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# Tax Benefits for Military Members and Families, Part 1

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As another tax season comes to a close, many tax practitioners will start evaluating new tax planning strategies for the upcoming year. In order to plan successfully, a tax practitioner must understand how each client's individual situation is seen through the eyes of the Treasury. And as more and more clients become members of the Armed Forces, it's even more crucial to

understand the tax law and special tax provisions that apply to these individuals and their families.

To begin with, who is deemed to be a member of the Armed Forces? According to IRS Publication 3, for federal income tax purposes, *all* commissioned officers, warrant officers, and enlisted personnel in all regular and reserve units under the control of the Secretaries of the Defense, Army, Navy, Air Force, and the Coast Guard are considered to be members of the U.S. Armed Forces. A key to accurately planning for a taxpayer's tax liability is to understand whether an item of income is *includible* in gross income (and thus taxable) or *excludible* (and thus nontaxable).

Members of the Armed Forces re-

ceive a vast array of pays and allowances. How do you know which items are or are not included in arriving at gross income for your military clients? IRC §61 broadly defines gross income to include *all* income from whatever source *unless specifically excluded* by another IRC section. Items that may be included in a service member's gross income, such as basic pay, special pay, bonuses, incentive pay, and other miscellaneous payments, are *excluded* if those items are pay for services performed in a combat zone. Pursuant to IRC §112, the combat zone exclusion is the exclusion from gross income of monies that would typically be included in gross income but were earned during active service while in a combat zone or qualified haz-

ardous duty zone. Afghanistan, Kosovo, and the Persian Gulf are all areas that have been designated as combat zones through executive orders of the President, while Bosnia and Herzegovina, Croatia, and Macedonia are qualified hazardous duty areas.

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The interesting aspect of this provision is that the service member doesn't have to receive the pay while in the combat zone, hospitalized, or even in the same year that the member served in the zone. The key here is that "the entitlement to the pay must have fully accrued in a month during which the service member served in the combat zone or was hospitalized as a result of wounds, disease, or injuries while serving in the combat zone." Even more interesting is if, as a result of serving in a combat zone, a service member becomes a prisoner of war or is missing in action, that service member is still considered to be serving in the combat zone for as long as the military maintains that status for pay purposes. Those payments for military service, therefore, would be *excludible* from gross income.

It should be noted that the amounts received as disability income for injuries sustained as a direct result of a terrorist attack while performing services outside of the United States qualify as *excludible* from gross income. Retirement pay and pension amounts attributable to active combat, however, don't qualify for the combat zone exclusion, and, therefore, *must be included* in gross income. Finally, a commissioned officer who receives combat pay may also exclude the monies from gross income calculations, but the amount of the exclusion is limited to the highest rate of enlisted pay.

Additionally, IRC §24(d)(1) and §32(c)(2)(B) permit combat pay that's *excludible* from gross income to be *included* in earned income for the purpose of the earned income tax credit and for determining the refundable portion of the child tax

credit for tax years beginning before January 1, 2006 (§104(b)(3) of the Working Families Tax Relief Act of 2004). To better appreciate this provision, it's best to look at the following example:

Thomas, an active service member, has \$10,000 of regular basic pay and \$12,000 of combat pay. In determining gross income, the \$10,000 is all Thomas would include. In calculating the amount of earned income for the earned income tax credit or refundable portion of the child tax credit, however, Thomas would include \$22,000 as total earned income. This represents the best of both worlds: lower income for taxable income calculations and higher income for determining maximum allowable credits.

Fortunately for service members, many items of income *are* excludible from gross income. According to Treasury Reg. §1.61-2, items such as living allowances, moving allowances, travel allowances, combat zone pay, family allowances, death allowances, in-kind military benefits, and other miscellaneous payments may be *excludible* when determining gross income. As stated in IRS Publication 3, the exclusion applies whether the item is furnished in kind or is a reimbursement or allowance.

So what happens if your military client ends up with pay or allowance that must be *included* in gross income? The good news is that they may be eligible for special adjustments that will lower their gross income. First and foremost, armed forces reservists who travel more than 100 miles away from home in connection with performing services as a member of the reserves are entitled to deduct the travel expenses against gross in-

come as opposed to a miscellaneous itemized deduction. Next, most taxpayers must meet certain time and distance tests in order to deduct moving expenses. If an active member of the Armed Forces is required to move in conjunction with a permanent change of station, however, he or she is *not* required to meet the time and distance test—though this generally is not an issue.

So what's the bottom line for tax practitioners? Practitioners with members of the Armed Forces as part of their client list need to carefully review the special tax benefits that are permitted for service members in order to plan accurately and successfully. More important, practitioners need to be aware that even though many of the states follow federal tax rules in regards to the military, many don't!

Next month, we will continue with our discussion on special tax benefits for military members and their families by exploring the special allowances for itemized deductions, the provisions of the Military Family Tax Relief Act of 2003, including the special allowances for gain on sale of personal residence, tax forgiveness, and filing deadlines. ■

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