Freedman v. Commissioner, 6 T.C. 915 (1946)

For a U.S. citizen working abroad, the source of income is determined by where the services are performed, not where the payment is made.

Summary

Freedman, a U.S. citizen and bona fide nonresident, received $95,000 for services performed in Germany. He sought to exclude this income from his U.S. taxes under Section 116(a) of the Internal Revenue Code, arguing it was earned income from sources outside the U.S. The Commissioner argued the income was profit from a joint venture or, alternatively, was sourced within the U.S. The Tax Court held that the $95,000 constituted earned income from sources outside the U.S. and was therefore exempt from U.S. taxation.

Facts

- Freedman, a U.S. citizen, resided outside the U.S. for more than six months during the tax year.
- He was contacted by Gottlieb and Romney regarding the potential sale of bonds in Germany.
- Freedman traveled to Berlin and negotiated with German financial officials (Siemens & Halske A.G., the German Reichsbank, and other German banks) to facilitate the sale.
- He received $95,000 for these services, deposited into his New York bank account.
- Freedman did not contribute any capital or credit to the transaction.
- The bonds were sold by General Electric Corporation to Siemens & Halske A.G.

Procedural History

The Commissioner determined that the $95,000 was not exempt from U.S. income tax. Freedman petitioned the Tax Court for a redetermination. The Tax Court reversed the Commissioner’s determination.

Issue(s)

1. Whether the $95,000 received by Freedman constituted “earned income” under Section 25(a)(4)(A) of the Internal Revenue Code.
2. Whether the $95,000 was received from sources “without the United States” under Section 116(a) of the Internal Revenue Code.
3. Whether, if the income was for personal services, a portion should be treated as income from sources within the United States because Freedman sent cablegrams to New York during his negotiations.

Holding

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1. Yes, because the $95,000 was compensation for personal services Freedman actually rendered in Germany.
2. Yes, because the source of income is determined by where the services are performed, not where the payment is made.
3. No, because all of Freedman's services were performed in Germany; sending cablegrams to New York did not constitute performing services in New York.

Court's Reasoning

The court reasoned that the $95,000 was paid to Freedman as compensation for his personal services in Berlin, where he contacted and negotiated with German financial officials. The court emphasized that Freedman had no prior commitments and did not contribute any capital to the transaction. His services were valuable, extending over two months, and he was uniquely positioned to handle the negotiations.

The court relied on established precedent (I.T. 2293, I.T. 2286, S.M. 5488, S.M. 5446, and Regulations 103, sec. 19.119-4) and Section 119(c)(3) of the Code, which states that "compensation for labor or personal services performed without the United States" is treated as income from sources without the United States. The court rejected the Commissioner's argument that the location of Gottlieb and Romney or the payment's origin in New York was relevant. "[I]n determining whether compensation is from sources within or 'without the United States,' the place where the services are performed and not the place where the compensation is paid is the controlling factor."

Finally, the court dismissed the argument that sending cablegrams to New York constituted performing services in the United States. All of Freedman's substantive work occurred in Germany.

Practical Implications

Freedman clarifies that the location of service performance is the primary factor in determining the source of income for U.S. citizens working abroad. This case provides a clear rule for applying Section 116(a) (now Section 911) of the Internal Revenue Code. Attorneys advising U.S. citizens working overseas should focus on documenting the location where services are rendered. Later cases and IRS guidance continue to emphasize this "place of performance" test. It also highlights the importance of distinguishing between earned income and investment income in this context, as only the former qualifies for the foreign earned income exclusion.

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