FTA bulletin
Federation of Tax Administrators
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B-28/03
November 24, 2003

MILITARY FAMILY TAX RELIEF ACT OF 2003

To State Tax Administrators:

SUMMARY
This bulletin provides details on H.R. 3365, Military Family Tax Relief Act of 2003, signed into law on November 11 as Public Law No: 108-121. Please refer your questions to Verenda Smith at 202-624-8443, verenda.smith@taxadmin.org.

This bulletin provides details on H.R. 3365, Military Family Tax Relief Act of 2003, signed into law on November 11 as Public Law No 108-121. Complete language is available on Thomas (http://thomas.loc.gov) and an explanation from the Joint Committee on Taxation is available on TaxExchange (federal legislation page).

This new law contains eight income tax benefits for members of the military, an income and estate tax benefit for families of astronauts who die in space, and a provision to facilitate denial of tax exempt status to terrorist organizations. Many of the tax benefits are structured as exclusions to income – or expansions of current exclusions – that may flow through to those states that conform to the Internal Revenue Code.

The bill will produce a small net gain for the federal government of $69 million (in 2004-2013) because of the inclusion of unrelated provisions that raise revenues, primarily an extension of customs fees. Not considering the revenue raisers, the bill will lower federal revenues by more than $1.2 billion over 10 years.

The 10 tax benefits are as follows, with costs given as a 10-year expense:

Exempt "extended official duty time away from home" from the five-year residence requirement that qualifies taxpayers for a capital gains exclusion from the sale of a principal residence ($212 million).

An individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. Certain exceptions are made to the two-year rule, including a change of employment.

Under the new law an individual can suspend the five-year test period for up to 10 years, if that individual or spouse is absent because of "qualified official extended duty as a member of the uniformed services" (the military, NOAA, and the Public Health Service). The provision is effective for sales or exchanges after May 6, 1997, and federal refund claims will be permitted for a one-year period.

Exclusion from gross income of certain death gratuity payments ($122 million).

The death gratuity benefit to survivors of U.S. military members killed in the line of duty will increase from $6,000 to $12,000. The tax-free treatment of the benefit will increase from $3,000 to $12,000. The provision is effective with respect to deaths occurring after September 10, 2001.

Exclusion for amounts received under the Department of Defense Homeowners Assistance Program ($19 million).

The Department of Defense Homeowners Assistance Program ("HAP") provides payments to certain employees and members of the Armed Forces to offset the adverse effects on housing values that result from a military base realignment or closure. In general, under HAP, eligible individuals receive either: (1) a cash payment as compensation for losses that may be or has been sustained in a private sale, or (2) an amount calculated to reflect a fair purchase price for the property.

These payments in the past, or at least the amounts that exceed the fair market value of the property, have been fully taxed as having been received in connection with the performance of services (e.g., relinquishing the home). The same payments also were considered wages for FICA and Medicare tax purposes. Now these amounts will be exempt from gross income and will not be considered wages. The provision was effective on the date of enactment.

Expansion of extensions of time to file to those serving in contingency operations ($13 million).

Deadlines in the tax code are suspended for a large number of activities, including filing returns, paying taxes, filing appeals and filing refund claims, when the taxpayer is serving in a presidentially declared "combat zone" during declared combat activities. The suspension of time applies not only to military personnel but also those serving in support roles, such as civilian personnel working for the military and Red Cross workers. Prisoners of war are similarly protected.

Under the new law the time periods will be suspended as well for persons deployed outside the United States, away from the individual's permanent duty station, while participating in an operation designated by the Secretary of Defense as a contingency operation or an operation that becomes a contingency operation. The Secretary of Defense will designate contingency operations. The provision applies to all existing contingency operations as well as any that will occur.

Modification of membership requirement for exemption from tax for certain veterans' organizations ($17 million).

Qualifying veterans' organizations are exempt from tax, and contributions are tax deductible if it is an organization of war veterans. To qualify, the organizations must have 75 percent of members who are active or past members of the Armed Forces. All but 2.5 percent of all of the remaining members must be cadets, spouses, or surviving spouses of a member. Now the "22.5 percent remaining members" may also consist of the lineal descendants or ancestors (parent, etc.) of past or present members of the Armed Forces.

Clarification of treatment of certain dependent care assistance programs (no revenue effect).

The cost of care provided under a dependent care assistance program for a member of the uniformed services by reason of such member's status or service as a member of the uniformed services will be excludable from gross income as a qualified military benefit subject to the present-law rules. The provision is effective for taxable years beginning after December 31, 2002.

Treat military academy appointments as scholarships for purposes of tax-preferred education savings accounts ($2 million).

The Code provides tax-exempt status to qualified tuition programs established by states. Similarly, the Code provides tax-exempt status to Coverdell education savings accounts ("ESAs"). These are trusts or custodial accounts created to pay the qualified education expenses of a designated beneficiary.

Distributions from an ESA or qualified tuition program are excludable from a recipient's income to the extent that they do not exceed a beneficiary's qualified education expenses in the year of the distribution. If they do, then the withdrawal is taxed on a pro-rata basis, based on the amount of distribution and the school expenses. Plus, an additional 10 percent tax usually applies. However, the 10 percent additional tax does not apply if the student dies, is disabled, or has received a scholarship.

Appointments to the military academies have not been considered scholarships for consideration of waiver of the 10 percent tax because the appointment requires the student to later serve in the military. Now, however, the additional 10 percent tax will not apply to withdrawals from Coverdell education savings accounts and qualified tuition programs made on account of the beneficiary's attendance at a military academy. The provision applies to taxable years beginning after December 31, 2002.

Suspension of tax-exempt status of terrorist organizations (negligible revenue effect).

The provision streamlines the process of an IRS revocation of an organization's tax-exempt status. The provision simply suspends the tax-exempt status of an organization for any period during which the organization is designated or identified by U.S. authorities as a terrorist organization or supporter of terrorism. The bill also makes such an organization ineligible to apply for tax exemption under section 501(a).

Above-the-line deduction for up to $1,500 of overnight travel expenses of National Guard and reserve members ($851 million).

National Guard and Reserve members may claim itemized deductions for their nonreimbursable expenses for transportation, meals, and lodging when they must travel away from home (and stay overnight) to attend National Guard and Reserve meetings. However, these overnight travel expenses have been combined with other miscellaneous itemized deductions on Schedule A of the individual's income tax return and were deductible only to the extent that they exceeded 2 percent of the taxpayer's adjusted gross income.

The law now will permit an above-the-line deduction (before the AGI calculation) for the overnight transportation, meals, and lodging expenses of National Guard and Reserve members who must travel away from home more than 100 miles (and stay overnight) to attend National Guard and Reserve meetings. This means the taxpayers will receive a deduction even if they don’t itemize, or if their deductions are less than 2 percent of AGI. However, the deducted expenses may not exceed the general Federal Government per diem rate applicable to that locale, and they must relate to service that is more than 100 miles from home. The provision is effective with respect to amounts paid or incurred in taxable years beginning after December 31, 2002.

Extension of certain tax relief provisions to families of astronauts who lose their lives on a space mission ($4 million).

The Victims of Terrorism Tax Relief Act of 2001 (the "Victims Act") provided certain income and estate tax relief to individuals who die from wounds or injury incurred as a result of the September 11 terrorist attacks, the Oklahoma City bombing, or the anthrax attacks. The tax relief granted is similar to treatment of military or civilian employees of the United States who die as a result of terrorist or military activity outside the United States. Such individuals generally are exempt from income tax for the year of death and for tax years going back one year before the date of attack. Estate tax benefits also apply.

The new law extends identical benefits to the families of astronauts who lose their lives on a space mission.

I hope you find the above information helpful. Please direct your questions to Verenda Smith at 202-624-8443 (verenda.smith@taxadmin.org).

Sincerely,

Harley T. Duncan
Executive Director