

## Foreign Earned Income Exclusion Election Surprise

These taxpayers filed late returns electing the foreign earned income exclusion (FEIE). IRS denied the exclusion stating the election to use the exclusion was not timely made. After discussing the case issues, this article will discuss the rules in the regulations for timely making the election to exclude the income.

Elena and Frederick lived and worked in Iraq during 2004 & 2005. In early 2005, Frederick and their children moved to Germany and continued working. Elena joined the family in Germany later in the year. They continued to work in Germany through 2006.

IRS had no record of returns for these years (2004-2006) and prepared substitutes for returns (SFRs) for 2004 & 2005 on May 22, 2007, and an SFR for 2006 on August 19, 2008. IRS claimed it did not receive any returns for 2004-2006 prior to January 8, 2016. The taxpayers submitted returns on January 8, 2016, at which time the assessments based on the SFRs were abated.

The submitted returns for 2004, 2005, and 2006 were dated September 30, 2005, September 15, 2006, and September 29, 2007, respectively. Each return showed a Texas address. The 2004 return did not include a Form 2555, Foreign Earned Income Exclusion, although a reference to the form was noted on the first page of the return. The 2005 return include separate Forms 2555 for each taxpayer, and the 2006 included one Form 2555 for Frederick. The returns claimed the FEIE for \$140,209; \$103,202; and \$71,929 respectively. Each return still had a tax after the FEIE was claimed. The returns included inaccuracies, such as the dates of physical presence noted on the 2005 return of “from 5/1/2005 through 12/31/2013” even though the return was supposedly filed September 15, 2006. None of the returns contained a statement on the first page that it was “Filed Pursuant to Section 1.911-7(a)(2)(i)(D)” as prescribed by the identified regulation.

An examination of the returns was conducted in August 2017. IRS originally argued that the taxpayers did not qualify for the exclusion because their tax home was not in a foreign country. However, surprisingly, IRS changed its arguments to claiming the taxpayers did not make a proper election to claim the FEIE. This meant Tax Court focused on this argument and did not address the “tax home” issue.

IRS contends it did not receive the returns for these years until January 2016. Due to the many inaccuracies in the returns, Tax Court accepted the IRS’ position that the “date of filing” was January 8, 2016. This means each return was filed years after the return’s due date.

Section 911(a) does not address the timing for election to claim the FEIE. However, section 911(d)(9) gives the Secretary specific authority to write regulations on the making of the election.

IRS argued the taxpayers did not make the election properly on the late filed returns, therefore, the FEIE should not be allowed. Tax Court agreed with IRS. Specifically since the returns were filed so late, the regulations state the return claiming the FEIE election is required to have at the top of the first page of the Form 1040: “Filed Pursuant to Section 1.911-7(a)(2)(i)(D)”. None of these returns had such a statement, therefore, Tax Court agreed with IRS that the FEIE election was invalid.

Now, we’ll share the rules for the TIMING for making the election for the FEIE. An election is valid if it is made:

- 1) With an income tax return that is timely filed (including any extension of time to file),
- 2) With a later return filed within the period prescribed in Section 6511(a) amending the foregoing timely filed income tax return,
- 3) With an original income tax return that is filed within one year after the due date of the return (determined without regard to any extension of time to file); this one year period does not constitute an extension of time for any purpose – it is merely a period during which a valid election may be made on a late return, or
- 4) With an income tax return filed after the period described above provided:
  - a) The taxpayer owes no federal income tax after taking into account the exclusion and files Form 1040 with Form 2555 or a comparable form attached either before or after the IRS discovers that the taxpayer failed to elect the exclusion, or
  - b) The taxpayer owes federal income tax after taking into account the exclusion and files Form 1040 with Form 2555 or a comparable form attached before the IRS discovers that the taxpayer failed to elect the exclusion.
  - c) A taxpayer filing an income tax return pursuant to paragraph (a) or (b) must type or legibly print the following statement at the top of the first page of the form 1040, “Filed Pursuant to Section 1.911-7(a)(2)(i)(D).”

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