

# I.R.S. ADVISES: SCRUTINY REQUIRED FOR PARTNER'S FOREIGN EARNED INCOME

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## Tags

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The Internal Revenue Service (the "I.R.S.") recently updated an international practice unit<sup>1</sup> ("I.P.U.") discussing the calculation of the foreign earned income exclusion ("F.E.I.E.") of a partner in a partnership with foreign earned income. I.P.U.'s are written documents used as training materials for I.R.S. auditors. They contain explanations of general international tax concepts and information about specific types of transactions, but they are not precedent. According to the I.R.S., they are designed to reflect changes in the compliance environment, new insights, and experiences. They are available to the public on the I.R.S.'s website.<sup>2</sup>

In the I.P.U., the I.R.S. suggests that a guaranteed payment received by a partner for services performed in a foreign country or a special allocation of foreign earned income to the partner is generally eligible for the F.E.I.E. In other cases, a partner's distributive share will be subjected to heightened scrutiny when under examination. The partner's distributive share will be considered foreign earned income for the purposes of the F.E.I.E. only to the extent of the partner's distributive share of the total earned income of the partnership which is derived from foreign sources, regardless of where he/she works.<sup>3</sup> In such cases, the I.P.U. recommends that the auditor review the partnership agreement, interview the partner, and ask the partner to obtain information and/or a letter from the partnership that provides the separately stated amounts (if they were not provided on the Schedule K-1 and/or if not all partnership earned income was foreign source).

## EXCLUSION FOR FOREIGN EARNED INCOME

The I.P.U. walks the auditor through the steps for calculating the F.E.I.E. and makes several cautionary remarks along the way, which provide insight into the issues that may be raised by an auditor during an examination.<sup>4</sup>

Internal Revenue Code (the "Code") §911 contains the exclusion for foreign earned income, which permits a U.S. citizen or a U.S. resident alien who works and lives abroad to exclude some or all of his/her foreign earned income. The exclusion is available only for compensation for personal services performed in a foreign country or countries.

<sup>1</sup> I.R.S., *Calculating Foreign Earned Income Exclusion – Partner in a Partnership with Foreign Earned Income*, DCN: JTO/P/09\_06\_05-19 (2016).

<sup>2</sup> I.R.S., "[International Practice Units](#)," last reviewed or modified Aug. 23, 2016.

<sup>3</sup> I.R.S., *Calculating Foreign Earned Income Exclusion*, p. 13.

<sup>4</sup> For example, the I.P.U. cautions that certain income tax treaties may reclassify U.S.-source income as foreign-source income (e.g., the U.S.-France income tax treaty) and reminds auditors that a taxpayer may not receive a double benefit by taking a foreign tax credit, which may be available under a treaty, that is attributable to amounts excluded from gross income under the F.E.I.E.

***“A guaranteed payment received by a partner is considered foreign earned income if it was paid for services performed in a foreign country, regardless of whether the partnership had any profits.”***

In order to exclude foreign earned income under Code §911, an individual must

- have foreign earned income (*i.e.*, compensation for personal services performed in a foreign country or countries),
- have a “tax home” in a foreign country, as defined in Code §911(d)(3),
- meet either the *bona fide* residence test or the physical presence test, and
- make a valid election to exclude the foreign earned income by filing Form 2555, *Foreign Earned Income*.

## DISTRIBUTIVE SHARE V. GUARANTEED PAYMENT

Although a partnership is a pass-through entity not subject to income tax, it is treated as a separate entity for the purpose of determining the taxable income of the partners. That is, the income, gains, losses, deductions, and credits from the partnership’s operations are determined at the partnership level.<sup>5</sup> These items are then allocated to each of the partners according to the partnership agreement or the rules of Code §704. A partner’s allocable share of the partnership’s income, gains, losses, deductions, and credits is referred to as his/her “distributive share.”<sup>6</sup>

In contrast, payments to a partner in his/her capacity as a partner constitute guaranteed payments under Code §707(c), to the extent that they are made for services or the use of capital, and are determined without regard to the partnership’s net income. Guaranteed payments for services are subject to tax as ordinary income and are generally deductible by the partnership as a trade or business expense.<sup>7</sup> A special allocation of partnership net income to a partner, in his/her capacity as a partner, as compensation for services is treated as a distributive share rather than a guaranteed payment. As the I.P.U. suggests, it may be possible to allocate foreign-source earned income to the partner responsible for such income.

The source of a partner’s income is determined at the partnership level.<sup>8</sup> Therefore, absent a special allocation, a partner in a partnership who performs all of his/her services outside of the U.S. may have a significant portion of income that is sourced in the U.S. and is therefore not eligible for the F.E.I.E. However, a guaranteed payment received by a partner is considered foreign earned income if it was paid for services performed in a foreign country, regardless of whether the partnership had any profits.<sup>9</sup>

## PLANNING CONSIDERATIONS

The I.P.U. cautions that if an amount received by a partner does not qualify as a guaranteed payment and the partnership agreement does not specify otherwise, the amount is foreign earned income only to the extent of the partner’s distributive share

<sup>5</sup> Code §§701-704.

<sup>6</sup> See Code §§702, 704.

<sup>7</sup> Code §707(c).

<sup>8</sup> Code §702(b).

<sup>9</sup> Code §707(c); Rev. Rul. 81-300, 1981-2 C.B. 143; Rev. Rul. 81-301, 1981-2 C.B. 144; I.R.S., *Calculating Foreign Earned Income Exclusion*, p. 3.

of the total earned income of the partnership which is derived from foreign sources, regardless of where the partner performs the services.<sup>10</sup> However, this result may differ if the partnership agreement specifies that the partner's distributive share is based on partnership foreign earned income. The partnership should properly document the foreign source of the partner's distributive share.

It may also differ if the partner receives guaranteed payments, which to the extent they are received for services rendered in a foreign country, will be foreign earned income.<sup>11</sup> Guaranteed payments for services have other advantages. They are generally deductible by the partnership as a business expense. They may serve to compensate a partner who provides services to the partnership and who needs a steady salary-type payment that might not be proportionate to his/her distributive share.



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<sup>10</sup> I.R.S., *Calculating Foreign Earned Income Exclusion*, p. 13.

<sup>11</sup> *Id.*, p. 14.