Foley v. Commissioner, 87 T. C. 605 (1986)

Incentive payments from foreign governments to U. S. citizens are taxable income under U. S. tax law, even if not considered income in the foreign jurisdiction.

Summary

James Foley, a U. S. citizen residing in West Berlin, received incentive payments under the Berlin Promotion Law. The U. S. Tax Court held that these payments must be included in Foley's U. S. taxable income under IRC §61, as they constituted accessions to wealth. However, the court also ruled that Foley correctly calculated his foreign tax credit without including these payments, as they were not considered income under German law. The decision underscores the broad scope of U. S. taxation on worldwide income of its citizens and the limitations of foreign tax credit calculations.

Facts

James M. Foley, a U. S. citizen and pilot for Pan American World Airways, resided in West Berlin from August 1978 through the relevant tax years. He received incentive payments of $2,068 in 1978, $6,931 in 1979, and $7,209 in 1980 under article 28 of the Berlin Promotion Law, which aimed to boost West Berlin's economy. These payments were not subject to German income tax. Foley did not report these payments on his U. S. tax returns but included all German taxes withheld in calculating his foreign tax credit.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Foley's federal income taxes for 1978, 1979, and 1980, asserting that the incentive payments should be included in income and reduce the foreign tax credit. Foley petitioned the U. S. Tax Court, which held that the payments were taxable under U. S. law but did not affect the foreign tax credit calculation.

Issue(s)

1. Whether incentive payments received by a U. S. citizen under the Berlin Promotion Law are includable in U. S. taxable income under IRC §61.
2. Whether such payments should be included in the calculation of the foreign tax credit under IRC §901.

Holding

1. Yes, because the payments represent accessions to wealth and are not exempt under U. S. tax law.
2. No, because the payments are not considered income under German law and thus do not affect the foreign tax credit calculation.

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Court’s Reasoning

The court applied IRC §61, which taxes all income “from whatever source derived,” to determine that the incentive payments were taxable. The court rejected Foley’s arguments that the payments were gifts or excludable under U. S. social welfare programs, noting that the payments were made in anticipation of economic benefits to West Berlin. The court distinguished the Berlin Promotion Law from U. S. social benefit programs, emphasizing that the payments were tied to employment and economic contribution rather than need or social welfare. Regarding the foreign tax credit, the court found that since the payments were not taxable under German law, they did not affect the calculation of the credit. The court also noted that the U. S. - Germany tax treaty did not exempt these payments from U. S. taxation.

Practical Implications

This decision clarifies that U. S. citizens must report foreign incentive payments as income on their U. S. tax returns, even if such payments are not taxable in the foreign jurisdiction. It highlights the importance of understanding the distinction between foreign and U. S. tax laws when calculating taxable income and foreign tax credits. Practitioners should advise clients working abroad to include such payments in their U. S. income, while ensuring that foreign tax credits are calculated correctly based on taxes paid on taxable income in the foreign jurisdiction. This case has been cited in subsequent decisions regarding the taxation of foreign income and the application of foreign tax credits, reinforcing the principle that U. S. citizens are taxed on their worldwide income.

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