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**TEXT:**

Consideration of VA Compensation Benefits in Computation of Tax Credits

**QUESTION PRESENTED:**

Would consideration of VA compensation benefits in computing the amount of a Federal tax credit constitute taxation in violation of 38 U.S.C. § 5301(a) (formerly 3101(a))? FN1

**COMMENTS:**

1. This question arose as the result of an inquiry concerning the consideration of VA compensation benefits in the computation of a tax credit for the elderly and the disabled under 26 U.S.C. § 22. That credit, as currently written and as originally enacted as a retirement-income credit for the elderly, was intended to provide those whose retirement benefits are taxable with a tax benefit generally equivalent to that enjoyed by those receiving tax-exempt retirement income. Accordingly, the credit base is reduced by the amount of tax-exempt retirement income received. E.g., S.Rep. No. 95-1263, 95th Cong., 2d Sess. 60, reprinted in 1978 U.S.Code Cong. & Admin.News 6761, 6823; S.Rep. No. 830, 88th Cong., 2d Sess., reprinted in 1964 U.S.Code Cong. & Admin.News 1673, 1710; S.Rep. No. 2202, 87th Cong., 2d Sess., reprinted in 1962 U.S.Code Cong. & Admin.News 4012, 4012-13; Senate Finance Committee Report (to accompany H.R. 8300), 83d Cong., 2d Sess., reprinted in 1954 U.S.Code Cong. & Admin. News 4621, 4799-801. The original law provided that the base for computation of the retirement-income credit was to be reduced by any amount received as a pension or annuity that was excluded from gross income, but specifically excepted amounts excluded from gross income as pension or similar allowance for injuries or sickness resulting from active service in the armed forces. Internal Revenue Code of 1954, Pub.L. No. 591, ch. 736, § 37, 68A Stat. 3, 15. The law providing for the credit was amended in 1983 to reduce the credit base amount by the amount received as a pension, annuity, or disability benefit which was excluded from gross income and payable under a law administered by VA, or which is excluded from gross income under a law not contained in title 26, United States Code. Pub.L. No. 98-21, § 122, 97 Stat. 65, 85 (1983). Whether VA dependency and indemnity compensation is properly considered a pension or disability benefit for purposes of computation of the tax credit is a matter of interpretation of title 26 within the jurisdiction of the Internal Revenue Service (IRS).

2. Section 5301(a) of title 38, United States Code, provides in pertinent part that " p ayments of benefits due or to become due under any law administered by the Department of Veterans Affairs ... shall be exempt from taxation." The tax-exempt status of VA benefits originated with an amendment to the act which created the Bureau of War Risk Insurance. That amendment exempted certain death and disability compensation from all taxation. See Act of October 6, 1917, ch. 105, § 311, 40 Stat. 398, 408. A subsequent amendment extended the exemption to all compensation, insurance, allotments and family allowances payable under that act. Act of June 25, 1918, ch. 104, § 2, 40 Stat. 609. The exemption was continued under section 22 of the World War Veterans' Act, 1924, ch. 320, 43 Stat. 607, 613. When section 22 was repealed in 1935, a new statute was enacted which provided a broad tax exemption for benefits payable "under any of the laws relating to veterans." Act of August 12, 1935, ch. 510, § 3, 49 Stat. 607, 609. A substantially similar provision is currently contained in 38 U.S.C. § 5301(a).

3. The meager legislative history of these provisions does not address the question of tax credits. However, it has been recognized that 38 U.S.C. § 3101(a) (now section 5301) served the dual purposes of "avoid ing the possibility of VA ... being placed in the position of a collection agency and preventing the deprivation and depletion of the means of subsistence of veterans dependent upon these benefits as the main source of their income." S.Rep. No. 94-1243, 94th Cong., 2d Sess. 147-48, reprinted in 1976 U.S.Code Cong. & Admin.News 5241, 5369-70; see also Rose v. Rose, 481 U.S. 619, 630 (1987). The consideration of VA compensation benefits in the computation of a tax credit is not contrary to these purposes because VA is not required to withhold any funds and there is no depletion of the funds paid the beneficiary by VA.

4. Taxes have been described as "compulsory payments ... involving a transfer of control over resources from persons or organizations to the state." 26 Encyclopedia Americana Tax 316 (1982). Section 5301(a) prohibits taxation of veterans' benefits, i.e., the transfer of VA compensation from the entitled beneficiary to the state. Requiring consideration of VA pension and disability benefits in the computation of a tax credit for the elderly and the disabled would not affect the beneficiary's control over his or her VA benefits. Therefore, such consideration would not conflict with section 5301(a).

5. This interpretation is consistent with application of the veterans-benefit and tax statutes in related situations. In Rev.Rul. 80-173, 1980-2 C.B. 60, the IRS held that a taxpayer could not take a deduction under 26 U.S.C. § 162(a) (expenses of trade or business) for flight training expenses that were reimbursed by VA under former 38 U.S.C. § 1677 (repealed 1981). That ruling was examined in Manocchio v. Commissioner, 78 T.C. 989 (1982), aff'd, 710 F.2d 1400 (9th Cir.1983), in which the Tax Court held that 26 U.S.C. § 265(1) bars deduction of the reimbursed expenses. Section 265(1) precludes deduction of expenses

allocable to income wholly exempt from taxation. Reviewing the legislative history of that provision, the court noted that "Congress sought to prevent taxpayers from reaping a double tax benefit by using expenses attributable to tax-exempt income to offset other sources of taxable income." Manocchio, 78 T.C. at 997. The court in Manocchio further stated:

W e are satisfied that our decision does not frustrate the purpose of either the exemption provided by 38 U.S.C. sec. 3101(a) or the reimbursement program created by 38 U.S.C. sec. 1677.

....

In short, there is nothing in the legislative history of the relevant veterans' provisions to suggest that Congress intended for a veteran to have both an exemption and a tax deduction where his reimbursed flight- training expenses otherwise qualify as deductible business-related education. 78 T.C. at 996-97 FN2 ; see also, e.g., Allen v. Commissioner, 51 T.C.M. (CCH) 427 (1986); Kendel v. Commissioner, 50 T.C.M. (CCH) 1279 (1985); Wells v Commissioner, 45 T.C.M. (CCH) 173 (1982); and Murphy v. Commissioner, 45 T.C.M. (CCH) 1 (1982) (following Manocchio in indicating that nothing in the legislative history of former section 3101(a) suggests that Congress intended thereby to authorize a double tax benefit). FN3

6. The rationale of avoiding double tax benefits applies to tax credits as well as tax deductions. In Rickard v. Commissioner, 88 T.C. 188 (1987), the Tax Court cited Manocchio and denied a deduction for losses from farming operations on Indian allotment land when profits from such operation are tax- exempt. The court then went on to deny entitlement to an investment tax credit derived from those farming operations, citing the language of the statutes authorizing the credit, 26 U.S.C. §§ 38(a) and 48(a), their legislative history, and the policy concern that it would be "a breach of faith with all other taxpayers ... to allow a double tax benefit ... without explicit Congressional approval." 88 T.C. at 197. While these cases involve statutes other than those at issue here, the policy of avoiding creation of a double tax benefit absent clear evidence of congressional intention is relevant.

7. We also note that Congress may be presumed to have been aware of former section 3101(a) when it adopted the tax credit for the elderly and disabled. 73 Am.Jur.2d Statutes § 180 (1974). Since Congress explicitly called for consideration of at least some veterans' benefits in computation of the tax credit, it either found no inconsistency between that provision and former section 3101(a) or deemed that, to the extent of any conflict, the more recently enacted statute would control. 2A N. Singer, Sutherland Statutory Construction, § 51.02 (4th ed. 1984).

8. In summary, the statutory language of the tax credit for the elderly and the disabled explicitly provides that VA pension and disability benefits are to be considered in computing the credit. Consideration of VA compensation benefits

in computation of the tax credit is not contrary to the terms or purposes of section 5301(a) because VA is not required to withhold any funds and because inclusion of the VA benefits in the tax-credit computation does not affect the beneficiary's control over his or her benefits. Further, to omit non-taxable income from the tax-credit computation would allow a double tax benefit with respect to that income, a result to be avoided in the absence of specific congressional authorization. Thus, we conclude that inclusion of VA benefits in computation of the credit would not undermine the tax-exempt status of VA benefits.

**HELD:**

Consideration of VA compensation benefits by deducting them from the credit base in computing the amount of a Federal tax credit would not constitute taxation of those benefits in violation of 38 U.S.C. § 5301(a), which exempts from taxation payments of benefits due or to become due under any law administered by the Department of Veterans Affairs.

1 The Department of Veterans Affairs Health-Care Personnel Act of 1991, Pub.L. No. 102-40, s 402(b)(1), 105 Stat. 187, 238 (1991), redesignated each section in, among other chapters, chapter 53 of title 38, United States Code, so that the first two digits of the section number are the same as the chapter number of the chapter containing that section.

2 The U.S. Court of Appeals for the Ninth Circuit affirmed the Tax Court ruling in Manocchio on the rationale that 26 U.S.C. § 162(a), which allows deduction for ordinary and necessary business expenses, does not apply to reimbursed expenditures. Manocchio v. Commissioner, 710 F.2d 1400, 1402 (9th Cir. 1983). Resting its decision on the definition of an expense under 26 U.S.C. § 162(a), the court did not reach the Tax Court's construction of former 38 U.S.C. § 3101(a) (now section 5301(a)) or 26 U.S.C. § 265(1). Id.

3 Subsequent to the Tax Court ruling in Manocchio, the IRS issued Rev.Rul. 83-3, 1983-1 C.B. 72, which expanded the holding of Rev.Rul. 80-173 to VA reimbursement of other types of educational expenses, holding that a veteran may not deduct educational expenses if the amounts expended are allocable to tax-exempt veterans' benefits. Not addressing the potential impact of former section 3101(a), the IRS relied upon the analysis in Manocchio and the purpose of section 265(1), i.e., prevention of "a double tax benefit." The IRS also cited United States v. Skelly Oil Co., 394 U.S. 678 (1969), in which the U.S. Supreme Court stated that the Internal Revenue Code should not be interpreted to permit the equivalence of double deductions.

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