Module X: Understanding Taxes

***Summary**: An income tax was first employed in the United States during the Civil War. Although many, including the Secretary of the Treasury, desired longer retention of the Civil War income taxes, these taxes were widely viewed as emergency measures and were repealed in 1872. America did not see another income tax until just before World War I. Federal taxes on individual earnings date back to 1913 when Congress passed the 16th Amendment stating:*

> *"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."*

Who does this tax law affect? Well, if you earn a paycheck from an employer, it affects you. If you earn your money from investments, rental income, interest distributed on savings and checking accounts, then it affects you. This module will discuss what types of military pay and allowances are and are not taxable, how withholding works, which tax form to use, how not to get audited, and other miscellaneous issues related to understanding taxes.

Some Do Not Qualify to Pay Taxes

People earning a minimal income do not have to file a tax return. To see if you qualify due to minimal earnings please refer to Table below:

Marital Status	**Filing Status**	**Age**	**Gross Income**
Single (Divorced/Legally Separated)	Single	<65	$7,450
		65 and older	$8,550
	Head of Household	<65	$9,550
		65 and older	$10,650
Married, with a child, living apart from your spouse during the last 6 months of 2001	Head of Household	<65	$9,550
		65 and older	$10,650
Married, living with your spouse at end of 2001 (or on the date your spouse died)	Married, joint return	<65 (Both Spouses)	$13,400
		65 and older (One Spouse)	$14,300

		65 and older (Both Spouses)	$15,200
	Married, separate return	Any Age	$2,900
Married, not living with your spouse at end of 2001 (or on the date you spouse died)	Married (Joint or Separate)	Any Age	$2,900
Widowed before 2000 and not remarried in 2000	Single	<65	$7,450
		65 and older	$8,550
	Head of Household	<65	$9,550
		65 and older	$10,650
	Qualifying Widow(er) with dependent child	<65	$10,500
		65 and older	$11,400

Table: 2001 Filing Requirements for Most Taxpayers

How Military Pay is Affected by Taxes

Some money received by military personnel is taxed by the federal government and some money is not taxed. These differences are listed in the table below:

TAXABLE	NON-TAXABLE
Base Pay Hazardous Duty Pay *Hostile Fire/Imminent Danger Pay Separation Pay Severance Pay Readjustment Pay Contract Cancellation Pay Reenlistment Bonus Do-IT-Yourself Moves Employer Provided Home-to-Work Transportation Any Special Pay Any Lump Sum Payment	Basic Allowance for Subsistence Basic Allowance for Housing Cost Of Living Allowance Family Separation Allowance Clothing and Uniform Allowances Overseas Stations Allowances

*No pay is taxable when you are in a combat zone designated for Combat Zone Tax Exclusion (CZTE), within limitations. If Hostile Fire/Imminent Danger Pay (HFP/IDP) is earned in a CZTE designated area, then all pay within the established pay limit (Sergeant Major of the Army Basic Pay plus $150) is not taxed. Currently, all downrange locations, with the exception of Taszar Hungary, are considered CZTE areas. You will have to check with your local finance unit to verify if you are or are not in a combat zone.

To read more about taxable and non-taxable military pay and allowances please visit the Finance Management Regulations web site at http://www.dtic.mil/comptroller/fmr. Find volume 7A and look under chapter 44, Withholding Income Tax.

State Income Taxes

Now, just a short note on state income tax. There are 50 different state taxes. Some states, like Florida and Texas, do not have a state income tax. Instead, they fund various activities through a state lottery, sales tax, or property tax, etc. There are other states, like New York and Virginia that tax an individual all the way down to the city level. Additionally, there are states, like West Virginia, that have a state income tax but do not tax military personnel while they are on active duty. You will have to find out how your state of legal residence taxes your income. Many states, like Minnesota, have a web site for their respective Department of Revenue where you can receive assistance on your state taxes. For example, Minnesota's web site is http://www.taxes.state.mn.us. Remember, if you have questions you can always talk to your JAG officer or unit tax advisor.

Federal Income Tax Withholding

Every soldier has taxes withheld from his/her paycheck every month. This is called Federal Income Tax Withholding and shows up as "FITW" on your LES in the Deductions column. The tax return that we file by April 15 each year is only a settlement of taxes we owe the government if we have not had enough withheld each month. We can also receive a refund of taxes paid in the event that we have withheld too much during the course of the year. There are two different schools of thought on how much you should have taken out of your paycheck on a monthly basis. First, there are those people who want to have large amounts of money taken out of their paycheck each month so they will get a big refund when they file their taxes on April 15. Second, there are those people who want the least amount of money, that the government, will allow taken out of their paycheck each month. Whichever way you decide is best for you, you must at least stay within federal guidelines, which state that you must have 90% of your tax liability paid by December 31, or you must have paid at least what your tax liability was for the previous year by December 31. Taxpayers who fail to meet this requirement will most likely have to pay a penalty to the IRS. The following provides an example:

Example:

1) If SPC Sniff made $20,000 in taxable income for 2000 and his tax liability is $1,054, then he must have paid at least $948.60 by 31 December 2001; OR

2) If SPC Sniff made $15,000 in 2000 and paid $574 in taxes and he made $20,000 for 2001 but has no idea what his tax liability will be for 2001, then he must pay at least last year's tax liability, which in this case is $574, by 31 December 2001.

Your choice for monthly withholding varies with each individual. They are simply: 1) Married or Single and 2) the number of withholding allowances (typically the number of dependents) you can claim. If a married soldier has three children, then he/she can claim M5 (this means married with 5 dependents including himself/herself) to have the least amount of taxes taken out of his/her paycheck each month. Or, this soldier can claim as low as S0 (single with 0 dependents) and have many more taxes taken out of his/her check each month to ensure a larger tax return on April 15 when he/she files next year. You can designate/change your withholding by submitting IRS Form W4 to your servicing finance unit. If you have trouble deciding how much you need withheld from your check each month, please see your tax advisor.

Generally, all income is subject to Federal Income Tax Withholding. Individuals who are self-employed, or work from their home earn income that is not subject to withholding and will have to file an Estimated Tax each quarter. If this applies to you and you or your spouse earn income that is not subject to withholding, then please see your tax advisor about how much you should pay throughout the year.

Which Tax Forms to Use

The three basic tax forms are: 1) Form 1040EZ; 2) Form 1040A; 3) Form 1040. With so many choices, how are you to decide which one is right for you? Let's explore.

Form 1040EZ. You can use Form 1040EZ if all of the following apply:

- Your filing status is single or married filing jointly. If you were a nonresident alien at any time in 2001, your filing status must be married filing jointly.
- You (and your spouse if married filing a joint return) were under age 65 on January 1, 2001, and not blind at the end of 2001.
- You do not claim any dependents.
- Your taxable income is less than $50,000.
- Your income is only from wages, salaries, tips, unemployment compensation, Alaska Permanent Fund dividends, taxable scholarship and fellowship grants, qualified state tuition program earnings, and taxable interest of $400 or less.
- You did not receive any advance earned income credit (EIC) payments.
- You do not claim any adjustments to income, such as deduction for IRA contributions or student loan interest.
- You do not claim any credits other than earned income credit.

You must meet all of these requirements to use Form 1040EZ. If you do not, you must use Form 1040A or Form 1040.

Form 1040A. You can use Form 1040A if all of the following apply:

- Your income is only from wages, salaries, tips, IRA distributions, pensions and annuities, taxable social security and railroad retirement benefits, taxable scholarship and fellowship grants, interest, ordinary dividends (including Alaska Permanent Fund dividends), capital gain distributions, qualified state tuition program earnings, and unemployment compensation.
- Your taxable income is less than $50,000.
- Your adjustments to income are for on the following items: A) The deduction for contributions to an IRA B) The student loan interest deduction.
- You do not itemize your deductions.
- Your taxes are from only the following:
    - Tax table.
    - Alternative minimum tax.
    - Advance earned income credit (EIC) payments, if you received any.
    - Recapture of an education credit.
    - Form 8615, Tax for Children Under Age 14 Who Have Investment Income of More Than $1,400.
    - Capital Gain Tax Worksheet.
- You can claim only the following credits:

- The credit for child and dependent care expenses.
- The credit for the elderly or the disabled.
- The child tax credit.
- The additional child tax credit.
- The education credits.
- The earned income credit.
- The adoption credit.

You must meet all of the above requirements to use Form 1040A. If you do not, you must use Form 1040 (Tax Publication 17, Chapter 1).

Form 1040. If you cannot use Form 1040EZ or Form 1040A, you must use Form 1040. You can use Form 1040 to report all types of income, deductions, and credits, including those you cannot put on either of the two forms mentioned above.

You may have received a Form 1040A or Form 1040EZ in the mail because of the return you filed last year. If your situation changed this year, it may be to your advantage to file Form 1040 instead. You may pay less tax by filing Form 1040 because you can take itemized deductions, some adjustments to income, and credits you cannot take on Form 1040EZ or Form 1040A.

Itemizing a Tax Return

Should you itemize your deductions? Or, should you just be happy with the standard deduction that Uncle Sam gives you? Conventional wisdom says that unless you have property to deduct on your taxes, you will want to stick with the standard deduction. There are numerous things that you, as a soldier, may deduct from your taxes. If you make the decision to itemize, you will most certainly want to seek the aid of a trained professional. One of the quickest ways to find yourself being audited by the IRS is to claim a whole bunch of nonsense deductions that do not even qualify as deductions.

What can you, as a soldier, itemize on you tax return? You can itemize moving expenses. However, you must make sure you keep all of your receipts. There is no such thing as the IRS not needing a receipt if your expense is below a certain amount. You can also itemize (this list is not all inclusive):

- Uniform maintenance (dry cleaning expenses, Kiwi purchased for boots, etc.)
- Expenses for work (if you have had to purchase something for work that the military did not reimburse you for)
- Tax preparation fees (incurred in the year you are filing for, i.e. you file for 2000 taxes in 2001 you may claim tax preparation fees incurred in 2000, not 2001)
- Donations and charitable contributions (to religious organizations, AER, CFC, United Way, etc.)
- Property and real estate tax and mortgage interest
- State taxes (but you will have to report your state refund as income)
- Medical and dental expenses that are more than 7.5% of your gross income

If you have a question on what does or does not qualify as a deduction, please ask your tax advisor.

Will I be Audited?

There aren't necessarily any tricks to the trade on how to avoid getting an audit on your tax return. But there are a couple of hints that might help you. First and foremost, be **honest** on your return. Second, make sure you file on time. Third, don't file anything unreasonable. Last, but not least, be very careful when you file expenses for travel. This last one will get you audited quicker than anything. Examples of people who fall in this category are those who have their own business requiring them to do a lot of traveling.

In the event that you are audited, you should keep immaculate records. Make a copy of everything you provide the IRS and keep records for anything that you claim on your tax return. If you claim dividend income from the interest on your checking or savings account on a 1099-DIV Form that your financial institution gives you, then keep a copy of it with your copy of your return. If you file electronically, make sure you print out a copy and keep that paper copy in your personal files. As a rule of thumb you should keep your records going back seven years.

Other Notes on Filing Your Tax Return

Alternative filing methods. Rather than filing a return on paper, you may be able to file electronically using IRS E-file.

Extensions of time to file. The two rules under which you may be able to get an extension of time to file your return are: 1) you live outside the United States; 2) you were serving in a combat zone. If you live outside the United States, you are allowed an automatic 2-month extension (until June 15th) to file your 2001 return and pay any federal income tax due. However, this does not relieve you of interest penalties incurred on taxes not paid by the deadline of April 15th. If you are serving in a combat zone (including Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of the Armed Forces) on the day of the deadline you get an automatic extension to file, to pay any taxes you may owe, and claim a refund, if one is due to you. The new deadline for individuals serving in a combat zone is 180 days after their last day in the combat zone, or the last day of any continuous qualified hospitalization for injury from service in the combat zone.

Your Social Security Number. You must write your social security number (SSN) in the spaces provided on your tax return. If you file a joint return, write the SSNs in the same order as the names.

Direct deposit of refund. Instead of getting a paper check, you can have your refund deposited directly into your account at a bank or other financial institution.

Alternative payment methods. If you owe additional tax, you may be able to pay electronically.

Installment agreement. If you cannot pay the full amount due with your return, you may ask to make monthly installment payments.

Service in a combat zone. You are allowed extra time to take care of tax matters if you are a member of the Armed Forces who served in a combat zone, or if you served in the combat zone in support of the Armed Forces.

Adoption taxpayer identification number. If a child has been placed in your home for purposes of legal adoption and you will not be able to get a social security number (SSN) for the child in time to file your return, you may be able to get an adoption taxpayer identification number (ATIN).

Soldiers can overcome the complexity of taxes if they adhere to the guidance published annually by the IRS. Read the booklet that the IRS provides for filing the return that is appropriate for you (i.e. Form 1040EZ, Form 1040A, or Form 1040) and follow its instructions line by line. If you encounter problems on any particular area, the military provides a tax service that is run by your JAG office on your installation at no charge to the service member. Good luck, happy filing, and may there be many "Happy Returns" in your future.

Recommended References

Tax Publication 17, Your Federal Income Tax for Individuals
Tax Publication 3, Armed Forces Tax Guide
Tax Publication 54, Tax Guide for US citizens and Resident Aliens Abroad
DODFMR Vol. 7a, Military Pay Policy and Procedures – Active Duty and Reserve Pay

Note: You may check out the IRS's web site for detailed information that may help you file your return this year and every year at http://www.irs.gov.