

**Legislative Recommendation #60**

## **Amend the Combat-Injured Veterans Tax Fairness Act of 2016 to Allow Veterans of the Coast Guard to Exclude Disability Severance Pay From Gross Income and File Claims for Credit or Refund for Taxes Withheld From Excluded Income**

**PRESENT LAW**

IRC § 61(a)(1) provides that compensation for services is includable in gross income. Severance payments generally are treated as compensation and therefore subject to taxation.

IRC § 104(a)(4) provides an exclusion from gross income for payments received for personal injuries or sickness resulting from active service in the armed forces.

IRC § 104(b)(2) clarifies that the exclusion from gross income in IRC § 104(a)(4) applies to an amount received because of a combat-related injury or if an individual, upon application, could receive disability compensation from the Department of Veterans Affairs. IRC § 104(b)(3) defines “combat-related injury” as a personal injury or sickness that occurred “as a direct result of armed conflict, while engaged in extrahazardous service, or under conditions simulating war; or which is caused by an instrumentality of war.”

To obtain a credit or refund, a taxpayer must file a timely claim. IRC § 6511(a) provides that a taxpayer generally must file a claim for credit or refund within three years from the time the tax return was filed or two years from the time the tax was paid, whichever period expires later.

In 2016, Congress passed the Combat-Injured Veterans Tax Fairness Act (the “Act”).<sup>1</sup> In a findings section, the Act states: “Since 1991, the Secretary of Defense has improperly withheld taxes from severance pay for wounded veterans, thus denying them their due compensation and a significant benefit intended by Congress.” Recognizing that the period of limitation for filing a claim for credit or refund to recover overwithheld tax had long since expired for most tax years since 1991, the Act created an exception from the general period of limitation.

Specifically, the Act directed the Secretary of Defense (i) to identify disability severance pay (DSP) that was not considered gross income pursuant to IRC § 104(a)(4) and from which the Secretary improperly withheld tax and (ii) to send notices to all affected veterans notifying them of their eligibility to receive credits or refunds and providing instructions for filing amended tax returns. It further provided that veterans who received DSP from the Department of Defense may file timely claims for credit or refund within one year from the date of the notice sent by the Secretary of Defense or by the date the period of limitations described in IRC § 6511(a) expires, whichever is later.

IRC § 7701(a)(15) defines the terms “military or naval forces of the United States” and “Armed Forces of the United States” to include “all regular and reserve components of the uniformed services which are subject

<sup>1</sup> Pub. L. No. 114-292, 130 Stat. 1500 (2016).

to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force [as well as] the Coast Guard.”

## REASONS FOR CHANGE

Notwithstanding that the IRC’s definition of “military or naval forces of the United States” includes the Coast Guard, the Act as drafted excludes veterans of the Coast Guard from its scope. Section 3(a) of the Act directed the Secretary of Defense to identify DSP paid after January 17, 1991, that should have been excluded from gross income, but the Coast Guard does not report to the Secretary of Defense. The Coast Guard reports to the Secretary of Homeland Security.

It seems likely that omitting the Coast Guard from the DSP tax relief provision resulted from a drafting error. Like members of the services within the Department of Defense, members of the Coast Guard often face perilous circumstances and potential injuries as they perform their mandated duties. For example, the Coast Guard maintains a “state of readiness to assist in the defense of the United States, including when functioning as a specialized service in the Navy pursuant to [14 USC] section 103.”<sup>2</sup> There is no reason Coast Guard veterans should not be provided the same additional time to file a claim for credit or refund as other veterans of the “military or naval forces of the United States.” While the number of veterans affected by this issue is relatively limited,<sup>3</sup> the National Taxpayer Advocate believes fairness and parity in treatment among the armed forces of the United States require that this apparent drafting error be corrected.

## RECOMMENDATION

- Amend Section 3(a) of the Combat-Injured Veterans Tax Fairness Act of 2016 to provide that the severance payments specified under Section 3(a) include those paid by the Secretary of Homeland Security (or predecessor) and to require the Secretary of Homeland Security to notify veterans of the Coast Guard about disability severance pay from which taxes were withheld.

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<sup>2</sup> 14 U.S.C. § 102.

<sup>3</sup> The Treasury Inspector General for Tax Administration (TIGTA) recently estimated that 1,116 Coast Guard veterans are affected. See TIGTA, Ref. No. 2020-40-029, *Improvements Are Needed to Ensure That Members of the Military Receive Tax Benefits to Which They Are Entitled* 13 (May 26, 2020).