18 T.C. 1241 (1952)

Section 116(a)(2) of the Internal Revenue Code exempts income earned abroad only in the year a U.S. citizen returns from foreign residence, not in subsequent years when that income is received.

Summary

James Flanagan, a U.S. citizen, resided in Canada from 1926 to 1942. After retirement, he received pension payments based partly on compensation for services performed outside the U.S. during his Canadian residence. The IRS assessed deficiencies, arguing that these pension payments were fully taxable because Flanagan was a U.S. resident when he received them. Flanagan's estate argued that a portion of the pension income attributable to his foreign service should be exempt under Section 116(a)(2) of the Internal Revenue Code. The Tax Court upheld the IRS's assessment, finding that the exemption applies only to the year of change of residence.

Facts

- James W. Flanagan was a U.S. citizen.
- He worked for Standard Oil Co. and Andian National Corporation from 1912 to 1942.
- From 1926 to 1942, he was a bona fide resident of Canada.
- In 1942, at age 70, he retired and returned to the U.S., remaining a resident until his death.
- Upon retirement, he received an annual pension from Imperial Oil, Ltd., based on his prior compensation, including that earned while a resident of Canada.
- In 1944 and 1945, Flanagan reported the pension income but claimed an exemption for the portion attributable to services performed in Canada during his period of Canadian residence.

Procedural History

The Commissioner of Internal Revenue assessed income tax deficiencies for 1944 and 1945. Flanagan's estate petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court, after considering the arguments and a similar case decided by the Court of Claims, upheld the Commissioner's assessment.

Issue(s)

1. Whether pension payments received by a U.S. citizen in 1944 and 1945, attributable to compensation for services rendered during more than two years of foreign residence but received after the taxable year of change of residence to the United States, are exempt from gross income under Section 116(a)(2) of the Internal Revenue Code.

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Holding

1. No, because Section 116(a)(2) applies only to the year in which the taxpayer changes his residence from a foreign country back to the United States, and not to subsequent years.

Court's Reasoning

The court relied heavily on the Court of Claims decision in *Wood v. United States*, which addressed the same issue. The court reasoned that while Section 116(a)(2) is not explicitly clear on its face, the title of the section, "Taxable year of change of residence to United States," clarifies that the exemption is limited to the year the taxpayer returns to the U.S. The court also examined the legislative history of the section, citing Senate Report 1631, which states that the same treatment (exemption of foreign-earned income) will be accorded to the taxpayer "for the year in which they return to the United States." The court further explained that the word "derived" in the regulations refers to the actual receipt of income. Therefore, Congress only intended to allow an exclusion in the year of the change of residence for funds earned and received during the period of foreign residence. The court prioritized consistency in the interpretation of federal tax statutes.

Practical Implications

This case clarifies that the exemption for income earned abroad under Section 116(a)(2) is strictly limited to the tax year in which a U.S. citizen returns to the United States after a period of foreign residence. It prevents taxpayers from claiming the exemption in subsequent years, even if the income received is directly attributable to services performed during their time abroad. This ruling emphasizes the importance of the "year of change of residence" in determining the applicability of the exemption. Legal professionals advising clients on foreign income exclusions must consider this case when determining eligibility for exemptions in years following the return to the U.S. This case, along with Wood v. United States, serves as a key precedent in interpreting Section 116(a)(2).

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