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Tax Planning for the Military

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Military Family Tax Relief Act of 2003

Introduction

On November 11, 2003, President George W. Bush signed the Military Family Tax Relief Act of 2003 (H.R. 3365), providing specified tax relief to members of the Armed Forces. A summary of the legislation is provided.

Increase in military death gratuity benefit

- Military death gratuity benefit is increased from \$6,000 to \$12,000
- Amount of military death gratuity benefit that is excludable from income is increased from \$3,000 to \$12,000
- Effective with respect to deaths occurring after September 10, 2001

Extension of five-year period for purposes of excluding gain from the sale of a principal residence

- When determining eligibility to exclude capital gain upon the sale of a principal residence, there is a general requirement that the homeowner must have lived in the residence for at least two of the previous five years
- Members of the uniformed services and foreign service personnel may elect to suspend the running of the above 2-out-of-5-year requirement during any period of qualified official extended duty up to a maximum of ten years
- Effective for sales made after May 6, 1997
- A minimum one year window of time beginning with the date of enactment is created for purposes of filing a claim for refund or credit which might otherwise be barred

Exclusion of amounts received under Department of Defense Homeowners Assistance Program

- Qualified amounts received by military homeowners under the Department of Defense Homeowners Assistance Program are excluded from income
- Effective for payments made after the date of enactment

Exclusion of amounts received for military dependent care assistance

- Clarification is made that dependent care assistance provided under a military dependent care assistance program is excluded from income
- Effective for tax years beginning after December 31, 2002

Exception created for additional ten percent penalty on distributions from 529 plans and Coverdell ESAs--service academy appointments

- Distributions from a 529 plan or Coverdell ESA not used for qualified higher education expenses are subject to a ten percent penalty in addition to federal income tax
- One of the existing exceptions to this additional ten percent penalty--distributions made on account of a scholarship received by the beneficiary--is extended to cover appointments to a military academy
- Effective for tax years beginning after December 31, 2002

Deduction for overnight travel expenses of National Guard and Military Reserve members

- A new above-the-line deduction is created for qualifying travel expenses of National Guard and Military Reserve members
- The expenses must relate to overnight travel more than 100 miles away from home, and include meal, transportation, and lodging expenses (subject to limitation)
- Effective for amounts paid or incurred in taxable years beginning after December 31, 2002

Membership requirements for certain veterans organizations are modified for purposes of tax-exempt status

- For purposes of determining eligibility for tax exemption, membership requirements are somewhat liberalized
- Effective for tax years beginning after the date of enactment

Tax-exempt status of designated terrorist organizations suspended

- Tax-exempt status of an organization is automatically suspended during any period in which the organization is designated as a terrorist organization or is listed in or designated by an Executive Order as supporting terrorism
- Effective for designations made before, on, or after the date of enactment

Combat zone filing rules are extended to contingency operations

- Existing extensions for filing tax returns and making tax payments that apply to individuals serving in combat zones are extended to individuals serving in "contingency operations"
- Contingency operations are operations designated by the Secretary of Defense in which members of the Armed Forces are or may become involved in military actions, operations, or hostilities against an enemy of the United States or against an opposing military force, or result in the call or order to (or retention of) active duty of members of the uniformed services during a war or national emergency declared by the President or Congress
- Effective for any period for performing an act which has not expired before the date of enactment

Extension of tax relief to astronauts

- Income and estate tax relief provisions of the Victims of Terrorism Tax Relief Act of 2002 are extended to astronauts who lose their lives in the line of duty
- Effective for any astronaut whose death occurs in the line of duty after 2002

Taxable vs. Nontaxable Income: Members of the Armed Forces

In general

If you're a member of the U.S. Armed Forces on active duty, you're generally not required to pay federal income tax on all the income you receive. What's taxed and what's not taxed depends on what form the income takes and, in some cases, where the income is earned. Generally, basic pay, special pay, and bonuses are taxable (unless they've been earned for service in a combat zone), while in-kind benefits, reimbursements, and allowances are not taxable.

Tip: A member of the Armed Forces is defined as a commissioned officer or an enlisted person in any regular or reserve unit under control of the Secretary of Defense, Army, Navy, or Air Force, or in the Coast Guard. Members of the U.S. Merchant Marine and the American Red Cross are not considered members of the Armed Forces for federal income tax purposes.

What is taxable?

Basic Pay

Basic pay must be included in gross income for federal income tax purposes, unless it's for service performed in a combat zone (explained below). Basic pay includes amounts received for:

- Active duty
- Attendance at a designated service school (e.g., the Air Force Academy)
- Drills
- Reserve training

Special Pay

Like basic pay, special pay is taxable unless it's earned in a combat zone. Special pay may include compensation for:

- Foreign duty (outside the 48 contiguous states and the District of Columbia)
- Hazardous duty
- Hostile fire or imminent danger

Bonuses and other payments

Unless you've earned them in a combat zone, you must include in gross income on your federal income tax return any bonuses or other payments received for:

- Enlistment or re-enlistment
- Accrued leave
- Student loan repayments from certain military educational loan repayment programs

What isn't taxable?

You may exclude from gross income certain items whether they are furnished in kind, as a reimbursement, or as an allowance. Among other items, you may exclude:

- Living allowances, such as the BAH (Basic Allowance for Housing), BAS (Basic Allowance for Subsistence), and OHA (Overseas Housing Allowance)
- Allowances for moving your household, personal items, trailer or mobile home, for placing your belongings in storage, and for temporary lodging
- Certain travel allowances for dependent students, for leave between consecutive overseas tours, and for per diem expenses
- Payments for group term life insurance, professional education, or uniform allowances
- The value of in-kind benefits, such as legal assistance, medical/dental care, uniforms furnished to enlisted personnel, and commissary/exchange discounts
- Benefits received after 2002 under a dependent-care assistance program

Tip: Military base realignment and closure benefits--qualified payments made under the Homeowners Assistance Program (HAP) after November 11, 2003 are generally excluded from income. However, certain limits apply. Consult a tax professional.

Tip: Generally speaking, as a member of the Armed Forces you are considered an employee of the United States, and any amounts paid to you by the U.S. government or its agencies, even if you are stationed outside the United States, are not considered foreign income. However, if you (or your spouse) earn income from a foreign company, and you meet the other requirements, you may be able to exclude that income from your gross taxable income. For more information, see Tax Issues for U.S. Citizens Living Abroad.

Combat zone exclusion

Who is eligible

A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. As an active member of the U.S. Armed Forces, you may exclude from gross income some or all of your otherwise taxable military compensation if it is earned during a month (or part of a month):

- While you're serving in a combat zone
- While you're hospitalized (inside or outside a combat zone) as a result of a wound, disease, or injury you incurred during your service in a combat zone

Caution: This exclusion doesn't apply to pay you receive for any month of hospitalization that begins more than 2 years after the end of combat activities in the combat zone.

Tip: This exclusion will apply when you're serving outside a combat zone if that service directly supports military operations in a combat zone and qualifies you for hostile fire or imminent danger pay

Tip: You're considered as serving in a combat zone if you're assigned to it on official temporary duty or you qualify for hostile fire/imminent danger pay while you're there. Service in a combat zone includes any periods you are absent from duty because you're sick, wounded, or on leave. If, while

-serving in a combat zone, you become a prisoner of war or are considered missing in action, you're still considered to be serving in that combat zone as long as you keep that status for military pay purposes.

You're not considered to be serving in a combat zone if you're:

- In the combat zone while you're on leave from a duty station located outside the combat zone
- Passing over or through the combat zone during a trip between two points that are outside the combat zone
- In the combat zone solely for your personal convenience

Excludable income

If you are an enlisted member, warrant officer, or commissioned warrant officer and you meet the combat zone exclusion eligibility requirements outlined above, all your military pay can be excluded from gross income. If you are a commissioned officer (other than a commissioned warrant officer), the amount of pay you can exclude from gross income is limited to the highest rate of pay for an enlisted person, plus any imminent danger/hostile fire pay you receive.

Tip: If you meet the combat zone exclusion eligibility requirements for one or more days during a particular month, you're entitled to exclude from taxation your eligible pay for the entire month.

Certifying the exclusion

The wages shown in box 1 of Form W-2, issued by your service branch, should not include any military pay that is excludable from gross income under the combat zone exclusion provisions. If you believe you're entitled to the exclusion, but it's not reflected on your Form W-2, you'll need to get a corrected Form W-2 from the appropriate finance office. You cannot exclude as combat pay any wages shown in box 1 of Form W-2.

Adjustments to Income and Itemized Deductions: Members of the Armed Forces

Introduction

As a taxpayer, you may be able to subtract certain amounts from your gross income to arrive at your adjusted gross income (AGI). Further, you may then subtract from your AGI the greater of either your standard deduction (which is based on your filing status) or the total of your itemized deductions. As a member of the U.S. Armed Forces, you may find the following considerations of particular interest to you.

Tip: A member of the U.S. Armed Forces is defined as a commissioned officer or an enlisted person in any regular or reserve unit under control of the Secretary of Defense, Army, Navy, or Air Force, or in the Coast Guard.

Individual Retirement Account (IRA) considerations

You're covered by an employer-sponsored retirement plan

Taxpayers who make contributions to a traditional IRA may be eligible to deduct their contributions from gross income, up to a certain limit. However, the amount of the deduction may be reduced or eliminated if the taxpayer (or the taxpayer's spouse) is covered by an employer-sponsored retirement plan (e.g., a 401(k) plan).

For purposes of the IRA deduction, if you are a member of the U.S. Armed Forces on active duty for more than 90 days in any one calendar year, you are considered covered by an employer-sponsored retirement plan. You therefore may only be entitled to deduct a portion of your IRA contributions, depending on the amount of your modified adjusted gross income (MAGI) and your filing status.

Check your Form W-2. If the "Retirement Plan" box is checked, you will need to complete the worksheet found in the 1040 and 1040A Instructions to calculate the amount you may deduct.

Extensions of time to contribute

Generally, if a taxpayer wants to make a deductible contribution to a traditional IRA for a given year, the taxpayer must do so before the taxpayer's federal tax return for that year is due. As a result, the deadline is usually April 15 of the calendar year following the year for which the taxpayer wishes to make the contribution. However, as a member of the U.S. Armed Forces, you may qualify to extend the time to file your federal income tax return, particularly if you serve (or directly support service) in a designated combat zone. If so, your deadline for making a deductible contribution to a traditional IRA becomes the same as the new deadline for filing your tax return and paying your taxes.

A large income exclusion may reduce or eliminate your allowable IRA contribution

Generally, to contribute to an IRA, you must receive taxable compensation (e.g., basic pay, special pay, bonuses) for the year, and the amount of the contribution cannot exceed your taxable compensation for that year. If you qualify for the combat zone exclusion, however, your taxable compensation for the year may be substantially reduced. The 2006 Heroes Earned Retirement Opportunities (HERO) Act allows you to include nontaxable combat pay as part of your taxable compensation when determining how much you can contribute to an IRA (your own or a spousal IRA) in tax years beginning after December 31, 2003. Prior to the Act, you were unable to make an IRA contribution if your only compensation was nontaxable combat pay. You have until May 28, 2009, to make retroactive IRA contributions for 2004 and 2005, and you'll have at least one year following the date of your contribution to claim any credit or refund that you may be entitled to for those years. If you have only nontaxable combat pay, a Roth IRA contribution will generally make more sense than nondeductible contributions to a traditional IRA.

Tip: Beginning in 2009, the Heroes Earnings Assistance and Relief Tax Act of 2008 provides that differential pay received by service members is considered compensation for IRA contribution purposes. Differential pay is defined as any payment which: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer.

If you've already made your IRA contribution and later determine that your taxable compensation will be less than the amount you contributed, you should withdraw the portion of your contribution that exceeds your taxable compensation. You won't be taxed on this distribution if you receive it on or before the deadline for filing your return and paying your taxes. You must also withdraw the amount of net income attributable to this contribution while it was an asset of the IRA. Further, that income must be included in your gross income for the year.

If the combat zone exclusion doesn't prevent you from making a contribution to an IRA, it might reduce your taxable compensation to such a level that you could become eligible for a partial, nonrefundable income tax credit for your contribution (the "saver's credit").

Moving expenses

Time and distance are of no consequence

Civilians who move to a new home for job-related reasons can only deduct unreimbursed moving expenses from gross income if the move meets certain time and distance tests. However, members of the Armed Forces on active duty who move because of a permanent change of station don't have to meet these tests.

A permanent change of station includes:

- A move from your home to your first post of active duty
- A move from one permanent post of duty to another
- A move from your last post of duty to your home (or to a nearer point in the United States)

Even if the military moves you and/or members of your household to or from separate locations, the moves are treated as a single move to your new permanent post.

Caution: A member of your household is anyone using both your old and your new home as his or her main home. The definition doesn't include a tenant or an employee who lives with you unless you can claim that person as a dependent.

Government services and reimbursements

You're allowed to exclude from gross income the value of moving or storage services provided by the government. You also need not include certain allowances you receive, such as a dislocation allowance or a temporary lodging allowance. However, if the total reimbursements you receive are greater than your actual moving expenses, the excess may be included in your wages on your Form W-2. Even if it is not, you must report the excess as part of your gross income on Form 1040.

Deductible expenses

Use Form 3903, Moving Expenses, to deduct qualified expenses that exceed your reimbursements and allowances. The following unreimbursed expenses may be deducted:

- Moving household goods and personal effects, including expenses for hauling a trailer, packing, crating, in-transit storage, and insurance
- Travel and lodging expenses, including automobile expenses or air fare from your old home to your

new home

- Moving your household goods and personal effects to and from storage, or storing these items for part or all of the time you're at your new post if you move to a foreign country

Caution: You cannot deduct any expenses for meals, moving furniture or other goods you acquired in transit, unnecessary side trips, or lavish and extravagant lodging.

Overnight travel expenses--National Guard and reserve

If you are a member of the National Guard or a reserve component of the Armed Forces and you travel overnight more than 100 miles away from home in connection with the performance of services, the Military Family Tax Relief Act of 2003 allows you to deduct your travel expenses as an adjustment to income rather than as a miscellaneous itemized deduction. Qualifying expenses can include meals, transportation, and lodging expenses. The deduction is limited to the amount the federal government pays its employees for their travel expenses.

Itemized deduction considerations

If you choose to itemize your deductions, here are some considerations to keep in mind as a member of the Armed Forces.

Home mortgage interest and real estate taxes

You may receive a tax-free Basic Allowance for Housing (BAH), and you may use these funds to make your mortgage payments and/or pay your property taxes. Nonetheless, you can still include the full amounts of your real estate taxes and interest you paid on your mortgage in your itemized deductions.

Work-related expenses

You can deduct unreimbursed work-related expenses as miscellaneous itemized deductions (subject to the 2 percent limit). If you are claiming only expenses for uniforms and/or professional society dues, you may do so directly on Schedule A. If you deduct travel expenses (other than those allowed as adjustments to income) or transportation expenses, you must also file Form 2106, Employee Business Expenses or Form 2106-EZ, Unreimbursed Employee Business Expenses.

Uniforms

Generally, you can't deduct the cost of your uniforms if you're on full-time active duty. There are two exceptions. If military regulations prohibit you from wearing them off duty, you can deduct the costs (purchase price and upkeep) of:

1. Battle dress uniforms and utility uniforms (fatigues)
2. Articles that don't replace regular clothing (e.g., insignia of rank, corps devices, epaulets, swords)

If you are a reservist, you can deduct the cost of uniforms only if military regulations restrict you to wearing them only while on duty as a reservist.

Caution: If you receive a tax-free allowance for your uniforms, you must reduce your deduction by the amount of the allowance.

Professional dues

You can deduct dues you pay to professional societies directly related to your military position. However, you can't deduct amounts you paid to belong to an officers' or noncommissioned officers' club.

Travel expenses

You can deduct unreimbursed work-related travel expenses only if they are incurred while you're away from "home" on temporary duty, temporary additional duty, or while you're carrying out official business while on "No Cost" orders. "Home" is defined as your permanent duty station (ship or base). You're away from "home" if you're away from your permanent duty station substantially longer than an ordinary day's work and you need to get sleep or rest to meet your work demands. While you're away from "home", you may deduct such expenses as:

- Lodging
- Taxicabs
- Tips
- Business-related meals (generally limited to 50 percent of your unreimbursed cost)
- Business telephone calls
- Laundry and dry cleaning

You can't deduct any expenses for travel away from "home" if the temporary assignment is in a single location and lasts for more than one year.

Tip: If you are a member of the National Guard or a reserve component of the Armed Forces and you travel overnight more than 100 miles away from home in connection with the performance of services, the Military Family Tax Relief Act of 2003 allows you to deduct your travel expenses as an adjustment to income rather than as a miscellaneous itemized deduction. Qualifying expenses can include meals, transportation, and lodging expenses. The deduction is limited to the amount the federal government pays its employees for their travel expenses.

Transportation expenses

If you must go from one workplace to another while on duty (e.g., as a courier or to attend meetings) but you're not considered to be away from "home" (see above) while doing so, you may deduct your unreimbursed transportation expenses. (If you're away from "home," these transportation expenses are considered part of your travel expenses.) These expenses include the costs of transportation by air, bus, rail, taxi, and driving and maintaining your car.

Caution: The expenses of getting to and from your regular place of business (commuting expenses) are not deductible. However, if you commute to a temporary work location as part of conducting your regular business, you can deduct the cost of the daily round-trip transportation between your "home" and that temporary location.

If you're a reservist or member of the National Guard who must travel from your regular (civilian) job location to a guard or reserve meeting at another location, and doing so doesn't involve overnight travel of more than 100 miles, you may include the expense of traveling between the two locations in your itemized deductions. Generally, you may only do this for days when you must both work your civilian job and attend a meeting.

Tip: If you are a member of the National Guard or a reserve component of the Armed Forces and you travel overnight more than 100 miles away from home in connection with the performance of services, the Military Family Tax Relief Act of 2003 allows you to deduct your travel expenses as an adjustment to income rather than as a miscellaneous itemized deduction. Qualifying expenses can include meals, transportation, and lodging expenses. The deduction is limited to the amount the federal government pays its employees for their travel expenses.

Personal and Dependency Exemptions: Members of the Armed Forces

In general

The federal government takes into account a taxpayer's family obligations by allowing an exemption for each family member. Exemptions reduce the amount of a taxpayer's income on which tax is computed. A taxpayer can generally deduct \$3,650 in 2009 (\$3,500 in 2008) for each exemption claimed (this amount phases out for higher levels of income).

Generally, a taxpayer is allowed one exemption for himself or herself and one exemption for a spouse. A taxpayer is also allowed additional exemptions for each qualifying dependent. Generally, a qualifying dependent is a person who is related to and supported by the taxpayer (e.g., the taxpayer's children).

However, there are many rules (and exceptions to the rules) regarding when a taxpayer can claim an exemption. For example, a taxpayer may be unable to claim an exemption for a spouse or a dependent who is not a U. S. citizen or resident. Because members of the U.S. Armed Forces are often stationed outside the United States, these rules may be of particular importance to you.

Citizenship status definitions

Before we begin this discussion, it may be helpful to define (for tax purposes) the following terms:

- U.S. citizen: A person who was either born in the United States, or is the child of at least one U.S. citizen parent, or who has been naturalized in the United States. A naturalized U.S. citizen is someone who was born outside the United States of non-U.S. citizen parents but who has lawfully become a U.S. citizen.
- Resident alien: A person who meets the green card test or the substantial presence test. A person meets the green card test if he or she holds an immigrant visa (also known as a green card). A person meets the substantial presence test if the person is physically present in the United States for 31 days during the current calendar year, and 183 days during the current year plus the 2 preceding years, counting all the days of physical presence in the current year, but only 1/3 the number of days of presence in the first preceding year, and only 1/6 the number of days in the second preceding year.
- Nonresident alien: A person who is not a U.S. citizen and does not meet either of the tests to be a resident alien.
- Dual status alien: A person who is both a resident alien and a nonresident alien during the same tax year.

Your own exemption

You can take one exemption for yourself (regardless of your citizenship status) unless you can be claimed as a dependent by another taxpayer. If another taxpayer is entitled to claim you as a dependent, you cannot take an exemption for yourself. This is true even if the other taxpayer does not actually claim your exemption.

Your spouse's exemption

On a joint return, you can claim one exemption for yourself and one for your spouse. If you file separate returns, you can claim the exemption for your spouse only if your spouse had no gross income and was not the dependent of another taxpayer. This is true even if the other taxpayer does not actually claim your spouse's

exemption. This is also true if your spouse is a nonresident alien.

Tip: If your spouse died during the year, you can generally claim your spouse's exemption under the rules explained above. If you remarried during the year, you cannot take an exemption for your deceased spouse.

Tip: If you obtained a final decree of divorce or separate maintenance by the end of the year, you cannot take your former spouse's exemption. This rule applies even if you provided all your former spouse's support.

Nonresident alien spouses with income

If your nonresident alien spouse earned income, he or she can be treated as a resident alien for tax purposes if all the following conditions are met:

- You're either a U.S. citizen or a resident alien at the end of the tax year
- You're married to the nonresident alien at the end of the tax year
- You both choose to treat the nonresident alien as a resident alien for tax purposes

If you both choose to treat the nonresident alien spouse as a resident alien, this choice will apply to all later tax years unless you or your spouse revoke it, you or your spouse die, or you become legally separated under a divorce decree or separate maintenance agreement. In some cases the IRS may end the choice because of inadequate records. If the choice is ended for any of these reasons, neither you nor your spouse may make the choice again for any later tax year.

Caution: Once you make this choice, the nonresident alien spouse's worldwide income is subject to U.S. tax. If he or she has substantial foreign income, there may be no advantage to making this choice. If he or she has little or no income, however, making this choice may reduce your tax liability.

If the nonresident alien spouse isn't treated as a resident alien, you and your spouse may not file a joint tax return. You may file as married filing separately or (if you qualify) head of household.

Exemptions for dependents

The dependency tests

You are generally allowed one exemption for each person you can claim as a dependent. To claim a dependency exemption, you must first have a "qualifying child" or a "qualifying relative." Then, you must meet three tests, described below. For more information on the dependency exemption in general, see IRS Publication 501, Exemptions, Standard Deduction, and Filing Information.

There are five tests that must be met for a child to be considered your qualifying child for purposes of the dependency exemption (in most cases, only the first four are relevant): (1) relationship test, (2) age test, (3) residency test, (4) support test, and (5) special test for qualifying child of more than one person.

If you don't have a qualifying child, you may be able to claim a dependency exemption if you have a qualifying relative. There are four tests that must be met for a person to be considered your qualifying relative for purposes of the dependency exemption: (1) not a qualifying child test, (2) member of household or relationship test, (3) gross income test, and (4) support test.

Once you've determined you have a qualifying child or a qualifying relative, you must meet three additional tests in order to take the dependency exemption: (1) the dependent taxpayer test, (2) the joint return test, and (3) the citizen or resident test.

- Dependent taxpayer test--If another person could claim you as a dependent, then you can't claim

anyone else as a dependent. This is true even if you have a qualifying child or qualifying relative. Similarly, if you are filing a joint return and your spouse could be claimed as a dependent by someone else, then you and your spouse can't claim any dependents on your joint return.

- Joint return test--You can't claim an exemption for a dependent who files a joint return. For example, assume you support your daughter for the entire year while her husband is in the armed forces, and the couple files a joint return. Even if your daughter is a qualifying child, you can't claim an exemption for her.
- Citizen or resident test--The dependent must be a U.S. citizen, U.S. resident, or U.S. national, or must be a resident of Canada or Mexico for some part of the year.

Claiming dependency exemptions for individuals living abroad

Children are usually considered to be citizens or residents of the country (or countries) of their parents. If you were a U.S. citizen when your child was born, your child may be a U.S. citizen even though the other parent is a nonresident alien and your child was born in a foreign country. If so, you may claim a dependency exemption for the child if the child meets the other dependency tests. It doesn't matter that the child may live abroad with the nonresident alien parent.

In such instances, the crucial test to meet may be the support test. You can authorize an allotment from your military pay for the support of a dependent. The amount of the authorization is considered as provided by you in figuring whether you provide more than half the dependent's support.

Example(s): You are a U.S. citizen in the U.S. Army. While you were stationed in Japan, you had a son with a woman who is a Japanese citizen. Your son has dual (U.S. and Japanese) citizenship. Later you were relocated to a new permanent duty post in the United States. At that time you authorized an allotment from your military pay that has provided half your son's support. As a result, you may claim a dependency exemption for your son on your tax return.

If the allotment you provide is used to support persons other than the one(s) named in the allotment authorization, you may also claim dependency exemptions for those other persons if they otherwise qualify as your dependents. (In the above example, your allotment also provides half the support for your son's mother. However, you cannot claim a dependency exemption for her because she isn't a U.S. citizen or resident.)

Claiming an adopted child who isn't a U.S. citizen or resident

If you're a U.S. citizen and you legally adopt a child who is not a U.S. citizen or resident, you can claim a dependency exemption for that child if all of the following are true:

- The other dependency tests are met
- The child had your home as his or her main home for the year
- The child was a member of your household for the year

Example(s): You are a U.S. citizen and have been in the U.S. Army for 16 years. You're stationed in Germany. You and your wife, a German citizen, have a 2-year-old son who was born in Germany and who has dual (U.S. and German) citizenship. Your wife also has a 12-year-old daughter from a previous marriage; the girl, a German citizen, lives in your household as her main home, but you have not adopted her. Because your son can be considered a U.S. citizen, you may claim a dependency exemption for him. You cannot claim a dependency exemption for your stepdaughter, however, because you have not adopted her and she doesn't meet the U.S. citizen or resident dependency test.

If your child is in the Armed Forces

Generally, a taxpayer can't claim a dependency exemption for a child who is in the Armed Forces or who has

attended one of the Armed Forces academies (e.g., the Air Force Academy) for the entire year because the taxpayer won't have met the support test for the year. However, if your child receives only partial support from the Armed Forces, you can claim the dependency exemption if you provide more than half the child's support and the other tests are met.

Example(s): Your daughter is 18 and single. She graduated from high school in June and entered the U.S. Air Force the following September. She provided \$4,400 (her wages of \$3,400 and \$1,000 for other items provided by the Air Force) for her own support that year. You provided \$4,100. You can't claim a dependency exemption for her because you didn't provide more than half her support.

Tax Credits: Members of the Armed Forces

In general

The federal government provides tax relief to qualifying individuals in the form of tax credits. Tax credits are valuable because they are dollar-for-dollar reductions of your tax liability. In some cases, they may result in tax refunds. In general, the rules regarding tax credits are the same for members of the Armed Forces as they are for everyone else. Nevertheless, certain tax credits may be of particular interest to members of the military. The following discussion explains eligibility requirements of the earned income credit (EIC), the child tax credit, and the child and dependent care credit (CDCC) (there are other available tax credits not discussed here). Also discussed are some eligibility factors as they specifically pertain to service members.

Background

Eligibility for the EIC, the child tax credit, and the CDCC (as well as other credits) is based on (among other factors) an income threshold. The IRS defines income differently for different purposes, but in general, income does not include nontaxable income. For members of the U.S. Armed Forces, this can mean that active duty pay and certain other types of pay that are subject to the combat zone exclusion, as well as certain allowances (e.g., Basic Allowance for Housing (BAH), Basic Allowance for Subsistence (BAS), moving and travel allowances), might not count as "income" for purposes of determining tax credit amounts. This can have many lower-paid servicemembers at a disadvantage; they might lose out on these credits because they do not have enough taxable income.

The Working Families Tax Relief Act of 2004, the Gulf Opportunity Zone Act of 2005, the Tax Relief and Health Care Act of 2006, and the Heroes Earnings Assistance and Relief Tax Act of 2008 provide that beginning with tax year 2004 servicemembers can elect to include excludable combat pay as earned income for EIC purposes. In addition, the Working Family Tax Relief Act of 2004 provides that, for the purposes of the child tax credit, earned income includes excludable combat pay beginning with the 2004 tax year.

For more information on nontaxable income, see [Taxable vs. Nontaxable Compensation: Members of the Armed Forces](#).

Earned income credit

In general

The earned income credit (EIC) is available to certain individuals who work. This credit is refundable--if the amount you claim exceeds your tax liability (even if your liability is zero), you'll receive payment for the difference. How much you get depends on how much your earned income is and how many children you have. For 2009, the maximum EIC amount is \$457 if you have no qualifying child, \$3,043 if you have one qualifying child, and \$5,028 if you have more than one qualifying child. (For 2008, the maximum EIC amount is \$438 if you have no qualifying child, \$2,917 if you have one qualifying child, and \$4,824 if you have more than one qualifying child.)

Tip: The American Recovery and Reinvestment Act of 2009 temporarily increases the earned income tax credit calculation for families with three or more qualifying children for 2009 and 2010. In 2009, the maximum credit for a family with three or more qualifying children is \$5,656.50.

Several factors determine your eligibility for the EIC. Generally, you (and your spouse, if applicable) must:

- Have earned income (i.e., income you work for; including wages and net earnings from self employment)
- Have a valid Social Security number

- Have investment income, if any, that does not exceed \$3,100 in 2009 (\$2,950 in 2008)
- Be a U.S. citizen or resident alien all year (or married to one and choosing for tax purposes to be treated as a resident alien for the year)
- Not be a qualifying child of another taxpayer
- Not file as married filing separately
- Not file Form 2555 or 2555-EZ (pertaining to foreign earned income)
- Meet appropriate income qualifications

In addition to the above requirements, you must meet other requirements. The specific requirements that apply depend on whether or not you have a qualifying child.

With qualifying child

If you have a child (or children) and wish to claim the EIC as a taxpayer with a qualifying child, your child must have a valid Social Security number and meet all three of the following requirements:

- The child has the same principal abode as you for more than half the year (temporary absences due to special circumstances are not treated as absences)
- The child must be your son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendent of such individuals. A child who is legally adopted by, or lawfully placed for adoption is a qualifying child. A foster child who is placed by an authorized agency, judgment, decree, or other such order is also a qualifying child.
- Generally, the child must be under age 19

Caution: If you file for the EIC as a taxpayer with a qualifying child, you must complete Schedule EIC and attach it to your tax return.

Without qualifying child

If you don't have a child who qualifies under the EIC criteria, you may still be eligible for the EIC. In addition to the general EIC eligibility requirements listed above, you (or your spouse if filing a joint return) must:

- Be at least age 25 but under age 65
- Not be eligible to be claimed as a dependent on another taxpayer's return (regardless of whether the taxpayer actually claims you as a dependent)
- Have your main home in the United States for more than half the year

Tip: Individuals in the Armed Forces who are stationed outside the United States on extended active duty are considered to be living in the United States. If you're temporarily absent from your home solely on account of military service, you may still be eligible for the EIC if you plan to return to your main home at the end of your assignment.

Income guidelines

Finally, to be eligible for the EIC, you must fall within certain income guidelines. To qualify for the full amount of the EIC, your earned income and AGI must each be less than:

- \$7,470 (\$12,470 if married filing jointly), if you don't have a qualifying child for 2009; \$7,160 (\$10,160 if married filing jointly) for 2008

- \$16,420 (\$21,420 if married filing jointly), if you have one qualifying child for 2009; \$15,740 (\$18,740 if married filing jointly) for 2008
- \$16,420 (\$21,420 if married filing jointly), if you have more than one qualifying child for 2009; \$15,740 (\$18,740 if married filing jointly) for 2008

If your earned income or AGI is above these limits, your EIC eligibility begins to phase out, and is eliminated completely when either amount reaches:

- \$13,440 (\$18,440 if married filing jointly), if you don't have a qualifying child for 2009; \$12,880 (\$15,880 if married filing jointly) for 2008
- \$35,463 (\$40,463 if married filing jointly), if you have one qualifying child for 2009; \$33,995 (\$36,995 if married filing jointly) for 2008
- \$40,295 (\$45,295 if married filing jointly), if you have more than one qualifying child for 2009; \$38,646 (\$41,646 if married filing jointly) for 2008

Tip: If you work, have at least one qualifying child, and expect that your earned income and AGI will be within certain qualifying guidelines, you are entitled to receive a portion of the EIC in advance as part of your paycheck.

Child tax credit

In general

If you have a child (or children), you may qualify for the child tax credit. If the credit exceeds your tax liability, you might be able to receive a refund for all or a part of the difference (see below for more on this). Like the EIC (see above), how much you get depends on your level of income and how many children you have. Currently, the maximum credit is \$1,000 for each qualifying child.

Caution: Absent further legislative action, the child tax credit is scheduled to decrease to \$500 in 2011 and thereafter.

A qualifying child

To qualify for the child tax credit, your child must meet all of the following tests:

- The child must have the same principal abode as you for more than half the year (temporary absences due to special circumstances are not treated as absences)
- The child must be your son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendent of such individuals. A child who is legally adopted by, or lawfully placed for adoption with you is a qualifying child. A foster child who is placed with you by an authorized agency, judgment, decree, or other such order is also a qualifying child.
- Generally, the child must be under age 17

Income limitations

The child tax credit is limited if your modified adjusted gross income (MAGI) is above a certain amount. (Your MAGI is your AGI plus income ordinarily not included in your AGI, such as foreign earned income and tax-exempt interest income.) The credit begins to phase out if your MAGI exceeds:

- \$110,000 for joint filers
- \$75,000 for single and head of household filers

- \$55,000 for those married filing separately

Refundable portion of the child tax credit

A portion of the child tax credit may be refundable (i.e., you can get a refund if the credit exceeds your tax liability). The refundable portion can be as much as 15 percent of your earned income in excess of \$3,000 for 2009 (\$8,500 for 2008).

Child and Dependent Care Credit

In general

The child and dependent care credit (CDCC) helps parents pay for child care so they can work. The CDCC is a nonrefundable credit for up to 35 percent of certain expenses you paid to provide care for a qualifying person. The qualifying person may be either a child under age 13 whom you claim as a dependent, or a spouse who is physically or mentally incapable of self-care. An individual of any age who is physically or mentally incapable of self-care and whom you can claim as a dependent (unless he or she had \$3,650 or more in gross income for 2009; \$3,500 for 2008) would also be a qualifying person.

To qualify to take the credit, you must meet all of the following eligibility criteria:

- You (and your spouse if you're married) must maintain a home that you live in with the qualifying person(s)
- You (and your spouse if you're married) must both have earned income (i.e., income you work for) during the year (only you must have earned income if your spouse was either a full-time student or physically or mentally incapable of self-care)
- You must pay child and dependent care expenses so you (and your spouse if you're married, unless your spouse was either a full-time student or physically or mentally incapable of self-care) can work or look for work
- You must make payments for these expenses to someone whom you (or your spouse) can't claim as a dependent, and you must identify the care provider on Form 2441 attached to your tax return
- Generally, your filing status must be single, head of household, qualifying widow(er) with dependent child, or married filing jointly (unless you meet certain exceptions)

Caution: The credit applies only to expenses that you paid. Dependent care assistance including child care provided by the Department of Defense to members of the military is not included in gross income. This means that you can only take this credit to cover expenses you paid to the extent that it exceeds any allowance you receive.

The amount of your work-related child and dependent care expenses is subject to both an earned income limit and a dollar limit. Expenses cannot be greater than either your earned income, or (if you're married at the end of the year) the lesser of your earned income or your spouse's earned income. The dollar limit for expenses is \$3,000 for one qualifying person or \$6,000 for two or more qualifying persons. The amount of your credit will be a percentage (20 percent to 35 percent) of allowable expenses.

Caution: Remember that the CDCC is a nonrefundable tax credit. As such, it is limited to the amount of your tax liability. If the amount of the credit is greater than your tax liability, you won't receive a refund for the difference.

For more information on this tax credit, see IRS Publication 503.

Maintaining and living in a home requirement

Generally, you're maintaining a home if you pay for more than half the annual cost of running the home with your own funds. The cost of running the home normally includes expenses such as paying property taxes and mortgage interest. As a member of the Armed Forces, you may receive a housing allowance--the BAH--and you may use these funds to pay those expenses. For the purpose of determining your eligibility for the CDCC, these funds are considered your own funds. When determining if you're paying more than half the annual costs of running your home, you need not reduce those costs by the BAH you receive.

Individuals in the Armed Forces who are stationed outside the United States on extended active duty are considered to be living in the United States. Therefore, if the qualifying person on whom you're basing eligibility for the CDCC lives in your home of record within the United States while you're stationed overseas, you satisfy the criteria of living with that person.

Earned income by both spouses requirement

It's important to note that, if you're married, both spouses must have earned income to be eligible for the CDCC. (An exception to this requirement exists if one spouse is either a full-time student or physically or mentally incapable of taking care of himself or herself). If your spouse did not work, you cannot claim this credit.

Earned income generally includes wages, salaries, tips, other taxable employee compensation, and net earnings from self-employment. For purposes of the credit for child and dependent care expenses, earned income is considered to include nontaxable employee compensation such as military basic quarters and subsistence allowances and in-kind quarters and subsistence, as well as military pay earned in a combat zone.

Your CDCC is a percentage of your allowable work-related child and dependent care expenses, and this percentage increases as your AGI decreases.

Members of the Military Killed in the Line of Duty

In general

Special tax provisions apply to members of the U.S. Armed Forces (commissioned officers, warrant officers, or enlisted persons in any regular or reserve unit under control of the Secretary of Defense, Army, Navy, or Air Force, or in the Coast Guard) who die as the result of active service in a combat zone. Similar provisions also apply to members of the Armed Forces and civilian U. S. employees who die as the result of a terrorist or military action.

Tip: For information on the tax relief provisions that apply to individuals who died as a result of the terrorist attacks on September 11, 2001 or the terrorist attacks involving anthrax, see Internal Revenue Service Publication 3920.

Tip: The decedent's surviving spouse or personal representative (an executor, administrator, or anyone in charge of the decedent's assets) generally handles duties such as filing tax returns and claims for refunds of withheld or estimated taxes.

Combat zone forgiveness

If a member of the Armed Forces dies while in active service in a combat zone (or from wounds, disease, or injury received in a combat zone), the decedent's federal income tax liability is forgiven for the tax year in which the death occurred. In addition, the decedent's tax liability is also forgiven for any earlier tax year that ended on or after the first day of the member's active service in a combat zone.

Tip: This provision also applies to a member of the Armed Forces serving outside the combat zone if that service was in direct support of military operations in the zone and it qualified the service member for either hostile fire or imminent danger pay. In addition, a qualified hazardous duty area is also treated as a combat zone.

If the decedent's tax liability (including interest, additions to the tax, and additional amounts) for these years has been assessed, the assessment will be forgiven. Any tax that has already been collected (regardless of the date of collection) will be credited or refunded.

For tax years ending prior to those mentioned above, any income tax that remains unpaid as of the decedent's date of death will not be assessed. If any unpaid tax (including interest, additions to the tax, and additional amounts) has already been assessed, this assessment will be forgiven, and any taxes attributable to these years paid after the date of death will be refunded.

Example(s): U.S. Army Sergeant John Smith was injured in October of 2003 while stationed in Afghanistan and died as a result of those injuries in February of 2004. His tax liabilities for tax years 2003 and 2004 are forgiven. Any taxes collected for those years will be refunded.

Example(s): At the time he was injured, Sergeant Smith was making monthly payments to the IRS as part of an installment agreement to pay his 2002 income tax. The remaining unpaid tax assessment, including interest and penalties, is also forgiven.

Tip: If the decedent had been reported earlier as missing in action or a prisoner of war, the service member's date of death is the date his or her name is removed from missing status for military pay purposes, even if death actually occurred earlier.

Terrorist or military action forgiveness

As of 2001, a decedent's federal income tax liability is forgiven if he or she is a member of the Armed Forces or a civilian employee of the U.S. government who dies as a result of wounds or injury incurred in a terrorist or military action, regardless of where the action occurred. A terrorist or military action is defined as:

- Any terrorist activity that most of the evidence indicates was directed against the United States or any of its allies
- Any military action (other than training exercises) involving the U.S. Armed Forces that results from actual or threatened violence or aggression against the United States or any of its allies

The forgiveness applies to the tax year in which death occurred and to any prior tax year in a period that begins with the year before the year in which the wound or injury occurred.

Example(s): Mary Jones died in 2005 as the result of wounds she incurred in a terrorist attack that occurred outside the United States in 2004. At the time of the attack, Mary was a civilian employee of the U.S. government. Her federal income tax liability will be forgiven for 2003, 2004, and 2005.

Refunds are allowed for any tax years for which the period for filing a claim of a refund has not ended (see below).

Tip: The Military Family Tax Relief Act of 2003 extends income and estate tax relief to astronauts who lose their lives in the line of duty after 2002.

Claiming forgiveness

Filing a claim

To file a claim for federal income tax forgiveness:

- Submit Form 1040 if a tax return has not been filed for the tax year. Form W-2 must accompany the return.
- Submit Form 1040X if a tax return has already been filed. A separate Form 1040X must be filed for each tax year concerned.
- Identify the IRS Form with the appropriate label for the triggering event (e.g., "Desert Storm--KIA").
- Attach Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, if appropriate.
- Attach appropriate certification from the Department of Defense or Department of State. This certification must include the decedent's name, social security number, date of injury, date of death, and a statement that the decedent died in a combat zone or from a terrorist or military action.
- Attach a computation of the decedent's tax liability before any amount is forgiven and indicate the amount to be forgiven.

Joint returns

Only the decedent's portion of a joint income tax liability is eligible for the refund or tax forgiveness. To determine the decedent's portion, the person filing the claim must:

1. Figure the income tax for which the decedent would have been liable as if a separate return had been filed.

2. Figure the income tax for which the spouse would have been liable as if a separate return had been filed.
3. Multiply the joint tax liability by a fraction. The top number of the fraction is the amount in (1) above. The bottom number of the fraction is the total of (1) and (2). The result of this calculation is the decedent's tax liability eligible for the refund or tax forgiveness.

Tip: If the decedent was married and domiciled in a community property state, and the decedent's spouse reported half of the decedent's military pay on a separate return, the spouse can get a refund of taxes paid on his or her share of the pay for the tax years involved in a forgiveness claim.

Claiming a credit or refund

If the tax-forgiveness situation applies to a prior year's tax and the period for filing a claim hasn't expired, any tax the decedent paid will be credited or refunded. The normal period for filing a claim for a tax credit or refund expires 3 years after the tax return was filed, or 2 years after the tax was paid, whichever is later.

If death occurred in a combat zone, or as the result of wounds, disease, or injury incurred in a combat zone, the period for filing a claim for a tax credit or refund is extended by:

- The amount of time served in the combat zone (including any period in which the decedent was in missing status), plus
- The period (if any) of continuous qualified hospitalization (any hospitalization outside the United States and any hospitalization of not more than 5 years in the United States) for injury from service in the combat zone, plus
- The next 180 days

Death gratuity

A tax-free death gratuity of \$100,000 may be paid to the next of kin of a member of the Armed Forces who dies while serving on (or traveling to or from):

- Active duty
- Annual training duty (for members of Reserve or National Guard units) for a period of more than 13 days
- Inactive duty training (for members of Reserve or National Guard units)

Because this gratuity is nontaxable, recipients do not have to report it on their federal income tax returns.

Income Tax Considerations for Members of the Armed Forces

Members of the Armed Forces receive many different types of pay and allowances. Some are included in gross income while others are excluded. Included items are subject to tax and must be reported on your tax return. Excluded items are not subject to tax, but may have to be shown on your tax return.

Included items

These items are included in gross income, unless the pay is for service in a combat zone.

Basic pay	<ul style="list-style-type: none"> • Active duty • Attendance at a designated service school • Back wages • CONUS COLA • Drills • Reserve training • Training duty 	Bonuses	<ul style="list-style-type: none"> • Career status • Enlistment • Officer • Overseas extension • Reenlistment
Special pay	<ul style="list-style-type: none"> • Aviation career incentives • Career sea • Diving duty • Foreign duty (outside the 48 contiguous states and the District of Columbia) • Foreign language proficiency • Hardship duty • Hostile fire or imminent danger • Medical and dental officers • Nuclear-qualified officers • Optometry • Pharmacy • Special duty assignment pay • Veterinarian 	Other payments	<ul style="list-style-type: none"> • Accrued leave • High deployment per diem • Personal money allowances paid to high-ranking officers • Student loan repayments from programs such as the Department of Defense Educational Loan Repayment Program when year's service (requirement) is not attributable to a combat zone
		Incentive pay	<ul style="list-style-type: none"> • Submarine • Flight • Hazardous duty • High altitude/Low altitude (HALO)

Excluded items

The exclusion for certain items applies whether the item is furnished in kind or is a reimbursement or allowance. There is no exclusion for the personal use of a government-provided vehicle.

<p>Living allowances</p>	<ul style="list-style-type: none"> • BAH (Basic Allowance for Housing). You can deduct mortgage interest and real estate taxes on your home even if you pay these expenses with your BAH • BAS (Basic Allowance for Subsistence) • Housing and cost-of-living allowances abroad whether paid by the U.S. Government or by a foreign government • OHA (Overseas Housing Allowance) 	<p>Combat zone pay</p>	<ul style="list-style-type: none"> • Compensation for active service while in a combat zone or a qualified hazardous duty area. Note: Limited amount for officers
<p>Moving allowances</p>	<ul style="list-style-type: none"> • Dislocation • Military base realignment and closure benefit paid after November 11, 2003 (the exclusion is limited) • Move-in housing • Moving household and personal items • Moving trailers or mobile homes • Storage • Temporary lodging and temporary lodging expenses 	<p>Death allowances</p>	<ul style="list-style-type: none"> • Burial services • Death gratuity payments to eligible survivors • Travel of dependents to burial site
		<p>Other payments</p>	<ul style="list-style-type: none"> • Defense counseling • Disability, including payments received for injuries incurred as a direct result of a terrorist or military action • Group term life insurance • Professional education • ROTC educational and subsistence allowances • Survivor and retirement protection plan premiums • Uniform allowances • Uniforms furnished to enlisted personnel

<p>Travel allowances</p>	<ul style="list-style-type: none"> • Annual round trip for dependent students • Leave between consecutive overseas tours • Reassignment in a dependent restricted status • Transportation for you or your dependents during ship overhaul or inactivation • Per diem 	<p>In-kind military benefits</p>	<ul style="list-style-type: none"> • Dependent-care assistance program • Legal assistance • Medical/dental care • Commissary/exchange discounts • Space-available travel on government aircraft
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