

SUBJECT : Taxation of Air America Employees: Foreign Residence

Attached are copies of correspondence between the Internal Revenue Service and certain Air America Employees situated in Thailand and in Laos, wherein the IRS takes the position that these employees are not entitled to a tax exemption based on foreign residence. This IRS position can be applied in principle to Japan, Vietnam and other Far East countries.

The IRS is taking the position that these employees cannot be considered to be foreign residents, for income tax purposes, unless they pay taxes to the country in which they are stationed. One IRS letter to an employee states:

"It appears from your 2555 that you do not qualify for exclusion as a bona fide resident of Thailand since you pay no taxes to that country. You may, however, qualify to exclude your income under the physical presence rules."

A similar letter to a Laos based employee revised his tax return to show a \$20,000 exclusion based on foreign physical presence rather than the claimed foreign residence; the reason being that no foreign residence was established as the employee allegedly did not meet such IRS requirements as:

". . . having a resident's visa; paying taxes as a resident; involvement in the cultural, social and economic life of Laos; treatment by Government similar to bona fide residents."

Similar letters from the IRS state;

". . . American citizens present in certain foreign countries under special arrangements and treaties that confer the privilege of exemption from taxation by the foreign country may not claim the status of being bona fide residents of that country if they avail themselves of the exemption. The United States has signed the Multilateral Mutual Defense Assistance in Indochina Agreement with Vietnam."

"Although Laos is not specifically mentioned in Publication 54 as having entered into agreement that members of the United States armed forces and the civilian component are exempt from the foreign country's laws and regulations on the registration and control of aliens and enjoy privileges and immunities not accorded native residents, unless you can substantiate claim of bona fide residence within the technical intent of Section 911, the maximum exclusion of earned income is \$20,000 for a full tax year."

Publication 54 is an IRS booklet entitled "Tax guide For U.S. Citizens Abroad".

"To substantiate claim of bona fide residence status the English translations of the following evidence may be furnished:

1. A copy of an income tax return filed with the Foreign Governments in which you claim residence and receipts for the taxes paid; or,
2. A copy of the law of the Foreign Government, which exempts from tax the income of the United States citizens; or,
3. A copy of any document furnished to a Foreign Government which is required by the Government in order to classify the residency status of aliens entering and leaving its territorial jurisdiction; or,
4. Proof of the absence of Income Tax Laws from the Foreign Government."

Irs Publication 54 states that persons entering Vietnam, Japan, and NATO countries may not claim foreign residence if they enter the country(ies) under treaties with those countries which provide for tax free status. Although the IRS apparently does not claim that the Indochina Agreement (applicable to Vietnam) applies to Laos, they still are apparently claiming the necessity of paying Laos taxes in order to be a Laos resident.

The Internal Revenue Code, as opposed to the IRS interpretation thereof, states in Section 911 (c) (6):

"(6) TEST OF BONA FIDE RESIDENCE - A statement by an individual who has earned income from sources within a foreign country to the authorities of that country that he is not a resident of that country, if he is held not subject as a resident of that country to the income tax of that country by its authorities with respect to such earnings, shall be conclusive evidence with respect to such earnings that he is not a bona fide resident of that country for purposes of subsection (a) (1)."

Subsection (a) (1) provides a tax exemption based on foreign residence.

The IRS is trying to expand the application of this Code provision, probably incorrectly, in two respects:

a. The Code denies the exemption if the person makes a "Statement" to a foreign government. The term "statement" means the "act of stating, reciting, or presenting, orally or on paper". A strict interpretation of the law would require that this statement be made orally or in writing. However, the IRS is interpreting this to mean that a mere failure to pay taxes, is a "statement" even though the person may never have had any communication with foreign government either orally or in writing. This IRS interpretation is very broad and possibly would not be upheld by the Courts (and was struck down by the U.S. Court of Claims in a decision discussed below).

b. The Code denies the exemption if, as a result of such statement, the person ". . . is held not subject as a resident of that country to the income tax of that country by its authorities . . ." This clearly seems to require some sort of "holding" on the part of the foreign authorities; and I interpret it to mean that if the foreign government ignores your "statement" and makes no response

then the exemption is not lost. To lose this exemption I believe that the foreign government must hold that you are not a local resident since the term held (or hold in the present tense) means to "decide, adjudge, or decree". It seems that the foreign government must accept your statement as being true and then accordingly permit you to avoid local taxation.

However, the IRS takes the position that you lose the exemption even though there is no action on the part of the foreign government. Publication 54 states:

"If you make such a statement, and if the authorities of the foreign country have made no adverse determination on your nonresident status, you will be considered to have been held not subject to the income tax of that foreign country as of any date a determination is being made as to whether you qualify as a bona fide foreign resident."

Thus, the Code says you must be "held" by the foreign government to be a nonresident; whereas, the IRS is attempting to deny the exemption on the basis that the IRS itself has "considered" the person to have been held not subject to the foreign tax. This interpretation is tenuous.

Attached is a copy of Revenue Ruling 69-449 wherein the IRS ruled that citizens of the U.S. could not be residents of Vietnam if their status is established therein under the Multilateral Mutual Defense Assistance in Indochina Agreement between the U.S. and Vietnam. As can be noted, the IRS ruled that the mere status of being tax exempt in Vietnam is "considered to be the equivalent of 'statement' referred to in Section 911 (c) (6) of the Code." This ruling is probably erroneous since the Code calls for a "statement", not something that the IRS considers to be the equivalent of a statement.

These precise points were considered by the U.S. Court of Claims in the case of Frank S. Scott, Jr. v. The United States, U. S. Court of Claims, Nos. 36-66, 64-66, 10/16/70, 70-2 USTC 9652.

Mr. Scott was a University of Hawaii professor who went to Argentina as an employee of the United Nations Food and Agricultural Organization, and entered Argentina under the terms of a treaty between the U.N. and Argentina, whereby he was not subject to Argentina income taxes; was not subject to Argentina immigration laws, and had the right of duty free import and other privileges usually accorded diplomatic personnel.

The IRS held that in view of his treaty status he could not be a bona fide resident of Argentina. The Court of Claims, however, ruled that the IRS was wrong and that the acquisition of tax-free status with related privileges under the terms of a treaty did not in itself prevent an employee from acquiring bona fide residence in the foreign country.

This Court of Claims decision has not been appealed (so far as I can determine here) and remains valid. Much of the IRS correspondence quoted above was written prior to this decision. The Court noted the following points in its decision:

a. The Code does not state that exemption from taxation under a treaty or other agreement between foreign countries and the U.S. will prevent bona fide foreign residence. The Court treated a United Nations treaty as being the same as a U.S. treaty for the tax principles involved here.

- b. It is not necessary to pay a foreign tax before you can claim the foreign residency tax exemption. This would be pertinent in those countries that might not have an income tax or do not enforce it in regard to U.S. citizens for some reason other than treaty provisions (Laos and Thailand, for example).
- c. Congress is fully aware that under the present law some citizens escape all taxation; but Congress has found this acceptable since it has not acted to rewrite the law to prevent this; and presumably prefers this situation for the help it offers U.S. business abroad.
- d. Payment of local taxes is only one of many factors, and not a controlling one, in determining whether a person is a local resident.
- e. Taking advantage of a tax-free treaty status is not in itself a "statement" that you are not a local resident. The court cited the U.S. Senate reports on this law to the effect that the Senate was aware that some persons could avoid taxes in both the U.S. and the foreign country under a treaty status; but the Senate was willing to allow such persons to have this benefit as long as they did not affirmatively deny residence in both countries. If the person remains silent he is neither denying or affirming his status.
- f. Revenue Ruling 69-449, quoted above about Vietnam, and Revenue Ruling 68-553 regarding Japan, were rejected as being erroneous. (These rulings had held that entry into those countries under treaty prevented local residency)

In regard to Air America's employees, it is my opinion that the employee in Laos and Thailand can successfully claim a bona fide foreign residence in those countries, regardless of whether they pay local taxes, so long as they meet the general requirements that are applicable to the definition of residency. This would also be true of the employees in Vietnam so long as they do not make a statement (oral or written) to the Vietnam Government that they are not residents of Vietnam. In regard to the employees in Japan, the general principles stated above would apply to them also. However, the IRS, in addition to their position that failure to pay taxes amounts to ~~making~~ making a "statement", might also claim that the various papers these employees file (or have filed by the Company on their behalf) amount to a "statement". These papers would of course be written and the IRS would have a more substantial foundation for their position in this respect. I am not aware of what papers, if any, the Japan employees file with Government of Japan, or with the U.S., but I assume that they do file applications for Article 14 status (including such privileges as special visas, P.X. privileges, import privileges, etc.). Also Article 14 specifically provides that persons who avoid U.S. taxes on the basis that they are residents of Japan will be subject to Japanese taxes even though they may otherwise have Article 14 status. Thus these employees may be exposed to taxes from one country or the other (unless they avoid U.S. taxes on the physical presence basis).