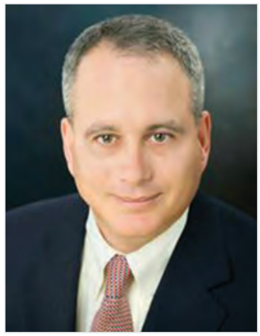

Maximizing your savings options while serving in a combat zone

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Military service in a combat zone can be dangerous and place a lot of stress on both the service member and his or her family. The biggest benefit of combat-zone service is that all compensation received by enlisted service members and warrant officers is tax-free (excluded from their taxable gross income). Officers only receive tax-free compensation up to the highest senior enlisted service member rate of basic pay. The tax-free compensation, coupled with all other tax-free benefits (hazardous duty pay, family separation pay, etc.) each service member receives, provides several financial and tax planning opportunities.

Thrift Savings Plan:

A Thrift Savings Plan (TSP) is a Federal Government-sponsored "defined contribution plan." A TSP operates similar to a 401(k) account by allowing: account loans from contributions and earnings, catch-up contributions (discussed later), hardship withdrawals, withdrawals on or after age 59, portability upon separation from military service, beneficiary designations, etc.

Service members (active duty and reserve) can lower their annual income tax bill by deferring a portion of their before-tax military compensation, bonuses, special pay or incentive pay into their TSP account. The contributed funds will grow tax-deferred, allowing them to compound quicker than if they were annually taxed, until they are withdrawn from the TSP account. It is important to understand that a TSP is not a savings account but designed to provide service members with a secondary source of retirement income after their military retired pay. In 2010, a service member may not contribute more than $16,500 of his/her basic, incentive and special pay (basic pay must be contributed in order for incentive and special pay to be contributed) to his/her TSP.

Catch-Up Contributions:

Service members age 50 and older, in the year in which the first deduction from pay occurs, are able to make catch-up contributions to their TSP account. In 2010, the catch-up deferral limit is $5,500 (meaning a total of $22,000 may be tax deferred into a TSP).

Differential Pay:

Employees who receive differential pay (the difference between their civilian compensation and military compensation) from their employer should consider utilizing these funds to maximize their employer-sponsored 401(k) account first. In many cases, the contributed funds or a portion thereof will be matched by the employer. In addition, if the differential pay is contributed to an employer-sponsored 401(k) account, it will not constitute taxable income to the service members and will allow them to maintain themselves in the lowest possible federal income tax bracket while saving for the future.

The differential pay can be subsidized by state grants to employers. In Florida, the Citizen Soldier Program provides matching grants to employers who pay wages to employees while they are serving in the Reserves or the Florida National Guard on federal active duty.

Additional Combat Zone Contributions:

While there is not a direct income tax benefit derived from contributing tax-free combat zone compensation to a TSP or other form of retirement account, the earnings on the contributions will grow tax-deferred until withdrawn. Notwithstanding the elective deferral limits, service members in a tax-free combat zone are eligible to contribute a total of $49,000 to his or her TSP and other retirement accounts in 2010. The $49,000 total includes both tax-exempt combat zone contributions and regular deferred contributions. Each type of contribution will be listed separately on the service member's monthly TSP account statement.

Once the service member reaches the age of retirement, the TSP account withdrawals will be taken proportionally from both the taxable and tax-exempt funds. The amount attributable to tax-exempt contributions will not be subject to income tax upon withdrawal.

If the service member leaves military service prior to retirement, the taxable and tax-exempt TSP funds can be transferred or rolled over into a traditional IRA, a Roth IRA, or transferred to certain eligible employer plans (only if the IRA or plan certifies that it accepts tax-exempt balances).

Alternatively, upon termination of military service or retirement, the tax-exempt funds can be rolled over directly into a Roth IRA. The funds and earnings will then grow tax-free and be tax-free to the recipient upon withdrawal from the Roth IRA.

Roth-IRA:

Service in a combat zone may provide a service member, who does not have a working spouse or is single, with negative taxable income after subtracting the personal exemption, standard deduction, or itemized deductions. This may create the perfect opportunity to convert an existing IRA into a Roth IRA.

Contributions to a Roth IRA come from after-tax compensation (unless you are in a combat zone and the compensation is not taxable). The benefits of a Roth IRA are that contributed funds grow tax free and will not be subject to income tax upon their withdrawal. In addition, there is no mandatory requirement that any funds be withdrawn from the account after reaching age 70.

Roth-IRA Conversion:

The lack of taxable income further provides a service member with an excellent opportunity to convert an existing IRA into a Roth IRA. While the conversion will be a taxable event, the tax will be minimized by the service member being in one of the lower federal income tax brackets. The payment of a little tax today can turn a tax-deferred account into a tax-free future account.

Savings Deposit Program:

Most individuals would jump at the opportunity to earn a guaranteed ten (10%) percent annual return on any investment. The Savings Deposit Program (SDP), administered by the Defense Finance and Accounting Service (DFAS), offers service members in designated combat zones this opportunity.

Eligibility and Contributions:

Eligibility for SDP requires more than thirty consecutive days or at least one day in each of three consecutive months (subject to new restrictions) of military service in (1) a designated combat zone, (2) a qualified hazardous duty area, or (3) certain contingency operations outside the United States. Beginning on the 31st day of service in a combat zone, qualifying service members may deposit all or part of their compensation after authorized deductions, including bonuses, into an SDP account and receive the ten (10%) percent taxable return during their deployment. SDP contributions can be made through the date of departure from the assignment. Interest will accrue quarterly and for up to ninety days after the service member returns from deployment. However, contributions in excess of $10,000 will not earn any interest.

Account Withdrawals:

Accrued interest and account balances over $10,000 may be withdrawn quarterly. Principal account withdrawals may only be made after the service member leaves the combat zone and is no longer eligible to participate in the SDP. In emergency situations only, early withdrawals can be made in the event of a health or welfare, service member or dependent emergency.

Retirement Savings Contributions Credit:

Tax-free combat zone compensation and benefits will increase the number of service members (enlisted and officers) eligible to take advantage of The Retirement Savings Contribution Credit (the Credit). In the 2009 tax year, the Credit was available to service members with an adjusted gross income less than: $55,500 if married and filing jointly; $41,625 if head of household; and $27,750 if single or married filing separately. Eligible service members will receive a tax credit of up to $1,000 ($2,000 if you file jointly) on their federal income tax return for each year they contribute to a TSP.

Capital Gains:

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) lowered the capital gain tax rates to 0% (for taxpayers falling into the 10% or 15% federal income tax bracket) and 15% (for taxpayers falling into the 28%, 31%, 36%, or 39.6% federal income tax brackets) for tax years 2009 and 2010. This provides service members in a combat zone with the opportunity, as a result of their tax-free income and low income tax bracket, to take advantage of the 0% capital gains tax rate by (1) selling an appreciated long-term capital asset (stock, bonds, mutual funds, etc.) for needed cash funds, (2) selling an appreciated long-term capital asset to reset its basis to a higher amount (selling the asset, realizing the tax-free gain, and repurchasing the same asset at a higher price), or (3) rebalancing (revision of asset-allocation percentages) a portfolio. The tax savings from the 0% rate will depend upon what the service member's applicable tax rate would otherwise have been.

Planning Summary:

Utilization of the financial and tax planning opportunities that combat-zone service provides can make a service member's retirement years a lot more pleasant. Unfortunately, the opportunities can only be exercised while a service member is serving in a combat zone. ⚓