

**TECHNICAL EXPLANATION OF H.R. 1307,
THE “ARMED FORCES TAX FAIRNESS ACT OF 2003,”
AS PASSED BY THE HOUSE OF REPRESENTATIVES**

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of the
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INTRODUCTION

This document¹, prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of H.R. 1307, the “Armed Forces Tax Fairness Act of 2003,” as passed by the House of Representatives.

¹ This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of H.R. 1307, the “Armed Forces Tax Fairness Act of 2003,” as Passed by the House of Representatives* (JCX-19-03), March 19, 2003.

EXPLANATION OF THE BILL

A. Exclusion of Gain on Sale of a Principal Residence by a Member of the Uniformed Services (sec. 2 of the bill and sec. 121 of the Code)

Present Law

Under present law, an individual taxpayer may exclude up to \$250,000 (\$500,000, if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the \$250,000 (\$500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to members of the uniformed services or the Foreign Service of the United States.

Explanation of Provision

Under the bill, an individual may elect to suspend for a maximum of five years the five-year test period for ownership and use during certain absences due to service in the uniformed services. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to five years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services. For these purposes, qualified official extended duty is any period of extended duty by a member of the uniformed services while serving at a place of duty at least 150 miles away from the taxpayer's principal residence or under orders compelling residence in Government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 180 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Effective Date

The provision is effective for sales or exchanges after May 6, 1997.

**B. Exclusion from Gross Income of Certain Death Gratuity Payments
(sec. 3 of the bill and sec. 134 of the Code)**

Present Law

Present law provides that qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) which: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income. Qualified military benefits include certain death gratuities. The amount of the death gratuity military benefit was increased to \$6,000 but the amount of the exclusion from gross income was not increased to take into account this change.

Explanation of Provision

The bill extends the exclusion from gross income to any adjustment to the amount of the death gratuity payable under Chapter 75 of Title 10 of the United States Code that is pursuant to a provision of law enacted before December 31, 1991, with respect to the death of certain members of the Armed services on active duty, inactive duty training, or engaged in authorized travel. Therefore the amount of the exclusion is increased to \$6,000.

Effective Date

The provision is effective with respect to deaths occurring after September 10, 2001.

**C. Exclusion for Amounts Received Under Department
of Defense Homeowners Assistance Program
(sec. 4 of the bill and sec. 132 of the Code)**

Present Law

HAP payment

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 military base realignment or closure. The payments are authorized under the provisions of Title 42 U.S.C. section 3374.

In general, under HAP eligible individuals either (1) receive a cash payment as compensation for losses that may be or have been sustained in a private sale, in an amount not to exceed the difference between (a) 95 percent of the fair market value of their property prior to public announcement of intention to close all or part of the military base or installation and (b) the fair market value of such property at the time of the sale, or (2) as the purchase price for their property, an amount not to exceed 90 percent of the prior fair market value as is determined by the Secretary of Defense, or the amount of the outstanding mortgages.

Tax treatment

Unless specifically excluded, gross income for Federal income tax purposes includes all income from whatever source derived. Amounts received under HAP are received in connection with the performance of services. These amounts are includible in gross income as compensation for services to the extent such payments exceed the fair market value of the property relinquished in exchange for such payments. Additionally, such payments are wages for Federal Insurance Contributions Act (“FICA”) tax purposes (including Medicare).

Explanation of Provision

The bill generally exempts from gross income amounts received under the HAP (as in effect on the date of enactment of this bill). Amounts received under the program also are not considered wages for FICA tax purposes (including Medicare). The excludable amount is limited to the reduction in the fair market value of property.

Effective Date

The provision is effective for payments made after the date of enactment.

D. Expansion of Combat Zone Filing Rules to Contingency Operations
(sec. 5 of the bill and sec. 7508 of the Code)

Present Law

General time limits for filing tax returns

Individuals generally must file their Federal income tax returns by April 15 of the year following the close of a taxable year. The Secretary may grant reasonable extensions of time for filing such returns. Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty on April 15 of the following year (the otherwise applicable due date of the return) outside the United States. No action is necessary to apply for this extension, but taxpayers must indicate on their returns (when filed) that they are claiming this extension. Unlike most extensions of time to file, this extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual timely filing that form and paying the amount of tax estimated to be due.

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

Suspension of time periods

In general, the period of time for performing various acts under the Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a “combat zone” during the period of combatant activities. An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspension of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. The President must also designate the period of combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the combat zone² or (2) time in missing in action status, plus the next 180 days.

² Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United States are applicable only to the hospitalized individual; they are not applicable to the spouse of such

The suspension of time applies to the following acts:

- (1) Filing any return of income, estate, or gift tax (except employment and withholding taxes);
- (2) Payment of any income, estate, or gift tax (except employment and withholding taxes);
- (3) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;
- (4) Allowance of a credit or refund of any tax;
- (5) Filing a claim for credit or refund of any tax;
- (6) Bringing suit upon any such claim for credit or refund;
- (7) Assessment of any tax;
- (8) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;
- (9) Collection of the amount of any liability in respect of any tax;
- (10) Bringing suit by the United States in respect of any liability in respect of any tax; and
- (11) Any other act required or permitted under the internal revenue laws specified by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension. Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

Explanation of Provision

The bill applies the special suspension of time period rules to 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 that becomes a contingency operation. A contingency operation is defined³ as a military operation that is

individual. Second, in no event do the suspension of time provisions based on continuous hospitalization inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

³ The definition is done by cross-reference to 10 U.S.C. 101.

designated by the Secretary of Defense as an operation 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 results in the call or order to (or retention on) active duty of members of the uniformed services during a war or a national emergency declared by the President or Congress.

Effective Date

The provision applies to any period for performing an act that has not expired before the date of enactment.

**E. Modification of Membership Requirement for Exemption
from Tax for Certain Veterans' Organizations
(sec. 6 of the bill and sec. 501(c)(19) of the Code)**

Present Law

Under present law, a veterans' organization as described in section 501(c)(19) of the Code generally is exempt from taxation. The Code defines such an organization as a post or organization of past or present members of the Armed Forces of the United States: (1) that is organized in the United States or any of its possessions; (2) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and (3) that meets certain membership requirements. The membership requirements are that (1) at least 75 percent of the organization's members are past or present members of the Armed Forces of the United States, and (2) substantially all of the remaining members are cadets or are spouses, widows, or widowers of past or present members of the Armed Forces of the United States or of cadets. No more than 2.5 percent of an organization's total members may consist of individuals who are not veterans, cadets, or spouses, widows, or widowers of such individuals.

Contributions to an organization described in section 501(c)(19) may be deductible for Federal income or gift tax purposes if the organization is a post or organization of war veterans.

Explanation of Provision

The bill permits ancestors or lineal descendants of past or present members of the Armed Forces of the United States or of cadets to qualify as members for purposes of the "substantially all" test. The bill does not change the requirement that 75 percent of the organization's members must be past or present members of the Armed Forces of the United States.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

**F. Clarification of Treatment of Certain Dependent Care Assistance Programs
Provided to Members of the Uniformed Services of the United States
(sec. 7 of the bill and sec. 134 of the Code)**

Present Law

Present law provides that qualified military benefits are not included in gross income. Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) which: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date. Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income.

Explanation of Provision

The bill clarifies that dependent care assistance provided under a dependent care assistance program (as in effect on the date of enactment of this bill) for a member of the uniformed services by reason of such member's status or service as a member of the uniformed services is excludable from gross income as a qualified military benefit subject to the present-law rules. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. Amounts received under the program also are not considered wages for Federal Insurance Contributions Act tax purposes (including Medicare).

Effective Date

The provision is effective for taxable years beginning after December 31, 2002. No inference is intended as to the tax treatment of such amounts for prior taxable years.

**G. Treatment of Service Academy Appointments as Scholarships
for Purposes of Qualified Tuition Programs and
Coverdell Education Savings Accounts
(sec. 8 of the bill and secs. 529 and 530 of the Code)**

Present Law

The Code provides tax-exempt status to qualified tuition programs, meaning programs established and maintained by a State or agency or instrumentality thereof or by one or more eligible educational institutions under which a person (1) may purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or (2) in the case of a program established by and maintained by a State or agency or instrumentality thereof, may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account. Contributions to qualified tuition programs may be made only in cash. Qualified tuition programs must have adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of amounts necessary to provide for the qualified higher education expenses of the beneficiary.

The Code provides tax-exempt status to Coverdell education savings accounts (“ESAs”), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified education expenses of a designated beneficiary. Contributions to ESAs may be made only in cash. Annual contributions to ESAs may not exceed \$2,000 per beneficiary (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18.

Earnings on contributions to an ESA or a qualified tuition program generally are subject to tax when withdrawn. However, distributions from an ESA or qualified tuition program are excludable from the gross income of the distributee to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made.

If the qualified education expenses of the beneficiary for the year are less than the total amount of the distribution from an ESA or qualified tuition program, then the qualified education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. In such a case, only a portion of the earnings is excludable (i.e., the portion of the earnings based on the ratio that the qualified education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary’s gross income.

The earnings portion of a distribution from an ESA or a qualified tuition program that is includible in income is generally subject to an additional 10 percent tax. The 10 percent additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary (to the extent it does not exceed the amount of the scholarship).

Service obligations are required of recipients of appointments to the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy. Because of these service obligations, appointments to the Academies are not considered scholarships for purposes of the waiver of the additional 10 percent tax on withdrawals from ESAs and qualified tuition programs that are not used for qualified education purposes.

Explanation of Provision

The bill permits penalty-free withdrawals from Coverdell education savings accounts and qualified tuition programs made on account of the attendance of the beneficiary at the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy.

The amount of funds that can be withdrawn penalty free is limited to the costs of advanced education as defined in 10 United States Code section 2005(e)(3) (as in effect on the date of the enactment of the bill) at such Academies.

Effective Date

The provision applies to taxable years beginning after December 31, 2002.

**H. Above-the-Line Deduction for Overnight Travel Expenses
of National Guard and Reserve Members
(sec. 9 of the bill and sec. 162 of the Code)**

Present Law

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. These overnight travel expenses are combined with other miscellaneous itemized deductions on Schedule A of the individual's income tax return and are deductible only to the extent that the aggregate of these deductions exceeds two percent of the taxpayer's adjusted gross income. No deduction is generally permitted for commuting expenses to and from drill meetings.

Explanation of Provision

The bill provides an above-the-line deduction 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. Accordingly, these individuals incurring these expenses can deduct them from gross income regardless of whether they itemize their deductions. The amount of the expenses that may be deducted may not exceed \$1,500 for any period during which the individual is more than 100 miles from home in connection with such services.

Effective Date

The provision is effective with respect to amounts paid or incurred after December 31, 2002.

**I. No Impact on Social Security Trust Funds Under Title II of the Social Security Act
(sec. 10 of the bill)**

Present Law

Present law provides for the transfer of Social Security taxes and certain self-employment taxes to the Social Security trust funds. In addition, the income tax collected with respect to a portion of Social Security benefits included in gross income is transferred to the Social Security trust funds.

Explanation of Provision

The bill provides that any amounts to be transferred to any trust fund under Title II of the Social Security Act are determined as if this bill has not been enacted. This will ensure that the income and balances of those Social Security trust funds are not reduced as a result of this bill.

Effective Date

The provision is effective on the date of enactment.