ten years to offset the tax reductions and remain within budget limits.<sup>142</sup> The controversial plan by Senator Grassley, chairman of the Senate Finance Committee, would have eliminated the tax exemption available to over 358,000 American taxpayers working overseas.<sup>143</sup>

Business leaders representing expatriates criticized the proposed repeal claiming that Congress should expand the foreign income exclusion instead of eliminating the provision.<sup>144</sup> The taxpayers affected are American citizens overseas, working in remote areas of the world with modest salaries that create jobs in the United States.<sup>145</sup> Many organizations with employees abroad expressed support for retaining the exemption, because without it they would have to replace those American employees with foreign nationals.<sup>146</sup> Nonprofit organizations such as the Catholic Relief Services and the International Rescue Commission, performing humanitarian work on behalf of the United States, also

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138. *Id.*

139. *Brummitt*, 329 F.2d at 969.

140. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (2003).

141. 108 CONG. REC. S1054 (daily ed. May 14, 2003) (statement of Sen. Grassley), available at <http://thomas.loc.gov> (last visited June 21, 2003).

142. *Id.*

143. *Id.*

144. *Proposal to Add Taxes for U.S. Citizens Abroad Draws Fire*, Agence France-Presse, May 15, 2003, available at 2003 WL 2802787.

145. 108 CONG. REC. S1054 (daily ed. May 14, 2003) (statement of Sen. Breaux), available at <http://thomas.loc.gov> (last visited June 21, 2003).

146. *Id.* Among the organizations voicing opposition to repeal the foreign earned income exclusion were “the Chamber of Commerce, the National Association of Manufacturers, the National Foreign Trade Council, the Financial Executives International, the U.S. Council for International Business, the Association of General Contractors of America, and, the American Council of Engineering Companies.” *Id.*

expressed their support for retaining the exemption.<sup>147</sup> Senator Breaux led the opposition and expressed his concerns to the Finance Committee regarding the elimination of the provision

[W]hy do American workers get a credit for working overseas? ... [T]hey are [neither] in this country... [nor] enjoy the benefits and the security of living in this country, and, therefore, ... in order to encourage American workers to have jobs overseas instead of hiring foreign citizens, the [Internal Revenue Code provides] American workers an \$80,000 tax exemption on [the] wages ... they earn overseas. In many cases, they work in dangerous places. In most cases, [American's working abroad do not] get the privileges and the security of living in the United States.<sup>148</sup>

It is a bad tax policy to place American businesses in an uncompetitive position with foreign companies, forcing them to replace American workers with foreign nationals.<sup>149</sup>

However, Senator Grassley justified his position in favor of repealing the foreign earned income exclusion, by stating on the Senate floor:

[t]he policy issue presented by repeal of section 911 is whether taxpayer dollars should be used to underwrite an employer's cost of sending employees overseas. Why do we subsidize moving employees overseas? I think sending employees overseas should be a business decision. Repeal will not cause U.S. citizens to be double taxed. A U.S. citizen who earns [foreign] income ... taxed by a foreign country [may elect]... to reduce ... U.S. taxes [by an amount equal to] ... any foreign income taxes paid.<sup>150</sup>

In a memorandum addressed to reporters and editors, Senator Grassley further stated that, “[a] worker in Des Moines pays federal income taxes, but his colleague working for the same company overseas probably pays nothing, that [does not] make sense.”<sup>151</sup>

Ways and Means Committee members verbally assaulted the Senate Finance Committee bill to offset tax reductions by repealing the exclusion

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147. *Id.*

148. *Id.*

149. 108 CONG. REC. S1054 (daily ed. May 14, 2003) (statement of Sen. Breaux), available at <http://thomas.loc.gov> (last visited June 21, 2003).

150. 108 CONG. REC. S1054 (daily ed. May 14, 2003) (statement of Sen. Grassley), available at <http://thomas.loc.gov> (last visited June 21, 2003).

151. Memorandum from Senator Charles Grassley, Section 911 repeal, U.S. Senate Commission on Finance, to Reporters and Editors (May 14, 2003), available at <http://finance.senate.gov> (last visited June 21, 2003).

provision.<sup>152</sup> Representative Foley, referring to the thirty-five billion dollar repeal of the tax exclusion declares “[t]he Senate’s idea of giving tax relief to American families is to increase their taxes.”<sup>153</sup> Senate Majority leader Tom Daschle voiced his concerns over the impact the exclusion would have on the American economy “[w]e need people to take ... jobs [abroad] to continue to grow this economy as much as we can ... [not] a huge tax increase on working families [overseas] at the time when we need ... them more than ever.”<sup>154</sup>

## V. CONCLUSION

Repeal of the long standing provision that allows for foreign earned income exclusion would result in a loss of jobs that is in direct conflict with the Bush administration’s “intentions to stimulate the economy.”<sup>155</sup> Eliminating the exclusion would result in United States businesses hiring foreign nationals in place of American workers employed in foreign countries.<sup>156</sup> Moreover, if businesses replace American workers with foreign nationals the unemployment rate would rise and exports would suffer.<sup>157</sup>

Those in opposition to the exclusion provision claim that American taxpayers working abroad have an advantageous tax position because they are not subject to double taxation, thus the provision is not necessary.<sup>158</sup> Some taxpayers qualified to elect section 911 may work abroad and earn income free of personal income taxation by working in a foreign country that imposes no taxes.<sup>159</sup> However, foreign countries that do not levy taxes on personal income use other means to tax individuals.<sup>160</sup> For example, the Bahamas does not levy taxes on the personal income of its citizens or any individual working in that country.<sup>161</sup> The Bahamian Government’s means of generating revenues to sustain governmental services is through indirect taxation on goods and

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152. Martin Vaughn and Keith Koffler, *Senate Tax Cuts Could Grow in Conference Report*, CONGRESS DAILY NEWSWIRE, May 9, 2003, available at 2003 WL 18098126.

153. *Id.*

154. *Proposal to Add Taxes for U.S. Citizens Abroad Draws Fire*, Agence France-Presse, May 15, 2003, available at 2003 WL 2802787.

155. Letter from Robert A. Zarzar, Chair, Tax Executive Committee, American Institute of Certified Public Accountants, to The Honorable Charles E. Grassley, Chairman, Senate Finance Committee (May 14, 2003), available at <http://www.cpabiz.com/ResourceCenters/Tax/International/section911.htm>.

156. *Id.*

157. *Id.*

158. 108 CONG. REC. S1054 (daily ed. May 14, 2003) (statement of Sen. Grassley), available at <http://thomas.loc.gov> (last visited on June 21, 2003).

159. Marguerite H. Vanlandingham, *Code Section 911 Tax Relief and the Cost of Living Abroad*, 24 INTL TAX J. 48, 50 (1998).

160. *Id.*

161. *Id.*



services.<sup>162</sup> Thus, an American citizen working in the Bahamas pays “approximately one-and-one-half times” more to purchase products than in the United States.<sup>163</sup> Based on these circumstances, an American citizen working in the Bahamas, and qualified to elect the exclusion, would earn income of “approximately one-and-one-half times” the income in the United States.<sup>164</sup> Simultaneously that same American citizen would pay to purchase products in the Bahamas one-and-one-half-times the cost of products in the United States.<sup>165</sup> The net result is no gain.<sup>166</sup>

The policy and purpose of the provision excluding foreign earned income continues to have a significant impact not only on the economy of the United States but also on its citizens working abroad.

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162. *Id.*

163. Vanlandingham, *supra* note 159, at 52.

164. *Id.*

165. *Id.* at 52–53.

166. *Id.* at 53.