

# INCOME TAX TIPS FOR NAVAL RESERVISTS

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## GENERAL

**A**s a member of the U. S. Naval Reserve, it is important to recognize that you have two employers, your civilian job and the Naval Reserve. Your civilian employer may be a corporation, a partnership, a sole proprietorship; or you may be self-employed. As a Naval Reservist, you are an employee of the U. S. Naval Reserve. Both of these affiliations are a trade or business and qualify your expenses as tax deductible.

This article will address a Naval Reservist's allowable deductions on his/her 2003 Federal Income Tax Return (Form 1040), assist you in filing your tax return, make you aware of the credits and tax deductions available to you, and briefly discuss what you can expect in the future. The deductions are applicable to all Naval Reservists in a pay category. If you incur any expense while performing duties as a Naval Reservist, your expenses are deductible to the extent you have not been reimbursed.

## Preparation of Your 2003 Federal Income Tax Return

Your 2003 Federal Income Tax Return must be filed with the Internal Revenue Service on or before 15 April 2004. The following portion of this article will assist you in preparing your 2003 Form 1040 tax return.

Lines 1-5: Filing Status: Notifies the IRS that you are a single, married filing jointly, married filing separate return, head of a household, a qualifying widow with dependent child, or non-resident alien taxpayer.

Line 6: Exemptions: Lists the number of dependents you are claiming and information about them, including their social security number(s).

Lines 7-22: Income: These lines provide the IRS with information about your 2003 income, wages, and benefits you received. It consists of your civilian job salary or wages, Naval Reserve wages, tips, foreign earned income (exclusion amount applicable), bonus, back pay, dividend income, alimony received, deferred compensation, dependent care benefits provided by your employer, education expenses reimbursed by your employer, business expense reimbursements, employer contributions to medical savings accounts, employer-provided vehicles, excess salary deferrals, moving expense reimbursements, severance pay, sick pay, and unemployment benefits received in 2003.

Income Exclusions (Qualified Hazardous Duty Areas): If you were in a war zone or were serving in support of the war zone, the combat pay you received should be reduced from your W-2 income. Military personnel below the grade of commissioned officer may exclude from gross income any compensation they receive while serving in a combat zone (IRC section 112(a)). For commissioned officers, the exclusion is limited to the maximum enlisted amount of combat-zone pay (IRC section 112(b)). For definition purposes, a combat zone means any area that the President of the United States designates, by executive order, as an area in which U.S. Armed Forces are or have been engaged in combat and includes a qualified hazardous duty area.

Lines 23-34: Adjustments to Income.

These deductions consist of the following: IRA deductions (maximum of \$3,000 plus a \$500 makeup of allowance for those over the age of 50 [subject to an income phase out]); \$2,500 student loan interest deduction (phased out between \$50,000 and \$65,000 adjusted gross income for single taxpayers and doubled for married filing jointly); moving expenses; in home office expense (if used as your "principal" place of business); self-employed health insurance deduction; Keogh Retirement Plan; Self-Employed SEP and SIMPLE deduction; alimony payments; mortgage interest paid; and legal and professional services.

It is important to note that there is only a 50 percent meal and entertainment expenses deduction and no deduction allowed for membership dues in any club organized for pleasure, recreation, or other social purpose.

Retroactive to 1 January 2003, members of the military are eligible to use an above-the-line deduction for the overnight transportation, meals, and lodging expenses they incur when traveling more than 100 miles away from home and staying overnight to attend meetings. The deduction amount will be calculated at the maximum rate allowed for travel expenses for employees of agencies under subchapter I of chapter 57 of title 5, United States Code. This deduction will impact and benefit all applicable Reservists regardless of whether they itemize on their income tax returns.

Most itemized deductions are phase-out for taxpayers with joint incomes exceeding \$139,500, or \$69,750 for a separate return filed by a married individual. Itemized deductions will also be reduced by three percent of the amount by which the taxpayers adjusted gross income (AGI) exceeds the income threshold up to a maximum of 80 percent of allowable deductions.

The following deductions are also available and more specific to drilling Reservists:

1. Expenses listed on Form 2106, Employee Business Expenses, that are deducted on Schedule A, Itemized Deductions. (It is important to recognize that unreimbursed expenses are subject to a two percent reduction of Adjusted Gross Income):
  - a. Unreimbursed travel expense to drills, if the location is less than 100 miles away;
  - b. Commuting expense to Temporary Drill Sites;
  - c. AT and ADT expenses in excess of Navy Travel Code 3 reimbursements;
  - d. Transportation expense calculation, mileage or actual vehicle operating expenses;
  - e. Lodging not furnished by the Navy;
  - f. Out-of-pocket meals (reduced by 50 percent for 2003);
  - g. Uniforms, uniform accessories, and maintenance of uniforms;
  - h. Dues to professional societies;
  - i. Subscriptions to Naval Reserve related periodicals; and
  - j. Computer expense, if the computer is used more than 50 percent for business and the Naval Reserve.
2. Expenses that reduce Adjusted Gross Income but are deducted on Schedule A as Itemized Deductions:
  - a. Charitable deductions:
    - (i) Representing a local Chapter at the semi-annual meeting(s) or EXCOM's and attending District/Chapter meetings;
    - (ii) Attending the Naval Reserve Association semi-annual meetings;
    - (iii) Expenses incurred while an officer of the Association or as a member of ANY of the Associations' committees; and
    - (iv) Donating monetary or property gifts to a charitable remainder trust (deferred giving) to the NRA or any qualified organization for the benefit of the Troops.
  - b. Withholding tax credit for excess Social Security tax withheld since Naval Reserve Drill, ADT, and AT pay is subject to Social Security tax.
3. Standard Deduction. The standard deduction amount, for joint returns, is increased to twice the amount for single returns.
4. Retirement Account Contributions:
 

Individual Retirement Account:

A member of the Naval Reserve is permitted to participate in an Individual Retirement Account (IRA). This decision is premised upon the fact that Reservists (not serving more than 90 days of Active Duty) are not considered covered by U.S. government retirement plans. In 1993, the State of California challenged this premise and mailed assessments to Reservists disallowing their IRA deduction for prior years. Their logic was that the Reservist was covered by the U.S. Government retirement plan. When IRC 219(g) (6)(A) and (B); Notice 87-16 was quoted to California, the assessment was removed. If your state disallows your IRA deduction due to your drilling as a Naval Reservist, quote the above IRC references and contact the Naval Reserve Association.

IRA contributions, to be deductible, are subject to various limitations. The limitation depends upon your filing status and the amount of your "Modified Adjusted Gross Income." As a result of the limitations, you may be entitled to deduct all, part, or none of the IRA contribution based upon your Adjusted Gross Income and your employment plans (if any).

If you or your spouse are covered by a Pension or Profit Sharing Plan, at your civilian work, you will only be able to deduct your contributions to an IRA if you meet certain income guidelines. All others can make contributions to an IRA on a nondeductible basis. In addition, deductible IRA contributions up to \$2,000 may be made for each spouse (including a non-income producing spouse) as long as the combined compensation of both spouses at least equals the contributed amount. (One spouse would have to make \$4,000 for the couple to make a \$4,000 IRA contribution.)

Thrift Savings Plan:

Members of the Ready Reserve are eligible to make deductible contributions to a Thrift Savings Plan ("TSP"). You have 60 days from the date you enter the Reserves to make your initial election. The amount you can contribute is based upon the applicable annual IRC contribution limit and changes annually. In 2003, the IRS elective deferral limit is \$12,000. If you are over 50 years of age, you may also make an additional catch-up contribution of \$2,000 in 2003. Those who contribute to the TSP from their basic pay may also contribute from their incentive or special pay (including bonus pay).
5. Deductible Expenses:
 

Unreimbursed Travel Expense to Drills

A Naval Reservist performing inactive duty by attending drill under competent orders, either in a pay or nonpay status, is entitled to deduct the cost of the travel between the city or general area which constitutes your principal or regular place of employment and the drill site (reserve center, base, or post) located outside such general area (if you stay overnight or the location is in excess of 50 miles from your tax home).

For example: A Naval Reservist living and working in Oskaloosa, Iowa, and performing drills at Belle Chase Naval Air Station, Louisiana, is entitled to deduct the mileage in driving to and from the drill site. You may deduct the cost of flying (commercially or in a private plane) to and from Oskaloosa plus any incidental costs; i.e., rental car in New Orleans, parking at the Des Moines airport, staying at the Belle Chase NAS BOQ (if available), out-of-pocket meals (subject to 50 percent limitation), mileage to and from the Des Moines airport, etc.) all related to performing the drill weekend.

You may deduct your round-trip transportation expenses, provided free transportation between such locations is not furnished to you. The deduction is applicable, regardless of whether the Reservist attends drills in the evening after his regular working hours or on an otherwise nonworking day.

If you are required to remain away from your principal place of employment overnight in performance of authorized drills (IDT's) and training duty (AT/ADT), you may deduct all of the cost of the travel expenses including meals (subject to 50 percent limitation) and lodging (if not furnished), whether you are compensated for such drills and training duty or not.

#### Administrative Travel

There are many occasions when the commanding officer or other unit members under his command are required to drive to the Reserve Center to sign correspondence, make MOBEX telephone calls, give Active Duty Examinations, install/maintain equipment, and so on. These trips are normally at dates and times other than normal drills. The Reservist involved is entitled to deduct round-trip mileage for such trips since the travel was performed in order to meet higher authority directives and during the normal workday. It is recommended that you maintain a log of these additional trips and miles.

#### Unemployed and Students Performing Reserve Drills

If you are unemployed or a student, you are not entitled to any mileage deductions as an Employee Business Expense. The premise is that you were not traveling between two employer business locations.

#### Commuting Expense to Temporary Drill Sites

The Naval Reserve Center to which you are assigned is considered your "normal location" for performing drills. If you drive from your residence to a location other than the NRC to attend drills, this will not be a deductible commuting expense for those drills since the first trip of the day is commuting.

Example: If you normally drill at NRC Tampa, Florida; live within a 50-mile radius of the NRC; and you do not stay overnight but return home from drill, all of your mileage to and from is considered commuting and nondeductible. However, if you are ordered to report directly to NRC St. Petersburg, Florida, or any other "temporary drill site," except NRC Tampa, your round-trip commuting mileage is deductible only if you report to NRC Tampa first; and then you go to the temporary drill site.

It is important to keep any documentation furnished that directs you to go to the other drill location. This documentation includes a Plan-of-Day/Month (POD/POM), written no-cost IDTT orders, letters from superiors or any other document that directs your actions. In order to be deductible, you will need to keep track of the mileage from your home to the NRC and then to the "temporary drill site."

You may not deduct any part of your transportation expenses incurred in attending drills that are conducted within the city or general locality that constitutes your principal or regular place of employment, unless you are also working at some other business location that same day or you go to a "temporary" drill site. When you attend prescribed drills within the city's general locality that constitutes your principal or regular place of employment and on that same day, you were working at some other business location, you may deduct your one-way transportation costs in getting from one such business location to the Reserve Center. Keep records as to the business location, the number of miles driven, and the date of such action.

#### At and ADT Expenses in Excess of Navy Travel Code 3 Reimbursement

Reservist AT is required to be performed annually. A Reservist is typically reimbursed at a rate less than 36.0 cents per mile. You are entitled to deduct the difference between the amount reimbursed from mileage reported on the original orders and the amount calculated using the actual miles driven times 36.0 cents per mile.

#### Transportation Expense Calculation

Effective 1 January 2003, the deductible mileage rate is 36.0 cents per mile for all miles driven for business through 31 December 2003. It is important to recognize that the IRS considers the useful life of a vehicle for which the standard mileage rate was used to be 60,000 miles of business use.

#### Actual Expenses Vs. Standard Mileage Rate Deductions

In order to deduct the actual travel expenses using your vehicle for Naval Reserve meetings:

- a. You may not use an Accelerated Cost Recovery System (ACRS or MACRS or Section 179) depreciation on any vehicle and use the mileage rate on that same vehicle during the life of the vehicle.
- b. You must supply the following information:
  1. The date the vehicle was placed in service;
  2. Total mileage that the vehicle was used in 2003;
  3. Miles used for business (including Naval Reserve);
  4. Percentage of business use;
  5. Average daily round-trip commuting distance;
  6. Miles that vehicle was used for commuting; and,
  7. Other personal mileage.
- c. In addition, you must answer the following questions:
  1. Whether another vehicle was available for personal use;
  2. Whether the employer provided the vehicle;
  3. Whether personal use was permitted during off-hours;
  4. Whether evidence exists to support the deductions; and, if so,
  5. Whether such evidence is written.

All this information is required whether you use the mileage or actual expense method. Your daily records can be used by you to determine which method, actual expenses or mileage, would result in a greater deduction.

**NOTE: You are not able to claim the standard mileage rate if you use the IRC Section 179 deduction. Annual Reserve/business use will affect the deduction amount. Consult with a tax practitioner before claiming the deduction.**

#### Summary of Reserve Mileage Deductions

If your normal work week is Monday through Friday and you attend a meeting of an Armed Forces Reserve unit that meets one weekend a month in the general area of your regular place of work and you return to your home on Saturday night, the cost of transportation from your home to the Reserve meetings is a commuting expense; and you cannot deduct it unless you go from the NRC to a "temporary drill site" rather than to the NRC.

If the meetings are held outside the general area, you can deduct the cost of your transportation to attend the meetings. The Navy's definition of "Outside General Area" is living fifty (50) miles or more from the Naval Reserve Center. If the Reserve meetings are held after work on a normal work day, the cost of transportation from your work place to the Reserve Center is deductible.

If you stay away from home overnight, the cost of hotel/motel rooms and the cost of meals not furnished or reimbursed are deductible. Effective for all years commencing 1994 and later, only 50 percent of the qualified meals and entertainment may be deducted. Hotel/motel/BOQ room cost is still deducted in full.

#### Lodging Not Furnished by the Naval Reserve

A Reservist who lives outside a fifty-(50) mile radius from the NRC and will be performing at least two (2) drills the following day is entitled to lodging. In the event the Reservist does not perform two drills the following day or does not schedule the drills timely, the lodging expense paid by the Reservist is a deductible expense which should be included on Form 2106. A Reservist on AT/ADT is reimbursed the cost of the room. If the lodging costs more than the amount reimbursed, the excess is deductible on Form 2106.

#### Out-Of-Pocket Meals (Reduced by 50 Percent)

Officers are not reimbursed for their meals, and the expense is deductible on Form 2106. In 2003, the cost of meals is reduced by 50 percent. It is important to keep records of each meal purchased.

Alternatively, instead of the actual cost of each meal, you may include your expenses for meals while away from your tax home overnight at the maximum-rate-authorized paid by the federal government for meals and incidental expenses in the locality where the travel was performed. For details, including the maximum rate, reference IRS Publication 1542 Per Diem Rates (for travel within the continental United States). You can use the new Standard Meal Allowance Rates.

#### Deductions for Uniforms, Uniform Accessories, and Maintenance

Inactive Reservists are allowed to list on Form 2106 all expense pertaining to the unreimbursed uniform expenses incurred whether in a pay billet or in a nonpay billet. These expenses include maintenance, repair, or alteration of uniforms and equipment especially required by the Navy,

which doesn't take the place of civilian clothing. This includes, but is not limited to: gold lace, devices on uniforms, coat and collar devices, shoulder boards, chin straps, cap devices, gold lace on officers' visors, wings, sword and full-dress belt, and for altering braid and devices on uniforms because of change of rank. If local military rules do not allow you to wear fatigue uniforms when you are off duty, you can deduct the amount by which the cost of buying and keeping up these uniforms is more than the uniform allowance you receive [IRS Publication 17, *Your Federal Income Tax*].

#### Deductions for Dues to Professional Societies Related to Reserve Components

Reservists are allowed to list, as Miscellaneous Deductions on Form 2106, all expenses relating to membership in the various professional societies related to the Reserve Components. These include but are not limited to: U.S. Naval Institute, U.S. Naval War College Foundation, Naval Reserve Association, Naval Order of the United States, Reserve Officers Association, Association of Naval Aviation, Vietnam Veterans Association, and others.

#### Educational Expenses

Educational expenses are deductible if they: (1) are required by your employer or by law or regulations to retain your salary, status, or job; (2) maintain or improve your skills required in your job whether within the Naval Reserve or not. [IRS Publication 3, *Employee Business Expenses*]

#### Subscriptions To Reserve-Related Periodicals And Purchase Of Books

The cost of subscribing to Reserve-related periodicals and the purchase of books which enhance the mobilization potential of the Reservist are deductible on Form 2106. This includes technical reference material, historical data, and computer programs detailing the strategy and tactics of historical battles and language training materials. Also, any material, written or magnetic media, or equipment, computer hardware or software that improves the mobilization potential of the individual Reservist is a deductible item.

#### Computer Expenses, If Used More Than 50 Percent for Business and Naval Reserve Purposes (Records Are Required)

The use of a computer and its peripheral equipment more than 50 percent of the time combined for business and Naval Reserve duties will make it deductible. Records are required to substantiate the deduction or depreciation on Form 4562, Depreciation and Amortization.

#### Office in Home If Used As Your "Principal" Place of Business

A home office expense can be deductible if it is used as your "principal" place of business. In 1993, the U.S. Supreme Court defined the meaning of "principal" as a two-part test: (i) exclusive or regular use for your trade or business; and (ii) the business part of your home must be one of the following: (a) your principal place of business, (b) a place where you meet with patients, clients, or customers in the normal course of your trade or business, or (c) a separate structure (not attached to your home) you use in connection with your trade or business.



Additional tests for an employee's use of a part of his/her home include: (1) your business use must be for the convenience of your employer; and, (2) you do not rent any part of your home to your employer and use the rented portion to perform services as an employee.

Based upon the above tests, it may be possible for a member of the Naval Reserve to deduct a part of the operating and depreciation expense on their home. You cannot deduct any part of personal expenses that are for family household purposes. Confer with your tax practitioner as to the likelihood of sustaining the deduction upon audit by the Internal Revenue Service.

If a percentage of the expenses are deductible, then include house interest, taxes, utilities, insurance, and depreciation and apply the percentage to the total amount of the house expense. Repairs are deductible ONLY for the home office. Other room repair is not allowed. Forms 8829, 2106, and 4562 must be completed to reflect the operating expense and depreciation on the home office. [IRS Publication 17, Part 5, Chapter 30, *Miscellaneous Expenses*]

#### Other Deductible Expenses

The following additional expenses may also be deductible: (i) change of command or change of office, and special award ceremonies expenses (printing, reception, etc.); and, (ii) legal expenses incurred by a Reservist in the defense of certain allegations. [IRS Publication 529, *Miscellaneous Deductions*]

#### 6. Expenses Deducted on Schedule A, Itemized Deductions

##### Charitable Deductions and Naval Reserve Association Deductions for Members (Regular Or Associate)

- a. **Representing local Chapter at EXCOM's and attending other Chapter meetings.** Officers of the Association who attended the 2003 National Conference and other chapter meetings at their own expense are entitled to deduct these expenses as a cash contribution deduction. This includes the unreimbursed cost of transportation, meals (limited to 50 percent), and lodging (can use per diem amounts rather than exact expenditures).
- b. **Attending NRA SemiAnnual meetings.** National Officers, Anchors, delegates, representatives, and committee members attending the semiannual meetings in 2003 are entitled to a deduction for nonreimbursed travel expenses. The expenses include air fare, the cost of meals (limited to 50 percent) using actual expenses or the per diem amount [IRS Publication 1542], and lodging while away from home in connection with the affairs of the NRA and/or in that direction. Parking fees and tolls attributable to such transportation are deductible as separate items.

- c. **Expenses incurred while an Officer of the Association or a member of any of the Association's Committees.** If you incur any expense, travel, meals, purchase supplies, long distance telephone calls, or have a separate telephone line put in only for NRA use, those expenses are deductible as a cash Charitable Contribution. NRA does not reimburse most of these expenses. If there is any reimbursement from NRA or the District/Chapter, ONLY the NET expenses are deductible as a cash charitable deduction. These expenses are not Unreimbursed Employees Business Expenses or subject to a reduction of two percent of Adjusted Gross Income.

#### Other Cash Charitable Contributions

In addition to your normal charitable contributions such as church, temple, united charities, etc., you are entitled to a charitable contribution deduction for sums given to your Ship, Post, Reserve Center, or Station. This is provided that the sums are used SOLELY for Recreation, Amusement, or Welfare (MWR) of service personnel. A list of service oriented organizations includes but is not limited to the following: USO, Navy-Marine Corps Relief Society, Naval Academy Alumni Association, Naval Academy Athletic Association, and the Naval Reserve Association.

Charities are now required to inform you of the deduction limits for quid pro quo contributions when you make a payment of more than \$75.00. If your gift is more than \$250, you must have a written acknowledgment from the donee receiving organization.

#### Contributions to the Naval Reserve Association

Contributions of money or property made to the Naval Reserve Association qualifies for deduction on Schedule A as a Charitable Contribution. If you make a gift of appreciated property to the NRA, you can get a deduction for the property's full market value without having to pay tax on its appreciation or pay any Long-Term Capital Gain.

#### Retired Reservists Participating with Permissive Orders

Retired Reservists who participate in the Reserve Program IAW permissive orders program do not file form 2106 but list all expense incurred as a Cash Charitable deduction on Schedule A. Permissive orders issued IAW BUPERSINST 1001.39 state that: (a) the member will not accrue additional retirement points; (b) the member will not perform additional service for pay purposes (annual training); (c) participation is strictly on a voluntary basis; (d) no IDTT or ADT can be performed; and (e) there is no drill reporting requirement.

#### Excess Social Security Withheld

If you had more than one employer in 2003, each withheld Social Security tax. If you had more than \$87,000 in wages, it is likely that too much Social Security (FICA) may have been withheld. You may claim the excess FICA amount as a credit against any income tax that is owed on your Form 1040. It is important to recognize that Social Security tax is withheld from Naval Reservists performing Reserve Drills (IDT's), IDTT, ADT, AT, or when on an extended period of Special Duty.

## SUMMARY OF NAVAL RESERVIST DEDUCTIBLE EXPENSES FOR 2003

The 2003 changes in the tax law, which include the following, affect the above deductions as follows:

Form 2106, Line 1.	Records must substantiate vehicle expenses. Use 36.00 cents per mile for all business miles.
Form 2106, Line 2.	Parking fees, tolls, and transportation including local commuting fees (buses, Metro, etc.).
Form 2106, Line 3.	Travel expense while away from home overnight (lodging, airplane, car rental, etc.). Do not include meal and entertainment expenses in this section.
Form 2106, Line 4.	Uniforms deduction, dues to professional organizations, and other expenses must be aggregated with the other employee business expenses.
Form 2106, Line 5.	Meals and entertainment cost not reimbursed. Note that this amount will be reduced by 50 percent on line 9, Form 2106.
Schedule A, Line 15.	Contributions, annual meeting expense, and meals are reduced to 50 percent; sightseeing tours are not deductible unless related to purpose of the organization.
Schedule A, Line 20.	Total from Form 2106 is deducted here.

An example of the impact of the reduction of two percent of Adjusted Gross Income is the following: A Naval Reservist with Adjusted Gross Income of \$45,000 must reduce his/her Naval Reservist Expenses by \$900 ( $\$45,000 \times .02$ ) before the Reserve expenses can be included in the total of itemized deductions. The total itemized deductions must then exceed the standard deduction (\$6,400) in order to receive a tax benefit. It is possible that the Naval Reservist will not receive any tax benefit for Naval Reserve expense amounts due to the two percent reduction rule.

Lines 35-43. Tax Computation.

### Income Tax Brackets

The new ten percent income tax bracket will apply to the first \$14,000 of taxable income for joint tax filers and surviving spouses and the first \$7,000 for single tax filers. The 15 percent income tax bracket will remain the same; however, the 27 percent rate will be lowered to 25 percent; the 30 percent rate will be lowered to 28 percent; the 35 percent rate will be lowered to 33 percent; and the 38.6 percent rate will be lowered to 35 percent.

### Alternative Minimum Tax

The exemption amount for 2003 is \$58,000 for joint filers and surviving spouses, \$40,250 for single filers, and \$29,000 for married filing separately.

### Kiddie Tax (Form 8814)

The Kiddie Tax applies to unearned income, in excess of \$1,500, of child under age 14. The child's investment income over \$1,500 will be taxed at the marginal income tax rate of his/her parent(s).

Lines 44-54. Credits.

- Credit for Dependent Care Expenses (Form 2441)
- Credit for the Elderly and Disabled Retirement Savings Contributions Credit
- Child Tax Credit (increased to \$1,000 per qualifying child)
  - Phased out for Adjusted Gross Income levels:
    - \$110,000 for joint filers;
    - \$55,000 for married individuals filing separately; and,
    - \$75,000 for single filers.
  - Under the phase-out rule the credit amount is reduced at the rate of \$50 for each \$1,000 (or fraction) by which a taxpayer's modified adjusted gross income exceeds the threshold amount.
- Mortgage Interest Credit (Form 8396)

Lines 55-60. Other Taxes.

This section includes taxes on IRA or Qualified Retirement Plans and household employment.

Lines 61-68. Payments.

This section includes: federal income tax withheld, estimated tax payments, earned income credit, excess Social Security, Medicare, and RRTA tax withheld.

Lines 69-73. Refund or Amount You Owe.

This section you either love or hate because it identifies whether you are due a refund or the amount you owe the government.

## MILITARY SERVICE IN A COMBAT ZONE AND THE IRS

The following is a short list of tax benefits available to our brave men and women who served in a combat zone in 2003.

### Exclusion from Gross Income

An enlisted member or warrant officer (including commissioned warrant officers) who performs service in a combat zone will have his/her military pay excluded from his/her gross income for all or any part of the month of his/her service in a combat zone. For commissioned officers, the monthly amount that will be excluded from their gross income will be capped at the highest enlisted pay, plus any hostile fire or imminent danger pay received. For the 2003 tax year, the exclusion amount equates to \$5,882.70.

The combat zone income exemption will apply to the following: (i) those serving directly inside a combat zone and those who participate in operations within the zone, including the airspace over it; (ii) any military pay received by a member who is hospitalized as a result of injuries sustained while serving in a combat zone, subject to a two-year limitation. (The two-year limitation period begins to run on the date of termination of service in the combat zone.); (iii) annual leave payments upon discharge from the service to the extent the leave was accrued during any month in any part of which the member served in a combat zone; and (iv) a reenlistment bonus received in a month that the member is outside the combat zone if they completed the necessary action for entitlement to the reenlistment bonus in a month during which they served in the combat zone. In order to be eligible for the income tax exclusion, your service branch must certify your entitlement to the military pay exclusion on your Form W-2.

### IRS Extensions

The deadline extension provision applies to most tax actions that are required to be performed on or after the beginning date for your combat zone, or the date you began serving in that combat zone, whichever is later. The deadline for performing certain actions, applicable to your federal taxes, will be extended for the period of your service in the combat zone plus 180 days thereafter. During the extension period, assessment and collection deadlines will be extended, and interest and penalties attributable to the extension period will not be charged. The extensions will apply without regard to the source of the income. The deadline extension provisions will also apply for a period of hospitalization inside the United States not in excess of five years.

The IRS deadline extension provisions also apply to individuals serving in the combat zone in support of the U.S. Armed Forces, such as merchant marines serving aboard vessels under the operational control of the Department of Defense, Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the U.S. Armed Forces in support of those forces. In addition, members who perform military service in an area outside the combat zone can qualify for the extension provisions if their service is in direct support of military operations in the combat zone and they receive special pay for duty subject to hostile fire or imminent danger as certified by the Department of Defense. The deadline extension provisions apply to both spouses whether joint or separate tax returns are filed.

The deadline extension provisions apply only to federal estate and gift tax returns. Federal tax and information returns, such as corporate income tax or employment taxes, are not entitled to the extension provisions. The extension provisions will also suspend compliance actions, such as audits or enforced collections.

### Qualified Retirement Contribution

If you qualify for an extension, you can make a timely qualified retirement contribution for the prior tax year to your IRA on or before the extended deadline for filing your income tax return for that year. Any amount contributed to your IRA that is more than the smaller of (1) your taxable compensation, or (2) \$3,000 (\$3,500 if you are age 50 or over) is an excess contribution and must be withdrawn to avoid a six percent excise tax.

If your taxable compensation will be less than \$3,000, you should withdraw the portion of your contribution that exceeds your taxable compensation. You will not be taxed on the distributed amount if you receive the distribution on or before the deadline for filing your federal income tax return. You must also withdraw the amount of net income attributable to the excess contributions while they were assets of the IRA. Alternatively, if you are married and file a joint return, you may be eligible to make an IRA contribution based on your spouse's taxable income.

### Estimated Tax Payments

The deadline extension provisions apply to estimated tax payments and will prevent penalties and interest from accruing if the tax is paid in full by the extended filing due date. In order to insure this protection, it is recommended that you print "COMBAT ZONE" across the top of the return.

### Installment Payment Plans

While serving in a combat zone, and for 180 days thereafter, you will not be required to make payments on past due taxes. Also, no additional penalties or interest will be charged during

this deadline extension period. In order to receive this benefit, you will need to contact the IRS office where you were making the payments.

### Form W-2, Wage and Tax Statement

Military pay, attributable to your active service in the combat zone, which is excluded from gross income will not be reported on your Form W-2 in the box marked "Wages, tips, other compensation." However, the military pay will be subject to Social Security and Medicare taxes and will be reported on your Form W-2 in the boxes marked "Social Security wages" and "Medicare wages and tips."

### Earned Income Tax Credit (EITC)

The U.S. Tax Code does not include combat pay, the Basic Allowance for Housing (BAH), and the Basic Allowance for Subsistence (BAS) in the definition of "earned income" for purposes of the EITC. However, these exclusions may leave you with no earned income and the inability to claim the credit.

### Hospitalization

The deadline extension provisions will apply to an injury sustained in a combat zone for the period that you are continuously hospitalized as follows: (i) outside of the United States, including 180 days thereafter; or (ii) not in excess of five years inside the United States. Also, subject to a two-year limitation after the date of termination of the combat zone, military pay received by a hospitalized enlisted member as a result of injuries sustained while serving in a combat zone will be excluded from gross income. Commissioned officers are entitled to the same benefit subject to the maximum enlisted per month amount discussed above.

### Dependent Children Tax Returns

You are not required to file individual income tax returns for your dependent children while one or more spouse serves in a combat zone. You may use the military service member's extension deadline to file their federal individual income tax return. It is recommended that you write "COMBAT ZONE" across the top of their tax returns. However, if they are entitled to a refund, you may want to file their tax returns as soon as possible.

### Accrued Annual Leave

Annual leave payments to enlisted members of the U.S. Armed Forces upon discharge from the service are excluded from gross income to the extent the leave was accrued during any month in any part of which the member served in a combat zone. If your spouse is a commissioned officer, a portion of the annual leave payment he/she receives for leave accrued during any month in any part of which he/she served in a combat zone may be excluded. The leave payment cannot be excluded to the extent it exceeds the maximum enlisted amount for the month of service to which it relates less the amount of military pay already excluded for that month.

### Reenlistment Bonus

A reenlistment bonus which is earned as a direct result of the completion of actions necessary for its entitlement in a combat zone will be excluded from gross income. This exclusion will apply even if the bonus is received in a month that you are outside the combat zone.

## EMPLOYER REIMBURSEMENT OF RESERVE EXPENSES

The National Committee for Employer Support of the Guard and Reserve enlists employers to show support for the National Guard and the Reserve. If you work for one of those supporting companies, you should explore with your employer a possible reimbursement of your Naval Reserve expenses. The major benefit of such an employer reimbursement is that you will have cash for the Naval Reserve expenses and not be subject to the two percent limitation.

If you own your own business or corporation, the following is required to allow you to reimburse all Reserve expenses:

1. Make a company policy to support the National Guard/Reserve Program as an employer;
2. Publish a policy within your company that anyone participating in any National Guard or Reserve Program will be reimbursed out-of-pocket expenses;
3. Require employee(s) to provide proof of participation in the National Guard/Reserve;
4. Require the completion of a detailed expense accounting form similar to the DD1351 Travel Expense form. Use of per diem for meals and lodging is allowable; and
5. Give the Reserve member a separate check for this reimbursement so specific identification can be made easily. The amount reimbursed is not included in the employee's W-2.

In the event you are a sole proprietor and are participating in the National Guard/Reserve Program, your business can reimburse your expenses and claim the Reserve expenses on your Schedule C. Since you are an employee of the business and also the owner, you would be reimbursed under the rules for all other employees.

### AUDIT BY IRS PERSONNEL

It is not unusual for a Naval Reservist to be audited and questioned about his/her Naval Reserve expenses. Normally the person conducting the audit knows little about the Reserves and the allowable expenses incurred by the Reservist/Taxpayer. Typical audit areas include:

#### Travel Expenses

The problem area involves the determination of whether the Reservist is entitled to deduct the round-trip mileage or only the one-way mileage to attend Naval Reserve drills or to perform other required duties when traveling from your regular employment location to the NRC. If you stay at provided quarters, you will not have a problem documenting your deduction of mileage expense.

#### Naval Reserve Expenses for Non-Pay Drillers

A Naval Reservist in nonpay status may be audited over his/her Naval Reserve expenses. These expenses have been challenged based upon the theory that, "(a) since the Reservist is not receiving any pay for his/her services; (b) the Reservist is assigned to a VTU (Voluntary Training Unit); (c) therefore, the Reservist is not an employee; and, (d) therefore, the Reservist is not entitled to claim the expenses as Employee Business Expenses." In the event your Naval Reserve deductions are challenged in pay or nonpay status, the following should be made known to the auditor:

1. The Reservist is an employee of the U.S. Navy and the U.S. Government;
2. The Reservist is required to attend drills, and the same rules are applicable to a Reservist in a pay or nonpay category; and,
3. The IRS, through the Revenue Ruling 55-109, 1955-1, CUMBULL 261, modified by Revenue Ruling 76-453 and Revenue Ruling 90-23, 1990-1 CB 28, modified by Revenue Ruling 94-47 allows a deduction for the Reserve expenses, whether in a pay or nonpay status.
4. The forms that identify you as an employee are:
  - a. NAVPERS FORM 1200/1 Ready Reserve Agreement;
  - b. CNAVRES FORM 1321/2 Officer Application/Orders for Inactive Duty Training;
  - c. NAVPERS FORM 1570/2 Satisfactory Participation Requirements Record;
  - d. CNAVRES FORM 1321/2, that assigns the officer to a unit in either a pay or nonpay status. Whether in the pay or nonpay, the Reservist MUST meet the same drilling requirements. The officer is assigned to a billet by a higher authority. The officer has NO OPTION as to this status. Therefore, the Reservist IS NOT A VOLUNTEER in the "Charitable" sense of the word.
5. All drilling Reservists are subject to the Uniform Code of Military Justice (UCMJ). As a civilian, you are not subject to the Code (UCMJ).
6. You are extended certain Exchange and Commissary privileges.
7. You earn one retirement point per drill performed regardless of your pay status.
8. You must maintain a satisfactory drilling year in order to remain in the Naval Reserve.
9. You must maintain a level of physical fitness to remain in the Naval Reserve.
10. You are not reimbursed expenses for attending drills (IDT).
11. You are entitled to deduct travel expenses when away from home carrying out "official business while on 'no cost' orders." [IRS Publication 3, *Tax Information for Military Personnel* and IRS Publication 17, *Your Federal Income Tax*]

#### Documentation

You should be prepared to document and justify the deduction of any expense on the tax return filed because each taxpayer and each audit stands on the peculiar facts and circumstances related to that taxpayer. All deductions claimed on the Federal Income Tax Return filed must be substantiated with records. You should maintain your records in an account book, diary, statement of expense, or other similar record. These records should be substantiated with additional documentation such as checks, invoices, credit card slips, or statements.

NOTE: THIS ARTICLE DOES NOT ATTEMPT TO ADDRESS ALL TAX LAW CHANGES MADE THIS YEAR. IT IS IMPORTANT TO CONSULT A TAX SPECIALIST WHEN PREPARING YOUR FEDERAL INCOME TAX RETURN.

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