

DESCRIPTION OF PROPOSALS
RELATING TO
TAX TREATMENT OF MILITARY PERSONNEL

Scheduled for a Hearing
Before the
SENATE COMMITTEE ON FINANCE
on February 27, 1991

Prepared by the Staff
of the
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CONTENTS

	<u>Page</u>
INTRODUCTION	1
DESCRIPTION OF PROPOSALS RELATING TO THE TAX TREATMENT OF MILITARY PERSONNEL	2
A. General Tax Proposals	2
1. Increase exclusion from tax for officers; replace combat zone designation with designation of "dangerous foreign area" (S. 199)	2
2. Exclude military pay of Operation Desert Storm MIAs/POWs from gross income	4
3. Expand authority to issue qualified veterans' mortgage bonds (S. 354 and S. 355)	5
4. Extend eligibility for the earned income tax credit to military personnel stationed overseas	7
5. Extend tax deadline deferral rules to reservists that are not in combat zone	9
6. Allow reservists to deduct certain expenses from adjusted gross income (S. 246)	10
7. Eliminate certain restrictions on rollover of gain on sale of principal residence for certain military personnel	11
B. Pension-Related Proposals	13
1. Allow penalty-free withdrawals from qualified retirement plans, annuities, and endowment contracts (S. 82 and S. 342)	13
2. Permit rollovers of military separation pay (S. 252)	13

Page

3. Provide that Desert Shield or Desert Storm service does not cause a break in service 14
4. Permit Desert Shield and Desert Storm Service to be taken into account for qualified plan purposes..... 15

INTRODUCTION

This document,¹ prepared by the Staff of the Joint Committee on Taxation, provides a description of proposals relating to the tax treatment of military personnel and their families, scheduled for a public hearing by the Senate Committee on Finance on February 27, 1991.

Part A of the document describes general income tax proposals relating to military personnel. Part B describes proposals relating to pension and retirement plans.

¹ This document may be cited as follows: Joint Committee on Taxation, Description of Proposals Relating to the Tax Treatment of Military Personnel (JCX-3-91), February 26, 1991.

A. General Tax Proposals

1. Increase exclusion from tax for officers; replace combat zone designation with designation of "dangerous foreign area" (S. 199)

Present Law

Exclusion for combat pay

Gross income does not include certain combat pay of members of the Armed Forces (sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income. In addition, if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone, military pay for that month is also excluded from gross income; this exclusion is limited, however, to hospitalization during any month beginning not more than two years after the end of combat in the zone. In the case of commissioned officers, these exclusions from income are limited to \$500 per month of military pay.

Designation of a combat zone

The President may issue an Executive Order declaring that an area is a combat zone. In addition to triggering the exclusion for combat pay (described above), such a designation of a combat zone triggers a suspension of the period of time for performing various acts under the Internal Revenue Code (such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax), as well as several other special provisions.

On January 21, 1991, President Bush signed Executive Order 12744, designating the Persian Gulf Area as a combat zone. The designation was retroactive to January 17, 1991, the date combat commenced in that area, and continues in effect until terminated by another Executive Order. Thus individuals serving in the Persian Gulf Area are eligible for the military pay exclusions described above, beginning January 17, 1991.

The Executive Order specifies that the Persian Gulf Area is the Persian Gulf, the Red Sea, the Gulf of Oman, a portion of the Arabian Sea, the Gulf of Aden, and the total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar and the United Arab Emirates.

Description of S. 199

Increase in exclusion limit for officers

In the case of commissioned officers, the limit on the

exclusion from income would be raised to \$2,000 per month of military pay.

Application to dangerous foreign areas

The bill would also replace the requirement that an area be designated a combat zone with the requirement that an area be designated a dangerous foreign area. To trigger the exclusion from income provisions described above, the President would be required to issue an Executive Order designating that Armed Forces of the United States in that area are being or have been subject to certain hostile activities. Those hostile activities are defined as: (1) hostile fire; (2) explosion of hostile mines; (3) imminent danger of hostile fire or the explosion of hostile mines; or (4) the threat of physical harm or imminent danger on the basis of civil insurrection, civil war, terrorism, or wartime conditions.

Effective date

The provisions of the bill would be effective as of October 1, 1990.

2. Exclude military pay of Operation Desert Storm MIAs/POWs from gross income

Present Law

Gross income does not include certain combat pay of members of the Armed Forces (sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income. In addition, if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone, military pay for that month is also excluded from gross income; this exclusion is limited, however, to hospitalization during any month beginning not more than two years after the end of combat in the zone. In the case of commissioned officers, these exclusions from income are limited to \$500 per month of military pay.

Members of the Armed Forces and civilian employees of the Federal Government in "missing status" as a result of the Vietnam conflict may claim an exclusion from income for their compensation for any month during any part of which such persons are in missing status. In order to be classified in "missing status," a person must be in active service and determined to be (1) missing, (2) missing in action, (3) interned in a foreign country, (4) captured, beleaguered, or besieged by a hostile force or (5) detained in a foreign country against his or her will.

The "missing status" exclusion applies to all compensation for active service of members of the Armed Forces (enlisted personnel and commissioned officers) and civilian employees of the Federal Government. A person absent from his or her post of duty without authorization is not eligible for the exclusion.

Description of Proposal

The proposal would extend the exclusion from income for those in "missing status" to members of the Armed Forces and civilian employees of the Federal Government in "missing status" as a result of Operation Desert Storm.

3. Expand authority to issue qualified veterans' mortgage bonds (S. 354 and S. 355)

Present Law

Interest on bonds issued by States and local governments to finance their direct activities is excluded from income (sec. 103). Interest on bonds issued by these governmental units to finance activities of private persons ("private activity bonds") is taxable unless a specific exclusion is included in the Code (sec. 141).

Present law excludes from income the interest on qualified veterans' mortgage bonds, which are general obligation private activity bonds issued as part of certain programs in effect before June 11, 1984, to provide mortgage loans to veterans (sec. 143(1)). Only five states are eligible to issue qualified veterans' mortgage bonds: Alaska, California, Oregon, Texas, and Wisconsin.

Mortgage loans made with the proceeds of qualified veterans' mortgage bonds may be made only to veterans who served on active duty before 1977, and who apply for the loan before the later of (1) 30 years after the veteran leaves active service or (2) January 31, 1985.

Issuance of qualified veterans' mortgage bonds is subject to annual volume limitations based on the historical level of issuance of these bonds between January 1, 1979, and June 22, 1984, in lieu of the general State volume limitations applicable to most other private activity bonds.

Description of S. 354

S. 354 would expand authority to issue qualified veterans' mortgage bonds from the five States currently eligible to all States (including D.C. and U.S. possessions). The bill also would repeal the annual volume limitations applicable to these bonds, and would expand the set of borrowers eligible for mortgage loans financed with the bonds to include veterans who served in Operation Desert Shield or Desert Storm.

The provisions of the bill would apply to bonds issued after August 1, 1990.

Description of S. 355

S. 355 would expand the set of borrowers eligible for mortgage loans financed with qualified veterans' bonds to include veterans who served in Operation Desert Shield or Desert Storm. All other present-law requirements, including

those determining which States are eligible to issue these bonds, would be retained.

The provisions of the bill would apply to bonds issued after August 1, 1990.

4. Extend eligibility for the earned income tax credit to military personnel stationed overseas

Present Law

Eligible low-income workers are able to claim a refundable earned income tax credit (EITC) of up to 16.7 percent (17.3 percent for taxpayers with more than 1 qualifying child) of the first \$7140 of earned income for 1991. The maximum amount of credit for 1991 is \$1192 (\$1235 for taxpayers with more than 1 qualifying child), and this maximum is reduced by 11.93 percent (12.36 percent for taxpayers with more than 1 qualifying child) of earned income in excess of \$11,250. The EITC is totally phased out for workers with earned income over \$21,245. Earned income consists of wages, salaries, other employee compensation (including certain allowances provided to military personnel), and net self-employment income.

To be eligible for the EITC, the taxpayer must have a "qualifying child". In order to be a qualifying child, an individual must satisfy a relationship test, a residency test, and an age test. The relationship test requires that the individual be a child, stepchild, a descendent of a child, or a foster or adopted child of the taxpayer. The residency test requires the individual have the same place of abode as the taxpayer for more than half the taxable year. This household must be located in the United States. The age test requires that the individual be under 19 (24 for a full-time student) or be permanently and totally disabled.

In addition, there are two additional credits that are part of the EITC. A supplemental young child credit is available for qualifying children under the age of one year old. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same base as the ordinary EITC (the maximum credit for 1991 is \$357). A supplemental credit for health insurance costs is also provided for taxpayers who purchase health insurance policies that include coverage for qualifying children. The health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. It is computed on the same base as the ordinary EITC (the maximum credit for 1991 is \$428). The maximum credit available to a taxpayer is limited to the amount paid for the health insurance coverage.

To claim the EITC, the taxpayer must complete a separate schedule and attach it to his or her return. In addition, to claim the EITC, the taxpayer must supply the taxpayer identification number (Social Security number) for each qualifying child over the age of one year old.

Description of Proposal

The first part of the proposal would extend eligibility for the EITC to military personnel stationed overseas. For purposes of determining eligibility for the EITC, a member of the military stationed outside the United States on extended active duty would be considered as maintaining a household in the United States.

The second part of the proposal would value basic allowances for housing and subsistence (provided by the military) as earned income for purposes of computing the EITC and would provide information reports on these valuations to recipients on an annual basis. This increased information flow to military personnel would allow persons claiming the EITC to determine more accurately the actual amount of their earned income.

5. Extend tax deadline deferral rules to reservists and members of the National Guard that are not in combat zone

Present Law

Section 7508 suspends the period of time for performing various acts under the Internal Revenue Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, for any individual serving in the Armed Forces of the United States (or in support of the Armed Forces) in an area designated as a combat zone.

The designation of a combat zone must be made by the President in an Executive Order. The starting date and the termination date of combat also must be designated by Executive Order.

Pursuant to Treasury regulations, members of the Armed Forces outside the combat zone who perform military service in direct support of operations in the combat zone and under conditions that qualify such members for Hostile Fire Pay (as specifically defined) are deemed to have served in the combat zone during the period of such qualifying service. (Treas. Reg. sec 1.112-1(j)(1)).

On January 21, 1991, President Bush signed Executive Order 12744, designating the Persian Gulf Area as a combat zone. The designation was retroactive to January 17, 1991, and continues in effect until terminated by another Executive Order.

Description of Proposal

The proposal would extend the tax deadline deferral rules to all reservists and members of the National Guard who are ordered to active duty in connection with Operation Desert Shield or Desert Storm, regardless of where they actually serve.

6. Allow reservists and members of the National Guard to deduct certain expenses from adjusted gross income (S. 246)

Present Law

Taxpayers may generally deduct from gross income the ordinary and necessary expenses of carrying on a trade or business (sec. 162). Unreimbursed employee business expenses are allowed only as itemized deductions and are allowed only to the extent they exceed 2 percent of the taxpayer's adjusted gross income (sec. 67).

Description of S. 246

S. 246 would allow reservists and members of the National Guard to deduct from adjusted gross income certain expenses made in connection with their duties, without regard to whether or not they itemize deductions. Such expenses include (1) expenses of travel, meals, and lodging while away from home and (2) expenses of transportation and uniforms.

The bill would be effective for taxable years beginning after December 31, 1989.

7. Eliminate certain restrictions on rollover of gain on sale of principal residence for certain military personnel

Present Law

No gain is recognized on the sale of a personal residence to the extent that the amount of the adjusted sales price of the old residence is reinvested in a new residence within a specified period of time (sec. 1034). In general, this reinvestment must occur within a period beginning two years before the date of sale of the old residence and ending two years after that date.

Special rules apply to members of the Armed Forces of the United States. In general, the running of any time period in connection with the rollover of gain on the sale of a principal residence is suspended during any time the taxpayer serves on extended active duty after the date of sale of the old residence, except that this suspension does not extend beyond four years after the date the old residence is sold.

Two special rules also apply. The first special rule applies to members of the Armed Forces who either are stationed outside the United States or are required (after returning from a tour of duty outside the United States) to reside in on-base Government quarters pursuant to a determination by the Secretary of Defense that adequate off-base housing is not available at a remote base site. For these individuals, the suspension period does not expire before one year after the last day of being stationed outside the United States or of being required to live in qualified on-base housing, except that the suspension period does not extend beyond eight years (rather than four years) after the date the old residence is sold.

The second special rule applies to members of the Armed Forces serving in a combat zone designated by the President pursuant to section 112. The IRS has stated that the suspension of time provisions (under section 7508) that are triggered by the designation of a combat zone suspend the running of the period within which a new residence must be purchased (Rev. Rul. 69-343, 1969-1 C.B. 305). Thus, the period during which the taxpayer is in the combat zone, plus the next 180 days, is not considered in computing the applicable replacement period within which a new home must be purchased.

Description of Proposal

The proposal would eliminate two requirements from the special rule applicable to members of the Armed Forces who are required to reside in on-base Government quarters. It

would delete the restriction making this provision applicable only to those who have returned from a tour of duty outside the United States. It would also eliminate the requirement that the Secretary of Defense must determine that adequate off-base housing is not available at a remote base site. Thus, members of the Armed Forces who are required to reside in on-base Government quarters would be subject to no further restrictions in order to be eligible for the same rules as members of the Armed Forces who are stationed overseas.

B. Pension-Related Proposals

1. Allow penalty-free withdrawals from qualified retirement plans, annuities, and endowment contracts (S. 82 and S. 342)

Present Law

Under present law, early withdrawals from employer-sponsored retirement plans, individual retirement arrangements (IRAs), annuity contracts, and modified endowment contracts are generally subject to a 10-percent tax in addition to income tax (secs. 72(q), (t), and (v)). The 10-percent tax does not apply to distributions (1) made after attainment of age 59-1/2, (2) made on account of death or disability, or (3) in the form of substantially equal periodic payments over the life of the individual or the lives of the individual and his or her beneficiary. Certain other exceptions to the additional tax also apply depending on the type of arrangement from which the withdrawal is made.

Description of S. 82

S. 82 would waive the 10-percent additional tax in the case of distributions from employer-sponsored plans and IRAs made to a reservist or the spouse of a reservist who is ordered to active duty in connection with Operation Desert Shield. To qualify for the exception, the distribution must be received during the period of such active duty.

Description of S. 342

S. 342 would waive the 10-percent additional tax applicable to retirement plans, IRAs, annuity contracts, and modified endowment contracts in the case of distributions to persons who have performed active duty service in connection with Operation Desert Shield or Desert Storm. To qualify for the exception, the distribution must be received during the period beginning on the date the individual first performs such active duty service and ending on the date which is 180 days after the termination of such service. The provision would apply to distributions after August 1, 1990.

2. Permit rollovers of military separation pay (S. 252)

Present Law

Present law provides for payments to officers and enlisted personnel upon involuntary separation from the armed services (10 U.S.C. sec. 1174). In general, such payments can be made to persons who have at least 6 and no more than 20 years of service in the military.² The amount of the payments is determined under one of the following formulas: (1) 10 percent of the product of (a) the individual's years

of service and (b) 12 times the individual's monthly basic pay at time of discharge; or (2) one-half of such amount. The formula used depends on the status of the individual and determinations made by the Secretary of Defense.

Separation payments are generally includible in gross income when received.

Under present law, certain distributions from qualified pension plans, qualified annuities, and tax-sheltered annuities may be rolled over to an IRA. Amounts that are rolled over are includible in gross income when withdrawn from the IRA and may also be subject to the 10-percent early withdrawal tax. In order to qualify for such treatment, the rollover must be made within 60 days of receipt of the distribution. Present law does not provide for the tax-free rollover of other payments (such as severance pay).

Description of S. 252

S. 252 would permit military separation pay (as defined in 10 U.S.C. 1174) to be contributed to an IRA. The contribution would be treated the same as a rollover of a distribution from a qualified pension plan. Thus, such amounts (and income thereon) would be includible in gross income when withdrawn. The 10-percent early withdrawal tax would apply to withdrawals of such amounts the same as it applies to other IRA withdrawals. The proposal would apply to pay received after December 31, 1990.

3. Provide that Desert Shield or Desert Storm service does not cause a break in service

Present Law³

In general, all years of service with an employer must be taken into account under a qualified pension plan in determining whether the employee meets the requirements for participation in the plan and in determining if the employee has a vested right to pension benefits. No credit need be provided, however, for periods during which an employee is considered to have a break in service. In some cases, an employee who returns to work for an employer after incurring a break in service may lose credit for pre-break service. A

² Payments may also be made in some cases to officers with at least 5 years of service.

³ This discussion relates only to the rules of the Internal Revenue Code. Other laws may also apply and may have more stringent requirements. A discussion of other laws is beyond the scope of this document.

plan may provide that a one-year break in service occurs in a 12-month measuring period in which the employee does not complete more than 500 hours of service.

In general, in the case of a nonvested participant, years of service with the employer maintaining the plan before any period of consecutive 1-year breaks in service are required to be taken into account after a break in service unless the number of consecutive 1-year breaks in service equals or exceeds the greater of (1) 5 or (2) the aggregate number of years of service before the consecutive 1-year breaks in service.

A plan may take into account service that is permitted to be disregarded under the break in service rules. A plan may also provide that a participant will not incur a break in service due to certain leaves of absence.

Description of Proposal

Under the proposal, absences from work due to active duty service in connection with Operation Desert Shield or Desert Storm could not be taken into account in determining whether an individual has had a break in service.

4. Permit Desert Shield and Desert Storm service to be taken into account for qualified plan purposes

Present Law⁴

Present law provides rules for determining years of service that are required to be taken into account for participation, vesting, and benefit accrual purposes. In general, these rules do not require that military service or periods in which the participant is on a leave of absence be taken into account.

Present law contains limitations on the contributions and benefits that are payable from a qualified pension plan. In the case of a defined benefit plan, the maximum annual benefit payable under the plan is the lesser of \$102,582 (for 1991) and 100 percent of the individual's average compensation for his or her highest 3 years. In the case of a defined contribution plan, the maximum annual additions that can be made on behalf of a participant is the lesser of \$30,000 or 25 percent of the participant's compensation for the year. A combined limit applies to individuals who

⁴ This discussion relates only to the rules of the Internal Revenue Code. Other laws may also apply and may have more stringent requirements. A discussion of other laws is beyond the scope of this document.

participate in a defined benefit plan and a defined contribution plan maintained by the same employer.

Under a special rule for defined contribution plans, the plan may provide that in the case of someone who is permanently and totally disabled and not a highly compensated employee compensation means the compensation the participant would have received for the year if the participant was paid at his or her rate of compensation immediately before becoming disabled. This rule applies only if the contributions made with respect to such compensation are nonforfeitable when made.

Description of Proposal

The proposal would clarify that service in connection with Operation Desert Shield or Desert Storm may be taken into account for all purposes under the plan. In addition, the proposal would permit compensation to be imputed during periods while the participant is in Desert Shield Service under rules similar to the present-law rule for disability.