FAQ: Tax Exclusions and Combat Pay

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1. What income is subject to tax?

Unless otherwise excluded, all income is subject to tax. Income is very broadly defined - "gross income means all income from whatever source derived" - including such items as compensation for services (wages, fees, commissions, etc.), income from business, interest earned, rents, royalties, and dividends received, receipt of alimony, annuity or income from life insurance and endowment contracts, pensions, discharge of debts, income in respect of a decedent, and income from an interest in an estate or trust. Even income derived from illegal activities is subject to tax.

2. What part of my paycheck is subject to Federal income tax?

Members of the Armed Forces have many types of pay and allowances. Some are includible in gross income while others are excludable from gross income. Includible items are subject to tax and must be reported on the taxpayer's tax return. Excludable items are not subject to tax, but may have to be shown on the tax return. The following items are includible in gross income, unless the pay is for service in a combat zone declared by an executive order of the President or in a qualified hazardous duty area declared by statute:

Basic Pay	Imminent Danger Pay
Diving Pay	Hostile Fire Pay
Proficiency Pay	Flight Duty Pay
Foreign Duty Pay	Medical/Dental Officer Pay
Responsibility Pay	Aviation Career Incentive Pay
Continuation Pay	Veterinary Officer Pay
Enlistment Bonus	Nuclear Qualified Officer Pay
Reenlistment Bonus	Personal Money Allowance
Separation Pay	Overseas Extension Bonus
Sea Duty Pay	Accrued Leave Payment
Student Loan Repayments	Scholarships (AFHPSP)

The following qualified military benefits do not have to be reported as income on Form 1040, 1040A, or 1040 EZ. The exclusion whether the item is furnished in kind or is a reimbursement or allowance. The personal use of a vehicle cannot be excluded from gross income as a qualified military benefit.

Basic Allowance of Housing (BAH)	Moving Storage
Other Quarters Allowances	Dislocation Allowances
OHA (Overseas Housing Allowance)	Trailer Allowances
Basic Allowance of Subsistence (BAS)	Family Allowances
ROTC Educational and Subsistence Allowances	Defense Counseling
	Uniforms (In Kind or Allowances)

Professional Education
Interment Allowance
Death Allowance
Evacuation Allowance
Group-term Life Insurance
Veterans' Benefits
Congressional Medal of Honor Pension
Medical Benefits
Survivor and Retirement Protection
Plan Premiums Deducted from Military
Pay

Combat Zone Compensation (including hostile fire pay, or imminent danger pay)(Limited Amount for Officers)

3. If I served in a combat zone, what portion of my pay may I exclude from income?

Members of the Armed Forces who served in a combat zone may exclude certain pay from their income. They do not have to receive the pay while in a combat zone, but it must be for service there or for a period during which they were hospitalized as a result of service there. The following military pay can be excluded from their income:

1. Active duty pay earned in any month during which they served in a combat zone.
2. A reenlistment bonus if the voluntary extension or reenlistment occurs in a month during which they served in a combat zone.
3. Pay for accrued leave earned in any month during which they served in a combat zone. The Department of Defense must determine that the unused leave was earned during that period.
4. Pay received for duties as a member of the Armed Forces in clubs, messes, post and station theaters, and other non-appropriated fund activities. The pay must be earned in a month during which the member served in a combat zone.
5. Awards for suggestions, inventions, or scientific achievements to which members are entitled because of a submission they made in a month during which they served in a combat zone.
6. Student loan repayments that are attributable to their period of service in a combat zone.

Note that retirement pay does not qualify for the combat zone exclusion.

4. What is a combat zone?

A combat zone is any area the President designates by Executive Order as an area in which the U.S. Armed Forces are or have engaged in combat. An area usually becomes a combat zone and ceases to be a combat zone on the dates that the President designates by Executive Order.

The President has designated by Executive Order No. 13119 the following locations (including airspace) as a combat zone beginning March 24, 1999.

Federal Republic of Yugoslavia (Serbia/Montenegro)
Albania
The Adriatic Sea
The Ionian Sea - north of the 39^{th} parallel (including all of the airspace in connection with Kosovo operation)

The President has designated by Executive Order No. 12744 the following locations (including airspace) as a combat zone beginning January 17, 1991.

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
The total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates.

Beginning March 24, 1999, a "qualified hazardous duty area" in the former Yugoslavia, adjacent waters, and airspace above is treated as if it were a combat zone during the period that any member of the armed forces is entitled to hostile fire pay or imminent danger pay for services performed in such area. The qualified hazardous duty area includes:

Federal Republic of Yugoslavia (Serbia/Montenegro)
Albania
The Adriatic Sea
The Ionian Sea-north of the 39th parallel

Beginning November 21, 1995, a "qualified hazardous duty area" in the former Yugoslavia is treated as if it were a combat zone during the period that any member of the armed forces is entitled to hostile fire pay or imminent danger pay for services performed in such area. The qualified hazardous duty area includes:

Bosnia and Herzegovina
Croatia
Macedonia

The law also provides that all members of the Armed Forces deployed overseas away from their permanent duty station in support of operations in a qualified hazardous duty area, but outside of the qualified duty area, are treated as if they are in a combat zone solely for the purpose of extension deadlines. These personnel are not entitled to other combat zone tax benefits.

5. Does service in a combat zone include periods of sickness or leave?

Service in a combat zone includes any period that the military members are absent from duty because of sickness, wounds, or leave. If, as a result of serving in a combat zone, they are missing in action or become prisoners of war, they are considered to be serving in the combat zone as long at they keep that status for military pay purposes.

6. When is military service outside the combat zone considered performed in the combat zone?

Military service outsider a combat zone is considered to be performed in a combat zone if:

The service is in direct support of military operations in the combat zone
The service qualifies a member for special military pay for duty subject to hostile fire or imminent danger.

Military pay received for this service will qualify for the combat zone exclusion if the other requirements are met. The following service does not qualify as service in the combat zone:

Presence in a combat zone while on leave from a duty station locate outside the combat zone
Passage over or through a combat zone during a trip between two points that are outside the combat zone
Presence in a combat zone solely for a member's personal convenience

These members do qualify for the exclusion if they are assigned on official temporary duty to a combat zone or if they qualify for hostile fire/imminent danger pay.

7. How much may I exclude from pay based on service in a combat zone?

Enlisted members - Enlisted members who serve in a combat zone during any part of a month can exclude all of their military pay for that month from their income. Commissioned warrant officers are considered enlisted personnel and their exclusion is not limited.

Officers - Commissioned officers (including limited duty officers) may exclude their pay as above. However, the amount of the exclusion is limited to the highest rate of enlisted pay per month plus the amount of imminent danger pay received each month during any part of which they served in a combat zone. Commissioned officers include officers holding temporary commission.

Military members can also exclude military pay earned while they are hospitalized as a result of wounds, disease, or injury in a combat zone. The exclusion of their military pay while they are hospitalized does not apply to any month that begins more than 2 years after the combat activities in that zone. Their hospitalization does not have to be in the combat zone.

Hospitalized while in a combat zone - if a member is hospitalized while serving in the combat zone, the wound disease, or injury causing the hospitalization will be presumed to have been incurred while serving in the combat zone unless there is clear evidence to the contrary.

Hospitalized after leaving the combat zone - In some cases the wound, disease or injury may have been incurred while serving in the combat zone, even though the member was not hospitalized until after he/she left.

8. Do I have to pay taxes on income earned abroad?

   Unless otherwise excluded, the amounts included in income are included whether they are earned in the United States or abroad. The law permits certain taxpayers an exclusion amount for earned income in foreign countries. This Foreign Earned Income Exclusion, however, does not apply to wages and salaries paid to both civilians and military employees of the United States Government. Employees of the United States Government include Employees of the Armed Forces post exchanges, officers' and enlisted personnel clubs, embassy commissaries, and similar personnel paid form non-appropriated funds. Other foreign income earned by military personnel or their spouses may be eligible for the foreign income exclusion. For more information, see Publ. 54, Tax Guide for US Citizens and Resident Aliens Abroad.

9. Is my military pay subject to state tax?

   Military pay is subject to state tax unless excluded by the state law. Certain states do not tax service members' income or a portion thereof.

10. In what state must I file income taxes?

   As a service member, you must file taxes in your state of domicile. Pursuant to the Soldiers and Sailors civil relief act you will not be treated as having changed your state of domicile simply because you were stationed in another state pursuant to military orders. No state may tax you on your military income, if you are not domiciled in that state. In order for your domicile to change two things must happen at the same time: (1) you must reside in the new state of domicile and (2) you must have an intent to make that state your new domicile. Your intent may be evidenced by such acts as changing your voter registration, your driver's license, and your automobile registration.

11. Can I exclude interest on Bonds utilized to pay for educational expenses?

   Since 1990, the Series EE US Savings Bonds have had an added feature that will allow owners to entirely exclude interest accrued on the bonds if used to pay for qualified educational expenses. There are four basic restrictions to the qualified Savings Bond exclusion program. First, the exclusion is available only for bonds purchased on or after January 1, 1990. Bonds purchased before this date will not qualify. Secondly, the bond must be issued to an individual who is at least 24 years old. Third, the exclusion is phased out as the adjusted gross income of the taxpayer exceeds certain levels depending on the owner's filing status. The final requirement is that the amount of the interest on the redeemed bonds must be lower than qualified higher educational expenses of the child, the taxpayer, or a spouse.

The limits are higher since 2000 for the exclusion of interest from income for Series EE Savings Bonds used for education. The ability to exclude interest from savings bonds used for educational purposes phases out on joint returns beginning at modified adjusted gross income of $81,100 and ending at $111,100 (was $79,650 to $109,650 in 1999). For single taxpayers the ability to exclude interest from savings bonds used for educational purposes begins at $54,100 and terminates at $69,100 (was $53,100 to $68,100 in 1999).

12. Am I eligible to make contributions to an IRA?

More service members will be eligible to make deductible contributions to a traditional IRA due to an increase in the phase out limitations. The phase-out limits for IRA deduction increase this year for employees covered by qualified retirement plans. Because service members are active participants and have coverage by a pension or retirement plan, deductible IRA contributions are subject to limitations. The adjusted gross income (AGI) limits are gradually increasing over the next several years. In 2007 and thereafter the maximum range will be from $80,000 to $100,000. For single filers (including head of household), the phase-out begins at $32,000 and ends at $42,000. In 2005 and thereafter the maximum range will be from $50,000 to $60,000. For married filing separately the limit remains $10,000.

New regulations became effective in 2000 that limit tax-saving ploys of investors who convert traditional IRAs to Roth IRAs. The intent of the new regulations is to close a loophole in the tax law where investors could undo Roth IRA conversions and then redo them simply to lower their tax bill. Before 2000, taxpayers converting to a Roth IRA could later undo the conversion by rolling the money back into a traditional IRA and then immediately reconvert back to a Roth IRA. The redoing of a Roth IRA conversion was a lucrative tax-saving move if the value of an IRA had dropped since the time of the conversion because the funds converted to a Roth IRA are subject to tax based on the value of the assets at the time of the conversion. If the conversion of a Roth IRA was performed when the value decreased, then the taxpayer paid tax on the lower value. By redoing a Roth conversion, the investor could take advantage of a downturn in stock prices to reduce the tax bite on a Roth conversion. There are now more restrictions on reconverting a traditional or regular IRA back to a Roth IRA. Beginning in 2000, taxpayers that convert to a Roth IRA will have to wait until the next tax year following the conversion to reconvert. In addition, the regulations require a minimum 30 day waiting period between the time the taxpayer undoes a Roth IRA conversion and conversion back to a Roth IRA.

13. Can I deduct Student Loan Interest?

Taxpayers can deduct student loan interest up to a certain point. The Student Loan Interest Deduction is not an itemized deduction, and taxpayers do not have to itemize to qualify for this deduction. However, the deduction declines for couples with adjusted gross income of $60,000 to $75,000. For single taxpayers, the deduction decreases with adjusted gross income of $40,000 to $55,000.

14. What is the Earned Income Credit?

The refundable EIC is available to certain low-income individuals who have earned income, meet adjusted gross income thresholds, and do not have more than a certain amount of disqualified income. Beginning in 2000, the EIC is denied if the aggregate amount of disqualified income exceeds $2,400 ($2,350 in 1999).

Those who seek to include eligible foster children in their households for purposes of the EIC face additional requirements. Previously, a child was an eligible foster child for the EIC if the taxpayer cared for the child as they would their own child and the child lived with the taxpayer for the whole year (Except for temporary absences). In addition to the prior rules mentioned, the child must be a brother, sister, stepbrother, or stepsister (or a descendant of your brother, sister, stepbrother, or stepsister) or have been placed with the taxpayer by an authorized placement agency. See Publ. 596.

15. What is a Nanny tax?

If a taxpayer pays a housekeeper or household helper less than a certain amount, the taxpayer will not have to pay Social Security or Medicare taxes on behalf of the employee. The threshold is adjusted for inflation each year based on increases in average wages. However, the federal unemployment tax (FUTA) limit for household employees does not change because this tax is not indexed for inflation. The FUTA applies whenever a domestic employee is paid $1,000 or more in a calendar quarter in the current or prior tax year.

16. What is an estate tax?

All property (and certain powers) that a person has at the time of his/her death is subject to tax. The estate tax is payable by your estate - it is usually paid by the estate of the decedent before property is distributed to the beneficiaries of the estate. Barring an extension, the estate tax is due within nine (9) months after your death.

Everyone's estate is subject to the estate tax; however, there is:

(1) an unlimited estate tax marital deduction when property is passed to a surviving United States citizen spouse of the decedent (so long as certain prerequisites are met),

(2) a unified credit which enables every individual to dispose of up to $650,000

(indexed) of property by gift during lifetime and distribution after death,

(3) an exclusion for disposition of property to a qualified charitable organization.

The unlimited marital deduction, qualified charitable organization deduction and unified transfer tax credit enables most estates to be distributed without incurring any federal estate tax. In addition, there are many ways in which you can structure your estate - to take advantage of available exclusions, exemptions, credits and deductions - so that the tax bite is reduced.

Some states likewise have an estate or inheritance tax. This tax is typically patterned after the federal estate tax system. The state estate/inheritance tax is often limited to the tax credit allowed for it in the federal tax system - the net effect being no increase over the transfer tax due.

17. What is a gift tax?

Gift Taxes basically are taxes that supplement the Estate Tax. Gift Taxes are placed on gifts given away to any person while you are still living. However, the law allows you to give up to $10,000 to an unlimited number of people each year without incurring Gift Tax liability -- so long as there are no strings attached. Married couples can give, as a couple, a $20,000 gift per year to as many people as they want. Beginning in 1998 there is a $625,000 lifetime exemption cap (increased from the $600,000 cap that was in effect for many years through 1997), meaning that gifts transferred during your life or left in your estate are untaxed until they reach the $625,000 threshold. Amounts over $625,000 trigger Gift Tax liability. Of course, any gift transferred between spouses (where both are US citizens) of any size is 100% Gift Tax-free.

In actuality, the payment of Gift Taxes is relatively rare, thanks to the annual exclusion, and the unlimited marital and charitable deduction.

18. What is a generation skipping tax?

Generation Skipping Transfer Tax is 55% tax that may be due -- in addition to Estate Tax. This tax is somewhat confusing and often misunderstood. The basic premise behind the generation skipping transfer tax - which is a tax that is separate and apart from income, estate and gift taxes - is to trap transfers of property within each successive generation. In other words, it is designed to allow transfers to spouses and children but tax transfers going to grandchildren and those deemed to be two or more generations below that of the person making the transfer. This tax is very steep - it is a flat 55% of the value of the property transferred.

Those who transfer all of their property to someone who is deemed to be in the same or one generation below do not have to worry about this tax. No tax is imposed at this level.

In addition, every individual is allowed a $1,000,000 generation skipping transfer tax exemption - no tax is incurred on the first $1,000,000 going to grandchildren and those deemed to be two or more generations below that of the transferor.

Many people escape imposition of the generation skipping transfer tax by transferring property only to those at his/her same generation or no more than one generation below - along with the allocation of the $1,000,000 exemption.

19. What is alternative minimum tax?

The tax laws give preferential treatment to certain kinds of income and allow special deductions and credits for some kinds of expenses. The alternative minimum tax attempts to ensure that all individuals who benefit from these tax advantages will pay at least a minimum amount of tax. The alternative minimum tax is a separate tax computation that, in effect, reduces the benefit of certain deductions and credits, thus creating a tax liability for an individual who would otherwise pay little or no tax. You may have to pay the alternative minimum tax if your taxable income for regular tax purposes, plus any of the adjustments and preference items that apply to you, is more than a specified exemption amount. To determine if you may be subject to the alternative minimum tax, refer to the Form 1040 Instructions for line 48, or refer to Form 6251, Alternative Minimum Tax - Individuals.

References:

- Form 1040 Instructions
- Form 6251, Alternative Minimum Tax - Individuals

20. Can I file electronically?

Electronic tax filing may be available to you through your command or through a Navy legal assistance provider.

21. Where can I go to get information on tax laws of interest to military people?

IRS Publication 3, which may be downloaded from the web, (see below) discusses various topics of interest to military members.

22. Does the IRS offer assistance with tax matters?

The IRS maintains a web site a www.irs.gov
Assistance concerning specific questions or where to file your return is available to at http://www.irs.ustreas.gov/where_file/index.html.
For additional answers to frequently asked questions visit
http://www.irs.ustreas.gov/prod/tax_edu/faq/faq1-1.html

23. Can I download forms from the web?

IRS forms may be downloaded at http://www.irs.ustreas.gov/forms_pubs/index.html