

CRS Report for Congress

Received through the CRS Web

Tax Benefits Enacted in the 108th Congress for Military Personnel

Pamela J. Jackson
Analyst in Public Sector Economics
Government and Finance Division

Summary

Many bills proposed tax relief for the armed forces in the 108th Congress. Two bills were enacted: the Military Families Tax Relief Act of 2003 (H.R. 3365), that became public law (P.L. 108-121) on November 11, 2003, and the Working Families Tax Relief Act of 2004 (H.R. 1308), that became public law (P.L. 108-311) on October 4, 2004.

The Military Families Tax Relief Act (MFTRA) contains several provisions that: 1) increase the death gratuity payment and make it fully tax-exempt; 2) provide members of the military with extended time to defer capital gains resulting from the sale of their principal residences; 3) exempt from income benefits received from the Department of Defense Homeowners Assistance Program; 4) expand combat zone filing rules to include military personnel involved in contingency operations; 5) extend the criteria defining membership in veterans' organizations; 6) create an above-the-line deduction for overnight travel expenses of National Guard and reserve members; and a few other items.

The Working Families Tax Relief Act (WFTRA) provides a variety of family tax provisions, some of which address military personnel. In particular, WFTRA allows the combat zone compensation of members of the armed forces to be included in earned income for the purpose of calculating the refundable portions of the Child Tax Credit and the Earned Income Tax Credit. This report, which provides information about the various forms of tax relief that were introduced and subsequently legislated, will not be updated.

Legislative History

The Military Families Tax Relief Act of 2003 (P.L. 108-121), introduced as H.R. 3365 on October 21, 2003, was passed in the House on October 29, passed in the Senate on November 3, and signed into law by President Bush on November 11, 2003. The act, which provides tax relief for members of the armed forces, improves tax equity for

military personnel and their families through a series of provisions with a variety of effective dates.

The Working Families Tax Relief Act of 2004 (P.L. 108-311), which was originally introduced as H.R. 1308, passed in the House in March 2003 and in the Senate in June 2003. While H.R. 1308 was originally scheduled for conference in November 2003, its conference did not begin until September 2004. The conference report, H.Rept. 108-696, was filed on September 23 and passed in both the House and the Senate that same day. The new law includes provisions that extend family tax relief, provide assistance to military families in combat zones, extend alternative minimum tax relief, create a uniform definition of a child for tax purposes, extend certain expiring provisions, and make technical corrections to current tax law.

Summary of MFTRA Provisions

Death Benefits. The MFTRA doubles the death gratuity payment for deceased members of the armed forces from \$6,000 to \$12,000. The new law makes these payments retroactive (effective after September 10, 2001). This was done so that members of the armed forces serving in military operations in Afghanistan, Iraq and other locations since the September 11, 2001 terrorist attacks would be covered.

MFTRA makes the full amount of the death gratuity payment tax-exempt and makes that exemption retroactive (effective after September 10, 2001). Under prior tax law, the death gratuity payment of \$3,000 was fully tax-exempt until 1991. When Congress increased the military death benefit from \$3,000 to \$6,000 it failed to increase the amount to be excluded from tax to \$6,000. Thus, between 1991 and the passage of MFTRA, one-half of the death benefit was taxable.

Home Sale Exclusion. The new law amends the Internal Revenue Code (IRC) to authorize a member of the uniformed services or the Foreign Service serving on "qualified official extended duty" (any duty in excess of 90 days while serving at a duty station which is at least 50 miles from the principal residence or while residing under government orders in government quarters), to extend for 10 years the five-year period utilized in determining full exclusion of gain from the sale of a principal residence. Included among the uniformed services are: (1) the armed forces; (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. This legislation makes such provisions effective as if included in section 312 of the Taxpayer Relief Act of 1997 (P.L. 105-34) and, therefore, retroactive. As such, it is effective for sales made after May 6, 1997. The law provides that all covered taxpayers will have at least one year from the date of signing MFTRA into law (November 11, 2003) to file a claim for refund of taxes previously paid.

Under present law, an individual taxpayer may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange date. Under MFTRA, an individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to

CRS-3

service for the government. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period (up to 10 years) during which the taxpayer or taxpayer's spouse is on qualified official extended duty as a member of the uniformed services and the Foreign Service.

Homeowners Assistance. MFTRA exempts certain fringe benefits received under the Department of Defense Homeowners Assistance Program from inclusion in gross income. In particular, the Department of Defense makes payments to members of the Armed Services to offset housing value declines due to military base realignment or closure. Under previous law, those payments were taxable as compensation.

Expansion of Combat Zone Filing Rules. Under existing law, military personnel stationed in a combat zone received an extended period of time for filing federal income tax returns and for paying any tax liability that may be owed. Through the MFTRA, this exception has been extended to include military personnel involved in contingency operations designated by the Secretary of Defense.

Membership in Veterans' Organizations. Qualified veterans' organizations are treated as tax-exempt organizations under the Internal Revenue code. Contributions to these organizations are tax deductible. To qualify as a veterans' organization 75% of the members must be current or former active military personnel and substantially all of the members must be either current or former active personnel or widows/widowers of former active military personnel. MFTRA extends the criterion needed to meet the test of "substantially all" by allowing for ancestors or lineal descendants of past or present members of the armed forces or of cadets to be considered qualifying members of veterans' organizations for their tax-exempt status determination.

Dependent Care Benefits. Dependent care assistance provided under a employer's dependent care assistance program for a member of the uniformed services is clarified as an income-excludable qualified military fringe benefit in the MFTRA. While a provision in the Internal Revenue code excludes benefits provided to members of the uniformed services from income, dependent-care benefits were never directly addressed in that provision. The clarification is effective for tax years beginning after December 31, 2002.

Above-the-Line Deduction. A provision of MFTRA allows a deduction for itemizers and non-itemizers for un-reimbursed overnight travel, meals, and lodging expenses of National Guard and Reserve members. In order to qualify for the provision they must travel more than 100 miles away from home and stay overnight as part of their official duties. Under previous law, those expenses could have been deducted as itemized deductions to the extent that they exceeded 2% of adjusted gross income. Prior law provided that reservists who did not itemize were not able to deduct these expenses and reservists who did itemize could deduct the expenses only in reduced form. The deduction applies to all amounts paid or incurred in tax years starting after December 31, 2002.

Education Savings Accounts Withdrawals. The new law exempts distributions from Coverdell Education Savings Accounts and qualified tuition programs from the 10% additional tax for non-educational use: (1) if made for an account holder at the United States Military Academy, the United States Naval Academy, the United

States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy; and (2) to the extent that the distribution does not exceed the costs of advanced education.

Tax Relief for Astronauts. The MFTRA provides tax relief for families of the Columbia Space Shuttle crew by making the tax relief provisions applicable to terrorist attack victims also applicable to the victims of the Columbia Space Shuttle disaster. As passed into law, the Act extends the exclusion from income tax, the exclusion for death benefits, and the estate tax relief provisions available under the Victims of Terrorism Relief Act of 2001 (P.L. 107-34) to astronauts who lose their lives on a space mission (including the individuals who lost their lives in the space shuttle Columbia disaster).

MFTRA Revenue Offsets and Impacts

Offset. The new law contains a revenue provision as an offset that amends the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA; P.L. 99-272) to extend customs user fee authority until March 31, 2005. Under COBRA, the Secretary of the Treasury was authorized to collect certain service fees. The Homeland Security Act of 2002 (P.L. 107-296) authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. These fees include processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and customs broker permits. COBRA was amended on several previous occasions and the most recent extension of authorization for the collection of fees was made by the enactment of P.L. 108-89 and effective through March 31, 2004.

Impact. The tax relief measures of H.R. 3365 that were passed into law are expected to cost \$1.24 billion in forgone tax revenue from 2004 through 2013 according to the Joint Committee on Taxation (JCT).¹ The measures that provide most significant impact on tax revenue over the nine-year period are the capital gain exclusion (\$212 million), the tax treatment of death gratuities payments (\$112 million) and the above-the-line deduction for travel expenses (\$851 million). The customs user fees extension is anticipated to yield \$1.31 billion in 2004 and 2005. The net effect from passage of this Act is anticipated to be a revenue gain of \$69 million from 2004 through 2013.

WFTRA Provisions Relating to Military Personnel

The Working Families Tax Relief Act of 2004 (P.L. 108-311) includes provisions that extend family tax relief and provide assistance to military families in combat zones. The provisions for military families were enacted in response to unintended consequences of earlier legislation.

Background. The Economic Growth and Tax Reconciliation Relief Act (P.L. 107-16) simplified the definition of earned income by excluding nontaxable employee

¹ U.S. Congress, Joint Committee on Taxation estimates posted on the Joint Committee on Taxation's website: [<http://www.house.gov/jct/x-100-03.pdf>]. All estimated revenue impacts in this report are those prepared by the staff of the JCT.

CRS-5

compensation, which included combat zone pay, from the definition of earned income. The amount of earned income that armed forces members reported for tax purposes was reduced and caused a net loss in tax benefits for some low-income members of the armed forces.

In May 2004, the Government Accountability Office (GAO) reported that of 430,000 members serving in a combat zone in 2003, between 5,000 and 10,000 members in one-earner households suffered a net loss of tax benefits. The amount of the tax benefit loss varied considerably with a maximum of about \$4,500 for enlisted members and \$3,200 for officers.²

Summary of WFTRA Provisions. Tax benefits for military personnel were included in the conference report, H.Rept. 108-696, to H.R. 1308. The report included a provision that allows combat pay that is otherwise excluded from gross income under Section 112 to be treated as earned income for the purpose of calculating the refundable portion of the child tax credit. The provision would apply to tax years beginning after December 31, 2003.

The conference report also included a provision that allows taxpayers to elect to treat combat pay as earned income for the purpose of the earned income tax credit. This election would be available for any tax year ending after the date of enactment and before January 1, 2006. The provisions in the conference report are estimated to provide \$199 million in assistance to military families with service in combat zones.³

Impact and Assessment of Military Personnel Tax Benefits

Impact. Many military benefits qualify for tax exclusion. That is to say, the value of the benefit (or cash payment made in lieu of the benefit) is not included in gross income. Since these exclusions are not counted in income, the tax savings are a percentage of the amount excluded, dependent upon the marginal tax bracket of the recipient.

An individual in the 10% tax bracket (the lowest income tax bracket) would not pay taxes equal to \$10 for each \$100 excluded. Likewise, an individual in the 35% tax bracket (the highest income tax bracket) would not pay taxes of \$35 for each \$100 excluded. Hence, the same exclusion can be worth different amounts to different military personnel, depending on their marginal tax bracket. By providing military compensation in a form not subject to tax, the benefits have greater value for members of the armed services with higher incomes than for those with lower incomes.

² U.S. Government Accountability Office, *Military Compensation* GAO-04-721R, (Washington: GPO, 2004), p. 3.

³ U.S. Congress, Joint Committee on Taxation estimates posted on the Joint Committee on Taxation's website, at [<http://www.house.gov/jct/x-60-04.pdf>], visited September 24, 2004.

CRS-6

Assessment. Some military benefits are akin to “for the convenience of the employer” benefits provided by private enterprise, such as the allowances for housing, subsistence, payment for moving and storage expenses, overseas cost-of-living allowances, and uniforms. Other benefits are equivalent to employer-provided fringe benefits such as medical and dental benefits, education assistance, group term life insurance, and disability and retirement benefits.

Some see the provision of compensation in a tax-exempt form as an unfair substitute for additional taxable compensation. The tax benefits that flow from an exclusion do provide the greatest benefits to high- rather than low-income military personnel. Administrative difficulties and complications could be encountered, however, in taxing some military benefits and allowances that currently have exempt status; for example, it could be difficult to value meals and lodging when the option to receive cash is not available. By eliminating exclusions and adjusting military pay scales accordingly, a result might be to simplify decision-making about military pay levels and make “actual” salary amounts more apparent and satisfying to armed forces personnel. If military pay scales were to be adjusted upward, it could increase the retirement income of military personnel. However, elimination of the tax exclusions could also lead service members to think their benefits were being cut, or provide an excuse in the “simplification” process to actually cut benefits, affecting recruiting and retention negatively.