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General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

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December 22, 1995

Congressional Requesters

This letter responds to your request that we examine the tax consequences to veterans of the legally required offset of certain types of Department of Defense (DOD) separation pay and Department of Veterans Affairs (VA) disability compensation.[1] Specifically, we requested that the Internal Revenue Service (IRS) determine whether veterans could (1) reclassify separation pay as disability compensation, or (2) deduct recouped separation pay from gross income. The IRS responded to our questions in two separate letters dated June 23, 1995, and September 28, 1995 (see enclosures). We summarize these documents with this letter.

BACKGROUND

In 1980, Congress authorized DOD to provide lump-sum separation pay to service members for involuntary separation. In 1991, to assist DOD in downsizing, Congress authorized DOD to pay a higher level of lump-sum separation pay (known as a special separation benefit) or an annual annuity (known as a voluntary separation incentive) to those who separate voluntarily. Subsequent to separation, some veterans qualify for service-connected disability compensation (paid monthly) from VA. Federal income taxes are withheld from separation pay. Disability compensation is tax exempt.

Federal law requires the recoupment of the gross amount of separation pay (known as an offset) from those who also receive disability compensation for the same period of service. The VA withholds disability compensation monthly until the full amount has been recouped from lump-sum recipients.

[1]For more information about the offset, see our report Veterans Compensation: Offset of DOD Separation Pay and VA Disability Compensation (GAO/NSIAD-95-123, Apr. 3, 1995).

Separated service members who qualify for disability compensation from VA have the gross (not the net) amount of their separation pay offset. For example, an E3 in the 15 percent tax bracket with 7 years of service who separates in fiscal year 1994 and qualifies for a special separation benefit payment of $13,936 (gross amount) receives $11,845 (net after taxes). If that E3 subsequently qualified for disability compensation from VA, the E3 would have $13,936, not $11,845, of the disability compensation withheld. Thus, veterans must repay the gross amount of their separation pay, even though they actually received only the net amount. For this reason, some veterans want to know whether they can reclassify their separation pay as non-taxable disability compensation to avoid paying federal income tax on separation pay or whether they may deduct from gross income the amount of their recouped separation pay to offset income taxes already paid on their separation pay.

RESULTS IN BRIEF

The IRS determined that veterans may not reclassify separation pay as disability compensation. The IRS also determined that veterans may not deduct recouped separation pay from gross income. The IRS position is set forth below.

VETERANS MAY NOT RECLASSIFY SEPARATION PAY AS DISABILITY COMPENSATION

Section 104 of the Internal Revenue Code provides that compensation received for personal injuries or sickness resulting from active service in the armed forces are not included in gross income. According to the IRS, Section 104 does not apply to separation pay. Veterans do not receive separation pay for personal injuries or illness, and thus cannot reclassify separation pay because the VA subsequently determines them eligible for disability compensation.

VETERANS MAY NOT DEDUCT RECOUPED SEPARATION PAY

The IRS concluded that veterans may not deduct recouped separation pay for two reasons. First, according to the IRS, the effect of the law requiring recoupment of separation pay is a reduced entitlement to disability compensation. Under Section 165 of the Internal Revenue Code, taxpayers who receive taxable income as compensation and who subsequently are required to repay the compensation are entitled to a deduction for the amount repaid. Here, a section 165 deduction is not

allowed because the veteran is considered as never having received the withheld disability compensation. Thus, the veteran cannot be treated as having repaid the separation payment for tax purposes, according to the IRS. Second, the IRS could not conclude that Congress intended to permit veterans to take a deduction for recoupment of separation pay. The IRS noted that Congress limited recoupment of separation pay under 10 U.S.C. § 687 (predecessor to the current 10 U.S.C. § 1174) to 75 percent to avoid recoupment of more than the net amount received by the veteran, assuming an average tax bracket of 25 percent. The IRS reasoned that such a limitation would have been unnecessary had Congress intended to allow veterans to deduct separation pay subsequently recouped. When Congress changed the law, it no longer limited recoupment to 75 percent but instead required the government to recoup all of the separation pay (that is, the gross amount) and left nothing in the legislative history to suggest that a deduction was subsequently permitted.

The IRS did conclude, however, that in one limited situation, veterans may retroactively exclude part of their lump-sum separation pay from gross income if they also qualify for disability compensation. According to the IRS, if a veteran executes a waiver of separation pay effective for the year the separation pay is received, and subsequently receives an award of disability pay retroactive to the year the separation pay was received, the veteran may exclude from income an amount equal to the disability pay for that year. To claim the exclusion, a veteran has to file an amended return for the year the separation pay was received. In general, tax returns may be amended within 3 years from the time filed.

However, at the time of this letter, VA officials told us they had no mechanism for waiving separation for disability pay (as they do for military retirement and disability pay). In contrast, voluntary separation incentive recipients receive tax exempt disability pay without filing a waiver because they receive 1 year's worth of disability compensation before DOD makes the annual separation payment (minus the offset amount).

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We will send copies of this letter to other interested congressional committees and individual Members; the Secretaries of Defense and Veterans Affairs; the Director, Office of Management and Budget; and the Commissioner, IRS. We will also make copies available to other parties upon request.

This correspondence was prepared by William E. Beusse, Assistant Director, and Brian J. Lepore, Evaluator-in-Charge, under the direction of Sharon A. Cekala, Associate Director. Please contact me on (202) 512-5140 if you or your staff have any questions.

Mark E. Gebicke
Director, Military Operations and
Capabilities Issues

Enclosures - 2

Congressional Requesters

The Honorable Strom Thurmond
Chairman
The Honorable Sam Nunn
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Alan K. Simpson
Chairman
The Honorable John D. Rockefeller IV
Ranking Minority Member
Committee on Veterans Affairs
United States Senate

The Honorable Floyd D. Spence
Chairman
The Honorable Ronald V. Dellums
Ranking Minority Member
Committee on National Security
House of Representatives

The Honorable Bob Stump
Chairman
The Honorable G.V. (Sonny) Montgomery
Ranking Minority Member
Committee on Veterans Affairs
House of Representatives

ENCLOSURE I

Internal Revenue Service

Department of the Treasury

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Date: JUN 23 1995

Ms. Rachel DeMarcus
Assistant General Counsel
General Accounting Office
Washington, D.C. 20548

Room 7T45

Dear Ms. DeMarcus:

This responds to your letter to Stuart L. Brown, IRS Chief Counsel, dated March 31, 1995. Because your letter raises issues under the jurisdiction of this office, Mr. Brown has asked that we respond to you directly. In connection with a report you have prepared for Congress under § 654 of the National Defense Authorization Act, you ask about the tax consequences to United States veterans of certain statutorily required offsets of veterans' separation benefits and disability compensation.

Your request raises two principal issues. The first concerns whether § 104 of the Internal Revenue Code (Title 26 U.S.C.)[1] applies to retroactively exclude from gross income the otherwise taxable separation pay that is recouped through offset. Our response to this issue is set forth below.

The second issue is, alternatively, whether veterans may deduct, under the claim of right doctrine or any other basis, an amount equal to the lump sum separation pay that the Department of Veterans Affairs (DVA) offsets against disability compensation. We are currently studying this issue and will respond to you in a separate letter as soon as possible.

Your request concerns three types of separation benefits that are payable to veterans upon discharge from active service in the Armed Forces. 10 U.S.C. § 1174 provides for a lump sum payment upon involuntary discharge. 10 U.S.C. § 1174a provides for a lump sum special separation benefit (SSB) payable at the veteran's election upon voluntary discharge. 10 U.S.C. § 1175 provides for a voluntary separation incentive (VSI), an annual annuity payable at the veteran's election also upon voluntary discharge. Each form of separation benefit is computed using a different formula that takes into account the veteran's length of service and rate of pay upon separation.

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[1] All section references are to the Internal Revenue Code unless otherwise noted.

Some veterans who received separation benefits qualify subsequently for disability compensation. In that event, regardless of the form of separation benefit received, some kind of offset of the disability compensation and the separation benefit is required. Concerning the lump sum payment benefits (involuntary discharge benefits and SSB), 10 U.S.C. § 1174(h)(2) provides, in part, as follows:

> A member who has received separation pay under this section, or severance pay or readjustment pay under any other provision of law, based on service in the armed forces shall not be deprived, by reason of his receipt of such separation pay, severance pay, or readjustment pay, of any disability compensation to which he is entitled . . . , but there shall be deducted from that disability compensation an amount equal to the total amount of separation pay, severance pay, and readjustment pay received.[2]

Concerning VSI annuity payments, 10 U.S.C. § 1175(e)(4) provides, in part, as follows:

> A member who is receiving voluntary separation incentive payments shall not be deprived of this incentive by reason of entitlement to disability compensation . . ., but there shall be deducted from voluntary separation incentive payments an amount equal to the amount of any such disability compensation concurrently received.

Thus, DVA offsets involuntary separation or SSB lump sum payments against disability compensation by withholding disability compensation payments until DVA recoups the prior lump sum separation amounts that the Department of Defense (DOD) previously paid. Conversely, DOD offsets currently payable VSI annuity payments against disability compensation by withholding the VSI payments up to the amount of disability compensation payable.

Section 61 provides that, unless otherwise excluded by law, gross income means all income from whatever source derived, including compensation for services. Rev. Rul.

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[2] 10 U.S.C. § 1174(h)(2). With respect to a SSB, § 1174a(g) of Title 10 provides that certain provisions of § 1174, including subsection (h), shall apply in the administration of programs established under § 1174a.

67-350, 1967-2 C.B. 58, holds that a member of the Armed Forces who is released involuntarily from active duty must include readjustment pay in gross income in the taxable year received.

Section 104(a)(4) provides, in part, that gross income does not include amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the Armed Forces, or as a disability annuity payable under the provisions of § 808 of the Foreign Service Act of 1980.

Section 104(b)(2) provides that § 104(a)(4) only applies to individuals who (A) were entitled to receive an amount described in § 104(a)(4) on or before September 24, 1975; (B) were members of an organization referred to in § 104(a)(4) or under a written commitment to become members on September 24, 1975; (C) receive an amount described in § 104(a)(4) by reason of a combat-related injury or; (D) would, on application, be entitled to receive disability compensation from the DVA.

Section 104(b)(4) generally provides that if some part of the compensation paid to a veteran was an amount to which § 104(a)(4) applied, the amount excludable under § 104(a)(4) is not less than the amount of disability compensation to which the veteran would be entitled for that period from DVA.

Title 38 U.S.C. § 5301(a)[3] generally provides that veterans' benefits, including disability compensation paid by the DVA, is exempt from tax.

The separation pay at issue in the present case is not an amount received for personal injuries or sickness under § 104(a)(4). A veteran cannot reclassify taxable separation pay as an amount received for personal injuries or sickness excludable under § 104(a)(4) simply because DVA subsequently determines that the veteran qualifies for disability compensation for the same period. See Berger v. Commissioner, 76 T.C. 687, 693-94 (1981); Rev. Rul. 80-9, 1980-1 C.B. 11.

Similarly, § 104(b)(4) does not apply. Section 104(b)(4) applies only if the veteran received, in the earlier year, some amount that was excluded from gross income under § 104(a)(4). Thus, in Grady v. Commissioner, T.C. Memo. 1989-55, the United States Tax Court held that § 104(b)(4) did not operate to exclude any portion of disability compensation paid under the

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[3] Formerly 38 U.S.C. § 3101(a).

Civil Service Retirement Act because no portion of that compensation is excludable under § 104(a)(4). Because the lump sum benefits payable under 10 U.S.C. §§ 1174 and 1174a are not amounts to which § 104(a)(4) applies, § 104(b)(4) is inapplicable.

However, some portion of the recouped separation pay may be excluded retroactively under 38 U.S.C. § 5301(a) if a veteran executes a waiver of the separation pay in the year the veteran receives it. In Strickland v. Commissioner, 540 F.2d 1196, 1199 (4th Cir. 1976), the taxpayer retired in 1964 from the Army and began receiving periodic taxable retirement payments based on rank and length of service. He subsequently applied to the Veterans' Administration (VA) for service-connected disability benefits and was awarded a 10 percent rating in 1965. In March 1965, taxpayer executed a VA-required waiver (VA Form 21-651) of so much of his retirement pay as equalled the disability compensation VA might award him. In March 1966, the taxpayer filed a supplemental claim requesting increased disability compensation. In January 1967, VA rated him 100 percent disabled, retroactive to March 1966, and increased his disability payments.

The court held that because the taxpayer had executed a waiver, VA's retroactive determination that the taxpayer was eligible for increased disability benefits was controlling. Thus, the taxpayer was allowed under former 38 U.S.C. § 3101(a) to exclude from gross income so much of the taxable retirement pay he had received beginning in March 1966 as equalled his total disability entitlement for that period. In Rev. Rul. 78-161, 1971-1 C.B. 31, the Service announced that it would follow Strickland in cases with substantially similar facts.[4] Thus, if a veteran is permitted to execute a waiver of separation pay

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[4] Rev. Rul. 80-9, 1980-1 C.B. 11, concludes that Strickland and § 104(a)(4) are inapplicable to readjustment payments under 10 U.S.C. § 687(b)(6) (now repealed) that were recouped due to the veteran's subsequent qualification for nontaxable disability compensation. Rev. Rul. 80-9 reasons, in part, that § 104(a)(4) only applies to amounts paid in the form of periodic payments. Because the readjustment pay at issue was paid in a lump sum, Rev. Rul. 80-9 concludes that § 104(a)(4) and (b)(4), and Strickland, do not apply. However, the court in St. Clair v. United States, 778 F. Supp. 894, 896 (E.D. Va. 1991) held that § 104(a)(4) is not limited to amounts paid in periodic form. The Service has acquiesced in St. Clair and no longer takes the position that amounts cannot be excluded under § 104(a)(4) solely because they are in the form of a lump sum.

benefits, and the waiver is effective for the year in which the veteran received the separation pay benefits, the veteran would be entitled to exclude from gross income under 38 U.S.C. § 5301(a) an amount equal to the veteran's disability compensation for that period.

In addition, 10 U.S.C. § 1175(e) requires that DOD offset currently payable VSI against DVA disability benefits by withholding the VSI up to the amount of the DVA compensation payable. Thus, the veteran in this situation is receiving DVA disability benefits that are excludable from gross income under 38 U.S.C. § 5301(a).

You ask whether the veteran may deduct, under the claim of right doctrine or on any other basis, an amount equal to the separation pay that DVA deducts from the disability benefits payable to the veteran. Rev. Rul. 80-9, 1980-1 C.B. 11, considers whether veterans are allowed to deduct under § 165 the amount of lump sum readjustment pay they received under former 10 U.S.C. § 687 (now repealed) that is later recouped through an offset against DVA disability for which the veterans later qualify. Unlike the present case, § 687 required recoupment of only 75 percent of the readjustment pay. Congress stated in the legislative history of 10 U.S.C. § 687 that it intended the fractional recovery to take into account the tax paid on the original payment, and thereby avoid recouping more than the amount of readjustment pay the veteran had received net of taxes.

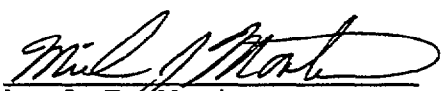
Rev. Rul. 80-9 concludes that the taxpayers may not deduct the recouped readjustment pay for two reasons. First, the taxpayers had suffered no deductible loss under § 165 because they had never constructively received the disability pay that DVA withheld. Second, § 687 only required recoupment of 75 percent of the readjustment pay, allowing the veterans to retain 25 percent to account for the taxes they had paid. Because Congress provided this mechanism to account for the taxes, to also allow the veterans a deduction under § 165 for the 75 percent recouped would result in an impermissible double benefit.

We are currently reconsidering Rev. Rul. 80-9, specifically regarding the first rationale. Concerning the second rationale, the present case appears to be distinguishable from Rev. Rul. 80-9 because 10 U.S.C. § 1174(h) requires recoupment of 100 percent of the separation pay. Because this issue is likely to require consideration at higher review levels within the Service, we intend to respond to your question about deducting the recouped separation pay in a separate letter.

We hope that the information we have provided is helpful to you. If you have any questions regarding this letter, please contact David A. Schneider of this office at (202) 622-8472.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

By: 
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ENCLOSURE II

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Ms. Rachel DeMarcus
Assistant General Counsel
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Dear Ms. DeMarcus:

This responds to the second principal issue raised in your letter dated March 31, 1995, to Stuart L. Brown, Chief Counsel of the Internal Revenue Service. This Office responded to your first principal issue in a letter dated June 23, 1995.

The second issue concerns veterans of United States armed services who have received taxable separation payments and who in a later year become eligible for nontaxable disability compensation. 10 U.S.C. section 1174 provides under certain circumstances for a lump sum payment upon involuntary discharge from active duty. 10 U.S.C. section 1174a provides under certain circumstances for a lump sum special separation benefit payable upon voluntary discharge from active duty. Some veterans who receive separation benefits qualify subsequently for disability compensation. As you note, 10 U.S.C. section 1174(h)(2) prohibits the receipt of both separation payments and disability compensation.[1]

The issue is whether veterans may deduct, under the claim of right doctrine or any other basis, an amount equal to the lump sum separation pay that the Department of Veterans Affairs (DVA) offsets against disability compensation. For the reasons stated below, we conclude that veterans are not entitled to an income tax deduction for the amount of the separation payment that is offset against their disability compensation.

Section 165(a) of the Code allows a deduction for any loss sustained during the taxable year which is not compensated for by insurance or otherwise. With respect to individuals, section 165(c) of the Code limits the deduction under section 165(a) to losses incurred in a trade or business, losses incurred in transactions entered into for profit, and casualty losses.

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[1] Section 1174(h)(2) provides, in pertinent part, that "[a] member who has received separation pay under this section . . . shall not be deprived by reason of his receipt of such separation pay, of . . . any disability compensation to which he is entitled under the laws administered by the Department of Veterans Affairs, but there shall be deducted from the disability compensation an amount equal to the total amount of separation pay . . . received."

In this regard, taxpayers who receive taxable income as compensation and who subsequently are required to repay all or a portion of the compensation to the employer may claim a deduction under section 165 of the Code for the amount repaid to the employer. United States v. Lewis, 340 U.S. 590 (1951).

In Rev. Rul. 79-322, 1979-2 C.B. 76, for example, a federal employee was injured on the job and missed a substantial amount of work. The employee initially received sick-leave compensation that was included in the employee's taxable income. The employee subsequently became eligible to receive tax-exempt compensation relating back to the date of the injury. In order to receive the tax-exempt compensation, the employee was required to return an amount equal to the amount he had previously received as sick-leave compensation. The Internal Revenue Service concluded that if a taxpayer, as a condition precedent to receiving tax-exempt income, must "buy back" leave that was taxable compensation in an earlier year, the amount paid to buy back leave is a loss deductible in the year paid under section 165 of the Code, provided the employee itemizes deductions.

In Rev. Rul. 80-9, 1980-1 C.B. 11, however, the Internal Revenue Service concluded that veterans were not entitled to a section 165 loss deduction for the amount of taxable readjustment payment that the Veterans Administration recouped through an offset against nontaxable disability compensation for which the veterans later qualified. Recoupment was under 10 U.S.C. section 687 (the predecessor to 10 U.S.C. section 1174(h)(2)), which provided that a veteran could receive a readjustment payment and disability compensation if an amount equal to seventy-five percent of the readjustment payment was deducted from the disability compensation.

Rev. Rul. 80-9 provided two rationales for its conclusion that a section 165 deduction was not allowed. The first rationale was that the recoupment provision did not give rise to a loss deduction because the veteran was considered as never having received the withheld disability compensation. This position is consistent with Rev. Rul. 67-350, 1967-2 C.B. 58, which dealt with a reduction in a reservist's military retirement pay to offset a previously received lump-sum readjustment payment. Rev. Rul. 67-350 held that there was no constructive receipt of the withheld retirement pay. Rev. Rul. 80-9 concluded that because the disability compensation was not received by the veteran, the veteran could not take a loss deduction as a result of the withholding of any disability compensation.

The second rationale of Rev. Rul. 80-9 was that even if the withheld disability compensation were regarded as the veteran's

repayment of the severance pay previously received and subjected to tax, a loss was nevertheless not allowed. The legislative history of the recoupment provision indicated that Congress intended that veterans would not be able to take any deductions as a result of the recoupment of readjustment pay. Congress limited the recoupment to seventy-five percent of the readjustment pay so as to avoid recoupment of an amount in excess of the net amount after tax received by a veteran, assuming an average tax bracket of twenty-five percent. Such a limitation would not have been necessary if the recoupment were to give rise to a loss deduction.

Congress replaced the recoupment provision, 10 U.S.C. section 687, at issue in Rev. Rul. 80-9 with the recoupment provision, 10 U.S.C. section 1174(h)(2), at issue here. In contrast with the seventy-five percent recoupment provided for by its predecessor, 10 U.S.C. section 1174(h)(2) provides for a one hundred percent recoupment of separation payments before any disability compensation can be paid.

We would make two points about the statutory change in recoupment provisions. On the one hand, since Congress no longer limits recoupment to seventy-five percent, the second no loss rationale of Rev. Rul. 80-9 does not apply here. On the other hand, we have been unable to find any legislative history of 10 U.S.C. section 1174(h)(2) that reflects Congress' intent in changing the recoupment provision. Thus, we are unable to conclude that Congress intended that veterans be entitled to a loss deduction when their disability compensation is reduced by the amount of separation payments previously received.

Application of the foregoing principles to the situation under consideration indicates that a veteran is not entitled to a deduction from gross income for amounts deducted from payments to which the veteran is otherwise entitled. With regard to the disability compensation, the effect of 10 U.S.C. section 1174(h)(2) is to reduce the total amount of disability compensation payable to the veteran by the amount of separation pay previously received. See Rev. Rul. 67-350. Because the veteran is considered as never having received the withheld disability compensation, the veteran can not be treated as having repaid the separation payments for tax purposes. This is in contrast to the situation in Rev. Rul. 79-322 where the federal employee received a loss deduction for the repayment of an amount equal to previously received compensation in order to qualify for tax-exempt income. Accordingly, the Veterans Administration's

recoupment provision does not give rise a loss deduction under section 165 of the Code. See Rev. Rul. 80-9.[2]

If you have any questions regarding the information provided, please call Elizabeth Wickstrom at (202) 622-4930.

Sincerely yours,

Assistant Chief Counsel
(Income Tax & Accounting)

By: Michael D. Finley
Michael D. Finley
Chief, Branch 5

[2] Section 1341 of the Code similarly is inapplicable. That section applies only in situations in which the Code provides a deduction from gross income under a provision other than section 1341 (i.e., section 1341 does not independently provide a deduction). Because we have concluded that the Code does not otherwise provide such a deduction, section 1341 by its terms is inapplicable to the situation addressed herein.

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