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Memorandum

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subject: Application of Foreign Earned Income Exclusion and the Combat Zone Exclusion to
Civilian Contractors Working in Combat Zones

This memorandum addresses the foreign earned income exclusion rules and potential areas for issue development regarding civilian contractors, and other civilian employees, who are not employees of the United States or an agency thereof, working in foreign country combat zones. It also discusses the inapplicability of the combat zone exclusion to these employees.

I. IRC Section 911 Foreign Earned Income Exclusion

IRC section 911(a)(1) allows a “qualified individual” to exclude his¹ foreign earned income and housing cost amount from gross income. IRC section 911(b)(2)(D) limits the amount of foreign earned income allowed to be excluded to an exclusion amount adjusted annually for inflation. The maximum amount allowed to be excluded for 2008 is \$87,600. IRC section 911(b)(1)(B)(ii) provides that foreign earned income does not include amounts paid by the United States or an agency thereof to an employee if the United States or an agency thereof. IRC section 911(d)(1) defines a “qualified individual” as one who has a “tax home” in a foreign country and who is: (1) a citizen or resident of the United States, and who is physically present in a foreign

¹ For purposes of the Code, use of the masculine gender includes reference to the feminine. See IRC section 7701(p)(1).

country for at least 330 full days during any period of 12 consecutive months (“330 day physical presence”); or (2) a citizen of the United States, and establishes to the satisfaction of the Secretary that he has been a “bona fide resident” of a foreign country or countries for an uninterrupted period which includes an entire taxable year (“bona fide residence”).²

Thus, to be eligible for the foreign earned income exclusion under IRC section 911, a taxpayer must either:

(1) have his “tax home” in a foreign country and satisfy the “330 day physical presence” test or

(2) have his “tax home” in a foreign country and satisfy the “bona fide residence” test.

This memorandum will discuss, in turn, potential issue development in respect of “tax home,” “330 day physical presence,” and “bona fide residence” in regard to civilian contractors and other non-U.S. government employees working in combat zones. It is to be emphasized that while a taxpayer must in every case establish a “tax home” in a foreign country, “330 day physical presence” and “bona fide residence” are alternative requirements. Thus, for example, a taxpayer may qualify for the foreign earned income exclusion if his tax home is in a foreign country and he meets the 330 day physical presence test in such country, even though he is not a bona fide resident of such country.

Taxpayers generally have the burden of proof, except as otherwise provided by statute or determined by the Court. Title 26 App., Rule 142(a).

A. Tax Home

1. In General

For purposes of IRC section 911, the term “tax home” means, with respect to any individual, such individual’s tax home for purposes of IRC section 162(a)(2) (relating to traveling expenses while away from home).³ Accordingly, Treas. Reg. §1.911-2(b) provides that an individual’s tax home is considered to be located either:

- at his regular or principal (if more than one regular) place of business, or,

² For the bona fide residence requirement, a “qualified individual” also includes a U.S. resident who is a citizen or foreign national of a country with which the United States has an income tax treaty in effect.

³ In 1992, Congress amended IRC section 162(a)(2) to provide that a taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year. See section 1938 of the Energy Policy Act of 1992, Pub. L. No. 102-486. See *also*, Rev. Rul. 93-86, 1993-2 C.B. 71.

- if the individual has no regular or principal place of business because of the nature of the business, then at his regular place of abode in a real and substantial sense.

2. U.S. Abode Trumps What Otherwise Might Be a Foreign Tax Home

An individual shall not be treated as having a tax home in a foreign country for any period for which his abode is in the United States. IRC section 911(d)(3). Treas. Reg. §1.911-2(b) provides, however, that:

- “Temporary presence of the individual in the United States does not necessarily mean that the individual’s abode is in the United States during that time”; and
- “Maintenance of a dwelling in the United States by an individual whether or not that dwelling is used by the individual’s spouse and dependents, does not necessarily mean that the individual’s abode is in the United States.”

The quoted regulation language clarifies that an individual’s abode is not necessarily in the United States, for purposes of the IRC section 911(d)(3) tax home requirement, if the individual maintains a dwelling in the United States, such as a home for his family. Also, this limitation does not require that the taxpayer’s abode be in a foreign country, if his regular or principal place of business is in a foreign country. It only requires that the taxpayer’s abode not be in the United States.

Neither IRC section 911, nor the regulations thereunder, defines “abode”. A brief examination of the history of section 911 provides some insight about the meaning of the term “abode”. The foreign earned income exclusion for U.S. citizens working abroad was first enacted in 1926. Since that time, there have been a number of modifications and changes to that provision. Of relevance, the Foreign Earned Income Act of 1978, Pub. L. No. 95-615, dramatically changed the tax treatment of U.S. citizens working abroad. Under former IRC section 911, the foreign earned income exclusion was limited to U.S. citizens living in camps in hardship areas because of employment or working for qualified domestic charities in lesser developed countries. The exclusion was retained for these workers because these persons were “typically required to make an unusual sacrifice in their standard of living when they went overseas.” 170 S. REP. NO. 746, 95th Cong. 2d Sess. 12 (1978). Under former IRC section 913, other U.S. citizens working abroad were allowed certain specified deductions for excess foreign living costs. In both cases, taxpayers had to satisfy either a bona fide residence or physical presence test. The Foreign Earned Income Act of 1978 also added the “tax home” requirement for purposes of the deduction for excess foreign living costs under former IRC section 913. See former IRC section 913(j)(1)(B).

The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, replaced IRC sections 911 and 913 with a new IRC section 911, allowing an exclusion for U.S. citizens working abroad who met either the bona fide residence or a liberalized physical presence requirement. The physical presence requirement was changed from requiring

individuals to be physically present in a foreign country for 17 months in an 18-month period to 330 days in a 12-month period. The tax home requirement was retained. IRC section 911 exists in essentially the same form today.

Thus, U.S. taxpayers living in camps in hardship areas for employment reasons, U.S. taxpayers working for qualified domestic charities abroad, and all other taxpayers working overseas are currently subject to the same foreign earned income exclusion rules. Based on the legislative history, there was no intention that U.S. taxpayers living in camps in hardship areas be excluded from present IRC section 911. Congress' reason for the change was the complexity of the old law and concern with the increasing competitive pressures that American businesses faced abroad. H.R. REP. NO. 1463, 95th Cong., 2d Sess. 10 (1978), see also S. REP. NO. 746, 95th Cong. 2d Sess. 7 (1978), U.S. Code Cong. & Admin News 1978, p. 7612. .

The "tax home" requirement under section 911 has been considered by the tax court and appellate courts in a number of decisions. The leading court decisions are Bujol v. Commissioner, 53 T.C.M. (CCH) 762 (1987), *affd. without published opinion* 842 F.2d 328 (5th Cir. 1988) and Lemay v. Commissioner, 53 T.C.M. (CCH) 862 (1987), *affd.* 837 F.2d 681 (5th Cir. 1988). In substantially all of these cases, including Bujol and Lemay, the taxpayers alternated blocks of time working abroad with blocks of time at home in the United States where their families lived. Specifically, in the Bujol case, the taxpayer alternated working 28 days abroad and returning home to the United States for 28 days. Similarly, in the Lemay case, the taxpayer spent approximately half of his time with his family in Louisiana. Therefore, in addressing the tax home requirement, the courts have focused on the requirement under IRC section 911(d)(3) that the taxpayer's abode not be in the United States. For this purpose, the tax court and appellate courts have used the following definition of "abode" found in the Bujol decision:

"Abode" has been variously defined as one's home, habitation, residence, domicile, or place of dwelling. Black's Law Dictionary 7 (5th ed. 1979). While an exact definition of "abode" depends upon the context in which the word is used, it clearly does not mean one's principal place of business. Thus, "abode" has a domestic rather than vocational meaning, and stands in contrast to "tax home" as defined for purposes of section 162(a)(2). Bujol, 53 T.C.M. at 763.

Using the above definition of abode, in most of the decisions, the courts have concluded, based upon the blocks of time spent in the United States and other factors, such as a U.S. bank account, U.S. driver's license, and U.S. voter's registration, that the taxpayers had strong familial, economic and personal ties in the United States and only transitory ties in the foreign country where the taxpayers worked, and thus, the taxpayers were held to have a U.S. abode. Accordingly, the taxpayers could not exclude their foreign earned income from gross income for U.S. tax purposes. See Harrington v. Commissioner, 93 T.C. 297 (1989); Doyle v. Commissioner, 57 T.C. M.

(CCH) 1436 (1989); Lemay v. Commissioner, 53 T.C.M. (CCH) 862 (1987), *affd.* 837 F.2d 681 (5th Cir. 1988); and Bujol v. Commissioner, T.C.M. (CCH) 762 (1987), *affd. without published opinion* 842 F.2d 328 (5th Cir. 1988). But cf. Jones v. Commissioner, 927 F.2d 849 (5th Cir. 1991), *revg.* T.C. M. (CCH) 689 (An airline pilot based in Tokyo is found to have an abode and tax home in Japan even though his job required that he be in Anchorage frequently, where he stayed with his family in a home he co-owned, and he had other ties to Alaska). Conversely, the IRC section 911 regulations contemplate that transitory presence in the United States would not constitute a U.S. abode.

If presented with a taxpayer whose facts involve alternating blocks of time (whether in or out of the foreign country, or on and off duty), other issues may also be raised.⁴ For example, as a result of determining that the taxpayers in the decided cases had abodes in the United States, the courts have generally not addressed any issues about the taxpayers' regular or principal places of business. See Bujol, 53 T.C.M. at 764 n.7. However, in Ritchie v. Commissioner, 57 T.C.M. (CCH) 1282 (1989), the Tax Court stated without any discussion that "under the facts presented here, it is obvious that petitioner's regular or principal place of business was located in Saudi Arabia during 1983". In that case, the taxpayer followed a 42 days on and 21 days off work schedule. He spent approximately one-half of his leave time in the United States and the other half in Europe or other foreign areas away from his work location. The court in Ritchie gratuitously answered the "regular or principal place" issue because the court ultimately concluded that the taxpayer was not a "qualified individual" for purposes of IRC section 911 because he was not a bona fide resident of Saudi Arabia. In cases where U.S. abode is not at issue, in order to satisfy the tax home requirement, taxpayers need to address the issue about whether their employment involving alternating blocks of time qualify as "regular or principal places of business". If not, those taxpayers need to prove that their abode is in a foreign country under Treas. Reg. § 1.911-2(b).

The tax home requirement is in addition to the 330 day physical presence test or bona fide residence test.

B. 330 Day Physical Presence Test and Bona Fide Residence Test

After establishing that they have a tax home in a foreign country, taxpayers must still also establish that they meet either the 330 day physical presence test or the bona fide residence test. See IRC section 911(d)(1).

1. Physical Presence Test

For purposes of satisfying the 330 day physical presence test, the taxpayer must establish that he is a U.S. citizen or resident of the United States, and is physically

⁴ We are not aware of any civilian contractors and employees who are working alternating blocks of time.

present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months. The taxpayer is to add together all full days in a foreign country or countries within the applicable period of 12 consecutive months. Treas. Reg. §1.911-2(d)(2) provides that the 330 full days need not be consecutive and may be interrupted by periods during which the individual is not present in a foreign country. Except as provided under IRC section 911(d)(4)⁵, there are no exceptions to the 330 day requirement for taxpayers trying to qualify under this test. For example, there is no provision for waiver of any part of the 330 day requirement for a taxpayer who must return early to the United States because of his special circumstances.

Further, the burden is on the taxpayer to prove that he is physically present for 330 days in a foreign country or countries during the relevant 12 month period by providing acceptable proof. Acceptable proof includes, but is not limited to, passport entries, official records of employment in the foreign country, or other reliable documentation that proves presence in the foreign country.

A taxpayer that satisfies the 330 day physical presence test need not also satisfy the bona fide residence test.

2. Bona Fide Residence Test

Treas. Reg. §1.911-2(c) provides rules for determining bona residence.⁶ The regulations provides that the principles under IRC section 871 and the regulations thereunder apply in determining whether a taxpayer is a bona fide resident of a foreign country. Treas. Reg. §1.911-2(c) also provides that bona fide residence in a foreign country or countries for an uninterrupted period may be established, even if temporary visits are made during the period to the United States or elsewhere on vacation or business.

Under the regulation, an individual with foreign earned income is not a bona fide resident of a foreign country if:

- (1) the individual claims to be a nonresident of that foreign country in a statement submitted to the authorities of that country, and

⁵ IRC section 911(d)(4) provides an exception to the eligibility requirements of IRC section 911(d)(1). If a taxpayer leaves the country during a period for which the Secretary of the Treasury, after consultation with the Secretary of State, determines that individuals were required to leave because of war, civil unrest, or similar adverse conditions that precluded the normal conduct of business by such individuals, such taxpayer will be treated as a "qualified individual". In order for this exception to apply, the taxpayer must establish that but for those conditions he could reasonably have been expected to meet the IRC section 911 eligibility requirements.

⁶ This memorandum does not address the relationship between the immunity of U.S. citizens from Iraqi and Afghan civil and criminal jurisdiction and IRC section 911. See Tax Notes Today, Dec. 22, 2008, p. 1387.

- (2) the earned income of the individual is not subject, by reason of nonresidency in the foreign country, to the income tax of that country.

In this case, it would be unnecessary to analyze the taxpayer's specific facts based upon the factors listed below as suggested by the courts. Note, if the foreign country's tax law specifically exempts the earned income of nonresidents who are present in the foreign country for the sole purpose of working in the foreign country's combat zone, then it should not be necessary to pursue an inquiry into whether a statement described in Treas. Reg. §1.911-2(c) has been submitted to the authorities in the country.

In the alternative, the determination of whether a U.S. citizen is a bona fide resident of a foreign country requires an analysis of all the facts and circumstances. IRC section 911(d)(1)(A) requires that the taxpayer establish bona fide residence to the "satisfaction of the Secretary". The courts have construed this statutory language as imposing a "strong proof" standard on taxpayers to demonstrate residence in a foreign country as opposed to the lesser preponderance of the evidence standard for proving tax home status. See Schoneberger v. Commissioner, 74 T.C.1016, 1024 (1980). Court opinions have provided guidance for determining bona fide residence by focusing on factors, such as the following:

- the taxpayer's intention;
- establishment of a home temporarily in the foreign country for an indefinite period;
- participation in the activities in the community on social and cultural levels, identification with the daily lives of the people, and, in general, assimilation into the foreign environment;
- physical presence in the foreign country consistent with the taxpayer's employment;
- the nature, extent, and reasons for temporary absences from the foreign home;
- assumption of economic burdens and payment of taxes to the foreign country;
- status of a resident of the foreign country as contrasted to that of a transient or sojourner;
- the treatment of the taxpayer's income tax status by his employer;
- marital status and residence of the taxpayer's family;

- nature and duration of employment; whether his assignment abroad could be promptly accomplished within a definite or specified time; and
- good faith in making his trip abroad; whether for purposes of tax evasion.

See Sochurek v. Commissioner, 300 F.2d 34 (7th Cir. 1962), *revg.* 31 T.C. 131 (1961), accepted by the Tax Court in Dawson v. Commissioner, 59 T.C. 264, 268 (1972).

As a general matter, in light of the foregoing, it is difficult for civilian contractors, and other civilian employees, who are not employees of the United States or an agency thereof, working in foreign country combat zones to meet to the bona fide residence test under IRC section 911.⁷

II. IRC Section 112 Combat Zone Exclusion

IRC section 112 (a) excludes from gross income compensation paid to noncommissioned U.S. Armed Forces personnel serving in a combat zone or hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone. Further, IRC section 112(b) excludes a portion of the compensation paid to commissioned officers of the U.S. Armed Forces. The term “combat zone” refers to any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. An area usually becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order. Further, Treas. Reg. §1.112-1(a)(4) specifically provides that the IRC section 112 exclusion only apply to compensation paid by the Armed Forces of the United States to members of the Armed Forces:

Only compensation paid by the Armed Forces of the United States to members of the Armed Forces can be excluded under section 112, except for compensation paid by an agency or instrumentality of the United States or by an international organization to a member of the Armed Forces whose military active duty status continues during the member’s assignment to the agency or instrumentality or organization on official detail. Compensation paid by other employers (whether private enterprises or government entities) to members of the Armed Forces cannot be excluded under section 112 even if the payment is made to supplement the member’s military compensation or is labeled by the

⁷ It should be noted that the taxpayers in the alternating blocks of time cases have taken the position that they were bona fide residents of a foreign country. In general, in these cases, the courts have either not addressed this issue or have concluded that the taxpayer was not a bona fide resident of a foreign country. See Harper v. Commissioner, 58 T.C.M. (CCH) 1509 and Ritchie, 57 T.C. M. 1282.

employer as compensation for active service in the Armed Forces of the United States. Compensation paid to civilian employees of the federal government, including civilian employees of the Armed Forces, cannot be excluded under section 112, except as provided in section 112(d)(2) (which extends the exclusion to compensation of civilian employees of the federal government in missing status due to the Vietnam conflict).

Accordingly, no civilian contractor, or other civilian employee, working in a combat zone is eligible for the combat zone exclusion provided by IRC section 112.