16 T.C. 909 (1951)

To qualify for a tax exemption on income earned abroad under Section 116 of the Internal Revenue Code, a U.S. citizen must demonstrate bona fide residency in a foreign country or countries for the entire taxable year, and the continuity of that residency cannot be broken by returning to the United States with no definite plans to return to the foreign country.

Summary

Richard Lovald, a U.S. citizen, sought a tax exemption on income earned abroad while working for UNRRA in China during 1946 and 1947. The Tax Court denied the exemption, finding that Lovald failed to establish bona fide residency in a foreign country for the entirety of either tax year. His prior work in Honduras did not extend his foreign residency through 1946 because he had returned to the U.S. without intending to return to Honduras. Furthermore, his intent to seek employment elsewhere after his UNRRA assignment ended prevented him from proving he remained a resident of China until the end of 1947.

Facts

From 1942 to September 1945, Lovald worked in Honduras for The Institute of Inter-American Affairs. In September 1945, he was instructed to return to Washington D.C. after the agreement between the U.S. and Honduras ended. He did not intend to return to Honduras. While in Washington, he accepted a position with UNRRA. He was on UNRRA's payroll beginning November 1945. In January 1946, he departed for China to work for UNRRA until September 1947. His family joined him in China. After his assignment ended, he spent three months in Shanghai before returning to the United States on December 31, 1947. He indicated he hoped to find employment in Afghanistan or elsewhere after his UNRRA assignment concluded.

Procedural History

Lovald filed individual income tax returns for 1946 and 1947 and claimed exemptions for income earned abroad. The Commissioner of Internal Revenue determined deficiencies for both years, arguing that Lovald was not a bona fide resident of a foreign country for the entire year in either year. Lovald petitioned the Tax Court for a redetermination of the deficiencies.

Issue(s)

1. Whether Lovald was a bona fide resident of a foreign country or countries for the entire 1946 taxable year, thus entitling him to an exemption under Section 116(a)(1) of the Internal Revenue Code.
2. Whether Lovald was a bona fide resident of a foreign country or countries for at least two years before changing his residence back to the United States in 1947, or whether he was a bona fide resident of China for the entire year of

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1947, thus entitling him to an exemption under Section 116(a)(2) of the Internal Revenue Code.

Holding

1. No, because Lovald's residency in Honduras terminated in September 1945, and he did not establish residency in China until approximately March 1, 1946, therefore he was not a resident of a foreign country for the entire 1946 tax year.
2. No, because Lovald was not a resident of Honduras after September 1945, therefore he was not a resident of a foreign country for at least two years before changing his residence. Furthermore, his intent to seek new employment after the termination of his UNRRA assignment shows his residence in China did not last throughout the entire year of 1947.

Court's Reasoning

The court reasoned that Lovald failed to meet the requirements for tax exemption under Section 116 of the Internal Revenue Code for either year. Regarding 1946, the court emphasized that Lovald's residency in Honduras ended in September 1945 when his work there concluded and he returned to the United States with no intention of returning. The court distinguished Lovald's situation from cases where foreign residence is not interrupted by temporary vacations in the United States, stating, "Terminal pay received until March 1, 1946, does not prove temporary vacation, but a mere contractual right." As such, Lovald did not meet the requirement of being a bona fide resident of a foreign country for the entire 1946 tax year.

Regarding 1947, the court found that even if Lovald was a bona fide resident of China, he did not prove that such residence lasted for the entire year. The court highlighted Lovald's own testimony that he "had no particular plan in China" after his UNRRA assignment and that he intended to seek employment elsewhere. The court stated, "It is apparent, we think from the record before us, that residence in China is not shown to have lasted throughout the year 1947. If anything, it tends to indicate termination of any such residence prior to the end of 1947, with intention on the part of the petitioner to seek some new field of activity, with Afghanistan in his mind." Therefore, Lovald did not qualify for the exemption under either Section 116(a)(1) or 116(a)(2).

Practical Implications

The *Lovald* case underscores the importance of maintaining continuous foreign residency to qualify for tax exemptions on income earned abroad. Taxpayers must demonstrate a clear intention to remain in a foreign country for the entire tax year and, if claiming the two-year exemption under Section 116(a)(2), for at least two years before returning to the United States. Returning to the United States without

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a definite plan to return to the foreign country breaks the continuity of foreign residency, even if the taxpayer receives terminal pay or expresses an interest in future foreign employment. This case serves as a cautionary example for individuals working abroad and seeking to minimize their U.S. tax obligations, demonstrating the need for careful planning and documentation to establish and maintain bona fide foreign residency.

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