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United States General Accounting Office
Washington, DC 20548

May 7, 2004

The Honorable Charles E. Grassley
Chairman
The Honorable Max S. Baucus
Ranking Minority Member
Committee on Finance
United States Senate

The Honorable Mark Pryor
United States Senate

Subject: *Military Personnel: Active Duty Compensation and Its Tax Treatment*

The Department of Defense's (DOD) total military compensation package for active duty members consists of both cash and noncash benefits. Since the late 1990s, Congress and the DOD have increased military cash compensation by increasing basic pay and allowances for housing, among other things. Military members also receive tax breaks, which are a part of their cash compensation. Moreover, active duty personnel are offered substantial noncash benefits, such as retirement, health care, commissaries, and childcare. In some cases, these noncash benefits exceed those available to private-sector personnel.¹ DOD relies heavily on noncash benefits because it views benefits as critical to morale, retention, and the quality of life for service members and their families.

To better understand the military compensation system, you asked us to provide you information on active duty military compensation and its tax treatment. At the outset of this engagement, we agreed to keep you periodically informed of the status of our work. In January 2004, we briefed your staff on our preliminary observations. Because our work identified that the combat zone tax exclusion² could impact some service members, you asked us to focus our work on military cash compensation and to do additional work to estimate the effect of the combat zone tax exclusion on service members' compensation. We provided your staff subsequent briefings that estimated the effect of the combat zone exclusion. As requested, we have updated and combined the briefings for this report to (1) summarize active duty cash compensation and describe how military compensation varies at different career

¹ U.S. General Accounting Office, *Military Personnel: Active Duty Benefits Reflect Changing Demographics, but Opportunities Exist to Improve*, [GAO-02-935](#) (Washington, D.C.: Sept. 18, 2002).

² The combat zone exclusion allows service members to exclude income earned for each month served in one of the 15 designated combat zones. Members who serve a minimum of 1 day in a combat zone are eligible to receive the combat zone exclusion for the respective month. For officers, the combat zone exclusion was limited to \$5,958 per month in 2003. Enlisted members' exclusion is not limited.

points for officers and enlisted members; (2) explain how military pay is taxed and any special tax treatment of military compensation; (3) estimate the effects of interactions between the combat zone exclusion and certain tax credits on military members' compensation; and (4) describe the benefits DOD provides active duty members as well as specific programs available to members that encourage wealth building (see enclosure I). To provide a rough estimate of the number of service members in 2003 who suffered a net tax loss because of the interactions between serving in a combat zone and certain tax credits, we used aggregate data compiled by the Defense Manpower Data Center on the number of members who served in a combat zone in 2003 and aggregate data on the percentage of spouses not in the workforce from the 2002 Active Duty Survey. We believe that the data is sufficiently reliable to estimate within a broad range the number of people affected. We conducted our review from October 2003 through April 2004 in accordance with generally accepted government auditing standards.

Results in Brief

The foundation of military cash compensation is what the DOD calls regular military compensation—the sum of basic pay, nontaxable allowances for housing and subsistence, and the associated federal tax savings. Some members also receive additional cash compensation in the form of special pays, incentives, and other allowances. In total, there are over 50 of these pays, incentives, and allowances, ranging from reenlistment bonuses to clothing allowances and family separation allowances. The annual amounts of these pays, incentives, and allowances range from a few hundred dollars to thousands of dollars, and some of these are also nontaxable. In general, regular military compensation progresses steadily with pay grade and years of service. For example, a junior enlisted member with 3 years of service might earn around \$40,000 in cash compensation, while a senior officer with 22 years of service could earn cash compensation of about \$130,000.

Military service brings with it significant tax advantages. Basic pay and most other pays are generally subject to federal income tax; however, certain allowances are not taxed, such as the basic allowances for housing and subsistence.³ DOD considers the federal tax advantage as the additional income military members would have to earn in order to receive their current take-home pay if their allowances for housing and subsistence were taxable. In fact, DOD views the federal tax advantage as part of service members' cash compensation when it compares military pay with civilian pay. In addition, pay earned—including basic pay, bonuses, special pays, and allowances—while members are serving in one of the 15 designated combat zones is excluded from taxes.

The complex interactions between the combat zone exclusion and certain tax credits (principally the Earned Income Tax Credit and the Additional Child Tax Credit) appear to be creating unintended consequences. Specifically, some low-income-

³ Although the allowances for housing and subsistence are the primary nontaxable allowances and account for most of service members' tax benefit, some members may receive other nontaxable allowances, such as the family separation allowance—that is, additional money provided to service members as compensation for being away from their spouses and/or children.

earning service members who serve in a combat zone are worse off for tax purposes, while some higher-income-earning members are better off because they become eligible for a tax credit that is normally targeted to low-income workers. Low-income members with children qualify for refundable tax credits that can not only offset all of their tax liability but can also leave them with payments from the government. The combat zone exclusion can actually cause a reduction or elimination of these payments to some service members. For example, over certain income ranges the amount of Earned Income Tax Credit that a taxpayer earns increases as his or her income increases. Service in a combat zone reduces the amount of earned income that a member reports for tax purposes and, thus, can reduce or eliminate the refunded portion of the member's credit. These members actually suffer a net loss in tax benefits because they receive no offsetting advantage from the exclusion. Our analysis suggests that some of the roughly 430,000 members serving in a combat zone in 2003—between 5,000 and 10,000 members in one-earner households—suffered a net loss of tax benefits.⁴ Data limitations make it difficult to produce a comprehensive estimate of the number of members who suffered a net loss of tax benefits. In particular, it is more difficult to make a reliable estimate of the number of members with working spouses who had net losses of tax benefits. However, we believe that number is not likely to be much higher than several thousand and could be less than that. Additionally, the number of members losing tax benefits could be larger in 2004 depending on the how many service members are in a combat zone and how long they are there. The amount of the tax benefit loss varies considerably, with a maximum of about \$4,500 or \$3,200, for enlisted and officer members, respectively. In general, the members losing tax benefits tend to be those who are serving in a combat zone longer than 6 months; who are in the lower pay grades; who are married with children; and who have little to no investment or spousal income. On the other hand, some other low-income members earned larger earned income tax credits by serving in a combat zone than they otherwise would have. Moreover, it appears that a large number of service members who had incomes exceeding the normal upper limit for Earned Income Tax Credit eligibility and who served in a combat zone for at least 6 months could become eligible to receive that credit as a result of this income exclusion. DOD is aware of service members who are disadvantaged and advantaged by these tax provisions, and it is seeking remedies that would require changing the rules of the tax credits so that income earned in a combat zone would not be excluded when calculating eligibility for the tax credits.

Benefits are a substantial portion of noncash military compensation. DOD offers a wide range of benefits to active duty members, including health care, retirement, education assistance, and installation-based benefits—that is, services found on military installations, such as commissaries and child care. While the value of benefits to members varies depending on the members' needs, the cost to provide such benefits is substantial.⁵ Some of the benefits DOD provides encourage wealth

⁴ Our estimates are based on information provided by DOD on the number of households with a spouse not in the labor force, the amount of military members' pay, and the 2003 deployment rates. They are also based on the assumption that deployed personnel in each pay grade have the same household characteristics as the total population of service members in each grade. These estimates are imprecise because we did not have information such as total family income, deductions, and other tax credits. See enclosure II for further details on our methodology.

⁵ According to a recent Congressional Budget Office report, noncash benefits in 2002 cost an average of \$56,000 per active duty service member. However, this cost includes noncash compensation that

building over a service member's career. Military retirement—a lifetime annuity generally provided to members who serve 20 years or more—is one of the primary wealth-building programs available to military members. However, DOD estimates that less than half of officers and only about 15 percent of enlisted members will become eligible for retirement. In addition, other savings programs are offered, such as the Thrift Savings Plan and the Savings Deposit Program. Since 2001, service members can contribute a percentage of their basic pay, before taxes, to be invested in one or more of the specific funds offered through the Thrift Savings Plan; about 21 percent of the active duty military participate. Service members deployed to a combat zone or other qualified areas can contribute to the Savings Deposit Program, earning a guaranteed 10 percent interest on their investment.⁶ However, less than 1 percent of the active duty force participates. Service members may also be eligible to participate in the Department of Veterans Affairs no-money down, mortgage-backed loan program. Moreover, military members can take advantage of a number of wealth-building tax provisions available to citizens, such as deductions for mortgage interest and tax credits for elective retirement accounts contributions.

Matter for Congressional Consideration

If the Congress wishes to remedy the unintended tax consequences associated with the combat zone exclusion, it should consider revising the rules of the Earned Income Tax Credit and the Additional Child Tax Credit with respect to income earned in a combat zone.

Scope and Methodology

Our audit work focused on military cash compensation and its tax treatment for active duty service members. To summarize the components of active duty military members' compensation, we reviewed policies, publications, and regulations governing military compensation. We interviewed officials from the Office of the Secretary of Defense and the Defense Manpower Data Center. We compiled 2003 data for basic pay tables, basic allowances for housing and subsistence rates, special pay amounts, incentive pay amounts, and allowance pay amounts. To describe how military compensation varies at different career points for officers and enlisted members, we created notional junior and senior enlisted service members and officers. We assigned these hypothetical service members typical years of service for their pay grades, locations across the United States, numbers of dependents, and special pays typical of their pay grades and locations. We discussed our examples with officials from the Office of the Under Secretary of Defense for Personnel and Readiness to ensure that our profiles were reasonable. We identified benefits offered to active duty military members and some associated values by reviewing past GAO reports, DOD documents, and the fiscal year 2002 DOD Actuarial Valuation Report.

service members receive while on active duty and estimated accrued cost of deferred compensation for the following noncash benefits: health care for service members, their dependents, and retirees; veterans' services; and other benefits, such as the Social Security Old-Age and Survivors Insurance and Disability Insurance programs. Also, this cost includes installation-based services for active duty members. Congressional Budget Office, *Military Compensation: Balancing Cash and Noncash Benefits* (Washington, D.C.: Jan. 16, 2004).

⁶ Members deployed to combat zones, qualified hazardous duty areas, or certain contingency operations are eligible to participate in the Savings Deposit Program.

To explain how military pay is taxed and any special tax treatment of military compensation, we reviewed DOD policies and regulations and the Internal Revenue Services' 2003 Armed Forces Tax Guide publication. To estimate the federal tax advantage of the exclusion of the housing and subsistence allowances from taxation, we estimated the tax liability for hypothetical members according to current tax rules as if the members' housing and subsistence allowances were taxable. We present the pre-tax value of this tax advantage—that is, the additional income the members would have to earn in order to receive their current take home pay if their allowances were taxable.

To estimate certain effects of the combat zone exclusion on military members' taxes, we estimated the number of members negatively affected and the number who may become eligible for Earned Income Tax Credit by the combat zone tax exclusion. For more detailed information on how we estimated the combat zone effect, see enclosure II.

To describe programs available to members that encourage wealth building, we reviewed documents and interviewed officials from the Office of the Secretary of Defense and the Department of Veterans Affairs. In addition, we also reviewed other documents to identify tax provisions that encourage wealth building for citizens.

Agency Comments

In providing oral comments on a draft of this report, DOD representatives from the Office of the Under Secretary of Defense for Personnel and Readiness stated that they generally concurred with the content of the report. Technical comments were incorporated as appropriate. DOD officials told us that they have been seeking to remedy the unintended tax consequence related to the combat zone tax exclusion. We also received comments on the tax-related sections of our draft from Internal Revenue Service (IRS). In providing oral comments, IRS representatives from the Office of the Commissioner, Wage and Investment Division and the Office of Legislative Affairs said that the IRS could administer a change in law that would include combat pay in earned income for purposes of computing eligibility for the Earned Income Tax Credit. Since earned income used for computing Earned Income Tax Credit is not reported anywhere on the IRS form 1040 or Schedule EIC, IRS would modify the Earned Income Tax Credit worksheets and related instructions to account for the combat zone pay. In addition, they would work with DOD to develop a process for identifying and processing returns from taxpayers who would be affected by this provision. The representatives noted that, although at the outset the process would likely be primarily manual, IRS would explore options for automation. The IRS officials also provided technical comments relating to the child tax credit, which we incorporated as appropriate, and made the point that changes to the treatment of income earned in a combat zone for the purposes of the two credits could affect other tax benefits, such as the dependent care credit and the exclusion for employer-provided benefits under a dependent care assistance program, depending on the specific wording of the changes. We also spoke to the Department of Treasury staff about the tax-related sections of our briefing documents and incorporated their technical comments as appropriate.

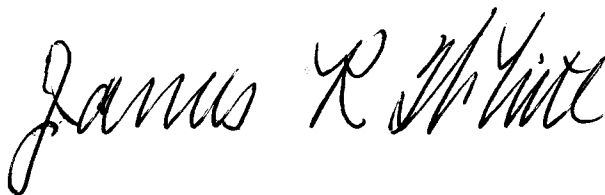
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As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies of this report to the Secretary of Defense and the Commissioner of the Internal Revenue Service. We will also make copies available to appropriate congressional committees and to other interested parties on request. In addition, the report will be available at no charge on our Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact Derek Stewart, (202) 512-5559, or James White, (202) 512-5594, or e-mail them at stewartd@gao.gov or whitej@gao.gov, respectively. Key contributors to this report were Lori Atkinson, Jennifer Gravelle, John Pendleton, Sonja Ware, and James Wozny.



Derek B. Stewart
Director, Defense Capabilities and Management



James R. White,
Director, Strategic Issues



Active Duty Military Compensation and Its Tax Treatment



Objectives

- Summarize the components of active duty military members' cash compensation and describe how military compensation varies at different career points for officers and enlisted members.
- Explain how military pay is taxed and any special tax treatment of military compensation.
- Estimate the effects of interactions between the combat zone exclusion and certain tax credits on military members' compensation.
- Describe the benefits the Department of Defense (DOD) provides active duty members as well as specific programs available to military members that encourage wealth building.



Results in Brief

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- The foundation of military cash compensation is what DOD calls “regular military compensation”—comprised of basic pay, allowances for housing and subsistence, and federal tax advantages. Some members also receive special pays, such as reenlistment bonuses, and other allowances. Military compensation progresses steadily with seniority. For example, a junior enlisted member with 3 years of service might earn around \$40,000 in cash compensation, while a senior officer with 22 years of service could earn cash compensation of about \$130,000 per year.
 - Basic pay and some other pays are taxed; however, certain allowances, such as those for housing and subsistence, are not taxed. Additionally, income earned—including special pays, bonuses, or allowances— while serving in a combat zone is not taxed.
 - Although most of the roughly 430,000 members who served in a combat zone in 2003 benefited from excluding their earned income for taxes, some lower-income members were actually worse off, because income earned in a combat zone does not count as earned income for purposes of calculating certain refundable credits
 - Between 5,000 and 10,000 members in one-earner households likely suffered a net loss of tax benefits by serving in a combat zone in 2003.
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Results in Brief, cont.

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- It is more difficult to estimate reliably the number of members with working spouses who lost tax benefits; however, we believe that number is not likely to be much higher than several thousand and could be less than that.
 - The size of the tax benefit loss varies considerably—the maximum is \$4,534 or \$3,229, for enlisted members and officers, respectively;
 - In general, the members losing tax benefits have served in a combat zone longer than 6 months, are in lower pay grades, are married with children, and earn little to no investment or spousal income.
 - Conversely, some other low-income members earn larger Earned Income Tax Credits than they otherwise would have by serving in a combat zone. Moreover, some members with incomes well above the normal cutoff for earned income credit eligibility become eligible for it when combat zone service reduces their earned income for tax purposes.
 - Benefits, such as health care and retirement, are a substantial portion of military compensation. DOD offers a wide range of benefits to members, including some that can assist military members in building wealth.
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Regular Military Compensation: Basic Pay

- Determined by a member’s rank and years of service. See table below for excerpts from the fiscal year 2003 pay chart.

Annual Basic Pay in Dollars

Pay grade	Years of service											
	<2	2	3	4	6	8	10	12	14	16	18	20
Officer-9	-	-	-	-	-	-	-	-	-	-	-	\$126,763
Officer-6	\$55,238	\$60,685	\$64,667	\$64,667	\$64,915	\$67,694	\$68,065	\$68,065	\$71,935	\$78,772	\$82,786	86,800
Officer-3	34,934	39,604	42,746	46,602	48,834	51,282	52,870	55,480	56,833	56,833	56,833	56,833
Enlisted-9	-	-	-	-	-	-	42,772	43,740	44,964	46,404	47,848	50,170
Enlisted-7	24,822	27,094	28,127	29,138	30,197	32,015	33,041	34,060	35,885	36,796	37,663	38,192
Enlisted-3	16,283	17,305	18,346	18,346	18,346	18,346	18,346	18,346	18,346	18,346	18,346	18,346

Source: DOD.



Regular Military Compensation: Basic Allowance for Housing

- All members receive a nontaxable allowance to offset the cost of renting civilian housing, unless they live in government-provided housing;
- Members' allowances depend on location, pay grade, and dependent status;
- Allowance accounts for about a quarter of regular military compensation.

Pay grade	Range of annual allowance in dollars	
	Without dependents	With dependents
Officer 1-10	\$5,532 – 35,064	\$6,336 – 41,292
Warrant officer 1-5	5,940 – 33,000	7,188 – 37,284
Enlisted 1-9	4,512 – 29,952	6,012 – 35,352

Source: DOD.

Related GAO product: U.S. General Accounting Office, *Military Personnel: Higher Allowances Should Increase Use of Civilian Housing, but Not Retention*, GAO-01-684 (Washington, D.C.: May 31, 2001). 6



Regular Military Compensation: Basic Allowance for Subsistence

- Nontaxable allowance intended to offset the cost of meals for members.
- All members receive an allowance for subsistence.

Pay grade	Annual allowance in dollars
Officer 1-10	\$2,006
Warrant officer 1-5	2,006
Enlisted 1-9	2,914

Source: DOD.



Special Pays, Incentives, and Other Allowances

Special Pays and Incentives

Examples:

- Flight Deck Duty
- Hostile Fire/Imminent Danger
- Aviation Career Incentive
- Career Enlisted Flyer Incentive
- Career Sea
- Medical Officers' Variable Special Pay
- Selective Reenlistment Bonus

Source: GAO analysis

Other Allowances

Examples:

- Family Separation Allowance*
- Uniform Allowance*
- Cost of Living Allowance
- Overseas Housing Allowance*
- Special Position Allowance
- Moving Allowance*

- There are over 50 special pays, incentives, and allowances;
- Annual payments can range from a few hundred dollars to \$30,000.

*Designates nontaxable allowance. However, any of these pays or allowances earned in a combat zone are generally nontaxable.

Related Product: United States General Accounting Office, *Military Personnel: DOD Needs More Effective Controls to Better Assess the Progress of the Selective Reenlistment Bonus Program*, GAO-04-86 (Washington, DC: Nov. 8, 2003).⁸



Cash Compensation for Notional Service Members

Compensation (Annual Amount in Dollars)	Enlisted-3	Enlisted-7	Officer-3	Officer-6
	-3 years of service -Camp Pendleton, California -Spouse and 1 child -Special pays: Imminent Danger and Family Separation Allowance	-14 years of service -Keesler Air Force Base, Mississippi -Spouse and 2 children -Special pays: Foreign Language Proficiency Selective Reenlistment Bonus	-6 years of service -Ft. Stewart, Georgia -Spouse and 3 children -Special pays: Parachute Jumping	-22 years of service -Washington, D.C. -Spouse and 1 child
Regular Military Compensation				
Basic pay	\$18,346	\$35,885	\$48,834	\$89,082
Basic housing allowance ¹	12,660	9,900	11,064	28,140
Basic subsistence allowance	2,914	2,914	2,006	2,006
Tax advantage from the two allowances ²	4,544	2,261	2,306	10,958
Regular military compensation	38,464	50,960	64,210	130,186
Special pays	3,000	9,632	1,800	0
Total cash compensation	\$41,464	\$60,592	\$66,010	\$130,186

Source: GAO analysis and DOD.

¹ We assume all members live off base in civilian housing; thus, they receive a housing allowance.

² These values vary significantly depending on spousal income, number of dependents, and other factors. We assumed no spousal income. The tax advantage for the enlisted-3 is relatively high because the allowances are not included in earned income for tax purposes, allowing that member to earn a larger earned income credit.



Federal Tax Benefits Specific to the Military

- The principal advantage for all military members is the exclusion of certain pay and allowances—particularly those for housing and subsistence—from taxable income.
- This tax advantage, as DOD considers it, is the additional income military personnel would have to earn in order to receive their current take-home pay if their allowances were taxable.
 - The value of such tax advantages varies significantly, depending on the many factors that determine the effective income tax rate of each military household.
- In addition, the income that members earn during each month in a combat zone is excluded from earned income for income tax purposes.¹

¹Members who serve a minimum of 1 day in a combat zone are eligible to receive the combat zone exclusion for the respective month. For officers, the combat zone exclusion was limited to \$5,958 per month in 2003. Wages earned in a combat zone are subject to social security and Medicare taxes.



Effects of the Combat Zone Exclusion

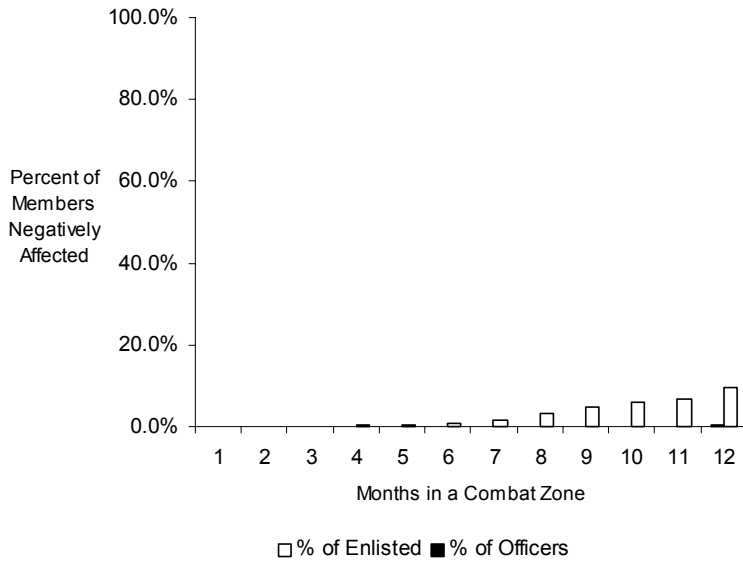
- Although most service members benefit from the combat zone exclusion, some members are actually disadvantaged by it.
 - Certain tax credits (principally the Earned Income Tax Credit and the Additional Child Tax Credit) are refundable, meaning that if a taxpayer's income is low enough, the credits not only offset all of that taxpayer's liability but can also leave him or her with a refund payment from the government.
 - But a service member who normally would receive one of these payments could actually have it reduced or eliminated due to service in a combat zone:¹
 - Over certain income ranges a taxpayer's refundable credits increase as his or her earned income increases.
 - Service in a combat zone reduces the amount of earned income that a member reports for tax purposes and, thus, can reduce or eliminate the refunded portion of the taxpayer's credit.
 - We refer to this effect as a net loss of tax benefits because these low-income members receive no offsetting advantage from the combat zone exclusion.
- Conversely, some other low-income members (whose incomes fall within the phase-out range of the credit) could earn larger earned income credits by serving in a combat zone than they otherwise would have.² Moreover, some members with incomes well above the normal cutoff for earned income credit eligibility become eligible for it when combat zone service reduces their earned income for tax purposes.

¹ In general, the members losing tax benefits have served in a combat zone longer than 6 months, are in lower pay grades, are married with children, and earn little to no investment or spousal income.

² Within that income range a taxpayer's credit could increase if his or her taxable earned income is reduced by the exclusion.



Percentage of Service Members in One-Earner Families Worse Off by Serving in a Combat Zone in 2003, by Length of Deployment



- A small percentage of members deployed for less than 7 months suffered overall losses of tax benefits.
- Roughly 10 percent of these enlisted members deployed for a full year had a net loss of tax benefits.
- Data limitations make these estimates imprecise, and we cannot make estimates for members with working spouses.

Source: GAO analysis.

Note: Our estimates are based on information provided by DOD on the number of households with a spouse not in the labor force, the size of military households, military members' pay, and 2003 deployment rates. They are also based on the assumption that deployed personnel in each grade have the same household characteristics as the total population of service members in each grade.



Number of Members Who Served in a Combat Zone in 2003, by Months Served



- In 2003 most deployed service members served less than 7 months in a combat zone.
- Very few were deployed for a full year.

Source: Defense Manpower Data Center, DOD

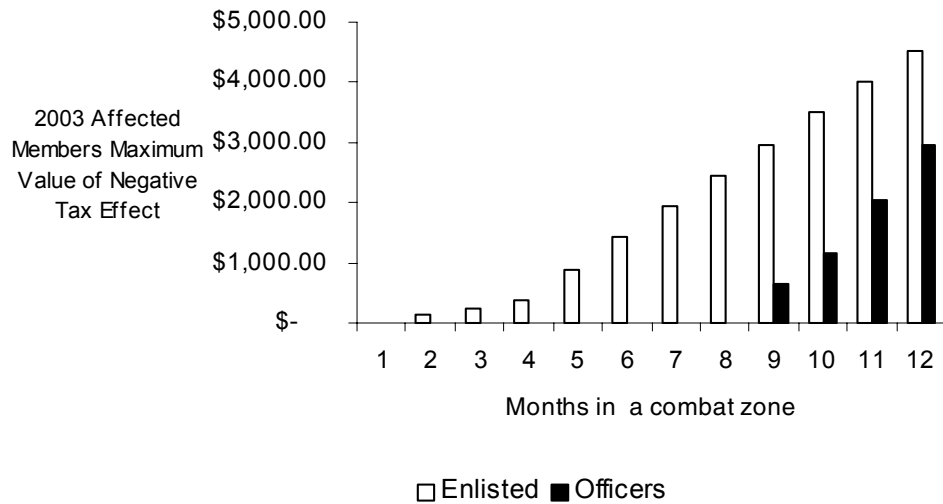


Some Military Members Serving in a Combat Zone Lost Tax Benefits in 2003

- Given that most service members were deployed for well under a full year, we estimate that a relatively small number of them were actually worse off--from a tax standpoint--due to service in a combat zone in 2003.
 - Most likely, between 5,000 and 10,000 members without working spouses suffered a net loss of tax benefits in 2003.
 - It is more difficult to make a reliable estimate for members with working spouses because we lack data on spouses' income. Although over 20,000 of these members could have lost tax benefits if their spouses' incomes were very low, we expect that only a small proportion of them—not likely much more than several thousand—had incomes that low.
- If long deployments in combat zones become more common in 2004, more members could suffer overall losses of tax benefits.



Potential Loss of Tax Benefits Resulting from the Combat Zone Exclusion



Source: GAO analysis.

Note: Our estimates are based on information provided by DOD on the number of households with a spouse not in the labor force, the size of military households, military members' pay, and 2003 deployment rates. They are also based on the assumption that deployed personnel in each grade have the same household characteristics as the total population of service members in each grade.



Some Service Members Become Eligible to Receive the Earned Income Tax Credit from the Combat Zone Exclusion

- Many members with incomes exceeding the normal upper limit for the credit could become eligible for the Earned Income Tax Credit if they are in a combat zone for at least 6 months.
 - All members who are 25 years or older, have no children, and have less than \$81,000 of income have the potential to become eligible for the credit by serving long enough in a combat zone. However, the amount of credit these members can earn is less than \$400.
 - Over 75 percent of members who have incomes between \$50,000 and \$60,000, have children, and have a spouse who is not in the labor force could become eligible to receive the earned income tax credit if they have served between 6 and 11 months in combat zone. The credit could be as high as \$2,547 for those with 1 child and \$4,204 for those with 2 or more children in 2003.
 - We cannot reliably estimate the total number of members who become eligible.

Note: Our estimates are based on information provided by DOD on the number of households with a spouse not in the labor force, the size of military households, military members' pay, and 2003 deployment rates. They are also based on the assumption that deployed personnel in each grade have the same household characteristics as the total population of service members in each grade.



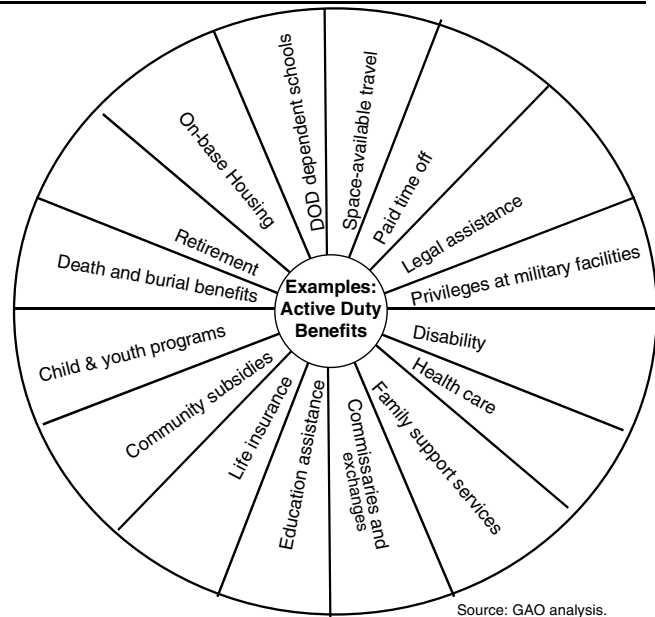
DOD Is Aware That Some Members May Be Affected

- The Department of Defense (DOD) has started receiving sporadic reports from members who are being disadvantaged (or advantaged) by these tax provisions.

- To address this situation, DOD officials told us that they have
 - Provided the Treasury with data on active duty and combat zone personnel;
 - Suggested changes to the Earned Income Tax Credit rules.

Benefits

- DOD offers a wide range of benefits; such benefits represent a large cost to DOD. The Congressional Budget Office recently estimated that these benefits cost about \$56,000 per active duty member.¹
- Many benefits are directed at members with family obligations. In addition, we found in some cases that benefits available to military personnel exceed those offered by private-sector companies.² DOD believes benefits are central to morale and readiness.



Source: GAO analysis.

¹Congressional Budget Office, *Military Compensation: Balancing Cash and Noncash Benefits* (Washington, D.C.: Jan. 16, 2004).

²U.S. General Accounting Office, *Military Personnel: Active Duty Benefits Reflect Changing Demographics, but Opportunities Exist to Improve*, GAO-02-935 (Washington, D.C.: Sept. 18, 2002).



Wealth-Building Programs Specific to the Military

Program	Description
Military Retirement	<ul style="list-style-type: none"> •Members who remain on active duty for 20 or more years are eligible •Members make no contribution to this. •No vesting is offered prior to 20 years of service—currently DOD estimates that 47 percent of officers and about 15 percent of enlisted members will reach retirement.
Thrift Savings Plan	<ul style="list-style-type: none"> •Since 2001, members can contribute a percentage of their basic pay to be invested in one or more of the funds offered by the Plan, before taxes. •Participation rates for active duty military personnel is 21 percent.
The Savings Deposit Program	<ul style="list-style-type: none"> •Members deployed to a combat zone, qualified hazardous duty areas, or certain contingency operations can contribute up to \$10,000 and earn a guaranteed 10 percent interest rate. •The interest earned is taxable. •Across the services, less than 1 percent of members participate.
Veterans Affairs Guaranteed Home Loan	<ul style="list-style-type: none"> •No money down, mortgage-backed loan program is available to service members who have served 181 days on regular active duty and have not been discharged from a previous qualifying period of active duty.

Source: GAO analysis.



General Wealth-Building Tax Provisions

- Military members can take advantage of tax provisions available to citizens that encourage wealth building, including
 - Individual Retirement Accounts (IRAs);
 - Tax credit for elective retirement account contributions;
 - Deduction for mortgage interest;
 - Deduction for property taxes; and
 - Exclusion of capital gains on principal residence sales.



Matter for Congressional Consideration

- If the Congress wishes to remedy the unintended tax consequences associated with the combat zone exclusion, it should consider revising the rules of the Earned Income Tax Credit and the Additional Child Tax Credit with respect to income earned in a combat zone.

Methodology for Estimating Tax Effects of the Combat Zone Exclusion

This enclosure describes the data and methodology we used to estimate (1) the extent of net loss of tax benefits from the combat zone exclusion and (2) the number of higher-income members who become eligible to earn the earned income tax credit as a result of service in a combat zone.

Estimating the Extent of Net Loss of Tax Benefits

The tax effect of the combat exclusion is the difference between what a member's tax liability would have been with no time spent in a combat zone and his or her actual tax liability after having spent one or more months in a combat zone. The only conditions under which this tax effect can be negative is if (1) the service member's tax liability would have been negative if he or she spent no time in a combat zone and (2) the member's actual liability was a smaller negative value, zero, or positive after service in a combat zone. The first of these conditions is met if the member would have been able to earn refundable tax credits that more than offset his or her precredit tax liability. The second condition is met if the combat zone exclusion reduces the member's earned income to such an extent that the refunded portion of the member's tax credit is reduced or eliminated.⁷

Due to significant data limitations, we were not able to make a precise estimate of the number of service members negatively affected by the combat zone exclusion in 2003. Nevertheless, the limited data available from DOD permitted us to estimate the rough order of magnitude of this number. The only way to make precise estimates of the two different tax liabilities (both in and out of the combat zone) for each member that served in a combat zone in 2003 would be to match personnel data from DOD with tax records from IRS for each of those members. We could not follow this approach because IRS records for 2003 would not be available to us for months. Given the time frames of this report, the only data we were able to use were Defense Manpower Data Center's aggregate numbers of service members in each enlisted and officer grade that were deployed in combat zones during 2003 and the limited data that DOD could provide us on relevant characteristics of service members, aggregated at the grade level. After discussing the reliability of the combat zone data with agency officials, we determined the data to be sufficiently reliable for our purposes.

Our overall estimation approach involved two steps. The first step was to compute the two tax liabilities for an extensive set of hypothetical service members. These hypothetical computations identified every combination of pay level, family size, and length of service in a combat zone during 2003 that could have resulted in a negative tax effect. The second step in our methodology was to use data on the characteristics of all active military personnel, by pay grade, as well as data on the number of service members from each pay grade that were deployed in a combat zone during 2003 to estimate the number deployed members who had

⁷ The only refundable tax credits that are likely to be widely used by members of the military are the earned income tax credit and the additional child tax credit. Over certain income ranges, the amount of credit that a taxpayer earns increases with earned income. Income earned in a combat zone is not included as earned income for the purpose of computing these credits. Consequently, there are cases where the combat zone exclusion reduces the refunded portion of the credits that members would otherwise have earned.

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income and family characteristics consistent with the hypothetical cases that showed negative effects.

Data from the DOD's *Selected Military Compensation Tables* (current as of October 2003) allowed us to make reliable estimates of the percent of married service members within each pay grade with one, two, three, and four or more children. The data indicated that the number of single service members with children in each grade was negligible, and so we excluded this subpopulation from our analysis. The same data source enabled us to determine the basic pay of service members, by pay grade and years of service. However, we did not have data on three other types of taxable income that we needed for our estimates: special pays, investment income, and spousal income.⁸ In the absence of the special pay and investment income data we used ranges of assumptions for the amounts of each of these types of income that each service member earned. These ranges of assumptions are reflected in the range that we provide for our end results. To deal with the lack of data on spousal income, we separated the service member population into two groups—those with spouses in the labor force and those without.⁹ The lack of data on spousal income does not affect our estimates for members without spouses in the labor force. Consequently, we could more easily estimate, at least within a broad range, the number of members in that group who were negatively affected by service in the combat zone. In contrast, we did not feel that we could reliably specify a range for the number of members with working spouses who were negatively affected; however, as we explain below, we were able to assess a rough order of magnitude for this group.

By combining the family and pay grade data listed above, we were able to estimate the number of all service members within a particular pay grade and with a specific number of years of service who had nonworking spouses and various numbers of children.¹⁰ We also had DOD data that allowed us to determine what percent of members in each pay grade were deployed in a combat zone for one month, what percent were deployed for two months, etc., for all possible lengths of stay in a combat zone. By assuming that the distribution of family characteristics across the deployed members within a particular pay grade and years-of-service category was the same as the distribution across all members (deployed or not) within that same grade and category, we were able to estimate the number of members with nonworking spouses who had the specific combinations of pay, family characteristics, and months of service in a combat zone that would have resulted in a net loss of tax benefits.

In the case of members with working spouses, we followed an approach similar to that just described; however, due to the lack of data on spousal income, there is greater uncertainty surrounding each member's household income and, thus, greater uncertainty about whether the member was negatively affected. Through our computations for hypothetical taxpayers, we determined that only members in grades E-1 through E-6 with working spouses were likely to

⁸ We did not need information on nontaxable allowances because they have no effect on tax liabilities either in or out of a combat zone and, therefore, had no effect on our estimates.

⁹ The July 2002 *Status of Forces Survey of Active-Duty Members* showed the percent of members with spouses not in the labor force. This survey percent is provided by broad pay grade groups, rather than for each individual grade (e.g., there was a single percent for all members in pay grades E1 to E3).

¹⁰ An important assumption that we made when combining these data is that the work status of a member's spouse was independent of the number of children that the member has. (The available data showed the percent of members by aggregated pay grade levels with a spouse not in the labor force and, separately, showed the percents of members in each grade with various numbers of children. The data did not show the joint occurrence of a nonworking spouse and a specific number of children.)

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be negatively affected, and the large majority of those would be affected only if their spouses earned less than \$6,000 in 2003. We estimate that up to about 25,000 members with working spouses were in a combat zone for long enough periods in 2003 to have the potential to be negatively affected if their spouses' incomes were sufficiently low. We do not have actual data on the number of spouses with income low enough to have a negative effect. However, we believe that likely only a small percentage of them actually were negatively affected.

Estimating the Number of Higher-Income Members Who Become Eligible for the Earned Income Tax Credit

To estimate the number of higher-income members who become eligible for the Earned Income Tax Credit, we follow the same general approach described above. However, instead of using tax rules and data on income, family size, and lengths of stays in combat zones to identify those members whose specific circumstances would result in a negative tax effect, we used the same information to identify those members who would not qualify for the Earned Income Tax Credit under normal circumstances, but who do qualify when they are deployed for a sufficient length of time in a combat zone.

As was the case with our estimates of the net loss of tax benefits, we cannot make a reliable estimate for members with working spouses. Although, we cannot make an estimate for the population of members without children, those members can qualify for an Earned Income Tax Credit of up to \$400, but only if they are over 25 years old. We have no information on the age of members deployed in 2003, so we cannot determine how many of these members would qualify.

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