

regardless of state law requirements, as long as they are executed by a competent testator eligible for military legal assistance in the presence of a military legal assistance counsel and at least two disinterested witnesses.²²

III. Step Two: Understanding the Tax System and The Wisdom of Tax Planning

Executing powers of attorney, advanced medical directives, and wills represent an important first step in the estate planning process. However, in order to meet current and future financial needs, servicemembers should also engage in basic tax planning. Understanding the multilayered and multidimensional tax system is crucial to building wealth. Forgoing basic tax planning can result in unintended and significant depletions of a taxpayer's income and, ultimately, a decedent's estate.

The law treats servicemembers like every other individual taxpayer, except that servicemembers receive extra tax benefits and considerations. For example, unlike other taxpayers, servicemembers can receive a tax-free housing allowance that they can use to generate mortgage interest tax deductions on their homes.²³ Despite these benefits, servicemembers, like all other taxpayers, face income, gift, estate, and generation skipping transfer taxes at both state and federal levels. Similarly, servicemembers must pay property, sales, use, and other types of taxes at the state and local government levels.²⁴

A. Income Tax Considerations

1. Federal Income Tax

To reduce their federal income taxes, servicemembers must first understand the six steps required to calculate the Federal Income Tax.²⁵ First, the taxpayer must calculate gross income, which includes numerous items such as compensation for services (e.g., military and non-military pay), interest, rents, and pensions.²⁶ Second, the taxpayer must calculate adjusted gross income by deducting adjustments (i.e., "above the line deductions"), such as expenses of producing rents and certain individual retirement account (IRA) contributions. Third, the taxpayer must calculate taxable income by deducting personal exemptions and the greater of the standard deduction or itemized deductions. Fourth, the taxpayer must look up the tax due based on taxable income.²⁷ Fifth, from this amount, the taxpayer must calculate the net tax due (i.e., "total tax") by deducting applicable credits, such as the credit for child and dependent care, educational credits, the child tax credit, and, if applicable, by adding in other taxes such as the self-employment tax.²⁸ Sixth, the taxpayer must calculate "total payments," which include federal income taxes withheld and credits, such as the earned income credit²⁹ and the additional child tax credit. If the taxpayer's "total payments" exceed the "total tax," the taxpayer can file for a tax refund. In contrast, if the "total tax" exceeds the "total payments," the taxpayer will owe taxes.

Taxpayers should be familiar with how important characteristics of the federal income tax system may affect their own tax liability. First, a taxpayer's filing status can provide significant benefits. For example, in general, married taxpayers filing joint returns pay less taxes and can qualify for the earned income credit, while married taxpayers filing separate returns

²² See 10 U.S.C. § 1044d (giving legal effect to military testamentary instruments without regard to state law requirements on form, formality, or recording).

²³ See, e.g., Treas. Reg. 1.61-2(b) (establishing that military housing allowances received by servicemembers are excludable from gross income). See also, I.R.C. § 265(a)(6) (allowing a servicemember to deduct mortgage interest on a home even though the servicemember receives a military housing allowance that is excludable from gross income). See *infra* note 32 and accompanying text.

²⁴ See generally Retirement Living Information Ctr., Inc., Taxes by State, available at <http://www.retirementliving.com/RLtaxes.html> (last visited Feb. 16, 2009) [hereinafter Retirement Living] (explaining the numerous types of taxes and the rates applied by each state including property, sales, fuel, cigarette, and other types of taxes, and providing links to official state tax websites); CCH, 2010 U.S. STATE TAX HANDBOOK (2009) (providing a quick-reference guide for state tax issues); OFFICE OF THE JUDGE ADVOCATE GENERAL, CODE 16, STATE TAX GUIDE (Jan. 31, 2010), available at <http://www.jag.navy.mil/organization/documents/tax/2009StateTaxGuide.pdf> (last visited Feb. 18, 2010) (providing a very useful quick reference guide for state income tax issues).

²⁵ See, e.g., INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, FORM 1040 INSTRUCTIONS (2009) [hereinafter FORM 1040 INSTRUCTIONS]; G. VICTOR HALLMAN & JERRY S. ROSENBLUM, PERSONAL FINANCIAL PLANNING 257-259 (7th ed. 2003) (describing, in general, how to calculate the federal income tax).

²⁶ See I.R.C. § 61(a) (2009) (defining the numerous components of gross income).

²⁷ See Internal Revenue Serv., U.S. Dep't of the Treasury, Form 1040: U.S. Individual Income Tax Return (2009) [hereinafter FORM 1040].

²⁸ See *id.* (describing how to calculate the "total tax" or net tax due). See *infra* note 37.

²⁹ See I.R.C. § 32(a) (defining the earned income credit and establishing its limitations).

pay more taxes and cannot qualify for the earned income credit.³⁰ Second, as individuals earn more taxable income, the Government taxes that income at gradually increasing rates.³¹ Third, the Government taxes different types of income at different rates, while excluding certain types of income from taxation, such as military housing allowances³² and combat pay.³³ Fourth, while the Government allows deductions, exemptions, and adjustments to reduce taxable income, these benefits have limits.³⁴ For example, if a taxpayer had an adjusted gross income (AGI) of \$100,000 in 2009, the taxpayer's first \$7,500 of unreimbursed medical and dental expenses incurred would not be deductible due to a 7.5% AGI threshold limitation.³⁵ Fifth, while the Government allows credits to offset taxes due, all credits are not created equal.³⁶ For example, if the credit is "nonrefundable" like the child and dependent care credit³⁷ and the credit is larger than the tax owed, tax refunds will be limited to the amount of the tax owed.³⁸ In contrast, if the credit is "refundable," like the earned income credit, taxpayers will receive a full refund for the credit even though the credit exceeds the tax due.³⁹

Ultimately, servicemembers should understand that, despite the existence of programs designed to reduce taxes, the Federal Government created the Alternative Minimum Tax (AMT) to ensure taxpayers pay a minimum amount of tax, regardless of deductions, exemptions, and credits.⁴⁰ To this end, the more income a taxpayer makes, the greater the possibility that the taxpayer will be covered by the AMT.⁴¹

2. State Income Tax

As states increasingly face "devastating" deficits,⁴² the state taxing authorities have increasingly become concerned with residents who have neither filed nor paid state income tax.⁴³ On one hand, military members who are ordered to move to a

³⁰ See INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUB. 4012, VOLUNTEER RESOURCE GUIDE, at H-2 (2009) [hereinafter PUB. 4012] (providing a very useful quick resource guide to identify the Earned Income Credit's qualification requirements).

³¹ See e.g., FORM 1040 INSTRUCTIONS, *supra* note 25 (Establishing six individual tax brackets for 2009: 10%, 15%, 25%, 28%, 33%, and 35%). For example, in 2009, married taxpayers filing jointly would have a 15% marginal tax rate if they had taxable income between \$16,700 and \$67,900, but would have a 28% marginal tax rate if they had taxable income between \$137,050 and \$208,850. *Id.*

³² See, e.g., Treas. Reg. 1.61-2(b) (establishing that military housing allowances received by servicemembers are excludable from gross income). See also, I.R.C. § 265(a)(6) (allowing a servicemember to deduct mortgage interest on a home even though the servicemember receives a military housing allowance that is excludable from gross income). See also, Rev. Rul. 61-5 (establishing that military housing and cost-of-living allowances received by servicemembers while stationed outside the United States are excludable from gross income). See generally Kan, *supra* note 4, at 2 (discussing military housing allowances, their non-taxability, and the broader consequences of receiving such allowances).

³³ See, e.g., I.R.C. § 112 (excluding certain combat zone compensation from gross income). See also, Treas. Reg. § 1.112-1(f) (2010) (providing examples excluding certain combat zone compensation from gross income). See also U.S. DEP'T OF DEFENSE FINANCIAL MANAGEMENT REG. 7000.14-R, DoD, vol. 7A, ch. 44, at 15-16 (July 2009) [hereinafter DoD FMR] (discussing combat zone tax relief areas for personnel in direct support of a combat zone). *But see* I.R.C. §§ 32(c)(2)(B)(vi) & 219(f)(7) (allowing combat pay to be included in earned income for purposes of the earned income tax credit and for purposes of making deductible IRA contributions).

³⁴ See generally INTERNAL REVENUE SERV., PUB. 17, YOUR FEDERAL INCOME TAX: FOR INDIVIDUALS 26-38, 121-140, 141-208 (2009) [hereinafter PUB. 17] (explaining personal and dependent exemptions, available adjustments to income; and available deductions).

³⁵ See I.R.C. § 213(a).

³⁶ See generally PUB. 17, *supra* note 34, at 209-263 (explaining available credits).

³⁷ See I.R.C. § 21 (establishing a credit for taxpayers who incur dependent care service expenses to allow them to have gainful employment).

³⁸ See INTERNAL REVENUE SERV., PUB. 4491, VITA/TCE-2008 STUDENT TRAINING GUIDE 8-3 (2008) [hereinafter PUB. 4491 (2008)].

³⁹ See *id.* See *supra* note 29.

⁴⁰ See The President's Advisory Panel on Federal Tax Reform, *America Needs a Better Tax System: Statement by the Members of the President's Advisory Panel on Federal Tax Reform* (Apr. 13, 2005), available at <http://www.taxreformpanel.gov/04132005.pdf> (last visited Jan. 28, 2010). By 2015, the AMT is estimated to apply to approximately fifty-two million taxpayers. *Id.* *But see* THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 5 (2005), available at http://www.taxreformpanel.gov/final-report/TaxReform_Intro.pdf (recommending the elimination of the AMT).

⁴¹ See generally PUB. 17, *supra* note 34, at 210 (explaining the 2009 income tax limits which may result in the need to pay the AMT). See generally GEORGE G. JONES, TOP FEDERAL TAX ISSUES FOR 2009 CPE COURSE 1.20-1.24 (2008) (discussing the history of the AMT, and the current AMT patch created by the Emergency Economic Stabilization Act of 2008). To determine whether the AMT applies, taxpayers should fill out the AMT Worksheet. See generally FORM 1040 INSTRUCTIONS, *supra* note 25, at 41. If applicable, taxpayers should fill out IRS form 6251 according to its instructions. See generally INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, FORM 6251 INSTRUCTIONS: ALTERNATIVE MINIMUM TAX—INDIVIDUALS (2009).

⁴² See, e.g., Ryan Kost, Oregon State Deficit Could Grow by \$1 Billion, available at <http://www.katu.com/news/local/37747104.html> (last visited Jan. 28, 2010).

⁴³ See e.g., Carr v. Dep't of Revenue, 2005 WL 3047252 (Or. Tax Nov. 4, 2005) (holding a servicemember liable for state income taxes in Oregon, even though the servicemember claimed to be from Nevada, a state without a state income tax).

new state may establish sufficient connections to the new state to justify the imposition of that state's income tax. On the other hand, military members who had a prior connection with a state before entering active duty service may appear to have neglected the payment of state tax, when, in fact, these servicemembers legally changed their state of domicile. In short, military members must be vigilant in understanding the meaning of domicile⁴⁴ and documenting the factors that prove their domicile. This section explores the fundamental distinctions.

a. Military Pay

In addition to paying federal income tax, many servicemembers must consider state income taxes, depending on their state of domicile.⁴⁵ A servicemember can establish a state as their domicile based on their physical presence in the state and their intent to make the state their permanent home.⁴⁶ Servicemembers may reap significant tax benefits based on the tax laws of their state of domicile because some states, like Texas, Nevada, and Florida, have no state income tax. In addition, other states exclude some or all military pay from income tax (see Appendix E).⁴⁷

To establish and maintain domicile, servicemembers must take specific steps to demonstrate their intent to make a state their permanent home rather than engaging in subterfuge to avoid paying state income tax.⁴⁸ First, after establishing physical presence in the state, servicemembers should visit their local finance office and fill out appropriate paperwork, such as the DD Form 2058, *State of Legal Residence Certificate*.⁴⁹ Second, servicemembers should establish as many ties as possible to the state, such as registering to vote, purchasing real property, and obtaining professional and driver's licenses within the state. Third, servicemembers should express their desire to make the state their permanent home by telling others, such as friends and family, about their intent.

Servicemembers must exercise caution due to the variations in state law⁵⁰ and level of aggressive enforcement by state revenue collection authorities. For example, in *Carr v. Dep't of Revenue*, the court held that a servicemember had no connection to Nevada, his claimed state of domicile, but had sufficient nexus⁵¹ to the State of Oregon even though he was not registered to vote in Oregon, had no Oregon driver's license, and had no intent to remain in Oregon once his military obligation was completed.⁵² As a result of his connections to Oregon, including the purchase of a home and registering vehicles in Oregon, and, more importantly, his lack of current connections to Nevada, the court held that the servicemember was liable for paying Oregon's state income tax on his military income.⁵³

⁴⁴ Domicile is defined as "[t]he place at which a person is physically present and that the person regards as home; a person's true, fixed, principal, and permanent home, to which that person intends to return and remain even though currently residing elsewhere." BLACKS LAW DICTIONARY 501 (7th ed. 1999).

⁴⁵ See generally Retirement Living, *supra* note 24 (providing various resources relating to individual state requirements).

⁴⁶ See generally Major Wendy P. Daknis, *Home Sweet Home: A Practical Approach to Domicile*, 177 MIL. L. REV. 49, 52 (2003) (explaining the requirements of establishing domicile).

⁴⁷ See *id.* at 102–09 (describing the extent to which each state includes or excludes military pay and military retirement pay). See also Major Richard W. Rousseau, *Update: Tax Benefits for Military Personnel in a Combat Zone or Qualified Hazardous Duty Area*, ARMY LAW., Dec. 1999, at 1, 15–29 (describing the extent to which each state taxes combat pay).

⁴⁸ See, e.g., *Texas v. Florida*, 306 U.S. 398 (1939) (discussing subterfuge situations).

⁴⁹ U.S. Dept. of Defense, DD Form 2058, *State of Legal Residence Certificate* (Feb. 1977), available at <http://www.dtic.mil/whs/directives/informgt/forms/efoms/dd2058.pdf> (last visited on Jan. 28, 2010).

⁵⁰ See e.g., *In re Gatchell* (N.Y. Tax Comm. 1984), available at http://www.nysdta.org/STC/Personal/1984/a_10170.pdf (last visited Jan. 27, 2010) (establishing that a servicemember who lives in a military barracks does not have a permanent place of abode and thus is not exempt from New York state income tax).

⁵¹ Nexus is defined as "[a] connection or link . . ." BLACKS LAW DICTIONARY, *supra* note 44, at 1066.

⁵² See, e.g., *Carr v. Dep't of Revenue*, 2005 WL 3047252 (Or. Tax Nov. 4, 2005) (holding a servicemember liable for state income taxes in Oregon, even though the servicemember claimed to be from Nevada, a state without a state income tax).

⁵³ See e.g., *id.* The court noted that if the taxpayers had "owned property in Nevada, had Nevada driver's licenses, voted in Nevada, registered their vehicles in Nevada, or spoke convincingly of an intention to return to Nevada, their case would be stronger." *Id.*

b. Non-Military (i.e., Civilian) Income

Although military income may not be subject to state income tax in certain states, non-military income of servicemembers and their spouses may be subject to state income tax based on the location where the income is earned. For example, if a servicemember owns rental property in a state that imposes state income tax, the servicemember may be obligated to file a non-resident income tax return for the state in which the rental income was earned. Similarly, if the servicemember receives compensation from a non-military job, the servicemember may need to file a state income tax return.

In a very important statutory development, civilian spouses who meet the domicile test of physical presence and the intent to make a state their permanent home can now receive protections similar to servicemembers due to the Military Spouses Residency Relief Act (MSRRA).⁵⁴ As a result of this Act, as of 2009, if military members and their spouses each separately establish and maintain domicile in the same state, they can keep this domicile even though they later move together upon the receipt of military orders to a new state.

For example, a servicemember and a civilian spouse may establish Texas as their domicile if both are physically present in Texas, express the intent to make Texas their domicile, and establish their own contacts to Texas, such as purchasing real property, voting, and becoming licensed in Texas. If the servicemember receives orders to move to Virginia and the spouse moves with the servicemember solely to be together, both can maintain Texas as their domicile. If the servicemember's spouse gets a civilian job in Virginia, the spouse can assert the MSRRA claiming Texas as the state where the spouse established and maintains domicile. By asserting and providing appropriate substantiation to this claim, the spouse's civilian pay would not be subject to taxation by Virginia. This result may seem unfair because the civilian pay of a servicemember who obtains civilian employment in Virginia would be subject to Virginia's income tax.

Servicemembers and their spouses should exercise caution because the Act may be interpreted differently by each state as the states react to the new federal legislation. Servicemembers and their spouses should be prepared to provide to their employers, as well as to the state taxing authorities, substantial evidence that they properly established and currently maintain a specific state as their domicile. If the claimed state of domicile has a state income tax, servicemembers and their spouses should ensure that their employers properly withhold the appropriate state's income tax.

B. The "Unified" Federal Transfer Tax System and "The Unified Credit"

In addition to taxing income, the Government designed a "unified" federal transfer tax system which incorporates the gift tax, the estate tax, and the generation skipping transfer tax to tax the transfer of wealth from one generation to the next.⁵⁵ The unified system targets individuals who fall into higher tax brackets and who possess more substantial assets. The gift tax covers lifetime transfers by gift; the estate tax applies to transfers at death; and the generation skipping transfer tax addresses "transfers designed to skip generations."⁵⁶ Career military members who have invested over time, built successful businesses during their service, or who have, themselves, inherited sizeable estates may be found throughout the active military.⁵⁷ They face unique concerns that are not normally capable of being addressed during the course of a brief meeting with an attorney, such as what occurs at a Soldier Readiness Processing (SRP) station preparing servicemembers to deploy to combat zones.

Although the Government designed a "unified credit" to allow for the tax-free transfer of a limited amount of wealth, the amount of the unified credit has diverged over time due to changes in tax law (see Appendix A). For example, in 2002, the

⁵⁴ 50 App. U.S.C. § 571. The Act, which amended the Servicemembers Civil Relief Act, states:

A spouse of a servicemembers shall neither lose nor acquire a residence or domicile for purposes of taxation with respect to the person, personal property, or income of the spouse by reason of being absent or present in any tax jurisdiction of the United States solely to be with the servicemember in compliance with the servicemember's military orders if the residence or domicile, as the case may be, is the same for the servicemember and the spouse. . . . Income for services performed by the spouse of a servicemember shall not be deemed to be income for services performed or from sources within a tax jurisdiction of the United States if the spouse is not a resident or domiciliary of the jurisdiction in which the income is earned because the spouses is in the jurisdiction solely to be with the servicemember serving in compliance with military orders.

Id.

⁵⁵ See HALLMAN & ROSENBLOOM, *supra* note 25, at 462.

⁵⁶ *Id.*

⁵⁷ *E.g.*, Editorial, *Augusta Soldier Wins \$1 Million in Lottery*, FLA. TIMES-UNION (Jacksonville), June 1, 2005, at B-4 (describing the lottery winnings of a Fort Gordon sergeant first class who chose to remain in the Army).