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Coffee? Tea? Section 863? Tax Court Dispenses Double Taxation in International Airspace

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In *Savary v. Comr.*,[1] the Tax Court, acting through a special trial judge in a summary opinion case, followed the path of its prior interpretation of Regs. §1.911-2(g);[2] accordingly agreeing with the Internal Revenue Service's conclusion that international airspace is not ''within a foreign country'' for purposes of creating a partial exclusion of salaries under §911 for foreign-resident U.S. citizen members of international airline flight crews. However, the court may have skidded off the runway when it blindly followed Regs. §1.911-2(g) to hold that international airspace is ''in the United States'' for purposes of computing the source of services income under §861.

The taxpayer in *Savary* was a U.S. citizen residing in Paris. She was employed as a flight attendant for United Airlines, working on round-trip flights between Paris and a U.S. gateway city. The taxpayer's work time could thus be divided by location as between: (1) hours spent in the United States and the airspace over the U.S.; (2) hours spent in France and other foreign countries, and in the airspace over France and other foreign countries; and (3) hours spent in airspace not over any country (''international airspace'').

TAXPAYER SUBJECT TO TAX ON WORLDWIDE INCOME

The Tax Court first properly rejected the taxpayer's contention that her entire salary was exempt from U.S. tax under Article 15(3) of the 1994 U.S.-France Income Tax Treaty (''Treaty''). Article 15(3) generally exempts from U.S. income taxation salary earned by a French resident who is a crew member of an aircraft operated in international traffic. The court noted that under the ''saving clause'' contained in Article 29(2) of the Treaty, the Article 15(3) exemption is unavailable to U.S. citizens like the taxpayer in *Savary*.[3]

UNAVAILABILITY OF §911(b)(1)(A) FOR INCOME EARNED IN INTERNATIONAL AIRSPACE

The *Savary* court then addressed the extent to which the taxpayer's salary attributable to each of the three above-enumerated locations of service hours qualified as ''from sources within a foreign country'' within the meaning of §911(b)(1)(A), and thus qualified for the foreign earned income exclusion. The

[1] T.C. Summary Opinion 2010-150 (10/6/10).

[2] All section (''§'') references are to the U.S. Internal Revenue Code of 1986, as amended (''the Code''), or the regulations thereunder, unless otherwise indicated.

[3] The Treasury's Technical Explanation of Article 15(3) of the Treaty provides, ''A U.S. citizen resident in France who . . . is a crew member on [an] airline operated in international traffic, is, nevertheless, taxable in the United States on [her] remuneration by virtue of the saving clause of paragraph 2 of Article 29. . . .''

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court resolved this issue by reference to its earlier opinion in *Rogers v. Comr.*[4]

Like *Savary*, *Rogers* involved a U.S. citizen flight attendant (coincidentally also working for United Airlines) residing in a foreign country, who worked on flights between a foreign country and the United States. In *Rogers*, the Tax Court seemed to endorse proportionately dividing the taxpayer's salary into three parts for purposes of analysis, based upon the relative fractions of working hours, including pre-flight and post-flight services, represented by: (1) hours spent in the United States and the airspace over the U.S.; (2) hours spent in foreign countries and airspace over foreign countries; and (3) hours spent in international airspace. The *Rogers* court made this determination of hours based in part on United Airlines' sample flight-hour duty time apportionment forms and in part on the taxpayer's self-prepared reports. These flight hours were adjusted to account for her pre-flight and post-flight service time.

The *Rogers* court proceeded to determine which of those three classes of income qualified as ''within a foreign country'' within the meaning of §911(b)(1)(A). The court seemed to assume that the salary attributable to hours spent in the United States and the airspace over the United States was U.S.-source, whereas the salary attributable to hours spent in foreign countries and the airspace over foreign countries was foreign-source. To determine whether, as the taxpayer in *Rogers* claimed, the salary attributable to hours spent in international airspace, was earned ''within a foreign country'' within the meaning of §911(b)(1)(A), the Tax Court in *Rogers* focused on Regs. §1.911-2(h). That regulation defines a ''foreign country'' as including only the territory of a foreign country and the airspace above that territory. With respect to income earned in international airspace, i.e., airspace over neither the United States nor any foreign country, the *Rogers* court found that such amounts were not earned from sources ''within a foreign country'' for purposes of §911(b)(1)(A) and therefore were not excludible under §911(a).[5]

Consistent with *Rogers*, the Tax Court in *Savary* held that: (1) the taxpayer's salary attributable to hours spent in the United States and the airspace over the U.S. was not income earned ''within a foreign country'' within the meaning of §911(b)(1)(A) and thus was not excludible;[6] (2) the taxpayer's salary attributable to hours spent in France and other foreign countries and in the airspace over France and other foreign countries was income earned ''within a foreign country'' within the meaning of §911(b)(1)(A) and thus was excludible; and (3) the taxpayer's salary attributable to hours spent in international airspace was not income earned ''within a foreign country'' within the meaning of §911(b)(1)(A) and thus was not excludible.

In *Rogers*, the U.S. citizen taxpayer was a resident of Taiwan. There was no mention of any foreign income tax being imposed on the taxpayer's salary.[7] In particular, the Tax Court did not address whether the taxpayer was eligible for a foreign tax credit for any Taiwanese income taxes imposed upon the taxpayer's salary, attributable to her services performed in international airspace held to be taxable by the United States. If Taiwan had imposed such an income tax, the question could have arisen as to whether the income earned by the taxpayer in international airspace was ''from sources without the United States'' for purposes of generating a positive §904(a) foreign tax credit limitation for the taxpayer.[8] By contrast, the *Savary* court did examine the extent of creditability of foreign income taxes imposed by the foreign country of residence of a U.S. citizen, with respect to income earned in international airspace.

TAX COURT DISALLOWS CREDITS

The *Savary* court framed the issue as ''whether petitioner is entitled to a credit under §901 for all or a portion of the taxes paid to France.'' The method of analysis used to determine the amount creditable was curious. The Tax Court apparently first determined that because the salary earned in international airspace was not from a foreign country under Regs. §1.911-

[4] T.C. Memo 2009-111 (5/20/09).

[5] The *Rogers* court relied on *Clark v. Comr.*, T.C. Memo 2008-71, which held that international waters are not a ''foreign country'' under Regs. §1.911-2(h), so that income earned there was not excludible income earned ''within a foreign country'' within the meaning of §911(b)(1)(A). *Rogers* does not mention, but is also consistent with, the Tax Court's holding in *Arnett v. Comr.*, 126 T.C. 89 (2006), *aff'd*, 473 F.3d 790 (CA-7, 2007), that, Antarctica is classified as not a ''foreign country'' within the meaning of Regs. §1.911-2(h), income earned in Antarctica is not described in §911(b)(1)(A). *See* Castro, ''Note: Peculiar Polar Policy: The Internal Revenue Service's Treatment of Antarctica,'' 60 *Syracuse L. Rev.* 385 (2010).

[6] The taxpayer in *Savary* claimed on her originally filed return a §911(a) exclusion for only approximately $33,000 of her $38,000 salary. This might reflect a concession on her original return that her salary attributable to hours spent in the United States and the airspace over the United States was 13% ($5,000/$38,000) of her total salary and was not excludible income described in §911(b)(1)(A). The Tax Court found that, based on a stipulation, somewhat more than $14,000 — 38% of her salary — was attributable to hours spent in France and other foreign countries, and in the airspace over France and other foreign countries, and thus was excludible income described in §911(b)(1)(A). By subtraction, her income earned in international airspace, found by the Tax Court to be taxable in *Savary*, was approximately $18,000, or 49% of her salary.

[7] *See* Chen, Yeh and Peng, 958 T.M., *Business Operations in the Republic of China (Taiwan)*, at VI (''Resident individuals are subject to the consolidated income tax only on their [Taiwan]-sourced income.'').

[8] Unlike the situation in *Savary*, involving the U.S.-France Income Tax Treaty, there is no income tax treaty between the United States and Taiwan providing for a U.S. foreign tax credit with respect to income taxable under internal statutory law by both Taiwan (on the basis of residence) and by the United States (on the basis of citizenship).

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2(h), it was necessarily U.S.-source under the Code. Then the court interpreted Article 24 of the Treaty as providing that, with respect to U.S.-source salary earned by a U.S. citizen resident in France, France would allow a tax credit for the pre-credit French tax on the salary income, and the United States would not allow a foreign tax credit.[9] Based upon Article 24, the Tax Court then evidently determined that the ''portion of the petitioner's income [that] is U.S. source income [is] therefore not eligible for a credit for foreign tax paid . . . under §901.'' Because the Tax Court interpreted the Treaty as denying a foreign tax credit for U.S.-source salary, and characterized as U.S.-source the salary earned in international airspace (as well as the salary earned in the United States and airspace over the U.S.), the Tax Court denied a foreign tax credit for the French-residence-based tax paid on the salary earned in international airspace.

CODE IGNORED?

Curiously, except for concluding ''petitioner is not entitled to a foreign tax credit under §901,'' the Tax Court opinion in *Savary* ignored the Code's foreign tax credit rules, contained in §§901(a) and 904(a), and focused exclusively on the provisions of the Treaty in determining the extent to which the taxpayer could claim a credit for the French income tax. By contrast, GCM 38792 [10] conceded that §901(a) permits a U.S. citizen who resides in France, and who under French law is taxable on her worldwide income in France, to claim a U.S. foreign tax credit for the French tax paid on her U.S.-source income, although only to the extent of her §904(a) limitation. GCM 38792 noted the Service's long-standing concession in Rev. Rul. 55-414[11] that the Code does not disallow a U.S. citizen a §901 tax credit for foreign income taxes merely because the income upon which the foreign tax is imposed is U.S.-source income under the Code. Rather, under Rev. Rul. 55-414, otherwise creditable foreign taxes imposed on U.S.-source income are creditable if the individual has sufficient limitation from foreign-source income under §904(a).

The §904(a) limitation is generally the income from sources without the United States times the pre-credit average U.S. income tax rate. In other words, the Tax Court should logically have perceived that, in deciding the creditable amount of the French income tax paid by the taxpayer, a key issue was likely whether the salary earned in international airspace was from sources without the United States and thus includible for purposes of applying §904(a), as well as whether the taxpayer's other items of income could have affected this §904(a) limitation. The *Savary* court's failure to analyze §904(a) is particularly puzzling because it referred to *Filler v. Comr.*,[12] where the Tax Court upheld the Commissioner's determination that the U.S. citizen residing in France was not eligible to include salary attributable to time spent working in the United States under the statutory §904(a) limitation, as well as not eligible to claim a larger U.S. tax credit under the Treaty.[13]

By contrast, in *Savary*, the Tax Court stated its view that the portion of the taxpayer's income that was U.S.-source was ''therefore not eligible for a credit for foreign tax paid.'' That is, the court apparently misinterpreted Article 24 of the Treaty to mean that no §901 credit was allowable for French taxes imposed on an item of salary unless the taxpayer demonstrated that such French-taxed salary income was foreign-source.

The view that U.S. citizen flight crews are entitled to the U.S. statutory foreign tax credit rules to compute their U.S. income tax liability is supported by IRS Technical Assistance Memorandum 200017045. There the IRS noted, in the context of an issue involving international flight crews, that ''non-aggravation clauses'' in U.S. tax treaties, which provide that the treaty is not to reduce any credit or other allowance accorded by U.S. law, prevent the IRS from applying treaty rules that would deny U.S. citizens benefits otherwise allowable under the Code. The non-

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[9] Although the Tax Court referred to the Treasury's Technical Explanation of the Treaty in connection with its discussion of Article 24 of the Treaty, and also referred to Article 15(3) of the Treaty, concerning French resident members of international flight crews, the Tax Court, curiously, did not refer to the Technical Explanation's discussion of Article 15(3) insofar as that discussion related to the availability of U.S. foreign tax credits under Article 24 of the Treaty to U.S.-citizen French-resident members of an international flight crew — the exact situation in *Savary*. The Technical Explanation of Article 15(3) states: ''A U.S. citizen resident in France who performs dependent services in the United States and meets the conditions of paragraph 2 [concerning temporary employment in the United States] or is a crew member on a ship or airline operated in international traffic, is, nevertheless, taxable in the United States . . ., subject to the special rule of subparagraph 1(b) of Article 24 (Relief from Double Taxation).'' As noted by the Tax Court in *Savary*, subparagraph 1(b) of Article 24 (since renumbered as subparagraph 2(b) by Article VIII(1) of the 2009 Protocol) provides for a U.S. tax credit, not a French tax credit. In particular, subparagraph 1(b) generally provides a U.S. credit for ''income that, but for the [U.S.] citizenship of the taxpayer, would be exempt from United States income tax under the Convention.'' But for the taxpayer's U.S. citizenship in *Savary*, she would have been exempt from U.S. tax under Article 15(3) of the Treaty. The Tax Court might have further discussed the possibility of a U.S. tax credit, given the reference in the Technical Explanation of Article 15(3) to a U.S. tax credit in the context of U.S.-citizen French-resident airline crew members performing services in the United States. However, as the Tax Court noted in *Savary*, the Tax Court in *Filler*, 74 T.C. 406 (1980), had held that, under the prior 1967 version of the U.S.-France Income Tax Treaty, France — not the United States — was to provide a tax credit with respect to the U.S.-source salary, derived from temporary employment in the United States, of a U.S. citizen who was resident in France. The Technical Explanation of Article 24 of the Treaty applicable in *Savary* provides that ''the format of the Article has been revised, but the provisions are substantially the same as in the 1967 convention.''

[10] 8/28/01.

[11] 1955-1 C.B. 385.

[12] 74 T.C. 406 (1980).

[13] *See* the Syllabus in *Filler* and fn. 1 of that opinion.

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aggravation clause in Article 29(1)(a)(i) of the Treaty likewise provides that nothing in the Treaty shall reduce any credit allowable by U.S. law. The Treasury's Technical Explanation of Article 29(1)(a)(i) characterizes that as a ''provision typically found in . . . U.S. income tax treaties [which] establishes that [a] taxpayer may always rely on the Code treatment.''

The absence of §904(a) limitation would apparently also have disposed of any claims for a credit under the U.S.-France Income Tax Treaty in *Savary*. The Technical Explanation of the Treaty states, ''[A]lthough the Convention provides for a foreign tax credit, the terms of the credit are determined by . . . Code section 904(a).'' This Technical Explanation's disallowance under the Treaty of a U.S. tax credit by reason of the absence of §904(a) limitation was noted by the Tax Court in *Savary*, which observed that the ''Technical Explanation . . . explains that the credit against U.S. tax is to be limited to the amount of U.S. tax due with respect to net foreign source income.''

In summary, the only relevant issue the *Savary* court needed to decide to determine whether the IRS correctly disallowed all foreign tax credits under both the Code and Treaty — namely, whether the salary earned in the United States, U.S. airspace, and international airspace created §904(a) limitation — was not discussed.

It may well be, however, that the *Savary* court made the unstated factual finding that the taxpayer had no other §904(a) general category foreign-source income besides her salary held excludible under §911(a) and possibly her earnings in the United States, U.S. airspace, and international airspace, and so finding such earnings to be U.S.-source resulted in a §904(a) limitation of zero. Rev. Rul. 62-67[14] held that if a U.S. citizen has no foreign-source income in a §904(a) foreign tax credit limitation category other than her foreign-source salary, and also has U.S.-source salary that creates a pre-credit U.S. tax liability, and if (as seems to be the factual situation as determined by the *Savary* court) the taxpayer's foreign-source salary is excludible under §911(a), then the taxpayer's §904(a) limitation is zero, so that no foreign tax credit is allowable to offset her pre-credit liability on her U.S.-source salary. Thus, if (as seems quite possible) the taxpayer in *Savary* had no §904(a) general category foreign-source income other than possibly the salary earned in the United States, U.S. airspace, and international airspace the source of which was under adjudication, then the Court's exclusive focus on whether that income was foreign-source was coincidentally justified.

Although not mentioned by the Tax Court in *Savary*, Article 24 of the Treaty expands the §904(a) limitation of a U.S. citizen residing in France by treating as French-source any income of a U.S.-citizen French resident for which the United States allows a credit for the French income tax under Article 24. By concluding that the United States would not, under Article 24, allow a credit for the French income tax on the U.S.-source salary, the Tax Court coincidentally denied any expansion under the Treaty for the foreign tax credit limitation.

There is a second conceivable rationalization (although also not discussed by the court) for the Tax Court's approach in *Savary*: that it relied on a perceived French concession in Article 24 of the Treaty that the pre-credit French residence-based tax on U.S.-source income will be offset by a French credit for U.S. income tax in order to affirmatively deny the taxpayer a U.S. credit for French income tax against her U.S. tax (ignoring the U.S. statutory foreign tax credit rules). Once the court (however erroneously) decided that the salary attributable to international airspace was U.S.-source, it might have rationalized that the French tax liability imposed on the taxpayer's international airspace salary was a non-creditable payment described in Regs. §1.901-2(e)(5), which generally denies creditability for foreign taxes paid in excess of those required by U.S. income tax treaties.[15]

However, Regs. §1.901-2(e)(5) does not apply if the taxpayer has determined her foreign tax liability based upon a reasonable interpretation of the foreign law and the foreign government's interpretation of its income tax treaty with the United States, and has exhausted all her procedural remedies, such as Competent Authority procedures, whose costs are reasonable in view of the amount at issue. The Tax Court in *Savary* concluded that the French tax authorities ''erred'' in concluding that international airspace income was not U.S.-source. The court further suggested that the taxpayer investigate presenting her case to the French Competent Authority.[16] However, the court also found that the IRS did not meet the §7491 burden of produc-

[14] 1962-1 C.B. 128.

[15] *See Proctor & Gamble Co. et al v. U.S.* No. 1:08-cv-00608 (S.D. Ohio 7/6/10).

[16] As a practical matter, the decision in *Savary* to deny a U.S. tax credit is, absent perhaps Competent Authority negotiation by France, final for that taxpayer. Judicial relief is unavailable, as §7463(b) provides that decisions in small tax cases such as *Savary* may not be reviewed in any other court. The taxpayer in *Savary* apparently cannot directly request assistance from the U.S. Competent Authority. Article 26(1) of the U.S.-France Income Tax Treaty allows a taxpayer to present her case to the Competent Authority of the country of which she is a national (the U.S. in *Savary*) or resident (France in *Savary*). Article 26(3)(c) and (d) of the Treaty provides that the Competent Authorities of the United States and France shall endeavor to resolve difficulties in application of the convention, and may agree to interpret the Treaty to reach ''the same determination of the source of particular items of income . . .with respect to past . . . years.'' However, Rev. Proc. 2006-54, 2006-2 C.B. 1035, at §7.05, provides that once a taxpayer's U.S. tax liability is determined by a final U.S. Tax Court decision, the U.S. Competent Authority will not undertake any action that would reduce the taxpayer's federal tax below such tax liability. Rather, §7.05 indicates that the U.S. Competent Authority would limit its efforts to seeking a French concession that the taxpayer's salary earned in international airspace was U.S.-source. Rev. Proc. 2006-54 does not state whether or not refusal to reduce taxes determined in a final Tax Court judgment will also apply to proceedings initiated by the French government. Arbitration under the Treaty appears to be unavailable, as Article 26(5) provides that

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tion required to impose a §6662(c) penalty on the taxpayer for failure to make a reasonable attempt to comply with the Code. Moreover, one may question whether the Tax Court would view Competent Authority or other procedural remedies, even if technically available, as reasonable in view of the less than $5,000 of income tax involved in *Savary*.

FOREIGN TAX CREDIT HELD UNAVAILABLE FOR INCOME EARNED IN INTERNATIONAL AIRSPACE

In *Savary*, apparently the French government imposed income tax on the entire salary of the taxpayer, including the salary attributable to: (1) hours spent in the United States and the airspace over the U.S.; (2) hours spent in France and other foreign countries and in the airspace over France and other foreign countries; and (3) hours spent in international airspace over the Atlantic Ocean and elsewhere.[17]

Irrespective of the amount of §904(a) limitation, the Tax Court might have concluded that the French income tax paid by the taxpayer on the salary earned in France and other foreign countries, and in the airspace over France and other foreign countries, was not creditable under the Code by reason of §911(d)(6), because that salary was excludible from U.S. income under §911(a).[18] Likewise, as §911(a) prevented duplicative U.S. taxation on the salary earned in France and other foreign countries, and in the airspace over France and other foreign countries, the Tax Court perhaps concluded that Article 24 of the Treaty did not require the United States to grant a tax credit for the French income tax paid by the taxpayer on that income.

The Tax Court considered the creditability or noncreditability of the French tax imposed on the salary attributable to the hours spent in the United States and airspace over the U.S. as well as international airspace. On that portion of the salary, the IRS proposed to assess an income tax, and the taxpayer had already paid a French income tax, so there was an element of double taxation presented to the Tax Court.

The Tax Court concluded that a fair reading of the Treaty was that no U.S. tax credit was allowable with respect to income that is U.S.-source. As the Treaty did not define ''source,'' the Tax Court decided to use the Code determination of source of income earned in international airspace. The finding that salary earned in the United States is U.S.-source under §861(a)(3) is non-controversial. *Rogers* seems to support the view that salary earned in the airspace above the United States is U.S.-source under §861(a)(3), although this is perhaps not entirely free from doubt.[19] In determining the Code rules of source as applied to international airspace, however, the Tax Court's thinking became muddled.

Regs. §1.911-2(g) provides that the term ''United States'' includes the airspace over the 50 U.S. states, the District of Columbia, and the possessions and territories of the United States. Regs. §1.911-2(h) provides that the term ''foreign country'' includes the airspace over any territory under the sovereignty of a government other than that of the United States. The theory of *Rogers* was that airspace over international waters was not airspace over the territory under the sovereignty of any government, and thus was not within a ''foreign country'' for purposes of Regs. §1.911-2(h) and §911(b)(1)(A). *Rogers* equally implies that airspace over international waters is not airspace over the United States, and thus is not within the ''United States'' for purposes of Regs. §1.911-2(h).

That is, *Rogers* seems to imply that airspace over international waters is neither within the United States nor within a foreign country. Non-excluded salary earned from sources ''without the United States,'' whether or not that salary is earned in a foreign country for purposes of Regs. §1.911-2(g), is literally foreign-source income for purposes of the §904(a) limitation. In *Savary*, the Tax Court acknowledged that Article 24 of the Treaty allows a U.S. foreign tax credit with respect to a French resident's income that is taxable by the United States solely because the individual is a U.S. citizen. Salary earned by a French resident from sources ''without the United States,'' whether or not that salary is earned in a foreign country for purposes of Regs. §1.911-2(g), is generally excluded from gross income under §872(a), unless the individual is a citizen of the United States. Similarly, salary that is earned by a French resident through employment that is not ''exercised in'' the U.S., whether or not that salary is earned in a foreign country for purposes of Regs. §1.911-2(g), seems generally excludible from gross income under Article 15 of the Treaty if the individual is not a citizen of the United States. Thus, *Rogers* seems to call for the conclusion that the taxpayer in *Savary* should have been allowed to include in her §904(a) statutory limitation, her salary earned in international airspace, or alternatively have been allowed a credit for the French taxes imposed on her salary earned in international airspace under Article 24 of the Treaty.

Such conclusion that flight crew salaries earned in international airspace are foreign-source is consistent with the position taken by the IRS in its 2001 Coor-

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a case previously decided by a court shall not be submitted to arbitration.

[17] *See* Milhac and Bailleul-Mirabaud, 961 T.M., *Business Operations in France*, at X, A (''Individuals domiciled in France for tax purposes (hereafter, residents) are subject to French tax on their worldwide income.'').

[18] The Tax Court did not cite §911(d)(6), but did conclude, ''Because . . . petitioner is entitled to exclude such part of her income that is attributable to sources in France, she is not entitled to a credit for U.S. tax payable on such foreign source income.''

[19] *See Rogers* at fn. 9 (excluding income earned over the U.S. from ''income earned in international airspace''); TAM 201014051 at fn. 3 (''the United States includes airspace over the United States''); Regs. §1.911-2(g). *But cf.* Regs. §1.199-3(h) (''The term United States does not include . . . airspace or space over the United States.'').

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dinated Issue Paper titled ''Air Transportation — Federal Income Tax Withholding on Compensation Paid to Nonresident Alien Crew Member by a Foreign Transportation Entity.'' There the IRS, citing the traditional §§861(a)(3) and 862(a)(3) place-of-performance rules for sourcing seemed to concede that salaries earned by a flight crew in international airspace are foreign-source income and thus are excludible by nonresident alien flight crew members.[20]

Nevertheless, the Tax Court ignored the traditional place-of-performance rules for sourcing, relied solely on Regs. §1.911-2(h), and did not mention Regs. §1.911-2(g) in finding that the salary earned in international airspace was from sources within the United States. The court, therefore, concluded that no U.S. foreign tax credit was allowable under the Treaty for any French tax paid on such salary. The court's reliance on Regs. §1.911-2(h) and disregard of Regs. §1.911-2(g) do not provide a satisfactory resolution of the source of income for salary attributable to hours of service performed in international airspace.

TRANSPORTATION INCOME APPROACH

Some commentators seem to conclude that personal services performed by pilots and flight attendants are characterized as ''transportation income'' for purposes of §863(c).[21] However, even these commentators conclude that such transportation income, when earned on flights between a U.S. airport and an airport that is both outside the United States and outside the U.S. possessions — such as the Paris-U.S. flights considered in *Savary* — is sourced under the place-of-performance rules for personal services income in §§861(a)(3), 862(a)(3), and 863(b)(1).[22] The *Savary* court seems to be incorrect when it concludes, in contradiction of the 2001 Coordinated Issue Paper, that, under these place-of-performance rules, salary earned in international airspace is U.S.-source income.

SPACE INCOME APPROACH — TAMs 9327001, 003, 004

Nevertheless, there is another approach to the sourcing of flight attendant salaries, not discussed in *Savary*, which could support the *Savary* Court's characterization of the salary earned in international airspace as U.S.-source. TAMs 9327001, 9327003, and 9327004 addressed casino and food-and-beverage concessions on board cruise ships in international waters. The TAMs characterized both the casino wagering income and food-and-beverage income as services income. Then the IRS stated that services income earned by a person that is not related by majority ownership to the operator of a vessel or aircraft cannot constitute transportation income as defined in §863(c). As a consequence, the TAMs concluded that §863(d)(2)(B)(i), which excludes transportation income described in §863(c) from characterization as income from a space or ocean activity, does not apply. Rather, once the possibility of ''transportation income'' characterization was removed by applying the TAMs' requirement of relation by majority ownership to the operator, the TAMs held that, to the extent that services income is earned in international airspace or waters, such income must be viewed as space or ocean income described in §863(d).[23] Under §863(d), space or ocean income earned by a U.S. person is U.S.-source.

Therefore, TAMs 9327001, 9327003, and 9327004, if applied to a flight attendant such as the one in *Savary*, would first impose a filter of majority ownership in determining whether transportation income characterization applied. Because as a practical matter no flight attendant would own a majority of the airline, such application of the TAMs would render transportation income characterization inapplicable, and space income characterization as applicable. Then, the source of the services performed by a U.S. citizen flight attendant in international airspace would, under the theory of those TAMs, be U.S.-source, as the *Savary* court concluded.

The characterization of on-board personal services as other than transportation income, and thus as space income, in the three TAMs has been criticized. One commentator, who represented the involved taxpayers in the resulting Tax Court litigation, rejects the rationale of those TAMs, concluding that ''income derived

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[20] The Coordinated Issue Paper states that ''performance of services in international waters is considered outside the United States,'' and cites Rev. Rul. 75-483, 1975-2 C.B. 286. As the Paper by its terms is limited to post-1997 salaries paid to crew members of aircraft, not vessels, it seems that the IRS likewise concedes that performance of services in international airspace is considered foreign-source income. By contrast, the Tax Court in *Savary* stated that ''petitioner's income is taxable in the United States not merely because she is a U.S. citizen, but rather because such income is U.S. source income earned while working in . . . international airspace.'' That is, the *Savary* court seemed to assume, in direct contradiction of the Coordinated Issue Paper, that wages earned by nonresident alien flight crew members in international airspace is U.S.-source income and thus taxable by the United States.

[21] Kuntz & Peroni, *U.S. International Taxation* (WG&L Electronic Edition 2010), §A2.03[10] (''most flight attendants, pilots, sailors and the like determine their *transportation income* under . . . the place-of-performance source rules'') (emphasis added).

[22] *Id.* at §A2.03[10] and §A2.03[6][e][v]. However, the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, at pp. 928–929, states, ''The Act modifies prior law, however, by excluding from transportation income income from the performance of services by . . . airline employees for transportation that begins or ends in the United States.'' Nevertheless, the Joint Committee goes on to state, ''Personal service income excluded from transportation income under the Act is sourced as under prior law: income attributable to services performed in the United States or within the U.S. territorial waters is U.S. source.''

[23] *See also* PLR 9012023 (in the course of holding that nonresident alien consultants on board fishing vessels in international waters do not earn taxable wages, IRS states that compensation for personal services rendered outside U.S. territorial waters constitutes income from an ocean activity described in §863(d)).

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from the performance of services in connection with the operation of a ship that was engaged in the transportation of passengers between ports of call is never income from a space or ocean activity because it constitutes 'transportation income' under §863(c) and the two are mutually exclusive.'' [24] Indeed, that commentator reported that the Service in 1999 conceded in Tax Court that the deficiencies asserted based upon those TAMs were not substantially justified, thereby allowing the taxpayers therein to recover their litigation costs.[25]

However, it is not clear whether this concession was based on an IRS acknowledgment that services income in international waters is transportation income and thus not space or ocean income, or rather was based only on some other conceded flaw in the IRS argument in the TAMs. For example, perhaps the IRS conceded that food-and-beverage sales income or gambling income was not ''services'' income at all — an alternative position advanced by the taxpayers in the TAMs. Therefore, it is not entirely clear that the IRS has definitively forsaken the argument that income from services performed in international airspace is space income governed by §863(d) and thus U.S.-source income if derived by a U.S.-citizen crew member, such as the taxpayer in *Savary*.

CONCLUSION

Fortunately for taxpayers, because *Savary* is a small tax case, under §7463(b) it should be unavailable as precedent to the IRS.[26] Troubling, nevertheless, are the Service's position in *Savary* that salary earned in international airspace on flights between the United States and a foreign country is U.S.-source, the Tax Court's adoption of that position based on weak reasoning, and the failure of the IRS or the Tax Court to address (and reject) the alternative U.S.-source ''space income'' characterization adopted in TAMs 9327001, 9327003, and 9327004. Under *Savary*, international flight crew members who are U.S. citizens but based in foreign countries that impose residence-based tax on their salaries face significant double taxation. Moreover, the theory of *Savary* could permit the IRS — in contravention of its 2001 Coordinated Issue Paper — to impose U.S. tax on salaries earned in international airspace by international flight crew members who are nonresident aliens.

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[24] Stankee, ''IRS Concedes That Concessionaire Profits Were Not Subpart F Income,'' 11 *J. of Int'l Tax'n* (Mar. 2000). *See also General Explanation of the Tax Reform Act of 1986*, fn. 22 above, at p. 829, concluding that even though §863(c) excludes from transportation income salaries of airline employees earned on flights between U.S. airports and foreign country airports, income attributable to services performed in the United States or in the U.S. territorial waters is U.S.-source. In TAM 20104051, the National Office sourced the salaries of nonresident alien flight crew members based on the place-of-performance rules, without mentioning either §863(c) or §863(d).

[25] *Id.*

[26] Given that the holding in *Savary* has potentially vast implications for international flight crews flying to and from the U.S., and their international airline employers insofar as their reporting and withholding obligations are concerned, one may question whether the small tax case procedure in *Savary* was appropriate. *See* CCA 200115033 (suggesting that the IRS should argue that the Tax Court exercise discretion to reject small tax case designation ''where a decision in the case will provide a precedent for the disposition of a substantial number of other cases or where an appellate court decision is needed on a significant issue''). Also troubling is the observation in the concurring opinion by Judge Holmes in *Mitchell v. Comr.*, 131 T.C. 15 (2008), that ''increase in the probability of error is reduced by our Rules [because] we decide [small tax] cases very much like regular cases.''

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