55 T.C. 251 (1970)

Expenses related to foreign earned income are not deductible to the extent they are allocable to income excluded under Section 911, even if the foreign business operates at a loss.

Summary

Anne Moen Bullitt Brewster, a U.S. citizen residing in Ireland, operated a farming business that consistently incurred losses. She sought to deduct all farm expenses on her U.S. tax returns. The Commissioner of Internal Revenue determined that a portion of her gross farm income constituted "earned income" from foreign sources, excludable under Section 911 of the Internal Revenue Code. Consequently, a proportional share of her farm expenses was deemed allocable to this excluded income and thus non-deductible. The Tax Court upheld the Commissioner's determination, finding that the exclusion and expense allocation are mandatory under Section 911, regardless of whether the business generates a net profit or loss.

Facts

Petitioner Anne Moen Bullitt Brewster was a U.S. citizen and bona fide resident of Ireland from 1956 to 1960. During this period, she operated a farming business in Ireland involving cattle and horses. This business was one in which both personal services and capital were material income-producing factors. For each year from 1956 to 1960, Brewster's farming business generated gross income but incurred significant expenses, resulting in net farm losses. On her tax returns, Brewster did not exclude any income under Section 911 and claimed all related farm expenses as deductions. The Commissioner determined that a portion of her gross farm income was excludable "earned income" under Section 911 and disallowed a proportionate share of her farm expenses as deductions.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Brewster for the tax years 1957 through 1960, based on the disallowance of a portion of her farm expense deductions. Brewster petitioned the United States Tax Court to contest the Commissioner's determination.

Issue(s)

1. Whether, for a U.S. citizen residing abroad and operating a business where both personal services and capital are material income-producing factors, a portion of gross income must be considered "earned income" excludable under Section 911, even when the business operates at a net loss.
2. Whether, if a portion of gross income is deemed excludable "earned income" under Section 911, a proportionate share of related business expenses is non-deductible, even when the business operates at a net loss.

© 2025 SCOTUSreports.com. All rights reserved.

Holding

1. Yes. The Tax Court held that Section 911 mandates the exclusion of a portion of gross income as "earned income" for qualifying taxpayers, regardless of whether the business generates net profits or losses, because the statute is not permissive or elective.
2. Yes. The Tax Court held that a proportionate share of expenses is properly allocable to the excluded "earned income" and is therefore not deductible, because Section 911 disallows deductions allocable to excluded income, and this applies even when the related business operates at a loss.

Court's Reasoning

The Tax Court reasoned that Section 911(a) explicitly states that "earned income" from foreign sources "shall not be included in gross income." Section 911(b) defines "earned income" for businesses where both personal services and capital are material income-producing factors as "a reasonable allowance as compensation for the personal services rendered by the taxpayer," limited to 30% of net profits. The court rejected Brewster's argument that the 30% net profit limitation implied that no "earned income" existed when there were no net profits. The court interpreted the 30% limitation as applying only when net profits exist, not as a condition for "earned income" to exist at all. The court emphasized that the exclusion is mandatory, not elective. Regarding the deductibility of expenses, the court pointed to the explicit language in Section 911(a) disallowing deductions "properly allocable to or chargeable against amounts excluded from gross income." The court found that a portion of Brewster's farm expenses was indeed allocable to her "earned income," even though it resulted in a net loss. The court acknowledged the dissenting opinion, which argued that this interpretation illogically penalizes taxpayers with foreign business losses and contradicts the purpose of Section 911 to encourage foreign trade. The dissent contended that the 30% net profit limitation should be interpreted as integral to the definition of "earned income" for service-capital businesses, meaning no "earned income" exists when there are no net profits, and thus no expense disallowance should occur in loss situations.

Practical Implications

Brewster v. Commissioner establishes that U.S. taxpayers residing abroad with businesses involving both personal services and capital must treat a portion of their gross income as excludable "earned income" under Section 911, even if the business operates at a loss. This case highlights that the foreign earned income exclusion and the corresponding disallowance of allocable expenses are not contingent on the business generating a profit. Legal practitioners should advise clients with foreign businesses to consider the potential impact of Section 911 even when businesses are not profitable, as it can lead to the disallowance of deductions. Taxpayers cannot simply deduct all business expenses in loss years if a portion of the gross income is deemed "earned income" from foreign sources. This ruling underscores the

© 2025 SCOTUSreports.com. All rights reserved.

importance of properly allocating expenses between excluded and non-excluded income in foreign earned income situations, regardless of profitability. Later cases and IRS guidance have continued to refine the methods of expense allocation in these contexts, but the core principle from *Brewster* remains: mandatory exclusion and related expense disallowance apply even in loss scenarios.

© 2025 SCOTUSreports.com. All rights reserved.