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## **COMBAT ZONE TAX OPTIONS FOR FAMILIES OF DECEASED SERVICE MEMBERS**

With the loss of over 3,000 U.S. service members since March 2003, during the global war on terrorism in both Iraq and Afghanistan, Internal Revenue Code Section 692 and Section 2201 have become important tax code provision for their families. The tax provisions provide families of deceased service members with the forgiveness of income tax liabilities incurred in both the year of their death and all prior years ending on and after the date they first served in a combat zone and a larger estate tax credit. Service members serving outside a combat zone, but in direct support roles and qualifying for hostile fire or imminent danger pay, are also covered under the provisions.

### **Income Tax Matters**

Under IRC section 692 a deceased service member's income tax liability will be "forgiven" when their death occurs in a combat zone or from wounds, disease, or injury incurred in a combat zone. The tax-forgiveness will apply to the year of the service member's death, through a cancellation of the liability, any prior year ending on or after the first day they served in a combat zone, through a refund, and any tax owing at the date of their death (including interest, additions to the tax, and additional amounts). The tax code provision insures that no income tax liability will be imposed on the beneficiary or trustee of the deceased service member's estate to the extent the liability is attributable to an amount received that would have been includible in the members gross income for the taxable year in which the date of death falls (determined as if the service member had survived).

Example: In 2005, LT John Smith is deployed and killed during combat in Iraq. LT Smith will receive the tax forgiveness benefits of IRC Section 692 only for calendar year 2005, based upon his service in a combat zone in 2005, and not any prior year.

Example: Sgt. Steve Paul is deployed to Afghanistan in September 2004. Sgt. Paul is injured during combat in 2005 and later dies of complications, resulting from the injury,

in 2006. Sgt. Paul will receive the tax forgiveness for 2004, 2005 and 2006 (his years in the combat zone and year of his death resulting from the injury sustained in the combat zone).

### **Claim Procedure:**

If the deceased service member has not filed a tax return for the year(s) in question then IRS Form 1040, accompanied by their W-2 statement, must be filed with the IRS. Alternatively, if a Form 1040 has been filed with the IRS, Form 1040X should be filed for each year subject to the tax forgiveness provision. All tax returns and claims for a refund must be identified by writing (Operation Enduring Freedom -KIA; KITA - 9/11; etc.) on the top of the form. The tax return must also include a computation of the decedent's tax liability, before any amount is forgiven, and the amount that is to be forgiven.

In addition, IRS Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, and a certification from the Department of Defense or the Department of State must accompany the tax return. The certification must include the deceased individual's name, social security number, date of injury, date of death, and that the individual died in a combat zone.

### **Joint Tax Returns:**

Only a deceased service member's portion of a joint income tax liability is eligible for the tax refund or forgiveness when a joint income tax return is filed with the IRS. The refund or forgiveness is calculated by figuring the income tax for which the deceased service member would have been liable, as if a separate return had been filed, and the income tax his or her spouse would have been liable, as if a separate return had been filed. The joint tax liability will then be multiplied by a fraction (top number is the deceased service member's liability and the bottom number is the joint tax liability). The result is the decedent's tax liability that is eligible for the income tax refund or tax forgiveness.

### **Retirement Accounts:**

The IRC section 692 tax forgiveness provision will not turn any of a service member's taxable income into "tax exempt" income or impact any of a service member's contributions to a retirement account (TSP, IRA, etc.). None of the deceased service member's retirement account contributions will be characterized as "tax exempt" and will be subject to all applicable tax provisions.

## Estate Tax Matters

IRC Section 2201 provides the families of a deceased service member (death resulting from combat zone service, or specified terrorist actions) with the option of using the rate schedule outlined under its provision or the applicable estate tax credit under IRC Section 2001. Eligibility for the use of the IRC section 2201 tax schedule is predicated on: (1) U.S. citizen or resident's death while serving in the U.S. military; and (2) death occurring in a combat zone or as a result of wounds, disease, or injury suffered, while serving in a combat zone.

IRC Section 2201 establishes an estate tax credit equal to the first \$8.5 million (approximate) of a decedent's taxable estate and shields approximately \$3.0 million of the decedent's estate from state inheritance taxes. In contrast, IRC Section 2001 provides for an estate exclusion of \$2.0 million in 2007 and 2008, and \$3.5 million in 2009.

Example: ADM. Kate Jones, a resident of the state of Florida, is a qualified decedent. During ADM. Jones lifetime she did not make any adjusted taxable gifts (as defined in IRC Section 2001(b)). When filing her Form 706, the United States Estate (and Generation-Skipping Transfer) Tax Return, the executor of her estate does not elect out of the application of Section 2201(a). At her death the amount of ADM. Jones taxable estate is \$5.7 million. Accordingly, in accordance with Section 2201(a), no federal estate tax will be due or owing to the IRS.