OHIO LEGISLATIVE SERVICE COMMISSION

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Office of Research and Drafting

Legislative Budget Office

H.B. 18
133rd General Assembly

# Fiscal Note & Local Impact Statement

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**Version:** As Passed by the Senate

**Primary Sponsors:** Reps. Vitale and Crawley

**Local Impact Statement Procedure Required:** Yes

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## Highlights

- The bill unequivocally exempts military disability severance pay from the personal income tax. The bill's fiscal effect on disability severance pay received on or after the effective date of the bill is minimal, if any.
- The bill authorizes a taxpayer to file a refund application with the Tax Commissioner on or before December 31, 2020, for an amount equal to state income tax erroneously paid by the taxpayer on income received as a disability severance payment. The provision applies only to those taxpayers whose federal tax liability or federal adjusted gross income was altered prior to January 1, 2019. In practice, this provision applies to veterans affected by recent federal legislation that corrects for a multi-year Department of Defense error originating in 1991.
- If one assumes that Ohio income tax was paid on this income source when it was earned, this provision could reduce income tax receipts by between $1.0 million and $1.5 million during the FY 2020-FY 2021 biennium. If fewer veterans than estimated in this analysis claim a credit, the revenue loss would be close to or below the lower end of this range.
- Under current law, the GRF would bear 96.62% of any revenue loss under the income tax during the current biennium, while the Local Government Fund (LGF) would bear 1.68% and the Public Library Fund (PLF) would bear 1.70% of any such revenue loss.

## Detailed Analysis

H.B. 18 permits taxpayers to deduct, to the extent not otherwise deducted or excluded in computing federal or Ohio adjusted gross income for the taxable year, amounts received by the taxpayer as a disability severance payment, computed under 10 United States Code

(U.S.C.) 1212, following discharge or release under honorable conditions from the armed forces.

The bill also authorizes a personal income tax (PIT) refund for an amount equal to taxes erroneously paid under that section on an amount received as a disability severance payment prior to January 1, 2019. Affected taxpayers must file an application with the Tax Commissioner on or before December 31, 2020. Applications must demonstrate that the taxpayer's federal adjusted gross income (FAGI) or federal income tax liability was "altered" for a year prior to tax year (TY) 2019.

The U.S. military makes disability severance payments to service members who are discharged because of physical disability and who have less than 20 years of service and less than a 30% disability rating. The income is not taxable at the federal level, but amounts were erroneously withheld by the Secretary of Defense from 1991 to 2016. H.B. 18 allows affected taxpayers to gain a retroactive state tax benefit by filing a refund application with the Tax Commissioner on or before December 31, 2020.

## Background – disability severance pay

Members who separate from the military before they are eligible for retirement may receive separation or severance pay. Disability severance pay is a one-time lump sum payment. The amount equals two months of basic pay for each year of service, which includes active service and inactive duty points, but the total service years cannot exceed 19 years. Additionally, the minimum number of years required for computation purposes is six years for a disability incurred in the line of duty in a combat zone, or three years in the case of any other member.[1]

A qualifying military member must meet all of the following requirements to be eligible:

- Be found unfit for duty;
- Have less than 20 years of service; and
- Have a disability rating of less than 30%.

Disability severance pay for personal injury or sickness resulting from active service in the armed forces is largely exempt from federal taxation under Section 104(a)(4) of the Internal Revenue Code. However, it is theoretically possible that disability severance pay is taxable if unique circumstances prevent the veteran from qualifying under the exemption's broad-based criteria. Since federal income serves as the starting point for determining taxable income in Ohio, income exempt from federal taxation would generally be exempt from state income taxation.

## State exemption for Ohio military retirement pay

Beginning with TY 2008, Ohio's personal income tax exempts "amounts received by the taxpayer as retired personnel pay for service in the uniformed services or reserve components

[1] https://www.dfas.mil/retiredmilitary/plan/separation-payments/disability-severance-pay.html.

thereof, or the national guard."[2] LSC is uncertain about the extent to which military disability severance pay was included in the personal income tax base, but it will unequivocally be exempt under H.B. 18. Potentially, taxpayers regarded their disability severance pay as retired personnel pay and either did not remit taxes on this income or claimed refunds for taxes withheld against this income. This sort of taxpayer behavior, and any associated audits that may have been completed by the Ohio Department of Taxation, are confidential in nature and unavailable to LSC.

## The Combat-Injured Veterans Tax Fairness Act of 2016

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.[3]

On December 16, 2016, the President of the United States signed into law the Combat-Injured Veterans Tax Fairness Act of 2016, which provides eligible veterans the right to seek a refund of taxes they may have paid on disability severance pay. The Defense Finance and Accounting Service (DFAS) and the Internal Revenue Service (IRS) are jointly responsible for ensuring that affected separated members receive notification of their rights under this new law.[4] During July 2018, DFAS and the IRS sent letters to approximately 130,000 separated military members who had received disability severance pay as income and with federal tax withholding applied.[5]

For veterans who received a lump sum disability severance payment after January 17, 1991, the Combat-Injured Veterans Tax Fairness Act of 2016 may provide additional time to claim a credit or refund for the overpayment attributable to the disability severance payment.

The amount of time for claiming these federal tax refunds is limited. However, the law grants veterans an alternative time frame – one year from the date of the letter from the Department of Defense (DOD). Veterans making these claims have the normal limitations period for claiming a refund or one year from the date of their letter from DOD, whichever expires later. As taxpayers can usually only claim tax refunds within three years from the due date of the return, this alternative time frame is especially important since some of the claims may be for refunds of taxes paid as far back as 1991.

LBO economists contacted both DFAS and the Congressional Appropriations Liaison for the Office of the Under Secretary of Defense (Comptroller) about potential information regarding Ohio veterans impacted by this federal legislation. Neither party responded with statistics.

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[2] Division (A)(26) of section 5747.01 of the Revised Code.

[3] Public Law 114-292 of 114th Congress.

[4] https://www.dfas.mil/dsp_irs.

[5] https://www.irs.gov/individuals/military/combat-injured-veterans-tax-fairness-act-claim-information-available.

# Fiscal effect

The revenue loss incurred due to H.B. 18 would be concentrated on those veterans with qualifying incomes between TY 1991 and TY 2016, which is the last year the Department of Defense erroneously withheld taxes on disability service payments. Affected veterans filing applications with the Tax Commissioner would subsequently be claiming PIT refunds in FY 2020 and FY 2021.

Current statistics from DOD Defense Manpower Data Center, as cited by Governing Magazine,[6] show that 6,793 active duty service members were stationed in Ohio as of September 2017, and a majority (5,358, or 79%) of these were serving in the Air Force. In total, there were approximately 184,000 Air Force active duty personnel stationed either domestically or overseas, so Ohio's share was approximately 2.9% of the Air Force. The state has an even smaller share of active duty personnel for the entire military. The nearly 6,800 service members stationed in Ohio comprise less than 1% of the total serving worldwide. Given the concentration of Air Force members among those currently serving in Ohio, this analysis will focus on that branch of the military.

The table below contains 22 years[7] of Air Force statistics about the number and average amount of disability severance payments awarded to its personnel. The total number of payments for a given year is the sum of those received by both enlisted and officers. The count and average values are presented separately for these two groups because of the significant differences between the two classifications.

| Disability Severance Payments for Active Duty Air Force Personnel, FFY 1995 to FFY 2016 | | | | |
|---|---|---|---|---|
| Federal Fiscal Year | Enlisted, Number | Enlisted, Average Payment | Officers, Number | Officers, Average Payment |
| 2016 | 874 | $44,851 | 28 | $88,536 |
| 2015 | 694 | $43,934 | 33 | $86,485 |
| 2014 | 816 | $45,056 | 39 | $66,718 |
| 2013 | 948 | $39,093 | 35 | $66,486 |
| 2012 | 972 | $38,451 | 34 | $64,706 |
| 2011 | 979 | $32,618 | 33 | $57,394 |

[6] https://www.governing.com/gov-data/public-workforce-salaries/military-civilian-active-duty-employee-workforce-numbers-by-state.html.

[7] Budget appropriations documentation for prior years is not posted to the U.S. Air Force website, so the table does not contain values for federal fiscal year (FFY) 1991 through FFY 1994. However, values were extrapolated for this analysis.

| Disability Severance Payments for Active Duty Air Force Personnel, FFY 1995 to FFY 2016 | | | | |
|---|---|---|---|---|
| Federal Fiscal Year | Enlisted, Number | Enlisted, Average Payment | Officers, Number | Officers, Average Payment |
| 2010 | 962 | $28,061 | 30 | $59,967 |
| 2009 | 875 | $24,855 | 27 | $57,222 |
| 2008 | 924 | $24,851 | 15 | $54,867 |
| 2007 | 867 | $27,775 | 37 | $50,146 |
| 2006 | 1,737 | $23,693 | 48 | $38,799 |
| 2005 | 1,045 | $24,013 | 38 | $46,630 |
| 2004 | 832 | $23,171 | 24 | $45,458 |
| 2003 | 598 | $19,615 | 32 | $35,694 |
| 2002 | 534 | $16,066 | 17 | $42,151 |
| 2001 | 603 | $16,088 | 25 | $50,512 |
| 2000 | 816 | $17,141 | 54 | $39,710 |
| 1999 | 798 | $17,799 | 45 | $34,889 |
| 1998 | 664 | $16,842 | 32 | $38,000 |
| 1997 | 575 | $14,538 | 20 | $42,867 |
| 1996 | 521 | $12,758 | 36 | $32,556 |
| 1995 | 491 | $12,070 | 23 | $28,909 |

Source: "Detail of Military Personnel Entitlements" tables within annual executive budget submission, https://www.asafm.army.mil/offices/bu/content.aspx?what=BudgetMaterials.

Based on historical information in the above table, the median disability service payment for enlisted Air Force members was about $24,000 and the median for officers was about $45,000. Marginal state tax rates applicable from TY 1991 to TY 2016 would likely be about 4.8% for enlisted and 5.7% for officers. Under these parameters, it may be reasonable to expect that H.B. 18 enables taxpayers formerly serving as enlisted members to claim about $1,150 in refundable PIT credits while former officers claim closer to $2,565. Since enlisted members outnumber officers in the above table by a factor of 25 to 1, a weighted average would make the typical taxpayer savings for an Ohio-based military member to be around $1,200. Based on a sum total of figures in the table above, Air Force members likely represent about 22,000 of the 130,000 veterans contacted by DFAS. If Ohio has 3% of the 22,000 affected

Air Force members, then 660 Ohioans could claim this credit and save a combined $792,000. Personnel from other military branches must also be considered for this analysis; after making allowance for them, H.B. 18 would likely reduce PIT receipts between $1.0 million and $1.5 million over the FY 2020-FY 2021 biennium as credits are claimed.

Prospectively, H.B. 18 has a minimal fiscal effect, if any, for income earned in taxable years on or after the bill's effective date. The GRF would bear 96.62% of any revenue loss under the income tax during the current biennium under an uncodified provision of H.B. 166 of the 133rd General Assembly, while the LGF would bear 1.68% and the PLF would bear 1.70% of any such revenue loss.[8]

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[8] Under current law, the GRF share would revert to 96.68% of the revenue loss beginning July 1, 2021, and the LGF and PLF shares would each revert to 1.66%; these shares are specified in codified law.