Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Michelle Benson
Governmental Liaison, Minnesota

from: William Jackson
Chief, Branch 5
Associate Chief Counsel
(Income Tax and Accounting)

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subject: Minnesota Military Service Tax Credit

You have requested Chief Counsel Advice from us in order to assist you in responding to inquiries concerning the federal tax treatment of a new income tax credit enacted by the State of Minnesota (State). This advice may not be used or cited as precedent. You have described the facts as follows.

FACTS

In May, 2006, State enacted a new income tax credit called the "Military Service Credit." See article 2 of H.F. No. 785, 4th Engrossment – 84th Legislative Session (2005-2006). State residents are allowed a credit against state tax equal to $59 for each month or portion of the month that a resident is or was in active military service in a designated area after September 11, 2001. If the allowed credit exceeds the resident's state tax liability, such excess is paid by State to the resident. The term "active military service" means active duty service in any of the United States Armed Forces, the National Guard, or reserves. The term "designated area" means: (1) a combat zone designated by Executive Order from the President of the United States; (2) a qualified hazardous duty area, designated in Public Law; or (3) a location certified by the U. S. Department of Defense as eligible for combat zone tax benefits due to the location's direct support of

military operations. Eligible areas include the Arabian Peninsula Areas, the Kosovo area, Afghanistan, and supporting areas.

If the resident is killed while performing active military service in a designated area, the resident's surviving spouse or dependent child may claim the credit. For active military service performed after September 11, 2001, but before December 31, 2006, the resident or survivor may claim the credit for the taxable year 2006. For active military service performed after December 31, 2006, the resident or survivor may claim the credit for the taxable year in which the active service was performed. Any individual entitled to this credit must claim the credit by filing an application separate from a State individual income tax return. On the application, the individual will provide personal data (name, address, social security number, phone number), a statement by the claimant regarding the number of months or part of months that the claimant was in a combat zone, and a copy of a federal form (DD 2058) that lists the claimant's military homes of record for the time period for which they were in the military.

For 2006, State estimates that the credit will be claimed by 12,000 individuals and amount to approximately $8,100,000. Payments will be made out of the State General Fund that is comprised of a variety of revenue streams.

ISSUES

1. Whether and to what extent the State military service tax credits are includible in gross income under § 61 of the Internal Revenue Code.

2. Assuming the refunded portion of the State military service tax credit is includible in income, whether such amounts are excluded from income as gifts under § 102(a).

3. Whether § 102(c) precludes treatment of the State military service tax credit as a gift when the credit is provided to members of the State National Guard or to individuals who are employees of State when they are not performing active military service for the United States Armed Forces.

CONCLUSIONS

1. The amount of the State military service tax credit applied against State tax liability is treated as a reduction in State tax thereby reducing the amount available as a deduction for state income taxes under § 164(a)(3). Any amount of the State military service tax credit in excess of State tax liability that is paid to the taxpayer is included in gross income unless an exclusion applies.

2. The refunded portion of the State military service tax credit is generally excludible from gross income as a gift under § 102(a).

3. Section 102(c) does not preclude treatment of the State military service tax credit as a gift when the credit is provided to members of the State National Guard or to individuals who are employees of State when they are not performing active military service for the United States Armed Forces even in cases where the credit is provided after the military member has returned to employment with State or service in the State National Guard.

DISCUSSION

1. Whether and to what extent the State military service tax credits are includable in gross income under § 61 of the Code.

Section 61(a) of the Code provides that, except as otherwise provided, gross income means all income from whatever source derived. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431, reh'g denied, 349 U.S. 925 (1955) (holding gross income encompasses any item representing "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

The value of benefits received from a state government, whether in kind or in cash or equivalent, by an individual as compensation for services is includible in gross income. Section 61(a)(1); Treas. Reg. § 1.61-2(d). In appropriate circumstances, a reduction in state taxes may be characterized as compensation for services. Cf. Watervliet v. Commissioner, 16 B.T.A. 604 (1929) (Discussing tax reductions as compensation for specific services; "If the town had paid for these services and the petitioner had used these . . . funds in satisfying the taxes which were assessed, it could hardly be argued that the former did not constitute income and the latter a deduction.") However, state benefits conferred in recognition of military service cannot be treated as compensation for such service because the published position of the Internal Revenue Service treats cash payments by a state in recognition of its citizens' military service as gifts for income tax purposes. Rev. Rul 68-158, 1968-1 C.B. 47. Hence, there is no basis for treating so much of the credit applied against tax liability as compensation. The better approach for federal income tax purposes is to treat so much of the credit that is applied against the state tax liability as a mere reduction in taxes thereby reducing the amount available for deduction in accordance with § 164(a)(3).

With regard to any refundable excess, payments received from a state government are generally items of gross income under § 61 unless the payment represents the recovery of an amount previously paid to the state. Cf. Rev. Rul. 91-36, 1991-2 C.B. 17; Rev. Rul. 79-356, 1979-2 C.B. 28 (state grants for purchasers of solar hot water systems includable in recipient's gross income). Accordingly, to the extent that the State military service credit exceeds the servicemen's State tax liability and is paid to the servicemen, such payment is included in gross income under § 61 unless some exclusion applies.

2. Whether the refunded portion of the State military service tax credit is excluded from gross income as a gift under § 102(a).

Section 102(a) of the Code provides that gross income does not include the value of property acquired by gift. Neither the Code nor legislative history accompanying § 102 defines the term "gift." A leading authority on the meaning of the term "gift" for § 102 purposes is Duberstein v. Commissioner, 363 U.S. 278 (1960). In Duberstein, the Supreme Court explained that a gift proceeds from a "detached and disinterested generosity," and is made "out of affection, respect, admiration, charity or like impulses." If a payment proceeds primarily from "any moral or legal duty" or from "the incentive of anticipated benefit" of an economic nature, it is not a gift.

In many cases the government payments fail to be gifts under § 102 because the payments are made in anticipation of future benefits or the payments are made out of the government's duty to relieve hardship caused by a natural disaster. For example, Kroon v. United States, 74-2 U.S.T.C. 9641 (D. Alaska 1974), involved homeowners who received payments by the State of Alaska pursuant to the Alaska Mortgage Adjustment Program in order to retire the mortgages on residences destroyed by an earthquake. The court held that the payments were not gifts under § 102 and were includible in the homeowner's gross income because the payments were prompted out of the state's moral obligation to its citizens rather than out of charity and disinterested generosity. See also Rev. Rul. 2003-12, 2003-3 I.R.B. 283; Notice 2003-18, 2003-1 C.B. 699 (grants of September 11, 2001, aid were not gifts because legislative intent indicated that the grant funds were for "economic revitalization," to help New York City in its "overall economic recovery," and to assist the "economic recovery" of areas affected by the terrorist attack); Rev. Rul. 85-39, 1985-1 C.B. 21 (Alaska dividend payments were not gifts because legislative intent indicated one of the purposes behind the payments was "reducing population turnover resulting in a more stable political, economic, and social environment"); Rev. Rul. 76-131, 1976-1 C.B. 16; Foley v. Commissioner, 87 T.C. 605 (1986) (holding that payments from the West Berlin government to its residents and workers designed to encourage consumption and spending to improve West Berlin's economic vitality were not gifts under § 102); Beattie v. United States, 635 F. Supp. 481 (D. Alaska 1986), aff'd, 831 F.2d 916 (9th Cir. 1987), cert. denied, 485 U.S. 1006 (1988).

However, payments by governments have been treated as nontaxable gifts under § 102 if the payments have been made to a class of individuals and the payments are based on the activities of that class.

Rev. Rul. 68-158, 1968-1 C.B. 47, is directly on point. This revenue ruling holds that payments made by a state to or on behalf of its qualified veterans who served in the Armed Forces of the United States during the Spanish-American War, the Philippine Insurrection, World War I, World War II, and the Korea and Vietnam conflicts are gifts and are not includible in the gross income of the recipients for federal income tax purposes. See also Rev. Rul. 55-609 (death gratuity payments specifically designated

by Congress as gifts); and Dewling v. United States, 101 F. Supp. 892 (Ct. Cl. 1952) (holding payments from the federal government were gifts in recognition of the services rendered for construction of the Panama Canal built thirty years prior to payment).

Whether the payments made by State to certain of its citizens are gifts under § 102 depends on all the facts and circumstances. Here, the State military service tax credit is limited to a class of recipients based on military combat service because the credit is paid to or on behalf of State residents who served in active military service in a designated area after September 11, 2001. Accordingly, these payments may be considered gifts under § 102 and are generally excludible from the recipient's gross income.

3. Whether § 102(c) precludes treatment of the State military service tax credit as a gift when the credit is provided to members of the State National Guard or to individuals who are employees of State when they are not performing active military service for the United States Armed Forces.

Section 102(c) of the Code provides that § 102 will not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee.

Individuals who serve in the State National Guard have a dual status as employees of State and employees of the Federal government. The Army and Air National Guard of the United States (collectively "NGUS") is defined by statute as "the reserve component(s) of the Army whose members are members of the Army National Guard." To become a member of the NGUS, a person must enlist in, and be federally recognized as a member of, the National Guard of a particular state. 10 U.S.C. §§ 12201, 12105 and 12107.

As a reserve component of the armed forces, the NGUS is ordinarily not on active duty. However, the NGUS may be ordered to active duty in a variety of circumstances. Under Title 32 of the United States Code, state governors are in command and control of the National Guard in their respective states and territories. When NGUS is operating under the direction and control of the governors of the various states, NGUS is referred to be in "Title 32" status. Congress likewise enacted a separate Title 10 of the United States Code, which permits the Guard to be activated as part of the regular forces under the President of the United States during times of war and national crises. When this happens, the NGUS is referred to be in "Title 10" status.

In determining whether members of a state National Guard are employees of the state government or the federal government, it is useful to review the employment tax regulations, which describe when an employment relationship exists. Section 31.3121(d)-1(c)(2) of the regulations provides that:

> Generally, such relationship exists when the person for whom the services are performed has the right to control and direct the individual who performs the

> services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but also as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if her or she has the right to do so.

Based on the structure of the state National Guard system, and its relationship to the Armed Forces of the United States, we conclude that a member of the state National Guard has two separate employers: the state government and the federal government. When members of the state National Guard are in Title 32 status, such as when they are performing services for the state Governor in the event of a natural disaster, they are employees of the state. However, when members of the state National Guard are in Title 10 status, such as when they are called to active military service in a combat zone, they are employees of the federal government.

The Service has ruled that the employment relationship between an individual and his or her civilian employer is terminated when the individual enlists or is called for active military service with the United States Government or for active service with the State National Guard for more than a very short temporary period of time. See Rev. Rul. 69-136, 1969-1 C.B. 252. Therefore, employees of State who enlist or are called for active military service with the United States Government or for active service with the State National Guard in a combat zone are no longer considered to be employees of State during the period of military service. Similarly, when a member of the State National Guard is shifted from Title 32 status to Title 10 status (such as when the military member is performing services in a combat zone), the military member is no longer an employee of the State National Guard but instead, is an employee of the federal government.

When the State military service tax credit is provided to individuals who were employees of State or the State National Guard prior to their service in the Armed Forces of the United States which made them eligible for the tax credit, it is not provided by virtue of the military member's employment relationship with State. The credit is extended to those who qualify irrespective of whether they were employed by State, by a private organization, or not employed at all prior to their military service. In order to be eligible for the new tax credit, an individual must: 1) be a resident of State; and 2) perform active military service after September 11, 2001 in a combat zone, hazardous duty area, or other location certified by the Department of Defense as eligible for combat zone tax benefits. Thus, for purposes of the State military service tax credit, an individual's employment prior to the time their military service began is completely irrelevant. Military members who meet the eligibility requirements are entitled to receive the credit irrespective of their employment status before or after the period of service in the United States Armed Forces which made them eligible for the credit.

Please call (202) 622-4960 if you have any further questions.