Matthews v. Commissioner, 94 T. C. 377 (1990)

Employees of nonappropriated fund instrumentalities of the U. S. are not eligible for the foreign earned income exclusion under section 911 of the Internal Revenue Code.

Summary

In Matthews v. Commissioner, U. S. citizens working for nonappropriated fund instrumentalities (NAFIs) in Germany sought to exclude their income under section 911 of the Internal Revenue Code. The Tax Court held that NAFIs are agencies of the United States and the taxpayers were employees of these agencies, thus ineligible for the exclusion. The court also found that the taxpayers' underpayments were not due to negligence, as they had a good faith belief in their eligibility for the exclusion. This case clarifies the scope of section 911 and the status of NAFI employees under U. S. tax law.

Facts

David Matthews and Ronald Davis, U. S. citizens living in Germany, worked for nonappropriated fund instrumentalities (NAFIs) associated with the U. S. Army's Morale, Welfare, and Recreation system. Matthews worked for the U. S. Army Community and Family Support Center, while Davis was employed by the U. S. Army Europe Morale, Welfare, and Recreation Fund. Both were salaried employees, supervised by NAFI personnel, and paid from nonappropriated funds. They claimed exclusions for their 1983 and 1984 income under section 911, which allows qualified individuals to exclude foreign earned income from gross income. The Commissioner of Internal Revenue determined deficiencies and additions to tax for negligence.

Procedural History

The Commissioner issued statutory notices of deficiency to Matthews and Davis, asserting that their NAFI income was not excludable under section 911 and that they were liable for negligence penalties under section 6653(a). The taxpayers timely filed petitions with the Tax Court, which consolidated the cases. The court found in favor of the Commissioner on the issue of eligibility for the section 911 exclusion but ruled against the Commissioner on the negligence penalties.

Issue(s)

1. Whether the taxpayers' income from nonappropriated fund instrumentalities (NAFIs) qualifies for exclusion under section 911 of the Internal Revenue Code.
2. Whether the taxpayers' underpayments of tax were due to negligence or intentional disregard of rules or regulations under section 6653(a).

Holding

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1. No, because the taxpayers were employees of NAFIs, which are agencies of the United States, and thus their income is not eligible for exclusion under section 911.
2. No, because the taxpayers acted in good faith and their position was not clearly untenable, so the negligence penalty under section 6653(a) does not apply.

Court's Reasoning

The court applied the statutory language of section 911, which excludes from foreign earned income amounts paid by the United States or an agency thereof to an employee of the United States or an agency thereof. The court held that NAFIs are agencies of the United States, as established by prior case law and the legislative history of section 911. The court then determined that Matthews and Davis were employees of their respective NAFIs under common law tests of employment, focusing on the right of control exercised by the NAFIs over the taxpayers' work. The court rejected the taxpayers' argument that section 2105(c) of title 5 and Army regulations deemed them not to be employees for purposes of section 911, as these provisions did not apply to income tax law. On the issue of negligence, the court found that the taxpayers' good faith belief in their eligibility for the exclusion, coupled with their full disclosure and receipt of prior refunds, negated the imposition of negligence penalties.

Practical Implications

This decision clarifies that employees of NAFIs are not eligible for the foreign earned income exclusion under section 911, impacting how tax professionals should advise clients working for such entities abroad. The ruling emphasizes the importance of common law employment tests in determining eligibility for tax exclusions and the need for careful consideration of statutory language and legislative history. The court's refusal to impose negligence penalties highlights the significance of good faith in tax disputes, potentially affecting how the IRS assesses penalties in similar cases. Subsequent cases involving NAFI employees and section 911 will need to consider this precedent, and tax practitioners should be aware of the limited scope of exclusions from taxable income.

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