Proposed Federal Income Tax Exclusion for Civilians Serving in Combat Zones

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Summary

Legislative proposals have been made to extend the combat zone income tax exclusion to civilian employees who are on active service in a combat zone. Under present tax law, the designation of an area as a "combat zone" confers tax benefits only to military personnel serving in the combat area. No comparable provision under present tax law provides tax relief for civilian or contract employees serving in combat. However, certain income tax exclusions exist for U.S. citizens who work overseas. As an example, the proposed combat zone exclusions in the Federal Employee Combat Zone Tax Parity Act (H.R. 1974 and S. 1166) would grant added tax relief to federal civilians who are not eligible for existing exclusions.

In the case of extending an exclusion to federal civilian employees or civilian contract employees serving in a "combat-type" zone, the primary issues revolve around the purpose of the extension, which has not been stated by proponents. The purpose could be to provide additional compensation for certain individuals serving in combat and thus facilitate recruitment for such work. Alternatively, the purpose could be one of equity, to make civilian employee benefits equal to those of the Armed Forces.

If the purpose of the extension is to provide additional compensation to individuals serving in combat, than a question of efficiency arises as to whether a tax subsidy is more appropriate than a direct payment. Direct spending programs are often more successful at fulfilling policy objectives than indirect subsidies made through the tax system.

If the purpose of extending the combat zone exclusion to civilians is to make civilian benefits equal to those of the Armed Forces, then the distinctions between military service and civilian employment become important in the analysis of the policy. In that context, it has been observed that military personnel cannot resign when facing danger; they cannot refuse assignment; they are considered to be on duty 24 hours a day, every day; and they may be required to work until the job is done with no specific relationship to compensation. Whereas military personnel must perform those duties, civilian employees may or may not, depending on for whom they work or the contracts they have negotiated, and those contracts could include monetary and other incentives for working in combat zones not available to military personnel. Also, there are distinctions between civilian DOD employees and civilian contractors that complicate the issue of equalization.

This report provides information about the tax treatment of both the earned income of members of the Armed Forces serving in combat zones and the earned income of U.S. citizens working overseas. A brief discussion of the possible expansion of income tax exclusion to government civilian employees in a combat zone and an analysis of the relevant policy issues is also included.

This report will be updated as warranted by legislative events.

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Under present tax law, the designation of an area as a "combat zone" confers tax benefits only to military personnel serving in the combat area. No comparable provision under present tax law provides tax relief for civilian or contract employees of the government. However, certain income tax exclusions exist for U.S. citizens who work overseas. The tax law's special treatment of earned income within war zones typically receives renewed attention during periods of armed conflict. During those periods in the past, a number of suggested changes were offered, including the extension of combat zone tax benefits to federal civilian employees (as proposed in H.R. 1974 and S. 1166, the Federal Employee Combat Zone Tax Parity Act) and government contractors.

This report provides information about the tax treatment of both the earned income of members of the Armed Forces serving in combat zones and the earned income of U.S. citizens abroad; a brief synopsis of the current legislative proposal to expand income tax incentives to federal civilian employees; and an analysis of the relevant policy issues.

Current Tax Law

Two areas of current tax law are related to the issue of income exclusion for civilians serving in combat zones: the income exclusion provision for military personnel, and the income exclusion provision for U.S. citizens working overseas.

Exclusion of Income Earned by Military Personnel Serving in Combat

Since the enactment of the Revenue Act of 1913,[1] all or portions of military pay have been exempt from taxation during periods of war for those serving in a combat zone. Internal Revenue Code Section 112 exempts from income taxation all compensation received for active service when serving as a warrant officer, or enlisted member for any month (during any part of which) such member serves in a combat zone. In the case of commissioned officers, the exemption amount is limited to the highest rate of basic pay for an enlisted person, plus the amount of hostile fire/imminent danger pay that the officer receives. Based on FY2007 pay rates, the officer exclusion was limited to $6,381 per month.[2]

For members of the U.S. Armed Forces who serve in a combat zone, the following amounts may be excluded from their income:[3]

- Active duty pay earned in any month during service in a combat zone.
- Imminent danger/hostile fire pay.
- A reenlistment bonus (when the voluntary extension or reenlistment occurs in a month served in a combat zone).

[1] 38 Stat. 114.

[2] U. S. Department of Defense, Office of the Secretary of Defense, website http://www.defenselink.mil/militarypay/pay/bp/paytables/fy2007_apr_basicpay.html, visited Jan. 10, 2008.

[3] U.S. Department of the Treasury, Internal Revenue Service, *Publication 3: Armed Forces' Tax Guide*, (Washington: GPO, 2004), p. 4. These exclusions apply only to individual income tax and not to payroll tax.

- Pay for accrued leave when earned in any month served in a combat zone. The Department of Defense must determine that the unused leave was earned during that period.
- Pay received for duties as a member of the Armed Forces in clubs, messes, post and station theaters, and other nonappropriated fund activities. Again, the pay must be earned while serving in a combat zone.
- Awards for suggestions, inventions, or scientific achievements when the taxpayer made the suggestion during a month while serving in a combat zone.
- Student loan repayments, such as those received from the Department of Defense Educational Loan Repayment Program, that are attributable to the period of service in a combat zone.

States may or may not adopt federal procedures for determining income tax liability. In general, almost all states with an income tax have laws extending the combat zone income tax exclusion to state income tax. However, the manner in which various states allow tax incentives for those serving in combat varies. Some states have legislation that mirrors the federal provisions while other states' tax laws address the matter differently. For instance, in the state of Michigan all military pay is exempt. However, in the state of Mississippi enlisted service members may exclude from gross income all income earned during any month served in combat, while officers may exclude up to $500 per month.[4]

Exclusion of Income Earned by U.S. Citizens Abroad

Current tax law allows some exclusions from U.S. income tax for citizens who work overseas. Thus a proposed civilian combat zone exclusion would provide added tax savings only to the extent overseas personnel still owe federal taxes after using the existing exclusions. U.S. federal civilian employees who work overseas can exclude certain special allowances under Section 912 of the Internal Revenue Code (IRC). The allowances are primarily for the general cost of living abroad, housing, education, and travel. Section 911 of the IRC permits other U.S. citizens (non-federal employees) to exclude up to $82,400 in foreign earned income and certain housing expenditures.

The exclusion of income earned abroad depends on several factors, some of which may or may not apply to civilians in combat zones. In particular, to qualify for the income tax exclusion, a person must be a U.S. citizen, must have his or her tax home in a foreign country, and must be a resident of that foreign country or have lived abroad for at least 330 days out of any 12 consecutive months. If a person qualifies for the exclusion for only part of the tax year, then only part of the exclusion can be claimed.[5]

All U.S. citizens can credit foreign taxes paid against their U.S. income taxes. However, federal employees are usually exempt from foreign taxes.

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[4] Major Richard W. Rousseau, "Update: Tax Benefits for Military Personnel in a Combat Zone or Qualified Hazardous Duty Area," DA-PAM 27-50-325, *The Army Lawyer*, December 1999, p. 20.

[5] U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, prepared by the Congressional Research Service, 108th Cong., 2nd sess., S.Prt. 108-54 (Washington: GPO, 2004) p. 27.

The tax treatment of income earned by U.S. citizens abroad is often justified by proponents by pointing to the differences in the cost of living and income tax rates that U.S. citizens experience overseas.[6] These differences in cost of living cause the tax liabilities of U.S. citizens working abroad to differ from the tax liabilities of individuals with identical incomes who live and work in the United States. Individuals working overseas may face high foreign taxes, in which case, the foreign tax credit can be used to offset that expense. For those individuals who experience low foreign taxes, the tax credit can reduce the amount of U.S. taxes paid.

Proposals for Change

In recent Congresses, proposals were made to modify the income tax exclusion to apply to federal civilian employees employed in combat zones. In the 110th Congress, the Federal Employee Combat Zone Tax Parity Act (H.R. 1974 and S. 1166) has been introduced. The proposal would expand the current armed forces income tax exclusion to include federal civilians employed in combat zones.

In the 109th Congress, H.R. 294 proposed to exclude from gross income compensation earned by certain DOD civilian employees on active service in a combat zone.[7] This proposal parallels the existing provision for members of the Armed Forces, which allows the exemption for all income earned in any month the taxpayer serves in a combat zone. The proposal follows current law by limiting the exemption amount so as not to exceed the maximum amount for enlisted personnel.

Proposed legislation in the 108th Congress, H.R. 117 and H.R. 1133, included provisions that proposed to extend the combat zone tax treatment to civilian employees of DOD serving in combat zones. Amendments were proposed to accompany H.R. 878 to extend the combat zone exclusion benefits to DOD civilians working in a combat zone.[8]

Policy Arguments

Current legislation proposes extending the combat zone income tax exclusion to civilian DOD personnel, but other proposals have been made in the past that would also extend the exclusion to civilian contractors. Thus, the analysis in this section includes both civilian DOD employees and civilian contractors.

[6] Ibid.

[7] Other legislation in the 109th Congress (H.R. 848) proposed to exempt any individual (or, in the case of a married couple, any individual and his/her spouse) from income tax for the entire year when the individual serves for any portion of such year on active Armed Forces service in a combat zone in Iraq. For example, this proposal would have allowed a member who returns home from Iraq and returns to civilian employment to earn income for the remainder of the year tax free. This tax exclusion would also have applied to the spouse, if married.

[8] In the 108th Congress several proposals were made to modify the combat zone income tax exclusion in ways other than extending the provision to civilian personnel. For instance, S. 394 and S. 721 proposed to expand the combat zone income tax exclusion to include income for the period of transit to the combat zone and to remove the income limitation on the exclusion for commissioned officers. S. 2824 proposed to exclude from income certain wages and self-employment income of spouses of members of the Armed Forces for any month while serving in a combat zone or hospitalized as a result of serving in a combat zone.

The combat zone income exclusion is a federal subsidy that treats income earned by personnel serving in combat favorably compared to other income. Typically, this kind of subsidy can influence how economic actors behave and how the economy's resources are employed. Yet the rationale for this military tax benefit was based on a desire to reduce the tax burdens of military personnel during wartime, rather than an incentive to encourage taxpayers to be employed in a combat zone.[9]

Efficiency

Generally, tax incentives are used to encourage more activity than would otherwise be undertaken. According to economic theory, in most cases an economy best satisfies the wants and needs of its participants if markets operate free from distortions by taxes and other factors. Market failures, however, may occur in some instances, and economic efficiency may actually be improved by tax distortions.

Market failures occur when a market, left on its own, fails to allocate resources efficiently. In particular, market transactions are inefficient when the marginal benefits are less than the marginal costs. Market failures may be due to a variety of circumstances, including the presence of externalities and common resources, public goods, imperfect competition, and/or asymmetric or incomplete information.[10]

If there is a market failure and a tax subsidy remedies that failure, then there is economic justification for the subsidy because of its efficiency gains. But a tax benefit lowers efficiency if it distorts behavior in the absence of a market failure. The combat zone income tax exclusion does not address a market failure, and as such, does not improve economic efficiency. At the same time, the exclusion is unlikely to distort behavior and thus may not lower efficiency.

Economic theory suggests that the efficiency of most tax incentives can be determined by examining their success in causing an intended response, or degree of response, by recipients of the tax incentive. Yet, the combat zone income tax exclusion is not designed to cause a response, such as encouraging more individuals to serve in combat. Instead, the provision is simply an additional benefit received by members of the Armed Forces.

In the case of extending an exclusion to federal civilian employees or civilian contract employees serving in a combat zone, the primary issues revolve around the purpose of the extension, which has not been stated by proponents. The purpose could be to provide additional compensation for certain individuals serving in combat and thus facilitate recruitment for such work. Alternatively, the purpose could be one of equity, to make civilian employee benefits equal to those of the armed forces.

[9] U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, prepared by the Congressional Research Service, 108th Cong., 2nd sess., S.Prt. 108-54 (Washington: GPO, 2004) p. 15.

[10] For more detailed information about market failures, see CRS Report RL32162, *The Size and Role of Government: Economic Issues*, by (name redacted).

Efficiency: Additional Compensation to Individuals Serving in Combat

If the intent of the exclusion is to provide additional compensation to individuals serving in combat, then a question of efficiency arises as to whether a tax subsidy is more appropriate than a direct payment. A subsidy in the form of an income tax exclusion benefits individuals differently based upon their household characteristics that influence their taxable income and liability. This variance in benefit is not related to the purpose of the subsidy, yet influences its value nonetheless. Economists consider this inefficient. Direct spending programs do not have this unintended variance in benefit.

In the case of the combat zone income tax exclusion, an alternative subsidy could be to increase income earned while in combat. Examples of existing income subsidies for combat include hazardous duty pay and imminent danger pay.[11] Increases in one or more of these types of income would, however, have adverse budgetary effects by increasing the cost of appropriations for military spending. Although the implementation of a tax benefit would also increase the cost of military spending, these costs do not require an appropriations process and, therefore, tend to receive less scrutiny.

Equity: Among Taxpayers

An exclusion refers to an item of income specifically excluded from the determination of adjusted gross income. An exclusion results in the subtraction of a portion of gross income before arriving at adjusted gross income. The beneficiaries of income tax exclusions, like most tax incentives, vary by type of taxpayer. Taxpayers differ by income, marital status, and number of dependents, and, as a result, the same tax incentive can affect taxpayers differently. Married individuals filing joint returns comprised 39.1% of all tax returns in 2001 (the most recent year for which those data are available), while single filers were 44.6%, and heads of households were 14.4%.[12] These differences in household composition, along with differences in the number of dependents, alter the distribution of taxes among income groups, which can affect the degree of fairness in the tax code.

Our income tax system is based on progressivity. Simply stated, the more taxable income a taxpayer has, the greater the percentage of income imposed as taxes. Because of this, the value of an exclusion from taxation increases with marginal tax rates (and income). That is to say, the tax liability of an individual in the 10% tax bracket (the lowest federal income tax rate) would be reduced $10 for each $100 of excluded income. In contrast, the tax liability of an individual in the 35% tax bracket (the highest federal tax bracket) would be reduced $35 for each $100 of excluded

[11] Hazardous duty incentive pay is available for members of the Armed Forces who perform certain duties, including parachute duty, flight deck duty, demolition duty, toxic fuels (or propellants) duty, and certain others. Imminent danger pay is a special rate of pay for members of a uniformed service who are subject to hostile fire or explosion of hostile mines; on duty in an area in which there was imminent danger of being exposed to hostile fire or explosion of hostile mines; killed, injured, or wounded by hostile fire, explosion of a hostile mine, or any other hostile action; or on duty in a foreign area in which there was a threat of physical harm or imminent danger on the basis of civil insurrection, civil war, terrorism, or wartime conditions.

[12] As reported by the Internal Revenue Service, website http://www.irs.gov/pub/irs-soi/01in53us.xls, visited January 9, 2006.

income.[13] The lowest-paid personnel, because of current personal exemptions, the standard deduction amount, and other federal tax provisions such as the earned income tax credit, may owe little or nothing in federal taxes, and thus would not benefit greatly from an exclusion. Those persons (notably commissioned officers) making the largest salaries, however, benefit the most from an exclusion. However, as mentioned previously, there is a limit on the amount of the exclusion for officers, and that limit also would apply to civilians.

The international tax provisions that benefit U.S. citizens working overseas may benefit certain civilians serving in combat, but not all civilians. As mentioned previously, federal civilians cannot benefit from the $82,400 income tax exclusion, though they can exclude the value of housing and certain other allowances they receive. Non-federal civilians benefit from the income exclusion to the degree that they meet the rules of the provision. In particular, if private sector civilians are located overseas for all or most of the 330 days out of 12 months required by the income exclusion, they may claim all or most of the exclusion.

An income tax exclusion for non-federal civilians serving in combat zones would benefit two types of individuals; those unable to meet the requirements for the existing foreign-earned income exclusion, and those who earn more than the $82,400 allowable amount of the existing exclusion. Thus, a proposal to extend the combat zone tax exclusion to non-federal civilians, to the extent that it would benefit primarily high-income households, would diminish the progressivity of the income tax system.

The foreign tax credit, however, was designed to offset the income taxation of individuals working abroad and alleviate double taxation, not as an economic incentive or subsidy. Personnel serving in combat are not subject to foreign taxes on the income earned while in the region, and thus do not require an income tax credit to offset foreign taxes paid.

Equity: Among Individuals Serving in Combat

If the intent of extending the combat zone exclusion to civilians is to make civilian benefits equal to those of the Armed Forces, then the distinctions between military service and civilian employment become important in the analysis of the policy. In that context, it has been observed that military personnel cannot resign when facing danger; they cannot refuse assignment; they are considered to be on duty 24 hours a day, every day; and they may be required to work until the job is done with no specific relationship to compensation. Whereas military personnel must perform those duties, civilian employees may or may not, depending on for whom they work, or the contracts they have negotiated, and those contracts could include monetary and other incentives for working in combat zones not available to military personnel. Also, military members are controlled, directed, organized, coordinated, and employed by a commander through a chain of command. Command is authority that a commander in the Armed Forces lawfully exercises over subordinates by virtue of rank or assignment. Should a subordinate fail to obey the lawful orders of a commander above him, he or she is subject to criminal punishment in accordance with the Uniform Code of Military Justice (UCMJ). This same authority does not exist over civilian employees except during times of war, in which case all civilian employees serving with or accompanying an armed force in the field are subject to the UCMJ.[14]

[13] The example assumes that the deduction does not drop the taxpayer into the next lower tax bracket.

[14] While there are combative military operations in Iraq, war has not been declared and, as such, the UCMJ does not (continued...)

Advocates of expanding the income tax exclusion to civilians note that such a change would act as an expression of national concern and gratitude to all individuals serving our nation in dangerous situations, whether they are military or civilian personnel. Civilians accompanying the armed forces in combat zones include civilian government employees, civilian members of military aircraft crews, supply contractor personnel, contractor technical representatives, war correspondents, and members of labor units or civilian services contributing to the welfare of Armed Forces. Certain civilians work close to hostilities, often wearing uniforms and carrying weapons, which makes them likely to appear as combatants to opposition forces.

Supporters of an extension of the income tax exclusion to civilians in combat assert that individuals in such dangerous situations are as likely as uniformed military personnel to become casualties of the operation. It may be more appropriate to argue that certain civilians, but not all, have a likelihood of becoming casualties of war. For instance, of the 2,363 fatalities of the Iraq war, as of December 2005, five were civilian DOD employees. Those five civilian DOD fatalities were in contrast to the fatalities of 2,145 members of the Armed Forces, and 110 contractors during the same time period.[15] As shown in **Table 1**, 85% of all individuals in service in Iraq are members of the Armed Forces, yet that group represents 95% of all fatalities. DOD civilian employees represent a little more than 2.5% of the people in service in Iraq, but 0.2% of fatalities.

Table 1. Individuals and Fatalities in Iraq

(as of December 2005)

	Number of people	Number of fatalities
Armed Forces	155,000	2,145
DOD Civilians	5,000	5
Civilian Contractors	25,000	110
Total	185,000	2,260

Source: CRS table created by the author using data obtained from Iraq Coalition Casualty Count, website http://icasualties.org/oif/default.aspx, visited Dec. 5, 2005, and U.S. Congressional Budget Office, *Logistics Support for Deployed Military Forces* (Washington: GPO, 2005), p. 46.

It could be argued that civilian individuals captured by an enemy force may be treated worse than military personnel. It may be further argued that such individuals, by accepting certain dangerous assignments, have demonstrated a readiness to put themselves in harm's way, and that extending the combat tax exclusion to them allows for more equitable treatment of all personnel serving in combat zones.

Alternatively, federal civilian employees in combat zones already receive benefits, like danger pay allowances, that provide additional compensation for hazardous working conditions. Thus, civilians do not require additional income tax incentives because they receive increased income. Imminent danger pay, for instance, is administered by the Department of State and provides additional compensation

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currently apply to civilians in Iraq. See CRS Report RL32419, *Private Security Contractors in Iraq: Background, Legal Status, and Other Issues*, by (name redacted), (name redacted), and (name redacted); and CRS Report RL33446, *Military Pay and Benefits: Key Questions and Answers*, by (name redacted).

[15] Iraq Coalition Casualty Count, website http://icasualties.org/oif/default.aspx, visited December 5, 2005.

> above basic compensation to all U.S. Government civilian employees for service at places in foreign areas where there exist conditions of civil insurrection, civil war, terrorism or wartime conditions which threaten physical harm or imminent danger to the health or well-being of an employee.[16]

In the case of civilian DOD employees, the amount of imminent danger pay varies between rates of 15%, 20% and 25% of basic compensation, based on the determined level of danger and the presence of non-essential personnel and dependents located in the area of assignment.[17]

Those who oppose extending income tax exclusion to civilian contractors could argue that civilian contractors receive significant differences in salary that serve as a risk premium for service in combat zones. Thus, in this view, the income tax exclusion is unnecessary and an erosion of potential tax revenue for the government. Also, exempting civilian income from federal income taxation could make civilian service in a combat zone more financially attractive in comparison to military service in a combat zone. This could in turn have a negative effect on military recruitment and retention. A CNN article that examined the use of private contractors in Iraq reported that private contracts paid from $350 to $1,500 a day. Although some justify these salaries on the basis that private contractors supplement the work of the military, others argue that such lucrative salaries, which can exceed $100,000 a year, deplete the ranks of the Armed Forces by attracting experienced military personnel.[18]

A Brookings Institution report indicated that former military personnel working for private sector security firms typically make between two to 10 times what they would have made if they were in the military. As an example, a former Green Beret can make up to $1,000 a day in Iraq as a private contractor (as mentioned previously, up to $82,400 of this income may be excluded from taxation).[19]

Examples of this pay differential for contractors can be found in many reports. One news article asserted that the basic labor rate for an individual to dispose of captured munitions was $350,000 per year under a contract that the U.S. Army Corps of Engineers awarded to a private firm.[20]

The Defense Contract Audit Agency (DCAA) published a memorandum that reported the results of surveys of 37 contractors working in Iraq. The DCAA found that, in addition to base pay, the contractors offered varying combinations of allowances, differentials, bonuses, and miscellaneous benefits for work performed in Iraq.[21] For example, all but five contractors offered hardship pay, which most paid at a rate of 20%-25% of base pay, and all but five contractors offered a danger pay allowance, which most paid at a rate of 25% of base pay. Approximately half of the contractors offered assignment completion bonuses, either in the form of a lump-sum payment (up to $10,000) or a percentage of base or total pay (up to 60% of total pay), and 12

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[16] U.S. Department of State, website http://www.state.gov/m/a/als/1767.htm, visited January 9, 2006.

[17] Ibid.

[18] High Pay—and High Risks—For Contractors in Iraq, CNN.com, April 2, 2004, website http://www.cnn.com/2004/WORLD/meast/04/01/iraq.contractor/index.html, visited January 9, 2006.

[19] Peter W. Singer, *Warriors for Hire in Iraq*, Brookings Institution Foreign Policy Studies, April 15, 2004, website http://www.brookings.edu/views/articles/fellows/singer20040415.htm, visited January 9, 2006.

[20] Kevin Begos and Phoebe Zerwick, "Civilians Working for U.S. in Iraq Making a Bundle," *Winston-Salem Journal*, February 13, 2005, p. 1.

[21] U.S. Department of Defense, Defense Contract Audit Agency, *Memorandum for Regional Directors 04-PPD-023(R)*, website http://www.dcaa.mil/mmr/m04ppd023.pdf, visited January 9, 2006.

contractors offered a foreign service premium or allowance, which most paid at a rate of 15%-25% of base pay.[22]

Civilian DOD Employees vs. Civilian Contractors

According to DOD, in Operation Iraqi Freedom, 83% of the civilians deployed into the theater of operations were contractors, while 17% were civilian federal workers.[23] Some contractors perform the traditional civilian support roles, whereas others do not. For example, some contractors may, like civilians, serve in such areas as vehicle maintenance and repair, while other contractors serve as security force members in very dangerous roles.

Distinctions between civilian DOD employees and civilian contractors complicate the issue of equalization of benefits for civilians and members of the Armed Forces. Civilian DOD personnel, it could be argued, operate with similar levels of commitment and control as military personnel. Contractors, on the other hand, may not. Commanders have some control over civilian DOD employees, yet it is not in the same way as control over military members. The penalties commanders can impose if civilians fail to perform are administrative rather than criminal.

While contractor personnel are civilians, they are unlike government employees because they are employed by third parties under contract to the United States. The ability to ensure that contractors abide by federal laws and codes of conduct is determined by the nature of the contract written and signed between the contracting firm and the DOD. Military commanders have less control over contractors and less recourse in the event of non-compliance. Essentially, a commander's remedy against a contractor who violates directives is to cancel the contract.

Simplicity

The combat zone income tax exclusion is relatively simple, with the majority of the administrative burden placed upon the employer. It is the employer's responsibility to separate nontaxable income from taxable income and to report that information to both the employee and to the Internal Revenue Service. In the case of DOD, these distinctions in type of income and the associated reporting to the IRS are already being performed for members of the Armed Forces. For the contractors who employ civilians in combat zones this type of reporting may be new and require additional administrative expense and complexity.

[22] Ibid.

[23] U.S. Department of Defense, *Prepared Statement on the National Security Personnel System, Remarks as Prepared for Delivery by Secretary of Defense Donald H. Rumsfeld to the Senate Committee on Homeland and Governmental Affairs*, June 4, 2003, website http://www.senate.gov/~govt-aff/index.cfm?Fuseaction=Hearings.Testimony&HearingID=71&WitnessID=234, visited March 24, 2007.

Appendix. List of Current Combat Zones

Combat zones can be designated by an executive order of the President and by Congress through enactment of public law. Additionally, the Department of Defense (DOD) has authority to extend combat zone tax benefits to military personnel that provide direct military support to combat zones but are not located in the combat zones.

Three combat zones are designated by executive order as areas in which the U.S. Armed Forces are engaging or have engaged in combat.[24]

1. *Military operations in the Persian Gulf area*. Effective January 17, 1991, the waters of the Persian Gulf, the Red Sea, the Gulf of Oman, the part of the Arabian Sea that is north of 10 degrees north latitude and west of 68 degrees east longitude, the Gulf of Aden, and the total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates have been designated as a combat zone for purposes of tax relief under Code Section 112 (Executive Order 12744).

Separately, DOD has certified that military personnel in Turkey, Israel, Jordan, Egypt, and the Mediterranean Sea east of 30 degrees East longitude, were eligible for all combat zone related tax benefits due to their service in direct support of military operations in the Persian Gulf-area combat zone. The effective date of the DOD certifications for Turkey and Israel was January 1, 2003, though the certification for Israel expired July 31, 2003. The effective date of the DOD certifications for Jordan, Egypt, and the Mediterranean Sea area was March 19, 2003. Two of these certifications expired: the certification for Egypt expired on April 20, 2003, and the Mediterranean Sea area on July 31, 2003.

2. *Military operations in Kosovo*. Effective March 24, 1999, the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the Ionian Sea north of the 39th parallel (including the airspace above those areas) have been designated as a combat zone for purposes of Code Sec. 112 (Executive Order 13119). These areas are also qualified hazardous duty areas and will be treated in the same manner as combat zones under Code Sec. 112 (P.L. 106-21), §1(a)). These areas will continue to be qualified hazardous duty areas for as long as any member of the Armed Forces of the United States serving there is entitled to hostile fire/imminent danger pay.

3. *Military operations in Afghanistan*. Effective September 19, 2001, Afghanistan and the airspace above have been designated as a combat zone for purposes of tax relief under Code Sec. 112 (Executive Order 13229).

Separately, DOD has certified that military personnel in Uzbekistan, Kyrgystan, Pakistan, Tajikistan, and Jordan are eligible for all combat zone related tax benefits due to their service in direct support of military operations in the Afghanistan combat zone. The effective date of the DOD certification began on September 19, 2001, for Pakistan, Tajikistan, and Jordan, and on October 1, 2001, for Kyrgystan and Uzbekistan. Kyrgystan and Uzbekistan were not eligible for imminent danger pay in September.

[24] U.S. Department of the Treasury, *Internal Revenue Service*, website http://www.irs.gov/newsroom/article/0,,id=108331,00.html, visited January 6, 2006.

Beginning on November 21, 1995, P.L. 104-117 designated three parts of the former Yugoslavia as a Qualified Hazardous Duty Area, to be treated as if it were a combat zone.

Military operations in and near Bosnia. Tax relief for members of the Armed Forces serving in the former Republic of Yugoslavia was also provided (P.L. 104-117, as enacted on March 20, 1996). The law designates Bosnia-Herzegovina, Croatia, and Macedonia as "qualified hazardous duty areas" and treats the areas as combat zones. These countries are considered qualified hazardous duty areas for as long as any member of the Armed Forces of the United States serving there is entitled to hostile fire/imminent danger pay. U.S. peace-keeping troops participating in Joint Endeavor (the NATO operation) or Operation Able Sentry (the United Nations operation) qualify for the exclusion of combat zone compensation from gross income under Code Section 112.

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